Perspectives on the regulation of Islamic Financial Institutions in a non-Islamic Environment

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Islamic Finance has been expanding at 15% per year, a rate that is expected to accelerate to 20% in the future. Islamic institutions manage currently about $265 billion, and operate in 23 countries.

The main feature of Islamic instruments is profit and loss sharing (PLS). Fixed interest on deposits, as an example, is prohibited. Also, the depositor/investor will share in the case of losses, but when a profit is made, bank owners will claim a share of it. As a result, the regulatory framework should require more information disclosure about bank strategy and performance. This information-availability can also benefit the supervisory authority in its prudential regulation.

In a non-Islamic environment, the regulation of Islamic finance will have to tackle the three following cases: (1) Islamic institutions willing to open shop in the West, (2) Islamic instruments issued by banks operating in Islamic countries, and (3) Islamic instruments issued by an international institution willing to attract Moslems' funds.

1 - regulation of Islamic institutions in the West.

The consensus here is that these institutions have strong incentives to take more risk than conventional banks. As a result, the capital adequacy ratio (CAR) should be higher. In order to come up with a precise figure about CAR, there is a need for clear and well defined asset valuation and provisioning. Obviously, international accounting standards are required to ensure investor's confidence.

In some instances, however, it could be argued that lower risk weights should be applied for risky assets financed by the mutual investment accounts of Islamic banks. And in the absence of a regulatory framework that takes into account the peculiarity of Islamic finance, the latter should submit to the current rules that apply to conventional banks (same monetary reserve ratios, same capital adequacy ratios, same credit ratios). But there are good reasons to believe that lower risk weights should apply to risky assets financed by instruments such as Musharaka (sharing in profit and losses) and Mudaraba (money management contracts). Setting up an appropriate regulatory framework tailored to the needs of Islamic Finance will help develop the latter by strengthening investors confidence and its is also in the interest of non-Islamic markets (such as the UK) since it will allow them to attract funds from Islamic countries. In a way similar to the cases of conventional banks, simple rules could be advised for risk-weighting according to the nature of the instrument (mudaraba, Musharaka,) and the existence of a mortgage collateral or not. To be consistent with BIS international rules, the same risk weight should be assigned to all similar categories of assets.

2 - Instruments issued in the West by Islamic banks operating in Islamic countries.

So far, these instruments will have to adapt to the framework that is already place. This may be no big constraint, since even in some Islamic countries, no separate regulatory framework exists for Islamic banks. But once a separate regulatory framework is in place in the international market, these banks will obviously have to submit to its rules.

3 - Islamic instruments issued by international institutions.

To tap on Islamic financial resources, an international bank (say citigroup) may issue sharia-compliant financing instrument. To be on an equal-footing, these institutions should be submitted to the same accounting and information disclosure rules that apply to Islamic banks.