PART THREE

Regulatory Issues

3.1

Prudential, Regulatory and Supervisory Criteria

Tim Plews and Antony Hainsworth, Clifford Chance

Introduction

Islamic financial institutions can, for the most part, be divided into two types:

1. Those institutions whose entire businesses are conducted in compliance with the Shari'a (often referred to as "fully" Islamic financial institutions (IFIs); and
2. Those institutions that offer Shari'a-compliant products and/or services, but whose businesses as a whole are not conducted in compliance with the Shari'a (often referred to as "conventional" financial institutions).

In this context, the need for appropriate divisions between conventional financial activities that the Shari'a would regard as impermissible (eg. interest-bearing loans) and Shari'a-compliant products and services has led to the development of the concept of "Islamic windows". Islamic windows are appropriately segregated divisions of a conventional financial institution specializing in Shari'a-compliant products and services.

Licensing models

Financial services regulators can be categorized into three broad types with regards to the approach that they take in the regulation of Islamic financial businesses:

1. **One-tier system of regulation of Islamic financial business** – A number of financial services regulators recognize Islamic financial activity as a specific category of regulated business and (either under formal regulatory rules or as a matter of practice) require any institution wishing to carry on such activities to obtain a dedicated financial services licence, and operate as a fully Islamic finance institutions (IFIs) offering

only Shari'a-compliant products and services (eg. the State Bank of Pakistan);

2. **Informal two-tier system of regulation of Islamic financial business** – A number of jurisdictions allow the operation of Islamic windows without having a formal system of regulation governing their operation. The relevant regulators may allow the operation of Islamic windows either alongside a system of licensing for fully IFIs (eg. the Central Bank of the United Arab Emirates) or in the absence of a dedicated system of licensing, for Islamic financial business (eg. the UK Financial Services Authority); and
3. **Formal two-tier system of regulation of Islamic financial business** – A small number of financial services regulators (including, notably, the Dubai Financial Services Authority [DFSA] and the Qatar Financial Centre Regulatory Authority [QFCRA]) have introduced a formal system of regulation of Islamic windows. These regulators commonly permit conventional financial institutions to carry on Islamic financial business, subject to those institutions receiving a specific permission or endorsement to carry on Islamic financial activity and putting in place appropriate prudential arrangements to ensure the proper segregation of their conventional and Shari'a-compliant businesses.

In the ÙK specifically, the Financial Services Authority (FSA) is responsible for carrying out supervisory functions over all banks, investment businesses, insurance companies and building societies, whether those firms carry on conventional financial business only, Islamic financial businesses only, or both – there is no separate regulator for Islamic financial businesses. As a general rule, therefore, no separate Part IV permission need be obtained from the FSA in order to offer Shari'a-compliant products and services. In addition, the FSA has emphasized that it is not necessary for the Islamic windows of UK financial institutions to be separately authorized, stating:

> Operations conducted by conventional banks for retail and wholesale clients through their Islamic windows do not require separate authorization. These activities are covered under the existing authorizations and permissions from the FSA.[1]

Shari'a Supervisory Boards

With regards to the governance arrangements applicable to Islamic financial activities, one common feature of both IFIs and conventional financial institutions is their use of Shari'a supervisory boards (SSBs). Those jurisdictions with either a one-tier system of regulation of Islamic financial

[1] FSA Paper, *Islamic Finance in the UK: Regulation and Challenges*, November, 2007, p 10.

business or a formal two-tier system of regulation of Islamic financial business typically have a formal regulatory requirement to appoint an SSB.

In the case of an IFI, the SSB will typically be responsible for overseeing the business of the IFI in its entirety, and to ensure compliance with the Shari'a, including reviewing the products and services offered by the firm. In the case of a conventional financial institution offering Shari'a-compliant products and/or services, the SSB's responsibilities will be more limited, focusing on the products and services themselves, although depending upon the terms of the appointment of the SSB, the SSB may also be responsible for overseeing that there are appropriate divisions between the conventional and Shari'a-compliant sides of the business. By way of practical example, any institution offering a borrower an interest-free loan (*qard al-hasan*) in compliance with the Shari'a would, according to most scholars, need to take steps with a view to ensuring that the monies leant to the borrower must derive from Shari'a-compliant sources.

Policies and procedures

Regulators in some jurisdictions (including the DFSA and the QFCRA) have introduced express laws and regulations requiring locally established IFIs to put policies and procedures in place to ensure compliance with *fatwas*, or guidance issued by their SSB. For example, Rule 4.2.1(1) of the Islamic Financial Business Module of the DFSA's Rulebook provides that:

> "[a]n Authorized Firm undertaking Islamic financial business must implement and maintain an Islamic financial business policy and procedures manual which addresses … the manner in which Shari'a Supervisory Board *fatwas*, rulings and guidelines will be recorded, disseminated and implemented and the internal Shari'a review undertaken."

This noted, financial services regulators rarely take a formal role in assessing compliance with the Shari'a. In its role as the financial services regulator in relation to Islamic financial business, the FSA has publicly stated that it is not in a position to assess compliance with Islamic law.[1] Briefing Note BN016/06 states that:

> "[t]he FSA's policy towards Islamic banks, and indeed to any new or innovative financial services company, can be summed up simply as "no obstacles, no special favours". We are keen to promote a level playing field between conventional and Islamic providers. One thing we are clear about is that we are a financial, not a religious regulator."

[1] In this context, the FSA's published policy in relation to the regulation of Islamic financial services can be found in FSA Briefing Note BN016/06 entitled "Islamic Banking in the UK," 2006.

Where specific regulation of Islamic financial business exists, such regulation usually addresses legal, risk or disclosure issues rather than issues of Shari'a compliance. For example, the DFSA's interest-free banking module contains specific documentary, disclosure and compliance requirements in relation to profit-sharing investments accounts (*mudarabas*). A DFSA authorized firm undertaking Islamic financial business and managing profit-sharing investment accounts must cover the following issues (amongst others) in its policies and procedures manual:

- The basis upon which the accounts will be deemed restricted or unrestricted (ie, as regards the restrictions on investments made by the firm on behalf of the account holders); and
- The manner in which the funds of each type of account holder will be managed.

Segregation of business lines

The need for appropriate segregation between Shari'a-compliant and non-Shari'a-compliant business has traditionally been guided by best practice guidelines published by industry bodies (including, in particular, the Islamic Financial Services Board [IFSB] and the Auditing Organization for Islamic Financial Institutions [AAOIFI]), although a number of financial services regulators (including the DFSA and the QFCRA) are starting to introduce formal regulatory rules on the subject.

Best practice guidelines in relation to the operation of Islamic windows provide that funds extended or transferred under Shari'a-compliant products should derive from Shari'a-compliant sources. With this aim in mind, it is common for the capital employed in relation to business conducted through the Islamic window to be segregated from conventional funds, and in some cases specifically raised from Shari'a-compliant sources, in order to ensure that the monies used are regarded as deriving from permissible sources under the Shari'a.

In circumstances in which it is necessary to establish an Islamic window with "mixed" funds from conventional and Shari'a-compliant sources, or otherwise accept or deal with mixed funds, many SSBs have recognized the ability of financial institutions to "cleanse" mixed funds by donating the proportion of the funds deriving from non-Shari'a-compliant sources to charity, notwithstanding the fact that under the equivalent secular law principles (e.g. the principles of tracing under English common law and in equity) a pro-rated proportion of the residual funds may (depending upon the circumstances) be regarded as representing the proceeds of the non-Shari'a-compliant activities. This process of cleansing funds has been approved of by AAOIFI in its Shari'a Standard on Conversion of a Conventional Bank to an Islamic Bank,[1] which advises that:

[1] AAOIFI Shari'a Standard No. (6).

> "[a]ny interest and other non-permissible earnings should be channelled to charity and general public utilities. It is not permissible for the bank to use this money, directly or indirectly, for its own benefit. Examples of charitable channels include, among others, training people other than the staff of the bank, funding research, providing relief equipment, financial and technical assistance for Islamic countries or Islamic scientific, academic institutions, schools, anything to do with spreading Islamic knowledge and similar channels. The charity money must go to these channels in accordance with the resolutions of the Shari'a board of the bank."

The difference between the approach taken for identification of funds by Shari'a and by the equivalent common law and equitable principles is based on the fact that, in this context at least, the Shari'a rules on handling mixed funds are concerned with questions of conscience rather than questions of ownership. Further support for a practical approach to the vetting of Shari'a funds can be found in the *Hadith*; a number of separate narrations support the principle that Muslims accepting payments from non-Muslims are not obliged to assume that the money received derives from impermissible sources. In the same manner as there are limits on the ability of any bank to confirm the source of funds received by it to ensure that they are not derived from the proceeds of crime (notwithstanding the existence of detailed regulation in this area) so IFIs can only trace ostensibly Shari'a-compliant funds so far in confirming their source.

Full operational segregation between conventional and Shari'a-compliant businesses is uncommon and, as a matter of domestic law, not required under English laws or regulations. For example, in a conventional financial institution that offers Shari'a-compliant products and/or services, it is common for front office staff promoting conventional products to also promote Islamic financial products.

Prudential considerations

The prudential rules applicable to Islamic financial business may differ from those applicable to conventional financial business, either because of the existence of dedicated prudential regulations applicable to Islamic financial business in the relevant jurisdiction or due to the different risks associated with Islamic financial products.

In particular, the principles of the the Basel II Accord may, depending upon the circumstances, apply differently to Islamic financial business as conventional financial business. For example, in respect of the calculation of liquid capital requirements under Pillar 1 of the Basel II Accord, the fact that Shari'a-compliant assets may be structured in a different manner to conventional products and services may impact upon the categorization of those assets for regulatory capital purposes and therefore the amount of free liquid capital that must be held by the institution in respect of them (eg, the principal credit risk that IFIs are exposed to in respect of *mudaraba* offered to customers is the risk of impairment of capital invested in respect of the IFI's share of the capital invested in the event that those investments do not lead to the return of capital envisaged).

In addition, in respect of the supervisory review under Pillar 2, the fact that IFIs and conventional financial institutions offering Islamic products and services may, respectively, be subject to different and additional risks in respect of their businesses means that their minimum capital requirements calculated under Pillar 1 may be subject to adjustment depending upon the risks associated with the relevant business lines. The fact that the Pillar 2 supervisory process may be of particular relevance to IFIs has been expressly acknowledged by the FSA, which stated that:

> "[if], in practice, certain risks affected Islamic institutions more than conventional firms, the FSA would expect these to be identified and quantified under Pillar 2…where this is no possible or capital is not an appropriate mitigating tool, then other ways of managing these risks would need to be identified."

Future developments

Historically, the prudential and governance arrangements of IFIs have been governed by best practice guidelines (including, in particular, those published by AAOIFI and the IFSB). As the amount of formal regulation of Islamic financial businesses grows, it is likely that the legal and regulatory challenges in carrying on Islamic financial business will give rise to new challenges for both bankers, lawyers and others operating in the industry.

3.2

Basel II and Capital Adequacy

Natalie Schoon, Bank of London and Middle East

Introduction

The ethical framework governing Islamic finance prohibits gambling, speculation and interest. Although at first glance this sounds like a risk manager's dream, it does not at all mean that an Islamic bank runs little to no risk. Like other banks, Islamic banks face risks inherent to the financial industry, and in most countries they have to abide by the same rules as other financial institutions for the calculation of regulatory capital. However, Islamic banks also have their own set of unique risk management challenges. The Islamic financial industry is young and the balance sheet size of the average Islamic bank is relatively small, as a result of which issues associated with the calculation of regulatory capital are in part similar to those faced by small, locally operating, conventional European and North American banks. In addition, because of the transaction structures they employ, Islamic banks face higher charges for regulatory capital under the Basel II capital accord.

Risks in Islamic banks

The absence of interest in Islamic finance means that Islamic banks are not subject to interest rate risk. However, this does not mean Islamic banks are subject to lower levels of risk than conventional banks. Like conventional banks, Islamic banks incur liquidity, credit, settlement, leverage, operational and business risk. In addition, Islamic banks also incur risks that are not common in conventional banks, such as:

- **Fiduciary risk**: specifically, risk related to the nature of the *mudaraba* contract, which places liability for losses on the *mudarib* (agent) in the case of malfeasance, negligence or breach of contract on the part of the management of the *mudaraba*;
- **Displaced commercial risk**: this risk type is related to the common practice among Islamic banks to "smooth" the financial returns to

investment account holders by varying the percentage of profit taken as the *mudarib* share, which can be compared to an arrangement or agency fee; and

- **Rate of return risk**: the risk of a mismatch between yields on assets and the expected rates of both restricted and unrestricted profit sharing investment accounts, which may in turn lead to displaced commercial risk.

Capital adequacy and minimum capital requirements

Capital adequacy is a measure of the financial strength of a bank or securities firm, usually expressed as a ratio of its capital to its assets. Basically, banks are required to hold a minimum level of capital to prevent over-lending and to ensure that the bank has sufficient funds in case any of its counterparties default without endangering depositors, the banking system or the economy.

The original capital adequacy rules, which came into effect in 1988, are generally known as Basel I and are still in use in a large number of countries outside the "Group of 10" (G10) countries (Belgium, Canada, Sweden, France, Switzerland, Germany, Italy, Japan, the UK, the US and the Netherlands). Within this framework, only credit risk and market risk have an impact on the level of regulatory capital. Each asset on the bank's balance sheet is assigned a risk weight as illustrated in the table below.

Example Asset Classes	Risk Weight (%)
Central governments, central banks, and Organization for Economic Cooperation and Development (OECD) governments	0
Multilateral development banks and banks incorporated in the OECD	20
Mortgages	50
Private sector, commercial companies owned by the public sector, and all other assets	100

Risk-weighted assets (RWAs) are determined by multiplying the outstanding exposures per counterparty by the risk weight that applies to the type of counterparty. Risk mitigation such as netting and pledged deposits can be applied to reduce RWAs, as long as a set of predefined conditions are met. Regulatory capital is then determined as the aggregate of all RWAs multiplied by 8 per cent. The 8 per cent ratio is set by the Basel Committee of Banking Supervision (BCBS) on the basis that it would result in sufficient levels of capital held in the banking sector to cover potential defaults.

Basel I was the first, fairly basic, framework to measuring capital adequacy, and one of the main issues with the implementation lies in the fact that there is no distinction between high and low quality borrowers. This becomes immediately apparent from the following examples:

- National Grid Group, one of the world's largest utilities companies, and Enron are both classified as "corporates". Their exposures are risk-weighted at 100 per cent, and this applied even when it started to became evident that Enron had a much lower credit quality. For every £100 of credit extended to each of these borrowers, the bank has to maintain £100 × 100 per cent × 8 per cent = £8 in capital; and
- The National Bank for Foreign Economic Activity of the Republic of Uzbekistan and HSBC are both classified as "banks", which means their exposures attract a 20 per cent risk weight. This implies that for every £100 of credit extended to them, the bank only has to maintain £100 × 20 per cent × 8 per cent = £1.60 in capital.

In both of the above cases, the chances of either party defaulting differ significantly due to their credit quality. However, the amount of capital required on their exposure remains the same.

There are more disadvantages to Basel I, such as the fact that there is no distinction between long and short-term loans, and the limited use of risk-mitigating techniques, which the BCBS attempted to address in the Basel II framework.

The intention of Basel II is to address the shortcomings that are inherent in the Basel I accord. For starters, it introduces counterparty grading to overcome the fact that there is currently no distinction between low and high quality borrowers. In addition, it introduces operational risk and market discipline. Basel II is organized around three mutually reinforcing pillars.

Pillar one: minimum capital requirements

The new framework maintains both the current definition of capital and the minimum requirement of 8 per cent of capital to RWA. There is an increased emphasis on credit risk measurement and mitigation techniques. Market risk, which was previously taken into consideration in the overall RWA calculation, is now segregated from credit risk. A capital charge is introduced for operational risk.

The Basel II framework does not introduce any changes to the calculation of capital for market risk beyond the specification of the 1996 market risk amendment to Basel I. For both the credit and operational risk components, three different approaches are available, each with a different level of sophistication.

Available approaches for credit risk

"Credit risk" is defined as the risk that a counterparty will default on one or more of his/her payments. Three approaches can be used to determine the required regulatory capital:

1. **Standardized approach**: the standardized approach is roughly the same as the current Basel I approach. In addition to the standard risk weights currently available, clients need to be graded by an External Credit Assessment Institution (ECAI). The rating of the counterparty is now incorporated into the overall risk weighting;
2. **Foundation internal ratings-based approach (FIRB)**: banks do not rely on ECAIs for their ratings, but determine the probability of default (PD) of their borrowers using an internally built model. Loss given default (LGD) and exposure at default (EAD) are determined based on supervisory rules defined in the Accord; and
3. **Advanced internal ratings base (AIRB)**: not only the PD but also the LGD and EAD are determined based on internally built models.

Available approaches for operational risk

"Operational risk" is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. This includes legal risk but excludes strategic and reputational risk. Similar to the calculation of the minimum capital requirements for credit risk, three methodologies are available for the calculation of operational risk regulatory capital charges:

1. **Basic indicator approach:** capital charge is calculated as a fixed percentage (15 per cent) of average gross income over the previous three years. This percentage is determined by the regulator;
2. **Standardized approach:** the banks' activities are divided into eight business lines and the capital charge is calculated per business line as a percentage of gross income. The percentages differ according to the business line and are set by the regulators; and
3. **Advanced measurement approach (AMA):** under the AMA approach, banks apply their own internally developed model which incorporates quantitative and qualitative criteria such as internal loss data, key risk indicators, scenario analysis and self-assessment.

Pillar two: supervisory review

Supervisors are required to ensure that each bank under its supervision has sound internal processes in place to assess the adequacy of its capital. Typically, they employ an internal capital adequacy assessment process

(ICAAP), which is prepared by banks and reviewed by supervisors. In addition, specific review visits are part of this process. The supervisor can request additional regulatory capital for any issues not covered under pillar one, such as interest rate risk in the banking book and concentration risk.

Pillar three: market discipline

The majority of disclosures are recommended and not mandatory. The intention is to reduce potential overlap with other disclosure standards such as International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS). As a result, additional disclosures are only mandatory in relation to the implementation of particular methodologies or instruments.

The general expectation is that large banks with sophisticated risk management systems will benefit from the new regulation, and the same assets will see their regulatory capital level reduced. However, this will strongly depend on overall counterparty credit quality and robustness of internal control processes and procedures. For the industry as a whole, the required capital is expected to remain as it is, or potentially even increase.

Impact on Islamic banks

The impact of the changed regulation on banks in general is quite significant. Substantial investments have been, and continue to be, made in enhanced technology. To date, the exact impact on regulatory capital is still unknown.

The impact on Islamic banks is largely the same as for the conventional banking industry. However, there are a few issues specific to Islamic banks.

Balance sheet size

Although the Islamic financial industry has grown substantially over the past decade, it remains relatively small when compared to the overall financial sector. Undeniably, the size of an individual Islamic bank is typically not large enough to justify the investment required for the advanced risk measurement approaches. As mentioned earlier, this is not restricted to Islamic banks, but the smallness of the Islamic financial industry makes it generally more difficult to lobby for changes in regulatory policy, such as Basel II.

The absence of significant amounts of loss data is one of the problems that hinder smaller sized banks that need to comply with Basel II. Islamic banks – most of which have only recently been established and which have not seen a complete economic cycle yet – do not have a long enough history and hence cannot meet the Basel II requirement for seven years of loss data.

Although this is also a problem for any other start-up bank, conventional European and North American banks have the opportunity to join one of the established data consortiums – such as the Pan European Credit Data Consortium (PECDC) or the North American Loan Loss Database (NALLD) – to gain access to a larger data set with a longer history of loss data. To date, no loss database for Islamic finance has been established.

Troublesome transaction types

The major drawback of the Basel II Accord is a direct result of transaction structures. The BCBS takes the stand that banks should not hold significant equity positions in companies that are also their counterparties. The underlying principle is that the risk a bank takes increases when ownership and the provision of debt funding are in the same hands. Profit-sharing structures in Islamic finance such as *mudaraba* and *musharaka* are not held with the intent of trading and are therefore, from a risk and capital adequacy perspective, similar to holding equity. Under the Basel II standards, these investments are calculated using the simple risk weight method and attract a 400 per cent risk weight. The Islamic Financial Services Board (IFSB) in their capital adequacy standard has addressed the treatment of two common forms of *musharaka* structures as follows:

- *Musharaka*-based mortgage financing as deemed akin to a conventional mortgage and attracts a similar treatment; and
- Projects can be assessed for capital adequacy using the supervisory slotting criteria for specialized financing, which depend on individual risk weights and are a lot less penalizing than the equity weighting.

However, other *musharaka* contracts may not qualify for this approach and will continue to attract a 400 per cent risk weight.

The future

Given the strong growth in Islamic finance, balance sheet size and lack of loss data is not expected to remain an issue for many banks in the long run and ensuring the use of robust counterparty ratings should have a positive impact on the risk management process and the level of capital required.

The structures of *mudaraba* and *musharaka* transactions are not necessarily capital efficient and are therefore more expensive from the bank's perspective. Consequently, Islamic banks will need to consider the cost of capital in the development of new transaction types and when advising clients. Whether the client's interest can be served equally well with a different structure is one of the questions that will need to be addressed as part of the advisory function of the bank. Although it could be argued that due to the stronger link between bank and counterparty, the chances of default in a *mudaraba* or *musharaka* transaction will reduce, the counterargument presented by the BCBS and the resulting higher capital charge for equity products is equally valid.

The IFSB has worked closely with the BCBS in the past and will continue to work with that committee to seek regulatory improvements for Islamic banks in the future. However, given that Basel II has only recently been finalized, no immediate changes to the accord's regulatory capital treatment of *mudaraba* and *musharaka* transactions are expected.

Looking at longer term developments, problematic issues related to Islamic banks' lack of historical loss data could potentially be resolved through the development of a loss experience database, such as those set up by member banks of the NALLD. While this would not resolve the issue concerning the length of time over which an Islamic bank can track data, it would at least enhance the quantity of loss history data.

Data sharing in the financial sector is a sensitive point, and such a project will need to be managed by a trustworthy third party. Following the selection of this third party is selection and the creation of a comprehensive loss database for Islamic finance, Islamic banks will have the ability to start designing advanced risk measurement models that would otherwise remain out of reach.

3.3

Regulations and Challenges in the UK

Michael Ainley, Ali Mashayekhi, Robert Hicks, Arshadur Rahman and Ali Ravalia, The Financial Services Authority

Regulatory developments

As banking regulators, the Bank of England and, from 1998, the Financial Services Authority (FSA) have been open to the development of Islamic finance in the UK for soakme time. The first important signal was given in a speech by Lord Edward George, then governor of the Bank of England, in September 1995 at a conference organized by the Islamic Foundation. In this, he recognized the "growing importance of Islamic banking in the Muslim world and its emergence on the international stage," as well as the need to put Islamic banking in the context of London's tradition of "competitive innovation." In pointing out that the supervisory issues raised were similar in many respects to those of conventional banks, he also noted there were a number of potentially difficult questions to resolve, such as liquidity and risk management. But the problems, he said, should prove "more tractable," the more they were understood by Western supervisors.

These sentiments were first translated into practice in 2001 when a high-level working group, chaired by Lord George with representatives from the city, government, the Muslim community and the FSA, was established to examine the barriers to Islamic finance in the UK. One of the main ones identified was the fact that Islamic mortgages attracted double stamp duty, both on the purchase of the property by the bank and on the transfer of the property by the bank to the customer at the end of the mortgage term. As noted above, any change here was clearly a matter of public policy; government legislation in 2003 to remove this anomaly was welcomed by both the Bank of England and the FSA.

This open approach was taken forward by Sir Howard Davies, when he was Chairman of the FSA. For example, in a speech to a conference on Islamic banking and finance in Bahrain in September, 2003, he told his audience that he had "no objection, in principle, to the idea of an Islamic bank in the UK." He went further in saying that, provided Islamic banks met the FSA's regulatory requirements, the UK had "a clear economic interest in trying to ensure that the conditions for a flourishing Islamic market are in place in London." A soundly financed and prudently managed Islamic institution would, he argued, be "good for Muslim consumers, good for innovation and diversity in our markets and good for London as an international financial centre."

These high-level contacts with the Muslim community have since been reinforced by working-level contact with Islamic institutions. The FSA now has good and growing links with the industry, other regulators and Islamic working groups in international organizations. It is also a participant in the recently established HM Treasury Islamic Finance Experts Group. These and other links have laid the foundation on which the FSA has been able to consider the authorization of wholly Islamic firms.

The FSA's approach to authorization

To date, the FSA has authorized three wholly Islamic banks, initiated by Middle Eastern investors and institutions. The Islamic Bank of Britain began operations as an authorized firm in 2004, and by June 2007 had a balance-sheet of around £140 million.

On the same date, the European Islamic Investment Bank, which was authorized in 2006, had a balance-sheet of £302 million. The Bank of London and the Middle East was authorized in July 2007, with a start-up capital of £175 million. The first of these is retail and the last two wholesale. Other applications are in the pipeline. The FSA has also authorized one Islamic hedge fund manager and is considering an application from the first wholly Islamic *takaful*[1] provider.

This article examines the authorization process and how it is applies to wholly Islamic finance firms. It is, however, worth noting that the operations conducted by conventional banks for retail and wholesale clients through their Islamic windows do not require separate authorization. These activities are covered under their existing authorizations and permissions from the FSA. Separate authorization, however, would be required if such banks were to establish subsidiaries or separate legal entities to carry out this business.

The Financial Services and Markets Act, 2000

Anyone seeking to conduct a regulated activity in the UK is required to apply to the FSA for permission under Part IV of the Financial Services and Markets Act (FSMA), 2000. The FSMA deals with the regulation of financial services in the UK, and is the legislation under which corporate bodies,

[1] *Takaful* is a form of Islamic insurance, based on the concept of collective risk pooling.

partnerships, individuals and unincorporated associations are permitted by the FSA to carry on those financial activities that are subject to regulation.

Under Section 19 of the FSMA, any person who carries on a regulated activity in the UK must be authorized by the FSA, or exempt. A breach of this section may be considered a criminal offence.

Regulated activities

Activities that are subject to regulation are specified in the FSMA (Regulated Activities) Order, 2001 (RAO). Examples include accepting deposits, effecting or carrying out contracts of insurance and advising on investments.

Before the FSA was established as the single financial regulator in the UK, several separate regulators oversaw different financial markets. The Bank of England, for example, was responsible for supervising banks under the Banking Act, 1987 and the Securities and Investment Board was responsible, under the 1986 Financial Services Act, for investment regulation, which was carried out by several self-regulatory organizations. However, under the FSMA, and subject to any specific restrictions, firms now seek a scope of permission from the FSA to be authorized for the full range of regulated activities they wish to undertake.

Most of the Islamic applications the FSA has received so far have been to establish Islamic banks. Banking itself is not a defined regulated activity; rather, the generally understood meaning is an entity which undertakes the regulated activity of "accepting deposits" (and is not a credit union, building society, friendly society or insurance company). As defined by the RAO, this covers money received by way of deposit lent to others or any other activity of the person accepting the deposit which is financed, wholly or to any material extent, out of the capital of or interest on money received by way of deposit. This activity warrants classification as a credit institution under the EU Banking Consolidation Directive, and firms undertaking it are subject to the appropriate capital requirements. A firm claiming to be a bank will therefore be expected to seek this activity within the scope of its permission.

Non-discriminatory regime

All financial institutions authorized by the FSA and operating in the UK, or seeking to do so, are subject to the same standards. This is true regardless of their country of origin, the sectors in which they wish to specialize, or their religious principles. This approach is fully consistent with the FSMA's six Principles of Good Regulation, in particular, facilitating innovation and avoiding unnecessary barriers to entry or expansion within the financial markets.

There is, therefore, a "level playing field" in dealing with applications from conventional and Islamic firms. The FSA is happy to see Islamic finance develop in the UK, but it would not be appropriate, nor would it be legally possible, to vary its standards for one particular type of institution. This was clearly articulated by Sir Howard Davies in his speech in Bahrain in September, 2003. The FSA's approach can be summed up as "no obstacles, but no special favours."

Authorization requirements

All firms seeking authorization are required to provide a credible business plan and meet, and continue to meet, five basic requirements known as the "threshold conditions." These are set out in the FSMA and described in further detail in the FSA Handbook.

In summary, the five conditions are that:

1. The firm must have the right legal status for the activities it wishes to undertake. This recognizes, for example, that European directives place certain limits on the legal form that a firm accepting deposits or effecting and carrying out contracts of insurance may take;
2. For a firm incorporated in the UK, its head office and "mind and management" must also be in the UK;
3. If the person or firm has "close links" with another person or firm, these are not likely to prevent the effective supervision of the firm;
4. The firm has adequate resources, both financial and non-financial, for the activities which it seeks to carry on; and
5. The firm is "fit and proper." This takes into account its connection with other persons, including employees and shareholders, the nature of the activities it wishes to undertake and the need to conduct its affairs in a sound and prudent manner.

These conditions can readily be applied to any type of firm, although the exact requirements may need to be shaped to fit differing sectors. For example, the requirement for adequate resources, which includes capital, would be different for a bank and an insurance company. However, the capital requirements for an Islamic and a conventional bank would be applied on the same basis.

Another example would relate to the requirement that a business must have reasonable systems and controls to manage the type of business it wishes to undertake. In this case, the threshold conditions are flexible enough to be as readily applied to an Islamic firm as to a conventional provider, whatever sector the firm is operating in.

Applying the FSMA

In applying the FSMA to Islamic firms, there are several areas where more work or clarification is needed. So far, however, they have not presented any obstacles that could not be overcome. This owes much to the collaboration between the FSA and the applicants to develop pragmatic solutions.

The FSA has identified three main areas of potential difficulty which are common to Islamic applications. These are:

1. The regulatory definition of products;
2. The role of Shari'a scholars; and
3. Financial promotions.

Regulatory definition of products

The definition of products offered by Islamic firms is a key factor that firms and the FSA need to consider as part of the authorization process. As explained earlier, the structure of Islamic products is based on a set of contracts acceptable under Shari'a. So while their economic effect is similar to or the same as conventional products, their underlying structure may be significantly different. This means the definition of these products under the RAO may not be the same as the conventional equivalent.

This has two important implications for applicants. First, firms need to be sure they apply for the correct scope of permission for the regulated activities they wish to undertake. This, in turn, highlights the need for firms to assess whether the structure of Islamic products can be accommodated within the RAO.

Secondly, the regulatory definition is relevant in determining the framework in which products can be sold, for example in the application or otherwise of conduct of business rules. If a product falls outside the FSA's regulatory framework, there may be restrictions on who the product can be sold to. For these reasons, new applicants are encouraged to engage at an early stage with the FSA and their legal advisers about the regulatory definition of the products they intend to offer.

The role of Shari'a scholars

The FSA also has to consider the role of the Shari'a Supervisory Board (SSB). The industry defines the key objective of SSB scholars as ensuring Shari'a compliance in all an entity's products and transactions. In practice, Shari'a scholars examine a new product or transaction and, if satisfied it is Shari'a-compliant, issue an approval. The FSA is, however, a secular and not a religious regulator. It would not be appropriate, even if it were possible, for the FSA to judge between different interpretations of Shari'a law. However, the FSA does need to know, from a financial and operational perspective, exactly what the role of the SSB is in each authorized firm. It needs, in particular, to know whether, and if relevant how, the SSB affects the running of the firm. The FSA has to be clear as to whether the Shari'a scholars have an executive role or one that is simply advisory.

This matters for two reasons. Firstly, in the UK, any person acting as a director of an authorized firm must be registered under the FSA Approved Persons Rules. To assess the suitability of a person, the FSA has a standard known as the “fit and proper test for approved persons.” One of the factors looked at is “competence and capability.”

So, for an individual to become a director of an authorized firm, we would expect them to have relevant experience. If, therefore, Shari’a scholars are seen to have a directorship role, it is possible that some of them may not meet the competency and capability requirements. Secondly, and assuming that Shari’a scholars are directors, their role is more likely to resemble that of an executive director than a non-executive director, as it might involve active participation in the firm’s business. In such cases, it would be very difficult to justify multiple memberships of SSBs of different firms because of significant conflicts of interests. This would put further constraints on an industry already facing a shortage of Shari’a scholars with suitable skills.

The key point from the FSA’s perspective is that firms can successfully show that the role and responsibilities of their SSB are advisory and it does not interfere in the management of the firm. The firms already authorized have been able to show this.

The factors that the FSA typically looks at with regards to SSBs include the governance structure, reporting lines, fee structure and the terms and conditions of the SSB’s contracts. On a related point, we understand from the industry that complex products, having gone through a long process of development, are sometimes rejected by the SSB for non-compliance with Shari’a. To some extent, this is seen to be a result of the lack of Shari’a-knowledge internally in the firm. One solution put forward by some practitioners is greater involvement by Shari’a scholars in the product development process. While this may prove beneficial, it could lead to a more executive role as outlined above. A good industry practice, now developing, is that firms are starting to recruit more staff with an understanding of Shari’a law. This could help to identify a product’s potential non-compliance with Shari’a at a much earlier stage.

Financial promotions

The third issue, financial promotions, is more relevant on the retail side. Reflecting its statutory objective to protect consumers, the FSA’s requirement is that all advertising should be “clear, fair and not misleading.” This has been important in the context of Islamic finance as the products are still new and their structure differs from more conventional products. This, together with the fact that by necessity those who will wish to use them may be relatively inexperienced in financial services, reinforces the need for the promotion of Islamic financial products to include the risks as well as the benefits.

AUTHORIZATION OF THE ISLAMIC BANK OF BRITAIN

In August 2004, the FSA authorized the Islamic Bank of Britain (IBB)_the first wholly Islamic retail bank in a country where most of the population is non-Muslim. Inevitably, the process raised new questions, and it took some 18-24 months to complete. The FSA was then able to carry over the lessons to later applications.

The main issue that arose concerned the definition of a "deposit." In the UK, a deposit is defined as a "sum of money paid on terms under which it will be repaid either on demand or in circumstances agreed by parties." The point is important because deposit-takers are regulated and the customer is assured of full repayment as long as the bank remains solvent. A savings account originally proposed by IBB as a "deposit" was a profit-and-loss sharing account, or *mudharaba*, where Shari'a law requires the customer to accept the risk of loss of original capital. This was not consistent with the FSA's interpretation of the legal definition of a "deposit," which requires capital certainty.

After extensive discussions, the solution IBB adopted was to say that, legally, its depositors are entitled to full repayment, thus ensuring compliance with FSA requirements. However, customers had the right to turn down deposit protection after the event on religious grounds, and choose instead to be repaid under the Shari'a-compliant risk-sharing and loss-bearing formula. The solution for IBB may, however, not necessarily be appropriate in other contexts. The FSA is prepared to review each case on its merits and will try to reach solutions that are acceptable to all those involved.

Another area which was new to the FSA was the role of the Shari'a Board, which we have already discussed above. Financial promotions are particularly important as the IBB was, and is, marketing its products directly to retail consumers. The FSA and the IBB looked at how the risks associated with its products were to be presented to customers. This has presented no problems so far. The FSA is currently taking a similar approach to the first *takaful* firm which has recently applied for authorization.

The IBB now offers a range of retail and business banking services. It has established eight branches in cities with large Muslim populations around the country. According to recent figures, the bank had over 50,000 accounts and some 42,000 customers.

This chapter appeared as part of the FSA document "Islamic Finance in the UK: Regulations and Challenges" (http://www.fsa.gov.uk/pubs/other/islamic_finance.pdf) published in November, 2007.

3.4

Shari'a Supervisory Boards and Shari'a Compliance

Richard T de Belder, Denton Wilde Sapte, LLP

Introduction

The role of Shari'a Supervisory Boards in relation to Islamic finance is crucial. When an Islamic finance structure or document is being prepared, how is one to decide whether or not it is Shari'a compliant? The answer is that it is the *fatwa* issued by the Shari'a Supervisory Board that will provide the assurance to the Islamic financier, its customer and investors that they are participating in something that is not *haram*.

What is a Shari'a Supervisory Board?

An Islamic financial institution will require such a board. It will consist of various Islamic scholars whose judgement and reputation is respected. In some countries, there is legislation that places a statutory obligation on an Islamic financial institution to have a Shari'a Supervisory Board, which also describes the powers and responsibilities of such a body.

Shari'a Supervisory Boards are not just found in financial institutions. For example, Shari'a-compliant funds will usually have boards because investors will want to be satisfied that the fund has been structured and will be operated in a Shari'a-compliant manner. Sometimes there will also be legislation regulating Shari'a-compliant funds that deals with the role and responsibilities of the fund's Shari'a Supervisory Board.

In addition to any applicable legislation, the constitutive documents of an Islamic financial institution (or a prospectus in the case of a Shari'a-compliant fund) will also usually have provisions dealing with various aspects of the formation and functioning of the Shari'a Supervisory Board.

Functions of a Shari'a Supervisory Board

The functions of a Shari'a Supervisory Board can cover the following:

- Reviewing and commenting on transaction structures;

- Reviewing and commenting on documents;
- Performing Shari'a-compliance audits on completed transactions to see whether they are in fact being performed in a Shari'a-compliant manner;
- Reviewing and approving marketing material; and
- Providing training and guidance.

Sanctions that can be imposed by a Shari'a Supervisory Board

Subject to any sanctions that may be provided by statute or applicable constitutive documents, a range of sanctions can be imposed, including:

- Insisting that structures and documents are amended so as to be Shari'a-compliant, failing which a *fatwa* will not be issued;
- If a Shari'a audit shows that a transaction is not in practice being carried out in a Shari'a-compliant manner, the Shari'a Supervisory Board can instruct that all of the profits from the transaction are paid to a Shari'a-compliant charity. For example, if, in connection with a *murabaha* transaction, it transpired that there was no purchase and sale of an asset resulting in actual passing of title, the Shari'a Supervisory Board would likely conclude that this was in fact a sham loan with interest. As such any profit arising from the *murabaha* transaction would have to be foregone and paid to charity; and
- A power that is sometimes found (by law or in the constitutive documents) is that the Shari'a Supervisory Board can mandate that the entity be wound up due to it being seriously in breach of the Shari'a.

The issue of a fatwa

A *fatwa* is a Shari'a opinion issued by the Shari'a Supervisory Board that it considers the structure and documentation of a transaction to be Shari'a compliant. Normally, it will list the documents that it has reviewed and describe the structure and possibly any key areas, especially those that are novel.

Once a *fatwa* has been issued this will provide assurance for the Islamic financial institution and other participants or investors in the underlying transaction that the transaction conforms to the Shari'a. The *fatwa* will usually not be made available to the public.

The Islamic finance industry is facing the challenge of developing Shari'a-compliant products, and this means that a lot of effort is being channelled into creating new structures and documents. This necessarily means that new products involve new ideas and structures, which will result in there being debates and, sometimes, disagreements amongst the Shari'a scholars as to what is Shari'a-compliant.

Attempts have been made by the Shari'a scholars to come to agreed positions on a range of matters. The most prominent forum is the Accounting and Auditing Organization for Islamic financial institutions (AAOIFI). This is based in Bahrain and has produced standards on a range of Islamic finance instruments.[1]

However, it should be recognized that there are different Shari'a schools of thought, which have differences in terms of their interpretation of the Shari'a. It does happen, therefore, that another Islamic financial institution that is invited to participate in a transaction will pass the structure and documents to its own Shari'a Supervisory Board to confirm that it is in order for it to participate.[2] Due to the differences amongst the Shari'a advisors, sometimes approval is not forthcoming and so, unless the arranging Islamic financial institution agrees to make amendments to take into account the concerns of the participant's Shari'a Supervisory Board (but in a manner which still means that its own Shari'a Supervisory Board can maintain the issuance of its own *fatwa*), the participant will not be able to proceed.

To the extent that an individual is an investor, it is likely that he will take at face value the fact that a *fatwa* has been issued and so will proceed with the investment. It is open to anyone to participate in an Islamic finance transaction and so a conventional financier or non-Muslim can also participate but, in this case, it is likely that such persons will not be so concerned as to whether the transaction is Shari'a-compliant (unless, for example, it wanted to re-package the investment in a Shari'a-compliant manner).

Can a fatwa issued for a transaction be overturned?

One concern that is sometimes raised is whether, after a *fatwa* has been issued, it can be amended or rescinded, or whether it can be overruled by another Islamic scholar. There is some uncertainty as to whether an existing fatwa can be revoked or amended. One view is that, once issued, it can be relied upon even if the fatwa provider subsequently changes his opinion. However, if not all the material information has been provided then, in those circumstances, it is possible to see a fatwa being revoked but this would be the same as with any legal opinion.

AAOIFI Standard No. 29 dealing with fatwas does, however, envisage a situation where the Shari'a Supervisory Board may come to a view that it can no longer follow an earlier fatwa in the future. It is not totally clear from the Standard what is the effect on the earlier ruling although it would seem

[1] AAOIFI has issued Standard No. 29 on "Stipulations and Ethics of Fatwa in the Institutional Framework," which deals with various aspects of fatwas and those who issue them.

[2] Paragraph 6/3 of AAOIFI Statement No. 29 states that an "institution should not follow the fatwas of other Shari'a Advisory Boards except with permission of its own Board."

that the institution that relied on the earlier fatwa, is to "correct all actions" and "rectify the effects and repercussions" of the old fatwa. Paragraph 11 of AAOIFI Statement No. 29 provides as follows:1. The board has to retreat from its fatwa if it is proved to be wrong on reviewing, or on examination by a higher body. In such case the board has to inform the institution so as to rectify the ruling and its consequent effects. The institution on its part has to correct all the actions that had been based on the wrong fatwa and refrain from adopting it any more.2. The board, on its own initiative or on request of the institution, has the right to review a previous fatwa even if such revision would lead to issuing a new fatwa that contravenes the former one. In such case the institution has to follow the new fatwa in the future and rectify the effects and repercussions of the old one.

With this issue still yet to be formally clarified it is the author's understanding that a fatwa on a transaction will not trump the earlier *fatwa*. The first *fatwa* remains a valid *fatwa* issued by the Shari'a scholar or Shari'a Supervisory Board – it is his or its view of Shari'a compliance and, while another person may disagree, it will not affect the first *fatwa*. In this regard, the position is no different to a conventional legal opinion in that, if another lawyer has a different opinion, this does not necessarily mean that the lawyer who issued the first opinion is wrong.

Conflicts of interest

One issue faced throughout the Islamic finance industry is the lack of persons experienced in Islamic finance. The same issue extends to Shari'a scholars. There has been a tendency to seek out the most respected and well-known Islamic scholars to sit on Shari'a Supervisory Boards. This has been driven by the desire to give comfort to persons dealing with the Islamic financial institution that Shari'a scholars of repute and experience are monitoring its affairs.

While steps are currently being made to bring on a younger generation of Shari'a scholars it is still true that a small number of Shari'a scholars sit on a very large number of Shari'a Supervisory Boards.[1] This means that it can often be difficult to easily access them to obtain their comments on structures and documents. Accordingly, in drawing up timeline for a transaction, sufficient leeway must be included for dealings with the Shari'a Supervisory Board.

One issue that is sometimes raised is whether serving on the boards of so many Islamic financial institutions could cause conflicts of interest for a Shari'a scholar. In the absence of an industry-wide standard that applies to Shari'a scholars serving on Shari'a Supervisory Boards, it is necessary to rely on the personal professionalism of the Shari'a scholars and it is generally

[1] Organizations such as AAOIFI have introduced and are expanding their Certified Shari'a Adviser and Auditor programme to increase the number of qualified Shari'a advisers who also understand the international financial markets.

the position that participants in the Islamic finance industry do not have major reservations on this issue.[1] It is, however, a topic that is likely to be considered in more detail and is one which has been raised by the Financial Services Authority (FSA) in the United Kingdom in its recent paper on Islamic finance.[2]

Alternative bodies

There has been a growth in companies that offer services that include the review and vetting of structures and documents as to Shari'a compliance and which will also issue *fatwa*s. Shari'a scholars own some of these companies, but all of them will have access to various Shari'a scholars. One possible advantage of using these companies is that they may be able to access a Shari'a scholar more quickly than if one had to rely on one Shari'a Supervisory Board.

Central Shari'a bodies

An on-going issue for bankers, their customers and other professional service providers is the lack of uniformity in approach found amongst different Islamic scholars. The idea of having a single body that would coordinate and resolve these conflicts is attractive and there are some bodies such as the AAOIFI that have made significant attempts to fulfil this role.

At the level of individual countries, Malaysia has taken steps to try and centralize the resolution of conflicting opinions. The Central Bank of Malaysia (Bank Negara Malaysia) formed the Shari'a Advisory Council in 1997, and it is the authority that will ascertain Islamic law for the purposes of Islamic banking business, takaful business, Islamic financial business, Islamic financial development business or any other business that is based on Shari'a principles and that is supervised and regulated by Bank Negara Malaysia. The Minister of Finance appoints its members. The Central Bank

[1] Paragraph 5/3 of AAOIFI Standard No. 29 does, however, provide: "The member of the [Shari'a Supervisory] Board should have no personal interest in the matter for which the institution seeks fatwa."

[2] The FSA (Financial Services Authority) issued its paper entitled "Islamic Finance in the UK: Regulation and Challenges" in November 2007: In the section entitled "The FSA's approach to authorization" it discusses the role of Shari'a Supervisory Boards. Its interest is the extent to which the Shari'a scholars have an executive role in the running of the Islamic financial institution or whether they just have an advisory function. If a Shari'a advisor was viewed as being a director of an authorized entity, then that person would have to meet certain suitability requirements by reference to a standard known as the "Fit and Proper Test for Approved Persons." This would entail a consideration as to whether the Shari'a scholar had sufficient experience to meet that test. The paper makes the point that if a Shari'a scholar was assumed to be a director, their role is more likely to resemble that of an executive director rather than a non-executive director as it might involve active participation in the firm's business. Furthermore, the FSA paper states that in such cases "it would be very difficult to justify multiple memberships of [Shari'a Supervisory Boards] of different firms because of significant conflicts of interests." The FSA states that the key point from its perspective is that firms must be able to show that "the role and responsibilities of their [Shari'a Supervisory Board] are advisory and does not interfere in the management of the firm."

of Bahrain has attempted to impose some uniformity through a reference to the AAOIFI standards in its regulations.[1]

In the United Arab Emirates (UAE), Islamic financial institutions are regulated by Federal Law No. 6 of 1985, which provides for the establishment of a higher Shari'a body that would have oversight on the Shari'a activities of Islamic financial institutions and would also offer a binding opinion on Shari'a-related matters. To date, however, no such body has been formed, although there appear to be current discussions on this.[2]

While there is a need to try and align Shari'a positions across borders, it is also important to achieve some uniformity within a country and the differing approaches taken by the Bank Negara Malaysia and the Central Bank of Bahrain are attempts to achieve this aim. The counterargument against having too much centralization is that it might inhibit the development of new ideas and interpretations that are required to develop the Islamic finance industry.

Fatwas and governing laws

It is important from the perspective of all parties involved in an Islamic financial structure or transaction that it is Shari'a compliant and that a *fatwa* is issued. However, the reality is that in many countries, if there is a dispute, that dispute will be heard before the secular courts. In view of this, a lawyer will also need to consider the effect of the applicable governing law. It may well be that the governing law would not recognize or apply the Shari'a or even be concerned with what a *fatwa* said, but rather would consider any contractual arrangements put before it in the context of the applicable national law.

Shari'a Supervisory Boards are usually aware of the position that a secular court might adopt regarding the governing law and there have been attempts by them to include governing law provisions that expressly refer to the Shari'a. Examples include:This Agreement shall be governed by, and construed in accordance with, the laws of [*], except where those laws conflict with the rules and principles of the Islamic Shari'a, when the latter shall prevail.This Agreement shall be governed by the provisions of the laws of [*] to the extent that these laws do not conflict with the Shari'a when the Shari'a shall apply. The interpretation of the Shari'a shall be conclusively decided by the Shari'a Supervisory Board of [*].

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[1] The Central Bank of Bahrain Rulebook has various provisions that refer to Shari'a supervisory committees. Rulebook HC-A.2.5 requires that all Islamic banks have a Shari'a committee. Rulebook HC-1.3.15 provides that there should be an independent Shari'a supervision committee complying with AAOIFI's governance standards for Islamic financial institutions No. 1 and No. 2 and Rulebook HC-1.3.16 provides that all Islamic banks must comply with all AAOIFI issued accounting standards as well as the Shari'a pronouncements issued by the Shari'a board of AAOIFI.

[2] Article 5 of Federal Law No. 6, 1985.

However, there is no certainty that the secular courts will enforce such provisions. Two English judgements have considered the impact of the Shari'a on an English governing law clause.[1]

In the *Gems Symphony* case, the relevant *murabaha* agreements were the subject of English law with no reference to the Shari'a. While arguments were raised that the *murabaha* agreements were void under the Shari'a as the essential features required to be present under the Shari'a were missing, the court took the position that, in accordance with the provisions of the governing law clause, it merely had to construe the agreements as English law contracts.

The *Beximco* proceedings involved various *murabahas* and *ijaras* and the applicable agreement had a provision that referred to the Shari'a.[2] In these proceedings the court discussed the fact that it was clear that the experts produced by both the plaintiff and the defendant had both agreed that there were indeed areas of considerable controversy and difficulty (including the existence of a variety of schools of thought) in determining what was meant by the principles of the Shari'a. While the court eventually decided it would not have to refer to the Shari'a in determining the dispute, it did observe that, if it had had to apply the Shari'a, it would be arguable which of the two parties' experts was right. This uncertainty would make it difficult for a court to reach a conclusion upon the principle or rule in dispute. In fact the court agreed with the trial judge that the reference to the Shari'a was merely a reference to the religious principles according to which Shamil Bank held itself out as doing business, rather than a system of law intended to 'trump' the application of English law as the law to be applied in ascertaining the liability of the parties under the terms of the agreement. The court also made the observation that the Rome Convention was not applicable to a choice between the law of a country and a *non*-national system of law such as the Shari'a.

Whether a court would look more favourably on a provision that sought to introduce more certainty by stating that the Shari'a is that as interpreted by the Shari'a Supervisory Board of the Islamic financial institution is somewhat uncertain. While the Shari'a Supervisory Board would be neutral, nonetheless having the Shari'a Supervisory Board of the Islamic financial institution that would likely be seeking to recover a debt from its customer, decide what the Shari'a meant, could well be viewed as being an unfair provision which should be struck out.

The dilemma facing secular courts in deciding how to deal with the Shari'a is not confined to the West. In Abu Dhabi, the Federal Supreme Court decided on a dispute that came before it which involved a *Musharaka* (a form of partnership) and where there was a mortgage securing certain

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[1] *Islamic Investment Company of the Gulf (Bahamas) Ltd. v Symphony Gems N.V. and others* [2002] EWHC 1 (Comm) and *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd & Ors* [2004] EWCA Civ 19.

[2] The governing law provision stated: "Subject to the principles of the Glorious Shari'a, this Agreement shall be governed by and construed in accordance with the laws of England."

indebtedness owed to the Islamic financial institution.[1] The Federal Constitution of the UAE provides that Islam is to be the main source of jurisprudence.[2] However, in these proceedings, the court considered that the proper interpretation of the contract was that it was in fact a conventional loan secured by a mortgage over land.

If a Shari'a Supervisory Board wanted the Shari'a to regulate any dispute then, in the context of English law, it might be better to have disputes arbitrated and with the Shari'a being the determining law. There has been a recent decision which has upheld an arbitration provision which directed the arbitral panel to decide disputes in accordance with the Shari'a.[3] While this might prove to be attractive to Shari'a Supervisory Boards, the other parties to a transaction may be concerned about the possible uncertainty as to the interpretation of the Shari'a, and how an arbitral panel would deal with this uncertainty.

As can be seen, therefore, the issue of the *fatwa* does need to be carefully considered in the context of the contractual governing law provisions and the jurisdiction or arbitration provisions. While a secular court might rule in a manner that construed the Islamic finance transaction as being a conventional financing document, this would not, however, affect the validity of the *fatwa* pronounced by the Shari'a Supervisory Board.

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1 Federal Supreme Court judgement issued on 18 November 2001 under appeal No. 411.
2 Article 7 of the UAE Constitution of 1971, as amended.
3 *Sayyed Mohammed Musawi v. R.E. International (UK) Ltd, Sayyed Mohammed Ali Shahrestani, Sayyed Reza Shahrestani and Sayyed Saleh Shahrestani* ([2007] EWHC 2981(Ch)).