

GLOBAL ISLAMIC FINANCE FORUM

NEXT PHASE OF DEVELOPMENT FOR ISLAMIC CAPITAL MARKETS
Evolving efficient and effective regulation to facilitate cross border ICM transactions



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**Evolving efficient and effective regulation to facilitate cross border Islamic
finance transactions**

(Salutation and introduction to topic)

From a regulatory perspective the critical starting point is to accept that the basic precepts of conventional financial markets regulation apply with equal force to Islamic financial markets.

That proposition has to be tested because it will impact fundamentally on the approach that Governments and regulators take as these markets extend their influence and reach.

If you focus on the key philosophies that differentiate conventional and Islamic financial markets you may well reach the wrong conclusion. The prohibition on Riba; unjust enrichment; the treatment of money as a commodity; proscriptions against uncertainty and speculation; the requirement that a seller has valid rights of

ownership prior to onwards sale; and the requirements of Halal – all taken together may suggest that the regulatory building blocks for regulating Islamic finance need to be different from those used for conventional regulation. I think that is wrong.

The principles that underpin conventional markets regulation are primarily designed to ensure that financial firms are able to deliver upon their promises. These may take the form of promises to indemnify policy holders against loss; or to repay investors or depositors upon particular terms agreed at the time of contract formation. Principles and standards have been developed by Basle (to reflect the characteristics of banking promises); by the IAIS (to reflect the characteristics of insurance promises); and by IOSCO (to reflect the characteristics of capital markets promises). Of course, regulation also extends beyond the assurance of promises, most obviously in the securities sector where integrity of the secondary market is a key policy objective. But, in the main, financial services regulation has developed to mitigate against the instability caused to a financial system when financial firms fail to honour their promises.

This should be the common starting point for all forms of financial services regulation, conventional or Islamic; because, although the particular terms of promise may differ, reflecting the special structural features of Islamic products, the underlying character of those promises and the consequences of their failure, are the same.

Accordingly, while regulatory rules will need some supplementation to accommodate areas of difference, the international standards already governing conventional finance should be adopted as the cornerstone for Islamic finance regulation. Organizations like the IFSB and AAOIFI play an important role in dealing with issues of supplementation, but should avoid duplicating or altering existing standards that can apply equally across both conventional and Islamic sectors. To do otherwise will add to industry's compliance burden, constrain cross border product flows, and hinder the acceptance of Islamic finance products as an integral part of the world's capital markets.

It follows that when considering how regulators might best facilitate cross border financial transactions we should start with the conventional market. If we identify the

core issues in that market, we can then deal with any supplemental issues arising in the Islamic finance context.

Facilitating international business flows by harmonizing regulation is not a new subject and remains a contentious one.

Last week I attended a meeting of Bank CEOs in Dubai. One CEO talked about the nightmare of complying with different regulatory requirements across the 45 jurisdictions in which he operates. Couldn't we just have one set of consistent rules, he pleaded? Many heads around the tables nodded in vigorous agreement. That group represents one view on regulatory harmonization. They generally come from large international organizations. For them, a harmonized global regulatory environment would represent massive savings in compliance resources and greatly facilitate their international product origination and distribution.

Within minutes of that conversation finishing a new speaker from the Middle East spoke eloquently about the dangers of imposing regulatory standards from advanced developed markets on emerging markets, without proper allowance for their different levels of sophistication and cultural features. Again, a lot of heads were nodding and it seemed to me that many were the same heads as before.

No-one in that room of extremely intelligent people seemed to register the polarity of the two discussions. But those of us who have practiced regulation for any length of time are very familiar with similar discussions and the almost opposite directions in which they take you.

International harmonization of regulation would undoubtedly facilitate cross-border business, and most business people support it in principle. But most of those people have their own idea of what the regulation should look like and will oppose the imposition of anything different.

It's not as if policy makers and regulators haven't tried. Take two contemporary examples of international accounting standards and Basle 2. Some years ago in Australia I lent my full support to the adoption of IFRS, primarily in response to the strong business case advocated by industry. But when it came to the crunch, many

from that same sector wanted carve outs to protect their special positions. If there's a man who deserves hero status it's Sir David Tweedie, Chairman of the IASB, because he has spent years battling this problem right around the world. You simply can't have it both ways. If you want harmonization of rules to facilitate global business you will need to cede some sovereignty on the issue and accept some outcomes that you don't like. Basle 2 is somewhat different, but it is another example of a well intentioned attempt to harmonize international regulation (in the interests of the banking sector I should add) that has become a quagmire in its practical implementation.

For regulatory harmonization to substantially reduce compliance costs, the detailed requirements of compliance have to be substantially synchronized. How does that reconcile with the almost universal cry for "principles based" regulation instead of "rules based black letter law". Don't get me wrong. I fully support principles based regulation. But as between different jurisdictions it will almost always result in differing interpretations and practices, and then you're back where you started. In fact that is my fear about the two examples I have given, IFRS and Basle 2. After all the time and money that has been invested in those initiatives, there remains a real and present risk that they will fail to deliver greater business certainty – and might even result in even wider differences in interpretation than we have now.

Europe may have the best immediate prospects for benefiting from regulatory harmonization across their Union. But they have a constitutional framework within which to act. They have addressed the issue of sovereignty, to the extent that a Directive is for all intents and purposes equivalent to a national law. They also seem open to discussions about some consolidation between regulators which one day may see fewer, perhaps only one, European regulator. In the meantime, Europe has already implemented an effective cross-border passport arrangement for prospective issues.

In the area of capital markets IOSCO has in recent years responded to this dilemma as best it can. Its statements of regulatory principles have become more comprehensive and relevant than in previous times. But they usually stipulate that the detailed implementation of their principles may differ from place to place and still

be effective. Quite right, they will be effective, but every difference will be a new cost to the international transaction of business.

The issues that I have raised are the same for all cross border business transactions, both conventional and Islamic. There are then supplemental questions about how the Shari'a components of Islamic finance transactions are dealt with in different jurisdictions. Last year at the Malaysian Islamic Finance Forum I spoke about the differences between the way in which Dubai and Malaysia deal with Shari'a compliance. Those differences remain, but I consider there are distinct advantages in Malaysia's approach of having a centralized Shari'a approval structure, as opposed to ours, which is based on each issuer having its own Shari'a Board. Our problem is that the number of differing Shari'a interpretations that prevail in the Middle East; the conviction with which they are held; and the fact that it is a cross border regional market: all place the prospect for conformity of interpretation and regulatory administration beyond reach –at least for the present.

Where does this leave the regulators? Overall, I'd say it leaves them pretty confused. But there is some hope offered by an increasing willingness of regulators to embrace concepts of mutual recognition with peer group counterparts. This is not harmonization. In fact, schemes of mutual recognition usually start from the understanding that there will be differences of regulatory detail between the relevant jurisdictions. However, there are now some good working examples of jurisdictions who have decided that the regulation of a foreign jurisdiction is sufficiently equivalent to their own as to permit a passport for product distribution, without requiring reconciliation or other regulatory intervention.

Such schemes do not yet apply across the board to cover entire regulatory regimes. Usually, they follow the format that we have recently adopted for our regulation of managed funds. If we consider that a foreign jurisdiction has funds management regulation that sufficiently tracks our own (either generally or more likely in relation to specific types of funds) we will grant that jurisdiction "recognized" status. That then permits managed funds to be sold within our jurisdiction without meeting our usual domestic requirements. Such arrangements have been applied by regulators to a range of financial products and market operations. To my mind they represent the

best chance we have of facilitating cross border capital market flows, including Islamic finance transactions.

In order for this to work there needs to be reciprocity. This means that each jurisdiction has to be satisfied about the other's regulatory equivalence. In the case of managed funds, this means looking at their respective requirements for the governance of funds, their disclosure requirements, their reporting obligations and the like. Each regulator will want to be satisfied that the other has appropriate compliance and enforcement powers and practices; that they are both in good standing with relevant international standard setters; and that they are committed to appropriate levels of information sharing and cooperation. If all of these hurdles can be overcome, each regulator can take comfort that differences of detail in regulatory approach will not prejudice domestic consumers of the foreign sourced products.

It all sounds pretty complicated, and it is. But for the reasons I have outlined today it is the most constructive avenue currently available to most regulators –and it can work, as yesterday's joint announcement by the SC Malaysia and the DFSA demonstrates.

In August of last year our two agencies concluded a Memorandum of Understanding and indicated our intention to streamline regulatory requirements, to the extent possible, to facilitate cross border flows of Shari'a compliant capital markets products and services. A lot of detailed work has been undertaken since that time.

This resulted yesterday in the first mutual recognition agreement entered into by both regulators and a significant milestone for us both in the area of cross-border regulation of Islamic investment funds. Under the mutual recognition framework, Islamic funds that have been approved by the SC may be marketed and distributed in the DIFC with minimal regulatory intervention. Similarly, Islamic funds which have been registered or notified with the DFSA will be more easily marketed to Malaysian investors. Supported by a bilateral memorandum of understanding, both regulators will work closely in the areas of supervision and enforcement to ensure adequate protection for investors.

Hopefully, this is only the first step towards a growing relationship not just between the two regulators but between two of the world's most important Islamic Finance centres.