FINANCIAL MODERNIZATION IN 21ST CENTURY AND CHALLENGE FOR ISLAMIC BANKING

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This note traces the impact of some important changes in global regulatory framework on the banking industry. In particular, it attempts to sketch the implications of these changes for the Islamic financial services industry.

1. Dynamism in the Banking Industry

Banking industry is changing fast. The following factors are believed to be responsible for the changing dynamics of the industry:

1 Changing client needs for financing and investment

2 Cost reducing strategies and technologies

3 Emerging new potential markets with different demographic and social characteristics

4 Technology based financial services products

5 Regulatory reforms to align with financial modernization

Each one of these factors is contributing dynamism in the industry and hence introducing new competitive environment and making the environment more and more challenging for the Islamic Banking movement. It is not possible here to discuss implications of all these factors for Islamic Banking. I am narrowing down the discussion to focus on the last factor only i.e. Regulatory Reforms for Financial Modernization (currently in process in USA and other countries may also follow) that will trigger new dynamics for the industry and will present a new competitive environment to Islamic Banking.

2. Glass-Steagall Act (1933) Repealed

Regulators are actively considering reforms to support the financial modernization and to align with the changing dynamics in the industry. One such reform recently introduced in USA is in the direction of relaxing some of the restrictions on banking activities and granting them flexibility in designing their products and services. This has been done by repealing a 65-year old act called Glass-Steagall Act. The Act (1933) prohibited banks from engaging in securities market activities including the sale of mutual funds. (This prohibition, however, did not apply when the American Banks operated in other countries).

There were several reasons for introducing this act. One important reason was that frequent failures of banks during Thirties were attributed to the bank's involvement in risky activities which included the investment in securities and mutual funds.

One failure or bad investment on asset side (particularly when the assets are highly concentrated) would make the assets substantially lower than the liabilities and hence creating apprehensions of bankruptcy. This increased the risk of run on the bank and the run did occur in several cases and resulted in banks' failures during 1930s.

A Small Digression: Such situation is less likely to arise under the concept of Islamic banking. Assets and liabilities are supposed to be balanced always under the concept of Islamic banking. If there is shock on asset side, it will be immediately reflected on the liability side (because deposits share the profits/losses of the banks). Also theoretically Islamic banks assets or investments may not be concentrated as much as they are in conventional system and hence a single shock on asset side may not be as damaging as it would be in conventional banking system where advances/loans are high concentrated.

Coming back to the point. It was considered in USA that prohibiting banks from dealing in securities, mutual funds etc. would contribute to reducing the problem of moral hazard and adverse selection and hence reducing the probability of bank failures. Hence the Act known as Glass-Steagall Act was introduced.

3. The New Rule

The commercial banks found it unfair to disallow them to compete with investment banks and brokerage firms. Their lobby finally succeeded in getting the law repealed. The new rule approved by federal regulators on November 20, 1999 allows commercial banks to establish subsidiaries to market new products and services including securities and insurance as long as subsidiaries' capital and operations are separate from the banks?

Is this a Good News for Islamic Banks?

Is this development good news for Islamic Banking? Some are arguing that it is good news because it removes the wall separating investment banking from commercial banking. Investment banking is an integral part of Islamic banking and hence a major hurdle has been removed from the way of Islamic banking to enter USA.

But will they now be really allowed to enter? That good news has yet to come.

Investment banking will be allowed only as a subsidiary to a commercial bank on case to case basis. This surely allows banks like Chase Manhattan or Citibank, to establish an Islamic bank as a subsidiary, if they so wish.

Islamic banking has already been slipping to the control of conventional banks and the new rule will make the way more slippery for Islamic banking. If other countries where Islamic banks have their presence also adopt such rules then Islamic banks will face a very tough competition from conventional banks. According to this rule, the conventional banks can establish Islamic banks subsidiaries, while Islamic banks will not be able to do conventional banking. The conventional banks thus will attract Islamic banking clientele and thus grabbing the substantial part of the market share of Islamic banks. Conventional bank may get bigger on account of Islamic clientele while Islamic bank may shrink. There is all the risk that Islamic banking may get diluted within the conventional banking unless Islamic banks do something to establish their distinction as "Islamic Banks".

Financial Reforms that Islamic Banks should seek from Regulators

Islamic banks in the last two decades have benefited from continued global economic expansion and low inflation. These good times may not last forever. Financial reforms like those mentioned above will make the competition for Islamic banks too tough. They need to make a lobby to persuade the regulators not to make competitive environment less conducive for them. Of course Islamic banks are too small to make any meaningful lobby. Yet there are at least two basic reforms that conventional banks are already pursuing and Islamic banks will not be at disadvantage or face unfair competition with the conventional banks if they join conventional banks lobby for these reforms. Demand for commercial banks loans is globally declining for various reasons. The conventional banks are looking forward to reforms that can allow them to expand the span and mode of their activities and some of their demands if accepted may open new horizons for the Islamic banking too.

There are two main areas in which the financial reforms sought by conventional banks can benefit Islamic banks as well:

a Allowing banks to engage in any genuine financial activity

b Allow them to choose the organization structure that best suits to their needs.

Flexibility in the Span of Activities for the Banks

The banking institutions are seeking a flexibility to allow them to take up activities relating to investment banking and insurance along with their commercial banking activities. Islamic banks should join their voice with them and should seek flexibility not only to allow investment banking and insurance but also to allow following also as a part of activities.

i) Trade (including export/import) banking

ii) Lease banking

iii) Infrastructure banking

Regulators can be persuaded to grant this flexibility, as a part of Twenty First-Century vision for financial reform. They may envisage this flexibility, not for the sake of Islamic banking but for the sake of enhancing competitive environment in the financial market. The competition of course will help reducing the cost of providing financial services to the users and to give all forms of alternative banking (such as Islamic Banking, Ethical Banking, Social Banking etc) fair chance to compete in the financial market.

The regulators of course, will have to develop innovative safeguards to ensure that banking activities continue to operate smooth and depositors or small business interests are not unduly put at stake by the reforms.

Flexibility in the Organization Structure of the Banks

The banking institutions are seeking flexibility in choosing the corporate organization structure that best suits their span of activities. There are three broad models of organization structure that the banking institutions can adopt to conduct non-banking financing activities as well (such as investment banking, insurance, trade banking etc.):

Bank Holding Company Model: Under this model a parent organization holds separate organization for different activities e.g. holding an organization for investment banking, an organization for commercial banking, an organization to conduct trade banking etc.

Bona Fide Subsidiary Model: Under this model a bank can establish bona fide subsidiary (rather than separate organization) that has its own capital and has all its operations physically separated and distinct from the operations of the bank. The subsidiary must maintain separate accounting and other corporate records. The subsidiary will have its own Board of Directors meeting (the majority not to be from the Directors of the Bank).

Universal Banking Model: Under this model all different activities are carried within the same entity/organization. Thus a bank would be doing commercial banking, investment banking, insurance etc. all under the same roof.

Universal banking, though exists in Germany, the Netherlands, and Switzerland and though have been successful for some time, is not being currently considered as a model to best fit dynamic financial market place in countries like USA and Japan. This model may suit some conventional banks to continue their commercial banking activities with insurance banking and insurance. The model, however, may not best suit the Islamic banking because of the wide difference in the nature of activities that Islamic banks would like to include, namely; investment banking, commodity trade based banking, leasing based banking, Istisna-based banking insurance and the normal commercial banking. The regulators may also find it difficult to regulate them if Islamic banks adopt such an organization structure.

Regulators may find difficulties in regulating the Bona Fide Subsidiary model as well, whether in the context of conventional banking or Islamic banking. The conflict of interest among the subsidiaries will be the main source of problem for the regulatory bodies to design rules for regulation. Subsidiary models, however, may be suitable for Islamic banks, if they intend to establish one or two subsidiaries. For example it may not pose much difficulty for regulators, if an Islamic bank has a subsidiary for insurance and/or for investment portfolio. But if they want to have more subsidiaries to cater to wide range of their activities then regulators may not find it a convenient structure from their point of view.

A holding company model will be more relevant for Islamic banks and can help them establishing the distinction of their financing operations compared to those of conventional banks and can also get them the support of regulators.

Islamic banks are currently criticized on the ground that their operations are almost similar, if not exactly similar, to those of interest based banks. And this can become a major hurdle in the growth of Islamic banks in the 21st century. The Islamic banks cannot escape this criticism because their present organization structure does not allow them to directly carry out trading, leasing or construction activities and hence they end up doing only financial operations. Operating under a Bank Holding Company Model, holding separate organizations for commodity trade based operations, leasing based operation, infrastructure operation, insurance etc. will help them wash away most of the above criticism and will make it convenient for regulators also to supervise and monitor their activities.

Conclusion:

Repeal of Glass-Steagall Act (1933) in USA that separated commercial banking from investment banking, currently, may not be more than a bad news for Islamic banking. The new rule, implicitly allows the conventional banks in USA to take up some Islamic banking activities as well and hence leaving little justification for the establishment of separate "Islamic banks" in USA. The big banking corporations are now in a position not to leave any room for an Islamic banks to compete with them in USA. They already had this privilege abroad (and they utilized it) as Glass-Steagall Act did not apply on US banks abroad.

A strategy for Islamic banks for 21st century would be to join hands with conventional banks to pursue with the regulators such financial modernization that will equally benefit the conventional banks and Islamic banks to enhance their business.

The Islamic banks may press for the following at national as well as global level:

i Flexibility for a banking institution to conduct any genuine financial activity in any genuine way. This is needed for Islamic banks to conduct their operations activities according to Shari'ah. This is also needed by conventional banks to enhance their span of activities because there is a declining trend in the demand for the banks' commercial loans.

ii Flexibility for a banking institution to choose an organization structure that suits it best. This flexibility is needed by Islamic banks as well as conventional banks. For Islamic banks it will be productive to adopt a Bank Holding Company Model and will help them maintain Islamic distinction in their operations and help them compete out conventional banks to do Islamic banking activities. The adoption of Holding Company Model by Islamic banks will make it convenient for regulators also to supervise and monitor their operations.

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