



HAWKAMAH
THE INSTITUTE FOR CORPORATE GOVERNANCE

Mainstreaming Islamic Finance: A (partial) agenda for action

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Agenda

1. Challenges Faced by the Islamic Finance Industry
2. Islamic Finance Standards & their application
3. Role of DIFC in promoting Islamic Finance
4. Corporate Governance of IFIs: Hawkamah's Task Force
5. Mainstreaming Islamic Finance:
 - GATS
 - Free Trade Agreements
 - Islamic Financial Passport proposal

ISLAMIC FINANCE INDUSTRY

- Islamic finance is nascent but has transcended borders and regions.
- Numerous challenges lie ahead before it can make the crucial leap from being a promising but niche market to becoming an integral part of global financial markets.
- Islamic finance has enormous potential: shift in risk preferences, demographics, ethical standards
- Need to develop both Wholesale & Retail products, services & markets

CHALLENGES FACED BY THE ISLAMIC FINANCE INDUSTRY

Challenges include:

1. Lack of standardization resulting in higher entry & transactions costs
2. Low levels of liquidity
3. Lack of reliable information & statistical data
4. Lack of regulatory convergence
5. Untested & opaque Islamic Insolvency & Creditor Rights Regime
6. Limited human capital resources: e.g. Shari'a scholars
7. Low levels of innovation

ISLAMIC FINANCE STANDARDS

- AAOIFI has issued:
 - 25 Accounting Standards,
 - 5 Auditing Standards,
 - 7 Governance Standards
 - 2 codes of ethics

- The IFSB has been main standard setter

- But Central Banks & Regulators need to impose these Standards and Guidelines & ensure compliance

IFSB Standards

- IFSB-10: Guiding Principles On **Sharia Governance Systems** For Institutions Offering Islamic Financial Services
- IFSB-9: Guiding Principles on **Conduct Of Business** For Institutions Offering Islamic Financial Services
- IFSB-8: Guiding Principles on **Governance For Takaful** (Islamic Insurance) Undertakings
- IFSB-7: **Capital Adequacy Requirements** for Sukuk, Securitisations and Real Estate investment
- IFSB-6: Guiding Principles on **Governance for Islamic Collective Investment Schemes**
- IFSB-5: Guidance on Key Elements in the **Supervisory Review Process** of Institutions offering Islamic Financial Services (excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)
- IFSB-4: **Disclosures to Promote Transparency and Market Discipline** for Institutions offering Islamic Financial Services (excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)
- IFSB-3: **Guiding Principles on Corporate Governance** for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)
- IFSB-2: **Capital Adequacy Standard for Institutions** (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)
- IFSB-1: **Guiding Principles of Risk Management for Institutions** (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)

SHARIA' COMPLIANT STANDARDS ACROSS JURISDICTIONS I

Currently, Shari'a compliance standards and their oversight varies across Jurisdictions:

- In Iran, Council of Ministers and Regulations under the Usury Free Banking Act, 1983 serve as the Shari'a Board and set guidelines for the Islamic Finance industry;
- In Malaysia, under Central Bank Act, 1958, Shari'a Advisory Council has sole responsibility for Islamic Finance and court of arbitrator refers disputed cases to this council for their position/advice;
- In Indonesia, the National Shari'a Board is responsible for Shari'a rulings on Islamic products, with IFIs required to establish a Shari'a Division in the institutions and NSB approves the Shari'a Supervisory Board to oversee the division;
- Bahrain, Sudan and Syria have adopted Shari'a standards issued by AAOIFI and some other jurisdictions use them as guidelines.

Recent International Regulatory Reforms

United Kingdom

- Positioning itself as European hub for Islamic finance ; FSA licensed 6 wholly Islamic banks
- UK Gov't has introduced legislation to promote IF and has made adjustments to stamp duties on income from Islamic products
- Plans for a sovereign issue denominated in GBP
- Gov't looking to legislate to help develop Islamic corporate debt

France

- Between 6 and 7 million Muslims in France
- Changes to the tax code to ensure that Islamic modes of financing do not attract extra tax penalties in relation to conventional transactions.
- At least 2 new Islamic banks reported to be requesting accreditation to operate in France.

Hong Kong

- Government changing tax laws to ensure Sukuk are treated in the same way as conventional bonds (stamp duty, profits tax and property tax)
- Hong Kong said it plans to issue a sovereign Sukuk when market conditions are right.
- Edge in pitching Islamic finance products to China-focused investors

Singapore

- Developed guidelines for Sukuk and introduced a concessionary tax rate on income derived from Sharia-compliant fund management, lending and insurance.
- Targeting the Islamic wealth management space
- Central bank established program to issue the first-ever Singapore-dollar denominated sovereign Sukuk.
- Issued new regulations to ensure equal tax, regulatory and liquidity treatment of Singapore-dollar Islamic bonds with government securities.

Indonesia

- Largest population of Muslims in SE Asia
- Government has allowed tax concessions for Sukuk and other instruments
- Issued new regulations governing Islamic banks, which include new rules on: minimum reserves; payments clearing; creation of an Islamic inter-bank money market; issuance of Bank Indonesia Wadiah-based promissory notes to provide liquidity to the market.

Other

- China, Japan and Thailand announced intention to issue sovereign Sukuk
- SK is planning to grant tax exemption on return on Sukuk to attract more funds.

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DIFC-DFSA Islamic Finance Regime

- Islamic finance recognised as an integral part of the financial system
- Clarity and certainty across wholly Islamic financial institutions and Islamic windows.
- Integrated regulatory structure conducive to the cross sectoral nature of Islamic finance
- Level playing field in Islamic finance- all institutions subject to the same standard of regulation
- Compliance with international standards such as risk and capital adequacy requirements set out by Basel, as well as IFI guidelines and applications specified by AAOIFI and IFSB

THE ROLE OF THE DIFC IN PROMOTING ISLAMIC FINANCE

- The DFSA is working with regional and international regulatory bodies and entering into co-operation and information-sharing arrangements with other regulators and counterparties.
- The DFSA has signed over 48 bi-lateral MoUs with various regulatory authorities around the world, including an MoU
- DFSA has also launched a series of electronic Islamic finance tailored handbooks, designed to help Firms undertaking Islamic finance activities in DIFC.
- Each handbook contains the parts of the DFSA Rulebooks which apply to that particular area of activity namely: Islamic Banking, Islamic Investment Business, other than Operating Funds; Islamic Insurance; Islamic Insurance Intermediation and Management; and Operation of Islamic Funds.
- DFSA signed a unique Mutual Recognition Agreement (MRA) with SC Malaysia to facilitate the cross-border flow of Islamic funds.

DFSA MRA WITH SC MALAYSIA: Main Clauses

- DFSA and SC Malaysia recognise the need to promote and develop their respective Capital Market segments and desire to facilitate marketing and distribution of funds in the other party's jurisdiction.
- Agreement establishes a framework for the mutual recognition of regulatory regimes governing Islamic funds in DIFC and Malaysia that will facilitate the cross border marketing and distribution of Islamic Funds with minimal regulatory intervention.
- DFSA will recognize Malaysia by including Malaysia in the DFSA's recognized jurisdiction notice and shall also designate all Islamic funds approved by the SC as designated funds
- SC shall deem approved all DIFC Islamic Funds registered with the DFSA and all DIFC operators and trustees authorised by the DFSA.
- Agreement applies to all Islamic funds that have been approved by the SC and that have been registered with or notified to the DFSA except for hedge funds or commodity funds in either jurisdiction.

HAWKAMAH'S TASK FORCE ON CORPORATE GOVERNANCE OF ISLAMIC FINANCIAL INSTITUTIONS

- Hawkamah the Institute for Corporate Governance, with the support of a number of Islamic Financial Institutions has set up a **Task Force on Corporate Governance of Islamic financial institutions (IFIs)**.
- Hawkamah developed a survey questionnaire to take stock of the existing CG frameworks of Islamic Banks and Financial Institutions throughout the MENA region and distributed it to over 90 banks and FIs in the region.
- The final results of the survey will be presented in the form of a Policy brief will be discussed at the Task Force members meetings scheduled for June 2010.
- Policy brief will aim to identify corporate governance challenges and priorities for standardization faced by the IFIS and propose concrete recommendations for implementation.

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GENERAL AGREEMENT ON TRADE IN SERVICES (GATS)

- The GATS agreement under the WTO recognises the growing importance of trade in services for the growth and development of the world economy;
- Aim is to establish a multilateral framework of principles and rules for trade in services with a view to:
 - Expansion of such trade under conditions of transparency and progressive liberalization;
 - Introduce new regulations, on the supply of services within the member territories in order to meet national policy objectives.
- **GATS should incorporate principle of “functional equivalence” between conventional and Shari’a compliant finance**

FREE TRADE AGREEMENTS (FTA)

- The UAE through the GCC are negotiating several Free Trade Agreements with a number of countries and economic blocs such as the EU, Japan, Australia, New Zealand, Korea, India and other countries.
- GCC has already signed 2 FTAs with Singapore and European Free Trade Association (EFTA)
- Trade in Services Chapter of these agreements include section which covers financial services. Upon request from the GCC there has been included an annexure on Sharia' compliant financial services.
- Purpose is to have these countries recognise Shari'a compliant services as a financial service that may be offered in their jurisdictions.

FTAs TO ELABORATE ON SHARIA' COMPLIANT SERVICES

- Free trade agreements (FTAs) have proved to be one of the best ways to open up foreign markets and we need to build upon the above initiative taken by the UAE to take Islamic finance to the next level.
- Countries should follow suit of the GCC and should elaborate on Shari'a compliant financial services under the 'New Financial Services' section introduced under the WTO.

ISLAMIC FINANCE PASSPORT Proposal

- The MIFID concept of 'European financial passport' should be developed for the Islamic Financial Industry as well.
- GCC moving towards greater economic & financial integration
- Starting point could be a GCC Islamic Finance Passport:
 - IFIs would have passporting potential
 - Regulated Funds passport
 - Takaful & Re-Takaful passport

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