CHAPTER 16

Regulatory issues: challenges and solutions

16.1 Introduction

The regulation of Shari'a-compliant products and services creates a special challenge for regulators and gives rise to specific issues. These include: the role and powers that regulators assume or should assume when regulating Shari'a-compliant products and services and the classification of Shari'a-compliant products and services within a conventional or non-Shari'a legal and regulatory framework to ensure that they are properly regulated. In framing solutions to these challenges, regulators and governments have looked at special regulatory regimes and, sensitive to the constraints on regulating Islamic finance, the focus on governance and disclosure. These are examined below.

16.2 The primary issue and challenge: formal or substantive regulation?

In addressing the issues of effective regulation of Shari'a-compliant financial services and products, a proper understanding of the underlying purpose of financial services and products regulation must be remembered. Generally, the interest that regulators have in protecting the users of financial services and products, including investors, the markets in which the providers of those services and products participate, including the exchanges on which financial instruments are traded, underpin and inform the use of regulatory authority and power. In the context of the regulation of Shari'a-compliant financial services and products, a further issue arises: should regulators leave it to the service and product providers to determine Shari'a-compliance by regulating the manner for and disclosure of such determinations – a formal approach? Or should regulators themselves seek to determine Shari'a-compliance within the matrix of investor protection and market integrity – a substantive approach?

Within a formal model of Islamic finance regulation, a regulator uses its powers to determine the standards for achieving a Shari'a-compliant outcome by, for example, setting out the requirements for SSBs. In this model, a financial institution's Shari'a scholars are responsible for ruling on the standards with which the institution's services or investment must comply for the institution to promote itself as Shari'a-compliant. In a substantive model of Islamic finance regulation, a regulator uses its powers to determine the substance of the Shari'a-compliant outcome. In this model, the regulator's scholars, or other scholars identified by the regulator, are responsible for ruling on the standards with which the institution's services or investment must comply for the institution to hold them out as Shari'a-compliant.

The model of regulation in the DIFC may be viewed as an example of the formal model; aspects of the regulation of Shari'a-compliant securities in Malaysia incorporate the substantive model. As part of the Malaysian Islamic capital market, the Securities Commission has its own Shari'a Advisory Council. The Council was given the mandate to ensure that the running of the Islamic capital market complies with Shari'a principles. Its scope of jurisdiction is to advise the Commission on all matters related to the comprehensive development of the Islamic capital market, and function as a reference centre for issues related to the Islamic capital market. The members of the Council consist of Islamic scholars/jurists and Islamic finance experts. The Council advises on and publishes a list of products which, in its view, are Shari'a-compliant.

Where a regulator is charged primarily with the protection of investors' financial welfare rather than their spiritual welfare, the formal model would seem the more appropriate. Against this is the argument that the standardisation of particular Islamic finance requirements, which the substantive model helps achieve, enhances liquidity by reducing the costs which the originators of investments have to incur on a case-by-case basis to ensure that the investments are Shari'a-compliant. Enhancing liquidity is hardly at odds with a financial regulator's objectives.

16.3 The categorisation challenge

In considering the regulation of financial services and products, one can categorise the services and products as follows: banking; securities and investments; and insurance. Even where one examines the regulation of Shari'a-compliant services and products, these categories remain broadly appropriate. The categorisation of financial services and products is particularly important for the regulators that regulate those products and services because it determines: (a) the manner in which those offering the services and products should be licensed, for example, as banks or investment managers; and (b) the manner in which their products should be regulated, for example, imposing registration requirements for an offering of securities to the public.

The issue of categorisation highlights one of the challenges for regulators and product services and providers alike: how to ensure that, despite their special characteristics which distinguish Shari'a-compliant products and services from their conventional counterparts, regulators properly protect the users of Shari'a-compliant services and appropriately regulate the markets in which their providers operate. This is a particular issue in countries without a dedicated Islamic finance regulatory regime.
For example, in the United Kingdom, where there is no special regime for the regulation of Islamic finance, the FSA requires an entity seeking to be licensed as a bank to apply for an authorisation to carry on the regulated activity of "accepting deposits". A deposit is categorised as a "sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by the parties." An Islamic bank which offers mudaraba or profit sharing investment account as a way for investors to maintain their savings would struggle to satisfy this requirement. However, in licensing the Islamic Bank of Britain, the FSA reached an agreement with the Bank whereby legally its customers would be entitled to full repayment, therefore satisfying the FSA requirements. However, the customers would have the right to turn down deposit protection after the event on religious grounds and choose to be paid out under a Shari'a-compliant risk and loss sharing formula. (See the FSA Paper on Islamic Finance Regulation in the UK: Regulation and Challenges, November 2007.)

The position in the United Kingdom can be contrasted with that in Bahrain which identifies, as regulated "Islamic banking services", the activities of "accepting Shari'a money placements and deposits" and "managing Shari'a profit sharing investment accounts (PSIAs)". This is backed up by an express requirement, as part of the general principle of integrity, for an Islamic bank to safeguard not only the interests of shareholders of the bank but also those of PSIA holders.

The issue of categorisation has also arisen in the context of sukuk. In addition to the regulation of those who offer and sell sukuk, the financial regulators in the countries referred to above also regulate those who manage collective investments, such as mutual funds. The definition of collective investment vehicles is not uniform. However, for the purposes of explaining the characteristics of a collective investment vehicle, the following features are common in the United Kingdom, the DIFC and the Qatar Financial Centre (QFC): any arrangement the purpose or the effect of the arrangements are to enable persons taking part to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income; the arrangements must be such that the participants do not have day-to-day control over the management of the property; and the contributions of the participants and the profits or income out of which payments are to be made to them are pooled or the property is managed as a whole by or on behalf of the operator of the scheme or fund.

On their face, most sukuk vehicles will have the characteristics set out above, e.g. the holders of the sukuk certificates will participate in or receive profits or income arising from the assets in respect of which the sukuk are issued, they will not have day-to-day control of the assets, their contributions will be pooled in order to make the investment in the assets, and the assets will be managed by the operator of the vehicle which has purchased the assets or delegated. Therefore, the presumption is that, in the United Kingdom, DIFC and QFC at least a sukuk manager will need to be licensed to operate a collective investment scheme or fund.

Fortunately, for sukuk managers there may be relief in the form of an exemption from the requirement to operate a scheme or fund where the rights or interests of the participants are represented by debentures issued by a single body corporate which is not an open ended investment company. For these purposes, debentures include instruments creating or acknowledging indebtedness, including but not limited to bonds.

The DFSA, the financial services regulator in the DIFC, was the first to exclude expressly sukuk from the scope of its collective investment fund regime. The DFSA provide the following rule: "An arrangement does not constitute a collective investment fund if the rights or interests of the participants are evidenced by sukuk certificates where the holders of the certificates are entitled to rely on the credit worthiness of: (a) the issuer of the sukuk certificates; or (b) any other person who has assumed obligations under the sukuk certificates, for obtaining their rights and benefits arising under the certificates."

The following reasoning underlies this rule: sukuk are similar to conventional bonds in that they are security instruments that provide a predicable level of return; they are structured to have the same risk characteristics as conventional bonds; therefore, they should be treated in the same manner as conventional bonds for the purpose of exempting managers from the requirement to be licensed or authorised. The UK Financial Services Authority and Treasury have developed similar rules.

16.4 Delivering regulation: general or special regimes

The regulators of Shari'a-compliant products and services have chosen different approaches to their regulation. Some do not require providers to submit to a special regime but regulate them as part of their general regulatory regimes. Others have dedicated regimes where institutions offering Shari'a-compliant financial services are required to do so using a special licence, while others only impose requirements on the part of providers' businesses that offer Shari'a-compliant products and services via the concept of the "Islamic window."

16.4.1 Regulation under a general regime

As discussed further below, some jurisdictions have adopted special regimes for governing Islamic finance service providers. The majority, however, regulate those firms offering Islamic financial services in the same manner as those offering conventional, i.e. non-Islamic financial services; when it comes to the manner in which Islamic securities are offered, the process for such offerings, even in those jurisdictions with special licensing regimes, the rules are, in effect, the same. (For example, the rules governing the listing of Islamic bonds issued by the Securities and Commodities Authority of the United Arab Emirates are near identical to the rules governing the listing of conventional bonds save for the use of word "profit" instead of "interest").

Therefore, a firm looking to carry out business in Shari'a-compliant securities and investments, will, as a matter of law, require a license or authorisation from that country's securities and investments regulator. Generally, the scope or type of the firm's business, both with respect to the particular activities it wishes to carry out, e.g. broking and dealing, asset management, and with respect to the particular securities or investments it wishes to carry on the activities, e.g. equities, mutual funds, commodity derivatives, will determine the type of license or authorisation for which the firm needs to apply. For example, in Saudi Arabia the Capital Market Authority (CMA) specifies five categories of activity for which it may grant a license: dealing, arranging, managing, advising and custody. It identifies the following securities and investments: shares (which include sukuk), debt instruments, certificates, warrants, units in investment funds, options, futures, contracts for differences and rights in any of these. A firm wanting to manage Shari'a-compliant investment funds would, therefore, need to apply to carry on all of the activities but, subject to the investment strategy and composition of the fund, it would not need to apply to carry on the activities with respect to all the securities and investments identified by the CMA.

In principle, the type of licence or authorisation held by a firm will determine the scope and extent of the rules or regulations with which it has to comply, and the levels of regulatory capital that the firm will need to hold. In general, regulators or other governmental authorities will impose rules and regulations governing subjects, such as the manner in which a regulated firm must organise and manage its business, market and sell its products, treat its clients and their investments.

16.4.2 Regulation under a special regime

The DIFC, QFC and Central Bank of Bahrain, have adopted special regulatory regimes, with similar provisions, to govern or supplement the general regulatory regime.

To take Bahrain as an example: In Bahrain the regulation of banking and financial services is governed by the Central Bank of Bahrain and Financial Institutions Law 2006. The law expressly recognises financial institutions governed by Shari'a principles as a specific subset of financial institution with respect to which a banking licence is required. It is perhaps, unsurprising, therefore that the Central Bank of Bahrain (CBB) has established a separate regulatory regime for Islamic banks alongside conventional banks, insurance institutions and investment business institutions. The law prohibits any entity from undertaking regulated Islamic banking services or from holding themselves out to be licensed to undertake such services without the relevant CBB licence. The CBB rules require any entity wishing to apply for a licence to carry on the activities of an Islamic bank to satisfy the conditions relating to legal status, mind and management, controllers, board and employees, board and employees, financial resources, systems and controls and other requirements, including those related to books and records, provision of information and general conduct.

Once licensed, the CBB rules require Islamic banks to comply with detailed provisions covering, inter alia, the financial promotion of products, rules for foreign exchange dealing, client confidentiality, customer account services and charges, margin trading and, as set out above, rules for mudaraba contracts. These rules rest on specific "Principles of Business" for Islamic banks similar to the principles of business for other entities and the principles under the regimes in the DIFC, QFC and United Kingdom, both of which apply to Islamic institutions in those jurisdictions. The "Principles of Business" for Islamic banks cover issues such as integrity, conflicts of interest, due skill and care, confidentiality, market conduct and management, systems and controls

16.4.3 Regulation of the 'Islamic window'

The DIFC Law Regulating Islamic Financial Business permits an authorised firm or authorised exchange, other than an institution that carries on its entire business in accordance with the Shari'a, to operate an Islamic window where it conducts a part of its business in accordance with the Shari'a as part of its overall business operations.

The Governance Standards recommended by AAOIFI contain special provisions governing Islamic window. The primary obligation for those institutions offering services through an Islamic window is to ensure that the Shari'a-compliant and non-Shari'a-compliant parts of their business are kept separate, with the Shari'a parts subject to financial reporting standards recommended by AAOIFI and oversight by a Shari'a Supervisory Board. The Islamic window provides a compromise for those institutions that wish to participate in both the Islamic and conventional financial industries while ensuring that its Muslim clients are appropriately protected.

16.5 Regulating form? The focus on governance and disclosure

Where regulators choose to regulate Islamic financial institutions, the one regulatory characteristic, more than any other, that sets the regulation of those institutions apart from the regulation of conventional institutions, is the focus on governance systems and controls for ensuring Shari'a-compliance. The issue of internal Shari'a governance may, arguably, be more acute where a formal approach to the regulation of Islamic finance is adopted with regulators placing the issue of determining Shari'a standards firmly with the institutions themselves as opposed to leaving them to centrally identified SSBs.

In the DIFC, the DIFC Law Regulating Islamic Financial Business sets out a single substantive requirement for the conduct of Islamic Financial Business: an authorised firm which has an endorsed license authorising it to conduct Islamic Financial Business must appoint a SSB.

In its rules, the DFSA amplifies these requirements by reference to the AAOIFI Governance Standards – an approach that the CBB follows in Bahrain, although even more so by merely referring to the relevant AAOIFI Governance Standards as opposed to seeking to incorporate the substance of those standards into its rulebook.

The DFSA sets out rules: (a) governing the appointment of the SSB, including the requirement to have at least three members who are competent and independent of the firm's management; (b) for demonstrating the process for appointing and retaining members of the Shari'a Supervisory Board, including the process for considering the suitability of the board; (c) governing the effectiveness of the SSB, including the requirement to ensure that the board is independent of and not subject to any conflict of interest with respect to the firm; and (d) governing the manner in which the SSB operates, including the requirement for reviews in accordance with relevant AAOIFI Governance Standards. With respect to rules governing the effectiveness of the SSB, the following requirements on a DFSA authorised firm's employees are noteworthy: (a) to provide such assistance as the board reasonably require to discharge its duties; (b) to give the board right of access at all reasonable times to relevant records and information; (c) not to interfere with the board's ability to discharge its duties; and (d) not to provide false or misleading information to the board.

The central role of Shari'a governance and focus of regulators that choose to regulate Islamic finance as the distinguishing practical feature that marks out any system of regulating Islamic finance is evident from the fact that the SSB issue arises in many contexts. These include: the governance of: Banks and other financial institutions, which would encompass the approval of the structure of particular products; the management of Shari'a-compliant investment funds – the DFSA and QFCRA rules referring expressly to the requirement for fund managers holding funds out as Shari'a-compliant to appoint SSBs to oversee the investment decisions of those funds; the governance of Shari'a-compliant markets and exchanges – the DFSA rules requiring markets and exchanges to appoint SSBs to oversee the activities of the relevant market or exchange; and listing of Shari'a-compliant products – the rules of exchanges, such as the Nasdaq Dubai, requiring the issuer of Shari'a-compliant securities, such as sukuk, to disclose the details of the Shari'a Supervisory Board which approved the securities to be listed as Shari'a-compliant.

Such is the importance of the SSB in the regulation of Islamic finance that, in plain terms, the question of what constitutes a Shari'a-compliant bank or financial institution may be answered simply by the statement: a bank or institution that has its own SSB.

This, in turn, highlights the central role of disclosure in the context of the regulation of Islamic finance, particularly where regulators employ a formal model where investors will rely on the Fatwa of a product provider's SSB instead of any fatwa issued by a central SSB.

This would appear to underpin the single requirement set out by the DFSA with respect to the marketing and promotion of Shari'a-compliant products or services: before a firm communicates any marketing material to a person, it must ensure that, in addition to the information generally required by the DFSA for inclusion in any marketing material, the DFSA requires that the marketing material state which SSB has reviewed the products or services to which the material relates. In addition, in Saudi Arabia, the Capital Markets Authority requires the manager of a Shari'a-compliant investment fund to disclose not only the identity of the SSB that approved investments made by the fund, but also the criteria for determination.

16.6 Conclusion

There is no doubt that the advent of Shari'a-compliant products and services introduced a fresh challenge to how financial services and products are to be regulated, taking into consideration the special features of Shari'a-compliant products and services and new challenges. The fact remained and remains that often it is the features which Shari'a-compliant products and services share with conventional products and services, such as the integrity of underlying investments and asymmetry of information regarding such investment, are likely to remain at the forefront of regulators' minds. However, this does not displace those challenges, but with the development of standards by international bodies such as AAOIFI and the IFSB and the increasing interest taken by national regulators, the challenge should be met. Even if the solutions are never perfect, and regulatory solutions seldom are, regulators' recognition of the issues that they and participants in the Islamic finance industry need to address can only be viewed positively.