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REGULATORY ISSUES AND CHALLENGES: GLOBAL NORMS AND RELIGIOUS CONSTRAINTS

In the early years of modern Islamic banking, a number of ambitious Islamic regulatory schemes were devised. There was talk of an Islamic Central Bank, of a global zakat fund, and of other collaborative schemes.[1] Scholars worked on an Islamic approach to bank regulation.[2] Most of these ideas were never put into practice: they were simply overtaken by events. Today, regulators have lost the margin of manoeuvre they once enjoyed. Most of the norms and practices of financial regulation are established internationally, with little input from regulators outside the industrial world. Although Islamic banks have thrived in the global economy, their compliance with many of the new norms is problematic. This chapter examines the regulatory issues and challenges facing Islamic finance.

10.1 Financial Regulation

Financial regulators must perform a number of tasks: ensuring that the financial sector is safe and sound; mobilizing savings by channelling them towards the most productive uses; and devising an efficient conduit for payments around the economy. Before the disruptions of the 1970s, regulators performed a mostly technical task outside of the political limelight. In recent years however, virtually every country – including those with well-established regulatory authorities and traditions – has been rocked by banking crises. Significant regulatory failures have occurred in the US (the Savings and Loans and bank failures of the 1980s), Britain (the BCCI scandal, the Barings collapse), and France (the Credit Lyonnais fiasco), to name just a few countries.[3] Emerging markets – the category to which most Islamic countries belong – are even more vulnerable, since they often lack a regulatory framework and tradition, and suffer from a wide array of structural problems. Typically, they are overbanked and in need of consolidation. Many are plagued with a bad loan overhang, and suffer – to an even greater extent than industrial countries – from the 'crony capitalism' syndrome, whereby cosy ties between politicians and bankers prevent effective compliance, let alone reform.[4] Whenever banking crises occur, their impact can be devastating. According to the statistics of

the Bank for International Settlements (BIS), the cost of supporting, recapitalizing or restructuring banks in emerging markets has cost $200 billion between 1982 and 1997.

Once confined to developed countries, the new rules of global finance are now extending to the rest of the world. Four broad sets of factors account for this evolution: the spread of the liberal ideology, the integration of emerging countries in the global economy, the growing involvement of international financial institutions in emerging markets, and the proliferation of currency and banking crises. National and developmental goals were once central to financial policy. But the developmental orthodoxy has changed in line with the 'Washington consensus' which favours free-market solutions, export orientation, fiscal discipline and, most recently, the overhaul of existing financial systems. Indeed, financial turmoil, most recently in Asia, has accelerated the push for bank reform. The IMF and the World Bank have determined that their programmes were undermined by troubled financial sectors; and international banks (as well as pension funds and mutual funds), given their increased exposure to emerging markets, have a lot more at stake than they did a few years ago. New norms are now expected promptly to be adopted by all countries. By October 1998, regulators worldwide were committed to the implementation of the 'Core Principles for Effective Banking Supervision' issued in 1997 by the Basle Committee. Similarly, as of March 1999, the 102 signatories of the December 1997 Free Trade in Financial Services Agreement (under the aegis of the World Trade Organization) were expected to liberalize their markets.

10.2 The Ideological Debates on Financial Regulation

Regulation is a balancing act. Different, often contradictory, goals – flexibility and consistency, freedom and strict controls, innovation and crisis-avoidance, consolidation and conflicts of interest, efficiency and consumer protection, openness and protection of national firms – must be applied in proper dosages by people familiar with the political and cultural environment. The audit systems and incentive structures must be flexible yet strict enough to allow innovation but prevent rogue operations. In case of fraud or heavy losses, the temptation is great to adopt a policy of 'regulatory forbearance' – bending the rules to avoid closing insolvent banks – as a way of preventing panic. But this often leads to distrust and simply postpones the day of reckoning. Yet overreacting can create a credit crunch. Other dilemmas are related to the need to ensure fair competition. The logic of economic freedom in a global economy tends to lead to bigness and thus unfair competition among firms of vastly different sizes. In addition, as firms are allowed to enter new lines of business, the potential exists for conflicts of interest detrimental to the interests of

consumers and investors. For example, as financial institutions get involved in the financial advisory business, the need to sell their products compromises their commitment to impartial advice. Yet building fire-walls between advisory activities and sales goes against the spirit of deregulation.

Such dilemmas are amplified by the transformations of global finance. Once clearly defined, financial functions are now blurred. Different types of finance – commercial banking, investment banking, securities, insurance – call for different forms of regulation. Yet the same financial institution can be a lender, an investor, a guarantor, a portfolio manager, etc. Balance sheets have changed beyond recognition. (Complicating matters further, many transactions do not even appear on balance sheets at all.)[5] In addition, traditional bank products such as loans are being securitized, creating more headaches for regulators who must decide what is a bank, and what types of products need what type of controls. Insofar as financial institutions engage in a wide array of activities, regulators must resolve a number of issues. Should there be functional regulation whereby a financial institution would deal with different regulators for its commercial, investment banking or insurance activities? Or should a financial institution have a single regulator which would oversee diverse functions? In one instance the financial institution would have to comply with complex and perhaps contradictory rules and be entangled in turf battles fought among regulators. In the other, the regulator may lack the expertise to oversee a wide array of activities and may risk being 'captured' by the firms it regulates.

Debates on financial regulation, in addition to being influenced by historical traditions and regulatory cultures, tend to go through cycles and are ideologically loaded. In the wake of financial failures, regulatory authorities are likely to tighten the rules, only to relax them when the memory of such failures fades. Partisans of laissez-faire argue in favour of minimal supervision, claiming that strict supervision does more harm than good and that the 'private provision of bank regulation through the marketplace' is far preferable to intrusive government regulation. The theory is that 'the market' through its proxies – analysts, rating agencies, the business press, etc. – evaluates financial institutions at all times, thus imposing its own discipline on participants. Such an approach also takes a benign view of bank failures, which are seen as a cost of doing business, rather than a cause for panic – or a pretext to tighten regulation. Simply put, the ideological issue can be reduced to a trade-off: laissez-faire fosters financial innovation, but also encourages fraud and abuse; conversely, strict regulation can help prevent problems but stifles innovation and dynamism.

In sum, regulators must thus be strict yet flexible, collegial but not too cosy. The problem is that while lip service is often paid to the principle of independence, regulators not beholden either to politicians or to the

industry they regulate are more an ideal than a reality. In most countries, bankers tend to be prominent figures, often involved in politics, or at the very least generous to politicians. Recent scandals suggest the many ways in which regulators can be influenced. In the case of the American Savings and Loans scandals, dubbed by Martin Mayer 'the worst public scandal in American history', money paid by operators to politicians (in the form of campaign contributions or sweetheart loans) led to bad laws and lax regulation: insolvent institutions were kept in business, fraud and abuse ran rampant, etc. (The bail-out initiated in 1989 will end up costing American taxpayers anywhere between $200 billion and $500 billion.)[6]

An additional problem of regulation is one of resources. The knowledge and skills necessary to be a competent regulator in today's complex, uncertain and constantly changing environment are such that governments can seldom afford the best possible regulators. The private sector in contrast can afford those lawyers, strategists and product innovators who are in a position to keep the industry one step ahead of the regulators.

In Islamic countries, the complications arising from international pressure are compounded by the added – and often conflicting – demands of religion. Religion is a touchy subject, and has on occasion been used as a cover for fraudulent activities. Independence and integrity are all the more important since regulatory issues are even more likely than in a conventional setting to degenerate into major political crises. Furthermore, despite similarities with conventional ones, Islamic products and practices do not fit neatly into existing legal, regulatory and accounting systems. In addition to establishing standard prudential rules (concerning capital and reserve requirements, capital/assets and other ratios), Islamic banking regulators have to devise rules to govern such issues as new finance methods, conditions of ownership of Islamic institutions (minimum capital, maximum individual ownership, etc.), fiscal status of income, and the like. In sum, they must operate under the watchful eyes of 'markets' and religious authorities, while complying with international practices and standards.

10.3 The Changing Paradigm of Financial Regulation: From National Control to Global Supervision

In 1944, John Maynard Keynes, who was then actively involved in shaping the post-war financial order, stated: 'We intend to retain control of our domestic rate of interest, so that we can keep it as low as suits our own purposes, without interference from the ebb and flow of international capital movements or flights of hot money.'[7] In the system of 'embedded liberalism' that prevailed for much of the post-World War II era, governments were committed to a liberal economic order, but reserved the right to control capital movements.[8]

Under such a system, the regulation of financial institutions was characterized by strict controls, clearly defined boundaries, and limits on foreign participation in the national market. Cartel-like arrangements within sectors prevailed, as well as stable relationships between borrowers and lenders. Financial markets were divided into distinct and clearly defined segments: commercial banks, investment banks, securities firms, insurance companies, etc. Interest rates were 'administered' as opposed to being left to market forces, and most financial operations were tightly regulated. Except for the United States and the United Kingdom, public ownership of banks (by federal or local governments) was common, allowing governments to channel credit to favoured sectors of the economy.[9] Even when banks belonged to the private sector, the logic was not fundamentally different, since government–bank relations were defined by a quid pro quo: managers gave away some autonomy in exchange for protection from outsiders. To be sure, a measure of openness was allowed in many countries, but this did not prevent national firms from remaining somewhat insulated from foreign competition since the occasional authorization given to a foreign firm to operate in the domestic market was designed not to upset existing cartels.

A chain of events, starting with the birth of 'euromarkets', led to a gradual internationalization of financial markets.[10] Change has greatly accelerated in recent years, resulting in a global financial market – which in turn calls for a global regulatory regime.[11] 'Harmonization' of norms is necessary, at a time when capital can move freely, to prevent 'regulatory arbitrage' (the switch by investors and financial institutions to lower-cost regulators). Also, there is a need to create a global 'level-playing field', so that investors and financial institutions from certain countries do not benefit from unfair advantages. Hence the need to agree on common standards and close 'loopholes' such as those provided by offshore financial centres.[12] Another rationale for consolidated global regulation is the fear of contagion. As financial systems are increasingly interconnected,[13] the possibility of problems spreading across the globe are ever-present, raising the spectre of systemic risk – a wholesale collapse of the world's financial system.

The need to contain crises and ensure the integrity of the global system (based on the underlying view that markets should operate fairly and safely in order to encourage the widest possible confidence in them, thereby promoting high levels of savings and investment) explains why, since 1995, financial regulation has taken centre stage in the annual summits of the Group of Seven (G7) heads of government. A succession of financial crises affecting firms – BCCI, Daiwa Bank, Sumitomo, Barings, etc. – or countries – Mexico, Thailand, Indonesia, Korea, Russia, etc. – has lent greater urgency to regulatory cooperation. With each crisis the new orthodoxy has been refined and the reach of global regulators expanded.

The most recent changes in global financial regulation were accelerated by the Asian financial crisis. Until July 1997, the 'tiger economies' of Southeast Asia were held out as models of well-run economies. Reports by the International Monetary Fund and the World Bank praised their macroeconomic management and predicted continuing growth and success. Rating agencies were still awarding high ratings to their debts. The successive crises that spread in domino fashion, starting in Thailand, caught the world by surprise.[14] Since the 'fundamentals' of these economies were sound, a frantic search for new culprits ensued. A new consensus soon emerged, helped in no small part by the steady deterioration of the Japanese banking system: the financial systems of these countries were to blame. Rescues of Thailand, Indonesia and South Korea by the International Monetary Fund (IMF) were directly linked to the transformation of these countries' financial systems, which came to epitomize 'crony capitalism'. Regulators from the developing world, including Islamic countries, now must be trained and counselled on an on-going basis by more experienced regulators. They have little choice, since the acceptance of new norms is the sine qua non to being allowed to expand abroad, or to have access to international financial markets.

10.4 The Making and Enforcement of the New Global Norms

An overlapping network of governments (directly and through the G7 and G10),[15] private corporations (including most large financial banks, securities companies and insurance companies), and international organizations (the World Bank, the International Monetary Fund [IMF], the Organization of Economic Cooperation and Development [OECD], the World Trade Organization [WTO], etc.) has played a key role in promoting global financial standards.[16] This section focuses on two little-known organizations, the Group of Thirty, a private think-tank, and the Bank for International Settlements (BIS), 'the central bank of central banks', both of which were instrumental in shaping the new norms of financial regulation.

The Group of Thirty, established in 1978, describes itself as 'a private, independent, nonpartisan, nonprofit body' whose aims are 'to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and to policymakers'. It is 'supported by contributions from private sources: foundations, banks, non-bank corporations, central banks, and individuals'. In reality it is dominated by the large financial conglomerates, and its role could best be described as that of a consensus-making body on matters of global finance. Through its papers, conferences and symposia, study groups and specialized committees, the Group of Thirty has in recent years

produced the prevailing orthodoxy on matters of capital requirements, harmonization of rules and procedures, derivatives regulation, risk management and cooperation among financial regulators. Because of its make-up, it is the ideal forum for discussions among regulators and practitioners and for consensus-making. Its membership is a who's who of leading financial institutions, central bankers and mainstream economists.[17] It also works in close cooperation with the main trade groups and regulatory associations.[18]

The Bank for International Settlements, created in 1930 and based in Basle, Switzerland, is the oldest international financial organization, and perhaps the most mysterious.[19] The bank is primarily owned by the central banks of industrialized countries. Until recently, the bank's Board was made up of representatives from 11 countries (Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States). In 1996–7, it extended its membership to nine emerging countries. Those nine countries, however, are not equal partners: they may join in some discussions, but may not attend G10 meetings unless invited. Yet the BIS has business and advisory relations with considerably more than its shareholding central banks because some 120 central banks and international financial institutions use it as their bank. The total of the currency deposits placed with the BIS amounted to about US$113.1 billion at the end of March 1997, representing around 7 per cent of the world's foreign exchange reserves. Furthermore, the central banks or official monetary institutions of all but a few countries throughout the world are regularly represented at the Annual General Meeting of the BIS each June.

As with other international organizations such as the World Bank and the IMF, the power of the BIS grew with the successive financial crises of the 1980s and 1990s. In 1982 for example, when the debt crisis erupted, the BIS, at the request of the leading central banks and with their support (in the form of guarantees), helped provide bridging finance to a number of central banks, mainly in Latin America and Eastern Europe, pending the disbursement of conditional credits granted by Western governments, the IMF and the World Bank.

Of special interest to us is the Basle Committee on Banking Supervision which was created by the central bank governors of the G10 countries plus Switzerland and Luxembourg in December 1974, in the aftermath of the failures of Franklin National Bank in New York and Bankhaus Herstatt in West Germany. Although formally distinct, the BIS and the Basle Committee are often confused with one another. Indeed, the Secretariat of the Basle Committee is provided by the BIS, and the activities of the two organizations overlap considerably. Under the aegis of the Basle Committee, cooperation among bank supervisors has steadily increased. The first International Conference of Bank Supervisors was held in 1979.

The Basle Concordat of 1975 – revised in 1983 and 1990 – clarified the sharing of supervisory responsibilities among national authorities with respect to banks' foreign establishments, the aim being to ensure effective supervision of banks' activities worldwide.[20] It is by virtue of those rules that bank regulators acted in concert to close down the Bank of Credit and Commerce International (BCCI) in 1991. In 1988 the Basle Committee reached an agreement designed to achieve international convergence in the measurement of the adequacy of banks' capital. The so-called Basle ratios (also known as the Cooke ratios) have been clarified and amended on a number of occasions. In 1997, the Basle Committee issued its 'Core Principles for Effective Banking Supervision'.

In addition to issuing papers and detailed compendia on implementation of sound supervisory standards, the Basle Committee and the BIS have been increasingly involved in the dissemination of global banking norms. There are frequent meetings of central bank economists and other experts on a variety of matters, such as economic and monetary issues of interest to central banks (monetary policy techniques, operating procedures and netting arrangements) and on specialized topics (data bank management, security, automation, internal management procedures, collection of international financial statistics). The BIS also participates with the European Bank for Reconstruction and Development (EBRD), the World Bank, the International Monetary Fund (IMF) and the Organization of Economic Cooperation and Development (OECD) in the 'Joint Vienna Institute', a training institution set up in 1992 to offer courses for central bankers and other economic and financial officials from economies that are 'in transition' from central planning to free markets. In 1998, the BIS announced the creation, in association with the Basle Committee on Banking Supervision, of an Institute for Financial Stability. Its purpose is to organize high-level seminars directed at key policy-making officials in central banks and supervisory agencies, to provide training for the officials in charge of implementation, and to act as a clearing house for the coordination and provision of technical assistance by central banks and supervisory bodies.[21]

A web of global regulation involving banking, securities and insurance regulators has thus taken shape and is continually gaining in size and scope. A number of principles govern this web: home-host cooperation, information sharing, lead regulator principle, transparency, disclosure, etc. How are those norms enforced? Initially, the Basle Committee had no formal authority since its agreements were carried out on a voluntary basis by the member countries. Today, however, it has considerable power due to the new, albeit mostly indirect, powers of enforcement of private, public and international organizations. Adopting certain norms – such as the new capital ratios or the comprehensive home supervision requirement – is now a pre-condition to being part of the global financial system. The

countries whose legislation inspired (in the case of the United States), or were inspired by, the Basle norms would not permit the operation on their territory of banks from countries that did not endorse such rules. Thus, in 1991, in the wake of the BCCI and Banca Nazionale del Lavoro (BNL)[22] scandals, the US Congress enacted the Foreign Bank Supervision Enhancement Act (FBSEA), which added a new layer of control to its regulatory framework. The centrepiece of the legislation was the requirement that a foreign bank show that it is subject to 'comprehensive supervision or regulation on a consolidated basis by the appropriate authorities in its home country' before any application to open a US office, or to significantly expand its business in the US, can be approved.[23] As for the 'Core Principles for Effective Banking Supervision', their implementation is to be monitored by the IMF as part of its regular surveillance procedures. More generally, and especially since an increasing number of countries are now rated by international ratings agencies such as Standard and Poor's and Moody's, any refusal to apply the new norms is likely to result in being sanctioned or even 'ostracized' by the international markets.

10.5 Recent Developments in Global Financial Regulation

This section focuses on three sets of recent developments: the new rules on capital and risk management, the Core Principles for Effective Banking Supervision, and the liberalization of trade in financial services.

10.5.1 Capital Standards and Risk Management

The Basle Accord concluded on 12 July 1988 was a landmark regulatory agreement. For the first time, regulations affecting banks in many different countries were jointly established: banks operating internationally had to have a minimum capital-to-assets ratio of 8 per cent; and the capital was divided into three tiers, each subjected to different definitions and rules.

The idea of imposing strict ratios was related to the banking problems in the United States in the early 1980s, in the wake of deregulation, and as a result of bank exposure to the international debt crisis. In 1984 and 1985, the Federal Reserve Board and the Federal Deposit Insurance Corporation issued new capital guidelines, forcing banks to choose between raising new capital or reducing their assets. The underlying logic was that in order to be able to weather bad economic times, banks needed a high ratio of capital to assets. In January 1987, an agreement between the United States and the United Kingdom extended the principle of uniform rules to the two countries.[24] The ostensible goals were to reduce the risk of the international banking system and to minimize competitive inequality arising from differences among national bank-capital regulations. A more political explanation was that it attempted to eliminate the funding-cost

advantage that had allowed Japanese banks to capture more than one-third of international lending for much of the 1980s.[25] Even before the 1992 deadline, 33 countries besides the Group of 10 had chosen to adopt the 8 per cent rule, arguing that it helped them establish credibility.[26] As of 1998, virtually all countries had officially changed their capital requirements to conform with the Basle ratios.[27] In other words, although aimed initially at banks from the industrialized world that operated internationally, the standards soon became universal. In addition to the 8 per cent rule, the Basle Committee on Banking Supervision devised a risk-based capital framework: different asset classes (both on and off-balance sheet) had to be weighted according to their riskiness. Five weights – 0%, 10%, 20%, 50% and 100% – were attached to different types of assets (cash, OECD and non-OECD government debt, secured and unsecured loans, etc.).[28] Increasingly, following the lead of the United States and the 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA), a two-tiered regulation system appeared in many countries: institutions that were well-capitalized would be subjected to a rather light, if not lax, regulatory regime, whereas the others would be subjected to tight controls.

A number of drawbacks appeared over the years, which modifications in the Basle standards attempted to address. Capital requirements moved from being simple mechanical rules to becoming sophisticated risk-adjusted models. For one thing, the world of finance had changed considerably with new financial instruments being devised every day. The Basle ratios concentrated almost exclusively on credit risk, while other risks were ignored. Also, at least in the United States, the financial sector had recovered its health, following a difficult decade (1982–92) and had become more assertive and politically influential.[29] The new paradigm, propounded in particular by the Group of Thirty, became that of 'self-regulation': the largest financial institutions would develop their own risk-management models and tools, and regulators, rather than micro-managing risk, would have to be satisfied that those models were accurate and that internal risk controls and disclosure policies were adequate. In an influential report, the Group of Thirty argued that:

> [T]he fundamental responsibility of ensuring financial stability of financial institutions, and thereby limiting systemic risk, rests with the Board and management of global institutions themselves. It also implies that supervisors will be readier to rely on institutions that they supervise, and that the institutions themselves will accept the responsibility to improve the structure of, and discipline imposed by, their internal control functions.[30]

From 1988, new guidelines on derivatives and off-balance sheet items were issued on a regular basis, as a new orthodoxy on risk management took shape. Each firm had to have a thorough understanding of the risks it

faced. In addition to the credit risk (the risk that a counterparty will fail to perform on an obligation to the institution), other risks had to be covered, with procedures drawn up for each category.[31] As of January 1998, internationally active banks in G10 countries must maintain regulatory capital to cover market risk (the risk to an institution's financial condition, resulting from adverse movements in the level or volatility of market prices of interest rate instruments, equities, commodities and currencies). Market risk is usually measured as the potential gain or loss associated with possible price changes over a specified time horizon. This is typically known as value-at-risk (VAR). Banks must set aside capital to cover the price risks inherent in their trading activities. A standardized measurement framework to calculate market risk for interest rates, equities and currencies is provided, but certain institutions that meet the criteria laid out by the Basle Committee can use their internal models.[32] Other risks include legal risk (the risk of loss because a contract cannot be legally enforced, for example because of insufficient documentation or insufficient authority of the counterparty), liquidity risk (the possibility that the firm may not be able to fund its financial-trading activities or to resell its products on the secondary market), and operational risk (the risk of unexpected losses due to deficiencies in information systems or internal controls, which may be caused by human error, system failure or inadequate procedures and controls).

The new regulatory framework thus focuses on an institution's risk control strategy, with risk control defined as the entire process of policies, procedures and systems an institution needs to manage prudently all the risks resulting from its financial transactions, and to ensure that they are within the bank's risk appetite. To avoid conflicts of interests, risk control had to be separated from and sufficiently independent of the business units which execute the firm's financial transactions.

In order to comply with the new rules, most firms devised checklists: who formulates the firm's guidelines and policies? What type of financial instruments may the firm use? Are the products and their implications understood by all concerned? How are the financial instruments valued? Is there a limit system in place? What are the major risks resulting from financial instruments? How is the information communicated to managers and shareholders? Firms also devised lists of approved financial instruments, where each instrument would be clearly described together with an analysis of its usefulness in relation to other activities and the firm's financial condition, as well as reasons for its use. A continuum of financial instruments distinguishes between non-derivative (cash instruments such as fixed-rate bonds), plain vanilla derivatives (such as currency swaps), exotic products (more complex instruments such as lookback options), hybrids (for example, fixed-rate bonds with options embedded in them) and leveraged derivative products (a specific type of derivative financial

instrument containing formulas or multipliers, which for any given change in market prices, could cause the change in the product's fair value to be several times what it would otherwise be). In every instance the amount at risk would be different. With traditional instruments such as loans, bonds or foreign exchange, the amount which the counterparty is obliged to repay is the full or principal amount of the instrument. In the case of derivatives, the risk is not equal to the principal amount of the trade, but rather to the cost of replacing the contract if the counterparty defaults. This replacement value fluctuates over time and is made up of current replacement and potential replacement costs.

Ironically, less than a year after the rules came into effect, the hedge-fund debacle of the summer of 1998 showed that the much-vaunted risk models of large financial institutions were woefully inadequate.[33]

10.5.2 The Core Principles of Bank Supervision

In 1992, the first minimum standards for cross-border supervision established four main principles: (1) All international banks should be supervised by a home country that is capable of performing consolidated supervision; (2) The creation of a cross-border banking establishment should receive the prior consent of both the host country and the home country authority; (3) Home country authorities should possess the right to gather information from their cross-border banking establishments; (4) If the host country determines that any of these three standards is not being met, it could impose restrictive measures or prohibit the establishment of banking offices.

With the proliferation of banking crises worldwide, the G7 pressed the Basle Committee to issue more detailed guidelines. Indeed, from 1995, G7 summit communiqués had repeatedly called for measures to strengthen banking regulation and supervision, in particular deeper cooperation among supervisors of global firms to 'promote the development of globally-integrated safeguards, standards, transparency and systems necessary to monitor and contain risks', and improved supervision in the emerging market economies.

In 1997, the Basle Committee issued for comment a draft of its '25 Core Principles for Effective Banking Supervision'. Among those principles are the following: all banks must have comprehensive risk-management systems as well as management information systems that enable management to identify concentrations within their portfolio; supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers; they must also determine that banks have adequate policies, practices and procedures in place, including strict 'know-your-customer' rules that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or

unintentionally, by criminal elements; and regulators must be able to supervise the banking group on a worldwide consolidated basis.

According to the press release, the Principles 'were drawn up by the Basle Committee in close collaboration with the supervisory authorities in fifteen emerging market countries and have benefited from broad consultation with many other supervisory authorities throughout the world'. They were 'intended to serve as a basic reference for supervisory and other public authorities worldwide to apply in the supervision of all the banks within their jurisdictions'. Supervisory authorities throughout the world were 'invited to endorse the Core Principles, not later than October 1998'. The Principles were designed to be verifiable by national regulators, regional supervisory groups and the market at large. The Basle Committee would monitor the progress made by individual countries in implementing the Principles. In addition, the International Monetary Fund, the World Bank and other international organizations were asked to use the Principles 'in assisting individual countries to strengthen their supervisory arrangements in connection with their work aimed at promoting overall macroeconomic and financial stability'. The Basle Committee also announced it was preparing a three-volume Compendium of its existing recommendations, guidelines and standards.

As of October 1998, emerging countries were expected to review their current supervisory arrangements and set a timetable to make changes in order to conform with the Principles. If legislative changes were needed, national legislators were requested to give urgent consideration to the changes necessary to ensure the application of the Principles. Some in the banking profession have criticized those Principles for being too vague – in effect, for being guidelines and not strict rules. The Principles, say other critics, pay insufficient attention to several issues, such as the profitability, the quality of deposits (which is especially important in emerging markets) and earnings.[34] Implementation of the Principles was to be reviewed at the International Conference of Banking Supervisors in October 1998 and biennially thereafter.

10.5.3 Free Trade in Services

Financial services were left out of the Uruguay Round Agreement that created the World Trade Organization in 1994. At the time, countries such as South Korea, India and Brazil feared that an onslaught of foreign competition would endanger their national firms. This unfinished business was taken up by the newly created organization. In 1995, an agreement was arrived at, but was rejected by the United States on the grounds that it did not go far enough in the direction of liberalization. For a time, the talks seemed deadlocked. It is in part as a result of the Asian financial crisis of 1997 that the deadlock over the financial services agreement was broken. By

the end of that year, Asian countries had lost much of their bargaining power as they desperately needed the help of Western governments and international organizations such as the IMF.[35] And the US and other developed countries, worried about the ripple effects of the crisis, were intent on drastic reform. In their view, the fastest way to cure a sick financial system and to reform it is to open it to foreign competition. In the words of US Deputy Treasury Secretary, Lawrence Summers: 'Emerging markets' growing importance to the global economy gives the international community a particularly strong interest in strengthening their financial systems to insure against financial-sector crises like the one in Thailand'.[36]

In December 1997, an agreement was finally signed, with 102 countries pledging to open, to varying degrees, their banking, insurance and securities sectors to foreign competition. The agreement, effective as of March 1999, covers 95 per cent of the world's multi-trillion dollar financial services – which according to US negotiators involves $18,000 billion in global securities assets, $38,000 billion in international bank lending and $2,500 billion in worldwide insurance premiums. Like other World Trade Organization agreements, the financial services agreement covers not just cross-border trade but all the ways foreign suppliers can deliver services to a country's market, including the establishment of local subsidiaries and branches. The interests of foreign firms were to be protected by the rules of the world-trade body.[37]

The WTO stressed the benefits of the new agreement to developing countries. Increased international competition in financial services would force domestic companies to reduce waste, cut costs, improve management and become more efficient. Liberalization would improve service quality, and benefit consumers, depositors and investors. Open markets would encourage the emergence of new financial instruments, allowing companies to choose the optimal combination of equity, loans or commercial paper to finance their activities. In addition, according to the WTO, broadening the volume of transactions and the spectrum of services would reduce the volatility of markets and their vulnerability to external shocks.[38]

10.6 Applying the New Norms in the Islamic World

While elaborating the '25 Core Principles for Effective Banking Supervision', the Basle Committee negotiators initially considered having two sets of principles, to be applied respectively to developed countries and developing ones. In the end however, they settled for a single set of rules that would be applicable worldwide. As this section shows, most Islamic countries are ill-prepared to implement these reforms. Only two Islamic countries – Malaysia and Indonesia – were nominally associated with the

work of the Basle committee,[39] and both have since had their differences with the global financial community. At the time of the Asian financial crisis of 1997, both countries saw themselves as victims of speculative financial flows. Indonesia only reluctantly accepted the conditions imposed by the IMF in exchange for its rescue package. Malaysia, in the WTO negotiations, fought vigorously in favour of maintaining limits on foreign ownership of some of its financial firms. Indeed, one of the last-minute stumbling blocks concerned the new 30 per cent limit on foreign ownership of insurance firms as part of the 'Malaysianization' programme.[40] After the signing of the agreement, the conflict between Malaysia and the international financial community escalated. Prime Minister Mahathir blamed international speculators for the country's woes. In September 1998, Malaysia took drastic steps to insulate itself from the vagaries of the international markets. Still, Islamic countries are expected to comply with many of the new norms of global banking, despite institutional, cultural, political and religious obstacles.

Although most Islamic techniques have conventional counterparts, they do not always fit conveniently within existing regulatory regimes. The main financing techniques often imply specific contractual obligations and different levels of risk than their conventional counterparts.[41] From the standpoint of Islamic bankers, Islamic financial techniques are fundamentally different from conventional loans, and they should therefore not be subjected to the same prudential ratios and capital requirements as conventional banks.[42] The attitude of many Western regulators can be summed up in a famous statement by Robin Leigh-Pemberton, former governor of the Bank of England, to the effect that Islamic banking is 'a perfectly acceptable mode of investment, but it does not fall within the long-established and well understood definition of what constitutes banking in this country'.[43]

From the standpoint of ownership and control, many such banks cannot comply with the 'comprehensive consolidated supervision by the home country regulator' requirements. Indeed, the majority of Islamic financial institutions belong to, or are otherwise associated with, transnational groups such as Dar Al-Maal Al-Islami (DMI) or the Dallah Al-Baraka group. DMI, controlled by Prince Mohammed al-Faisal al-Saud, is headquartered in the Bahamas and runs its network of banks out of Geneva. Commercial operations extend throughout the Islamic world though not in Saudi Arabia. Similarly, the Dallah Al-Baraka group is controlled by Saleh Kamel, a Saudi citizen, but does not operate a bank in his home country. Ever since the collapse of the Bank of Credit and Commerce International (BCCI), which had used loopholes within the global regulatory system to engage in illegal practices, regulators have frowned upon such structures. In 1993, the Bank of England ordered the closure of Al-Baraka International Bank, the British subsidiary of the Dallah Al-Baraka Group,

on the grounds that the bank's true 'mind and management' were in Saudi Arabia although it did not operate as a bank there.[44]

Another set of issues faced by Islamic financial institutions is the new emphasis on internal risk management. Because of the religious injunctions against gharar,[45] financial institutions and their Shariah boards tread carefully around all issues involving risk,[46] including complicated financial instruments designed to control risk. Thus, although such products are supposed to control risk and reduce it (although as we saw, they sometimes have the opposite effect), they do not always pass muster with Shariah boards. Islamic banks have thus been lagging in their efforts to devise the risk management techniques required by regulators.

Other regulatory complications are posed by the nature of interest-free banking. In the United States for example, Islamic financial institutions have found it hard to comply with the Truth-in-Lending Act, the federal regulation that governs full disclosure of terms and costs in lending transactions. The law requires the use of the term 'annual percentage rate'. Even replacing it, as some have suggested, by a 'profit participation rate' would be tricky since it would mean the endorsement of the 'fixed, predetermined rate' concept to which many Islamic scholars object.

One of the flaws of the principle of global and compulsory norms is that it ignores the fact that banking structures are embedded within a religious, institutional, political and cultural context that cannot, international prodding notwithstanding, be changed overnight. Consider for example the new norms of banking supervision: arms'-length relations between banks and their customers, 'know-your-customer' rules,[47] limits on sizable exposure to a single client or to a group of connected clients; disclosure and transparency, etc. It is unrealistic to expect the successful implementation of such principles in countries where the business community is small and enjoys close ties with the political elite.

Matters of disclosure and transparency also have a cultural dimension. The openness with which Americans discuss financial matters – such an executive's salary or an individual's net worth – contrasts sharply with the way such matters are discussed (or the fact that they are not discussed at all) in other cultures. The opacity extends to issues such as bank ownership, where the use of 'fronts' is common and does not necessarily imply sinister intent. In the first high-profile instance of application of the 1991 Foreign Bank Supervision and Enhancement Act (FBSEA), Saudi Arabia's National Commercial Bank, the largest bank in the Middle East, was accused of helping the Bank of Credit and Commerce International conceal its ownership and financial condition, and was ordered by the Federal Reserve Board to close its New York branch. In a compromise, it eventually chose a 'voluntary liquidation', and a $170 million penalty was levied against its former head, Sheikh Khalid Bin Mahfouz.[48] His attorney Laurence Tribe, the Harvard University constitutional law expert, undertook to

rehabilitate him by arguing that the case highlighted a lack of cross-cultural understanding and an international financial and regulatory system more adapted to pursuing and controlling corruption than to defending individual rights.[49]

10.7 The Supervision of Islamic Financial Institutions

10.7.1 Prudential Regulation

Left to its own devices, the financial industry is prone to various excesses and types of fraud. These in turn undermine confidence and can shake the economy to its foundations.[50] A central function of the regulators is 'prudential' – making sure that financial institutions operate in a prudent manner. Confidence is instilled by establishing the right safeguards and enforcing strict supervision. A number of monitoring mechanisms – prudential ratios, accounting, auditing and disclosure rules – are available and have far-reaching implications. The sudden liberalization of finance has revealed the predicament of regulators. On the one hand, they are dedicated to a free market and strive to encourage financial dynamism and innovation. But on the other hand, a free-wheeling climate is highly conducive to fraud, in particular to speculative bubbles and 'pyramid' schemes – whereby institutions pay dividends from new deposits, rather than from profits generated by legitimate business operations. In Egypt in the 1980s, billions of dollars 'evaporated' and the fact that the IMMCs operated under the veil of Islam was particularly damaging.[51]

Islamic financial institutions present special problems. Due to the lack of suitable Islamic investments, many banks have been prone to placing their excess liquidity in risky places. Insofar as they do not usually purchase Treasury Bonds, and frequently place their assets overseas, regulators are often unable to properly monitor the bank. Another potential problem has to do with profit-sharing ratios and the bank's relation to its depositors. Typically, 70 per cent of these profits go to depositors and 30 per cent to bank owners, but at times of low profits, banks sometimes choose to subsidize profit distributions to depositors out of the bank owners' share of profits, which is clearly unsustainable in the long run.[52]

10.7.2 The Question of Dual Regulation

Countries having a dual – conventional and Islamic – financial system must contend with a dilemma: should both types of banks be subjected to the same rules and regulations (on capital adequacy ratios, liquidity provisions, depository reserves, accounting and auditing standards, etc.)? And should they be supervised by the same supervisory authorities? Given the current emphasis among international regulators on comprehensive regulation, a

strong case can be made in favour of a single regulator that would be in a position to see the 'big picture' of the financial system. Regulators may not accomplish their mission if a whole segment of the industry is beyond their reach.

Most Islamic banks however favour separate treatment. Their argument can be divided into two parts: a religious argument, based on the belief that religious factors should be paramount; and an economic argument, to the effect that Islamic operations are fundamentally different from conventional ones. It is unfair, in their view, to treat the main Islamic financing techniques – mudaraba, musharaka and murabaha – as conventional loans since many such operations do not constitute lending, but merely financing, or even sales. Also, as they lobby in favour of special treatment, Islamic banks argue that only by being treated separately could they be in a position to develop their identity and in turn create new products.

A related issue is that of discrimination – whether positive or negative. Conventional banks have repeatedly decried the 'special privileges' enjoyed by their Islamic counterparts, which in their view amount to unfair competition. Conversely, at times Islamic institutions have complained about not having the same prerogatives as their conventional competitors. Consider for example the case of Faisal Islamic Bank of Egypt. Created in 1977 by a special law, it was given countless privileges that went far beyond the already considerable advantages provided to foreign investors by 1974 (Law Number 43). The new bank was exempted from foreign exchange controls, corporation regulations, credit control (except for credits in local currency), labour laws and social legislation, and customs duties. Also, for a period of 15 years, it would not be subject to income, corporate or real estate taxes. It was further given ironclad guarantees against nationalization or seizure of deposits. And it was placed above the law since any conflict between the bank and any other party would be resolved solely by the bank's board of directors. Such an array of privileges (some of which were later rescinded) led to accusations that the bank would become a 'state within the state'.[53]

Similar criticisms were levelled at Turkish 'Special Finance Houses'[54] which were, from their inception, subjected to lower reserve requirements than their conventional counterparts.[55] In 1996, during the rule of Islamist Prime Minister Necmettin Erbakan, the six Islamic institutions were given a further boost when their performance bonds were deemed acceptable in state tenders. At the same time however, Islamic institutions were arguing that they were in fact the ones discriminated against. As proof that they were victimized by a political vendetta led by the military-dominated political establishment, they put forth the following evidence: the authorities had made it nearly impossible for them to expand their branch network; an earlier increase in reserve requirements had already slowed down the flow of deposits; and they were more thoroughly inspected by the Treasury and

the Central Bank than the conventional banks.[56] But soon after the Islamic Prime Minister was forced to resign in 1997, new legislation brought Islamic financial institutions under the jurisdiction of the banking law.

Worldwide, the current trend in bank regulation and central banking is towards 'independence', meaning that regulators ought to be technocrats insulated from political pressures. A case can be made that such insulation is more difficult to achieve in the case of Islamic banks, as regulatory considerations are more likely to be overridden by political, and of course religious, considerations. Another issue is that of experience. The regulation of Islamic financial institutions requires an understanding of both Islamic and conventional finance. If anything, the novelty of Islamic financial products calls for greater vigilance, especially as rapid growth and competitive pressures are likely to lead financial institutions to take on greater risks.

Within the Islamic world, the dilemma of dual regulation has generally been resolved in one of two ways: by establishing, within the central bank, a division dealing with Islamic banking, or by coordinating the supervision of the respective banks. Bahrain has chosen the first path: the Bahrain Monetary Authority has its own Shariah advisers who oversee matters of concern to Islamic institutions. In Kuwait, on the other hand, the regulation of Islamic institutions (the International Investor and the Kuwait Finance House) is conducted not by the Central Bank but by the Finance Ministry, although both types of banks are subjected in practice to the same general rules. The Central Bank and the Finance Ministry coordinate their supervision, and there is an implicit understanding that, should the Islamic institutions run into difficulties, they would receive the same kind of support as conventional banks.

10.7.3 Deposit Insurance and the Lender of Last Resort Issue

Another unresolved issue is that of deposit insurance. In most countries, if a bank fails, a government agency, drawing on a special fund, steps in to reimburse depositors. The underlying philosophy is that certain types of deposits and certain groups of people deserve to be protected – in effect insulated from the ups and downs of the economic cycle. In the United States, deposits are insured by the Federal Deposit Insurance Corporation (FDIC), up to $100,000. Customers, in exchange for the protection, accept a lower remuneration. Banks pay a premium and agree to strict controls by the FDIC.

Insofar as Islamic banking is supposed to be primarily based on profit-and-loss sharing, deposit insurance should not normally apply. Depositors are shareholders of sorts, whose fortunes are tied to the institution's fate (or to the fate of the specific investment being financed). Only if the institution (or the investment being financed) makes a profit will they be

entitled to a share of the profit. Potential losses carry a heavy political and economic cost. Typically, the government is likely to step in. No consensus exists among Islamic banks which are caught in a dilemma: the logic of PLS accounts does not lend itself to deposit insurance; yet human psychology is such that depositors want to have it both ways – sharing in the profits and being insured against losses. The absence of a 'fixed, predetermined' interest rate complicates the determination of premiums, and of course such protection has the unfortunate consequence of discouraging the typically Islamic profit-and-loss sharing accounts in favour of conventional demand deposit ones.

In reality, the share of PLS transactions has been very low.[57] On a number of occasions, Islamic banks (and thus indirectly their depositors) had to be rescued, usually as a result of losses on commodities and foreign exchange markets and sometimes as a result of fraud. In most instances, there was one of three outcomes (or a combination thereof): temporary takeover by the Central Bank (it happened temporarily for Egypt's International Islamic Bank for Investment and Development [IIBID]), injection of funds from the government (it happened in 1984 with the Kuwait Finance House), or emergency funds from consortia of Islamic banks, usually led by the Islamic Development Bank (IDB) (it happened with the Dubai Islamic Bank in 1998).

There is everywhere, therefore, at least implicitly, some deposit insurance scheme and a lender of last resort. When South Africa's Islamic Bank Limited was recently liquidated, the South African Reserve Bank announced that, although the country does not have deposit insurance protection, it would compensate all depositors up to 50,000 rand ($11,000) each. The decision was taken 'in the interest of financial stability of the country'. The announcement also stated that '[t]his arrangement should not be seen as creating a precedent'.[58]

Such a caveat was to be a reminder that expecting bail-outs can lead to reckless behaviour – one example of the all-pervasive moral hazard, which extends to many aspects of financial supervision. The concept, which originated in the insurance industry, is that certain rules and practices tend to encourage reckless behaviour. For example, once a business has obtained fire insurance, it may be inclined to reduce its expenditures on fire safeguards and prevention, thus increasing the likelihood of a fire as well as the size of the losses that the insurer may incur.[59] By the same token, insured depositors care little about the financial health of their bank, while unscrupulous financial operators may be invited to gamble with the public's money. For a slightly higher interest rate on insured deposits, a weak or even insolvent financial institution can obtain almost unlimited funds.[60] A similar incentive to engage in risky behaviour occurs when management operates without substantial net worth or stockholder capital. Indeed, US legislation aimed at allowing S&Ls (Savings and Loans) to

diversify their investments beyond financing home purchases, combined with lax supervision and an increase in the insured deposit amounts, turned out to be an invitation to gamble with the insured public's money through real-estate speculation or junk bonds.[61]

By the same token, announcing that the government will be a lender of last resort can encourage risky behaviour. In most instances, there is an implicit 'too big to fail' policy – an unspoken guarantee against failure given to the largest institutions for fear of either run contagion or a gridlock shutdown of the payment or banking system. The predicament of regulators in a free-enterprise system is that they must act as if such a safety net did not exist – or else they would invite customers of small banks to transfer their deposits to largest banks – yet be ready to rescue those institutions whose collapse is likely to trigger a domino effect.[62]

A related question is that of the resources of a central bank in an interest-free setting. Assuming no deposit insurance scheme, where would the resources of the central bank come from? One suggestion was that Islamic Central Bank acquire some equity in the commercial banking sector, giving it access to the resources necessary for it to act as lender of last resort.[63]

10.8 Conclusion

In the early years of Islamic finance, national regulators enjoyed wide autonomy. Islamic regulators could devise rules and practices with minimum interference from the outside world. This chapter has explained why this is no longer the case. Today, they are urged to comply with new international rules, as well as to liberalize and open up their financial sector to foreign competition. Islamic regulators thus face a daunting task to which they are singularly ill-prepared: they must engage in consolidation and reform in the face of considerable obstacles before domestic banks confront the onslaught of foreign competition. As one analyst remarked:

> The terrible truth is that supervisors in developing countries, capable and well intentioned though they may be, typically lack the resources, independence and clout to do their jobs properly. As a result, the banks in their care are often able to expand recklessly, lend carelessly and run themselves unwisely. To make things worse, supervisors sometimes come under pressures to turn a blind eye to the imprudent practices of some bankers.[64]

At a time of harmonization of regulatory practices, the interest-free Islamic regulators have a hard time achieving convergence with interest-based conventional regulators. Interest rates have been an essential (and convenient) tool of regulation and control. By raising or lowering a variety of rates, regulators can influence the money supply and achieve specific

policy goals. In an interest-free system, such a tool cannot in theory be used. Advocates of Islamic banking argue that other tools can be used – such as modifying reserve requirements for banks, injecting liquidity into the system (for example by manipulating surpluses or deficits), or imposing new 'lending ratios' (the proportion of demand deposits that commercial banks are obliged to lend out as interest-free loans) or 'refinance ratios' (the central bank refinancing of a part of the interest-free loans provided by the commercial banks).[65] Original solutions have been offered to deal with issues such as deposit insurance or the ability to be lenders of last resort.[66] It remains to be seen how such schemes can fit with new approaches to bank regulation as promulgated by the Basle Committee, or be 'harmonized' with the prevailing practices of other regulators.

The main problem with one-size-fits-all approaches is that they ignore the fact that different countries have different institutional frameworks and regulatory cultures. To be sure, there are a number of escape clauses,[67] and the makers of the new global norms usually pay lip service to the notion that differences across regulatory systems should be part of rule-making. Clearly, the timetables and expectations of the new global regulations are unrealistic. It remains that, given the firm deadlines associated with the implementation of the 'Core Principles' and the WTO Agreement, and given the various surveillance and enforcement mechanisms discussed earlier, there is little doubt that the new norms – openness and transparency, free flow of capital, internal controls, better informed and more consistent supervision – will define, if not the extent of change, at least its direction. As countries build legal and regulatory infrastructures – especially in regard to nascent stock and financial markets – they will be bound by the new rules.

Notes

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2. Mohammed Ariff (ed.), *Monetary and Fiscal Economics of Islam*, Jeddah: International Centre for Research in Islamic Economics 1982.
3. Ibrahim Warde, 'Financiers flamboyants, contribuables brûlés', *Le Monde diplomatique*, July 1994.
4. Ibrahim Warde, 'Regulatory Cultures', IBPC Working Papers 1998.
5. Itzhak Swary and Barry Topf, *Global Financial Deregulation: Commercial Banking at the Crossroads*, Oxford: Blackwell 1992.
6. Kathleen Day, *S&L Hell: The People and the Politics Behind the $1 Trillion Savings and Loan Scandal*, Norton 1993; Martin Mayer, *The Greatest-Ever Bank Robbery*, Scribner's 1991.
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8. John Gerard Ruggie, 'International regimes, transactions, and change: embedded liberalism in the postwar economic order', in Stephen D. Krasner (ed.), *International Regimes*, Cornell University Press 1983.

9. John Zysman, *Governments, Markets and Growth*, Cornell University Press 1983.
10. Susan Strange, *Casino Capitalism*, Manchester University Press 1997.
11. See Chapter 5.
12. Claude E. Barfield (ed.), *International Financial Markets: Harmonization versus Competition*, Washington: The American Enterprise Institute Press 1996.
13. François Chesnais, *La mondialisation financière: Genèse, coût et enjeux*, Paris: Syros 1996.
14. Ibrahim Warde, 'Les remèdes absurdes du Fonds monétaire international', *Le Monde diplomatique*, February 1998.
15. The G7 and the G10 refer respectively to the seven and the 10 most industrialized countries. The G7 should more accurately be called the G8 since it now formally includes Russia.
16. Ethan B. Kapstein, *Governing the Global Economy: International Finance and the State*, Harvard University Press 1994.
17. In 1998, its chairman was Paul Volcker, the former Chairman of the Federal Reserve Board, and its members included prominent international regulators (including Andrew D. Crockett, General Manager of the Bank for International Settlements, Jean-Claude Trichet, Governor of the Banque de France, and Jacob A. Frenkel, Governor of the Bank of Israel), major financial firms (such as Morgan Stanley, Merrill Lynch and Dresdner Bank) and leading economists (such as Princeton's Peter Kenen and the Massachusetts Institute of Technology's Paul Krugman).
18. Based on a variety of Group of Thirty publications, and on information from its website.
19. It was initially created upon the adoption of the Young Plan, which was designed to settle the problem of German reparations after World War I, at the Hague Agreements of 20 January 1930. Initially, it was owned by six European central banks and an American financial institution. The United States, although an active participant, did not formally become a shareholder until 1994. The history of the bank has left it many quirks: although owned by central banks, its shares are trades on stock exchanges in Paris and Zurich; its also has its own 'currency', the gold franc.
20. Miroslava Filipovic, *Governments, Banks and Global Capital: Securities Markets in Global Politics*, Aldershot: Ashgate 1997, p. 175.
21. Based on publications, press releases and the website of the Bank for International Settlements.
22. The Atlanta (Georgia) branch of the Banca Nazionale del Lavoro had made illegal loans to the Iraqi government.
23. Raj K. Bhala, *Foreign Bank Regulation after BCCI*, Durham, N.C.: Carolina Academic Press 1994.
24. Filipovic, p. 180.
25. John D. Wagster, 'Impact of the 1988 Basle Accord on International Banks', *Journal of Finance*, September 1996.
26. *Global Finance*, November 1992.
27. Ibrahim Warde, *The Regulation of Foreign Banking in the United States*, San Francisco: IBPC 1998.
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34. David Fairlamb, 'Beyond capital adequacy', *Institutional Investor*, August 1997.
35. *The Wall Street Journal*, 15 December 1997.
36. *Far Eastern Economic Review*, 2 October 1997.
37. *Financial Times*, 15 December 1998.
38. *Far Eastern Economic Review*, 2 October 1997.
39. The countries outside the G10 are Chile, China, the Czech Republic, Mexico, Russia and Thailand, Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore.
40. *The Wall Street Journal*, 10 December 1997.
41. See Chapter 7.
42. Chibli Mallat, *Islamic Law and Finance*, London: Graham and Trotman 1988.
43. *Financial Times*, 28 November 1995.
44. *Financial Times*, 3–4 April 1993.
45. Chapter 3.
46. Nabil A. Saleh, *Unlawful Gain and Legitimate Profit in Islamic Law: Riba, gharar and Islamic banking*, Cambridge University Press 1986.
47. The 'know-your-customer' rule is primarily designed to make sure that the bank is not a conduit for illicit funds, such as those obtained from money laundering. Banks are expected to report suspicious transactions to regulators.
48. Ibrahim Warde, *Foreign Banking in the United States*, San Francisco: IBPC 1999.
49. *Financial Times*, 10 January 1995.
50. See the episodes described in James Grant, *Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken*, New York: Farrar, Straus Giroux 1992, and John Kenneth Galbraith, *A Short History of Financial Euphoria*, New York: Viking 1990.
51. See Chapter 4.
52. Frank E. Vogel and Samuel L. Hayes III, *Islamic Law and Finance: Religion, Risk, and Return*, The Hague: Kluwer Law International 1998, p. 8.
53. Michel Galloux, *Finance islamique et pouvoir politique: le cas de l'Egypte moderne*, Paris: Presses universitaires de France 1997, p. 57.
54. Turkish legislation did not allow the use of the word Islamic in either the name of the financial institution or the description of their operations.
55. Conventional banks must keep 8 per cent of all deposits and 11 per cent of all foreign exchange with the Central Bank. Islamic houses must keep 10 per cent of their current accounts held before June 1994 in cash and another 10 per cent with the Central Bank, among other requirements. *The Wall Street Journal*, 8 January 1998.
56. *The Wall Street Journal*, 8 January 1998.
57. See Chapter 7.
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59. Kenneth E. Scott and Barry R. Weingast, *Banking Reform: Economic Propellants, Political Impediments*, Stanford: Hoover Institution Press 1992, p. 2.
60. Scott and Weingast, p. 3.
61. Michael Lewis, *Liar's Poker: Rising Through the Wreckage on Wall Street*, 1989, p. 218.
62. Scott and Weingast, pp. 8–9.

63. Mohammed Uzair, 'Central banking operations in an interest-free banking system', in Mohammed Ariff (ed.), *Monetary and Fiscal Economics of Islam*, Jeddah: International Centre for Research in Islamic Economics, 1982.
64. Fairlamb, August 1997.
65. See Mohammed Ariff (ed.), *Monetary and Fiscal Economics of Islam*, Jeddah: International Centre for Research in Islamic Economics, 1982, especially Mohammed Ariff, 'Monetary policy in an interest-free Islamic economy – nature and scope'; Mohammed Uzair, 'Central banking operations in an interest-free banking system'; and Mohammed Siddiqi, 'Islamic approaches to money, banking and monetary policy: A review'.
66. Uzair, 'Central banking operations …', in Ariff (ed.).
67. Article 21 of the World Trade Agreement (WTO), for example, allows members to take trade actions to protect their 'essential security interests'.