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No regulatory favors for Islamic banks

Islamic banks often with regulatory systems designed for conventional banks. There are efforts to encourage Islamic finance through 'equal treatment' of Islamic and conventional finance and some countries have incentives designed to help Islamic finance grow more rapidly.

While many of these incentives are good, they risk becoming entrenched, (I have discussed in several posts recently). The first link specifically focused on Indonesia, which is considering offering government support to Islamic finance (based on statements from the head of the central bank). Around the same time, Bank Indonesia raised down payment requirements for loans, and extended the same rules to Islamic banks.

The head of Bank Indonesia Edy Setiadi, said in that context "The principle of BI also has to make similar regulation for Islamic banks." This is important because the argument could be otherwise made that down payment rules for conventional banks are not needed for Islamic banks since their financing products are based on 'real assets' and more connected to the 'real economy'.

The principal that Islamic banks should have equal treatment from regulators is important and, while substantive differences in Islamic banks' products should receive different treatment from conventional loans, it is important for Islamic banks to face similar regulation on products that have the same economic effect as conventional loans, even if this slows their growth.

The case of the down payment rules are illustrative because, while the contracts may be structured differently so an asset is bought and leased to a customer, or bought and resold for a customer, the economic outcome is the same as a conventional loan. Islamic banks should not be put in a more favorable position compared with conventional banks, which would amount to an incentive, even if it were over time designed to converge with the rules for conventional banks.

It would create an opportunity for regulatory arbitrage, as well as an interest group that would later lobby against the convergence of regulatory standards.

And, more importantly, allowing Islamic banks to operate under looser standards would make them less sound and subject them to greater risks down the line of failure if loans started going bad. And widespread failures of Islamic banks would be devastating to the future of Islamic finance.

Until next week,
Blake Goud

My Reading List

Bank Indonesia to Apply Minimum Down Payment Regulation to Islamic banks (link)

BI: Bank Syariah Not Treated Special (link)

Islamic finance players call for a regulatory framework that does not impede growth (link)

Fitch Lauds Central Bank's Shariah Down Payment Plan (link)

Blog Posts This Week

Arcapita's district cooling investment in jeopardy

Will Saudi Hollandi return with another mudaraba sukuk

Look forward for the future of Islamic finance, not to the past

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