

**Islamic Finance In the United States --
The Regulatory Framework**
Remarks by

Ernest T. Patrikis, First Vice President
Federal Reserve Bank of New York

before the

Islamic Finance and Investment Conference

New York, New York

May 23, 1996

It is my pleasure to be here with you today. As some of you may know, this is the second time this week that I will have had the pleasure to address Arab bankers in New York City. I accepted your kind invitation to speak to you today as a way of broadening my education. To be frank, until preparing for this program, my knowledge of the nature of Islamic banking was quite slim. I will need your indulgence as I proceed this morning because my approach will be quite academic. The reason for this is that those of us at the New York Fed have not had the opportunity to address supervisory issues related to Islamic banking in the United States. Therefore, I regard this as my initial voyage into the area. As you will see, there are few clear answers to many issues. What that means is, if you decide to pursue Islamic banking in the United States, that you, the bankers, and we, the bank supervisors, will have to have a dialogue on those issues. We view that dialogue as a way of jointly working out problems. To the extent we can, we will try to help you resolve any thorny issues.

There is one point that I want to make especially clear to you this morning. That is, the fact that Islamic banking and finance is based on religious principles is irrelevant to us. Issues of religion are not supervisory matters of concern. If an Islamic banker needs to structure a transaction in a given way, we will work to try to assist in that process. The fact that this need is grounded on religion does not affect our view of the matter. We will keep our focus on bank supervisory concerns.

As I am sure you appreciate, in the United States, we have a complex, if not confusing, financial structure. Over the years, it has grown in a haphazard way. We are just beginning to rationalize our financial system in terms of who can engage in certain activities and who regulates and supervises those firms and/or activities. Broadly speaking, we separate commercial banking from insurance and investment banking. We also separate banking from commerce. Commercial banking and investment banking are supervised or regulated at both the State and Federal level. Insurance is regulated primarily at the State level. There are a number of exceptions to these broad separation principles; at some point, those exceptions might overcome the general rule. The reasons for these separations are many. Some go back to the roots of the country in the 18th century, when some banks were associated with business enterprises. Over time, banking became separate from commerce, which became the standard and eventually was codified in the Bank Holding Company Act and the Glass-Steagall Act. In the 1930s, commercial banks were blamed, in part, for bringing on the depression, through links with investment banks and alleged funding of speculative securities transactions. Whether that was an accurate assessment of the facts is far from clear today. Currently, while investment banks and insurance companies can be linked, there are severe restrictions on the affiliation between commercial banks and insurance companies.

One of the key issues of public concern over the years has been the concentration of wealth in banking. That is, if banks were able to invest deposits as equity investments in commercial enterprises, banks would be controlling commercial firms and would not be impartial arbiters of credit. This policy of separating banking and commerce is grounded upon a mixture of safety and soundness concerns and a broader public policy concern about fair and equal access to credit and control over society's resources by banks. Americans have long had a distrust of the power of banks to allocate credit. Even though the percentage of bank financing transactions has waned as our capital markets have grown, the vestiges of that age-old concern about banks has not gone away, although it is much lessened today.

As you think about conducting Islamic banking or finance in the United States, you must think about the form that enterprise would take -- a commercial bank, a branch of a foreign bank, an investment bank, or an ordinary business corporation -- such as a finance company or an investment bank.

If you select the route of a domestically chartered commercial bank or a branch of a foreign bank, you will begin your introduction to the intricacies of our complex banking structure. In the short period of time available to me this morning, I will not be able to delve into the details of that structure. Instead, I will mention some of the more significant issues which are apparent to me at first glance.

Generally speaking, a bank supervisor looking at an application will give consideration to several factors; key among these are financial and managerial factors. A supervisor will look to ensure that the bank is well capitalized and has a business plan that shows how that well-capitalized position will be maintained over time. The bank supervisor will also look to ensure that directors and management have the requisite expertise for their respective positions. In addition, if a foreign bank is applying to establish a bank or a branch in the United States, the Board of Governors of the Federal Reserve System would need to determine that the foreign bank is subject to comprehensive consolidated supervision in its home country.

An Islamic financial institution will raise novel questions, in addition to the traditional issues that need to be considered. I understand that the general principles of Islamic banking involve the adherence to the Islamic prohibition on the charging or receiving of interest, absentee landlordism, and speculative activities. Islamic banking stems from the Islam's teaching that money should not be created out of money but generated by taking risks on productive investments.

I understand that Islamic banking arrangements are based on profit sharing. Account holders obtain a share of the bank's profits; this is similar to a shareholder's dividend. The bank may have something akin to a partnership agreement with the depositor, with a guarantee not of a rate of return but, instead, of a portion of profits. Thus, the bank acts something like a fund manager. If the bank loses money on the transaction, so does the account holder. This would come as a surprise to the typical depositor in the United States. There would be a need to ensure that the "depositor" was well aware of the risks involved with such a transaction.

On the asset side of the balance sheet, the transaction must be structured so as to not involve the payment of interest on a loan. I must say as I read through material on this subject, I have been impressed with the creativity involved in carrying on financial transactions consistent with the teachings of the Koran. For example, I understand that, when some Islamic banks make a home loan, the bank will be repaid the principal amount along with a percentage the bank estimates the house could be rented for. In a business loan, the bank might estimate the potential profit over the course of years and require the borrower to pay back a percentage of that estimate. Islamic banking, as all banking, entails risks. If a bank underestimates the profitability of the borrower, and the borrower fails, the loan will not be repaid. That is nothing new to banking. This will require the bank supervisor to assess how to characterize the risks involved in such a transaction. Should it be regarded as a loan or is it more like an equity investment? If a bank does not have a legal obligation to return its customers' principal, does it take on a moral obligation

to do so?

I have learned that an Islamic bank may provide investment funds to a project and receive a share of profits in return. An Islamic bank can act as an intermediary or middleman in trade transactions by importing a product and then selling it at a markup. An Islamic bank can enter into lease or a lease-purchase transaction. An Islamic bank can also enter into an advance payment transaction, such as purchasing goods before they are produced and then selling the goods at a profit. Another form of transaction is the deferred-payment sale, where an asset is purchased from and resold to the same person, the difference in the two prices involving a predetermined profit. There are also money-market instruments or inter-bank instruments where the rate will be based on the profitability of the borrowing bank.

I now would like to try to see how all of this fits with the banking system in the United States. The first issue encountered is whether these transactions are "banking" within the definitions of our statutes. In the United States, banks are one of the few types of corporate entities that have separate charters and limited powers. There is the often told story of how Alexander Hamilton founded the Bank of New York, receiving a charter from the New York legislature. Aaron Burr wanted also to establish a bank but could not get a charter. Burr ultimately sought a charter for a water company and snuck in a reference to banking. That bank is now the Chase Manhattan Bank. Aaron Burr later killed Alexander Hamilton in a duel in New Jersey. At the Chase Bank you can find two reminders of this, the dueling pistols and a piece of the wooden water pipe of the original Manhattan Company. [I could be facetious and say that the early Manhattan Bank was quite liquid, but I will not do so. Neither will I comment that competition has become more gentlemanly.]

History aside, the relevance here is that banks are limited to banking as defined in the relevant Federal or State law. For example, the powers permitted a New York State-chartered bank are defined in the New York Banking Law and for a national bank in the National Bank Act.

In addition, in order to establish a branch, a foreign bank must be engaged in banking activities usually in connection with the business of banking in the country in which it is located. (12 U.S.C. Section 3101(7).) The Board of Governors of the Federal Reserve System has defined this to mean that foreign banks must: (1) be foreign chartered, (2) engage in the business of banking, (3) be recognized by the bank supervisory or monetary authority of its home country, (4) receive deposits to a substantial extent in the regular course of its business, and (5) have the power to accept demand deposits. Therefore, in order to establish a branch in the United States, the foreign bank must meet that definition. If it does not do so, it would not be able to establish a banking branch. But that would not be the end of the inquiry. It may well be that the Islamic bank is something in the nature of an investment company and might come under the jurisdiction of the Securities and Exchange Commission as an investment company.

If the desire is to charter a domestic bank, then what will need to be done is to explore the proposed activities of the proposed Islamic bank to ensure that they are consistent with the relevant banking law. Activities such as repurchase agreements and financial lease transactions may well be appropriate activities. Taking equity investments might be impermissible depending on the bank's ownership structure and whether there is a need for Federal deposit insurance.

On the liability side, it is not clear to me that an account where the return is measured in a way that could result in a loss of the paid in principal amount is not a deposit. I have come across references to some accounts offered in New York State where the return of the full amount of principal was not deemed to be a necessary feature of a deposit.

Another issue to be considered is how our usual supervisory tools would be applied to an Islamic bank. Bank supervisors' first concern is with safety and soundness and systemic risk. Systemic risk concerns the impact of the financial failure of an organization on other financial organizations and on financial markets and ultimately on the real economy. Safety and soundness concerns whether the institution is being operated with appropriate controls and limits and is otherwise in compliance with relevant laws and regulations. A good deal of the process is supervisory that is qualitative, not regulatory that is prescriptive. What I mean by that is that it involves an assessment by bank examiners of the financial strength and managerial controls of the bank. This is done in a "hands on" way by examiners looking at the bank's systems, books, and records on site and assessing the quality of its management. In addition, we rely on reports of the bank which are issued quarterly and made public to allow the public -- investors, depositors and counterparties -- to assess the creditworthiness and risk profile of the bank. Another issue to be considered is the bank's liquidity management. The examiners will need to assure themselves that the bank has sufficient liquid assets to repay claims on the bank. Of course, another issue will be whether the examiners' traditional tools of assessing capital adequacy can be applied to a bank engaged in Islamic banking.

There may be questions of accounting. I do not have any knowledge or information on Islamic accounting. The one article I did come across was somewhat over my head.

Another area which I cannot explore today is extent to which a particular arrangement resembles a mutual fund where the investors money is pooled into investments that meet Islamic requirements. It seems to me that this fits within our traditional notion of a mutual fund. Many mutual funds target certain types of investments. This does not strike me as a complex issue, although, I need to remind you that I am a simple central banker and not a securities regulator.

Where does all of this lead us? I would like to come full circle. I have enjoyed preparing for this presentation because it opened new windows of the world to me. I had an elementary understanding of Islamic banking when I started to prepare for this talk. I have learned much and indeed have much more to learn. The primary message that I want you to take with you today is that as bank supervisors we have an open mind on how to approach any issues you may raise. Islamic bankers have been quite ingenious in developing financial transactions that suit their needs: we bank supervisors, too, can be ingenious and will want to work with any of you should you decide that you want to engage in Islamic banking in the United States. That is not to say that all issues can be resolved to your satisfaction. But our doors are open; indeed, that is the American way. Again, thank you very much for your kind invitation to address you this morning. I hope that your program is as informative to you as it has been instructive for me.
