

**10th Meeting of the Advisory Expert Group on National Accounts,
13-15 April 2016, Paris, France**

Agenda item: 9.2.2

Islamic Banking in SNA2008 “Proposals by various experts”

Introduction

Topics related to the financial corporations sector were discussed in several meetings held within the ESCWA region in order to find appropriate solutions to the problems facing countries with respect to methodologies and data sources for the compilation of the accounts for the sector according to the 2008 SNA. Important issues were raised during these meetings on the treatment of Islamic Banks in the 2008 SNA and two viewpoints emerged from the discussions on how to deal with the Islamic Banks. The two viewpoints are described in this paper.

Documentation

Paper: Islamic Banking in the 2008 SNA “Proposals by various experts”

Main issues to be discussed

The AEG is requested to:

- Provide its views on the proposals by the experts and decide if further research is needed on this issue.

Islamic Banking in the 2008 SNA “Proposals by various experts”

ECONOMIC AND SOCIAL COMMISSION FOR WESTERN ASIA¹

I. Introduction

1. Several meetings were held during the last two years in the Arab Region to discuss the implementation of the System of National Accounts (2008 SNA) by ESCWA Member States.² Agreement was reached regarding the appropriate methods and sources to be used on several issues but not on those related to the treatment of Islamic Banking in the 2008 SNA. Further work on the implementation issues related to the financial corporations was considered necessary in order to find appropriate solutions to the problems facing countries regarding methods and sources for compiling the accounts according to the 2008 SNA.

2. Many experts found that the IMF Monetary and Financial Statistics Manual and Compilation Guide (MFSMCG) provide adequate guidelines to compile the accounts for Islamic Banking according to the 2008 SNA. Nevertheless, they believe that further modification may be required to overcome practical issues and finding logical interpretation of the results. The second group of experts believes that the activities of Islamic Banking are completely different than that of conventional banks and thus should be treated differently.

3. The two viewpoints on the treatment of the Islamic Banks in the SNA that emerged from the discussions are described in detail in the next section. They can be summarized as follows:

4. The first point of view is to advise countries to follow the international recommendations related to Islamic Banking: to measure the financial services provided by Islamic Banks as FISIM; and to treat the deposits and loans of Islamic Banks in the same way they are treated for conventional commercial banks. However, the accounting system of the Islamic Banks is different from that of commercial banks, which leads to problems adjusting the data related to measuring the services provided by Islamic Banks. More guidance and clarifications are therefore required.

5. The second point of view is to consider the transactions, assets and liabilities of Islamic Banks as quite different from those related to commercial banks since the majority of their deposits are in fact shares by depositors in investments or investment funds managed by the Islamic Bank. Moreover the depositor is the one who bears the risk and not the Bank. The only types of loans granted by the Islamic Banks that are similar to the loans provided by commercial banks are the “Qard El-Hassan”. In this case the Bank is the one who bears the risk and assumes all liabilities of deposits that have been lent as Qard El-Hassan. Other loans of the Bank are either financing for purchases or projects managed by the Bank through investment funds. In these cases the Islamic Bank does not assume the responsibility of loss of the deposits, since the risk is borne by the depositors in their capacity as shareholders of these investments. Accordingly, it is believed that the Islamic Banks can be considered as managers of Non-money Market Funds (non-MMF) and the funds within the Islamic Banks can be classified under the Non-MMF.

6. The paper presents the two views in order to receive feedback from the AEG.

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² [National Seminar on Developing a Programme for the Implementation of the 2008 SNA and Supporting Statistics in Jordan UNSD/UNESCWA and DOS 23 June 2013, Amman, Jordan; High Level meeting and Regional Seminar on the Implementation of 2008 SNA and Supporting Statistics in the Arab Region 24-27 June 2013 \(ESCWA-UNSD-AITRS\) Amman, Jordan](#)

7. Based on the discussions on the treatment of Islamic Banking that took place during the Expert Group Meeting convened by ESCWA³ in November 2015, two views emerged among the experts and they are described below.

II. Viewpoint 1

8. Many experts agreed with the recommendations included in the Monetary and Financial Statistics Manual and Compilation Guide (MFSMCG) regarding the classification of Islamic Banking and the classification of the various kind of deposits (Islamic) and financing instruments. Accordingly, they believe that Islamic Banking produce financial services that should be indirectly measured (FISIM). The experts had identified the following as issues that require further research:

A. The Murabaha (Mark-Up or Cost-Plus-Based Financing): The experts agreed to classify the funds provided through Murabaha contract as a loan and thus the Bank income generated (the Mark-up) is similar to interest. This implies that the Murabaha is the same as the loan provided by conventional banks but they have a problem in explaining the cost related to the services linked to trading with commodities that were sold by the Bank such as storage and ownership transfer fees.

B. The Islamic Banks impose some management fees for the deposits and this may contradict with the definition of the deposits. Usually the banks pay interest on deposits so how can they interpret the depositor paying management fees to the Bank?

III. Viewpoint 2

9. The other group of experts believes that most of the guidelines and recommendations provided in the MFSMCG may not reflect the situation of all Islamic Banking especially those compliant fully with Islamic principles (Shariah). The following paragraphs show the experts' opinions on various issues included in the manual.

A. The Islamic Banks do not really borrow funds from the depositors, neither do they lend the funds to entrepreneurs as it is the case with the conventional banks. An Islamic Bank accepts funds from individuals and institutions in the capacity of a fund manager under a fund management contract. The customer "depositor" who provides the funds is called the "Rab Al Mal" and the Islamic Bank who accepts the funds "investment funds" is called the "Mudareb", "investor", and the transaction is referred to as a "Mudaraba". Thus, classifying the mudaraba money as deposits contradicts with the concepts of Islamic Banking (if fully compliant with Shariah). The investment deposits accepted by Islamic Banks differ from the investment deposits accepted by the conventional bank. The conventional banks borrow funds from depositors, and hence they become the owners of such borrowed funds and accordingly they bear all the risk when they lend these funds to a third party. The Islamic Banks do not borrow funds from depositors and therefore do not assume an ownership over these funds. The Islamic Banks' responsibility to their depositors instead follows from the fact the Banks have merely assumed the role of a trustee or an agent and handle the depositors' funds, thus having fiduciary capacity and the responsibility related to such capacity. Accordingly classifying the investment as shares or units in an investment pool is more appropriate than classifying them as other deposits especially since the Islamic Banks charge the depositors management fees to run and invest their deposits.

B. Consequently, classifying Islamic Banks under other depository corporations subsector based on the assumption that they obtain deposits could be not adequate because Banks are prohibited, according to Shariah, from accepting deposits except, Amanah and Qard El-Hassan deposits which are conventional deposit and transfer accounts for safekeeping and transferable checking, and they pay no returns, thus cannot be used by the Bank for financing. The Islamic Bank raise funds by accepting investment deposits which is similar to shares rather than deposit as

³ [Expert Group Meeting \(EGM\) on Financial Services and Business Register 24 to 25 November, 2015, Istanbul, Turkey](#)

mentioned above because they accept them according to Modarabah or Mosharaka contract which means that the depositor himself would be exposed to the risk, not the Bank. The depositor in this case will have a share or a unit similar to the participants of a mutual fund or non-money market fund. Accordingly the second group of experts believes that the Modarbah contracts provided by Islamic Banks are profit and loss sharing agreement and thus it is similar to stocks (units) and cannot be classified as deposits as recommended by the Manual and thus Islamic Banks cannot be classified under the other depository corporations. The second group of experts believes that Islamic Banks can be classified as managers of mutual funds or non-money market funds.

C. According to the (MFSMCG), the fund provided by the Islamic Banks to investors in the form of Musharakah should be classified as a loan. The second group of experts believes that the Musharakah is a tool of financing used by Islamic Banks that could roughly be translated as partnership. In this tool, two or more financiers provide finance for a project where all partners are entitled to a share in the profits resulting from the project in a ratio which is mutually agreed upon. However, the losses, if any, are to be shared exactly as in the proportion of capital. All partners have a right to participate in the management of the project. However, the partners also have a right to waive the right of participation in favor of any specific partner or person. In fact there are three major kinds of Mosharkah contract. Permanent Musharaka is when Islamic Bank participates in the equity of a project, without specifying the period, and receives a share of profit on a pro rata basis. This form of financing is used for financing projects with longer life where funds are committed over a long period and gestation period of the project may also be long. In this case it is obvious that the provided fund is not a loan but it is a share in the equity. The second type of Mosharkah is the diminishing Mosharakah which have the same proprieties of the permanent Musharakah but provides a method through which the Bank keeps on reducing its equity in the project and ultimately transfers the ownership of the asset to the participants. The contract provides for a payment over and above the Bank's share in the profit for the equity of the project held by the Bank. The experts believe that this should also be classified as shares. Other kinds of Musharakah are the same and if they were considered as loans, then the profits that are generated by the project and distributed to the Bank need to be considered as interest on loans. This could create serious practical problems and lead to a reclassification of the profits of the projects from the distribution of profits to interest payable.

D. A Murabaha contract is considered a loan according to MFSMCG because it considers it as a financial institution purchasing goods upon the request of a client, who makes deferred payments that cover costs and an agreed-upon profit margin to the financial institution. The financial institution handles payments to a supplier and incidental expenses of delivery (against a deferred payment that is made by the buyer to cover delivery costs and an agreed-upon share of the buyer's markup). This classification implies that all of the profit margin should be classified as interest and thus, the experts find that this treatment neglects the existence of an economic activity (trade activity) that employs resources and incurs some cost to perform the trading activity. The Bank really buys the commodities and resells them and acts as trader. The conventional banks provide the loan without dealing with the commodities. Therefore considering all the morabaha as a loan means that it is similar to the conventional loan. The experts believe that when the Islamic Banks want to specify the profit margin they take into account the cost of time by taking into consideration the interbank interest and they add to it a normal profit margin. Therefore the second group of experts thinks that the Morabaha doesn't create FISIM but produces trade margin and generate SNA interest.

E. Considering the profit generated from Morabaha as interest would create many practical problems and may be conceptual. The first practical problem will be obtaining the data from the users of the commodities bought with a Marabaha contract. The user will record the total value of the commodity, including the markup profit as the value of the commodity, while if the same

commodity was purchased according to conventional loan the value of the commodity will not include any extra amount other than the price of the commodity. The experts believe that if the Morabahah is treated as loans, then it would be necessary to provide some instructions on how to deal with practical implications resulting from this interpretation.

F. If the above recommendations made by the second group of experts were accepted, it means that the set of the transactions made by the Islamic Banks should be revisited accordingly.

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