Dubai Financial Services Authority

THE DFSA'S APPROACH TO REGULATING ISLAMIC FINANCE IN THE DIFC

The Dubai International Financial Centre (the DIFC) is a financial free zone in the Emirate of Dubai, part of the United Arab Emirates (UAE). It has its own legal and regulatory system, based on common law, its own civil and commercial Courts, and its own financial services regulator, the Dubai Financial Services Authority (DFSA). In this article, I explain how the DFSA created a regulatory regime for Islamic finance, and the challenges it faces in keeping that regime up to date with such a rapidly developing area of financial services.

The federal law under which the DIFC is established provides that within the Centre the normal civil and commercial laws of the UAE do not apply. That means that the DIFC has had to create its own legal regime (including, for example, Companies Law and Employment Law), and of course its own laws and rules for financial services. The significance of this is that we had to think through from scratch what kind of regulatory regime we should create for Islamic finance.

There were three important factors that drove our decisions:

- We are a risk-based regulator. That means that we try to align our laws and rules, as well as our supervisory practice, to the actual risks posed by the business in question. A corollary of this is that similar risks should be treated similarly. So where the risks in Islamic and conventional finance really are similar, then similar rules should apply. But of course a regulator needs a substantial knowledge of Islamic finance to know when the risks are similar, and where they are subtly different.

- We offer world-class regulation based on international best practice and experience. So we will always look at the relevant international standards, which for Islamic finance are those of the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). We are active members of both bodies, helping to shape the standards as well as implement them. But business models in Islamic finance continue to develop rapidly, standards are being created year by year, and there are still important gaps. So we cannot simply implement a full suite of standards that many regulators have implemented before.

- The third factor is the character of the Centre. It is an international centre and, largely, a wholesale one. This means that most customers of DIFC firms will be either other businesses or high net worth individuals. Some issues concerned with the retail market will therefore be less important for us; for example, it is difficult to see the DIFC becoming a centre for microfinance. On the other hand, as an international centre, we have businesses from many countries operating here. Where we can, we should offer them an international framework, rather than one that is tailored to the needs of a specific national market.

So we made some fundamental decisions early on to allow a great deal of flexibility. We allow the use of Islamic windows as well as pure Islamic firms, and we do not prescribe the contract forms that must be used for particular types of transaction.

The most important decision was about Shari'a governance. Although there are regulators in some countries who believe they should play no part in anything with a religious dimension, when a firm or product claims to be Islamic, that is a very significant representation it makes to its customers, and we believe that regulators cannot simply ignore that claim. Other regulators make themselves the arbiters of Shari'a matters, typically by establishing their own Shari'a Council as the effective authority within their area of responsibility. That has the advantage of securing uniform interpretation locally, but in a world where there is no overall consensus – and if there were, a Shari'a Council would probably not be necessary – it does risk solidifying divisions along national lines.

In a centre where both firms and customers are international, we decided to be a Shari'a systems regulator. This means that any firm that claims to be Islamic must have a Shari'a Supervisory Board (SSB) made up of competent scholars. It must have systems and controls to implement the SSB's rulings, and must have annual Shari'a reviews and audits, following AAOIFI standards. It must also disclose details of its SSB to its customers, allowing them to make their own decisions about the reliance they are prepared to place on its rulings. As an active regulator, whose staff are well-experienced in evaluating systems and controls, we supervise to ensure that these arrangements are working in practice as well as on paper.

We believe, incidentally, that this is a model well-suited to many Muslim-minority jurisdictions, where regulators would balk at arbitrating on religious matters, because it places the onus of compliance on the firm, and transforms the problem into one of systems and controls.

The next question we had to consider was the prudential regime for Islamic firms, particularly how much capital they need to hold. For Islamic banks, we have drawn on the standards of the IFSB. In particular, we have recognised the concept of Displaced Commercial Risk (DCR) for Profit Sharing Investment Accounts (PSIAs).

In principle, PSIAs are investment accounts, in which the investors bear risk to both principal and return. In practice, they are often offered as an alternative to a conventional interest-bearing deposit account, and it is not always clear that banks' customers understand the risks to which in principle they are exposed. Even if they do, many PSIAs share the basic problem of banking: maturity transformation. Fundamentally, the customers can withdraw their money faster than the bank can recover its loans or realise its investments. This creates pressure on the bank to maintain returns at market-competitive rates, even where it is not obliged to do so – so-called Displaced Commercial Risk (DCR).

The IFSB standards recognise this through a variable parameter (ά), which allows regulators to set a capital requirement for PSIAs at any level up to that which would be applicable to deposits, and on a similar basis of calculation. We set ά relatively low, at 35%, reflecting the relatively sophisticated market I have already mentioned. We have also used the IFSB standards to give guidance on the treatment of Islamic instruments, even where they are held by conventional firms.

For Takaful, although we included provisions on the treatment of Islamic instruments and Zakat, when we drafted our regime there were no international standards available. Indeed, at that time the business models of Takaful companies had not yet settled into a clear pattern. However, we have extensive powers to waive or modify our Rules in particular cases, and have used them to recognise properly the typical structure of a modern Takaful company, which involves one or more pools of money which are considered to belong to policyholders, within a shareholder company. In this area, the IFSB has issued a draft standard, in the preparation of which we have been heavily involved. This is aligned with the standards for conventional insurance which are emerging from the IAIS, and we may well implement both at the same time.

We have also implemented a set of disclosures specific to Islamic finance, in addition to those about the SSB. For example, a Takaful company has to disclose the basis on which any surplus in the Takaful fund will be shared; a bank managing a PSIA must disclose how profit is allocated between the bank and the client. Again, these disclosures largely follow standards from the IFSB and AAOIFI.

There are also specific rules for Islamic funds and for Sukuk. In both cases these are reasonably straightforward, and relate mainly to Shari's governance.

We have recently restructured our Rulebook to group more of the material relating to Islamic finance in one place, and we have also, through our website, made available tailored Islamic finance handbooks so that firms undertaking Islamic finance business in a number of areas can see quickly all the rules that apply to them.

For the future, we see a number of challenges for regulators. One will be to keep up with the development of standards, both conventional and Islamic. The financial crisis has spurred the development of new standards in conventional finance, and Islamic finance will need to respond. To give just one example among many, the Basel Committee is consulting on new standards on liquidity and stress-testing. Regulators of Islamic finance will need to consider their response, and in fact the IFSB is working on standards of its own. But standards are no use unless they are implemented, and we are also seeing new international pressure for standards implementation. So any regulator will have a sustained challenge to implement new standards. In Islamic finance the challenge will be greater because of the relative novelty and complexity of this area.

Second, regulators will need to keep up with the continuing rapid development of the business itself. New models and structures are constantly being proposed and tested in the market, and it is unclear which of them will survive. For example, the range of possible Sukuk structures is enormous and their economic characteristics, and hence the regulatory risks, are not necessarily specified by the principal contract involved. For example, it is possible to have a Mudarabah Sukuk which, economically, looks very like a conventional debt instrument, or one which looks like a collective investment fund, or one which looks like an equity. Although in practice most Sukuk have been structured to resemble debt instruments, it is possible that future Sukuk will have more elements of genuine asset, rather than counterparty, risk and so need different market disclosures. In another area, there is a constant search for short-term liquidity management instruments not based on Commodity Murabahah, and should a new structure become an industry standard, regulators will need to consider what risks it poses.

Third, the whole industry faces the challenge of how to deliver Shari'a governance as it grows. There are at least two sets of issues here. One is the relatively straightforward one that in an industry with more firms, and larger firms, a governance regime in which an SSB has to sign off on each new structure, transaction or product implies a requirement for more scholars, while the training and development of new scholars is a long process. The second, related, set of issues is that the existing governance and review standards were drafted with Islamic banks mainly in mind. But the industry now has a wide variety of firms and for the intermediary sector – brokers, advisers, etc – which is generally characterised by smaller firm sizes, the full burden of the standard Shari'a governance structures may impose transaction costs which inhibit the ability to compete with the conventional industry, and which may not be justified by the volume and complexity of the Shari'a decisions that need to be made. Most likely, these problems will not be solved by one means alone. We are already seeing changes in the Shari'a advisory industry, whose effect is both to shift some of the burden away from the most senior scholars and to provide a better development path for new scholars. Another means is the development of industry standards to reduce the need for individual transaction approvals. Standard documentation structures are one example, but standard Shari'a screens for equity investments are another. A third may be the development of new governance standards. Regulators will have their part to play in these developments, which will be essential if the industry is to grow at anything like its recent speed.

The DFSA believes that the DIFC has some unique advantages as a centre for Islamic finance, and is determined to do what it can, as a regulator, to help the industry to grow with confidence.

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