

# Western Regulatory concerns about Islamic Banks



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## Concerns expressed in the 1990s

- Bank of England Gov. Eddie George (1996), New York Fed FVP Ernest T. Patrikis (1996):
    - Need to understand "Islamic banking" better
    - Need uniformity in accounting and Shari`a rules
    - Is the business truly "banking"? (e.g. deposits)
    - Is it chartered in the "home country"? – Global supervision issues raised by BCCI
    - Liquidity and risk management issues
    - The nature of "assets" and liabilities
  - Most issues were addressed by AAOIFI standards
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## The AAOIFI Approach

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

## On the "Liabilities" Side

- Most Islamic finance studies ignored, dismissed, or reversed early indications of greater-"moral hazard"-induced concerns
- Replacing deposits with PSIA as a strength:
  - PSIA are not "liabilities"
  - PSIA are not risk-weighted assets of any tier
  - PSIA-holders bear their own commercial risk
  - This only leaves us exotic risks such as:
    - Fiduciary risk (mismanagement)
    - Displaced commercial risk (smoothing)
    - Those are borne by shareholders

## Meanwhile – on the “assets side”

- It was easy to convince regulators that Murabaha and Ijara 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) 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 depositors) was not addressed in the west
- Need for “Islamic lending” is obvious, thus: chartering process mainly concerned with 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?
- Reported "PSIA-return-smoothing" suggests that an industry-wide shock has not yet occurred – will the post 9/11 crackdown/hunt be the test?
- What would western regulators think about the "liabilities side" of Islamic banking?

## Conventional vs. Islamic Banks

- In conventional banks, private or public regulators act as a proxy for debt-holders and take control away from equity holders
- If un-sophisticated observing Muslims are forced to hold bank equity (PSIA) instead of debt, and they are deprived of the private right to take control, public regulators should act as their representatives

## Regulators' Concerns I

- Islamic bank manager answers to shareholders rather than PSIA holders
- Reward schemes encourage manager short-term horizons, and "gains trading"
- Securitization enables more gains trading
  - Sell assets that are under-valued in the accounts, keep those that are over-valued!
- Shareholders will be more lenient in bad times and stricter in good times: amplify the risk to which PSIA holders are exposed

## Regulators' Concerns II

- AAOIFI accounting standards (cost of acquiring accounting) encourages manager to engage in gains trading
- When private rating and auditing agencies raise a flag, it exacerbates the crisis of confidence and increases risks
- 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

- To address regulatory concerns regarding Islamic banks, we need to go beyond mimicking the Basle formula mechanics
- Instead, consider the true substance of regulation: protecting small investors from carrying more risks than they should
- This concern has not yet been addressed for PSIA-holders in Islamic banks
- The issue goes beyond mismanagement that can be addressed in litigation: It requires a coherent regulatory framework for Islamic banks