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**IFSB WORKING PAPER ON
FINANCIAL CONSUMER PROTECTION
IN ISLAMIC FINANCE**

Professor Volker Nienhaus

October 2015



**ISLAMIC FINANCIAL
SERVICES BOARD**



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Note: This Working Paper should not be reported as representing the views of the Islamic Financial Services Board (IFSB). The views expressed are those of the author and do not necessarily reflect those of the IFSB.

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The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, among others, the issuance of exposure drafts, holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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ABBREVIATIONS

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CFEB	Consumer Financial Education Body
CIS	Collective investment scheme
CPIF	Consumer protection in Islamic finance
EU	European Union
FOS	Financial Ombudsman Service
GFC	Global Financial Crisis
G20	Group of Twenty
IAH	Investment account holders
IAIS	International Association of Insurance Supervisors
IFSB	Islamic Financial Services Board
IIFM	International Islamic Financial Market
IIFS	Institutions offering Islamic financial services in banking segments [other than Islamic insurance (<i>Takāful</i>) institutions and Islamic collective investment schemes]
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IRR	Investment risk reserve
MAS	Money Advice Service
NAO	National Audit Office
OECD	Organisation for Economic Co-operation and Development
PER	Profit equalisation reserve
RSAs	Regulatory and supervisory authorities
SC	Securities Commission Malaysia
SRI	Socially responsible investing
UPSIA	Unrestricted profit-sharing investment account
WP	Working Paper
UAE	United Arab Emirates

ABSTRACT¹

In the aftermath of the Global Financial Crisis widespread mis-selling practices and unfair treatments of consumers by banks and financial advisers became apparent. This paper briefly highlights the reactions of governments and international institutions and the increasing attention now being paid to financial consumer protection. It lists the most important findings of behavioural economics regarding the relevance of financial consumers' information-processing capabilities and cognitive biases in ensuring the effectiveness of consumer protection measures. A summary of traditional and innovative approaches to financial consumer protection follows. Instruments for better-informed choices range from disclosure requirements to subsidised consumer advice services. Product regulations comprise recommended and mandatory product standards, criteria for "simple financial products" that are easy to handle and offer users reasonable deals, and a ban on or restriction of distribution channels for products that are considered "too dangerous" for retail customers. Conduct regulations become more effective by stipulating a liability for financial advice and sanctions for selling unsuitable products, but also by making a radical change of incentive structures for financial advisers from commissions paid by producers for sold products to fees charged to the clients. Regulators face special consumer protection challenges regarding legally unregulated ("grey") capital markets, social and community-oriented investments, and financial intermediation through crowdfunding platforms. The consumer protection instruments outlined so far have been developed for conventional finance, but they can also be applied with minor adjustments in Islamic finance.

The second part of the paper outlines the regulatory implications of *Shari'ah* compliance as a defining product feature. It considers different interpretations of the *Shari'ah* compliance of more complex consumer products and stresses the importance of robust *Shari'ah* governance structures in those jurisdictions where no central *Shari'ah* authority exists and the regulator painstakingly avoids any own stance in *Shari'ah* compliance debates. One example each from the deposit and the financing business of Islamic banks is discussed in some detail to illustrate how even secular regulators could protect consumers in Islamic finance. In the deposit business, disclosure requirements for *Muḍārabah*-based

1 The working paper greatly benefited from the feedback and coordination of a core team of the IFSB Secretariat, led by Assistant Secretary-General, Mr Zahid ur Rehman Khokher and including Mrs Noor Ashikin Ismail and Mr Dong Choon Yi. Ms Nur Khairun Nissa Zawawi of the IFSB Secretariat provided support in distribution of the survey questionnaire. Similarly, Mrs Siham Ismail and Ms Rosmawatie Abdul Halim provided assistance in the formatting and publication of the paper. I am also grateful to the regulatory and supervisory authorities, multilateral bodies, and other institutions that are members of the IFSB for their participation in the survey and useful comments on the draft paper.

unrestricted investment accounts can be tightened (in particular, regarding the profit distribution formula, profit payout smoothing practices, and risk profiles). This tightening should facilitate better-informed choices (maybe with the help of some intermediaries). In the financing business, the suitability of products and the fair treatment of customers could pave the way for a mitigation of rigidities of nominate contracts and for consumer-protecting product and conduct regulations in Islamic banking. A country with a separate legal structure for Islamic finance and central *Shari'ah* authorities can go even further. For example, Malaysia will enforce a strict separation of risk-free Islamic deposits from risk-taking investment accounts (for which profit smoothing is no longer permissible). This separation offers consumers clear choices. The bundling of investment account funds from different banks and the use of the pooled resources for risk-sharing financing of small- and medium-sized enterprises through a government-supported platform could become a real game-changer. Some thoughts on *Shari'ah*-compliant crowdfunding and on dispute settlement schemes conclude the paper. The paper includes major findings of an IFSB survey on "Consumer Protection in Islamic Finance" that was conducted in 2014Q3.

EXECUTIVE SUMMARY

The Global Financial Crisis (GFC) had laid bare questionable practices of mis-selling of financial products and unfair treatments of customers by banks and financial advisers. Financial consumer protection gained prominence on the political agendas of governments and international standard-setters such as the Basel Committee on Banking Supervision, International Organization of Securities Commissions and International Association of Insurance Supervisors. The issue was taken up by the Organisation for Economic Co-operation and Development and the Group of Twenty (G20), which issued in 2011 the *G20 High-level Principles on Financial Consumer Protection*. The most important principles are transparency, impartiality and reliability. The G20 document is not binding, but it signals the consensus of the governments of the financially most advanced jurisdictions. This will become the benchmark for financial consumer protection in other parts of the world, including Muslim countries.

Neoclassical economic models of financial markets assumed well-informed and rational market players, but the persistence of widespread questionable practices made it obvious that retail investors and clients of financial advisers did not match the ideal. The combination of economics with psychology in behavioural economics was able to explain the actual behaviour of consumers of financial services. Any regulation of financial retail markets has to take into consideration consumers' limited skills and capabilities in the processing of information, as well as a host of deep-seated cognitive biases. As most of these deficits could be overcome only in the long run (if at all), consumer protection cannot be confined to transparency and disclosure regulations (for better-informed consumer choices) only. To some degree, consumers have to be supported by the pre-processing of information (to facilitate easy comparisons of different offers) or impartial financial consumer advice.

The regulator may furthermore define requirements for basic financial products (such as the *Simple Financial Products* in the United Kingdom), which are structured such that consumers will not be cheated and normally get a reasonable deal. Products that meet the criteria set by the regulator can be marketed under a special label, which should signify to consumers their special quality. A stricter form of product regulation is mandatory minimum standards applicable to all products of a particular class. The most interventionist forms of product regulations are restriction of distribution channels (thus keeping specific products out of reach for "ordinary" retail clients) and the total ban of particular products (with destabilising potentials such as short selling or credit default swaps) from the retail market.

Product regulations may protect consumers against products considered too “dangerous” (which could cause capital losses), but they do not ensure that consumers get the products most suitable for them. This is the prime objective of conduct regulations, which, ideally, shall synchronise the interests of service providers with those of the customers. A precondition is the proper determination of the financial needs and capabilities of customers. Conduct regulations were already in force in many jurisdictions long before the GFC, but they were seemingly not sufficient to prevent widespread mis-selling of products that primarily served the interest of the service provider and not that of the customers. To give existing need assessment regulations more vigour, legal liability for the advice of financial service providers could be established. Such liability would give customers the right to proceed against banks and advisers if they felt they had been sold an inappropriate product or given inappropriate advice. It is in the interest of the bank or adviser to avoid costly lawsuits and therefore to provide appropriate services in the first instance. Regulators can even take more radical measures to synchronise the interests of service providers and customers, such as by changing the remuneration structure for advisers through the prohibition of commissions. Advisers then earn their income exclusively from fees charged explicitly to their clients, instead of from commissions paid by the producers of the products sold.

Should all these regulations fail and consumers are still not satisfied with the financial services they have received, regulators could enact fair treatment rules by mandating internal procedures for complaint handling. In cases where no internal settlement is reached, external dispute resolution schemes (e.g. Ombudsman systems) can be installed. Finally, regulators and legislators can improve consumers’ access to the court system and strengthen their position by allowing class actions.

Challenges for regulators are recent developments in unregulated capital markets and new forms of financial intermediation – for example, for community projects or through crowdfunding platforms. The special features of these segments of the financial markets (e.g. the relatively small volumes and the particular profiles or motivations of the parties involved) have justified both exemptions from general regulations and specific requirements to limit the risk exposure of retail investors.

All measures for financial consumer protection in the conventional system are also applicable in Islamic finance with minor adjustments. But there is one additional dimension which regulators of Islamic finance have to consider – namely, the claim of *Sharī‘ah* compliance as an essential and distinguishing product feature. The objective of consumer protection requires that the regulator takes adequate

measures to ensure that this claim is sufficiently justified. However, regulators face the problem that there are different views on the *Sharī'ah* compliance of products: while basic consumer products have been more-or-less standardised (in particular, by Accounting and Auditing Organization for Islamic Financial Institutions [AAOIFI] *Sharī'ah* standards), opinions on more complex consumer products diverge. Some jurisdictions have established *Sharī'ah* committees or boards at the supervisory level with the authority to decide on the applicable *Sharī'ah* view. Other jurisdictions do not have such institutions, and the regulators do not want to take an own stance in *Sharī'ah* debates. That shifts the “burden of proof” to the financial institutions. The most effective instrument for ensuring *Sharī'ah* compliance in these jurisdictions is the implementation of a robust *Sharī'ah* governance system within the financial institutions. The Islamic Financial Services Board (IFSB) has issued a standard on *Guiding Principles on Sharī'ah Governance Systems for Institutions offering Islamic Financial Services* (IFSB-10). However, even an elaborate *Sharī'ah* governance system does not guarantee identical *Sharī'ah* interpretations by all financial institutions, or ensure that interpretations are consumer friendly. There are two outstanding examples of financial products whose *Sharī'ah* compliance or fairness to customers can be challenged.

The first example of a debatable practice is the smoothing of profit payouts for unrestricted profit-sharing investment accounts (UPSIA). This practice is widespread and legally permissible in most jurisdictions, but it nevertheless has incurred substantial criticism from a *Sharī'ah* perspective as it converts *Muḍārabah*-based accounts into close substitutes of conventional interest-bearing deposits. Malaysia is the only jurisdiction to have taken a decisive step and prohibited profit smoothing for UPSIA. Jurisdictions that do not follow Malaysia's example should, in the interests of consumer protection, make better explanations and a detailed disclosure of their smoothing practices mandatory. Given that *Muḍārabah* contracts are pooling resources among risk-sharing partners, disclosure requirements could be structured in analogy to collective investment schemes, for which the IFSB has issued the *Guiding Principles on Governance for Islamic Collective Investment Schemes* (IFSB-7).

The second example is based on experiences during the financial crisis. The strict adherence to the letters of Islamic contracts such as debt-creating *Murābaḥah* sale contracts may lead to hardships for consumers and put them in a position that is considered unfair and worse than in a conventional setting. For example, if the purchase of a house is financed by a *Murābaḥah* contract, the consumer owes the bank the full purchasing price plus the profit markup that was calculated for the whole financing period. If the customer who financed the purchase by a

conventional loan is forced to terminate the loan contract early, the bank will claim the outstanding loan amount, any outstanding interest payments for past periods, and (most probably) a penalty for the early termination, but not the scheduled future interest payments. If the termination happens in the early years of a long-term financing arrangement, the conventional penalty would be considerably less than the outstanding markup in a *Murābahah* financing. Islamic banks can grant a rebate (*Ibrā'*), but that would be completely at the discretion of the bank unless the regulator intervenes and makes a rebate mandatory. The rationale for such an intervention can be based on two arguments: first, a claim of the full profit markup for a longer-term financing is unreasonable and unfair (especially compared to conventional practices); and second, more flexible *Sharī'ah*-compliant contracts (e.g. *Ijārah* or diminishing *Mushārahah*) are available that imply more reasonable and fairer results in cases of early termination. The argument boils down to the charge of selling an unsuitable product for long-term financing that is not in the best interest of the consumer. This is in line with general consumer protection regulations. It does not require specific *Sharī'ah* arguments by the regulator, but only knowledge about the existence and the economic characteristics of alternative, *Sharī'ah*-compliant contractual arrangements (for which AAOIFI standards do exist).

These examples indicate ways in which secular regulators also can deal with the issue of consumer protection for *Sharī'ah*-compliant products without the need to take a particular stance in ongoing *Sharī'ah* discussions.

INTRODUCTION

One of the root causes of the Global Financial Crisis (GFC) of 2007–2009 was reckless lending practices in the retail market – in particular, sub-prime mortgages. These mortgages were securitised and became the basis of complex securities that were sold off in large part to retail clients² who were unable to assess their high-risk structure. (The risk was actually not fully understood even by professional rating agencies.) Courts later found many financial institutions guilty of misconduct, and sometimes even of fraud, and some were required to make compensation payments and to pay fines of an unprecedented size. The mistreatment of retail clients by financial institutions (in particular, banks and financial advisers) and the protection of financial consumers gained prominence on the political agendas in jurisdictions all over the globe.³ The issue was escalated to the international level of the Group of Twenty (G20) when, in early 2011, the finance ministers and central bank governors called on the Organisation for Economic Co-operation and Development (OECD) and other international organisations to develop common principles on financial consumer protection. Section 1 of this paper will briefly summarise these principles. Section 2 indicates differences between the rational decision makers of models of mainstream economics and the observed serious cognitive biases and limited capabilities of real world consumers of financial services. Section 3 outlines the main instruments that are applied by different G20 jurisdictions (in particular, the United States, the United Kingdom and the European Union) in their consumer protection policies for conventional finance. Section 4 discusses implications and adaptations for consumer protection in Islamic finance.

2 The directive 2014/65/EU of the EU (the so-called MiFID 2 Directive) defines a retail client as one who is not a professional client “who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs” (EU 2014, p. 483 [Annex II]). It is noteworthy that the ability to properly assess or manage financial risks has become a crucial criterion for the distinction between retail and professional clients and for the level of protection to be provided by the regulatory system.

3 This does not mean that financial consumer protection is a totally new topic in politics. The need for consumer protection became apparent, for example, in the UK in the 1990s and led to regulatory initiatives in the late 1990s and early 2000s when elements of a “simple financial products” policy were implemented; see section 3.2.1.1. Investor protection was always a concern of securities market regulators and securities exchanges – either explicitly or implicitly as a result of their policies to ensure market integrity (e.g. by preventing insider trading and other market manipulations).

SECTION 1: THE GLOBAL COMPASS: G20 FINANCIAL CONSUMER PROTECTION

Up to the 1990s, financial regulation was primarily focused on the stability of the financial system – in particular, the banking system. Although regulators also had a mandate for financial consumer protection in a number of jurisdictions,⁴ the regulatory practice was dominated by prudential regulation. In cases of conflict between stability and consumer protection, priority was given to stability, which was often equated with the profitability of financial institutions (in particular, banks). The perception was that when consumer protection puts a strain on profitability, it may impact the stability of the firm and, possibly, the system as a whole. Therefore, profit-enhancing practices were tolerated even if they implied extra costs or poorer product qualities for consumers. A dual mandate (stability and consumer protection) for one authority is probably not the best regulatory and supervisory structure for effective financial consumer protection.

A number of spectacular cases of fraud and mis-selling in several jurisdictions gave financial consumer protection more prominence, and national regulators and legislators as well as international standard-setters started initiatives aimed at ensuring more effective consumer protection by issuing new or revising existing guidelines and high-level principles and by amendments of the statutes of the regulatory authorities. Some jurisdictions modified the institutional set-up of their financial market regulations by creating a new regulatory body exclusively for financial consumer protection – such as the *Consumer Financial Protection Bureau* in the US in 2011⁵ – or even by replacing an existing sole regulator by two separate regulatory authorities for prudential regulation and supervision and for financial consumer protection – such as the replacement of the *Financial Services Authority* (FSA) by the *Prudential Regulation Authority* and the *Financial Conduct Authority* (FCA) in the UK in 2013.⁶

4 The Islamic Financial Services Board (IFSB) survey on “Consumer Protection in Islamic Finance” (CPIF) found that 73% of the responding regulatory and supervisory authorities (RSAs) have a mandate for financial consumer protection (besides their responsibility for financial stability), and most of them seek a balance between prudential regulation and consumer protection.

5 See Levitin 2013, Zywicki 2013.

6 See NAO 2014. Such a “twin peak” structure had been implemented in Australia in the late 1990s when the government adopted recommendations of the “Financial System Inquiry” (the so-called Wallis Inquiry; see Wallis et al. 1997): the two regulatory authorities (“peaks”) are the Australian Prudential Regulation Authority and the Australian Securities and Investment Commission (ASIC); the latter is in charge of market integrity and consumer protection; see also IMF 2005. This system has recently been reviewed by the 2014 Financial System Inquiry; see Murray et al. 2014. For a cross-country comparison of changes of financial supervision architectures during the decade prior to the GFC, see Masciandaro and Quintyn 2011; for recent consumer protection measures in the EU retail markets, see Moloney 2014 (Chapter IX); and for changes in reaction to lessons learned from the financial crisis, see Cukierman 2011; see also Peláez and Peláez 2009; Porter, Glauber and Healey 2011; Andenas and Chiu 2014.

The recent implementations in several jurisdictions provide a large pool of empirical examples for different legal and technical approaches, which can be utilised by other countries that intend to enhance their financial consumer protection regulations. It can also become a starting point for reflections on consumer protection in Islamic finance. For this reason, it is of particular relevance to look at cross-sectoral regulations, because savings and investment products of Islamic banks share many characteristics of collective investment schemes (CIS), which are usually regulated by a capital market authority. Different regulations for functionally very similar products by different regulators for banking and capital markets should be avoided, as they may create opportunities for an undesirable regulatory arbitrage.

Country-specific implementations of financial consumer protection regulations have to fit into the overall legal and regulatory system and must take into consideration the state of development of the financial sector of a given jurisdiction. Since implemented solutions can rarely be transferred to another jurisdiction without specific adaptations, the focus here should not be on technical details of individual countries but on the underlying concepts and guiding principles and their substantiation and operationalisation.

An IFSB survey on “Consumer Protection in Islamic Finance”⁷ found that 73% of the responding RSAs have a mandate for financial consumer protection in addition to their responsibility for financial stability, and most of them seek a balance between prudential regulation and consumer protection. A dedicated financial consumer protection authority has been established in only a few jurisdictions.

1.1 Consumer Protection and International Standard-setters

International standard-setters have been following national initiatives and subsumed major developments in their own documents after due consultation and interaction with their members. Although the standards and guidelines of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS) are not binding for their members, they are globally appreciated and respected. Some recommendations have become de facto standards (in particular, those of BCBS), and all indicate the direction in which the regulatory systems in many jurisdictions worldwide will move.

⁷ The CPIF was conducted by the IFSB Secretariat in Q3 of 2014, with Mr Dong Choon Yi, Member of the Secretariat, as the project manager. The survey questionnaire was completed by 30 RSAs, including central banks and supervisors in the banking, capital market and insurance sectors. Apart from collecting information related to the “good practices on consumer protection” in the respective sectors, the survey also covered the legal and regulatory framework, as well as Shari’ah-related issues associated with consumer protection. The key reflections of this survey are included in various parts of this paper.

All three standard-setters have laid down their basic positions in separate documents that were initially issued in the late 1990s and updated and revised several times. The latest versions are:

- *Core Principles for Effective Banking Supervision*, issued by BCBS in September 2012;
- *Objectives and Principles of Securities Regulation*, issued by IOSCO in June 2010; and
- *Insurance Core Principles, Standards, Guidance and Assessment Methodology*, issued by IAIS in October 2011 and revised in October 2013.⁸

To deal with cross-sectoral issues, the three sectoral standard-setters formed the Joint Forum in 1996. It is particularly active in the examination of “cross-sectoral gaps and conflicts in regulation and supervision”, and it “develops guidance and principles and/or identifies best practices on cross-sectoral technical, regulatory and/or policy issues to encourage cross-sectoral consistency and alignment where appropriate, and reduce opportunities for regulatory arbitrage”.⁹ The Joint Forum produced, among other studies, a cross-sectoral comparison of the core principles (BCBS 2001) and a *Review of the Differentiated Nature and Scope of Financial Regulation* (BCBS 2010).

The 2001 comparison of core principles revealed differences between the banking, capital market and insurance regulations: while, in banking, consumer protection is hardly mentioned and stability (of institutions and the financial system) is the predominant objective,¹⁰ “[i]nvestor protection is a fundamental objective of securities regulation. Therefore, all Principles generally are aimed at achieving this objective.”¹¹ Similarly, the insurance supervisors shall “maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders”.¹²

8 See BCBS 2012, IOSCO 2010 and IAIS 2013.

9 Quoted from the website of the Joint Forum (www.bis.org/bcbs/jfmandate.htm), accessed 23 January 2015

10 The entry in the summary table for the comparison of the core principles displays under “customer protection” only the following brief entry (plus a reference to deposit protection): “The key objective of supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors” (BCBS 2001, p. 38).

11 Ibid, p. 38.

12 Ibid, p. 38. The Joint Forum notes that the core principles for insurance “put less emphasis =on reducing systemic risks than for instance the principles underlying banking supervision”. This reflects the fact that insurers “generally are not very dependent on short term debt financing, and therefore are less sensitive to instability caused by confidence effects and liquidity shortages” (BCBS 2010, pp. 89–90). Insurance implies the least, banking the most, severe threats to the stability of the financial system.

During the 2000s the awareness of consumer protection issues in banking and in a cross-sectoral context has increased, although even the latest version of the core principles for banking do not mention consumer protection as a key objective. However, the Joint Forum has been working on priority issues of financial consumer protection in a cross-sectoral perspective, including banking. Two papers are of particular relevance – namely, *Customer Suitability in the Retail Sale of Financial Products and Services* (BCBS 2008) and *Point of Sale Disclosure in the Insurance, Banking and Securities Sectors: Final Report* (BCBS 2014). Between these, the Joint Forum published a *Review of the Differentiated Nature and Scope of Financial Regulation: Key Issues and Recommendations* (BCBS 2010), which gives financial consumer protection a more distinct quality. The review recommends, for example, that work should “be carried out to strengthen consistency in core principles related to market conduct, consumer protection, and prudential requirements. For example, ensuring that there are adequate principles regarding market conduct and customer protection would be for the benefit of customers and would enhance confidence. This assurance would also help reduce the possibilities for regulatory arbitrage regarding product manufacturing and distribution across sectors.”¹³

There are other recognised international institutions that are not themselves standard-setters but which promote and support the implementation of financial consumer protection standards. For example, the OECD has been engaged in this field with a particular emphasis on financial literacy as a tool for consumer protection.¹⁴ The OECD runs the *International Gateway for Financial Education*, a dedicated website (www.financial-education.org) that gives access to a global database on financial education and publications, including standards and examples of good practices on financial education and awareness. The World Bank launched its *Global Program for Consumer Protection and Financial Literacy* in November 2010 and published in 2012 a detailed report on good practices for financial consumer protection based on the experiences of 14 middle- and four low-income countries.¹⁵ The IFSB survey on CPIF used these good practices as the basis for an analysis and evaluation of perceptions and actual practices of RSAs with respect to institutions offering Islamic financial services (IIFS). The survey found that 25 of 34 good practices in Islamic banking are implemented by at least 50% of the respondent RSAs, 27 of 27 in Islamic capital markets, and 25 of 36 in *Takāful*.

13 BCBS 2010, p. 12. “Work should also be carried out to update and make more consistent principles related to market conduct, consumer protection, and prudential requirements.” Ibid, p. 38.

14 See OECD 2009.

15 See World Bank 2012.

1.2 G20 High-level Principles of Financial Consumer Protection

Although financial consumer protection is still not a major issue in the core principles for banking, its political status was elevated by the G20 in 2011 when the finance ministers and central bank governors adopted the *G20 High-level Principles of Financial Consumer Protection*. These principles are the result of joint efforts of international organisations (including the BCBS, IOSCO and IAIS) coordinated by the OECD. “The high-level principles are designed to assist G20 countries and other interested economies to enhance financial consumer protection. The principles complement and do not substitute any existing international principles and/or guidelines. In particular they do not address sectoral issues dealt with by standard setter bodies such as BCBS, IAIS and IOSCO. These (non-binding) principles will be applicable across all financial services sectors” (OECD 2011, p. 3).

The G20 initiative signals a global consensus of the governments of the jurisdictions with the most advanced financial industries. This consensus will become the benchmark for financial consumer protection in other parts of the world, including Muslim countries.¹⁶

The following summarises the ten *High-level Principles of Financial Consumer Protection* endorsed by the G20 in October 2011:¹⁷

- (i) *Legal, Regulatory and Supervisory Framework*: “Financial consumer protection should be an integral part of the legal, regulatory and supervisory framework.... Regulation should reflect and be proportionate to the characteristics, type, and variety of the financial products and consumers, their rights and responsibilities and be responsive to new products, designs, technologies and delivery mechanisms. Strong and effective legal and judicial or supervisory mechanisms should exist to protect consumers from and sanction against financial frauds, abuses and errors.”
- (ii) *Role of Oversight Bodies*: There should be an explicit and clearly defined responsibility of oversight bodies for financial consumer protection with adequate powers, resources and capabilities.
- (iii) *Equitable and Fair Treatment of Consumers*: “All financial consumers should be treated equitably, honestly and fairly at all stages of their relationship with financial service providers”, with special attention to the needs of vulnerable groups.

¹⁶ Many of the good practices of financial consumer protection compiled by the World Bank in general and by the IFSB survey on CPIF for Islamic finance in particular are already in line with G20 principles.

¹⁷ See OECD 2011; all following quotations are from this text, pp. 5–7.

- (iv) *Disclosure and Transparency*: Financial service providers and agents should provide consumers key information on:
- the fundamental benefits, risks and terms of the product (including prices, costs, penalties, surrender charges, risks and termination modalities);
 - conflicts of interest of the agent through which the product is sold; and
 - (where relevant) possible alternatives they provide (including simpler ones).

The information provided should be clear, concise, accurate, reliable, comparable, easily accessible, and timely. In particular, promotional material should be accurate, honest, understandable and not misleading.

- (v) *Financial Education and Awareness*: Financial education should give consumers knowledge, skills and confidence to understand risks and opportunities, and to make informed choices.
- (vi) *Responsible Business Conduct of Financial Services Providers and Authorised Agents*: Financial service providers and agents should work in the best interests of their customers, be responsible for upholding financial consumer protection, and assess the consumer's financial capabilities, situation and needs before providing a product, advice or service.
- (vii) The remuneration structure of staff and agents should encourage responsible business conduct and fair treatment of consumers; it should not create conflicts of interest. If conflicts cannot be avoided or managed, the remuneration structure should be disclosed to customers.
- (viii) *Protection of Consumer Assets against Fraud and Misuse*: Consumers' deposits, savings and similar financial assets should be protected – in particular, against fraud, misappropriation and other misuse.
- (ix) *Protection of Consumer Data and Privacy*: Consumers' financial and personal information should be protected, and consumers should be informed about data sharing.
- (x) *Complaints Handling and Redress*: Consumers should “have access to adequate complaints handling and redress mechanisms that are accessible, affordable, independent, fair, accountable, timely and efficient”. Financial service providers and agents should have such mechanisms in place, supplemented by independent mechanisms for disputes which cannot be settled by the internal mechanisms. Information on complaints and their resolution should be published (at least in an aggregate format).

- (xi) *Competition*: Competition should provide consumers with greater choices, stimulate innovation and ensure high service quality. “Consumers should be able to search, compare and, where appropriate, switch between products and providers easily and at reasonable and disclosed costs.”

To support the implementation of the principles, the G20 established a *Task Force on Financial Consumer Protection* that presented reports in 2013 and 2014.¹⁸ It should be noted that the OECD principles have already been taken up by governments of non-OECD Muslim countries such as Indonesia. The newly established Financial Services Authority (Otoritas Jasa Keuangan, OJK) issued as its first regulation in 2013 a regulation on Consumer Protection in the Financial Services Sector.¹⁹ The ten OECD principles have been accommodated in the following five principles by OJK: (1) transparency, (2) impartial treatment, (3) reliability, (4) secrecy and security of consumer data, and (5) simple and quick handling of consumer complaints and dispute resolution at affordable costs.²⁰

The ideal outcome of the implementation of all high-level principles would be an empowered financial consumer who has the necessary skills and tools to make well-informed choices in his or her own best interest and who is protected against not only illegal but also unfair practices of providers of financial services. This ideal may be difficult to achieve, not only because of resistance and evasive movements of service providers but also because of inherent limitations of the capabilities of many, if not most, financial consumers.

18 The first report (OECD 2013a) covers disclosure and transparency, responsible business conduct of financial service providers and their authorised agents, and complaints handling and redress; the second report (OECD 2014a) covers the legal, regulatory and supervisory framework, role of oversight bodies, equitable and fair treatment of consumers, protection of consumer assets against fraud and misuse, protection of consumer data and privacy, and competition. An addendum (OECD 2014b) deals with financial education and awareness.

19 OJK Regulation No. 1/POJK.07/2013; for an English summary, see n.a. 2013, 2014.

20 Implications of the principles of transparency, impartiality and reliability for Islamic finance will be indicated in Section 4.

SECTION 2: CAPABILITIES AND CONSUMER BEHAVIOUR IN FINANCE

The GFC confirmed long-standing doubts about the explanatory power of neoclassical mainstream models of near-perfect financial markets. It also brought into discredit concepts of self-regulation and market discipline as the result of interactions of rational market players. Policymakers felt the need for a deeper understanding of financial decision-making, and they gave their attention to alternative approaches for the explanation of adverse market phenomena – in particular, to models and insights of behavioural finance. Empirical studies on financial consumer behaviour were initiated by regulators, and their results were alarming. Consumers often do not understand financial products, are not well informed, and tend to choose, on the average, products and services that are not in their best interest. This weakness has been exploited by service providers who sold products that maximised their income (often from commissions).

2.1 From Deductive to Behavioural Economics

In an ideal competitive world, the economic agents can get and process all relevant information they need in order to make rational choices in their own best interest. On an aggregate level, the outcome of these individual decisions can be seen as an optimal allocation of resources or as a system of fully coordinated individual plans. The basic premise underlying such concepts is that of “rational” economic agents (representatives of a species called “*homo oeconomicus*”²¹).

2.1.1 Methodological Differences

If the common premise of “deductive economics”²² is taken to its extreme, collective action of the state is only needed to define and protect individual property rights. In a society with a legislator, a judiciary, and a law enforcement system, competitive markets ensure consumer protection, and there is no place for further state intervention in the interests of consumers.

Over time, extreme assumptions of (in particular, neoclassical) models were softened and some “market imperfections” were conceded. For example, it was recognised that information is not freely available to everybody, and self-

21 On various aspects of this economic model of individual behaviour and its applications in economics and other social sciences, see Kirchgässner 2008.

22 This term indicates a methodology that is shared by otherwise quite distinct economic schools of thought such as the neoclassical mainstream and the Austrian heterodoxy. For a formal introduction to neoclassical finance, see Ross 2005; for an introduction to Austrian economics, see Holcombe 2014; and for a comparison, see Bosch, Koslowski and Veit 1990.

interested economic agents can withhold information relevant for the decisions of other agents. Information asymmetries were integrated into the models, and it was deduced how the aggregate results deviate from an optimum (due to adverse selection processes or moral hazard behaviour). The deviation from the ideal made room for state interventions and for regulation in order to prevent or correct suboptimal results.²³ For example, the state could try to prevent information asymmetries by disclosure requirements, or grant the less informed party compensation rights for hidden defects. Consumer protection through disclosure requirements was made compatible with models of deductive economics.

The effectiveness of a mandatory disclosure for the protection of consumer welfare can no longer be taken for granted as soon as another approximation of the models to realities is conceded: capacities of human beings (and institutions) to process information are rather limited. It is logically impossible for a human being with a limited lifetime to calculate the consequences of each and every possible decision that could be taken in order to find the alternative that gives the absolute maximum gain of money or utility. Human beings have to simplify (radically) their decision-making – for example, by changing the decision rule from “maximisation” to “optimisation” or “satisfaction”. Yet, the introduction of concepts of “bounded rationality” into traditional economics (in particular, the neoclassical mainstream) neither changed the basic methodology of the discipline – deduction – nor abandoned the basic premise of rational choice.²⁴ Consumer protection could now take the form of decision support measures. For example, financial service providers could be required to provide information in specific formats that facilitate easy comparisons of, for example, the total costs of competing products or of standardised future scenarios of long-term contracts.

While the integration of information asymmetries and limited information-processing capacities brought the models of deductive economics closer to reality, the paradigm of (bounded) rational decision-making and rational choice as such was not questioned. This changed only during the last decade with the rapid advancement and wide adoption of behavioural economics.²⁵ This new approach started with the empirical observation that decision makers frequently do not make rational choices. Choices made by economic agents were often found to be suboptimal or even inconsistent with their objectives. Casual observations of non-rational choices often inspired experiments, and non-rational choices

23 For a brief summary from the perspective of the global standard-setter for banking (the Basel Committee), see BCBS 2010, pp. 87–91.

24 On bounded rationality, see Gigerenzer and Selten 2001, Munro 2009.

25 For example, Altman 2006, Baddeley 2013, Shleifer 1999, Decision Technology Ltd 2010, Burton and Shah 2013, Erta et al. 2013.

could be replicated in experimental settings.²⁶ Seemingly, there were behavioural (ir)regularities (systematic biases) with far-reaching implications for economic models that called for an explanation which economics did not provide. The large number, diversity and persistence of non-rational choices became a challenge for the paradigm of deductive economics. The general modelling of economic agents as rational decision makers could not be upheld as a reasonable general assumption. In particular, observed behavioural patterns of financial consumers were found to be in stark contrast to those deduced from rational choice models.

2.1.2 Findings and Policy Design

From the late 1990s, regulators and policymakers became increasingly concerned about ongoing developments and persistent phenomena in the financial system that did not resonate with what they expected in efficient markets. For example, savings ratios in general and provisions for old age were too low, the level of household debt was too high, and financial consumers often bought useless or too expensive or too risky financial products and were cheated by unscrupulous financial service providers. Seemingly self-correcting market mechanisms did not work as effectively as expected. Against this background, several governments and regulators (including some who had been strong advocates of financial deregulation) as well as international organisations commissioned reports and research papers in order to learn more about financial consumers and their behaviour. For example, the Financial Services Authority – until March 2013 the sole financial regulator in the UK – had started its own consumer research scheme in 2000. The programmatic title of the first issue of its Consumer Research papers was “Better Informed Consumers”.²⁷ The FSA had identified two distinct policy objectives: (1) “*financial capability* – providing individuals with the knowledge, aptitude and skills base necessary to become questioning and informed consumers of financial services and to manage their finances effectively”; and (2) “*consumer information and advice* – providing impartial and generic advice to help enable consumers to plan their finances and make informed choices”.²⁸ Persistently low savings ratios and continuing complaints about mis-selling caused the UK government in 2007 to commission a study on the financial capabilities of consumers. The result was the *Thoresen Review*, published in 2008.²⁹ The review suggests that 19 million people in the UK (out of a total population of 63 million, or 52 million aged 15+) would benefit from generic financial advice.

26 Experiments had been introduced into economics in the context of game theoretic models, which dealt with a very specific type of economic interaction and behaviour. The laboratory techniques of economists were often adopted from psychology. With the spread of behavioural economics, the collaboration between economists and psychologists went further in so far as economists not only borrowed lab techniques from psychologist but also adopted theorems and theories for their own explanatory models.

27 See FSA 2000.

28 Ibid, p. 8.

29 See HM Treasury 2008.

The government decided to set up a *Consumer Financial Education Body* in 2010, which was rebranded as the *Money Advice Service (MAS)* in 2011.³⁰ MAS updated some findings of the *Thoresen Review* with a survey on *The Financial Capability of the UK*.³¹ The results were quite alarming, as it was found that “a larger proportion of people are now struggling with their money, that savings have not increased, and people have poor knowledge and understanding of financial services”.³² Seemingly, consumers’ financial capabilities, knowledge and skills had eroded. In more colloquial language used by MAS, “[w]e should be worried that 16% of the population can’t read a bank statement and three in ten can’t pick the best out of three Individual Savings Accounts. We should be concerned that a third (33%) of us don’t understand the impact of inflation, which for many erodes the true value of our savings and our income. And we should seek to help the one in six (16%) who continue to spend even when they know they can’t afford it, both for them as individuals and for those, including family, industry, and the government who often pick up the bill.”³³ However, before rushing to action it is important to find out the reasons for the low and further deteriorating financial capability of consumers.

Roughly at the same time as the HR Treasury commissioned the *Thoresen Review*, the FSA commissioned a “review of the behavioural economics literature, examining what this literature has to say about consumer behaviour when making financial management and/or choosing financial products, and in particular, the likely impact of financial capability initiatives, or other information provided to consumers with the intention of encouraging better choices about financial products”.³⁴ This review provides explanations for the low capability and bad financial decisions of the average financial consumer. Some of the major issues identified are the following:

- “Financial capability involves knowledge and skills, but attempts to improve these may not lead to better outcomes. What people choose to know and what they do with their knowledge may primarily depend on their intrinsic psychological attributes.
- Behavioural economics has identified a collection of deep seated cognitive biases that influence decisions in both financial and non-financial contexts....
- Psychological rather than informational differences may explain much of the variation in financial capability....

30 See CFEB 2010, MAS 2011.

31 See MAS 2013.

32 NAO 2013, p. 10.

33 MAS 2013, p. 25.

34 FSA 2008, second and third page of unpaginated foreword.

- Some of the principal cognitive biases potentially relevant to the FSA agenda are procrastination,³⁵ regret and loss aversion,³⁶ mental accounting,³⁷ status quo bias³⁸ and information overload³⁹....
- There is a set of biases involving incorrect information processing that we group under the heading ‘curse of knowledge’. People draw incorrect inferences, focus on inappropriate or unimportant data, are distracted by too much information and choice, may over-deliberate and otherwise misuse information.⁴⁰ Unjustified optimism is rife.
- Behavioural economics has been directed more to explaining choices than to changing them.... A relatively small literature has looked at remedies for various cognitive biases.
- [L]ow financial capability is more to do with psychology than with knowledge. Institutional design and regulation are probably far more effective than education, though crisis counselling may be helpful. More research is needed on whether cognitive biases can be overcome in the personal finance domain.”⁴¹

In a slightly different terminology, the list of biases that affect the decision-making of retail consumers can also be summarised and somewhat extended as follows:

- “*Emotion* – Investors make decisions based on how they feel as opposed to what they know or think they know;”⁴²

35 “Procrastination is ... the tendency of many people to have high short-term discount rates but lower long-term discount rates (hyperbolic discounting). Postponing a cost, even one that generates high future benefits, is therefore attractive. So too is advancing a benefit to the present, even if this implies high future costs. This leads to outcomes such as credit card borrowing at high interest rates and unwillingness to engage in painful activities such as financial planning” (FSA 2008, p. 2).

36 Regret and loss aversion means that people “are concerned not only with what they have but how it compares to what they used to have and with what they might have had” (FSA 2008, p. 2). Loss aversion implies, for example, that people are reluctant to sell shares if the selling price is lower than what they initially paid for the shares; they tend to hold shares with falling prices too long. Regret aversion entails that choices are not made if there is a chance of a loss (= reason for regret) and the loss can be easily determined subsequently (which then causes regret). Regret aversion may lead to an underinvestment in risky assets, and if there are many complex options to choose from, inaction is likely because there are more chances to make regrettable decisions. Decision makers tend to prefer simple options (FSA 2008, pp. 38, 39, 40).

37 “Mental accounting is the common tendency to create artificial budgets covering different categories of spending and saving. People use this technique to evaluate and keep track of their finances but it can lead to seemingly irrational decisions such as saving at low interest rates whilst simultaneously borrowing at high rates” (FSA 2008, p. 2).

38 “Status quo bias is the tendency for people to stick with their prior choices. It is therefore relevant to the selection of financial products and the incentive to stay informed” (FSA 2008, p. 2).

39 A special form of information overload is the choice overload, which has been outlined in the context of regret aversion. “The obvious remedy for information overload [= choice overload, V.N.] is to restrict choice rather than to try to educate consumers to handle excessive variety in a stress-free fashion” (FSA 2008, p. 40).

40 The “curse of knowledge” is a particular problem for people who have attended financial education events: empirical studies found that financial decisions after the attendance were worse than before, because decision makers overestimated their (increase in) capabilities.

41 FSA 2008, pp. 2–4; see also Belsky and Gilovich 1999.

42 It is said that consumers often base investment decisions on their “gut-feeling”.

- *Overconfidence and overestimation of investment knowledge and abilities* – Retail investors may interpret past successes as due to their own expertise rather than market conditions;
- *Representativeness biases* – Investors are overly influenced by strong or poor recent past performance or false reference points; and
- *Inertia, procrastination and status quo biases* – Investors stick with a familiar, pre-existing or established position, for instance relating to the appropriateness of following a particular investment strategy.⁴³

In addition to these biases it has to be noticed that financial decisions are often the result of some interaction with other people. “Investors rely on a wide range of types of information when making investment decisions. In particular, they rely on the advice of others, who may be peers, professional advisors or salespeople.”⁴⁴ This can be of particular relevance for the design of financial literacy and education programmes in emerging markets and developing countries where the general level of literacy is low and where trusted local opinion leaders have a strong influence on the individual behaviour.

In summary, behavioural economics may enrich regulatory policies, but actually some of the findings look more like bad news for policymakers and regulators: poor decision-making of financial consumers is most probably not primarily due to a lack of knowledge and skills but the result of cognitive biases which are deeply rooted in human nature. This implies a formidable challenge for financial consumer protection policy: if the objective is “better choices”, then the consumers must not only be protected against “malevolent” financial service providers, but to a certain degree also against themselves. Another disillusioning finding is that tools which have been held in high regard for long may be far less effective than assumed in the past.⁴⁵

But this does not mean that governments and regulators could or should do nothing. Traditional instruments may be less effective than assumed, but it does not imply that they are completely ineffective. It may be possible to achieve a stronger impact by a better calibration of individual instruments or by new combinations of old instruments. Hence, it is not futile to take a look at the traditional instruments of financial consumer protection in the next section. Furthermore, it should be noted that governments and regulators have initiated substantial research activities in the field of behavioural economics and behavioural finance. There is a good chance that this research will not only enhance our understanding of

43 IOSCO 2011, p. 11.

44 Ibid, p. 11.

45 However, behavioural economics can help to improve traditional instruments to enhance their effectiveness – for example, by a better design of communication material that meets the needs and demand of consumers.

cognitively biased choices of financial consumers, but also shed light on systemic implications for competitive financial markets as well as on processes of “bias evolution” and “de-biasing”. Research can contribute to the development of better consumer protection instruments and strategies.

2.2 Two Types of Retail Clients: Investors and Consumers

The findings of empirical studies suggest distinguishing between “retail investors” and “consumers” as two very different types of retail clients:

- The *retail investor* is a recurrent market participant with considerable experience and sophistication.⁴⁶ He is aware of investment risks and can manage them reasonably well; he can also absorb occasional losses. The portfolio of risk-taking investors is diversified by significant investments in CIS and direct investments in bonds and equity. This type of client resembles in many respects the market players of neoclassical models, and the main problem of the retail investor is access to reliable information. The enforcement of better *disclosure* (i.e. more information in readily comparable format) by regulation would *empower* the investor-type retail clients and facilitate better-informed choices in pursuance of individual preferences.
- The *consumer* has very little experience in and limited knowledge about financial markets. His income and wealth situation makes this type of retail client vulnerable, and he must avoid investment losses by all means. However, his understanding of complex products is poor, and he has difficulty in comparing investments and assessing their performance. If consumers make choices – even after consulting advisers – these are often not in their own interest. Long lists of decision-making defects have been compiled,⁴⁷ and

46 However, the retail investor is not a professional market participant.

47 A summary of these defects is given by Moloney 2010, pp. 69–70 (footnotes removed, italics and bullet points added):

- “*Rules of thumb* are used to ease complex decisions and lead to poor decision-making.
- The *status-quo bias*, which means that decision-makers are reluctant to make changes and undervalue the risks of the status quo and the benefits of choice, leads investors to hold investments for too long and to a related tendency not to ‘shop around’.
- The *endowment effect*, or the tendency to demand more to surrender an asset than its acquisition cost, leads to investors assessing risks in terms of loss aversion rather than in terms of final return.
- *Cognitive conservatism* also limits the extent to which investors change their decisions, even in the face of evidence that change is optimal.
- The *framing effect* means that investor vulnerability to marketing is significant; the way in which an investment choice is framed (in terms of the loss of an investment opportunity, for example) can drive the investment decision.
- The *hindsight bias* increases investor vulnerability to past performance information.
- The limitations of disclosure are borne out by the *confirmation bias*, which leads investors to rely on evidence or disclosures which reinforce their decisions, and by the availability shortcut, which leads investors to rely on information which is most easily brought to mind.
- Biases can also be contrarian. While loss aversion and the status quo bias suggest conservative decision-making, *over-confidence* is a particularly well-documented bias. It leads to investors being overoptimistic as to their skill, discounting the impact of chance (save with respect to losses), over-emphasizing positive returns and underestimating risk levels. Ultimately, poor decision-making based on over-confidence can lead to a wider misallocation of resources.
- *Trend-chasing* is also common, as is *herding behaviour*.”

overall, consumers “simply tend to make bad decisions”.⁴⁸ Better disclosure would not remove these defects. The appropriate policy approach for the consumer-type retail clients would be *protection* – against mis-selling by financial service providers, but also against their own (systematic) mistakes. Since regulatory protection has to deal with the specific weaknesses of consumers in a particular existing regulatory and market environment, country-specific empirical studies on decision-making defects should identify the peculiarities and prepare the ground for consumer protection policies in the respective jurisdiction.

An empowerment strategy for better information implies only minimal regulatory interventions, but decision-making defects are not reduced by more information. Therefore, additional protective measures are deemed necessary. Some measures such as the creation of institutions for independent and unbiased generic advice are not “intrusive”, but other instruments imply interventions into the financial markets that could be branded as “paternalistic”. Examples are restrictions of the retail investors’ access to particular instruments (e.g. closed-ended real estate funds) or the promotion of a suite of basic financial consumer products that are classified as safe by the regulator.

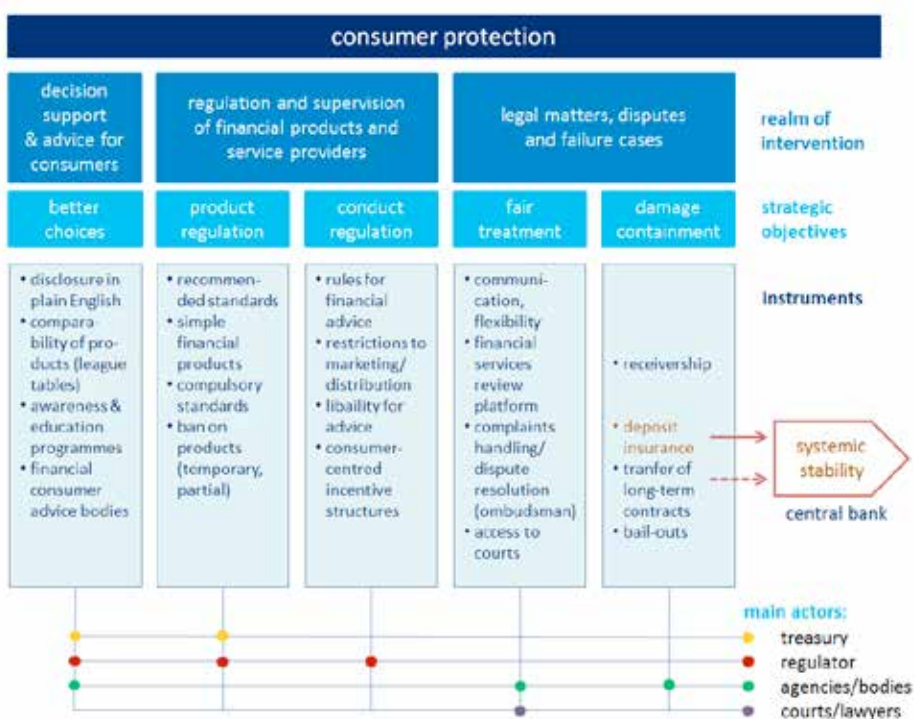
48 Moloney 2010, p. 70.

SECTION 3: INSTRUMENTS OF FINANCIAL CONSUMER PROTECTION

A presentation of financial consumer protection instruments can follow different classification schemes. The one used here is summarised in Chart 3.1, which distinguishes primarily between three realms of intervention:

- (i) The first realm is *decision support and advice* to consumers with the strategic objective of *better choices* of financial products by consumers in the future. In the past, bad choices prevailed: consumers have bought financial products which were not the best for their needs but most lucrative for the financial firms and advisers who recommended these products (“mis-selling”).

Chart 3.1: Realms, Objectives, Instruments and Actors of Financial Consumer Protection



- (ii) The second realm is the regulation and supervision of financial products and service providers (producers as well as advisers) to implement good practice. It is useful to distinguish between product regulation and conduct of business regulation.

- The strategic objectives of *product regulation* range from a protection of consumers against “dangerous” products by a ban on particular products over mandatory general product standards to ensure a minimum product quality to incentives for the development of products particularly suitable for specific target groups such as consumers with low and unstable income (“vulnerable consumers”).
 - *Conduct regulation* addresses problems of information asymmetries and conflicts of interest or – more generally – problematic incentive structures in the finance industry.
- (iii) The third realm comprises *legal matters, disputes and defaults* of financial service providers. While the first two realms address issues under normal circumstances (i.e. the “ordinary business”), realm three addresses issues when “something went wrong” – either on the side of the consumer or the provider. From a strategic perspective it makes a big difference whether the financial service provider stays in business (going concern cases) or ceases operations (gone concern cases).
- Consumer protection in *going concern cases* should ensure that consumers who have a complaint or a legal dispute with a service provider get a fair treatment by the provider and have easy access to legal advice and out-of-court dispute settlement schemes (but also to courts if other options fail).
 - Consumer protection in *gone concern cases* (where the financial service provider is wound up) aim at a containment of the financial damage for the consumer – for example, through a deposit insurance scheme.

The chart not only shows the classification of the instruments outlined in the following text, but also indicates (at the bottom) the *main actors* for the implementation of different classes of instruments.

- The *treasury* plays a crucial role when it comes to tax incentives for consumer-friendly products.
- The main actors in the realm of regulation and supervision are *regulatory authorities*, which can be a single regulator or separate regulators for product and conduct regulation, or a department of the central bank.
- Consumer protection tasks – in particular, in the areas of consumer advice and dispute settlement – can be assigned to *specialised government agencies* or other bodies, including legal entities set up by the industry (e.g. for the management of a deposit insurance scheme). In addition to these public or publicly approved assignments, *consumer associations* and *media* have become important actors in the realm of decision support and advice.

- In the realm of legal matters, *public bodies* as well as *private legal experts* act as consumers' advocates and look after consumers' rights and cost-effective, out-of-court dispute settlement schemes.

The instruments listed in Chart 3.1 are prominent and typical examples for the respective classes. Compilations of all actually applied instruments would produce much longer lists, but that is beyond the scope of this paper.⁴⁹ The following paragraphs are much more limited with respect both to the number of considered instruments and the covered sectors. The focus in the following is primarily on banking (and financial advisers).⁵⁰ The reason is that the aim of this paper is a discussion of typical consumer protection issues that emanate from the Islamic substance of a financial product or transaction. These issues are analysed for the banking sector, but this analysis is also relevant for the other sectors in so far as the issues can be found in a similar form in Islamic capital markets and *Takāful*.

3.1 Better-informed Choices

The starting point for consumer protection interventions is the fundamental information asymmetry between consumers and financial service providers. In the ideal world of *homo oeconomicus*, it would be in the self-interest of financial service firms to provide consumers “voluntarily” all the information of relevance for their rational decisions because consumers would expect it. Hiding information is not a good idea in this competitive world; consumers will notice it and may switch to another service provider.⁵¹ However, in the real world of human beings with limited information-processing capacities, it can be lucrative to be less than fully transparent and, for example, to make obscure information on fees, contractual restrictions or possible conflicts of interest. There is empirical evidence that such concealment practices were widespread in financial markets and went largely unnoticed by the consumers.

49 The World Bank has compiled consumer protection and financial literacy practices from a wide range of 114 low- to high-income countries, and the OECD reports further instances from high-income countries; see World Bank 2014, OECD 2013b.

50 The IFSB survey on CPIF covers in some detail also instruments for the Islamic capital market and the *Takāful* business.

51 The real world is certainly more complicated than this simple argument suggests. For example, the switching to another service provider may induce significant switching costs. Furthermore, it may factually be impossible to assess in full the quality of information when a product is bought. For example, the performance of long-term savings plans depends on decisions by an investment manager that have not been taken at the time when the product was bought. Hence, information that allows the assessment of the quality of information (e.g. the actual performance compared to forecasts presented when the product was sold) will reach the market only a long time after the product has been sold.

3.1.1 Disclosure Requirements: Relevant Information in Understandable Form

There is an extensive debate in the literature and in studies written or commissioned by regulators on what information consumers should receive about products and providers, and what the most appropriate form would be.⁵² While there is a convergence of the different views on what should be disclosed, the views on the most suitable format (which are strongly influenced by the findings of behavioural economics) still differ.

- Disclosure requirements are the least “intrusive” form of regulatory intervention, but (on their own) probably not very effective. It is crucial for a reasonably efficient financial retail market that the consumers get the information relevant for their choices in a format and language that not only clarifies the costs and features of a particular product but also facilitates comparisons with products of competing providers. Therefore, regulators may not only determine what information has to be provided (e.g. the total cost of a financing with due regard to interest, fees, disagio, etc.), but also in what format.
- For example, the regulator may require that all cost elements are clearly stated, not concealed in the fine print of a contract, and not obscured by professional jargon that the average consumer does not understand. Instead, it could be made obligatory to use plain English, to abandon fine print, to use the same font size for the whole contract (i.e. for beneficial features as well as for burdening terms and costs), to apply uniform templates for the presentation of data, etc.
- Regulators can postulate the disclosure of specific product features such as the total effective costs of a loan or the net returns of an investment product, taking (compound) interest, various fees and charges, and inflation into consideration.
- The regulator may require not only that easy-to-understand summary information is provided to the consumer at the point of sale, but that full disclosure of all product details is made on the provider’s website. Although this may not be of much direct use for the individual consumer, financial advisers or consumer advocates could use the full disclosure for product analyses and recommendations. The media could also play a role, provided qualified financial journalists do exist (which cannot be taken for granted in emerging markets or developing countries).

If the typical consumer of financial products were a *homo oeconomicus*, then

⁵² For a summary with a large number of references to studies written or initiated by regulators, see IOSCO 2011, Appendix 2.

the provision of all relevant information would be sufficient to come to a market equilibrium that balances in a fair manner the interests of the supplier and the consumer. But if the typical consumer is a human being with limited financial capabilities and information-processing capacities, this may not be enough. Mis-selling of financial products can be observed even in countries where rather strict disclosure requirements exist. Bad practices of service providers are persistent as long as particular incentive structures in imperfect markets are not changed by a rather radical conduct regulation, such as the prohibition of commissions paid by product providers to financial advisers in the UK.⁵³

3.1.2 Comparable Information (League Tables)

A regulator could require not only that financial service providers present relevant information in a specific format, but that the information be compiled and processed in a way that encourages easy comparisons by consumers. The regulator may produce a huge catalogue (“league table”) as a web-accessible searchable database that “is likely to contain basic comparable information on price and other features of hundreds of individual financial products. The provision of such comparative information is to be designed precisely to enable individuals to shop around effectively in the financial services marketplace – to act as more knowledgeable consumers and thus make competition work more effectively.”⁵⁴ The fundamental challenges for such a database are how to make products comparable that often have been designed intentionally to be different or even unique, and then to identify those products that are most suitable for a particular customer. The typical situation will not be that one product dominates the other products in all features. Instead, products will be superior in some features and inferior in others, so that the choice depends on the importance (weight) attached to the different features. These weights may differ from consumer to consumer so that it is usually not possible to identify one product as “the” best choice for everybody.

A solution could be the definition of a small number of “typical” consumers with different financial needs and preferences. For each consumer type, the available products could be ranked according to their suitability. This solution implies at least one technical and one political issue. The technical issue is that a certain number of real consumers will not fit any of the defined consumer types. The political issue arises if the suitability ranking of actual products is done by the regulator himself: this transgresses the rule of “generic advice only”. More pointedly, the regulator will factually recommend particular products of specific providers to certain types of consumers – and this may not be acceptable in most jurisdictions.

53 For further details, see 3.2.2.4.

54 Johnson 2000, p. 9.

A way out could be that the regulator maintains only the database as the “raw material” and leaves the evaluation to the private sector. There are numerous examples for how print and electronic media, consumer associations or non-profit organisations structure and execute tests and comparisons of complex products, including financial services. Some offer even web-based tools by which the consumer can attach own weights to different product features and generate a customised product ranking. Even the underlying database of financial products could be produced by the private sector, but an involvement of the regulator could accelerate the emergence of a “culture of comparison”, reduce the costs for private actors, and ensure an easy and open access to the data.

3.1.3 Consumer Awareness and Education Programmes

Financial retail products (such as capital-protected funds or whole life pension schemes) can be rather complex, and the complexity does not vanish through the use of plain language or the compilation of a database. Empirical studies in advanced economies found a surprisingly low level of financial literacy of the average consumer of financial services. This means that many consumers are unable to make good use of available information even if it is worked up by the regulator. Hence, it is very important to raise the level of financial awareness, knowledge and competency of consumers. Special attention should be given to people of small means, because wrong financial choices can be most harmful to them (in relation to their limited financial resources).

Consumer education should be a high priority, in particular in countries where the state reduces its involvement in health care and pensions, and favours more individual initiatives and market-based approaches for health insurance and retirement planning, as well as in countries where financial markets are just emerging. However, even if consumer education gets a high political priority, results must not be expected overnight. Printed brochures, training courses, learning modules for schools, workshops, web-based self-assessments, TV shows, ... there is hardly any form of communication that has not yet been applied for consumer education. But it seems that the learning outcome is not very impressive. Financial decisions of participants in financial education programmes were not much different before and after the participation, and if learning effects were achieved, they were not long lasting.⁵⁵ Alternatives such as the use of more examples from the world of finance in math classes at school may have a longer-lasting impact, but only after a decade or more. Hence, it may take not just a few years but a whole generation to achieve a significant rise in the financial literacy level. But people have to take financial decisions now, and governments may wish to extend support beyond education to those whose literacy is and remains limited.

⁵⁵ See Mak 2012, Willis 2013.

3.1.4 Financial Consumer Advice Institutions

Educational programmes may have been too ambitious in trying to teach participants to find the solutions to their financial problems by themselves. It might be better to be more modest and try only to teach how to ask the right questions in order to approach people (e.g. brokers, advisers or bank staff) who have the expertise to find the right answer.

If consumers want to use the expertise of others, they must be able to communicate their financial needs (to “reveal their preferences”). Trustworthy and permanently accessible institutions that provide comprehensive impartial generic advice could bring consumers to this level. Trustworthiness may be achieved by an institution that is run or supervised by a regulator who himself is recognised by the people as a credible advocate of consumer interests. Permanent accessibility is important because the need for advice can occur at any time. The institution should be able to offer comprehensive (financial) advice because financial problems can often be related to different segments of the financial market at the same time (e.g. investment funds and life assurance). The advice should be generic in so far as it helps to identify and articulate the specific financial needs of the consumer, and to explain the basic features of different options without the recommendation of a specific product of a particular provider. This is a task for an adviser (agent, broker, sales staff of a bank, etc.) who knows and can compare the actual products in the market and can assume liability for his advice.

An example of such a permanently accessible institution that provides comprehensive impartial generic and free advice is the publicly funded Money Advice Service under the supervision of the Financial Conduct Authority in the UK.⁵⁶ The rapidly increasing number of users indicates both a growing acceptance and trust in the services of this institution, and its usability and usefulness. But the example of MAS also shows that such an institution requires significant resources, and it is not yet clear whether it can reach, in particular, those people who need advice most (low-income households and elderly people) through its predominant channel for the provision of advice, the internet.⁵⁷

Another issue that may surface is the relation between well-established and widely used non-profit financial consumer advice institutions such as MAS and distinct consumer education initiatives. One could argue that the repeated use of MAS will enhance the financial capabilities of its users. If so, one can question whether

56 See MAS 2014; another example is ASIC's *MoneySmart*. Its website was set up in 2011 as the successor to two other consumer websites (FIDO and Understanding Money); see <https://www.moneysmart.gov.au>.

57 See NAO 2013.

additional consumer education programmes could or should achieve much more. Otherwise, separate consumer education programmes might be useful. However, if consumers can get – on a case-by-case basis – all the advice they need from MAS, their motivation to participate in additional financial education programmes may evaporate.

It should be noted that the elaborate MAS model may be very suitable for the UK, but not necessarily for other jurisdictions. In other advanced countries such as Germany, no comparable public institution exists or has seriously been contemplated. This may be due to a number of reasons. First, the capital market orientation of households is considerably lower in Germany than in the UK, since the pension system is still predominantly based on a national insurance scheme and not on individual capital formation. Second (as a consequence of the first reason), the financial advisory industry is much smaller in Germany than in the UK, so that the issue of mis-selling by advisers was less relevant. Third, empirical studies on financial literacy in Germany are very rare. There may be the same serious problem of financial illiteracy in Germany as in the UK, but Germany is not (yet) aware of it.

The lesson to be learned from a comparison of the UK and Germany is that the design of financial consumer advice institutions has to reflect national specificities of welfare, tax and pension systems as well as the relevance of financial markets for individuals and households, in particular with respect to savings for health care and retirement. This means that, for some countries, less comprehensive and more specialised consumer advice institutions may be more appropriate than the “universal” MAS for the UK. Institutions with a more limited mandate may focus only, for example, on supplemental retirement savings schemes or debt advice services for young people. On the other hand, the comprehensive UK model can be used as a point of reference or benchmark even for more specialised interventions.

3.2 Regulation and Supervision of Financial Products and Providers

The regulation and supervision of financial products and financial service providers is the core business of regulatory authorities, but some regulations – in particular, in the field of conduct regulation – interfere with the freedom of contract and hence require backing by a legislative Act. Further, regulations that restrict the permissible range of products or product features require a solid justification in an economic order based on competitive markets and the freedom of contract.

3.2.1 Product Regulation

Product regulations deal with restrictions regarding particular products or specific features of products. The intensity of the restriction of the freedom of contract can range from very moderate – in cases where the regulator makes product-related recommendations but leaves the implementation to the discretion of the financial service provider – to very strict in cases where the regulator prohibits or mandates the provision of particular products and services. For most cases, the intensity of the regulatory intervention lies between these extremes, such as obligatory minimum standards for product features deemed critical from a consumer protection perspective. Another common type of regulation requires the use of specific legal forms that have certain structural or governance features embedded (e.g. CIS for which a custodian has to be separate from the manager).

A general justification for product regulations is the safety of the consumer – that is, the protection against damage resulting from the use of a product. This general argument has been applied in analogy to the finance industry. A problem is that the potential damage depends very much on how or by whom a particular financial product is used. There are certain types of inherently risky financial products (from junk bonds to complex derivatives) that may meet the needs of advanced finance professionals and firms; however, if inexperienced retail consumers buy such products, the probability of losses is very high. A total ban that would protect one group of customers but impair another group would not be an optimal solution. What could be more appropriate than a ban is regulation of access to “dangerous” products being distributed by financial firms. A regulator could, for example, require a documented assessment of the financial knowledge and capacities of consumers who want to buy such a product, and it may only be offered to those with sufficient knowledge and loss-bearing capabilities. Such a regulation would not alter the features of the product itself but restrict its distribution channels. Regulations of this type are classified under “conduct regulation” and are summarised in a separate section.

3.2.1.1 Recommended Standards and Simple Financial Products

Recommended standards are intended to help consumers to make better choices. For example, there is a growing interest in socially responsible investing (SRI), and many financial service providers position themselves or some of their products in this field. There is a vast (and sometimes confusing) variety of

different approaches and products claiming to be SRI.⁵⁸ National regulators may come forward with a set of best practice examples of what they consider good SRI products, or they may endorse and propagate principles for SRI products that have been established by international bodies or industry associations. By propagating and recommending them to domestic market players, the best practice examples and endorsed principles may gradually be adopted by more and more firms and finally become a de facto industry standard without compulsory measures by the regulator.

Another example for what may be considered as a “moral suasion policy” by the regulator (or the government) is the development of simple financial products. The underlying idea is to develop a suite of easily understandable financial products with standardised, and hence comparable, basic features that cover the typical financial needs of consumers with limited knowledge and capabilities. The initial focus in the UK was on simple savings and protection (life insurance) products. The advantage for the consumers is that they cannot go wrong with these products: the products are structured in such a way that consumers will not only not be cheated but will normally get a reasonable deal.⁵⁹ Products that meet all the criteria set by the regulator can be marketed under a special “quality label”. The expectation of the regulator is twofold: that the consumers will find these products appealing; and that the products are lucrative enough for the financial service providers so that they will offer them. The experience of the UK shows that both cannot be taken for granted, but some elements can enhance the likelihood of success, such as a product certification by a reputable institution well known to the customers, and provisions for price transparency without price caps.⁶⁰ A step beyond moral suasion could be tax benefits exclusively for financial products that meet the recommended minimum standards.

The criteria for simple financial products are set by the regulator, and they have to be observed if products are to be marketed under this protected “quality label”. But it remains at the full discretion of financial service providers to ignore the recommended standards and offer products with somewhat different features to the target group of simple products under their own brand name.

3.2.1.2 Mandatory Standards

Mandatory standards are typically minimum standards applicable to all products of a particular class. A financial service provider could not market a product that

58 The IFSB has dealt with this topic in its *Islamic Financial Services Industry Stability Report 2013*; see IFSB 2013 sub-chapter 4.3.

59 See HM Treasury 2013.

60 See Johnson 2000, Devlin 2010.

falls into a particular class (such as savings accounts) without meeting all the mandatory standards.

Minimum standards are of particular relevance for products with long-term bindings, such as assurance contracts with investment components. Minimum standards may require, for example, a capital protection or a minimum investment return, but they could also prescribe exit clauses or asset qualities. Minimum standards could set ceilings to product features – for example, a cap to interest on deposits.

A problem with such product regulations is that they may be circumvented if market participants find them too restrictive. New financial products that do not fall under the defining criteria of any restricted product class emerge (e.g. certificates of deposit at a time when savings deposits were restrictively regulated), or new types of financial institutions pop up (e.g. shadow banks), especially in legal systems where the freedom of contract allows all kinds of innovations unless they are explicitly prohibited (for reasons which could be challenged in courts).

3.2.1.3 Ban on Products

The most severe form of product regulation is a ban on specific products. The general trend since the 1990s was not a tightening but the easing of regulatory restrictions. However, the trend was reversed after the GFC of 2007–2009. A serious debate started on the social benefits and macroeconomic needs for highly complex derivative structures, and a “back to basics” movement set the tone for quite a while. Cost–benefit analyses of regulatory interventions were made to compare the microeconomic benefits of complex structures for individual market players with the macroeconomic costs of instabilities in the financial system. Seemingly, the balance for some instruments was negative, and the financial services industry has experienced a partial ban or temporary suspension of instruments with particularly destabilising potential, such as short selling or credit default swaps. Such instruments may not be prohibited completely but may be banned from particular markets, especially from the retail market because they are considered too complicated and too risky for the average consumer.⁶¹

A milder form of regulation than the complete ban of a product is a restriction of its distribution channels; as this affects the conduct of business of financial service providers and advisers, this instrument is classified as a conduct regulation.

61 For example, Regulation (EU) No. 236/2012 of 14 March 2012 on short selling and certain aspects of credit default swaps (CDS) bans naked short selling in the European Economic Area (= all 28 member states of the EU plus 3 of 4 European Free Trade Association members) completely and defines specific conditions for CDS as of 1 November 2012.

3.2.2 Conduct Regulation

Over time the understanding of what is an “unsuitable product” has changed. The “traditional” view was that, for example, a loan is unsuitable if the debt service exceeds a certain percentage of the current income of the borrower, or an investment product is unsuitable if it freezes funds for a long period while the customer’s need for an earlier access to liquidity is apparent. The problem was not the product as such, but its inappropriate use that could have been noted and prevented by the seller or adviser.

The choice of an unsuitable product is one form of mis-selling; another is the sale of a product that is suitable in principle, but is not the best choice for the consumer. This “suboptimal” choice can result from a conflict of interest between the consumer and the adviser in a commission-driven system. The adviser’s income depends on the product that he sells, but not on the suitability or optimality of this product for the consumer.

Consumers could protect themselves against attempts to be sold an unsuitable product if they could compare the different products available. But it has been shown that many consumers lack this ability, especially in a world with a continuously growing variety of increasingly complex products with different risk/return and liquidity profiles.

The consumers’ limited capacity to compare products facilitates “non-rational” consumer choices, and market forces alone are not strong enough to overcome these deficiencies – especially not if sellers have strong incentives to exploit the weakness of consumers. Hence, regulatory interventions may be needed to protect the consumers against mis-selling. These interventions can have very different intensities and may range from better information for the consumers to fundamental changes of the incentive structure of the sellers.

3.2.2.1 Financial Advice Rules

It is said that complex financial products (such as unit-linked insurance plans) are not bought by the consumer but sold by the financial service provider, meaning that the provider (broker, agent, adviser, etc.) plays the leading role in the decision process. Retail clients often rely on the advice of a provider, and a first step towards an effective consumer protection would be to ensure that the adviser or seller of a product gives the consumer unbiased advice based on a screening of the financial market – that is, of available alternatives that meet the needs of the consumer. Several countries have regulations in place that require

an assessment of the financial needs and capabilities of the consumer, especially for long-term contracts, and this has to be documented in written form.

Regulators can go further and oblige financial advisers in the retail market to inform their customers explicitly on whether they give an independent or restricted advice. Advice is restricted if the adviser advises only on certain types of products or on products of only a few providers. An independent adviser has “to offer advice on a comprehensive range of retail investment products that might be suitable for ... [his] clients, including: life policies, units in collective investment schemes, stakeholder and personal pension schemes, investment trust savings schemes, securities in investment trusts, investment companies, or other investment funds structured as special purpose vehicles, structured investment products”.⁶²

3.2.2.2 Restrictions on Marketing and Distribution Channels

Although independent advisers must be able to advise on a wide range of products, they have to observe restrictions set by the regulator in the interest of consumer protection. Some “products are unlikely to be appropriate for the average retail investor. In particular, unregulated collective investment schemes (UCIS) and certain structured investment products, investment companies and other investment funds structured as special purpose vehicles are deemed to be non-mainstream pooled investments (NMPs). NMPs are subject to a marketing restriction ... and generally speaking cannot be promoted to retail investors other than those who are certified as high net worth or sophisticated.”⁶³

3.2.2.3 Liability for Advice

Regulators have to give teeth to their regulations. One possibility is significant penalties for the violation of rules. The problem with this approach is that it may create a strong incentive for advisers to avoid the detection of a breach of a rule by the regulator, but not necessarily a strong incentive to observe the rule in the interest of the customer. For example, if an adviser claims to be independent but factually gives restricted advice, this can enhance his or her income in a system where advisers are remunerated by commissions paid by providers. If the probability of detection is low, the gain from higher commissions may exceed the expected value of losses from a penalty, and hence the conflict of interest between the consumer and the (restricted) adviser is not removed.

The situation changes if the adviser becomes financially liable for losses suffered

62 Quoted from the FCA website: www.fca.org.uk/firms/firm-types/financial-adviser, last modified 14 November 2014, accessed 18 March 2015.

63 Ibid; see also FSA 2012.

by a customer arising from “wrong” advice. Disregarding the problem of the proof of a claim made by a consumer against an adviser, the liability for mis-selling is an important step towards a more incentive-compatible arrangement between consumer and adviser. If it is not too difficult for a consumer to prove that the adviser should have known that a product recommended was not suitable and caused financial damage, then it is in the genuine interest of the adviser to find at least a reasonably suitable product for the consumer.⁶⁴

3.2.2.4 Consumer-centred Incentive Structures

Neither product regulations nor disclosure requirements or rules for financial advisers eliminate the root cause of mis-selling – namely, commissions paid by the product provider to the distributor. This creates an incentive to advise or sell the products with the most attractive commissions, which may not be the products that are best suited for the customer. A radical solution to this problem is a complete change of the remuneration system for advisers: the adviser should not be paid by the seller of a product, but by the buyer. With this incentive-compatible structure, it is in the genuine interest of the adviser and seller to find the best product for the customer. The ban on commissions for financial advisers in the UK is an example that such a fundamental change of a long-established incentive structure is possible if there is a political will.⁶⁵

A consumer-centred incentive structure would make it the self-interest of advisers and service providers to know their customers – that is, to identify their needs, and to find suitable financial products. Otherwise, “know your customer” regulations which require, for example, the documentation of a counselling interview or the assessment of the customer’s financial capacity, degenerate into box ticking exercises without much real impact.

Part of the incentive problem is de facto bail-out guarantees for banks. If banks can reasonably expect to be rescued, they tend to take more risks than otherwise. For example, reckless lending (e.g. “NINJA loans”⁶⁶) can be a viable option for an aggressive growth strategy of the management, which may be backed by the shareholders. Retail depositors who are protected by comprehensive deposit insurance schemes will not exercise market discipline. The only countervailing power against reckless lending that remains could be risk-weighted contributions to a mandatory deposit insurance scheme, but many schemes do not have risk-

64 This proof may be difficult if the adviser recommended a product that was not optimal but generated a positive return. In generally rising markets, advisers can get away with a great deal of rather poor advice.

65 From 1 January 2013 onwards, advisers who deal with investments, pensions, retirement income products (such as annuities) and general financial planning are no longer allowed to take commissions from product providers but have to explicate their fees and charge their customers; see FSA 2010.

66 NINJA = No Income, No Job, no Asset.

weighted contributions. As bail-out guarantees have an impact on the behaviour of financial service providers, changes in this field could be considered in a section on conduct of business regulations. However, the primary objective of bail-out efforts is (or should be) the stability of the financial system. Hence, this topic has to be discussed in the wider context of prudential regulation, which is beyond the scope of this section.

3.3 Legal Matters, Disputes and Failure Cases

Decision support, as well as product and conduct regulation, should become effective in the pre-sales and sales phase. Legal issues, disputes and failures of financial service providers occur in the after-sales phase, which should also be covered by a comprehensive consumer protection system.

3.3.1 Fair Treatment of Consumers

Regulators have received an increasing number of complaints about unilateral modifications of contract clauses by financial service providers on very short notice, harsh practices for the collection of overdue payments, lengthy procedures for the correction of mistakes made by financial firms (e.g. wrong information given by a bank to a credit bureau), ignorance of complaints, etc.

3.3.1.1 After-sales Communication and Contractual Flexibility

In all these instances, consumers were not treated appropriately or were treated in an unfair manner. In response, regulators have implemented various instruments to ensure a fair treatment of consumers of financial services, including:

- rules for after-sales communication (e.g. regular reports on the status of long-term investment plans or insurance contracts with saving schemes in understandable language);
- rules for timely information on adjustments of contract clauses which allow consumers to look for alternatives if they do not agree to the announced changes;
- regulations that prohibit or restrict unwanted direct sales practices (by phone or unrequested visits of sales persons); and
- cooling-off periods, which give the buyer of a financial product time to reconsider a decision and the option of a cost-free cancellation of a contract.

Regulators have become aware that consumers consider contractual rigidity as a special form of unfair treatment. In times of financial turbulence and stagnating economies, increasing numbers of consumers have problems in meeting their regular payment obligations (for savings plans, mortgages, etc.) or want to get access to savings before the maturity of long-term contracts. Consumers are

often disappointed with what they consider a lack of flexibility of financial service providers. However, one has to recognise that the financial service provider as the other contracting party has a legitimate interest that contracts are fulfilled. To avoid future hardships and to treat both sides fairly, model contracts with reasonable flexibility clauses (on a temporary suspension of payments, the freezing of a long-term savings plan, an exit from a long-term contract before maturity, an early withdrawal of funds, etc.) could be developed.

3.3.1.2 Financial Services Review Platforms

A contentious issue is the support for a moderated financial services review website by the regulator (or other government institutions). Consumers could share their pleasant and unpleasant experiences with financial service providers and give them good or bad marks. Such a platform and the marks of individual firms have become rather significant decision aids for consumers in areas such as tourism (especially hotels) and internet trade. Although there is reluctance of regulators to run such a platform, government support is possible. For example, private consumer advocacy groups could run a review website and receive public funding. However, there is an issue regarding the verification of the correctness of reports, and at least the popular websites for hotel reviews and internet trade are seemingly not immune against manipulations.

3.3.1.3 Complaints Handling: Internal and External (Ombudsman)

Of more relevance than the sharing of consumer experiences is the handling of consumer complaints (which co-determines consumer experiences). This has led to rules regarding the implementation of internal complaint-handling procedures and external dispute resolution schemes that are essential components of consumer protection regulations. The G20 has called for accessible, fair, accountable and efficient complaints-handling and redress mechanisms of financial service providers.

If a complaint cannot be resolved by these internal routines, it may be transferred to an external mediator for an out-of-court settlement. A presently popular model is that of an ombudsman service. For example, the UK had set up a Financial Ombudsman Service (FOS) in 2001 as an “independent expert in settling complaints between consumers and businesses providing financial services”.⁶⁷ The FOS clarifies: “We’re not a regulator or an industry trade body. Nor are we a consumer champion or a government body. Our job is to settle individual disputes without taking sides.”⁶⁸ Financial firms are obliged to give each consumer a final

67 FOS 2014, p. 1.

68 Ibid.

written response to a complaint, accompanied by a leaflet about the FOS that explains its services and how to access the ombudsman. If the final response is negative, the consumer may submit the complaint to the ombudsman service, where an adjudicator will look into the case and try to settle the dispute informally through mediation or conciliation. If the consumers and the firm accept the adjudicator's findings, the dispute is settled. If the dispute is not resolved, either side may ask for a final decision by the ombudsman. If the consumer accepts this decision, the consumer and the firm are bound by it. If the consumer does not accept the ombudsman's decision, the firm is not bound, and the consumer has the right to take court proceedings against the firm. The ombudsman can tell a financial firm "to pay a consumer an amount for financial loss and/or pain and suffering, damage to reputation, and distress and inconvenience" up to an amount of £150,000. The advantage of the ombudsman model is that the system is cheaper and usually resolves complaints more quickly than regular courts.

3.3.1.4 Court Procedures

With an increasing complexity of financial products and financing structures with intricate special purpose vehicles on the one hand and a rapidly growing number of legal disputes in the retail market on the other hand, the establishment of specialised (benches of) courts could help to manage both complexity and quantity.

In recent years, courts became very actively involved in consumer protection. Following the GFC, many consumers filed lawsuits against their financial service providers for mis-counselling or mis-selling of financial products. In many cases the firms were sentenced to pay the consumers compensation, and in some countries banks were also fined for violating existing laws and regulations. The availability of class actions or representative actions by a body on behalf of consumers may have a significant impact on the value of the court system in ensuring liability for poor products or advice.

3.3.2 Damage Containment: Deposit Insurance

Court decisions in mis-counselling and mis-selling cases which sentence financial service providers to pay customers compensation can also be seen as a form of ex-post damage containment.

The consumer protection instruments so far assume that the provider of financial services stays in business. However, it happens that a financial service provider closes its business. This can be a voluntary and orderly, or an involuntary and unprepared, closure. Failure cases are of the latter type and can have a negative

impact on assets that belong to customers of the failed firm. Today, it is a widely shared view that bankruptcies of banks are dangerous events because they could trigger a bank run (in a fractional-reserve system⁶⁹). To prevent a systemic crisis, the regulatory systems of many jurisdictions protect depositors against losses caused by a bank failure by compensation from a deposit insurance scheme.⁷⁰

An argument against deposit insurance (without any retention) is that the depositors lose any incentive to monitor the activities of the bank's management and tolerate any level of risk-taking by the bank. This argument presumes that the depositors would monitor the risk strategy of the management if there were no deposit insurance. In the light of behavioural economics, this argument is not very convincing, at least as regards retail depositors.⁷¹ Depositors would not only need regular and timely access to risk information, but also the capacity to process this information and the will to argue over the risk strategy with the management. Most depositors will not have these qualifications. The few who have the capability (and will) to monitor the risk strategy of the management can hardly claim to be representatives of "the" depositors: no individual depositor has access to the names and addresses of the other depositors to organise a "general assembly" of depositors where results of a risk monitoring could be discussed among a representative group of depositors. In short, depositors would probably not be able to impose market discipline on the management in a well-organised manner, even if their deposits would not be protected by a deposit insurance scheme.

3.4 Unregulated Capital Markets, Community Projects and Crowdfunding

The direct interaction between seekers and providers of funds (without the intermediation of regulated financial institutions) has increased substantially over the last decade. This trend has been fostered in recent years by adverse developments in the financial sector (disappointment of customers about speculative practices of conventional banks; a long-lasting low-interest environment) as well as a wider acceptance of the non-capitalist business models (such as a revival of cooperatives and the spread of the sharing economy⁷²). Inexperienced retail investors have provided funding for ventures of very different sizes and natures, ranging from small community-oriented non-profit projects such as village shops or housing cooperatives to huge energy ventures that promised extraordinarily high profits. In many jurisdictions, existing regulations did not apply in these contexts. On the one hand, regulations may cover only

69 For a critical assessment of fractional reserve banking (including stability problems and the bank run issue), see Rothbard 1994.

70 See Demirgüç-Kunt, Kane and Laeven 2008.

71 Financial institutions depositing money in the interbank market are a different matter, and are commonly not protected by deposit insurance schemes.

72 See Aigrain and Aigrain 2012.

financial institutions, and fund seekers in the “grey capital markets” are typically non-financial enterprises, cooperatives or non-profit organisations. On the other hand, fund seekers used contracts such as subordinate loans, shareholder (profit-participating) loans, and direct investments or issued certificates that did not qualify as regulated securities. This resulted in growing unregulated capital market segments with very risky investment vehicles and rather inexperienced retail investors.

Seekers and providers of funds found each other in three very different (stylised) contexts:

- through personal proximity (as family, friends, neighbours), mainly for community-related projects;
- through public advertisements (posters, television spots, mass mailings, etc.) attracting middle-class investors to large projects by (unusually) high advertised expected profits; and
- through crowdfunding⁷³ internet platforms (often popularised via social media), for innovations of all kinds (initially for technical innovations and start-ups with a particular appeal to younger people, but now expanding to new areas such as social entrepreneurship with a growing acceptance in all age groups); crowdfunding investors often give priority to technological or social criteria over commercial criteria in their project selection. Crowdfunding can be based on equity or loan contracts.

The grey capital market was tolerated by regulators for quite a while, but in some countries spectacular insolvencies caused the governments to extend investment protection regulations to previously unregulated segments of the capital markets. Germany may serve as an example: the renewable energy developer Prokon had used public advertisements to sell subordinated profit-participating loan certificates with a promised return of 6–8%. The company (probably running a fraudulent Ponzi scheme) managed to raise nearly €1.4 billion from 75,000 retail investors before it became insolvent in January 2014.⁷⁴ The number of affected people and their losses were so large that the German government felt the need for an immediate reaction. It tabled a bundle of measures in May 2014, and the parliament finally passed a *Retail Investors’ Protection Act (RIPA)* on 23 April 2015.

73 Crowdfunding is a form of financial intermediation where large numbers of people, who are willing to contribute to the funding of specified projects, are directly linked through internet platforms with individuals who seek funding for project ideas which they present on these platforms. Platforms usually have a particular profile in terms of types of projects, geographic orientation, intermediation services, modes of funding, etc. For example, one platform may provide only the technical infrastructure and marketing services to profile itself in a particular segment – say, donations for works of art – while another platform teams up with microfinance institutions in developing countries and offers monitoring services for projects that individuals select and fund by pooled loans. There are also platforms that provide equity financing similar to venture capital companies but on a smaller scale and with a larger number of financiers. On crowdfunding in general, see Lawton and Marom 2013, Dresner 2014.

74 See Vasagar 2014.

The RIPA was the response to the raising of a large volume of funds through public advertisement with the promise of extraordinary profits on the basis of subordinated loans. This was possible because the borrower took advantage of a gap in the existing *Investment Products Act* (IPA) that did not apply to some specific types of financing contracts. The RIPA closed that gap and extended the coverage of the IPA to include shareholder loans (profit-participation loans), subordinated loans and other investment products with the same economic substance. RIPA also “upgraded” collective financial retail consumer protection to the level of an explicit objective of the regulatory authority (BaFin) whose interventionist powers were strengthened. Finally, the RIPA made warning notices in all advertisements for formerly grey market investment products mandatory, including the following (translated from German by V.N.): “The purchase of this investment product entails considerable risks and can result in a complete loss of the invested capital.”

It became obvious during the debates on the draft of the RIPA that a general application of the IPA to all previously unregulated capital market transactions could lead to a “regulatory overkill” for the debt financing of proximity-based community-related projects as well as internet-based crowdfunding activities. The contracts typically used in these contexts would fall under the amended IAP. This implies, among other things, the obligation to publish a sales prospectus.⁷⁵ The costs of its production and publication could reach the dimension of €30,000 to €50,000, which is prohibitive for many (if not most) community projects and crowdfunding ventures with relatively small capital needs, thus effectively killing these forms of direct financial intermediation.

The parliament finally gave in to these concerns, and the adopted version of the RIPA includes qualified exemptions for crowdfunding, social projects, public-benefit projects and projects of religious communities from the sales prospectus and some elaborate reporting and auditing requirements.⁷⁶ The qualifications for crowdfunding are as follows:

75 The prospectus has to be approved by the regulatory authority (BaFin); for the details of the RIPA, see (in German) Deutscher Bundestag 2015a, 2015b.

76 Social projects, public-benefit projects and religious communities are exempted if no commission is paid for the sale of investment products, the total size of the offered investment does not exceed €2.5 million, and the annual interest rate does not exceed 1.5% or, if higher, the market emission rate of mortgage bonds of the same maturity. For social projects, social objectives have to be stipulated in the statute of the issuer and its total balance sheet, and the revenues of the last 12 months, must not exceed €100,000, respectively. The exemption for public-benefit projects applies only to projects of public-benefit corporations as defined by the German Fiscal Code, and the exemption for religious communities applies only to religious communities being public law entities. This excludes Muslim communities in Germany, as they do not have the status of public law entities. It remains to be seen whether the associations of Muslim communities can negotiate an equal treatment agreement for *Shari'ah*-compliant instruments with the economic substance of shareholder loans or subordinated debt.

- The total size of the offered investment does not exceed €2.5 million.
- The maximum individual investment in a project of a particular issuer is limited to €10,000 per investor with disposable assets of at least €100,000 or (for investors with smaller amounts of disposable assets) to twice the average monthly net income up to the maximum of €10,000.
- The investor has to submit a self-disclosure on disposable assets or the average monthly net income to the crowdfunding platform.

The exempted projects are required to provide, instead of a full prospectus, a much simpler investment product information leaflet with a formalised summary of the salient features of the investment project on a maximum of three A4 pages. This leaflet does not require approval by the regulator, and the annual statement of accounts of the exempted projects does not require an external auditing.

The general requirement of a prospectus for investment products enhances the capital market transparency and gives investors more and better information for their decisions. Compared to the general standard, the quantity and quality of information on exempted projects with only an investment product information leaflet remain on a significantly lower level. Better information for investors comes at a significant price, and the legislator has to balance collective costs and benefits. The German legislator seemingly concluded that the collective benefits of (debt-based) crowdfunding and social and public-benefit projects outweigh the higher risk for individual retail investors.⁷⁷ This seems to be a reasonable position: on the one hand, the RIPA sets ceilings on the maximum investment in one project and, by this, limits the maximum loss of an individual investor to a bearable dimension. On the other hand, insights of behavioural finance suggest that retail investors are hardly able, and probably not willing, to digest all the detailed information of a full-blown sales prospectus and of audited annual reports – in particular, not if the capital at risk is of relatively small size. If that is correct, high information costs would have only marginally contributed to better financial decisions of the retail investor.

Crowdfunding has been discussed here in the context of regulations for a (formerly) grey capital market of a European country. However, the concept of crowdfunding has spread globally and has also taken root in Muslim jurisdictions. Examples of a *Sharī'ah*-compliant crowdfunding platform in Egypt, and the new regulatory framework for conventional and *Sharī'ah*-compliant crowdfunding in Malaysia, are outlined in 4.4.6 below.

⁷⁷ With reference to the difference in available information, investors are granted a cooling-off period of 14 days after the signing of a contract for an investment in an exempted project.

3.5 Evolution of Multi-layered Financial Consumer Protection Regimes

Financial consumer protection regimes are rarely (if ever) the result of a single creative act that brings a comprehensive legal framework and a complete set of regulatory institutions into existence. Usually, financial consumer protection regimes emerge in an evolutionary process; their elements (laws, regulations, institutions) are to be found in various legal documents that have been revised, amended or added over time. A brief example may serve as an illustration for the evolution of such a multi-layered regime. In contrast to previous examples in this chapter, the focus here is not on banking but on insurance, and the regional context is not the West but the Middle East.

Article 2 of the UAE Civil Code of 1985 declares that the “rules and principles of Islamic jurisprudence (*Fiqh*) shall be relied upon in the understanding, construction and interpretation” of the law for civil transactions.⁷⁸ An insurance contract is considered as an adhesion contract in which one side has all the bargaining power, while the other party cannot negotiate the terms and has to take it or leave it. If an adhesion contract “contains unfair provisions, it shall be permissible for the judge to vary those provisions or to exempt the adhering party therefrom in accordance with the requirements of justice, and any agreement to the contrary shall be void” (article 248). This can be a very strong instrument for consumer protection, and article 2 supports the application of Islamic principles of justice. The law explicates further: ambiguous wordings which are “detrimental to the interests of the adhering party” are not permissible, and doubts “shall be resolved in favour of the obligor” (article 266).

The Civil Code has a dedicated part on insurance contracts (articles 1026–1055), which also applies to *Takāful*. Most relevant for consumer protection is article 1028, which declares the following provisions in an insurance policy void:

- any provision according to which rights of the insured will lapse if the insured committed a contravention of a law (unless the contravention is qualified as a felony or deliberate misdemeanour);
- any provision according to which rights of the insured will lapse if the insured delays the reporting of an insured incident but has a reasonable excuse for the delay;
- any printed clause leading to the lapse of rights of the insured if the clause was not printed conspicuously; and
- any arbitrary clause in a contract (including unfair conditions) if a breach of

78 Quoted from the (unofficial) English translation of the Civil Code by James Whelan; see UAE 1987.

it would have no effect on the occurrence of the incident against which the policyholder is insured.

An arbitration clause is void if it is included in the insurance policy. A separate agreement is required for an arbitration clause.

The consumer protection provisions of the Civil Code are supplemented by a directive of the *Insurance Authority of the UAE* (IA) concerning the code of conduct (issued in 2010). The directive specifies, among other things, that insurance companies are obliged to:⁷⁹

- operate on the basis of utmost good faith;
- provide clients all relevant information about their products and services (including all fees and taxes) clearly, honestly, concisely and in an understandable language;
- print the text of policies clearly and legibly (i.e. no “small print”), and all clauses that are “related to an event that would render the contract void or lead to denial of the insurance claim” have to be printed in a conspicuous manner;
- “raise awareness amongst the insured on how to prevent accidents and mitigate their effects”; and
- maintain a register of all client complaints.⁸⁰
-

The latest development in consumer protection is the development of draft regulations by the IA for the establishment of funds to compensate policyholders and beneficiaries in case of bankruptcy of an insurance company.⁸¹ Besides funds for conventional insurance, two separate funds for general and for family *Takāful* shall be set up. All *Takāful* operators will be required to become members of the respective fund. The insurance companies and *Takāful* operators have to finance the funds by a levy on the premium income, but as long as no bankruptcy occurs, no cash transfers are required. Instead, the companies have to build provisions in their balance sheets and be ready for payment if required.

A bankruptcy of a *Takāful* operator has somewhat different implications than the bankruptcy of a conventional insurance company – in particular, in the life business. The assets financed by the *Takāful* participants’ savings fund belong

79 For the following quotations, see El Zeini 2011.

80 In addition, a special section for complaints has been established at the IA.

81 Based on information provided by the IA.

to the participants of a *family Takāful* undertaking and should be segregated from the assets of the *Takāful* operator. Creditors should have no access to the participants' assets. Nevertheless, a compensation fund *Takāful* can be beneficial as it can reduce friction, ensure a timely claim settlement, and support efforts for the continuity of policies by a smooth transfer of the *Takāful* portfolio to a new operator.

SECTION 4: REGULATION IN AN ISLAMIC PERSPECTIVE

Since Islamic financial institutions are primarily *financial* institutions that operate in a dual financial system alongside conventional financial service providers, it is reasonable to suggest that, in principle, consumer protection regulations and initiatives implemented in conventional finance should also apply to them.⁸² However, the *Islamic* identity of Islamic financial institutions could call for additional regulations that do not have full equivalents in conventional finance, and it may require adjustments of conventional regulations to cater for the peculiarities of Islamic finance.

4.1 Behavioural Peculiarities of Muslim Consumers

Suppose that, in principle, the whole range of consumer protection instruments of conventional finance should (after some technical amendments to ensure *Shari'ah* compliance) be applied in Islamic finance. In conventional finance, insights from behavioural economics – in particular, those related to cognitive biases – are used for the design and calibration of instruments (such as information tools and suitability assessments).

The empirical studies and experiments of behavioural economics – and hence the insights gained therefrom – took place in the “Western world”, in particular in North America. However, the findings are usually presented as universal – that is, as generally valid irrespective of the socio-economic and cultural (including religious) predisposition and environment of the decision makers. This cannot be taken for granted, but unfortunately behavioural economics studies that control for “cultural factors” and deal explicitly with non-Western environments in general and cognitive biases of Muslim consumers in particular are hard to find (if they exist at all). But there are two indications that such studies are needed and may produce results that could be relevant for the proper design of consumer protection instruments for Islamic finance.

- A first indication is that the cognitive biases have a strong explicative power for “irrational” phenomena such as low overall savings rates and insufficient provision for old age, or, at the same time, savings on accounts with low interest rates and financing of consumption at very high costs via credit cards and payday loans. If the cognitive biases were the same everywhere, the irrational phenomena explained by them should also be observable

⁸² Accordingly, the questions about consumer protection in Islamic finance that RSAs were asked by the IFSB for the survey on CPIF were largely developed from the good-practice examples compiled by the World Bank (2012) for conventional finance.

everywhere. This, however, is not the case. For example, in Germany the savings rate is rather high, Germans tend to be “over-insured”, and credit card financing or payday loans so far do not play any major role. Hence, either the cognitive biases do not exist or there are other country- or culture-specific factors that neutralise and over-compensate the biases so that the observable decision-making in Germany differs from that in the US. This means that there could be a conditioning factor that has even more explicatory power than the cognitive biases identified to date, but this factor has not yet been identified and analysed properly.⁸³

- The second indication is that Islamic economists claim that Muslims’ economic behaviour is different from that of non-Muslims in general and of non-religious people in particular. This view dates back to the beginnings of Islamic economics as a new discipline in the 1970s, when no systematic empirical studies on Muslims’ economic behaviour existed. Islamic economists often presented their arguments as factual. But the lack of broad empirical evidence nurtured doubts about whether their arguments were analytical and descriptive or normative and prescriptive. The early claims of a distinctive Muslim economic behaviour may have been, from today’s perspective, too simplistic and bold, but they should not be ignored altogether.⁸⁴ Some evidence indicates that Muslim consumers behave differently compared to non-Muslims, at least in multi-religious societies such as Malaysia.⁸⁵ This should give reason to explore more systematically the possibility of cognitive biases that differ from those that have been uncovered in behavioural economics (with a North American bias).⁸⁶ A related area where empirical knowledge is scanty is the attitude of Muslim consumers towards financial risk. For many proponents of Islamic finance, risk-sharing between capital providers and capital users is the prime distinguishing feature of Islamic finance compared to debt- and interest-based conventional finance.

83 Many insights of behavioural economics have been gained from economic experiments, and it may well be that a “cultural” factor is dominant in real-life situations but hardly observable in abstract experimental settings.

84 Differences in the consumer behaviour of Muslims and non-Muslims and a theory of consumer behaviour in an Islamic perspective were widely discussed by Islamic economists in the 1970s and 1980s. Typical examples of these early contributions have been reprinted in a reader edited by Tahir, Ghazali and Agil 1992; see also Farooq 2011.

85 Alam et al. 2011 explored in an empirical research paper whether religiosity is an important determinant of Muslim consumer behaviour in Malaysia. Two points are remarkable: First: The authors refer extensively to the early writings of Islamic economists. Second: “All the hypotheses examined in this research have supported the assumption that religion has greater influence on purchase decisions of Muslim consumers. Hence, it is true that in Islam the behaviour of a consumer is governed by religious injunctions” (p. 93).

86 Islamic economics is still an emerging discipline with presently only a limited number of specialised journals. A screen of Islamic finance and Islamic business-related journals (such as the *International Journal of Islamic and Middle Eastern Finance and Management* or the *Journal of Islamic Marketing*) and of conference papers submitted to large national or international conferences (such as the *International Conferences on Islamic Economics and Finance*) may unearth some papers on “Islamic behavioural economics”, but the number is most probably very small. Regulators who want to promote Islamic finance may look at the example of the FSA in the early 2000s and consider launching a research programme in this field with own contributions, commissioned research and open calls for papers for a high-calibre conference.

Although a risk-sharing economy may have some appealing macroeconomic features,⁸⁷ it is not so obvious that risk-sharing is the most preferred mode of investment by the average Muslim financial consumer. Cognitive biases such as loss and regret aversion would suggest otherwise, but they may not be relevant for Muslim savers and investors. Empirical research should clarify such issues.

If behavioural peculiarities of Muslim consumers could be specified, they should be taken into consideration for the design and calibration of financial consumer protection measures in Islamic finance.

In this context, it would also be worthwhile to study in depth the communication links between consumers of financial services and the “others” who influence their decisions. It may be that the character of these “others” differs in Islamic finance from that of “others” in a conventional context. For consumers of Islamic financial products, the Islamic character of the product and the provider is important. If consumers seek advice on Islamic qualities, they may consult religious authorities who are within their reach – for example, the imam of the local mosque.⁸⁸ Whether an imam can give qualified advice or not depends on his understanding of Islamic finance products and processes (with respect to financial technicalities as well as *Shari'ah* requirements). As Islamic finance is hardly part of the education of imams, Islamic banks and regulators who want to promote Islamic finance should consider special financial education programmes for imams to enhance their financial knowledge and familiarise them with *Shari'ah* basics in finance. This is of particular relevance in countries where the general level of financial literacy and capability is low, the financial services industry is still emerging and Islamic finance is in an early stage of development.

4.2 *Shari'ah* Compliance as a Defining Product Feature

Conduct-of-business regulators in G20 countries are in charge of all aspects of financial consumer protection. When it comes to Islamic finance, there is one obvious peculiarity with prime relevance for consumer protection in the Islamic sector that is absent in the conventional sector: for Muslim consumers of financial

87 This was another big topic of Islamic economists in the 1970s and 1980s, and it has again attracted much attention in the aftermath of the GFC of 2007–2009.

88 As information provided in brochures hardly substitutes for face-to-face contact with a trusted individual, a written *fatwa* issued by prominent *Shari'ah* scholars may not suffice for Islamic finance consumers. First, *fatwas* tend to be very brief or rather complicated – neither is appropriate for the needs of retail customers. Second, the issuing scholars may be famous among experts but unknown to retail customers. Third, retail customers may be aware of conflicts of interest of *Shari'ah* board members (similar to that of rating agencies being paid for their ratings by the rated) and look for an independent opinion.

products, a feature of high, or even crucial, relevance is the *Sharī'ah* compliance of products and services. Islamic financial institutions claim that their products and services (as well as their internal operations) do have this quality, and it is consistent with a general mandate for consumer protection that a regulator takes a stance on how to ensure the correctness of this claim.⁸⁹ The IFSB survey on CPIF deals with *Sharī'ah* and consumer protection in a general section.⁹⁰ In the specific sections on banking, capital market and *Takāful*, the regulators were asked whether they agree that IIFS should explain to consumers the differences between conventional and Islamic products. The result is somewhat surprising: only 44% of the responding RSAs agreed for Islamic banking, 73% for Islamic capital markets, and 54% for *Takāful*.

4.2.1 IFSB-10 on Sharī'ah Governance Systems

A regulated screening for *Sharī'ah* compliance does not necessarily imply that the regulatory authority has to make *Sharī'ah* judgments by itself. The *Sharī'ah* compliance validation could be externalised, in two different ways (each with further variants):

- either by the establishment of a *national Sharī'ah authority* that has the final say in all matters related to the *Sharī'ah* compliance of financial products;
- or by a decentralised system of *Sharī'ah* boards on the level of the *individual institutions* that offer Islamic financial services (without a national authority on top).

In practice, variants of both approaches are applied by different jurisdictions. According to the survey results, 58% of 30 RSAs do have a *Sharī'ah* committee or board at the supervisory level, and a few more jurisdictions plan to establish such a body. The vast majority (89%) of the respondent RSAs agreed that a *Sharī'ah* governance system for the Islamic financial services industry on the supervisory (government) level would enhance financial consumer protection.

In 82% of the jurisdictions that responded to the survey questionnaire, a *Sharī'ah* committee or board is required at the level of the IIFS. The IFSB issued a standard on *Guiding Principles on Sharī'ah Governance Systems for Institutions*

⁸⁹ At first sight, this is somewhat similar to the claim of a conventional financial service provider to invest clients' funds only in, for example, socially responsible projects. However, while the meaning of socially responsible investments is framed in contemporary public debates, *Sharī'ah* compliance is more demanding. It requires the adherence to, or at least observance of, maxims of a comprehensive but not codified legal system that evolved over centuries. Experts in Islamic law – traditional *Sharī'ah* scholars, as well as specialised Western law firms – are working towards the compatibility of Islamic law and the national secular laws in force in the jurisdictions where Islamic finance is practised.

⁹⁰ The survey reproduces, among other things, the divergent views of RSAs on whether Islamic finance products are per se more or less consumer-friendly. The views of the RSAs are rather evenly distributed – namely, 14 (more) to 13 (less).

offering *Islamic Financial Services* (IFSB-10) in 2009. It devised the following nine principles:

- Principle 1.1: The *Shari'ah* governance structure adopted by the IIFS should be commensurate and proportionate with the size, complexity and nature of its business.
- Principle 1.2: Each IIFS must ensure that the *Shari'ah* board has:
 - clear terms of reference regarding its mandate and responsibility;
 - well-defined operating procedures and lines of reporting; and
 - good understanding of, and familiarity with, professional ethics and conduct.
- Principle 2.1: The IIFS shall ensure that any person mandated with overseeing the *Shari'ah* governance system fulfils acceptable fit and proper criteria.
- Principle 2.2: The IIFS shall facilitate continuous professional development of persons serving on its *Shari'ah* board, as well as its ISCU [internal *Shari'ah* compliance unit/department] and ISRU [internal *Shari'ah* review/audit unit/department], if any.
- Principle 2.3: There should be a formal assessment of the effectiveness of the *Shari'ah* board as a whole and of the contribution by each member to the effectiveness of the *Shari'ah* board.
- Principle 3.1: The *Shari'ah* board should play a strong and independent oversight role, with adequate capability to exercise objective judgment on *Shari'ah*-related matters. No individual or group of individuals shall be allowed to dominate the *Shari'ah* board's decision-making.
- Principle 3.2: In order to fulfil its responsibilities, the *Shari'ah* board should be provided with complete, adequate and timely information prior to all meetings and on an ongoing basis.
- Principle 4.1: *Shari'ah* board members should ensure that internal information obtained in the course of their duties is kept confidential.
- Principle 5.1: The IIFS should fully understand the legal and regulatory framework for issuance of *Shari'ah* pronouncements/resolutions in the jurisdiction where it operates. It should ensure that its *Shari'ah* board strictly observes the said framework and, wherever possible, promotes convergence of the *Shari'ah* governance standards.

The implementation of these *Shari'ah* governance principles should assure the consumers that products labelled as “Islamic” are indeed *Shari'ah*-compliant.

4.2.2 The Relevance of Conventional Financial Consumer Protection

Many (if not most) initiatives of Western regulators and international organisations aiming at the prevention of mis-selling and the facilitation of better consumer choices could easily be transferred or adapted to Islamic finance: from basic disclosure requirements over reporting in plain language and a ban on hidden clauses in the fine print, to financial advice rules and dispute resolution mechanisms.⁹¹ In some areas, adapted standards for IIFS have already been elaborated – for example, IFSB-4 on *Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services*, issued in 2007. Even best practice examples of awareness and education programmes could be adapted as far as the financial dimension is concerned. Whether and how such programmes should also incorporate the Islamic dimension – that is, the *Shari'ah* compliance of products – is a different issue. However, since the terminology of Islamic finance (even for standard products) is less well-known to financial consumers in most jurisdictions compared to conventional finance, the principle of transparency could justify the stipulation of specific product information and supplementary explanatory material on *Shari'ah*-compliant products in understandable local language.

The adaptation of conventional models to Islamic finance gets more complicated when a regulator wants to adapt initiatives for an easy comparison of financial products (such as the “league table” or database models) or to establish a body for generic advice on the suitability of different products: most jurisdictions where Islamic finance is practised operate dual financial systems.⁹² Consumers – including Muslims – may not only want to compare conventional products with other conventional products and Islamic products with other Islamic products, but also conventional products with Islamic products and vice versa.⁹³ Even Muslims who would not buy conventional products when Islamic alternatives are available may want to use conventional products as a benchmark for the performance of *Shari'ah*-compliant products.

But there are more fundamental adaptation issues: Islamic banks – under the guidance of their *Shari'ah* boards – have structured functional equivalents of contemporary financial products on the basis of traditional *Shari'ah* nominate contracts to ensure the *Shari'ah* compliance of their products. These contracts

91 This is attested to by the IFSB survey on CPIF, which is largely based on the compilation of good-practice examples compiled by the World Bank (2012) for conventional banking, the capital market and insurance.

92 The principle of impartial treatment may require in dual systems the facilitation of a comparison of conventional and Islamic products. This should also include financial services for consumers with special needs. Regulatory guidelines should define minimum standards in this respect.

93 The persistence of dual financial systems and Islamic retail market shares of 20% or less may mirror preferences for conventional finance by large parts of the population in Muslim countries. This behaviour may be considered morally or religiously wrong, but it is actually a fact; on market shares, see IFSB 2015, section 1.1.1.

(in particular, *Murābahah*, *Salam*, *Istiṣnāʿ* and *Ijārah*) were never intended to be stand-alone *financing* contracts; instead, they were and still are *sales* contracts with financing components – in particular, deferred payment (or delivery) clauses. These contracts in their stand-alone form either require the ownership of a real asset by the financier at the beginning, or the transaction ends with ownership of a real asset by the financier. However, financial institutions neither own large varieties of real assets, nor do they want to become owners of large pools of real assets. Their business is not trade, but the *financing* of trade. Therefore, they combine, roughly speaking, one traditional contract with a second contract in the reverse direction⁹⁴ or an auxiliary contract or a unilateral promise (*Waʿd*)⁹⁵ in order to structure functional equivalents for conventional financial products. Not all modern combinations of traditional contracts are accepted by all *Sharīʿah* scholars, so that different legal structures exist for the same financing purpose, or similar legal forms are filled with different commercial substance.

As a result, even basic products (such as *Sharīʿah*-compliant alternatives to conventional savings and term deposits or long-term loans) are more complex and can have different characteristics depending on the practice of the banks. The higher complexity poses particular challenges to the reliability of the technical systems, as well as the human resources of Islamic banks.

Given the involvement of multiple contracts and more parties in *Sharīʿah*-compliant transactions than in conventional functional equivalents, and taking note of the resulting need for qualified explanations to customers, regulators may consider adequate requirements for the robustness of, in particular, the accounting and IT systems as well as the qualification of the customer service staff of Islamic financial institutions.

Major conceptual regulatory issues will be discussed in the following with the aid of one illustrative example for the deposit business and one for the financing business of IIFS.

4.3 Islamic Peculiarities in the Deposit Business

Until recently, the predominant *Sharīʿah* nominate contract for the structuring of *Sharīʿah*-compliant equivalents of income-yielding savings and term deposits was *Muḍārabah*.

94 For example, combined *Murābahah* contracts constitute *Tawarruq*, *Salam* is applied as parallel or hybrid *Salam*, and *Istiṣnāʿ* as parallel *Istiṣnāʿ*; see, for example, Arbouna 2007, Rahman 2012.

95 The combination of a single *Murābahah* contract with a promise of the customer to buy an asset at a mark-up from the bank is known as "*Murābahah* to the purchase order(er)"; on the principles and use of *Waʿd*, see Hasan and Muhammad 2011.

In their abstract or legal form, *Muḍārabah* contracts are loss-bearing and profit-sharing arrangements, and the respective customer accounts are known as unrestricted profit-sharing investment accounts (UPSIA): one party (the *Rabb al-Māl*) entrusts his capital to another party with entrepreneurial skills (the *Muḍārib*) for profitable investments. Since only the *Rabb al-Māl* provides capital, all capital losses have to be borne by him, while the *Muḍārib* would receive no compensation for his efforts. Should the investment generate a profit, it is distributed among the *Rabb al-Māl* and the *Muḍārib* according to an agreed ratio.

In contrast to the formal characterisation, *Muḍārabah*-based UPSIA are in practice often managed by Islamic banks in such a manner that their substance resembles capital-protected, fixed-income deposits. This is achieved by reference to prudent risk management techniques and, more importantly, by the application of profit-smoothing techniques that attune the actual profit payouts for investment account holders (IAHs) to the profits expected by them.⁹⁶ The abstract form of *Muḍārabah*-based profit-sharing and loss-bearing UPSIA diverges significantly from the business practice of Islamic banks. Smoothed investment accounts hardly look and feel like investments where a significant risk-taking justifies ex-ante unknown returns for the capital provider. Instead, they resemble conventional interest-bearing deposits. This impression is reinforced by reference to a *Sharī'ah*-compliant “deposit” insurance scheme for investment accounts.⁹⁷ Both the formal characterisation and the practice of Islamic banks are backed by recognised *Sharī'ah* scholars and institutions such as AAOIFI.

4.3.1 Better Explanation and Disclosure of Smoothing Practices

A consumer protection issue can arise if, for example, an Islamic bank follows the smoothing approach but uses promotional material with idealistic views by which it attracts clients to its UPSIA who would have gone for a different investment if they had fully understood the practice of the bank. There is a lot of enthusiasm for Islamic finance, especially among young people who subscribe to the view that only the productive investment of capital and its exposure to risk legitimises a return for capital owners. Smoothed investment accounts would not be the best choice for this group. “Unsmoothed” accounts or an investment in shares of an Islamic mutual fund or direct investments in capital market products might be more suitable for these risk-sensitive retail clients.

96 The expectations of account holders are often formed by the advertisement of an expected rate of return by the Islamic bank. If no specific rates are advertised, account holders expect that their returns are in line with the prevailing deposit interest in the conventional sector.

97 The IFSB has recently completed a study on the role of *Sharī'ah*-compliant deposit insurance schemes for the strengthening of the financial safety net. The major findings are summarised in IFSB 2015, section 2.2.2(a).

There are several general consumer protection principles that suggest a more detailed disclosure of smoothing practices – in particular, the principles that financial service providers should:

- treat customers fairly;
- inform clients of fundamental benefits, risks and terms of products;
- contribute to financial education;
- work in the best interest of their customers; and
- respond to competitive pressure by providing more suitable products.

More detailed disclosure of smoothing practices would also support IAHS who, in principle, approve the smoothing approach but require more information to assess the past performance of their bank for informed choices on where to place their funds in the next period. For these clients, it is of particular interest to know how much of the profit payout was actual investment income and how much came from the release of profit equalisation reserves (PER) and other sources (in particular, adjusted *Muḍārib* profit shares or transfers from shareholders' funds). A high percentage of actual payouts taken from reserves and other sources could indicate that depleted reserves have to be replenished and that shareholders will look for a future compensation if actual payouts were beefed-up at their expense. Both – replenishing reserves and compensating shareholders – will reduce the payout potential in good years, which may induce informed IAHS to switch to a competing bank with a stronger investment performance. Conventional finance regulators encourage consumers to “shop around for the best deal” and to make informed choices, and there is no reason why this should not also apply to Islamic finance. Disclosure should facilitate such behaviour.

The urge for more disclosure on smoothing practices is not new: major disclosure requirements regarding PER were already spelled out in AAOIFI Financial Accounting Standard (FAS) No. 11, adopted in 1996 and addressing primarily the expert readers of balance sheets and income statements. The IFSB took a broader approach and issued IFSB-4 in 2007 with detailed disclosure requirements for UPSIA, including:

- written procedures and policies applicable to the investment accounts, including a synopsis of the following:
 - range of investment products available from the IIFS;
 - characteristics of investors for whom various investment accounts may be appropriate;
 - purchase, redemption and distribution procedures;
 - experience of portfolio managers, investment advisers and trustees;

- governance arrangements for the IAH funds;
- procedures for trading and origination of assets;
- bases of allocation of assets, expenses and profit in relation to IAH funds;
- disclosure on the policies governing the management of IAH funds, which covers the approaches to the management of investment portfolio, establishment of prudential reserves, and the calculation, allocation and distribution of profits;
- disclosure on the major changes in the investment strategies that affect the investment accounts (including commingling of funds);
- method for calculation and distribution of profits;
- share of profits earned by unrestricted IAH, before transfers to or from reserves;
- share of profits paid out to unrestricted IAH, after transfers to or from reserves;
- rules governing the transfer of funds to or from investment risk reserves (IRR) and PER,;
- disclosure of the utilisation of PER and/or IRR during the period; and
- profits earned and profits paid out over the past three to five years.

The above information should be provided not only to professional clients but also, in a form that is easily understood, to retail clients.⁹⁸ The IFSB's GN-3: *Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders*, published in 2010, provides a survey of smoothing practices and explains in detail the use of and disclosures on IRR as well as PER and the underlying displaced commercial risk. The IFSB has placed disclosure on smoothing in the context of consumer protection and considers it not only as an obligation towards IAHs but also as a matter of public concern, and suggests the publication of information on the use of IRR and PER in media that address the general public.⁹⁹ The IFSB survey on CPIF found a high acceptance (71%) for more disclosure on the use of PER and IRR for profit smoothing.

98 "Retail investor-oriented disclosures for IAH ... shall contain true, factual and balanced statements, and not projections or estimates of future performance of the funds. These disclosures shall include all explanations, qualifications, limitations and other statements that are necessary to prevent the performance information from misleading investors.... In addition to the current period's performance information, the disclosures shall contain information on historical returns for IAH and shareholders compared to general market and asset returns, and the underlying profit calculation and allocation method(s), which are consistent over a reasonable comparative period to enable IAH to make performance comparisons and to evaluate risks" (IFSB-4, paras 43, 45).

99 "An IIFS should be transparent to the IAH in respect of any Smoothing practices. This is in due recognition of the rights of IAH as *Rabb-ul-Māl* to monitor the performance of IIFS as *Muḍārib*, which is crucial in preserving equitable treatment of investors and enhancing market discipline. As much as shareholders must be informed when a company utilises reserves to maintain a certain level of dividends distributions to them, similarly the IAH have a right to know when profits distributed to them are affected by appropriations to or releases from reserves. Indeed, a good track record of profit distribution is aimed not only at retaining IAH but also at enticing potential new investors. Smoothing should thus be treated as an issue of public concern. Therefore, it is reasonable for IIFS to publicise information about the aforementioned reserves in major media organs as well as in their annual reports" (IFSB GN-3, para. 73).

4.3.2 Disclosure in Analogy to Collective Investment Schemes

If banks do not apply smoothing techniques but operate UPSIA as risk-bearing and profit-sharing products, other disclosure requirements become relevant with reference to the same consumer protection principles as quoted earlier. In this instance, investment accounts share basic characteristics with CIS. Islamic banks should explain to customers in some detail the differences between *Muḍārabah*-based investment accounts and (other) Islamic collective investment schemes (ICIS) – for example, exchange-traded Islamic funds for retail clients.

Since the IAHS are the ultimate risk bearers, banks should disclose, by analogy to CIS, details of the use of IAHS' capital and the bank's investment strategy. The risk/return profile is of particular interest, but also the valuation of assets. AAOIFI has adopted (in 2000) FAS 14 on investment funds with a comprehensive list of items for disclosure, including:

- significant investment policies and the investment objectives;
- accounting policies adopted to value investments, receivables, financing and other assets;
- the accounting policy adopted to recognise income;
- the bases and terms that govern transactions that are jointly financed by resources of the *Muḍārib* and the investment fund, and
- non-*Sharī'ah*-compliant earnings, if any, and how those amounts are disposed of.

The IFSB issued a specific standard on *Guiding Principles on Governance for Islamic Collective Investment Schemes* in 2009 (IFSB-7).¹⁰⁰ Based on IOSCO documents, the standard provides five principles with a number of recommended best practice examples:

- Principle 1: The ICIS's highest governing body (GB) shall establish a comprehensive governance policy framework which protects the independence and integrity of each organ of governance, and sets out mechanisms for proper control and management of conflicts of interest and duty.
- Principle 2: ICIS insiders shall ensure that disclosure of material information is not only done with appropriate accuracy and timeliness, but also presented in an investor-friendly manner.

¹⁰⁰ This standard explicitly classifies investment accounts as one form of an ICIS [para. 7(v)].

- Principle 3: ICIS's GB shall ensure that appropriate systems and mechanisms for monitoring ex-ante and ex-post *Shari'ah* compliance are in place, and are effective.
- Principle 4.1: The ICIS's GB shall ensure that any movement of the ICIS's funds or assets, to the extent that such is lawful, will be carried out in conformity with the ICIS's investors' objectives and their best interests and always supported by appropriate and objective valuations.
- Principle 4.2: ICIS insiders shall be transparent in the imposition of any fees, creation of any reserves and the smoothing of any dividend payments.

An area where detailed disclosure is required and most relevant for participants in "truly" profit-sharing structures is the determination of the profit that is to be shared and the formula for the calculation of the IAHS' profit share as well as the terms for modifications during an investment period (including conditions for incentive profits, if any). AAOIFI FAS 6 (which has been transferred into the recently adopted FAS 27) explicitly addresses "Disclosure of Bases for Profit Allocation between Owners' Equity and IAHS". As in the case of smoothed investment accounts, this particular AAOIFI standard may become the basis of a consumer-protecting regulation even in jurisdictions that otherwise do not apply AAOIFI standards. Even more elaborate alternatives – with considerably more technical details – are the standards IFSB-4 and IFSB-10. Irrespective of whether regulators in dual systems refer to AAOIFI or IFSB standards, both facilitate a regulation of Islamic finance that is at least equivalent to, if not more elaborate than, corresponding requirements for conventional CIS.

4.3.3 Quasi Risk-free and Quasi Fixed-income Term Deposits on a Wakālah Basis

Consumer protection by disclosure is the least interventionist method, but it can be effective only if the disclosed information is understood and processed adequately by the consumers. There are serious doubts as to whether this will be the case for *Muḍārabah*-based investment accounts, as these *Shari'ah*-compliant investment accounts are inherently more complex and ambivalent in their practical utilisation than conventional counterparts. Further, Islamic banks – in particular, in developing countries and emerging markets – should also cater for the financial needs of poorer and less educated people whose financial literacy is very limited. Finally, disclosure does not eliminate the risk of a capital loss, and any risk exposure may be beyond the capabilities of financially vulnerable groups. UPSIA are probably not the most suitable savings vehicle for them, and it would be in their interest that Islamic banks provide simple, risk-minimised products.

Wakālah-based accounts of a specific type could be a solution. This structure has gained popularity among Islamic banks in recent years. However, at present, *Wakālah*-based accounts target mainly high-net-worth individuals instead of risk-averse low-income customers, but it should be possible to develop a standardised mass-market version of this product (in analogy to the “simple products” approach in conventional finance). The commercial features of *Wakālah* accounts can come close to those of conventional savings or term deposits: the bank acts as the agent (*Wakīl*) of the customer and invests his money for a specified period of time in *Sharī'ah*-compliant businesses as agreed upon in the agency contract. To minimise the risk of capital losses, the contract could, for example, restrict the investments to asset-backed bank financings (e.g. *Sharī'ah*-compliant home financings) and top-rated *Sukūk*, and it may prescribe a minimum asset diversification. It could also specify an investment strategy (for pooled *Wakālah* accounts) that replicates capital protection strategies of conventional finance.¹⁰¹ This does not eliminate the risk of capital losses completely,¹⁰² but the remaining risk may be considered the lowest achievable for a *Sharī'ah*-compliant security that yields a regular income.¹⁰³ A voluntary guarantee against investment losses by a third party could eliminate even this residual risk. This makes the *Wakālah* account quasi risk-free.

As for the fixed-income feature, the bank and the account holders agree on an expected target profit from the investments. The resulting target rate of return is not guaranteed, but it can be calculated with high accuracy for a specified investment period. The bank does not have an incentive to set an unrealistically high target profit if the *Wakālah* contract stipulates that profits above the target will go (partially or in full) to the *Wakīl* as an incentive fee. This should motivate the bank to meet and beat the target profit. If the extra profits go to the bank in total, the *Wakālah* account becomes a quasi fixed-income deposit.

The internal structure of such a product is all but simple.¹⁰⁴ Nevertheless, the commercial features are easy to understand by the consumer, and they should

101 For example, the bank could invest a sufficiently large part of the pooled funds of the *Wakālah* account holders in financial assets with non-negative returns and a guaranteed payment at maturity (e.g. in sovereign or top-rated corporate *Ijārah Sukūk*) that covers the nominal value of the initial deposit; the remaining funds could be used for investments with higher profit potentials but also higher risks.

102 Losses could occur, for example, in case of a default of the issuer of an *Ijārah Sukūk* that is used as backup for the account holders' capital.

103 A “true” deposit with a capital guarantee by the accepting institutions could be based on *Sharī'ah* contracts such as *Qard* and *Wadī'ah*, but these contracts do not allow a regular income for the capital provider (i.e. explicitly agreed or customarily expected payments by the deposit-accepting institution to the depositor).

104 There are contractual complexities to ensure *Sharī'ah* compliance, challenges for the investment manager, and liquidity management issues if withdrawals should be allowed on short notice or even at any time.

be particularly appropriate for financially vulnerable people with small savings who cannot afford losses but would like to earn a modest return on their capital in a *Sharī'ah*-compliant way. The regulator could offer banks that offer such a product incentives such as a (free or subsidised) third-party capital guarantee for the account holders (up to a maximum amount commensurate with the savings capacity of the average target consumer).¹⁰⁵ Furthermore, capital-protected *Wakālah* accounts tailored to the needs of vulnerable consumers might be promoted by the authorities under the quality label of a “*Sharī'ah*-compliant simple consumer product”. However, it is important to note that the *Wakālah* contract in itself does not imply a quasi risk-free investment.¹⁰⁶ It is the agency agreement on a particular investment strategy that can give the *Wakālah* account a quasi risk-free character. Without an explicit risk-minimising investment strategy, *Wakālah*-based accounts should be classified as a form of risk-taking investment accounts (with *Muḍārabah*-based accounts as another form).¹⁰⁷

4.3.4 Strict Separation of Risk-free Islamic Deposits and Risk-taking Investment Accounts

Most countries where Islamic finance is practised do not have a national *Sharī'ah* authority to decide on *Sharī'ah* compliance issues, and in many of these countries regulators painstakingly avoid authoritative comments on substantial *Sharī'ah* issues. This leaves the responsibility for the *Sharī'ah* compliance of products with the *Sharī'ah* boards of the financial institutions. As a result, different practices may prevail in the same jurisdiction. For example, some banks may apply smoothing techniques for *Muḍārabah*-based investment accounts to mitigate market fluctuations, while others refrain from this practice, and some banks may structure quasi risk-free accounts on a *Wakālah*-basis while others aim at highest quasi fixed returns (for the account holders) and tolerate higher market risks. Hence, the same name may be used for commercially very different products. This can create confusion and misunderstandings among retail clients regarding the risk profiles of investment accounts.

Malaysia has taken legal and regulatory steps to make a clear distinction between two fundamentally different types of Islamic accounts. The *Islamic Financial Services Act 2013* differentiates between Islamic investment accounts and Islamic deposits, and Bank Negara Malaysia (BNM) released a policy document in 2014

105 This would be an incentive in jurisdictions where such deposit insurance schemes are financed by fees that banks have to pay to the deposit insurance institution.

106 Like in a *Muḍārabah* contract, the bank client is the capital owner under *Wakālah* and as such has to bear losses as long as the agent (bank) invests the capital within the limits defined by the agreement with the *Wakil*.

107 This is done in Malaysia; see sub-section 4.3.4.

on regulatory requirements of investment accounts.¹⁰⁸ The clear demarcation line is the existence of a legal obligation for the financial institution to repay money accepted from account holders in full.

- The obligation to repay in full is constitutive for an Islamic deposit (e.g. a current account or a savings account) that could be based on a *Qard* or *Waqf'ah* contract. The Islamic depositors' claim for a full repayment can be covered by a deposit insurance scheme, and Islamic deposits are formally risk-free. However, these contracts do not allow a regular income for the capital provider (i.e. explicitly agreed or customarily expected payments of the deposit-accepting institution to the depositor).
- Money paid into an Islamic investment account is exposed to commercial risks. The accepting bank is not obliged to repay in full (notwithstanding a liability for misconduct and negligence); investment accounts can be based on *Mud'arabah*, *Musharakah* or *Wakalah* contracts. A regular (but not predetermined) income can be expected as long as the investment's performance is positive. If the performance turns negative, the IAHs have to bear the losses proportionately.

Banks are obliged to point out unmistakably that money paid into investment accounts is exposed to a market risk. BNM made it mandatory for financial institutions to place a disclaimer statement¹⁰⁹ and a risk warning¹¹⁰ on all promotional material for investment accounts. In addition, BNM has stipulated that financial institutions have to provide a product disclosure sheet for each type of investment account offered to retail customers. This is very similar to what is common practice in capital markets (especially for CIS).

The product disclosure sheet must contain, among other things, the following information:

- adopted *Shar'ah* contracts (including details of the profit distribution policy such as the application of the profit-sharing ratio and incentive fees, as well as the nature of losses that had to be borne by the IAH);

108 See BNM 2014.

109 BNM gives an illustration of such a statement, to be written in bold capital letters: "**IMPORTANT/ DISCLAIMER: THIS IS AN INVESTMENT ACCOUNT PRODUCT THAT IS TIED TO THE PERFORMANCE OF THE UNDERLYING ASSETS, AND IS NOT A DEPOSIT PRODUCT**" (BNM 2014, p. 31).

110 The illustration reads for such a warning, to be written in bold capital letters: "**WARNING: THE RETURNS ON THIS INVESTMENT ACCOUNT WILL BE AFFECTED BY THE PERFORMANCE OF THE UNDERLYING ASSETS. THE PRINCIPAL AND RETURNS ARE NOT GUARANTEED AND CUSTOMER RISKS EARNING NO RETURNS AT ALL. IF THE INVESTMENT IS REDEEMED EARLY, CUSTOMER MAY SUFFER LOSSES IN PART OR THE ENTIRE PRINCIPAL SUM INVESTED. [WHERE THE INVESTMENT ACCOUNT IS NOT PROTECTED BY PIDM TO ADD: "THIS INVESTMENT ACCOUNT IS NOT PROTECTED BY PERBADANAN INSURANS DEPOSIT MALAYSIA."]**" (BNM 2014, p. 32).

- the product structure, including investment objectives, strategies and proposed investment assets;
- fees and charges, if applicable;
- a risk disclosure statement highlighting risk factors; and
- an analysis of past and future performance (which not only presents best case scenarios and potential upside returns, but also spells out downside risks of losses).

BNM has made rather detailed stipulations for a suitability assessment,¹¹¹ and only after the financial institution has satisfied itself that a client is eligible for investment products can it recommend the particular investment account (or another investment product) that it deems most suitable for the needs and capability of the retail client.

4.4 Islamic Peculiarities in the Financing Business

Assume that a regulator becomes aware of actual or potential financing practices in Islamic finance that are considered to be or that may become a serious threat to the interest of consumers. His possible reactions and the issues involved can best be illustrated by an example.

4.4.1 Product Features: From Recommended to Mandatory

Islamic banks can apply sales contracts for the long-term financing of consumer assets – for example, *Murābahah* or *Bay' Bithaman Ajil* (BBA) contracts with tenures of 15 years or more for house financing. The bank and the customer agree on a selling price for the house that comprises the object's cost price (at which the bank acquires the house) plus the profit margin of the bank. The selling price is paid in instalments, and each instalment reduces (according to an agreed formula) the outstanding cost price and profit margin. If a customer wants to settle his debt before maturity, the *Sharī'ah*-compliant sales contract gives the bank the right to claim the full outstanding amount of the selling price, which includes a profit component that was calculated for instalments in the future. In an early settlement of a conventional loan, the bank (ignoring any charges, penalties, etc.) would only claim the repayment of the outstanding loan amount – which is equivalent to the outstanding cost price in a sale-based Islamic financing – but no interest for future periods because there will be no outstanding debt. Obviously, the customer of the Islamic bank would be in a disadvantaged position, and his treatment could hardly be considered as fair, if the sales contract was not modified

¹¹¹ The financial institution must gather information on the investor's age, the annual income and number of dependants, his investment objectives, financial situation, risk profile and current portfolio, and his level of financial knowledge and experience, which should correspond to the complexity of the product.

but enforced by the bank.

A significant disadvantage for retail clients of Islamic banks should be a concern for regulators with a consumer protection mandate: if retail clients are familiar with conventional practices, and if an Islamic bank has presented the sale-based financing as a *Shari'ah*-compliant equivalent to an interest-based loan financing without any exposition of early settlement issues, then the client was misguided (intentionally or unintentionally) by incomplete information. To avoid this outcome, Islamic banks and regulators have worked out the following solution: while the customer is contractually obliged to pay the full outstanding selling price, the bank has the right to waive all or part of it. Such a voluntary debt reduction or rebate is known in Islamic jurisprudence as *Ibrā'*. The bank, for example, may offer a rebate equivalent to all profit components of future instalments. By this means, the customer will pay the cost price of the object and the profit margin for only those periods in which he had used the resources of the Islamic bank. This is equivalent to what a customer of a conventional bank would have to pay.

The problem with this solution is that the granting of *Ibrā'* is at the discretion of the bank, and the customer cannot legally claim a rebate unless *Ibrā'* was explicitly mentioned (promised) in the financing contract. This may lead to a situation where some banks mention *Ibrā'* while others do not, and some of those who do not mention *Ibrā'* may nevertheless grant a full or partial rebate in cases of need while others insist on a full payment of the selling price. Different practices create confusion and uncertainty among customers and may damage the reputation of banks that do not mention *Ibrā'* in the documents (although these banks may actually offer even the most generous rebates).

Seemingly, an *Ibrā'* clause in the documents of a sale-based financing contract is a product feature that would facilitate a solution for serious customer protection issues. Regulators with a consumer protection mandate can take measures to come to a more unified fair treatment of customers of Islamic banks.

- The mildest form of product regulation would be a *recommendation* of an *Ibrā'* clause in sale-based financing contracts and an explication of the rebate policy of the bank. It remains in the discretion of each financial institution whether to follow the recommendation or not, but the regulator could give its recommendation more teeth by requiring the institutions to inform all customers of their practice; if they do not follow the regulator's recommendation, they may be obliged to explicate their decision and practice.
- The appellative approach does not ensure that all banks accede to the

request and explicate *Ibrā'* in their contracts. If this were the goal, the regulator should *require* an *Ibrā'* clause as a mandatory product feature of sale-based financing contracts.

- The mere requirement of a clause does not ensure that all banks follow the same *Ibrā'* policy. Conditions and percentages for rebates may differ, and it can be difficult for consumers to find out which bank offers the best terms for different scenarios. To achieve a harmonised *Ibrā'* practice, the regulator has to make a particular method for the calculation of *Ibrā'* mandatory.¹¹²

Regulators who cannot take an explicit stance on *Shari'ah* issues may be reluctant to prescribe an *Ibrā'* formula or to make an *Ibrā'* clause in contracts mandatory. Instead, they may follow a “comply-or-explain” approach.¹¹³ The regulator recommends an *Ibrā'* clause (including, possibly, even an *Ibrā'* formula), but leaves the decision to adopt, modify or reject this proposal to the IIFS. Institutions that do not adopt the regulator’s proposal are required to explain to their customers in written form and plain language why they have rejected or modified the regulator’s proposal and what that means for customers who seek early settlement.

4.4.2 Specific Product Restrictions

Islamic finance has progressed not only in size but also in sophistication. While buy-and-sell arrangements were the predominant financing technique for the retail market in the formative years of Islamic banking, today the spectrum of instruments for medium- to longer-term consumer financing has become much wider. For example, banks today widely apply *Ijārah* or diminishing *Mushārah* structures for house financing. These techniques are much less plagued by issues of transparency, fair treatment and flexibility than *Murābahah* or *Bay' Bithaman ājil* when confronted with a demand for restructuring or early settlement. Two thirds (68%) of the RSAs responding to the IFSB survey questions on CPIF agreed that terms and conditions of all products of IIFS should be subjected to approval by, or at least be under the purview and/or review of, the regulatory authority.

If better alternatives are at hand, the regulator may consider a restriction of

112 Bank Negara Malaysia has taken this tougher approach and issued *Guidelines on Ibrā' (Rebate) for Sale-based Financing* in 2011 (updated 2013) (see BNM 2013). The objectives of the guidelines are to promote transparency and an equitable mechanism of the grating of *Ibrā'* by Islamic financial institutions. The guidelines explicate in detail for sale-based financings with fixed or variable rates and for different early settlement scenarios the method for the calculation of *Ibrā'*. The financial institutions have to apply this method and, among others, illustrate the application of the *Ibrā'* formula by a detailed payment schedule that can be easily understood by the customers.

113 Although the regulator does not make an explicit *Shari'ah* pronouncement by himself, he is not totally detached: by proposing an *Ibrā'* clause, he sides with those *Shari'ah* scholars who deem *Ibrā'* permissible.

the use of a particular type of contract for specific purposes – for example, of *Murābahah* or *Bay' Bithaman Ajil* for long-term financing in general, or home financing in particular. The restriction of the specific use of an instrument that is

- permissible from a *Sharī'ah* perspective,
- but critical from a consumer protection point of view,
- and substitutable in its functions by less conflict-prone instruments,

does not involve an explicit or implicit *Sharī'ah* argument. Instead, the rationale for the restriction is plainly technical – namely, the prevention of opacity, uncertainty, unfairness and unequal treatment of substantially equal cases (i.e. long-term financing by conventional and by *Sharī'ah*-compliant contracts). Restrictions on the use of a *Sharī'ah* contract may raise questions from a *Sharī'ah* perspective, but they do not affect a regulator who deliberately does not refer to *Sharī'ah* but only to the technical implications of a *Sharī'ah* contract for the justification of his decision.

4.4.3 General Suitability of Products for Retail Clients

The protection of retail clients – in particular, of vulnerable individuals and households with limited debt servicing capacity, unstable income and a high risk of unemployment – against rigid and unfavourable instruments could also be achieved by an approach with no direct interventions by the regulator. In principle, *Sharī'ah* contracts may not be restricted in their use for any purpose, including sale-based contracts for house financing. However, it is a high-level principle of financial consumer protection that all products comply with the *suitability criterion*: all banks (Islamic or conventional) have to assess the suitability of a specific product for a particular retail client, taking into consideration the features of the product and the economic situation of the customer, as well as the features of alternative products for the same purpose. A product that creates an unreasonable financial burden for customers when changes of the original financing arrangement become necessary was seemingly not the most suitable one.

The suitability criterion is relevant both for financing and for savings/investment products. The IFSB survey on CPIF asked RSAs whether they agree that: (1) IIFS should fully understand the consumer's capability, experience and transaction objectives (Know Your Customer Rule) before selling investment products; (2) IIFS should document the efforts to keep the Know Your Customer Rule; and (3) IIFS should consider the suitability of the suggested investment product for the consumer's need and should not offer products that are deemed not suitable for the consumer. While 84% agreed with statements (1) and (2), only 50% agreed with

the logical implication of (1) and (2) as spelled out in statement (3). Surprisingly, almost two-thirds of the responding RSAs did not agree that sales personnel of IIFS should meet certain qualification criteria reviewed by the regulator to ensure that they possess proper knowledge and experience of Islamic products. The majority of RSAs seemingly see the responsibility for a (minimum) qualification of personnel exclusively with the financial institution. This may not be the optimum from a consumer protection perspective.

However, the suitability criterion can be framed in such a way that it gives financial consumers *enforceable rights* – for example, the right for compensation of extra costs that could have been avoided by the sale of a more suitable product.¹¹⁴ A long-term house financing contract based on *Murābahah* or BBA with no *Ibrā'* clause offered to a vulnerable household will hardly pass the test of suitability. It should be in the bank's own interest to offer an alternative structure (*Ijārah* or diminishing *Mushārahah*) with more flexibility than a rigid sale contract.¹¹⁵

The advantage for regulators with a neutral stance on Islamic finance is that the suitability approach leaves the responsibility for *Sharī'ah* compliance and fair treatment to the Islamic financial institution. What is required is a:

- definition of “suitability” (and of the responsibilities of financial institutions), in such a way
- that it creates enforceable consumer rights, and
- the installation of an effective dispute settlement system (see below).

The downside of the approach is that it does not ensure a uniform treatment of retail clients by different banks. Furthermore, it may evoke a large number of cases that have to be decided by the dispute resolution bodies during a formative period.

4.4.4 Ban on Products and Restriction of Distribution Channels

The regulator may screen the risk/return profile of more complex *Sharī'ah*-compliant structures. As in conventional finance, he may ban (temporarily or permanently) particularly risky products and contractual arrangements (such as *Sharī'ah*-compliant futures or short selling techniques) from the retail business. A milder version (systematically between product and conduct regulation) would

¹¹⁴ Such a right would create a strong incentive for financial institutions to enhance the expertise of the sales personnel and to take the Know Your Customer Rule very seriously.

¹¹⁵ Furthermore, the bank always has the option to grant *ibrā'* if the situation requires a concession (even if *ibrā'* was not mentioned in the disputed contract) to avoid a judicial escalation of a customer's complaint.

be restrictions on marketing and distribution channels for high-risk products and structures in analogy to conventional finance.

4.4.5 Conduct Regulation

Major new conduct regulations in conventional finance were the implementation of stricter rules and regulations for financial advisers (including the liability for advice) and the radical change of the remuneration scheme for financial advisers in the UK. If such reforms are considered for Islamic finance, regulators with a neutral stance on *Shari'ah* could conceptually justify them by reference to the public good. The Islamic understanding of the public good (*Maṣlaḥah*) is not fundamentally different from the conventional one in this field.

4.4.6 Shari'ah-compliant Crowdfunding

The era of “spontaneous crowdfunding” through unregulated internet platforms seems to be over. Organised crowdfunding through crowdfunding platforms is becoming subject to regulation in more and more jurisdictions where such arrangements are considered securities. Hence, debt as well as equity crowdfunding is becoming subject to some form of capital market regulation.

A more recent phenomenon is the emergence of *Shari'ah*-compliant crowdfunding platforms. Many characteristics of equity crowdfunding correspond with ideals of Islamic finance, such as the direct funding of the real economy, the use of funds for specific projects chosen by the providers of funds, job creation and the promotion of entrepreneurial activities, and the sharing of entrepreneurial risks by the fund providers. The promoters of Shekra,¹¹⁶ a *Shari'ah*-compliant crowdfunding platform in Egypt, have identified a financing gap for entrepreneurial projects of start-ups and small enterprises which are too large for microfinance, too small for venture capital and too risky for banks. Combined with protective measures for investors and educational support for entrepreneurs to increase the success rate of start-ups, they see the major advantage of *Shari'ah*-compliant equity crowdfunding in the reconciliation of profitable investments with social development. Specific benefits are the opening up of a new asset class for small- and medium-sized investors, risk reductions for individual investors through capital injections into multiple projects, promotion of innovation and keeping talents local (counteracting the brain drain).

From a financial consumer protection perspective, macroeconomic benefits have

116 See Root 2013 and www.shekra.com.

to be balanced against risks for the individual retail investor. Furthermore, it has to be noted that regulation can induce costs for the regulated that can be so significant as to seriously threaten the survival of a whole segment of an emerging market.¹¹⁷ Therefore, regulation should be adapted to the size and character of this segment of the financial system. But regulators should also consider the implications of the claim of a crowdfunding platform to be “Islamic” or “*Shari’ah*-compliant”.

The *Securities Commission Malaysia* (SC) has released guidelines for the registration of equity crowdfunding (ECF) platforms in February 2015. “ECF is a new form of fundraising that allows start-up or other smaller enterprises to obtain capital through small equity investments from relatively large numbers of investors, using online portals to publicise and facilitate such offers to crowd investors.”¹¹⁸

The guidelines deal not only with requirements for the registration of a platform but also with selected operational details. They specify, for example, limits for funds raised per issuer¹¹⁹ and the amounts invested by different types of investors.¹²⁰ But there is only one sentence explicitly mentioning *Shari’ah* compliance: The ECF operator must submit to the SC a report “by the *Shari’ah* adviser certifying that its business and operations are managed in accordance with *Shari’ah* principles”.¹²¹ As the term “business and operation” can have different meanings, this does not clearly define what exactly is expected from a *Shari’ah*-compliant platform.

- “Business and operations in accordance with *Shari’ah* principles” could mean that the platform itself is financed and run in a *Shari’ah*-compliant manner, but that is only the bare minimum.
- Users of an ECF platform with a preference for *Shari’ah* compliance will probably expect more, namely (at least) that the platform itself and the contracts traded through the platform are *Shari’ah*-compliant.
- The most comprehensive interpretation would be that the platform itself, the contracts traded and the financed businesses are and remain *Shari’ah*-compliant.

Ensuring the *Shari’ah* compliance of contracts and financed businesses should

117 See the example for a conventional environment in sub-section 3.4.

118 SC 2015a.

119 RM3 million within a 12-month period per issuer (for all projects combined) and up to a total of RM5 million maximum; see SC 2015b, para. 11.17.

120 RM5000 per issuer with a total of RM50,000 maximum within a 12-month period for retail investors, RM500,000 within a 12-month period for angel investors, no limits for sophisticated investors; see *ibid*, para. 11.21.

121 *Ibid*, para. 7.01(b).

be a manageable task for equity crowdfunding platforms. Contracts that create equity positions (such as joint ownership by shares) are widely accepted as secular proxies for the Islamic nominate contracts *Muḍārabah* and *Mushārahah*. The legal structures of equity contracts are generally understood quite well, not only by legal experts but also by retail investors. On the basis of their ownership rights the crowd investors themselves, or the crowdfunding platform as their representative, can monitor the *Sharī'ah* compliance of the business – not only at the time when the issuer offers the investments but also on an ongoing basis as long as the ownership rights exist. If *Sharī'ah* compliance is an explicit claim and is considered an essential element of an issuer's business proposal, then the crowdfunding platform could be obliged to take the prime responsibility for monitoring the *Sharī'ah* compliance of the financed businesses. This can be the implication of a general stipulation like the following: "An ECF operator must (a) carry out a due diligence exercise on prospective issuers planning to use its platform; (b) monitor conduct of issuer and take action against misconduct of the issuer."¹²² The due diligence includes "reasonable steps to ... verify the business proposition of the issuer".¹²³ Such wording can also be used for a regulation in a jurisdiction where the legislator or regulator does not intend to establish an explicit or specific regulation for Islamic finance in any form.

The near future will bring more clarity about the interpretations and procedures in Malaysia. In June 2015, the SC approved six (out of 27) applications for ECF platforms to start operations by end-2015. One of these platforms – *Ata Plus* – aims at "matching *Sharī'ah*-compliant businesses with investors seeking substantial business opportunities. The firm focuses on local SMEs and social impact initiatives."¹²⁴ On the occasion of the announcement of the names of the first registered ECF platforms, the chairman of the SC emphasised the developmental dimension of crowdfunding: "The establishment of the ECF is a component of SC's strategy to democratise finance.... [F]or capital markets to be inclusive, small and medium enterprises (SMEs) and start-ups must also be able to obtain market-based financing. Hence, it is timely to further widen access through innovation in financial technologies such as ECF platforms."¹²⁵

The regulation of crowdfunding platforms is more complicated for *Sharī'ah*-compliant debt crowdfunding. Debt-creating Islamic modes of finance are based on sales contracts for real assets (such as *Murābahah*, *Salam* or *Istiṣnā'*) or

122 Ibid, para. 11.05.

123 Ibid, para. 11.06.

124 Hobey 2015.

125 SC 2015c.

for the usufruct of real assets (such as *Ijārah*), all with some form of a deferred payment. However, crowdfunding investors do not offer any real assets but money. This is similar to the situation of banks: they are not traders but financial institutions, and their main resource is money. Therefore, the original Islamic nominate contracts have been amended or combined in such a way that they are suitable for debt financing by Islamic banks – for example, as *Murābaḥah* to the purchase order, commodity *Murābaḥah*, *Tawarruq*, hybrid *Salam*, parallel *Istiṣnāʿ*, diminishing *Mushārakah* or *Ijārah Muntahia Bittamlik*. It is conceivable that similar arrangements can be structured for crowdfunding investors. Conventional debt crowdfunding may be based on particular types of subordinated debt (see the example of Germany, sub-section 3.4). A *Shariʿah*-compliant replication of the economic substance of contracts such as shareholder loans or subordinated loans may be a challenge for scholars and financial engineers. However, in recent years several Islamic banks have issued *Sukūk*, which are explicitly and intentionally structured as certificates of unsecured and subordinated debt.¹²⁶ This indicates that the design of such instruments for *Shariʿah*-compliant debt crowdfunding should, in principle, be possible with the operator platform as the facilitator of respective arrangements for the crowd investors.

The economic substance of these arrangements may be easy to understand, but the legal structure will most probably be very complex. The assessment of its *Shariʿah* compliance requires expert knowledge that exceeds by far the capabilities of retail investors. It could become the responsibility of the crowdfunding platform to verify the *Shariʿah* compliance of the contractual arrangements as well as the *Shariʿah* compliance of the financed businesses at the time when the issuers offer investments on the crowdfunding platform. If the platform operator himself is involved in the structuring of the contractual arrangements, a third party should certify the *Shariʿah* compliance as implied by general principles of good corporate governance. The monitoring of the ongoing business is less straightforward than in equity crowdfunding. In debt crowdfunding, neither the investors nor the platform operator have genuine information rights based on ownership. Hence, the regulations should include a stipulation that issuers that use a crowdfunding platform must agree on the continuous monitoring of their business with regard to those salient features of their business proposition and business plan that were crucial for the investment decision of the crowdfunding investors. It is reasonable to assume that the *Shariʿah* compliance of the financed venture is a crucial feature for investors who used a *Shariʿah*-compliant crowdfunding platform.

126 See IIFM 2014.

Hence, the issuers have to provide information that enables platform operators (or external bodies acting on their behalf) to assess the *Sharī'ah* compliance in regular intervals (e.g. quarterly).

In summary, the regulation of *Sharī'ah*-compliant crowdfunding does not require specific “*Sharī'ah* regulations” if:

- crowdfunding platform operators have to ensure the quality of the funding contracts applied on their platform;
- operators have to monitor whether funded enterprises adhere to the salient features of their business propositions and business plans; and
- *Sharī'ah* compliance is for investors who invested through a crowdfunding platform that claims *Sharī'ah* compliance as a salient feature.

Crowdfunding retail investors would benefit from clear laws or regulations regarding their rights in cases where salient features are ignored by the platform operator or the funded enterprise. But this, again, is a general issue and does not require a particular *Sharī'ah* regulation.

4.5 Fair Treatment in Disputes and Damage Containment for Islamic Consumers

There is no reason why initiatives in the conventional finance sector for improved after-sales communication, timely information on contractual changes, the prevention of unwanted direct sales practices, or the introduction of cooling-off periods should not be applied in the Islamic finance sector.¹²⁷ The IFSB has underlined the great importance that Islamic law attributes to the overarching principle of fairness in financial transactions (in particular, if participatory elements as in UPSIA are involved).

4.5.1 Islamic Specificities in Dispute Resolution

Like conventional banks, Islamic banks should implement a complaint-handling system. In cases where complaints are related to the *Sharī'ah* compliance of products or processes, the system should interact with the *Sharī'ah* governance bodies of the financial firm up to its *Sharī'ah* board.

In parallel to the strengthening of consumer rights, many jurisdictions have

¹²⁷ There could be some reluctance because details of classic Islamic commercial law and nominate contracts are at odds with some of these regulatory proposals. For example, cooling-off periods are not provided for in classic *Sharī'ah* nominate sale contracts. However, *Sharī'ah* scholars have devised methods to adapt classic contracts to the needs of modern finance in secular legal systems for significantly more complicated cases (e.g. by combinations of contracts with promises). Therefore, it is reasonable to expect that appropriate *Sharī'ah*-compliant structures can be found.

upgraded their systems for the settlement of legal disputes: from specialised courts for consumer-related cases to a variety of alternative dispute resolution (ADR) systems (such as ombudsman models). Similar structures could also be applied for Islamic finance, and this topic (as well as the broader issue of the enforceability of Islamic finance contracts in secular jurisdictions) is well covered in the literature.¹²⁸ Sixty per cent of the respondent RSAs in the IFSB survey on CPIF confirmed that they have ADR mechanisms to resolve financial disputes.

Matters of dispute include the financial suitability of specific products for particular retail clients. This has some peculiarities in Islamic finance. The example of sale-based contracts for long-term house financing illustrates that there can be additional suitability dimensions in Islamic finance compared to conventional finance. Although disputes about suitability are not disputes about *Shari'ah* compliance (but about “unfair” financial burdens due to “inappropriate” products), it would enhance the quality of consumer protection efforts if the members of dispute resolution institutions (judges, arbitrators, ombudsmen, etc.) have a good understanding of *Shari'ah* concepts and contracts as well as Islamic finance products.

- If a customer’s complaint over an Islamic finance arrangement has not been settled internally by the complaint-handling mechanism of the Islamic bank because the bank insists on a particular *Shari'ah* interpretation, then the external institution for dispute resolution should be able to understand whether the *Shari'ah* stance of the bank is serious or just a pretext.
- The judge, arbitrator or ombudsman should know (either by himself or with the help of advisers) about the peculiarities of Islamic contracts and possible alternatives that the bank should have considered before offering the disputed product.
- When it comes to a proposal for the solution of a dispute or, in the last instance, a sentence in favour of the customer, this should be sensible with respect to the *Shari'ah* stance of the financial institution.

4.5.2 Damage Containment in (Near) Failure Cases

In conventional finance, savings deposits are financial claims against the bank. In a bankruptcy case, savers would have the status of unsecured creditors, and they could suffer losses if the total claims of all creditors exceed the value of the total assets of the bank. To prevent such an outcome, the capital of the savers can be protected by a deposit insurance scheme.

In Islamic finance, the legal status of the savers in respect to their funds can be

128 See, for example, Abikan 2011, Yaacob 2012, White 2012.

rather different. If the underlying structure is a *Muḍārabah* or *Wakālah* contract, then the savers are not creditors of the bank but owners of their funds, and the bank is only the investment manager. The IAH have to bear all investment losses (except for misconduct and negligence). If the bank fails, a deposit insurance scheme can step in and pay out the net value of the accounts to the IAH. Such a support for IAH should not raise serious *Shari'ah* concerns. This could be different if the deposit protection scheme shall also protect the IAH's capital against investment losses. A *Shari'ah*-compliant loss protection – at least for cases of bank failures – may be structured on the basis of a third-party guarantee,¹²⁹ and it could be justified by reference to public good considerations (*Maṣlahah*) as it protects systemic stability by preventing an imminent bank run.¹³⁰ If a regulator requires a loss protection scheme, this may face criticism in particular from those Islamic economists who considered profit and loss sharing the most distinctive feature of Islamic finance, in contrast to debt- and interest-based conventional finance.

129 According to AAOIFI *Shari'ah* Standard No. 5 (Guarantees), a third party can compensate an investment loss: "It is permissible for a third party, other than the *Muḍārib* or investment agent or one of the partners, to undertake voluntarily that he will compensate the investment losses of the party to whom the undertaking is given, provided this guarantee is not linked in any manner to the *Muḍārabah* financing contract or investment agency contract" (AAOIFI SS-5, para. 7/6).

130 An even more "generous" justification has been given by the Bank Negara Malaysia's *Shari'ah* Advisory Council (SAC): "A guarantee of capital and/or expected profit by a third party in a *Muḍārabah* transaction is based on *Maslahah* which is to ensure continuous investors' confidence in investing into the country's significant projects" (BNM 2010, p. 39 [resolution 28]).

CONCLUDING REMARKS

Most of the approaches and instruments of financial consumer protection in conventional finance can be applied in Islamic finance either directly or with only minor modifications. These minor modifications have not been spelled out here. Major savings and investment products of Islamic banks have participatory features that are very similar to (if not identical with) capital market products – namely, collective investment schemes. Investment-linked savings plans of family *Takāful* operators also share many characteristics with CIS. A compartmentalised regulatory environment with separated and poorly coordinated regulators for banks, capital markets and insurance/*Takāful* (and in the worst case, each with a different consumer protection philosophy) will provide opportunities for regulatory arbitrage and undermine the effectiveness of financial consumer protection policies. The close cross-sectoral linkages of IIFS call for a cross-sectoral regulation, which is not the standard in all jurisdictions.

Financial consumer protection is briefly mentioned in the recently adopted IFSB-17 on *Core Principles for Islamic Finance Regulation (Banking Segment)*, but it is not covered by a principle of its own. Conventional finance has seen in recent years a growing public demand for more transparent and “responsible” products, as well as for a better protection of financial consumers. Many jurisdictions have responded by the strengthening of consumer rights, better dispute resolution schemes, and an overhaul of regulatory systems with an upgrading of consumer protection. In Islamic finance the diversity of retail products is growing: ranging from retail *Sukūk* over pooled “truly” risk-sharing investment accounts and funds for impact investment to crowdfunding platforms. Most of the innovative retail products imply increased complexity, new risks, and a wider scope of potential disputes – all with a particular *Sharī‘ah* dimension. Regulators of jurisdictions where Islamic finance is practised have to react to the dynamics of the markets. The expected discussions on standards for Islamic consumer protection (including adequate dispute resolution schemes) may lead to the formulation of a further core principle for Islamic finance regulation.

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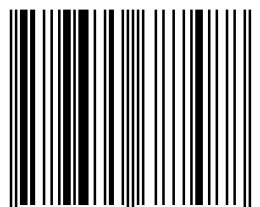
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