

Islamic Finance and the FSA*

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Thank you for the invitation here today, and for giving me the opportunity of setting out the Financial Services Authority-FSA's approach to financial regulation, in general, and to Islamic finance and Islamic banking, in particular.

It is a good moment to devote some thought and discussion to the way in which Islamic finance fits into the global financial system, and to the way in which it should be regulated, in all its manifestations. One particularly good reason for doing so is that, in recent years, there has been a significant revival of the historic tradition of Islamic banking. Some countries, notably Iran, Pakistan and Sudan, have moved to structure their systems on a purely Islamic footing. In rather more countries, Islamic banks have been established alongside conventional banks on the Western model.

There are no solidly reliable statistics on the size of Islamic finance, but it is clearly of growing importance globally and is attracting increasing attention and visibility. Some commentators estimate that the Islamic banking and finance market has grown at between 10% and 15% annually over the past decade and that it is currently worth between \$200 and \$500 billion. As President Reagan once memorably remarked, 'a billion here, a billion there and pretty soon you are talking real money'.

Bahrain and Malaysia are regarded as perhaps the market leaders in the development of international Islamic finance. And indeed both the Bahrain Monetary Agency and Bank Negara Malaysia, the Malaysian central bank, have been among the authorities who have

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come together to establish the Islamic Financial Services Board. They have been helped by the Islamic Development Bank and the IMF to set up the Board, which aims to promote, disseminate and harmonise best practice in the regulation and supervision of the industry. It will be launched in new premises in Kuala Lumpur on 3 November of this year, in the presence of Prime Minister Mahathir. The FSA has been invited to attend.

We hope it will play an important role in guiding authorities, including our own, which so far have limited experience of regulating Islamic financial institutions. One of the expressed aims of the Board will be to set standards and principles for supervision and regulation, consistent with the Sharia law and principles, and to liaise and cooperate with other standard setters around the world.

In the UK, of course, we do not yet have a large well-developed Islamic financial structure. But there is already a reasonably significant amount of business of various kinds. There are no purely Islamic banks in the UK today, but London is an important centre for Islamic banking products. Some UK banks have Islamic windows. HSBC is one notable example. They, of course, have considerable expertise elsewhere in the world of operating within financial systems in which Islamic banks are their competitors and collaborators. And some banks here use the London Metal Exchange for *Murābahah*. The customer buys and sells forward a metal on the London Metal Exchange and earns a profit.

But it is fair to say that most Islamic banking in the UK at present is transacted by relatively wealthy individuals or large institutions. Since there is no focused Islamic bank, and some retail sector Islamic products are rather difficult to construct here at present, I would acknowledge that there is a market gap.

There are approximately 1.8 million Muslims permanently resident in the UK. They make up around 340,000 households. A rough estimate suggests that they have, collectively, savings of approximately £1 billion. And in addition to the permanently resident population there are many Muslims who visit the UK. Last year over half a million Muslims came here from the Middle East and Pakistan, spending nearly £600 million during their visits. So the potential market, whether for savings products, borrowing, or simply transaction-related finance is very large.

Against that background, it is perhaps surprising that, in spite of many initial expressions of interest, and much energy expended by knowledgeable enthusiasts, there have so far been no dedicated Islamic banks established in this country. That certainly does not reflect any lack of dialogue between the FSA and the Islamic community. Those links go well back into the time when banking supervision was the province of the Bank of England, and the current Governor has throughout his time of office taken a particular interest in Islamic financial issues. In September 1999, early in my term of office at the FSA, I hosted a meeting with the Citizens Organising Foundation and Representatives from the Islamic community, at which I tried to set out the FSA's likely new approach to banking regulation and supervision, when we became fully responsible for it, which we did in December last year.

But time has moved on since then. The FSA is now well established as a single regulator for the whole of the UK's financial system, so it is a good moment to take stock of the way we now operate, of the objectives given to us by Parliament, and the way in which those objectives, and the regulations which flow from them, can be transposed to handle the particular needs and demands of Islamic financial institutions.

You will be pleased to know that I do not plan to take you through all 500 clauses of the Financial Services and Markets Act, passed in the year 2000, and which provides the legal basis for our work. Indeed, I will restrict myself to a few words only about clause 1, which sets out the objectives of financial regulation. We are given four main tasks.

First, we are required to work to maintain confidence in the UK's financial markets. That has been something of a challenge in recent months, as we have been blown by forces from across the Atlantic.

Our second principal objective is to promote public understanding of the financial system. That is a new role for a regulator. It has taken us into areas of consumer education which previous regulators have not touched. We have developed materials for use in schools to educate children in the principles of finance. That applies from primary schools right up to the 16–18 age group. We hope that, over time, all that work will have the effect of enhancing financial literacy which is distressingly low in the UK.

Our third objective is to protect consumers of financial services, but bearing in mind their own responsibilities. In other words we are not meant to protect people from any mistaken saving or investment decision they may make. The principle 'buyer beware' certainly still applies. Under that heading we try to ensure that financial institutions in our care are reasonably sound in financial terms, that they offer fair contracts which can be reasonably well understood by consumers, and that there is an ombudsman scheme, and a compensation scheme, to underpin the market when things go seriously wrong, as they sometimes do in even the best ordered markets.

Our fourth objective is to work to reduce financial crime. That objective has gained particular prominence in the last twelve months as international concerns about money laundering, in particular, have come to the top of the political agenda. It is our responsibility to try to ensure that financial institutions have systems in place which protect them against abuse by those who wish to launder the proceeds of organised crime, or who wish to finance terrorism.

I mention these four objectives, because they underpin everything we do, and we must ensure that however we regulate financial businesses we are contributing to those aims set for us by Parliament.

When we translate that to the arrangements for supervising banks, we require new applicants to meet five – what we call – threshold conditions for authorisation as an institution entitled to take deposits in the UK. Some of those conditions, such as the legal status of a bank, its location etc, are entirely straightforward. And the two key conditions are that a bank must have adequate resources and must have reasonable systems and controls to manage the type of business it wishes to undertake in a reasonably sound and prudent way.

How do these principles apply, or how would they in principle apply to an Islamic bank? I should emphasise that we have not yet received a formal Islamic bank application, though we are aware of some interest in doing so, and as I have said we have held preliminary discussions already about how our conditions might be met.

Perhaps the first important thing to say is that we welcome diversity and innovative developments in the world of finance, such as the growing Islamic finance market. London has prospered over the centuries by providing a congenial home for international financial

institutions, and innovation has been its life blood. So we have a clear economic interest, as a nation, in trying to ensure that the conditions for a flourishing Islamic financial market are in place in London. The business opportunity is large and potentially very attractive. We recognise that there are no banks catering specifically to the large and growing UK Muslim population, and I can tell you that in principle we have absolutely no objection to the idea of an Islamic bank on our patch.

But, that said, we will treat applications from Islamic institutions no differently from any other. Of course there has to be a level playing field and it would not be appropriate, or even legally possible for us, to lower our standards for one particular type of institution. Indeed I would strongly argue that since, if it was to be successful, an Islamic bank would need a reputation for capital soundness and proven management, it would in any but the very shortest term be entirely counterproductive to authorise a bank on a different basis from that which we apply to conventional institutions.

But we recognise that, to fit the bill, our requirements would need to be shaped to suit the particular demands of an Islamic bank. Islamic banks differ from conventional banks in four main ways. They offer a rather different range of types of Islamic finance, from *Murābahah* through *Ijārah* and *Salam* to *Istiṣnāʿ*. I know that there are other – to me – exotic products like sukuks. I am not going to stand here today and tell you that I am expert in these different types of transaction. But, ‘I know a man who is’. And we have a small team in the FSA who have made a study of Islamic banking, and its regulation.

We recognise that the risk sharing characteristics of these Islamic contracts are rather different from those in place in a conventional bank. We recognise that there is a mix of contracts on the liability side. In particular, unrestricted Islamic investment account holders share in the risks of the bank, since their deposits have some of the characteristics of equity stakes. It is entirely reasonable to take some of these defined features into account when looking at the capital structure of the bank. If customers genuinely share risks, and understand that they are doing so, that may reduce the amount of capital required.

We also think it is important for Islamic banks themselves to be clear about the type of products they wish to offer. If we were to authorise an Islamic bank we would look carefully at its business plan, just as we do with any other institution. We want to know that it has understood the nature of its market, the profit opportunities open to it in that market, the nature and intensity of the competition, and the types of products it wishes to offer. For example, will the bank offer capital-certain deposit products or not? In some, but not all, Islamic deposits the client's capital is generally at risk if the bank loses money, even if it doesn't fail. If that is so, then it is important potential customers understand that they do not benefit from the deposit protection arrangements in quite the same way as depositors in Western style institutions.

Relevant to this point is the question of whether Islamic banks are truly banks, or are essentially more like fund managers, even though they may offer traditional banking services such as money transmission. I know that this question is one which is often discussed in the Islamic financial community. But I have to say that, now that we are a single regulator, we think it is of rather secondary importance. At least, that is, from a regulatory perspective. Since we have one regulator we have one basic set of conditions for authorisation, which needs to be met by any firm transacting financial business, albeit the details will differ in the case of a fund manager, on the one hand, or a bank on the other.

These differences are, I believe, less important than the similarities. What we are really looking for when we authorise a bank is an organisation which abides by sound principles of corporate governance, which has adequate capital for the risks it plans to take on, and which has a capacity for managing those risks which we believe to be robust. In the case of an Islamic institution, we would include in that advice and assessment of legal and documentation risks, though I think it would not be appropriate, or even possible, for us to check compliance with Sharia law, which is perhaps an additional risk factor which needs to be taken in to consideration. That in our view is a matter for the institution itself.

Before I finish, I wonder if I might say a word about one particular issue which has been of some concern in the Islamic community, the question of Islamic mortgages and how they might be

treated. A working party led by the Governor of the Bank of England, and of which one of my staff is a member, has been looking specially in recent months at the barriers to Islamic mortgages. The main problem we see is that they unwittingly attract stamp duty twice: once when a lender buys a property and a second time when its transferred to the mortgagor. That is a matter for the Treasury and the Inland Revenue to resolve. It seems to me to be the crucial issue to get right, and one on which I cannot offer you a certain answer today.

There is another potential difficulty, though one which I believe to be of somewhat less importance than the stamp duty point.

As far as we can see, the current Basel Capital Accord which governs the principle and practice of banking supervision around the globe today, does not appear to give us discretion for anything other than 100% capital treatment for Ijarah mortgages. For those who find this a baffling statement, perhaps it will clarify things if I simply state that this means a bank would have to carry twice as much capital in respect of an Ijarah mortgage as it would for a conventional mortgage, where the weighting is 50%.

While that it is not necessarily a complete block on the development of the market, it certainly would make Islamic mortgages a little more expensive than conventional ones. This is something we are looking at very carefully at present, in conjunction with the Bank and the Treasury. It is a particularly difficult issue because the Basel rules are incorporated into European Union law. We are trying to look in a sympathetic way at the possibility of a different treatment under the existing rules, and we have asked Islamic financial institutions for more information which might conceivably allow us to propose a case for different treatment.

Even if that were to prove impossible, there is help on the horizon. On the 1st of next month the Basel committee will publish a new version of its capital accord, for consultation. And that would allow a more flexible treatment of Islamic mortgages if it goes through on current plans, which would probably remove this competitive disadvantage. I have to say, however, that we do not expect it to be finally approved for use until around 2006, which undoubtedly is a problem for institutions wishing to get into this market at present.

So let me end where I began. We see no objection of principle to the establishment of an Islamic bank in the UK. Indeed, we would welcome a soundly financed and prudently managed Islamic financial institution in this country, which would be good for Muslim consumers, good for innovation and diversity in our markets, and good for London as an international financial centre. But we have to treat applications from Islamic institutions in the way we do those from other, conventional firms, to ensure that they can compete effectively, and in the long term, on a level playing field with conventional finance providers.