



Speech by Jamie Orchard, QFC Regulatory Authority, Chief Operating Officer and Managing Director- Legal and Regulatory Compliance

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## **Regulatory Treatment of Islamic Finance Firms**

Thank you for the opportunity of addressing you today. As a representative of one of the newer regulators on the financial services landscape, it is indeed a pleasure to speak at a forum which has very quickly become one of the leading gatherings of participants in the Islamic Finance industry.

Let me commence by making reference to the jurisdiction I represent. The Qatar Financial Centre (or QFC) is a financial and business centre characterised by a legal and regulatory infrastructure meeting current international standards. The QFC is designed to attract international financial services institutions and major multi national corporations and to encourage participation in the growing market for financial services in Qatar and elsewhere in the region.

The regulator responsible for the implementation of the regulatory infrastructure and therefore the regulation of financial services firms is the QFC Regulatory Authority.

The Regulatory Authority has a wide area of responsibility in the QFC being responsible for all aspects of the supervision of financial services firms, regardless of the specific industry in which they operate. My comments today however are focused on one particular area, namely the supervision of those firms undertaking Islamic financial business.

In the course of developing our approach for the regulation of Islamic Finance firms in the QFC we took into account the specific issues confronted by Islamic Finance firms while at the same time seeking to ensure that all firms operating in the QFC operated to the same basic standard.

The starting point for the consideration of our regulatory approach in respect of any particular industry is obviously the Regulatory Authority objectives. You will be pleased to know that I am not going to take you through each one but simply point out three of the more relevant objectives. These are:

- The promotion and maintenance of efficiency and the integrity of the QFC;
- The promotion and maintenance of confidence in the QFC of users and prospective users of the QFC; and
- The maintenance of financial stability of the QFC including the reduction of systemic risk relating to the QFC.

We pursue these objectives in the course of regulation of all firms in the QFC regardless of whether they are conducting Islamic Financial business or conventional financial activity. Indeed to treat firms differently on the basis of whether or not they are undertaking Islamic Finance activity would be counter productive to the development of the Islamic Finance industry – unless there is a proper regulatory purpose.

Why would it be counterproductive? To impose a greater regulatory burden on Islamic firms would limit their ability to develop their business and therefore stifle the industry. It would also represent a disincentive to firms to establish in, or convert to, Shari'a compliant form.

On the other hand, to impose a lighter regulatory regime on Islamic firms exposes them to greater risk of failure and failure in an industry that is still young and comparatively small could be disastrous for the industry.

So what are the specific requirements that apply to those firms undertaking Islamic Finance activities?

Firstly, there is a general prohibition in our Islamic Finance Rulebook on firms holding themselves out as carrying on financial services in accordance with Shari'a unless they have an appropriate endorsement on their licence.

Why is it that the prohibition is on firms 'holding themselves out' as carrying on Islamic finance business? Simply put, we wanted to ensure that only those firms which seek to have their activities comply with Shari'a and which promote their business or products on that basis are subject to the specific requirements that attach to Islamic finance firms. So, for example, a mutual insurance product offered by a conventional firm may well be structured in a way that is Shari'a compliant. However, the conventional firm did not seek to achieve that end and is not promoting the product in that way and so should not be the subject of additional requirements. Immediately that firm does decide to promote its business or product as being Shari'a compliant, then it must seek an endorsement on its licence and comply with all additional specific requirements applicable to Islamic firms.

It is because there are additional specific requirements that apply to those firms carrying on Islamic finance business that the Regulatory Authority will not grant an endorsement to a firm unless it is satisfied that the firm is ready, willing and able to comply with the particular requirements.

One specific requirement is that a firm with an endorsed licence must appoint a Shari'a Supervisory Board that complies with certain minimum requirements.

Another requirement is that the firm must have systems and controls to ensure that those parts of its business that are to be operated in accordance with Shari'a do in fact comply with Shari'a.

I note at this point that we as the financial services regulator do not claim the ability to determine if products or operations are Shari'a compliant. It is for that reason that we impose the systems and controls requirement to make sure that those that are qualified to form a view (the Shari'a Supervisory Board) do in fact determine whether the business does comply with Shari'a and to require that there is an internal review process designed to ensure that the firm complies with the fatwas and rulings of the Board.

Having made these general comments, there are two particular areas relevant to the supervision of Islamic Firms that are worthy of closer consideration – disclosure and capital requirements.

In respect of disclosure, regulators the world over seek to ensure that financial services firms make disclosure to their customers of such information that they need about the firm, product and fees so that those customers can make an informed decision about whether to invest. They also seek to ensure that such information is provided in a way so that consumers can understand it and make comparisons, between firms and between products.

This requirement applies equally to Islamic firms and certainly in the QFC we make no distinction between firms in respect of their obligations to make such disclosure. However there are some specific requirements that Islamic Firms must address. In determining what additional disclosure requirements are appropriate to impose, we have been heavily influenced by the various AAOIFI

standards and we are awaiting the results of the IFSB working party on Transparency and Market Discipline to determine if further requirements may be useful.

In particular, an Islamic finance firm must disclose amongst other things:

- Details of the membership of the firm's Shari'a Supervisory Board;
- The manner and frequency of internal Shari'a reviews;
- Where a client will become a participant in a Profit Sharing Investment account, the fact that the risk of loss rests with the client and that the firm will not be responsible for loss except that arising from negligence or misconduct;
- How monies of the client will be managed;
- The basis for allocation of profit between the firm and the client;
- Any restrictions that may be imposed by the client on the investment.

A firm operating an Islamic window must make those disclosures required by AAOIFI FAS 18 to its clients. Essentially, that FAS requires disclosure in respect of co-mingling of funds and details of the sources and application of funds.

Further, an Islamic Insurance Company is required to make the disclosures set out under AAOIFI FAS 12 and FAS 13.

As with conventional firm disclosure, these requirements are designed to ensure that clients have all necessary information in respect of those issues that may influence their investment decision before deciding whether to proceed.

The other major area in which specific provision is made for Islamic finance firms is in respect of capital adequacy or prudential requirements.

The common question that arises at this point is as to whether a firm operating on a profit sharing investment account basis ought to be treated as a bank or a fund manager. Such firms have characteristics associated with both types of conventional firm but are not sufficiently similar to categorise them as one or the other. While this may be a particularly difficult problem in many jurisdictions as the consequences may be quite significant in a prudential context, the matter is not as significant in the QFC in light of the fact that we have developed an integrated approach to prudential regulation with the consequence that all firms must meet common prudential requirements. Specific requirements are then imposed on those undertaking Islamic financial business.

The major specific requirement is the imposition of a Displaced Commercial Risk capital charge to reflect the additional risk posed by those firms offering profit sharing investment accounts. The particular risks this charge seeks to address are the risks arising from commercial expectation of smoothing and the possibility of contribution for loss arising from misconduct or negligence.

In the QFC, the DCR is set at 35% of the value of the risk weighted assets funded by the PSIA.

The other prudential matter addressed specifically for Islamic firms is the risk weighting for each type of Islamic contract. In the QFC, our prudential requirements provide a risk weighting table specifically designed for Islamic finance firms to ensure that the capital to be held against each contract is calculated as accurately as possible, in light of the risk posed by that contract.

I pause at this point to note the work of the IFSB in this area. The consultation paper issued by the IFSB in respect of capital adequacy earlier this year provides an excellent framework for the

implementation of prudential standards in those jurisdictions with an Islamic finance industry. Once the final form of the standard is determined by the IFSB it will be something that we will very carefully consider in the QFC.

Finally today, let me offer a comment in respect of the question “what can regulators do to encourage or at least not discourage the development of the Islamic financial services industry”?

Obviously regulators are not responsible for marketing but they can nonetheless play an important role in encouraging the development of a particular industry, or indeed discouraging it, by the determining the nature of regulatory requirements and the general approach to regulation of the industry.

I mentioned at the outset that the easy answer of reducing standards to allow more firms to participate is not a long term solution – it simply poses too great a risk of failure of the particular firms and therefore reputational damage to the entire industry.

I do think though that regulators have a duty to understand the operation of the industry, the firms within it and the manner in which Islamic products and operations differ from those in the conventional financial services industry. Regulators should strive to develop rules, processes and procedures which recognize the specific requirements of Islamic firms and allow for them without increasing risk. It is through this understanding and appropriately responsive regulations that regulators will contribute to the stability of firms and therefore the continued development of the Islamic Finance industry in general.

I am pleased to say that this is the approach we have adopted in the QFC and that is why we are confident of seeing the development of a strong Islamic Finance industry in the Centre.

As an example of this responsive approach, we recently published a consultation version of our Islamic Finance Rulebook which we believed represented an effective approach to the specific issues arising in respect of firms operating in the Islamic finance industry. We were delighted to receive comments from a number of industry participants which allowed us to add to our understanding of the industry and further tailor the rulebook thus ensuring more effective regulation of Islamic Firms in the QFC. The final product is indeed an example of effective, responsive regulation.

I thank you again for the opportunity of addressing you today.