

WP/15/107

IMF Working Paper

Islamic Finance, Consumer Protection, and Financial Stability

by Inutu Lukonga

I N T E R N A T I O N A L M O N E T A R Y F U N D

IMF Working Paper

Middle East and Central Asia

Islamic Finance, Consumer Protection and Financial Stability

Prepared by Inutu Lukonga

Authorized for distribution by Zeine Zeidane

May 2015

IMF Working Papers describe research in progress by the author(s) and are published to elicit comments and to encourage debate. The views expressed in IMF Working Papers are those of the author(s) and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

Abstract

Consumer protection and financial literacy are essential pillars of a well functioning and stable financial system. As the global financial crisis demonstrated, inadequate attention to consumer protection and financial literacy can lead to financial instability. Though Shari'ah principles provide a strong foundation for consumer protection, the principles alone cannot provide adequate protection because not all providers are guided by ethical precepts and the practices have deviated from the principles. To safeguard the stability of the Islamic finance industry, consumer protection frameworks that cater to the specifics of Islamic financial products should be an integral part of regulatory frameworks.

JEL Classification Numbers: G20, G21, G24, G32, G38, K22

Keywords: Islamic Finance, Consumer Protection, Financial Stability.

Author's E-Mail Address: ilukonga@imf.org

CONTENTS	PAGE
Abstract	2
I. Introduction	4
II. Consumer Protection and Financial Stability.....	5
A. The Financial Stability Nexus.....	5
B. Elements of Consumer Protection.....	6
III. The Case for Consumer Protection in Islamic Finance	7
A. Industry Growth But Limited Consumer Choice.....	8
B. Product Characteristics.....	11
C. Conventional Deposit Insurance Schemes	19
IV. Current Practices in Consumer Protection.....	19
V. Conclusions and Options for Strengthening Consumer Protection	24
 Tables	
1. Status of Legal Frameworks for Consumer Protection.....	21
 Figures	
1. A Framework for Consumer Protection in Islamic Finance	7
2. Growth of Islamic Finance Assets	9
3. Sukuk Market Size, Growth, and Structure	10
4. Concentration in the Islamic Banking Sector	11
5. Strength of Legal Rights	22
 Boxes	
1: Sukuk Defaults and Legal Risks.....	17
 Appendixes	
1. Sukuk Structures	33
References.....	30
 Annexes	
1. Characteristics of Selected Islamic Financial Products	38

I. INTRODUCTION¹

1. Consumers of Islamic financial products have increased to critical proportions, thus consumer protection frameworks that cater to the specifics of Islamic financial products should be an integral part of regulatory frameworks in countries where the industry exists. Although still a small share of global finance, Islamic finance is growing rapidly in value and geographical reach. The banking sector is now systemically important in a dozen countries and growing in many other countries. By end December 2013, consumers of Islamic banking products were estimated at 30 million (Enerst and Young (2013)). The Sukuk market has also registered phenomenal growth; the structures have become increasingly complex; and the issuer base has broadened to include advanced, emerging market and developing countries on one hand, and sovereigns and corporates on the other. The growing complexity of products can make it difficult for consumers and investors to discern risks while the broadening of issuers exposes investors to differing counterparty risks.

2. In the aftermath of the global financial crisis, many countries integrated consumer protection in their regulatory frameworks, but progress has been uneven across countries and few have tailored the frameworks to address the unique risks of Islamic finance. A number of international bodies, including the Islamic Financial Standards Board (IFSB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI); and the International Islamic Financial Market (IIFM), have issued standards to cater to the specifics of the Islamic finance industry, but adoption of the standards has been uneven across countries and the development of standards is still evolving.

3. This paper aims to contribute to ongoing efforts to strengthen the architecture for consumer protection in Islamic finance as part of the broader effort to safeguard the sound development of the sector. Outside the work of the regulatory bodies, research on the protection of consumers of Islamic financial products is limited and remaining gaps in the regulatory architecture for consumer protection in Islamic finance have not been assessed. The few studies on consumer protection in Islamic finance include the paper by Mamhood [2012] which analyzed the prospects of extending an Investor Protection Framework to the Islamic Capital Market in Malaysia; the IFSB [2013] paper that analyzes product regulation that could foster stronger protection for consumers of Islamic financial products; and the IFSB/IOSCO [2013] joint review on issues, risks and challenges arising from potential inadequate disclosure in the areas of Sukuk and Islamic Collective Investment Schemes.

4. The paper focuses on Islamic banking products and Sukuk, which together account for 95 percent of the Islamic finance industry. It highlights sources of information asymmetries that can result in consumers making uninformed decisions, as well as potential avenues for consumer exploitation in the design of Islamic financial products that could

¹ For clarification of the Islamic terms, please see Appendix 1

affect the sound development of the industry. It also evaluates the adequacy of current legal and regulatory frameworks for consumer protection, and discusses policy options for strengthening them. The analysis is based on the experiences of a sample of countries, including Bahrain, Egypt, Iran, Jordan, Kuwait, Lebanon, Malaysia, Oman, Qatar, Saudi Arabia, Sudan, the United Arab Emirates, the United Kingdom and Yemen.

5. The main conclusions of the paper are that Shar'iah principles, which govern Islamic finance, provide a strong foundation for consumer protection, but the features alone cannot guarantee adequate protection for consumers, because not all providers are motivated by ethical precepts, and the practice sometimes deviate from the principles. Consumer protection frameworks for conventional financial products are relevant to Islamic finance, but they need some adaptation to address risks specific to Islamic financial products. In particular, reforms are needed to address consumer vulnerabilities from current practices with respect to Profit Sharing Investment Accounts (PSIA), Ijārah Muntahia Bittamlīk, and conventional deposit insurance schemes as well as to address the legal risks for investors in Sukuk, particularly in cross border default cases.

6. The remainder of the paper is structured as follows. Section II presents the conceptual framework for consumer protection, highlighting the nexus between consumer protection, financial stability, and financial sector development. Section III identifies sources of information asymmetries, in Islamic banking products or Sukuk, that can lead consumers to make uninformed decisions or take excessive risks; and which also lead to power imbalances that place consumers at a disadvantage. Section IV discusses cross country practices with respect to consumer protection in Islamic finance, and evaluates the adequacy of the legal and institutional framework for consumer protection. Section V summarizes the findings and discusses the policy implications.

II. CONSUMER PROTECTION AND FINANCIAL STABILITY

A. The Financial Stability Nexus

7. Consumer protection and financial literacy are essential pillars of a well functioning and stable financial system. Inadequate understanding of the risks inherent in financial products, because of insufficient disclosures or low financial literacy, can lead consumers to take on excessive debts, which can impact banking system stability. Inadequate information about entailed risks can also cause panic and herd behavior among investors and can precipitate crises. Deceptive advertising increases legal costs for financial institutions which, apart from its ability to erode bank profitability, can undermine confidence in the financial system.²

² In the United Kingdom, the mis-selling of payment protection insurances (PPI's), cost the country's largest financial institutions billions in compensation. In the United States, banks have had to settle huge fines for credit card practices, abusive debt-collection practices and inadequate disclosures on some products.

8. Effective financial education and awareness campaigns help individuals to understand financial risks and products and thus take decisions better adapted to their personal circumstances. Financial literacy can also lead to higher uptake of financial products, and to better understanding of recourse options, if disputes arise. Financial education also contributes to more efficient, transparent and competitive practices by financial institutions. Better educated citizens can also implicitly help in monitoring markets through their own decisions, and thus complement prudential supervision.

9. Ensuring the financial stability of institutions also helps protect consumers of financial services from loss, thus effective prudential regulations should be an integral part of consumer protection frameworks. In addition, institutional arrangements, such as deposit insurance schemes, also help protect consumers from financial loss and contribute to financial stability and development of the Islamic finance industry. They can also instill public confidence in the sector, help maintain the competitiveness of Islamic deposits vis-à-vis conventional deposits, prevent any outflow of Islamic deposits from Islamic banks to conventional banks and help maintain stability.

B. Elements of Consumer Protection

10. Effective consumer protection frameworks are anchored on three complementary pillars that include laws, financial education and enforcement mechanisms. For Islamic finance, there are additional requirements for Shari'ah oversight and audit for Islamic financial institutions (Figure 1).

11. Laws and regulations are needed to govern the relations between service providers and users. They help promote fairness and transparency, and ensure clarity on recourse rights for consumers. Government intervention and regulation to protect consumers is necessary because of inherent information asymmetries, and because of the imbalance in power and resources between financial institutions and consumers. In particular, whereas financial institutions are very familiar with the terms and conditions of their financial products and characteristics, investors and retail consumers especially, may find it difficult or costly to obtain information on their financial purchases. Complex financial services can also be difficult to assess, even when all relevant information is disclosed.

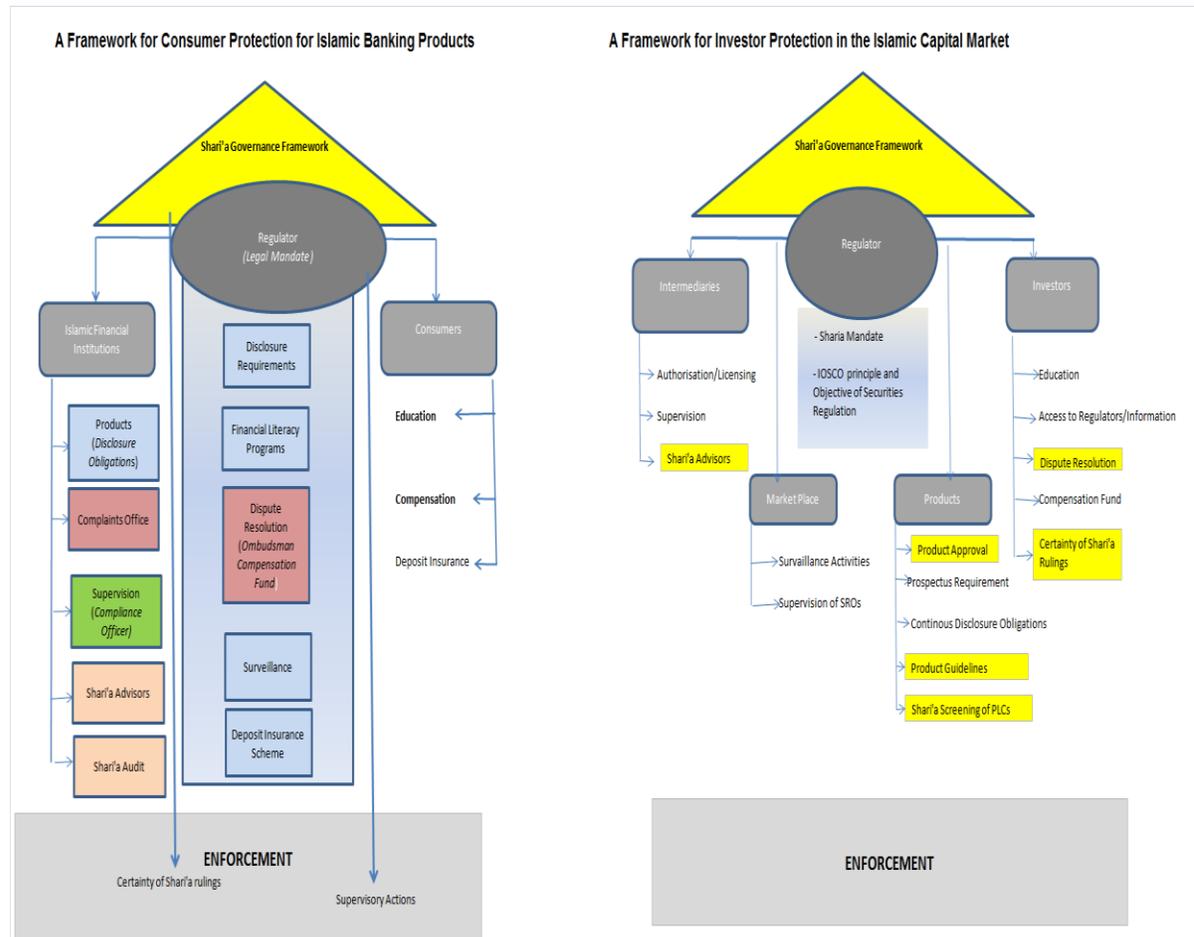
12. Financial education can help empower consumers and make disclosures effective. Investor confidence rests on the integrity and transparency of financial reporting and disclosures. Giving individuals clear and complete information that covers both the financial condition of the financial institutions as well as risks in the products they purchase or invest in, allows the consumers to make informed decisions. Financial illiteracy, on the other hand, can render households vulnerable to unfair and abusive practices by financial institutions and to financial frauds and scams.

13. Effective enforcement mechanisms should include cost-effective dispute resolution. The cost of litigation could be prohibitive to consumers relative to the values that may be in

dispute, thus consumers may fail to seek redress in instances of unfair treatment. In the event of a dispute, resolution processes that are simple and cost-effective are critical to ensuring that consumers are given fair treatment.

14. Finally, an effective Shar'iah governance framework is critical. Islamic finance consumers expect their funds to be invested in Shar'iah compliant products, thus a mechanism for ensuring compliance with is needed.

Figure 1. A Framework for Consumer Protection in Islamic Finance



III. THE CASE FOR CONSUMER PROTECTION IN ISLAMIC FINANCE

15. Shar'iah principles, on which Islamic finance is founded, have inherent features that potentially promote the protection of consumers and investors. In particular, Islam prohibits transactions based on *Gharar* (uncertainty in transactions), *Maysir* (gambling or the acquisition of wealth by chance instead of effort) and *Riba* (interest rate). These principles are beneficial for financial stability and consumer protection.

16. However, these features alone cannot ensure consumer protection. Islamic financial products are provided within the same moral, regulatory, and economic paradigm as conventional products, and not all providers of Islamic financial products are motivated by religious or ethical precepts. Empirical evidence abounds of disparities between the principles and the practice. Moreover, Islamic banking products and Sukuk are structured differently from conventional products, thus they entail a unique set of and consumer protection frameworks designed for conventional products would not adequately address consumer vulnerabilities arising from selected Islamic products.

17. Consumer protection frameworks that cater to the specifics of the industry are, therefore, necessary for the efficient development of the Islamic finance industry. The growth of the Islamic finance industry has increased the number of consumers, but the limited number of Islamic banks in each jurisdiction reduces choice for consumers. A number of Islamic financial products (such as PSIA, Ijārah, and Sukuk) also entail unique vulnerabilities for consumers and investors. Corporate ownership structures that include non financial corporations also create conflicts of interest between the business interest of the financial institution and the fiduciary responsibility of the banks to Investment Account Holders (IAHs). Partial coverage of deposits characteristic of conventional deposit insurance schemes is not consistent with Shari'ah principles governing the treatment of current account deposits.

A. Industry Growth But Limited Consumer Choice

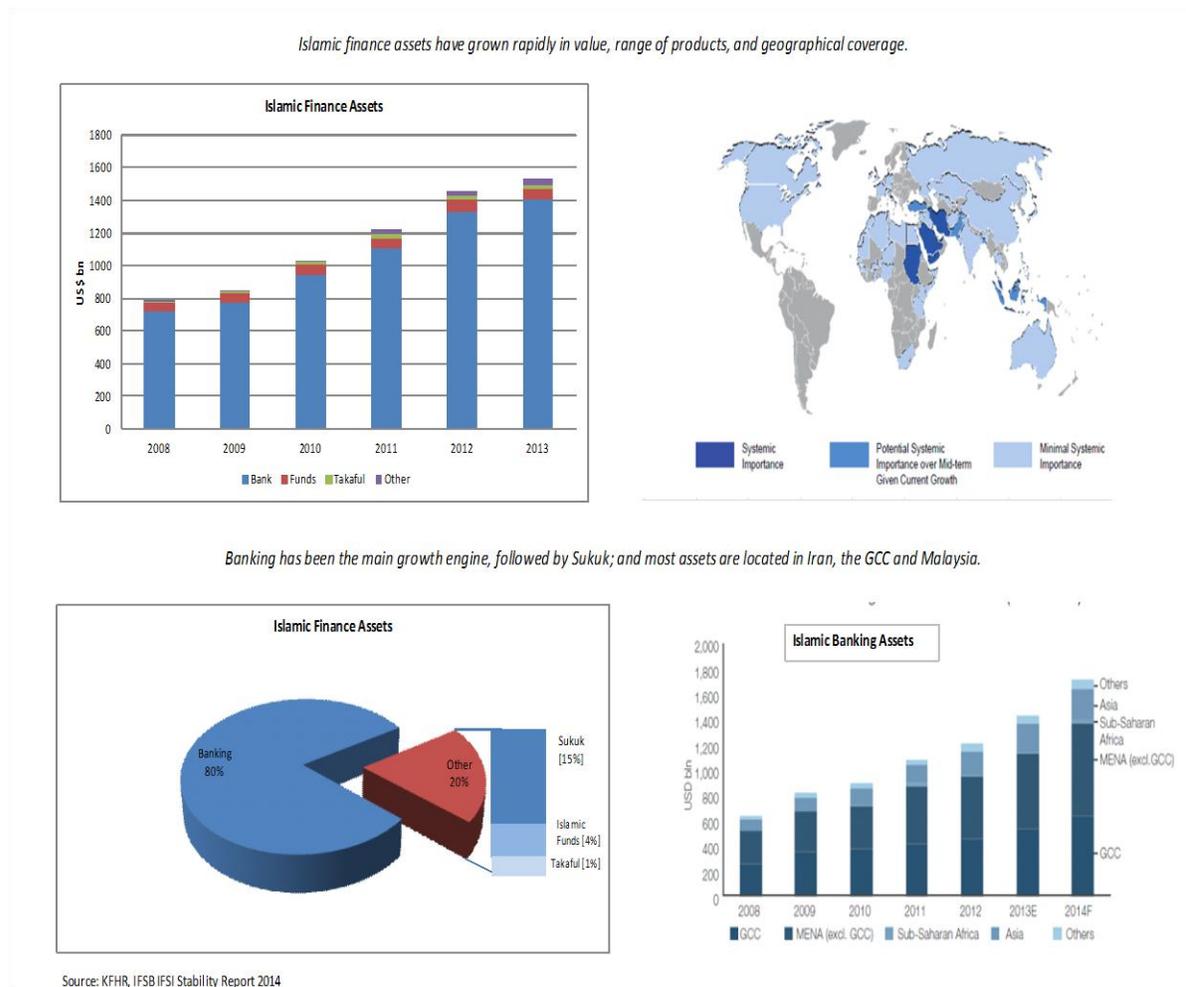
18. Islamic finance has grown rapidly in value and geographical reach. Measured by the size of Shar'iah-compliant assets, Islamic finance has grown by an annual average of 20 percent since 2007, reaching US\$ 1.8 trillion by end-December 2013 [IFSB 2014]. In addition to Iran and Sudan, whose banking systems are exclusively Islamic, the Islamic banking sector is systemically important in Bangladesh, Brunei, most Gulf Cooperation Council (GCC) countries, Malaysia, and Yemen³. Islamic finance also has great potential in markets with large Muslim populations and low penetration, such as in Egypt, Jordan, Kenya, Libya, Morocco, Nigeria, Tunisia; and the countries of the Caucasus and Central Asia (CCA).

19. Most Islamic banks provide retail products. In tandem with the deepening and geographic expansion of Islamic finance industry, consumers of Islamic financial products have increased. Ernst & Young [2013] estimates that Islamic banks serve 38 million customers globally. With such a large number of consumers, disputes, claims, and complaints related to financial transactions can also be expected to increase.

³ Using a threshold of 20 percent of total banking sector assets.

20. The banking industry has been the main growth engine, but other financial products are growing rapidly, particularly the Sukuk market. The banking sector accounts for about 80 percent of the assets [IFSB 2014] and these assets are mostly financed by PSIA [Lukonga 2015]. The Sukuk market follows distantly, with assets equivalent to about 15 percent of the Islamic finance industry, but the market is growing rapidly in volume, issuers and breadth of investors. There are also around 900 investment funds that account for 4 percent of the industry. The balance comprises investment companies, the *Takaful* or insurance industry, leasing, and micro finance [IFSB 2014].

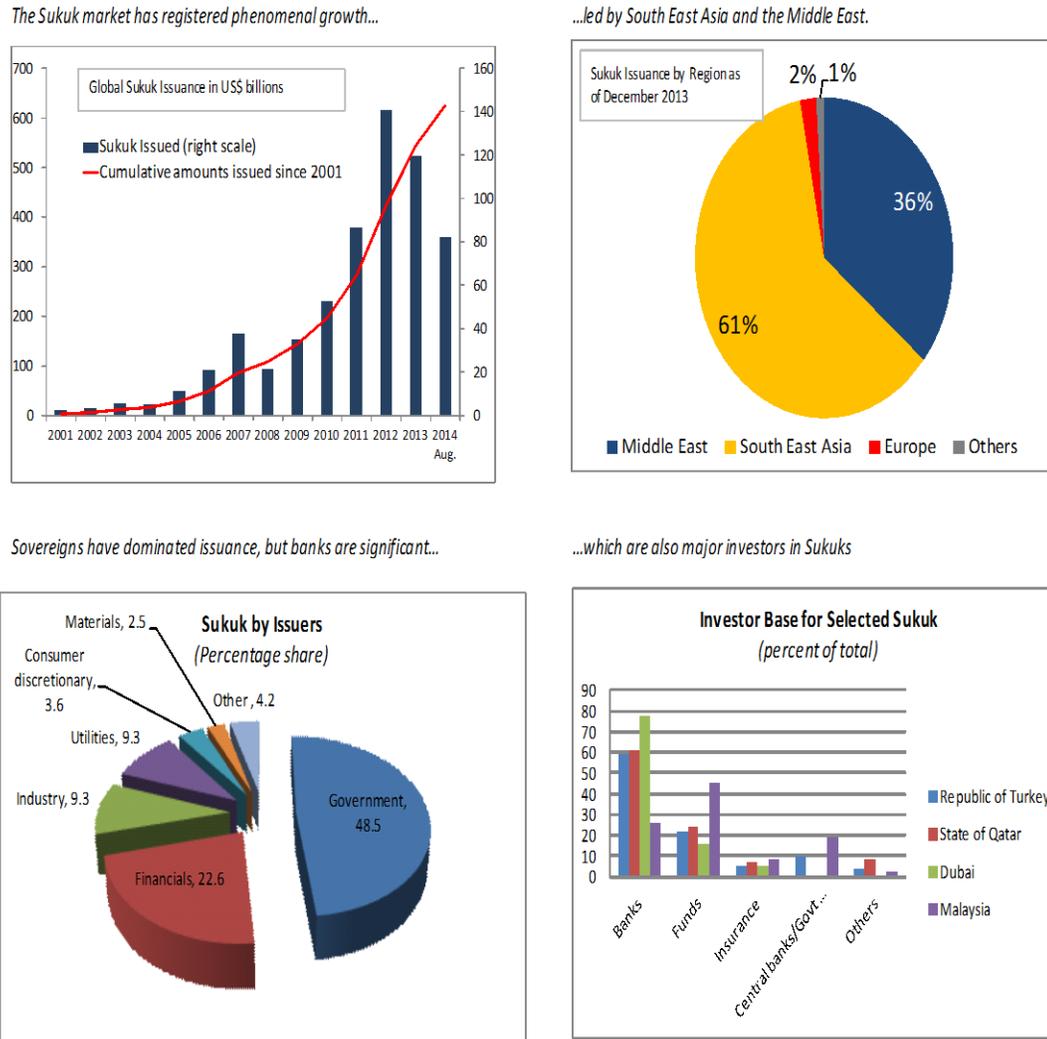
Figure 2. Growth of Islamic Finance Assets



21. Growth of the Sukuk market has been accompanied by a broadening in the range of issuers and they include advanced, emerging market and developing economies, thus investors face credit risks of differing counterparties. With large financing gaps for infrastructure investment, an increasing number of countries are now issuing Sukuk. Sovereign issuers accounted for 45 percent as of [June 2014], and the balance is accounted for by supranational institutions and corporations, including banks, non-financial

corporations, and quasi-sovereign or government-related entities. In the GCC, where governments have large fiscal surpluses and have not needed financing from the market, corporations have been the main issuers.

Figure 3. Sukuk Market Size, Growth, and Structure

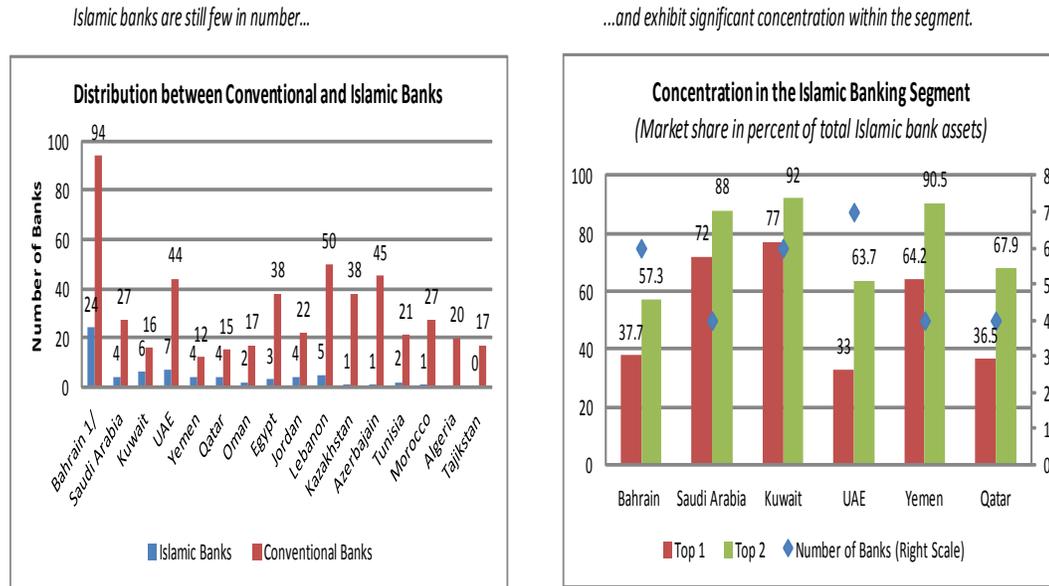


Source: KFHR, Zaywa

22. Despite the rapid growth, competition in the Islamic finance sector is more limited than in the conventional banking sector, consequently consumers who prefer Shari’ah-compliant products do not enjoy the same level of choice. Apart from Iran and Sudan which do not allow conventional banks, and excluding Islamic windows, most countries have between four and seven Islamic banks whereas the number of conventional banks mostly ranges between 15 and 50. Market concentration is also very high. In Kuwait, Saudi Arabia, and Yemen, the largest Islamic bank represents more than 50 percent of Islamic banking assets. In other countries, where Islamic banking is in a nascent stage, the concentration is

even more pronounced because usually there are only one or two banks offering Islamic financial products.

Figure 4. Concentration in the Islamic Banking Sector



Source: Central Bank websites and company annual reports.

Note: For Bahrain, this includes retail and wholesale banks but the market shares refers to domestic banks.

B. Product Characteristics

23. Some Islamic financial products have characteristics that, in the absence of well-defined regulations, could place consumers or investors at a disadvantage relative to the financial institutions. The products identified in this review include: (i) PSIAs based on Muḍārabah or Wakālah; (ii) Ijārah Muntahia Bittamlīk or Lease to Purchase; (iii) Sukuk.

Profit-Sharing Investment Accounts (PSIAs);

24. PSIAs currently constitute a significant share of Islamic banks' funding sources in most countries.⁴ The PSIAs are usually based on a Muḍārabah partnership contract between the bank and the customer, where the Investment Account Holder (IAH) acts as an investor and the Islamic bank acts as the entrepreneur. In some instances, a Wakālah agency contract is used; and in this arrangement the Islamic bank acts as wakeel (agent) and receives a management fee for managing the customer's funds.

⁴ Other funding instruments include current accounts and Sukuk.

25. PSIAAs can be either *restricted* or *unrestricted*. In the case of *restricted* PSIA, the IAHs impose restrictions as to where, how and for what purpose the funds are to be invested. This arrangement is similar to non-discretionary wealth management accounts offered by private banks. However, unlike mutual funds, account holders' funds are not vested in a separate legal entity. Instead, they are managed by the Islamic banks and they are reported as "off balance sheet" Funds Under Management (FUM). For *Unrestricted* PSIAAs, the IAHs authorize the bank to invest their funds in a manner that the Islamic bank deems appropriate, without laying down any restrictions. The arrangement has some similarities to the discretionary wealth management accounts offered by private banks, but a major difference is that these are offered to retail clients and not to High Net Worth (HNW) clients; account holders' funds are also commingled with current accounts and with shareholder funds; and they are reported as "on balance sheet" items.

26. The returns to PSIAAs are influenced by a variety of factors. The capital value and returns to PSIAAs depend on the banks' profits, and banks determine the profits on which the payout is based. The proportionate share of profits, between the bank and the holders of PSIAAs, is determined ex-ante by mutual consent, but the losses, if any, are borne by the account holders, unless the loss has been caused by mismanagement or negligence on the part of the bank as a manager of the funds, or by a violation of the terms of the contract.⁵ The returns depend on the profitability of the individual enterprises that are financed, but funding is comingled and payouts smoothed through a "profit equalization reserve" (PER) or Investment Risk Reserve (IRR). Industry or International Financial Reporting Standards (IFRS) specific policies on maintaining appropriate reserves to manage PSIA returns also affect the risk-return mix for PSIAAs. Unlike deposits in conventional banks, investment accounts are not liabilities of banks and the bank is not obligated, in the event of loss, to return the original amount.

27. These features of PSIA place consumers at a disadvantage, unless there are well-defined regulations to protect the account holders. In particular, since payouts are largely determined by bank management and there are large asymmetries in accounting information, banks can inflate the expenses, and thereby reduce the profits available for distribution. The PER and IRR raise an intergenerational distribution conflict because profits added to the banks PER do not accrue to existing investors. Because PSIAAs are not treated as deposits, in resolution, the claims would be subordinated to creditors. Finally, because the bank stands to benefit from the upside but is protected from losses, this asymmetry creates incentives for a bank to take on excessive risks.

⁵ A review of the annual reports and audited accounts of Islamic banks showed that according to the terms of acceptance of the unrestricted investment accounts, 100 percent of the funds is invested taking into consideration the relevant weightage, if any. For some banks, the Mudarib's share of profit ranges between 40 percent and 50 percent operating expenses are charged to shareholders' funds and not included in the calculation.

28. The conglomerate structures of Islamic banks also have the potential to create a conflict between the business interests of the group and the fiduciary responsibilities of Islamic banks, and may not incentivize Islamic banks to act in the best interests of IAHs. In particular, Shar'iah principles require Islamic banks to link transactions to real productive economic activities, thus the banks have been permitted to establish subsidiaries of non financial corporations to facilitate investment activities. These SPVs, joint ventures and associate companies benefit from the parent banks in terms of liquidity provisions, operations from shared services, and business referrals. Therefore, from a business perspective, there is an incentive to invest client funds in group companies. However, investments in group companies may not always ensure the best returns for IAHs, who bear the risk of loss. Moreover, the presence of non financial corporations in the group pose challenges for board composition and oversight, which is critical in internalizing a strong risk culture, creating a synergy between risk governance and ensuring a Shar'iah governance framework, and aligning the risk appetite between shareholders and IAHs.

29. IAHs with a strict preference for investment in Shar'iah compliant products could also face Shar'iah non compliance risk, arising from banks breaching client mandate. While a number of countries (Jordan, Malaysia, United Arab Emirates) require banks to separate funds raised by way of Islamic deposits from other funds, there are many others where there are no such requirements, thus the potential for commingling funds is high, particularly for Islamic windows. In addition, some Wakālah contracts contain provisions that guarantee a specified rate of return or certain profits despite the results of the transaction(s). Such provisions arguably contravene Shari'ah principles as guaranteed returns or profits are not Shari'ah compliant in that they do not enable risk sharing between the wakeel and the muwakkil.⁶ Non compliance with Shar'iah is also possible if there is no governance structure to ensure that products issued by the Islamic banks are Shar'iah compliant.

30. To protect consumers, regulations on disclosures and governance need strengthening. To enable clients make informed choices among the different banks based on risk preferences, Islamic banks would, ex-ante, need to publish investment strategies, objectives, and risk-reward thresholds in addition to ex-post audited financial statements. There is also a need for board representation to ensure that investment decisions are in their best interest

31. The IFSB and AAOFI have issued a number of standards and guidelines to improve disclosures, transparency and governance, but adoption and enforcement of the standards is highly uneven across countries. Currently, while PSiAs share many features of Collective Investment Schemes (CIS) with respect to fiduciary responsibilities on the part of the bank,

⁶ Recent court decisions regarding disputes involving such Wakālah contracts underscore this risk. One such dispute involving Blom Developments Bank, S.A.L. ("Blom"), a Lebanese bank, and the Investment Dar ("TID"), a Shari'ah-compliant finance house based in Kuwait, was litigated in England in late 2009. In addition, a case with a similar fact pattern has been litigated in Kuwaiti courts.

in practice, Islamic banks, in many countries, undertake this fiduciary role without being subject to Conduct of Business (COB) rules that ensure adequate disclosures to holders of PSIA on investment objectives, strategies, risks, computation of profits and valuation of assets.⁷

Ijārah Muntahia Bittamlīk or Lease to Purchase

32. Ijārah is a contract of sale of the right to use an asset for a period of time. Under Ijārah Muntahia Bittamlīk, the legal title of the assets only passes to the lessee at the end of the Ijārah term, through gift, consideration or gradual sale, provided all Ijārah installments are settled.

33. In the absence of tailored oversight, Ijārah Muntahia Bittamlīk contracts could place consumers at a disadvantage in the event of a default on lease payments and with respect to capital gains. Whereas in conventional mortgages property can be sold to pay off the bank, a customer who fails to meet payments mid-way through the term of an Ijārah agreement could lose all past payments. In addition, because lenders retain property ownership (Ijārah and Murābahah loans) or release it only progressively (Mushārahah templates) the consumer cannot take advantage of capital gains to prepay or refinance the mortgage, if his financial position deteriorates.

Sukuk

34. Sukuk are certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or in the ownership of the assets of particular projects or special investment activity [AAOFI 2010]. Although Sukuk instruments rely on common concepts such as equity participation and asset securitization, the production process is akin to project finance, where each deal is structured based on project characteristics. The underlying structure varies, depending on issuer, investors, country-specific and or lead managers. Commonly used structures for Sukuk are Ijārah, Wakālah, Mushārahah, Murabaha, Istina, Muḍārahah and Salam or a combination of these structures (hybrid).

35. Sukuk structures may be either asset-backed or asset-based.

- For asset-backed Sukuk, the certificate holders, in principle, have recourse to the underlying assets in the event of default, provided that all the legal arrangements required to become a genuine owner of the assets are put in place. Thus, the risk faced

⁷ Some countries (for example Yemen) have significant Islamic banks but do not have capital markets and by extension no securities law or capital market regulator to oversee the investment business side of the Islamic banks. Some countries with Capital markets are silent on the treatment of Islamic banks. For some countries (Bangladesh, Malaysia, Pakistan) where the investment activities of banks are required to be licensed by capital markets authority, coordination between the regulators is weak. Selected countries have issued guidelines on the calculation of profits.

by the investors is at most the risk of capital loss resulting from a decline in the prices of underlying assets (market risk) and/or default of the lessee on rental payments.

- On the other hand, if the Sukuk are asset-based, investors or Sukuk holders have no recourse to the assets. The structuring element embeds a purchase undertaking by the issuer, which then creates a debtor/creditor relationship in the event of a default. The investor, therefore, takes the risk of the “Obligor”—the party providing an undertaking.⁸ Prospective investors, therefore, rely on the creditworthiness of the obligor or sponsor of an asset-based Sukuk rather than on the quality of the assets underlying the Sukuk. In the event of default of the originator, Sukuk are given the status of unsecured debt subordinated to the originator’s other obligations.

36. So far, most outstanding Sukuk are “asset-based”. Sukuk structures have also tended to be complex, in some cases motivated by regulatory arbitrage or tax efficiency considerations. Whatever the motivation, the resulting complex structures render it difficult for investors to discern the risks they are taking on. Appendix 1 presents schematic pictures and description of the cash-flows for various Sukuk structures, including those based on Ijārah, Murabaha, Mushārah and Muḍārah.

37. Sukuk restructurings and defaults exposed inconsistencies between theoretical principles of Sukuk products and actual structures, as well as gaps in investors’ understanding of the risks. Some of the prominent Sukuk defaults or restructurings include Nakheel and Dana Gas Sukuk of the United Arab Emirates., Golden Belt Sukuk of Saudi Arabia, and The Investment Dar Sukuk of Kuwait. These Sukuk were based on different structures, including Mushārah, Ijārah and Ijārah manfaa and the majority were issued as asset-based rather than asset-backed. The resolution resulted in unexpected outcomes for investors who believed that they would have recourse to the underlying assets. In other cases (Nakheel and Dana Gas Sukuk) investors ignored the credit risk on expectations of government intervention.

38. The Sukuk default and restructuring cases also highlighted the fact that investors’ rights depend on local laws and on the strength of legal rights in the country where the collateral is likely to be contested. Sukuk are issued in environments with varying legal traditions and divergent views on Shar’iah as a source of law. The outcome, in default cases, depended on decisions taken after a default event and varied with the local laws of the jurisdiction where the underlying assets were domiciled. The cases demonstrated a lack of legal certainty in cross-border insolvencies, lack of transparency, unequal treatment, and a risk of contract unenforceability with respect to Shar’iah compliance issues. The cases also

⁸ The initial sale of the original assets by the originator to the SPV is for administrative purposes and the SPV has no role in a default or insolvency scenario, so the ownership (title) of assets remains with the originator of the Sukūk.

highlight differing understanding of rights between the issuers, investors, traders, lawyers and regulators. For instance:

- When Saudi Arabia's Golden Belt 1 Sukuk defaulted in November 2009, a royal commission was created to restructure the debts. However, the commission only addressed the amount owed to local investors. Foreign investors, on the other hand, have not been able to gain access to the assets held by the Sukuk sponsor.
- In the case of US-based East Cameron Sukuk, though the issuer filed an adversary proceedings requesting the court to consider the primary Sukuk transaction with the purchase SPV as secured loans and not as true sale of assets, the U.S. court ruled that it was an asset-backed Sukuk and that investors had the right to a certain quantity of gas produced by East Cameron over the life of the Sukuk.
- Very few restructurings of Sukuk securities have been finalized, and most have been ongoing for years. Without a swift resolution precedent and a clear legal framework for debt restructuring, Sukuk holders have to seek resolution and recovery of their investment in case-by-case negotiations, subject to local judicial systems.

39. IIFM review (2013) found that in practice, even in cases of asset-backed Sukuk, legal transfer of ownership, in most cases, where international investors are involved, is either not permissible under applicable local laws or, is a complicated and expensive legal and regulatory process. The restructuring of defaulted Sukuk also faced major obstacles because of minority holders hijacking the restructuring and demanding full repayment.

Box 1: Sukuk Defaults and Legal Risks

The experiences of East Cameron Partners (ECP) and Investment Dar Company (TID) underscore the critical role of legal frameworks in the country in which the collateral is being contested and how disparities in these frameworks can lead to different resolution outcomes, even for similar Sukuk structures.

East Cameron Partners (ECP): Sukuk Al Mushārahah

The contract: The underlying contract was Mushārahah (co-ownership/joint venture) in which Sukuk investors co-owned with the originator (ECP) the so-called Overriding Royalty Interest in two gas properties through an SPV acting as a trustee of Sukuk holders. The SPV was incorporated in the Cayman Islands. The Sukuk was secured by a mortgage on the assets of the issuer and was rated CCC+ by Standard & Poors (S&P).

Default: In 2008, ECP filed for Chapter 11. ECP defaulted on periodic payments to the Sukuk holders, not because of low prices, but because of financial problems arising from the shortfall in oil and gas production triggered by damage from a hurricane.

Outcome of resolution process: ECP filed for protection under Chapter 11 of the U.S. bankruptcy court to reorganize its debts and operations. ECP also filed adversary proceedings and requested the court to consider the primary Sukuk transaction with the purchase SPV as secured loans and not as true sale of assets. Granting this request would imply that in the liquidation process Sukuk holders would have to share the assets with other creditors of the originator. The bankruptcy court rejected ECP's request, setting a precedent about protection of Sukuk holders' rights. ECP filed a revised lawsuit, but the case was eventually resolved through negotiation and the underlying Sukuk assets were transferred to the issuer for the benefit of Sukuk investors.

Investment Dar Company (TID): Mushārahah Sukuk

The Contract: TID an Islamic investment company issued a Mushārahah (co-ownership) Sukuk with the collaboration of ABC Islamic bank (Bahrain). The SPV for the Sukuk was established in the Cayman Islands and the Sukuk involved complex layers of transactions. The originator also provided an undertaking to repurchase the SPV share in the underlying assets at the end of the Sukuk period or upon any earlier insolvency event. The structure of the Sukuk was approved by the Shar'iah boards of both the partners.

Nature of Default: In May 2009, TID failed to make the periodic payments on a \$100 million Sukuk. Subsequently, the holding company went through a restructuring process because of its inability to service its debt of about \$3.5 billion, including two Sukuk for US\$250 million. The originator made losses on its other investments which, in the end, caused the downfall of the company.

The resolution and its outcome: Shortly after the default on the first Sukuk, the company entered into a restructuring process and demanded a temporary standstill on all its debt. Meanwhile the Central Bank of Kuwait appointed a supervisor to monitor the debt restructuring. The Kuwait court granted protection to TID from creditors under the Financial Stability Law (FSL). The FSL stipulates that no law or execution of any court judgment against TID from minority banks and investors would proceed until the court had approved it. Another restructuring plan was approved that involved repayment of the debt in tranches; part of the debt was converted into equity in the company and shareholders had to inject fresh liquidity. The case is yet to be resolved.

Box 1 : Sukuk Defaults and Legal Risks (Continued)

The default by Golden Belt points to issues of investor rights and enforceability of contracts in cross-border resolution. Nakheel, on the other hand, underscores how despite disclosures, perceptions about government guarantees can lead to underestimation of risk even by financially literate investors.

Golden Belt 1 (Saad) Ijārah Sukuk

The Contract: Golden Belt, an SPV of the Saad Group issued an Ijārah Sukuk to finance investments and property purchases in London and Saudi Arabia. The SPV was registered in the Kingdom of Bahrain, and it issued leasehold rights on the land parcels. SPV transfers periodic rentals to the Sukuk holders, and upon maturity, when the Sukuk are redeemed by the Sukuk holders, Saad transfers the Sukuk amount to the SPV. A service agreement was also entered into and fees were deducted from the rental paid by the SPV. The contract included a dissolution event.

Nature of Default: On June 2, 2009 the Saad Group, a Saudi business conglomerate, defaulted on periodic payments, including its Islamic bonds, as the company faced a liquidity crisis. The originator was singularly opaque; proper information was not even provided to the regulators. As a consequence, the Saudi Arabian Monetary Authority (SAMA) froze the assets of the Saad Group. Accounts of Saad in the Cayman Islands were also frozen.

Restructuring and outcome: Sukuk holders exercised their right to dissolve the trust and voted for dissolution. However, there were legal issues that needed to be resolved before the Sukuk investors were given the status of unsecured creditors of the Saad Group. Upon dissolution of the trust, Saad, the guarantor of the repayment of the Sukuk would have to repay the Sukuk amount, but its assets were frozen. The litigation dragged on for three years and the case is still in the Saudi courts. Saad later argued that a previously provided promissory note was not genuine.

The Nahkeel Sukuk (Ijārah manfaa)

The Contract: The Nahkeel Sukuk were issued as an asset-based Ijārah-manfaa in which Sukuk holders, via an SPV, buy the leasehold interest of the primary assets without acquiring title to the assets. Therefore, Sukuk holders only had rights on the stream of income generated by the assets and not on the assets themselves. The originator, Nahkeel Holdings 1, was a subsidiary of Nahkeel World, which, in turn, was owned by another public sector company, Dubai World. Nahkeel Holdings 1, Nahkeel Holdings 2 and Nahkeel Holdings 3 cumulatively hold shares of 100 percent in Nahkeel Co. PSJS. Because they were issued by a public sector enterprise, the Sukuk were given the status of a sovereign bond by the rating agency, hence investors assumed an implicit government guarantee for the Sukuk, and Moody's rated it A1 while Standard & Poor's rated it A+.

Nature of Default : On November 25, 2009, the macroeconomic situation led the Dubai government to seek a standstill for US\$59 billion in debt owed by Dubai World, which included the Islamic Sukuk of US\$3.5 billion.

Outcome of Resolution: During the discussions, it became obvious that the majority of the Sukuk certificate-holders were not aware that there was no recourse to the trust assets through the purchase undertaking and that consequently, no sale of the trust assets could be effected. Outright default was eventually prevented through the bailout by Abu Dhabi at the eleventh hour and all the Sukuk holders were paid out.

C. Conventional Deposit Insurance Schemes

41. Deposit schemes for conventional banks that offer partial coverage of current deposits contravene Shar'iah principles. Under Islamic banking, noninterest-bearing current accounts, such as Wadi'ah, that are for safekeeping are investments that is to be redeemed at par, and as such an Islamic bank is contractually committed to return the full amount placed on deposit by the client. In addition, in countries where Islamic banks are covered by conventional deposit schemes, the investment of the deposit insurance schemes assets in non Shari'ah compliant products poses the risk of Shar'iah non compliance. There is also a lack of clarity as to the insurability of profit-sharing investment accounts.

IV. CURRENT PRACTICES IN CONSUMER PROTECTION

42. Consumer protection in financial services has become a major focus of global regulatory initiatives. A number of principles and guidelines have been issued to improve consumer protection in financial products in general. Specifically, in November 2010, the World Bank launched a global program on consumer protection and financial literacy, developed good practices for financial consumer protection in 2012, and has since been undertaking a Global Survey on Consumer Protection and Financial Literacy. In 2011, the G20 endorsed the high level principles on consumer protection for financial services.

43. A number of international bodies have also initiated efforts to develop regulations that cater to the specifics of Islamic finance. The Islamic Financial Services Board (IFSB) has also issued a number of standards and guidelines on aspects relevant to consumer protection in Islamic finance. These include IFSB-4 on Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services;⁹ IFSB-6 on Governance of Islamic Collective Investment Schemes; and IFSB-9 on Conduct of Business Standards. There is also a joint publication by the IFSB/IOSCO and Malaysia Securities Commission on the Disclosure requirement for Islamic Capital Market (ICM) products released in 2013. In 2015, the IFSB also plans to issue a Working Paper on guiding principles on disclosures related to specificities of Sukuk, Islamic Collective Investment Schemes (ICIS) and Shar'iah compliant equities.

44. In addition, AAOIFI has issued a number of standards and guidelines on disclosures, to promote transparency. AAOIFI's Financial Accounting Standards (FAS) Number 11 (1996) spells out disclosure requirements related to investment accounts, and its FAS 14 (2000) on investment funds provides a list of items for disclosure. Detailed guidance on the

⁹ IFSB 4 states that the fundamental similarities between management of IAH funds and the operation of CIS imply that the IOSCO principles applied to CIS disclosure requirements continue to be relevant in designing the relevant disclosures for IAH, particularly restricted IAH, and investment funds that operate in accordance with Shari'ah rules and principles, including Islamic mutual funds managed by IIFS in the form of restricted investment accounts and stand-alone Islamic funds.

calculation of profit shares for IAHs, initially in AAOIFI FAS 6, and now transferred to FAS 27, addresses the disclosure requirements for profit allocation between equity and IAHs. The International Islamic Financial Market (IIFM) has also initiated efforts to address Sukuk standardization which can help improve transparency, lower costs for consumers and reduce legal challenges.

45. Countries are also increasingly integrating consumer protection in financial services into their regulatory frameworks. In the aftermath of the global financial crisis many countries embarked on reforms to address the short-comings in consumer protection, including the low levels of financial capability among users of financial services, lack of effective disclosure and the existence of deceptive advertising on the provider's side. Some countries like the United Kingdom, Australia, South Africa, made changes to the institutional framework to give emphasis to consumer protection with the introduction of the *twin peak models* for supervision, whereby one regulator focuses on the safety and soundness of financial institutions and another focuses on Conduct of Business rules. Many others introduced consumer protection regulations within the overall prudential framework and established processes for addressing consumer complaints and providing redress.

46. However, implementation is highly uneven across countries. The 2014 World Bank Global Survey shows that not all countries have enacted consumer protection laws. Among those that have enacted laws, the regulations in most cases are either not consistently applied or not enforced. Less progress has been made with respect to integrating consumer protection issues that are specific to Islamic finance.

The Legal and Regulatory Framework

47. The legal and regulatory frameworks for consumer protection in financial services are fragmented and have important gaps and overlaps. Most countries have in place a broad legal framework for consumer protection, but legal provisions relevant to financial services are in many cases diffused in multiple pieces of legislation (Table 1) and the coverage of issues is generally not comprehensive. In addition, very few countries (Oman, Malaysia, Bahrain) provide explicit guidance for Islamic financial products in the regulations governing consumer protection.

48. There are no international guidelines with respect to specific disclosures and country practices vary significantly. Some countries (Malaysia, Pakistan, Bangladesh) have issued guidelines on calculation of profits by Islamic banks but for many others the rules are silent.

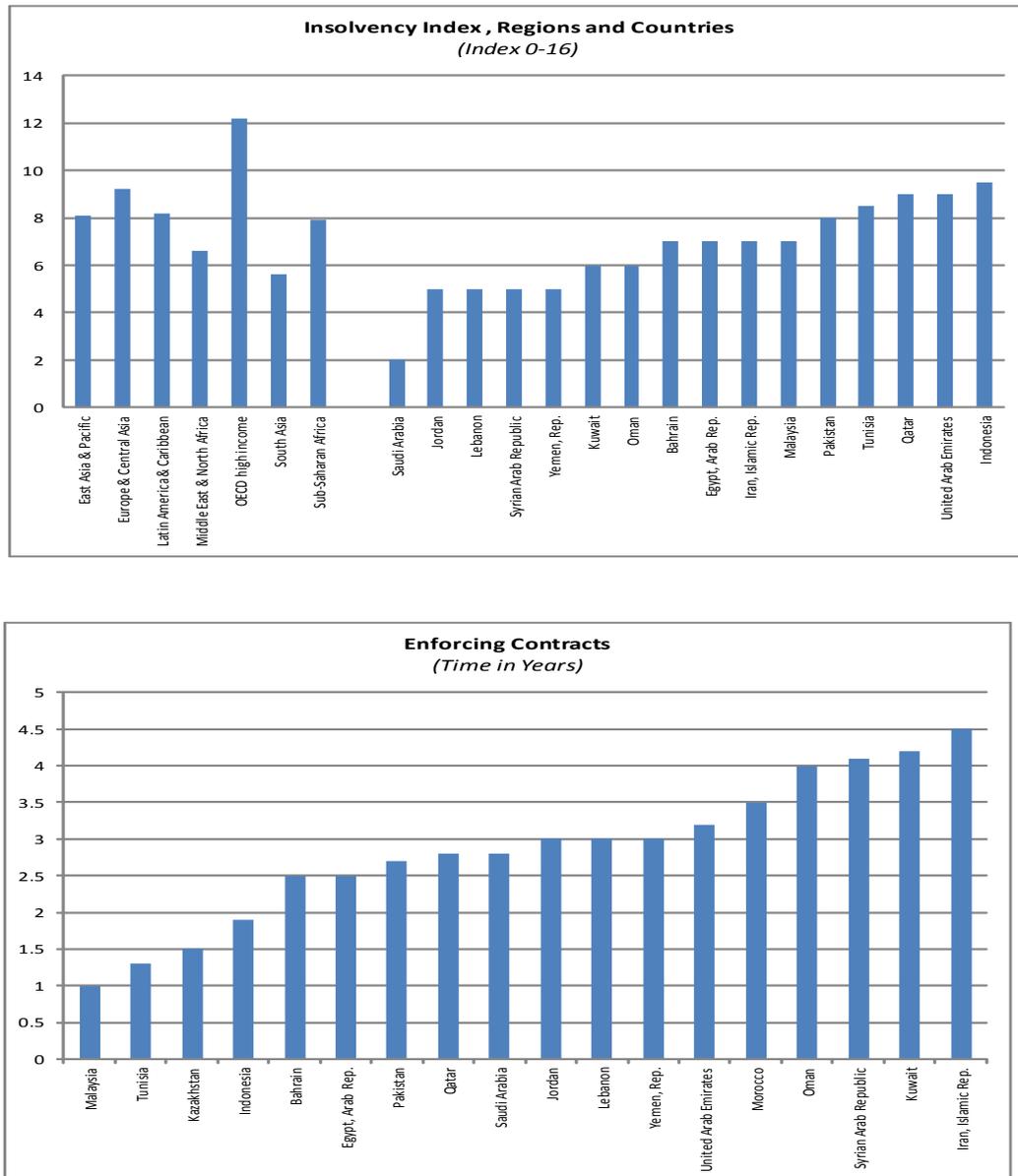
Table 1. Status of Legal Frameworks for Consumer Protection

	General CP law without explicit reference to financial services	CP law with explicit reference to financial services	Separate FCP law	CP regulations within the framework of financial sector legislation	Other FCP law or regulation	Explicit provision for Islamic Finance
Algeria	✓			✓		
Azerbaijan	✓			✓		
Bahrain				✓		✓
Egypt		✓				
Indonesia	✓			✓		
Iran		✓		✓		
Jordan			✓			
Kazakhstan		✓	✓	✓	✓	
Kuwait	✓	✓		✓		
Lebanon	✓			✓	✓	
Malaysia						✓
Morocco		✓		✓	✓	
Oman	✓			✓		✓
Pakistan	✓			✓		
Saudi Arabia	✓	✓	✓	✓	✓	
Syria		✓				
Sudan	✓					
Tajikistan	✓			✓		
Tunisia						
Turkey		✓		✓	✓	
UAE	✓			✓		
Yemen						
Source: World Bank CPFL Global Survey						
Red means not covered in the survey						
For countries not covered by the survey, information was obtained from an earlier publication by Ardic et al (2011)						

49. The regulatory treatment of PSiAs in supervisory frameworks remains unclear and does not offer adequate protection for the IAHS. Only a few countries (such as Saudi Arabia) require Islamic banks' investment activities to be licensed by the Capital Market Authority (CMA). Some countries (Yemen) do not have capital markets and therefore no securities regulation, thus, Islamic banks in these countries would be undertaking investment activities in a regulatory vacuum. In the absence of clear Conduct of Business rules governing the investment—such as disclosure requirements, segregation of funds, certification of investors, custody rules—the potential for comingling investor assets is high and, in bankruptcy, IAHS could suffer losses unrelated to their investments.

50. Many countries that have issued Sukuk have weak Insolvency frameworks (Figure 6). Enforcing contracts still takes several years in most of these countries. Also, as indicated by the index of insolvency, the legal framework applicable to liquidation and reorganization proceedings also remains weak, with most of the countries ranking below 7 on a scale of zero to 16. The underdeveloped domestic bankruptcy laws, cross-country differences in local laws, and limited legal precedents create uncertainty over the enforceability of investor rights, particularly in default events.

Figure 5. Strength of Legal Rights



Source: World Bank Doing Business Survey, 2015

51. Bankruptcy remoteness and enforceability of investors' rights are indispensable prerequisites for any innovation in Sukuk securitization, but at present a robust legal framework for securitization is also lacking in many countries. The absence of a conducive legal and regulatory infrastructure (for example, true asset sale or separation of title from beneficial ownership; trust laws; taxation, insolvency, and bankruptcy laws) is a major challenge for Sukuk securitization, and it explains the prevalence of "asset-based" Sukuk over "asset-backed" Sukuk.

Enforcement Mechanisms

52. The regulations are, in many cases, not systematically implemented and enforced. A recent survey by the World Bank [2014] shows that financial institutions in some countries are required to report statistics on the number of complaints, operate a hot-line for complaints or monitor the market's advertising. These programs, however, relate to financial services in general and not specifically to Islamic financial products. Statistics on consumer complaints that could help in formulating effective policies were generally not available; and this raises questions about the extent of monitoring and enforcement.

53. Disclosure practices are improving but progress is uneven. Market pressures, International Financial Reporting Standards (IFRS), Basel II and the IFSB's 2007 guidance on disclosures for Islamic financial institutions have contributed to enhanced disclosure requirements. Islamic financial institutions, like conventional banks, now disclose a wide range of information, including management policies, risk exposures and risk management practices. However, there are notable variations in the disclosures that are specific to Islamic finance, such as investment objectives, strategies, payout formulas related to IAHs and Shar'iah compliance. Many respondents to the IMF survey indicated that not all countries are required to publish statements about Shar'iah compliance and for many countries, Islamic and conventional banks are subject to the same disclosure requirements. The IFSB/IOSCO/Malaysia [2013] review on disclosure requirements by capital market regulators in various jurisdictions found that the contents of Sukuk prospectuses varied significantly, and there is no international standards in respect of specific disclosures.

54. The dispute resolution framework in Islamic finance continues to evolve and encompass both litigation and Alternative Dispute Resolution (ADR) mechanisms. The complexity of the Islamic financial instruments, which needs the attention of Shar'iah experts in dealing with disputes and the inadequacy of the present contract laws to deal with Islamic transactions, is contributing to the use of ADRs. A number of countries (for example, Malaysia, Qatar, United Arab Emirates) have established local arbitration centers to resolve disputes in Islamic finance. The kinds of ADR commonly used are negotiation, conciliation, mediation and arbitration. For retail clients, many countries have established an Ombudsman office. A survey of the arbitration centers by Jonathan Lawrence (2012) showed that there have been very few cases involving Islamic finance. Overall, while sound grievance and redress mechanisms exist for bank customers, their effectiveness is undermined by inadequate awareness of the process and by the complexity of the procedures. Information on whether the Ombudsman offices have expertise in Shar'iah laws was not available.

Deposit Insurance Schemes

55. Deposit insurance is relatively new to Islamic finance. Despite the large number of countries adopting Islamic finance, only selected countries (Bahrain, Jordan, Kuwait, Malaysia, Turkey, Singapore, Sudan, the United Kingdom) have introduced Islamic deposit insurance schemes (IDIS). Among these countries, there are notable variations in the

approaches. Bahrain introduced an ex post IDIS in 1993 and, to date, remains the only country to have implemented such a system. Sudan developed a full-fledged ex ante IDIS in 1996. Malaysia has a dual deposit insurance system that includes parallel but separate insurance schemes for Islamic banks and for conventional banks. In other countries (Indonesia, Jordan, Kuwait, Singapore, the United Kingdom), Islamic deposits are protected under the country's deposit insurance system.

Financial Literacy and Capability

56. Programs to improve financial literacy in Islamic finance are still in the developmental stages. In several countries, there is a growing trend of offering degree programs and professional qualifications in Islamic finance among major institutions of higher learning and training organizations in a number of countries. The Islamic Development Bank (IsDB) has been collaborating with central banks on jointly organized programs for regulators and policy makers. Financial supervisors in some economies (Malaysia, Saudi Arabia) are actively involved in financial education activities. In Bahrain, a special fund (the Waqf Fund) was established to support Islamic finance training, education and research.¹⁰ Many other countries, however, are yet to provide education programs for financial literacy, especially in Islamic finance. Shar'iah scholars also remain scarce.

V. CONCLUSIONS AND OPTIONS FOR STRENGTHENING CONSUMER PROTECTION

57. Consumer protection is important for the sustained stability and efficient development of financial systems, including for the Islamic finance industry. However, progress in developing consumer protection frameworks for financial services has been highly uneven and even lesser progress has been made to tailor the frameworks to the specifics of the Islamic finance industry in those countries where the industry exists. Regulations on consumer protection for Islamic finance are also often new and further analysis is needed to inform the policy making process and develop effective solutions. Therefore, strengthening consumer protection for financial services should be among the policy priorities, and countries with Islamic finance segments should adapt their frameworks to cater to the specifics of Islamic financial products.

58. This paper identifies six areas for reform. These include: (i) strengthening the overall regulatory and supervisory framework for Islamic banks; (ii) strengthening consumer protection frameworks for financial products in general and incorporating provisions to cater for the specifics of Islamic finance; (iii) promoting financial literacy among consumers; (iv) strengthening the governance structure so as to protect IAHs and ensure Shar'iah

¹⁰ The Waqf Fund was established in November 2006 under the auspices of the Central Bank of Bahrain (CBB) in partnership with Islamic Financial Institutions (IFIs) in Bahrain. The member institutions made one-time contributions to the Waqf Fund's corpus which is invested in Islamic money market instruments and the return is used to finance the Fund's initiatives.

compliance; (v) improving investor protection for Sukuk investors; and (vi) developing Shar'iah compliant deposit insurance schemes.

Strengthening the regulatory and supervisory framework

59. A sound and stable banking system protects consumers from losses, thus it is important that regulatory and supervisory frameworks seek to address the risks facing an industry more comprehensively. Islamic banks undertake investment banking in addition to standard banking intermediation functions; their corporate structures are made complex by the prevalence of subsidiaries of non financial corporates in the groups; and their transactions are required to be Shari'ah compliant. Therefore, regulatory and supervisory frameworks need additional provisions to address these risks that are specific to Islamic finance.

60. International standard setting bodies for Islamic financial institutions have developed standards to address these unique risks, but progress in adopting these standards has been uneven across the countries and the standards have also not been consistently applied. Regulators do not always have the capacity (or willingness) to ensure Shari'ah compliance, which undermines consistency of approaches within and across borders.

61. A broad range of reforms are, therefore, needed. Islamic banks require a hybrid of banking and capital markets regulations to cover the cross sector operations in banking and investment business; and to enforce conduct of business rules, including those related to segregation of funds for restricted investment account holders, best execution principle and breach of client mandate. Tailored regulations are also needed to minimize group risks arising from the complex conglomerate structure of Islamic banks and which fall out of the scope of consolidation for consolidated supervision. There is also a need to address the risk that the financing of Islamic banks do not have any secondary market, which serves as a key to manage withdrawal risk in open ended mutual funds. Shari'ah governance structures also need strengthening and harmonized.

Strengthening Consumer Protection Frameworks

62. Many countries have been reforming their consumer protection frameworks for financial services, but important gaps remain. The areas for further reform identified in this review include: (i) streamlining the legal and regulatory framework for consumer protection in financial services; (ii) providing regulatory clarity for IAHS; (iii) enhancing disclosure requirements; (iv) monitoring compliance; and (v) establishing cost-effective dispute resolution frameworks.

63. The current diffused nature of legal provisions relevant to consumer protection for financial services poses a number of challenges. First, different laws may contain conflicting provisions, making compliance difficult. Second, the laws may assign supervisory and regulatory powers to a number of different agencies which creates difficulties for effectively implementing legislation. An effective coordination mechanism among regulators and key stakeholders is, therefore, needed to help define strategic priorities and clarify roles and responsibilities.

64. The treatment of IAHs in resolution should be clarified in law. Currently, many regulators treat these as deposits, but their ranking in bankruptcy situations remains unclear and it is often not codified in law. Under a conventional deposit insurance scheme all depositors are ranked equally, but this is not necessarily the case under an Islamic deposit insurance scheme, where a distinction could be made, first, between actual deposits (Wadiah) and Qard on the one hand and PSIA on the other hand, and second, between restricted and unrestricted PSIA.

65. Disclosure practices can be enhanced by implementing IFSB and AAOIFI standards and guidelines on disclosures and governance. Because unrestricted investment accounts allow the bank to commingle its own funds with IAHs funds, adequate transparency is absolutely essential to enable the IAH to assess the performance of the management. Islamic banks should, therefore, disclose the policies, strategies, and profit allocation basis of investment accounts; differences between restricted and unrestricted IAH; and the role of various reserves and other policies used to manage the rates of returns and the risks associated with PSIA. Banks should also make available accurate, relevant, and timely financial statements on the investments, including their performance and valuation; clarify their governance structure for ensuring Shar'iah compliance, the circumstances where losses are to be borne by IAHs, and the investors' contractual rights with regard to early withdrawal or redemption. For Ijārah Muntahia Bittamlīk, consumer rights in default should be clarified ex ante.

66. Consistent with IFSB recommendations, the management of restricted IAHs funds should be governed by International Organization of Securities Commission (IOSCO) principles governing Collective Investment Schemes (CIS). Such investment business should be subject to capital markets regulations related to client mandates, commingling of client assets, segregation of client funds, disclosures on investments and requirements for training and certification of fund managers. For countries without capital markets and therefore no securities regulation, the regulator should be given legal powers to develop a prudential framework for Islamic banks that incorporates conduct of business rules and to oversee these rules. Supervision should ensure that customer agreements are followed.

67. Monitoring compliance with financial consumer protection regulations is essential to effective implementation of the legislation, and can help inform public policy. Therefore, regulators should build capacity to enforce and monitor the consumer protection mandate. Country level impact assessments of the regulation on the users of Islamic financial services, as well as on the cost to financial institutions, are important in determining the most effective approaches to ensure fairness and transparency. Data on consumer complaints should be compiled and used to inform consumer protection policies.

68. Cost effective dispute resolution mechanisms are needed, including ADR mechanisms while retaining the customer's right to go to court. This is particularly important for retail clients where amounts in dispute for each consumer are usually not large enough to

warrant the expense and time of litigation. Also, litigation is not geared towards resolving Islamic finance disputes, unless the judges are schooled in Shar'iah principles. Therefore, arbitration procedures that involve a financial ombudsman who has the requisite knowledge both of Shar'iah and relevant commercial transactions, are particularly useful. There is also a need to increase consumer awareness of redress mechanisms.

Promoting Financial Literacy

69. Islamic finance education and training opportunities are more readily available now than in the past, but there is significant scope for improvement at all levels. A major challenge continues to be the human resource development of practitioners, Shari'ah scholars, lawyers, accountants, regulators, judges, politicians and other stakeholders. A related issue is limited awareness about Islamic finance among the general public, including among the educated and influential elite. Addressing the shortage of Shari'ah scholars should therefore be a policy priority as well as expediting financial literacy programs.

Strengthening Corporate Governance Structures

70. Governance arrangements need strengthening to ensure the protection of IAHs and Shar'iah compliance. In line with IFSB guidelines, the establishment of a Governance Committee with the responsibility to oversee governance issues relating to IAHs, can help to enhance the transparency of returns and risks, and ensure that investment decisions are in the best interest of IAHs. Consumers who want to invest in Shar'iah compliant products would need protection to ensure that their requirements are complied with.

71. An important decision that would need to be made is whether to establish a centralized Shar'iah board that covers Islamic banks or keep Shar'iah governance decentralized at the bank level. Supervisors need to have full understanding of the pros and cons of each model and any Shar'iah governance system, at the national or institutional level, should have the necessary features of "competence, independence, confidentiality and consistency". Overall, a centralized Shar'iah board offers the advantage of harmonizing Shar'iah rulings across the Islamic sector, reducing the cost of Shar'iah compliance for Islamic banks, enhancing consumer confidence and easing constraints arising from the lack of sufficient numbers of Shar'iah scholars.

Strengthening the Protection of Sukuk Investors

72. Sukuk structures can be very complex and this can make it difficult for investors to discern risks. In addition, the legal and regulatory frameworks are not harmonized across countries, thus investors are exposed to legal risks, particularly in cross border defaults. Therefore, protection of Sukuk investors requires action on four broad fronts. These in the main include strengthening domestic bankruptcy regimes, harmonizing the international legal and regulatory environment; standardizing contracts and strengthening securitization laws.

73. There is a need to strengthen domestic bankruptcy regimes and harmonize the international legal and regulatory environment for Sukuk. The experience with Sukuk defaults exposed the vulnerability of investors' to cross-country differences in legal frameworks, demonstrated how ex-post outcomes were contingent on local laws, and also exposed disparities between ex ante provisions and ex-post outcomes. The rights of investors were also better protected in countries with stronger insolvency regimes.

74. The rising volume of cross-border Islamic financial transactions underscores the urgent need to harmonize regulatory frameworks and so reduce the legal risk in Sukuk default. Sukuk issued from jurisdictions with underdeveloped legal and regulatory infrastructures have resulted in investor rights not being upheld. Although asset-backed Sukuk are expected to behave differently in the event of stress or the originator's default, even true asset securitization may be challenged given the limited experience with the instrument and the variation in legal opinion across jurisdictions. Collaboration at the international level is, therefore, needed to address cross-country differences in the insolvency regimes.

75. Standardization of contracts would also enhance consumer protection. The growing number of structures used to construct Shari'ah-complaint Sukuk has brought its own complexities and differences in understanding between the issuers, investors, traders, lawyers, and regulators. To protect consumers or investors, there is a need for clearer understanding with documentation, guidelines, best business practices, and transparency, while strengthening and streamlining the Shari'ah approval processes. The IIFM efforts to create greater transparency, market unification and Shari'ah harmonization are an important step. Current work by the IIFMs in the area of Islamic Capital & Money Market (ICMM) standardization will play an important role.

76. Finally, securitization laws need strengthening to facilitate issuance of asset-backed Sukuk. Apart from consumers and investors' preference, and their unwillingness to accept the risk of underlying assets and limitations in available assets, the inadequacies in securitization laws are among the reasons that most countries issue asset-based Sukuk in which the investors do not have recourse to the underlying assets. For some countries, it will be necessary to enact new laws; others will need to ensure that the existing laws cater to the specifics of Islamic capital market products.

Deposit Insurance Schemes

77. Countries that offer Islamic financial services should seek to ensure that the Deposit Insurance Schemes are Shari'ah compliant and should clarify the treatment of PSIA. The IFSB has not adopted a standard or guideline on Shari'ah-compliant deposit insurance. At present, jurisdictions are divided on the definition and treatment of PSIA; some countries provide protection to both unrestricted and restricted PSIA holders, some only provide protection to unrestricted PSIA, and some do not provide any protection to PSIA. But apart

from PSIA's, there are other types of accounts, such as *Wadiah*, which are a type of current account. The latter should, therefore, be guaranteed and unlike conventional accounts for which coverage is usually up to a specified amount only, these accounts would require full coverage. To minimize the risks of Shari'ah non compliance, there is need to strengthen governance structures and ensure that investments are consistent with Shari'ah rules.

References

- AAOIFI Financial Accounting Standards (FAS) Number 6 (Undated) Equity of Investment Account Holders and their Equivalents
- AAOIFI (2010), Shar'iah standards, item 2 Shar'iah Standard Number 17, pp. 307-309.
- AAOIFI Financial Accounting Standards (FAS) Number 11 (1996), Provisions and Reserves
- AAOIFI Financial Accounting Standards (FAS) Number 14 (2000) on Investment Funds
- AAOIFI Financial Accounting Standards (FAS) Number 27 (2014) on Investment Funds
- Ernst & Young (2013), *World Islamic Banking Competitiveness Report 2013–14*. The transition begins
- Ernst & Young (2014), *World Islamic Banking Competitiveness Report 2014–15: Participation Banking 2.0*
- Financial Stability Board (2013), *Financial Stability Report for 2013*. Malaysia.
- Financial Stability Board (2011); Consumer Finance Protection with particular focus on credit. http://www.financialstabilityboard.org/2011/10/r_111026a/.
- IFSB -4 (2007), *Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services*.
- IFSB-6 (2008), *Guiding Principles on Governance for Islamic Collective Investment Schemes*
- IFSB-9 (2009), *Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services*
- IFSB GN 3 (2010), *Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders*
- IFSB, IOSCO and Securities Commission Malaysia (2013), *Disclosure Requirements for Islamic Capital Market Products*, Kuala Lumpur Malaysia. <http://www.ifsb.org/sec03.php>
- IADI (2010), *Deposit Insurance from a Shar'iah Perspective*. Discussion Paper February 2010 Switzerland. <http://www.iadi.org>
- Inutu Lukonga (2015), *The Growth of Islamic Banking in the Middle East and Central Asia Countries and Implications for Financial Stability*. Forthcoming

Islamic Financial Services Board (2014), IFSB Summit 2014. “New Markets and Frontiers for Islamic Finance: Innovation and Regulatory Perimeter”. Mauritius 19-22, May 2014

Islamic Financial Services Board (2007), Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services, excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds. www.ifsb.org

Lawrence Jonathan, Peter Morton and Hussain Khan (2012), Dispute Resolution in Islamic Finance in *Global Islamic Finance Report 2012* in April 2012 (London: Edbiz Consulting).

López-Mejía, A., Aljabrin, S., Awad, R., Norat, M., & Song, I. (2014), Regulation and Supervision of Islamic banks. IMF Working Paper 14/219. (Washington: International Monetary Fund).

Mahmood Nick Ramla (2012), Developing a Platform for Consumer Protection in the Islamic Financial Services Industry. Paper Presented at the Sixth Islamic Financial Stability Forum. (Malaysia: Islamic Financial Services Board)

Malaysia World Islamic Finance Market Place (2014), A Landmark Year for the Global Finance Industry. (Malaysia)

Moody's (2010), Derivatives in Islamic Finance: Examining the Role of Innovation in the Industry. <https://www.moodys.com>

Oseni, Umar, and Ahmad Faruq (2011), Dispute Resolution in Islamic Finance: A Case Analysis of Malaysia. Eighth International Conference on Islamic Economics and Finance, December 15-21, Doha.

Oya Pinar Ardic, Joyce A. Ibrahim, and Nataliya Mylenko (2011), Consumer Protection Laws and Regulations in Deposit and Loan Services. A Cross-Country Analysis with a New Data Set—Policy Research Working Paper 5536. Financial and Private Sector Development, Consultative Group to Assist the Poor (Washington: World Bank)

Sajjad Zaheer (2013), Sukuk Defaults: On Distress Resolution in Islamic Finance, Tinbergen Institute, Amsterdam School of Economics, University of Amsterdam and Tinbergen Institute

Shabbir Muhammad (2014), Adequacy of Disclosure in Islamic Financial Institutions. Institute of Islamic Banking and Insurance.

Song, I., & Oosthuizen, C. (2014), Islamic Banking Regulation and Supervision: Survey Results and Challenges. IMF Working Paper 14/220. (Washington: International Monetary Fund)

World Bank (2014), Global Survey on Consumer Protection and Financial Literacy Oversight Frameworks and Practices in 114 Economies.

——— (2014), Islamic Republic of Pakistan, Diagnostic Review of Consumer Protection and Financial Literacy

World Islamic Funds & Financial Markets Conference (2014), Manama, Bahrain: 19 May 2014. Keynote Address by: Mr. Abdul Rahman Al Baker, Executive Director of Financial Institutions Supervision, Central Bank of Bahrain

Appendix 1. Sukuk Structures

Ijārah Sukuk (SEC Sukuk)

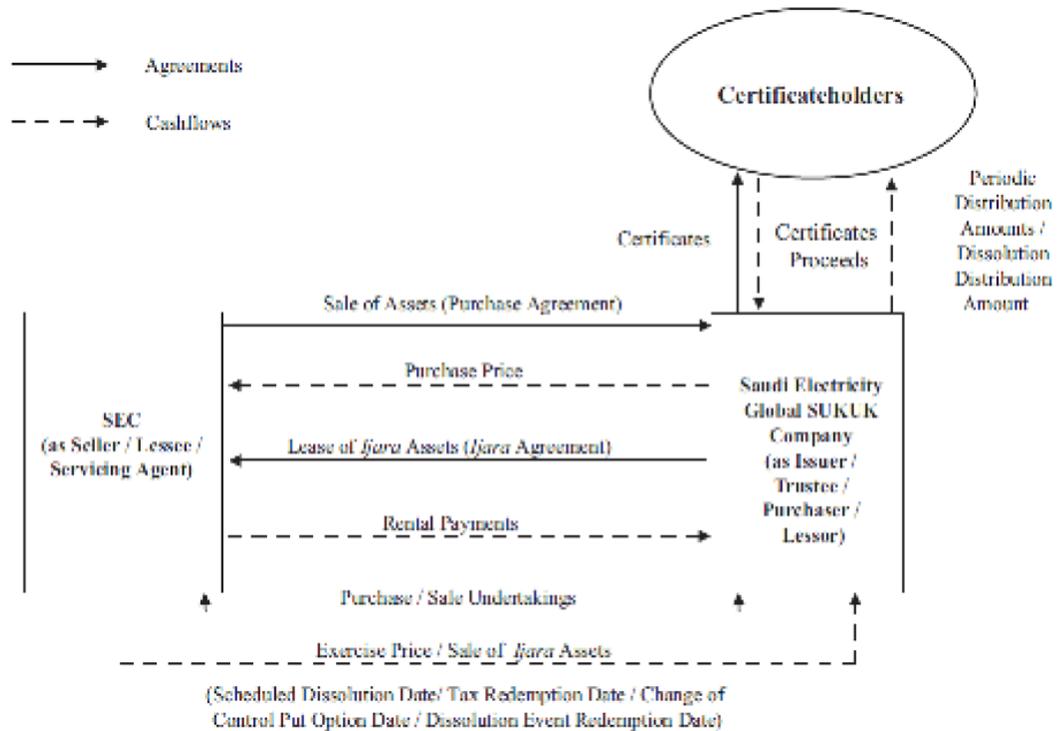
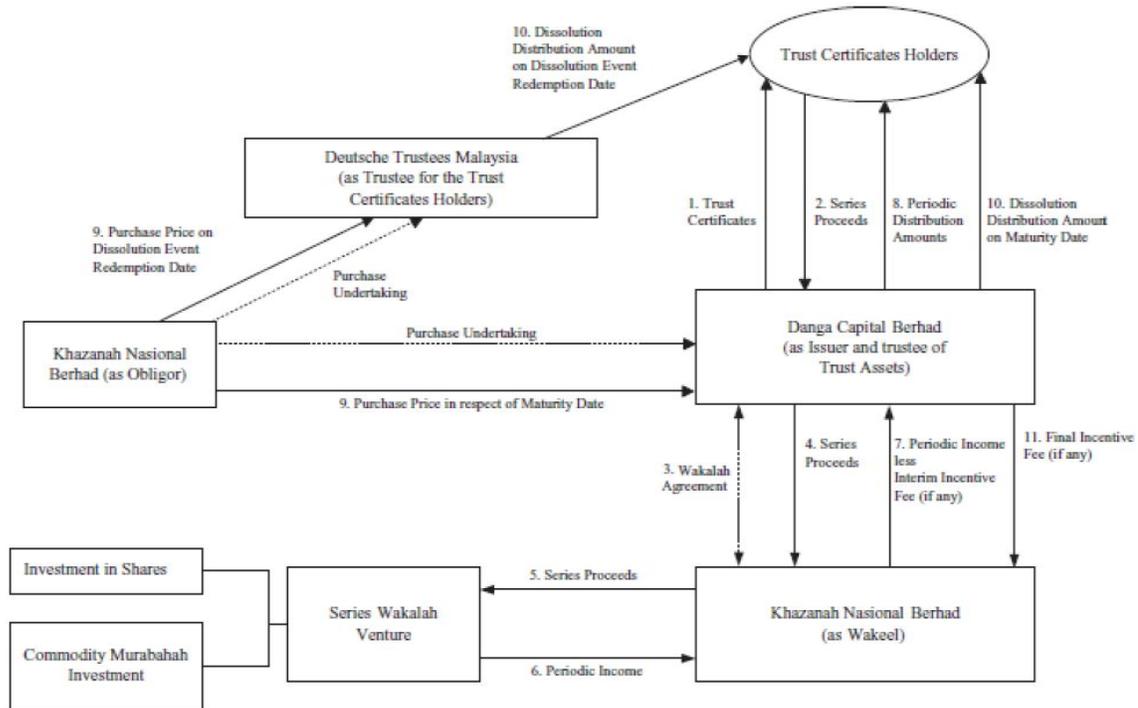


Diagram Explanation

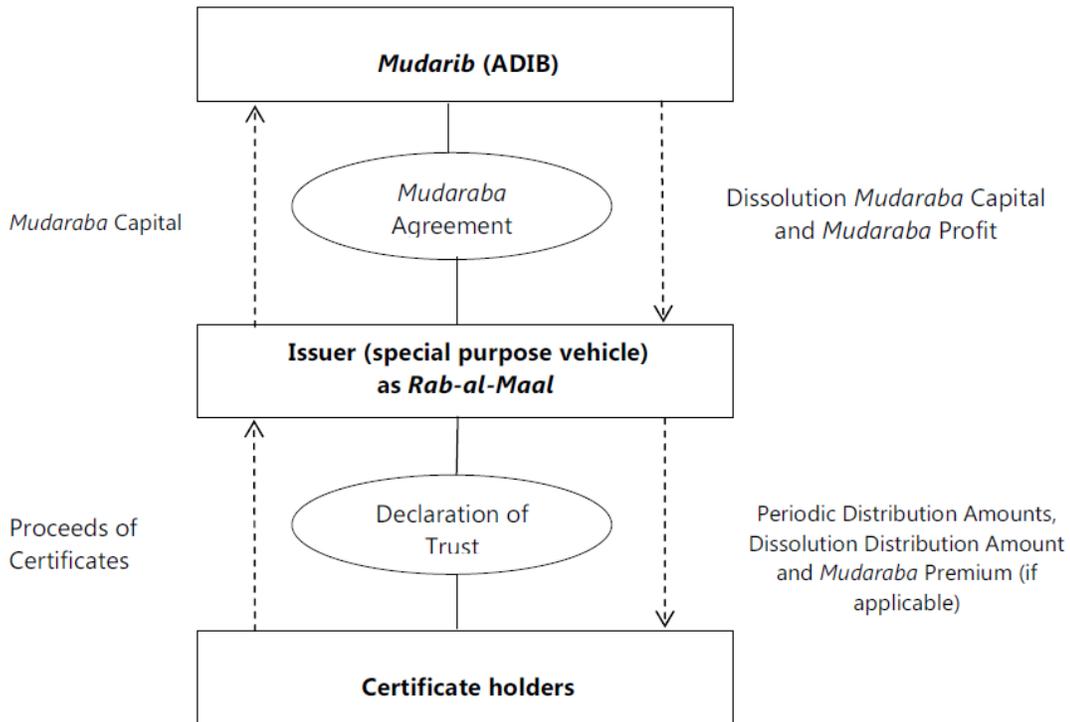
1. SEGSC (as the Issuer/Trustee/Purchaser) will purchase power generation assets (Ijārah Assets) from SEC (as Seller/Lessee/Servicing Agent) pursuant to a Purchase Agreement.
2. SEGSC (as the Lessor) will lease the relevant Ijārah Assets to SEC (as the Lessee) pursuant through an Ijārah Agreement.
3. SEC will pay rental payments which are intended to be sufficient to fund the periodic distribution amounts to SEGSC.
4. The Trustee may, on the dissolution date, or prior thereto following the occurrence of a dissolution event, exercise its rights under the relevant Purchase Undertaking and require SEC to purchase the relevant Ijārah Assets as well as repay any unpaid and accrued periodic distribution amount.
5. SEC may also, in the event that it wishes to cancel any certificate, exercise its rights under the Sale Undertaking, to require the Trustee to transfer the relevant Ijārah Assets to it.

Wakālah Sukuk Structure (Danaga Sukuk)



1. Investors will subscribe to Islamic certificates issued by Danga Capital Berhad (as Issuer) through payment of proceeds.
2. The Issuer (on behalf of the Trust Certificates Holders) shall instruct Khazanah (as the Wakeel) to invest the proceeds in a Wakālah Venture under a Wakālah Agreement.
3. The Venture shall comprise investments in: 1) certain Shari'ah-compliant shares owned by Khazanah and 2) the Commodity Murabahah Arrangement with Khazanah ("Murabahah Investment") holders
4. Khazanah, as Wakeel, shall manage the Venture for the Islamic holders.
5. Returns generated from the Venture shall be distributed by Khazanah to Sukuk holders as Periodic Distributions or One-off Distribution, as the case may be up to the Expected Returns. Returns in excess thereof shall be retained by the Khazanah as an incentive fee for the Wakeel. Any loss shall be borne by the Islamic Securities holders based on their respective capital contribution in the Venture.
6. Khazanah (as Obligor) will enter into a Purchase Undertaking with the Issuer (acting on behalf of the Islamic Securities holders) and the Trustee to purchase the Investments at market value upon an Event of Default or upon the maturity of the Trust Certificates, whichever is earlier.

Muḍārabah Sukuk



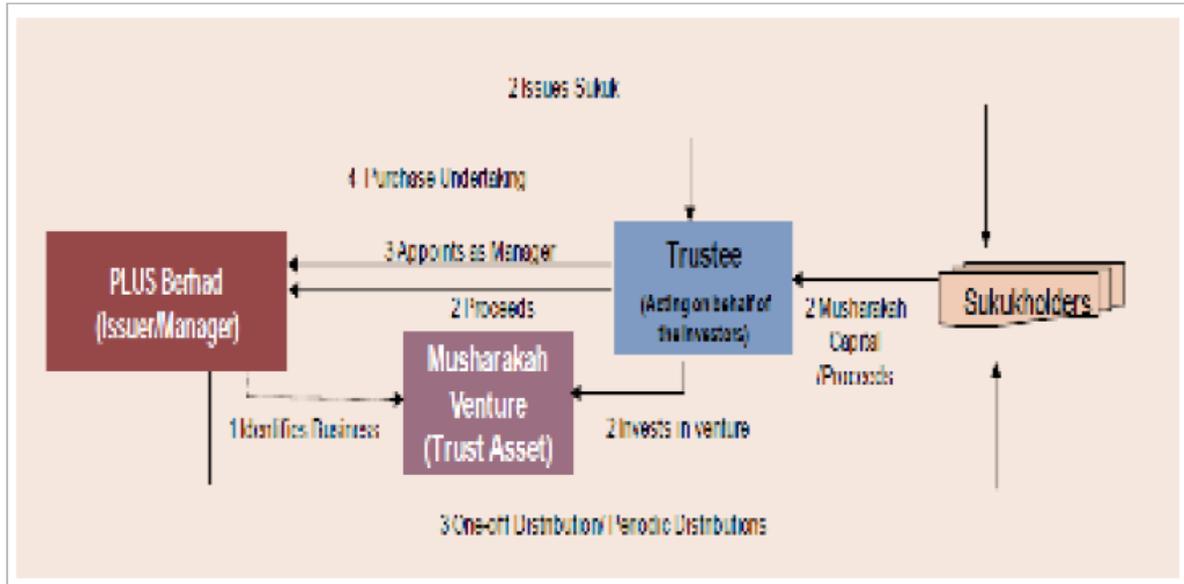
Analysis of Structure and Cash flow

1. On the Issue Date, ADIB Capital Invest 1 Ltd. (a special purpose vehicle) will issue the Certificates, and the Certificate holders will pay the issue price in respect of the Certificates to it (as Issuer/Trustee).
2. ADIB Capital Invest 1 Ltd. will apply the proceeds of the issuance of the Certificates towards the capital of the Muḍārabah pursuant to the Muḍārabah Agreement (the "Muḍārabah Capital").
3. ADIB (as Mudareb) will invest the Muḍārabah Capital in the business activities of ADIB in accordance with an agreed Investment Plan prepared by the Mudareb.
4. Unless a Non-Payment Event or a Non-Payment Election has occurred, prior to each Periodic Distribution Date, the Mudareb shall distribute the profit generated by the Muḍārabah to both the Issuer and the Mudareb in accordance with an agreed percentage split (90 per cent. to the Issuer (as Rab-al-Maal) and 10 per cent. to the Mudareb). Payments of Muḍārabah Profit by ADIB (as Mudareb) are at the sole discretion of ADIB (as Mudareb) and may only be made in circumstances where ADIB will not be in breach of certain conditions as a result of making such payment. The Mudareb shall not

have any obligation to make any subsequent payment in respect of such unpaid profit (whether from its own cash resources, from the Muḍārabah Reserve or otherwise).

5. The Issuer shall apply its share of the profit (if any) generated by the Muḍārabah on each Periodic Distribution Date to pay the Periodic Distribution Amounts due to the Certificate holders on such date.
6. The Certificates are perpetual securities in respect of which there is no fixed redemption date. Accordingly the Muḍārabah is a perpetual arrangement with no fixed end date.
7. Subject to certain conditions, ADIB (as Mudareb) may at its option liquidate the Muḍārabah in whole, but not in part, on the basis of an actual liquidation of the Muḍārabah in the following circumstances:
 - a. at its option on the First Call Date (being 16 October 2018) or any Periodic Distribution Date after the First Call Date; or
 - b. on any date on or after the Issue Date (whether or not a Periodic Distribution Date):
 - upon the occurrence of a Tax Event (being circumstances where the Mudareb or the Issuer would be required to pay tax on amounts due under the Muḍārabah Agreement or the Certificates, as applicable, due to a change in law); or
 - upon the occurrence of a Capital Event (being circumstances where ADIB is notified in writing by the UAE Central Bank to the effect that the notional amount of the Certificates which qualifies as regulatory capital would cease to qualify for inclusion in full in the consolidated Tier 1 capital of ADIB).
8. Upon the occurrence of the circumstances set out in paragraph (vii) above, the Trustee shall (only upon the instructions of ADIB) redeem the Certificates. Alternatively, upon the occurrence of a Tax Event or a Capital Event, ADIB (as Mudareb) may require the Trustee to make such variations to the terms of the Certificates and the Muḍārabah Agreement as may be required to ensure that the Certificates become or, as appropriate, remain qualifying Tier 1 capital instruments. ADIB (as Mudareb) agrees in the transaction documents that such variation will not be materially prejudicial to the interests of Certificate holders.

Mushārahah Sukuk



Analysis of Structure and Cash flow

1. Sukuk holders through Mayban Trustees Berhad (as the Trustee) will form a Mushārahah amongst themselves under a Mushārahah Agreement, to invest in the underlying asset (“Mushārahah Venture”) via the subscription of the Sukuk.
2. PLUS Berhad (as Issuer/Obligor) shall receive Mushārahah Capital arising from the subscription of the Sukuk.
3. Trustee shall appoint PLUS Berhad as the Manager of the Mushārahah Venture through a Management Agreement.
4. Income from Mushārahah Venture shall be distributed as periodic distributions or one-off distribution to Sukuk-holders as the case may be. In the event of any shortfall between the periodic/one-off distribution and the Expected Distribution, PLUS Berhad shall make top-up payments to compensate for the shortfall. The top-up payments will be set-off against the Exercise Price. Any income in excess of the Expected Return shall be retained by PLUS Berhad as an incentive fee.
5. PLUS Berhad (as “Obligor”) shall undertake to purchase the Sukuk-holders interest in the Mushārahah Venture pursuant to a Purchase Undertaking granted by it in favor of the Trustee (acting on behalf of the Sukuk-holders).
6. The Exercise Price will be paid on either the maturity date of the Sukuk Mushārahah or on the Dissolution Date, whichever is earlier

Annex 1. Characteristics of Selected Islamic Financial Products	
Murābahah	A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin.
Mushārahah	A contract between the IIFS and a customer whereby both would contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or moveable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of the Mushārahah agreement, while losses are shared in proportion to each partner's share of capital.
Diminishing Mushārahah	A form of partnership in which one of the partners promises to buy the equity share of the other partner over a period of time until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, after which buying and selling of the other partner's equity takes place at market value or the price agreed upon at the time of entering into the contract. The 'buying and selling' is independent of the partnership contract and should not be stipulated in the partnership contract, since the buying partner is only allowed to promise to buy. It is also not permitted that one contract be entered into as a condition for concluding the other.
Ijarah	An agreement made by an institution offering Islamic financial services to lease to a customer an asset specified by the customer for an agreed period against specified rental. An Ijarah contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the Ijarah contract.
Ijārah Muntahia Bittamlīk (or Ijarah wa Iqtina)	A form of lease contract that provides a separate promise of the lessor giving the lessee an option to own the asset at the end of the lease period either by purchase of the asset through a token consideration or payment of the market value or by means of a Hibah contract.
Istisna•	A contract of sale of specified objects to be manufactured or constructed, with an obligation on the part of the manufacturer or builder to deliver the objects to the customer upon completion.
Restricted investment accounts	The account holders authorize the institution offering Islamic financial services to invest their funds based on Mur;irabah or agency contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
Qar<J'Qar(f al-Hasan	A non-interest-bearing loan intended to allow the borrower to use the funds for a period with the understanding that this would be repaid at the end of the period, where it is not permissible for any increase in cash or benefit.
Salam	An agreement to purchase, at a pre-determined price, a specified kind of commodity not currently available to the seller, which is to be delivered on a specified future date as per agreed specifications and specified quality. The institution offering Islamic financial services as the buyer makes full payment of the purchase price upon conclusion of a Salam contract. The commodity

	may or may not be traded over- the-counter or on an exchange.
Sukuk	Sukuk is plural of the Arabic term sakk which means certificate, legal instrument or deed. Sukuk, also known as Islamic bonds, are certificates that represent a proportional undivided ownership rights in tangible assets or a pool of predominantly tangible assets or a business venture. Funds raised through issuance of Sukuk should be applied to investment in specified assets rather than for general unspecified purposes. This implies that identifiable assets should provide the basis for Islamic bonds.
Unrestricted investment accounts	The account holders authorise the IIFS to invest their funds based on Mu{i!irabah contracts without imposing any restrictions. The IIFS can commingle these funds with their own funds and invest them in a pooled portfolio.
Wadi'ah; Amanah	Deposits held at the bank for safekeeping purpose. They are guaranteed in capital value and earn no return
Wakālah	An agency contract where the customer (principal) appoints the IIFS as agent (Wakil) to carry out the business on their behalf and where a fee (or no fee) is charged to the principal based on the contract agreement.