Address by Simon Gray, Director - Supervision

How to regulate Islamic Financial Markets and Products

Clare College, Cambridge

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Case study: the DFSA approach to regulating Islamic finance (fostering a conducive regulatory environment)

- The principles of Islamic Finance
- Product innovation and divergent views
- Learning from the DIFC / DFSA experience
- A shari'a system based approach
- Outreach and training
- Islamic windows and wholly Islamic Financial institutions
- Recent changes to the DFSA's Islamic finance and funds regime
- Regulatory issues in capital markets

(Salutation and introduction to topic)

Introduction – slide 1

> Oh, *East is East and West is West, and never the twain shall meet,*
> *Till Earth and Sky stand presently at God's great Judgement Seat;*
> *But there is neither East nor West, Border, nor Breed, nor Birth,*
> *When two strong men stand face to face, tho' they come from the ends of the earth!*
>
> Rudyard Kipling, The Ballad of East and West - 1895

I am pleased to have been invited here today to speak at this Forum. It is perhaps appropriate for me to speak in the context of our work in Dubai – the location of the world's first Islamic commercial bank[i] and now home to the worlds largest Sukuk market[ii]. And I have great pleasure to speak on behalf of the DFSA and the DIFC to share with you our approach to the regulation of Islamic Finance. I believe it to be a practical approach but I appreciate that such a judgement is perhaps best made by you as industry practitioners.

Slides 2 and 3 (context – DIFC before and after)

The principles of Islamic Finance

The first part of my talk today sets out the basic principles of Islamic finance and their application. This provides a useful introduction into the DIFC / DFSA experience as we have managed to fuse the conventional with the Islamic without, I think, prejudicing either – rather using our *systems based approach* to acknowledge how they can effectively complement one another.

It is important to note that the Shari'a is not a codified system but rather a set of core principles which are open to interpretation. This interpretive approach leads to some very divergent opinions which we were alert to when engineering our DFSA regime. However, from a regulatory point of view the most important starting point is to accept that the basic precepts of conventional financial markets regulation apply with *equal* force to Islamic financial markets.

That proposition has to be tested because it will impact fundamentally on the approach that Governments and regulators take as these markets extend their influence and reach.

Of course, the main principles of Islamic Finance are found in various prohibitions and these include the taking of interest, or riba, with Islamic banking being intolerant of the notion of a risk free reward for return. The other haram, or banned, principles cover uncertainty of contract (gharar); gambling (quimar) and games involving speculation (maysir), as well as unethical investments and unfairness or unjust gain at the expense of the other party.

However, if you focus on the key philosophies that differentiate conventional and Islamic financial markets then you may well reach the wrong conclusion. If one takes these prohibitions together then this may suggest that the regulatory building blocks for regulating Islamic finance need to be different from those used for conventional regulation. I think that is wrong.

The principles that underpin conventional markets regulation are primarily designed to ensure that financial firms are able to deliver upon their promises. These may take the form of promises to indemnify policy holders against loss; or to repay investors or depositors upon particular terms agreed at the time of contract formation. Principles and standards have been developed by Basle (to reflect the characteristics of banking promises); by the IAIS (to reflect the characteristics of insurance promises); and by IOSCO (to reflect the characteristics of capital markets promises). Of course, regulation also extends beyond the assurance of promises, most obviously in the securities sector where integrity of the secondary market is a key policy objective. But, in the main, financial services regulation has developed to mitigate

against the instability caused to a financial system when financial firms fail to honour their promises.

This should be the common starting point for all forms of financial services regulation, be they conventional or Islamic; because, although the particular terms of promise may differ, reflecting the special structural features of Islamic products, the underlying character of those promises and the consequences of their failure, are the same.

Accordingly, while regulatory rules will need some supplementation to accommodate areas of difference, the international standards already governing conventional finance should be adopted as the cornerstone for Islamic finance regulation. Organizations like the IFSB and AAOIFI play an important role in dealing with issues of supplementation, but should avoid duplicating or altering existing standards that can apply equally across both conventional and Islamic sectors. To do otherwise will add to industry's compliance burden, constrain cross border product flows, and hinder the acceptance of Islamic finance products as an integral part of the world's capital markets.

It follows that when considering how regulators might best adopt a practical approach to Islamic financial services regulation we should start with the conventional market. If we identify the core issues in that market, we can then deal with any supplemental issues arising in the Islamic finance context. This is the same approach we have adopted at the DFSA and it seems to be working well.

Product innovation and divergent views

Of these prohibitions already mentioned, I wish to spend a little time discussing the issue of certainty which then feeds neatly into the concept of gambling and speculation. This is significant given the pace of product innovation and the often divergent views held amongst different Islamic scholars.

A contract lacking in certainty poses problems for conventional contracts of insurance which presupposes payment of compensation for an event that may happen but which people rather hope will never happen. This will be contrary to the Shari'a as the trigger event for payout is not guaranteed and indeed the actual amount of compensation payable bears no predictable relationship with the amount paid by way of premium. However, insurance is of course a good thing and is actually a legal requirement in some cases and so the Shari'a compliant solution is to use Takaful which means mutual or joint guarantee. Takaful is different from conventional insurance as it uses the concepts of solidarity and co-operation with both parties agreeing mutually to share both losses by making periodic donations with

the right to share in any surplus profits. Of course, I fully accept that Takaful is not a subject that one might normally associate with esoteric financial instruments such as structured products but I think this example has relevance in the context of some Scholars taking an increasingly flexible approach in their interpretation of more complex financial instruments. There is of course still some way to go and some financial instruments may remain off limits for some time – but the sign of this flexibility is proving most welcome to investment bankers involved in product design.

Contracts entered for purely speculative purposes will be void. However, it is important to make clear that this ban does not exclude general commercial speculation where there is a risk of incurring losses as well as earning profits – the test is one of making a gain via chance rather than the use of productive effort. This prohibition on speculation can lead to complications where firms are using financial derivatives – especially where there may be no physical delivery. Lack of physical delivery will be banned – however, there are certain Islamic products which have characteristics not dissimilar to conventional derivatives: for example, Salam, Istisna'a and Arbun but each of these products anticipate physical delivery. In terms of certain strategies used by hedge funds, such as the long / short strategy, it is likely that this subject will continue to exercise the minds of both alternative asset managers and Shari'a scholars for some time to come.

The ban on unethical investments is actually very similar to investment restrictions imposed on conventional financial products either at a fund level or indeed demanded at an investor level. For example, the Shari'a prohibits a number of activities including gambling, armaments, alcohol and pornography. However, depending on which Shari'a Scholar you speak with, you will get some differing views – for example, some might argue that either an airline or a hotel which happens to serve alcohol would still be acceptable as an investment using the approach of proportionality – after all what is the real purpose of those entities – they are to allow people to stay there or to fly from "a" to "b". Others might argue a more purest interpretation. This is not dissimilar to the use of ethical fund management in conventional finance – personally, I would *not* ban investing in a certain supermarket just because they sell alcohol or tobacco.

Of course product innovation comes about via demand, - demands close ally - opportunity and the response to opportunity - endeavour and this goes beyond coping with prohibitions. In this sense one must also discuss potential legal and tax impediments to Islamic Finance as a benign tax and legal regime can also help foster a conducive environment for Islamic finance.

In respect of the legal implications of Islamic Finance, it is important to have a sound legal structure which provides clarity of obligations and certainty in dealings. The Middle East is a predominantly Civil Law jurisdiction in contrast with the key capital markets which tend to have common law legal structures. The DIFC has also implemented a common law system, based on English common law (and where silent, the law of New York State) which provides a sound legal system and enforcement structure to ensure that commercial parties have adequate obligations and protections in all commercial transactions – once again we have sought to remove an impediment to the growth of Islamic Finance.

A specific issue in respect of Islamic Finance, which has become exacerbated by the international nature of sukuk offerings, is the need to standardise legal documentation. In an industry which depends on innovation and expeditious delivery of new products to the market, delays caused by ensuring Shari'a consistency and approvals continues to be an impediment to the industry. The industry needs a more practical approach to such issues.

In respect of the tax challenges which are commonly debated in the context of, for example, sukuks, coming from a jurisdiction whose tax rate is zero, there are few taxation related impediments in the GCC countries, and more specifically within the DIFC. Long may this continue!

However, the impediments which certain tax regimes can pose to Islamic Finance is well documented and I am conscious that there are those far more qualified than I am to discuss such matters. However, I would argue that a benign and non prejudicial tax regime is a core aspect of adopting a practical and conducive approach to Islamic financial services regulation.

The application of tax regimes should be on par with conventional financial products, Islamic capital market products (and general Islamic products) should not be disadvantaged as a result of the legal mechanism that are required to give full effect to a transaction. Changes have already been seen in the UK which has brought Islamic products in line with the tax treatment for conventional products, including the recent announcement during the UK budget in March 2007 where Sukuks have also been brought into the comparable tax regime. This is timely and most welcome.

Learning from the DIFC / DFSA experience

Slide 4 - Filling the gap

Let me begin with a description of the Dubai International Financial Centre (DIFC). As you will see Dubai sits in the enviable position of spanning east and western time zones. The

DIFC has been engineered to fill the gap between Europe and Asia. It has done so effectively and in a variety of ways and my next slide explains the core characteristics of the Centre.

Slide 5 – characteristics of the DIFC

- Onshore capital market / international standards
- Designated as a Financial Free Zone
- Foreign currency denominated / zero tax rate
- Tailor made laws for the DIFC
- No local partner requirements
- Professional and retail clients (latter since 1st July 2008)
- A *Shari'a system* approach to Islamic Finance

Slide 6 – DIFC Value Proposition

On the issue of Consultation I wish to dwell on our open approach with firms – we consult widely with our Authorised Firms but only after we have already benchmarked ideas against those operating in other jurisdictions. In addition, we are also alert to changes happening globally – just as firms are often international, it is important for regulators to respond appropriately. This is one core reason we have established Memoranda of Understandings with over 50 international regulators**.**. You may have heard of our signing an MoU with the four US Banking regulators in 2007 which have been added to an earlier one with the CFTC and our signing the IOSCO Multilateral Memoranda of Understanding gave us access to the SEC. Once again, this fits in well with our approach to fostering a conducive regulatory environment, especially as the international regulators seek solutions to avoid a repetition of the current global banking crisis.

Slide7 – structure of the DIFC

The DIFC has three core parts – the DIFC Authority which provides overall direction for the development and marketing of the DIFC. The DIFC Judicial Authority which is its own court system with DIFC laws and regulations applicable within the DIFC – effectively a quasi "state" within a state, albeit still subject to the criminal law of the UAE and lacking any form of sovereignty. And finally there is the DFSA.

First, as an introduction to the DFSA, we are the integrated regulator for the DIFC and our regime is based on IMF FSAP inspected international best practice. As an integrated regulator, we have applied our regime across all firms, including Islamic Firms on the following grounds:

1. the DFSA is a **risk based regulator** and focuses on the **risk** posed by the firm;

2. as an integrated regulator, our framework and approach is more conducive to the regulation of Islamic Finance which by its nature is cross-sectoral;
3. a degree of modification to the integrated, international standards has been made to reflect the specifics of Islamic Finance which are not ordinarily accommodated within international standards; and
4. underpinning all this is our **Shari'a systems philosophy**, whereby we prescribe the obligation for a firm to have systems and controls in place to ensure that the business is operating in accordance with Shari'a. I will expand on this subject later.

Slide 8 – About the DFSA – Significant Features

Let me now focus on the significant features of our regime. The DFSA is an independent integrated regulatory authority based on the UK's FSA model. It has statutory authority with guaranteed operational independence and funding. Its regulatory approach is based on international standards, best practices and the laws of the world's leading financial jurisdictions. Anything else would not have attracted the sorts of firms that we have within the centre. Finally, we have modelled our regime on that of the following sources – IOSCO, Basel, IAIS (we hosting the IAIS conference in 2010), FATF and the IFSB. It is a great advantage having the chance to learn from others and many of my colleagues have many years experience as both regulator and regulated.

Slide 9 – DFSA key activities

Our Approach

Our integrated, or cross-sectoral approach to regulation has many benefits and is key to our practical approach to Islamic Financial services regulation. The cornerstone of our regime is to be a risk focussed regulator. We have intentionally sought to create a level playing field in the form of our regulatory environment by applying the same set of regulations, subject to due modification, to all authorised firms regulated in the DIFC. The DFSA developed its regulatory approach on a blank piece of paper and devised its integrated risk based regime with both conventional firms and Islamic Firms in mind from the outset. We have the advantage of not having to modify legislation, or 'bolt on' Islamic Finance to an established conventional financial system. This structure provides a sound basis to address the specific features of capital markets regulation, including Shari'a compliant capital markets products.

Slide 10 – DFSA Rule making and Policy Development

Slide 11 – Prudential categories of AFs (focus on cat 5)

One issue which is often associated with Islamic Finance, is the lack of standardisation. This is a consequence of inconsistencies in respect of laws and regulation of the markets within which Islamic Finance operates and the issues which may arise as a result of the incorporation of Islamic and conventional finance into the same capital markets framework. There is also the ongoing issue of lack of commonality of Shari'a contracts and rulings.

It is this very inconsistency and indeed the divergence of Scholarly opinions that has led us to adopt our Shari'a systems based approach to Islamic regulation.

Slide 12 – Proactive approach (Outreach and preventative medicine)

The DFSA engages in a number of core activities. For example, rule making and policy development with the DFSA Board of Directors empowered to make Regulations and Rules and to develop policy. The DFSA also assists in the drafting of DIFC laws.

Our Authorisation team believes in preventative medicine – ensuring that firms are only admitted to the Centre once they satisfy a robust fitness and properness test. Authorisation is involved in the licensing and registration of Authorised Firms, Authorised Individuals and Ancillary Service Providers. Our Markets Department is responsible for the Authorised Market Institutions – for example Nasdaq Dubai and DME.

Our approach to Supervision builds on the preventative medicine approach adopted at the Authorisation stage. Once authorized, our regulatory duties continue and risk assessments take place on all firms with the scope and frequency dependent on the nature of the firms activities, its perceived risks to achieving our financial objectives. In addition, we may carry out themed reviews inspired by topical events which have both local and international relevance. A core aspect of our supervision also involves the monitoring of prudential returns.

Supervision also handles changes to scope of licenses. We feel that it would not best serve the industry if such cases did not remain with Supervision as this allows ongoing continuity of the relationship between regulator and regulated. Finally we have the Enforcement Department which has a range of powers to enforce the legislation that we administer.

One of our core initiatives at fostering a practical and conducive regulatory environment is our Outreach programme. As a relatively young regulator, the DFSA is probably far more active in the realms of Outreach and training of the industry than other regulators in more mature markets. We call this promoting public understanding. In part, we seek to fill the

absence of formal trade bodies which will of course come to the DIFC and of course informal arrangements already exist. We do this for two reasons – the first is a *selfless* motive – to help fill the void and enable firms to avoid simple errors which will hinder their regulatory growth – we call this *preventative medicine* on the grounds that where sensibly applied this can help firms avoid a costly cure later. The second reason is more *selfish* – by educating firms to avoid making errors, this not only helps them but allows us as the regulator to practice its risk based regulation better and to avoid the distraction of simple errors. We call this risk based regulation – it is principle based, practical and proportionate and I believe benefits both regulator and regulated alike. Having spent much of my working life on the receiving end of regulation, I consider this approach most attractive.

Slide 13 – DFSA and Islamic finance

A Shari'a system based approach

As a regulator it is important to identify and understand the implications of such impediments. While we may not have the remit to address all of these challenges, regulatory bodies can seek to provide an "enabling" regulatory framework in place which can seek to limit any further impediments and encourage sustainable growth in the industry.

The DIFC is a financial free zone which has enacted its own legal and regulatory structure. The legal system is based on common law and includes a specific trust regime. In respect of the regulation of Islamic Finance, the DFSA has taken steps to create an '***enabling regulatory framework*** for inter alia, the Islamic Financial Services industry by creating clearly defined, international regulatory parameters yet an environment which is conducive not only to the cross sectoral features of Islamic Finance but the pace of innovation in this industry.

The general approach in respect of regulating Islamic finance under the DFSA's approach, is to provide an integrated regulatory framework with due modification to reflect the specificities of Islamic Finance. Mindful of some of the differences in opinion in Shari'a interpretation, the DFSA has implemented a ***Shari'a systems*** approach to regulation. Islamic Firms operating in the DIFC must implement systems and controls to ensure that the firm operates in compliance with Shari'a, this includes the appointment of a Sharia Supervisory Board 'SSB', in accordance with guidance provided.

We have a specific category to cover a **wholly Islamic Financial Institution** – acknowledging this defined market. However, our regime is flexible enough to allow the use of **Islamic Windows** – effectively providing conventional financial houses with the flexibility

of continuing with what they know and do best but allowing them to also seize the opportunity arising from Islamic Finance. It is this sector where we are seeing the greatest growth and I suspect that this will continue – combining the best of all worlds and perhaps a good manifestation of East meeting West.

In addition to the obligation on firms to have Shari'a systems and controls, the DFSA requires the same degree of disclosure for Islamic transactions as we do for conventional products. Transparency and disclosure is an obligation on all authorised firms and is particularly relevant in respect of Sukuks.

Let me provide you with a specific example. The DFSA regime prescribes regulations for the offer of sukuks; and holding sukuks as investments. In this case the prudential requirements, which are based on international standards, but duly modified for Islamic Finance, will apply, including the specific risk weights prescribed for Sukuks. In respect to the offer of securities, the DFSA requires the following initial and ongoing disclosures to be made:

- details of the Sharia Supervisory Board (SSB) that has undertaken the Shari'a review for the offer;
- the opinion of the SSB as to whether the offer is Shari'a compliant;
- description of the underlying structure of the transaction;
- any applicable disclosures prescribed by AAOIFI Shari'a Standards;
- any subsequent changes to the SSB

Slide 14 –Islamic finance rule changes

I would now like to explore the issues faced by regulators that seek to regulate capital markets, which by its very nature transcend geographical boundaries and which of course have a material impact on the issue of alternative investments.

In the regulation of any capital market, the regulator will seek to protect investors and ensure that the market is transparent and operating in an orderly manner. To this effect, clear requirements of market conduct and disclosure are often put in place - as we at the DFSA have done in the modules developed under the Regulatory Law and Markets Law.

Investor protection relies to a large extent on the information provided by market participants, and the issue of transparency and disclosure is also particularly relevant to the regulation fo alternative assets. The greater information is given to investors in respect of alternative assets, including performance figures, and disclosures in respect of the Shari'a approval

process and the Shari'a certification, the more knowledge and understanding, and in turn acceptance of the products will result.

Slide 15 – liaison with industry bodies

Slide 16 – why DFSA undertook a funds review

Slide 17 – Visible and viable angles

Slide 18 – Mutual recognition

Conclusion

Islamic Finance continues to evolve and its adaptation and innovation will continue to drive the need for a practical response from regulators. I firmly believe that the DFSA's enabling infrastructure and our use of Islamic windows to bridge the gap between the conventional and the Islamic provides a helpful approach to the regulation of this growing industry.

Rudyard Kipling's *Ballad of East and West* is often mistakenly taken as an example of irreconcilable differences between two great cultures – however to read that great poem in its entirety leads one to a different conclusion – the two are in fact readily reconcilable and indeed remarkably similar. I can think of no better metaphor to describe the DFSA's regulatory response to the challenge and opportunities of Islamic Finance.

Thank you for your time.

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