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Challenges for the Islamic Finance Industry—the Need for Uniform Standards of Shari’ah-Compliant Finance

The growth in Shari’ah-compliant financial services over the last decade has been dramatic. Globally, both local and international banks have sought to introduce compliant products and services to their customers in an effort to reach a market eager for Islamic products. However, one of the greatest challenges facing this market are the so-called “after-sales” issues, including the need for clear legal protection, full disclosure and standardization. Government regulation of Shari’ah-compliant finance in the form of regulatory frameworks may provide the harmonization and standardization that the industry needs to succeed.

Shari’ah-compliant finance is one of the fastest growing sectors in the global financial market, with total funds committed to this sector estimated to be in excess of US\$1 trillion worldwide. By definition, Shari’ah-compliant finance refers to a financial product that has been structured or operates in a way that is considered “legal” or “authorized” pursuant to the principles of Islam. Compliance with Shari’ah is achieved by having a Shari’ah authority, either an individual (an Islamic scholar) or most often a group of individuals (a Shari’ah advisory board) possessing authoritative status, approve the particular financial product.

One of the greatest challenges facing Shari’ah-compliant finance is that it is difficult to find consensus among the body of practice that has been adopted by banks and the financial service industry to comply with the legal dictates of Muslim jurisprudence. Similarly, amended regulatory standards and governance requirements now applicable to international financial institutions have not been integrated into the Islamic finance industry to the same extent. The lack of consistency among Shari’ah-compliant products that now exists has made negotiation of contracts more difficult and enforceability of contractual terms less certain and creates conflict and ambiguity in decisions on the veracity of a transaction in terms of its compliance with Shari’ah.

The impact of government regulation on Shari’ah-compliant finance requires a

rudimentary understanding of Shari’ah to grasp the implications. Shari’ah is considered the divine will of Allah as articulated in the Qur’an (the holy book that records the expression of Allah’s will for man) and the Hadith (the body of documents that records the life and behavior of Prophet Muhammed). The legal or instructional verses of the Hadith together make up the Sunnah. In order to discern the detailed laws, norms and customs for a Muslim, the Shari’ah authorities over time have developed schools of jurisprudence to guide their interpretation of the Qur’an and Sunnah. While the jurisprudential rules are generally consistent among the schools, some important distinctions result in different legal interpretations and rulings. As a consequence, the same financial product presented to different Shari’ah schools or advisory boards may result in a very different ruling regarding its Shari’ah compliance. The challenge for government regulators is to harmonize and standardize these interpretations into a consistent and efficient regulatory framework.

Although government regulation of Shari’ah-compliant products may provide more consistency, it may also face opposition. When we consider the basis on which Shari’ah compliance is determined (that is, the infallible, unalterable and authoritative expression of Allah’s will) and then try to impose government regulation (that is, laws created by man) on a Shari’ah-compliant

financial product, such regulation is bound to encounter resistance among the Islamic community. Global standard setting bodies such as the Islamic Financial Services Board (IFSB) and Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) would no doubt need to be involved in developing a regulatory framework to be implemented by any government.

There is no question, however, that a need exists to strengthen regulatory and legislative environments to ensure that Shari’ah-compliant financial products are legally enforceable. Such regulation would need to include, at a minimum, guidelines on product structures, accounting policies and taxation implications. The new regulatory framework must also be compatible with the practices of both mainstream and Islamic finance companies - a framework that is supportive of the key aspects of Islamic finance, while incorporating high standards of disclosure and transparency.

Any regulatory framework would also need to recognize that regulatory attitudes between the Western and Islamic systems can differ greatly. For example, a Western regulator may question whether a Shari’ah advisory board is merely advisory or whether it has executive powers, which would require additional scrutiny. Likewise, the asset and liability structures in Shari’ah-compliant finance ultimately lead to risk sharing (in comparison to risk transfer in conventional finance) and may be viewed negatively by regulators.

As investment in Shari’ah-compliant finance in the West continues to grow and an increasing number of global professional services firms are now embracing Shari’ah-compliant bank products, the introduction of regulatory structures, increased transparency and better corporate governance could boost the uptake of Shari’ah-compliant products.

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