Irving Fisher Committee on
Central Bank Statistics

BANK FOR INTERNATIONAL SETTLEMENTS

Ninth IFC Conference on "Are post-crisis statistical initiatives completed?"

Basel, 30-31 August 2018

Reporting practices of Islamic financial institutions in the BIS locational banking statistics[1]

Siew Koon Goh,

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[1] This paper was prepared for the meeting. The views expressed are those of the authors and do not necessarily reflect the views of the BIS, the IFC or the central banks and other institutions represented at the meeting.

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Reporting practices of Islamic financial institutions in the BIS locational banking statistics

Siew Koon Goh[1]

In the implementation of the *System of National Accounts* 2008 (2008 SNA), statisticians raised some concerns related to Islamic banking. One concern is related to the measurement of financial intermediation services indirectly measured (FISIM) provided by Islamic bank. The 2008 SNA and the sixth edition of the *Balance of Payments and International Investment Position Manual* (BPM6) recognize FISIM produced only by financial corporations and only on their loan assets and deposit liabilities. For this reason, the mapping of Islamic financial instruments to conventional financial instruments becomes very important. For those instruments which stay out from the categories of "loan assets and deposit liabilities", they will not be included in FISIM calculation. Another concern is whether an "Islamic bank" should be considered as a bank. If the balance sheet structure and the risk profile of an Islamic bank is very different from that of a conventional bank, should it be considered as a bank? To address these concerns, the UN Working Group on National Accounts set up a task force on Islamic finance to formulate recommendations concerning the treatment of Islamic banking transactions in national accounts.[2] As part of its contribution to the work of the task force, the BIS collected information about the reporting practices of Islamic banks in the BIS locational banking statistics (LBS).[3] This paper summarises these practices.

Islamic banking

Islamic banking is a system of banking that is based on the principles of Shariah law. Shariah law prohibits the receipt and payment of interest, known as "riba". It also prohibits undertaking excessive uncertainty, gambling and short sales or financing activities that it considers harmful to society. The fundamental concept of Islamic banking is that money itself has no intrinsic value; it is simply a medium of exchange.

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2 This paper was originally prepared for a meeting of the Task Force on Islamic Finance held in Beirut, Lebanon, 24-26 October 2017. For information about the task force, see https://unstats.un.org/unsd/nationalaccount/ud-IF.asp.

3 The LBS capture the outstanding claims and liabilities of banks located in 47 reporting countries on counterparties resident in each of over 200 countries, including intragroup positions between offices of the same banking group. The LBS are collected based on the residence of entities, meaning that they follow the same principles as national accounts and balance of payments.

Therefore, profit cannot be made by exchanging money with another person. In other words, a Muslim is not allowed to benefit from lending money or receiving money from someone.

Islamic banks use either a trading model or a profit-and-loss sharing model in their business to make profits. As a result, financial instruments issued by Islamic bank may be recorded differently than those issued by conventional bank in its balance sheet. As discussed in H van Greuning and Z Iqbal (2009), IMF (2015) and IMF (2017), the balance sheet structure as well as the risk profile of an Islamic bank is different from that of a conventional bank. First, the 'pass-through' nature of the balance sheet of an Islamic bank. An Islamic bank's customers' return is linked to the return on the assets of the bank. This feature removes the typical asset-liability mismatch exposure of a conventional bank. Second, the assets of an Islamic bank contain financing assets where the tangible goods and commodities are purchased and sold to the customers. This practice creates distinct exposures. For example, in a conventional car financing a car is financed by a loan from the bank to the customer. But in case of an Islamic bank, the asset and the financing are coupled together. Therefore, an Islamic bank is not limited to the exposure as a "banker", but may develop additional exposures resulting from dealing with physical assets. Finally, due to prohibition of interest, an Islamic bank cannot issue debt to finance the assets. This discourages the creation of leverage in the balance sheet. As a result, an Islamic bank is considered less risky. The conventional banking system may develop multiple layers of intermediaries, which result in the financing becoming remote from the underlying assets. In an Islamic bank, the financial intermediary is always closely associated with the asset. Therefore, an Islamic bank is able to perform better monitoring of the asset as well as the customers.

Reporting practices

The remainder of this paper summarises the responses to a questionnaire sent by the BIS to LBS reporting countries with significant Islamic banking activities. The questionnaire asked how Islamic institutions are treated in LBS, as well as how they currently report financial claims and liabilities, including derivatives. Six countries responded to the questionnaire: Bahrain, Indonesia, Malaysia, Saudi Arabia[4], Turkey and United Kingdom.

a. Type and size of Islamic banking institutions

The questionnaire showed that, in terms of the business model, different countries allow different models for Islamic banking business to take place (Table 1). Some countries permit conventional banks to offer Islamic banking business through a "window" concept, others require the establishment of a separate entity to engage in the Islamic banking activities, ie through dedicated standalone Islamic banks, or through subsidiaries. Table 1 also showed approximate size of assets held by Islamic banking institutions as a percentage of total assets of the domestic banking system. Annex A provides an overview of the global Islamic financial sector in these countries.

4 Saudi Arabia is preparing to join the LBS reporting population.

Table 1

Country	Type of Islamic banking institutions[1]			Assets of Islamic banking assets as a percentage of total assets of the domestic banking system (approximate size, %)
	Stand-alone institutions not affiliated with conventional banks	Islamic banking subsidiaries affiliated with conventional banks	Islamic windows that are part of conventional banks	
Bahrain	Yes			≈17
Indonesia	Yes	Yes	Yes	≈6
Malaysia	Yes	Yes	Yes	≈24
Saudi Arabia	Yes		Yes	≈26
Turkey	Yes			≈5
United Kingdom	Yes		Yes	<0.1

[1] "Yes" indicates types of Islamic banking institutions that are available in respective LBS reporting country.

b. Classification of financial institutions

In the BIS's Guidelines for reporting BIS international banking statistics, Section B.2.2 explains the definition for LBS reporting institutions:

> Reporting institutions cover mainly internationally active banks. In particular, they cover institutions located in each reporting country whose business it is to receive deposits (and/or close substitutes for deposits) and to grant credits or invest in securities on their own account ("banks" or "banking offices" in these Guidelines). Thus, the reporting institutions include not only commercial banks but also savings banks, savings and loan associations, credit unions or cooperative credit banks, building societies, and post office giro institutions, other government-controlled savings banks and other financial institutions if they take deposits or issue close substitutes for deposits.

The BIS's Guidelines also clarify that reporting institutions generally should not include money market funds. Money market funds are included in the reporting population only when their liabilities (ie the shares and units issued) are treated as close substitutes for deposits or as deposits.

This definition of "banks" in LBS is fully consistent with the harmonised definition in macroeconomic statistical guidance. Banks in the LBS conform with terms such as:

(i) "deposit-taking corporations, except the central bank" used in 2008 SNA, code S.122 and BPM6, paragraph 4.71-4.73;

(ii) "Other depository corporations excluding money market funds" in the IMF's *Monetary and Financial Statistics Manual and Compilation Guide 2016* (MFSMCG); and

(iii) "Other monetary financial institutions excluding money market funds" as used in the new *European System of National and Regional Accounts* (ESA 2010).

The BIS's current Guidelines do not discuss the treatment of Islamic banking institutions. Nevertheless, for statistical purposes, countries reporting to the LBS treat Islamic banking institutions as conventional banking institutions. Responses to the questionnaire showed that, even though their operation and accounting recording concepts are different, **Islamic banking institutions are treated as "deposit-taking corporations, except the central bank" and are included in the current LBS reporting population**. The questionnaire, however, did not collect information on factors that determine these institutions be classified as "deposit-taking corporations, except the central bank" in these countries.

c. Classification of financial instruments

The BIS Guidelines, Section B.3.1 describes the scope and coverage for instruments in LBS. There are three types of instrument classifications in LBS: loans and deposits, debt securities and other instruments, ie those not included under loans and deposits and debt securities.

The banks' financial assets, or claims, should be broken down into:

(i) loans and deposits, which comprise interbank deposits and loans and advances (to banks or non-banks), including reverse repurchase agreements;

(ii) holdings of debt securities; and

(iii) other claims, including financial derivatives with a positive market value.

Similarly, banks' liabilities should be broken down into:

(i) loans and deposits, which comprise interbank loans received and deposits (from banks or non-banks), including repurchase agreements;

(ii) own issues of debt securities; and

(iii) other liabilities, including financial derivatives with a negative market value and equity.

Arrears and accrued interest as well as principal in arrears should be included in the claims and liabilities under the respective instruments, whenever possible.

The LBS does not distinguish between loans and deposits. In contrast, in national accounts and balance of payments statistics (BOP) loans are distinguished from deposits on the basis of the representation in the documents that evidence them. Annex B maps the three instrument classifications in the LBS to six broad categories in BOP.

Responses to the questionnaire showed that **Islamic banking institutions in each country follow different practices for reporting financial assets and liabilities in the LBS**. Taking Murabaha[5] as an example, some Islamic banking

[5] An Islamic financing structure (also known as mark-up financing) that is done in two stages. First, the bank buys a specific good that a customer is requesting from a third party (a supplier). Second, the

institutions considered it a "deposit" on the understanding that extending loan to earn interest is not permitted, while others classified it as a "loan" because its characteristics are similar to those in conventional banking business. There are also countries that considered Murabaha financing structures as "debt securities", "trade credits" or even "other instruments". Annex C summarises the reporting practices in the selected LBS reporting countries. While Islamic banking institutions generally do not report financial derivatives because Islamic transactions must not involve trading of excessive uncertainty (gharar), or speculative behaviour (maysir), the questionnaire showed that one country reports Islamic instruments with derivative-like features, ie Bai bil-Istighlal, under the derivative category. This indicates that there are already some Islamic financial instruments that partially resemble conventional derivatives being reported in LBS and BOP.

Notably, the diversity of reporting practices cannot be explained by accounting practices. In terms of the accounting framework, the accounting standards that are adopted by countries with significant Islamic transactions are either International Financial Reporting Standards (IFRS) or national standards that converge toward IFRS. These standards can fundamentally reflect Islamic finance without compromising Shariah principle, and therefore are being applied to Islamic finance in a number of territories including Saudi Arabia and Malaysia. Annex D summarises the accounting standards in LBS reporting countries with significant Islamic banking activities.

Instead, the diversity of reporting practices can be explained by the absence of international statistical guidelines for reporting Islamic financial instruments. Different countries apply different concepts when it comes to mapping the Islamic financial instruments within the conventional statistical categorisation. To address this, developing international guidance on the statistical treatment of Islamic financial products is important to facilitate cross-country comparison.

Developing international guidance

The growing importance of Islamic financial institutions across the world calls for increased attention to the appropriate statistical treatment of Islamic financial instruments to effectively monitor economic and financial developments and facilitate cross-country comparison of data. The IMF has taken important steps in this direction. The Annex 4.3 of the MFSMCG provides guidance on the classification of Islamic financial institutions and instruments in the context of compiling monetary statistics. The guideline focuses on various types of Islamic financial instruments in comparison with conventional ones in the context of macroeconomic and financial statistics.

Moving forward, the following may be considered when developing a guideline for statistical reporting of Islamic financial instruments:

- focus on the characteristics of underlying Islamic financial products (including discussion on Islamic instruments with derivative-like features) when providing

bank resells the good to the customer with both parties agree to a payment schedule (ie the payment covers both costs and the agreed upon profit margin). The customer made a deferred payment to the bank, where the good serves as collateral until the agreed payment is paid in full. The bank takes risk between the purchase of the goods from the seller and the sale of the assets to the customer requiring the goods. The bank is compensated for the time value of its money in the form of profit margin.

guidance to Islamic banks for reporting financial instruments. To have an exhaustive list may become impossible as there are continued product innovations in the financial markets.

- add a comparison of balance sheet structure between Islamic banks and conventional banks in guidelines, such as system of national accounts, balance of payments manual, monetary and financial statistics manual to highlight the differences in statistical treatment of different instruments.

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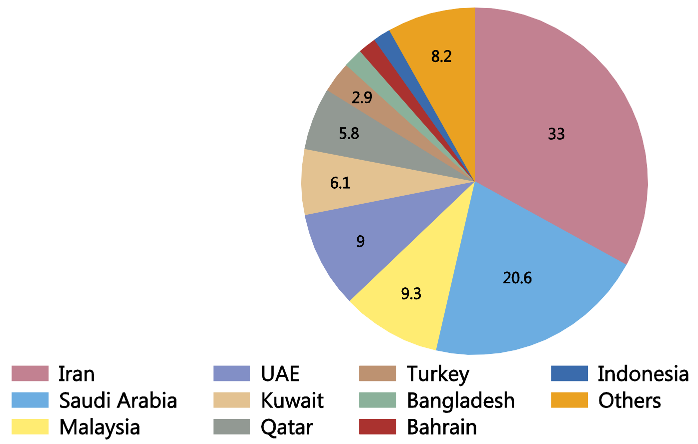
Annex A: Islamic financial sector globally

In the *Islamic Financial Services Industry Stability Report*, with data as of end-June 2016, global Islamic banking assets amounted to US$1.5 trillion. By jurisdiction (Graph 1), Iran is the largest market, accounting for 33% of the global Islamic banking industry. The Gulf Cooperation Council countries accounted for a total share of 43.2% (Saudi Arabia: 20.6%; UAE: 9%; Kuwait: 6.1%; Qatar: 5.8%; and Bahrain: 1.7%). The shares of Malaysia, Turkey and Indonesia were 9.3%, 2.9% and 1.4%, respectively.

Global Islamic banking assets[1]

Percentage share, as of end-June 2016 Graph 1



[1] Shares are apportioned in US dollar terms.

Source: Islamic Financial Services Industry Stability Report 2017 (Chart 1.1.6)

The following summaries of Islamic business activities in selected LBS reporting countries are based on information in the IMF's Country Report on Ensuring Financial Stability in Countries with Islamic Banking, published in June 2017:

Bahrain: Bahrain operates a dual system where Islamic financial institutions operate in parallel with conventional banks. Bahrain, with 22 Islamic banks, has the largest concentration of Islamic banking operations among the countries that operates dual banking systems. While Bahrain accounts for less than 2% of the global Islamic banking assets, the market share of Islamic banks is 13.2% of the banking industry assets.

Indonesia: The Islamic banking sector in Indonesia, comprising 12 standalone banks and 22 Islamic windows of conventional banks, accounts for 7% of the domestic Islamic finance industry and 5% of the total banking system assets.

Malaysia: In Malaysia, Islamic financial institutions operate in parallel with conventional financial institutions, both offering a full range of financial products and services and often using the same infrastructure. The Islamic finance industry is dominated by the Islamic banking sector, which accounts for 42% percent of industry assets. Nine of the 16 Islamic banks are part of banking groups that also operate as commercial banks in Malaysia.

Turkey: Participation finance is a term that used in Turkey for financial practices structured in accordance with Shariah law. The participation finance institutions operate alongside conventional financial institutions in Turkey. The participation banking segment dominates with a market share of 83% of the total participation finance industry assets, but this accounts for only 5.2% of Turkey’s banking industry.

Annex B: Instrument classifications between LBS and Balance of Payments (BPM6)

LBS financial assets and liabilities classification	**Balance of Payments - broad category**
Assets	
▪ Loans and deposits	▪ Currency and deposits ▪ Loans (including financial lease)
▪ Debt securities holdings	▪ Debt securities
▪ Other assets (*ie equity investment, equity securities, participations, derivatives instruments, any other residual on-balance sheet financial claims*)	▪ Other accounts receivable ▪ Equity ▪ Financial derivatives
Liabilities	
▪ Loans and deposits	▪ Currency and deposits ▪ Loans (including financial lease)
▪ Debt securities issuance	▪ Debt securities
▪ Other liabilities (*ie equity capital, retained earnings, equity securities, derivatives instruments, any other residual on-balance sheet liabilities*)	▪ Other accounts payable ▪ Equity ▪ Financial derivatives

Annex C: Reporting practices in LBS countries with significant Islamic banking activities

The tables below show how some commonly used (ie list is not exhaustive) Islamic financial instruments are categorised within the conventional statistical categorisation in LBS reporting countries with significant Islamic banking activities. The numbers in the parentheses indicate the number of reporting countries that categorise a particular Islamic financial instrument under the conventional statistical categorisation. Countries are allowed to indicate more than one category in each type of instrument.

A. Categorisation of Islamic financial assets

	Islamic financial instrument	Equity	Debt	Derivatives	Non-financial assets
1	Bai bil-Istighlal (eg option-like instrument)			Option (1)	
2	Bai Muajjal (eg deferred payment contract)		Loans (1) Trade credits (2) Others (2)		
3	Bai Salam (eg advanced payment contract)		Loans (2) Trade credits (2) Others (1)		(1)
4	Bail bil-wafa (eg repo-like instrument)		Debt securities (2)		
5	Ijarah (eg leasing or renting contract)		Debt securities (1) Loans (4) Deposits (1) Trade credits (1) Others (2)		
6	Istisnaa (eg progressive financing)		Loans (3) Trade credits (1) Others (1)		
7	Joala (eg derivatives-like instrument)		Others (1)		
8	Mudaraba (eg profit sharing)		Debt securities (1) Loans (2) Deposits (3) Others (2)		
9	Murabaha (eg cost plus)		Debt securities (1) Loans (3) Deposits (2) Trade credits (1) Others (2)		
10	Musharaka (eg joint venture)	(1)	Debt securities (1) Loans (3) Deposits (1) Trade credits (1) Others (2)		
11	Qard-hasan (eg deposit with no interest)		Loans (3) Deposits (1) Trade credits (1) Others (1)		
12	Mushtarakah (eg a combination between Musharakah and Mudarabah)		Loans (1)		

B. Categorisation of Islamic financial liabilities

	Islamic financial instrument	Equity	Debt	Derivatives
1	Amanah (eg trust)		Deposits (1) Others (1)	
2	Ijarah (eg leasing or renting contract)		Loans (2) Trade credits (1) Others (2)	
3	Istijrar (eg leasing or renting contract)		Loans (1) Deposits (2) Trade credits (1) Others (2)	
4	Mudaraba (eg profit sharing)		Loans (2) Deposits (1) Others (2)	
5	Mudaraba Sukuk (certificate on the basis of mudaraba)		Debt securities (2) Loans (2) Deposits (1) Others (1)	
6	Qard (eg deposit with no interest)		Loans (2) Deposits (2) Others (1)	
7	Qard-hasan (eg deposit with no interest)		Loans (3) Trade credits (1)	
8	Restricted Mudaraba	(2)	Deposits (1) Trade credits (1) Others (1)	
9	Sukuk (eg Islamic bonds)		Debt securities (4) Loans (2) Deposits (1) Others (1)	
10	Wadiah (eg custody of fund)		Deposits (3) Others (2)	

Annex D: Accounting standards in LBS countries with significant Islamic banking activities

An excerpt from IFRS official website (http://www.ifrs.org/)

- Are IFRS Standards required for domestic public companies in these countries?

Country	Description
Bahrain	IFRS Standards are required.
Indonesia	Indonesia has not adopted IFRS Standards for reporting by domestic companies. Indonesia has been converging its national standards toward IFRS Standards, but without a plan for full adoption of IFRS Standards.
Malaysia	Public companies are required to use the MFRS Framework, which is substantively equivalent to IFRS Standards.
Saudi Arabia	IFRS Standards are required for all listed companies, banks, and insurance companies.
Turkey	IFRS Standards adopted as Turkish Accounting Standards are required for listed companies, financial institutions, and other public interest entities.
United Kingdom	All domestic companies whose securities trade in a regulated market are required to use IFRS Standards as adopted by the EU in their consolidated financial statements.

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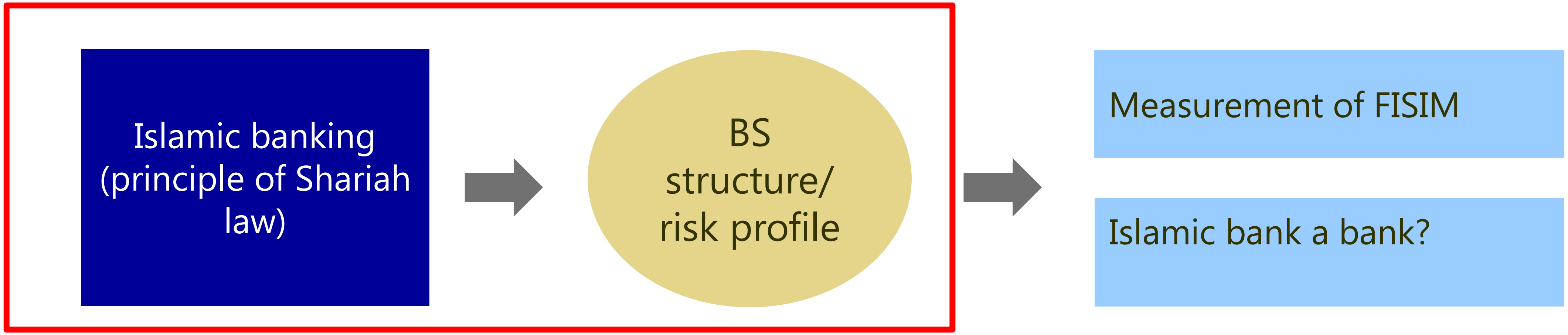
Introduction

- Implementation of 2008 SNA recommendations

1. Measurement of FISIM	• Mapping of Islamic financial instruments to conventional financial instruments, ie loan assets and deposit liabilities
2. Islamic bank a bank?	• Balance sheet structure • Risk profile

Islamic Banking (Shariah law)



- Balance sheet structure is different
- Risk profile
  - Customers' return is linked to the return on the assets of the bank
  - Assets contain financing physical assets
  - Discourage creation of leverage

Questionnaire on reporting practices of Islamic financial institutions

LBS-reporting countries

- Bahrain
- Indonesia
- Malaysia
- Saudi Arabia
- Turkey
- United Kingdom

Coverage of questionnaire

- Islamic banking business models in different countries
- How central banks treat IFIs
- How transactions of Islamic financial instruments are captured in statistical reporting

Response to the questionnaire

- Islamic banking business models in different countries

Country	Type of Islamic banking institutions[1]			Assets of Islamic banking assets as a percentage of total assets of the domestic banking system (approximate size, %)
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Malaysia	Yes	Yes	Yes	≈24
Saudi Arabia	Yes		Yes	≈26
Turkey	Yes			≈5
United Kingdom	Yes		Yes	<0.1

[1] "Yes" indicates types of Islamic banking institutions that are available in respective LBS reporting country

Response to the questionnaire (cont'd)

- How central banks treat IFIs
  - IFIs are treated as "deposit-taking corporations except the central bank" (S.122) in LBS
- How Islamic financial instruments are captured
  - Islamic banks in each country follow different practices for reporting financial assets and liabilities in the LBS
  - Accounting standards fundamentally reflect Islamic finance without compromising Shariah principle

What‘s next step

- Develop an international statistical guidelines for reporting Islamic instruments
  - Characteristics of underlying Islamic financial products
  - Differences in statistical treatment of different instruments