

SNA Treatment of Islamic Windows of Conventional Banks

A significant complication in the SNA treatment of Islamic finance is the treatment of Islamic windows, which are Islamic financial operations of conventional banks. A window by definition covers branches, divisions, offices of the conventional bank that handle Islamic finance. A separately incorporated Islamic subsidiary of a conventional bank is not treated as a window but as a full-fledged Islamic bank.

A window is consolidated into the financial accounts of its parent bank, but as discussed below separate information on the Islamic financial activity is required. In contrast, a separately incorporated Islamic subsidiary is not consolidated into financial accounts of its parent bank, but is included in banking group level consolidations.

Although windows are consolidated into their parent, there are multiple reasons why separate accounts must be prepared and reported for Islamic windows. Per the IFSB, windows – however they might be organized within the conventional bank’s structure – should be treated as virtual branches for which there should be separate accounting.

An examples, Shariah rules restrict financing to Shariah-compliant activities and forbid some conventional activities such as holding interest-bearing instruments, Shariah-compliant funds must not be intermixed with conventional bank funds, and risk and profit sharing between the bank and depositor/investors requires detailed calculations of gains and losses. Moreover, rules exist for the types of liquidity support the parent bank can offer its windows, and to prevent Shariah-compliant funding of windows being diverted to the parent.

From a prudential perspective, windows and their parents are likely to have different funding and financing patterns, react differently to economic stimuli and shocks, present different soundness and risk profiles, and regulatory arbitrage between the parent and the window must be avoided.

And from accounting and statistical perspectives, standard accounting and statistical rules can misrepresent the underlying economic flows and values of the Islamic financial activity and could provide distorted views of the financial condition of the consolidated parent bank.¹

The requirement for separate information on windows is incorporated into the IFSB’s *Core Principles for Supervision of Islamic Financial Regulation (Banking Segment) (CPIFR)*, which is patterned after the Basel Committee’s *Core Principles for Effective Banking Supervision*.² The CPIFR specifically requires “the institution to publish a full separate set of financial statements

¹ For example, the IFSB mandates that supervisors should understand the implications of window’s Shariah compliance and risk sharing in evaluating the capital adequacy of the parent bank.

² The *Core Principles* is a concise set of principles that national supervisors should follow to bolster the soundness of their banks. They were initially issued in 1997 and influenced the development in 2004 of Basel II, Pillar 2 on effective supervision of banks. They have been periodically amended, most recently in 2012.

for its window operation,” either in its financial statement notes or in a separate readily accessible separate form. The disclosures will include sources of funds to windows’ liquidity deficits, and capital adequacy information.

These separate accounts form the basis for statistical reporting of windows’ economic activity. The IFSB separately collects and disseminates data for windows to capture information on the economic roles of windows as a part of total Islamic financial and economic activity and to better understand the macroprudential soundness and risks of windows. Windows and full-fledged Islamic banks are asked the same questions on separate forms and data are disseminated separately.

Islamic banking in consolidated national accounts statistics

Consolidation of Islamic and conventional banking data might result in double-counting of the Islamic banking component. The IFSB seeks information on total Islamic banking activity in a country, and thus covers both full Islamic banks and windows. However, the windows are also consolidated into the regular financial accounting report of the parent bank.

In national accounts statistics, if primary data reporting is on an individual bank basis, (that is, the reporting institutional unit is the individual bank) only the stand-alone Islamic banks and conventional banks should be consolidated into the consolidated national data.

Alternatively, if national practice is to collect primary data from consolidated banking groups, (that is, the reporting institutional unit is the group of parent banks and their branches and subsidiaries, which corresponds to IFRS-type consolidated financial accounts) then windows *and* subsidiary Islamic banks of conventional banks will be included within the consolidated group reports. In this case, only those standalone Islamic banks that are not subsidiaries of conventional banks should be consolidated into national accounts totals.

In either case, it will be an empirical issue whether the consolidated national accounts data might be distorted by biased reporting of the Islamic banking component in the data.

The situation is likely to differ country-by-country. National accounts compilers need to be aware that they cannot simply aggregate IFSB data with data for their conventional banks. Bank-by-bank adjustments might be needed.

This potential double-counting also complicates macroprudential surveillance, including comparisons of the Islamic banking PSIFIs and the full banking system FSIs.

National practices

National practices for windows differ greatly. Supervisors and national regulations define the types of windows permitted in their countries, but rules might not specifically address Islamic finance in general nor windows in particular. Also, international money center banks that operate windows in multiple countries might impose various home country practices and standards on their windows operations throughout the world.

The IFSB data on windows reveals their importance in providing Islamic financial services and indicates some of the variations that exist between countries. At present, 7 countries report data on windows – Afghanistan, Bangladesh, Indonesia, Malaysia, Oman, Pakistan, and Saudi Arabia.

Three of the countries do not report separate data on their regulatory capital, evidently indicating that the windows do not maintain supervisory capital separately from their parent conventional bank.

In Afghanistan, there are no stand-alone Islamic banks, only windows. Five of the remaining six countries have more windows than full Islamic banks, although the banks often have more branch offices.

In terms of total Islamic banking assets within a country, windows are relatively minor components in Bangladesh and Malaysia, but hold at least one-quarter of Islamic banking assets in the other countries, and in fact exceed the assets of full Islamic banks in Oman and Saudi Arabia.

The data above indicate that windows play important roles in most countries in which they exist, but information on much of their influence is buried within the data on conventional banks.

Within the SNA context, the issues are (1) determining the extent to which windows and perhaps full Islamic bank activity is included in the conventional bank or banking group data, and (2) whether the Islamic financial activity undertaken by windows distorts the picture of overall banking activity.

Within the contexts of understanding the growth and structure of Islamic banking activity within a country, as well as understanding financial stability and surveillance issues related to Islamic banking, information on windows should be deconsolidated from the parent banks and evaluated along with the information about full Islamic banks, as is done in the IFSB PSIFI surveys.

Appendix:

Core Principles for Supervision of Islamic Finance Regulation – Excerpts from CPIFR 32: Islamic “windows” operations

Supervisory authorities define what forms of Islamic “windows” are permitted in their jurisdictions.¹ The supervisory authorities review Islamic windows’ operations within their supervisory review process using the existing supervisory tools. The supervisory authorities in jurisdictions where windows are present satisfy themselves that the institutions offering such windows have the internal systems, procedures and controls to provide reasonable assurance that (a) the transactions and dealings of the windows are in compliance with Sharī`ah rules and principles; (b) appropriate risk management policies and practices are followed; (c) Islamic and non-Islamic business are properly segregated; and (d) the institution provides adequate disclosures for its window operations.

2. The supervisory authority determines that an Islamic window has, both initially and on an ongoing basis, a minimum amount of funding from the conventional parent as required by the laws and regulations of the jurisdiction, including its capital adequacy and liquidity requirements.

3. The supervisory authority determines that an institution with Islamic windows has a system such that the separation of Islamic assets and funds from non-Sharī`ah-compliant assets and

funds is made transparent. The system should act both to prevent the window from investing in non-Sharī`ah-compliant assets, and from channelling investors' funds back to the conventional parent entity.²

4. Supervisory authorities in jurisdictions where windows are present satisfy themselves that the institutions offering such windows have the internal systems, procedures and controls to provide reasonable assurance that: (a) the transactions and dealings of the windows are in compliance with Sharī`ah rules and principles; and (b) appropriate risk management policies and practices are followed.

5. The supervisory authority requires a window to apply Sharī`ah governance arrangements comparable to those of a full-fledged IIFS. If the supervisory authority permits any variation to those arrangements (in respect of the institution's Islamic business), it should have clear reasons for doing so. In such cases, the supervisory authority should satisfy itself that pertinent Sharī`ah Fatāwa and resolutions are complied with by the financial institution's management in their offering of Islamic financial services.

6. The supervisory authority takes account of the Sharī`ah-compliant assets of the window, as well as the risk-bearing nature of the Sharī`ah-compliant funds that are invested in these assets, in assessing the capital adequacy of the conventional financial institution concerned. The IFSB's Revised Capital Adequacy Standard provides a measurement approach that may be used for this purpose, although in general the overall capital regulatory requirement is embodied in the regulatory requirement at the main institutional (consolidated³ or parent) level, irrespective of whether the parent is in the same jurisdiction or in another jurisdiction.

7. The supervisory authority determines and understands the manner in which capital and liquidity are to be made available to Islamic windows, and how losses generated by the windows will eventually be absorbed.

8. In cases where a conventional bank offers Islamic operations through Islamic windows, supervisory authorities fully evaluate the liquidity risk management framework at both the group/parent level and Islamic entity level. The supervisory authority also determines that senior management of a conventional bank operating Islamic operations in the form of an Islamic window is aware of the differences, complexities and constraints in managing liquidity in the Islamic operations vis-à-vis at the bank level.

9. The supervisory authority requires the Islamic window to disclose information that is material in the sense that its omission or misstatement could influence a user relying on that information for the purpose of making economic and legitimate assessments or decisions in accordance with Sharī`ah requirements. The supervisory authority requires the institution to publish a full separate set of financial statements for its window operation either in the notes to the financial statements of the conventional financial institution of which the window is a part, or separately in readily accessible form. In particular, the supervisory authority requires the institution to disclose publicly, among other things: a. sources of funds to cover a liquidity deficit⁴ of the window, if any. b. capital adequacy related disclosures; c. risk management and governance; d. appointment of a competent Sharī`ah scholar or Sharī`ah board; and e. a Sharī`ah compliance report covering, among other things, the mechanism established to provide Sharī`ah oversight of the activities of an Islamic window.

10. The supervisory authority's approach to a window, including its prudential approach, reflects its best understanding of how an Islamic window will be treated in liquidation or other insolvency, including the contractual rights of the window's clients, including UIAHs, according to applicable law.

11. If the supervisory authority has a policy requiring Islamic windows to be converted into Islamic banking subsidiaries, the criteria for requiring conversion are clearly specified (e.g. in terms of asset size of the window in absolute terms or as a percentage of the parent's balance sheet, years of operation, etc.). Such criteria are clearly grounded in the overall legal and regulatory framework in the jurisdiction as well as its overall strategic plan for the Islamic banking industry, if any.

1 The term "window" may be used in two different senses.

(a) An Islamic "window operation" is defined as being part of a conventional financial institution (which may be a branch or dedicated unit of that institution, but not a separate legal entity) that provides both fund management (investment accounts) and financing and investment that are Sharī'ah compliant. In principle, these windows are potentially "**self-contained**" (or "**full windows**") in terms of Sharī'ah-compliant financial intermediation, as the funds managed will be invested in Sharī'ah-compliant assets, and segregation of assets (with separate accounting for profit and loss) is properly maintained between the Islamic window and its parent funds.

(b) The term "window" is used in some jurisdictions to refer to an operation whereby an institution invests funds in Sharī'ah-compliant assets (such as home purchase plans based on Ijārah Muntahia Bittamlīk, Diminishing Mushārakah or Murābahah) without such funds having been mobilised on a Sharī'ah-compliant basis or specifically for Sharī'ah-compliant investment purposes. Such operations clearly do not meet the definition of an Islamic window given in (a) above, but are referred to as "**asset-side only windows**". Such operations may be carried out through either branches that offer current account facilities or other units of the institution. The supervisory issues raised by such operations are substantially different from those raised by full-fledged IIFS, but include issues of risk management in respect of the Sharī'ah-compliant assets and of applying appropriate risk weightings to those assets for capital adequacy purposes.

A particular issue arises when the parent entity of an Islamic window operation is situated in another jurisdiction and there are restrictions on, or impediments to, fund transfers between the parent and the window.

2 The window's share of profits from managing those funds may, of course, be channelled back to the parent. However, any losses of the parent conventional financial institution should not lead to a withdrawal of funds from the Islamic window, which would leave it unable to meet its capital adequacy and liquidity requirements.

3 For the purpose of the principle on Islamic windows, the term "consolidation" refers to consolidation of the window with its parent conventional bank of which it is a branch or division. This term should not be confused with the group consolidation of a parent company and its subsidiaries at the banking group level.

4 Normally, in the case of Islamic window operations, a dedicated funding line is made available from the head office treasury to meet any liquidity shortfalls in normal and stressed times, on a Sharī'ah-compliant basis.