A cross sectoral approach to the supervision of Islamic Financial Services:

the IOSCO view

Philippe Richard, IOSCO Secretary General

Introduction

IOSCO is the global standard setter for securities regulation, with members from all over the world. The markets of these members range from small emerging markets to the largest and most dynamic markets in the world. As a global standard setter one of IOSCO's main challenges is to take into account the many specific characteristics of the markets and products that fall under the supervision of IOSCO's members. Islamic Finance is one of the segments that fit into IOSCO´s framework but, for IOSCO to achieve its objectives, work needs to be done to identify any regulatory gaps in these markets.

IOSCO has always recognised the need for cross sectoral cooperation, especially in recent years when products and services in financial markets have started to move beyond the traditional borders of securities trade, insurance and banking. This is especially so in relation to Islamic Finance. As an active participant in the Joint Forum, IOSCO joins with its counterparts from the other financial sectors to discuss and cooperate on a wide range of issues. With regard to Islamic Finance, we have not participated in any official cross sectoral initiatives yet. For today, as far as Islamic Finance is concerned, I will have to limit myself to the sectoral approach of IOSCO.

To begin with I wish to talk to you about the role of IOSCO in standard setting but, most of all, I will raise a few questions about the supervision on Islamic finance and the regulatory challenges that we face. Unfortunately I do not have the answers to the questions but I think that asking and sharing the right questions means making progress in understanding the true issues and therefore beginning solving the problems.

Islamic finance in general

Islamic Finance is gaining ground in the financial world. While having its origins in Asia and the Middle East, it is increasingly recognised as a significant investment opportunity for both Islamic and non-Islamic people in Europe and the US. The UK, for example, is developing into an important hub for Islamic finance in Europe, aided from the start by the UK-FSA which has done its best to develop a good regulatory environment for Islamic product. All over the world conventional banks are entering the Islamic market.

It is not clear what the future of Islamic finance is. While having had a promising start, the actual share of Islamic finance has not increased that significantly in recent years, partly due to insufficient products, funds and liquidity. However, increasingly, conventional banks are responding to this need as well. New Islamic products are developing which will help Muslim and non-Muslim investors to have access to the full array of financial products. Further growth, therefore, is likely, thus placing a responsibility on IOSCO to monitor events closely. After all, it is well understood internationally that financial markets will not function properly without adequate regulatory supervision.

The IOSCO principles in relation to Islamic Finance

So one needs to consider what the connection is between IOSCO and Islamic finance. It must be stressed that IOSCO is a secular organisation which has no religious or political views. IOSCO´s interests lay in the cooperation among securities supervisors in order to create a healthy international regulatory environment which promotes fair and transparent markets, investor protection and level playing fields for securities firms.

For this reason the IOSCO principles have been created. These include principles on the main fields of securities trading as well as on the operations of the supervisor. The principles on the supervisor are directed at such things as the quality of the staff, checks and balances of the enforcement decisions of the regulator and independence of the regulator from both market parties and governments. In addition, there are principles that address the regulator’s abilities to cooperate with other regulators in exchanging information in order to combat cross border fraud.

Other principles address the operations of intermediaries, investment funds, issuers, secondary markets and clearing and settlement. These principles form the basis for all the securities regulations of all members of IOSCO and are internationally recognised as the leading standards for securities supervision: The Financial Stability Forum has endorsed the IOSCO principles on securities supervision as one of the 12 key standards for sound financial systems. The IMF and the World Bank assess the securities sector of a country on the basis of the IOSCO principles. Finally, in developing new European regulations the European Commission often refers to the IOSCO principles as well.

An important characteristic of the IOSCO principles is that they serve as a framework for securities regulations and aim to “cover” all products and services that are offered on the global markets. This means that they do not explicitly address such specific products as green funds, ethical funds or, for that matter, Islamic funds. The IOSCO principles, thus, form the basis for the regulations and supervision of Islamic capital markets.

There is one first challenging question that should be asked though. Are Islamic finance products securities ? In other words what is the nature of Islamic financial products ? IOSCO has never officially published a definition of “security” but has always adhered to a common understanding of a security. This understanding is in line with the following definition:

- a tradable share, right or certificate of ownership; or
- a tradable bond (or other tradable debt- instrument); or
- any other tradable certificate through which, by exercising the rights of this certificate, any of the mentioned instruments (or the underlying value) can be acquired

There is some discussion about whether Islamic products meet this definition. Due to the predominant use of profit and loss sharing on the underlying assets it could be argued that an Islamic fund, for example, qualifies as an investment instead of a deposit. The answer to this question leads to entirely different frameworks for the regulation of Islamic finance products.

However, if we maintain the notion that Islamic funds fall under securities laws and while IOSCO´s principles form the basic principles for securities regulations worldwide, individual regulators need to "fill in" their own supervisory framework. We then come to the question of whether conventional securities regulation can be used, one on one, for Islamic finance. The answer: broadly speaking yes but with some limitations and gaps.

Conventional securities regulations and Islamic finance

While IOSCO has published, in 2004, a report on Islamic finance in which it highlighted some points that required attention, to this time it has not made an in depth analysis of the appropriateness of conventional regulations for Islamic finance. One of the reasons for this could be that, up till now, the size of Islamic finance is still only a fraction of conventional finance, especially in those countries where conventional finance is firmly grounded. Also, until now no large scale frauds have occurred within Islamic finance and this seems to show that the conventional systems are appropriate up to a certain extent.

Without reflecting an official IOSCO position, there are some important aspects of financial regulation in general which could be of importance to Islamic finance. Here I will mention rules relating to conflicts of interest, integrity rules and standardisation.

What, for instance, are the rules relating to conflicts of interest in Islamic Banking? IOSCO is currently working on a paper on conflicts of interest in underwriting public offerings. In that paper IOSCO identifies conflicts that might occur and ways to address them. Are these conflicts the same as in Islamic Banking? While some remain the same, like conflicts of interest between the advisory part of a firm and the underwriting part, there could be others. What about, for instance, conflicts involving Sharia board members when they are providing advisory function and then endorsing the underwriting transactions ? What about conflicts between the bank and the underlying entity in which it has invested? It is important that such possible conflicts of interest are analysed.

Another important aspect of securities regulations are integrity rules. Rules on knowing your customer, acting in the best interest of the customer and giving full disclosure of costs and risks to a customer are an essential part of investor protection and well established in the conventional regulations. Again a question: How about integrity rules in Islamic finance? Have analyses been made about the pitfalls in Islamic products for customers? Are they fully informed of what it means to invest in such products and what their rights and risks are? This is particularly the case in relation to the nature of each product as well as consideration of whether they are risk-free deposits or investments.

Disclosure to clients could differ from traditional products in the following example: The dealings of Islamic banks with depositors are based on profit and loss sharing rather than a fixed pre-determined interest. Therefore, Islamic bankers are obliged to be transparent by making adequate disclosures to their investment account holders, not only with regard to their own financial condition as is the case with conventional banks but also in respect of the management of trust money

Without the trust of the retail investor there can be no liquid capital market so these issues are important to consider.

Who is responsible for analysing these questions? It speaks for itself that governments and regulators play a leading role. They are the ones setting the national agenda and creating rules and policies. However, a central part should also be played by the compliance officer within the firms.

In 2006 IOSCO published principles on the role and responsibilities of compliance officers. The first principle says:

> *The role of the compliance function is, on an on-going basis, to identify, advise on, monitor and report on a market intermediary's compliance with securities regulatory requirements and the appropriateness of its supervisory procedures.*

The report states that, other than *monitoring* for compliance with securities regulatory requirements, a compliance officer should also engage in the *identification* and *prevention* of violation of these securities regulatory requirements. It states also that regulators should support and promote the role of compliance officers in securities firms.

While, as I stated before, there is still some unclarity about the regulations, it is of the utmost importance that compliance officers are actively involved in these new Islamic markets. Leaving aside the religious aspects of Islamic Finance it is their responsibility to guard the integrity of the products and services as well as the conduct of business of their firm, in line with international best practices. They also play an important role in having an open dialogue with their regulators in order for them to identify weaknesses in their regulations and safeguarding the integrity of their markets.

One final area of attention for regulators that I would like to mention concerns investors' involvement and the smooth functioning of capital markets. In this context we need to consider standardisation. Naturally, standardisation of products is a prerequisite for growing, deep and liquid capital markets. Of course, an important reason for this is that it makes them less expensive to trade thus increasing the access for retail investors. It also enhances the trust in markets as the products stick to well recognised standards.

Conclusion

In conclusion, it is clear that when it comes to regulating Islamic banking there is a lot to think about. I am confident that a lot of preparatory work has already been done by IOSCO. It has created a comprehensive framework for securities supervision that has proven its worth in the past years. However, it seems that there are important details in Islamic finance that differ from conventional banking. I have mentioned a few, but there might be others. We need to identify and analyse them. IOSCO will do so, in cooperation with the IFSB and other international bodies so that, whatever happens, together we can continue to ensure fair, orderly and stable international markets for generations to come.

Dubai, 15/16 May, 2007