



**"Religion-Regulation Mismatch 2.0": A Doctrinal Challenge  
for Islamic Banking Raised by Global Trends of Macroprudential Regulation**

*Etsuaki Yoshida\**

Waseda University

**Abstract:**

This paper describes possible “risk” of a mismatch between global trends of macroprudential regulation and religious values of Islam.

The financial authorities and international organizations cooperated, after the global financial crisis, to cope with risks that the financial crisis may hit the world again. They have sought for stability, using various types of measures, including macroprudential regulations on financial systems.

The increasing trend of macroprudential regulations is of course essential for maintaining stability in the financial system. One notable trend among them is regulations to segregate simple banking operations of deposit and lending from equity investment and other different types of risk, as seen in the Dodd-Frank Act in the US and the retail ring fence regulation in the UK. This trend heads for the opposite direction that the Islamic financial industry is aiming at, in the sense that the industry shows some signs of development of equity-based transactions, which is more desirable in terms of *Shariah*. Islamic private equity funds, venture capital, and crowdfunding are good examples.

A financial authority may face the difficulty of choosing a policy option, under the situation of trade-off. If the industry is required to set up a different entity, it will be a big cost.

In order to achieve well-balanced choice of the policy, more discussion among regulators, academic scholars, *Shariah* scholars, and practitioners should be made to develop the industry toward the direction of *Maqasid al-Shariah*.

**Keywords:**

Macroprudential regulation, Islamic economics and finance, Equity, Dodd-Frank Act, Retail ring fence

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\* E-mail: [yetsuaki@gmail.com](mailto:yetsuaki@gmail.com) / [yetsuaki@aoni.waseda.jp](mailto:yetsuaki@aoni.waseda.jp)  
Address: Center for Finance Research, Waseda University  
1-4-1 Nihon-bashi, Chuo-ku, Tokyo, Japan 103-0027

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1. Introduction: Islamic Finance and Macroprudence

Islamic finance has enjoyed stable growth so far, although we witnessed significant negative impact due to the global financial crisis in 2008 and after. The financial authorities and international organizations cooperated to cope with risks that the financial crisis may hit the world again. They have sought for financial stability, using various types of measures, including macroprudential regulations on financial systems. The overall situation looks improved by these measures. Also, stability in the overall (conventional) financial system is positive for stable growth of the Islamic financial markets.

However, as the macroprudential regulatory measures are globally enriched, there is emerging “risk” of inhibiting sound growth of the Islamic financial markets. This paper intends to raise a question on this point.

In the first place, “macroprudence” or “macroprudential regulation” is relatively a new concept, and it is more so in the field of Islamic finance. Although there are many pieces on microprudence of Islamic banks, such as Errico and Farahbaksh (1998), Chapra and Khan (2000), and Sundararajan and Errico (2002) to name just a few, papers on “macro” is hardly found. “Google Scholar” gives no results, when searched under “macroprudence & Islamic” and “macroprudential & Islamic”. Under these circumstances, Arvai et al. (2014) covers overall macroprudential regulations in the GCC region, but it only refers to Islamic banking as part of the banking system; it does not discuss specific features of macroprudential regulation on Islamic banking activities.

Hence, this paper attempts to argue a new area of research according to the conference theme.

2. Desirable direction of development of Islamic finance

2-1. Historical development of Islamic financial products

The practice of contemporary Islamic Finance enjoys tremendous growth since its inception, with establishment of Dubai Islamic Bank in 1975. The current market size is estimated around 2 trillion USD or more. It also shows geographical spread, not just within the Middle East and Southeast Asia, but also to emerging economies such as South Asia, CIS region and Africa, and even to Muslim-minority countries such as the United Kingdom, Singapore, Luxembourg, France, Japan, Hong Kong, South Africa and so forth.

On the product front, practitioners in the financial industry have developed various types of Islamic products, and now it is not too much to say that the product suite of Islamic finance is roughly similar to that of the conventional equivalent. It has continued to evolve, mainly in the direction of realizing the same function with conventional instruments, by skillful arrangement of financial and legal techniques.

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Figure 1 shows the brief history of product development of Islamic finance in a chronological order.



(Figure 1) Chronological development of major Islamic financial products

Year	Content [Main Area of Product Development]
1950-63	Prototypes of financial institutions [South Asia, Egypt, Malaysia]
1975-79	Genuine practice of banking activity [Middle East, North Africa]
1979	<i>Takaful</i> [Sudan]
1986-93	Equity funds [US, Singapore, South Africa, etc.]
1990	<i>Sukuk</i> [Malaysia]
1994	Project finance (non- or limited-recourse financing) [Pakistan]
2005	Securitized (residential mortgage-backed) product [Malaysia]
2006	Exchange-traded fund (ETF) [Turkey]
2006	Derivatives (profit-rate swap) [UAE, Malaysia]

Source: collated by the author using various sources<sup>1</sup>

## 2-2. Critiques by academicians

Although the Islamic finance industry has shown remarkable growth as sketched in the previous section, the current situation is not necessarily welcomed by Islamic economists (in this paper, the definition of "Islamic Economists" and "Islamic Economics" are simply scholars that deal with economic issues in consideration of religious values of Islam, and academic approach by them, respec-

<sup>1</sup> For prototypes of Islamic financial institutions and Islamic banks in the industry's incipient stage, see (Wilson 1983; Ali 2000; Lewis and Algaoud 2001) as major sources of information. Comprehensive history of Islamic finance, including financial products, is depicted in the literature of Iqbal and Molyneux (2005), including *Takaful* and *Sukuk*. For Islamic equity investment funds, Al-Rifai (1999) is of use. Dar (ed.) (2010) provides information on the first Islamic project finance, while details of Islamic RMBS is written in Leong (2014). Diaw et al. (2010) is a good reference on Islamic ETF, while Askari et al. (2010) refers to development of Islamic derivative products.

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tively). There is wide agreement among them that the majority of Islamic financial markets, or assets, should not be occupied by debt-based transactions, such as *murabaha* and *ijara*, as it actually is today. This tendency is concisely represented by the phrase, "Murabaha Syndrome", a terminology by Tarik M. Yousef (2004).

On top of that, Chapra (2007) argues that the share of equity-based transactions should increase in the current financial system, while that of the debt-based ones should decrease substantially. El-Gamal (2003) described the current situation as "Islamic finance quickly turned to mimicking the interest-based conventional finance". In addition, Hamoudi (2007) called the current situation as "Jurisprudential Schizophrenia" and De Lorenzo (2007) bantered it as "Shariah-conversion technology". Ahmed (2011) observed the situation in a more objective manner, saying "Contemporary practice of Islamic finance has been criticized for not fulfilling the *maqasid*".

These opinions can be summarized that principles of Islam prefer "equity-based" transactions to "debt-based" ones. Nagaoka (2012) called this widespread preference among Islamic economists as "mudaraba consensus". The original and major supporters of this idea were economists such as Umer Chapra, Nejatullah Siddiqi and Osman Ahmed, who were called as the "Jeddah School" by Zubair Hasan (2005).

Figure 1 showed the development of Islamic financial products and this is the achievement by tremendous amount of efforts and knowledge of people involved. However, from the viewpoint of Islamic economists, the direction of this development is not heading toward pursuing the objective of the religion, or *maqasid al-Shariah*. Actually, GIFF (2012) indicates that 93.4% of Islamic financial assets is debt-based. Such being the case, practitioners (and some other economists) tend to consider that their idea on product development as above is natural, implying that equity-based financial system, which Islamic economists prefers, is not realistic. Gainor (2000) describes this recognition in a very concise manner. "Much of the research and development that has worked its way into existing products in the marketplace has been generated from adapting conventional products. It may follow that if a product was successful in the conventional marketplace, then if successfully engineered as to not be inconsistent with Islamic Sharia, it should be successful in the Islamic marketplace." In short, Islam theoretically prefers development of equity-based financial transactions, whatever practitioners think for their profit-making.

### 3. Global Trend of Macroprudential Regulation

#### 3-1. Overview of macroprudential regulation

The definition of the term "macroprudence" is not necessarily rigid and not widely accepted even among the regulators' community. However, many will agree that macroprudence is "to maintain stability of the comprehensive financial

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system in a jurisdiction by implementing policy measures against risks affecting the whole financial system". Or, others are more persuaded by saying that macro-prudence is an antonym of more usual "microprudence" that refers to stability of one financial institution. The terminology became well-known in the period of the global financial crisis after the Lehman Shock in 2008, although the word was already there in 1970's according to the Bank for International Settlement (BIS).

Figure 2 shows salient features of macroprudence in comparison with micro-prudence.

(Figure 2) Comparison of macroprudential and microprudential policies

	Macroprudential policy	Microprudential policy
Short-term objective	Preventing financial crisis to expand	Avoiding default of a financial institution
Long-term goal	Preventing negative effects on stable economic growth	Protecting investors and depositors
Risk nature	Result of collective behaviors of financial institutions	Result of behaviors of one financial institution
Corr. & common exposure among FI's	Important	Not considered predominantly
Direction of prudential control	Top-down: controlling systemic and related risk	Bottom-up: checking risks in individual financial institution

Source: arranged by the author using Borio (2003)

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Major policy measures for macroprudential stability usually taken by financial authorities are shown in Figure 3.

(Figure 3) Major macroprudential policy measures and countries introduced

	examples	advanced countries	emerging countries
Loan to Value (LTV) / Debt to Income (DTI)	Establishing a cap on LTV/DTI ratios	2	9
Credit limit	Capping amount of new loans, growth rate of a specific sector	-	4
Leverage	Total asset / equity capital	2	2
Concentration limits	Capping amount on interbank transaction loans	1	2
Capital	Buffers on variable capital / restrictions on outside distribution	1	1
Provisioning	Variable provisioning	1	1
Liquidity requirements	Loans to Deposits, reserve requirement	1	8
Foreign Currency	Limit on open position	-	8

Source: arranged by the author using CGFS (2010)

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3-2. Recent trend and implication to Islamic finance

Among these measures, one outstanding trend in recent years is to segregate business investment risk from deposit-loan operations of a bank, which is a fundamental business of a banking institution. This is, for example, seen in (1) the "Volcker Rule", as stipulated in the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was established on July 21, 2010 in the United States, and (2) the idea of the "retail ring-fence" regulation in the United Kingdom as a proposal of the Independent Commission on Banking headed by Sir John Vickers.

The Dodd-Frank Act in the US prohibits deposit-taking banks from principal investment (equity investment on their own), investment into hedge fund and private equity fund, to eliminate those business and market risk. Retail ring-fence in the UK is more radical. It allows a ring-fenced bank only limited area of banking business: deposit, lending, and settlement, and others are prohibited (ICB 2011).

At the moment, the author understands there is no such macroprudential regulation in Muslim-majority countries. However, if the trend of segregation of equity-based operations from a bank becomes one of the policy options that a regulator in a Muslim-majority country must take, it will cause a big issue. The next section discusses this in detail.

4. Religion-Regulation Mismatch 2.0

4-1. "Religion-regulation mismatch 2.0": A doctrinal challenge

The previous two sections discussed equity-preference nature of Islamic finance and global development of macroprudential regulations. However, it is difficult to achieve these two objectives concurrently. If financial institutions must segregate investment functions from their main entities and must establish a subsidiary according to macroprudential regulations, there will be less efficiency which will give negative impacts on fostering equity-based financial system. In this sense, there is a mismatch between the direction of religious pursuit and one of the trends of macroprudential regulation.

The author observes this possible situation as "Religion-Regulation Mismatch 2.0". The first version of the religion-regulation mismatch is regarding *riba*. The current financial system largely depends on interest rate-based deals, and the interest-bearing nature of lending is usually eliminated by structuring asset-related financing mainly in the form of *murabaha*, *ijara* and *istisna'a*. Sometimes, existing legal systems in many jurisdictions face a difficulty of including asset-related financing transactions in their "financial activities" of banks. This issue of the "religion-regulation mismatch 1.0" was obvious in countries like USA, Singapore and Japan. The authorities successfully arranged appropriate legal measures in order to include Islamic "non-financial activities" into their financial system.

The "religion-regulation mismatch 2.0" is more difficult. It will work as a trade-off. At the moment, the problem is not big because the degree of the devel-



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Development of Islamic finance is still immature and equity-based transactions is still a very small portion of the whole Islamic financial system. On the other hand, financial stability is the very first thing that the financial authorities would pursue to maintain, and hence, there are possibilities that segregation of equity-based assets from banks will be imposed on banks in Islamic countries.

In this sense, the global regulatory trend will surely cast a doctrinal challenge upon policy-makers and practitioners of Islamic finance. The section 4-3 argues this point with some hypothetical allocation of two dimensions, i.e., pursuit of religious values and financial stability.

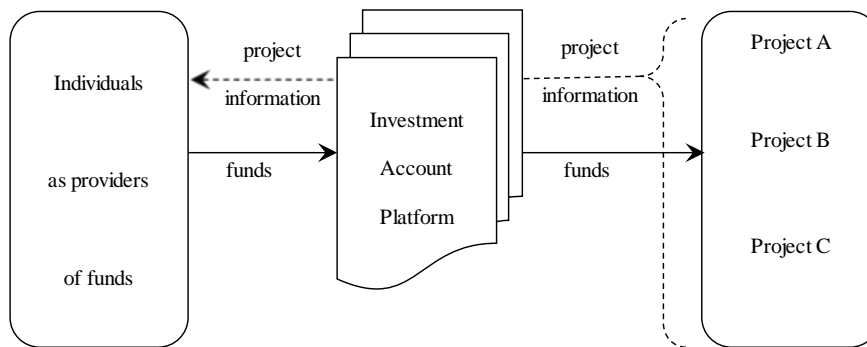
#### 4-2. Growth of equity-based Islamic financial transactions

While the regulatory trend is in the direction of possible segregation of banks from equity investments, roughly two types of equity-based transactions in the Islamic financial industry are showing signs of growth.

One is equity investment/ investment funds. Bank Negara Malaysia (2014b) expects stable growth of Islamic private equity funds and venture capital. Given the overall agreement that equity is more preferable than debt in Islamic finance, as well as general industrial policy to promote SMEs and start-ups, this increasing interest in private equity is something that should be more welcomed by Muslim bankers and recipients of financial services.

The other is crowdfunding. It is, though there is no official definition, "fund-raising mechanism from the public, mainly many and unspecified individuals, or "crowd", using internet-based platform with specified information on the usage of funds raised". Although crowdfunding has mainly four kinds of fund provision, i.e., equity investment, loans, reward (e.g. manufactured products) and donation, there are expectations, among practitioners, that equity-based one will be essential because it is in line with the teaching of Shariah, as discussed earlier in this paper as "mudaraba consensus". There are at least three Islamic crowdfunding platforms, two in Egypt (Gabr 2013, Siddiqui 2013) and one in Singapore. The idea of this fund mobilization mechanism is now being put forward by Bank Negara Malaysia (BNM). BNM in its report showed a direction of introducing this mechanism by banks as one of financing mechanism to promote business (BNM 2014a). The mechanism is called "Investment Account Platform", the idea of which is same as crowdfunding. Figure 4 shows the modus operandi of it.

(Figure 4) Concept of Investment Account Platform by BNM



Source: Author's own based on BNM (2014)

#### 4-3. Some combinations of two dimensions

Let's just consider what will happen when a Muslim-majority country faces this issue. Given this is a trade-off, the authority will must choose one of the following.

##### (a) No segregation – pursuing religious values of equity-based financing

This policy option may be appropriate when the portion of equity business is not large enough to be a threat of a big loss for a bank. In many countries, the current situation of the banking sector may be categorized as this group. If this is the case, the authority must keep an eye on when to implement the segregation policy, based on the development of the financial sector, which means growth of equity-based business.

##### (b) Implement segregation – leaving promotion of equity-based financing alone

For some authorities, this may be the option to take. Also, there may be an opinion that regulators are “defender” of a financial system, not of Shariah. However, people must consider if it is a right attitude. Regulators may want to maintain and promote their Islamic financial markets, not just for business, but for the people's religious comfort. Some may think bankers just need to set up different entities and they are the same as a financial holdings group, but this idea lacks cost-effectiveness. To have and maintain a separate entity requires too much indirect costs.

Regulators may prepare exceptions for Islamic banks, keeping investment business under a bank. But, the different treatment on similar banking services may raise debates among practitioners as competitors.

## 5. Conclusion and prospects

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This paper pointed out that the global trend of segregation of investment-related financial activities from a bank, as seen in the Volcker Rule in the US and retail ring-fence regulation in the UK, will collide with the fundamental doctrine of Islam that puts emphasis on profit/loss sharing and providing equity-type of funds for business promotion.

When constructing a macroprudential regulatory framework for (or including) Islamic banks in a country, each authority must consider and face sincerely with this trade-off. No authority should make light of possible regulatory limitation of investment activities by banks, as it may give negative effects on financial stability. But, no authority should just follow the trend of the limited-banking regulatory framework, as it will deter the Islamic financial industry from developing in a religiously-desirable direction.

More discussion among regulators, academic scholars, Shariah scholars, practitioners should be made in order to develop the industry toward the direction, not just of growth in size and profits, but of *maqasid al-Shariah*.

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