Please give a historical background to the origin and development of Islamic Banking in Pakistan.
We introduced Islamic Banking in Pakistan when I was the Governor. The supreme court of Pakistan has an appellate bench which deals with Islamic laws. Someone approached this appellate bench in 2000 and represented that the banking system in Pakistan was anti-Islamic because 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 was 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.

Being the Governor that time, I formed a commission for transformation of Banking into Islamic Banking. The commission comprised of academicians, practitioners, bankers and Islamic scholars. The commission came with recommendations that there should be a parallel banking system in the country which allows Islamic Banking to coexist with conventional banking. The choice would be available to the 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 will implement the decision of Supreme Court but 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.
We decided that there could be three forms of Islamic banking. First, full fledged Islamic bank could be established and licensed if they meet the prescribed criteria. Second, conventional banks could set up a subsidiary bank which would be totally separate from the bank in terms of deposits, assets, balance sheets etc. Third, the conventional bank can have Islamic banking windows which will operate independent of conventional bank wihout any comingling of deposits and assets. They would offer only Islamic instruments and products to the public. Meezan Bank was the first bank which applied to us to become a full fledged Islamic bank and the first license of Islamic Banking was granted to it. Since then the bank has done extremely well with innovative products, services and staff. It is the market leader with one-third market share.

What is your view on Islamic banking in the recent bank failure and debt 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. The Islamic banks did not suffer as much during the crisis as the conventional banks because they did not deal in exotic derivatives or artificial money creation instruments such as Collateralised Debt obligations.

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Second, the borrower is a partner in the business in which the bank has invested as a financier. There is no guaranteed fixed rate of return. If the business is not doing well the bank will also suffer along with the account holder. In contrast, the 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 interest rate is determined at the end of the year from the profits and loses earned. 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 and does not contribute to the safety of international banking system because 98% of the banking is done in the other way.

What are the major reforms that banking system must undergo to prevent 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 strength of the underlying assets. That is what the Dodd-Frank legislation and the Volcker rule in the US 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 60-70 percent is shareholders' money and 30-40 percent is borrowed. If you look at nature of financial service businesses, it is quite different.. Shareholders' equity is 7-8 percent and 92 percent 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, tax payers 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 thus their banking system survived during crises. This was not the same in US and Europe.

What are your views on BASEL III?

I believe the capital and liquidity buffers are appropriate but the risk weighting schema need 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 banking institutions have to be strengthened and examined from time to time.

What can the emerging markets learns from the Western crisis? Can it happen in India and Pakistan?
The crisis can happen here if the 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, regulations by the Government become important. This was not done in the US and Europe. Shadow banking systems were not allowed to emerge in India and Pakistan, 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 high fiscal deficits. Are populism politics and subsidies to be blamed?

The starting point and the initial conditions of a country determine as to what policies need to be pursued . The current debate between fiscal and monetary stimulus against fiscal austerity cannot be taken as an abstract proposition but in the context of the circumstances prevailing there. 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 very high Debt to GDP ratio has recently decided to embark on monetary easing because for last 15 years the economy was trapped in low level equilibrium and was not able to come out of the trap.

Is austerity the answer?

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

What about regulatory and political challenges that emerging markets face, especially 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 FSA 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 FSA had information at micro level only. They could not use Macro-prudential regulations to supplement the micro prudential measures. Furthermore, they did not have bank resolution authority as only the BOE was the lender of last resort. Likewise, South Asia should strengthen its Central Bank and should not have separate regulatory bodies.

What are your views on Africa? Is Africa the next BRICS? Which are the countries that investors could look at favorably?

Africa has done remarkably well in the last decade. It has grown at 5 percent per year on average and this pattern was not limited only to the commodity and oil producing countries but a much broader set of countries such as Ghana, Kenya, Tanzania, Rwanda, Mozambique etc. The investment opportunities in Africa are enormous and the first mover advantage will certainly help .

What are the challenges that Africa faces in emerging 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 and they do not treat Africa as a monolitihic, homogenous territory but are selective in their choices. The demonstration 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 is a challenge faced by many of the emerging nations, including the African nations. What is the way out? Do multilateral organizations like the World bank and the 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. But the primary responsibility for raising awareness and Financial Literacy remains that of the Central banks and the Governments . The conditions of each country do differ and therefore the solutions have to tailor made and specific.