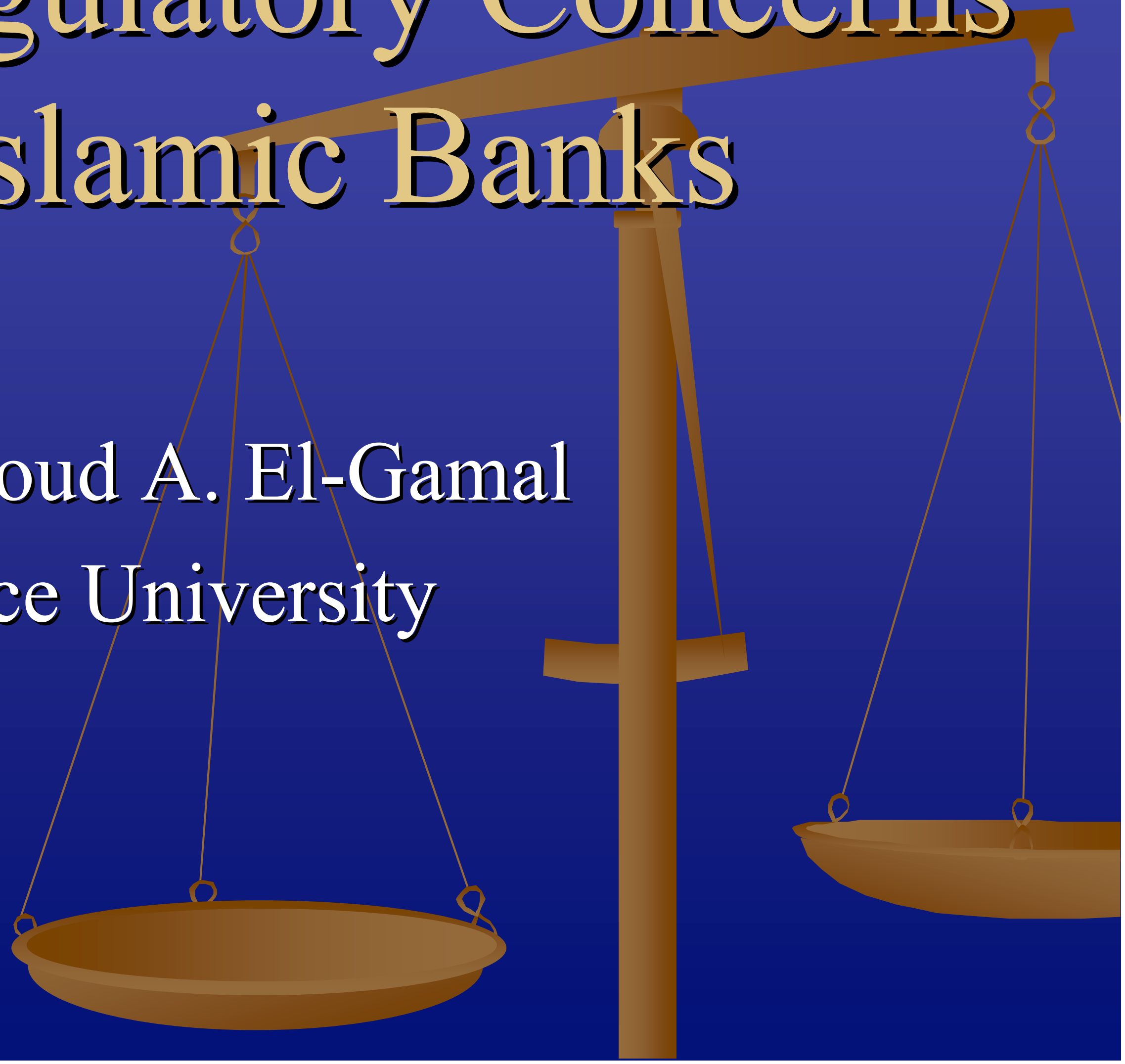
# Western Regulatory Concerns about Islamic Banks

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# Concerns Expressed in the 1990s

- Bank of England Governor Eddie George (1996), New York Fed First-VP Ernest T. Patrikis (1996):
  - Need to understand "Islamic banking" better
  - Need uniformity in accounting and *Sharīʿa* rules
  - Is the business truly "banking"? (e.g. accepting deposits)
  - Is it chartered/regulated in the "home country"?
    - (Global supervision issues raised by BCCI)
  - Liquidity and risk management issues (reserve requirements)
  - The nature of "assets" and "liabilities" (what is what?)
- Most issues were addressed, or are being addressed, by AAOIFI standards

# The AAOIFI Approach

- Standardize on-balance-sheet accounting
- Adopt uniform *Sharīʿa* standards for the most popular Islamic finance contracts
- Lobby national regulators to adopt standards
- Mimic as closely as possible Basle's approach, accounting for Islamic-contract peculiarities :
  - Capital adequacy
  - Risk assessment
  - Asset quality assessment

# On the "Liabilities" Side

- Efforts to-date have ignored, dismissed, or reversed early indications of "moral hazard"-induced regulatory concerns (esp. re: Profit Sharing Investment Accounts)
- Focusing on solvency and capital adequacy ratios, replacing deposits by PSIA *looked like* a strength:
  - PSIA are not "liabilities" (Exceptions: Turkey treats them as deposits)
  - PSIs are not risk-weighted assets of any tier (debated tier-2b; 3)
  - PSIA-holders bear their own commercial risk
  - This only leaves us with minor and exotic risks such as:
      - Fiduciary risk (mismanagement subject to litigation)
      - Displaced commercial risk (due to return-smoothing)
    - Those risks are borne by shareholders, do not impact bank-"capital"

# Meanwhile – on the "assets side"

- It was easy to convince regulators that *Murābaha* and *Ijāra* are in fact "secured loans", part of the business of [conventional] banking:
  - OCC #867, 1999 : "… lending takes many forms … Murabaha financing proposals are functionally equivalent to, or a logical outgrowth of secured real estate lending and inventory and equipment financing, activities that are part of the business of banking."
  - OCC #806, 1997: "Today, banks structure leases so that they are equivalent to lending secured by private property… a lease that has the economic attributes of a loan is within the business of banking. ...Here it is clear that [ ]'s net lease is functionally equivalent to a financing transaction in which the Branch occupies the position of a secured lender…"
- Once that is accepted, securitization/pass-through (e.g. FMAC, FNMA, …etc.) is equally easy

# No “Depositors” to Protect?
## *Is There Islamic Banking in the West?*

- Most of the Islamic banking funds in the west were imported from oil-rich gulf countries or bankrolled by large banks

- The real concern of regulators (to protect small, uninformed, and disorganized PSIA-holders in Islamic Banks) has not yet been addressed in most western countries

- The need for “Islamic lending” is obvious
- Thus: chartering Islamic banks in the west mainly focuses on the potential for money-laundering, etc.

# Causes for Regulatory Concern

- The much-touted phenomenal growth of gulf-originating Islamic banking funds raises a flag:
  - Is it a pyramid scheme (a la Egypt, Albania, Turkey, etc.)?
- Reported "PSIA-return-smoothing" suggests that an industry-wide shock has not yet occurred – will the post 9/11 shock/crackdown/hunt be the test?
  - The Asian crisis was somewhat locally contained
  - A pyramid scheme facilitates the return-smoothing strategy
- <u>What would western regulators think about the "liabilities side" of Islamic banking?</u>

# Conventional vs. Islamic Banks

- In conventional banks, private or public regulators act as a proxy for debt-holders and take control away (perhaps through a regulator) from equity holders in bad times

- Un-sophisticated observing Islamic Bank "depositors":
  - Hold quasi-equity (PSIAs) instead of debt (guaranteed deposits)
  - Do not have the shareholders' voting and control privileges
  - Thus, public regulators should act as their representatives

- <u>Solvency is sufficient for protecting the interests of debt-holding depositors (first claimants), but the same is not true for quasi-equity PSIA-holders</u>

# Regulators' Concerns I

- Islamic bank managers answer to share-holders rather than to PSIA holders – (interests may be in conflict)
- Reward schemes encourage managers to have short-term horizons/performance goals → "gains trading"
- Securitization-innovations enable more "gains trading"
  - Sell assets that are accounting-under-valued, keep those that are accounting-over-valued! (Not in the interest of PSIA-holders)
- Risk-cushioned shareholders allow excessive risk taking in bad times and insufficient risk-taking in good times:
  - Amplifying the PSIA-holders' risks in bad times
  - Causing too little risk-taking in good times (lower returns)

  

# Regulators' Concerns II

- AAOIFI/Basle accounting standards (cost-of-acquiring accounting) encourage managers to engage in gains trading (which is harmful to PSIA-holders)
- When private rating and auditing agencies raise a flag, they exacerbate the crisis of confidence and increase risk-taking → (the double moral hazard problem)
- AAOIFI standards focus on "bank's own capital" risk measures, giving managers and shareholders the incentive to shift more risks to the helpless PSIA-holders (especially under adverse macro shocks)

# Concluding Remarks

- We need to go beyond mimicking the Basle solvency-oriented formulas (designed to protect debt-holders)

- The true goals of regulation are:
  - Protecting the interests of small un-represented investors
  - Protecting the financial system against meltdowns

- The first concern has not yet been addressed adequately

- We need a coherent Islamic bank regulatory framework to protect PSIA-holders from managers adopting inappropriate strategies (too much or too little risk-taking) catering to shareholder interests
  - <u>Efficiency+risk-monitoring of Islamic Bank management, &/or</u>
  - <u>Alternative Islamic-banking claims structure to bring PSIA-holders' rights closer to  debt-holders' rights</u>