

Islamic Banking: A Central Banker Looks Back

Posted on July 3, 2013 by Nupur Bang

Ishrat Husain on Pakistan's reforms, global banking risks and emerging-market prospects

by

Nupur Pavan Bang and Vikram Kuriyan

The interview was first published by the Global Association for Risk Professionals on July 2, 2013

<http://www.garp.org/risk-news-and-resources/2013/july/islamic-banking-a-central-banker-looks-back.aspx?altTemplate=PrintStory>

For six years starting in 1999, Dr. Ishrat Husain was governor of the Central Bank of Pakistan. He was responsible for a significant restructuring of the central bank and implementation of banking sector reforms. During his tenure, a court decision mandated that the nation's banking system conform to Islamic law. Husain's skillful oversight helped to maintain banking sector stability during a period of economic growth.

"Islamic banks did not suffer as much during the financial crisis as conventional banks because they did not deal in exotic derivatives or artificial money creation instruments such as collateralized debt obligations," Husain observes.



"There should not be a division between the central bank and supervisory authorities," says former Central Bank of Pakistan governor Ishrat Husain.

As central bank governor, he was a member of the government's economic management team. Later, from 2006 to 2008, he was chairman of the National

Commission for Government Reforms, reporting to the president and prime minister. In March 2008 he took charge of the office of the dean and director of the Institute of Business Administration, Karachi, the oldest graduate business school in Asia. He was also a member of the Mahathir Commission 2020 and advised the Islamic Development Bank on the creation of its poverty reduction fund.

Commented [HH/RFC@I1]: Only a 5% match
Ishrat's profile on the IBA website. Could consider
rephrasing.

With degrees from Williams College (master's in development economics) and Boston University (doctorate in economics), Husain also graduated from the joint executive development program of Harvard University, Stanford University and INSEAD. He spent much of his earlier career with the World Bank, including as head of the Debt and International Finance Division and chief economist of the East Asia and Pacific region.

Author of numerous books and monographs including "Pakistan: The Economy of the Elitist State" (Oxford University Press, 1999), Husain is currently a member of the International Monetary Fund's Middle East Advisory Group and the United Nations Development Program's Regional Advisory Group; chairman of the World Economic Forum Global Advisory Council on Pakistan; and board member of the Benazir Income Support Program, the largest social safety net and conditional cash transfer program serving the poor in Pakistan.

Commented [HH/RFC@I2]: Only a 4% match
internet, due to the titles used

In this recent interview — conducted by Dr. Nupur Pavan Bang (Nupur_Bang@isb.edu), senior researcher, and Dr. Vikram Kuriyan, director of the Centre for Investment, [Indian School of Business](#), Hyderabad — Husain reflects on the introduction and development of Islamic banking in Pakistan, as well as risks faced by the conventional banking system, financial crises and the challenges faced by emerging economies.

Please give the historical background on the origin and development of Islamic banking in Pakistan.

The Supreme Court of Pakistan has an appellate bench that deals with Islamic laws. Someone approached this bench in 2000 and represented that the banking system in Pakistan was anti-Islamic, as it is based on usury and exploitative interest rates and Islam is against usury and exploitation. Thus, the banking system should be declared illegal. The court decided that by June 30, 2001, all banks should conform to Islamic banking, and the existing banking system should be abolished. I was astonished because the repercussions on the economy of such a drastic measure were not fully realized. The economy would have been completely dislocated if a change of such a magnitude was implemented in a short period of time.

As central bank governor, I formed a commission for the transformation to Islamic banking. The commission comprised academicians, practitioners, bankers and Islamic

scholars. It recommended that there should be a parallel banking system that allows Islamic banking to coexist with conventional banking. The choice would be available to consumers to shift from conventional banking to Islamic banking if they wished to do so. If every consumer decides Islamic banking, it will emerge in the country. I persuaded the cabinet and the president that we would implement the Supreme Court decision in a practical way that did not adversely affect the smooth functioning of the economy. The decision ought to be taken by 28 million customers whether they wish to opt for Islamic banking, and not by the government or the central bank. On this basis, we introduced Islamic banking in 2001 and provided the regulatory framework.

What options were available to the public?

We decided that there could be three forms of Islamic banking. First, full-fledged Islamic banks could be established and licensed if they met the prescribed criteria. Second, conventional banks could set up a subsidiary bank that would be totally separate in terms of deposits, assets, balance sheets, etc. Third, the conventional bank can have Islamic banking windows that operate independent of the conventional bank without any commingling of deposits and assets. They would offer only Islamic instruments and products to the public. Meezan Bank was the first to apply to become a full-fledged Islamic bank, and it was granted the first license. It has since done extremely well with innovative products, services and staff. It is the market leader with a one-third market share.

What is your view on Islamic banking in the context of the recent crisis?

There are two characteristics of Islamic banking which distinguish it from conventional banking. One is that every transaction has to be backed by real assets. Every loan should be backed by collateral such as real estate, business, etc. You cannot create wealth or money without associating it with real wealth creation.

Second, the borrower is a partner in the business in which the bank has invested as financier. There is no guaranteed fixed rate of return. If the business is not doing well, the bank will suffer along with the account holder. In contrast, conventional banks offer a fixed return to depositors. The bank has to pay interest irrespective of the performance of assets.

In Islamic banking there is no predetermined interest rate. The rate is determined at the end of the year based on the profits and losses. These distinguishing features of Islamic banking, if applied to International banking, would have avoided the possibilities of panic, failure and crisis. The fact is that Islamic banking is too small and insignificant to contribute to the safety of the international banking system, because 98% of the banking is done in the other way.

What major reforms are necessary to prevent future crises?

First, there should be separation between trading and retail banking, because banks have become trading platforms putting the depositors' money at risk. Assets are piled up, and buying and selling happens at prices which are not related to the intrinsic value of the underlying assets. That is what the Dodd-Frank legislation and the Volcker Rule in the U.S. are about — that client-based trading should be separate from proprietary trading. Proprietary trading should be carried out separate from the main bank and limited in scope.

Second, the bank should have adequate capital. In manufacturing and services sectors, 60% to 70% is shareholders' money and 30% to 40% is borrowed. The financial services business is quite different. Shareholders' equity is 7% to 8%, and 92% of the money belongs to depositors. If shareholders take excessive risk with the depositors' money, the upside gains are captured by the shareholders and managers, and the depositors don't get anything extra. But, if they lose money, taxpayers have to bail them out. This asymmetric relationship in incurring risk and appropriation of reward makes the financial sector more vulnerable to exogenous shocks. Indian and Pakistani central banks had tough regulations, and thus their banking systems survived during crises. This was not the same in the U.S. and Europe.

What are your views on Basel III?

I believe the capital and liquidity buffers are appropriate, but the risk-weighting schema needs to be carefully reviewed. Internal models do not always adequately capture the risks assigned to different loans, and the supervisors have to develop the capacity to test the veracity and accuracy of these internal models by rigorous stress testing. Risk management systems and internal controls within the banks, particularly the systemically important institutions, have to be strengthened and examined from time to time.

What can the emerging markets learn from the crisis? Can it happen in India and Pakistan?

The crisis can happen there if financial institutions are not continuously monitored and supervised. It is asymmetric risk taking in the sense that all positive gains are preempted by shareholders and managers and losses are borne by someone else. Therefore, government regulation becomes important. This was not done in the U.S. and Europe. In India and Pakistan, shadow banking was not allowed to emerge, exotic products were discouraged, and cautious liberalization was pursued in respect to capital account opening. These are the safeguards that need to be observed.

A lot of countries are facing very high debt-to-GDP ratios and fiscal deficits. Are populist politics and subsidies to blame?

The starting point and initial conditions of a country determine what policies need to be pursued. The current debate between fiscal and monetary stimulus versus fiscal austerity cannot be taken as an abstract proposition, but rather in the context of prevailing circumstances. If Spain has half of its youth unemployed, fiscal austerity measures over an extended period of time will become politically and socially unacceptable. Japan, despite having a very high debt-to-GDP ratio, has recently decided to embark on monetary easing because for the last 15 years the economy was trapped in low-level equilibrium and was not able to come out of it.

Is austerity the answer?

No. Lending standards by the banks should not be compromised, and credit should flow to the private sector to stimulate the economy if public sector imbalances do not permit this. We should not overextend and must learn from the subprime mortgage crisis. Why should we give a loan to a person who does not have income to qualify for a loan? The lenders were assuming that the price of housing will keep on going up and the owner's equity in the house will be built up, enabling him to repay the loan. That was a wrong premise — it was unrealistic to expect a unidirectional movement of housing prices.

What about regulatory and political challenges in emerging markets, particularly South Asian countries?

South Asian countries must strengthen their supervisory and regulatory bodies. There should not be a division between the central bank and supervisory authorities. The Financial Services Authority model in England that everyone cheered did not work out, and supervision has gone back to the Bank of England. This is because the central bank has information both at the macro and micro level, but the FSA had information only at the micro level. They could not use macro-prudential regulation to supplement the micro-prudential measures. Furthermore, they did not have bank resolution authority that the Bank of England had as the lender of last resort. Likewise, South Asia should strengthen its central banks and not have separate regulatory bodies.

Is Africa the next BRICS? Which countries might investors look at favorably?

Africa has done remarkably well in the last decade. It has grown at 5% a year on average. And this pattern was not limited to the commodity- and oil-producing countries, but also encompassed Ghana, Kenya, Tanzania, Rwanda, Mozambique and others. Investment opportunities in Africa are enormous, and the first-mover advantage will certainly help.

What challenges does Africa face as the next investment destination?

Political instability and fragility of institutions of governance continue to pose serious risks, although this varies from country to country. Investors have become more discerning; they do not treat Africa as a monolithic, homogeneous territory and are selective in their choices. The effect of these choices on the countries that are left out is positive, as they also take measures to improve their policies and business environment.

Financial inclusion and financial literacy are challenges for many emerging nations.**What is the way out? Do multilateral organizations like the World Bank and IMF have a role to play?**

I think the multilateral institutions can only provide the lessons of experience and exchange information as to what has worked and what has not in some countries. The primary responsibility for raising awareness and financial literacy remains with the central banks and governments. The conditions of each country differ, and therefore the solutions have to be tailor-made and specific.