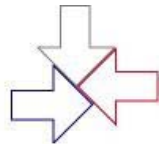


**Islamic Finance Focus Group**

**June 2008**

**Comments upon MFSA Consultation Document**

**“Islamic Finance in Malta – Application to Banking and Securities”**



**MALTA EMPLOYERS' ASSOCIATION**



## **Introduction**

The Malta Institute of Management (MIM), the Malta Union of Bank Employees (MUBE) and the Malta Employers Association (MEA) are firm believers in Malta's potential to attract Islamic finance. The organisations have been organising activities and discussing with the Financial Services Industry on matters relating to Islamic Finance for a number of months. In fact the first ever public activity in Malta was organised jointly in October 2007 following public declarations made in April 2007. The organisations also set up a Focus Group in order to carry out further study into the possibility of Malta becoming an attractive jurisdiction for Islamic finance.

The feedback from the financial services industry was markedly positive and there were various queries on the possibility of tapping into this lucrative market. In this light, the MIM, the MUBE and the MEA have been closely monitoring the development of Islamic Finance.

MIM, MUBE and MEA welcome the MFSA's initiative in issuing the consultation document, and this current document is aimed at providing an analysis on the consultation document issued by the MFSA and to provide suggestions and recommendations for the general benefit of the development of the sector in Malta.

This document includes general feedback on the necessary changes that need to be enacted in Malta's legislation. However, this document is not intended to provide an exhaustive list of changes – this will require a thorough and detailed study that is beyond the remit of this document.

The consultation document issued by the MFSA is a good introduction but naturally does not cover all the legislative changes required. Furthermore a deeper analysis of the Islamic Finance model is required together with the various structures that could be created through the purification of conventional finance.

The consultation document does not include an analysis of some important features. For example, Sukuk is today one of the fastest growing asset classes in the financial industry. EU member states are recognising this and the UK Government, for example is already working on the necessary legislative changes necessary for the application of special purpose vehicles. These may include changes in Duty, tax, Value Added Tax and the eligibility of Sukuk as acceptable collateral by the Central bank amongst others.

The MIM, the MUBE and the MEA feel that the MFSA is to take a more inclusive approach to the introduction of Islamic Finance in Malta – the abovementioned entities were not consulted prior to the issue of the consultation document, and apparently neither was the Islamic community.

This document is made up of two papers commissioned by the MIM, the MUBE and the MEA. The first paper, by Reuben Buttigieg looks into the various aspects of Islamic Finance in Malta and the second paper by Dr. James Muscat Azzopardi takes

a more legal focus. Both papers have been circulated to the members of the focus group and to the respective members in the Financial Services Sector.

Hereunder, one may find the main recommendations that the two papers come up with;

### **Main Recommendations**

- A good understanding of all available contracts in Islamic Commercial law is required by the persons responsible for the development of the sector;
- Liaison with main international bodies on Islamic Finance particularly on Standardisation issues is a must;
- Malta needs to avoid repeating the mistakes made with respect to the Pension Funds which resulted in the failure to attract of appropriate investment. In this respect a team of experts should be set up in order to monitor the developments and study ways on how to attract Islamic Funds to Malta. This may be done within Finance Malta. However, the mechanics of this team should be different from that of the other expert groups in Finance Malta. Finance Malta needs to invest in this lucrative niche;
- The Ministry of Foreign Affairs should be directly involved in the experts group particularly experts of relations with Islamic Countries. Double taxation agreements should also be sought with major Islamic Financial Centres;
- The Focus Group is concerned about issues relating to legal certainty and about the role of Sharia Supervisory Boards;
- The Group also expressed concerns regarding transparency and corporate governance;
- The Group generally agrees with the MFSA's approach towards Sharia compliant funds although ;the Group has some concerns in this regard.

The Focus Group will continue to actively work in the area in order to assist in Malta tapping into this lucrative market. The Focus Group is willing to meet with the appropriate section within the Malta Financial Services Authority in order to develop further its arguments and recommendations.

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15 July 2008

## **Islamic Finance Focus Group**

**June 2008**

### **Comments upon MFSA Consultation Document**

#### **“Islamic Finance in Malta – Application to Banking and Securities”**

##### **A Holistic view – Reuben Buttigieg**

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This Paper has been prepared in view of the MFSA Consultation document issued by the Malta Financial Services Authority. It aims at providing a constructive analysis of the necessary steps Malta needs to take in order to attract Islamic Finance to Malta.

It has been recognised by all major stakeholders including the two main Political parties that this is an important strategic direction that Malta needs to take. In principle, the focus group has agreed to this vision. This paper outlines the considerations and changes necessary in order to ensure to meet this vision. It also provides for some main recommendations that are a must for Malta to succeed in becoming the EuroMed Financial centre.

## **General Comments**

The MFSA Consultation document has some very positive aspects. It however, seems not to have incorporated the main aspects in Islamic Finance as there are certain misconceptions in the document that may lead the MFSA in the wrong direction.

Perhaps the first recommendation with respect to the Islamic Finance, is to analyse the various aspects within a team of experts that possibly include persons already active in the Islamic Community. This is an approach that was taken by the UK FSA and which seems to have been a successful way of taking this market forward.

The document gives the impression that maybe there are only a few changes that are necessary and that there are no major issues or concerns. Whilst in itself this promotes a can do attitude it is also of some concern as it is not evident whether the person developing the document is fully acquainted with Shariah Finance.

## **Central misconceptions**

There is a fundamental central aspect to Islamic banking missing from the MFSA Consultation document document. Islamic banking differs fundamentally from conventional banking. Islamic banks cannot involve capital guarantees to their investment account holders. This goes against the whole principle underlying deposit protection in the Banking Act of every country in the world. In other words depositors

in Islamic banks must accept the principle that their deposits could be totally wiped out in the event of some negative developments on the asset side of the balance sheet. Bank failures, in turn, bring about the risk of System risk to the whole of the banking system.

There is no mention in the document of how the MFSA plan to deal with this risk or whether the nature of the risk is acknowledged. This is a major concern and as highlighted in the second paper of this document this should be of major concern to the MFSA on how the message given to the investors.

### *Basel 2*

The broad framework of Basel 2 consists of three pillars. Pillar 1 sets out the minimum capital requirements firms will be required to meet for credit, market and operational risk. Under Pillar 2 firms and regulators have to decide whether a firm should hold additional capital against risks not covered under pillar 1. The aim of Pillar 3 is to improve market discipline by requiring firms to publish certain details of their risks, capital and risk management.

The apparent incompatibility of the Basel accords with Islamic finance may be an issue for Malta. Internationally, this apparent disaccord drove the foundation of the Islamic Financial Services Board. The MFSA should confront the issue at the early stages and prior to any application possibly through discussions with the aforementioned board.

In view of the nature of Islamic Finance one may say that Certain risks affect Islamic institutions more than conventional firms. These risks would need to be quantified and where this is not possible or capital is not an appropriate mitigating tool then other ways of managing these risks will need to be identified and addressed.

## **Risks Specific to Islamic Finance**

There are various risks which are common to both Islamic Finance and conventional finance. However, as stated beforehand there are risks which are specific to Islamic Finance. From experiences of other European countries it is evident that there are also risks of firms operating Islamic Windows. This section aims at highlighting some of these risks.

There are contrasting views on whether certain practices or products are Shariah compliant or not. The MFSA will be in no position to assess the suitability of scholars consulted by the specific firms. However, if Malta is to have any valid credibility or reputation in promoting itself as an Islamic Finance centre it needs to ensure that claims of Shariah compliance is true for the protection of the investors. In this respect the MFSA should initiate discussions with standards organisations such as the Islamic Financial Services Board and the Accounting and Auditing Organisation for Islamic Financial Institutions. The MFSA should promote together with other FSAs the standardisation in order to ensure the risk of arbitrage.

### **Solvency**

Islamic Finance Institution may have a higher risk of solvency than conventional finance institutions. Shariah Compliance is a continuous process and in this respect they need to be continuously monitored. Some products, if they breach Shariah compliance rules, can adversely affect a firm's solvency by turning an asset into a liability.

In view of this, the MFSA needs to ensure that the firms have the necessary structures to constantly comply with Shariah law if they claim to be Shariah compliant. The MFSA has the duty and responsibility to ensure that investors are being properly informed.

### **Contracts**

In contracts for Islamic transactions, the enforceability of terms and conditions depends on the governing law. However, it is unlikely that a Maltese court will give a verdict based on Shariah Law. There is a precedent in the UK that is the case of *Shamil Bank of Bahrain EC v Beximco Pharmaceuticals Ltd et al*. In that case, the court of appeal ruled that it was not possible for the case to be considered based on principles of Shariah law.

To mitigate this risk, contracts have to be written very carefully to minimise potential disputes and state the governing law. In this respect standardisation is crucial and continuous discussion with Islamic Community to ensure to take all necessary measures to mitigate risks is fundamental.

### **Risk of Success**

If Malta is successful in attracting a number of Islamic Finance Institutions there is the risk that Islamic Finance takes a substantial share of the market. This with it brings a major risk in the case of an economic downturn.

Islamic Finance industry is still a very young industry. However, the various business models have not yet been tested in a severe economic or market downturn. In this scenario, a significant failure in the Islamic market might have a damaging impact on the future development of not only the sector but also on the development of Malta as an International Financial Services Centre.

Malta should ensure that the appropriate balance between Islamic Financial Institutions and conventional institutions remains as such to mitigate such risk.

### **Risk Mitigation**

Many of the tools used by conventional finance to manage risk such as hedging are not acceptable to almost all Shariah Scholars. Although risk management in the past has been difficult for Islamic Firms, new products and techniques are emerging.

Liquidity management may also be difficult in view of the non availability of Shariah compliant products. For example, investment such as Government bonds and intra bank deposits may not be possible if insufficient Shariah compliant products are available. The attraction of Islamic Financial Institutions to Malta may also want or

need to ensure that certain products are available. For example the Government of Malta may start issuing Sukuk which will not only provide solutions but will in itself act as a Marketing tool in the Islamic world. Also in this area new products are emerging also in European countries such as Commodity Murabaha transactions . The use of Special Purpose Vehicles may also be necessary.

### *Synergy and Correlation between Islamic Finance Products*

The synergy and correlation between the three components of Islamic Finance can be illustrated as follows. A customer may seek Islamic house financing under Murabahah or Ijarah Financing. To secure the interest of the bank, the bank may impose the customer to subscribe to mortgage Takaful. Under this scheme, if the customer were to die during the financing period, then the Takaful fund, which is based on donation , will settle all outstanding financing amount to the bank. On the other hand, a Takaful company will also have to invest the Takaful contribution or premium unapproved shares and fixed income instruments. The Islamic Capital Market will provide products for this purpose. Also, Islamic Banks may need to hedge some risks in their operation. Islamic risk management tools or Islamic derivatives provided by Islamic Capital market will be useful

## **Human Resources**

There is a global shortage of experienced professionals in the Islamic Finance sector. The shortage of resources is at all levels. Malta's main advantage may be the investing in resources and in education and training. There has been a clear interest from the sector in the activities organised by the MIM and the MUBE and the sector has shown an eagerness to learn.

Close relations with Islamic countries and a highly trained finance sector may present a unique opportunity for Malta not only through Islamic Finance products made available in Malta but also through the provision of services to Islamic Finance Institutions in other countries. One may work on the same example of the Valletta Fund Services but with respect to Islamic Finance. This might sound straightforward but the various services may influence on whether a financial product remains Shariah compliant or not. In this respect , it is not just an exercise of applying the current structures to Islamic Finance.

## **Marketing**

Islamic Finance will not flow to Malta merely because it has changed legislation. The Malta Government should be ready to invest in this niche. There are various ways on how major Islamic Finance Institutions may be attracted to Malta.

Malta's main advantage over other jurisdictions is that there is one regulator who can be close to the industry. Finance Malta can also act as a fast track analyst to ensure that the necessary changes on various laws occurs within reasonable timeframes.

The Malta Government can have a major role in marketing Malta. It can be the first to issue Sukuk and to attract the Islamic Finance world attention onto Malta. Strategically one may also use the Smart City project to promote Malta as an Islamic Finance Centre. Malta can benefit even more than it planned from such a project.

The Malta Stock Exchange can have a main role in Malta becoming a Islamic Finance Centre. It could be an opportunity and a way of increasing the scope of the Malta Stock Exchange. The Islamic Indexes in other countries such as Dow Jones had a major role, The Malta Stock Exchange may create a Shariah Capital Market. Maybe this could also reactivate the Borzamed project. The stock exchange may have a Shariah Index and a Shariah Screening process.

The Muslim community in Malta can assist in the promotion of Malta as an Islamic Financial Services Centre. The Muslim population of Malta is estimated to be about 3,000, of whom 2,250 are foreigners, 600 naturalized citizens, and 150 Maltese, mostly women who converted soon after marrying Muslim men. The Community should be involved even in the process of developing the necessary products and they should be part and parcel of the consultation process.

The consultation process of the Islamic Finance can be a promotion tool in itself. The MFSA should take a more inclusive approach for the benefit of the industry.

## **Operations**

### **Contracts under Shariah**

Islamic financial products are based on a variety of contracts. The selection of a particular contract is relatively easy compared with the incorporation of all the relevant terms and conditions to render a product both Shariah Complaint and commercially viable.

It is possible to have a number of contracts that meet the requirements of common products. For example in both savings and current accounts three contracts are used namely Wadiah, and/ or Hassan and Mudarabah.

#### *Musharakah*

The MFSA report refers to the Musharakah contract. This contract imposes on both parties to contribute capital. The loss must be borne by both parties in proportion to their capital contribution. However, the profit is negotiable based on certain ratio or percentage. Both parties under this type of contract can participate in the management of the business venture, although either one of them or both have the right not to be involved. However, it is likely that they will be involved given that this is one of the main difference with Mudarabah contract.

This type of contract may be preferred to other types of contract since it gives the Islamic Finance Institution the right to oversee the management of the project and hence limit its risk. This contract gives executive powers to all partners

Depending on the type of contract their could be tax and Duty on Documents implications. The partnership, for example, would invest in the project jointly but the Islamic Financial Institution may want under a separate contract to transfer its share to the other party. Further more the tax issues related to rent should be considered as well. Some structures may also lead to some VAT implications.

In doing its analysis and review the MFSA should also consider the various Musharaka structures that may exist and how these may be regulated. In fact, there could be circumstances whereby through the use of Special Purpose Vehicles conventional finance may be effectively used in the Musharaka structures This could also lead to current credit institutions windowing into Islamic finance.

Various clauses in the Financial Institutions Act may heavily limit commonly used structures in Musharaka contracts. The MFSA report makes reference to possible changes in the Banking Act but has not referred to the limitations that the Financial Institutions Act may bring particularly in the management of the Institution.

### *Mudarabah*

Mudarabah is based on one party providing capital to the partnership and the other providing work and management. There cannot be a situation where both contribute capital and work. To be consistent with the contract construction, the losses must be borne by the capital provider only. The manager will only lose his time and effort . Also, the capital provider cannot be in charge of the administration and management of the venture. These are to be assumed by the manager.

### **Security Contracts**

The MFSA report does not address the issue of security contracts. There are some distinctive features that differentiate one contract from another in the context of security contracts. The features suit different circumstances in real market practice. One feature that is common to all contracts in this category is that they are not primary contracts with original rights and liabilities. The need for a security contract arises only to secure the rights and liabilities that originate from primary contracts, such as sale, lease and investment contracts. In the absence of a primary contract these security contracts are meaningless because they have no interests to protect.

The way security is provided and given that they are two separate contracts may give rise to a higher risk assessment by the authorities on the transactions done by Islamic Finance Institution.

### **Istitina**

Istitina is a contract designed to enable a purchaser to order an item to be constructed and delivered in the future. The payment could be made in advance or any manner agreeable to both the purchaser and the seller/contractor. Typically, , both the purchaser and the seller are the ultimate purchaser and seller respectively. An advance

payment or payments based on the progress of the construction, if applicable, would help the contractor finance his cost of construction.

Realising that an Islamic Bank is neither an ultimate purchaser nor an ultimate seller or contractor, jurists have put forward an alternative structure that is based on proper and approved financial engineering. This structure is called parallel Istisna' (Istisna Muwazi) refers to a contract of two independent and non related contracts of Istisna.

The liability of both buyer and seller in these two parallel Istisna Contracts are not contingent upon one another.

There are various implications in this scenario with respect to Malta legislation including taxation and duty issues.

### **Operating and Financial Leases**

An Ijarah involving the usufruct has two main types , namely an operating lease (Ijarah Tashghiliyah) and a financial lease (Ijarah muntahia bi tamlek)

An operating lease is a straightforward lease where the owner/bank will purchase the asset from the vendor and subsequently leases it to the lessee/customer at an agreed rate of rental for a defined period. Upon the expiry of the lease contract, the lessee must return the asset to the same lessee or decide to lease to a third party . The lessee has no right to purchase the leased asset from the lessor.

Another type of lease is the Ijarah Muntahia bi tamleek, which is loosely translated in English as Financial lease or an Islamic hire and purchase contract. It refers to the transfer of the usufruct of a particular property to another person to exchange for rent. The lease will end with the transfer of the leased property from the lessor to the lessee. The price and manner of ownership are normally agreed in advance.

Financial leasing is not a common practice in Malta particularly in the case of houses and property. If this practice evolves there could be high implications from an Income Tax point of view.

### **Bank Accounts**

The analysis of the bank accounts made within the consultation document seems to be superficial. In actual fact the document does not refer to the types of underlying contracts that exist under each type of account.

Savings accounts aim to facilitate the keeping of depositors' money in an account that is safe whilst giving the depositors the flexibility to withdraw their money and opportunity to benefit from some income from the savings. The contract that could facilitate this purpose could be Wadiah (Safe custody) , Qard/Hasan (interest free loan) and Mudarabah (profit sharing). Although each of these contracts has their distinctive features they are able to satisfy the above aim and objective in their own way. So the initial statement within the MFSA report is not a precise one with respect to savings accounts. It depends on the type of contract.

The same contracts are used to structure Islamic Current Accounts. Account holders under both Qard/Hassan and Wadiah contracts are deemed to be lenders to IFIs and the rules and principles regarding money lending would be the same as those that relate to Islamic savings account. However, Mudarabah contract is not used as a primary contract in Islamic Current Accounts. Currently, it is coupled with either a Qard/Hassan or Wadiah contract to make it more feasible. This account is simply a hybrid of both a liability contract and an investment contract. It is a condition of such accounts that they must maintain a minimum balance to enjoy Mudarabah features, otherwise they will be treated as under a liability contract with no profit sharing feature.

Investment account is typically based on a Mudarabah contract in which depositors provide the capital and IFIs provide the work and management. The profit, if any, is to be shared between the depositors whereas any loss will mean that the bank loses time, effort and expected profit.

An Islamic deposit account can give a fixed income to the depositors. The contract used is Tawarruq which is simply a sale transaction involving three independent parties or more. For this account, the depositor, for example will appoint IFIs to purchase a particular asset from a prime broker at “x” amount on cash basis and subsequently, thereafter, sell the same asset to this bank at “x+y” to be paid, let us say, after one year, which corresponds to the tenure of this deposit account. Under this contract and structure, the depositor is deemed to deposit the “x” amount in the bank but will get “x+y” in return.

The MFSA report does not analyse the different financing aspects of products and no distinction seems to be made between the equity based financing and debt based financing. Contracts like Inah and Kafalah which are used in overdraft, credit card usage and cash financing are not analysed at all.

### **Shariah Funds**

Although generally one may be in agreement with the statements in the MFSA document there are incorrect statements in this section as well. For example equity funds can involve haram activities as long as they are later “purified”

From a Shariah perspective there are no major issues with regards to the structure or features of funds. Indeed the Shariah perceives investors as one entity that pools its monies together for the same investment objectives. Investors in this scheme are Musharakah partners as each investor invests in the scheme. What is more relevant is the possible investment assets, for example, stocks, bonds, bank deposits or short term papers or money market instruments.

MFSA needs to ensure that the investors are really investing in the funds they require. Henceforth the funds should be monitored and be requested for example to submit on a regular basis a shariah compliance certificate if they claim to be a shariah fund.

## **Types of Fund**

### *Ijara*

Ijara in Arabic means rent or lease. An Ijara fund is therefore a fund which buys real estate, machinery, vehicles or other equipment in order to lease the said assets to the ultimate users. The ownership of the property/goods remains with the fund and the users are charged rental fees.

An Ijara fund is usually managed by an agent who is paid a fixed fee. This is because Shariah scholars were of the view that mudaribs may only be used for the sale of commodities and not for leasing businesses and the provision of services. However, this view is generally being replaced by that of more contemporary scholars, who argue that it would be permissible for an Ijara fund to be managed by a mudarib as opposed to an agent.

For an Ijara fund to be considered compliant it must fulfil the following conditions:

- Asset Leased must have usufruct
- Rent may only be charged from the moment the usufruct is handed over;
- The leased asset must not be used in prohibited business;
- The lessor must retain all responsibilities of ownership of the assets;
- At the beginning of the lease contract, the rental price must be known to the parties; and
- The rental price must be fixed.

### *Commodity Fund*

A commodity fund may be considered Shariah Compliant if the following conditions are fulfilled:

- At the time of sale, the commodity is owned by the seller;
- The sale is not a forward sale (unless it fulfils the conditions of salam or istisna contract
- The commodities bought and sold are not of a prohibited nature
- The seller exercises physical or constructive possession over the asset to be sold; and
- The commodity's price is fixed and known to parties

### *Murabaha funds*

A murabaha is a type of commodity fund in which the fund purchases a commodity for a certain price and then sells it immediately to the ultimate user on a cost plus basis. The user agrees to repay the purchase price on a deferred payment basis. In

order for such a fund to exist, it must be closed ended and its shares cannot be negotiable. This is because the fund will not own any tangible assets; its entire assets will consist of the receivables owed to it by the ultimate users.

### *Mixed*

A mixed fund is one which invests in leases, commodities and/or various other equities. Such a fund must follow the rules prescribed for each type of investment, whether it is investing in leases or commodities. The units in a mixed fund may be negotiable or non negotiable depending on the proportion of liquid to illiquid assets.

### **Main concerns that one needs to address**

- Muslims have the duty to object if the fund is not Shariah Compliant. In order to have credibility, the MFSA should think of ways how to ensure minority rights.
- There might be tax implications and discriminations one may need to address in the case of certain structures for example since the fund may be seen as trading in property will it still be exempt from income tax as other collective investment schemes?
- One needs to ensure that the customers are protected and that if any fund claims to be Shariah compliant it really is.

## **Islamic Finance Focus Group**

**June 2008**

### **Comments upon MFSA Consultation Document**

**“Islamic Finance in Malta – Application to Banking and Securities”**

**Legal aspects – Dr. James Muscat Azzopardi B.A., M.A., LL.D**

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#### **Introduction**

Dr. James Muscat Azzopardi has been commissioned by the MIM and the MUBE to draft a legal reaction to the MFSA’s Consultation Document on Islamic Finance in Malta.

The comments are numbered according to the relative Chapters within the Consultation Document for ease of reference.

#### **1. Chapter 3 - Sharia Principles and the Islamic Economic Model**

The Consultation Document includes a brief summary of the basic principles that form the basis of Sharia law regarding commercial transactions. We would like to point out some other points to be taken into consideration in this regard – our comments will highlight both positive as well as negative issues.

##### **1.1 Positive Aspects**

First of all, the Focus Group points out that Malta’s decision to embrace Islamic finance will be perceived as a political issue as well as a financial and legal decision. This decision is seen as a positive step in terms of inclusion - the setting up of a regulatory system that includes the possibility of Islamic finance will allow Muslims to access markets that have until today been solely based upon Western principles. This approach has been followed both by the FSA in the UK as well as by the Federal Reserve in the US, in accordance with the principle that all citizens should be allowed to fully observe their religious convictions (unless contrary to public policy).

We are aware that the decision to promote Malta as a centre for Islamic finance will also lead to a concerns regarding terrorist finance. However, we see this as a positive rather than a negative issue – Malta is today known to be a reputable jurisdiction and the MFSA has an excellent reputation in addressing concerns regarding the source of

funds. It is naturally far easier to control funds that are domiciled in reputable jurisdictions, as has been the case with London.

Islamic finance is also attractive to non-Islamic investors who are seeking ethical investment, also referred to as Socially Responsible Investment (SRI). Such investors are attracted by the prohibition of investment in morally questionable activities such as the gambling and betting industry or the pornography industry.

## **1.2 Concerns**

The decision to allow Islamic finance also leads to other concerns, principally about the lack of certainty surrounding the principles of Sharia law and in relation to issues of corporate governance, especially in relation to the role of the boards of scholars that decide upon the interpretation of Sharia law.

### *i. Legal Uncertainty*

Unlike the Western systems of civil and common law, Sharia law remains largely subject to varying interpretations, and this leads to legal uncertainty. A particular transaction may be deemed to be Sharia-compliant by one Board but rejected by a different Board.

This uncertainty is outside the scope of the MFSA and of Maltese legislation, but the Focus Group is concerned about the possibility that any disputes about structures that are set up in Malta may have a negative effect on Malta's reputation as a financial services centre, especially if the structure is internationally well known.

A lack of certainty may also lead to loss of consumer confidence in products offered by credit institutions. In extreme cases, a lack of defined rules regarding Sharia compliance or otherwise may lead to a sudden and general lack of confidence in a credit institution should the institution enter into a transaction/s that may be viewed by certain scholars as being contrary to Sharia principles.

One possibility is that of introducing legislation whereby all contracts are regulated by a recognised and approved law, such as the law of an EU member state. Indeed, several Islamic transactions are today regulated by UK law. It would then be up to the parties to ensure that their relationship is compliant with Sharia law, however Maltese Courts will be able to decide on the transaction by applying Maltese law.

### *ii. Role of Sharia Supervisory Boards.*

It is clear that the MFSA is not in a position to decide upon whether a proposed structure is compliant with Sharia law – this would be up to the Board of Islamic scholars, usually known as the Sharia Supervisory Board (SSB).

In brief, the Focus Group is concerned at the corporate governance issues that arise as a result of the influence on a credit institution that is exercised by a Board, which Board is itself unregulated, unsupervised and unaccountable.

The Focus Group is also closely following developments in London, and shares the FSA's concern about the precise role of these Boards. The FSA currently examines whether the role of the SSB is executive or advisory – the FSA's concern being that an executive role may lead to issues relating to the fitness or otherwise of the advisors and possible conflicts of interest if the same SSB is advising several different structures.

The SSB is responsible for verifying that all banking operations are practised in accordance with Islamic law. Thus it has the authority to reject any application or project that is believed to be in contradiction with Islamic law. The Focus Group is concerned that this may lead to a situation where the SSB exercised an unhealthy measure of discretion over a credit institution's commercial decisions, which may ultimately be prejudicial to shareholders. The integrity of a credit institution is therefore directly dependent on the integrity of the SSB, but the SSB will not be regulated by the MFSA.

Another concern is the possible issue of conflict of interest - in a relatively small jurisdiction such as Malta, credit institutions will be depending on the same SSB, who will therefore be provided with detailed information about transactions carried out by different institutions.

The Focus Group is also concerned about the increased risk of insider trading associated with these Boards, especially in view of the fact that the SSB are not regulated per se.

The Focus Group recommends that as far as possible, the MFSA attempts to ensure that the role of the SSB is clearly defined and is well-known to customers, in light with the Basel II requirements regarding transparency, as discussed below.

### iii. *Transparency and Corporate Governance*

Another of the Focus Group's concerns relating to the role of the SSB is that of transparency. Article 809 of Basel II states that market discipline requires measures that "allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution." The MFSA is to ensure that Islamic Banking institutions that are licensed in Malta keep customers fully informed about the principles that govern the Bank's governance. Any uncertainty regarding the interpretation of Sharia law will inevitably lead to uncertainty about the corporate governance of Islamic Banks. We will address this concern in further detail in due course.

## **2. Chapter 4 – Islamic Banks and Financial Institutions**

### *2.1 Musharaka: Joint Ventures/Equity Participation*

The Focus Group has several concerns regarding musharaka transactions, especially in regard to corporate governance and project risk. One concern is the potential liability of the financial institution in the eventuality of insolvency of the joint venture. Will banks be required to ensure that all liabilities are immediately accounted for?

One must also consider the possibility of Maltese Courts piercing the corporate veil (vide recent judgements in Price Club cases), which would lead to the Bank being held to be liable for any debts incurred by the joint venture. We recommend that the MFSA ensures that these concerns are adequately addressed while enabling musharaka transactions, and we also recommend that the MFSA retains the current limitations on credit institutions' funds being invested in other companies as arising from the Banking Act.

We note that the MFSA intends to “review these requirements in order to determine whether they should be retained/revised in view of the above operational structure of a Sharia Institution”. The Focus Group recommends that the requirements are not changed specifically for Islamic banks – there cannot be any discrimination between Islamic or other credit institutions, as this would naturally be unfair on non-Islamic institutions.

### *2.2 Mudaraba: Profit Sharing*

These types of transactions lead to the credit institution's association in the risk factors inherent in the borrowers' business, and as regulator the MFSA is to ensure that this risk is adequately catered for.

It is very important to point out that under the traditional view of mudaraba, customers who “deposit” assets in an Islamic credit institutions are not depositories but are effectively holders of profit-sharing and loss bearing investment accounts. Indeed, in a typical Islamic bank structure, these accounts make up the majority of the assets that are available to the Bank for investment.

However, holders of these accounts do not enjoy any governance rights, although they are effectively shareholders in the credit institution. In fact, there is a considerable difference between the rights enjoyed by actual shareholders in the credit institutions and those enjoyed by customers, who as we have seen are effectively shareholders since they participate in any profit or loss by the institution.

The Focus Group has also considered the difficulty that arose in the UK regarding the definition of a deposit. Under our Banking Act, a deposit is defined as “a sum of money paid-in on terms under which it will be repaid, with or without interest or a premium and either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and the person receiving it”. However, under a typical mudaraba contract the customer is required to accept the loss of the capital.

The FSA’s solution was to require the credit institution in question to state that all its depositors were entitled to full repayment of all deposits. The customer would then enter into a voluntary agreement whereby he/she would accept to relinquish to the right to full repayment.

Finally, the Focus Group highlights the concern regarding the compatibility of mudaraba transactions with Basel II requirements regarding the necessary mechanisms for effective discipline over the governance of the credit institution.

### *2.3 Murabaha: Cost Plus Contracts*

The Consultation Document has already mentioned the risk factors associated with the ownership of the assets by the credit institution.

However, it is our view that murabaha contracts will be facilitated in Malta by our system of hypothecs as security over assets, as opposed to jurisdictions where the only security allowed in the actual pledging of the assets in question.

In fact, the Focus Group is of the opinion that from the legal point of view a murabaha transaction is not that different from a traditional loan secured by a hypothec over property, apart from the question of transfer of ownership – until a loan that is secured by a hypothec is paid, a credit institution in Malta is effectively the owner of the property in question, and may exercise the right to such ownership in the case of default on loan repayments.

The similarities and differences between murabaha transactions and Maltese Civil Law provisions relating security for loans deserves more detailed study.

### *2.4 Bai’ muajjal: Deferred Payment Contracts*

We note that the Consultation Document has already addressed the two principal legal concerns associated with this type of transaction – the operational restrictions imposed by the Banking Act and the necessity of drafting legislation that will avoid the imposition of additional stamp duty on the extra transaction.

## *2.5 Ijara: Leasing*

In the view of the Focus Group, as long as a transaction is treated by an Islamic credit institution as a finance lease, then this type of transaction should not create any significant legal obstacles in light of current Maltese legislation. However, this will depend on the particular interpretation of Sharia law that is applied - according to certain interpretations, the bank as lessor in an ijara transaction is to be exposed to a significantly higher level of operational risk than a lessor under a conventional finance lease.

The Focus Group recommends that the MFSA ensures that contracts relating to ijara transactions are based on standard deeds that are compliant with Maltese law relating to finance leases.

One must keep in mind that the concept of an Islamic contract is fundamentally different from the common law/civil law notions regarding contracts. This is a general observation, and does not only apply to ijara leasing. Islamic contracts are to be based on equality, and it is fundamental that the different options available to each party are included in the contract. This implies that a party may avoid the transaction that is the object of the contract even after the contract has been signed – this is a notion that does not fit in with the Maltese legal system and this is why we are recommending the use of Maltese law in regard to products to be licensed by the MFSA. An Islamic contract may also be null if it is found to result in *riba* or *gharar* – generally translated as interest and inequality or uncertainty.

The Focus Group also points out that Ijara leasing (including an ijara with diminishing musharaka) may lead to civil law issues relating to creditors' rights in the case of insolvency of the purchaser/lessee – there appear to have been no reported cases in the UK until now, but we look forward to this issue being clarified by UK courts in due course.

## *2.6 Bai 'Salam: Pre-Paid Purchases of Goods*

The Focus Group is concerned about the level of risk that is associated with this type of transaction – as we are dealing with commodities, the principal risk is the price risk in case of default. Again, this risk is to be assessed in the light of the requirements of Basel II.

## *2.7 Bank Accounts*

We have already addressed our concern in this regard in Section 2.2 above.

## **3. Chapter 5 – Sharia Funds**

The Focus Group agrees with the position taken by the Consultation Paper – as long

as Sharia-compliant funds confirm to the requirements set up by Maltese law, such funds are to be allowed to set up as PIFs. The question of whether the funds are Sharia compliant or otherwise is strictly outside the remit of the MFSA, for obvious reasons.

However, this is another area where the role of the SSB (as well as the extent of influence) is to be clearly defined when structuring and licensing the fund in Malta.

#### **4. Chapter 6 – MFSA’s approach to authorisation**

The Focus Group strongly recommends following the approach taken by the FSA in this regard. This recommendation is based on the fact that Malta is in a similar position to the UK – a non-Muslim country attempting to accommodate Sharia compliance within a common law jurisdiction. We are following developments in other centres of Islamic finance such as Dubai and Bahrain, however these developments are of limited relevance within the local scenario. Notwithstanding the above, one cannot ignore developments in Malaysia, since Malaysia has proven to be remarkably innovative in the field of Islamic finance - in 2005 Malaysia issued the world's first rated Islamic residential mortgage backed securities, and in 2006, the world's first listed Islamic Real Estate Investment Trusts (REITs).

The recent paper on Islamic Finance in the UK, published by the FSA in November 2007, describes the FSA’s approach as “non-discriminatory” and correctly points out that it would not be fair for the FSA to vary its standards for any one type of operation. We recommend that the MFSA adopts a similar attitude, summed up by the abovementioned paper as “no obstacles, but no special favours”.

In fact, as long as properly regulated, Sharia compliant structures may prove to be ultimately even safer than conventional financial products. Apart from the normal KYC and anti-money laundering provisions, professionals working on Sharia compliant products are also required to carry out a thorough examination of all sources of funds in order to ensure Sharia compliance, and this may be considered to be an extra level of filtering. The prohibition of any funds coming from the gaming and alcohol industries is also an advantage, as the gaming industry is well-known for its high prevalence of money laundering opportunities such as online poker rooms.

The Focus Group feels that it is in the interest of the MFSA to issue clear guidelines about the possibilities of structuring Sharia compliant products in Malta. This will allow the promotion of Malta as a possible jurisdiction for Sharia compliant products.

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