Overview of Lecture

- Islamic financial Subsectors
  - Reviews elements of each subsector specific to Islamic finance
- Islamic windows – Reviews separate facilities at conventional banks that handle Islamic finance
  - Full windows
  - Asset-side only Windows
2008 Redefinition of the Financial Sector

- Financial corporations engage in financial activities and financial services for the market.
- Traditionally defined as financial intermediation, which involves raising funds on own account then investing or lending of funds in order to earn income.
- SNA 2008 expanded the definition to include financial risk management and liquidity transformation.
- Three major changes;
  - Lending of funds on own account (such as money lenders in developing economies) is recognized as a financial intermediation service
  - Special purpose vehicles (SPVs) can be organized as financial entities classified as financial corporations
  - Ancillary (captive) financial corporations that provide financial services only to their parent corporation (either asset or liability side) can be treated as financial entities classified based on the type of financial service provided.

SNA 2008 Financial Sector

- **Financial Corporations Sector**
  - Depository Corporations
    - Central bank
    - Other Depository Corporations
  - Other Financial Corporations
    - Money Market Mutual Funds
    - Other Investment Funds
    - Other Financial Intermediaries
    - Insurance
    - Pension Funds
    - Captive Financial Institutions
    - Financial Auxiliaries
Other Depository Corporations

- An ODC is a financial intermediary with deposit liabilities or close substitutes for deposits that are classified as part of the national definition of broad money.
- Banks (conventional and Islamic) are ODCs central to a country’s monetary and banking system.
- Islamic banking subsector includes all Islamic banks and windows classified as ODCs per IMF definitions (that is, unrestricted PSIA is treated as equivalent to retail deposits at conventional banks).
- Islamic banks can be central to a country’s monetary system, issue current account and safe-keeping deposits, provide PSIAs to the public that functionally compete with conventional deposits, provide basic banking services, act as intermediaries to accept funds from the public and extend financing.
- Islamic banks might also be part of the official monetary policy system of a country and participate in interbank markets.

Investment Funds

*Islamic Collective Investment Schemes (ICIS)*

- Investment funds receive and pool capital from investors who have equity shares in the common pool of assets, manage the funds to generate income, are compensated as the manager through service fees or share of profits or other gains), then distribute the income or losses to the investors based on each’s share.
- Investment funds can be an important alternative credit channel to banks, and are often called “shadow banks”.
- Investment funds are collective arrangements always have a set of accounts separate from entities that manage them.
  - Differ from fiduciary or custodial arrangements in which a manager acts as agent for an individual investor. Restricted PSIA (RPSIA) appear to be custodial arrangements.
Differences between Islamic banking and ICIS

- **PSIA at banks** have some characteristics of investment funds because IAH participate in equity-like sharing of profit and risk.
- Many types of investment funds exist that are unrelated to money and banking activity – no general case that Islamic banks should be classified as investment funds.
- Islamic banks often are identifiable as banking institutions and can be regulated like banks; Part of monetary policy infrastructure.
- Structure of accounts of banks and funds differ:
  - Investment funds are owned by the pool of investors and are managed as a pool – each pool is managed separately.
  - Capital structure is different.
  - Managers charge fees which can be fixed or variable.
  - Type of returns can vary depending on type of assets held (interest, dividends, commodity prices, capital gains, exchange rates).
  - Distributions to investors often in the form of dividends.
- **IMF views Islamic banks as ODCs because of their clear monetary role and involvement in monetary policy.**

Money Market Mutual Funds (MMMF)

- SNA 2008 subdivides investment funds into Money Market Mutual Funds (MMMF) and Other Investment Funds.
- MMMF have accounts that are close substitute to regular bank deposits accounts and some offer transferrable deposits.
- A high degree of capital certainty is a feature of MMMFs, based on strategy of investing in liquid instruments with nearly constant value.
- Characteristics of Islamic MMMFs:
  - (1) indicative returns (returns indicated as likely but not guaranteed) are similar to conventional deposit rates.
  - (2) Investors accounts are highly liquid and
  - (3) Smoothed distributions to IAH are similar to transferrable deposits or money market instruments.
- All funds without a high degree of capital certainty are Other Investment Funds.
- An IFSB survey found that about one-third of ICIS are money market funds, used as a capital certain harbor for placement of Islamic funds.
- Classification of investment funds as MMMFs or as other investment funds is based on assets and financial flows of each fund. Data must be collected and evaluated for each fund for this purpose.
Other Investment Funds (OFIs)

- Other investment funds could be common in Islamic finance with its emphasis on investment in trading, commercial ventures, project development, and real estate, direct investment in Shariah-complaint ventures, or purchase of sukuk or other Islamic financial instruments.
- Restricted PSIA could be classified as OFIs if they are organized as separate entities and not consolidated into the financial accounts of their managing Islamic bank.
- However, recent accounting standards changes will require some RPSIA to be consolidated into the bank’s financial accounts.
  - Per IFRS, RPSIA type accounts should be consolidated into their parent bank's accounts if they are controlled by the bank and the parent bank benefits from or is at risk from variable income due to its management of the account.
  - AAOIFI FAS 27 (2014) follows similar lines

Other Financial Intermediaries

- Catch-all category excluding all other enumerated subsectors
- Funding must not be through broad money deposit liabilities; Funding could be through longer-term deposits, equity, sukuks, etc.
- Possible Islamic OFIs
  - Finance companies that provide murabahah or bai ajel installment sales
  - Leasing companies that provide longer term construction, Istisna, or Ijara financing funded through sukuk or longer-term deposits.
  - Haj funds that receive long-term deposits in order to finance future trips are OFIs.
Insurance (Takaful)

- This subsector includes organizations that provide life, accident, health, fire, and other insurance services. Insurance companies take premium payments from policyholders and agree to make benefits payments when an insured event occurs.
- Islamic insurance (takaful), which is growing fairly rapidly in some countries, is included in this subsector.
- Reinsurance companies (retakaful) and exchanges that insure the risks of other insurance companies.
- SNA 2008 added Standardized Loan Guarantees as a form on nonlife insurance to cover expected defaults in a portfolio. It is unknown whether any standardized loan guarantee units exist in Islamic finance.

Pension funds

- Pension funds provide benefits for retirement or disability. This subsector includes only units that are "autonomous"—separate from the unit that creates them.
  - "Nonautonomous" funds are classified as part of the employer who created them.
  - Social security pension plans are part of government
- Islamic pension funds are classified in this subsector, with many apparently integrated into takaful companies.
- Are there separate Islamic pension funds? Or should they be treated within the Insurance (takaful) subsector?
- Currently, there a relatively few Islamic pension funds, partly because of a limited pool of long-term Shariah-compliant investments, such as in sukuk. (Several initiatives are underway to build sukuk markets to support growth of Islamic pension funds.)
Captive Financial Institutions (and money lenders)

- SNA 2008 expands the definition of the financial sector to cover units that provide financial services “captive” only to a single financial entity or closely related group of companies.
- Captives do not have market-based transactions with their parent – either their assets or liabilities are transacted only with their parent.
- Previously, captives were considered as financial arms of parent corporations called “ancillary corporations” and were consolidated into the parent corporation, including into nonfinancial corporations.
- Under SNA 2008, captives that operate as separate entities – including in foreign countries – can be classified within the financial sector.

Types of captives

- Trusts, estates, and brass plate companies
- Holding companies as defined in SNA 2008
- Special purpose vehicles (SPVs; also called structured entities) that raise funds in open markets for their parent
- Money lenders
- Pawn shops
- Firms lending funds received from a sponsor such as government or nonprofit institution

This is a highly diverse group – any unit that operates in a Shariah compliant way could be treated as part of Islamic finance

- What are country practices – any significant Islamic captive institutions?
**SPVs**

- Per SNA 2008, SPVs are financial entities without employees or nonfinancial assets owned by or affiliated with other units, often set up in different countries for tax or legal reasons.
- SPVs have been used to securitize assets off of a bank's books, shift credit risk by bundling assets with derivatives or guarantees, or shift insurance or reinsurance obligations.
- SPV potentially relevant for Islamic finance securitizes bank's holdings of Shariah-compliant financing by issuing securities to fund purchase of the financings. Also, separate financing arms set up in offshore centers or International Finance Centers to issue sukuk in the name of their parent.
- SPVs have also been set up in conjunction with sovereign or official infrastructure sukuk, but they should be classified as separate financial captive units only if they are effectively separate from their parent.

**Sovereign Wealth Funds (SWFs)**

- Not yet concluded whether SWFs funded by governments, central banks, or extractive industries to hold and invest financial assets including Shariah compliant assets for future beneficiaries are separate entities that can be treated as financial captives.
- Views of Working Group?
Financial Auxiliaries

- SPVs are of special interest. SNA 2008 defines SPVs as financial entities without employees or nonfinancial assets owned by or affiliated with other units and which are often set up in different countries for tax or legal reasons.
- SPVs have been used to securitize assets off of a bank’s books, shift credit risk by bundling assets with derivatives or guarantees, or shift insurance or reinsurance obligations.
- A SPV potentially relevant for Islamic finance securitizes bank’s holdings of Shariah-compliant financing by issuing securities to fund purchase of the financings.
  - A type of Islamic financial unit that might fall into this classification are separate financing arms set up in offshore centers or International Finance Centers to issue sukuk in the name of their parent.
- SPVs have also been set up in conjunction with sovereign or official infrastructure sukuk, but they should be classified as separate financial captive units only if they are effectively separate from their parent.

Financial Auxiliaries

- Financial auxiliaries are units not directly engaged in financial intermediation, but which provide closely related services.
- Many are financial infrastructure companies (brokerages, exchanges, clearing houses, securities depositories, collateral agents, and asset management companies resolving financial crisis situations, etc.)
  - Financial infrastructure specifically designed for Islamic financial instruments (exchanges, depositories, credit bureaus, etc.) should be classified here.
- Includes “Nonprofit institutions serving the financial sector”.
- Infrastructure units that act as intermediaries (like Centralized Clearing Houses that take intervening positions in over-the-counter derivatives) are not financial auxiliaries and should be classified in other financial subsectors.
Windows

Windows definition

- “Windows” are subdivisions of conventional banks (branches, divisions, offices) that handle Islamic finance.
  - A window is consolidated into the financial accounts of its parent bank
  - Under financial and legal control of the parent bank

- A separately incorporated Islamic subsidiary of a conventional bank is not treated as a window but as a full-fledged Islamic bank.
  - Own legal identity
  - Own capital
  - Explicit investment relationship with parent bank
  - Not consolidated into financial accounts of its parent bank, but is included in banking group level consolidations.
Separate data for windows

- Although part of parent’s financial consolidation, separate information on the Islamic financial activity is required.
- IFSB: however windows are organized, they should be treated as virtual branches with separate accounting.
  - Core Principles for Islamic Financial Regulation (CPIFR) specifically require "institution publish a full separate set of financial statements for its window operation,” either in financial statement notes or in a separate readily accessible separate form. The disclosures must cover capital adequacy information and sources of funds for windows’ liquidity deficits.
- Per accounting concept of "materiality”, significant differences in behavior of subordinate units require "subconsolidation” – a separate set of accounts for the unit

Why separate data for windows?

- Financing restricted to Shariah-compliant activities
- Some conventional activities such as holding interest-bearing instruments are forbidden
- Shariah-compliant funds must not be intermixed with conventional bank funds
- Shariah-compliant funding of windows cannot be diverted to the parent
- Risk and profit sharing between bank and depositor/investors requires detailed calculations of gains and losses.
- Rules exist for the types of liquidity support the parent bank can offer its windows.
Why separate data for windows?

- Windows and their parents are likely to have different funding and financing patterns, react differently to economic stimuli and shocks, soundness and risk profiles differ.
- Regulatory arbitrage must be avoided;
- Bankruptcy and resolution regimes can differ
- Standard accounting and statistical rules can misrepresent the underlying economic flows and values of the Islamic financial activity; could provide distorted views of the financial condition of the consolidated parent bank.
- Windows practices differ greatly between countries – specific country data needed to understand actual practices
- *The IFSB collects separate data for windows to better understand the diverse practices described above*

Windows as part of banking sector

- Treatment of windows affects options for compiling measures for consolidated banking subsector
- **Total Islamic** banking activity is the sum of Islamic banks and windows
  - Some estimates of total Islamic banking have not included windows
- **Total bank** activity is the sum of conventional banks and standalone Islamic banks – (windows are consolidated into their conventional bank parents)
  - Does inclusion of Islamic banking in parent bank consolidation significantly distort the measure of total bank activity? – an empirical country-by-country question
- How windows should be treated depends on the type of analysis – Total, Islamic, Supervisory, Soundness, etc.
Pieces of the banking sector

- In countries with mixed conventional/Islamic banking, the total banking sector might include (peer groups).....
  - Conventional banks
    - Those without windows
    - Those with windows
    - Windows
  - Standalone Islamic banks
- Often, statistics might cover all banks with no subdivision as above
- Windows data often are not covered
- Type of primary reporting can dictate availability of data on categories above
  - Reporting at individual bank level
  - Reporting at consolidated group level including all subsidiaries and branches
- Type of analysis can affect types of data needed

Special case – Asset-side only windows

- In some countries, banks raise funds in conventional accounts, but invest funds only in Shariah compliant instruments – these are “Asset-side only windows”
- These raise substantial supervisory and statistical issues.
  Statistical options
  **One** – Treat as a full-fledged window by reclassifying the funding as effectively equivalent to Islamic finance based on observed intent to purchase SC assets.
  The amount of SC financing would be subtracted from conventional deposits and reclassified as SC funding of the window. A footnote explaining the special nature of the reclassification is needed.
  This option retains the link between the transaction and the bank, which treats the funding as a deposit equivalent consistent with an ODC classification and relevant for monetary analysis, and as part of the supervisory and policy framework applicable to banks.
Special case – Asset-side only windows

- **Two** – Treat like a RPSIA account with both sides handled off-balance-sheet, but generating fees for the bank. This loses information about the size of these financing. Moreover, off-balance-sheet treatment appears to clash with the requirement under the “control” concept to consolidate into the bank’s financial account those accounts under the management of the bank that affect the parent bank’s income.

Special case – Asset-side only windows

- **Three** – “Look-through” method. Funding is not SC and not part of Islamic banking; Asset side is SC and is part of broadly construed Islamic finance.
  - That is, funding transaction is treated as direct purchase by the public (households or other macroeconomic sectors) of SC assets (that is, the transaction is deconsolidated from the bank’s financing side and parent acts as a broker and is not treated as an obligor).
  - In this case, the PSIFI windows form covers all financing activity of the window; funding side shows customers’ funds as PSIA accounts (with some footnote); no bank capital or other bank resources are reported on the form.