Seminar on Islamic Finance

"Challenges in Developing Islamic Financial Services in Europe"

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Speech by

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Excellencies, distinguished guests, ladies and gentlemen,

A very good afternoon to all of you.

I wish to thank Banca d'Italia for inviting me to speak at this seminar on the challenges in developing Islamic financial services in Europe. Indeed, the recent global financial crisis has brought significant changes to the international financial landscape. Major regulatory reforms are now underway to bolster the resilience of the international financial system in order to prevent a re-occurrence of a crisis on such a scale. The crisis has also heightened the interest in Islamic finance as a form of financial intermediation that can promote financial stability. The initial resilience demonstrated by the institutions offering Islamic financial services (IIFS) against the first wave of the financial shock provides some indication of this resilience of *Sharī`ah*-compliant finance. This is due, in part, to the *Sharī`ah* requirement of direct links between financial activities and the real sector, the prohibition of speculation and interest-based debt structures, as well as the promotion of high ethical standards in business conduct. In addition, Islamic finance makes no use of derivative instruments such as credit default swaps and does not permit the sale of debt. Moreover, the 'originate-to-distribute' model of debt securitisation has no place in Islamic finance.

These 'stability-protecting' characteristics of Islamic finance offer an opportunity for countries in Europe venturing into Islamic financial services, such as Italy, to reap the benefits of not only enhancing wealth creation but more importantly, to achieve it within the context of greater financial stability.

However, these benefits can be achieved only if the jurisdictions opening the door to Islamic financial services are willing to develop their financial system architecture so as to accommodate the specificities of *Sharī`ah*-compliant finance. This applies, *inter alia*, to the regulatory and supervisory framework, the relevant parts of the legal framework, the liquidity framework (interbank market

and lender of last resort facilities), the crisis management and resolution framework as well as the accounting, auditing and disclosure framework. Today, I will share with you some of the challenges faced by the Islamic Financial Services Board (IFSB) in drafting and issuing standards and guidelines dealing with these specificities.

On the regulatory front, the IFSB has issued a set of prudential and supervisory standards, which constitute the equivalent of Basel II in Islamic finance – covering capital adequacy (including capital adequacy standards for Sukuk securitisations and real estate investment, and prudential limits on the latter), risk management, corporate governance, and transparency and market discipline. In addition, the IFSB has issued standards on *Sharī`ah* governance and the governance of Islamic investment funds. An exposure draft of a standard on solvency of Islamic insurance (*Takāful*) institutions is in the process of being issued. Given that IIFS combine, in an unique way, commercial banking and investment management services as well as direct real estate investment, these standards take into account international prudential standards across the banking, investment and securities markets sectors and simultaneously cater for the specificities of IIFS in terms of their risks and *Sharī`ah* compliance.

One of the challenging aspects of Islamic financial services relates to the unique funding structure of IIFS. The on-balance-sheet funding structure of IIFS in almost all countries is composed mainly of current accounts and unrestricted profit-sharing and loss-bearing investment accounts (UPSIA), and in most IIFS these investment accounts constitute the major source of funding (although one may note an increasing use of *Murabahah* accounts payable as a form of term deposit). These UPSIA, although similar to the discretionary wealth management accounts offered by private banks, are normally treated by both the bank and its customers as a *Sharī`ah* compliant substitute for conventional retail deposit accounts. However, unlike deposits, UPSIA are not debt obligations of the Islamic bank. In particular, UPSIA, being loss bearing, are not "capital certain"

and are essentially a type of investment product. This has caused problems since IIFS offering UPSIA as a substitute for conventional deposits do not fit into the regulatory framework for banks in a typical Western jurisdiction, for which banks are regulated as 'deposit-taking' institutions whose deposits are debt instruments that are capital certain.

In developing the IFSB capital adequacy framework, a different type of difficulty arose, namely how the credit and market risks arising from the assets financed by UPSIA are to be allocated between the IIFS's own capital and that of the UPSIA. Because UPSIA are used as a substitute for conventional deposits, a number of banking supervisors require IIFS to treat them as virtually 'capital certain' (through constructive obligation) and to pay a relatively stable rate of return. Even in the absence of such supervisory pressure, competitive forces may have a similar influence.

Hence, although in principle credit and market risks arising from the assets financed by UPSIA are to be borne (absent misconduct or gross negligence on the part of the IIFS) entirely by the UPSIA holders, in practice we find a phenomenon which the IFSB has called 'displaced commercial risk' (DCR), whereby a substantial proportion of such risks may fall onto the IIFS's own capital.

To address this situation, the IFSB has introduced a method of calculating the capital adequacy ratio (CAR) of an IIFS in a manner that takes account of DCR. This method incorporates a coefficient 'alpha' in the CAR which takes values between 0 and 1 based on the amount of DCR to which the IIFS is exposed, ranging from a minimum value of 0 if the PSIA are treated for capital adequacy purposes purely as investors to a maximum value of 1 if they are treated exactly like conventional depositors. The parameter 'alpha' is in effect a measure of the extent of DCR, i.e. volatility of returns on PSIA-funded assets 'displaced' onto shareholders in order to smooth the profit payouts to PSIA. In the event that

‘alpha’ takes the value of zero, the PSIA being treated purely as investors, the risk-weighted assets (in respect of credit and market risk) funded by the PSIA and their reserves will be deducted from the total risk weighted assets in the denominator of the CAR formula. In this case, the IIFS is not required to hold capital against the credit and market risks arising from the assets financed by the PSIA funds as these risks would be borne entirely by the PSIA. By contrast, if ‘alpha’ takes the value of one (for example, if the supervisory authority requires the IIFS to treat PSIA as ‘capital certain’ deposits), then the IIFS would be required to hold capital against such risks as though the assets were financed by the IIFS’s own capital or by accounts such as current accounts that are capital certain.. In this connection, it should be noted that the *Sharī’ah* rules of the *Mudaraba* contract do not permit the IIFS as *mudarib* to make good any losses suffered by the PSIA holders. The *mudarib* may, however, forgo part or all if its share of profit (to which it is entitled as a fee for fund management) in order to increase the profit attributable to the PSIA holders.

Since from a strictly contractual point of view PSIA bear their own risk of loss, logically central banks would not be expected to have the same concern for protecting the capital of PSIA holders as they would for that of depositors. It would thus be more logical for PSIA holders, like investors in collective investment schemes (CIS), to be governed by capital markets rules which are more concerned with investor protection, not depositor protection. However, given that in general, UPSIA are provided as a *Sharī’ah* acceptable substitute for conventional interest-bearing deposits, a central bank may have a concern for systemic risk in connection with UPSIA comparable to that with conventional deposits. Specifically, there is a risk that if UPSIA are paid no returns on their investments or very low returns compared to the market return on competitive instruments, or believe that they are likely to suffer a loss of their capital, they may withdraw their funds and start a run on the IIFS, thus plunging it into a liquidity crisis, with a risk of contagion throughout the sector as a result of counterparty risk and a possible ‘herd effect’. This risk has been termed

withdrawal risk. The risk of being unable to pay competitive returns has been referred to by the IFSB as *rate-of-return risk* (an analogue of 'interest rate risk in the banking book' conventional banks), and may entail withdrawal risk which in turn may threaten the bank's solvency and trigger systemic risk. This risk is particularly serious since, unlike the case of a CIS, the assets of an IIFS cannot be liquidated in a short time. In addition, Islamic money markets are not developed for the IIFS to make use of them in such a situation.

Hence, a regulatory issue arises when supervisory authorities, in particular in Western markets such as Europe and North America, require IIFS to treat unrestricted PSIA as (in substance) capital certain. For example, in the UK, the FSA requires Islamic banks to offer a product that is contractually "capital certain", so that although returns were based on profit-sharing, PSIA holders are not required to accept shares of losses provided the bank remains solvent, but can (if they so chose, for religious reasons) volunteer to accept them. This arrangement allows the bank's customers to be *Sharī`ah* compliant, but this raises a *Sharī`ah* issue as the bank's unrestricted investment accounts (being contractually "capital certain") are not themselves *Sharī`ah* compliant.

One possible solution to this regulatory issue is to establish a separate legal entity for undertaking the fund management activities of the IIFS. This entity can be established as either a subsidiary of the Islamic retail bank or a fellow subsidiary of a holding company. The Islamic retail bank can offer normal banking facilities while the fund management company can take PSIA (both restricted and unrestricted) from the public under a *Mudarabah* contract and invest them in *Shari'ah*-compliant assets.

The fund management subsidiary might, in appropriate circumstances, be authorised to securitise the PSIA into negotiable *Mudarabah* shares or units, tradable either over the counter or on an exchange (as with a variable capital investment company or trust). However, the corporate governance and financial

reporting requirements for variable capital investment companies would need to be satisfied.

This subsidiary structure offers distinct advantages given that it (i) permits the bank to be regulated as such, as it would offer only accounts that were capital certain; (ii) allows PSIA to be treated as a pure investment product and hence addresses the related regulatory and *Shari'ah* issues; (iii) enables the banking activities and fund management activities to be separately supervised, with the latter being supervised by the investment industry supervisor; and (iv) helps to promote the development of Islamic capital markets. However, this structure poses a further challenge in determining the fair value of the *Mudarabah* shares. The separation of the commercial banking activities from the investment banking activities is as we know a topical issue dominating the debate on the future of the financial regulation.

These intricacies of the funding structure of IIFS also have important implications for the implementation of deposit insurance in IIFS. While for current accounts, explicit depositor protection may be provided under a *Sharī`ah* compliant (*takaful* based) deposit insurance scheme, an issue arises when insurance coverage is provided for unrestricted PSIA. Contractually, unrestricted PSIA should bear their own commercial risks like investors in a CIS. While *Sharī`ah* requirements in this respect would be met by the unrestricted PSIA themselves being the participants in the *takaful* scheme, providing insurance coverage for unrestricted PSIA might raise valuation and policy issues relating to such matters as the appropriate fair value of unrestricted PSIA that should be insured and the evaluation of the riskiness of the underlying assets and the quality of the asset management for the purpose of setting the levels of the *takaful* premium contributions.

The development of Islamic financial services also creates challenges on the legal front. The IFSB has been organizing a series of annual Legal Seminars as part of the efforts to promote awareness on some of the legal complexities in the

Islamic financial services industry. These legal issues have been documented in a series entitled “Islamic Finance: Global Legal Issues and Challenges”, the first volume of which was published in 2008. Hopefully, this will help to disseminate a better understanding and appreciation of the importance of an effective legal and regulatory framework for the IFSI.

The interface between existing civil law systems that govern banking and finance practices generally, and *Sharī`ah* rules and principles that govern Islamic financial contracts specifically, raises numerous legal complexities that need to be addressed. Islamic finance transactions are typically governed by national (secular) commercial law (either statute or common law) and not *Sharī`ah* law. This exposes the IIFS to legal risks. We have recently experienced some litigation cases in which the courts' decisions were based on conventional banking laws and the reference to *Sharī`ah* in the governing provision was not enforceable as it was not sufficiently explicit to be regarded as part of the contract. In a common law jurisdiction, such as the UK, the terms of a *Sharī'ah* compliant contract will normally be enforceable under the Law of Contract provided they are spelled out explicitly. (If a term of the contract is in conflict with statute law, such as that on investor or consumer protection, then it will be considered invalid). Interpretations of *Sharī'ah* rules by *Sharī`ah* scholars will not be taken into account if they are not explicitly incorporated into the contract. The situation in code law jurisdictions may be more complex, as there may be more risk of conflict between *Sharī'ah* rules and applicable provisions of the commercial or civil code. A particular risk is that of a legal hiatus where there is a conflict between the *Sharī'ah* rules applicable to the contract and the applicable secular law, and it is clear that the contracting parties expected the *Sharī'ah* rules to be followed.

In dealing with the interplay between *Sharī`ah* and conventional laws, Malaysia for example, found that the most practical solution in its present constitutional setup was to make a provision in the law that any *Sharī`ah* issue in Islamic

banking and *Takāful (*Islamic insurance) arising in any court or tribunal should be referred to the *Sharī`ah* Advisory Council of Bank Negara as the highest authority to decide on Islamic banking and financial matters. The reference to the Council for ruling by the court or arbitrator was made compulsory and the ruling by the Council shall be binding on the IIFS, the court and the arbitrator. Jurisdictions offering Islamic financial services should therefore consider how to have an appropriate infrastructure within their constitutional setup to ensure the enforceability of Islamic financial contracts in the courts that would give due recognition to the *Sharī`ah* rules and principles. This for example may also encompass amendments to other related laws and procedures such as the rules of court relating to the granting of interest by the court upon judgement which is prohibited by the *Sharī`ah*.

Challenges on the legal front also relate to the issue as to whether the existing legal systems, whether common law jurisdictions or codified systems, adequately address such matters as asset recovery and the arrangements for dealing with distressed assets, insolvency and liquidation of Islamic banks and insurance undertakings and other insolvency issues arising from *Sharī`ah*-compliant financial operations, with particular reference to the rights of PSIA holders and *Takāful* policyholders. For example, in terms of the priority of claims during liquidation of an IIFS: (i) UPSIA holders would have to accept all losses in respect of their share of the assets in the bank's asset pool, with no right to recover any such losses from the shareholders (absent misconduct or gross negligence) or from other assets of the bank such as those financed by current accounts; (ii) UPSIA holders should be given first claim to their share of the assets; while (iii) the shareholders' claims would be subordinated to those of current account holders and other creditors,. The IIFS would also be exposed to a number of risks in jurisdictions with established insolvency rules that are not tailored to deal with insolvency issues in Islamic financial transactions.

The specificities of Islamic finance must also be accounted for in the accounting, auditing and disclosure framework for the IIFS. The IFSB standard on transparency and market discipline requires disclosures from a prudential perspective that would assist market forces to enhance the stability and soundness of the Islamic financial services industry. These disclosure principles are designed to enable market participants generally, and PSIA in particular, to assess key information on the IIFS which includes, *inter alia*, its capital structure, capital adequacy, investment accounts, including specific disclosures on unrestricted investment accounts and restricted investment accounts, risk management, the extent of risk-sharing and displaced commercial risk borne by shareholders, the practice of smoothing returns on PSIA as well as key aspects of general and *Sharī`ah* governance arrangements.

In the context of the IIFS, if accounting information is to give a faithful representation of the economic transactions or events that it purports to represent, it is necessary that they are accounted for and presented in accordance with the substance as well as the form of the *Sharī`ah* contracts that govern these transactions or events. It is the specificities in many *Sharī`ah* contracts that have no parallels in the conventional financial instruments, and which have significant accounting implications, that if not subjected to appropriate financial reporting standards could lead to the financial statements not fairly representing the financial health of the IIFS.

In response to the global financial meltdown, the IFSB, together with the Islamic Development Bank (IDB) Group, has established a Task Force on Global Financial Stability and Islamic Finance.

Recognizing the pressing need to meet the challenges in developing the various aspects of the Islamic financial architecture, the Task Force recommends the establishment of an Islamic Financial Stability Forum based, which is considered to be, *inter alia*, a broad-based and constructive dialogue platform for the IDB Board of Governors and the IFSB Council members.

In conclusion, let me highlight the key points that I have outlined in my speech. First is the importance of incorporating the specificities of Islamic finance in all aspects of the financial architecture in order to reap the benefits offered by Islamic finance in terms of sustainable growth with financial stability. Second is the regulatory benefit of separating the commercial banking and fund management activities of IIFS in order to permit the banking activities, narrowly defined to exclude offering PSIA, to be regulated as banks with due regard for issues of systemic risk and financial stability as viewed by the supervisory authorities. Third is the importance of having an appropriate framework within the constitutional setup to ensure the enforceability of Islamic financial contracts in the courts that would give due recognition to the *Sharī`ah* rules and principles when these are explicitly set out in contracts and clearly reflect the intentions of the contracting parties, and allow the resolution in such cases of any conflicts between *Sharī`ah* rules and principles and the secular law.

On that note, I thank you for your attention.