

SECTION 7: THE DIFC's ISLAMIC FINANCE REGIME: COMPARATIVE POSITION

Challenges and opportunities ahead for Islamic finance

There are a number of key strengths of the DIFC's operating environment for the offer of Islamic Finance in or from the DIFC starting with its regulatory regime. The DFSA's regulatory regime for Islamic Finance is based on the importance of implementing regulatory standards according to international best practice, whilst ensuring that this incorporates an appropriate structure for Islamic Finance to provide a sufficient degree of Shari'a oversight that may not be prescribed in widely-used international standards. The DFSA has developed a model which has successfully integrated international regulatory standards with detailed Shari'a oversight requirements, drawing upon the established standards of IOSCO, Basel, FATF, IAIS, IFSB and AAOIFI in respect of Shari'a-compliance as stipulated in its governance standards (GSIFI).

The overall regulatory regime integrates and extends international standards to the fullest extent possible to all DFSA authorised firms, including wholly Islamic financial institutions and Islamic windows. An appropriate degree of modification to these standards has been made to provide an appropriate regulatory model for the specificities of Islamic finance, including but not limited to:

- Implementation of AAOIFI (including extension of AAOIFI's Shari'a review process to Islamic windows)
- Modification of prudential requirements to reflect the specific prudential risks and Shari'a risk mitigation techniques for Islamic finance
- Enhanced disclosure in respect of Shari'a oversight, and periodic information in respect of products and services offered in accordance with Shari'a

There are many commercial benefits to the operating environment in the DIFC which are summarised below.

1. Shari'a systems model

The DFSA's regulatory structure for Islamic finance is referred to as the Shari'a System. This means that the firm must implement appropriate systems, controls and processes to ensure that the financial services and products offered are in compliance with Shari'a.

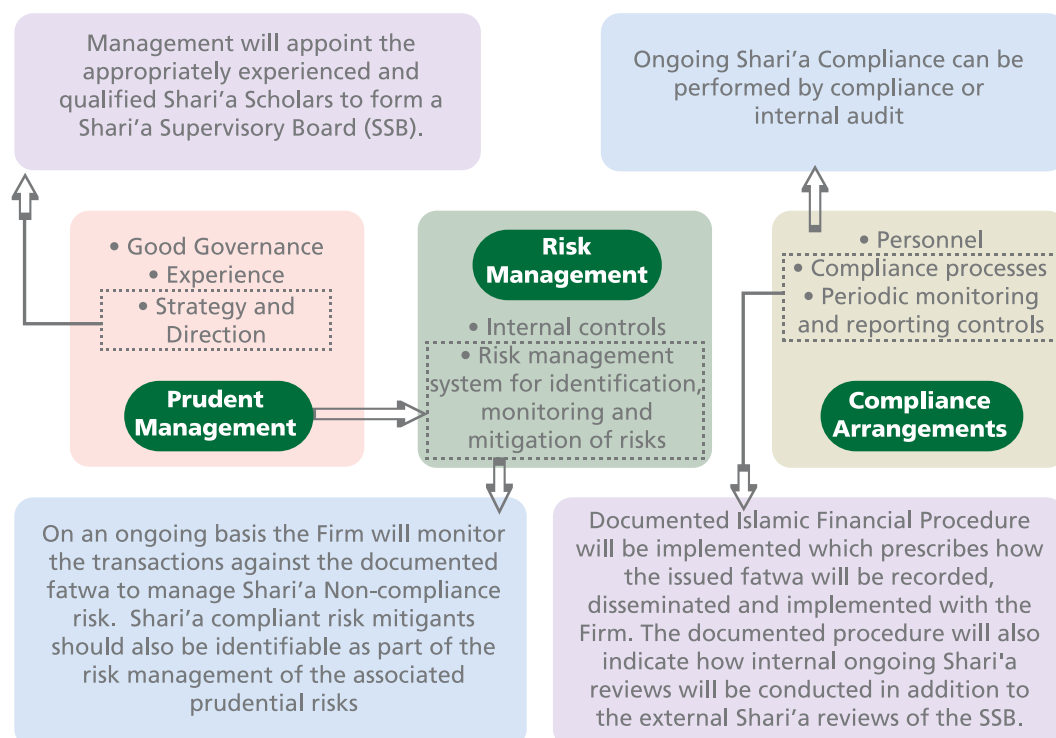
The Shari'a Systems model obliges DFSA authorised firms to implement adequate systems to ensure compliance with Shari'a. The DFSA provides detail on what such systems should include and also requires that the relevant provisions of AAOIFI's governance standards (GSIFI) are implemented to ensure initial and ongoing Shari'a compliance.

The Shari'a Systems model, provides benefits from two perspectives: firstly, financial institutions that operate in financial markets which are consistent with the international regulatory standards can transfer their business and compliance models into the DIFC with relative ease by implementing the Shari'a System prescribed by the DFSA as an overlay to the compliance and risk-management infrastructure commonly used in conventional finance, subject to appropriate degree of modification. This is depicted in Figure 15 below.

The second perspective is that financial institutions that operate in key Islamic jurisdictions (where regulatory requirements stipulate Shari'a oversight requirements) can easily adapt their compliance models to meet the DFSA's requirements. The DFSA's regime prescribes in sufficient detail the Shari'a system for oversight and compliance with Shari'a that must be implemented to enable institutions to offer Shari'a-compliant financial services in or from the DIFC.

The DFSA has developed an international regulatory model, duly modified to provide an appropriate regulatory structure to ensure compliance with not only regulatory standards, but also Shari'a.

Figure 15-Summary of compliance structure for Islamic Finance reflecting adaptation of a conventional compliance model



2. Clarity and certainty of regulations across wholly Islamic financial institutions and Islamic windows

The DFSA regime has many key strengths compared to some of the regulatory counterparts across the key Islamic jurisdictions, for example, the DFSA regime explicitly requires compliance with AAOIFI.

This is to ensure consistency and instill confidence. Clients offered financial services in accordance with Shari'a by DFSA authorised firms will have confidence that these firms are subject to the same regulatory obligations in respect of Shari'a oversight to ensure that their products or services are Shari'a-compliant, regardless of whether the firm is a wholly Islamic financial institution or an Islamic window.

3. Integrated regulatory structure conducive to the cross-sectoral nature of Islamic finance

The DFSA is structured as a unitary regulator, which means that it regulates all sectors of the market, including asset management, capital markets, banking, insurance, and Islamic finance. Consequently the DFSA is able to view regulatory issues across the market as a whole and is able to identify and respond more efficiently than perhaps a sectoral regulator where regulatory overlap may occur. Additionally, certain Islamic finance products are cross-sectoral in nature. For example, certain products, such as Profit Sharing Investment Accounts (PSIA) are treated in some jurisdictions as hybrid banking and capital market products. A cross-sectoral, unitary regulator, like the DFSA is able to address these risks more effectively.

From a business perspective, the unitary structure makes it easier for authorised firms to raise issues relating to new products and financial services with a unitary regulator, as opposed to having to seek clearance and approval from a number of sector specific regulators operating in a single jurisdiction.

4. The importance of a level playing field, including a reverse level playing field in Islamic finance

It is important to ensure that all financial institutions operating within the DIFC, and other financial centres, are subject to the same standard of regulation.

This applies equally in the context of Islamic finance, where firms offering Islamic financial services and products should be subject to the same degree and standards of regulation as their conventional counterparts.

Of course regulations may need to be modified to reflect the specifics of Islamic finance that perhaps a purely conventional regulatory model cannot accommodate

While it is important to have a level playing field when considering the regulatory regime which applies to Islamic finance vis-a-vis conventional firms, it is also important to ensure that there is a reverse playing field. For example,

conventional firms offering Islamic financial products and services (Islamic windows), must follow the same requirements in respect of Shari'a oversight as their Islamic finance counterparts.

The DFSA regime has sought to create this level playing field by specifically applying AAOIFI's governance standards to Islamic windows to ensure that the appropriate Shari'a systems are in place in both wholly Islamic firms and Islamic windows, thus ensuring customers have confidence that Islamic products offered in or from the DIFC have been subject to an appropriate degree of Shari'a oversight.

Current DIFC Initiatives

The DIFC provides an enabling environment for Islamic Finance from a number of perspectives as discussed above. However, the DIFC is constantly working to make the Centre even more conducive to Islamic Finance and is currently working on a number of initiatives in this field to address some of the impediments currently facing the industry. These are illustrated below:

Issue	DIFC Initiative
Need for greater product innovation	Provision of clearly defined legal and regulatory framework which facilitates innovation in the field of Islamic Finance
Promote greater liquidity in Islamic Finance	The DIFX provides a conducive framework for the listing and trading of Islamic securities
Industry benchmarks	The DIFC in collaboration with HSBC have developed a series of industry benchmarks including the Sukuk Index
Shortage of Talent	The DIFC has a well defined education strategy and has begun to offer prestigious courses specializing in Islamic Finance, such as the Cass Executive MBA
Standardisation	The DIFC is seeking to provide an environment for Islamic Finance forums to attract the best talent in Islamic Finance to spearhead standardisation.
Passportability of Islamic Products	The DIFC has been leading the direction of convergence and regulatory standardisation in the field of Islamic Finance with the successful implementation of the Mutual Recognition Model with other established Islamic Finance jurisdictions

The DIFC is ideally located to become a leading jurisdiction, or a hub for Islamic Finance. Aside from the ongoing initiatives and developments, the DIFC is located in the Middle East, the heart of Islamic Finance. The DIFC and participants in the DIFC have a genuine belief in the underlying legitimacy and value of Islamic Finance, and this feature is a core strength which demonstrates not only the DIFC's commitment but passion to provide the most conducive, world class operating environment for Islamic Finance.