

Developing a Regulatory Framework for Islamic Finance to thrive in Europe

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- What are the challenges for regulating and supervising Islamic banking in Europe?
- What can be learned from regulatory best practice at well established hubs for Islamic finance?
- Can effective regulation be the catalyst for industry growth?



Challenges for regulating and supervising Islamic banking in Europe

- European Union and European Economic Area – a single market
- Directives cover banking, insurance and other investment services – establish minimum standards
- Home state regulation – passport rights



- Once a firm is authorised to provide services in one member state it qualifies for authorisation to provide services or establish a branch in any other member state subject to certain conditions
- Regulation and supervision devolved to individual member states



Islamic Finance in the UK: Regulation and Challenges

- The UK is the only EU member state which has authorised Islamic banks
- The Financial Services Authority - a single financial regulator
- Financial Services and Markets Act 2000 (FSMA)



Islamic Finance in the UK: Regulation and Challenges

- The Financial Services Authority has authorised
 - 5 Islamic banks
 - 1 Takaful firm
- The FSA's approach - 'no obstacles, but no special favours'



- All institutions authorised by FSA are subject to the same standards
- This approach contrasts with that in other centres for Islamic banking eg Bahrain, Malaysia, DIFC, which have separate authorisation and regulation for Islamic banks



Islamic Finance in the UK: Regulation and Challenges

Regulatory Challenges identified by FSA

- Regulatory definition of products
- Role of Shari'ah board
- Financial promotions



Regulatory definition of products

Deposits

- A 'deposit' is defined as 'a sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by the parties'
- Profit and loss sharing accounts do not qualify



■ Importance:

- Regulated activity – accepting deposits
- Deposit protection

■ Solution

- Customers have a contractual right to be repaid in full
- May choose instead to be repaid on Shari'ah compliant basis



Regulatory definition of products

Home purchase plans

- Ijarah and musharaka products – did not qualify as regulated mortgage products
 - regulated home purchase plans added to the list of regulated products
 - providing a home purchase plan became a regulated activity



Sukuk

- Are they collective investment schemes or debt securities?
- Listing: debt security or asset-backed security?



Role of Shari'ah board

- Executive or advisory?
- Directors – the ‘fit and proper’ test
 - competence and capability
 - conflicts of interest
- FSA wants to see role is advisory – no interference with management



Financial promotions

- Advertising must be ‘clear, fair and not misleading’
 - unfamiliar products
 - inexperienced customers
- FSA looks at how risks are presented to customers

Challenges in other European countries would be similar
– but different in detail



Risk Management

- Risks specific to Islamic finance
 - lack of Shari'ah standardisation
 - shortage of Shari'ah scholars and experienced professionals
- Financial risk and liquidity management
 - lack of Shari'ah compliant tools
- Basel 2
 - shortage of acceptable instruments
 - Islamic banks may be more exposed to certain risks than other banks



What can be learned from regulatory best practice?

- Advantages of FSA's approach
 - flexibility
 - no need for a separate regulatory framework
 - political acceptability
- Disadvantages of FSA's approach
 - regulatory product definition does not match product structure
 - solutions may not be universally applicable



What can be learned from regulatory best practice?

- Central Bank of Bahrain
 - Regulated Islamic banking services
 - CBB Rulebook – separate volume for Islamic banks
- Dubai Financial Services Authority
 - Islamic Finance Business
 - Endorsement – Islamic Financial Institution or Islamic Window



- Bank Negara Malaysia
 - Islamic banking business
 - Licensed Islamic Banks and International Islamic Banks



Can effective regulation be the catalyst for industry growth?

- Regulation – responds to change and innovation, it does not precipitate it
- UK government and FSA have responded to the industry's needs
- Government policy is to facilitate and encourage development, but is still responding to perceived needs



Can effective regulation be the catalyst for industry growth?

- Government has a wider role to play
 - tax reforms
 - proposal to issue sukuk or savings products
- FSA's regulatory objectives include promoting public understanding of the financial system including
 - awareness of benefits and risks
 - provision of information and advice



- Growth has been slower than expected
 - UK retail sector
 - other European markets
- Is there scope to expand the market to non-Muslims?
- Growth needs to be led by real demand for Islamic financial products

