

Importance of the Legal and Regulatory Framework for the Development of Islamic Finance

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ASEAN INSIDERS
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Importance from Risk Perspectives

**Importance from Stakeholders'
Perspective**

Key Infrastructures

Case Example: Malaysia

Concluding Remarks

Risks in failure of the Boardroom (*read: 'governance'*) functions



Among others:

- Breach of law and regulations
- Breach of Shariah principles
- Financial loss due to poor investment and/or financing decisions
- Damage to reputation/ image of Islamic financial institutions and the industry
- Systemic pressure on the rest of the market

The GFC in 2007/08 has proven that strong legal and regulatory intervention remains key to sound governance

Risks in failure of the Courtroom (*read: 'dispute resolution'*) functions

Among others:

- Injustice to disputing parties
- Breach of Shariah principles, which defeats the key purpose of Islamic financial contracts
- Unfair infliction of financial loss due to poorly conceived court decisions
- Damage to reputation/ image of Islamic financial institutions and the industry
- Systemic pressure on the rest of the market



Parties have no where else to turn to in seeking fair resolution of their disputes – the Court cannot abdicate from this duty.

The big challenges -

- ❖ To ensure orderly and harmonised interface between the existing the legal and regulatory framework with the Shariah principles that underlie the Islamic financial contracts
- ❖ To serve the law and serve justice in cost efficient and timely manner
- ❖ To be cautious about the impact of a single decision on the rest of the Islamic finance industry ('public interest'/ *maslahah* consideration)

Notwithstanding that the legal and regulatory bodies (from the Boardroom ... to the Courtroom) are still *learning* about Islamic finance, the risks of failures remain real and must be managed effectively.

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Characteristics of an Effective Legal and Regulatory Framework for Islamic Finance

Nik Thani & Othman (2007):

- ❖ An enabling environment that accommodates and facilitates the development of the industry
- ❖ A clear and efficient system that preserves enforceability of Islamic finance contracts
- ❖ A credible and reliable forum for settlement of legal disputes arising from Islamic finance transactions



Common Hurdles every where ...

- ❖ To ensure a harmonized interface between Shariah principles, which form the backbone and *raison d'être* of the Islamic financial services industry, with the existing legal and regulatory framework;
- ❖ To implement a tax regime which does not penalize or discriminate against consumers of Islamic financial services;
- ❖ To strengthen the sustainability and competitiveness of Islamic financial institutions as a business, in view of its contribution to the society and to the economy.

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● An enabling environment that accommodates and facilitates the development of IFSI should have:

- ❖ Clear policy decisions and directions
- ❖ Legislation that provides for the licensing and supervision of Islamic financial institutions
- ❖ Mechanisms to ensure the Shariah-compliance system is comprehensive and rigorous
- ❖ Friendly and neutral taxation system that makes Shariah-compliant products at par and competitive with their conventional cousins
- ❖ Supporting infrastructures such as accounting standards and human resource development, and any other non-fiscal initiatives
- ❖ Participation in global initiatives, such as the Islamic Financial Services Board (IFSB)

A clear and efficient system that preserves enforceability of Islamic financial contracts should take into consideration:

- ❖ That the legal system are bifurcated – in the case of Malaysia it comprises a hybrid of English common law, Shariah and native's customary laws
- ❖ The interaction between two or more sets of laws has led to the existence of legal pluralism, affecting the certainty, predictability and enforcement of legal transactions and procedures, which, if not managed carefully, may impair the smooth functioning of a banking and financial system

A credible and reliable forum for settlement of legal disputes arising from Islamic finance transactions may, among others, constitute:

- ❖ Special courts/benches/committees within the judicial system comprising of judges well exposed to the Shariah principles, especially in the area of *Muamalat*
- ❖ The Court must have access to authoritative Shariah resolutions (such as by the National Shariah Council)
- ❖ As far as possible there should be dedicated efforts to publish high quality law reports to record precedents
- ❖ An internationally recognised adjudicating body (e.g. an International Islamic arbitration tribunal) to adjudicate disputes that arise in cross-border Islamic finance transactions

- ❖ A comprehensive set of law and regulations which provides the requisite legal infrastructure not only for a satisfactory resolution of disputes, but also a general guideline for Islamic financial institutions
- ❖ Greater use of arbitration (*tahkim*) and mediation (*sulh*) by Shariah and Islamic finance experts who qualify as arbitrators to adjudicate cases of dispute. Other methods could be explored are mini-trials and hybrids of arbitration and mediation (arb-med)

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While most jurisdictions have adopted international best practices for Boardroom (*read: 'governance'*) functions, Malaysia is unique -



BNM Guidelines on Introduction of New Products require that every new product can only be offered upon approval from BNM.

BNM new Shariah Governance Framework requires, among others, that the management and the Board share the responsibility in supporting the Shariah Committee to oversee the Shariah compliance issues.

BNM Shariah Parameters set out the basic ingredients that must be adhered to in the documentation and operation of some products, thus minimizing errors and strengthening compliance with Shariah.

These help to ensure that the Boardroom is always cautious and prudent in its decision making.

While most jurisdictions rarely have clear Courtroom processes in resolving Islamic finance disputes, Malaysia is unique -

Sections 56 and 57 of the BNM Act 2009 provides that resolutions of the National Shariah Advisory Council on any Shariah issues that arise in an Islamic finance dispute are binding on the Courts and arbitrators.

The constitutionality of Sections 56 & 57 have been challenged in the case of Mohd Alias Ibrahim v RHB Bank & Anor [2011]. However the Kuala Lumpur High Court decided that the sections are constitutional.

BNM has proactively acted as 'amicus curae' (friend of the Court) in some cases – thus ensuring that the Court listens to legal arguments from the prudential regulator's perspectives.



These help to strengthen public confidence in the Court system.

● Alhamdulillah and insha Allah, Malaysia has ...

- ✓ An enabling environment that accommodates and facilitates the development of the industry
- ✓ A clear and efficient system that preserves enforceability of Islamic finance contracts
- ✓ A credible and reliable forum for settlement of legal disputes arising from Islamic finance transactions

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Issues & Challenges

- Regulatory framework for cross border transactions
- Standardization and contractual enforceability
- Jurisdictional issues
- Tax Issues
- Disputes and Mechanism for Its Resolution

Concluding Remarks

- ✓ Jul 2014: UK became the first country outside of the Muslim majority nations to issue Sukuk. The **£200m** (USD343m) issue with maturity of 5 years, priced at **2.036%**, was **11.5 times** oversubscribed attracting orders of more than £2b from global investors.
- ✓ Sep 2014: The Hong Kong government's **USD1b** 5-year Sukuk, priced at 2.005%, were oversubscribed **4.7 times** with orders of US\$4.7b.
- ✓ Sep 2014: South Africa, the third non-Muslim majority country to issue sovereign Sukuk, issued **USD500m** Sukuk which were more than 4 times oversubscribed, with an order book of **\$2.2b**. The Sukuk, with maturity of 5 years and 9 months, were priced at **3.90%** with a spread of 180 b.p. above the corresponding mid-swap benchmark rate.
- ✓ Oct 2014: Luxembourg issued its debut **€200m** (USD253m) 5-year Sukuk, with an order book that was more than 2 times oversubscribed. The AAA-rated sovereign Sukuk were priced at a profit rate of **0.436%**.

Is it not time for more OIC countries?

Q&A