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Basel Capital Adequacy Ratio Standard in The Light of Islamic Law Perspective

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Abstract: Bank is one of the most important pillars of economy activities. However, banking sector has a real potential crisis threat. Alongside with the steady current global banking development, financial crises that have happened clearly affected global economy. Based on that situation, BIS (*Bank for International Settlement*) – an international financial standard setting organization, realizes the urgency to establish an international financial standard and supervision to anticipate future potential financial crises. This research aims to identify how Capital Adequacy Ratio Standard in Basel Capital Accord (II) based on Islamic law perspective. The research is conducted by analyzing Basel Capital Accord published by BIS. The research uses *library research method* to find out the aimed result. The focus is on the 1st pillar of Basel II publication that is Minimum Capital Requirements (CAR) policy. CAR, as an Islamic economics policy, will be analyzed using *falāh* approach. *Falāh* is an Islamic economics objective that consists of happiness, success, accomplishment or good luck concept. The earthly dimension of *falāh* has some parameters that can be used to analyze Islamic economics policy. Additionally, the Islamic fiqh maxim takes part in analyzing the policy. The *maṣlahat* concept in fiqh maxim approach shares aim with *falāh* concept in the sense that all of sharia law aims for success, happiness, eternal survival etc. The *maṣlahat* can be accomplished by extinguishing *mafsadat* or seizing *maṣlahat*. The *maṣlahat* aspect is essential to determine the compatibility Basel Capital Accord with jurisprudential maxim i.e harm must be dispelled (*al-dharāru yuzāl*). The conclusion results are, 1) Basel Capital Accord focuses on macro-prudential aspect in order to anticipate potential financial crises, 2) beneficial/interest (*maṣlahat*) aspects of the hereafter, cooperation principle, justice, fairness and the prohibition of exploitation are not the core value of Basel Capital Accord frame work, thus 3) the achievement of *maṣlahat* as intended by sharia i.e. jurisprudential maxim are not convincing. Therefore, 4) Basel Capital Accord as a regulation basis is not in line with jurisprudential maxim i.e harm must be dispelled (*al-dharāru yuzāl*).

Keywords: *basel capital accord, car, jurisprudential maxim, falāh, maṣlahat*

A. Introduction

Financial crisis has been a main and one of the most anticipated news in this information era. However, those are not a brand new phenomenon. The shock and the effect resulted from financial crisis had been suffered even before the modern banking system came into practice. Emperor Tiberius,

the Roman Emperor ruled in 33 AD, had injected 1 million gold to Roman financial system to prevent it from collapsing¹. In modern era, for the last 30 years there were 16 financial crises (see figure 1).

In modern era, as the financial system globally and systematically connected, the effects of financial crisis become

¹ Liaquat Ahamed, *Lords of Finance* (New York: Penguin, 2009), 4

unpredictable, riskier and systemic. For example, Citigroup – one of the biggest banks in the United States, operates in more than 140 countries around the world. Its global operation contains potential systemic crisis. The term “systemic” means if a bank collapses the effect will deteriorate national banking system as a whole². In Indonesia context, the systemic financial crisis happened when Century Bank losing its capital stability in 2008.

The crises have become attention for several international organizations – one of

those is BIS (Bank for International Settlement) which is based in Basel, Switzerland. BIS is the oldest international financial institution that established in 1930³. The members are central banks from around the world. In respond of financial turmoil following the breakdown of Bretton Woods system in 1973, the central banks of G10 countries – the motor of BIS, established the Basel Committee on Banking Supervision. Its aim was and is to enhance financial stability by improving supervisory knowhow and the quality of banking supervision worldwide⁴.

Year	Crises
1987	U.S. stock market crashed
1990	Collapse of U.S. high-yield bond market
1991	Oil price surge
1992	Britain removes pound from the European Exchange Rate Mechanism
1994	U.S. bond market crashes
1995	Mexican crisis
1997	Asian crisis
1997	Russian default, ruble collapses; Long-Term Capital Management bailout
2000	Technology, media, and telecom sectors collapse
2001	September 11 payment system disruption
2002	Argentine crisis
2002	German banking crisis
2007	U.S. subprime mortgage turmoil
2009	Iceland's financial crisis
2009	Dubai's financial crisis
2010	Greece's financial crisis

Figure 1. International Financial Crisis for the last 30 years⁵

In 1989 BIS published *Basel Capital Accord*, more popular by the term Basel I. Then, in 2004 International Convergence of Capital Measurement and Capital Standard or

Basel II was published by BIS. There are 3 main pillars in Basel II standard. The first pillar is the focus of this paper i.e the minimum capital requirements. Under Basel

² Bank of Indonesia, *Krisis Global dan Penyelamatan Sistem Perbankan Indonesia*, (Jakarta: Bank of Indonesia, 2010), 58

³ Bank for International Settlement, this is The Biz, (Basel: BIS, 2005), 6

⁴ Bank for International Settlement, A Brief

History of Basel Committee, (Basel: BIS, 2015), 1

⁵ Benton E Gup, *Banking and Financial Institutions, A Guide for Directors, Investors and Counterparties* (New Jersey: John Wiley and Son Inc, 2011), 2

II regime, the minimum capital requirements are set based on CAR measurement. Basel II introduces new approach in measuring CAR by adding operational risk in the CAR formula. Whereas, there were only two risks introduced in Basel I i.e credit risk and market risk. The implication of this approach is that banks reserve (statutory reserve) more capital buffer to prevent potential financial crises and to settle its financial obligation during stress period.

In Islamic financial institutions (IFIs) car have also important role. Simon Archer dan Abdel Kareem⁶ noted that CAR has an important role in IFIs because it's functioned as a capital buffer during crisis. The fund/capital is derived from retained profit like in many jurisdictions (but not in the United Kingdom). Umer Chapra⁷ stresses that CAR is not only to prevent crises but also to serve as a stabilization instrument. Moreover, he adds, there is a challenge that must be responded by Islamic financial policy that is to derive as much mashlahat as possible for the good of the community in order to reach justice (*'adl*). Justice is the main object of Islamic financial policy because fairness is one of the objects of *maqashid al-syariah* as stated in *al-Qur'an* :

لَقَدْ أَرْسَلْنَا رُسُلَنَا بِالْبَيِّنَاتِ وَأَنْزَلْنَا مَعَهُمُ الْكِتَابَ وَالْمِيزَانَ
لِيُقِومَ النَّاسُ بِالْقِسْطِ...

"We have already sent our messengers with clear evidence and sent down with them the Scripture and the balance that the people may maintain [their affairs] in justice."⁸ (*al-Hadid* : 25)

Basel Capital Adequacy Ratio formulated by the BIS and will be used worlds wide

⁶ Simon Archer dan Rifa'at Abdel Kareem, *Islamic Finance : The Regulatory Challenge*, ed. Simon Archer and Rifa'at Abdul Kareem, (Singapore: John Wiley & sons, 2013), 286

⁷ Umer Chapra, "Challenges Facing the Islamic Financial Industry" ,dalam *Handbook Of Islamic Banking* ed. M. Kabir Hasan dan Mervyn K Lewis (Clatenham: Edward Edgar Publishing, Inc.,2007), hal 325

⁸ *Al-Qur'an dan Terjemahnya*, (Madinah : Departemen Haji dan Wakaf Saudi Arabia, 1411 H)

⁹*Cambridge Advance Learner Dictionary 4th ed.* (Cambridge: Cambridge University Press. 2013)

including Indonesia. Considering Indonesia is the biggest Moslem country, it is an urgent agenda to analyze Basel CAR in the light of Islamic law perspective. Furthermore, Moslems in Indonesia has been long known to contribute and to affect the development of law and the law system in the country. So, the Moslems must be seen as the main stake holders of the implementation of any policy, including the formulation Basel CAR into their country's law system. Based on this consideration, this paper aims to analyze Basel II CAR in the light Islamic law perspective.

B. Basel II Capital Adequacy Ratio (CAR) as A Financial Crisis Mitigation Instrument

Mitigation is derived from English word "to mitigate"⁹ which means an action or treatment to reduce or lessen injury or hurt. In Indonesian context, the word is adapted into Bahasa and used in many language contexts. Bank of Indonesia¹⁰ uses the word in the context of credit management i.e. credit mitigation is a group of techniques where banks may protect some parts of their possession toward the counterparties failure to meet their obligation.

Basel II standard contains 3 main pillars, they are¹¹ :

1. Minimum capital requirements (CAR):

Based on Basel II standard bank's CAR may not be lower than 8 %¹². the CAR formula is :

$$\frac{\text{Total Capital}}{*RWA \text{ market risk} + RWA \text{ credit risk} + RWA \text{ operasional risk}} \geq 8\%$$

RWA : Risk Weighted Asset

The total capital elements definition in Basel II remains unchanged than the one in Basel I. The elements consist of 2 (two) tiers¹³ :

¹⁰Bank of Indonesia. *Implementasi Basel II di Indonesia*, (Jakarta: Directorate of Research and Regulation Bank of Indonesia, 2006), 29

¹¹Basel Committee on Banking Supervision. *International Convergence of Capital Measurement and Capital Standards*, (Basel: BCBS, 2005)

¹²Basel Committee on Banking Supervision. *International Convergence ...*, paragraph 40

¹³Basel Committee on Banking Supervision, *International Convergence Of Capital Measurement And Capital Standards*,(Basel : BCBS, 1988 updated in 1998), 14

- a. Tier 1
 - 1) Paid-up share capital/common stock
 - 2) Disclosed reserves
- b. Tier 2
 - 1) Undisclosed reserves
 - 2) Asset revaluation reserves
 - 3) General provisions/general loan-loss reserves
 - 4) Hybrid (debt/equity) capital instruments
 - 5) Subordinated debt

The sum of tier 1 and tier 2 elements will be eligible for inclusion in the capital base, subject to the following limits :

- a. The total of tier 2 (supplementary) elements will be limited to a maximum of 100% of the total of tier 1 elements;
 - b. subordinated term debt will be limited to a maximum of 50% of tier 1 elements;
 - c. where general provisions/general loan-loss reserves include amounts reflecting lower valuations of asset or latent but unidentified losses present in the balance sheet, the amount of such provisions or reserves will be limited to a maximum of 1.25 percentage points;
 - d. asset revaluation reserves which take the form of latent gains on unrealised securities (see below) will be subject to a discount of 55%.
2. Supervisory review of an institution's capital adequacy and internal assessment process; and
 3. Effective use of disclosure as a lever to strengthen market discipline and encourage sound banking practices.

a. Risks Sensitivity

Basel II is formulated to be more risks sensitive. The addition of operational risk shows that goal. Paragraph 10 Basel II stated¹⁴ :

"The revised Framework is more risk sensitive than the 1988 Accord, but countries where risks in the local banking

market are relatively high nonetheless need to consider if banks should be required to hold additional capital over and above the Basel minimum. This is particularly the case with the broader brush standardised approach, but, even in the case of the internal ratings-based (IRB) approach, the risk of major loss events may be higher than allowed for in this Framework."

There are 3 (three) risks in Basel II capital adequacy requirements:

1) Operational Risks

Operational risk¹⁵ is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputational risks.

2) Market Risks

Market risk¹⁶ is defined as risk of loss from on and off-balance sheet positions from changes in market factors (interest rates and exchange rates).

3) Credit Risks

Credit risk¹⁷ is defined as risk of loss from default by debtors/counterparties.

The critics say that these risks are not enough to represent real risks faced by financial industry especially when the Enterprise Risk Management (ERM) approach is used to analyze. The ERM approach sees far beyond market risks, operational risks and credit risks. The keys in ERM approach is considering wide range of risks, potential and others factors affecting banks in the future¹⁸. The others risks faced by banks are but not limited to

¹⁴ Basel Committee on Banking Supervision. *International Convergence ...*, paragraph 10

¹⁵ Basel Committee on Banking Supervision. *International Convergence ...*, paragraph 644

¹⁶ Bank Indonesia, *Basel II at Glance*, (Jakarta :

Bank Indonesia,2006) 2

¹⁷ Bank Indonesia, *Basel II ...*

¹⁸ Benton E Gup, *Banking and Financial Institutions ...*, 199

breakdown of vital infrastructure, changes in laws or regulations, changes in technology, defaults of sovereign debts, foreign exchange, natural disaster, changes in oil prices, terrorism and global¹⁹.

b. Macro Prudential Aspect

Basel II standard focuses on macro-prudential aspects. In financial context, macro-prudential refers to policy frameworks which aim to resolve and anticipate instability in financial system²⁰. Specifically, macro-prudential policy is formulated to mitigate 3 (three) systemic risks i.e. 1) risks resulted from the rapid growth in credits issuance, 2) liquidity risks and 3) capital overflow²¹. Whereas, based on G20 Working group, macro-prudential policy is a policy which its object is to increase financial system strength and to mitigate systemic risks that caused by inter-relation between institutions and institutions' tendency to follow economy-procyclical cycle²².

Based on macroeconomics perspective, Basel II policy tends to make banks more selective in issuing credit for corporations. The use of macro-economic parameters is an important factor to take in considerations when banks are about to issue credit²³. In other words, Basel II standard has reciprocal effect on macro-economy condition. In the long term, Basel II standard acts in the same line like monetary policy²⁴.

C. Basel II CAR, It's Implementation In Indonesia: An Islamic Financial Institutions Perspective

In Indonesia, Basel II capital requirements transformed into Bank Indonesia Regulation No.13/23/PBI/2011 concerning Application of Risks Management for Sharia Banks and Sharia Business Units. It is stated in Article 5 verse no.4 "Implementation of Risk Management as mentioned in verse no.3 is not yet included in the Valuation of Bank Risks²⁵". Whereas, Article 5 verse no.1 states that banks should apply the risks management framework over 10 (ten) type risks. The interesting thing is 8 (eight) risks are obligatory (verse 2) and the last 2 risks are optional (verse 3). In brief, the regulation doesn't oblige sharia banks and sharia business unit to manage Rate of Return Risk and Equity Investment Risk.

Sharia banks (SBs) operate based on different principles, code of conduct and assumption comparing to those operate based on conventional principles. Consequently, SBs endure different type of risks relative to conventional banks (see figure 2). It is questionable when Bank Indonesia stated the risks but doesn't oblige SBs to calculate and include the risks in the risks management framework. As a result, there is no consequence when a bank evades the calculations of those risks.

There are 4 (four) risks typical to IFIs. a) Equity Investment Risk, b) Sharia Non-compliance Risk, c) Displaced Commercial Risk, d) Rate of Return Risk. Equity Investment Risk is defined as risks faced by IFIs when they expose to loss risk occurred from profit and loss sharing scheme. Sharia

¹⁹ Benton E Gup, *Banking and Financial Institutions ...*, 200

²⁰ Muhammad Edhie Purnawan dan M. Abd. Nasir, *The Role of Macroprudential Policy to Manage Exchange Rate Volatility, Excess Banking Liquidity and Credits*. (Banking and Monetary Economics Bulletin, Volume 18, No 1, July 2015), 22

²¹ Muhammad Edhie Purnawan dan M. Abd. Nasir, *The Role of Macroprudential Policy...*

²² Group G-20, *Enhancing Financial Stability and Resilience: Macroprudential Policy, Tools, and Systems for the Future*, (Group G-30: Working Paper G-20, 2010), 4

²³ Read Kenneth Carling Tor Jacobson Jesper Lindé Kasper Roszbac, *Capital Charges under Basel II: Corporate Credit Risk Modelling and the Macro Economy*, (Sweden: Sveriges Riksbank Working Paper Series No 142

September 2002)

²⁴ According to macro-economic perspective, government tries to stabilize national economy through two main policies: a) fiscal and b) monetary policy. Fiscal policy is a set of policies that is formulated in local, state or national level related to taxes and government expenses. Monetary policy is a set of policies to regulate and manage the growth of money in circulation and is conducted under central bank supervision.

Read Andrew S Abel, Ben S Bernanke, Dean Crushore. *Macroeconomics 7th edition*, (USA: Addison Wesley, 2011), 18

²⁵ *Penerapan Manajemen Risiko sebagaimana dimaksud pada ayat (3) belum diperhitungkan dalam penilaian Risiko Bank*".

non-compliance risk is a risk which occurs from the un-lawful practices of IFIs' operational in the light Islamic/sharia law. Then, displaced commercial risk and rate of return risk are connected risks. Rate of return risk is a risk which occurs when the difference returns between IFIs and conventional banks potentially affect the economic and decision-making behavior of the clients/investor. Therefore, to prevent the negative effect of this condition, banks tend to practice smoothing approach. The approach means taking some parts of bank's profit (displaced) to compensate the potential loss/loss (smoothing). This approach is taken to prevent the depositor/investor pulling out its capital.

Risk management in IFIs in Indonesia context is important. To make sure the

security of depositors and investors fund, sound and prudent practice of IFIs services is highly vital. Prudent and sound practice will support the asset development of IFIs in Indonesia. Currently, IFIs asset in Indonesia is so small i.e. under 10 %²⁶. A specific and comprehensive risk management regulation will assure the prudent and sound IFIs operational and in the long run will attract more depositors/investors. If this situation goes for quite long time, Indonesia IFIs' asset will increase by quite significant number.

However, Bank Indonesia has published several regulations concerning Basel II implementation. The regulation is projected as the basis for full implementation of Basel III framework in 2018 (see figure 2).

Figure 2. Legal basis for Basel II standard in Indonesia

Minimum Capital Requirements Under Basel II			
Risks	Legal Basis		Effective
CREDIT RISK			
Standard Approach	Circular Letter Number 13/6/DPNP – 02/18/2011		Jan 2 nd 2012
Rate and Independent Rating Institutions which are recognized by Bank Indonesia (BI)	Circular Letter Number 13/31/DPNP – 12/22/2011		Dec 22 nd 2011
MARKET RISK			
Standard Method	Circular Letter Number 9/33/DPNP – 12/18/2007		July 22 nd 2008
	Circular Letter Number 14/21/DPNP – 07/18/2012		August 1 st 2012
Internal Method	Circular Letter Number 9/31/DPNP – 12/12/2007		Dec 12 2007
OPERATIONAL RISK			
Basic Indicator Approach	Circular Letter Number 11/3/DPNP – 01/27/2009		Jan 27 th 2009

The approach, Bank Indonesia (BI) taking to bring Basel II standard forward is simply translating and transforming into Bahasa. There is lack of two ways communication between banks and BI. The preparation is a

slow and long-term process. The economic stability and human resources capability are vital in this process. The legal basis for the new standard is an achievement but that is not enough. So, more comprehensive and

²⁶ Financial Services Authority, *Indonesian*

Banking Statistic, (Jakarta: Vol: 14 No. 1, Desember 2015)

practical approach are needed. The separation between BI and Financial Services Authority (OJK) is taking place. The separation should be used as reformation and reconstruction for Indonesia's financial system towards more professional operation and adjustable legal system to modern needs of financial regulation and supervision.

Therefore, systemic stability in financial systems with Islamic banks requires a multi-aspects consideration to bring about²⁷ :

1. A suitable regulation and disclosure framework for Islamic banks.
2. A robust financial system infrastructure and adequate macroprudential surveillance to provide the preconditions for effective supervision and risk management.
3. Strengthened internal controls and risk management processes within Islamic banks.

D. Basel II CAR and Islamic Law Perspective: Islamic Maxim Approach

Islam is the final, highest and perfect risalah (teaching/good news) brought by the last prophet Muhammad pbuh as stated in Qur'a>n :

الْيَوْمَ أَكْمَلْتُ

لَكُمْ دِينَكُمْ وَأَتْمَمْتُ عَلَيْكُمْ نِعْمَتِي وَرَضِيتُ لَكُمُ الْإِسْلَامَ دِينًا

"This day I have perfected your religion for you and completed My favour upon you and have chosen Islam as religion for you."²⁸ (Al Maidah : 3)

*Ibnu Katsir*²⁹ explained that this ayat functions as guidance that Islam with its all sets of rules and code of conduct is the highest favour from God for Moslem. In other words, Moslem doesn't need any religion except Islam. Likewise concerning prophet, Moslem doesn't need any prophets except Muhammad pbuh, all good news and information from him is true, there is no lies and deceits therein. So, there is no prohibition (*haram*) except what he determines as forbidden and there is no permission (*halal*) except what he determines as permitted. In conclusion, he truly delivers Allah SWT commands as stated in Qur'an.

وَمَتَّ كَلِمَاتُ رَبِّكَ صِدْقًا وَ عَدْلًا

"And Complete is the word of your Lord in veracity and justice."³⁰ (*Al An'am*: 115)

Based on above explanation, the basis of Islamic law is faith (*iman*) towards Allah and His Messenger. This is different with western tradition which bases the legal jurisdiction on legal professions that are products of secular school or university³¹. The consequence of this (*iman*) Moslem base their economy, politics, everyday life routine, moral code, education and cultural practice on sharia³². Sharia is not just law. It's a complete jurisprudence that every single aspect of Moslem life must comply with. Jurisprudential maxim (*qawaid fiqhiyyah*), along with Qur'an, hadits and other sharia sources, is the one which simple and fit enough to analyze Basel II CAR standard.

²⁷ Simon Archer dan Rifa'at Abdel Kareem, *Islamic Finance : The Regulatory Challenge*, ed. Simon Archer dan Rifa'at Abdul Kareem, (Singapore: John Willey & sons, 2013), hal 286

²⁸*Al-Qur'an dan Terjemahnya*, (Madinah : Departemen Haji dan Wakaf Saudi Arabia, 1411 H)

²⁹Ad-Dimasqi, Al Imam Abul Fida' Isma'il Ibnu Katsir, *Tafsir Ibnu Katsir Juz 6. Terj, Bahrun Abu Bakar*, (Bandung: Sinar Baru Algensindo, 2005), 207 - 208

³⁰*Al-Qur'an and Its Translation*, (Madinah : Departement of Hajj dan Waqf of King Saud of Arabia, 1411 H)

³¹Wael B Hallaq, *An Introduction To Islamic Law*(New York, Cambridge University Press.2009), 7

³² Wael B Hallaq, *An Introduction To ...*

Figure 2. IFIs Risks Profile³³

Risks	Islamic Financial Institution	Conventional Financial Institution
Fiduciary Risk	√	√
Operational Risk	√	√
Credit Risk	√	√
Market risk	√	√
Liquidity Risk	√	√
Rate of Return Risk	√	
Displaced Commercial Risk	√	
Sharia Non-compliance Risk	√	
Equity Investment Risk	√	

But, the majority of jurisprudential maxims are based on the Qur'an and/or the Prophetic Tradition hadith. It shows that jurisprudential maxim was and has been developed after the most basic sharia sources i.e. Qur'an and/or hadith. This paper uses the term jurisprudential maxim to refer *al-qawaid al-fiqhiyah*.

al-Jurjani³⁴ defined jurisprudential maxim as:

قَضِيَّةٌ كَلِيَّةٌ مُنْطَمَّةٌ عَلَى جَمِيعِ جُزْئِيَّاتِهَا

“a comprehensive principle or law that is applicable to all of its particulars”

Whereas, Tāj al-Dīn ibn al-Subkī³⁵ defined it as follows: “a comprehensively valid rule which applies to many particulars, so that their legal determinations can be comprehended from it”

There are 5 main jurisprudential maxims as follows³⁶ :

1. الأُمُورُ بِمَقْصَدِهَا

“Acts are judged by the intention behind them”

2. اليَقِينُ لَا يَزَالُ بِإِسْكَ

“Certainty is not overruled by doubt”

3. المَشَقَّةُ تَجْلِبُ التَّيْسِيرَ

“Hardship begets facility”

4. الضَّرَرُ يَزَالُ

“Harm must be dispelled”

5. العَادَةُ مَحْكَمَةٌ

“Custom can be the basis of judgment”

This paper takes the 4th maxim i.e. harm must be eliminated as the basis to analyze Basel II CAR requirements.

Islamic economics policy or regulation should aim mashlahat (people interest) as the sole object. *Izzudin bin ‘Abd al-Salām*³⁷ stated that all of sharia is mashlahat either by dispelling mafsadat (harm) or taking interest. People deeds may lead to harm or mashlahat. The mashlahat could be used for worldly benefit. On the other hand, it could be used for hereafter benefit. but, it could be used also for both benefit. Based on the above statements mashlahat is not only earthly or

³³Ronald Rulindo, *Understanding Unique Risks of Islamic Banking*, proceeding at the 2nd Seminar on Islamic Deposit Insurance Understanding the Fundamentals of Islamic Banking and Deposit Insurance (Kuala Lumpur: IFSB, 2009)

³⁴ Al-Jurjani, Ali Ibn Muhammad, *Al-Ta'rifat*, (Tt, Dar Al-Fikri Al Arabi), 171

³⁵ Tāj al-Dīn al-Subkī, al-Ashbāh wal-Nadhāir, (Beirut: D [r al-Kutub al-Ilmiyyah, 1991), 1:11

³⁶ Djazuli, H.A. *Kaidah-kaidah Fikih: Kaidah-kaidah Hukum Islam dalam Menyelesaikan Masalah-masalah Praktis*, (Jakarta: Kencana, 1st ed, 2006), 33 - 34

³⁷ *Izzudin bin ‘Abd al-Salām, Qawaid al-Ahkām fi Mashālih al-Anam*, (tt: Dār al-Jail, 1980), juz 1, 11

material concept but also a hereafter concept and should be approached with.

Akram Khan³⁸ used different redaction concerning *masalahat* that the final aim of Islamic economic system is *falāḥ*. *Falāḥ* derived from Arabic root *فَلَاحٌ* which comes from verbal *أَفْلَحَ-يَفْلَحُ* meaning : to become happy, to thrive, to have a good luck or success. According to *Rāghib al-Isfahani*³⁹, *falāḥ* contains both worldly and hereafter concept. The worldly concept represents : *baqā* (*survival*), *ghinā* (freedom from want), 'izz (power and honour). Whereas the hereafter concept represents : *baqā bilā fanā* (*external survival*), *Ghinā bilā faqr* (*eternal prosperity*), 'izz *bilā dhull* (*everlasting glory*) dan 'ilm *bilā jahl* (*knowledge free of all ignorance*).

Akram Khan formulated 4 conditions to meet in order achieve *falāḥ*. The conditions categorized into four : 1) spiritual, 2) economical, 3) cultural dan 4) political. Since Basel II is a set of economy standard so this paper focuses on the second condition. There are 4 (four) elements in economical condition that is : *Infāq* (spending for the community solely to seek Allah's favor), prohibition of interest, fulfillment of covenants and trusts, justice and enterprise.

1. *Infāq*

Infāq is the manifestation of altruism. The altruism dimension, according to Akram Khan, is projected through the awareness of hereafter obligation (*iman*). So, in economy and financial context, every policy and regulation made is solely for both world and hereafter benefit. Therefore, Basel II as a policy must consider both worldly aspect (profit, material etc) and spiritual, religious and hereafter aspects.

Up to this point, Basel II CAR doesn't consider hereafter aspects as a factor in formulating standard and frame works. Basel II CAR fails to accommodate the variety the background of every local country and government. Displaced commercial risk is the

sample of this failure. Basel II CAR considers banking system as single type i.e. conventional one. So, it can grasp the unique feature of IFIs banking system.

Infāq also means sympathy and generousness for community and the interest of people. The buffer reserve increase and regulatory cost (cost driven by following and adjusting to new regulatory policy) imply the indirect increase in capital cost suffered by corporation. The increase in capital cost to compensate regulatory cost tends to make corporation more selective and conservative in creating or developing new business line. Meanwhile, some banks try to evade the regulation in order to reserve less than they must do⁴⁰. This will not significantly affect macro economy situation in the short term. However, this situation could affect economy growth⁴¹. This is because corporations are waiting for more conducive economy condition or the decrease in capital cost and postponed developing new business.

2. Prohibition of Interest

According to Akram Khan, *ribā* causes inequality and exploitation. As a policy, Basel II must comprise justice and prevent economy from systematic exploitation. Similar to *Infāq*, the prohibition of *ribā* is not or not yet being important factor in formulating more advance Basel capital accord. The calculation of CAR based on Basel II doesn't differ the asset of interest-based financial institution and the asset of free-interest-based financial institution. The separation of those two type of asset in calculating CAR is considerably possible to be facilitated by BIS considering one third of BIS members are the countries with Moslem majority citizen⁴².

Moslem countries have a unique population profile and economy mode. The countries also have extensive economical potential in the future. Additionally, some middle-east countries are preparing to

³⁸ Akram Khan, *An Introduction to Islamic Economics*, (Islamabad: The International Institute of Islamic Thought, 1994), 34

³⁹ *Rāghib al-Isfahani, al-Mufradāt fī al-Gharib al-Qur'ān*, (Beirut: Darul Ma'rifat, 1324 H), 285

⁴⁰ Patrick Slovik, *Systemically Important Banks and Capital Regulation Challenges*, OECD Economics Department Working Papers, No. 916, OECD Publishing, 2012

⁴¹ Beatrice Weder and Michael Wedow, *Will Basel II Affect International Capital flows to Emerging Markets?*, (France: OECD Development Centre - Technical Papers), 24

⁴² Bank for International Settlement, *This is The BIS: An exhibition celebrating 75 years of the Bank for International Settlements*, (Basel : BIS, 2005)

become one of the greatest economy powers in the world, one example is United Arab Emirates (UAE) with its amazing Dubai.

3. Fulfillment of Covenants & Trusts, Justice and Enterprise

The above values are manifested in Islamic economy by profit & loss sharing (PLS) system. This system is considerably possible to accommodate in Basel capital accord. The PLS system potentially decrease operational risks because the loss in an Islamic funding scheme will be borne by both parties. By using this system both the investor (shāhibu mā) and entrepreneur (mudhārib) borne the loss potential equally. Halal and speculation-free transactions are the manifestation of the above values. Basel II doesn't differ financial institution based on its investment scheme. Financial investment scheme involving interest (ribā) and speculation are still at present in Basel II capital adequacy requirements frame work. Whereas, freedom and cooperation value can be facilitated through inter-connection between banks and real-business sectors (entrepreneurs). Basel II capital adequacy requirements in some parts are contra-productive when force banks to retain more of it fund. Bigger capital reserve functions as a buffer but instead of improving the safety, financial managers tend to invest frantically.

Umer Chapra⁴³ noted this situation as an indication of severe consumerism driven by easy powered money provided by banks – either easy credit and deficit budgetary deficit through printing new money. The increase in consumption is a good sign for economy growth, but in the other hand an indication of unbalance attitude between control and economic goals. Form macro-economic perspective, Umer Chapra⁴⁴ also stated that consumerism decrease saving. However, government does the same thing, indicated by negative budget. In this situation, Islamic economic system shows its strength, uniqueness and advantages in solving this problem. Moreover, Islamic promotes equality, balances and teaching to eradicate harm (zūlm).

Based on the above argumentation Basel II minimum capital requirements aim to prevent crisis by creating maslaha (interest) towards wide range community and values is frail. Based on Islamic law perspective i.e jurisprudential maxim, the maslaha intended by the maxim is not convincing. The falāh concept parameter fails to be met by Basel II minimum capital requirements frame work. So, the maslahat projected by the maxim can be met by Basel II minimum capital requirements in the sense that it can't achieve economic falāh parameter.

E. Conclusion

The publication of Basel II (minimum capital requirements) was intended to strengthen macro-prudential aspect. As a part of Islamic and Islamic economic law, the regulations made must be intended to achieve mashlahat. The mashlahat aspect mentioned is not only for worldly life but also hereafter. The hereafter side is manifested in cooperation and equality principle. These principle realized by profit and loss sharing scheme which is not in Basel II. So as with justice and exploitation-free principle that can be realized through interest-free financial system. It is found that 1) Basel Capital Accord focuses on macro-prudential aspect in order to anticipate potential financial crises, 2) beneficial (*maṣlahat*) aspects of the hereafter, cooperation principle, justice, fairness and the prohibition of exploitation are not the core value of Basel Capital Accord frame work, thus 3) crises prevention aspect as stated to be Basel Capital Accord object are frail. Therefore, 4) Basel Capital Accord as a regulation basis is not in line with jurisprudential maxim i.e harm must be dispelled (*al-dharāru yuzāl*).

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⁴³ Umer Chapra, *Toward a Just Monetary System*, (Leicester : The Islamic Foundation, 1986), 22-23

⁴⁴ Umer Chapra, *Towards ...*, hal 26 - 27

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