13th Islamic Financial Stability Forum

Consumer Protection in Islamic Finance

Cairo, Egypt

In conjunction with the 28th Meeting of the Council of the IFSB

Organised By: IFSB
Hosted By: Central Bank of Egypt
13th IFSF : Speaker & Discussants

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Consumer Protection in Islamic Finance

Prof. Dr. Volker Nienhaus

Presented at the 13th Islamic Financial Stability Forum on Consumer Protection in Islamic Finance

Cairo, 12 April 2016
Aims of Financial Consumer Protection

- Protection of consumers against:
  - (systemic) financial risks
  - Unsuitable products, unfair treatment
  - Sharīʿah non-compliance

Type of risk:
- Prudential and product regulation, safety nets
- Conduct regulation, complaint/dispute handling
- Sharīʿah governance framework

Type of intervention:
- Overlap with conventional finance
- Unique to IFSI
Aims of Financial Consumer Protection

- Protection of consumers against 
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- Type of risk
  - Prudential and product regulation, safety nets
  - Extended mandate

- Type of intervention
  - Challenge for "secular" or "neutral" regulators
Policies and Theories of Financial Consumer Protection

Protection of consumers against:

- *(systemic)* financial risks
- Unsuitable products, unfair treatment
- Sharīʿah non-compliance

### Type of Risk

- Basel III, LoLR, deposit insurance, transparency
- BCBS, IOSCO, IAIS, World Bank, G-20 (OECD)
- AAOIFI, IFSB, Sharīʿah boards of regulators

### Policy

- Neoclassical economics/finance
- Behavioural economics/finance
- *fiqh al-muʿāmalāt*, Islamic economics
Protection of consumers against systemic financial risks

**Type of risk**
- Neoclassical economics/finance
- Behavioural economics/finance

**Main themes**
- Well-informed rational choice (self-correcting efficient markets)
- Improper markets, limited capabilities and skills, cognitive biases

**Findings**
- Customers = consumers + retail investors ("Islamic behaviour"?)
- Information asymmetries
- Incentives for mis-selling
- Limited information-processing capacities
- Psychology vs. knowledge
- Cognitive biases (emotions, overconfidence, etc.)
- Herd behaviour

**Policy objectives**
- Improved financial capabilities
- Consumer information and advice
- Consumer education (long-term) → "Empowerment"
Strategies and Interventions for Financial Consumer Protection

**Strategies**

- **Decision Support & Advice for Consumers**
  - Disclosure in plain English
  - Comparability of products (league tables)
  - Awareness & Education Programmes
  - Financial Consumer Advice Bodies

- **Regulation and Supervision of Financial Products and Service Providers**
  - Recommended standards
  - Simple financial products
  - Compulsory standards
  - Ban on products (temporary, partial)

- **Conduct Regulation**
  - Rules for financial advice
  - Restrictions to marketing/distribution
  - Liability for advice
  - Consumer-centred incentive structures

- **Legal Matters, Disputes and Failure Cases**
  - Communication
  - Flexibility
  - Financial services review platform
  - Complaints handling and dispute resolution (ombudsman)
  - Access to courts

- **Fair Treatment**
  - Receivership
  - Deposit insurance
  - Transfer of long-term contracts
  - Bail-outs

- **Damage Containment**
  - Bankruptcy
  - Deposit insurance
  - Transfer of long-term contracts
  - Bail-outs

**Main Actors:**
- Systemic Stability
  - Central Bank
  - Treasury
  - Regulator
  - Agencies/Bodies
  - Courts/Lawyers

**Relevant Financial Instruments:**
- Disclosure in plain English
- Comparability of products (league tables)
- Awareness & Education Programmes
- Financial Consumer Advice Bodies
Objectives of Financial Consumer Protection

- Protection of consumers against
  - Unsuitable products, unfair treatment
  - Sharīʿah non-compliance
    - Sharīʿah governance framework
      - IFSB-10: commensurate system, Sharīʿah board, fit & proper, ISCU, ISRU, understand legal/regulatory Sharīʿah framework
  - Conduct regulation, complaint/dispute handling
  - Unique to IFSI

Conventional regulations: relevant, but not always easy to adapt:
- Generic advice for suitability of products
- Comparison of products: Islamic/Islamic and Islamic/conventional
- Complexity of products
- Form (trade) and substance (financing)

Specific issues:
- Deposit business
- Financing business
Unrestricted Profit Sharing Investment Accounts (UPSIA)

- Protection of investment account holders (IAH) against:
  - Systemic financial risks
  - Unsuitable products, unfair treatment
  - Sharīʿah non-compliance

- Type of risk:
  - Regulatory capital (IFSB α), arbitrage?
  - Deposit guarantee?
  - Incentives for more risk taking by bank?

- Disclosure (regulation?):
  - Profit calculation
  - Profit smoothing
  - Investment policy
  - Investment risk

- Sharīʿah governance = voice of IAH?

- Unique to IFSI

- Differences UPSIA / CIS?
consumer protection (CP) in financing transactions against

(type of risk)

(systemic) financial risks

unsuitable products, unfair treatment

Sharīʿah non-compliance

(instruments)

• limited flexibility of trade-based financing contracts
• suitability of Sharīʿah contracts for retail customers?

• specific product bans from voluntary to mandatory flexibility: Ibrāʾ clause

• CP in "grey" capital markets: Islamic crowdfunding
• dispute resolution
• damage containment.
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