



# THE CHANGING LANDSCAPE OF ISLAMIC FINANCE

**Imminent Challenges and Future Directions**



ISLAMIC FINANCIAL  
SERVICES BOARD

# **The Changing Landscape of Islamic Finance: Imminent Challenges and Future Directions**

Islamic Financial Services Board  
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### **ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)**

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.

For more information about the IFSB, please visit **[www.ifsb.org](http://www.ifsb.org)**.



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## Preface

In the name of Allah, the Most Gracious, the Most Merciful.

As the international standard-setting body for the Islamic financial services industry, the primary objective of the Islamic Financial Services Board (IFSB) is to promote and enhance the soundness and stability of the industry. As part of its efforts to achieve this objective, the IFSB issues standards and guiding principles which focus on the prudential aspects of the industry. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organising roundtables, seminars, and conferences for regulators and industry stakeholders as part of its awareness programme.

In response to the recent global financial and economic crisis, the IFSB has taken the initiative in conducting original research to assess the impact of the crisis on the Islamic financial services industry. The results of this research will provide important insights into how the crisis has changed the marketplace and operating environment, and how the Islamic financial services industry must adapt in order to cope with these changes, including adjusting its operations and formulating new strategies based on a new financial architecture. The industry also needs to learn how to deal with the factors that led to the occurrence of the crisis, such as weaknesses in the existing regulation, supervision and infrastructure of financial markets.

It is hoped that this book will enlighten industry stakeholders, provide them with future direction, and assist them in facing the new challenges that have resulted from the recent crisis. The book comprises chapters written by several reputable scholars and international firms commissioned by the IFSB to share their thoughts and experiences on related issues. Several topics are discussed by the contributors: (i) Islamic finance and the financial crisis: the implications for Islamic banking; (ii) Islamic finance and the financial crisis: the implications for *Takāful*; (iii) emerging financial architecture: implications for Islamic finance; (iv) capital requirements, counter-cyclicity and Islamic finance; (v) Islamic financial law: back to basics; and (vi) the meaning of ratings for Islamic financial institutions and *Sharī'ah*-compliant instruments. We believe this book is among the first initiatives to cover these important issues and hope that it will be of great benefit to the industry.

Chapter One, by Professor Volker Nienhaus, explores the sources of the financial crisis and compares its impact on the conventional financial services industry and the Islamic financial services industry. Professor Nienhaus also proposes several reasons why the Islamic financial services industry is relatively resilient compared to its conventional counterparts. Nevertheless, he is critical of some practices of Islamic financial engineering and *Sharī'ah* juristic techniques, which have produced products with similar characteristics to conventional speculative products such as derivative instruments, because these products will



ultimately remove most of the differences *in substance* between the Islamic financial services industry and the conventional industry. Professor Nienhaus concludes his chapter by revisiting three issues that may enhance the resilience of the Islamic financial services industry. These issues are: (i) fundamental system reforms, (ii) moral suasion and regulation, and (iii) liquidity tools and governance structures.

Chapter Two, by Professors Simon Archer, Rifaat Ahmed Abdel Karim and Volker Nienhaus, examines *Takāful* (Islamic insurance) in the light of the challenges facing the industry and its regulators. Many of these challenges result from the hybrid structure of *Takāful* undertakings and the contractual relations between the *Takāful* operator, a company which manages the undertaking, and its policyholders who own the risk and investment funds and bear the underwriting risk on a mutual basis. These relations give rise to problems of corporate governance, while the structure more generally poses problems of how solvency is to be managed.

In Chapter Three, Professor Douglas Arner begins with a discussion of the development of the international financial architecture prior to the global financial and economic crisis of 2007–2009. This is followed by a description of the evolution of the emerging Islamic financial architecture. From this basis, the chapter discusses the global financial crisis, the international responses, and the implications for the international financial architecture. The chapter concludes with an analysis of the possible implications of the global financial crisis for the future of Islamic finance and the international Islamic financial architecture, focusing on the twin objectives of financial development and financial stability. The author suggests that international Islamic financial standard-setting organisations need to pay especial attention to financial stability arrangements, albeit not to the detriment of financial sector development. Attention should be focused on three main aspects: (i) crisis prevention, especially regulatory and supervisory design and coverage; (ii) financial regulation and financial infrastructure; and (iii) mechanisms to support crisis resolution, especially liquidity and resolution mechanisms.

Chapter Four, by Professor Simon Archer, highlights the problem of pro-cyclicality in the financial services industry, paying special attention to Islamic finance. Pro-cyclicality is experienced not only by the banking industry, but also by insurance undertakings. However, the problem of pro-cyclicality in the banking sector has more serious macroeconomic implications. This chapter starts with a discussion on the problem of pro-cyclicality, the factors that contribute to it, and the various proposals for mitigating the problem (anti-cyclical methods). It then examines the problem, and the various proposed mitigation techniques, in relation to Islamic banks and *Takāful* undertakings. Overall, the analysis presented in this chapter suggests that from both macro-prudential and micro-prudential perspectives, pro-cyclicality may be less of a problem in Islamic finance than in conventional finance.

In Chapter Five, Professor Barry Rider discusses the legal issues and challenges facing Islamic financial products, with a particular focus on legal and

regulation risk. The fact that the regulatory framework for the financial industry is constantly undergoing improvements does not result in protecting the industry from financial crises. Thus, the legal and regulatory infrastructure must ensure good governance in fiduciary activity, promoting integrity and good stewardship as an integral part of the industry practices. In the case of Islamic banking, there are issues associated with the relative lack of transparency, and with the very nature of essentially commodity-based transactions. There are also issues of off book activity and, in particular, the use of secret reserves for, among other things, smoothing investment returns. These issues should be resolved not only from a *Sharī'ah* compliance perspective, but also from the conventional law perspective. The conventional law needs to be strengthened with both special and secular laws not only to ensure compliance with the *Sharī'ah*, but also to facilitate effective and stable markets and institutions.

Chapter Six, by Anouar Hassoune, Khalid Howladar and Simon Harris discusses the meaning of rating for Islamic financial institutions and *Sharī'ah*-compliant instruments. Rating methodologies for these institutions and *Sharī'ah*-compliant instruments have, to some extent, many similarities with those for their conventional counterparts; however, there are some special considerations arising from the process of rating for Islamic financial institutions and *Sharī'ah*-compliant instruments due to their unique characteristics. For example, for Islamic banks, the authors explore issues relating to profit-sharing investment accounts, which, despite being equity-like instruments, are treated as debt-like instruments in the rating process. For *Sukūk*, issues arising from asset-backed or asset-based *Sukūk* are discussed in detail, together with the rationale, considerations and challenges for this instrument. For *Takāful*, the authors point out that *Takāful*, while having much in common with conventional mutual insurance, differs crucially in terms of capital structure. The rating process focuses on a number of factors comprising the business and financial profiles of a *Takāful* undertaking.

We are grateful to Professor Simon Archer and Dr V. Sundararajan for reviewing the chapters in the book. Thanks are also due to Madzlan Mohammed Husain, Senior Project Manager, Siham Ismail, Manager and Ronald Rulindo, Senior Executive, of the IFSB, for their efficient management of the production of the book.

Professor Rifaat Ahmed Abdel Karim  
Secretary-General, IFSB

## About the Contributors

**Professor Simon Archer** MA PhD FCA FRSA is Visiting Professor at the ICMA Centre in the Henley Business School, University of Reading, UK. Previously, he was Professor of Financial Management at the University of Surrey, UK, having been Midland Bank Professor of Financial Sector Accounting at the University of Wales, Bangor. He has been a visiting professor at various universities and business schools, including Bordeaux, Paris-Dauphine, Metz, ESCP-EAP and HEC in France, Frankfurt and WHU Koblenz in Germany, Copenhagen Business School in Denmark and IIUM in Malaysia. After studies in Philosophy, Politics and Economics at Oxford University, he qualified as a Chartered Accountant with Arthur Andersen in London and then moved to Price Waterhouse in Paris, where he became Partner in charge of Management Consultancy Services in France and Scandinavia. His academic career thus began after substantial experience as a practitioner, mainly in management consulting.

Professor Archer's main research interests are in the fields of international accounting, accounting theory and financial sector accounting, including the financial reporting, capital adequacy, risk management and corporate governance of financial institutions. His recent work has been particularly concerned with Islamic financial institutions. He is co-author of the *International Accounting and Financial Reporting Standards Guide* (published by CCH) and co-editor of the *Miller European Accounting Guide* (published by Aspen), in addition to being co-editor (and chapter author) of *Islamic Finance: Innovation and Growth* (published by Euromoney Books) and of *Islamic Finance: The Regulatory Challenge* and *Takāful (Islamic Insurance): Concepts and Regulatory Issues* (published by John Wiley). He is also the author of a considerable number of academic papers on accounting theory, international accounting, and accounting, finance and governance issues in financial institutions, including those in Islamic finance. He supervises PhD research students in these areas, and has been an invited speaker at numerous conferences and seminars.

Professor Archer's consultancy work has included the following: Consultant to AAOIFI Capital Adequacy Committee; Consultant to AAOIFI on English-language versions of Standards on Financial Accounting, Auditing, Governance and *Sharī'ah*; and Consultant to AAOIFI on the relationship between AAOIFI's Financial Accounting Standards and IASB's IAS. He was also consultant to A'Ayan Leasing and Investment Co., Kuwait on the capital adequacy implications of conversion into an Islamic bank. For the IFSB, Professor Archer has acted as consultant on the following projects: capital adequacy, corporate governance, supervisory review process, transparency and market discipline, governance of *Takāful*, *Sharī'ah* governance, governance of collective investment schemes, conduct of business of Islamic financial institutions, and solvency of *Takāful*.

**Professor Douglas Arner** is Director of the Asian Institute of International Financial Law and a Professor at the Faculty of Law of the University of Hong Kong (HKU). In addition, at HKU, he is Deputy Head (Research & Postgraduate Studies) of the Department of Law, Director of the LLM (Corporate and Financial Law) Programme, and a member of the Board of Management of the East Asian Economic Law and Policy Programme. He is Co-Director of the Duke University–HKU Asia-America Institute in Transnational Law and a Visiting Research Fellow of the University of New South Wales, Australia. In 2007, he received HKU's Outstanding Young Researcher Award, and in 2008, he was named Convenor of HKU's Law, Policy and Development Strategic Research Theme.

Prior to his appointment at HKU, Professor Arner was the Sir John Lubbock Support Fund Fellow at the Centre for Commercial Law Studies (CCLS) at Queen Mary College, University of London, and a consultant with the European Bank for Reconstruction and Development (EBRD).

Professor Arner specialises in economic and financial law, regulation and development. He is author, co-author or editor of nine books, including *Financial Stability, Economic Growth and the Role of Law* (Cambridge University Press) and *Financial Markets in Hong Kong: Law and Practice* (Oxford University Press), and is author or co-author of more than 70 articles, chapters and reports on related subjects.

Professor Arner has served as a consultant with, among others, the World Bank, Asian Development Bank, APEC, EBRD and Development Bank of Southern Africa. He has lectured, co-organised conferences and seminars, and been involved with financial sector reform projects in over 20 economies in Africa, Asia and Europe, and has been a visiting professor or fellow at the Universities of London, Melbourne, New South Wales, Singapore and Zurich, as well as the Shanghai University of Finance and Economics and the Hong Kong Institute for Monetary Research.

Professor Arner holds a BA from Drury College (where he studied literature, economics and political science), a JD (*cum laude*) from Southern Methodist University, an LLM (banking and finance, with distinction) from the University of London (Queen Mary College), and a PhD from the University of London.

**Mr Simon Harris** is a Team Managing Director within Moody's Financial Institutions Group, based in London. He is responsible for analytic teams maintaining Moody's ratings on European insurers and, since summer 2009, Nordic banks.

Mr Harris joined Moody's European Insurance team in 1998, working on analysis of UK and German life and non-life insurance groups. In his position as Team Managing Director he is now responsible for the management and development of Moody's EMEA insurance and Nordic banking franchises.

Prior to joining Moody's, Mr Harris was an actuary with Co-operative Financial Services in Manchester, England. He holds a BA in Economics from Leeds University, and is a Fellow of the UK Institute of Actuaries (FIA).

**Mr Anouar Hassoune** is a Vice President and Senior Credit Officer based in the Paris office of Moody's Investors Service. Before this position, Mr Hassoune was a credit analyst at Standard & Poor's. Mr Hassoune is responsible for the rating coverage of banks in the Middle East and North Africa, and also handles the global coordination of Moody's endeavour in the field of Islamic finance.

Mr Hassoune's academic background includes a master's degree in Business Administration from Paris-based HEC Business School, a master's degree in Political Science from the Paris Institute for Political Studies, a post-graduate degree in Economics from the University of Paris, as well as the "Agrégation" certification in Business and Finance earned at the French "Ecole Normale Supérieure".

**Mr Khalid Howladar** is the Senior Credit Officer in the Structured Finance Group covering Middle Eastern asset backed and *Sukūk* finance and also helps drive Moody's Islamic finance initiatives globally. In this capacity he has worked on every publicly rated securitisation in the region and is a leading figure in the industry, focusing thus far on auto, mortgage/*Ijārah* residential and commercial real estate assets.

Mr Howladar is currently based in the Dubai International Financial Centre. He joined Moody's in London in 2001 and was initially an analyst responsible for rating cash, synthetic, structured and project finance collateralised debt obligations. Subsequently, he became a senior member of the Business Development team with responsibility for new markets, structured products and clients in the MENA region.

In addition to providing various educational workshops for local market participants, Mr Howladar has enjoyed lecturing at universities in Dubai and Beirut and is a popular speaker at regional conferences. In addition to Moody's own research, he has also authored many articles for numerous finance journals and books across the globe on the subjects of credit risk, securitisation, *Sukūk*, Islamic finance and ratings.

Previously Mr Howladar spent four years at Credit Suisse where he worked in the emerging market fixed income group as an analyst in the Risk Management team. He holds an MSc in Finance from the London Business School, an MSc in Information Technology and a BEng in Software Engineering, both from the Imperial College of Science, Technology and Medicine, London.

**Professor Volker Nienhaus** was President of the University of Marburg from 2004 to 2010. He was previously Professor of Economics at the German universities of Trier (1989–1990) and Bochum (1990–2004), and has been Honorary Professor at the University of Bochum since 2004.

Currently, he is a member of the Academic Advisory Board of the Federal Agency for Civic Education in Bonn (since 2002), of the Governing Council of the International Centre for Education in Islamic Finance (INCEIF) in Kuala Lumpur (since 2006), and a consultant to the IFSB. Professor Nienhaus previously also served as a member of the academic advisory committees of the German Orient-Foundation (1993–2006) and the Federal Ministry of Economic Co-operation and Development (1998–2008). His main research interests are in the fields of service sector economics, economic systems, international economics, and Islamic economics and finance. He has published numerous books and articles on Islamic economics and Islamic banking and finance since the 1980s.

**Professor Barry Rider** has taught law at the University of Cambridge since 1976. He is a Professorial Fellow in the Development Studies Programme of the University of Cambridge and has been a Fellow of Jesus College, Cambridge since 1976. He has held a number of offices in Cambridge, including that of Dean of Jesus College and Graduate Tutor. From 1995 to 2004 he was Director of the Institute of Advanced Legal Studies (IALS), University of London. He continues to supervise research at the IALS as a Professor of Law and Honorary Senior Research Fellow. He also holds a number of other honorary and visiting appointments at universities around the world. These include the University of the Free State, South Africa; University of Florida, United States; Remin University, China; Beijing Normal University, China; and the National Prosecutors University, China. Over the years, he has held a number of visiting and other chairs, including a Distinguished Visiting Professorship at the University of Hong Kong. Professor Rider is President of the British Institute of Securities Laws and Executive Director of the Centre for International Documentation on Organised and Economic Crime, Cambridge.

For a number of years, Professor Rider was an international civil servant responsible for a mutual assistance and intelligence unit in an inter-governmental organisation. He has also worked with many international organisations, including the European Union, Commonwealth Secretariat, IMF, World Bank, UN and the Islamic Financial Services Board (IFSB), as well as numerous governmental agencies in many different jurisdictions. Until 2008 he was International General Counsel to the International Compliance Association and is now Counsel to the international law firm Bryan Cave LLP.

Professor Rider has doctorates from the University of Cambridge, University of London, University of the Free State South Africa, and Penn State University in the United States. He holds a master's degree from the University of Cambridge and a bachelor degree from the University of London. He is also a member of the English Bar. Professor Rider has published and edited books and articles on financial law, corporate law and financial crime, and is General Editor of a number of publications, including *The Company Lawyer*, the *Journal of Financial Crime* and the *Journal of Money Laundering Control*.



## **CHAPTER ONE**

### **ISLAMIC FINANCE AND FINANCIAL CRISIS: IMPLICATIONS FOR ISLAMIC BANKING**

**Professor Volker Nienhaus**

#### **I. Introduction**

The present financial crisis started from the sub-prime market and then spread through the whole financial system. There are detailed explanations of the specific causes of this crisis and the subsequent contagion of the global system. However, one cannot ignore that the sub-prime crisis is only the last in a series of crises and bubbles related to the financial sector. This supports the view that the financial sector has lost its grounding in the real economy, and that financial crises are inevitable in the conventional system, which makes it inherently unstable and inefficient. Claims that a financial system based on Islamic principles would be more stable, efficient and just, and that it would have prevented – or at least mitigated – the global financial crisis, have gained much popular attention. This claim and its implications for Islamic banking shall be discussed in this chapter.

- Part II deals with the problems of an increasing detachment of the financial sector from the real economy. The accelerated growth of the financial sector with continuously weakened links to the real economy, the increasing complexity and opaqueness of financial techniques and products, and monetary mismanagement led to the collapse of the financial system.
- Part III takes up the explanations for the crisis and the conceptual claims of Islamic finance and contrasts these with recent practices of Islamic banks. Discrepancies between the concept and the reality become apparent. It seems that not all these discrepancies are temporary anomalies; some point to internal dynamics which could drive the Islamic sector further away from its ideal and closer to the conventional sector, with all its stability problems.
- Part IV highlights the perspectives of Islamic finance. It deals in particular with fundamental and incremental reform proposals that have the potential to narrow the gap between concept and reality in Islamic finance, and to improve the efficiency and stability of the global financial system.

#### **II. Finance, Crisis and the Real Economy**

Entrepreneurs typically need more resources than they own in order to realise profitable investment projects that create additional wealth. From a resource perspective, entrepreneurs are deficit units, while savers are surplus units: they typically do not consume their total current income – that is, all the resources at their



disposal. The resources of the surplus units should be channelled to the deficit units for productive investments. The resources are not transferred in kind and directly, but through the intermediation of the financial system – that is, the capital market and the banking system. In this process, financial institutions fulfil important functions: they bundle small savings into larger amounts; they collect and process information; they mitigate mismatches of risk preferences of savers and risk profiles of investments; they balance liquidity preferences and gestation periods, etc. All these are socially beneficial activities.

However, the social benefits of their activities are hardly the prime concern of financial institutions that are profit-oriented enterprises. Banks have two options to earn profits, namely:

- to use savings to facilitate the creation of *new* assets; and
- to use savings for transactions with *existing* assets – for example, for the purchase of assets whose prices are expected to rise.

With opaqueness and limited competition in the banking industry on the one hand, and limited direct access of entrepreneurs to savers on the other hand, banks were traditionally in a strong position to determine the terms and conditions for their financing of productive investments.

Bankers seem to be rather risk averse when the financial results of an investment depend on the correctness of the expectations of others. Therefore, the bulk of corporate financing is based on debt contracts with predetermined rates of return (= interest). Equity-type participatory financing is a rare exception and is mostly done by specialised financial institutions (e.g. venture capital companies). Interest-based debt financing shifts most risks to the borrower and shields the lender broadly from fluctuations in the real economy. But even under such unfavourable conditions for the borrower, bank lending to entrepreneurs facilitates the creation of *new* assets. It is open for debate whether the overall wealth effects could be larger under risk-sharing and participatory financing arrangements, because such arrangements arguably curtail entrepreneurial potentials less than debt modes of financing.

What is more important with respect to welfare effects is that banks – at least in systems where regulation did not stand against it – became increasingly engaged in transactions dealing with *existing* assets (or notional assets, or no assets at all). Profits can be earned if price trends in asset markets are anticipated correctly. Profits can be huge in highly leveraged and risky transactions. Bankers are willing to take much more risk when the financial results of the deal depend on their own expectations (which sometimes are speculations). Financial institutions can borrow from other financial institutions at predetermined rates to purchase assets whose prices are expected to rise. Complex instruments have been designed to mobilise more resources in such processes through securitisation and to transfer risks through derivatives. As a consequence of such processes, the fractional reserve

banking system has created excess liquidity that was readily available to fuel asset price bubbles. Savings channelled into such activities do not generate new wealth but facilitate the redistribution of existing wealth. From the perspective of the society as a whole, savings are “lost” and the financial intermediation does not enhance social welfare. This does not mean, however, that such activities could not be very profitable and accumulate wealth for individual players, but only at the expense of others (in a “zero-sum game”).

When financial markets become detached from the real economy and develop their own momentum, the interest rate is obviously no longer an indication for the scarcity of capital – that is, a price which balances real savings and investments – but it has apparently become the price for liquidity (mostly created within the financial sector itself and without a backing by savings). It is decoupled from the average productivity growth in the real economy and the marginal productivity of capital; instead, it is strongly influenced by speculative price expectations in bubble-prone asset markets. Benchmarking investments in the real economy against interest rates determined in detached financial markets with logic and momentum of their own can create distortions and disruptions in the real economy, with losses of social welfare.

Processes in the financial sector can be influenced by central bank policies. For example, reserve requirements and capital adequacy regulations, as well as open market operations, could limit the potential for credit expansion and money creation. However, lax regulations and an easy money policy can have just the opposite effect: they support the build-up of (inverted) credit pyramids and thus contribute (maybe unintentionally) to the instability of the financial system. A strong belief in the efficiency of un- or self-regulated financial markets, in combination with a policy of low interest rates in the aftermath of the “dotcom” crisis and the 9/11 shock, had such destabilising effects. The policy of the US Federal Reserve prepared the ground for the sub-prime crisis, which was triggered by a well-intended but ill-implemented policy of the US government in support of low-income households.<sup>1</sup>

The present global financial crisis started as a crisis of the financial sector in the United States. Other countries – in particular, OECD (Organisation for Economic Co-operation and Development) countries – were affected subsequently due to contagion effects. However, the financial sectors did by no means collapse all over the world. In a considerable number of countries with less international exposure, stricter regulations and a tighter monetary policy, the financial systems (dominated by conventional financial institutions) showed a remarkable resilience. This group includes more advanced Muslim countries such as Malaysia and Turkey.

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<sup>1</sup> For detailed accounts of the current crisis and an analysis of causes, see Financial Stability Forum, 2008; G-20, 2008; International Monetary Fund, 2008a, 2008b; Financial Services Authority, 2009; see also Woods, 2009. From an Islamic perspective, see for example Siddiqi, 2008a; Chapra, 2009; Mirakhor and Krichene, 2009; Askari, Iqbal and Mirakhor, 2010, pp. 94–111.

Against this background, the present crisis is not an empirical proof that the interest- and debt-based conventional system is doomed to fail completely and that a systemic collapse is unavoidable. The conventional system comprises both the market players and the market regulators. The present crisis is the result of a combined market and a policy “failure”. But it is possible that a market failure is corrected, or at least contained, by a prudent regulatory and monetary policy. However, the crisis has shown what a prudent policy has to deal with and what it has to take into consideration. Some of the lessons from the crisis are as follows:

- Financial markets are opaque, and complex structured products had increased the opaqueness of the financial sector. Even specialised institutions such as rating agencies have not been able to fully understand and communicate the risks associated with these products. The financial market by itself does not create the transparency that is necessary for its efficient functioning.
- A policy of easy money fuels the process of creating inverted debt pyramids by banks and enhances the fragility of the financial system based on fractional reserve banking. This policy does not add to the real wealth of the society and does not have a sustainable effect on the growth of the real economy.
- Bank managers were driven by individual profit motives, and they were willing to take high risks for high short-term profits. Prevailing compensation schemes rewarded short-term gains and encouraged excessive risk-taking. The governance structures of most financial institutions did not prevent bank managers, as agents, exposing the capital of their principals to risks far beyond their risk appetite. Examples of moral hazard are abundant.
- The risk models of large banks turned out to be insufficient. They did not adequately cover clustered risks and interdependencies.
- The level of leverage went far beyond what could be handled in times of distress.
- Financial institutions with the highest leverage ratios – for example, hedge funds – were not subject to stricter banking regulations and capital requirements.
- A risk widely ignored by US banks during the last decade because of the policy of easy money was liquidity risk. It struck the banks in the recent crisis with full force.
- Contracts between players in the financial market developed into mere bets and zero sum games. Gambling was widespread.

It is claimed that in an Islamic financial system a crisis such as the recent one would have been prevented. This is because Islam:

- requires that all financing is linked to transactions in the real economy (production, trade);
- demands that surplus units (savers) should not behave as rentiers (encashing risk-free fixed returns for the mere provision of funds) but as investors

- (sharing the results – risks and returns – of the entrepreneurial use of their funds); and
- prohibits interest-bearing debt contracts, debt trading and speculation.

The combination of (1) real asset backing of finance and (2) risk-sharing, supported by (3) the ban on debt trading, does seriously limit (although not completely eradicate) leverage effects. Further, the prohibition of speculation would have prevented excessive risk-taking (gambling), and the unavoidable entrepreneurial risks would have been spread over a larger base of investors. The analysis of the causes of the crisis suggests that the collapse of the financial system could have been prevented if all these principles were applied and rules observed.

Only one – but very fundamental – question remains: How can adherence to the standards of Islamic finance be ensured in practice? This question is very relevant because a closer look at the practice of Islamic banks reveals that they apply techniques and design products the economic characteristics of which fall short of the standards required by these principles.

### **III. Emulation of Conventional Techniques and Products in Islamic Finance**

To repeat the well-known argument again: Islamic modes of finance tie the financing to real economic activities such as trade or production. Therefore, the unrestricted creation of debt is not possible. The following portrays widely used instruments<sup>2</sup> which facilitate exactly this: the provision of untied loans – that is, of loans not providing specific goods or services but pure liquidity in unrestricted quantities. Insofar as the contracts are asset backed, it must be noted that the underlying assets can be either notional or irrelevant.

#### **A. *Tawarruq and Commodity Murābahah***

In a *Tawarruq* transaction, the customer requests the bank to purchase a specific asset (e.g. a commodity for which an organised market exists) on his behalf, and he buys this asset from the bank at a specified price on deferred payment. The customer then sells the asset for cash to a third party (e.g. a commodity trader). The cash amount will be less than the price the customer has to pay the bank in the future.

*Tawarruq* frequently came under criticism because the predetermined mark-up for the bank is economically equivalent to interest. This becomes very obvious when the bank combines the sale and purchase transactions into one transaction and buys and sells the commodity from the same broker.

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<sup>2</sup> For a survey of more advanced structured products, see McMillen, 2009; Zubairi, 2009.

*Tawarruq* is also criticised as a technique with the potential to create unlimited debt. “As it currently stands, both in the conventional and in the Islamic financial markets, debt documents, like those resulting from *Tawarruq*, are subject to repeat financial and speculative transactions. At their limit, these transactions sever all links with the real assets with which they could have been associated at the start ... This process leads to an inverted pyramid of financial instruments with a small asset base” (Siddiqi, 2008b, p. 1). Since the object of trade is used for productive purposes neither by the bank nor by the customer, the same asset can be used over and over again for *Tawarruq* transactions and thus create a volume of debt that is completely detached from the real wealth.

Where *Tawarruq* is not accepted,<sup>3</sup> Islamic financial institutions apply a slightly different legal construct with the same economic effects: *Commodity Murābahah*. Here the sales and purchase contracts are separated, and usually two different brokers are involved: one from whom the commodity is purchased and another to whom it is sold.<sup>4</sup> *Commodity Murābahah* is widely used as a treasury instrument in corporate financing (Ashraf, 2007) as well as in the Islamic interbank (money) market (Mokhtar, 2008; Schoon, 2008, 2009) .

Islamic financial institutions apply techniques which detach the financial sphere from the real economy. They even have the potential to create *Sharī'ah*-compliant debt without effective built-in restrictions if the bank management wants to move in this direction.

## **B. Instruments for Speculation**

The speculative use of derivative instruments contributed substantially to the emergence and spread of the present financial crisis. Prohibition of both the sale of debt and of speculation should rule out such practices in an Islamic system. But what Islamic economists may consider a major advantage of an Islamic financial system is often seen as a serious shortcoming by Islamic bankers. Therefore, financial engineering has been applied very successfully to ease or overcome the limitations. Today, “basically every contract can be ‘Islamised’ using concepts from modern financial engineering. The question is rather how high the transaction costs are, and, especially, whether one regards such mechanics as *Sharī'ah*-compliant, or as just an undesirable ploy, which strikes at the foundations of the objectives of Islamic finance” (Mahlknecht, 2008a). This includes various forms of *Sharī'ah*-compliant structured finance from futures, options and swaps over short selling to “Islamic plugs” or “*Sharī'ah* Conversion Techniques” which facilitate *Sharī'ah*-compliant investments in non-*Sharī'ah*-compliant assets (see below).

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<sup>3</sup> The debate on *Tawarruq* has recently been fuelled by a *fatwa* of the Organization of Islamic Conferences (OIC) Fiqh Academy. For a reconciliation of the positions of the Accounting and Auditing Organization Academy. For Islamic Financial Institutions (AAOIFI) and the OIC Fiqh Academy, and a critical account of the recent practice of *Tawarruq*, see Khan, 2009.

<sup>4</sup> For a critical assessment of recent practices, see Jarrar, 2009.

“In Islamic finance, derivative instruments have long been frowned upon. Nevertheless, over the past few years, new derivative structures approved by *Shari’ah* scholars have come onto the market” (Hussaini, 2008, p. 40). “Islamic structured products are financial instruments that create cash flow or delivery obligations linked to the performance of a defined underlying benchmark that is compliant with the principles of *Shari’ah* (such as equity markets, indices and commodities). For example, a Dow Jones Islamic Market (DJIM) index-linked note has a return linked to the performance of the DJIM index” (Miller, Naumowicz and Atta, 2008, p. 33). Islamic structured products cover a wide range of financial instruments – for example, range accruals on currencies based on roll-over *Murabahah*, *Urbun*-based capital-guaranteed investments or *Wa’d*-based total return swaps – and they seem to be in high demand (Mahlknecht, 2008b). Only a few examples can be quoted here.<sup>5</sup>

### **(1) Collateralised Debt Obligations**

It has been argued that the prohibition of debt trading would have prevented the creation of toxic assets (by repackaging and tranching sub-prime debts) and their spread throughout the financial system which led to the global systemic crisis. The main vehicles were collateralised debt obligations (CDOs). It is correct that Islamic financial institutions cannot trade CDOs directly, but it is possible to design instruments with similar characteristics, and if advanced swapping instruments are available, a link to conventional CDOs could be established. “The task of an Islamic financial engineer is to design a *Shari’ah*-compliant structure that can replicate the risk–return profile of a conventional CDO” (Dar, 2007). “Given that there are a number of CDOs that have non-debt underlying assets ... the prohibition of trading in debt can be circumvented in structuring *Shari’ah*-compliant CDOs. CDOs are a tool to leverage a financial portfolio by issuing securities of different ratings to match the risk appetite and investment policies of investors” (Dar, 2007, p. 57). The originator can have exposure to the reference portfolio through an Islamic plug. “Islamic plugs allow a *Shari’ah*-compliant entity to have exposure to a non-*Shari’ah* asset, while observing *Shari’ah* requirements. The idea behind Islamic plugs is rather simple. It makes use of the *Shari’ah* permission that the two transacting parties can agree on an off-market price and that the price, once paid to a non-*Shari’ah* seller, can be used in any activity (including in activities which are not permitted for Muslims)” (Dar, 2007, p. 58). The basics of an Islamic plug are explicated in more detail in Section III.C, where total return swaps are discussed.

### **(2) Short Selling**

Short selling is often considered to be the major amplifier of the global financial crisis. Islamic economists make the criticism that short selling is not only highly speculative but – because of its high leverage (or small initial capital

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<sup>5</sup> For more, see de Belder, 2009; Jobst, 2007a, 2007b; Sapte, 2008; Schoon, 2009.

requirement) – also highly risky and destabilising. It is claimed that the observance of Islamic finance principles would have saved the financial world from these evils.

However, the basic legitimacy of transactions based on the expectation of changing prices of a real or financial asset is not questioned. Thus, it should be permissible and possible to earn a profit from the correct anticipation of decreasing prices – which should include decreasing prices of stocks which are considered to be overvalued. The technique to realise profits from decreasing prices in the conventional system is short selling: “The conventional method of short selling is borrowing a stock and selling it on the market. The short sale is made with the expectation of the price going down, which would allow the investor to purchase the shares at a lower price in order to deliver the securities earlier sold short. This method is not acceptable according to the AAOIFI Standard No. 21, 3/9 and 3/16” (Gassner, 2007, p. 29). Such a short sale violates the general *Sharī'ah* prescription that one cannot sell what one does not own (even if the object of this transaction does exist). However, there are some exceptions to this general rule, and it is the task of the financial engineer to redesign the transaction – with the help of auxiliary contracts – in such a way that it falls under the permissible exceptions. “To profit from declining markets, Islamic finance offers a range of possibilities other than just replicating conventional short-selling. Besides other Islamic derivatives and hedging methods, strategies based on *Salam*, *Arbun* and *Wa'd* provide investors with the necessary flexibility in this context” (Mahlknecht, 2008a). Such techniques are applied by Islamic financial institutions, although they are not generally accepted by all *Sharī'ah* scholars, and sometimes they are even in open contradiction to AAOIFI standards and recommendations (which, however, are not binding in most jurisdictions). If short selling is possible and is applied in Islamic finance, the systemic evils for which conventional short selling is blamed can also occur in an Islamic financial system.

### **C. Islamic Plugs / Sharī'ah Conversion Technology**

The instruments discussed so far make it possible to mimic conventional techniques and products within the Islamic system. An Islamic system where these instruments are applied will be exposed to similar stability risks as a conventional system, but it stands as a separate system. Recently, financial engineering went even one step further. *Wa'd* shorting and Islamic profit rate swaps prepared the ground for *total return swaps*. This new technique allows Muslim investors to invest in non-*Sharī'ah*-compliant assets or to finance non-*Sharī'ah*-compliant activities. A *Sharī'ah* board with prominent scholars has approved this construct, but there is also a forceful critique of this “*Sharī'ah* Conversion Technology” by another eminent *Sharī'ah* scholar. Should this technique be widely applied, the demarcation line between conventional and Islamic finance disappears. Islamic finance then is no longer an alternative concept or competing system, but seems to get sucked in by conventional finance.

## **(1) Islamic Profit Rate Swaps**

Islamic profit rate swaps can be seen as precursors of the total return swaps. The profit rate swap can be used to transform a fixed rate income stream into a floating rate income stream, or *vice versa*. Such a transformation allows a bank to eliminate uncertainties or discrepancies between incoming and outgoing profit streams.

This is achieved by the execution of opposite *Murābahah* contracts (or series of contracts), the first with fixed payments and the second with a floating rate of payments. The contracting parties sell *Sharī'ah*-compliant assets to each other on deferred payment terms. For example, the first contract may be a long-term fixed rate *Murābahah*, while the second contract is the first of a series of short-term *Murābahah* with rates of mark-up which, while fixed for each contract, are floating for the series – being, for example, benchmarked to KLIBOR plus an agreed mark-up at the inception of each contract. The party that starts with the short-term *Murābahah* makes the promise (*Wa'd*) to enter into subsequent short-term *Murābahah* until the maturity of the long-term *Murābahah* is reached (Hussaini, 2008; Uberoi and Evans, 2008).

In their basic form, profit rate swaps are designed by the use of two core elements only, namely *Murābahah* transactions and promises (*Wa'd*). The *Sharī'ah* approval of this basic swap structure paved the way for much more complex swaps using the same core elements.<sup>6</sup>

## **(2) Islamic Total Return Swaps**

The concept of the Islamic total return swap was developed and propagated by Deutsche Bank. The structure is designed as follows (Deutsche Bank, 2007): The bank will issue *Sharī'ah*-compliant securities to investors upon receipt of a so-called commitment amount which is credited to an Islamic Account. This account may have its own legal personality as a special purpose vehicle (SPV).

- The commitment amounts are used for the purchase of *Sharī'ah*-compliant assets, such as *Sharī'ah*-approved shares.
- The value of the commitment amounts is equivalent to the index value of a basket of another financial asset (the reference asset).
- On the day the commitment amounts are used for the purchase of *Sharī'ah*-compliant shares, two promises are made:
  - Promise 1: The Islamic Account gives a promise to the bank to sell the *Sharī'ah*-compliant shares (the relevant shares) on the date of settlement at the predefined settlement price.

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<sup>6</sup> For an introduction to derivatives and hedge funds as recent product innovations, see Rilk and Dar, 2009.



- Promise 2: The bank gives a promise to the Islamic Account to buy the *Sharī'ah*-compliant shares (the relevant shares) on the date of settlement at the same settlement price.
- The definition of the settlement price relates the initial level of the index value of the basket of the reference asset – and not of the relevant shares – to its final level on the closing date (adjusted for a management fee).

The two promises are mutually exclusive: which one will be claimed depends on the market price of the relevant shares compared to the performance of the reference asset:

- Case 1: If the performance of the relevant shares is better than that of the reference asset (i.e. the share prices increased more than the index value of the basket), then the bank can purchase the shares at a lower-than-the-market price from the Islamic Account. Promise 1 becomes relevant.
- Case 2: If the performance of the relevant shares is worse than that of the reference asset (share prices increased less than the index value of the basket), then the Islamic Account will sell the shares at a higher-than-the-market price to the bank. Promise 2 becomes relevant.

Although the Islamic Account deals only in relevant shares, the returns of the investors are factually those of the reference asset (which may be less [case 1] or more [case 2] than the returns of the relevant shares).

Deutsche Bank points out that, in technical terms, the *Wa'd* structure is the *Sharī'ah* equivalent of a total return swap. There are no restrictions on the type of reference asset: it can be any financial asset – *Sharī'ah*-compliant or conventional, with predictable or speculative returns, equity based or highly leveraged, etc. “In essence we arrange for the client to invest in liquid *Sharī'ah*-compliant assets (*Sharī'ah*-compliant equity shares) and we ‘swap’ away his return (total return swap) for another return (for example a hedge fund linked return). As the investment of the client is *Sharī'ah*-compliant (since he only invests in *Sharī'ah*-compliant assets) and as the swap transaction is conducted in a *Sharī'ah*-compliant manner, we have found a *Sharī'ah*-compliant method to make an investment pay-off (or exposure to an asset class) that would not normally be *Sharī'ah*-compliant” (Deutsche Bank, 2007, p. 5).

The *Wa'd* structure was approved by the Dar Al Istithmar *Sharī'ah* Supervisory Board, which is composed of five leading *Sharī'ah* scholars. A *Sharī'ah*-approved technique has been designed which amalgamates Islamic finance and conventional finance. If this structure were widely applied, Islamic banks would be reduced to outlets or distribution channels for conventional products in a niche market. Apart from the legal documents, the economic differences between Islamic finance and conventional finance would be wiped out. It needs no lengthy exposition that in such an amalgamated system Islamic investors and institutions are exposed

to the same systemic vulnerability, risks and instabilities as their conventional counterparts.

Sheikh Yusuf Talal DeLorenzo circulated a paper in 2007 in which he sharply criticised such constructs, which he named “*Sharī‘ah* Conversion Technology” (DeLorenzo, 2007). For him, this is a circumvention of *Sharī‘ah*. He holds that the *Sharī‘ah* scholars who approved this structure “have made a serious mistake. So serious, in fact, that in my paper on the subject I have called their decision the Domsday Fatwa. ... Whatever you call it, it seems to me that when jurists lose sight of the big picture, of the *maqasid*, of the Islamic financial industry and its meaning for the future of the entire Muslim community then it is possible to explain why they might approve such swaps. I am happy to share with you the knowledge that several of the scholars who first approved these swaps have since reversed their opinions. And I am certainly hopeful that the market itself will reject these products. That, perhaps more than anything else, will be the most important step in the process of ridding the industry of this problem and others like it” (Staff Reporter, 2008).<sup>7</sup>

#### **IV. Perspectives in View of Crisis and Anomalies**

The use of instruments based on notional assets, financial derivatives and binding promises enhances the technical efficiency of Islamic banks and financial markets. But this gain in efficiency through the emulation of conventional instruments comes at a high price. The conceptual and economic differences between Islamic and conventional finance get blurred, and all the criticism levelled against conventional finance has a backlash effect on Islamic finance. If notional trading, shorting and swapping are permissible (and applied on a large scale), claims that Islamic finance possesses superior systemic stability and stabilising qualities become hollow. Slightly exaggerating, one might even say that the fact that Islamic banks were less affected by the global financial crisis is not due to the conceptual superiority of the system but to its practical deficiencies: the advanced instruments of liquidity and risk management which emulate those conventional instruments that have caused or reinforced instabilities are so new that they have not yet been applied by most of the Islamic banks.

Financial engineers have been very successful in designing constructs which emulate nearly all types of instruments of conventional finance (including derivatives and hedging tools). The “Islamic finance industry is now heading in a direction that is defined by the nature of products that are in the [conventional] marketplace” (Alam, 2007, p. 51). “The Islamic industry drifted into a wild impasse of intricate financial engineering, under the pretext of proving the ability of *Sharī‘ah* to satisfy all investors’ needs” (El-Din, 2008, slide 7).

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<sup>7</sup> See further critical comments by Firoozye, 2009b.

All innovative structures are communicated within the Islamic finance industry (via conferences, publications, training courses, etc.). The instruments can be used for more efficient liquidity and risk management in conservative Islamic banks, as well as for the more aggressive investment strategies of Islamic financial institutions with a strong risk appetite. It is extremely difficult to draw a clear demarcation line between risk management and speculation. The technology is the same, and the instruments for both – risk-averse and risk-inclined business strategies – are at hand. Therefore, it is not very convincing to assert that *Sharīʿah* principles alone provide an effective shield against speculative hedging, excessive leverage and induced systemic crises.

*Sharīʿah* compliance is not deduced from a codified written law but is largely based on the legal opinion of individual *Sharīʿah* experts or bodies of *Sharīʿah* experts (*Sharīʿah* Boards, *Sharīʿah* Advisory Councils, *Sharīʿah* Committees, etc.). Given the fact that Islamic finance is a relatively new development, and that five major schools of law are recognised in *Sharīʿah*, it should not come as a surprise that opinions on particular techniques and products differ between Islamic banks or respectively their *Sharīʿah* scholars. But what does come as a surprise is that, over the last two to three years, several controversies have started about fundamental concepts and widespread practices of Islamic finance (especially *Tawarruq*, *Sukūk* and the scope of structured products).

One can say that there is a discrepancy between the claims made in favour of a systemic superiority of Islamic finance and the practices of existing market players. Due to the opaqueness of Islamic banking, it is hard to assess the quantitative relevance of critical techniques and products. *Tawarruq* and *Commodity Murābahah* seem to be widespread practices, and the majority of *Sukūk* issued until 2008 were of the “interest emulating” type which was rejected by Sheikh Taqi Usmani of AAOIFI (Usmani, 2008). The complex structures of *Sharīʿah*-compliant derivatives and *Sharīʿah* Conversion Technologies are of more recent origin and probably not yet common property of the Islamic finance industry. However, if one looks at the subjects of conference papers, training courses, expert seminars and media news, one can safely say that there is a tremendous interest in these innovations. Once a new technique or product has been engineered and is successfully utilised by a pioneering market player (for higher returns and/or a superior risk position), imitations by others will follow soon. It seems that basically the same market forces as drove the conventional industry in the past are driving the Islamic finance industry towards more complex structures.<sup>8</sup> If this trend is seen as a problem, then what can be done to stop or even reverse it?

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<sup>8</sup> Firoozye (2009a) is even more explicit: He observes that “in most conventional investment banks Islamic finance is merely a branch (or a desk) of other groups, usually Structured Product and Securitizations. Typically, bankers with significant backgrounds in conventional securitization and an interest in Islamic Banking are tasked with structuring and issuing *Sukūk*. This has of course developed into a discipline in and of itself. Thus, those with a background in conventional structured products have merely to figure how to deal with (and oftentimes circumvent) *Sharīʿah* constraints on top of the legal, tax, and regulatory issues they already deal with and the pricing, hedging, and willingness of traders and risk managers to take on the residual risk, matters that always come with the territory. Hence, being a branch of Structured Products and one that has managed to

## A. ***Fundamental Systemic Reforms***

A number of quite radical proposals have been made for a fundamental reform of the financial (and monetary) system. In spite of differences in justification and design, all have in common that they severely restrict or eliminate maturity mismatches and leverage effects. Two proposals had already been made long before the current crisis, but they have gained new attention and supporters recently.

- The first proposal is inspired by the reform concepts of Chicago economists in the 1930s, namely the replacement of the fractional reserve banking system by “100% money” – that is, by a 100% reserve requirement for bank deposits. This would eliminate the power of the banking system to create money and to build up the fragile inverse credit pyramids. The idea had been picked up by Islamic economists in the 1980s in view of several bank failures at that time (see (Al-Jahri, 1983, 2004; Khan and Mirakhor, 1994).
- The second proposal achieves a similar effect by the introduction of a Gold Dinar – that is, a gold currency where bank deposits must be backed by corresponding quantities of gold. The idea of a gold currency became popular after the former Malaysian Prime Minister Mahathir Mohamad called for the establishment of a gold payment system among Islamic countries (the “Islamic Gold Dinar”) to protect them from monetary shocks as experienced in the Asian crisis in the late 1990s. Academic writers went beyond the more limited scope of an international payment system and suggested the national changeover to a gold currency (Dali, Alrazi and Hamid, 2004; Ibrahim, 2006; Meera, 2002, 2004; Vadillo, 2004; Yusuf, Dali and Husin, 2002; for a critical assessment, see Hasan, 2007).
- A third proposal, which has been put forward recently, has a very different background: Islamic banks are often forced by regulators in conventional systems to guarantee the principals of investment account holders. They treat investment accounts as deposits, which is not in accordance with *Shari’ah*. To overcome the resulting inconsistencies, it has been proposed to set up separate legal entities for the “narrow banking” business (offering non-remunerated current accounts but not remunerated deposit accounts) and for the savings and investment business of Islamic banks under the umbrella of one holding company (Archer and Karim, 2009). The savings and investment business of the Islamic banks becomes similar to the business of collective investment schemes (e.g. investment funds) and should be regulated

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survive while other areas are drying up, it makes sense that conventional bankers should be falling all over themselves to come up with the next best Islamic Structured Product. In a sense this also explains why *Sukuk* is engineered to fit into a fixed income device – when it rightfully belongs as an equity-hybrid instrument” (p. 7). “One can’t help notice that Islamic investors flock to structures that have long been disfavoured in the conventional world. This has happened before, when a product loses favor in conventional finance it is wrapped for delivery to Islamic finance. This is not confined to structured products though, there are cases of suboptimal real estate, quasi-distressed projects, highly-adventurous venture capital, downward-sloping equities. They all find a new life as *Shari’ah*-compliant vehicles (often garnering attention as trail-blazers, first-of-its-kind, unique). ... So while the rest of the world sits back, the Islamic world is moving headlong into structured products. The marriage is not necessarily optimal” (p. 9).

accordingly. It is suggested that the narrow bank may invest surplus funds with the savings and investment institution, but only in (very) short-term transactions to avoid serious mismatches of maturities. If the narrow bank does so, it must have sufficient liquid capital resources to guarantee the liquidity of current accounts at all times. In countries where a *Sharī'ah*-compliant (interest-free) money market and lender of last resort facilities are non-existent, this comes close to a 100% reserve requirement.<sup>9</sup>

Whatever the conceptual merits of such fundamental system reforms may be, they are at present not on the reform agendas of central banks and regulators. Thus, they will not have a strong impact on the direction of Islamic finance in the foreseeable future. Therefore, other measures must be taken into consideration to prevent the practice from drifting further from the model of Islamic finance.

### ***B. Moral Suasion and Regulation***

Moral appeals are very weak instruments in secular finance. But the impact may be stronger in the Islamic sector. Several central bank governors of Muslim countries have repeatedly referred to the ideals of risk-sharing and real sector finance in recent speeches, and they also recalled the need to support economic development. They reminded the audience that Islamic finance should be more than just an interest-free finance technology. It seems that they want to reverse an industry trend which finds its linguistic expression in the replacement of the adjective “Islamic” by the term “*Sharī'ah*-compliant”. The references to the social values of Islam and the obligations of individual Muslims are accompanied by the debate of *Sharī'ah* scholars and institutions on “substance over form”. It remains to be seen whether recent campaigns against *Tawarruq*, some *Sukūk* structures and the *Sharī'ah* Conversion Technology combined with general calls for “back to basics” in finance will lead to a substantial strengthening of the ethical dimension of Islamic finance and a renunciation of anomalies.

Once an erosion of values or “trust capital” has started, it is very hard to stop, let alone reverse, it by moral suasion alone. After “Islamic” (signalling a programmatic perspective) has been reduced to “*Sharī'ah*-compliant” (indicating a legalistic approach), one should not place too much confidence in social self-correcting mechanisms. Therefore, committed governments could consider implanting crash barriers in the Islamic financial sector.

- In the most interventionist form, the legislator or regulator could allow or ban specific techniques and products and/or issue a positive list with permissible modes of financing. Pakistan has some experience with such a policy. If the measures of the authorities are not appreciated by the regulated parties, they

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<sup>9</sup> While the previous 100% reserve models of Islamic economists called for a general reform of the banking system, the implicit monetary reform dimension of the new proposal is confined to the Islamic finance sector only.

will make all efforts to find loopholes and tricks to circumvent the restrictions. The undermining of the Islamisation of Pakistan's financial system in the late 1980s and 1990s, and its final dissolution in 2002, provide a telling case study (see Zaidi, 1987; Zaidi, 1987; Pakistan Federal Shariat Court, 1992; State Bank of Pakistan, 2002).

- Another problem with such direct interventions is that they involve a strong risk of factual discrimination against Islamic financial institutions in mixed systems: what is considered an undesirable anomaly in Islamic finance against which measures should be taken is most probably conceptually unproblematic in the conventional sector. Although it might be ideologically consistent to restrict the toolbox of Islamic financial institutions (and be more permissive in the conventional sector), a crude unequal treatment of Islamic and conventional market players would create a competitive disadvantage for Islamic banks and probably violate the principle of equality before the law.
- Therefore, only non-discriminatory measures (adapted to the specificities of Islamic finance) can be applied – for example, stricter capital adequacy rules for all financial institutions, stricter risk management requirements, limits to maturity mismatches, or stress testing procedures and benchmarks. All this should be accompanied by more and better disclosures to promote transparency and market discipline<sup>10</sup> and be supplemented by adjusted financial safety net mechanisms and crisis management and resolution procedures.

Measures that treat Islamic and conventional financial institutions as equal (notwithstanding adjustments for the specificities of Islamic finance) will hardly affect the internal dynamics in the two sub-systems. If the Islamic sub-system drifts towards more complexities and emulations of conventional instruments, adapted regulations will not change the direction.

### **C. Liquidity Tools and Governance Structures**

The internal dynamics of the Islamic finance industry will only be challenged by measures that change the present competitive environment for Islamic market players substantially. There are two sets of measures with such a potential. They are addressing (1) the problems of liquidity management, and (2) the internal governance structures.

#### **(1) Liquidity**

Much of the *Tawarruq* and Commodity *Murābahah* deals are transacted between Islamic banks and should be regarded as treasury operations. This is their

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<sup>10</sup> The Islamic Financial Services Board (IFSB) has issued several standards recommending measures to the regulators. See, in particular, the standards IFSB-1 (on risk management, 2005), IFSB-2 and IFSB-7 (on capital adequacy for Islamic financial institutions except insurance institutions, 2005, and for *sukuk*, securitisations and real estate investments, 2009) and IFSB-4 (on disclosure, 2007). All IFSB documents quoted in this text can be downloaded from the IFSB website, [www.ifsb.org](http://www.ifsb.org).

way out of the dilemma that Islamic banks cannot have recourse to the conventional interbank (money) market for the management of their liquidity position. The central banks of only very few countries such as Bahrain, Malaysia and Sudan have taken up the task of providing *Shari'ah*-compliant instruments suitable for the liquidity management of Islamic banks operating in their jurisdictions. The central banks of these countries regularly issue government or central bank *Sukuk* that are used, on the one hand, for *Shari'ah*-compliant open market operations (i.e. as tools of monetary policy) and, on the other hand, by Islamic banks for their liquidity management. At least for banks which have access to these facilities, the need to have recourse to the London metal exchange for treasury operations should cease.<sup>11</sup>

But since these facilities are only available for Islamic banks licensed and operating in their respective jurisdictions, they are not yet a true alternative to the global conventional interbank market. This problem has been recognised, *inter alia*, by the Islamic Development Bank (IDB), and it seems that a global solution is in the making: the IDB announced on 11 October 2009 “an initiative to create a mega Islamic investment bank ... to promote the growth of the Islamic financial industry, global reach and liquidity management with initial capital of one billion US dollars. The new bank is also aimed at facilitating the establishment of an inter-Islamic banking market in line with *Shari'ah* principles.”<sup>12</sup> The press release stresses several times that the new bank shall provide Islamic financial solutions to the problems of liquidity management. Since the IDB is not a private bank but an intergovernmental semi-public financial institution with the highest credit rating, this bank has the potential to issue instruments with desirable characteristics for liquidity management and money market operations, namely “relatively low risk, simply designed, regularly issued, widely held, and supported by a robust payment and settlement system.”<sup>13</sup> This step alone may not be sufficient to create a global Islamic money market, but it is clearly an important step in this direction and a kind of calling for central banks of Muslim countries to take similar initiatives and adapt their toolboxes to the needs of Islamic financial institutions.

The emergence of a global Islamic money market and the adaptation by national central banks of these new tools will greatly reduce the need of Islamic banks to take for recourse to the London metal exchange. Once this is established, it will be an interesting test case: if the volume of commodity *Murabahah* and *Tawarruq* transactions not shrink substantially, this may indicate that Islamic financial institutions do not only use the metal markets as a makeshift construction for treasury operations but find it attractive to earn widely risk-free returns from such

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<sup>11</sup> The problems of liquidity management and *Shari'ah*-compliant money markets have been covered comprehensively in an IFSB Technical Note of March 2008 on “Issues in Strengthening Liquidity Management of Institutions Offering Islamic Financial Services: The Development of Islamic Money Markets”.

<sup>12</sup> Press release of IDB: “Mega Islamic Investment Bank Initiative Launched, Initial Capital of One Billion US Dollars”, 14 October 2009: [www.isdb.org/irj/servlet/prt/portal/prtroot/NewsAppEU.NewsDetails?idbNews=Mega\\_Islamic\\_Investment\\_Bank\\_Initiative\\_Launched,\\_Initial\\_Capital\\_of\\_One\\_Billion\\_US\\_Dollars.xml](http://www.isdb.org/irj/servlet/prt/portal/prtroot/NewsAppEU.NewsDetails?idbNews=Mega_Islamic_Investment_Bank_Initiative_Launched,_Initial_Capital_of_One_Billion_US_Dollars.xml).

<sup>13</sup> IFSB Technical Note on “Issues in Strengthening Liquidity Management ...”, p. 1.

types of financial transactions with only notional asset backings. In this case, claims of a strong link between Islamic financing and assets or activities in the real sector would be hard to maintain, and the door to leverage would stay wide open.

## **(2) Governance**

There is another field where legislators and regulators may initiate more fundamental changes in Islamic finance, namely with respect to the internal governance structures of Islamic banks. The financing business of Islamic banks is dominated by debt-like relations between the bank and the client (*Murābahah*, *Ijārah* and more complex structures built on such types of contracts), and participatory modes of finance (*Muḍārabah*, *Mushārah*), which involve risk-sharing between the bank and the client, are rarely applied. In a legal sense this is different on the liabilities side of the balance sheet: here investment account holders share risks and returns with the Islamic bank – at least contractually, in many jurisdictions. However, the *de facto* situation differs in most cases from the legal concept, because Islamic banks smooth payouts on investment accounts and keep them in line with interest paid on conventional savings or term deposits. Islamic banks can utilise “profit [i.e. payout] equalisation reserves” and investment risk reserves (both in accordance with AAOIFI standards), and if this is not sufficient to meet the expectations of investment account holders, the shareholders can “voluntarily” reduce the share of profits contractually due to them.

While the *Sharī'ah* compatibility of such practices seems to be beyond doubt from a legal perspective, it is very hard to accept this smoothing from a conceptual point of view.<sup>14</sup> There are many good reasons why Islamic banks are extremely reluctant to apply participatory techniques in their financing business (asymmetric information, moral hazard and adverse selection problems, high transaction costs, lack of demand for profit-sharing financings, missing or unreliable benchmarks, etc.). But if one accepts these arguments for the financing business and at the same time takes seriously the claim that a distinctive feature of Islamic banking is risk-sharing, then this should materialise in the “deposit” business. If that were the case, the status of investment account holders would be fundamentally different from that of depositors in conventional banks. Conceptually, their risk exposure in cases of bankruptcy is comparable to that of the shareholders of the bank, since they would have recourse only to their proportionate share of the residual assets (before deduction of the amounts owed to creditors such as current account holders, for which the shareholders are liable). This, however, is not reflected in the corporate

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<sup>14</sup> Smoothed returns for the depositors do not (only) originate from the financial results of the investment of their funds but (also) from some kind of an average return of a much wider pool of past and present (and maybe even future) deposits, and even shareholders, funds. Smoothing blurs the difference between profit and risk-sharing investment accounts and conventional interest-bearing deposits. For the basic *Sharī'ah* principles and a compilation of deposit facilities offered by Islamic banks, see Haron and Azmi, 2009, pp. 128-159, 267-301 and Ismail, 2010, pp. 55–59, 103–118.



law of any jurisdiction (except maybe Sudan) that determines the governance structure of all corporations, including Islamic banks.

If the secular law of a particular country does not recognise “investment account holders” as a distinctive category but equates them with depositors of conventional banks, their legal status is the same as that of depositors whose claims have priority over shareholders’ claims in a bankruptcy case (and whose money may even be guaranteed by a deposit insurance scheme). But even in countries where they are forced by law and regulation to provide deposit protection to investment account holders, Islamic banks must not ignore the conceptual difference between investment accounts and deposits. In cases of losses that exceed profit equalisation reserves, investment account holders in such countries are entitled by secular law to demand back their principal amount in full. However, *Sharī’ah* scholars have suggested that in such cases of loss, investment account holders volunteer to accept a share of the loss and disclaim the full repayment. In this case, the secular law and the *Sharī’ah* principles are in conflict. Islamic banks and their customers should try to follow the *Sharī’ah* rules as far as possible. In the case of a loss, this could mean, for example, that the Islamic bank suggests to its investment account holders how much of the loss they should accept voluntarily. But it is a totally open question how such a voluntary disclaimer should be calculated and executed. Furthermore, the voluntary sacrifice of the investment account holders would not be an act of charity but be to the benefit of the shareholders or the capital of the bank.

The request for a voluntary disclaimer looks very unreasonable if investment account holders did not have any chance to participate in, or at least be adequately informed about, the management of the business that finally ended in a loss. Although secular laws do not envisage any incorporation of investment account holders into the corporate governance structure, they would not outlaw voluntary measures of Islamic banks.

- To start with, the status of investment account holders is similar to that of participants in collective investment schemes (such as investment funds). Therefore, comparable disclosure and information rules should be applied.<sup>15</sup> This would not only greatly enhance the transparency of the Islamic banking industry in general, but would in particular support strongly the recalling of (Islamic) banking basics. It has become a consensus in conventional finance that the basic principles of prudent banking should be rediscovered (“back to basics”) and that the complexity of financing structures should be reduced (“understand/explain your business”). Similar calls have been raised for Islamic finance. If Islamic banks accept their moral or conceptual duty to enhance transparency, chances are that these calls will not remain lip service in the Islamic sector (as sceptical observers suspect for the conventional sector).

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<sup>15</sup> See also IFSB-6, “Guiding Principles on Governance for Islamic Collective Investment Schemes”, published in 2009.

- Further, investment account holders also share some characteristics with participants in Islamic insurance schemes (*Takāful*). Both are groups that share rewards and risks of the employment of funds managed by an entity in which they do not have any institutionalised corporate rights.<sup>16</sup> In analogy to proposals for *Takāful* operators, Islamic banks could consider the (voluntary) installation of a representation of investment account holders' interests in the corporate decision-making bodies. For example, they could nominate one non-executive director with the specific mandate to trace preferences and concerns of investment account holders and to advocate their interests in board meetings. A bank could also form a (sub)committee of the board of directors for investment account holders' affairs (e.g. a Governance Committee as proposed in the IFSB's "Guiding Principles on Corporate Governance of Institutions offering Islamic Financial Services, (IFSB, 2006)). Several other options are conceivable.

The common denominator of such arrangements is the rise in status of investment account holders: they are no longer one group of stakeholders equal to several others without any institutionalised representation. Their embodiment in the corporate structure of an Islamic bank would be more than a symbolic act:

- It would imply recognition of the role of investment account holders as risk bearers.
- It would produce evidence for the awareness of the management and the shareholders of the bank that conflicts of interest with investment account holders cannot be ruled out, and that communication (in addition to market forces) could help to reconcile the controversial positions.
- It would give credibility to the claim that Islamic banking takes ethical criteria seriously in its financing business and investment policy.
- It could become the nucleus of an early warning system whose signals precede market reactions (such as withdrawals of funds from investment accounts).
- It could help to establish a trust relationship between the bank and its investment account holders (which are the major source of funds for retail banks). Customer loyalty can be a very valuable asset in difficult times.

Obviously, there are good conceptual reasons why Islamic banks should take into consideration modifications of their governance structures which go beyond the establishment of *Sharī'ah* bodies.

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<sup>16</sup> See the exposure draft ED8 for an IFSB standard on "Guiding Principles on Governance for Islamic Insurance (Takāful) Operations", published in 2008; see also Archer, Karim and Nienhaus, 2009.

## V. Conclusion

*Shari'ah* compliance is a necessary condition for financial techniques, products and procedures to be considered “Islamic”. Since *Shari'ah* compliance is a legal requirement, the crucial role of scholars of Islamic law in the design of an Islamic financial system cannot be disputed. *Shari'ah*-compliant instruments are applied in the banking industry, and therefore bank practitioners are vital for systemic development. However, *Shari'ah* scholars and bankers are not the only players in this field. In the 1970s and 1980s – the early days of Islamic banking – the public image of Islamic finance was largely formed by Muslim economists who insisted that the main difference between conventional and Islamic banking is a distinctive distribution of risks and rewards between the financier and the user of funds (entrepreneur) due to the application of participatory financing techniques (then often called “profit- and loss-sharing (PLS) modes of finance”) – in particular, *Muḍārabah* and *Musharakah*. In later years it became apparent that participatory financing was rarely adopted by Islamic banks – not because of ignorance or malevolence, but for a host of good commercial reasons (high transaction costs, weak accounting and governance standards, information asymmetries, lack of benchmarks, adverse regulations, etc.). But despite the discrepancy between the conceptual ideal and the market reality of Islamic banking, the ideal was never substantially revised. Today it is the background and basis for two lines of argument:

- the critique of conventional finance which is accused of having lost its grounding in the real economy and of being transformed into a system of global speculation; and
- the critique of Islamic finance which is accused of giving legal form preference over economic substance in the design of *Shari'ah*-compliant products and techniques.

The creation of a “genuine” Islamic banking system not only requires contributions from law and banking, but must also consider economics. There is nothing inherently wrong in the emulation of efficient conventional products and techniques, but there is also nothing inherently meritorious in it. Claims of superiority cannot be based on emulation. What is needed is innovation – not only in contractual form but also and mainly in economic substance. This is not a new message, but it has recently gained in relevance in two respects:

- The latest achievements of contractual engineering have driven Islamic finance much closer towards conventional finance than ever before. If this trend continues, Islamic finance runs the risk of losing its own systemic qualities and of lapsing into a mere niche market of the global financial system where universal products are sold in a local Islamic dressing.
- The new financial architecture after the current crisis will most probably provide more restrictive regulations regarding risk-taking, leveraging, securitisation and structured finance for all types of financial institutions (conventional as well as Islamic).

With a more restricted set of (conventional) instruments, competition will become tougher – not only in the conventional sector, but also between the conventional and the Islamic sector as well as within the Islamic banking industry. The return on conventional instruments (straightforward or in emulated Islamic forms) will come under pressure. Therefore, it should be in the best interests of Islamic financial institutions to develop more genuine Islamic financial products with economic features that do not replicate conventional ones. Islamic banks must look for financial and economic innovations which better reflect the ethical and social dimensions of Islamic finance (in contrast to a mere formalistic *Sharī'ah* compliance). Islamic banks may be able to gain a competitive edge in the widely neglected field of participatory finance for projects in the real economy. A crucial success factor for the success of venture capital finance or private equity initiatives is the expertise of the human capital of a bank. In their search for new forms of participatory financing, Islamic banks could gain first mover advantages if they anticipate early the new competitive environment in their countries and markets.

Islamic banks should start a bold initiative to develop new forms of participatory financing with innovative risk and return characteristics which are inspired by *Sharī'ah*-compliant contracts from domains other than trade and finance – for example, by share-cropping contracts as traditionally applied in agriculture. *Sharī'ah* scholars and bankers have developed a remarkable inventiveness for the emulation of conventional products. It may be a task of Muslim economists to come forward with new *Sharī'ah*-inspired products and techniques with unique risk/return characteristics. *Sharī'ah* scholars must then combine their legal creativity with established methods of legal reasoning for a *Sharī'ah* sanctioning of economically innovative instruments. However, the creative work of *Sharī'ah* scholars should become more public and transparent. For example, *Sharī'ah* scholars should always publish a legal opinion together with its rationale. This would allow, *inter alia*, a better rational control of the *Sharī'ah* system, a better support of its systemic consistency, a faster correction of errors, and a better identification of legitimate irreconcilable differences. It could also help to extend the reservoir of scholars with profound knowledge and understanding of *Sharī'ah*, banking and economics.

Such a process of genuine innovations in Islamic finance could be supported by the central banks, which have the power to design effective and efficient tools for the liquidity management of Islamic banks and for the establishment of a *Sharī'ah*-compliant interbank money market. If central banks help to solve the problems of liquidity management – as they do for the conventional sector – they would create a level playing field on which Islamic financial institutions can develop more stable, resilient and just products and techniques which can promote economic welfare and be profitable at the same time. This would be a real progress compared to the present state of affairs and it could contribute to the emergence of an Islamic financial system with genuine economic qualities.

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## CHAPTER TWO

### ISLAMIC FINANCE AND FINANCIAL CRISIS: IMPLICATIONS FOR *TAKĀFUL*

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#### I. Introduction

While the last decades of the 20th century saw the emergence of Islamic banking as a significant development in a number of predominantly Muslim countries, *Takāful* (Islamic insurance) has been slower to emerge. This is in spite of the fact that schemes for mutual protection against losses have traditionally existed in Islamic societies. As will be seen from the analysis presented below, modern versions of such schemes face a number of highly complex juristic<sup>1</sup>, institutional, legal and regulatory issues some of which are far from being resolved.

The first modern *Takāful* undertaking was founded in Sudan in 1979. Its foundation was due to the solution by a Sudanese *Sharī'ah* scholar<sup>2</sup> of a juristic problem: how may the *Sharī'ah* prohibition of trading in insurance (and in indemnities and guarantees more generally) be overcome? Part of the solution lies in the adoption of a mutual structure for underwriting insured risks: the insureds (participants) mutually insure one another, on a non-profit basis, according to the principle of *Takāful* (the Arabic word for 'solidarity'). Another aspect of the solution consists of characterising the policy contributions (premiums) to the risk fund as incorporating an element of conditional and irrevocable donation (*tabarru'*), the donor making the contribution to the risk fund subject to being entitled to benefit from mutual protection against insured losses. The fact that the premium contribution incorporates *tabarru'* is considered to mitigate the element of *gharar* (contractual uncertainty) in the transaction, which is a forbidden element making the transaction non-*Sharī'ah* compliant (as the contribution would be made in return for an uncertain benefit). According to the Maliki school of thought, *gharar* in *tabarru'* is permissible, and this view has been widely accepted as a basis for *Takāful* insurance.

However, the adoption of a mutual structure runs into two kinds of institutional obstacles. First, the legal systems of many countries do not accept mutual or cooperative forms of company without share capital. Second, even if such forms of

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<sup>1</sup> The term 'juristic' is used here to refer to issues of *Sharī'ah* commercial jurisprudence (*Fiqh al Muamalat*), as distinct from matters of secular law.

<sup>2</sup> Professor Al-Sideeq Mohammed Alamin Al-Dareer.

company are accepted for insurance undertakings, they need to be able to raise enough capital from policyholders to meet regulatory capital adequacy and solvency requirements. To surmount these two obstacles, the vast majority of *Takāful* undertakings have a two-tier, hybrid structure in which the risk funds operate on a mutual basis but are managed by a *Takāful* operator, which is a company with shareholders. However, this hybrid structure involves complexities and raises juristic and legal issues which are yet to be satisfactorily resolved. These are discussed in the sections below.

So far as financial crises are concerned, *Takāful* undertakings are not exposed to credit default swaps, which are not permissible according to the *Sharī'ah*<sup>3</sup>. This protects them from the kind of inter-sectoral risk spill-overs from the banking sector which caused such havoc in the US insurance sector. They are, however, exposed to asset risk, liquidity risk and risk concentrations that may make them vulnerable. The exposure to asset risk is related to *Sharī'ah* restrictions on the asset classes in which they may invest. These may lead them to invest more heavily in real estate assets than do conventional insurers. This will affect Life (Family) *Takāful* and Non-life (General) *Takāful* with long-tailed business. The dearth of *Sharī'ah*-compliant liquid assets may also induce them to place funds in profit-sharing investment accounts with Islamic banks (including those in the same financial group), which are potentially more risky than conventional liquid assets.<sup>4</sup> Also, *Takāful* undertakings that operate mainly on a regional basis may be exposed to geographical risk concentrations on the liabilities side.

In addition to the need to overcome juristic and institutional problems, the development of *Takāful* is inevitably constrained by the economic and social development of predominantly Muslim countries, which affects the market for and the propensity (especially at the retail level) to take up insurance cover. At the same time, *Takāful* can contribute to economic development at the micro level by enabling more efficient risk management by firms and households, and at the macro level (particularly in Life or Family *Takāful*) by mobilising savings and providing funding for investment in long-lived assets.

## **II. Business Models**

### **A. Basic Structure**

*Takāful participants* (TPs) are individuals (or institutions) who enter into a *Sharī'ah*-compliant scheme of mutual risk cover. In contrast to the emergence of conventional mutual insurance since the 18th century, the Islamic solidarity arrangements of today are initiated and managed by *Takāful operators* (TOs), which are commercial corporations (joint stock companies). Thus, the *Takāful* business

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<sup>3</sup> A form of *Sharī'ah*-compliant credit insurance has been developed by ICIEC, an operation that is part of the Islamic Development Bank.

<sup>4</sup> See Tolefat (2009).

(risk cover and investment) is executed in *Takāful undertakings* with a hybrid structure consisting of a commercial management company (the TO) and a separate risk fund or underwriting pool, the *Participants' Takāful Fund* (PTF).

The TPs pay contributions to the PTF from which compensations and operating expenses have to be financed. The contributions of each TP are contractually fixed and recorded in the *Participants' Risk Accounts* (PRAs; in Malaysia: *Participants' Special Accounts*, PSAs); the *Takāful* contracts also specify the (monetary value of) claims in cases of damage. While conventional insurance policy holders buy a risk cover from and transfer the “ownership” of the money they pay to the insurance company, the TPs remain the owners of the PTF. In *Takāful* it is not an insurance company but the TPs themselves who provide mutual risk cover out of their PTF. The TO only manages the underwriting and investments on behalf of the TPs. Underwriting surpluses and investment profits belong to the TPs, who also should bear deficits and losses (except for cases of misconduct and negligence of the TO). In practice, however, TOs are forced by law in many countries to provide an interest-free loan (*Qarḍ hasan*) if the underwriting leads to a deficit in the PTF. This loan is to be recovered from future underwriting surpluses. The mandatory *Qarḍ* facility requires sufficient *shareholders' funds* (SHF) of the TO.

The structure outlined so far was for General *Takāful*, i.e. for the *Sharī'ah*-compliant alternative to non-life insurance. For the alternative to life insurance – called Family *Takāful* – the *Participants' Investment Fund* (PIF) has to be added (see Table 2.1). Family *Takāful* contributions comprise, in addition to the risk component, a savings and investment component which is credited to the individual *Participants' Investment Accounts* (PIAs). This portion of the contribution is not part of the mutual risk cover. It is invested in order to build up wealth for the participant in case of survival or for the beneficiaries in case of death. The TO is responsible for the profitable investment of this part of the *Takāful* contribution.

**Table 2.1**  
**Comparison between General *Takāful* and Family *Takāful***

| General <i>Takāful</i>                                   |   |  |
|--|---|--|
| <i>Takāful</i> Operator                                  | Participants  |  |
| Shareholders' Fund (SHF)<br><i>(in need provision of</i> | Participants' <i>Takāful</i> Fund (PTF)<br><i>Qarḍ hasan)</i> |  |
|  | Participants' Risk Accounts (PRAs)                            |  |
| Family <i>Takāful</i>                                    |   |  |
| <i>Takāful</i> Operator                                  | Participants  |  |
| Shareholders' Fund (SHF)<br><i>(in need provision of</i> | Participants' <i>Takāful</i> Fund (PTF)<br><i>Qarḍ hasan)</i> | Participants' Investment Fund (PIF)      |
|  | Participants' Risk Accounts (PRAs)                            | Participants' Investment Accounts (PIAs) |

For third parties, a *Takāful* undertaking seems to be identical with the TO who enters into contractual relations with them. The PTF is a distinct entity only in the internal setting (relevant for the relations between the TO and the participants) but does not have a separate legal personality (relevant for relations with third parties). Only in Pakistan is a different arrangement possible: The shareholders of the TO have the option to dedicate capital to the formation of a *Waqf*, which transforms the PTF into a separate legal entity. The implications of this option will be discussed later.

The TO can decide freely on how to fulfil its contractual duties towards the *Takāful* participants. For example, the TO has the right to enter into re-*Takāful* (or even conventional re-insurance) arrangements. It is reported that some TOs have ceded up to two-thirds of their underwriting to re-insurance companies. This implies that most of the risk management is not done by the TO. It can also be questioned whether such a practice is compatible with the idea of a well-defined solidarity group formed by the participants of a specific *Takāful* fund. The participants' contributions are factually merged with others in a wider risk pool on the re-*Takāful* or re-insurance level. Another example of the outsourcing of duties is the asset management (especially for the savings part of Family *Takāful* contributions). This can be transferred explicitly or implicitly to an independent asset manager: explicitly, if this task is contractually assigned to another company; implicitly, if the TO places substantial parts of participants' funds in investment accounts with Islamic banks. Although there are no legal objections against such practices, it is difficult to reconcile them with the concepts of mutuality, donation and participants' ownership of *Takāful* contributions, and they raise corporate governance issues that are mentioned below and discussed at greater length in Chapter 4 of this book.

## **B. Standard Models and Variants**

The basic structure of a *Takāful* Undertaking is designed by the TO. From a regulatory perspective, a major concern is how the TO is remunerated for its services. Two standard models have emerged (which allow for variations in details) – the *Wakālah* (agency) *Model* and the *Muḍārabah* (profit-sharing) *Model*. Variants are the *Wakālah Model with Performance Fees* and the *Modified Muḍārabah Model*.

In practice, a combination of these two standard models is widely applied: the *Wakālah Muḍārabah Model*. It applies *Wakālah* principles to the underwriting (PTF) and *Muḍārabah* principles to the investment business (both with respect to reserves and excess resources in the PTF and to participants' contributions to the PIF). An even more specific arrangement is the *Wakālah Muḍārabah Waqf Model*, which is permissible and applied in Pakistan.

## **(1) *Wakālah Model***

In the *Wakālah Model*, all relations between the TO and the participants are based on an agency contract: the TO is the *wakīl* (agent) who acts on behalf of the participants (principal) both in underwriting and investment. The *wakīl*'s services in both fields are remunerated by fees which are contractually specified either as an absolute amount or as a percentage of the turnover (i.e. the volume of contributions or of invested funds), but not as a percentage of the profit of the undertaking. The fees must cover all management costs (not including claims and direct costs of claim handling) plus the profit for the shareholders.

### ***Wakālah Model with Performance Fees***

Turnover-related fees imply incentives for profit-oriented TOs to enhance the volume of contributions and invested funds while the performance in underwriting and investment does not have a direct impact on the income. This cannot be in the interests of the *Takāful* participants. Therefore, fees sometimes include "performance" elements, where performance is measured in relation to the underwriting surplus or the investment profit. This changes the incentive structure and governance problems considerably and brings them close to those of the *Muḍārabah Model* (see below). This becomes a problem especially if the performance element is strong and if higher underwriting surpluses lead to higher fees.

## **(2) *Muḍārabah Model***

In a *Muḍārabah* contract, one party (*rabb-ul-māl*) provides the capital (the participants) and the other party (*Muḍārib*) provides the entrepreneurial skills to manage the capital (the TO). Both parties share the profit generated from the employment of the capital in a pre-agreed ratio, while a loss has to be borne by the capital providing party alone. In case of a loss, the entrepreneurial efforts of the *Muḍārib* are not remunerated. In a pure *Muḍārabah Model*, the TO has to cover all its costs out of its profit share and must not charge additional fees. Proponents of the *Muḍārabah Model* initially subsumed under profit both the underwriting surplus and the investment profit. Meanwhile, however, *Sharī'ah* scholars clarified that the underwriting surplus is not a profit which can be shared between the TO and the participants (see below). This restriction makes the pure *Muḍārabah Model* factually useless for General *Takāful* where only relatively small amounts (reserves and temporary excess liquidity of the risk pool) are at hand for investments on a profit-sharing basis.

### **Modified *Muḍārabah Model***

Especially in the early years where reserves have not yet been built up in the PTF, the pure *Muḍārabah Model* implies a high risk for the TO. If claims exceed contributions – i.e. when the underwriting leads to a deficit – the TO will not only

receive no remuneration for its services but must also provide a *Qard hasan* to keep the PTF solvent. This may threaten the existence of the TO itself, especially if such a situation occurs in more than one year. Therefore, some *Takāful* arrangements allow the TO to charge not only the direct costs of claims handling, but also all management expenses to the PTF, before the underwriting surplus or deficit is calculated. Although the *Sharī'ah* compliance of the *Modified Muḍārabah Model* is questionable, it is applied in practice, and is also applicable to General *Takāful*. For the underwriting part, its incentive structures (and governance problems) are very similar to a *Wakālah Model with Performance Fees*. Therefore, it is possible to transform a *Modified Muḍārabah* arrangement into a commercially equivalent *Wakālah Model with Performance Fees* in order to avoid debates about the *Sharī'ah* qualities.<sup>5</sup>

The authorities in Malaysia have permitted the *Muḍārabah Model* for underwriting, but in most other countries it is frowned upon if not actually prohibited. The main juristic argument against it is that the underwriting surplus is not a profit which could be shared between the participants and the TO. It is the excess of participants' funds contributed for the specific purpose of mutual help, and any excess not needed for this purpose belongs exclusively to the participants and must not be shared with the TO. There is also an economic argument against surplus sharing: if the TO receives a share of the underwriting surplus, its remuneration increases with the size of the surplus (as in the *Muḍārabah Model* and in *Wakālah Models with Performance Fees* tied to the size of the surplus). Then the TO has an incentive to maximise the surplus. However, from the perspective of the participants, the optimal underwriting surplus would be (close to) zero (provided sufficient reserves have been built up). Any systematically higher surplus means that their contributions would exceed the risk equivalent level as determined by actuarial calculations.

### **(3) *Wakālah Muḍārabah Model***

The *Wakālah Muḍārabah Model* seems to have become the most widely applied arrangement for *Takāful*. It combines the *Wakālah Model (with Performance Fees)* for underwriting with the *Muḍārabah Model* for investment (in General and Family *Takāful*). From a TO's perspective, this model avoids the *Sharī'ah* disputes raised by *Modified Muḍārabah* in underwriting but allows for equivalent commercial results. It has the potential to combine the advantages of both standard arrangements for TOs. The flip side of this coin is that it also has the potential to maximise the governance issues from the participants' perspective.

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<sup>5</sup> Without going into any details, it should be noted that notwithstanding the use of the Arabic names of the traditional contracts, as developed by the early Islamic jurists (often called the 'nominate contracts' for that reason), all of the contracts as employed today are modern adaptations, and the fundamental question is how far modern adaptations can deviate from classical constructs and still claim *Sharī'ah* compatibility derived from the contracts of classical Islamic law.

#### **(4) *Wakālah Muḍārabah Waqf Model***

The structural difference between the *Wakālah Muḍārabah* and the *Wakālah Muḍārabah Waqf Model* is that the PTF gets the legal personality of a *Waqf*.

The *Waqf* comes into existence by a *Waqf* deed. The initiators of the *Takāful* scheme (i.e. the shareholders of the TO) provide the initial capital of the *Waqf*, which can be nominal. The purpose of this capital is not to ensure the solvency of the *Takāful* undertaking, but only to establish the *Waqf* as a legal personality. The funds needed for its operation are provided by the participants, and the solvency has to be backed up – as in the other models – by a *Qarḍ* facility.

The purpose of the *Waqf* is to support the beneficiaries in cases of damages and financial losses. *Takāful* participants donate their contributions to the *Waqf* and become its beneficiaries for the period specified in their donation contracts.

The *Waqf Model* has provoked a debate among *Sharī'ah* scholars which is still ongoing. The majority is particularly sceptical with regard to the permissibility of a *Waqf* with a nominal capital which is insufficient to support any beneficiary, and to temporary memberships based on term contracts. In addition to *Sharī'ah* arguments, the legal specificities lead to economic differences between the *Waqf Model* and the other models, with far-reaching conceptual implications. An essential feature of the *Waqf Model* is that the ownership of the donated funds is transferred from the participants to the *Waqf*. This establishes claims of the participants against the *Waqf*, but they lose other rights which are based on their ownership of funds in the other *Takāful* models. For example, the participants do not have any rights to the underwriting surplus. The surplus remains within the *Waqf*, and decisions on its appropriation are at the full discretion of the TO managing the *Waqf*. But participants also lose some obligations. In a conventional mutual insurance, participants have – at least conceptually – an obligation to make further contributions (i.e. pay calls) when the risk pool runs into a deficiency. Conceptually, *Takāful* participants have similar obligations.

However, this obligation may not become fully effective: the obligation to make further contributions is cushioned in *Takāful* insofar as the shareholders of the TO are obliged to provide a *Qarḍ*. In theory, the same *Takāful* participants who benefited from this loan should also repay the *Qarḍ* so that they bear the deficiency. In practice, the payback of a *Qarḍ* cannot take place in the same period as that in which the deficiency occurred, but only later. By then, most probably the composition of the solidarity group will have changed, implying that those who benefited from the *Qarḍ* and those who are burdened with the payback are not fully identical. Therefore, it is not the obligation of each participant individually<sup>6</sup> but of the PTF as such to repay the *Qarḍ*. In the worst case, it may not be possible to recover the *Qarḍ*

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<sup>6</sup> The participants may not even have an explicit clause in their contracts regarding additional contributions in the case of an underwriting deficit.



if potential participants shy away from a PTF that is burdened by the need to recover a former deficiency. Thus, in the last instance, the shareholders of the TO bear the deficiency.<sup>7</sup> The *Waqf Model* is clearer with respect to obligations in the case of an underwriting deficiency: the PTF is established as a separate legal entity which receives and has to pay back the *Qard*. But this legal precision does not change any of the underlying economic relations. It is not the *Waqf* (with nominal capital), but only future participants, that can repay a *Qard*; otherwise the TO's shareholders will suffer a loss.

While the participants' obligation to make further contributions in case of an underwriting deficiency does exist – although somewhat blurred – in the standard models, such an obligation does not exist in the *Waqf Model*, where the *Waqf* is a legal personality that benefits from and has to repay the *Qard*. This eliminates the essential feature of mutuality in risk protection and raises the question: What is the basic conceptual difference between *Takāful* based on *Waqf* and conventional insurance? If policyholders or participants are not locked into long-term insurance or *Takāful* contracts but have periodic options to change their insurance or *Takāful* providers and products, it is highly probable that in a competitive environment underwriting deficiencies could be recovered from future premiums or contributions. If reserves are not available, and the theoretical recourse to the previous policyholders or participants is ruled out by the *Waqf* construction, then deficiencies must ultimately be borne by the shareholders of the TO. This is the same as in a conventional proprietary insurance. Thus, no substantial economic differences remain in the underwriting business between conventional insurance and a *Waqf*-based *Takāful* scheme.<sup>8</sup> The *Waqf Model* looks and feels as if participants are not members of a solidarity group based on the principle of mutuality, but rather as if they have just purchase a risk cover policy from a legal person without any further individual obligations and rights.

The *Waqf Model* is permissible and practised in Pakistan. However, the practice differs among the existing *Takāful* Undertakings, and the conceptual debate has not yet come to a final conclusion – although it seems that a majority of *Shari'ah* experts reject the model.

### **(5) BancaTakāful**

Another business model is *BancaTakāful*. It is not fundamentally different from the previous models at the core, but is distinct in the combination of features with governance implications. TOs utilise different channels for the selling of their *Takāful* products – for example: employed sales personnel, independent brokers, and telecommunication tools (internet). A distribution channel which is becoming

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<sup>7</sup> This looks reasonable if the deficit is due not to adverse market trends or an unforeseeable general increase of damages, but to the poor management of the TO.

<sup>8</sup> Differences in substance may be found with respect to the asset management, which has to observe criteria of *Shari'ah* compliance in *Takāful*. But the claim that *Takāful* is fundamentally different from insurance, is only of limited relevance.

increasingly more popular in conventional insurance, as well as in *Takāful*, is the branch network of banks (conventional or Islamic). This distribution channel offers benefits to TOs, banks and customers as well.

- Customers increasingly look for comprehensive financial services at one point of sale (e.g. money transfer, house financing, insurance/*Takāful* products, savings schemes, wealth management, etc.). A convenient point of sale can be (the branch of) a bank.
- Banks meeting such customer expectations by selling *Takāful* products not only contribute to customer satisfaction, but also open up new sources of revenue (mainly from fees and commissions).
- TOs get access to a large pool of potential participants and benefit from the reputation and knowledge of a bank as distribution partner.

In practice, three *BancaTakāful* arrangements are applied which differ with respect to the relation between the bank and the TO:

- The Islamic bank sells *Takāful* products of *independent third party* TOs under the brand names of those TOs. It is apparent to the customers that the bank acts only as a broker for those *Takāful* products.
- The Islamic bank sells *Takāful* products under its *own brand name*. The first variant is that the bank provides *Takāful* services through a TO which is its *own subsidiary*. Even if this TO is legally and commercially independent from the bank (which is a regulatory requirement in most jurisdictions), the bank – or, more precisely, the shareholders of the bank – can determine the business of the TO. This justifies the expectation of customers that the bank and the TO operate on the basis of a consistent set of management rules, disclosure policies, reporting standards, *Sharī'ah* interpretations, business ethics, governance procedures, etc.
- The Islamic bank sells *Takāful* products under its *own brand name*. The second variant is the distribution of *Takāful* contracts which are produced by an *independent* TO in cooperation with a *White Label Service Provider* (WLSP, see below). For the customer, the difference between the first and second variant is hard or even impossible to recognise, and he or she may have the same expectations regarding consistency of basic principles and procedures. However, these expectations are much harder to satisfy because the views of three legally and commercially independent partners with different shareholders have to be reconciled.

Although the *White Label BancaTakāful Model* does not induce fundamentally new governance issues, its complexity and the coordination needs are much higher than in the other business models. A distinctive feature of *White Label BancaTakāful* is that an Islamic bank sells under its own brand name a *Takāful* product which combines basic administrative services of a local TO and conceptual and managerial services provided by an independent financial service provider, the WLSP. More specifically:

- The Islamic bank does not only sell the white label *Takāful* product through its own personnel and other channels (telephone, internet). It can also influence the investment portfolio (e.g. by including its own mutual funds into the funds selection model of the WLSP), and it is the custodian of the participants' assets.
- The local TO holds the licence needed to create the *Takāful* product for the Islamic bank by complementing the services of the WLSP with its own input, which includes the processing of customer applications, the administration of the product in accordance with local regulatory requirements (including accounting and reporting), and the valuation and handling of claims. The basic structure can be a *Wakālah* or a *Muḍārabah Model*. If the local TO is an independent company (as it actually is in most cases), it can also offer *Takāful* products on its own (under its own brand name).
- The services of the WLSP are essential and include the design of the product, the assurance of its *Sharī'ah* compliance, the risk assessment, and the provision of a powerful tool for the asset management (such as a dynamic funds selection and allocation model) which can be customised to specifications of the Islamic bank. The WLSP may also provide additional services such as a web-based point of sale application processing tool with immediate individual risk assessment or customer data access facilities. Further, the WLSP can negotiate re-*Takāful* arrangements.

A WLSP usually cooperates with only one Islamic bank and one TO per jurisdiction, but in several jurisdictions. In this respect the WLSP is a global player. *White Label BancaTakāful* is established in Family *Takāful* – that is, in *Takāful* contracts with a savings component (and with unit-linked investments).

### III. Business Structures and Regulatory Implications

A particular focus of this chapter is on the relations between the TOs and the participants in different business models and the respective regulatory concerns. Regulation may become necessary where market discipline cannot bring forth an effective protection of the consumers – that is, the *Takāful* participants. It is assumed that *Takāful* participants are interested in:

- the financial solidity and solvency of their *Takāful* scheme,
- contributions which are risk equivalent (based on actuarial calculations) and allow for a reasonable build-up of reserves;
- an underwriting performance which does not worsen the quality of the risk pool (by adding poorer risks to the solidarity group for the sake of higher fees or larger underwriting surpluses); and
- adequate information about other financial institutions and service providers which contribute essential components to their *Takāful* product.

## **A. Risk Management and Investment**

Regulatory regimes for insurance typically include restrictions on the right to invest in the riskier asset classes. A more recent approach, followed in the European Union directive Solvency II, is to replace such restrictions by an asset risk reserve that is part of the minimum capital requirement, which implies an explicitly risk-based approach to supervision. However, the emerging market countries where most *Takāful* undertakings are based mostly do not have regulatory regimes for insurance that take appropriate account of investment risk, let alone regimes that allow for the particular risk characteristics of *Takāful* undertakings.

## **B. Capital Adequacy and Solvency**

As noted above, the participants' risk funds in *Takāful* undertakings will typically not contain sufficient reserves (participants' equity) to meet regulatory solvency requirements. There seems to be a widespread assumption that the capital of the TO is available to stand behind the risk funds. Indeed, in a jurisdiction where mutual forms of company were accepted, the TO as a company with shareholders would arguably have no *raison d'être* other than the provision of capital backing to the risk funds.

From a *Sharī'ah* perspective, however, the TO is not permitted to take on underwriting risk in return for a reward. On the other hand, to do so for no reward would hardly be fair to the shareholders, whose capital would be put at risk. An ingenious way around this dilemma, as indicated in the previous section, has been found in the form of a *Qarḍ* facility offered by the TO to the *Takāful* risk funds. As any such loan is repayable out of future underwriting surpluses, making it does not *per se* constitute exposure to underwriting risk. The operator is not entitled to any return on the loan, but receives a fee for managing the underwriting of the risk funds.

Various issues, in addition to those already mentioned, arise in connection with this *Qarḍ* facility.

- Since the operator presumably has to hold capital to cover the amount of the *Qarḍ* facility offered, does the TO's right to earn a fee for managing the underwriting of the risk funds represent an appropriate reward for the shareholders?
- As a *Qarḍ* is a *benevolent* loan in *Sharī'ah* terms, making it available cannot be an obligation of the TO within the contractual structure of the *Takāful* undertaking. Any such obligation needs to be a regulatory requirement backed up by law (in case the shareholders seek to oppose its being made by legal action).
- How is the facility to be treated in evaluating the capital adequacy of the *Takāful* undertaking? From a *Sharī'ah* perspective, the loan cannot be

considered as being formally subordinated to the rights of other creditors, as the *Sharī'ah* requires all creditors to be treated equally, and does not permit subordination. However, the intention in making the loan is clearly to enable the risk fund to meet its obligations to claimants and hence to avoid insolvency; thus, the obligations to claimants in this case would be met prior to any repayment of the loan. But if the fund subsequently has to be wound up or go into run-off, what then is the status of the loan? The answers to these questions may affect the treatment of the *Qard* facility in meeting regulatory solvency requirements.

Other questions arise with regard to the winding-up of an insolvent *Takāful* operator. To what extent, if at all, are the assets of the participants' risk funds available to meet claims of creditors of the operator? It might seem obvious that these assets would be "ring-fenced" against such claims, as according to the *Sharī'ah* they belong to the participants (or in the *Waqf* model, to the *Waqf*), not the shareholders. However, given that the secular law might not recognise these funds as separate entities from the TO, it may not make the distinction which is clear in the *Sharī'ah*, and thus there might be no "ring-fencing".

Such considerations regarding the capital of the undertaking, and how its solvency may be evaluated, are also highly relevant, for the infrastructure applicable to them is not yet well understood in a number of jurisdictions.

A further point concerns the treatment of underwriting surpluses, particularly in General (non-life) *Takāful*. As noted above, in the structures of some *Takāful* undertakings, the TO is entitled to a substantial share of underwriting surpluses, as though they are part of profits (which, in a mutual structure, they are not). In addition, it is quite common for distributions to be made to policyholders out of underwriting surpluses. Given that a major issue with regard to the solvency of *Takāful* undertakings is the lack of participants' equity and the consequent dependence on a *Qard* facility from the TO (which raises the various problems mentioned above), it would seem desirable for underwriting surpluses to be retained in the risk funds so as to build up participants' equity, and for the regulatory framework to encourage, if not to require, this. Conventional mutual insurers have typically followed such a policy, which enabled them to build up the reserves permitting them to survive without any other capital backing. These crucial issues are discussed further below.

The concept of *Takāful* implies that all claims are settled out of the participants' contributions. Thus, it should be the participants who take measures to ensure the solvency of the risk pool. This could be achieved either by the participants accepting limits to their claims (determined by the sum total of contributions in the respective period) or by an obligation to pay additional contributions in case of need (or a combination of both). If these options are not appealing, an alternative for the participants is to pay regularly somewhat more than what is needed for the anticipated compensations in a given period and use the

extra to build up reserves as back-up capital for extraordinary damages (with high losses but a low probability).<sup>9</sup>

Suppose there is a desired (or required) level for this back-up capital based on actuarial calculations for irregular events with low probabilities and high losses. As long as the reserves have not reached this level – that is, especially in the early years of a *Takāful* scheme – they are too small to cover such irregular losses. If claims are not to be limited, additional payments are the only way out. For many practical reasons, these additional payments can only come from *future* contributions. This creates the need for bridging finance, and it is consistent for regulators to require this – in the form of a *Qard* – from the TO.

For each period the solvency of the PTF should be guaranteed by the reserves and the *Qard* facility. If a risk pool in deficit is not in a position to get *Sharī'ah*-compliant bridging finance from the capital market or from an Islamic financial institution, then the equity of the TO must be sufficiently large and invested in assets which allow the provision of the *Qard*. As a consequence, regulators should set capital adequacy standards accordingly.

- It is appropriate that the TO's shareholders expect some remuneration for the provision of back-up capital for emergencies. It should be noted, however, that an increase in reserves implies a decrease in the need for TO's equity as back-up capital. In the extreme, the TO's equity could be released completely from being back-up capital once the reserves have reached the desired (or prescribed) level.
- If the participants participate not only in one *Takāful* scheme for one specific type of risk, but in several schemes for different and uncorrelated risks, it would be possible to pool reserves and achieve the same back-up level with less funds compared to segregated reserves of isolated PTFs.<sup>10</sup> If a TO manages separate risk pools in such a way that synergies can be realised and reserves are used more efficiently (without a transfer of regular risks between the different PTFs), this is a service of the TO which deserves some remuneration.

It is debatable whether and how these features should be reflected in the remuneration structure of the TO. In any case, disclosure rules should induce the dissemination of information on the remuneration structure of TOs (in a format comparable between TOs and comprehensible to *Takāful* participants) in order to stimulate competition.

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<sup>9</sup> The reserves could be built up by not returning an underwriting surplus (and profits from the investment of risk pool funds) to the participants in full, but retaining and transferring part or all thereof to the reserve. This is common practice in conventional mutual insurance.

<sup>10</sup> This also implies that each fund requires less equity – or that a TO can operate more PTFs with the same amount of equity.

### **C. Transparency, Disclosure and Business Conduct**

Transparency and disclosure provisions serve two purposes. On the one hand, they are a prerequisite for comparisons of products and services, and they facilitate informed choices of consumers. On the other hand, they are needed for a better understanding of the functioning and for an evaluation of the systemic qualities of *Takāful* business models as alternatives to conventional insurance. Both dimensions have regulatory implications.

#### **(1) Multiple Fees and Charges**

A *Takāful* contract of a TO in the Gulf region serves in the following as a concrete example of a contract allowing for a multitude of fees which together constitute strong incentives to expand the number of participants and the volume of contributions. The TO benefits from a high volume of underwriting due to:

- an *upfront payment* in the first year, calculated as a percentage (30-60%) of the first year's contribution;
- annual *Fund Management Charges* of 1.5% of the value of the funds under management; and
- *Contract Administration Charges* of 0.25% of the fund value.

Further, an increasing volume of underwriting implies an increase in the volume of contributions to the risk pool (PTF), which are the basis for the calculation of the periodical *Wakālah fee* of 25% of the risk charges (contributions to the PTF). If the management feels the need to increase the risk charge element of the contributions for whatever reason without altering the percentage for the *Wakālah fee*, the TO benefits from this increase – irrespective of whether or not management expenses have also increased.

Finally, the TO receives a *share* of 30% of the *profits* earned by the investment of the PTF. The remaining portion of the investment profit belongs to the participants but is not paid out to them; instead, it is retained in the PTF until the event of death, surrender or maturity. These retained profits can be invested again with a profit share for the TO.

Most components of the remuneration of the TO are directly proportionate to the volume of *Takāful* contributions collected from the participants. TOs with such a remuneration structure have strong incentives to increase the volume of contributions – both by an increase in the number of participants, as well as by fixing contributions above the risk adequate level.

- In conventional insurance, sub-marginal risks (when expected future claims exceed cumulated premiums) have a negative impact on the long-term income of the insurance company. In a *Takāful* scheme, this long-term effect

burdens not the TO but the participants (especially if they are factually locked in by contracts). As a consequence, and for identical risk populations, the number of *Takāful* participants accepted and the total amount of contributions paid will, other things being equal, exceed the number of conventional policyholders and the total amount of insurance premiums.<sup>11</sup>

- The fixing of contributions above the risk equivalent makes sense for the TO even if an “excess” (underwriting surplus) will be returned to the participants. The reasons are:
  - (1) All the multiple fees and charges are levied on the basis of the contributions including the excess, and they are final and will not be corrected at the end of the period when an excess is refunded.
  - (2) If there is a performance fee which is related to the underwriting surplus, this fee will further reduce the amount available for refund.
  - (3) The participants will forgo that share of profits from the investment of the excess which is due to the TO as fund manager. If this share is high, or if the investment is less profitable than alternative investments, the participants forgo returns which they might have achieved if they invested the excess on their own.

It can be questioned whether specific regulatory action is justified. If competition were effective in the *Takāful* market, excessive underwriting and overcharging would not be sustainable. However, as long as transparency is generally low, consumers lack in education in and experience with insurance products, information asymmetries prevail, and the number of TOs is very limited, at least some milder forms of regulation (e.g. disclosure requirements) could be considered.

## **(2) Commissions (in Family *Takāful*)**

In Family *Takāful*, the commission to be paid to the distribution partner poses a major problem. The commission is generally calculated as a percentage of the underwritten amount, including the savings component of a contract. For long-term contracts, this commission is usually paid upfront after the contract has become effective. The commission payment may well exceed the total amount of the participants' contributions in the first year(s). As a result, the surrender value of conventional life insurance policies is very low or even zero in the early years. Unlike in conventional insurance, the savings element of the contributions of a *Takāful* contract cannot be used for commission payments. If the commission has to be paid out of the underwriting element only, even a fee which absorbs fully this part of the contributions of the first year(s) – and therefore looks excessive from the participants' perspective – may not be sufficient to cover what is due to the distribution partner. This problem of an excessive absorption of risk contributions by

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<sup>11</sup> It is assumed that the individual payments for the risk cover are identical for *Takāful* and conventional insurance.



commissions could be mitigated by a participation of the TO in the underwriting surplus (and in the profits of the short-term investment of the surplus funds). Against this background, it is not surprising that the *(Modified) Muḍārabah Model* is most popular with TOs mainly engaged in Family *Takāful* (as in Malaysia), and that a high underwriting surplus is desirable for these TOs. But this does not invalidate the *Sharī'ah* critique of surplus sharing, and it also does not take into consideration the long-term interests of the participants. They will benefit neither from risk contributions far above the risk equivalent nor from a membership that goes well beyond the optimal size.

An alternative to surplus sharing could be to pay the commission not upfront but *pro rata* over the term of the contract. But if *Takāful* products compete with conventional insurance policies for the support of distribution partners, and if conventional insurers pay commissions upfront, TOs would be at a serious disadvantage. To overcome this problem, initiatives are being launched to develop a *Sharī'ah*-compliant scheme for the transformation of future *pro rata* payments into an upfront lump sum payment.

### **(3) Complexity of Structures**

The *White Label BancaTakāful Model* is the best illustration of the possible complexity of the construction of *Takāful* products. If a product is sold under a specific brand name, the buyers should get at least some basic information on essential contributions from other parties. If their reputation is as good as that of the selling bank, such a disclosure could even be used for marketing purposes by the bank itself. But if this is not the case, or if some components are contributed by providers which have a good reputation within the industry but are hardly known to anybody else, disclosure regulations may be needed to create a minimum of transparency. This is also true for less complex but equally opaque relations between the original TO and re-insurance or re-*Takāful* companies (and their respective business models).

Transparency of complex structures is a precondition for an assessment of the systemic (and ideological) qualities of a *Takāful* system. It is clear that the modern *Takāful* system with multiple actors and anonymous markets is moving away from the ideal of traditional (Islamic) solidarity in small communities, and also presents differences from solidarity or mutuality in underwriting as understood in conventional mutual insurance. For the hybrid *Takāful* undertakings, regulatory standards are still in the formative stage.

The insurance industry generally, and life insurance in particular, does not enjoy the best of reputations for the quality of its conduct of business, the most notorious failings being in the area of product mis-selling. *Takāful* is not exempt from the dangers of such failings, particularly in view of the complex and somewhat ambiguous structure of *Takāful* undertakings, and the resultant questions regarding policyholders' rights. Moreover, as indicated above, *Takāful* undertakings may be

exposed to a particular type of insider dealing, when the TO invests policyholders' funds in the equity of companies that are significant shareholders of the TO company.

#### **D. Corporate Governance**

In contrast to policyholders in a conventional mutual insurance company, who are the owners of the company, participate in General Meetings and have the right to remove the management, *Takāful* participants have no such governance structures or rights, although in principle they are exposed to similar insurance risks. In fact, *Takāful* participants seem to have no more governance rights than the policyholders of a conventional proprietary insurer, and (in the absence of supervisory action backed up by appropriate regulation) must rely on market competition to get a fair deal and good value for money in their dealings with the TO. Yet, typically, there are not many competitors in each national market for *Takāful*, so market competition may not provide much protection.

The use of the classical *Fiqh* contracts, notably *Muḍārabah* and *Wakālah*, in *Takāful* structures has had the effect that such structures give virtually unfettered power to the operator, subject to the governance rights of shareholders, and make no provision for any governance rights of participants. The only restraint on the powers of the operator in its dealings with participants lies in its fiduciary duty to them. In the circumstances, one must expect the operator to give the interests of its shareholders priority over those of participants. The implications of this for insurance supervisors are discussed below.

Corporate governance problems of conventional insurance are not solved in *Takāful*, and the need for regulation is not less here than in conventional insurance. The ideological dimension of *Takāful* even adds some governance issues which do not exist in conventional insurance: the participants are the owners of the funds which the TO manages on their behalf. Compared to conventional insurance companies and mutuals, the risk/reward and control structure in *Takāful* undertakings is heavily biased against the *Takāful* participants (as ultimate risk bearers and owners of the PTF) and in favour of the shareholders and managers of the TO:

- It is not the participants, but the management of the TO, that took the initiative to establish the undertaking. It was not a group of participants who searched for managers for an existing solidarity fund; rather, it was the managers who looked for participants to create a new solidarity fund.
- All crucial decisions – such as the establishment and design of the *Takāful* scheme, the choice of the business model and risk strategy, the determination of the *Takāful* “donation” (premium contribution), the asset management, and the allocation of surpluses and profits – are taken by the managers of the TO.

- It is not the *Takāful* participants, but the shareholders of the TO, who appoint and dismiss the TO's managers, define the performance criteria for them, and reward or sanction management decisions.
- Because of the separation of the *Takāful* funds from those of the TO, the participants do not have any institutionalised influence on even the most crucial decisions of the TO. In the terminology of the principal – agent theory: the participants only have (at best) an “exit” but no “voice” option. The corporate structure of the *Takāful* system does not reflect the ownership of the participants in any significant way.<sup>12</sup>

This would not constitute a serious problem if the incentive structure were such that the TO is factually forced by its self-interest to act in the interest of the participants. Since this is not the case, regulations should require a more balanced representation of the interests of *Takāful* participants in the governance bodies of *Takāful* undertakings. The practice in Sudan may serve as an example. Modifications of the institutional setting – which are not specific to a particular business model – are discussed by the industry and regulatory bodies. Several proposals have been made on how to implant participants' interests into the governance structure:

- The *role and autonomy of the actuary* in the determination of risk adequate contributions, the desirable level of reserves, etc. should be strengthened. Actuarial recommendations should be of a more binding character. However, independent external actuaries are in short supply and their services are rather costly. This can impede *Takāful* undertakings in competition with conventional insurers. Issues of confidentiality of relevant information will complicate the setting further. If, therefore, only employed actuaries are available, conflicts of interest are inevitable and a formally strengthened autonomy is by no means a guarantee for a more balanced consideration of participants' interests in management decisions.
- Another proposal is to extend the *mandate of the Sharī'ah board* and to assign to it the role of a custodian of participants' interests. This proposal suffers not only from the shortage of *Sharī'ah* scholars and their high fees. It further assumes an acquaintance of experts in Islamic law with commercial strategies and procedures, which cannot be taken for granted.
- The most promising suggestion is that the Board of Directors (BoD) should set up a *Governance Committee* (GC) to give policyholders' interests more consideration in management decisions, as is proposed by the Islamic Financial Services Board (IFSB)<sup>13</sup>. The GC should comprise at least three people, including an independent non-executive director who should act as a kind of advocate for the *Takāful* participants. It is debatable whether this director should be a *Takāful* participant or not, and if not, whether a representative of the *Takāful* participants should be added to the GC (with a

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It seems that the Sudanese model is the only exception to such a structure.

<sup>13</sup>

See Islamic Financial Services Board (2009a).

status different from that of a director). A direct representation of the participants in the GC would be difficult to organise – it requires not only participants with specific expertise, but also a selection mechanism by which suitable candidates would be chosen by a kind of (annual?) general assembly of participants. The GC should oversee the implementation of a governance policy framework and monitor the financial management of the *Takāful* undertaking (including the fee structure, reserve policy, risk and asset management, and surplus and profit-sharing).

The character of *Takāful* undertakings as hybrids introduces additional and more complex governance issues compared to conventional insurance. These issues should not be ignored by regulatory authorities, but procedural and structural rules and regulations specific to *Takāful* are still rare exceptions. In most jurisdictions, the same legal requirements with only minor adjustments are applied to both *Takāful* and conventional insurance. This must not be the last word, because competition can hardly be considered effective while a rapid expansion of the industry is anticipated. Under such circumstances, consumer protection should not be left to market forces alone.

#### **IV. Conclusions: The Structure of *Takāful* Undertakings and Unresolved Issues in the Context of the Financial Crisis**

The origins of *Takāful*, as its name suggests, lie in forms of mutual protection against losses (solidarity) that existed traditionally in Muslim societies. Yet in many, if not most, of the countries in which *Takāful* is now developing, not merely are mutual forms of legal entity not recognised by company law, but the very concept of such entities is unfamiliar. Instead, regulators and legislators are aware of the structures of proprietary insurance companies. Consequently, a hybrid form of insurance undertaking has been developed for *Takāful*, in which the participants' funds operate on a mutual basis but are managed by a TO, which is a company with shareholders. This hybrid structure raises a number of issues, discussed above, that have yet to be resolved, with negative consequences for the quality of the legal and regulatory infrastructure for *Takāful*. From a corporate governance perspective, the respective rights and obligations of the policyholders and the shareholders need to be clarified.

The situation is further complicated by the fact that the participants' (policyholders') risk funds typically have not built up the reserves needed to meet regulatory requirements for capital adequacy and solvency, so that the issue arises of whether, or of the extent to which, the capital of the TO stands behind the participants' risk funds for regulatory purposes, given that the TO is prohibited by the *Sharī'ah* from taking on underwriting risk in return for a reward. In this context, the treatment of the assets of policyholders' funds and of shareholders' funds, respectively, in the event of the winding-up of an insolvent risk fund, or of an

insolvent TO, is a key issue with which the legal system needs to be able to deal equitably and in compliance with the *Shari'ah*.

Some emphasis may be placed on the need for regulators of *Takāful* to require greater transparency and public disclosure, and to promote and be able to place reliance on market discipline. Nevertheless, in an emerging market environment it is not evident how much faith may be placed either in market discipline or in competition as a substitute for regulation and effective supervision.

#### **A. The Need for, and Scope of, a Comprehensive Framework for *Takāful***

Earlier sections of this chapter have drawn attention to aspects of *Takāful* which are inadequately addressed by existing legal and regulatory frameworks that are not designed to cope with the specificities of *Takāful*. An appropriate framework needs to address the issues of:

- corporate governance and policyholders' rights;
- risk management and investment;
- capital adequacy and solvency; and
- business conduct.

It was noted above that, while the character of *Takāful* undertakings as hybrids gives rise to issues for regulators that are additional to, and in some ways more complex than, those raised by conventional insurance, procedural and structural rules and regulations specific to *Takāful* are still rare exceptions. Moreover, there are examples of national regulations for *Takāful* that fail to take account of the mutual character of underwriting in *Takāful* and the inappropriateness of treating a *Takāful* underwriting surplus as a profit of which the TO may receive a large share.

Developing an appropriate regulatory and supervisory infrastructure for *Takāful* represents a formidable challenge for the authorities in an emerging market environment. The IFSB has endeavoured to facilitate meeting this challenge by developing a series of guidelines which are briefly described below.

#### **B. The Work of the IFSB in Developing International Prudential Guidelines for *Takāful* Undertakings**

The IFSB has produced two standards and one exposure draft that are applicable to *Takāful* undertakings, two of which, on governance and solvency, are specifically intended for *Takāful*, while the third, on conduct of business, will be applicable to all Islamic financial institutions.

A major concern of the IFSB in drafting the *Guiding Principles on Governance of Islamic Insurance (Takāful) Operations* (IFSB, 2009a) was the protection of policyholders (participants), in the light of their lack of governance rights in a structure that includes shareholders with the governance rights to which

shareholders are normally entitled. Such a situation may well result in shareholders' interests being systematically given preference over those of policyholders. The idea of giving policyholders the right to participate in governance, by having the right to elect representatives to the BOD and to attend and vote at General Meetings, was not, however, pursued, even for Family *Takāful*. Under a *Muḍārabah* contract, the policyholders would be in the position of *Rabb ul māl*, and as such would have no right to interfere in management. Whether this prohibition extends to a role of oversight (which is not the same as interference) is not clear. The prohibition would also apply in the case of a *Wakālah* contract.

In any event, research has indicated that policyholders in conventional mutual insurance companies tend to behave passively rather than availing themselves actively of a right to elect directors and to vote at General Meetings. This implies that such a right would probably not afford *Takāful* policyholders effective protection of their interests. Instead, the *Guiding Principles* propose that the governance structure should include a Governance Committee, being a committee of the BOD but with only non-executive members. It is suggested that these include at least the following:

- an independent non-executive director (selected for the director's experience and ability to contribute to the process);
- a *Sharī'ah* scholar (possibly from the TO's *Sharī'ah* Supervisory Board); and
- an independent actuary.

One of the main roles of the Governance Committee would be to ensure fair treatment of participants.

The IFSB *Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services* (IFSB, 2009b) was also written with the protection of actual and potential *Takāful* participants' interests very much in mind. Apart from the issues arising from the complex structure of *Takāful* undertakings that were discussed above, and their implications for the protection of policyholders' interests, the life insurance industry more generally has had a poor record in recent decades in its treatment of customers, notably though the mis-selling of products that lack transparency and fail to meet policyholders' reasonable expectations.

The exposure draft of the IFSB guidelines on capital adequacy and solvency of *Takāful* undertakings (IFSB, 2009c) was at the stage of public exposure when this book went to press. However, the most knotty issues with which these guidelines need to deal have been discussed above. From a legal and regulatory point of view, the rules for the evaluation of solvency are set out as part of the regulatory framework of each jurisdiction. For the IFSB guidelines to be effectively implemented, some changes in these rules, to take account of the specific structural characteristics of *Takāful* undertakings, are likely to be necessary in a number of countries.

### C. Concluding Remarks

*Sharī'ah* prohibitions on the trading of debt and on conventional forms of credit insurance have provided protection to the *Takāful* sector from the gross deficiencies in credit risk management that resulted in the sub-prime mortgage securitisation *débâcle* and the need for one of the world's largest insurance companies to be rescued. Nevertheless, the *Takāful* sector has a number of vulnerabilities to which attention has been drawn in this chapter. In particular, the issue of solvency is problematic, as are those of risk concentrations and liquidity management.

Moreover, it should be borne in mind that mortgages based on *Ijārah* are securitised and the resultant *Sukūk* are tradable. Some of these (*Ijārah* asset-backed *Sukūk*) are without recourse to the originator or the issuer. Moreover, types of *Sharī'ah*-compliant credit insurance (based on *Takāful*) exist and may well develop so as to offer improved facilities for credit risk management in Islamic finance.

Hence, a scenario is conceivable in which: (a) unscrupulous agents or brokers arrange such *Ijārah*-based financing without normal credit criteria being applied to the *Ijārah* lessees; (b) Islamic banks agree to such financing, which they securitise without recourse in such a way as to avoid any credit risk; (c) the resultant *Sukūk* are traded and widely purchased by Islamic banks, among others; and (d) the real estate market enters a downturn in which the value of the underlying *Ijārah* assets is impaired. With respect to the subject of this chapter, favourable credit ratings helped by *Sharī'ah*-compliant credit insurance offered by *Takāful* undertakings might form part of such a scenario, and such undertakings would then be likely to find themselves in difficulty. Obviously, any such phenomenon would be on a far smaller scale than the conventional sub-prime mortgage securitisation crisis, but that should not be a reason for complacency either in regulation and supervision, or in risk management within *Takāful* undertakings.

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## **CHAPTER THREE**

### **EMERGING FINANCIAL ARCHITECTURE: IMPLICATIONS FOR ISLAMIC FINANCE**

**Professor Douglas W. Arner\***

#### **I. Introduction**

Over the past decade, Islamic finance has grown rapidly internationally and in an increasing range of domestic markets. At the same time, this growth has been paralleled and supported by the emergence of elements of an Islamic financial “architecture”, especially through the Islamic Financial Services Board (IFSB) and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and their development of standards for Islamic finance. During 2007–2009, Islamic finance was tested by the global financial and economic crisis. Unlike the global financial system generally (and especially Anglo-American finance), Islamic finance has held up well throughout. Nonetheless, the global financial crisis and the responses of the international financial architecture hold important lessons for the future development and stability of Islamic finance and the emerging Islamic financial architecture.

In analysing related issues, this chapter begins with a discussion of the development of the international financial architecture prior to the global financial and economic crisis of 2007–2009. This is followed by a description of the evolution of the emerging Islamic financial architecture, focusing on AAOIFI and the IFSB. From this basis, the chapter discusses the global financial crisis, the international responses and the implications for the international financial architecture. The chapter concludes with analysis of the possible implications of the global financial crisis for the future of Islamic finance and the international Islamic financial architecture, focusing on the twin objectives of financial development and financial stability.

#### **II. Evolution of the International Financial Architecture**

In the post-war period, politics, finance and law have been inextricably combined in the development of the international financial architecture. If one thinks of international financial law from a traditional positivist standpoint in which it would

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\* I would like to thank Simon Archer and V. Sundararajan for comments. All opinions, unless otherwise specified, are my own.

be seen as formal state-to-state legal relationships, we have seen remarkably little, given the importance of finance for the stability and development of both individual domestic economies and the international economy. In this context, international financial law would essentially comprise monetary, liquidity and surveillance arrangements through the International Monetary Fund (IMF) and the financial services provisions of the World Trade Organization (WTO) General Agreement on Trade in Services (GATS). Outside of these, financial law has generally been domestic in nature, though often operating in a cross-border context, with English and New York law being the dominant systems for financial activities. In general, private actors structuring their relationships under domestic law are the realm of private law and private international law, along the lines of an anarchic vision of international political economy. However, in between these two extremes is an ever-growing range of non-traditional activities, bringing together politics, finance and law, usually in the form of “soft law”<sup>1</sup> or “global administrative law”.<sup>2</sup>

In discussing the evolution of international finance and the international financial architecture, three major periods can be identified in which differing regimes and dynamics dominated arrangements respecting international finance:<sup>3</sup> the Bretton Woods period (1944–1973); the period of internationalisation (1974–1994); and the period of globalisation (1994–present). While it is possible that the global financial crisis of 2007–2009 will mark the end of the period of globalisation, it appears that rather than a shift to a different regime, the existing regime will be reformed to some extent and reaffirmed through increased legalisation.<sup>4</sup> At the same time, it remains possible that the current financial crisis will mark the beginning of a new period. Nonetheless, it does appear that the global financial crisis marks the end of US financial (and probably monetary) hegemony, replaced by an as yet unordered multi-polarity.

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<sup>1</sup> For discussion, see G. Bertezolo, “The European Union Facing the Global Arena: Standard-Setting Bodies and Financial Regulation”, 34(2) *European L. Rev.* 257 (2009); T. Meyer, “Soft Law as Delegation”, 32 *Fordham Int’l L.J.* 888 (2009); P. Verdier, “Transnational Regulatory Networks and their Limits”, 34 *Yale J. Int’l L.* 113 (2009); A. Hamann and H. Fabri, “Transnational Networks and Constitutionalism”, 6 *Int’l J. Constitutional L.* 481 (2008); S. Piccioto, “Constitutionalising Multilevel Governance?”, 6 *Int’l J. Constitutional L.* 457 (2008).

<sup>2</sup> For discussion, see B. Kingsbury, “The Concept of ‘Law’ in Global Administrative Law”, 20 *European J. Int’l L.* 23 (2009); S. Cassese, “Administrative Law without the State? The Challenge of Global Regulation”, 37 *NYU J. Int’l L. & Politics* 663 (2005); B. Kingsbury, N. Krisch and R. Stewart, “The Emergence of Global Administrative Law”, 68 *L. & Contemporary Probs.* 15 (2005); see generally [www.iilj.org/GAL/](http://www.iilj.org/GAL/). For application of the GAL approach to international financial regulation, see D. Zaring, “Rulemaking and Adjudication in International Law”, 46 *Columbia J. Trans’l L.* 563 (2008); M. Barr and G. Miller, “Global Administrative Law: The View from Basel”, 17 *European J. Int’l L.* 15 (2006); D. Zaring, “Informal Procedure, Hard and Soft, in International Administration”, 5 *Chicago J. Int’l L.* 547 (2005).

<sup>3</sup> At an international level, regimes may be defined as “sets of implicit or explicit principles, norms, rules, and decision-making procedures” structuring behaviour. S. Krasner, “Structural Change and Regime Consequences: Regimes as Intervening Variables”, 36:2 *Int’l Org.* (1982).

<sup>4</sup> In the international relations context, “legalisation” refers to a set of characteristics defined as “obligation”, “precision” and “delegation”. K. Abbott, R. Keohane, A. Moravcsik, A. Slaughter and D. Snidal, “The Concept of Legalization”, 54:3 *Int’l Org.* (2000).

## **A.     *The Bretton Woods International Financial Architecture, 1944–1973***

During the period of globalisation (1870–1914) prior to World War I, the international economic regime operated in a largely hegemonic context, with the United Kingdom in the leading role at least from around 1870. The regime of the time was largely an informal one, based on principles of free trade and fixed exchange rates under the gold standard. The norms, rules and decision-making procedures derived from these principles reflected the tradition of great power politics (the combination often expressed in neo-mercantilist economic competition), with little international formality, and with Britain and other Western countries acting to impose the regime upon others through empire and coercion, if necessary. During this period, the only truly institutionalised framework was the gold standard – not an internationally legalised institution but, rather, a principle that imposed norms and rules on domestic behaviour through domestic views of the necessity of maintaining the link between paper currencies and gold and/or silver. During this period of global finance prior to World War I, not only was there no international financial regulation, but in fact there was very little domestic financial regulation and capital flows were generally unconstrained.

The period 1914–1945 marked the end of the preceding international economic regime and great power balance. While the period between the two World Wars was marked by various attempts to return to the previous regime of free trade and the gold standard, these were unsuccessful, with international economic relations fragmenting to support conflicting needs. At the same time, the United Kingdom's role at the centre of the previous regime was eroded but without the United States being willing to take on Britain's former role. At the end of World War II, a new regime was designed to avoid the specific problems that existed.

At the end of World War II, the Atlantic Charter laid out a vision of the post-war international order,<sup>5</sup> essentially based on three pillars: peace, financial stability and trade between equal nations. The second and third pillars (discussed in 1944 under the auspices of the United States and the United Kingdom) focused on preventing international economic instability and supporting economic development through reintegration of domestic economies. At Bretton Woods and Havana, countries agreed on an overall design for the international economic system, with a new regime based on free trade, fixed exchange rates, domestic financial systems, and international cooperation and coordination of both macroeconomic affairs and reconstruction and development. While in relation to trade and fixed exchange rates the Bretton Woods regime resembled the previous liberal economic order, in relation to finance and cooperation it took the opposite approach to the previous regime: rejection of global finance and support for international macroeconomic, reconstruction and development cooperation and coordination.

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<sup>5</sup> See S.I. Rosenman (ed.), *The Public Papers and Addresses of Franklin D. Roosevelt, New York 1938–1950* (1941), vol. 10, p. 314.

Unlike the previous regime, the Bretton Woods system was highly institutionalised and legalised. Based fundamentally on open trade flows, fixed exchange rates, restricted capital flows, and international economic cooperation and coordination, the system was to be embedded in a series of international treaty-based institutions and formal arrangements for interactions between sovereign nation-states in four main areas. Under the design, economic policy coordination was to take place through the United Nations (established in 1945), with the United Nations Economic and Social Council (UN EcoSoc) at the centre.<sup>6</sup> Macroeconomic matters and monetary arrangements (“macroeconomic stability”), based on currencies fixed to the US dollar, which was in turn fixed to gold, were to be maintained through the IMF (established in 1945).<sup>7</sup> Responsibility for finance for, and coordination of, reconstruction and development was placed with the International Bank for Reconstruction and Development (the World Bank, established in 1945).<sup>8</sup> Liberalisation of trade was the responsibility of the International Trade Organization (ITO). Reflecting the view that while global trade was desirable, global finance was not, the Bretton Woods structure did not provide a specific hard-law, international institution-based structure for finance because the design was based on the premise that finance would be domestic and subject therefore only to domestic regulation.<sup>9</sup> Financial stability was to be achieved through limiting the role of finance. As capital flows were to be restricted, there was no international treaty-based organisation designed to address such issues and the existing organisation, the Bank for International Settlements (BIS), was to be wound up.

The regime design encompassed three fundamental features. First, its structure was formal and institutional, based on an interlinked set of international treaties and institutions. Second, it assumed closed national financial markets, with limited capital flows, but open markets for trade in goods. Third, relationships among closed national systems were structured through an international institutional framework.<sup>10</sup> Institutionally, the Bretton Woods system was to include three new interlinked international organisations: the IMF, the World Bank and the ITO. In each area, there was to be a high level of legalisation, with treaty-based obligations drafted with precision, and with monitoring responsibility delegated to a specifically created international organisation.

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<sup>6</sup> See UN Charter (1945), chs IX–X, esp. 57, 63; [www.un.org/ecosoc/](http://www.un.org/ecosoc/).

<sup>7</sup> The IMF Articles of Agreement were adopted at the United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire, on 22 July 1944 and entered into force 27 December 1945. They have subsequently been amended three times: (1) Board of Governors Resolution No. 23-5, adopted 31 May 1968 and effective 28 July 1969; (2) Board of Governors Resolution No. 31-4, adopted 30 April 1976 and amended effective 11 November 1992; and (3) Board of Governors Resolution No. 45-3, adopted 28 June 1990 and effective 11 November 1992. See [www.imf.org](http://www.imf.org).

<sup>8</sup> World Bank Agreement; [www.worldbank.org](http://www.worldbank.org).

<sup>9</sup> For discussion, see D. Arner, *Financial Stability, Economic Growth and the Role of Law* (Cambridge University Press, 2007); R. Weber & D. Arner, “Toward a New Design for International Financial Regulation”, 29 *U. Pa. J. Int’l L.* 391 (2008).

<sup>10</sup> See *Proceedings and Documents of the United Nations Monetary and Financial Conference, Bretton Woods, New Hampshire, July 1–22, 1944* (Washington, DC: US Governmental Printing Office, 1948).

However, the Bretton Woods international economic architecture as designed never actually functioned: the ITO was still-born<sup>11</sup> (though ultimately reincarnated as the WTO in 1994 after 50 years in the limbo of the General Agreement on Tariffs and Trade [GATT]) and Cold War politics quickly rendered UN EcoSoc ineffective. Likewise, the role of the World Bank was quickly usurped in many ways, first by the bilateral efforts of the United States through the Marshall Plan and related reconstruction initiatives, complemented later by the European Community with its aid programmes for Southern and Eastern European countries, and in competition with the efforts of the Soviet Union in building alternative arrangements. This left the World Bank to focus on developing (often post-colonial) countries – the role it continues to play today. Nonetheless, the design for monetary relations, with the IMF at the centre of a system of fixed exchange rates based on the US dollar and its link to gold, did function – arguably quite well – until the early 1970s. Finally, the BIS was not abolished – and continues to function today much as it has functioned since its establishment in the wake of World War I.

During the Bretton Woods period (1945–1973), international economic relations were dominated both by the Cold War and by US and Soviet interests. In the area of finance, while there was general support at the outset for an atomised international financial system with limited cross-border capital flows (evidenced by the IMF Articles of Agreement, which only require current account convertibility – to support trade – and not capital account liberalisation), this principle was violated from the outset to support the interests of individual states, especially the United Kingdom. Nonetheless, capital flows remained largely limited until the 1970s, with the rise of the euromarkets.

#### **B. *Internationalisation of Finance and the Financial Architecture, 1973–1997***

Following the gradual erosion of support for the underlying principle of limited capital flows, combined with the unwillingness of the United States to sacrifice domestic interests in support of maintaining the fixed relationship between the US dollar and gold, at the heart of the Bretton Woods international monetary system, the Bretton Woods regime effectively ended in 1973 (with a general decision that it was impossible to return to the principle of fixed exchange rates and the decision to amend the IMF Articles of Agreement accordingly). This effectively ended the Bretton Woods international monetary regime and removed the central pillar supporting international macroeconomic stability. At the same time, commitment to atomised finance continued to erode, especially with decisions in Europe to move towards financial integration in support of economic integration. This gradual process, however, was not accompanied initially by the establishment of a new regime supporting international financial stability.

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<sup>11</sup> See J.H. Jackson, *The Jurisprudence of GATT and the WTO: Insights on Treaty Law and Economic Relations* (2000), pp. 21–22.

Since the end of the Bretton Woods international monetary system in 1973, financial markets have changed dramatically through a process of liberalisation, internationalisation and globalisation, undergirded by rapid technological change. In response to the risks raised by the increasing internationalisation of finance, domestic central banks and regulators established informal committees hosted by the BIS. As finance continued to internationalise during the 1970s and 1980s, these initial efforts expanded beyond banking to a range of other areas, including securities and accounting. As a result of the 1980s debt crisis and other cross-border financial problems, these informal committees began to agree common approaches to common problems, with such approaches implemented via domestic legal and regulatory systems – a network-based, soft-law approach of which the 1988 Basel Capital Accord is the leading and most widely implemented example.<sup>12</sup>

During this period, the regime which replaced the Bretton Woods structure was based on principles of free trade, floating exchange rates and international capital flows. Existing institutions continued, but adapted to the new realities. Without its fundamental role in the international monetary system, the IMF focused on macroeconomic surveillance and related financial support for economic restructuring (essentially signalling an increasing role in development, as opposed to international macroeconomic and monetary stability) and the World Bank continued to focus on developing countries. At the same time, the BIS began to take a quiet though influential role in serving as a meeting place for domestic central banks and financial authorities, laying the groundwork for the development of a new financial stability regime in the wake of the Asian financial crisis. Two other aspects also became significant during the period of internationalisation of finance. First, this period witnessed the rise of the various ‘Gs’, with the Group of 7 (G-7)<sup>13</sup> and the Group of 10 (G-10) eventually becoming the most significant fora for international economic dialogue, cooperation and policy coordination. Second, it is during this period that the European Union was established, with commitments not only to free trade but also to integrated financial markets (underpinned by free movement of capital) and fixed exchange rate arrangements (eventually to be institutionalised as the single currency, the euro).

The international economic regime during this period could thus be characterised by the principles of free trade, floating exchange rates, free movement of capital, network-based cooperative and coordinative mechanisms, and competition in development (among both domestic and multilateral arrangements). Unlike the previous system, with the exception of trade and European arrangements (the legalisation of both of which increased during this period), it was lightly legalised, with few formal obligations, a high level of generality, and a general weakness or even absence of international delegation, with existing international organisations such as the IMF, World Bank and Organisation for Economic

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<sup>12</sup> “Transnational Networks”, in A. Slaughter, *A New Global Order* (Princeton University Press, 2004).

<sup>13</sup> The G-7 includes Canada, France, Germany, Italy, Japan, the United Kingdom and the United States. The Group of Eight (G-8) also includes Russia. The European Union is also a member of both the G-7 and the G-8.

Co-operation and Development (OECD) weakening during the period. However, also during this period, one can identify increasing development of transnational network-based approaches in order to address common issues relating to finance, with increasing levels of domestic adherence to the informal approaches, arrangements and standards agreed, generally at the level of individual central banks and government or quasi-governmental agencies.<sup>14</sup>

As noted above, the major exceptions were the establishment of the WTO (marking the establishment of a new regime for international trade) and the European Union (marking a major deepening and strengthening of the regime for European integration) in the first half of the 1990s. In the area of finance, significantly, the WTO encompassed institutionalisation and legalisation of one of the principles of the new regime: financial liberalisation, expressed as trade in financial services under the GATS and ancillary agreements relating to financial services. In Europe, the 1986 Single European Act and the 1992 Maastricht Treaty both formalised financial liberalisation within Europe and also the move to fixed exchange rate arrangements at the regional level. Moves away from generalised commitment to floating exchange rates can also be seen in the widespread use of pegged exchange rate arrangements outside of the OECD, with developing countries in most cases seeking to maintain fixed exchange rate relations between domestic currencies and the US dollar.

In addition, during the 1990s, as a further expression of the principle of financial liberalisation, G-7 and G-10 nations sought to amend the IMF Articles of Agreement to include free movement of capital. As such, while the 1970s was a period of regime disintegration and the 1980s a period of convergence towards principles underlying a new regime, the 1990s were marked by developed country efforts to legalise arrangements relating to the principles of financial liberalisation and global finance.

At the beginning of the 1990s, as the United States assumed a truly dominant role for the first time since the late 1940s in the wake of the collapse of the Soviet Union, it sought to institutionalise and legalise a liberal economic and financial regime based on the Washington Consensus with the support of Europe, through WTO financial services provisions, amendments to the IMF Articles, and pressure (through international organisations and bilaterally) for free trade, floating exchange rates and global capital flows (based on the US dollar).

Unfortunately, during the 1990s, as finance became increasingly global, so did financial crises, especially in emerging market economies. In the 1990s, the deficiencies of the existing international institutions and arrangements for financial stability (the “international financial architecture”) to deal with these changes came

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<sup>14</sup> See J. Norton, *Devising International Bank Supervisory Standards* (Kluwer, 1995); J. Norton, “Comment on the Developing Transnational Network(s) in the Area of International Financial Regulation: The Underpinnings of a New Bretton Woods II Global Financial System Framework”, 43 *Int'l Lawyer* 175 (2009).



dramatically to light through the Mexican, East Asian and other financial crises which followed. Since that time, countries, international organisations (especially the IMF, World Bank and WTO) and regional arrangements have gradually been forced to come to grips with the increasingly globalised nature of finance and coordinate financial stability arrangements. Discussions both in these institutions and elsewhere have focused on whether there was a need to reform the existing international institutional arrangements – whether there was a need for a “new international financial architecture”<sup>15</sup> to form the institutional basis of a new global financial stability regime.

### **C. The International Financial Architecture and Global Finance, 1997–2008**

Following the Asian financial crisis, a number of actions were taken to address these issues and to build on the initiatives undertaken after the Mexican financial crisis, centring on the IMF (transparency and liquidity), the World Bank (technical assistance) and international financial standards. In addition to these, the G-20<sup>16</sup> was established to serve a coordinating function. Overall, the result was the emergence of a new regime to support global financial stability.

First, the IMF acted to further enhance its role both in the provision of international liquidity and in encouraging transparency. Second, following the Mexican and Asian financial crises, the World Bank and the other multilateral development banks (MDBs) increasingly focused on efforts to strengthen the domestic financial systems of their member countries.

The third major area of concern was prevention of financial crises through enhancement of the quality of individual financial systems. In response to an initiative at the Lyon summit of the G-7 in June 1996, representatives of the G-10 countries and of emerging and transition economies jointly sought to develop a strategy for fostering financial stability through the analysis of experiences in previous crises and to elucidate basic standards and principles to guide individual economies in the development of stronger financial systems.<sup>17</sup>

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<sup>15</sup> For an overview, see R. Weber, “Challenges for the New Financial Architecture”, 31 *Hong Kong L.J.* 241 (2001); M. Giovanoli, “A New Architecture for the Global Financial Market: Legal Aspects of International Financial Standard Setting”, in M. Giovanoli (ed.), *International Monetary Law: Issues for the New Millennium* (Oxford University Press, 2000).

<sup>16</sup> As originally constituted, the G-20 was comprised only of finance ministers and central bank governors from 19 countries (Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the United Kingdom and the United States), plus the European Commission and the European Central Bank (ECB), the Managing Director of the IMF, the President of the World Bank, and the chairs of the International Monetary and Financial Committee and Development Committee of the IMF and World Bank.

<sup>17</sup> G-10, Report of the Group of Ten (G-10) Working Party on Financial Stability in Emerging Markets, *Financial Stability in Emerging Market Economies: A Strategy for the Formulation, Adoption and Implementation of Sound Principles and Practices to Strengthen Financial Systems* (April 1997). This framework was developed further in Group of 22 Systemically Significant Countries (G-22), *Reports on the International Financial Architecture* (October 1998).

Since the Mexican financial crisis, the concept of “financial stability” has become the primary target in preventing financial crises and reducing the severe risks of financial problems when they occur. Financial stability, however, is not a clearly defined term but is generally seen as both the absence of financial crisis and the normal operation of financial intermediaries and markets. Marc Quintyn and Michael Taylor go one step further, suggesting that the financial sector plays a special and unique role in an economy, and that as a result, “the achievement of *financial stability* ... is now generally considered a *public good*”,<sup>18</sup> thus echoing one of the underlying principles of the Bretton Woods system. With financial stability the agreed international objective, a system was developed to assist countries to achieve this goal.

The post-Asian crisis international strategy for the development of financial stability was a system of international financial standards, with the following primary characteristics: (1) development of an international consensus on the key elements of a sound financial and regulatory system by representatives of the relevant economies; (2) formulation of sound principles and practices by international groupings of technocratic authorities with relevant expertise and experience, such as the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), the International Accounting Standards Board (IASB), the International Association of Insurance Supervisors (IAIS) and the Joint Forum on Financial Conglomerates; (3) use of market discipline and market access channels to provide incentives for the adoption of sound supervisory systems, better corporate governance and other key elements of a robust financial system; and (4) promotion by multilateral institutions such as the IMF and the MDBs of the adoption and implementation of sound principles and practices, most significantly through the establishment of the Financial Sector Assessment Programme (FSAP). Importantly, however, the ultimate responsibility for policies to strengthen financial systems lies with the governments and financial authorities in the economies concerned.

Most generally, this system can be described as having four levels, incorporating both existing and new international institutions and organisations. At the first level, there is a structure which has mainly been established through political processes. The second level is international standard-setting, largely of a technocratic nature. At the third level is implementation of standards – in principle, a domestic process but with technical assistance through a variety of international, regional and bilateral sources. The fourth level focuses on monitoring the implementation of standards, primarily through the FSAP process.<sup>19</sup>

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<sup>18</sup> M. Quintyn and M. Taylor, “Regulatory and Supervisory Independence and Financial Stability”, IMF Working Paper WP/02/46 (March 2002), p. 8 (emphasis in original).

<sup>19</sup> This essential structure was affirmed by the G-7 Finance Ministers in the Communiqué from their Köln summit in 1999 (G-7 Finance Ministers, *Report of the G7 Finance Ministers to the Köln Economic Summit*, Cologne, Germany, 18–20 June 1999).

This system of international financial standards was the only truly new element of the international financial architecture to emerge from the series of financial crises culminating in the Asian financial crisis. The only new institution to emerge from discussions of the international financial architecture was the Financial Stability Forum (FSF, renamed and reconstituted as the Financial Stability Board [FSB] in the wake of the global financial crisis)<sup>20</sup> established to serve the role of the international financial standard coordinator and promoter. In addition to coordination and standard-setting through the FSF/FSB, the established international financial institutions such as the IMF, World Bank and BIS were given non-legalised mandates to support standard-setting, through implementation and monitoring primarily in the FSAP context. The WTO, however, was not formally included. Finally, much standard-setting takes place through various international financial organisations of varying levels of formality.<sup>21</sup> In addition to the FSB, the BIS plays an important role in coordination, providing the secretariat for the FSB, as well as the Basel Committee, the Committee on Payment and Settlement Systems, the Committee on the Global Financial System, G-10 and IAIS.

At the political level, prior to the global financial and economic crisis of 2007–2009, the G-7 industrialised countries generally took the lead in establishing an operating framework for the process. In addition, the G-10 initiated efforts to elaborate the details. Finally, other groups such as the G-20 were also involved in various technical aspects.

In addition to the various organisations discussed above, foreign participation in domestic financial services is dealt with largely through bilateral, regional and international negotiations, with the latter centred on the WTO. While the WTO provides the international framework for foreign participation in financial services, unlike areas such as trade in goods, in the area of financial services, commitments made by members are exclusive rather than inclusive. Therefore, liberalisation is at the discretion of individual WTO members and remains quite limited in most cases. Moreover, since 1999, there has been essentially no progress in negotiations in this area.

Overall, at the onset of the global financial crisis of 2007–2009, the international financial regime addressed the five central elements: (1) macro-economic cooperation and coordination through the G-7 (largely non-legalised); (2) trade in financial services through the WTO (largely legalised, but of limited effectiveness); (3) macroeconomic monitoring through the IMF (institutionalised, but with limited legalisation); (4) financial stability through the FSF (institutionalised, but

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<sup>20</sup> The FSF, as originally constituted in 1999 in the wake of the Asian financial crisis, comprised financial authorities from developed financial systems (Australia, Canada, France, Germany, Hong Kong, Italy, Japan, Netherlands, Singapore, Switzerland, UK, US, ECB), and the major international financial institutions (BIS, IMF, World Bank), international regulatory and supervisory bodies (Basel Committee, IOSCO, IAIS, IASB) and committees of central bank experts (Committee on the Global Financial System [CGFS], Committee on Payment and Settlement Systems [CPSS]).

<sup>21</sup> D. Zaring, "International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations", 33 *Tex. Int'l L.J.* 281 (1998).

with limited legalisation); and (5) development through the MDBs. Arguably, a new international financial regime had emerged, with a supporting institutional framework of mixed levels of legalisation. We return to the international financial architecture and related post-global financial crisis developments in section IV.

### **III. Evolution of the Emerging International Islamic Financial Architecture**

While its origins date back over a thousand years, modern Islamic finance dates back only to the end of the 19th century, with significant development mainly occurring towards the end of the 20th century, paralleled and supported by the emergence of an international Islamic financial architecture, largely based on the experiences of global finance.

#### **A. Evolution**

Modern Islamic finance is usually dated to the establishment of the first commercial bank by Barclays in the 1890s. From this initial establishment, there has been a continuing Islamic critique of Western finance and development of Islamic alternatives based on Islamic principles, with the intellectual basis largely formulated by the 1950s. From this basis, during the 1960s and 1970s, initial Islamic finance initiatives emerged in Malaysia (1962) and Dubai (1975). During the oil shocks of the 1970s, although hopes were initially high for rapid development of Islamic finance, in reality oil revenue generally was directed into Western financial institutions through petrodollar recycling, culminating in the developing country debt crisis of the early 1980s. At the same time as the 1980s debt crisis was triggering the development of international arrangements through the Basel Committee, IMF and World Bank, discussions began to be implemented through legislative support in Pakistan (1980) and extensive research and development relating to equity investment compliant with *Sharī'ah* principles in the 1980s.

In the 1990s, as finance increasingly internationalised, Islamic finance likewise developed, supported by the establishment of AAOIFI in 1990 and the launch of the Dow Jones and Financial Times Islamic indices. With increasing interest, a wider range of countries introduced legislative and regulatory support for Islamic financial development and stability. To underpin the development and stability of emerging Islamic finance, the IFSB was established in 2002.

Together, AAOIFI and the IFSB comprise the main elements of the existing international Islamic financial architecture.

## **B. AAOIFI: Accounting and Auditing Organization for Islamic Financial Institutions**

Formed in 1990 and established in Bahrain in 1991, AAOIFI is the first of the international Islamic financial standard-setting organisations. Its objectives focus on the development and dissemination of accounting and auditing standards for Islamic financial institutions.

AAOIFI comprises associate members (financial institutions, organisations and firms operating *Shari'ah*-compliant businesses), regulatory and supervisory authorities supervising Islamic financial institutions, and observers (institutions with Islamic banking operations, organisations regulating accounting and auditing, and accounting and auditing firms involved in Islamic finance). The General Assembly brings together all members at least once a year. The General Assembly appoints the Board of Trustees, comprising 20 part-time members serving five-year terms. The Trustees are responsible for appointing members of the various AAOIFI boards and committees, appointment of the Secretary General and arrangement of AAOIFI's finances. At present, AAOIFI boards and committees include the Accounting and Auditing Standards Board (responsible for preparing, adopting and interpreting accounting and auditing standards, codes of ethics and educational standards for Islamic financial institutions) and the *Shari'ah* Board (responsible for achieving harmonisation and convergence among *Shari'ah* supervisory boards of Islamic financial institutions and reviewing AAOIFI standards to ensure *Shari'ah* compliance). The Accounting Standards Committee and the Auditing and Governance Standards Committee support the Accounting and Auditing Standards Board, while the *Shari'ah* Board is supported by the *Shari'ah* Standards Review Committee and three *Shari'ah* standards committees.

To date, AAOIFI has been most influential in developing *Accounting, Auditing and Governance Standards (for Islamic Financial Institutions)*, with the most recent comprehensive version dating from 2008 and comprising 26 accounting standards, five auditing standards, seven governance standards and two codes of ethics. AAOIFI has also developed a set of *Shari'ah* standards, most recently released in 2008 and addressing 35 areas of Islamic finance. AAOIFI also now provides two professional qualifications, the Certified Islamic Professional Accountant (CIPA) and the Certified *Shari'ah* Adviser and Auditor (CSAA). Initially in 1999, AAOIFI also addressed capital adequacy,<sup>22</sup> but related initiatives have since been centralised with the IFSB.

## **C. IFSB: Islamic Financial Services Board**

The IFSB was established in 2002 and commenced operations in 2003 in Kuala Lumpur. It serves as the international standard-setting body for the Islamic

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<sup>22</sup> AAOIFI, *Statement on the Purpose and Calculation of the Capital Adequacy Ratio for Islamic Banks* (1999).

financial services industry and is Asia's only international financial standard-setting organisation.

Full membership is available to the supervisory body responsible for supervision of Islamic finance and international intergovernmental organisations that have an explicit mandate for promoting Islamic finance. Associate membership is available to any central bank, financial supervisory authority or international organisation involved in setting or promoting standards for international financial and monetary stability which does not qualify as or seek to become a full member. Observer membership is available to any firm or association involved in Islamic financial services.

The IFSB is structured under the IFSB Articles of Agreement, Malaysia's IFSB Act 2002, the IFSB By-Laws and its Guidelines and Procedures for the Preparation of Standards/Guidelines. Its structure includes the following: (1) General Assembly, (2) Council, (3) Technical Committee, (4) Working Groups, (5) Taskforces, (6) Editing Committee, and (7) Secretariat, which has around 20 staff.

Under the IFSB Articles of Agreement, the objectives of the IFSB are to: (1) promote the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with *Shari'ah* principles, and recommending these for adoption; (2) provide guidance on the effective supervision and regulation of institutions offering Islamic financial products and to develop for the Islamic financial services industry the criteria for identifying, measuring, managing and disclosing risks, taking into account international standards for valuation, income and expense calculation, and disclosure; (3) liaise and cooperate with relevant organisations currently setting standards for the stability and the soundness of the international monetary and financial systems and those of the member countries; (4) enhance and coordinate initiatives to develop instruments and procedures for efficient operations and risk management; (5) encourage cooperation among member countries in developing the Islamic financial services industry; (6) facilitate training and personnel development in skills in areas relevant to the effective regulation of the Islamic financial services industry and related markets; (7) undertake research into, and publish studies and surveys on, the Islamic financial services industry; and (8) establish a database of Islamic banks, financial institutions and industry experts.

Overall, the IFSB has emerged as the international standard-setting organisation in the area of Islamic finance, thus coordinating international, regional and domestic efforts to support the development of Islamic finance. To date, with the development of a range of standards and a wide outreach programme, it has had an important impact in standardisation to support market development and stability, especially in Asia and the Middle East. As at December 2009, the IFSB has issued 12 standards, guiding principles and technical notes, as well as a number of other documents, and is currently working on an additional standard relating to solvency of *Takāful* institutions.

Published standards address: risk management (non-insurance); capital adequacy (non-insurance), including recognition of external ratings and requirements for *Sukūk*, securitisation and real estate investment; corporate governance (excluding insurance and mutual funds); transparency and market discipline (excluding insurance and mutual funds); supervisory review (excluding insurance and mutual funds); governance of Islamic collective investment schemes; governance of *Takāful* undertakings; conduct of business; and *Sharī'ah* governance. In addition to these, the IFSB has released reports discussing regulation and supervision of Islamic insurance (with the IAIS), a ten-year strategic development framework for the industry, a compilation addressing prudential and structural indicators for institutions offering Islamic banking services, and development of Islamic money markets and liquidity management frameworks.

#### **D. Other Institutions**

In addition to these, a range of other Islamic financial standards organisations have emerged, including the International Islamic Financial Market (IIFM, 2002), the Council for Islamic Banks and Financial Institutions (CIBAFI, 2001), the International Islamic Rating Agency (IIRA, 2005) and the Liquidity Management Centre (LMC, 2002). In addition, the Loan Market Association has supported transaction development through standardised documentation, with the International Swaps and Derivatives Association (ISDA) seeking to play a similar role in the context of Islamic derivatives development. Domestic regulators, especially in Bahrain, Dubai and Malaysia, have played an important role in supporting both the development and stability of Islamic finance. Finally, both the Islamic Development Bank and the Asian Development Bank are active in supporting Islamic financial development and stability initiatives.

### **IV. The Global Financial Crisis: Implications for the International Financial Architecture**

While significant thought and effort had gone into the development of the international financial architecture, especially following the Asian financial crisis of 1997–1998, unfortunately, this was not sufficient to prevent the global financial and economic crisis of 2007–2009, although arguably certain elements of the framework were significant in preventing a systemic collapse of the global financial system in late 2008.

#### **A. The Global Financial and Economic Crisis of 2007–2009**

In essence, the global financial crisis of 2007–2009 resulted from an unprecedented period of excessive borrowing, lending and investment incentivised by a series of significant economic and regulatory factors. Over-borrowing and lending most directly arose in the context of the market for sub-prime residential

mortgages in the United States, especially during 2005 and 2006. However, excesses in borrowing and lending were prevalent in virtually all asset classes globally, including commercial real estate, corporate lending (especially for mergers and acquisitions, and private equity transactions), commodities and international (especially emerging markets) equities. This situation was not limited to the United States; it was truly global, impacting almost every market and asset class. This broad-based over-borrowing and lending was fuelled by investment from a wide range of investors around the world.

Excesses in borrowing, lending and investment were inextricably interconnected through a range of transaction structures derived from well-understood techniques of securitisation – the transmission mechanism between borrowing, lending and investment. Essentially, securitisation is a transaction structure in which loans (such as loans secured by residential real estate – that is, mortgages) are pooled together (“repackaged”) as collateral underlying the issuance of securities, predominantly debt securities. At its simplest, securitisation makes a great deal of sense: it allows the distribution of risks to a wider pool of investors, thereby reducing the cost of borrowing for ultimate borrowers and reducing the risk to lenders of defaults on underlying loans. At the same time, however, the structure has the potential to provide significant opportunities for abuse, including excessive complexity and financialisation (essentially, a disassociation between financial and real economic activity), and this in many ways lies at the heart of the global financial crisis. Especially in the United States, loans came to be made not by banks with an ongoing interest in their repayment, but instead by specialists – mortgage brokers for real estate, and a range of financial institutions, especially investment banks, for corporate loans – intent on profiting from charging to arrange loans and, in the extreme form of the originate-and-distribute model of finance which became common at the beginning of this century, with no intention of maintaining an interest in the ability of the borrower to repay in the future.

Securitisation was thus the central linkage between excessive investment in credit securities and excessive borrowing and lending. Investment excesses were largely the result of two economic factors: (1) the period of low interest rates in Japan in the wake of the onset of its banking crisis at the beginning of the 1990s and in the United States following the bursting of the dotcom bubble in 2001; and (2) the imbalances in saving and investment between the Anglo-American economies, especially the United States and the United Kingdom, and the rest of the world, especially Japan, China and the major oil-producing countries such as Russia and Saudi Arabia, largely resulting from the build-up of foreign exchange reserves in the wake of experiences during the Asian financial crisis of 1997–1998. The combination of low interest rates and large volumes of investment funds from outside the United States and the United Kingdom supported massive investment in debt securities in New York and London designed to produce an appealing combination of perceived safety and attractive yields.



In addition to issues which arose in the context of relatively simple securitisation transactions, the technology of securitisation was expanded over the decade preceding the global financial crisis to encompass a range of ever-more complex techniques and structures, including structured investment vehicles (SPVs) and conduits, CDOs, collateralised loan obligations (CLOs), synthetic securitisations and a range of other exotics such as CDO<sup>2</sup>s and synthetic CDOs. Many of these took the technology of securitisation (pooling of portfolios of risks, off-balance sheet structure, capital markets funding) and combined it with that of over-the-counter (OTC) derivatives, especially credit derivatives such as credit default swaps (CDS). While such transaction structures in hindsight may seem an obvious source of risk, in fact, in the period leading up to the global credit crisis, such techniques received important support and developmental incentives from regulators around the world. This combination of complexity, financialisation, regulatory incentives and failures, corporate governance and risk management failures, excessive liquidity and massive global investor demand set the stage for the crisis.

Following interest rate increases in major markets and peaks in the US residential real estate market and resultant shifts in market sentiment, the complex transmission mechanisms at the heart of the financial excesses preceding the onset of the global financial crisis ceased to function. Lack of transparency resulting from complexity and risk distribution, a process of adverse selection, loss of confidence, and changes in market psychology and investor preferences among wholesale market participants resulted in closure of the primary interbank funding mechanisms in the global financial markets, eventually leading to the failure of significant international financial institutions around the world. As complexity and lack of transparency hindered market and regulatory responses, moral hazard and improperly designed financial infrastructure and regulatory systems hindered appropriate responses.

In hindsight, it is now clear that excessive attention was placed on monetary policy, rather than balancing monetary policy and financial stability; that regulatory attention focused excessively on the safety and soundness of individual financial institutions, rather than on systemic risks and linkages across institutions and markets; that prudential regulatory and risk management systems did not take adequate account of market cycles and crises; and that the realities of potential failures of large, complex financial institutions had not been adequately addressed in advance.

## ***B. International Responses***

In addressing responses to the global financial crisis, in November 2008, the G-20, meeting for the first time at the heads of government level, established five main principles to guide reforms: (1) strengthening transparency and accountability; (2) enhancing sound regulation; (3) promoting integrity in financial markets; (4) reinforcing international cooperation; and (5) reforming the financial architecture. For each of these five principles, G-20 leaders established a detailed action plan,

incorporating immediate and medium-term actions. The detailed action plan establishes the core content of the refinements to international financial regulatory standards to take place. In addition, leaders tasked finance ministers to give highest priority to six areas: (1) mitigating pro-cyclicality in regulatory policy; (2) reviewing and aligning global accounting standards, particularly for complex securities; (3) strengthening the resilience and transparency of credit derivatives markets and reducing their systemic risks, including by improving the infrastructure of the OTC markets; (4) reviewing compensation practices as they relate to incentives for risk-taking and innovation; (5) reviewing the international financial architecture; and (6) defining the scope of systemically important financial institutions and determining their appropriate regulation and oversight.

In April 2009, in their second meeting, G-20 leaders pledged to do whatever is necessary to: (1) restore confidence and growth; (2) repair the financial system; (3) strengthen financial regulation; (4) fund and reform the international financial institutions; (5) reject protectionism and promote global trade and investment; and (6) build an inclusive, green and sustainable recovery. In relation to financial regulation and supervision, the leaders committed to build a stronger, more globally consistent supervisory and regulatory framework for the future financial sector that will support sustainable growth and serve the needs of business and citizens.

In addressing these objectives, the leaders focused on nine major areas. First, the FSF was renamed and reconstituted as the FSB, including all G-20 countries, FSF members, Spain and the European Commission. This is the foundation of reform of the system of international financial standards, as opposed to their content, the focus of the Washington meeting. Second, the FSB and IMF were directed to develop appropriate early macroeconomic and financial warning systems. Third, leaders committed to reshaping regulatory systems to address macro-prudential risks. Fourth, regulation is to be extended to all systemically important financial institutions, instruments and markets, including systemically important hedge funds. Fifth, the leaders endorsed new principles on pay and compensation<sup>23</sup> and committed to supporting sustainable compensation schemes and the corporate social responsibility of all firms. Sixth, in the context of eventual recovery, the leaders agreed to improve the quality, quantity and international consistency of capital, including with regulation to prevent excessive leverage and require buffers of resources to be built up in good times. Seventh, the G-20 committed to take action against non-cooperative jurisdictions, including tax havens.<sup>24</sup> Eighth, leaders called on accounting standard-setters to improve standards on valuation and provisioning and to achieve a single set of high-quality global accounting standards. Ninth, leaders agreed to regulate and supervise credit rating agencies.<sup>25</sup> These final two

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<sup>23</sup> FSF, *FSF Principles for Sound Compensation Practices* (April 2009).

<sup>24</sup> See OECD Global Forum on Taxation, *A Progress Report on the Jurisdictions Surveyed by the OECD Global Forum in Implementing the Internationally Agreed Tax Standard* (April 2009).

<sup>25</sup> See IOSCO Technical Committee, *Code of Conduct Fundamental for Credit Rating Agencies* (May 2008); IOSCO Technical Committee, *International Cooperation in Oversight of Credit Rating Agencies – Note* (March 2009); IOSCO Technical Committee, *A Review of Implementation of the IOSCO Code of Conduct*

commitments largely reiterate the November commitments but with some reinforcement. In relation to other commitments, an annex to the leaders' statement provides greater detail in eight major areas: (1) FSB, (2) international cooperation (focusing on financial institution failures), (3) prudential regulation, (4) scope of regulation, (5) compensation, (6) tax havens and non-cooperative jurisdictions, (7) accounting standards, and (8) credit rating agencies. The chapter returns to these in the final section.

### **C. *Reforming the International Financial Architecture***

From the discussion above, the question emerges: is there a need for a new design for the international financial architecture? On balance, one can say with some degree of clarity that the arrangements put in place following the Asian financial crisis were neither effective in preventing a global systemic financial crisis nor (with the possible exception of the G-20) effective in dealing with such a global systemic financial crisis when it actually occurred. One can also say at the very least that most of the fundamental features underlying the original post-war design (open trade, fixed money, domestic finance, centralised development) no longer hold true. Instead, our world is one of largely open trade, generally floating fiat currencies, global finance and decentralised development. The implications are well known: financial and monetary instability resulting in economic crises.

Certainly, one possibility (little discussed) would be a return to the post-war design: finance does not have to be global and currencies can be fixed. At the same time, assuming that finance will remain global (and the research does generally suggest that this is beneficial over the long term) and that there continues to be general support for open trade (the economic benefits of which are largely unquestioned), then it makes sense to develop international arrangements which are supportive of these objectives.

In looking at this question, then, if the objective is sustainable global development based upon economic growth supported by liberal trade and global finance, how would an effective international design look, and how could it be realistically organised?

As one example, Zhou Xiaochuan, Governor of the People's Bank of China (PBOC), has suggested the following lessons from the current financial crisis and the resulting elements of a design to address the issues which have arisen. In "On Savings Ratio", he focuses on the question of imbalances at the heart of the global economy. In this respect, he highlights four points. First, comprehensive prescriptions are required, with the United States stimulating consumption now and rebalancing its economy later, while East Asia undertakes structural reform to reduce savings. Second, countries and international organisations must strengthen and intensify regulation of international speculative capital flows, including

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*Fundamentals for Credit Rating Agencies* (March 2009). See also IOSCO, 'IOSCO Update on Progress Made in Addressing G-20 Concerns', IOSCO Media Statement IOSCO/MS/05/2009 (3 April 2009).

reinforcing regulation, enhancing transparency, developing early warning systems and other preventive measures for developing countries, increasing aid, and providing mechanisms to address temporary balance of payments problems that are swift and with limited conditionality. Third, there must be appropriate measures to channel more savings into developing countries and emerging markets as the future growth engines of the world economy. Fourth, reform of the international monetary system away from reliance on the US dollar is necessary.

Overall, this is a good start, but it is not in fact a comprehensive prescription, except for the specific issues of global imbalances and currency instability, which it addresses rather well. Instead, focus should be placed on the aspects which have proven necessary in the context of the global economy. First, there is a clear need for some sort of mechanism to support economic cooperation and coordination, the role originally intended for UN EcoSoc and now being filled by the G-20. Second, trade arrangements are at the heart of the design, with special needs for financial liberalisation and cross-border provision of services. Third, there is a need for some system of macroeconomic policy standard-setting and monitoring, to some extent the role that the IMF has come to play most of the time. This would include monetary arrangements. Fourth, there is a clear necessity if finance remains global for appropriate financial stability and development arrangements to both prevent financial crises and resolve those crises which do occur, both at the sovereign level and at the level of global financial institutions and markets. Fifth, sustainable development is now no longer just a domestic issue but one with global implications – positive and negative.

In looking at these issues, from the overall objective and specific needs, one can turn to questions of organisation and allocation of responsibilities, mandates and powers, and only then to questions of the design of individual organisations, including membership, governance, funding, independence and accountability.

### ***(1) Coordination***

The need for international economic cooperation and coordination has been clearly demonstrated by the variety of arrangements which have been attempted, from the League of Nations to the BIS to the UN to the OECD, Comecon and the European Economic Community, to the various “Gs”, most recently the G-20. At the most basic level, it is clearly significant for heads of government and senior economic officials to meet periodically at the multilateral level in order to discuss common issues and concerns which are probably an unavoidable element of a global economy. However, immediately issues of inclusiveness and exclusiveness arise: who should be there, and who should not, in order to have the most effective discussion? While the formal idea of UN EcoSoc appears initially sensible, it is probably the case that the near-universal membership of the UN makes it an unwieldy forum, albeit one that (at the General Assembly level) is useful in those cases (e.g. the Millennium Development Goals) where there is in fact universal

agreement. Notably, however, the 2009 Copenhagen climate change summit demonstrated the limits of this sort of approach.

As a result, a range of fora have developed over time to bring together smaller numbers of like-minded and/or important economies. Following the Asian financial crisis, the G-7 served such a global coordinating function but was always regarded as a less than perfect solution. As the current global financial crisis has developed, the G-20 has assumed the central roles', explicitly at the G-20 leaders summit in Pittsburgh in September 2009, with the G-7 and other groups increasingly acting as interest groups manoeuvring around issues to be discussed at the G-20.

On balance, though perhaps a bit unwieldy, the G-20 has during the current crisis emerged as a relatively effective forum for cooperation and coordination. A similar group (of 16) has also been active in climate and trade negotiations, but at the moment the general view among members appears to be that the G-20 is both useful and appropriate and probably does not require any greater level of formality than has previously been the case, albeit with the probable exception of the need for some sort of formal secretariat to provide support. One issue that may arise, however, is if the creation of the IMF Council is eventually agreed. In such a circumstance, there would be questions of respective functions and overlap. At the same time, an IMF Council would have the potential to address issues of concern respecting the G-20, such as the potential need for permanent political representatives and a secretariat.

## ***(2) Trade***

Overall, the WTO has not been overtly significant during the current crisis. However, it has arguably played an important role in providing an outlet for disputes arising from crisis-inspired protectionist inclinations of a range of countries around the world. At the same time, the April G-20 directive to the WTO to engage in third-party monitoring of protectionist measures is a potentially significant development for the organisation and its role in the global economy. At the least, it is indicative of general support for continued global trade. At the same time, the Doha round remains largely stalled, not only as a consequence of the crisis but also as a result of attentions directed to other issues such as food, energy and climate change.

In addition, while support continues for liberalisation of trade in goods, issues respecting multilateral liberalisation of investment, competition policy and financial services have largely been abandoned, with interest in these issues in all likelihood suffering as a result of the crisis. In respect of financial services, the crisis likely means that there will be very limited support for further liberalisation in the near future. On balance, this is probably a good thing, as financial services liberalisation brings with it a range of risks and challenges which are not inherent in trade in goods or even investment.

### ***(3) Macroeconomic and Monetary Policy***

In a global economy, and especially one with a global financial system, problems in one country can quickly spread to others, whether or not similarly situated. This was a clear lesson of the crises in the 1980s, 1990s and today. As a result, self-protection indicates the need for some sort of mechanism for monitoring the macroeconomic stability of countries. While this could be done at the bilateral level (and is in some cases), efficiency arguments would suggest the use of the centralisation of this sort of function – perhaps at the regional level in some cases, as well as at the global level. Such monitoring includes transparency at the sovereign level (one area in which changes following the Asian financial crisis have been largely effective), as well as issues relating to fiscal policy and monetary policy.

In the context of macroeconomic policy, the IMF has arguably been rather effective in terms both of enhancing transparency and providing external monitoring (through its data, research and surveillance functions, including the FSAP). That being the case, there is a strong argument for building upon its effectiveness in these areas. At the same time, it has been much less effective in the context of financial stability (which it has not regarded as a central mandate) and development (where its structural adjustment policies and approaches have been subject to significant criticism).

The Fund was also quite effective under the Bretton Woods monetary system, until political and economic circumstances changed such that that system was no longer sustainable. Since the 1970s, however, the role of the IMF in monetary affairs has arguably been much less effective.

This crisis has brought back to light questions regarding international currency arrangements which have largely been dormant since the 1970s and the end of the Bretton Woods system of fixed exchange rates. In this context, the highest-profile proposals have come from Zhou Xiaochuan, PBOC Governor, who begins with the premise that, as demonstrated by the current global financial crisis, the risks of the current system of floating exchange rates and fiat currencies exceed its benefits and fail in the overall objective of supporting trade and enhancing economic growth and financial stability. In place of the current system, he proposes a new system based on an international reserve currency disconnected from individual nations and able to remain stable. While this is not a new idea, harking back to ideas of Keynes and discussions from the 1970s, it is the first major proposal along these lines from a major economy in decades.

Overall, Zhou suggests that achieving this is a grand long-term vision, requiring a long-term process with specific deliverables. In this context, he suggests three. The first, developed in more detail in his proposal “On Savings Ratio”, is to strengthen surveillance of reserve currency countries – rather a reverse of the approach traditionally taken by the IMF. Second is to broaden Special Drawing Rights (SDR). In this respect, Zhou suggests several elements, including

development of a settlement system between the SDR and other currencies; promoting use of the SDR in international trade, commodities pricing, investment and corporate accounts; creating financial assets denominated in SDR – for example, from the IMF; and improving valuation and allocation, with the SDR based on a basket comprising all major economy currencies, GDP-weighted, with allocation on the basis of real assets. Finally, he suggests entrusting member reserves to the IMF, with an open-ended SDR fund and centralised management.

#### ***(4) Financial Stability and Development***

As highlighted by the November 2008, April 2009 and September 2009 G-20 meetings, financial regulation has been the central focus at the domestic, regional and international levels in the context of the current crisis. In looking forward, three elements need to be addressed: (1) crisis prevention (largely focusing on regulation); (2) crisis management (largely focusing on liquidity arrangements); and (3) crisis resolution (focusing on mechanisms to address both sovereign and global financial institution crises).

##### **Crisis Prevention: Regulation**

As a result of the global financial crisis, the existing post-Asian financial crisis system, while not fundamentally a cause of the crisis, has been exposed as insufficient to meet the realities of global finance and its attendant risks. In looking at this issue, there are a variety of potential approaches.

At the most fundamental level is the question which was addressed at Bretton Woods: whether, on balance, finance should be global. While the decision taken at Bretton Woods was in the negative, in the context of the global financial crisis, despite some misgivings, the consensus appears to be settling in favour of continued globalisation of finance, albeit with enhanced mechanisms for prevention and resolution of problems arising.

In this context, the discussion in many ways has followed the forms of global administrative law, with approaches ranging from a traditional hard-law treaty-based approach centred on a formal international organisation, down to uncoordinated domestic responses. While the latter have been found to be ineffective in the context of global finance (albeit not domestic finance under the Bretton Woods design), despite periodic proposals for a global financial regulator, a traditional international law/institution approach does not seem feasible at this time, even in the context of the European Union: issues of domestic sovereignty continue to make a global regulator for global finance unlikely for the foreseeable future. In looking forward, on balance, it appears to make little sense to incorporate financial regulation into the WTO framework, both because the WTO system is already overburdened and also due to its focus on negotiated liberalisation combined with dispute resolution, which is not overly useful in the context of financial regulation. At the same time, however, if amendments are to be undertaken to the IMF Articles of Agreement, then this

would also present an opportunity to provide the Fund with a specific mandate and related tools in relation to financial regulatory surveillance. Nevertheless, it is uncertain at this time whether actual amendment will be the path chosen – though for a variety of reasons beyond the scope of this chapter, this is probably in fact necessary while not politically simple, even in the present crisis environment.

At the other end of the spectrum, purely soft-law cooperative arrangements (such as the Basel Committee and the 1988 Basel Capital Accord) as existed until 1999 have proven ineffective in preventing and resolving international crises such as the Asian financial crisis. Following financial crises in the 1990s, to some extent, the cooperative mechanisms were given a greater level of coordination through the FSF and a higher level of formality through the FSAP monitoring mechanisms. Once again, however, a hardened soft-law approach of coordinated networks with limited external monitoring of compliance proved insufficient to address either prevention or resolution of a truly global financial crisis.

Discussion has thus turned towards intermediate arrangements. At the next level down from a hard-law/international organisation approach are discussions of creating a hard-law underpinning for the existing network model. While this is the approach which is largely being pursued in the European Union following the Larosière Report, with European authorities composed of domestic agencies responsible for setting regional regulation but with domestic enforcement, this approach has to date not been followed at the international level and may still prove impossible even in the EU context.

Instead, the approach which has been adopted at the international level by the G-20 is a further hardening of the pre-crisis system, through the strengthening of the FSF into the FSB, with a wider range of member commitments and strengthened peer review and external monitoring mechanisms. Overall, the FSB might work reasonably well when it comes to coordination and prevention functions without it being a hard-law institution, but the issue which remains is how to handle cross-border financial institution failures. Although the FSB will play a role in facilitating discussion among its members, what is lacking from the system is the ability to put its members under binding obligations that will lead to a greater willingness to burden-share the costs of cross-border bank failures. Some form of binding arbitration mechanism might be the best way to achieve this (and this in fact is the approach being pursued in the European Union). However, without a more formal and binding arrangement for burden sharing and dispute resolution, probably through a formal treaty and/or international organisation, the problems raised by the failure of global financial institutions will not be adequately addressed by the current approach to international financial regulation. As in many ways these problems were among the major causes of the systemic phase of the global financial crisis, failing to properly address them must be seen as indicating either that significant risks will continue to exist in the context of global finance or a tacit conclusion that finance and financial institutions will no longer in fact be global. Unfortunately, based on the unsuccessful experience of the IMF's proposals for a sovereign debt restructuring



mechanism,<sup>26</sup> the outlook in the context of the perhaps even more complicated arena of failure resolution mechanisms for cross-border financial institutions is not overly bright.

### Crisis Management: Liquidity

Assuming that crises will happen in future – both at the country level and in individual global financial institutions and markets – there is a clear need to put in place appropriate liquidity arrangements in advance. One lesson of the current crisis has been the continued validity of Bagehot's classic lender of last resort prescription: a lender of last resort ready to provide liquidity to solvent borrowers on the basis of any reasonable collateral. Those central banks (such as the ECB) that planned in advance for such circumstances and built the appropriate systems were those that were best able to mitigate the contagious failure of financial institutions during the acute phases of the current crisis.

At the international level, there are two sides to this: (1) countries that experience temporary liquidity problems, and (2) individual global financial institutions. In relation to countries, the initial response largely came from the major central banks (especially the Federal Reserve and, to a more limited extent, the ECB). This, however, is a function that could reasonably be centralised within the IMF and is arguably being performed through the new Flexible Credit Line. The weakness – already identified by the G-20 – is that any such arrangement in today's global financial system must be backed by the availability of very large amounts of money, certainly beyond the Fund's current capacity. As such, the mechanism – essentially, an emergency liquidity mechanism – requires major extension of the IMF's access to funding, including SDR allocations and multilateral borrowing arrangements, potentially from not only public-sector lenders but also private-sector lenders. While the details remain problematic, enhanced IMF funding is already progressing.

At the level of individual cross-border financial institutions, the Fund is probably not well-suited as a potential lender of last resort. As a result, it seems that individual global financial institutions are likely to remain quite closely associated with their home jurisdictions and the major central banks of jurisdictions in which they operate.

### Crisis Resolution

Unfortunately, not all crises are liquidity crises and it is certain that in future both countries and individual global financial institutions will periodically face insolvency, as has always been the case.

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<sup>26</sup> See IMF, Proposals for a Sovereign Debt Restructuring Mechanism, [www.imf.org/external/np/exr/facts/sdrm.htm](http://www.imf.org/external/np/exr/facts/sdrm.htm).

In the context of resolving international insolvencies, the IMF has emerged as the default option: if problems are not severe, bilateral central bank, sovereign or regional assistance may be available (and was made available during the current crisis). However, in circumstances involving severe financial problems (such as those of Iceland), the politically acceptable solution has been to send the problem to the IMF. Overall, this appears a valid approach going forward in such circumstances, even in the context of regional arrangements such as those in Europe or being developed in East Asia.

Unlike sovereign crises, it is certain that the Fund is not the appropriate entity to address individual cross-border financial institutions. At the moment, the solution is largely domestic, suggesting that individual economies must require separately capitalised and regulated subsidiaries rather than cross-border branching in financial services and highlighting one of the greatest conflicts between financial services liberalisation (negotiated through the WTO) and the requirements of domestic financial stability. As noted above, any other solution probably requires an international treaty, perhaps administered by the FSB.

#### Sustainable Growth and Development

In looking at this issue, it is becoming increasingly clear that issues relating to climate change and development are inextricably linked. As already indicated, this is an area not only for a formal international agreement but also for the MDBs to take an active role.

### **V. The Global Financial Crisis: Implications for the Emerging International Islamic Financial Architecture**

While issues relating specifically to financial regulation appear likely to be well-addressed at the international level, unfortunately other issues relating to global financial stability appear likely to remain outstanding. As a result, there are two primary sets of implications for Islamic finance: the first concerns regulatory issues relating to the crisis, while the second relates to the design of the Islamic financial architecture more generally.

In looking forward, international Islamic financial standard-setting organisations will need to pay especial attention to financial stability arrangements, albeit not to the detriment of financial sector development. In these respects, attention should focus on three main aspects: (1) crisis prevention, especially regulatory and supervisory design and coverage; (2) financial regulation and financial infrastructure; and (3) mechanisms to support crisis resolution, especially liquidity and resolution mechanisms.

## **A. *Crisis Prevention: Regulatory and Supervisory Design and Coverage***

In addressing prevention, the global financial crisis has shown that the overall design and coverage of a regulatory system are vital to its effectiveness. As highlighted by the G-20, there is an urgent need to design and implement effective macro-prudential financial system oversight. This requires a reshaping of regulatory systems so that authorities are able to identify and take account of macro-prudential risks, with the scope of regulation and oversight extending to systemically important financial institutions, instruments and markets, including non-bank financial institutions, and to credit rating agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest. In addition, prudential standards must be designed to address cross-sectional dimensions – how risk is distributed across a financial system – and time dimensions – how aggregate risk evolves over time – to build buffers for use in bad times.

As demonstrated by the global financial crisis, there is a complex interplay between monetary policy, fiscal policy, and supervision and regulation at the level of individual economies, regions and globally. Monetary policy and macro-prudential supervision are complementary, but fiscal policy and the private sector also need to be addressed. In the context of Islamic finance, while the industry did not experience the trauma of global finance, the lesson of macro-prudential oversight nonetheless applies, with a need to address mechanisms to consider macro-prudential risks in both individual jurisdictions, across Islamic finance, and between Islamic finance, the real economy and global finance.

## **B. *Financial Regulation and Financial Infrastructure***

As noted above, the G-20 has highlighted nine major regulatory issues relating to the global financial crisis: (1) the FSB, (2) international cooperation (focusing on financial institution failures), (3) prudential regulation, (4) scope of regulation, (5) compensation, (6) tax havens and non-cooperative jurisdictions, (7) accounting standards, (8) credit rating agencies, and (9) OTC markets. Each raises issues for regulation and supervision of Islamic finance.

### **(1) *Financial Stability Board***

As reconstituted, the FSB will: (1) assess vulnerabilities affecting the financial system, and identify and oversee required actions; (2) promote coordination and information exchange among authorities responsible for financial stability; (3) monitor and advise on market developments and their implications for regulatory policy; (4) advise on and monitor best practice in meeting regulatory standards; (5) undertake joint strategic reviews of the policy development work of the international standard-setting bodies, such as the Basel Committee, IOSCO, etc., to ensure their work is timely, coordinated, focused on priorities, and addressing any gaps; (6) set guidelines for, and support the establishment, functioning of, and participation in, supervisory colleges, including through ongoing identification of the most

systemically important cross-border firms; (7) support contingency planning for cross-border crisis management, particularly with respect to systemically important firms; and (8) collaborate with the IMF to conduct early warning exercises.

In turn, FSB members, subject to FSB elaboration and reporting, commit to: (1) pursue the maintenance of financial stability; (2) enhance the openness and transparency of the financial sector; (3) implement international financial standards; and (4) agree to undergo periodic peer reviews.

In looking at the FSB, at the international level the organisation is primarily intended to address deficiencies in international financial regulatory standards and in domestic implementation and regulatory design. These issues are equally pertinent to regulation of Islamic finance. In this context, while the IFSB plays a similar role to the previous FSF, the global financial crisis highlights the need not only for comprehensive international standards but also for mechanisms to achieve effective domestic implementation. In this context, the IFSB is presently designed primarily as a standards development organisation rather than one for implementation and monitoring. In looking at implementation, as is the case with global finance, it is highly unlikely that Islamic finance will move to an international regulator. At the same time, the IFSB provides a possible mechanism for hardening current soft-law arrangements, modelled on changes to the FSB. One model would be the IOSCO Multilateral Memorandum of Understanding (MMoU), in which the IFSB could propose a voluntary framework for members to both pre-commit to adoption of principles (as a prerequisite to signature) and also to periodic peer review – essentially an international self-regulatory mechanism. Related mechanisms are currently being addressed by the FSB and may provide useful models for the IFSB to consider going forward. In addition, it would be useful to consider whether the IFSB should be included in the FSB and whether its standards should be specifically incorporated into both FSB monitoring arrangements and the FSAP.

## ***(2) International Cooperation***

In relation to international cooperation, the G-20 leaders agreed: (1) to establish supervisory colleges for significant cross-border firms; (2) to implement the FSB principles for cross-border crisis management immediately, and that the home authorities of each major international financial institution should ensure that the group of authorities with a common interest in that financial institution meet at least annually; (3) to support continued efforts by the IMF, FSB, World Bank, and Basel Committee to develop an international framework for cross-border bank resolution arrangements; (4) the importance of further work and international cooperation on the subject of exit strategies; and (5) that the IMF and FSB should together launch an early warning exercise.

In this context, the most significant element is the increased focus on mechanisms to address failure of financial institutions operating on a cross-border

basis – a problem that is not easy to solve and one which will probably require significant time and effort to agree any sort of workable approach.

For Islamic finance, three issues stand out in this context: (1) regulation and supervision of cross-border Islamic financial institutions; (2) cross-border provision of Islamic financial services; and (3) resolution of failures of cross-border Islamic financial institutions. In relation to the first, the FSB approach is of relevance to the IFSB, with supervisory colleges for Islamic financial institutions operating in multiple jurisdictions appearing a valid approach and one that could be adopted through mechanisms similar to those being developed and implemented through the FSB for supervisory colleges for systemically significant cross-border financial institutions. In relation to the second, and unlike the general context of global finance, many significant Islamic finance jurisdictions still largely limit market access by foreign financial institutions. As such, this provides an opportunity for many jurisdictions not available to the major global financial jurisdictions, namely linking regulation and liberalisation. Specifically, jurisdictions could agree to permit market access by foreign Islamic financial institutions only from jurisdictions participating in the FSB / IFSB / FSAP process. In addition, and leading to the third, it probably makes the most sense to base cross-border Islamic financial services business on the model of separately capitalised and regulated subsidiaries, albeit separately capitalised and regulated to common principles and standards. At the same time, it is essential in light of crisis experiences that Islamic financial regulators and supervisors have in place appropriate arrangements and contingency plans to address the failure of any Islamic financial institution operating in a given jurisdiction. The inadequacy of arrangements to address failure has been one of the key lessons of the global crisis and one that bears direct relevance for all aspects of financial services, including Islamic finance and Islamic financial institutions.

### ***(3) Prudential Regulation***

In respect of prudential regulation, the G-20 made eight specific commitments, with four of these addressing capital. Specifically, until economic recovery becomes certain, the current 8% minimum international capital adequacy ratio standard will remain unchanged. In addition, capital levels above that level should be allowed to decline to facilitate lending as required in the context of poor economic conditions. However, once recovery is assured, prudential regulatory standards should be strengthened, specifically with capital requirements above the current minimum standards and also (returning to the reality that in the context of the crisis, equity capital has become far more important) that the quality of capital should be enhanced. Significantly, the G-20 also committed to implementation of Basel II, with all G-20 countries to progressively adopt the Basel II capital framework, although in a revised form reflecting experiences and lessons of the credit crisis.<sup>27</sup>

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The issues relating to cyclicalities are addressed in more detail in the following chapter.

Beyond capital, the FSB, the Basel Committee, the BIS Committee on the Global Financial System and the IASB are tasked to implement recommendations to address pro-cyclicality by end 2009. Further, in addition to capital and aspects of pro-cyclicality, for the first time, the G-20 committed to a simple, transparent, non-risk-based measure which is internationally comparable, properly takes into account off-balance sheet exposures, and can help contain the build-up of leverage in the banking system, essentially a leverage ratio to restrict overall leverage across the financial system. Returning to themes relating to securitisation from the November statement, the Basel Committee is tasked to develop a framework by 2010 to improve incentives for risk management of securitisation, including considering due diligence and quantitative retention requirements. Finally, in addition to capital and leverage standards, the G-20 committed to a new liquidity standard, with the Basel Committee tasked to develop by 2010 a global framework for promoting stronger liquidity buffers at financial institutions, including cross-border institutions.

In this context, the key lessons relate to, first, capital: a need to review existing Islamic capital requirements both in terms of amount (in all likelihood, to raise levels to still-to-be agreed global levels) and pro-cyclicality, the latter being a second key aspect of the global crisis. In addition, a key challenge for Islamic finance will relate to liquidity issues, especially problematic in the context of products and instruments with limited liquidity.

#### ***(4) Scope of Regulation***

Following on from the November 2008 G-20 Declaration, which agreed that all systemically important financial institutions, markets and instruments would be subject to appropriate regulation, the G-20 Financial System Declaration of April 2009 provides a much greater level of detail. Specifically, the April Declaration includes eight aspects. First, regulatory systems will be reformed to ensure authorities are able to identify and take account of macro-prudential risks across the financial system, including in the case of regulated banks, shadow banks, and private pools of capital to limit the build-up of systemic risk, with the FSB, BIS and international standard-setters tasked to develop specific macro-prudential tools and report by autumn 2009. Second, the leaders agreed that large and complex financial institutions require particularly careful oversight given their systemic importance. While seemingly self-evident, this reflects an important shift in emphasis from the pre-crisis (in which such firms were viewed as better able to address the risks they faced than regulators) to the post-crisis period (in which financial institutions', especially large financial institutions', internal risk management systems will be closely monitored by regulators). In support of this, G-20 national regulators will have the powers necessary to gather relevant information on all material financial institutions, markets and instruments in order to assess the potential for their failure or severe stress to contribute to systemic risk. In addition, in order to prevent regulatory arbitrage, the IMF and the FSB are producing guidelines for national authorities to assess whether a financial institution, market or instrument is systemically important.

Beyond traditionally systemically significant firms, as noted above, hedge funds or their managers will be registered and will be required to disclose appropriate information on an ongoing basis to supervisors or regulators, including on their leverage, necessary for assessment of the systemic risks that they pose individually or collectively. At the same time, supervisors will require institutions that have hedge funds as their counterparties to have effective risk management, including mechanisms to monitor the funds' leverage and set limits for single counterparty exposures. In relation to credit derivatives, standardisation and resilience of credit derivatives markets – in particular, through the establishment of central clearing counterparties subject to effective regulation and supervision – will be promoted, with industry tasked to develop an action plan on standardisation. Finally, in relation to keeping pace with future innovation, G-20 members will each review and adapt the boundaries of the regulatory framework regularly in order to keep pace with developments in the financial system and promote good practices and consistent approaches at the international level.

In relation to Islamic finance, the central issue is coverage: like other financial institutions, all Islamic financial institutions and activities should be subject to appropriate regulation. Thus, there is a clear need in jurisdictions to review overall regulatory design to ensure that there are no gaps, allowing for potential risks or regulatory arbitrage.

#### ***(5) Compensation***

As noted above, the G-20 April 2009 communiqué contained a strong commitment on compensation, which has been supported by the release of related principles from the FSB. According to the G-20 and the FSB, the principles require: (1) firms' boards of directors to play an active role in the design, operation and evaluation of compensation schemes; (2) compensation arrangements, including bonuses, to properly reflect risk and the timing and composition of payments to be sensitive to the time horizon of risks, with payments not finalised over short periods where risks are realised over long periods; and (3) firms to publicly disclose clear, comprehensive and timely information about compensation to stakeholders, including shareholders. Significantly, the G-20 committed that national supervisors implement the principles in order to be effective for 2009 compensation arrangements, with the Basel Committee integrating the principles into guidance, with supervisors assessing firm compensation and inventing as necessary.

Philosophically, this is an issue that should be less contentious in the context of Islamic finance but one which remains relevant nonetheless: namely, the need for regulatory review of compensation arrangements in Islamic financial institutions in order to ensure that they do not encourage inordinate risk-taking.

## ***(6) Tax Havens and Non-cooperative Jurisdictions***

Building on the statement from November 2008, the G-20 made strong commitments regarding tax havens in the April 2009 communiqué. In respect of actions, the G-20 Financial System Declaration includes a toolbox of six measures: (1) increased disclosure requirements on the part of taxpayers and financial institutions to report transactions involving non-cooperative jurisdictions; (2) withholding taxes in respect of a wide variety of payments; (3) denying deductions in respect of expense payments to payees resident in a non-cooperative jurisdiction; (4) reviewing tax treaty policy; (5) asking international institutions and regional development banks to review their investment policies; and (6) giving extra weight to the principles of tax transparency and information exchange when designing bilateral aid programs.

In addition to tax haven issues, the G-20 also tasked the FSB and IMF to develop a similar mechanism for international prudential regulatory standards. This latter indicates that the existing system of international financial standards for the first time will be given an effective enforcement mechanism, based on those previously used in the context of money laundering and now tax havens.

This is an issue where the IFSB provides a potential mechanism to address possible G-20 concerns about Islamic finance and Islamic financial institutions. To the extent that the IFSB were to move towards review arrangements, this is likely to provide reassurance regarding the appropriateness of Islamic regulatory arrangements in the context of global finance.

## ***(7) Accounting Standards***

In relation to accounting standards, the central issues relate to consistency across jurisdictions, to transparency of complex products and institutions, and to pro-cyclicality. While AAOIFI has in many respects developed beyond the IASB in terms of monitoring, it will nonetheless be important to consider issues emerging from international accounting standard-setters and their possible implications for Islamic financial and Islamic accounting and auditing standards.

## ***(8) Credit Rating Agencies***

Credit ratings and credit rating agencies (CRAs) played a central role in the global financial crisis. In this context, the two central issues to emerge relate to (1) overreliance by investors on credit ratings, and (2) overreliance by regulators on credit ratings. The result is a two-pronged focus: on regulating CRAs and reducing the regulatory support for their use. Both of these have clear implications for Islamic finance, with a need to provide for adequate regulation of CRAs and to carefully consider the role that credit ratings play in the regulation of Islamic finance. At the same time, the development of the IIRA provides a potentially significant avenue for addressing certain of these issues.



## **(9) OTC Markets**

One additional issue relates to counterparty risk in the context of OTC markets – perhaps the central mechanism of contagion in the global financial crisis. In relation to OTC markets, to date, the US and Europe have taken a leading role in addressing issues relating to regulation, clearing and settlement. This is an area which merits further attention in the context of Islamic finance.

### ***C. Crisis Resolution: Liquidity, Intervention and Resolution Frameworks***

The global financial crisis has highlighted that, in addition to effective monetary policy frameworks, economies the world over must have in place effective financial stability arrangements, extending not only to prevention but also to crisis resolution. At the early stages of the crisis, the Bank of England and the US Federal Reserve found themselves less effectively equipped in the context of liquidity provision than was the ECB, with both the Bank of England and the US Federal Reserve forced to dramatically extend their existing arrangements to non-traditional institutions and collateral. Clearly, liquidity arrangements in Islamic finance are philosophically problematic. Nonetheless, such arrangements are an issue requiring further consideration. In relation to resolution, there needs to be in place a comprehensive framework and contingency plan to address the failure of any financial institution operating within a given economy, including appropriately designed consumer protection measures.

### ***D. Implications for the Emerging International Islamic Architecture***

Could the current global financial crisis provide an incentive to the further development of the Islamic financial architecture?

The global financial crisis has hastened changes to the setting for international economic and financial cooperation, chiefly a migration from the G-7 and G-10 mechanisms to the G-20. As a result of the crisis and the view that the participation of major developing countries, especially from Asia, is central to its resolution and also to necessary reforms to the international financial architecture, emerging market economies are being asked to assume a new prominence at the international level, with China's role especially becoming increasingly prominent.

As noted above, any redesign of the international architecture should have a number of central elements: (1) economic policy cooperation, coordination and surveillance; (2) trade in goods and services liberalisation; (3) financial stability and development arrangements (including prevention, management and resolution); and (4) sustainable development coordination and assistance. Assuming that these issues will not entirely be addressed at the international level, it is important for discussions of the Islamic financial architecture to consider whether specific arrangements are necessary.

Overall, one can argue that each of these issues merits greater attention in Islamic finance, especially in relation to regulation and supervision, liberalisation, financial stability, and financial development arrangements. While regulation and supervision, liberalisation and financial stability have all been discussed in detail above, one issue that has not received sufficient attention is the implication in the context of the development of Islamic finance. In this context, in addition to considerations of stability and liberalisation, the Islamic financial architecture could play a greater role in supporting not only the development of Islamic finance, but the role of Islamic finance in economic development more generally. While the agenda relating to stability is likely to be quite full, the developmental aspects should not be ignored.



## CHAPTER FOUR

### CAPITAL REQUIREMENTS, COUNTER-CYCLICALITY AND ISLAMIC FINANCE

Professor Simon Archer

#### I. Introduction

The problem of the pro-cyclicality of capital adequacy regulations is well known, and has been discussed extensively in the literature (see, for example: Borio, Furfine and Lowe, 2001; Borio, 2003; Goodhart, Hoffman and Segoviano, 2004). However, in the context of a grave economic recession, the issue of how to mitigate this problem is widely discussed, and controversy reigns regarding the (counter-cyclical) remedies that have been proposed. Not only banks, but also insurance undertakings, are affected by the problem of pro-cyclicality, but the effects on banks have more serious macroeconomic implications. This chapter will therefore mainly focus first on banks generally, and then on Islamic banks. Issues concerning the insurance industry, including Islamic insurance (*Takāful*), will, however, be touched on.

The next section outlines the problem of pro-cyclicality, with the factors that contribute to it, in relation to conventional banks. Then, in section III, the various proposals for mitigating the problem (anti-cyclical methods) are reviewed. Section IV examines the problem and the various proposed mitigants in relation to Islamic banks. Section V briefly considers pro- and counter-cyclicality in conventional and Islamic (*Takāful*) insurance, and Section VI sets out some concluding remarks.

#### II. The Problem of Pro-cyclicality

As explained in a Financial Stability Forum (FSF) Note for the FSF Working Group on Market and Institutional Resilience, *Addressing Financial System Procyclicality: A Possible Framework* (FSF, 2008), the problem of the pro-cyclicality of a financial system consists in the fact that the effect of various components of the system (including capital requirements and financial reporting standards) on financial institutions in general, and banks in particular, tends to aggravate the economic cycle. “[A] financial variable is said to behave pro-cyclically if its co-movement with the real economy is such as to strengthen the evolution of the latter. For example, if measures of risk *increase* as the economy *contracts*, they are said to be pro-cyclical (even if they actually move counter-cyclically in a numerical sense) because they would tend to strengthen the contraction” (ibid.). However, the FSF (op. cit.) makes the point that the fundamental causes of pro-cyclicality lie in economic behaviour,

rather than in institutional arrangements such as capital requirements or accounting rules. It identifies two fundamental causes of pro-cyclicality: limitations in the measurement of risks, and distortions in incentives. The first of these has an impact on the estimates of capital requirements, both economic and regulatory. The second has its effects both through measures taken to limit credit or counterparty exposures such as collateral or margin requirements, which can exacerbate pro-cyclicality through linking funding to asset valuations, and through actions that appear rational from the perspective of individual economic actors but which collectively may have undesirable outcomes. For example, foreclosing on collateralised loans such as those for home purchase may induce distressed sales of properties which drive down the prices and undermine the value of the collateral. In this context, elements of the policy framework such as prudential and accounting regimes are seen as contributory rather than fundamental factors, which can aggravate the positive feedback processes that are characteristic of the economic cycle. Addressing pro-cyclicality is seen as an integral part of a move to strengthen the *macro-prudential* orientation of regulatory and supervisory frameworks relative to their *micro-prudential* one (FSF, op. cit.).

The element of prudential regimes that is often cited in this context is minimum capital requirements. Under Basel II, capital requirements for banks take the form of a minimum required capital adequacy ratio (CAR). During the expansion phase of the economic cycle, the following factors make it easier for banks to meet this minimum requirement (an effect which is reversed during the contraction phase, thus resulting in pro-cyclicality):

1. *Profits and reserves.* Banks' profits tend to be buoyant and this leads to increases in their reserves – that is, in their own capital.
2. *Asset values* are also buoyant. In the case of assets held for trading, their market values are positively affected by the economic circumstances. For banking book assets such as loan portfolios and debt securities not held for trading, the risk of impairment (probability of default) is considered to be less than in harder times, so that lower provisions are thought to be necessary. The result of this buoyancy of asset values is to amplify the magnitude of profits and reserves, and hence to reduce leverage.
3. *Risk weights* applied to banking book assets tend to be lower. Under the standardised approach, the credit ratings applied to such assets by external credit assessment institutions (ECAIs) will reflect the favourable economic climate, while under the internal ratings based (IRB) approach the credit ratings calculated by banks themselves will reflect the same optimism. In general, because of the methodology for estimating expected losses (EL) being the product of probability of default (PD) and loss given default (LGD), under the IRB approach the problem of pro-cyclical risk-weighting (especially due to cyclicity of estimates of PD) is more severe for IRB banks than for those using the standardised approach.

The influence of these three micro-level factors on the behaviour of banks has the effect of aggravating the economic cycle. During the expansion phase, the ease with which banks are able to meet the capital requirement allows them to take on more loans, which contributes to an expansion of credit in the economy, which in turn feeds the economic expansion. The result is an example of positive feedback in the economy which continues until some shock (such as the bursting of an asset price bubble) causes the process to go into reverse – the contraction phase of the economic cycle. The three factors then have the opposite effects, and in particular banks reduce the amount of credit they are prepared to offer, both because they are constrained by the capital requirements and because credit ratings are reduced and estimates of PD are more pessimistic. The result is a “credit crunch” which may be more or less severe. When it is severe, its effect is to aggravate the contraction phase of the economic cycle, leading to a serious recession or, worse, to a depression.

However, it should be noted that financial institutions have found ways of bypassing regulatory capital requirements as currently laid down – for example, by using off-balance sheet special-purpose vehicles (SPVs) in which financial instruments such as asset-backed securities (ABS) are placed, being financed in some cases by short-term debt. As the debt of the SPVs in question generally falls to be honoured by the parent institution for reputational or other reasons, the latter is effectively exposed to the default risk of the ABS while avoiding regulatory capital requirements. SPVs are also used as issuers for the securitisation of collateralised financial assets, thus resulting in the said ABS. This has come to be known as the “originate-to-distribute” model. The resultant spreading of what is effectively anonymous credit risk throughout the system is an obstacle to its effective management. There seems to be no doubt that the increasing prevalence during the decade up to 2008 of the originate-to-distribute model in the United States, and to a lesser extent elsewhere in the West, was a major factor in the explosion of uncontrolled credit risk (including, notoriously, that of “sub-prime” mortgages) and the subsequent financial crisis. This was aggravated by the proliferation of trading in credit default swaps (CDS), which had the effect of spreading the risk to the insurance sector, with dire consequences for what was then the world’s largest insurer, AIG. Thus, a focus merely on capital requirements and other micro-level factors in the search for counter-cyclical mitigants is insufficient; there is also a need for “macro-prudential” mitigants in financial regulation and supervision, as discussed below.

While much attention has been paid to credit risk and the impairment of banking book assets, market risk exposures also played a major part in bringing about the financial crisis. According to the Joint FSF–BCBS [Basel Committee for Banking Supervision] Working Group on Bank Capital Issues (2009), since the financial crisis began in mid-2007 the majority of losses and most of the build-up of leverage occurred in the trading book. Losses in many banks’ trading books were significantly higher than the minimum capital requirements under the Pillar I market risk rules. Measures of market risk such as Value at Risk may thus have pro-cyclical

effects when converted into capital requirements, notably by underestimating the magnitude of potential losses in stressed situations. Capital requirements for market risk thus need to be considered in any search for counter-cyclicity.

It has also been suggested that remuneration practices within financial institutions may have pro-cyclical effects, since they provide further incentives for banks to engage in credit expansion and to take on additional risks during expansion phases.

Financial accounting standards, and in particular the International Accounting Standards Board's (IASB's) IAS 39 (IASB, 2009a) and its US counterparts, have been alleged to contribute to pro-cyclicity (FSF, op. cit.). This is because these standards tend to favour the use of "fair values" for assets, including those that are not held for trading but are classified as "available for sale". Using "fair values" (market prices or estimates of market prices) for assets held for trading or available for sale, rather than original or amortised cost adjusted for any impairment in value, is considered to contribute significantly to the effects of factor (2) above when economic circumstances lead to there being no active market for the assets in question, with the result that "fair values" may be very low. Recent controversy concerning IAS 39 has involved proposals to allow a longer-term view of "fair value", rather than one based on short-term disposal (exit) value, to be used. Proposals regarding financial accounting methods in relation to counter-cyclicity, including "dynamic provisioning", will be discussed below.

### **III. Proposed Method for Mitigating Pro-cyclicity**

The following counter-cyclical mitigants have been proposed (see, for example, FSF, 2008; ECOFIN, 2009):

- macro-prudential regulation and supervision (monitoring system-wide risks);
- capital buffers;
- funding liquidity standards;
- maximum gearing or leverage limits as a backstop to a minimum CAR requirement;
- financial accounting measures:
  - "neutral" or "dynamic" provisioning
  - modification of "fair value" rules; and
- elimination of pro-cyclical remuneration practices.

#### **A. Macro-prudential Regulation and Supervision**

The macro-prudential and micro-prudential perspectives in regulation and supervision may be distinguished in stylised fashion as shown in Table 4.1 (Borio, 2009), bearing in mind that both orientations inevitably co-exist in current prudential frameworks.

**Table 4.1 Macro- and Micro-prudential Regulation and Supervision**

|   | <b>Macro-prudential</b>                                  | <b>Micro-prudential</b>                                 |
|---|--|---|
| Proximate objective                                   | Limit system-wide financial distress                     | Limit distress of individual institutions               |
| Ultimate objective                                    | Avoid output (GDP) costs linked to financial instability | Consumer protection                                     |
| Characterisation of risk                              | Seen as dependent on collective behaviour (endogenous)   | Seen as independent of individual behaviour (exogenous) |
| Correlations and common exposures across institutions | Important  | Irrelevant  |
| Calibration of prudential controls                    | In terms of system-wide risk: top-down                   | In terms of risks of individual institutions; bottom-up |

The importance of the macro-prudential perspective follows from the costs of financial crises to the real economy, and hence to social welfare. Endogenous risk plays a crucial role in financial instability, which has pro-cyclical (positive feedback) characteristics as a result of self-enforcing mechanisms, both within the financial system and between the financial system and the real economy, which tend to exacerbate “booms” and “busts”, and are most prominent in the contraction phase but most insidious in the expansion phase (Borio, loc. cit.). In addition, the soundness of individual institutions cannot be properly assessed on a stand-alone basis. *Systematic* risk entails common exposure across institutions to the same risk factors, such as the bursting of stock market bubbles, or currency collapses; while *systemic* risk involves contagion whereby the failure of one institution brings about a chain reaction affecting others, either through inter-linkages such as counterparty exposures or because of herding behaviour on the part of market participants.

No prudential regime takes a purely micro perspective in practice, because of the awareness of systemic risk. However, the recent financial crisis has provided examples of systemic risk spreading inter-sectorally, from the banking to the insurance sectors, through various credit insurance products. On the other hand, a macro-prudential approach takes account of, but goes beyond, micro-level measures in a cross-sectional manner. In addition to capital requirements, for example, it includes monetary and fiscal policies.

A macro-prudential approach thus considers aggregate risk in two dimensions: cross-sectional and time-series. The cross-sectional dimension is concerned with the distribution of risk in the financial system at a point in time, distinguishing between idiosyncratic and systematic risk. The time-series dimension considers the evolution of system-wide risk over time, with reference to pro-cyclicality.



A concern with pro-cyclicality may cause the cross-sectional dimension to be overlooked, but it is a key part of the macro-prudential approach. In the cross-sectional dimension, the need is to calibrate risk-weighting so as to increase the weights on exposures to systematic risks as compared to idiosyncratic risks. (Current regimes do not make this distinction, as the focus is on the overall risk of an institution.) This implies that standards should be tighter for exposures that are common to a number of institutions and for institutions whose failure would have a major impact on the system. This may apply particularly to market risk exposures.

In the time-series dimension, the need is for counter-cyclical buffers at the institutional level, built up during the expansion phase so that they may be drawn down “in a controlled way and within limits [during the contraction phase] as strains threaten to emerge” (Borio, *ibid.*). The building up of the buffers should act to restrain the taking on of risky assets during the expansion phase, and their running down should cushion blows to the system in the contraction phase. In this way, the pro-cyclicality of capital requirements is mitigated.

Borio (*ibid.*) sets out five points to be followed for an effective macro-prudential regime:

- *A holistic approach* – capital is just one prudential tool, and the degree of pro-cyclicality of the system depends on the functioning of several other factors: monetary and fiscal policies; accounting practices (provisioning, fair value accounting); deposit insurance; liquidity requirements, etc.
- *Building on Basel II* – making simple and transparent adjustments to reduce the pro-cyclicality of capital requirements by introducing counter-cyclical elements (macro-prudential buffers).
- *Reliance on rules, rather than discretion* – rules give some protection to supervisors against pressure not to take action during boom times even if they see risks building up; but some room should be left for discretion.
- *Strengthening the institutional setup* – better cooperation between central banks and supervisory authorities, with more clarity of mandate, accountability, transparency and independence.
- *Adjusting the scope of regulation* – need to find a way of dealing effectively with the unregulated sector, and with pro-cyclical remuneration practices.

## **B. Capital Buffers**

Counter-cyclical capital buffers may be used to mitigate the pro-cyclicality of regulatory capital requirements, as mentioned above in connection with the time-series dimension of a macro-prudential approach. Insofar as regulatory capital requirements have pro-cyclical effects, capital buffers seem to be an obvious response (Persaud, 2009). However, to the extent that they involve banks holding

more capital in “normal” times – that is, most of the time – they have been criticised as entailing an increase in the expected cost of funds with adverse consequences on the level of intermediation activity and hence on economic activity in general (Kashyap, Rajan and Stein, 2008). Moreover, it should be borne in mind that the pro-cyclical effects of Basel II capital requirements, such as they are, were not the major cause of the “credit crunch”; the major cause was asset impairments and trading book losses, together with the need to take back the credit risk exposures of off-balance sheet SPVs, with their effects on banks’ capital adequacy, as the bubble burst.

Capital buffers may be introduced at either the Basel Pillar I or Pillar II level. The Pillar I level is mostly concerned with the mechanics of the IRB approach, whether inputs such as PDs or outputs in terms of capital requirements. As most, if not all, Islamic banks use the standardised approach, the issues raised by the IRB approach will not be examined here.

Pillar I capital requirements under the standardised approach will be driven to some extent by ECAI ratings, which tend to be pro-cyclical. As relatively little capital is required to be held against highly rated assets, a set of major downgrades of asset ratings may result in significant pressure on banks’ capital (a micro-prudential consideration) typically leading to a credit squeeze which will aggravate the downturn (a macro-prudential concern). Coupling this with the effect on profits of an economic contraction, including the need to increase provisions for asset impairments and trading book losses, a lack of capital adequacy may thus occur even in a bank that had an apparently comfortable capital cushion in a favourable economic climate. On the other hand, counter-cyclical capital buffers must be allowed to work counter-cyclically – that is, supervisors must keep their nerve and allow them to be run down in periods of severe economic contraction. This leaves the issue of whether counter-cyclical capital buffers are to be located at the Pillar I or Pillar II level. There is also the further issue of the extent to which provisioning practices for asset impairments and fair value accounting are pro-cyclical, and whether changes are called for. This issue will be examined in section III.D below.

While capital buffers at the Pillar I level have been criticised for increasing the cost of funds, buffers at the Pillar II level may suffer from too much reliance on discretion and not enough on rules, so that supervisors have difficulty in enforcing them. The Committee of European Banking Supervisors (CEBS) Position Paper (CEBS, 2009) expressed a preference for such counter-cyclical mechanisms to operate “under the Pillar II umbrella [which would] allow for flexibility in testing new prudential tools”.

### **C. *Funding Liquidity Standards***

The issues regarding funding liquidity are analogous to those concerning capital buffers. The availability of funding liquidity tends to move pro-cyclically, together with credit terms and market conditions. Perceptions of counterparty risk in

interbank markets are naturally pro-cyclical. Minimum liquidity requirements that are time- and cycle-invariant, especially if they are hard constraints, can aggravate pro-cyclicality. The question is: how far can liquidity requirements be structured with these concerns in mind, in the context of measures to improve liquidity management? The range of options is broadly similar to that for capital, except that standards for funding liquidity have been the subject of much less international harmonisation (FSF, op. cit).

#### ***D. Maximum Gearing or Leverage Limits***

Because risk weights tend to be pro-cyclical, the same applies to capital requirements based on risk-weighted assets. In particular, as noted above, dramatic falls in capital adequacy may result from a set of major rating downgrades. One way of mitigating this problem is for the regulator to set a maximum leverage limit in terms of non-risk-weighted assets. This may be expressed as a minimum ratio of eligible capital to total assets.

#### ***E. Financial Accounting Measures***

Certain financial accounting practices or requirements are considered to have pro-cyclical effects namely, provisioning for expected credit losses and fair value accounting.

##### ***(1) Loan Loss Provisioning***

Loan loss provisioning is pro-cyclical to the extent that optimism regarding PDs and (to a lesser extent) LGDs prevails in favourable economic conditions, while the opposite is true in unfavourable conditions. This pro-cyclical effect is significant if provisions are made on a point-in-time (PiT) basis, but not if they are made on a through-the-cycle (TTC) basis (i.e. based on default statistics for homogeneous categories of credit, either compiled through a complete economic cycle or adjusted to take account of the effects of the economic cycle). Provisions on this statistical basis are made when loans or other credits are originated, based on the expected TTC losses (Griffith-Jones and Ocampo, 2009; Saurina and Jimenez, 2006). Thus, while actual losses and write-offs will be greater when economic conditions are adverse, adequate provisioning on a TTC basis should remove the need to increase the provisions in such conditions.

TTC or “neutral” provisioning should be distinguished from so-called dynamic provisioning, which consists of “fattening up” provisions in good times and running them down in bad times to a greater extent than a TTC approach would require. This is, in fact, a form of income smoothing. It is favoured by a number of Continental European banks that have never been reconciled to the clear distinction in International Financial Reporting Standards (IFRS) between liabilities (of which certain provisions are a subset, loan loss provisions being “contra-assets”) and equity, and which still yearn for the times when “hidden reserves” were permitted. It

is significant in this context that when the EC Bank Accounts Directive was issued in December 1986, member state options were included which permitted the maintenance of “hidden reserves” by reporting banking book assets at values lower than that required to provide a “true and fair view” (subject to a limit of 4% of the value of such assets), and also to include in liabilities a “fund for general banking risks”. The latter is not, strictly speaking, a hidden reserve but performs a similar function by leaving discretion for income smoothing.

Such practices are ruled out by IASB standards (IASB, 2009a), but European banks have been lobbying to have the IASB standards softened up. ECOFIN (2009), paragraph 5, is an example of the difficulty in distinguishing between a neutral TTC approach to provisioning and an “income smoothing” approach, referring approvingly, but misleadingly, to “forward looking provisioning which consists of constituting provisions deducted from profits in good times for expected losses on loan portfolios”. Because TTC provisioning requires provisions to be made when loans are originated, based on TTC loss statistics as described above, amounts set aside in provisions for any homogeneous category of credit are automatically larger in an economic expansion phase when the volume of credit accorded is greater (and credit standards are laxer), and smaller in a contraction phase when the volume is smaller (Saurina and Jimenez, loc. cit.)

According to IFRS, impairment of a financial asset has occurred if it becomes “probable” that not all amounts due will be collected by the holder of the asset. In making provision for impairments, loans and similar financial assets “may be measured and recognized on a portfolio basis for a group of similar financial assets that are not individually identified as impaired” (IAS 39, pars. 63–65) (IASB, 2009a). While this wording might seem compatible with a TTC approach based on loss statistics for homogeneous categories of credit, such compatibility would depend on how the words “becomes probable” were interpreted, and the requirements of IAS 39 have been interpreted as entailing PiT rather than TTC provisioning. However, following the meeting of the G-20 in April 2009, the IASB was asked to review the position with regard to provisioning. In August 2009, the Basel Committee for Banking Supervision (BCBS) issued a set of *Guiding Principles for the Replacement of IAS 39*, one of which includes a proposal for an “Expected Loss” model with the stipulation that “expected credit losses are estimated losses on a loan portfolio over the life of the loans and considering the loss experience over the complete economic cycle” – that is, a TTC approach different from the “Incurred Loss” model in the existing IAS 39. The IASB responded on 5 November 2009 by issuing an Exposure Draft, *Financial Instruments: Amortised Cost and Impairment*, in which the Expected Cash Flow (ECF) model (a type of “Expected Loss” model) is proposed as a replacement of the “Incurred Loss” model. However, the ECF model proposed in the Exposure Draft does not constitute a TTC approach.<sup>1</sup>

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<sup>1</sup> See paragraphs BC22 and following of the Basis for Conclusions issued together with the Exposure Draft. It was clear from paragraph 10 of the IASB May 2009 Staff Paper, “Amortised Cost – an expected cash flow approach”, that the IASB was uncomfortable with a version of the ECF model that would accommodate TTC provisioning.

## **(2) Fair Value Accounting**

Fair value accounting (FVA) is applicable to trading book assets and, according to the IASB Exposure Draft *Financial Instruments: Classification and Measurement* which is intended to replace parts of IAS 39 (IASB, 2009b), to all items except those that (a) have only basic loan features and (b) are managed on a contractual yield basis. Fair value (FV) is defined in IAS 39 as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arms length transaction”. In the Exposure Draft *Fair Value Measurement* of a new standard that will replace parts of IAS 39 (IASB, 2009c), the proposed definition is “the amount that would be received to sell an asset or paid to transfer a liability in an *orderly transaction* between *market participants* at the transaction date ... in the most advantageous market (an exit price), whether that price is directly observable or estimated using a valuation technique” (italics in the original). Use of FV is pro-cyclical to the extent that “fair values” tend naturally to follow the economic cycle. However, a more serious problem in a financial crisis is that measurement of an asset at FV is problematic in the absence of a reasonably active market in that type of asset. In particular, in certain market conditions there may be a lack of willing buyers. Does this imply that holders of assets for which there are no willing buyers have to measure them on a “distressed sale” basis? If so, when the holders are banks, the resultant re-measurement losses put pressure on their capital and reduce their capacity to extend credit, thus aggravating the crisis. A possible solution in such circumstances, which has been suggested by the Chairman of the IASB, would be to measure assets held for long periods on the basis of the expected cash flows from them to the holder.

### **F. Elimination of Pro-cyclical Remuneration Practices**

Large performance-related bonuses for members of bank managements, particularly in trading but also in credit origination, have had the effect of encouraging excessive risk-taking, as the decision-maker receives a large bonus if the outcome is a gain but does not face a “negative” bonus if the outcome is a loss. This problem is exacerbated by the fact that the gains, if any, tend to be short-term while the losses may occur later.

It is not clear how setting strict rules on management remuneration schemes would be effective, since such rules are not difficult to avoid in the absence of rigorous international enforcement (which presupposes international agreement). It may therefore be argued that regulatory policies should aim mainly at improving disclosure on incentives (Columba, Cornacchia and Salleo, 2009), together with greater Pillar II supervision of risk management.

## IV. Pro-cyclicality in Islamic Banks

For various reasons, pro-cyclicality may be considered to be a less serious problem in Islamic than in conventional banks. This may be true of the micro-level factors, and hence also from the macro-level perspective. The main reason for believing that pro-cyclicality may be a less serious problem in Islamic finance is that, in general, Islamic banks do not raise most of their funds in the form of deposits or extend credit in the form of loans unrelated to the acquisition or provision of assets or asset services. Most of the funds raised by Islamic banks are in the form of profit-sharing and loss-bearing investment accounts (PSIA), which are to a greater or lesser extent risk-absorbent (see section IV.B). The relationships between deposits, leverage, credit extension and capital requirements are, at any rate, less mechanical than in conventional finance. However, the growing practices among Islamic banks of raising term deposits (generally, short-term) and making term loans based on Reverse *Murābahah* or *Tuwaruq* transactions have the effect of reducing this difference. Whether in fact Islamic finance is inherently less pro-cyclical thus remains an open question, but it may be noted that its institutions suffered less in the financial crisis that began in 2007 than those in the conventional financial sector. With this provision, the various factors considered in Section III will be considered below.

### A. *Macro-prudential Regulation and Supervision: Monitoring System-wide Risks*

Islamic banks are prone to risk concentration, because of both *Sharī'ah* restrictions on asset classes and the geographical concentration that tends to come with being regional, rather than international, banks. In particular, they tend to have disproportionate exposures to real estate in a particular region, both through *Ijārah*-based credit origination and participation in financing real estate development.

The IFSB has issued a standard (IFSB-7) which sets out limits for Islamic banks on risk concentrations in real estate. While this standard has a micro-level orientation, its enforcement by supervisors will also play a macro-prudential role. More generally, supervisors need to pay particular attention to risk concentrations in Islamic banks.

While Islamic banks may not have much exposure to the systemic risks of the conventional financial sector, this should be a matter for supervisory attention within the cross-sectional dimension as described in section III.A above. Islamic banks will be affected, like conventional banks, by the effects on profits and asset values of the economic cycle. In the oil- and gas-producing countries, the prices of these commodities have macroeconomic effects which impact the financial sector, including Islamic banks.

## **B. Capital Requirements**

So far as Pillar I capital requirements are concerned, most if not all Islamic banks use the standardised approach, as they lack the data and other tools necessary for an IRB approach. Pro-cyclicality enters the scene, however, via the ECAI ratings which have tended to be heavily pro-cyclical. Hence, it is reasonable to expect Islamic banks to maintain counter-cyclical capital buffers.

The extent to which these are necessary depends, however, on the amount of credit and market risk that falls on a bank's unrestricted investment account holders (UIAH). The latter place their funds on the basis of a *Mudārabah* profit-sharing and loss-bearing contract or, in a minority of countries, on the basis of a *Wakālah* contract. In either case, it is the investment account holders (IAH) and not the bank which are, in principle, exposed to the credit and market risks of the assets financed by the IAH funds. In practice, however, a part of such exposures may fall on to the bank's own capital by virtue of displaced commercial risk (DCR). That is, either for competitive reasons or because of supervisory concerns for the protection of UIAH, the Islamic bank may be obliged to "smooth" the profit payouts to the UIAH by forgoing part or all of the profits which would otherwise have been attributable to shareholders (Archer, Karim and Sundararajan, 2009). While it is not *Sharī'ah*-compliant for an Islamic bank to guarantee the capital of its UIAH, and hence to cover an overall loss to UIAH by using shareholders' funds, the UIAH share of losses on assets within a portfolio leading to a small or zero overall profit may effectively be borne by the shareholders in the form of the "smoothing" of payouts to UIAH by means of transfers from shareholders' profits or reserves.

For this reason, rather than requiring Islamic banks to maintain counter-cyclical buffers under Pillar 1, it may be preferable for supervisors to deal with this matter under Pillar II. While an institution-by-institution approach, taking account of the level of DCR and other matters at the institutional level, would seem to be called for, the supervisory approach should rely on rules and not just on discretion, for the reasons mentioned in section III.A above.

## **C. Funding Liquidity Standards**

There are no funding liquidity standards that have been developed specifically for Islamic banks, which are therefore governed by whatever funding liquidity standards are in force for conventional banks. Liquidity management is, however, a particular challenge for Islamic banks, given the lack of *Sharī'ah*-compliant interbank markets and lender of last resort facilities in almost all of the countries in which they operate (Malaysia being an exception). In addition, there is a dearth of *Sharī'ah*-compliant negotiable paper that could be held by Islamic financial institutions as a liquid resource (IFSB, 2008). Insofar as Islamic banks, *faute de mieux*, make use of instruments based on Commodity *Murābahah* transactions on both sides of the balance sheet, such arrangements will be prone to pro-cyclicality because of pro-cyclical perceptions of the counterparty risk to which the *Murābahah* creditors are

exposed. In this respect, such arrangements are comparable to conventional interbank markets.

#### **D. Maximum Gearing or Leverage Limits**

In principle, Islamic banks do not use return-paying deposits to leverage their capital. They may use unremunerated current accounts for this purpose, but with few exceptions current accounts do not constitute the bulk of an Islamic bank's funding, which comes from UIAH. More recently, however, some Islamic banks have been using Reverse *Murābahah* or similar transactions to generate a form of return-paying term deposits. Any maximum gearing limit set by the regulator should obviously apply to such deposits.

#### **E. Financial Accounting Measures**

In a majority of countries, Islamic banks apply IFRSs, and to that extent the comments made in section III.E may be applicable to them. Where AAOIFI Financial Accounting Standards are applied, the situation regarding fair value accounting may be different. However, AAOIFI standards aim to be compatible with IFRSs as far as possible.

##### **(1) Loan Loss Provisioning**

The points raised in section III.E above apply to loss provisions made by Islamic banks for exposures in respect of *Murābahah*, *Salam* and *Istisna'a* receivables and to lessee defaults on *Ijārah Muntahia Bittamleek* assets. The latter are "quasi-collateralised" by the lessor's right to repossess the leased asset in case of default, but in certain market conditions the value of the asset may be impaired.

##### **(2) Fair Value Accounting**

The effects of FVA on the trading book assets of Islamic banks are similar to those for conventional banks. A different issue may arise, however, in respect of *Sukūk* that are not held for trading (e.g. those held in the banking book to meet liquidity requirements). Under IFRSs, an Islamic bank may elect to classify such assets as measured at amortised cost, provided they have only "basic loan features" and are managed on a contractual yield basis. While *Ijārah Sukūk* are neither loans nor based on loans, their cash flows will generally be such that they meet the conditions for having only basic loan features. For *Salam* and *Istisna'a Sukūk*, the same will generally be true. Also, if they are held in the banking book they will generally be managed on a contractual yield basis. However, in the case of *Mudārabah* or *Mushārah Sukūk*, the conditions for having only basic loan features will not be met, as there are no contractually determined cash flows. If held in the banking book, they will fall to be measured on the basis of FV. It should also be borne in mind that a pool of assets may be securitised provided the proportion of financial assets included in it does not exceed a specified percentage (such as



49%). Hence, part of the pool of assets backing a *Sukūk* issuance may be *Murābahah*, *Salam* or *Istisna'a* receivables.

#### **F. Elimination of Pro-cyclical Remuneration Practices**

There is no evidence that the remuneration practices that have had pro-cyclical effects in conventional banks have been prevalent in Islamic banks. In trading, the type of speculative risk-taking that has been linked to the seeking of large bonuses in conventional banks is strongly discouraged, when not totally forbidden, in Islamic finance. In credit origination, the originate-to-distribute model is in principle prohibited by the *Sharī'ah* as it involves the sale of debt. However, certain *Ijārah Sukūk* issuances may have the effect of transferring lessee default risk (effectively a form of credit risk) from the originator and the issuer to the *Sukūk* holders, and this could provide an incentive for something similar to risky credit origination. (Moreover, as noted above, *Sukūk* issuances may be backed by a pool of assets that contains only a majority of *Ijārah* assets.<sup>2</sup>) This, together with other issues with respect to *Sukūk* structures that do not involve pro-cyclicality, should therefore be a matter for regulatory and supervisory attention.

### **V. Pro-cyclicality in Insurance**

The macro-level implications of pro-cyclicality in the insurance industry (including *Takāful*) are not comparable to those in the banking industry, as the former plays little or no part in the expansion and contraction of credit. With regard to system-wide risk, however, the insurance industry played a significant role in increasing it through selling credit default swaps. The risk of another huge build-up in the volume of CDS will surely be carefully monitored in future. CDS are not *Sharī'ah*-compliant, so *Takāful* institutions are not involved in such risks.

Apart from that, the issues of pro-cyclicality of capital requirements in insurance, and the effects of counter-cyclical measures, concern mainly the micro level – namely, their role in policyholder protection against the insolvency of the insurer. There is, however, a macro-level (welfare) issue, which is the effect of counter-cyclical capital buffers on the cost of insurance. If the average amount of capital to be held is increased, the cost of insurance will be pushed up and this is likely to result in underinsurance on the part of both businesses and households.

The economic cycle affects the capital of insurance undertakings through its impact on the values of assets. This impact concerns particularly an undertaking's holdings of equities and hence the capital charge applied to cover the risk arising from changes in equity prices. Article 105a of the EU's proposed Solvency II Framework, as approved by the European Parliament on 29 April 2009, requires a

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<sup>2</sup> Hence a version of the "originate-to-distribute" model that did not breach *Sharī'ah* rules might be a possibility.

counter-cyclical mechanism referred to as a “symmetric adjustment”, based on the current level of an appropriate equity index and a weighted average level of that index calculated over an appropriate period of time. The resulting adjustment is not to exceed 10% of the standard capital charge in either direction.

The above reasoning applies to solvency regimes that are risk-based in the sense that risk-based capital charges are applied to assets. The IFSB is currently preparing an Exposure Draft of a standard on *Takāful* solvency which advocates a similarly risk-based approach, but without going into the details of how capital requirements are to be calculated.

## **VI. Concluding Remarks**

These concluding remarks focus on pro-cyclicality in Islamic finance. The analysis presented above suggests that, from both macro-prudential and micro-prudential perspectives, pro-cyclicality may be less of a problem in Islamic than in conventional finance. So far as system-wide risks are concerned, in general, Islamic banks and *Takāful* institutions have limited counterparty risk exposures compared to conventional institutions (although Islamic banks may have such exposures in the case of Commodity *Murābahah* transactions undertaken for liquidity management purposes, and *Takāful* institutions may have exposures to conventional reinsurers); moreover, they do not engage in highly speculative trading transactions. Nor do they apply the originate-to-distribute model of credit origination, although in theory they might do so to a limited extent through *Sukūk* issuances. There are, however, dangers of risk concentrations in real estate assets and in geographical areas. Profits and asset values of Islamic financial institutions will also be affected by the economic cycle and in some regions by the behaviour of oil and gas prices.

The need for counter-cyclical capital buffers in Islamic banks will depend on the level of DCR and of reverse *Murābahah*-based term deposits in individual banks. The degree of prevalence of the latter will also determine the applicability of overall gearing limits to Islamic banks.

So far as financial accounting measures are concerned, the situation as regards FVA is complicated by issues that arise in applying IFRSs to Islamic banks’ and *Takāful* undertakings’ assets, including holdings of *Sukūk*, and by the fact that in some countries Islamic financial institutions apply AAOIFI standards, not IFRSs. The issues in loan loss provisioning in Islamic banks applying IFRSs are the same as those for conventional banks. Moreover, AAOIFI standards tend to be compatible with IFRSs so far as the need for *Shari’ah* compliance allows.

For *Takāful* institutions, pro-cyclicality raises some micro-level issues concerning capital buffers similar to those for conventional insurers. But the macro-level risks associated with CDS do not concern Islamic financial institutions.

Finally, it should be noted the macro-prudential issues of pro-cyclicality and counter-cyclical mitigants call for close cooperation between regulators and supervisors of the various sub-sectors of Islamic finance. Moreover, the underlying micro-prudential issues, such as capital buffers and credit loss provisioning, are technically challenging for Islamic financial institutions and their supervisors.

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## CHAPTER FIVE

### ISLAMIC FINANCIAL LAW: BACK TO BASICS

Professor Barry Rider

#### I. Introduction

The author has been invited to address the legal issues and challenges facing Islamic financial products and services. This is a very wide topic and, frankly, one that has not been particularly well addressed in the literature. While in recent years there has been a considerable growth in the interest of lawyers in many jurisdictions in *Shari'ah*-compliant investments and financial services, given the commercial imperatives, this has tended to focus on transactional, rather than regulatory, issues.<sup>1</sup> Indeed, while the City of London has made much of the domination over the international *Sukūk* market of UK law firms, in reality this involves little more than the preparation of transactional documentation. In fact, in the main even this has often played little more than lip service to Islamic law. There is very little interest in or learning relating to issues of governance or, for that matter, legal risk. The reason for this is, sadly, almost entirely commercial. In reality, the City law firms have not been instructed to address issues relating to regulation, governance and the more institutional aspects of Islamic finance. Consequently, it has not been appropriate for them to make an investment in developing knowledge, let alone expertise, in this area. It is also the case that even in jurisdictions such as Saudi Arabia and Malaysia where there is developed and a much deeper relevant legal expertise, such issues have rarely presented themselves to practising lawyers. Interest in the academy has also tended to focus on the facilitative issues, and in most jurisdictions regulatory issues tend not to be addressed in business schools and even law schools. The emphasis tends to be on what many see as the more positive and constructive aspects of creating wealth. Of course, as we shall see, the situation has changed with the collapse of the traditional Western banking system and the emphasis that is now being placed on stability and integrity.

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<sup>1</sup> It is worth noting that "*Shari'ah*", as a body of laws applicable to Islamic financial services, more often than not remains largely uncoded, and as such does not take the form of "positive law". Rather, quite commonly, the reference to "*Shari'ah*" in Islamic financial services simply means a set of interpretations and opinions which constitute *Fiqh al Mu'amalat* (Islamic law of transactions and commerce). The expression "*Shari'ah* law", despite being widely used, again usually does not refer to a form of codified statute or "positive law", except in the context of jurisdictions where the *Shari'ah* is actually applied by the courts. Hence, *Shari'ah* is a deontological – meaning a duty-based system of ethics – rather than a legal system. It follows that even in jurisdictions where the *Shari'ah* is the principal source of law, the absence of a tradition of "positive law" (law as "social fact"), or of the related concern for legal certainty and predictability, leaves a broad space for diverging interpretations; thus, it may raise issues on how the *Shari'ah* is actually applied or enforced.

The primary thesis within this chapter, although to the reader this may not emerge for some pages yet to come, is that unless those advancing the cause of Islamic financial services and products can give proper emphasis to the core values of Islamic law, then a significant opportunity will be missed. At the heart of Islamic law, as it relates to the looking after of other people's wealth, is essentially a concept of stewardship (*Amāna*). It might be more accurate to say that the concept of stewardship is a fundamental principle of *Sharī'ah* as a deontological system of rules and principles. The Prophet repeatedly uses the analogy of good shepherding. Indeed, everything is in the ownership of Allah, and human beings are but for time stewards of his bounty. The *Sharī'ah* persistently underlines the importance of integrity in commerce and the handling of other people's wealth – for example, "The Messenger of Allah has forbidden dishonesty and bad behavior in transaction" (Al-Bukhari). The attitude of the common law in so far as it has, at least in terms of its conceptual heritage, a partially common heritage also recognises the significance of stewardship. It is this concept that has been at the cornerstone of much of the legal development that has taken place, particularly in those jurisdictions where law is derived from the common tradition. We shall see that in recent months President Obama and others have reasserted the self-evident truth that those who look after other people's wealth are in character trustees or stewards. And as the *Qur'ān* states, "...if one of you deposits in trust a thing with another, let the trustee faithfully discharge his trust, and let him fear his Lord" (*Qur'ān*, Ch. 2:283).

In our following discussion, we shall start setting the issues in the context of the development of Islamic finance, including governance, legal risk and *Sharī'ah* compliance. We will focus on the significance of these concepts, including its risks implications and potential liabilities, especially in dealing with crisis and problems. We shall finally discuss how these areas might be better emphasised and managed in reinforcing the appeal of Islamic financial services and products.

The legal challenges that confront those creating and marketing *Sharī'ah*-compliant financial products and services are in many ways much the same as those offering ordinary non-*Sharī'ah*-compliant investments, viewed from the perspective of most legal systems. Indeed, the jurisdictions in which the main financial markets are located generally take the view that financial services and products that claim to be *Sharī'ah* compliant must, as a prerequisite, conform to the general laws and regulations that govern access to the markets. The Islamic character of the product or service is, in legal terms, an additional dimension. While there may be issues as to whether there is, as a matter of law or fact, due compliance with the *Sharī'ah*, in most non-Islamic jurisdictions these would simply manifest themselves, if at all, as matters of contract law or possibly fraud. Obviously, if products and services have been offered on the basis that they are in compliance with the Islamic law and they are in fact non-compliant, there may well be liability for breach of contract and/or misrepresentation. Of course, in a jurisdiction where Islamic law is constitutionally relevant the position will be very different. (See, for example, in the case of *Arab-Malaysian Finance Berhad v. Taman Ihsan Jaya Sdn Bhd* (2008) 5 MLJ 631.) The significance of the impact of Islamic law varies from one Islamic state to another and

much will depend upon the constitutional significance of the *Sharī'ah*. For example, as we shall see, in some Islamic states a rule of secular law that does not comply with the *Sharī'ah* will have no effect, whereas in others its legal validity may be less clear cut. There is also the complicating factor that, in certain areas of the law and practice, the various Islamic schools of law take different positions. It is interesting that in the *Arab-Malaysian Finance* case, the learned judge held that under the Constitution of Malaysia a transaction needed to be compliant with the opinions of all schools of law in order to meet the requirement of legality under Islamic law. The point was also aptly made in another Malaysian decision, that many cases “involve the marriage of two distinctly diverse worlds, namely the Islamic world and the common law sourced civil law...” (*Arab-Malaysian Merchant Bank Berhad v. Silver Concept Sdn Bhd* (2006) 8 CLJ 9).

When considering legal challenges it must also be remembered that different jurisdictions may take very different approaches. This point was forcefully made by Potter LJ in *Shamil Bank of Bahrain EC v. Beximco* [2004] 4 All ER 1072 at 1081. Indeed, he pointed out that “strictly interpreted ‘the Glorious *Sharī'ah*’ refers to the divine law as contained in the *Qur'ān* and Sunnah. However, most of the classical Islamic law on financial transactions is not contained as ‘rules’ or ‘law’ in the *Qur'ān* and Sunnah but is based on the often divergent views held by established schools of law formed in a period roughly between 700 and 850 CE.” In some states where there is a diversity of jurisdiction within the state, not all courts may take the same approach. Indeed, the complexity and uncertainty that so-called “forum shopping” creates is potentially a real problem for the development of Islamic financial products and services. This is exacerbated by the underdeveloped law in many Islamic jurisdictions in relation to arbitration and the recognition of the orders and judgments of other courts, particularly those in other jurisdictions. It is also the case that as Khan J, an expert witness in the *Beximco* case explained, a certification or decision of, for example, a bank’s *Sharī'ah* board “would not be a decision binding on any court dealing with a dispute under *Sharī'ah*. The dispute would fall to be resolved by the court in the light of its own view of the position under *Sharī'ah* law.” However, in this chapter we will focus rather more on the substantive issues than those of essentially a procedural nature, albeit recognising their practical significance.

Given the constraints of time and space in this present discussion, the author intends to focus on a very important area of legal risk that has not received, even in the secular Western jurisdictions, the attention that it deserves. This is the legal and regulatory risks that are thrown up by the obligations imposed on those who mind other people’s wealth to act with integrity and good stewardship. These issues are to some extent bound up with governance, but in their relevance and potential impact are rather more significant. In the context of Islamic financial business there has been little debate and almost no legal analysis. However, it is these issues which, as we will see, are likely to be crucial considerations in the new regulatory environment that is currently being planned for the world financial system. If Islamic finance is to play the important role that so many hope it will, these issues will need to receive much more attention by lawyers, regulators, scholars and the business community.



Let us set out initial debate in the context, first, of a well-rehearsed area – that of governance.

## **II. Governance – A Starting Point**

As we have seen, a key aspect of governance concerns putting in place systems that are capable of demonstrating that general and specific risks to the enterprise are identified and addressed in a manner that is acceptable in terms of the law, current business morality and good sense. Of course, any process that depends upon procedures requires not only that the relevant procedures be properly adhered to, but that there should be some “control factor” at work supporting the efficacy of the procedures. For example, transparency cannot be a justified end in itself. The costs and risks associated with imposing additional transparency must be justified. In the context of our present discussion, it is possible to discern at least three roles for transparency – or, rather, disclosure. The first is where disclosure of facts facilitates “enforcement” of some other rule. A good example of this is rules which require certain insiders – such as directors, officers and, in some cases, substantial shareholders – to report on a relatively timely basis dealings in the securities of their own companies. This, it is argued, may well facilitate the enforcement of other rules prohibiting insiders abusing inside information. In some societies the mere requirement to disclose conduct that would be considered anti-social may be sufficient to discourage that activity. Second, disclosure may be used to provide decision-makers, or more likely those who advise them, with sufficient information to reach a sensible decision. An obvious example of this is the disclosure that attends issues of new securities, but there are many others. Third, there is the use of disclosure to censure, particularly associated with facilitating the enforcement of another rule. However, there are situations where the disclosure of information has a distinct “mark of shame” effect and itself serves as a punishment.

Given the inherent relationship of governance to the identification and management of risks, whether related to integrity or more grounded in commerce, and the attention that has been focused in developing effective prudential banking regulation and in particular risk control, it is not surprising that governance has been a pervading issue in the deliberations that led to Basel II. One of the issues that has received much attention, but (with all due respect) little intellectual analysis, is the need to properly “account” for risk, and in particular “operational risk”. This is, of course, as we have seen, at the heart of the international governance movement. Risk is the dynamic factor in all businesses and will to some degree vary with the nature, extent and location of the enterprise. Indeed, over the last 15 years or so a veritable industry has developed, particularly in North America and Europe, focused on the identification, assessment and management of risk. Of course, in truth concern about these issues is not as novel as perusal of the business and financial press might suggest. The insurance industry has long been concerned with these issues and it is perhaps in this area of activity that most real expertise resides. The identification of risks and an assessment of their impact on the viability and

profitability of a business venture in general or specific terms is, of course, a pretty basic business skill. There is nothing new in the concern and probably not in the rationalisation of the process. History throws up many examples of societies seeking to institutionalise the issues and modifying accepted rules and procedures to address exceptional or specific risk. An example that is, perhaps, particularly apposite in our present discussion is the willingness of early Christian communities to tolerate the charging of interest – *riba* – for exceptionally risky ventures such as in maritime commerce. In the ordinary course of business, usury was forbidden.

We are not able here to focus on the wider issues associated with risk, whether within the scope of Basel II or in the wider world. It is sufficient here to express the view that perhaps too little attention has been given, other than within the narrow confines of particular disciplines, whether actuarial or otherwise, to the analysis of the phenomenon of risk, particularly in terms of its subsidiary implications. This is particularly the case, as has been so dramatically illustrated with the so-called sub-prime crisis, especially in the US, the UK and certain other European countries, in regard to legal risk, an issue to which we will return shortly. There are those who, with some justifications, have sought to distinguish a threat from the risk that ensues as a result of the threat, actual or potential. To focus on the identification of risk is therefore seen as a secondary process, which may not accord sufficient attention to the underlying threat and its proper control. The implication of risk consequent upon a threat will depend upon how the risk develops. The containment and control of the impact of a risk once occurred is a different, albeit related process, requiring somewhat different skills. While all this may not be particularly important in the context of the broad stroke approach to the determination of risk factors and the attendant accounting under Basel II, there is clear relevance in the institutions and procedures of governance. Simply to lump these issues together as risk management to, and, fashion the due procedures of supervision and governance accordingly, may not even amount to plausible cosmetics. We have seen a similar failure to grasp the underlying analytical issues in the area of compliance result in little more than cosmetic treatment being applied to some of the most unacceptable “warts” on the ugly face of capitalism – to misquote former British Prime Minister Edward Heath when speaking of a particularly controversial corporate scandal in 1973. That regulators are willing to ignore these issues, or rather to connive in the “fix it” approach of governments concerned primarily with responding to scandals and achieving an apparently credible response within the short period of their own exposure to accountability, is to be regretted. It is, however, understandable. The reality is that, on the whole, business activity is consistently sound and the threats that do present real issues in terms of risk impact are few and far between. Even looking to the threat of terrorist activity, when sensibly analysed and assessed, the possible impact for most businesses is minimal.

It is also the case that often the responses to identified threats, once established, soon become disproportionate to the risks. Take, for example, the initiatives that have been launched, largely from Washington, in regard first to the

illicit trade in drugs and then, after 9/11, to the financial activities of terrorist organisations. Once it became accepted that organised crime, particularly in the case of drug-related activity, appeared to function like any other enterprise, the argument that enforcement and then regulatory activity should be focused on the vulnerability of its financial systems became indisputable. The US and its allies erected a vast complex of laws, regulations and various procedures designed to identify and then interdict the proceeds of crime. The cost in direct and indirect terms that this has imposed on the financial system has never been more than “guesstimated”. However, that it is vast cannot be denied. It is also the case that the impact on transactional costs and the regulatory and compliance burden thrown on, in particular, the developing and transition economies is wholly disproportionate to any sensible assessment as to the threats posed to them. On the other hand, these measures which the US and its allies, directly and through inter-governmental organisations, have foisted on the world have had dubious success. Demand for and supply of illicit drugs has arguably not been impacted upon. The amounts of money actually taken out of the “criminal pipeline” are minimal and represent, in most countries, a ludicrously small proportion of the estimated exposure to “illicit” finance, let alone criminal enterprise. The adoption of a similar model of control to address the financing of terrorist organisations after the atrocities of 9/11 was entirely misconceived. While there are obviously some terrorist organisations that function in whole or in part as ordinary criminal organisations and engage in enterprises that, at least theoretically, might be amenable to disruption and interdiction, in the case of many others, their funding will be from non-criminal sources. Despite imposing a regulatory strait-jacket on the financial world, which has effectively deprived certain communities of access to Western banking and greatly increased the costs in terms of compliance for all concerned, it is now admitted, even by many in Washington, that trying to identify terrorist finance in the financial system is rather like trying to catch one kind of fish by draining the ocean. Indeed, the consequence of such ill-conceived measures is not just to waste resources and foster instability in the developing and transition economies, but to foster the development of alternative and underground financial systems which are essentially below the radar of those properly concerned with the advancement of integrity and the protection of our societies.

The financial crisis facing virtually every economy in the world, to a greater or lesser extent, is a result not of one predominant factor, but many. To attribute what has happened to the collapse of the so-called sub-prime credit market is simplistic and misleading. By the same token, to focus on the mantra of deregulation, or even the bonus-motivated culture that dominated the financial markets for nearly a decade, indicates but part of the story. The complexity and interdependence of markets and financial systems, instead of spreading risk and containing harm, has served to promote systemic contagion. What is perhaps even more surprising than the speed and vehemence of the collapse of Western banking is the fact that so few, even with the benefit of hindsight, appeared to have seen it coming.

An entirely reasonable question in the minds of many is that if we are so good at perceiving and managing risk, why are we in this mess? A partial answer – apart from the obvious: that we are not as good as we thought we were – is that we were over-focused on the plethora of regulations relating to anti-money laundering, terrorist finance, economic sanctions, insider dealing and corruption. However, the effect of much of this law is to transfer risk – legal, regulatory and, perhaps most importantly, reputational – on to financial institutions. In recent years the threat of a serious fine for mere compliance failures is real. A number of leading financial institutions have been hit with substantial financial penalties, particularly in the US and the UK, for failing to maintain proper records and other, relatively trivial, compliance breakdowns. Those responsible for identifying risk and reacting to it were understandably rather more focused on the prospect of serious personal and professional sanctions for failure to ensure effective compliance. In such circumstances it is perhaps not surprising that other risks, even if they came on to the radar, did not get the attention they deserved by the risk management professionals and their superiors. As the US Congressional investigation into the events surrounding 9/11 found, before the attacks the agencies of the US government and the financial institutions were too concerned with pursuing drug-related money and the proceeds of fraud even to consider the funding of terror. Terrorist finance did not feature in the US Treasury's strategy before 9/11. Of course, as a matter of risk assessment, before 9/11 more Americans died as a result of slipping on soap in the bath than as a result of terrorism!

Perhaps the greatest problem with all this is the impact that it has on the incidence and management of risk – in particular, legal risk. Those involved in handling other people's wealth have in most jurisdictions long been held to the standards of good stewardship. They are invariably cast in some sort of fiduciary relationship to those who have entrusted them to deal with their money or securities. While the terminology and the ability to secure effective remedies may vary considerably from one legal system to another, in most there are certain basic obligations that are both common and commendable. It is also the case that, in recent years, states have imposed, both directly and indirectly, on such persons an increasing burden of obligations that often go somewhat beyond the basic duties of stewardship. It is no exaggeration to say that in the UK, for example, the impact of anti-money laundering laws and procedures on the way that business is actually done in the financial system is probably as great as, if not greater than, that of any other set of rules and regulations. Consequently, those who are engaged in the professional intermediation of wealth will expect to be bound by these obligations and will be aware that adverse and occasionally serious consequences will flow from non-compliance. In many developed financial systems, the focus has been on the relationship of the regulator, charged with the supervision and administration of such laws, with the regulated industry. Whether this is desirable or not is beyond the scope of this chapter. However, the replacement – in practical terms, by technical compliance-based rules – of the traditional notions of good stewardship may not be in the interests of those ultimately paying for the service in question, whether as customer or investor. The compliance industry tends to operate at the lowest

common denominator, and a box-ticking approach to issues of integrity, conflict and fairness may not serve the long-term interests of the markets.

### III. Legal Risk and *Sharī'ah* Compliance

The wider issues of governance in financial and business structures that are in compliance with the *Sharī'ah* are beyond the scope of this chapter. What we seek to address here is the determination and management of legal risk, within the context of accounting for operational risk. Of course, legal risk may manifest itself to a greater or lesser degree in many contexts and, at least in academic terms, may only be circumscribed by the imagination of lawyers. In the real world, however, and given the confines of this discussion, we will not attempt to explore the varieties of legal threat that arise. Here we focus on the relationship of those who exercise the obligations of management. At the outset it has to be recognised that there is considerable uncertainty as to what Basel II is intended to cover. Indeed, the General Counsel of the UK's Financial Services Authority, Mr Andrew Whittaker, observed in May 2003: "There is, so far as I am aware, no authoritative guidance, from the Basel Committee or elsewhere, on the appropriate systems and control needed to manage legal aspects of operational risk." Speaking in the context of the management of legal risk by lawyers, Mr Whittaker, on another occasion, stated: "When talking about legal risk, people mean different things. There is no standard definition of legal risk and it may not be very helpful to produce one."

In the context of *Sharī'ah*-compliant institutions, it is at least arguable that the constraints within which the business will be operated are likely to produce better standards of governance than conventional business forms. Irrespective of the delimitation of business to activities that are *halal*, the *Sharī'ah* board might be expected to achieve certain limitations on otherwise unacceptable conduct on the part of those charged with management. As was observed by Lord President Salleh Abbas in the Malaysian Supreme Court, "There can be no doubt that Islam is not just a mere collection of dogmas and rituals but it is a complete way of life covering all fields of human activities, may they be private or public, legal, political, economic, social, cultural, moral or judicial. This way of ordering the life with all the precepts and moral standards is based on divine guidance through his prophets and the last of such guidance is the *Qur'ān* and the last messenger is Mohammad S.A.W. whose conduct and utterances are revered" (*Che Omar bin Che Soh v. Public Prosecutor* (1988) 2 MLJ 55). However, there are other aspects to Islamic financial activity which might well be thought to raise specific issues of concern in governance. For example, there are issues associated with the relative lack of transparency and problems that arise from the very nature of essentially commodity-based transactions. There are also issues of "off balance sheet" activity and, in particular, the use of undisclosed or inadequately disclosed (not to say "secret") reserves for, among other things, "smoothing" investment returns. Indeed, there are those who claim that these and other factors significantly increase the potential for abuses such as conflicts of interest, insider misconduct and even money laundering. The reality is

that there is little evidence to support such contentions. Perhaps of greater concern, particularly in the focused discussion in which we are engaged, are the legal problems that are associated with the provision of *Shari`ah*-compliant financial products and services and the implications that this has for the creation of a viable international Islamic financial system.

At the outset it has to be remembered that with the notable exception of the US, very few jurisdictions have addressed in any detailed and deliberative manner the development of appropriate legal structures for creating, raising and then trading financial instruments. The Americans did it in the 1930s in the context of their “New Deal” in an attempt to resurrect the financial markets after the “Great Crash”. In many respects, their legislation was driven by the scandals and abuses that came to light during this turbulent period. Indeed, it has to be admitted that in many countries substantial reform only comes about as a consequence of a “crash” or series of major scandals. Cool and deliberative reform is a luxury that few have had. It is also the case that scandal-driven regulation inevitably tends to focus on issues of abuse and does not adequately address the more important issues for development and sustainability. It remains to be seen whether the collapse of the banking and financial system in many countries will present an opportunity for the creation of a more robust and viable regulatory environment that can deliver stability and sustainable development. While it had been thought that those states that are keen to see the development of Islamic financial products have an opportunity to craft carefully their laws and institutions, the direct and indirect impact of the collapse of the Western banking system has brought into question whether the luxury of extended deliberation is in fact available to them.

In this context, we acknowledge that the creation of financial institutions and financial products that are accepted as being in compliance with *Shari`ah* rules and principles (“Islamic law”) is a relatively recent development. Indeed, while there is some debate, it is arguable that the first truly Islamic bank was not established until 1975 in Dubai, although there were experiments in Malaysia and Pakistan in the late 1950s, and the establishment of the “Pilgrim’s Management Fund” in Malaysia in 1962 and the Nasser Social Bank in Egypt in 1972. Of course, discussion of the legal issues can be traced back much further and sophisticated expression can be found in the 19th century Ottoman Codes. It must also be remembered that in the realm of our discussion, we are talking as much about culture as we are about legal tradition – or law, in the sense that we would recognise it today. Indeed, some of the issues which remain problematic today in fashioning the rules for finance relate back to pre-Islamic values and practices. For example, we sometimes forget that Islam is not alone in condemning the taking of *riba*. In the ancient world the taking of interest was considered usurious and was generally, albeit not universally, condemned as “eating” away the resources that should be utilised in repayment. While the Code of Hammurabi and even earlier Babylonian laws appear to sanction the taking of interest, commercial loans were not the practice in the ancient world. Lending was seen to be an act of charity and obviously would not sit well with the taking of additional and unearned payment by way of interest. There are coffin texts in ancient

Egypt which appear to condemn usury in this sense. The Old Testament has many such references (see, for example, “if you lend money to My people ... you are not to act as a creditor to him; you shall not charge him interest” (Exodus 22:25 and see also Deuteronomy 23:19; Proverbs 14:31 and 28:8; Psalms 15:1, 2 and 5; Nehemiah 5:7; and Ezekiel 18:8 and 9 and 22:12), and the *Qur’ān* itself refers to the law being the same for Jews (Surah An-Nisaa, Ch. 4:161). Those of us who follow, in one way or another, the legal traditions of Rome would recognise laws of both the Republic and the Empire condemning the taking of excessive interest, although it would seem that loans were rarely advanced without the prospect of some reward, financial or political. Christianity has also been forceful in its condemnation of usury, or in the early Church interest at all, save, as we have already mentioned, in the case of risky maritime ventures. Jesus, while endorsing the earning of income from investment (Matthew 25:27 and Luke 19:23), condemned the taking of interest: “Give without hoping to make gain” (Luke 6:31). Indeed, Dante goes as far as to place usurers in the third ditch of the seventh circle of Hell, along with the blasphemers and sodomites!

Furthermore, it is not only the Islamic scholars who accepted the creation of finance through real commercial transactions, with reward being found in the sharing of profit. The Medici used similar devices and, in particular, deployed staggered payment through timed bills issued in series – a practice which, in some trades, continues in one form or another to this very day. Where the laws of Islam part company with many of the other great legal traditions is that, given its founding on indisputable principles of a profound and theocratic nature, it has not willingly tolerated a dispute as to the difference between the mere taking of interest and the charging of excessive interest, with the condemnation of usury being focused on the latter. Thus, today, in most secular legal systems, largely as a result of commercial and pragmatic factors, the taking of interest is accepted, but the demanding of excessive interest is outlawed as usury. Unconscionable bargains will be struck down and rendered unenforceable.

While the inherent integrity of Islamic thinking must be applauded, it is increasingly being recognised that in certain contexts the Islamic law needs to be developed – albeit within the confines of the established *fiqh* methodology. The eminent *Sharī’ah* lawyer and scholar the late Shaikh Dr Zaki Badawi has observed that *Sharī’ah* boards should “resurrect the tradition of imaginative solutions formulated and implemented by the Hanafi Scholars of the past”. He considered that such a dynamic approach might well result in certain derivative securities being considered acceptable. There are those respected in Islam, such as a number of scholars from Al-Azhar University in Egypt in 2002, who have contended that interest payable in ordinary banking transactions is outside the concept of *riba*, although it must be said that the vast majority of scholars would have serious objections to such a view.

We have already referred to the diversity of opinions and learned interpretations within the accepted schools of Islamic law. On many important

issues, again particularly in regard to financial law, there is real discussion and debate. The uncertainty of the law – and, in particular, its application, is, as we have pointed out, one of the most serious hurdles facing the development of Islamic finance. Take arguably the most fundamental issue in any legal system, that of constitutionality. Most Islamic states provide in their constitutions that *Sharī'ah* is a source – or in some, such as that of Egypt, the principal – source of law. This means that all other laws and decisions made in the relevant jurisdiction are subordinate to, and may be considered at some time in the future non-compliant with *Sharī'ah*, and therefore null and void. The very dynamic nature of interpretation of the *Qur'ān* and Holy Teachings itself becomes a factor in certainty. That this is a problem in the context of our present discussion cannot be denied. For example, article 2 of the Constitution of Kuwait provides that *Sharī'ah* is a principal source, albeit not *the* principal source of law. The Constitution of Oman provides that Islam is the religion of the state and *Sharī'ah* is the basis of all legislation. Whereas in Jordan, Islam is declared to be the religion of the state, the nation itself is the source of all powers under article 24 of the Constitution. Just imagine how difficult it is in practice to arrive at a view, across the region, as to how a particular transaction, under different laws and subject to different interpretations of even the *Sharī'ah*, might be enforced. Even on the issue of *riba*, views will differ, as we have seen. But let us take another important legal concept where there is probably rather more controversy within the Schools, that of *gharar*. In the *Qur'ān* and the Hadiths, this word is used on more than 50 occasions, in very different contexts, appearing to mean things as diverse as “danger” and “deception”.

Much of the “nuts and bolts” of the legal architecture that we are discussing is to be found in so-called special laws specifically enacted. These do not always sit particularly well with even the wording of various constitutions, let alone the interpretation of *Sharī'ah*. Dr Lu'aay Al Rimawii, formerly of the Universities of Cambridge and London, has written with authority on this issue in regard to the securities laws of Jordan. In his view, these special laws, such as the Financial Market Law of 1976, sit uncomfortably with the strict limitations imposed by *riba* and *gharar*. A particular area of concern is the scope of the definition of securities. For example, section 3 of the new Securities Act of 2003 is, in his view, in certain respects excessively vague, thus introducing issues of certainty and risk. Dr Rimawii observes: “As far as the Arab countries maintain this incongruous dichotomy between general principles of law enshrined in the *Sharī'ah* and particular secular laws, juridical risks will always jeopardise the certitude of modern commercial legislation.” While Dr Rimawii's comments are largely focused on the experience of Jordan, it is not difficult to find other examples in the region. For example, the Capital Market Law of 2003 in Saudi Arabia faces similar issues, particularly in the context of securitisation. As we are all aware, this risk is sadly not confined to the Middle East and the Arab world, as is indicated by the decision of the High Court of Pakistan in 1999 outlawing the charging of interest under certain legal provisions. There are, of course, more recent examples in both Malaysia and Indonesia, albeit in different areas of the law. The uncertainty in the “nuts and bolts” of the *Sharī'ah* in general, and *Fiqh al Mu'amalāt* in particular, was a factor in the decisions of the



Court of Appeal in England in 2004, which found that the references to the *Glorious Sharī'ah* and to *Murābahah* were not precise enough to sustain the defendant's claim that an Islamic bank had breached the contract by failing to adhere to the *Sharī'ah* (*Shamil Bank of Bahrain v. Beximco Pharmaceuticals Ltd* [2003] 2 All ER 849, affirmed [2004] 4 All ER 1072).

These uncertainties of law at many levels within the legal system are exacerbated by the failure of practitioners to address standardisation of documentation in transactional situations such as, in particular, the *Murābahah*. While practitioners seek to justify this on the grounds of diversity of fact and environment, the failure to have standard documentation increases not only interpretational risk but also transactional costs. It is also the case that the approach of Islamic law to the creation of rights and their necessary synchronisation tends to further complicate these processes.

At the heart of the strategy to achieve an enduring and efficient international Islamic financial system that is capable of providing Islamic products and services to those who wish to avail themselves of them, whether for religious or other reasons, is the recently published *Islamic Financial Services Industry's Ten-Year Framework and Strategies* (2006), published by the Islamic Research and Training Institute of the Islamic Development Bank and the IFSB. This important document makes it very clear that if markets of the depth and breadth that are required to accommodate the expectations of those who wish to use Islamic products are to become a reality, the number, strength and capitalisation of Islamic financial institutions and intermediaries will need to increase significantly. To achieve this, the availability of financial products that have the flexibility, liquidity and security to service this demand is vital. Perhaps the most significant element in the equation today, in this context, is the efficacy of the *Sukūk* in meeting the demands of not just the primary markets, but also the developing secondary markets. There are also profound issues in regard to the acceptability of certain derivative rights and, indeed, the practice of hedging. While Islamic financial institutions and conventional banks and institutions that offer more-or-less Islamic products and services through their "windows" have achieved some success in the issues market, for the secure, stable and efficient market that is required to sustain and develop Islamic finance, a viable and reliable secondary market operating at an international level is vitally important. Therefore, it is necessary for us to examine in a little more detail the problems that remain – primarily of a legal nature – in regard to this crucial vehicle. It is in regard to the issuance, administration and trading of these particular securities that there are real concerns as to legal and regulatory risks.

A practical issue of some significance is the location of the special purpose vehicle (SPV) necessary for the effective creation and operation of this particular form of investment. In contemplating suitable venues, discussion has tended to be dominated by considerations of tax – and in particular, exposure to the US tax regime. While this is understandable, a number of governments in recent years have become increasingly concerned about the use of so-called offshore financial havens

providing such corporate vehicles with a degree of tax sheltering. More recently, in the context of the present financial crisis, several governments, including both the US and UK governments, have been particularly critical of the use of offshore SPVs, and it remains to be seen whether those wishing to construct tax-efficient structures will have in the future the freedom that they have enjoyed hitherto. Given the significance in Islamic financial transactions of conveyances of property – and, in particular, land and interests in realty – the diversity of approaches that the law exhibits in Islamic states to the rights, if any, of foreigners and the procedures for transference and retention is a veritable minefield. With all due respect to the authorities concerned, it must be said that the domestic laws of many states wishing to facilitate the development of Islamic financial systems and products require urgent attention in this regard. Until there is an assurance that transfers of interests in land are effective and will be accepted by all courts as such in the relevant jurisdictions, it is hardly surprising that those who advise major financial institutions, and especially the credit rating agencies, will be cautious. If the *Sukūk* is going to become the vehicle that so many assume, it will be desirable to expand the scope of obligations that can be brought within it. To depend just on the *Ijārah Sukūk* (a structure involving sale and lease-back) places considerable practical difficulties in the face of development of the sort of market contemplated in the Ten-Year Framework. Indeed, we have already referred to the problems that exist in many jurisdictions in regard to property law and the creation of transferable interests. Another serious practical issue is the reluctance of credit rating agencies to rate Islamic financial products satisfactorily. This is a major stumbling block to the development of viable secondary markets. As far as leading international agencies are concerned, there has long been considerable caution as a result of the perceived, and no doubt actual, uncertainties in the law and its application. In particular, there is real uncertainty, in many *Sharī'ah*-compliant transactions providing a vehicle for finance, as to whether effective resort can be had to the underlying security or collateral.

In the so-called pure *Sharī'ah* jurisdictions such as Iran, Pakistan and the Sudan, there is a perception in some quarters that the courts are relatively unpredictable in their handling of financial legal issues, and the lack of precedent, in the conventional sense of the word, exacerbates investors' and professional advisers' sense of unease. The degree of discretion in the process of determination within Islamic courts, as compared with secular courts, is a matter for debate. Courts vary from one jurisdiction to another and even within jurisdictions. While it may be true that, in practice, there is little difference in the way tribunals, whether seeking to apply the principles of Islamic law or wholly secular law, actually function, the perception is that Islamic courts are more likely to express themselves in discretionary terms. It is also the case that the process of adaptive and applicable reasoning from the principal tenets of Islam is a broader approach than interpretative processes found in secular systems. It must also be acknowledged that in many Islamic jurisdictions there is no range or depth of, in particular, interim and pre-trial measures. This is a particular issue in instances of insolvency. There are those who also express concern as to the adequacy of financial remedies before certain courts. It is not without interest that in Malaysia the courts, even in considering Islamic

principles of law, have made the point that the remedies that are available are those under the general civil law (for example, see *Bank Kerjasama Rakyat Malaysia Bhd v. Emcee Corporation Sdn Bhd* (2003) 3 MLJ 408).

There are other issues which are of practical significance and worry the rating agencies. For example, it is uncertain whether under *Sharī'ah* an agreement not to petition for a winding-up, or some equivalent procedure, would be enforceable. Indeed, it is unclear as to whether even an agreement for only limited recourse would be recognised and given effect. It is questionable whether under *Sharī'ah* it is possible to waive a right before it accrues. The schools take different views on this issue. The rights, if any, of *bona fide* purchasers and other third parties who act in good faith in relation to property that may be subjected to a legal claim remain obscure. We have already emphasised that it is important to appreciate that in legal systems which are not wholly Islamic, with a unitary source of law, *Sharī'ah* will have to operate to a greater or lesser extent alongside other laws. A good illustration of this is the recent case of *Ryad Bank v. Ahli United Bank (UK) Plc* [2006] EWCA Civ 780 in which a duty of care arose between the parties and had implications for the business relationship of two institutions that were engaged in providing *Sharī'ah*-compliant financial products and services.

#### **IV. Looking after Other People's Money**

Having, albeit in a somewhat perfunctory manner, indicated some of the uncertainties in Islamic financial law and practice, let us turn to our central concern, the issue of legal risk in the context of stewardship. It is important to note at the outset that the Holy Law places considerable obligations of fair dealing and honesty on those involved in business. For example, the *Sharī'ah* requires personal honesty: "Mix not the truth with falsehood, nor conceal the truth..." (Surah al-Baqara, Ch.2:42). Fair dealing is also emphasised in many texts: "He has raised the sky, and He has set the balance. In order that you may not transgress the balance. And observe the weight justly and do not make the balance deficient" (Surah ar Rahman, Ch.55:7–9 and "Woe to al-Mutaffifin (those who deal with fraud). Those who when they have to receive by measure from men, demand full measure. And when they have given by measure or weight to other men, give less than what is due. Do they not think that they will be resurrected (for reckoning)" (Surah al-Mutaffifin, Ch.83:1–4). Integrity is also underlined: 'O you who believe! Betray not Allah and His Messenger, nor betray knowingly your Amanat (the things entrusted to you) ..." (Surah al-Anfal, Ch.8:27), and perhaps more dramatically: "The signs of the hypocrites are three: when he speaks, he lies; when he makes a promise, he breaks it; and when he is charged with a trust, he violates the trust" (Sunna of the Prophet Muhammad). There are many condemnations of fraud and injustice: "...for He commands them what is just and forbids what is evil..." (Surah al-A'raf, Ch.7:157). Of course, in the common law and many civilian systems of law, it is the fiduciary law that imposes the most important obligations of stewardship.

Lord Chancellor Herschell MR, in the leading English case of *Bray v Ford* [1896] AC 44, emphasised that it is an inflexible rule that the courts will not permit a person in a fiduciary relationship to place himself in a position where his own interests conflict with those he is bound to serve. Nor is he to be permitted to derive an unauthorised benefit – a “secret profit” – from his position of trust. He must be loyal to his principal. Of course, with all such simple rules, their application in practice is anything but simple. For example, there is still debate as to whether Lord Herschell intended to require those in a fiduciary position to eschew all conflicts of interest and duty, no matter how insubstantial or theoretical. Nor is it certain whether the rule that a fiduciary should not benefit – without express authority – from his position is a separate rule or stems from the primary obligation to avoid all conflicts of interest. It is also uncertain as to how far it is appropriate to apply these rules to the situation where a fiduciary is in a conflict of duties to different principals, as opposed to merely his own self-interest. A broad approach could create serious problems for those in several fiduciary relationships. Also, there is the real problem of financial intermediaries who engage in activities that might well produce conflicts between their different customers. Chinese walls and similar devices may inhibit the flow of actual information from one function within the bank to another, but they do not address the essential conflict of duty that the bank has placed itself in (see B. Rider and T.M. Ashe (eds), *The Fiduciary, the Insider and the Conflict* (Sweet & Maxwell, 1995) and, in particular, *Australian Securities and Investments Commission v. Citigroup Global Markets Australia Pty Ltd* (2007) FCA 963).

The concept of fiduciary obligation in English law was authoritatively set out by Millet LJ in *Bristol and West Building Society v. Mothew* [1998] 1 Ch 1 at 118. The learned judge stated: “a fiduciary is someone who has undertaken to act for or on behalf of another in a particular matter in circumstances which give rise to a relationship of trust and confidence. The distinguishing obligation of a fiduciary is the obligation of loyalty. The principal is entitled to the single-minded loyalty of his fiduciary...” Therefore, company directors in their dealings with the company, partners in dealing with each other, an agent in dealing with his principal, a trustee in dealing with his beneficiary, a public official in regard to his office, and a professional adviser in dealing with his client would all be included. It is also probable that an employee in his dealings with his employer would be covered. While employees are not generally considered to be fiduciaries (but note that employees in senior management positions who act on behalf of their company may well be considered to owe fiduciary obligations, in much the same way as the company’s directors do – see *Canadian Aero Services Ltd v. O’Malley* (1973) 40 DLR (3d) 771 and 381), they are within a duty of fidelity which has much in common with the obligations cast upon a fiduciary. An employee is “trusted” by his employer not to make use of the employer’s property or premises for the employee’s benefit. It is important to note, however, that unlike an ordinary fiduciary relationship, the obligations, albeit different, flow both ways.

While it is certain that those in a position of stewardship or a fiduciary relationship must not subordinate, without a clear mandate, the interests of the

person for whom they act or serve to their own, it is unclear how conflicting duties might be resolved. For example, would a trustee be under a duty to use inside information that he learnt by virtue of some other relationship for the benefit of the trust? It might be less easy for him to excuse himself when the information in his possession indicates that the trust will suffer a serious loss unless he takes action. Indeed, it has been said that a stockbroker may be under a duty to ensure that privileged information that he possesses does not work to the disadvantage of his client (see G. Cooper and B. Cridlan, *The Law of Procedure of the Stock Exchange* (Butterworths, 1971), p. 104). Indeed, it has been argued that there are Biblical texts that emphasise the virtue in taking advantage of opportunities to profit that come to one innocently. But see the comment of Lord Browne-Wilkinson in *Kelly v. Cooper* [1993] AC 205: “stockbrokers ... cannot be contractually bound to disclose to their private clients inside information disclosed to the brokers in confidence by a company for which they also act” (see also B. Rider, K. Alexander, L. Linklater and S. Bazley, *Market Abuse and Insider Dealing*, 2nd ed. (Tottle, 2009)). To what extent it could be argued that a broker may come under a duty to search out such information or act upon information of a positive quality that results in profits, rather than the avoidance of an otherwise certain loss, is rather more debatable.

Although it is true that the trust is a creature of the common law, other systems of law impose obligations on individuals not too dissimilar to those under discussion. For example, in civil law jurisdictions, agents and those operating under mandate might well be held to duties of good faith and care which would give rise to issues not unrelated to those discussed above (see, in particular, C. Nakajima, *Conflicts of Interest and Duty* (Kluwer, 1999)). The issue as to whether similar obligations exist in Islamic law has been a matter of controversy. Many Islamic scholars basing their views on the numerous texts requiring personal integrity and fair dealing, some of which we have already noted, forcefully contend that Islam imposes on those in positions of trust very similar obligations to those the common law and, in particular, the civilian law would recognise. For example: “Every one of you is a keeper or a shepherd and will be questioned about the wellbeing of his fold ... Every man is a shepherd of his family and will be answerable about every member of it. Every woman is a shepherd to the family of her husband and will be accountable for every member of it, and every servant (or employee) is a shepherd to his master and will be questioned about the property of his master” (*Sunna* of the Prophet Muhammad) and “O you who believe! Eat up not your property among yourselves unjustly...” (Surah an-Nisaa, Ch.4:161). While to a Western lawyer such statements may lack specificity, it has been strongly argued that they recognise an obligation to look after and protect the property of others. What is clear, however, is that such fiduciary notions as exist in Islamic law have not yet been expressed, let alone applied, with the rigour of the common law. In most common law jurisdictions, it is generally thought that liability under the fiduciary law is, in large measure, strict. Thus, if a person in a fiduciary position does take an unauthorised benefit from his position, then he should be held accountable whatever his state of mind. While such a draconian approach might be appropriate in the case of trustees in the strict sense, there are many situations involving those in a fiduciary or analogous position

where the courts have considered that proof of lack of probity is a material factor (see, for example, *Royal Brunei Airlines Sdn Bhd v. Philip Tan Kok Ming* [1995] 2 AC 378).

In the business and financial world, those in a fiduciary position will, it seems, be allowed to enter into situations where there is a possible – and even, on occasion, real – conflict of duties, provided they act with integrity. On the other hand, where there is a conflict between a duty to another and the self-interest of a fiduciary, the courts will be far more prepared to examine what has in fact taken place. Self-interest has been considered to be almost presumptive of abuse. The greater the degree of self-interest or benefit, the stronger will be the inference of corruption. On the other hand, it must be recognised that even in the case of conflict of duties, an intermediary will often expect to receive a benefit, be it in terms of commission or simply the retention of a business relationship. Consequently, it will rarely be the case that there is absolutely no element of self-interest in the equation.

Let us turn to a rule of stewardship that is perhaps even clearer in its articulation than the “no conflict” rule. Those in a fiduciary relationship must not derive from their position, or rather by virtue of the relationship, a “secret profit”. Perhaps the most authoritative exposition of the rule is that of Lord Russell of Killowen in *Regal (Hastings) Ltd v. Gulliver* [1942] 1 All ER 378: “The rule of equity which insists on those, who by the use of a fiduciary position make a profit, being liable to account for that profit, in no way depends on fraud, or absence of bona fides; or upon such questions or considerations as whether the profit would or should otherwise have gone to the plaintiff, or whether the profiteer was under a duty to obtain the source of the profit for the plaintiff, or whether he took a risk or acted as he did for the benefit of the plaintiff, or whether the plaintiff has in fact been damaged or benefited by his action. The liability arises from the mere fact of the profit having, in the stated circumstances, been made. The profiteer, however honest and well intentioned, cannot escape the risk of being called to account.” In other words, any calculable benefit that comes into their possession that has not been expressly approved or permitted by the principal must be handed over to the principal. (For a dramatic example of this, also see Roskill J in *Industrial Development Consultants Ltd v. Cooley* [1972] 2 All ER 162 and *Bhullar v. Bhullar* (2003) 2 BCLC 241.) This is an important rule of stewardship and is a core principle in any system of good governance. It strikes at the very root of self-dealing. While it is clear that in Islamic law there is an obligation on those who are in the position of trustees to protect and account for the property they hold, absent a specific contractual obligation or obligation imposed by, for example, the *waqf*, it is not at all certain a *Shari’ah* court would impose liability for the taking of “secret profits” in the range of situations that a common law court might.

## **V. The Nature of Risk**

While it has always been an obligation on those who are responsible for the protection of other people's property to consider how best to ensure that it is safeguarded against reasonably foreseeable risks, it is relatively recently that this obligation has become, in many legal and regulatory systems, a specific legal duty. Of course, in many systems of law those who look after other people's property have defined duties, determined by contract or custom. In some, the obligation will be strict; in others, it will be at most a duty to exercise reasonable care. Much will depend upon the circumstances of the relationship and the nature of the property. In many situations, it is foreseeable that the criminal activity of others may present a threat to the custody, integrity or value of the property in question. In the protection of one's own property as well as that of others, legal and regulatory systems are increasingly placing specific obligations on relevant persons to consider such threats and take steps to prevent or avoid their occurring or minimise their impact. This is justified not merely in terms of stewardship, but also good governance. In Basel II, for example, financial crime is recognised as an operational risk that banks must specifically address and account for.

The concept of integrity is both dynamic and pervasive. It includes all those issues which, alone or when combined with others, constitute and support a reputation for integrity. This is both a wider and yet more specific concept than, for example, good governance. In particular, it involves conduct, or in some instances an absence of conduct, which results in a perception that individuals or the organisation have or has acted with a lack of integrity. This may, and probably will, involve dishonesty, or at least something lacking in fairness and tending to undermine confidence in the probity of those responsible. Typically, the threat may involve fraud, misappropriation, breach of fiduciary duties, unfair conduct, abuse of inside or confidential information, culpable negligence, involvement in or facilitating money laundering or the improper disposal of assets, abuse of opportunities and privileges, excessive remuneration, inappropriate behavior to others or a general failure of stewardship. In the abstract these threats may appear vague and even unlikely, but when taken in the context of particular enterprises and specific opportunities, they become all too real. While the motivation for such abuses will often be greed, there are on occasion other factors, such as malice or jealousy.

### **A. *Integrity Audit***

Those in positions of managerial responsibility have an obligation to address these issues, and perhaps the most efficacious is to conduct or commission a competent integrity audit. In particular since the financial crisis in 2009, a number of regulatory authorities in the Gulf have expressed interest in developing such procedures and services as a means of not only promoting integrity but also being seen to do so. Integrity audits should not be a "box ticking" exercise in the manner that financial audits have become in recent years. Indeed, it is an audit in the real

sense of the word – a thorough and disciplined examination resulting in a dedicated report. In the present case, however, the audit does not focus on financial issues but on those relevant to reputation and sustainability. It follows that the examination must not only take into account the environment within which the business operates, but also be tailored to the particular structure, ethos and nature of the enterprise. Probity is assured through a rather more complex and sophisticated process than the determination of solvency.

While there is never a shortage of those wishing to make their expertise available to others, in considering the sort of legal and regulatory challenges to the development of Islamic financial products and services, it is of the utmost importance to ensure that such audits and their attendant processes are sufficiently comprehensive to address the particular issues that arise under the *Sharī'ah*. Given the uncertainties that exist in the law and its application, this is not an easy task. Ideally, each exercise should be tailored to the circumstances of the institution in question. However, there are certain stages which would normally be gone through in all audits. For example, after instruction, those responsible for the audit would normally profile the institution or business using both inside and outside sources of information. This may or may not involve discussions with staff. Once the profile has been prepared, it should then be discussed with the institution and any appropriate adjustments made. On the basis of the profile, the “auditor” will search for actual and potential threats within predetermined “cores”. These will include those areas of activity, management and control which are prone to risk either in the ordinary course of things or by virtue of special factors indicated in the profile. Typically, the cores that will be “surveyed” for possible threats, whether systemic, causal or engineered, include:

- the legality (and acceptability) of the business under Islamic law;
- the structure of governance – in particular, supervision;
- the role and responsibilities of the *Sharī'ah* council (or equivalent function);
- the structure of management (and control);
- employment practices and personnel (including those within the governance and management structures);
- financial control systems;
- property (including the control of intellectual property and information);
- relations with stakeholders (including partners and investors);
- suppliers;
- consumers/clients;
- associated activities/enterprises;
- relations with competitors; and
- support and professional services.

Additional areas of concern should also be addressed in particular circumstances. Each core area of activity will be surveyed to ascertain the actual and potential scope that exists, or could exist, for exploitation and abuse. While the conduct in question will inevitably depend upon the circumstances and the context



within which the enterprise operates, the survey should be specifically designed to identify the following threats:

- *haram* investments and actions;
- self-dealing and breach of fiduciary obligations;
- fraud;
- conflicts of interest;
- conflicts of duty;
- corruption;
- abuse of privileged information;
- abuse of position;
- misappropriation and diversion of opportunities;
- misuse of property;
- exploitation and inappropriate conduct;
- money laundering – in particular, the impact of “purification”; and
- tax fraud and other financial misconduct that could harm the reputation of the client.

In the context of Islamic financial institutions and businesses, there is a further factor that needs to be specifically addressed. The Prophet recognised that “whosoever relieves a fellow human being of a burden in this world, Allah would relieve him of a burden on the Day of Judgment” and “no one can be a true believer unless he loves for his fellowmen what he loves for himself”. Consequently, there is, if not an obligation, an aspiration for *baraka* or a blessing that actions shall be considerate. Therefore, it has been argued by scholars that in assessing the acceptability of proposed actions their impact on society and the environment should be weighed in the balance. In regard to the more specific obligations, the scope for actual or potential harm to the integrity of the institution or business presented by misconduct should be identified on a confidential basis. Obviously, considerable care always needs to be exercised in any process that seeks to identify and record areas of vulnerability. In regard to each threat that is identified, a careful assessment should be made as to the likely incidence of a problem arising. In appropriate cases it will be possible to indicate in what manner such a threat is likely to manifest itself. An assessment should then be made, taking account of all relevant facts, as to the probable impact, in terms of risk, of such an incident. The risks will vary in relation to the nature of the client, its enterprise, and the environment within which it operates. The issues that might be assessed in this exercise include:

- legal risk under the secular law;
- legal risk under Islamic law;
- regulatory risk;
- reputational risk;
- business risk; and
- damage to stakeholder relations, including the wider responsibilities to society recognised in Islamic law.

Obviously, some of these issues involve a host of related considerations. For example, in the case of legal risk it will be necessary to address the threat of legal liability arising in regard to the conduct in question, on the part of the institution or those responsible for its management, to those who suffer damage as a result of the misconduct. It will also involve issues as to how the person responsible for the incident, or for failure to prevent, discover or control it, may be made liable. It should also involve issues relating to the responsibility to assist others, including possibly law enforcement agencies or the owners, in addressing the matter within their respective areas of responsibility or concern. In assessing the likely impact of an incident, proper account should be taken of the ability of the institution or business to minimise risk and loss exposure and to seek cover and indemnity. An audit would not normally, however, address the control and containment of an incident.

#### **B. Court's Stand with Regard to Adherence to the *Shari'ah***

In regard to the obligations imposed by Islamic law, there are special considerations. The jurisprudence as to the consequences of a prohibited act – that is, something that is *haram* – is articulated in different ways by the various schools. It is important to appreciate that in Islamic law the obligation to obey the letter and spirit of the *Shari'ah* is a personal duty of the believer. Indeed, given the overarching virtue of *tawhid*, involving the full submission of the believer to God, an attempt to evade or circumvent the *Shari'ah* becomes itself unacceptable and worthy of condemnation. It has also been emphasised in judicial decisions that “regardless of whether a person is a follower of the religion of Islam or not, the logic remains true that if a God is omniscient, that God knows the truth of what is done and intended, regardless of the terminology or language used. The effect of the assumption of omniscience is therefore that legal devices or trickery (*hila*) would fail in the eyes of Allah” (per Justice Datuk Abd Wahab Patail in *Arab-Malaysian Finance Berhad v. Taman Ihsan Jaya Sdn Bhd* (2008) 5 MLJ 631). While the character of the violation may have specific consequences in terms of other legal rules, particularly of a criminal nature, the essential obligation is on the relevant individual. In other words, there is not as such a doctrine of illegality as recognised by common law systems. A resulting transaction may well be unenforceable because no other believer, including a *Shari'ah* court, would wish to recognise an obligation, “...for He commands them what is just, and forbids them what is evil...” (Surah al-A'raf, Ch.7:29) and “...for He commands them what is just and forbids them what is evil: He allows them as lawful what is good and pure and prohibits them what is bad...” (Surah Al-A'raf, Ch.7:157). Under the *Shari'ah* there are significant obligations of disclosure (such as *katman*), and where these are not discharged due to dishonesty (*khiyanah*) then the law might regard a resulting transaction as void on the basis that its very purpose has failed. It is also the case that property or wealth derived from a *haram* act is unacceptable. As the Prophet observed, “*Min ayna laka hadha?*” (Where did you get it from?). In another *Hadith*, the Prophet stated: “The flesh gathered on one's body by means of unclean earning deserves to be thrown into the fire of hell.” Thus, it is important to recognise in Islamic law that “not only the ends sought must be right (and pure) but

also the means to achieve those ends must also be right” (see, for example, Surah Ta-Ha, Ch.20:124 and Surah al-A'raf, Ch.7:96).

There have been court decisions involving issues of Islamic law which indicate that, where parties to a contract enter into it with full knowledge of its terms, then the presumption is that it is enforceable and the court will not look into the issue of compliance with the *Sharī'ah* (see *Bank Islam Malaysia Berhad v. Adnan Omar* (1994) 3 CLJ 735). However, in the *Arab-Malaysian Finance Berhad* decision (to which reference has already been made) the court, rejecting what it characterised as a traditional common law approach, took a rather more robust stance and considered that it had a curial responsibility to inquire into whether challenged transactions were in compliance with the Islamic law as interpreted by all schools. The substance was more important than the form.

## **VI. The Value of an Integrity Risk Audit**

As we have seen, the notion of integrity is complex and in some respects a construct. It is multifaceted and, in the context of a business, comprehends the probity of both the business and those through whom and with whom it operates. The implications for the reputation of the enterprise of even an isolated incident involving misconduct or abuse can be extremely serious. The perception that most people, including the media and relevant regulatory authorities, have of reputation is not sophisticated or even perhaps fair. Taint arising even by virtue of the default of one individual can spread through an organisation like cancer, destroying respect, undermining confidence and resulting in dysfunction. While there is legitimate debate as to the value of reputation in different businesses in differing environments, it cannot be seriously contended that reputation is not an important asset, held and managed in trust – as is any other asset within the enterprise. There is clearly an obligation on those responsible for the governance and management of businesses to advance and protect this asset. This is of particular significance in the context of Islamic institutions – indeed, the Prophet, who had himself engaged in trade on behalf of Lady Khadijah, observed: “a trustworthy and an honest and truthful businessman will rise up with martyrs on the day of Resurrection.”

Reputation is, however, a particularly fragile and vulnerable asset. Once harmed or undermined, it is extremely difficult to restore – perhaps, in certain contexts, impossible. It is not simply the acts or defaults of the enterprise itself which may devalue reputation. Indeed, in the majority of cases it will be the acts of others associated with the enterprise. Their misconduct will taint their employer or principal. Indeed, the very failure of the employer or principal to prevent, or control the problem, or contain its impact, may well itself harm the business's reputation for probity and, thus, its standing. Indeed, the *Sharī'ah* recognises this by placing responsibility for the acts of agents and employees on the shoulders of their masters.

It is also the case that, within any organisation, those involved and associated with it will to a greater or lesser degree have tied their own personal and professional reputation to that of the organisation. The English courts have, for example, recognised that an employee, or former employee, has a right to be compensated for being devalued in the employment market as a consequence of their employer's failure to address frauds and abuses which undermined the reputation of its business. As we have seen, many regulatory systems recognise the very real obligation on those in supervisory positions to exercise care and concern in ensuring that the business, and the integrity of those associated with it, is not tainted by the frauds and misconduct of those over whom they have authority. Indeed, in some cases, those in control or with supervisory responsibilities will be held accountable to the same degree as the person for whom they had responsibility and who abused his or her position. By the same token, the obligation of non-executive directors and those placed in a position to assure or validate systems of good governance are no less onerous. In this context we are not talking simply in terms of a moral or even a professional obligation, but a legal duty with the real risk of liability. This might manifest itself in direct personal liability to pay significant amounts of compensation in the civil court, in regulatory and disciplinary actions in regulated industries, and even, in extreme cases, in personal exposure to the criminal law.

It must also be remembered that in today's business environment many businesses will be amenable to the laws and regulatory systems of other countries, even if their actual involvement in that other jurisdiction is indirect and possibly insubstantial. For example, the reach of US laws relating to integrity and, in particular, combating money laundering and the provision of financial assistance to terrorists and the like, is exceptional. Due to the perception that strategies designed to attack the profitability of economically motivated crime have positive results, there has been a significant increase in the responsibilities cast by a host of international and domestic laws on those who handle other people's wealth to, in effect, become informants to law enforcement. A dramatic example of this is the many provisions in the 2004 *United Nations Convention against Corruption*, and in particular those relating to "politically exposed persons". In practice, in the majority of countries, as we have seen, it is open to question whether so-called proceeds of crime laws actually do have a significant impact on criminals. However, such laws – in particular, those aimed at money laundering – do have the effect of imposing legal and regulatory compliance risks on financial institutions, intermediaries and professional advisers. Furthermore, exposure to the matrix of laws and regulations which may or may not apply at an international level is a particularly difficult issue, even for those who consciously operate at this level.

It is open to debate how far the *Shari'ah* imposes affirmative obligations on believers to interfere to prevent unlawful and immoral acts. Where the deliberate failure to act allows the commission of a crime or other *haram* act by another, then it is arguable that an individual who does not complain is morally at fault ("Who so ever of you sees an evil action, let him change it with his hands; if he is not able to

do so, then with his tongue; and if he is not able to do so, then with his heart – and that is the weakest of faith” (Hadith Al-Nawawi, no. 34). For legal responsibility, the majority of scholarly opinions would require some form of active participation in the wrongdoing. However, the *Sharīʿah* does recognise the appropriateness of “whistle-blowing”. For example, the Prophet condemned immoral conduct and extolled the virtue of those who voluntarily revealed conduct that was against the interests of society. Jabir b. Abd Allah reported the Prophet as stating: “Meetings are confidential except in three situations; those for the purpose of shedding blood unlawfully, or for committing fornication, or for acquiring property unjustly” (Sunan Abu Dawud, no. 4851).

## **VII. The Real Risks**

The audit should be designed not merely to provide institutions with a list of possible threats to the reputation of their business and themselves. Many threats will, in the light of experience, be fanciful; and many, even if a reality, result in negligible harm. It is upon real threats that are likely to occur, and to result in a significant risk of harm to reputation, that the process should focus. Thus, the audit should determine, according to the probability of incidence and harmful impact, an analysis of those issues that those charged with the proper management and governance of the organisation need to consider in the discharge of their duties and their own self-protection. While we are concerned rather more with “legal risk” manifesting itself in a devaluation of reputation, it is pertinent to identify the sort of liability that might arise for the enterprise and those associated with it personally. Let us therefore consider the liability of the business itself and those involved in managing it.

### **A. *Complicity in a Crime***

Islamic criminal law generally requires the direct involvement and complicity of the defendant. The exceptions are narrow and, with the exception of the Maliki School, largely irrelevant to our present discussion. Indeed, the Malikis only recognise collective responsibility in the context of a concerted action. Having said this, the *Sharīʿah*, by imposing obligations directly on an individual who is in fact responsible for a wrongful act, cuts through many of the conceptual issues that arise in Western legal systems in cases where corporations or joint actors are involved. Of course, in many secular legal systems companies can be held liable under the criminal law to the same extent as individuals. The dishonesty of those who act for the company may be attributed to or merged with the company so that not only are the acts of its agents and representatives those of the company, but also their state of mind. Where a company is convicted, or even accused, of a serious crime, it can have immediate and direct implications for its business. When a company is held liable, this may also result in civil and other liability to those who have suffered as victims of the crime, or who have otherwise suffered loss as a result of the misconduct. Loss of reputation may well be actionable on the part of employees.

### ***B. Complicity in a “Regulatory Offence”***

As in the case of criminal liability, a breach of regulations by an individual may well be attributed to his or her employer. Indeed, in some cases the courts have held that the misconduct of the individual is the misconduct of the company and the company has been fined or otherwise penalised accordingly. It may well be that the commission, directly or indirectly, of a regulatory offence will have as adverse consequences for the business as a conviction before the criminal law courts. In some respects, there is even a greater likelihood of civil liability.

### ***C. Complicity in a Civil Wrong***

The law of tort applies much the same rules as the criminal and regulatory law. Indeed, it may well be that the civil law will go even further than the criminal law in being able and willing to attribute the liability of an employee or agent to the principal. It is important to appreciate that in cases where this occurs the business will be liable at least to the same extent as the individual who actually engaged in the wrongdoing.

In the civil law there is also a real prospect of a business becoming involved in liability for breach of trust or dishonesty in assisting another, perhaps an employee or even a member of its board, in breaching a fiduciary duty to another person. Again, in such cases where it is necessary for the law to find a “guilty mind”, the state of mind of certain individuals through whom the business operates will be that of the company. In this process the civil courts have gone somewhat further than those concerned with criminal liability.

### ***D. Secondary Liability***

While the Islamic criminal law generally does not distinguish between primary and secondary offenders, in the secular law it is quite possible for a business to become liable under the criminal, regulatory and civil law as a “secondary” party. Again, in the case of a company, the conduct and state of mind of those who act for it becomes the state of mind of the business. Thus, a company may well be considered to have aided and abetted one of its employees or directors to commit a fraud or engage in money laundering or a breach of trust. Indeed, it may even be considered to have “handled” or laundered the proceeds of one of its employee’s thefts or deceptions. It is also possible for companies – and, of course, individuals within a business – to conspire in the commission of a crime or a tort. Regulatory provisions often throw the net over those who have “participated in” or facilitated a breach of the rules. It is important to remember that so-called secondary liability may well result in exactly the same kind of penalties and consequences as per the primary offender.

## VIII. Liability for Those who Manage or Supervise

There is in regard to most, but not all, forms of liability a distinction between those who are responsible for exercising a general or specific management function within an organisation and those who are charged simply with supervision. However, it is important to remember that the distinction is not always clear cut, and that in the civil law, for example, there is no distinction, in terms of the duties that a director is required to carry out, between an executive director and a non-executive. Furthermore, the law is dynamic and there is an increasing trend to articulate and enforce specific duties of surveillance on non-executive and supervisory directors and officers. For example, in the UK, the English Law Commission has recently recommended that in cases of overseas corrupt payments, managers and directors of the company on whose behalf the bribe was paid should be held criminally liable unless they can prove that they had done everything in their power that could reasonably be expected to prevent the commission of the crime. A similar approach to the imposition of responsibility for risk has long been common in health and safety legislation. It should also be remembered that other legal systems, such as at the state and federal level in the US, may impose even more responsibility.

Particular issues arise in regard to *Sharī'ah* boards, as we have seen. While the method of appointment varies, members of such boards are often appointed directly by the shareholders or participants in an Islamic business upon the proposal of the board of directors. In most Islamic jurisdictions the legal obligations of members of the *Sharī'ah* board have tended to be taken for granted. Given the personal integrity of scholars appointed to such boards, specific problems have been merely anecdotal. However, given the overlap in many legal systems of general laws relating to, for example, conflicts of interest and insider dealing, there is scope for both uncertainty and perhaps liability.

### A. *Liability under the Criminal Law*

While as a general rule there must be personal fault before the law will contemplate liability under the criminal law, the level of “blameworthiness” may well vary. There are crimes of strict liability requiring no proof of personal blame, but these are the exception. Having said this, however, there is a real prospect of “falling foul” of the criminal law through ignorance. For example, the threshold of liability under certain of the provisions relating to money laundering and, in particular, terrorist finance is relatively low. There is an ever-increasing host of regulatory offences that similarly impose liability under the criminal law on the basis of gross negligence. While direct personal liability under the criminal law is not a common risk, if and when it occurs, the results can be devastating in professional and personal terms. It must also be borne in mind that there are other ways in which “culpable conduct” may lead to personal liability of a “quasi-criminal” character. For instance, proceedings against an individual to disqualify him or her from involvement in the management of a company may have extremely serious implications, as will being subject to a formal statutory investigation.

## **B. *Regulatory Liability***

In the case of regulated industries and regulated activity, the law has long attempted to foster compliance by placing emphasis on the personal responsibility of individuals. The threshold of liability will generally be less than under the criminal law, but the implications are often no less severe. Indeed, given the interface with disciplinary jurisdiction, the institution of proceedings by a regulatory authority may impact on a person with professional qualifications more immediately and directly. Regulatory penalties may involve significant fines and penalties, disqualification and referral of a case for prosecution.

## **C. *The Civil Law***

It is, however, in the realm of the civil law that individuals associated with businesses that sustain a reduction in their reputation and standing may be at greatest risk. It has already been pointed out that reputation is an important asset which it is the duty of those involved in management to protect. Failure to do so may well involve crushing civil liability for their negligence or complicity. Directors have a clear responsibility to do what is reasonable in the circumstances to prevent, control and minimise the impact of frauds and abuses against their company. Directors serving under a contract of employment may be held to a higher standard of care, as may all directors and officers should their company become insolvent.

Directors have arguably higher obligations to avoid and control conflicts of interest and conflicts of duties. The scope and vitality of fiduciary accountability has increased and there is a clear indication in the courts that those who manage or are responsible for other people's property will be held to high standards of stewardship. In some respects this has been made a matter of statutory or regulatory obligation. Therefore, it is not simply an issue of acting bona fide in the best interests of the company and avoiding personal conflicts of interest, but also of ensuring, as far as one reasonably can, that those for whom there is a responsibility do not abuse their position or opportunities. The days of the ostrich at the boardroom table are over!

## **IX. Responding to a Crisis – Assurance, Mitigation and Avoidance**

The audit process is concerned with ascertaining what threats exist and whether there are adequate procedures for minimising exposure and providing containment. It is not concerned with handling specific problems. However, in evaluating the likelihood of serious harm occurring, the audit will assess whether the client has in place and could successfully operate appropriate procedures designed to minimise and limit harm to its reputation. One of the issues that will be of concern is the institutional and procedural ability of the business, once a problem is detected or becomes obvious, to respond with timeliness and efficacy to preserve evidence, contain harm, reduce the risk of further damage and initiate a recovery strategy. As more is increasingly expected of management in assisting the authorities in pursuing



their enforcement or regulatory mandates, the greater are the legal and other obligations to cooperate on those who, for example, employ a fraudster. Therefore, the prospect of corporate and personal liability is not confined to the direct consequences of the misconduct in question. A failure to have proper recording or compliance procedures may throw up a real threat, as might an inability to control the environment within which the fraud of misconduct occurs.

Not every threat to integrity will be a result of dishonest conduct on the part of an identifiable individual. While it is not possible to commit fraud or even money laundering inadvertently, it is possible to become inveigled into a situation which appears egregious. For example, from the standpoint of the company that employs someone who it is alleged has engaged in money laundering or insider dealing, there is a legitimate concern as to whether it has properly operated procedures designed to curb and prevent such misconduct, even if as a matter of forensic analysis the “perpetrator” lacks the requisite degree of mental culpability. While this may not be objectively fair, let alone logical, the impact of adverse publicity on reputation is damning and often irrecoverable. Indeed, ironically it may be more difficult to deal with a perceived, let alone actual, systems failure than where there is a culprit that can be publicly blamed. The smell of fraud can be very pervasive. The audit will be concerned with identifying potential weaknesses and thereby allow management to reinforce its defences.

An audit cannot assure management, let alone those responsible for the governance of an enterprise, the safety of its reputation. It can and should, however, provide those whose responsibility it is to protect the integrity of the enterprise with sufficient information and advice to enable them to initiate measures that can be reasonably assumed to provide the best defences. Whether those defences are satisfactorily erected and maintained is a matter for the relevant organisation to decide. However, the fact that management has commissioned an audit and initiated appropriate action will be a relevant issue in establishing that it has done everything that it reasonably could have done to address the threat in issue. This may well mitigate the legal and regulatory consequences of a determination of liability. Thus, the audit may prove to be a significant item of confirmation that the board and management have taken reasonable steps to protect the integrity of the business and comply with the relevant legal and other obligations. Of course, the fact that an audit has been commissioned will not of itself serve as mitigation if the information that it provides is not taken properly into account.

There are offences and issues of liability the scope of which can be narrowed, or even closed, by showing that reasonable steps have been taken in addressing a particular problem or risk. This is particularly so in the management of conflicts of interest. What might otherwise be considered to be a conflict of interest may be regularised by providing for disclosure and appropriate authorisation. Where the core of an offence or complaint is that the management or a particular manager failed to exercise adequate supervision, then proof that everything that could reasonably be done in the circumstances *had* been done might well resolve the

issue. Thus, an audit which enables appropriate action to be initiated may of itself contribute in a significant way to a reduction in the scope of liability.

It must be appreciated, however, that at the end of the day the protection and advancement of a business's reputation is a matter for those charged with the management of that business. Indeed, the new English Companies Act 2006 in the UK makes this crystal clear. While this responsibility can be shared, it cannot be delegated or transferred to outsiders. Integrity is all about taking responsibility! This is echoed in the *Sharī'ah*.

One of the most serious and pervasive threats to the integrity of an enterprise is conduct that is motivated by greed and seeks to exploit an opportunity to make what lawyers call a "secret profit"; in other words, an unauthorised profit. As we have seen, this can take many forms, including accepting bribes, insider dealing, fraud, and misuse of property. The one link is greed. Criminologists have argued that with many forms of what they describe as "white collar" or business crime, the issue is really one of balancing the possible rewards from breaking the rules, against the costs and risks. This does not mean that honesty is simply an issue of cost/benefit, as it is clearly not. However, this approach does indicate that by increasing the costs of breaking the rules, and in particular making it more difficult to take advantage of the system without getting caught, the scope for and incidence of this type of activity may be reduced. Consequently, within any organisation it is possible to reduce the threat of fraud – and its impact, should it occur – by designing procedures that reduce the opportunities for abuse and for getting away with it. It is this process which we seek to provide, ensuring that what is designed for the specific circumstances of a particular organisation is compatible with its ethos, structures and business aspirations. Ill-fitting or inappropriate rules and procedures can be harmful and undermine the business that we seek to protect. If an integrity audit has already taken place, it will be much easier and more efficient to design and implement procedures to achieve a reduction in the risks associated with fraud and other types of misconduct. However, an integrity audit is not a necessary precursor, and where such an exercise has not taken place sufficient information can be obtained through a threat survey and evaluation.

A threat survey and evaluation should be conducted in much the same manner as an audit, but will focus rather more on procedural and institutional issues than the broader reach of an audit. It will be necessary to involve those working within the enterprise to ensure that the information that is obtained through the survey is accurate and of practical relevance. It will, in most cases, be desirable to have the same facility for liaison and assessment as in the case of an audit. On the basis of the survey and its assessment, or where there has been an audit, we will specifically design a variety of mechanisms and procedures tailored to the needs and operations of the enterprise, with the intention of minimising the incidence of threats and controlling the risks to which the client and its staff are exposed.

These mechanisms and procedures may well include drafting or redrafting internal procedures for verification, authorisation and control, and/or designating individuals or panels to monitor and approve certain actions. In appropriate circumstances, mechanisms for disclosing and reporting information may need to be refined, as might the taking, recording and protection of information. It is important that whatever is proposed to the organisation's management and governance facilitates and strengthens its business and does not inhibit its legitimate aspirations. Integrity systems must strive to achieve an assurance of integrity without undermining good business or compromising relationships within the enterprise or organisation. The exercise must be constructive and reassuring. It must also be sufficiently flexible to accommodate changed circumstances, including new personnel. Those involved in the design, implementation and monitoring of integrity systems should see their role as facilitative of good business. Good governance is good business. The systems must demonstrably contribute to attaining the objectives of the enterprise or organisation.

Consequently, draft proposals should be tested and refined at different levels within the enterprise before being proposed to those responsible for the management of the organisation. In testing the suitability and practicality of each adjustment, specific care will be taken to ensure that what is being proposed is not disruptive or uneconomic. It is only when we are satisfied that a new procedure or device will contribute in a positive sense to better governance and greater protection of the integrity of the enterprise and its staff, that we will make specific proposals to management and the board. The exercise will, of course, involve detailed explanation of the purpose of what is being proposed and the likely implications. It will be for those charged with ultimate management to decide on the acceptability of the systems in question. However, it is important to appreciate that systems are often interrelated and need to be adequately and properly resourced. Therefore, considerable care needs to be taken in evaluating the systems that are proposed and ensuring the appropriate level of commitment over a period.

Once the relevant systems are settled, they will need to be implemented with appropriate expedition and thoroughness. It is appreciated that the introduction of new procedures can be of concern to employees and those dealing with the enterprise. It may well be that there is a need for training of existing staff or the recruitment of additional resources. It will also be necessary to see that the systems are properly and efficiently bedded into the working practices of the organisation. It might well mean that certain procedures and rules require further refinement during this process of implementation. There may also be issues relating to employment and methods of work.

No matter how well crafted systems are, there will be developments which render them possibly inappropriate or in need of amendment. New threats may present themselves as a result of a change in the business environment, or new legislation, or for a host of other reasons. Consequently, it is important that the systems are adequately monitored on a timely basis. The extent to which this is

necessary will depend upon many factors. In most cases, apart from the need to address novel and exceptional threats, monitoring may well be undertaken on an agreed periodic basis. Defective and deficient procedures may be worse than having none, as, while not providing protection, they might lull management into a sense of false security. Indeed, once steps have been taken to address a perceived threat, it may be negligent of management not to ensure that its defences are adequately maintained. Having said this, there are obviously real dangers of too much “red tape” and interference. As in all things, a balance needs to be struck.

## **X. Dealing with Problems**

There are a number of very important legal, regulatory and managerial issues that need to be carefully addressed in outsourcing significant areas of responsibility. It is debatable to what extent responsibility for the integrity of an organisation can be delegated, let alone outsourced. This is a particular issue in regard to the traditional role of *Shari'ah* boards. While it is perfectly appropriate, and often necessary, to obtain expert advice in the discharge of the duties attaching to stewardship, it is not possible to delegate to another all the duties attaching to, for example, the office of director. There is a real issue that those who condone or seek to “pass the buck” in cases of fraud or other types of serious abuse, including the control of money laundering, will nonetheless be considered complicit in the wrongdoing. There are professional firms that are prepared to advise on and actually conduct monitoring. It is important, however, that such services are primarily concerned with systems and their ability to prevent, discover and address misconduct that would damage the integrity of the enterprise. They should not be designed or intended to replace the responsibility of management to ensure that their duties of stewardship are properly discharged. Of course, in most cases of potential liability, the fact that competent advice has been taken and acted upon will obviate or lessen liability, should an incident actually occur.

In recent years, a number of more or less professional services have been developed within or in association with law, accounting and management consultancy firms. In truth, the level and calibre of service varies enormously and is generally not cheap. However, there are circumstances where resort to such outsider service providers is both sensible and expedient. In some cases, the relevant firms have access to former officials in the relevant regulatory authorities and a high and topical level of knowledge and understanding. It is important, however, to be aware of potential conflicts of interest within these professional firms. There are different approaches to conflict issues in different jurisdictions, and not all would operate the sort of no-conflict policies run by most law firms.

A particular issue that arises in regard to the audit and in the course of monitoring is what happens if the external adviser discovers a serious regulatory failure or crime, or suspects that such is – or is in the process of – occurring. It is probable that the response will not be the same in every jurisdiction and profession.

Of course, to some degree this issue has already arisen for accountants engaged in audit, and in many countries there are legal rules. Generally speaking, an auditor who is not satisfied with the response that he receives from the management of the relevant business would have a duty to take the matter further. In some countries there is a legal duty to report concerns to the appropriate regulator and even the police. While much depends upon the contractual terms of employment of any consultant, it would normally be the case that information disclosed to the appropriate authorities in the public interest, such as to assist in the discovery of crime or a serious regulatory offence, would not expose the auditor or other professional to liability, provided that such was done reasonably and in good faith. Perhaps more interestingly from the standpoint of a client is the converse issue as to whether the police or a regulatory authority could demand information and documentation from such a consultant to prove that the client organisation was aware of certain problems or shortcomings and yet failed to properly address them. Generally speaking, such material, albeit of a confidential nature, might well be required pursuant to specific investigative procedures. While it would probably not, in most cases, be appropriate for the consultant to simply hand over such documents, where such are demanded pursuant to statutory investigatory powers it would be difficult to resist. Indeed, for example, there are cases in the US, Britain and France which clearly show this. Where the review and advice has been proffered by lawyers, it is possible that legal privilege may be claimed. Whether this would defeat the exercise of statutory powers in all jurisdictions is a moot point. However, law firms in the City of London and elsewhere have specifically marketed such services on the basis that, unlike in the case of accountants and other professional advisers, there is the probability that legal privilege would be a protection. Indeed, I have had the privilege as a barrister of supporting this view in a number of opinions for regulatory agencies.

No system is foolproof. There are no panaceas in dealing with fraud and abuse. Indeed, as we have seen, the very existence of systems may encourage those within them to play games of evasion, sadly often ending in more egregious conduct. Even the most secure systems within sensitive organisations have been breached. Ingenuity and greed can undermine the most robust of defences. Even if it is possible to construct systems that would deter or disrupt most conceivable misconduct, the price in terms of constraining business and the flair of entrepreneurship may not justify their imposition. As always, there needs to be a sensible balance between too much and too little control.

If an incident of serious misconduct occurs within an organisation, there may well be a series of legal, regulatory, and other decisions and actions that need to be taken within a very short space of time. Properly crafted integrity protection systems should kick in and provide for at least the containment of the fraud or abuse, the preservation of records and the evidential environment within which the incident occurred, and the notification of the appropriate authority, whether inside or outside the enterprise. Of course, there remains always the danger that the attack will not have been foreseen and the defences in place are in fact proven to be inadequate.

There is also the danger – and a very real one, in the case of fraud and deliberate misconduct – that the protection systems, or at least some part, will have been corrupted or incapacitated.

A considerable amount of management time can, and in some instances must, be taken up with addressing these and other issues. As we have seen, it is an important obligation of management to protect the asset of reputation, and a failure to do this may well lead to personal as well as institutional liability. Faced with so many problems and the potential for making mistakes, possibly resulting in far more harm and liability, it is vital that the organisation has in place procedures for addressing such crises. So-called crisis management should be addressed as a key issue in any integrity protection system. On the other hand, while the procedures may impose a degree of order and offer the prospect of protection for those working through them, there will inevitably be a host of specific issues which the procedures can at best only present to management for proper decision-making. While the facts of each case will vary, in a typical case the following legal and regulatory issues might well arise more or less simultaneously:

- the contractual (possibly employment) position of the perpetrator;
- related contractual issues, perhaps with persons with whom the perpetrator was dealing;
- issues arising from detection, such as whether there was a “whistle-blower”; and if so, how that individual (who might also be an employee or in a sensitive business or contractual relationship) has been dealt with;
- the need to protect both the environment within which the “crime” occurred and the integrity of evidence (particularly electronic and documentary evidence);
- the presentation of what has occurred to those who have a proper interest in knowing – and, in particular, the need to avoid making defamatory statements or interfering with subsequent proceedings and investigations;
- ensuring “containment” of the fraud or other abuse, including making sure that it is disrupted and steps are taken to close down the opportunity for others to copy and/or exploit it;
- in the case of Islamic businesses, ensuring a prompt and effective return to *halal* activity;
- notification to the relevant authorities, bearing in mind the risks of defamation and improper disclosures;
- liaison with appropriate investigative and regulatory authorities (including possibly those overseas) and, in particular, determining under what circumstances there is an obligation to assist in the securing and provision of evidence;
- how to deal with requests for assistance, and possibly threats, from those who have suffered harm as a consequence of the fraud or the company’s failure to prevent (or control) it;
- how to deal with the media, public and stakeholders;
- how to initiate proceedings to recover losses that the company has suffered,

or on behalf of those for whom the company has a responsibility to assist, including attempting to freeze the assets of the perpetrator and possibly his associates;

- liaison with insurers;
- in Islamic businesses, how to deal with “tainted” property;
- liaison with professional organisations; and
- liaison with bankers and others who may be adversely implicated.

In attempting to address each of these issues, and perhaps more, it will be necessary to seek the assistance of individuals inside and outside the enterprise. All these relationships will need to be managed, controlled and documented. For example, it is appropriate to disclose information relating to the suspected perpetrator and the circumstances of the “crime” only to certain persons and for specific purposes. A mistake could well not only harm the position of the institution, but also expose those responsible for an inappropriate or unlawful disclosure to civil and even criminal liability. For example, in certain circumstances it is a serious criminal offence for information to be disclosed relating to suspected instances of money laundering. Most frauds and other financial crimes will involve at least the prospect of a money laundering offence. The dilemma of management faced with all these issues may well be dramatically aggravated by similar issues arising in other jurisdictions in which the rules and legal procedures may be very different. In today’s business environment it is not unusual for even the smallest business to be exposed, directly or indirectly, to overseas regulatory regimes. In cases of serious fraud, it is not unlikely that by the time the problem is discovered the money will have been sent overseas, as might relevant evidence and even some of those involved.

A particular issue in Islamic law arises in regard to the proceeds of activity that is *haram*. In secular law the issue is relatively straightforward. If the property or money in question is the proceeds of a crime, the law will generally require that it be forfeited to the state. Where property is the proceeds of a fraud or other tort, then it might be subject to some process in the civil law of restitution. The analysis is somewhat different in the *Shar’ah*, as we have seen. While in a given case the secular law may well apply, the notion of unclean or tainted property is somewhat broader. Controversy has arisen among the scholars in regard to what might be described as “purification”. In some jurisdictions the proceeds from investments that are later discovered not to be *halal* have been contributed by *Sadaqah* and *Zakat* as charity. It is argued that this serves to “purify” the mistake. Where, however, what has been done is *haram*, it is highly questionable whether this is acceptable. For example, the *Hadith*, says: “Whosoever gathered unlawful riches and then gave out in charity, he will have no reward: on the contrary he will have to bear the burden of his evil deed”; and the Prophet said: “When a servant of Allah earns property in an unlawful manner and then gives it in charity, it will not be accepted of him. There will be no blessing (*baraka*) in that he spends and that he leaves behind (for his dependants) but it becomes a provision for the fire of hell. In reality, Allah does not wipe out evil with evil, but erases evil with good action. Undoubtedly, dirt does not clean dirt.”

As in the case of the audit, having a properly planned and designed *Threat Response* is not intended to relieve management of their responsibility to manage the situation and discharge their obligations to protect the reputation of the enterprise. We have already emphasised that this is a fundamental responsibility of those in a position of stewardship. However, what an effective *Integrity Threat Response* does do, is to provide those responsible for making decisions with adequate and expert advice and, when appropriate, legal and investigative support. Furthermore, it will also assume responsibility for those matters, in the control of the threat and its fall-out, which can properly be delegated, such as liaison with the relevant authorities. This will allow management to focus on the most important issues and the protection of their good name.

## **XI. Compliance and the Management of Risk**

The present author has already identified effective and efficient compliance as playing a most important role in the prevention and control of financial crime and associated problems. The degree to which those involved in the delivery of compliance should be involved in the design and implementation of systems and procedures is a proper issue for discussion. Although there will always be special situations to justify different approaches, in the same way in which the police are not normally encouraged to get involved in the legislative or, for that matter, the prosecutorial and judicial processes, there is much sense in recognising the division of skills. On the other hand, designing, let alone trying to implement, systems that are not practical or which may have unintended adverse impacts requires the sort of experience that those who deliver compliance will normally have. Compliance systems address far more than the containment of threats and the management of risks. Nonetheless, in our present context – that of the control of risk associated with misconduct – it is the case that compliance will have a more specific and dedicated focus. The identification of threats, the risks of such occurring and their likely impact, will need to be undertaken in the design of effective compliance. In the identification of threats, it will be necessary to throw the net rather wider than the purely legal and regulatory issues that we have so far discussed.

Compliance will increasingly be recognised as an important issue in those jurisdictions that seek to develop Islamic financial products and services. However, compliance is often, and for most jurisdictions, at a relatively young stage of development. Indeed, this is a proper concern of regulators. Expertise is limited and has generally been imported. This is not always satisfactory, as compliance systems and their operation must achieve a balance between what is required to comply with the relevant laws and to achieve an acceptable degree of protection for the risks that we have been discussing on the one hand, and not inhibiting proper and lawful business on the other. Not all jurisdictions and environments are the same, particularly in terms of their institutional arrangements and the approach of regulatory authorities. Therefore, rather like laws, it does not necessarily follow that what possibly works in the City of London or New York will achieve the same results



in Doha or Dubai, let alone Jakarta. Furthermore, compliance in the realm of the *Sharī'ah* is a new and largely untested science. Indeed, even within the confines of the Islamic world there is debate as to the appropriate roles of internal *Sharī'ah* audit and the responsibility of *Sharī'ah* boards to take a wider surveillance role over management. This is compounded by the inherent uncertainty of certain principles of Islamic law, both in their application and interaction with secular laws. Recent judicial decisions have, in some quarters, been thought to seed additional uncertainty. For example, Justice Datuk Abd Wahab Patail in *Arab-Malaysian Finance Berhad v. Taman Ihsan Jaya Sdn Bhd*, mentioned earlier, in a robust judgment, emphasised the importance of examining a series of transactions (in the context of *Al-Bai' Bithaman Ajil*) as a whole and considering the substance of what was in issue. He rejected resort to “legal devices or trickery (*hila*)”, pointing out that God was all-seeing and could not be deceived by artifices. He stated: “In developing a *Fiqh al-Muamalat*, caution must therefore be exercised for it is all too easy, when creating and then relying on legal fiction, to fall into the pit of complacency and inadvertently developing a '*fiqh al-hiyal*'. Bearing this in mind it is not sufficient that the distinction between a sale and a loan is maintained in form, but it must also be maintained in substance. It is the reality and not the form and labels that matter.” It is also interesting that the court underlined that it had an affirmative obligation on it to inquire whether a transaction violated the *Sharī'ah* under the relevant provisions of the Malaysian Constitution and laws, and could not merely assume compliance.

## XII. Protect and Survive

The law relating to Islamic financial products and services in many jurisdictions is at a crossroads. In the Islamic world, there is an increasing recognition that the traditional law needs to be strengthened with special and secular laws not only to ensure compliance with the *Sharī'ah*, but also to facilitate effective and stable markets and institutions. While there has been considerable headway in the development of accounting standards, notwithstanding the impressive work of the IFSB, there is a great deal to be done in developing a coordinated approach to regulation and supervision. The resources needed to ensure a proper interface between the *Sharī'ah* and the secular laws that are necessary for the effective and efficient creation, marketing and trading of Islamic financial paper are not inconsiderable. The burdens imposed by now-numerous international obligations are considerable. Outside those jurisdictions, as we have noted, there is a growing awareness for a variety of political, social and economic reasons of the importance of facilitating access to *Sharī'ah*-compliant investment. This interest is almost worldwide, but varies considerably in its sophistication. In Britain, for example, the government has recognised the need to take legislative and regulatory action to preserve London's role in this market (see, for example, *Islamic Finance in the UK: Regulation and Challenges* (Financial Services Authority, November 2007); *Consultation on the Legislative Framework for the Regulation of Alternative Finance Investment Bonds (Sukūk)* (Financial Services Authority, December 2008); and *The Development of Islamic Finance in the UK: The Government's Perspective* (HM

Treasury, December 2008). However, in the context of the present worldwide financial crisis and the pressure on governments, such as that of the UK, to participate in the development of a new regulatory landscape for the financial system, it remains to be seen what priority will in fact be given to Islamic finance. The indications are that, in the space of months, interest within governments has to some degree evaporated. As one senior official from the UK Financial Services Authority (FSA) stated when explaining why the FSA could not send a representative to a key working party convened by, *inter alia*, the UK government: “We are just too busy saving our banks!” What is probable, as we have already noted, is that in the new financial world issues relating to stewardship and integrity will play a much greater role. Those concerned to advance the cause of Islamic finance would be well advised to take on board the rhetoric of President Obama and other leaders and ensure that those who create and manage Islamic financial products and services hearken to these words of President Roosevelt, uttered some 80 years ago: “What we seek is a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people’s money are trustees acting for others.”



## CHAPTER SIX

### THE MEANING OF RATINGS FOR ISLAMIC FINANCIAL INSTITUTIONS AND *SHARĀH*-COMPLIANT INSTRUMENTS

Mr Anouar Hassoune  
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#### I. Summary Opinion

Islamic financial institutions (IFIs), like conventional banks, act as financial intermediaries, transforming the characteristics of the financial inflows they capture, as part of their funding strategies, into *Sharāh*-compliant placement, financing and investment instruments. However, *Sharāh*-compliant asset classes managed by IFIs may sometimes differ from those of conventional banks, not so much in their economic substance, but more in their financial form. Indeed, Islamic banks and those essentially conventional financial entities that offer Islamic services must abide by a series of rules and principles without which a transaction would not be deemed to be in line with the principles of Islamic finance (see Box 1).

Moody's assigns ratings to financial institutions globally, irrespective of their form or nature, including IFIs. As Islamic finance, in its modern form, has come of age over the past three decades and now more extensively serves the financial needs of a growing proportion of the Muslim communities in an increasing number of jurisdictions, IFIs have become increasingly entrenched in their domestic, regional and global markets. Therefore, despite their young age, Islamic banks, *Takāful* (*Sharāh*-compliant insurance) companies and *Sukūk* (or Islamic bonds/trust certificates) are expanding rapidly, along with the spectacular growth of several of their core markets in the Middle East and Asia.

In such a context, IFIs face a number of challenges stemming from the accelerated pace of their successful inclusion within more competitive and interrelated, if not integrated, financial markets across borders. For financial intermediaries globally, robust governance, enhanced transparency, consistent communication, sufficient credibility, fortress reputation, financial flexibility, swift access to diversified funding sources, and strong liquidity have become of utmost importance. Such endeavours are more vital now than ever, and emerging markets and IFIs are no exception.

### Box 1. The Five Core Principles of Islamic Banking and Finance

Islamic banking and finance essentially abide by five core rules, three being banning principles and two being positive obligations:

1. **The ban on interest (*riba*).** No financial transaction should be based on the payment or receipt of interest. Profit from indebtedness or the trading of debts is seen to be unethical. Instead, the investor and investee should share in the risks and profits generated from a venture, an asset or a project.
2. **The ban on uncertainty (*gharar*).** Uncertainty in the terms of a financial contract is considered unlawful, but not risk per se. Consequently, speculation (*maysir*) is forbidden. Therefore, financial derivatives are usually not permissible under *Sharī'ah*-compliant finance despite the possible application for risk mitigation or risk transfer.
3. **The ban on unlawful (*haram*) assets.** No financial transaction should be directed towards economic sectors considered unlawful as per the *Sharī'ah*, such as the arms dealing, tobacco or gambling industries, as well as all enterprises for which financial leverage (indebtedness) would be deemed excessive (including conventional banks).
4. **The profit-and-loss sharing (PLS) obligation.** Parties to a financial contract should share in the risks and rewards derived from such financing or investment transaction.
5. **The asset-backing obligation.** Any financial transaction should be based on a tangible, identifiable underlying asset.

It should be noted that Moody's analysis does not extend to forming an opinion on whether or not a transaction, a security or an issuer is in compliance with *Sharī'ah* law, and therefore credit ratings should not be interpreted as addressing this issue.

This report:

1. explains what ratings address specifically in the case of IFIs, given the characteristics of several of their funding instruments;
2. provides details of Moody's rating approach for *Sukūk*, explaining the distinction between asset-based and asset-backed *Sukūk*; and
3. highlights the main drivers of Moody's assessment of *Takāful* companies' credit profiles.

### II. Different Categories of Islamic Financial Institutions' Liabilities are Addressed by Different Rating Types

Overall, Moody's process for assigning ratings to IFIs and to the various classes of their funding instruments does not materially differ from that applicable to

conventional banks. The criteria and methodology used by Moody's to form its credit opinions on financial institutions globally are flexible enough to encompass the subtle characteristics of Islamic banks, and the differences they may display in terms of their funding structures.

**A. *IFIs' Classes of Liabilities Sometimes Differ from Traditional Funding Mechanisms***

For funding, IFIs raise non-remunerated current accounts and sight deposits, term deposits from customers (usually in the form of commodity-based buy-and-sell *Murābahah* contracts), profit-sharing investment accounts (PSIAs) and *Sukūk*.

IFIs' deposit-like funding instruments are addressed by Moody's local and foreign currency deposit ratings, as is the case with any other deposit-taking financial institutions. Deposit ratings reflect Moody's opinion on the probability that an IFI would lack the capacity or willingness to honour, in full and on time, its obligation towards depositors. This means paying back principal to current account holders and sight depositors on demand, and paying back both principal and profit share to term *Murābahah* depositors at maturity. The definitions of the various categories of ratings assigned by Moody's to banks in general, and IFIs in particular, are set out in Box 2 below.

**Box 2. About Moody's Bank Ratings**

***Bank Financial Strength Rating***

Moody's bank financial strength ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's bank deposit ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honour its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Moody's uses the Baseline Credit Assessment (BCA) to map BFSRs on to the 21-point Aaa-C rating scale. The BCA, like the BFSR, reflects a bank's stand-alone default risk. Each point on the Aaa-C scale represents a specific probability of default and therefore allows Moody's to use the BCA as an input to Moody's Joint Default Analysis (JDA) methodology, described below. The BCA reflects what the local currency deposit rating of the bank with the given BFSR would be without any assumed external support from a government or third party.

### ***Global Local Currency Deposit Rating***

A deposit rating, as an opinion on relative credit risk, incorporates the BFSR as well as Moody's opinion regarding any external support. Specifically, Moody's bank deposit ratings are opinions on a bank's ability to repay its deposit obligations punctually. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's bank deposit ratings do not take into account the benefit of deposit insurance schemes that make payments to depositors, but they do recognise the potential support from schemes that may provide assistance to banks directly.

According to Moody's JDA methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's BCA. In assigning the local currency deposit rating to a bank, the JDA methodology also factors in the rating of the various potential support providers (parent company, cooperative group, regional or national governments), as well as the degree of dependence that may exist between each one of them and the bank. Moody's assessment of the probability of systemic support (by a national government) is derived from the analysis of the capacity of a government and its central bank to provide support on a system-wide basis. The systemic support indicator is determined for a particular country and serves as an input for all bank ratings in that country. The support indicator can be set at, above or, in rare cases, below the government's local currency bond rating for that country.

### ***Global Local Currency Issuer Rating***

For conventional banks, Moody's rates long- and short-term deposits of both foreign and domestic currency, with the emphasis being on wholesale deposits. These ratings act as good proxies for issuer, or overall, ratings of the bank. We are rating relative creditworthiness as captured by an assessment of expected losses to depositors and other creditors. In addition, we rate the financial strength of the institution on a stand-alone basis, excluding both support and sovereign ceiling considerations.

For Islamic banks, we will generally use *issuer ratings* and *financial strength ratings* to describe the overall creditworthiness of the bank and focus on the expected loss that might be incurred by a fund provider. In some circumstances, where the funding of the Islamic bank is similar – in all but name – to that of a conventional bank in its own market, we will assign *deposit ratings* to allow easy comparison of creditworthiness among peers. It is our intention that any credit ratings assigned to Islamic financial institutions be comparable – in the dimension of expected loss – to ratings assigned to conventional banks.

#### ***Foreign Currency Deposit Rating***

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

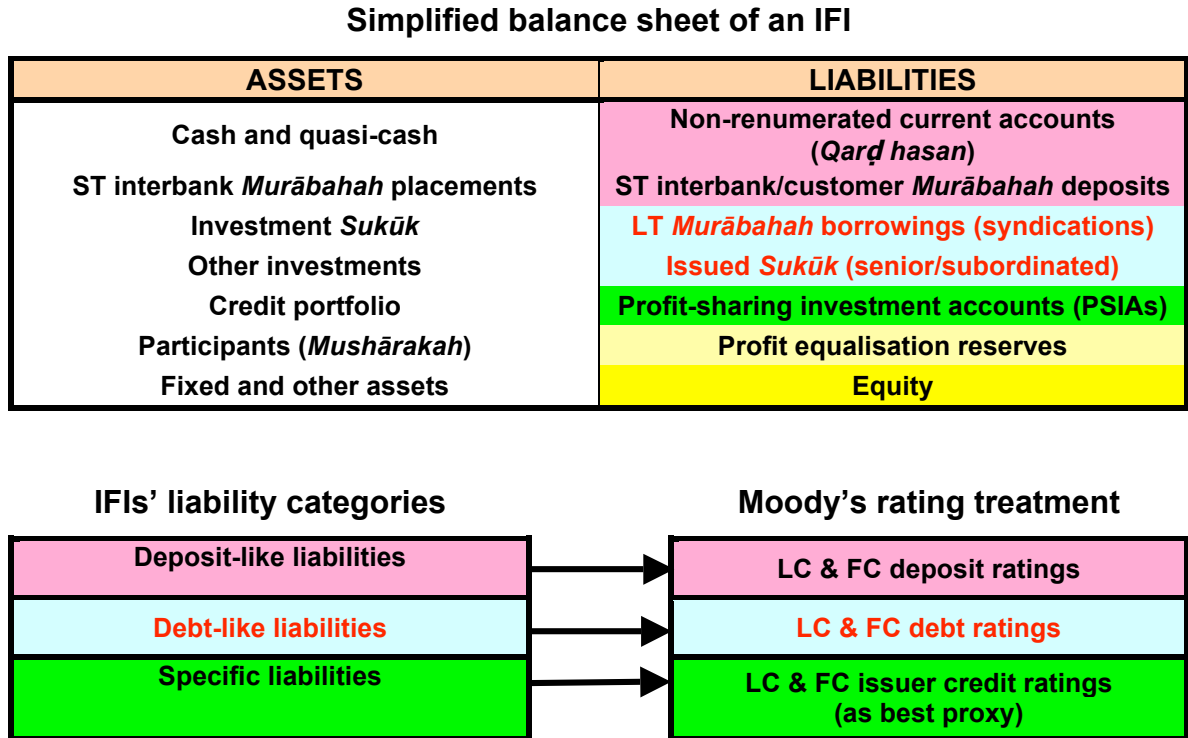
#### ***Foreign Currency Debt Rating***

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors is taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. These factors include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds, and the debt's eligibility to pierce that ceiling.

However, PSIAAs and *Sukūk* attract a more specialised treatment. For both categories of liabilities, credit ratings may have different meanings, as summarised in Figure 6.1 and further made explicit in the following sections.



**Figure 6.1**  
**Moody's Rating Treatment for IFIs' Liability**



### **B. PSIAs, Default and Credit Ratings**

PSIAs are the combination of *Mushārahah* and/or *Muḍārahah* contracts. A *Mushārahah* is a co-ownership contract whereby the IFI and the customer together hold the ownership of a range of asset classes. A *Muḍārahah* is a contract whereby the IFI, as *Muḍarib* (investment manager), manages a range of asset classes on behalf of the *Rab al-Māl* (the customer who provides the funds to be invested).

IFIs offer two classes of PSIA: restricted and unrestricted. The first category, i.e. restricted PSIAs, includes off-balance-sheet *Muḍārahah* investment accounts whereby the investor (the customer of the IFI) agrees to clearly identify the assets under the IFI's management. In this case, the IFI is remunerated with a *Muḍarib* (management) fee, and restricted PSIAs resemble more assets under management than funding instruments for the bank, and are thus addressed by Moody's fund ratings rather than credit ratings.

Unrestricted PSIAs, on the other hand, are on-balance-sheet funding instruments with, in theory, loss-absorbing features. They are based on both

*Mushārah* and *Muḍārah* agreements between depositors collectively and shareholders, who jointly commingle funds subsequently allocated into the IFI's various asset classes (the *Mushārah* component) with those assets then managed by the bank on behalf of unrestricted PSIA holders (the *Muḍārah* component).

From an analytical perspective, Moody's does not classify PSIAs as equity-like liabilities, despite their (theoretical) loss-absorbing characteristics. PSIAs are rather considered as more debt-like liabilities. The rationale behind this analytical treatment of PSIAs as liabilities with no capital benefits is that, from an economic and practical perspective, PSIAs:

- are not permanent capital, as they tend to be very short-dated (with maturities typically below one year);
- can be withdrawn before maturity, provided that the PSIA holder gives up his or her contractual return to be earned at maturity;
- have no voting rights; and
- in practice, are very rarely allowed to absorb losses.<sup>1</sup>

Unlike deposit-like funding instruments of IFIs, which the IFI guarantees, there is no such guarantee for unrestricted PSIAs: the IFI is not committed towards an identified rate of return on the PSIAs, and may not pay back the full principal amount should the IFI register a loss during the period the PSIA is held by the investor.

Therefore, a negative return on PSIAs would not be considered per se as default by Moody's. Negative returns on PSIAs might be registered without any breach of the contractual obligations due by the IFI to PSIA holders. Default in case of negative returns on PSIAs would be recognised only in the case of proven misconduct or negligence, as assessed by the IFI's *Shar'ah* Supervisory Board. Default in case of negative returns on PSIAs would also be recognised by Moody's if the IFI fails to pay back to PSIA holders the fair amount due to them after the loss is recorded. For example, assuming that a PSIA is worth \$100 at the beginning of the period (say, a quarter) and that, because of a quarterly loss, the PSIA is worth only \$95 after three months, if the IFI were to pay back less than \$95 to the PSIA depositor, the IFI's obligation towards its customer would not be met and default would be recognised.

In any case, default on individual PSIAs, defined as breach of any contractual obligation, would in practice be difficult to trace. Consequently, PSIA holders (particularly wholesale fund providers) should refer to the IFI's issuer credit ratings as an overall assessment of its creditworthiness. These ratings also take into

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<sup>1</sup> In the International Accounting Standards Board's accounting classification, unrestricted PSIAs are a type of 'puttable instruments'. Some puttable instruments are classified as equities, but unrestricted PSIAs do not meet the criteria for such classification, and are thus properly classified as liabilities (Alexander and Archer, 2010, ch. 16).

account the so-called “displaced commercial risk” to reflect the risk of massive and severe withdrawals of PSIA funds should returns on such instruments fall materially below expectations or benchmark profit rates, or even be negative. PSIA withdrawals, if sudden and material, would trigger liquidity pressures on the IFI’s balance sheet and increase its probability of default. To manage displaced commercial risks, IFIs tend to set aside investment risk reserves against expected losses on their portfolios of managed assets, as well as profit equalisation reserves to cater for unexpected losses, and thus smooth returns to be served to PSIA holders across the cycle.<sup>2</sup>

In short, at this stage, Moody’s does not capture in its credit ratings any form of “soft default” – that is, the incapacity of an IFI to serve a positive and competitive return on PSIA, in line with PSIA holders’ expectations.

### **III. Moody’s Approach to Rating *Sukūk***

#### **A. Summary**

The key distinction Moody’s makes when looking at corporate, sovereign and bank *Sukūk* is whether they are (i) asset-backed, or (ii) asset-based via a repurchase undertaking. In other words, do *Sukūk* holders rely on the assets themselves, or on the ultimate originator, for repayment? While the term “asset-based” may imply some security or claim over the assets, this is usually not the case, and therefore the credit ratings on the *Sukūk* are the same as those on the IFI issuing the *Sukūk*, further emphasising the importance of issuer credit ratings in this case.

Given the current lack of broad standardisation of the terms applied to the various structures, the actual name given to describe the type of *Sukūk* structure used may prove misleading and investors therefore need to look at each structure individually to understand its risk/return profile. “Asset-backed” and “asset-based” are semantically similar descriptions but mask significant risk/return differences.

Moody’s “pure” focus on credit risk, our extensive coverage of regional and global structured finance, and a long experience of looking at hundreds of structured transactions means we are well placed to strip away the sometimes excess complexity and confusion surrounding *Sukūk* products and get to the “substance” of the *Sukūk* investment risk without being distracted by the “form”.

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<sup>2</sup> IRR is a *reserve* against *unexpected* losses on asset portfolios, as a result of which the overall result is a loss. *Expected* losses on specific assets are covered by *provisions* against those assets, which reduce profits in the period in which the provisions are made. Expected losses are charged against the provisions and only impact profit for the period if the provisions are inadequate. PER is a reserve set aside in more profitable periods which can be released in less profitable periods, so as to “equalise” the level of profit *payout* (not the profits as such).

Due to the nature of *Sukūk*, all transactions are likely to involve a set of underlying assets. Both parties – the issuer and the investors – share the risks in the transaction. Where investors enjoy asset-backing, they benefit from some form of security or lien over the assets, and are therefore in a preferential position over other, unsecured creditors. In other words, in the event that the issuer were to default or become insolvent, the *Sukūk* holders would be able to recover their exposure by taking control of and ultimately realising the value from the underlying asset(s). In such a case, the transaction may achieve ratings that are higher than the unsecured issuer rating of the originator, subject to certain conditions.

Where the transaction is asset-based (which has been the case for the vast majority of bank *Sukūk* so far), the originator undertakes to repurchase the assets from the issuer at maturity of the *Sukūk*, or upon a predefined early termination event, for an amount equal to the principal repayment. In such a repurchase undertaking, the true market value of the underlying asset (or asset portfolio) is irrelevant to the *Sukūk* holders, as the amount is defined to be equivalent to the notes. In this case, investors in *Sukūk* rely wholly on the originator's creditworthiness for repayment. This class of *Sukūk* is identical to unsecured lending from an exposure perspective and hence attracts a similar capital charge.

Thus, if the originating IFI is unable to honour its obligation to repurchase the assets, the note-holders are in no preferential position to any other similar creditors, or indeed in no weaker position to any other creditor ranking *pari passu*. With very few exceptions of bank *Sukūk* subordination, purchase undertakings usually rank *pari passu* with the originator's other senior unsecured obligations. Where the issuing IFI already has a senior unsecured credit rating, the rating of the transaction would most likely be equal to the existing issuer rating. Otherwise, a bond rating can also be assigned without an issuer rating, although this would follow the same analytical approach. Subordinated *Sukūk* would be notched down from the senior unsecured ratings according to our published methodology, like any other subordinated conventional bond.

While most *Sukūk* will have assets in the structure, Moody's will only consider them to be asset-backed if the key securitisation elements are in place to ensure that *Sukūk* holders have beneficial title and realisable security over the assets. These elements essentially include bankruptcy remoteness, a set of legally watertight covenants, and generation of independent cash flows that are aimed solely at servicing the transaction. If this is not the case, then our rating is likely to be governed more by the borrower or originator and our conventional corporate or bank analysis applies.

We expect that *Shari'ah*-compliant securitisation will expand going forward, and that therefore asset-backed *Sukūk* sponsored by IFIs and other corporations will grow materially in number and size. For IFIs, these structured *Sukūk* would play the roles of both attractive funding mechanisms and powerful balance-sheet and risk management tools.

So far, IFIs have preferred an originate-and-hold business model due to the lack of a secondary market for loans and *Sukūk*; however, in the longer term, IFIs with limited capital resources might be more inclined to adopt an originate-and-distribute business approach, provided disintermediation picks up, market depth and liquidity improves, and growth in Islamic assets continues unabated. Unquestionably, a wider range of rated IFIs and *Sharī'ah*-compliant securities would in this context help accelerate the emergence of modern capital markets beyond bank intermediation in Muslim countries.

As noted earlier, Moody's does not opine on *Sharī'ah* compliance. However, given its relative importance in deriving a sound structure, we would expect an endorsement by a recognised *Sharī'ah* board that the structure is indeed *Sharī'ah* compliant, particularly where non-compliance constitutes an event of default or acceleration event. The limited precedents and the lack of formal universally agreed validation criteria may add a further element of legal complexity to *Sukūk* transactions, given that *Sharī'ah* is widely regarded as a matter of expert and consensual opinion rather than objective fact.

More importantly, Moody's examines the strength of the underlying purchase obligation, as this constitutes the backbone of the *Sukūk*'s principal repayment. Accordingly, Moody's prefers to see the undertaking agreed under types of law that have precedents in enforcing such undertakings. This does not entirely eliminate the risk of a local court overruling any applied law in the event of dispute, but such risk is commonly factored into any underlying rating of the company.

As a *Sukūk* transaction will involve not only the offering circular but also a variety of underlying agreements, Moody's requires draft versions of all these agreements at an early stage in order to determine the instrument rating. Given the importance of enforceability and jurisdiction of a number of related legal documents that make up a *Sukūk* transaction, Moody's would normally ask for legal opinions on the legal, valid and enforceable nature underlying contracts of a *Sukūk* transaction. Moody's therefore places strong emphasis on the applicable law, the most common and widely recognised being English or New York law, due to their creditor-friendly nature. We would expect opinions to address the enforceability of such contracts under local law.

## **B. Detailed Examination of Moody's Rating Methodology for *Sukūk***

*Sukūk* notes are bond-like investments that follow the five key principles of *Sharī'ah*-compliant finance (see Box 1). Especially in the case of Islamic bonds, principle No. 5 – which states that *Sukūk* issuances should be backed by or based on underlying tangible assets – has recently been highlighted by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) and has created much discussion in the market.

From this genuine asset-backed nature (i.e. in “substance” and not just “form”), the instrument’s compliance with the four other principles naturally follows. Indeed, the underlying assets generate cash flows that serve as the basis to pay coupons to *Sukūk* holders. In this, *Sukūk* preserve their participating (or income-/loss-distributing) content, as *Sukūk* investors share with the bond originator the returns extracted from the underlying assets (as per principle No. 4). Those coupons thus are not interest flows, but rather a form of transfer of rents or wealth accumulated by the underlying assets to their ultimate owners – that is, the *Sukūk* holders (as per principle No. 1). The repayment of the bond principal is in turn ensured by the sale of the underlying assets at the maturity of the *Sukūk* contract or, in some structures, entirely from asset-related cash flows.

The underlying (*Sharīʿah*-compliant) assets in a *Sukūk* are selected and pooled in amounts sufficient to provide the returns commensurate with the risk taken. The assets are “securitised”, and can take many forms such as rental payments, instalments attached to lease/purchase contracts or investment returns, but in all cases the cash flows must be considered lawful by at least one *Sharīʿah* supervisory board. Therefore, the *Sukūk* issuance finds itself in line with the principle that bans *haram* assets (as per principle No. 3).

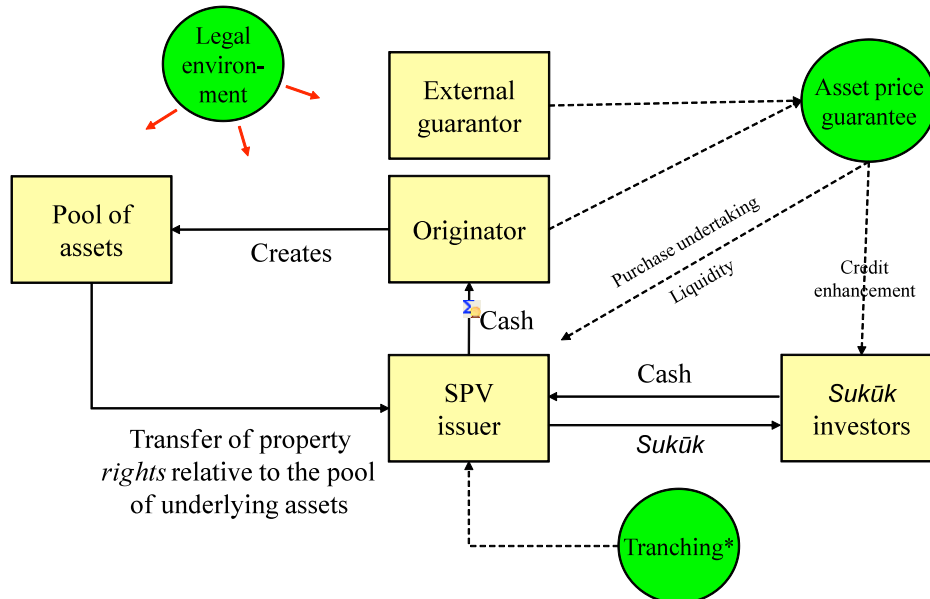
It should be noted that the term “Islamic securitisation” has been used erroneously in many instances to describe existing structures that, when the detail of the associated contracts is examined, reveal no real asset ownership by *Sukūk* investors; indeed, there is no legal recourse to the assets. Should the “borrower” become insolvent, the investor would, in the majority of issuances to date, join the unfortunate queue of unsecured creditors behind those who are secured.

To create a bond-like *Sukūk*, the cash flows extracted from the underlying assets should be characterised by a fair degree of predictability. However, this feature does not necessarily make them risk-free instruments. Indeed, risk-taking is valued in Islam, and Islamic investment theory validates the distinction between “risk” (a random quantity subject to probabilistic measures) and “uncertainty” (radical randomness out of the scope of probability distributions). Such a nuance is at the heart of principle No. 2, which bans *gharar* and *maysir*.

### **(1) *Sukūk* are Always Structured Notes**

There are numerous ways of structuring *Sukūk*. For example, AAOIFI – the organisation most widely recognised and active in standardising the accounting rules applicable to IFIs – identifies 14 different *Sukūk* structures. Notwithstanding such diversity, which reflects the variety of contracts underlying *Sukūk* structures, the latter most often include a limited number of recurring features, as summarised in Figure 6.2.

**Figure 6.2**  
**The Typical Structure of Current *Sharī'ah*-compliant Notes**



\* Tranching: division of assets into *Sukūk* classes of varying risk/return profiles.

Any asset-backed *Sukūk* issuance starts with the identification and segregation of a pool of underlying *Sharī'ah*-compliant assets on the balance sheet of the company seeking finance. Tangible assets such as properties and land are naturally eligible for *Sharī'ah* compliance. In addition, most *Sharī'ah* supervisory boards have recognised the eligibility of expected asset-related receivables not fully identified at the time the *Sukūk* are issued. Ownership rights attached to the pool of assets are then transferred to an *ad hoc* economic entity in the form of an issuing special purpose vehicle (SPV) that has no capital and seeks to isolate the underlying assets from the “borrower”. The SPV will usually purchase the assets with the investors’ funds, and ultimately the SPV constitutes the legal issuer of the *Sukūk*. The cash payment made by *Sukūk* holders to the SPV as a price for acquiring the *Sukūk* serves as the basis for the issuing SPV to acquire from the originator the rights on the future cash flows to be generated by the pool of underlying assets. Legal or beneficial ownership is passed to the investors, but with a “security agent” or trustee (although there is no recognised trust law in most local jurisdictions).

In current asset-based *Sukūk*, the underlying assets are sold (usually back to the originator at maturity), and the proceeds of this sale are used to pay back the *Sukūk* principal, usually at a predetermined price. During the lifespan of the *Sukūk*, coupons are served to investors on the basis of the expected returns extracted from the pool of underlying assets. Should there be a gap or mismatch between coupons served and asset returns, the originator or any other external liquidity provider (guarantor) can make up for such a shortfall – this gives the *Sukūk* the fixed-income characteristics of a conventional unsecured bond. *Sukūk* issuances can also be

subject to some form of “tranching”, as in any conventional securitisation transaction, between different classes of *Sukūk*: “senior”, “mezzanine” (or “junior”) and “equity” classes can be issued, depending on their relative creditworthiness as reflected in their respective credit ratings.

Finally, whatever the form of the *Sukūk* structure, the legal environment surrounding the issuance is always a key component of an analysis of the risk factors attached to *Sukūk*. Indeed, not only the applicable legal framework, but also the nature of the legal courts expected to possibly handle the eventual disputes emanating from *Sukūk* contracts, can to a large extent alter the return expectations of *Sukūk* holders.

## ***(2) Moody’s Criteria for Rating Sukūk Distinguish between the Broad Categories of Islamic Bonds***

Moody’s assigns ratings to bond issuances, be they conventional or Islamic. The analytical criteria applicable to rating *Sukūk* depend on their nature and characteristics. As shown in Table 6.1, our analysis distinguishes between two broad categories of structures under which *Sukūk* may be issued, and which dictate to a large extent the applicable rating methodology.

The first category of *Sukūk* includes all Islamic bond issuances that benefit from the originator’s guarantee. Such *Sukūk* are said to be “asset-based”, whereby asset transfer is essentially in form rather than in substance.

The second *Sukūk* category comprises all *Sukūk* that do not benefit from the explicit support of the asset originator. Such *Sukūk* are said to be “asset-backed”, to reflect the fact that the most critical rating factor lies in the credit quality of the underlying assets. Here, the asset transfer is effective in substance and not just form.

This distinction determines the appropriate rating approach. In short, the first category of *Sukūk* usually attract ratings that reflect both the creditworthiness of the originator providing the guarantee and the ranking of the *Sukūk* compared to the originator’s other senior unsecured obligations, whereas the ratings on the second category of *Sukūk* are a function of the credit features of the assets underlying the whole *Sukūk* structure.



**Table 6.1**  
**Rating Methodologies Applicable to *Sukūk* Depending on Whether they are Asset-based or Asset-backed**

| <b><i>Sukūk</i> category</b>                                      | <b>Analytical characteristics</b>   | <b>Rating approach</b>   |
|---|---|--|
| <b>Unsecured asset-based <i>Sukūk</i></b>                         | The issuance principal is effectively “guaranteed”, in most cases by the originator, via a purchase undertaking agreement – i.e. a commitment to buy back the underlying assets at the <i>Sukūk</i> maturity.<br>The coupons (periodic distribution amounts) are protected by a liquidity provision – i.e. the commitment of the originator/guarantor to provide sufficient liquidity to make up for any shortfall between asset returns and periodic distribution amounts. | The issue-specific ratings are placed at the same level as the issuer ratings assigned to the originator. The <i>Sukūk</i> constitute an obligation ranking <i>pari passu</i> with the originator’s “guarantee” (which can be either senior – in most cases – or subordinated – which has been much scarcer so far). |
| <b>Secured asset-backed <i>Sukūk</i> (Islamic securitisation)</b> | Neither the principal nor the coupons are subject to formal guarantees. <i>Sukūk</i> performance is asset-driven and the effective legal transfer of assets to investors is critical. Credit enhancement mechanisms are intrinsic to the structure of risk repackaging.   | The applicable rating approach is similar to that for securitisation transactions, but with some focus on Islamic features. The quality of the cash flows extracted from the underlying assets, as well as the features of the structure, are the key factors for rating asset-backed <i>Sukūk</i> .                 |

The main analytical feature of unsecured asset-based *Sukūk* lies in the fact that both coupons and principal reflect an unconditional and irrevocable obligation of the originator. In cases where the underlying assets generate insufficient cash flows to pay the coupons (periodic distribution amounts) to *Sukūk* investors, the originator, as asset manager and guarantor, makes up the shortfall and serves coupon payments to *Sukūk* holders.

At the *Sukūk* maturity, the originator repurchases the *Sukūk* underlying assets at a predetermined price equivalent to the *Sukūk* principal. In this case, the *Sukūk* rank *pari passu* with all other obligations of the originator, senior or subordinated, depending on the ranking of the guarantee. Most of the rated *Sukūk* in this category constitute senior unsecured obligations of originators-obligors, and by way of consequence their ratings have been placed at the same level as the originators’ issuer ratings. So far, very few subordinated *Sukūk* have been issued and rated.

Secured asset-backed *Sukūk*, on the contrary, are subject to an analytical treatment similar to that applicable to bond classes emanating from securitisation transactions. This means that the ratings on those secured asset-backed *Sukūk*, like those on securitisation tranches, essentially depend on the economic and financial

attributes of the pool of underlying assets, not on the creditworthiness of their originator. One of the many benefits of Islamic securitisation transactions encompassing secured asset-backed *Sukūk* is the ability of the originator to issue *Sukūk* that are rated higher than the originator's issuer credit ratings.

### **(3) Asset-backed *Sukūk*: Substance over Form**

The *Sharī'ah* ideal is that *Sukūk* should grant the investor a share of an asset or business venture along with the cash flows and risk commensurate with such ownership. However, most current structures have more in common with conventional fixed income instruments from a risk/return perspective. As discussed earlier, the assets in many *Sukūk* structures are commonly for *Sharī'ah* compliance only, and ultimately have no bearing on risk or performance of the *Sukūk* investments. Investors should note that, while not all conventional asset-backed securities (ABS) may be *Sukūk*, all true asset-backed *Sukūk* transactions should be accessible not only to Muslims but also to the vast universe of conventional ABS investors.

This section looks at Islamic securitisation in conjunction with some of the recent statements of AAOIFI, the relevant Islamic principles and structural features from a purely analytical perspective with regard to the issues as they affect credit risk, and avoids making any judgements with respect to *Sharī'ah* compliance.

#### *AAOIFI, Sharī'ah and the Role of Opinions*

The disparity between the “ideal” and the “reality” of *Sukūk* was highlighted by AAOIFI in February 2008, when it published six recommendations regarding *Sukūk* and noted that 85% of existing *Sukūk* were not in compliance with these principles. Moody's believes, however, that the decline in *Sukūk* market volume in 2008 was due more to prevailing global credit market conditions (it was, and still is, a very difficult time to raise funds, whether conventional or Islamic), rather than to any direct reaction to the AAOIFI statements.

AAOIFI's comments constitute a positive effort towards improving transparency and bringing the “substance” of *Sukūk* products closer to the tangible risk-sharing principles on which there is consensus – it is on the implementation of these principles that things become complex for investors. Whether or not the market agrees with AAOIFI is a different story, but at the very least it prompts the right questions.

A key question is whether the goal of the Islamic finance movement is to replicate in its entirety the conventional financial system. Should practitioners create instruments and investments that are identical in substance to conventional ones but with Arabic names? Or perhaps the goal should be to encourage and favour particular types of investment (such as more tangible risk-sharing ones) and funding that are closer to *Sharī'ah* principles, regardless of terminology and origin, that are

relevant to all parties? For example, private equity in the technology companies of Silicon Valley in the United States is inherently compliant with the *Shar'ah* investment principles despite there not being any Arabic words in sight.

In addition, an Islamic financial market will always need to interact and engage with the conventional one – it does not exist in some “isolated” bubble. The credit crisis that took hold during 2008 has proved the globalised nature of the world we live in: imagining that a sub-prime crisis could never happen in Islamic finance would be to encourage complacency. As the Gulf countries now contemplate the effects of property and stock market declines coupled with low economic growth prospects in the short term, Islamic and conventional institutions alike are feeling the pain of reduced liquidity.

The different motives of the parties involved also need to be considered – it is not always Islamic ethics that drive the market forward. The pursuit of profit is a legitimate and powerful driver that is in keeping with human nature, but there exist moral hazards and possible conflicts of interest that need to be dealt with, or at least acknowledged, for the longer-term transparency health, future and sustainability of the industry.

Ultimately, much is subject to interpretation and opinion, and the Islamic approach is that individuals are generally not really empowered to judge on Islamic “compliance”, but to offer advice, guidance, opinions and education. AAOIFI has its views, but market participants can, and will, make their own decisions based on the precedence given to *Shar'ah* compliance in their own agendas and economic objectives – most often the need for financing is the key driver. Conventional finance has had many hundreds, if not thousands, of years to reach its current form and is still evolving. “Modern” Islamic finance is relatively young and going through its own path before it reaches a point of stability/consensus. From a *Shar'ah* perspective, it is the *niyyah*, or intention, of the parties that is probably the most important.

#### Asset-“based” vs. Asset-“backed”: Is There a Difference?

The first point highlighted by AAOIFI relates to assets. It proposes that *Sukūk* investors should have rights over the *Sukūk* assets, that they should be sold “legally” and that the originating company should “transfer” the assets. As discussed earlier, Moody’s methodology also looks at this same point to determine whether asset transfer has taken place in substance, rather than just in form. This is not the case in the majority of *Sukūk* issued to date – although we have seen a couple of notable Islamic securitisations where the assets were “truly” sold: Tamweel and Sorouh PJSC, both UAE transactions. They still account for the minority of overall issuances to date.

This point derives from the fact that *Shar'ah* promotes the concept that financing should be raised only for trading in, or construction of, specific and identifiable assets. Trading in general “indebtedness” is prohibited, and therefore the

issuance and trading of conventional bonds is not seen to be compliant. Conventional bonds usually represent non-asset-backed interest-based funding for general corporate purposes.

Thus, it is encouraged that all *Sukūk* returns and cash flows should be linked to assets purchased, or (in the case of project finance) those generated from an asset once constructed, and not simply be income that is interest-based. This requirement for “tangibility” has significant – and problematic – effects in other areas, such as derivatives. For borrowers to raise “compliant financing”, they will need to utilise assets in the structure. These “companies or banks” that provide the assets are commonly referred to as “originators”. It is interesting to note that much of the current crisis originates from the use of excess debt or leverage of non-tangible assets.

In essence, the substance of a *Sukūk* is the risk (of loss) and return/profit/payment characteristics of the instrument or investment – how much income/profit the investors can expect to receive, and how likely it is that they will lose on the investment or that the *Sukūk* will default. In our assignment of ratings to such instruments, it is exactly these aspects that we analyse, both quantitatively and legally, to assign our credit ratings.

It is the efforts to adhere to this recommendation that have given rise to the term “asset-based” *Sukūk*, but in most cases the resulting structures address it mostly in form but not in substance. Understanding this substance should be the first and most important step in any analysis of either the structures’ *Shari’ah* compliance or their credit risk. In the majority of the *Sukūk* rated by Moody’s, as per our usual credit analysis, we have gone into great detail in the *Sukūk* documentation (sometimes hundreds of pages) to understand the actual source of risk, and of the profit and principal/capital payments.

Although there are many *Sukūk* structures, most of them (be they *Ijārah*, *Mushārah* or *Mudārah*) effectively “reduce” to a form that is an Islamic equivalent to a conventional unsecured bond. Much complexity is generated by asset-based aspects of the structure, but the objective is to replicate the risk and return characteristics of a fixed-income bond.

So, what of the assets in these structures? Usually there is indeed some plot of land, a building or something tangible at the heart of the *Sukūk*. The critical question is (as per the AAOIFI statement): is there any “legally” recognised asset ownership or interest for *Sukūk* investors?

**Do Investors Own or Have Enforceable Rights to the *Sukūk* Assets?**

If our analysis validates some form of ownership or security, then we conclude that the *Sukūk* risk/profit is driven more by the value and cash flows of the asset. In such a case, we believe that, even if the originator were to default and go

bankrupt, the *Sukūk* investors should be in a good position to recover much of their investment, obviously depending on asset quality; that is, if the building or land was truly sold to the *Sukūk*, then it is the building or land value that affects how much the *Sukūk* investors will recover. However, if the security is property and the originator is a real estate developer, there is a significant chance that both may be impaired at the same time. In most existing cases, the originator would actually aim to retain the asset in the *Sukūk* and so it is structured to effect this.

When is something “truly” sold? Simplistically, when there is an agreement that is evidence of a binding sale transaction from the originator to the *Sukūk* investors. It does not, however, end there. While there is a freedom of contract principle in the UAE (the most active international *Sukūk* market), such a contract needs to be shown to be legal, valid, binding and ultimately enforceable on all parties under the laws of the country where the assets and company are based in order for Moody’s to give any value to the asset security. Most often, effective registration of the property in the name of the new owner(s) is conclusive evidence of legal transfer and binding in any court process.

Moody’s relies heavily on legal opinions from law firms expert in local and international law as to how the law would be expected to operate in such a circumstance. If we believe that such contracts are not binding or are voided in a bankruptcy court situation, then we give limited value to the assets in the structure, and the risk and rating analysis is usually focused on the issuing corporate or bank.

It is important to note that, under disclosure and securities laws and regulations of the exchanges, it is very unlikely that the “asset” risk/return of a *Sukūk* will be misrepresented directly to investors. However, Moody’s has met market participants who, without access to (or interest in) the legal detail, sincerely believe there is asset security. We therefore believe the term “asset-based” is confusing; currently, we see in substance only two types of *Sukūk* – secured and unsecured.

In Moody’s efforts to help promote a healthy and long-term *Sukūk* market, we aim to encourage as much transparency and awareness as possible. This helps prevent investor disputes at a later stage should the company or assets become distressed.

From a risk perspective, it is critical for investors to note that, currently, upon the insolvency of a *Sukūk* originator, the assets “involved” in an asset-based structure would be clawed back into the bankruptcy estate. The *Sukūk* investors would have no first-lien or prior ranking or security above any other unsecured creditor. It is this aspect that drives the rating of corporate and bank *Sukūk*. If the likelihood of a loss on the *Sukūk* is based not on the assets but on the performance of the originating company – then the rating will be the same. However, compared to conventional bonds, the immaturity of the market means that most of the *Sukūk* mechanisms are untested in a distressed environment.

To recap, without evidence of a legal “true sale” or a local court-recognised beneficial interest, we give little or no benefit to the assets in an “asset-based” *Sukūk*. The “form” of the risk and return may appear to be that of assets, but the “substance” is purely that of corporate or bank risk – not asset risk.

### Where is the *Sukūk* Profit Coming From?

As *Sharāh* considers money to be a measuring tool for value and not an “asset” in itself, it requires that one should not be able to receive income from money alone. This “self-generation” of money from money is *Riba*, and is typically forbidden. However, some note that it is the “usury” interpretation that is the more prohibited; that is, when interest is applied in an exploitative manner (indeed, many non-Muslim countries also have usury laws) that forces individuals into debt traps and a cycle of poverty.

The implications for Islamic financial institutions and securitisations are that the trading/selling of debts or receivables (without the underlying asset) for anything other than par is not permissible. However, it should be noted that, for some of the existing *Sukūk*, some *Sharāh* boards appear to accept that, as long as such receivables are a “small” portion of the overall income flows, their presence is acceptable (although there is some variation in the definition of “small”).

### **Box 3. Malaysia vs. Gulf**

It is worth noting that Malaysia, which has a comprehensive domestic Islamic capital market, allows *Sukūk* to be 100% backed by receivables. This is a major difference between the two largest markets (the Far East and the Gulf) and affects the overall liquidity potential of a global “Islamic capital market”.

In the Gulf *Sukūk* structures, there is typically a rent – lease management income derived from the “asset”. Under the (*Ijārah*) lease-type agreements, the company usually agrees to pay *Sukūk* holders income for use of the asset, and these form the periodic fixed-income stream that replicates the coupon in a conventional bond. In other structures (*Mudārabah*, *Mushārah*), there may be some cash flows from the assets that are passed to the *Sukūk* holders to pay the profit. If, however, there is an excess income, it is taken as an incentive fee; if there is a shortfall, the originator has (ultimately) an obligation to pay the difference. The third AAOIFI recommendation appears to relate to this, and discourages payments or loans if there is a shortfall in the expected earnings.

Thus, similar to the purchase undertaking, the investors again rely on the corporate or bank to pay their profit – not the underlying assets.

The second point raised by AAOIFI prohibits the selling of receivables or debts. As such, in both of the *Sukūk* securitisations seen to date, the physical assets (land and properties that are generating the cash flows) have been sold to the investors as well as the payments/receivables due on those assets. In the event that Tamweel or Sorouh PJSC were to go insolvent, the legal ownership of the properties and land reside with the investors.

#### Purchase Undertakings: Moving the *Sukūk* Risk/Return Away from the Assets

The purchase undertakings are key in most of the asset-based structures. This mechanism is used to repay principal to the *Sukūk* investors and generally is a contract that obligates the originator to “buy” back the assets at par value (i.e. independent of the “actual” realisable asset value). This “par” element of the purchase is discouraged in the fourth and fifth of AAOIFI’s recommendations. Repurchasing the assets at some measure of actual value – for example, the present value of future lease income – is acceptable, as is having an unaffiliated third party (i.e. not the originator/*Muḍarib*) agree to purchase for a nominal fixed value.

Given that the assets are unlikely to have been the subject of a legal sale initially, the main purpose of this contract is to create a payment obligation on the originator. In the event of the corporate going bankrupt, investors should have a claim for this amount (i.e. the principal due). Again, given its key place within the *Sukūk* structure, Moody’s requires a legal opinion that supports the enforceability of the claim generated by the undertaking. Assuming the opinion is satisfactory, *Sukūk* investors have an unsecured claim, and this ranks at the same level as other unsecured creditors, both conventional and Islamic.

The sixth and final AAOIFI recommendation is more operational and regards the assignment of *fatwas* and approvals, rather than any structural comments, noting that approving boards should be more hands-on in the documentation and execution. While good in theory, there are some practicalities that make this difficult. First and foremost, the shortage of qualified scholars means relatively little time can be devoted to each and every *Sukūk*. Second, the complexity of English legal documentation can prove problematic even to native speakers without a legal background and most scholars are fluent first in Arabic and have little familiarity with the civil codes or common laws involved that dictate asset rights. In most instances, *Sharī’ah* laws only take precedence where explicitly incorporated into the laws of the country. Only in Saudi Arabia can *Sharī’ah* judges possibly preside over institutional and investor disputes that could arise.

#### Asset-backed or Securitisation *Sukūk*

It is into this market that we are now beginning to see securitisation *Sukūk* or Islamic securitisations. These innovative and legally complex structures are the closest that *Sukūk* currently get to the financing ideals of asset ownership and risk-

sharing, although the structures raise another controversial topic: the tranching of different classes of *Sukūk* holders (i.e. each has a different rank in the allocation of profits and losses).

The critical difference is that these structures (notable are Tamweel and Sorouh PJSC's *Sukūk*) have a "true sale" of the underlying assets to the investors. In Tamweel, the freehold titles to approximately 1000 properties are transferred to the *Sukūk* along with the associated *Ijārah* cash flows; these are the *Sukūk* assets. In Sorouh again, the underlying titles to the plots of land are transferred to the investors with the associated cash flows (payments for land purchase). In both cases, the property/land titles are registered in the name of the investors at the relevant land department. Any losses on those cash flows are passed on to *Sukūk* holders.

In both cases, there is no recourse back to the originators; these *Sukūk* should survive their bankruptcy. Some key features are:

- The risk of principal/capital repayment depends on asset performance, not a purchase undertaking from the corporate at nominal (or market) value.
- The risk of profit payments depends on the performance of the assets, not that of the *Muḍarib*/originator. If the assets perform badly, investors may lose profit as well as principal. If they do well, they get paid the expected profit. If the corporate defaults, the *Sukūk* holders retain the assets and the cash flows should continue.
- Profit varies according to the *Sukūk* class. The senior-most classes have fixed profit rate spreads due to their less risky and more senior position in the investment. The junior-most class or equity is the most risky by far but retains all the excess variable profit that may be generated. In the Sorouh *Sukūk*, they did not issue an equity note, but returned all the excess profit beyond the due amounts to repay the capital invested in order of seniority.

The substance of securitisation *Sukūk* is one of asset ownership and risk-sharing (of the assets and associated cash flows) and satisfies many of the AAOIFI recommendations. Again, it should be emphasised that the structural "substance" of many existing *Sukūk* is a deliberate construction; many companies do not want to "sell" their quality assets to investors, but need the equivalent of conventional debt funding. Widespread structuring approaches mean they get this desired debt funding in *Sukūk* form, and investors are happy with this for the most part.

It should also be emphasised that while certain sectors of securitisation have recently come into disrepute, the financing technology applied is a critical part of the global landscape. As in many other (less complex) markets, losses are usually the result of very high leverage and an unexpectedly rapid turn in the quality of the underlying assets. A total loss of confidence would be another key driver. The issues involved being relatively new in the Middle East, *Shar'ah* could become a key driver



of securitisations if *Sukūk* compliant with the AAOIFI guidelines become favoured by investors.

### The Future for *Sukūk*

That *Sukūk* have been successfully issued since the publication of AAOIFI's comments shows that there is still diversity of opinion and that, with a topic so subjective, no one agency, institution or individual can "legislate" *Sharī'ah* law; only through *istihad* (mental effort/struggle/evolution/reasoning) and mutual consensus will the market reach consistency. However, the debate triggered here is a good starting point.

Rapidly changing market conditions and unprecedented events are all playing a key part in reshaping the *Sukūk* markets. However, the overall uncertainty means that bond, *Sukūk* and debt market growth has stalled, awaiting some stability in pricing and a return of investor confidence, but, given the long-term local need and sizeable Muslim populations in Europe, the Middle East, Africa and Asia, it is just a matter of time before growth resumes.

As they stand, the first five AAOIFI recommendations encourage movement away from the bulk of current unsecured structures towards secured, asset-backed ones. This complements the broader trend towards more secured lending that is evident across the region.

While securitisation *Sukūk* are closer to the *Sharī'ah* ideals, they are still not perfect, and if interest and evolution continue, it is likely that we will see more hybrid equity-type structures where the profit on all (asset-backed) *Sukūk* classes may be able to exceed the returns paid on debt-like instruments issued so far.

Moody's believes the AAOIFI comments are appropriately timed for a moment for self-reflection for the industry – in particular, the scholars whose role in the market is currently critical. Although it would probably be more beneficial in the long term if such *fatāwa* were provided by institutions, it is likely to be these learned individuals who will drive the shape of the market for some time.

We also believe that, for the long-term health and sustainability of the industry, all parties need to be very clear about the "substance" of underlying *Sukūk* in order to avoid the risk of some parties being confused/distracted/misled by complex Islamic terminology or legal jargon.

If the key features of risk and return are, in substance, the same as those of an interest-bearing conventional bond, then perhaps it may be best to make this clear to *Sukūk* scholars and investors at inception. This may result in the unsecured market not being as large or fast-growing (although in 2007 global market volumes for securitisation were higher than those of corporate and sovereign issuance combined); however, the asset-backed market may instead come to the fore. In any

case, it is only by supporting and encouraging those features that make Islamic finance different that it will likely add any value to the global financial system.

#### **IV. Moody's Approach to Rating *Takāful* Companies**

It is believed that one of the key reasons for the remarkable pace of growth in *Takāful* over the past few years relates to the difficulties that traditional insurers are facing in complying with *Sharī'ah* as a result of their investment strategies. A typical conventional insurer will commit a substantial portion of its investment portfolio, usually in excess of 80%, to fixed-income securities in order to reduce risk on the asset side of its balance sheet and maximise the amount of capital available to support its liabilities.

Indeed, asset risk can often be one of the more important factors driving an insurer's credit ratings. However, under *Sharī'ah*, *riba* (interest) is forbidden, which disqualifies conventional bonds as an acceptable asset class. This restriction also imposes limitations on certain sources of funding for the insurer, such as senior or subordinated debt, or hybrid capital. In addition, equity investments can only be made in *Sharī'ah*-compliant companies; this rules out investments in businesses involved in alcohol, gambling, pork-related products or conventional financial services, to name just a few.

##### **A. *Types of Takāful***

The development of *Takāful* goes hand in hand with that of other types of innovative *Sharī'ah*-compliant financial products, such as Islamic banking and Islamic capital markets. Indeed, access to Islamic financial products is very important for a *Takāful* company as they offer the best way to build a non-*riba* asset base without exposing the company to excessive risk, as would be the case if *riba* was avoided by allocating a large portion of the portfolio to equities and/or real estate.

There are two main lines of *Takāful*: General (non-life) and Family (life). In addition to long-term life insurance products, Family *Takāful* also offers medical and health, education, accident, as well as hajj plans.

The main concept that differentiates *Takāful* from conventional insurance is that of cooperation, or solidarity. A *Takāful* company is similar to a conventional mutual insurer in that its purpose is not to generate profits but to share risk between members, thus making it more manageable for each of them. Importantly, however, consideration for the insurance service is classified as a "donation", not "premium", which may have implications for the structure of certain long-term life insurance products.

There are three main operational models of *Takāful*:

- ***Al-Wakālah***, common particularly in the Middle East, distinguishes between the operating company and the *Takāful* fund. The operating company does not share in the underwriting result but rather is compensated by a fee deducted from contributions made by participants and/or investment profits generated by the *Takāful* fund. The surplus of the *Takāful* fund belongs to the members; the operating company does not have a claim on it under any circumstances.
- ***Al-Muḍarabah***, common in Malaysia, stipulates a profit-sharing agreement between the operating company and the *Takāful* fund, typically based on the underwriting result of the latter. This may give the operating company an additional incentive to improve its underwriting performance. Similar to *Al-Wakālah*, the surplus of the fund belongs to the plan members only.
- ***Waqf***, in contrast to *al-Wakālah* and *al-Muḍarabah*, operates as a public foundation. Whereas the *Takāful* fund is owned by members in the first two models, in *Waqf* it belongs to nobody in particular. While any surplus from the first two models can be theoretically distributed between members (although this rarely occurs in practice, other than in Family *Takāful*), such distribution is not possible in the *Waqf* model. Other things being equal, this may have a positive effect on the company's financial strength over time.

*Retakāful* is *Sharī'ah*-compliant reinsurance of *Takāful* companies. The rapid development of *Takāful* institutions fuels demand for *Retakāful* as an alternative source of enhancing the financial strength of the *Takāful* fund. The *Retakāful* industry is still in its early days; however, a *Takāful* syndicate was established by Creechurch Underwriting and the Salama Islamic Arab Insurance Company at Lloyd's in 2005. Other significant companies include *Takāful* Re Limited, and other *Retakāful* start-ups may follow in the near future.

Availability of ample *Takāful* reinsurance capacity would seem to be very important for the further successful development of the primary *Takāful* industry as a whole, as this is often the most appropriate tool for managing catastrophe exposure and accumulation of risk, particularly bearing in mind that most *Takāful* companies tend to operate in a single geographical region and their diversification may be less than fully adequate. In addition, many *Takāful* companies are relatively young and therefore tend to use greater amounts of reinsurance capacity, sometimes in the form of quota shares, to meet the capital requirements. Finally, a relationship with a sophisticated *Retakāful* company may also give a primary *Takāful* start-up access to valuable expertise which may be of assistance in structuring and pricing its product range, particularly for General *Takāful*.

## **B. *Moody's Approach to Analysing the Financial Strength of a Takāful Company***

As noted, there are substantial similarities between most common types of *Takāful* and mutual insurance. As a result, and given that the distinction between a “premium” and a “donation” is in most cases more cultural than economic, Moody's approach to analysing a *Takāful* company is very similar to that for a conventional mutual insurance company.

Below is a description of Moody's global methodology for rating insurance companies. (The overall framework applies to both life companies and property and casualty companies, with some minor differences.) However, the credit strengths and weaknesses of a typical *Takāful* company will be influenced by a number of considerations that do not apply to a Western mutual insurer. As a result, at the relevant point in the description of the methodology we will discuss additional considerations relating to corporate governance, asset allocation, structural features, capitalisation strategies and the regulatory environment that need to be taken into account when rating a *Takāful* company.

It should be noted that in general Moody's does not view mutual (cooperative) operating structures as better or worse than shareholder structures. Indeed, many mutual insurers in Western Europe are rated A3 or better for insurance financial strength, generally in line with publicly traded peers of a similar size and business profile.

### **(1) *The Methodological Framework***

Moody's insurance ratings reflect our opinion of a company's long-term relative risk and are, of necessity, forward-looking in nature because they apply to liabilities that may pay out over long periods of time. Historical experience has shown that looking only at the current financial condition of a company is not always an accurate predictor of its future financial performance and financial strength. Therefore, Moody's analytical approach includes not only quantitative analysis but also a significant degree of qualitative analysis incorporating the opinions and judgements of experienced analysts.

Moody's approach to rating the various obligations of insurance organisations is rooted in an assessment of the financial strength of the main operating units within those organisations. This assessment is represented by insurance financial strength ratings that we assign to operating insurers. We first develop a financial strength rating for a stand-alone entity before taking into consideration any parental support that may also be factored into the final rating. We frequently also assign other ratings within the group (e.g. on senior unsecured debt issued by the insurer or its parent company); any such ratings are typically determined with reference to the insurance financial strength ratings of the group's main subsidiaries.

We next review the seven key factors underlying an insurer's business and financial profile. This discussion illustrates how these factors are assessed in the rating process, and why each factor is important to the assignment of stand-alone ratings. We will then explain the other most common, more qualitative considerations that Moody's takes into account, before moving on to a brief discussion of how we factor in parental support, which is the final stage in arriving at the assigned insurance financial strength rating.

Note that what follows is a summary outline of the rating process involved. Moody's has recently published detailed reports explaining how our insurance analysts globally measure each rating factor, combine these measurements to arrive at the stand-alone rating, and then build in other considerations to arrive at the final rating.

## **(2) *Takāful* Business Profile**

### **Factor 1: Market Position, Brand and Distribution – *Takāful* Fits in the National Market**

A company's market position, brand and franchise strength represent its ability to develop and sustain competitive advantages in its chosen markets, which can have a direct bearing on its future profitability and ability to generate capital internally. In addition, an insurer with a strong market position, brand and competitive advantage should be well positioned to withstand prolonged difficult market conditions, and be better able to capitalise on new, potentially profitable opportunities that may develop in the future. We believe that such companies are more likely to meet their obligations through varied economic periods, thus suggesting higher ratings. Conversely, a weak business franchise can indicate financial stress for a company if it generates low or erratic core profitability, and may tempt management to enter unfamiliar businesses, take on new and unfamiliar risks, or leverage the company to a greater extent.

As with other companies with a defined focus on selected markets, Moody's will consider a *Takāful* company's position not only within the national and regional insurance markets overall (e.g. *Takāful* plus conventional insurance) but also in terms of its market share specifically among *Takāful* providers. In many markets (e.g. Malaysia), *Takāful* is the dominant form of insurance, and consequently there may be little discrepancy between these two approaches. However, in other markets (e.g. UAE, Qatar), *Takāful* still represents a relatively small proportion of the whole market, notwithstanding the substantial growth opportunities present. One of the key challenges for *Takāful* operators would seem to be to grow within non-personal lines since, although many individuals will want to insure themselves on a *Shari'ah*-compliant basis to attain personal religious compliance, the same is not always true of large, often multinational, commercial operations.

The methods and mechanisms by which an insurance company delivers its products are another fundamental aspect of the company's business and credit profile. A company's access to distribution channels, its ability to control those channels and its relationship with its producers relate directly to its ability to grow revenues, retain business, align its distribution with specific product/customer segments and control its costs.

#### Factor 2: Product Risk and Diversification – Limited *Takāful* Offering

A company's chosen lines of business affect its creditworthiness, as individual product segments and classes of business exhibit different volatility and competitive attributes. Product risk appears in many forms and can have significant adverse effects on earnings and capital adequacy. In addition, diversification in earnings, product and geography is a positive credit characteristic because it can reduce the volatility of a firm's earnings, capital and cash flow, promoting more efficient use of capital resources. However, if a company enters a business line without appropriate underwriting expertise, diversification can be a credit negative.

The most logical growth opportunities for *Takāful* non-life operators would tend to be in retail personal lines, which would usually offer a relatively low-risk product profile. However, as many providers seek to expand into commercial lines of business, management and controlling of underwriting procedures and risk will be a key driver in Moody's analysis.

### **(3) *Takāful* Financial Profile**

#### Factor 3: Asset Risks – High for *Takāful*

Insurance companies' core assets are typically concentrated in high-quality liquid assets in recognition of the uncertainty of their liability payout stream. However, companies will often allocate a portion of their investment portfolios to higher-risk assets. Such exposures must be monitored constantly, as changes in the market environment, especially during periods of stress, can depress asset values, earnings and, ultimately, the capital base.

A significant asset of uncertain value on property and casualty insurers' balance sheets is recoverables/receivables from reinsurers. The analysis of the amount of a company's reinsurance recoverables, its concentrated reliance on a few reinsurers, and the credit quality of the individual reinsurers is important. This is because write-offs of the recoverables as uncollectible could impact the insurer's income and capital, and because the loss of reinsurance capacity could require the insurer to modify its market/product focus.

Another potentially significant asset of uncertain value on insurers' balance sheets is the goodwill associated with acquisitions whose economic value is often highly uncertain and not readily realisable.

A *Takāful* company's assets may differ from those of a typical Western insurer as regards their liquidity and volatility characteristics and risk/return profiles. For example, some *Takāful* insurers may exhibit a propensity to overweight *Sharī'ah*-compliant equities and real estate assets. *Sharī'ah*-compliant bonds may have concentration in certain geographical areas (e.g. the Gulf states and Malaysia), which, in the absence of credit enhancement by an international institution, may increase the risk profile of the *Takāful* fund. The effect of the alternative investment strategy on overall profitability will also need to be ascertained.

#### Factor 4: Capital Adequacy and Solvency – *Takāful* Relies on Various Forms of Capital

At the heart of Moody's assessment of an insurer's creditworthiness is an opinion about the company's economic capital and its capital adequacy (e.g. solvency) or operational leverage. Capital adequacy is critical for an insurer because regulators require minimum capital levels or ratios for the company to continue to operate. Capital constraints can also restrict a company's ability to grow its business and impact its strategy.

Depending on the *Takāful* model adopted, various capital management systems exist. Moody's evaluates each *Takāful* operator's capitalisation according to the model used and the specifics of the company. For example, under the "*al-Wakālah*" system, policyholder and shareholder investments would be held separately. Shareholders' capital grows according to fees generated from the sale of products and investment income generated within the fund. Any surplus generated within the policyholder fund is either paid out to policyholders or is retained in the shareholders' fund and is not paid to shareholders. However, from a policyholder perspective, elements of capital that could absorb loss in a time of stress could include, in addition to shareholder funds, any retained policyholder surplus. Similarly, different regulatory systems globally have developed in terms of how a *Takāful* operator's capital adequacy is assessed, and Moody's analysis of capitalisation necessarily reflects the local regulatory environment.

#### Factor 5: Profitability – The Measurement Issue

An insurer's earnings capacity – quality and sustainability – is a critical component of its creditworthiness because earnings are a primary determinant of its ability to meet its policy and financial obligations, the primary source of internal capital generation to assure capital adequacy, and a key determinant of access to the capital markets on favourable terms. Diversification across multiple product lines and markets can result in more stable levels of earnings, increasing the predictability of internal capital growth and strengthening claims/debt-paying ability.

Similar to mutual insurers in Western Europe, traditional metrics to analyse profitability (RoE) may be somewhat misleading for *Takāful* operators, since in many cases a successful (i.e. surplus-producing) *Takāful* operator would return much of

the created surplus to policyholders. Consequently, in addition to our usual metrics for profitability, Moody's would evaluate other profitability metrics such as combined ratio (*Takāful* non-life and reinsurance) or embedded value profitability (*Takāful* Life).

#### Factor 6: Reserve Adequacy, Liquidity and Asset–Liability Management – All Challenging for *Takāful* Companies

##### *Reserve adequacy (property and casualty)*

Inadequate loss reserves have been a key cause of most property and casualty insurance company failures over the past decade. Given the broad accounting latitude endemic to the insurance business, the importance of credible loss reserves cannot be over-emphasised. The evaluation of redundancy or deficiency in an insurer's loss and loss adjustment reserves impacts the analysis of its reported earnings as well as the assessment of capital adequacy. When property and casualty insurers' loss reserves develop unfavourably, the impact on the company's financial profile and flexibility can be material as seen by the decrease in capital, the increased operating and financial leverage ratios, and reduced dividend-paying capacity to the holding company.

##### *Liquidity and asset liability management (Life)*

Life insurance liabilities are highly confidence-sensitive in nature. Lack of liquidity can quickly result in a company's inability to meet the demands on its liabilities. As a result, financial problems, real or perceived, can lead policyholders to surrender their policies, and in doing so create a "run-on-the-bank" scenario and prompt regulatory intervention or a company's insolvency. Consequently, a life insurer's ability to carefully manage its asset/liability risk and its associated liquidity is critical.

##### *Structural features of family products*

The profit-sharing mechanism of long-term *Takāful* products may have certain distinctive features. For example, the determination, crediting and payment of profit participation on life policies, as well as the structure of any explicit or implicit guarantees, will need to be carefully examined when evaluating a *Takāful* company's asset/liability management.

#### Factor 7: Financial Flexibility – Profit-and-loss Sharing and Long-term Capitalisation: Two Key Issues for *Takāful*

It is important that a company is able not only to fund its business growth via internal capital generation, but also to demonstrate the ability to service its obligations without stress. Insurers benefit from being able to raise capital externally for additional growth or acquisitions, and to meet unexpected financial demands. Financial flexibility – as dictated by financial leverage/double leverage, earnings



coverage, dividend coverage, and access to capital markets – is a key determinant of the insurer’s credit profile.

Many *Takāful* operational models would typically, in line with the “profit/loss sharing” system, have the ability in a loss-making period to approach policyholders for additional contributions. Moody’s would typically attribute low value to such a mechanism, since in practice such a capital raising is often difficult to achieve, although we consider such cases individually to allow for the company’s specific position.

While the capital structure of a *Takāful* company is not in itself conducive to large distributions (the fund is in many cases *de facto* not distributable), ongoing profit-sharing may be subject to competitive pressures and, as such, vary in time and by market. The position of the supervisory authority with regard to capitalisation and its ability and willingness to enforce the regulation in place will also tend to influence the *Takāful* company’s financial strength.

#### **(4) Qualitative Assessments**

Management, Governance and the Risk Architecture

##### *Management characteristics*

The quality of management underpins corporate success or failure, and is a major factor in determining ratings. The rating company assesses the management’s credibility, experience and reliability. Management’s ability both to develop and to execute a strategic vision are critical factors for a company’s success in a competitive industry where the status quo is changing rapidly. A review of the insurer’s strategy includes the firm’s long-term vision, risk/return appetite, attitude towards financial and operating leverage, strategies for raising capital, and value creation.

Growth strategies can also impact its risk profile. The overall risk culture that management has built will strongly affect the company’s appetite for and management of risk and leverage. As a result, management’s strength, its discipline in financial planning and risk management, and its ability to execute are vital elements in our evaluation of credit risk. Throughout the rating process, Moody’s forms an opinion of a management team’s likely response to challenges in the firm’s economic, competitive and regulatory environment given their goals and motivations.

##### *Corporate governance*

Corporate governance as promoted by the board of directors is equally responsible for the financial health and credit profile of the company. We evaluate the corporate board’s independence, expertise and involvement, as well as its ability to align governance practices with proper oversight of the management team and

corporate strategy. Independent review of the key financial reporting and risk-management processes is important, as is oversight of compliance and regulatory issues.

We also assess how policyholders may behave with regard to their investment, in the normal course of events and times of stress. They believe there is a natural and effective alignment between the interests of managers and directors with policyholders and creditors at a mutual insurer. However, drawbacks associated with the mutual structure often include less management accountability and transparency – a concern that becomes significant when the mutual has adopted an aggressive strategy that is more characteristic of a stock company.

Corporate governance of a *Takāful* company has some distinct features. The founding members of the company appoint a *Sharī'ah* advisory board, which then opines on the compliance status of the company with Islamic law. Management is also appointed by (and is accountable to) the founders, not the *Sharī'ah* board. Therefore, while their management is under no formal obligation to follow guidance of the *Sharī'ah* board, in practice instances of insubordination are rare as it is the prerogative of the board to declare non-compliance with *Sharī'ah* rules, which may prejudice the status of the company as a going concern. The key performance indicators used by the *Sharī'ah* board to assess the management of the operating company may have a greater focus on compliance with Islamic law than technical issues such as underwriting performance and risk management. The nomination process to the board, as well as the background of members appointed to it, will also be critical in ascertaining the quality of corporate governance and its ramifications on the financial strength of the *Takāful* fund. Moody's regards certification by the *Sharī'ah* board of compliance with the *Sharī'ah* as critical to any *Takāful* operator's ongoing ability to source business. However, we do not perform an audit of such compliance as part of the rating process, instead relying on the overview of the *Sharī'ah* board.

### *Risk management*

Although taking risks, in underwriting, investments, sales practices, acquisitions or other areas, is a necessary activity for an insurance company, it is vital that management (and the board of directors) understand and adequately manage the risks assumed in order for the company to maintain its financial performance and flexibility, reputation, market position and confidence in the capital markets.

### Accounting Policies and Disclosure

Relevant and timely financial information is a critical part of any financial analysis. Although many insurers prepare information under generally accepted accounting principles, others may use a regulatory basis of accounting that may differ from such principles. The presence of a strong government/independent body

for financial reporting standards is considered a positive factor when evaluating an accounting regime.

When evaluating accounting principles, Moody's considers how well financial reporting mirrors economic reality. Where we believe that the economics of a transaction are not consistent with financial reporting, we may adjust financial statements to facilitate our analysis.

### Sovereign and Regulatory Environment

The local jurisdiction's economic and political stability and the degree of government support or interference can have a strong impact – either positive or negative – on an insurer's credit profile. A well-developed local capital market may aid a company's ability to raise sufficient capital efficiently to grow or cushion itself against adverse conditions. The credit profile is also influenced by local regulatory rules and practices, potential changes in regulations or product taxation, and failure-resolution mechanisms. In measuring a company's sovereign and regulatory environment, Moody's makes use of foreign currency and local currency country ceilings.

### Evaluating Support

While the above factors are critical in determining an insurer's stand-alone rating, analytical consideration of support – explicit or implicit – from a parent company or affiliate is required to arrive at the public rating, which is sometimes higher than the company's stand-alone rating.

#### *Support from a parent company or affiliate*

Any such support, once determined, is generally “added” to the rating by narrowing the spread between the stand-alone credit rating of the entity/security and the rating of the entity providing the support. Ultimately, the extent to which the affiliation benefits the rating is a matter of judgement, not convention, given the many variables that must be considered. Moody's assessment may vary depending on our view of how important that entity is to the overall enterprise business model, its integration with the rest of the organisation, and the company's ability and willingness to support it. Support is evaluated in terms of past actions of the supporter as well as current public statements of support, combined with its judgement of prospective economic motivations. Support may raise a company's rating, but not necessarily to the same level as that of the supporting entity.

#### *Factoring in support from other than related entities*

Moody's does not ascribe a meaningful level of implicit government support to insurance companies: history has shown that governments have allowed insurers – even large ones – to fail without intervention. However, if the insurer were directly

government-owned, support would be considered under our methodology for government-related issuers. If the insurer is part of a bancassurance group, and there is clear evidence that failure of the insurer will affect the creditworthiness of banking operations, the likelihood of support by the government may increase in selected cases.

### **C. Conclusion**

*Takāful* has many similarities with conventional mutual insurance, although there are several important differences. As in the case with other mutual (cooperative) structures, Moody's does not view *Takāful* as being better or worse than shareholder structures. Our approach to rating *Takāful* companies is consistent with the rating methodologies we apply to conventional insurers, and encompasses both qualitative factors (e.g. market position, brand, distribution, product risk, diversification) and quantitative factors (e.g. asset risk, capital adequacy, profitability). An assessment of risk management and corporate governance, external support, as well as the sovereign environment, also plays a very important role.

## Reference

Alexander, D. and S. Archer (2010), *International Accounting/Financial Reporting Standards Guide* (Chicago, IL: CCH)

## CONCLUDING REMARKS

### THE CHANGING LANDSCAPE AND THE IFSB PERSPECTIVE

The discussion in the preceding chapters of this book starts by examining the severe financial crisis that broke out in 2007 and its implications for Islamic finance. The implications for the emerging financial architecture in general and for Islamic finance in particular are then examined, including issues of cyclicity in prudential requirements. Finally, the book deals with the important topics of governance and legal risk in Islamic finance, and the rating of Islamic financial institutions and instruments by external rating agencies. The issues examined imply major challenges and opportunities for the Islamic financial services industry (IFSI), and, in particular, challenges for the regulatory and supervisory authorities concerned.

These concluding remarks are intended to provide a brief review of these issues from the perspective of the Islamic Financial Services Board (IFSB) as a body concerned with international standards of prudential regulation and supervision for the IFSI. Since its inception in 2002, the overall aim of the IFSB has been to make the major contribution to the development of a prudential infrastructure for the IFSI that is needed to underpin its soundness and stability. To this end, the IFSB has issued ten standards and statements of guiding principles, with one draft standard at the exposure draft stage. In addition, the IFSB has organised numerous conferences and seminars to discuss and clarify key issues, as well as seminars for training purposes in a number of countries attended by the staff of supervisory authorities and market players.

In developing its standards and statements of guiding principles, the approach used by the IFSB has been to take account of existing international standards (such as those issued by the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors and the International Organization of Securities Commissions) and adapt them to the specificities of *Shari'ah*-compliant financial institutions. For this purpose, the IFSB has used working groups composed of representatives of supervisory authorities and industry members, assisted by specialist consultants.

The key areas of risk management, capital adequacy and solvency have been addressed by three standards and one exposure draft, as well as guidance notes and technical notes. IFSB-1 *Guiding Principles on Risk Management* is concerned with risk management in institutions other than Islamic insurance (*Takaful*) undertakings, while IFSB-2 and IFSB-7 are concerned with capital adequacy in Islamic banks and *Sukuk* securitisations. A major issue in risk management and capital adequacy is displaced commercial risk (DCR – the use of mechanisms to smooth payouts to Profit-Sharing Investment Account (PSIA) holders in Islamic banks which have the effect of passing a proportion of the risk that is contractually to be borne by the PSIA holders on to the bank's shareholders. (See

Chapter 1, where the governance issues raised by such practices are discussed). IFSB-2 provides a means for taking account of DCR in calculating the capital adequacy ratio. ED-11 *Solvency Requirements for Takāful Undertakings* deals with the difficult issue of how a mutual insurance structure with risk funds owned by policyholders, but managed by a limited company (*Takāful Operator*) with shareholders, may legitimately meet regulatory solvency requirements even when the risk funds themselves may have little in the way of surplus assets (or policyholders' equity) and the *Takāful Operator* does not assume any underwriting risk.

Because of the potentially important role played by ratings issues by external credit assessment institutions (ECAI) in measuring capital adequacy, and certain specific issues that arise in Islamic finance, the IFSB has issued GN-1 *Guidance Note in Connection with the Capital Adequacy Standard: Recognition of Ratings by ECAs on Sharī'ah-Compliant Financial Instruments*. This guidance note is addressed primarily to industry supervisors. A guidance note taking account of specific issues in the rating of *Takāful* undertakings was in the course of preparation when this book went to press.

The very important topic of liquidity management is addressed by the IFSB TN-1 *Technical Note on Issues in Strengthening Liquidity Management in Institutions Offering Islamic Financial Services: The Development of Islamic Money Markets*.

The equally crucial areas of governance, transparency and business conduct are the subjects of five statements of guiding principles. IFSB-3 *Guiding Principles on Corporate Governance* applies to Islamic banks but not Islamic collective investment schemes or *Takāful* undertakings, which are covered by IFSB-6 and IFSB-8, respectively. Both Islamic banks and *Takāful* undertakings face important issues of corporate governance resulting from their having stakeholders who are types of equity holder but do not enjoy the governance rights that equity holders normally possess. This is the case for PSIA holders in Islamic banks, as noted above, and also for participants (policyholders) in *Takāful* undertakings. Hence, arrangements to deal with potential conflicts of interest between shareholders on the one hand and PSIA holders or policyholders on the other hand are key issues addressed by governance structures recommended in IFSB-6 and IFSB-8. Transparency is another key governance issue, and for Islamic banks this issue is addressed in IFSB-4 *Disclosures to Promote Transparency and Market Discipline*. This standard, which reflects the requirements of both International Financial Reporting Standard No. 7 and Pillar 3 of Basel II, calls for extensive disclosures both of financial information and product-related information, especially that which is relevant to PSIA holders. Finally, IFSB-9 *Guiding Principles on Conduct of Business* lays down a set of principles of business conduct for all Islamic financial institutions reflecting the ethical principles of the *Sharī'ah*.

Compliance with the *Sharī'ah* is, indeed, the very *raison d'être* of Islamic financial institutions. Yet in general, supervisory authorities are not in a position to

determine issues of *Sharī'ah* compliance in the institutions in their jurisdiction. However, what supervisors *can* do is to determine whether these institutions have a sound system of *Sharī'ah* governance such that issues of *Sharī'ah* compliance can be expected to be properly dealt with by that system. IFSB-10 *Guiding Principles on Sharī'ah Governance Systems for Institutions Offering Islamic Financial Services* provides guidance enabling them to do so, as well as principles that Islamic financial institutions should follow in setting up their internal systems and procedures.

Supervisors of Islamic banks may also look for guidance to IFSB-5 *Guidance on the Key Elements of the Supervisory Review Process* which reflects those parts of Pillar 2 of Basel II that are pertinent to Islamic banks. In particular, IFSB-5 deals with the supervisory review with respect to matters covered by other IFSB standards, such as capital adequacy, risk management, corporate governance, and transparency and market discipline, as well as other matters such as consolidated and home-host supervision and “windows” operations. IFSB-5 also provides a basis for facilitating international and inter-sectoral cooperation between supervisors of Islamic banks, a matter the importance of which has been highlighted by the financial crisis.

Building the prudential infrastructure for the IFSI, a relatively young and very fast developing industry, is a continuous process which presents major challenges to regulators and supervisors, particularly with respect to establishing the position of Islamic finance within the emerging global financial architecture. The IFSI has benefited considerably from the *Sharī'ah* prohibitions which kept it free from the excesses in speculation and leverage, and the abuses in the treatment of credit, which led to the implosion of numerous conventional financial institutions. But its specificities lead to complexities in areas such as capital adequacy, solvency, corporate governance and transparency that constitute potential vulnerabilities. In these areas, there are clear limits to what a body such as the IFSB can achieve. To deal with them satisfactorily requires the cooperation and goodwill of the industry stakeholders. To promote such goodwill and cooperation, a role is played by the IFSB's outreach activities, including the seminars and conferences that it organises on behalf of its members.





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