DNB Occasional Studies

Occasional Studies

Vol.6/No.3 (2008)

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Islamic Finance and Supervision: an exploratory analysis

Bastiaan Verhoef, Somia Azahaf and Werner Bijkerk

Summary

Islamic finance is a growth market worldwide. There also appears to be substantial demand in the Netherlands. Several financial companies offer Islamic financial products while various others are exploring opportunities for entering this market. There are certain essential differences between traditional financing and financing according to '*Sharia*' principles, notably in terms of risk profile and organisational structure. In addition, compliance with *Sharia* principles results in non-standard financial products. The main financial supervision issues in relation to Islamic finance lie in the fields of market entry, business conduct, capital adequacy and information provision. While the supervisory framework offers a sufficient basis for regulating and supervising Islamic finance, solutions must be sought for these issues.

Contents

1 Introduction

The present study provides an exploratory analysis of Islamic finance and the main issues related to the financial supervision of Islamic finance in the Netherlands. With estimated annual growth averaging 15 per cent, Islamic financial services constitute a rapidly growing niche market around the world. KPMG (2006) put the global assets of the 300-plus Islamic financial companies at about USD 300 billion at the end of 2006 and their total assets under management at USD 400 billion.

Islamic finance is no longer just a theory in the European financial world. In mid-August 2004 the UK regulator, the Financial Services Authority (FSA), granted a banking licence to the Islamic Bank of Britain (IBB), which thus became the first-ever Islamic bank in the UK. Early in 2006, the European Islamic Investment Bank (EEIB) became the second Islamic bank to open its doors in the UK, followed in mid-2007 by the Bank of London and the Middle East (BLME). Alongside these purely Islamic banks, large international banks such as Deutsche Bank, HBSC and Lloyds also offer Islamic banking and investment products.

In the Netherlands, too, established financial institutions are exploring opportunities to provide for a perceived substantial latent demand for Islam-compliant financial services among Muslim residents. It is therefore not surprising that this subject has regularly cropped up in the public and political debate over the past two years. In response to these developments, the present study analyses the implications for, and adequacy of, the financial supervisory framework in the event that Islamic financial products are introduced in the Dutch market. Specific attention is devoted to determining whether any essential differences exist between the risk profile of these products and that of conventional products (i.e. the most commonly and frequently used products in the current financial system).

This exploratory analysis is in no way intended as an exhaustive overview of Islamic financial products and is confined to those Islamic financial products which appear to be attracting the most interest in the Netherlands. Various experts on Islamic banking were consulted for this exploratory analysis, including scientists, bankers and foreign regulators with experience in this particular field. Discussions were also held with organisations that are active in the mainstream of the Muslim community and consequently have first-hand knowledge of the potential demand for Islamic financial products within this community.

Chapter two describes the background to Islamic financial services, particularly the principles underlying Islamic financial products (section 2.1), the role of the

Sharia review board in this connection (section 2.2) and the most common Islamic financial products (sections 2.3 and 2.4). Chapter three analyses the origins of Islamic financial services (section 3.1) and the current market (section 3.2), as well as the expected market developments in the Netherlands. Chapter four outlines the issues that need specific attention in relation to financial supervision and discusses whether Islamic financial products are compatible with the existing supervisory framework. The conclusion is given in chapter five.

2 Background to Islamic financial services

Islamic finance differs from conventional finance. The most important difference is that Islamic financial products must conform to Islamic principles, the proper application of which is determined by the scholars of the *Sharia* review board. This chapter centres on the principles for Islamic banking (section 2.1), the role of the *Sharia* review board (section 2.2), the various types of Islamic financial contracts (section 2.3) and the financial products used in connection with these contracts (section 2.4).

2.1 Principles of Islamic banking

The principles of Islamic banking can be found in the *Sharia*.[1] This Arabic term stands for Islamic law or the law of God. Islamic law is not a law in the western sense. For one thing, there are no written civil codes for the avoidance and settlement of disputes. The *Sharia* is a religious code of ethics that governs the manner in which people act in secular and religious matters, both in their mutual relationships and in the relationship between man and God.

With regard to financial products the Islamic code of ethics, the *Sharia*, imposes certain stipulations:

- The use of instruments based on interest is forbidden. Interest is considered to be unjust, because remuneration for the use of money is agreed in advance. As a consequence, all the risks lie with the borrower and not with the lender. This imbalance is in conflict with Islamic views on income and risk distribution.
- The use of products that are based on uncertainty (*gharar*) and gambling (*maysir*) is forbidden. This translates into the rejection of conventional insurance products. The notion that the policyholder pays a premium without knowing whether and when he will reap the benefits is regarded as gambling and rejected as such. Taking advantage of uncertainty, which is perceived to be another characteristic of insurance, is also forbidden.
- Investments in bonds and other interest-based debt securities as well as in e.g. alcoholic beverages, entertainment or pork are not permitted, nor investing in companies that act in contravention of the *Sharia* (e.g. conventional financial institutions).

- An Islamic financial institution must in principle do business with institutions that respect the *Sharia*. In practice, however, dealings with non-*Sharia*-compliant financial institutions are permitted if that institution cannot do business with an Islamic financial institution.

Due to the *Sharia*-imposed restrictions, including the interest prohibition, Islamic financial products are often more complicated than conventional ones. This would suggest that Islamic finance is relatively inefficient compared to conventional finance and consequently also less attractive from an economic perspective. However, theory and practice are not conclusive about this (Box 1).

Strict adherence to the *Sharia* denies Islamic banks access to the conventional interbank market which, after all, is based on interest rate instruments. For the same reason, the central bank's lender-of-last-resort function is not compatible with the *Sharia*. Consequently, interest rates cannot be used for monetary policy purposes in a fully Islamic system. If an economy only depends on Islamic banking to a limited extent, this phenomenon will not have significant implications for monetary policy.

Islamic law has various sources. First of all, there is the *Koran*, containing prescriptions that every Muslim must observe. Next there is the *hadith*, the description of the life of Mohammed that serves as a guideline for Muslims. Also relevant are the *qiyas* (reasoning by analogy) and the *idjma* (consensus of opinion). Finally, there are the *fatwas*, which are rulings issued by authoritative Islamic scholars on diverse issues, usually in the form of a commandment or prohibition.

At the centre of the *Sharia* lies the Koran. Charging interest (referred to as 'usury') is forbidden in various places in the Koran.

'Those who charge usury are in the same position as those controlled by the devil's influence. This is because they claim that usury is the same as commerce. However, GOD permits commerce, and prohibits usury.' (Sura 2, 275)

Sura 3 puts it even more explicitly:
'O you who believe, you shall not take usury, compounded over and over. Observe GOD, that you may succeed.' (Sura 3, 130)

Some Muslims believe that the ban only applies to exorbitant interest (usury) and not to a reasonable interest charge. This is a question of interpretation.[2] If *riba* is derived from *arba* (= usury), then it means that only usurious interest is forbidden. If *riba* is derived from *raba* (= increase prosperity) then every form of interest is prohibited. In practice, the latter seems to be the most common interpretation in Islamic financial products.

The ethical concept underlying the Islamic interest prohibition has a long

Box 1 The economic case for Islamic financial products

Due to the restrictions of the Islamic code of ethics, the *Sharia*, Islamic financial products often have a more complicated construction than conventional financial products. In addition, an incongruent interpretation of the *Sharia* may result in non-standard contracts, thus causing further complexity. Islamic financial products are therefore less transparent for households and investors, so that the risk profile is difficult to assess and risks may be wrongly priced (Bhambra, 2007; and Witteveen and Verhoef, 2007). This could diminish the economic efficiency by resulting in e.g. higher transaction costs or an inefficient distribution of funds.

Nevertheless, several economists have made an economic case for Islamic finance (see e.g. Uzair, 1981; Nienhaus, 1982; and Siddiqi, 1981). They argue that Islamic finance permits more active and productive utilisation of capital than conventional financing methods. The reasons they cite are the following:
1. Interest inhibits consumption and production because it ties up income.
2. Interest causes an accumulation of capital among a limited section of the population. These people can thus live on the interest from their income, which is bad for production and bad for them personally (assuming that production is healthy).
3. Interest increases the costs of production and hence the costs for the consumer, thus further widening the class difference between rich and poor.
4. Fluctuations in interest rates cause changes in the supply of credit, possibly leading to instability, stagnation, depression and undesirable monopolies.

A further argument for the efficiency of Islamic finance concerns the distribution of risk via partnership contracts. This enables Islamic banks to pass on part of their losses on loans and investments to account holders and investors. This protects the solidity of the bank and promotes the stability of the overall financial system. The concept of risk sharing also counters immoral behaviour among borrowers because they own investment projects together with the bank. An Islamic bank can thus monitor the borrower's actions and prevent him from undertaking excessively risky investment projects. This, incidentally, does not apply to every partnership contract.

However, Hassan's empirical analysis (2006) of the efficiency of 43 Islamic banks in 21 Muslim countries for the period 1995-2001 suggests otherwise. His findings indicate that on average, Islamic banks are relatively less efficient than conventional banks, particularly in terms of cost efficiency. This may be because Islamic financial products have far higher contractual costs than standard financial products. Another possible reason is that the limited scale of Islamic banking precludes economies of scale.

history. Most (monotheistic) religions found the charging of interest a problematic issue and ancient philosophers as well as modern socialists have censured this practice. The Greek philosopher Plato saw the charging of interest as a threat to the stability of his ideal state, while money and commerce were a necessary evil for creating wealth. Interest could lead to the accumulation of possessions among the custodians of the state, which would make them susceptible to corruption. Aristotle made a distinction between the practical value and exchange value of goods. He considered the practical value as natural and the exchange value as unnatural. The charging of interest is at odds with the natural purpose of money (i.e. a means of exchange) and was therefore reprehensible. This concept corresponds with the views of Marx and later socialist philosophers such as Baudrillard. Medieval Europe also had ethical objections to the practice of making money from money. The Scholastic philosopher Thomas Aquino wrote that charging interest was tantamount to usury. Commerce was only allowed to be conducted at a reasonable price, i.e. a price that exclusively covered the costs incurred without a profit mark-up. However, these ethical objections to charging interest have entirely vanished in modern conventional banking.

2.2 The role of the *Sharia* review board

All over the world financial products must be approved by a review board of *Sharia* scholars before they can be designated as Islamic. This guarantees that the products genuinely meet all the principles outlined above. These scholars have in-depth knowledge of the *Sharia* and are preferably also knowledgeable of financial products. The *Sharia* review board assesses whether the product complies with *Sharia* principles and is correctly designed according to Islamic contract forms. After approving a financial product, the review board issues an approval report to the banking institution in question. This report is also known as a *fatwa*. The *fatwa* contains the argumentation of the review board and describes the *Sharia* rules underlying the contract form (Thomas, 2005).

Sharia review board scholars usually consist of an uneven number of members with a minimum of three. This avoids stalemates in the case of conflicting opinions; the review boards decide by majority vote. The *fatwa* describes the underlying considerations, including any dissenting views. The *Sharia* review board can base its judgments on diverse Islamic schools of thought. There are some ten different schools of thought around the world, of which four are Sunni and two Shiite, varying from extremely liberal to ultra-conservative. As a consequence, it is possible that a *fatwa* of one review board is based on an interpretation that is not endorsed by other *Sharia* review boards. Therefore, a product may be considered *Sharia*-compliant by one review board and non-compliant by another. However, sufficient consensus has meanwhile been achieved on many Islamic banking issues (Sinke, 2007).

Ensuring that products comply with *Sharia* law as well as national law can be a complex business, demanding a great deal of ingenuity on the part of both product developers and *Sharia* scholars. This means that the costs of obtaining a *fatwa* can be considerable and sometimes represent a substantial component of the overall cost price of products. Financial companies rarely disclose the entire fatwa issued for a specific product. Customers either receive a summary of the fatwa or have the opportunity to read the full text at the office of the institution.

Apart from approving Islamic financial products, the *Sharia* review board also assesses whether business is conducted in a *Sharia*-compliant manner. This concerns e.g. the product development process, the financing method, the sales process and the administrative handling. Usually the review board meets periodically to assess the ongoing business processes. The *Sharia* review board thus plays a role that is comparable to that of a Supervisory Board at a conventional financial institution.

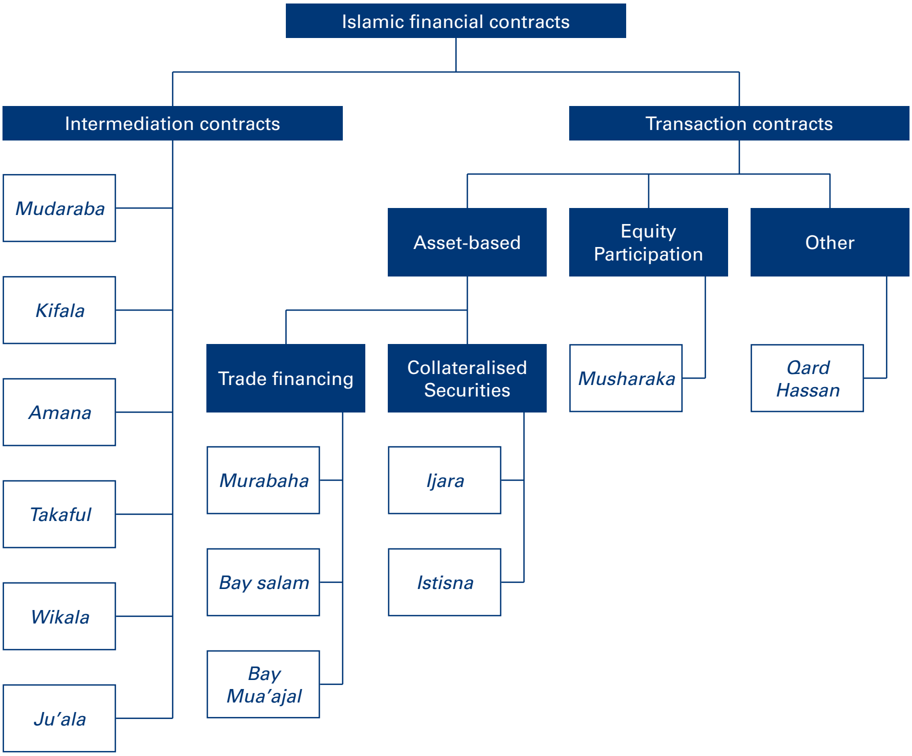
It is worth noting, incidentally, that detailed manuals and regulations describing procedures for the proper conduct of business have been compiled by *Sharia* scholars under the auspices of international Islamic financial committees, such as the Islamic Financial Services Board, the Accounting and Auditing Organisation for Islamic Financial Institutions and the International Islamic Rating Agency.

2.3 Islamic financial contracts

Islamic financial contracts can be subdivided into two categories: transaction contracts and intermediation contracts (figure 1). Transaction contracts concern transactions in commodities and the financing of economic activities. Intermediation contracts promote the efficient and transparent execution of these transaction contracts. Combined, these contracts offer a broad range of instruments with different objectives, terms and risk categories (El-Harway, Grais and Iqbal, 2004, p. 7).

Transaction contracts can be distinguished into contracts with a short term and low risk (*Murabaha*) and contracts with a short to medium term and a high risk (*Musharaka*). The first group of contracts usually involves a profit mark-up, while the latter group is based on profit and loss sharing. In practice the profit mark-up can consist of remuneration for the service and administration costs, the credit risk and the use of the financed commodity. In some cases, compensation for inflation is also charged (Vogel and Hayes, 1998, p. 203; and Visser, 2004, pp. 23 and 33). The extent to which this profit mark-up differs in essence from interest is therefore difficult to ascertain; and in cases where Muslims believe that the interest prohibition exclusively concerns usury and not a reasonable interest charge, the differences are even smaller. Other transaction contracts are based on lease contracts (*Ijara*). The terms and risks of intermediation contracts differ from those of transaction contracts. With an intermediation contract like a *Mudaraba* contract, only the profits are

Figure 1 Overview of Islamic financial contracts



Source: El-Hawary *et al.* (2004, p. 7).

shared between the lender and borrower. Any losses are exclusively borne by the lender. Other intermediation contracts, such as *Kifala*, *Amana*, *Takafal*, *Wikala* and *Ju'ala*, involve the provision of financial services such as advice, guarantees and insurance.

2.4 Common types of contracts

The most common types of Islamic finance for diverse activities are *Murabaha* (profit mark-up), *Ijara* (leasing), *Musharaka* (partnership), *Mudaraba* (partnership) and *Sukuk* (bond). Table 1 provides an overview of the contracts generally used for each type of finance. The most common types of contract for home finance, consumer credit and the financing of consumer durables are *Murabaha*, *Ijara* and *Musharaka* contracts, while trade finance and venture capital investments are mainly arranged through *Murabaha*, *Musharaka* and *Mudaraba* contracts (see e.g. Vogel and Hayes, 1998; and Visser, 2004).

Table 1 Overview of products and contracts in Islamic finance

	Type of contract				
	Murabaha (profit mark-up)	*Ijara* (leasing)	*Musharaka* (partnership)	*Mudaraba*	*Sukuk* (bond)
Commodity or property finance					
Mortgage	✓	✓	✓	-	-
Consumer credit	✓	✓	✓	-	-
Consumer durables	✓	✓	✓	-	-
Working capital	✓	-	✓	-	-
Trade finance	✓	-	-	-	-
Investment					
Short-term	-	-	-	✓	-
Long-term	-	-	✓	-	✓
Saving					
Savings account	-	-	✓	✓	-
Investment account	-	-	✓	✓	-

The liabilities on an Islamic bank's balance sheet consist largely of Islamic investment accounts based on *Mudaraba* and *Musharaka* contracts and, to a lesser extent, nominal guaranteed deposits. The assets consist predominantly of (tangible) goods that have been acquired for a customer via hire purchase-type structures (e.g. *Murabaha* and *Ijara*), accounting for about 70-80 per cent of the balance sheet) and venture capital-type investments (usually *Mudaraba* and *Musharaka* contracts).

Murabaha

Murabaha is a financing method where the lender purchases the commodity or property and then re-sells it to the customer with a profit mark-up. Sometimes the customer, acting as the agent of the lender, purchases the commodity or property. This is to avoid disputes between the lender and the customer about the quality of the property after the purchase is finalised.

The *Murabaha* contract form consists of two transactions: the purchase of the commodity or property by the lender and the resale to the customer. The customer repays the purchase price plus the charged profit mark-up to the lender in instalments. The lender can remain the owner of the commodity or property until the buyer has paid the final instalment, but can also deliver the commodity or property immediately to the buyer. In principle, the *Murabaha* contract cannot be cancelled, but the parties can agree to do so if, for instance, the buyer wants to sell his house before the expiry of the contract. In this case, the lender must decide whether he is prepared to accept a lower total payment than initially agreed. Please note, incidentally, that a buyer who fails to pay the instalments on time cannot be charged a penalty by the lender as the risk of non-payment is already priced into the profit mark-up. Consequently, there is no scope for imposing an additional penalty for late or non-payment.

If the customer defaults despite being able to meet his payment obligations, the contract can be enforced by law. In this case, the court may also decide to impose a penalty. However, there is disagreement about this among *Sharia* scholars; some contend that a penalty can only be imposed if the money goes to charity.

Ijara

An *Ijara* contract is comparable with a lease contract, where the legal ownership rests with the lessor. This means that the commodity or property remains on the lender's balance sheet during the contract period. The right of use rests with the customer, who pays the lender a fixed periodic amount in exchange for this right. An *Ijara* contract cannot be cancelled, but the parties can agree to alter the terms of the contract. In the case of the *Ijara wa-iqtina* the customer becomes the legal owner of the commodity or property after paying the final instalment. With both types of *Ijara* contract, as with the *Murabaha* contract, the lender cannot in principle impose a penalty in the case of late or non-payment.

Musharaka

Where a *Musharaka* finance contract is used for the purchase of a commodity or property, the lender and the customer jointly enter into a partnership and both take a share in the commodity or property. The customer thus becomes co-owner of the commodity or property. Subsequently, the customer periodically pays the lender a fixed amount, thereby acquiring a steadily larger share of the property and eventually obtaining full ownership.

When a long-term investment is financed, two or more parties take a stake. The profit or loss during the contract term is shared on the basis of a pre-determined ratio.

Mudaraba

Mudaraba finance is also based on a partnership contract. The lender provides the capital to an entrepreneur who is responsible for the management of the investment project. The lender is comparable to a dormant owner. In this case the lender can impose restrictions on the entrepreneur in advance (known as a *restricted Mudaraba*). Unlike with *Musharaka* contracts, only the profit is settled between the lender and the entrepreneur on the basis of a pre-determined ratio. Any loss is fully borne by the lender and not by the entrepreneur. The reason for this is that according to the Islam one cannot lose something that he/ she does not own.

Islamic investment accounts

Islamic investment accounts involve a partnership between an account holder and a bank where the remuneration paid to the account holder is based on profit and loss sharing. The account holder extends capital to the bank. On the basis of the contract, the loss is partly (*Musharaka*) or entirely (*Mudaraba*) borne by the account holder. In practice, the return is often normalised by spreading the profit evenly over various instalments. In practical terms this means that upon withdrawal of the investment the account holder at least receives the nominal invested capital.

Sukuk

Another common method for financing investments is the *Sukuk*. A *Sukuk* is an asset-backed security that closely resembles a conventional bond. However, a *Sukuk* does not pay out any interest. Instead, the income is generated by the underlying assets.

A *Sukuk* can be constructed in different ways. One of the best-known structures is the *Ijara Sukuk*. This consists of three transactions. The party that needs the financial resources sells its assets to a Special Purpose Vehicle (SPV). The SPV finances the purchase by issuing the *Sukuk*. The second transaction takes the form of a lease, where the SPV leases the assets to the former owner and the resulting cash flows go to the *Sukuk* holders. The third transaction concerns the buy-back of the assets by the former owner at the end of the term.

3 Development of Islamic Financial Services

3.1 History

3.1.1 Origins

Islamic banking first took off in the 1940s and 1950s as decolonisation spawned numerous independent Islamic nation states. Pakistan, founded in 1947, was among the pioneers in the quest for Islamic identity and Islamic statehood, including an Islam-compliant financial sector. (Ahmad, 1952; and Hans, 1952).

Not surprisingly, therefore, it was in Pakistan that the first-ever Sharia-compliant lending bank came into being. Instead of demanding interest, the bank charged a small fee to cover its operating costs. The bank's loan portfolio grew rapidly but its success proved to be its downfall. Unable to attract sufficient deposits to meet the swelling demand for credit, the bank was ultimately forced to discontinue its lending business.

But the drive to create an Islamic identity in the post-colonial era soon prompted fresh efforts to set up Islamic financial institutions. In 1963, the Islamic savings bank Mit-Ghamr opened its doors in Egypt. Despite its popularity, the bank was compelled to close for political reasons, but was subsequently relaunched in 1972 under the name Nassar Social Bank. In Malaysia too, Islamic financial institutions were set up as early as 1963.

3.1.2 Regional expansion

In the early 1970s, Islamic banking received a major impulse from the first oil crisis that erupted in 1973. Oil prices quadrupled and funds flooded into the Middle East, creating unprecedented affluence in the region. A sizeable portion of these oil dollars was channelled via western banks in London and New York to developing countries in the form of loans. But a considerable amount was also used to set up Islamic financial institutions in order to stimulate the social and economic development of Islamic countries (Visser, 2004, p. 54). Islamic banking institutions sprang up all over the region: in Dubai in 1975, Kuwait in 1977 and Bangladesh in 1983 to mention but a few. A further impulse came from the foundation of the Islamic Republic of Iran in 1979. By this time, closer international cooperation in the field of Islamic banking had already culminated in the establishment of the Islamic Development Bank in 1975. The object of this multilateral bank is to promote the social and economic development of Islamic countries (Hassan and Zaher, 2001).

Islamic insurance developed more slowly than Islamic banking owing to the difficulties in achieving sufficient consensus on the specific interpretation and form of Islamic insurance products. Some scholars believed conventional insurance conflicted with the principles of *gharar* and *maysir*. Others disagreed, arguing that the pooling of large sums of money virtually eliminated the element of uncertainty in insurance contracts at the aggregated level. In the late 1970s, the overwhelming majority of scholars managed to agree on a form of Islamic insurance named *Takaful*, which closely resembles mutual insurance (Vogel and Hayes, 1998, pp. 150-154; and Visser, 2004, pp. 39-41). Since then, Islamic insurance has also started to gain ground.

The only countries with a fully Islam-compliant financial sector are Iran, Pakistan and Sudan. Malaysia has a dual system where the Islamic and conventional financial sectors exist side by side. The conventional banks are regulated under the Malaysian Banking and Financial Institutions Act (BAFIA) of 1989. Islamic banks also fall within the scope of this Act. In addition, Islamic financial activities must comply with all civil laws as well as the *Sharia*. The Act that accommodates this, the Islamic Banking Act 1983, is a hybrid form of the BAFIA legislation and the Sharia code of ethics (Maysami and Low, 1998).

3.1.3 Global expansion

Starting in the early 1990s, Islamic financial products also started coming onto the market in Europe and the United States. This rise of Islamic financial services was spurred by the migration of Muslims to Europe and the United States. In France and the UK many Islamic migrants came from former colonies; in other countries, like the Netherlands and Germany, the immigrants from Islamic countries had few if any colonial ties with their new countries of residence. Meanwhile, millions of Islamic migrants have settled in Europe and are increasingly eager to live their lives according to Islamic principles. More and more conventional financial institutions are responding to this demand. Examples in Europe are Deutsche Bank, HSBC and Lloyds TBS.

In addition, several Islamic financial institutions are active in Europe and in the UK in particular. These include the National Bank of Pakistan (NBP), which offers Islamic mortgages, the Bahrein Middle East Bank (BMEB), the Islamic Bank of Britain (IBB), which offers consumer banking products, and the European Islamic Investment Bank (EIIB) and the Bank of London and the Middle East (BLME), which both serve the business segment. The Islamic financial institutions in Europe are mainly locally oriented.

Finally, a further impulse for the development of Islamic financing is coming from the state funds of Dubai and Qatar, which are very actively taking stakes in (financial) companies around the world. They are driven by the sustained high oil prices and the realisation that economic diversification is key to the long-term viability of small oil states. These funds are seeking expansion outside the Gulf region and construct their investments on Islamic principles wherever possible.

3.2 The market for Islamic financial products

3.2.1 Global

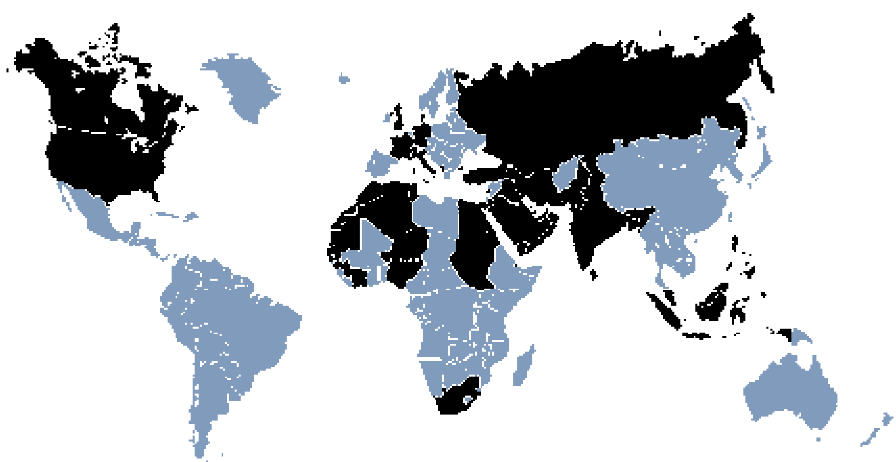
Following the rise of Islamic finance in the late 1990s, Islamic financial products are now available virtually all over the world (see figure 2).

Recent analyses put the worldwide assets of about three hundred Islamic financial institutions at over USD 300 billion at year-end 2006, excluding assets under management of USD 400 billion (KPMG, 2006). In addition, the global growth rate of Islamic finance is estimated at 15 per cent annually, which underscores the increasing significance of Islamic finance in global banking. However, compared to the scale of the global financial sector, the international Islamic financial sector is still a niche market.

3.2.2 United Kingdom

Islamic financial products are establishing a foothold in Europe, particularly in the UK. Tangible indicators are the trading activities in Islamic financial instruments of large players like Citigroup, Deutsche Bank, HSBC (via its subsidiary Amanah), Lloyds TBS and UBS, the foundation of the retail bank IBB, the subsidiaries of the BMEB and the NBP that are active in the British retail market and, finally, the foundation of the EIIB early in 2006 and the BLME in mid-2007. In addition, the first Islamic bond was quoted on the London Stock Exchange (LSE) in March 2007. This bond was issued by Dubai Islamic Bank and is also listed on the Dubai International Financial Exchange. Since this first issue, new Islamic bonds have been issued nearly every month on the LSE.

Figure 2 Global presence of Islamic financial products



Source: The Institute of Islamic Banking and Insurance (www.islamic-banking.com).
Note: Islamic financial products are available in the countries that are coloured black.

Whether new Islamic banks like IBB, EIIB and BLMB can compete successfully with established players depends on their ability to build market share. At the end of 2006, the IBB reported a loss of GBP 8.8 million on a balance sheet total of about GBP 118 million, as opposed to a loss of about GBP 6.4 million on a balance sheet total of about GBP 89 million in 2005. Despite the reported losses, the expectations for the future are positive given the considerable demand within the British Muslim community. This is evident from the rising volumes of deposits and credits which grew by, respectively, 76% and 31% in 2006 (IBB, 2007). In addition, the loss at IBB is directly attributable to start-up costs such as investments in staffing and the establishment of a branch network. These costs are expected to decrease in the future, while income will steadily rise on the back of accelerating consumer demand. The EIIB faces the same challenge of expanding its income. Provisional results show that its balance sheet total increased by 17% to GBP 236 million at the end of 2007, with deposits almost doubling from GBP 49 million in 2006 to GBP 90 million in 2007. The operating result before tax advanced strongly as well, soaring by 155% to 4.8 million.

The development of the Islamic financial market is also being stimulated by a big push from the British government in order to help London establish itself as the Islamic financial centre of Europe. The British government is currently considering issuing an Islamic bond loan. Furthermore, it is seeking to remove legal obstacles that currently impede the development of Islamic financial products. Among other things, the double transfer tax on Islamic mortgages has been eliminated. This double taxation arose from the Islamic practice whereby the bank purchases the house first and then resells it with a profit mark-up (instead of interest) to the customer. Each of these sale transactions formerly attracted transfer tax, even though the bank usually only owned the property for a very brief period. In addition, working in close cooperation with the FSA, the British Ministry of Finance has amended the law to bring certain forms of Islamic contracts within the regulatory scope of the FSA.

3.2.3 The Netherlands

The Netherlands is home to just under one million Muslims. The potential demand for Islamic financial products would therefore appear considerable. Some financial institutions already offer Islamic investment products, while others are eyeing the market for Islamic financial services with interest. Below we will look at the characteristics of the demand side, followed by the supply side and the institutional obstacles.

Demand

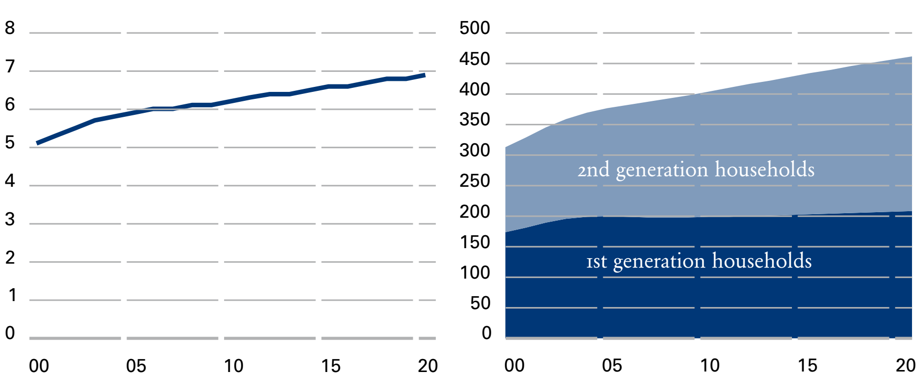
Islamic mortgages have attracted the most attention in recent years. Apart from Islamic home finance, the retail market may also offer opportunities for e.g. Islamic car finance, nominal guaranteed deposits and a type of investment account where the profits and losses are shared between the Islamic financial institution and the account holder. The demand for Islamic finance among small and medium-sized businesses is difficult to estimate as yet.

However, the potential demand for Islam-compliant financial services is expected to rise in the coming years in view of the expanding Muslim population, among other factors. Netherlands Statistics (*Centraal Bureau voor de Statistiek* / CBS) forecasts that the Muslim community will grow from 6% of the total population in 2007 to about 7% in 2020 (chart 1). Particularly second-generation Muslim households, defined as persons born in the Netherlands with at least one foreign-born parent, are displaying an interest in financial products, preferably ones that are Islam-compliant. The fact that many attend meetings and congresses on Islamic banking and insurance speaks volumes. The number of second-generation households is expected to increase from 189,000 in 2007 to an estimated 253,000 in 2020.

Apart from the relative size of the Muslim population, other determinants of the potential demand include socio-economic factors such as income and education, faith, knowledge and confidence. Between 2000 and 2005, the estimated gross income of a second-generation Muslim household increased by 14% to about EUR 34,800 (table 2), whereas the gross income of non-ethnic households rose in the same period by 18% to EUR 51,300. Regarding the level of education, the CBS integration monitor (2007) shows that non-Western ethnics, in particular, underperform non-ethnics in all stages of their educational career, though this study also shows that the gap is closing. If this trend is also expressed in a further increase in the income levels of Muslims, the potential demand for Islam-compliant financial services will receive a further boost. Rising incomes would offer this group of Muslims more scope to save and invest, as well as better opportunities to buy their own home.

Chart 1 Size of Muslim population in the Netherlands

a) As a % of the Dutch population b) First and second generation households (x 1,000)



Source: CBS and DNB.

Table 2 Estimated gross income per Muslim household
In EUR 1000

	Muslims Total	1st generation	2nd generation	Non-ethnics
2000	31.2	31.2	30.5	43.5
2001	33.1	33.1	33.1	46.1
2002	33.9	34.0	34.0	47.9
2003	34.0	33.9	34.7	48.9
2004	34.8	34.9	33.8	50.6
2005	35.3	35.4	34.8	51.3

Source: CBS and DNB.

The actual demand for Islamic financial products depends on the extent to which Muslims practice their faith. The development of the second generation of Muslims plays a central role in this respect, as they appear to be the principal target group for Islamic financial products. This generation was born and bred in the Netherlands, but was partly raised with the traditional values of their parents. The second generation's ties with their parents' native country are not as strong, but they do feel a need to establish an identity for themselves within Dutch society. Faith can play an important role in the cultivation of that identity and Islamic financial products can cater to this need.

On the other hand, Islamic financial products do not form part of the traditional values of first-generation Muslims in the Netherlands. In Turkey and Morocco – the countries of origin of most Muslims in the Netherlands – Islamic banking was a rare phenomenon until recently. So neither the first nor the second generation of Muslims in the Netherlands is familiar with such products.

The social structure of the various Muslim communities can also influence the demand for Islamic financial products. For instance, Muslims of Moroccan and Turkish origin have different social structures. The first group has a looser social structure, which is less conducive to the rapid dissemination of knowledge on Islamic financial products. By contrast, the latter group constitutes an extremely close-knit community, which may serve to accelerate the propagation of knowledge. The rate at which knowledge of Islamic financial products is diffused can influence the demand for these products.

In this connection we should note that special meetings on Islamic finance that are currently being organised by Muslim network organisations are also attended by many Muslims of Moroccan origin. In addition, Islamic products and services are increasingly being promoted on the strength of their specific Islamic identity. *Halal* meat, for instance, now carries its own clearly visible '*halal*' certificate. Finally, the internet can play a pivotal role in disseminating knowledge on Islamic financial products. There are already special websites where Muslims discuss topics and exchange information.

Product range

Established financial companies are also showing an interest in Islamic financial services. In 2004 and 2006 ABN AMRO and Rabobank studied the potential of Islamic banking. ABN AMRO launched a structured investment product called the LLB Top 20 Middle East Total Return Index Certificate. This product was brought onto the market in April 2007 with a tranche of EUR 5 million, followed by a second tranche worth EUR 45 million early in October. Thus far, ABN AMRO has not developed any mortgage products. Rabobank has estimated the potential demand for Islamic mortgage products at about 200,000 households (Parool, 2006) and is also experimenting with savings accounts where the earned interest is donated to charity. Finally, Barclays launched three Amsterdam-listed Islamic investment products in January 2008. These are trackers that follow the movements on Islamic indices.

Institutional obstacles

Despite these developments, Islamic financial products are barely getting off the ground in many European countries, including the Netherlands. The Islamic mortgage is a case in point. Though market research has identified a potential interest in this product, its development has so far been impeded in the Netherlands by the following institutional obstacles:

- The Islamic mortgage is not interest-based and therefore not eligible for mortgage interest relief, which denies the customer a considerable tax advantage and makes the product substantially more expensive than a conventional mortgage. This problem does not occur in other European countries where there is no mortgage relief. This obstacle must be removed to permit a successful launch of Islamic mortgages.
- With some forms of Islamic mortgage the bank buys the property first and then (gradually) resells it to the customer at a price that includes a profit mark-up for the entire mortgage period. If the second transfer does not take place within six months of the first transfer, transfer tax is charged twice, thus making Islamic mortgages more expensive than conventional mortgages. Here too, Dutch law impedes the introduction of Islamic mortgages.
- With some forms of Islamic mortgage, the ownership of the property is gradually transferred to the customer with each instalment payment. To qualify for mortgage relief, the property must be at least 50%-owned by the customer. Again, this restriction stands in the way of Islamic mortgages.

4 Supervision of Islamic financial services

There are several key differences between Islamic and conventional financial products, both in terms of underlying principles and structure. Among other things, the specific Islamic contract forms and compliance with *Sharia* law lead to different risk profiles. In addition, Islamic financial companies conduct their business in a different manner than their conventional counterparts. These differences give rise to prudential and conduct of business supervision issues, notably in the fields of market entry (section 4.1), conduct of business (section 4.2), capital adequacy (section 4.3) and provision of information (section 4.4). The challenge here is to ensure as much consistency as possible between the supervision of Islamic financial products and the supervision of conventional financial products (Witteveen and Verhoef, 2007). The analysis below is confined to Islamic banking, with a specific focus on the Islamic mortgage, which appears to be attracting the most interest in the Netherlands.

4.1 **Market entry**

Before being permitted to offer financial products on the market, the provider must obtain a licence from one of the financial supervisors. The Dutch central bank (DNB) is responsible for granting licences to banks, insurers, pension funds, money transaction offices and trust offices. The Netherlands Authority for the Financial Markets (AFM) grants licences to investment companies and institutions as well as financial service providers. Before granting a licence, the supervisors test various aspects, including the expertise and reliability of the policymakers and the effectiveness and efficiency of its business processes. DNB's standard supervisory procedures are designed to ensure the proper management of solvency and liquidity risks, the integrity of business processes and compliance with supervisory laws and regulations. The standard supervisory procedures of AFM focus mainly on the conduct of the financial companies, which are required to comply at all times with the standards and rules laid down in the Act on Financial Supervision (*Wet op het financieel toezicht* / Wft).

All financial companies seeking a licence are subject to the same market entry requirements as outlined in the Wft, irrespective of their country of origin, sector or religious principles. This is in line with one of the key objectives of the Wft, namely to guarantee a level playing field. In other words, equal treatment must be given to equal cases, not only in the national and international arenas but across sectors.

Strictly speaking, these market entry requirements can be applied to all types of financial companies but in practice the supervisor also takes the specific circumstances of the company into account. For instance, a one-man business will obviously not need to meet the same requirements as a large financial institution. Islamic financial companies must meet these market entry requirements in the same way as their conventional counterparts. In this context, particular attention must be devoted to the requirements relating to the assessment of the expertise and reliability of policymakers and the conduct of business. The latter is discussed in section 4.2.

New providers of Islamic financial services will need to comply with supervisory regulations if they engage in activities that are defined as banking or investment-related. Certain legal complications may arise in this connection. An Islamic financial company that wants to provide banking services must be a bank in the sense of the Wft. The Wft defines a 'bank' as a party whose business it is (i) to receive funds from private parties other than professional market parties (ii) to grant credit at its own account. The starting point of an Islamic bank is to attract nominal guaranteed deposits from the public, which means that condition (i) is satisfied. Looking at condition (ii), however, the most common types of Islamic commodity finance, viewed from a legal perspective, cannot always be interpreted as credit. Whether they qualify as credit depends on the specific contract form. Contracts that take the form of a finance lease are interpreted as credit. However, contracts with operating lease or hire-purchase characteristics will generally fail this test. If the applied Islamic financial contracts cannot be interpreted as credit, the Islamic financial institution cannot be classified as a 'bank' under the Wft. A problem also arises in relation to Islamic investment accounts. This can be solved by applying for a licence as a bank investment company, but this solution is only available to Islamic financial companies that already have a banking licence. Banks that already have a licence are, in principle, permitted to offer Islamic financial products, provided they meet the supervisory requirements.

In relation to market conduct supervision legal complications exist also. In this respect, it is important to ensure that financial products that are offered by new and established financial companies fall within the scope of the Wft. When considering lending products, for instance, the Wft definition of credit is relevant in the context of market conduct supervision. This definition consists of two components, namely cash credit and commodity credit. However, an Islamic mortgage does not fulfil this definition. First of all, a consumer who takes out an Islamic mortgage does not receive a cash credit but buys the house on an instalment plan. Secondly, an Islamic mortgage is not a commodity credit, as this relates to movable, not immovable goods. If an existing financial company were to offer such an Islamic mortgage, it would fall outside the scope of the market conduct supervision. And new providers of these products would not be eligible for an AFM licence as a financial service provider. In addition, the intermediaries and advisers would not be subject to licensing requirements as they are only obliged to have a licence if their advice or mediation concerns financial products that fall within the scope of the Wft. In principle, therefore, a consumer has less protection when taking out an Islamic mortgage than a conventional mortgage. This problem does not occur with prudential supervision where all activities of existing financial companies – i.e. including Islamic mortgages – fall within the supervision of DNB.

At present, no banks in the Netherlands provide Islamic mortgages or other Islamic forms of credit. Nor have any bank licences been granted to Islamic financial companies at this stage. However, some experience has been gained in the field of market conduct supervision with an Islamic-based investment product issued by ABN AMRO. This structured investment product, called the LLB Top 20 Middle East Total Return Index Certificate, falls within the scope of the Wft because it qualifies as a security in the sense of the Wft. The prospectus that ABN AMRO prepared for this product was approved by AFM as being in accordance with its completeness, comprehensibility and consistency requirements.

Another market entry issue that arises with Islamic financial institutions is the role of the *Sharia* review board. With each licence application the expertise and reliability of policymakers – i.e. executive board and/or senior management – are assessed by the licensing supervisor. The question here is whether, in view of their influence on product decisions, the members of the *Sharia* review board can be regarded as senior management and as such fall within the required expertise and reliability assessment. Alternatively, the *Sharia* review board can be seen as a kind of approval committee, which does not carry ultimate strategic responsibility. In this case, an assessment would not be required but it would then seem necessary to explicitly lay down the scope of their advisory tasks and responsibilities in e.g. the company's articles of association.

4.2 Conduct of business

As regards the licence application as well as the continuous supervision, it is vital for a financial institution to conduct its business on the basis of effective control and integrity. Both prudential and market conduct aspects come into play here. First of all, an institution must control its business processes to minimise risks. At the very least, controlled conduct of business entails (1) a clear and adequate organisational structure; (2) a clear and adequate distribution of duties, powers and responsibilities; (3) uniform reporting lines and (4) an adequate information and communication system. Secondly, it is important for the business processes to be set up in such a way that integrity of business is safeguarded thus, by extension, promoting the integrity of the financial sector. Integrity, alongside solidity, is a key condition for a healthy financial system.

The organisational structure and risk profile of an Islamic financial company differ from those of a conventional financial company in several aspects. Among other things, an Islamic financial company has a *Sharia* review board of scholars who assess whether the financial products are compliant with the *Sharia*. Received funds are also usually placed in a single large pot (known as co-mingling of funds) and then loaned out. This is one of the two most common types of business for Islamic financial companies (Errico and Farakbaksh, 1998).

The existence of effective control and integrity procedures is assessed on market entry and as part of the ongoing supervisory process. Regarding the business operations and financial products, sufficient checks and balances must be in place to reduce any risks (notably reputation and legal risks) that may arise from incorrect assessment and failure to comply with the *Sharia*. The *Sharia* review board has a key role to play in this respect. If the (Islamic) financial company decides to make use of an external *Sharia* review board, other internal committees must guarantee compliance with the *Sharia*. It is, incidentally, not up to the supervisors to judge the Sharia aspects or to assess whether the financial services are *Sharia*-compliant.

To prevent any conflict of interest, an overlap of *Sharia* scholars on diverse *Sharia* review boards is another supervisory issue. The fact that the number of *Sharia* scholars is limited increases the potential for this problem. One example of this overlap concerns the current composition of the *Sharia* review boards of the Islamic banks IBB and the EIIB in the UK: the *Sharia* review board of the IBB consists of two members who also sit on the four-man *Sharia* review board of the EIIB, while one scholar of the *Sharia* review board of EIIB was previously on the review board of the IBB.

In this connection, the supervision – and market conduct supervision in particular – may insist on transparency about the role and composition of the *Sharia* review board, as well as any other activities that its members engage in. Reputation and legal risks can thus be reduced. The basic assumption is that consumers must be able to trust a financial company to be *Sharia*-compliant if it makes this claim. Transparency is essential so that the consumer can make a well-considered choice. Practice shows that transparency cannot always be taken for granted. For instance, unlike the British banks EIIB and IBB, some Islamic financial institutions provide no information whatsoever about their *Sharia* review board on their websites.

A third issue concerns the co-mingling of funds. This can result in non-transparent transactions where it is unclear which funds belong to which clients or beneficiaries. From the perspective of integrity risks, this practice requires specific supervisory attention (know your customer, duty of care and fraud as well as for creditor protection reasons). An adequate administration of cash flows reduces the integrity risk. In addition, increased transparency can promote the market discipline of account holders.

A fourth issue is known as *zakat*. The *zakat* concerns obligatory alms that Islamic financial companies must give from their initial capital, reserves and profits. Since the 9/11 attacks, more attention is being devoted to the risks attendant on charitable institutions and their possible associations with terrorism financing. Reputation risk also plays a role in this connection. In principle, every financial company that performs transactions on behalf of or with charitable institutions runs this risk, but within Islamic financial companies the risk is heightened because this practice is institutionalised and carried out on a grand scale. In this connection, accurate record-keeping and sound business processes are vital to make the *zakat* cash flows transparent, so that it is always possible to trace what amounts were paid to whom.

Finally, the specific balance sheet structure of an Islamic financial company has financial reporting implications (El-Hawary et al., 2004, pp. 27-28). Among other things, attention must be devoted to the treatment of savings deposits based on profit- and loss-sharing when calculating the capital adequacy ratio (defined as the capital/risk-weighted assets ratio). In one method, the deposit holders share in the overall risk of the Islamic financial company. As a result, these account holders are effectively treated as shareholders and their deposits are counted as part of the capital of the Islamic financial company. Another method implies that the account holders only share in the specific risk of their own 'investments'. This means that their deposits are not included in the capital.

4.3 **Capital adequacy**

The prudential supervision focuses on e.g. the solidity of a financial institution. For a bank, this means that it must maintain sufficient capital, given the risk profile of its activities. Practice shows that the credit, market and operational risks attendant on Islamic banking differ from those of conventional banking. Another risk that is characteristic of Islamic banking is known as the *displaced commercial risk*, i.e. the risk that the required return as agreed with the account holders will not be achieved. On the other hand, interest rate risk plays no role whatsoever (Sundarajan and Errico, 2002).

The credit risk, i.e. the risk that a counterparty will fail to fulfil its obligations, is estimated to be higher than with conventional financial contracts. *Mudaraba* finance, for instance, gives rise to a counterparty risk with a greater 'moral hazard' than business lending. One reason for this is that the Islamic bank, being a dormant owner, has only a limited ability to monitor the borrower. In addition, not all forms of collateral are accepted by the *Sharia*. For instance, the use of credit derivatives to mitigate credit risk is not permitted. Another factor that heightens the counterparty risk is the *Sharia*'s fundamental rejection of the imposition of penalties in the event of e.g. default. This means that an Islamic bank is less able to reduce its credit risk.

The market risk, i.e. the risk resulting from exposure to changes in market prices of tradable assets in the trading portfolio, plays a greater role for Islamic financial institutions because they have less investment flexibility. As a result, the concentration, correlation and volatility of the trading portfolio are expected to be higher than with conventional banks. The hire-purchase nature of the contracts also means that an Islamic financial company runs a market risk on the goods that it receives in ownership when extending credit.

The more limited investment flexibility can also confront Islamic banks with a greater market liquidity risk, i.e. the risk that due to market illiquidity or excessive supply certain assets can no longer be transacted at the applicable market rate. This risk is consequently often perceived to be part of the market risk. A second form of liquidity risk, namely the funding risk that a bank can no longer attract sufficient short- or long-term funding in the market, also affects Islamic banking. This is because Islamic banks, in principle, are not allowed to borrow in the interbank market. Sometimes these two forms of liquidity risk coincide.

The operational risk, i.e. the risk arising from the ineffective organisation or implementation of business processes, also differs from that of a conventional bank. On the one hand, the operational risk is lower with Islamic financial companies, e.g. because they are not allowed to trade in financial derivatives. On the other hand, the interpretation of the *Sharia* constitutes an extra operational risk, particularly in the form of a legal risk because there is no uniform interpretation of the *Sharia*. Finally, the need to develop new ICT systems specifically for Islamic financial contracts may be a source of extra operational risk.

As noted, one specific risk for Islamic financial companies concerns the *displaced commercial risk*. When concluding partnership contracts with account holders, the expected return on assets is determined in advance. In practice, however, the return may turn out lower, so that the account holder fails to achieve the expected return. To remain competitive and prevent mass withdrawals by disappointed account holders, Islamic banks often decide to pay out the agreed return anyway and charge this loss to their equity. In contrast with conventional banks, however, Islamic banks run no interest rate risk, which is a risk-mitigating factor compared to conventional banks.

Whether the characteristics of Islamic financial products result in a substantially higher risk profile remains to be seen and depends on the specific features of these products. Basel II, the new Capital Accord, provides a sufficient basis for calculating the capital adequacy of Islamic banks. However, specific attention must be devoted to the market risk arising from the loans in the banking book, the financing risk, the displaced commercial risk and the operational risk. The Islamic financial institutions must provide sufficient transparency on their risk exposures and maintain sufficient capital to cover these risks.

A few further difficulties arise in relation to the calculation of the capital adequacy for credit risk purposes. One such difficulty is that, for example, due to the legal ownership structure not every mortgage falls in the 'mortgage' risk category with the related risk weighting. The best way forward here would probably be to adopt a pragmatic approach where, in principle, Islamic mortgages are given the same risk weighting as conventional mortgages. This prevents the provision of Islamic financial products being unnecessarily impeded by the imposition of higher capital requirements. In due course, the collection of sufficient data will make it possible to compare the risk profile of an Islamic credit portfolio with that of a conventional credit portfolio. And if any substantial risk differences occur, the capital requirements can be adjusted to match the specific risk profile.

4.4 Provision of information

One of the aims of market conduct supervision is to ensure that financial companies provide adequate information to consumers. The provision of information on financial products is designed to enable consumers to form a well-informed opinion on financial products. This seeks to reduce the risk of misselling, i.e. the risk that consumers misguidedly buy financial products that do not meet their needs. Islamic financial products were developed to meet the same needs of consumers as conventional ones. The financial structure of Islamic financial products is comparable with that of conventional ones, but the legal form of the contracts can differ greatly. In some cases this can result in complex legal structures and, hence, different types of risks for consumers than with conventional products. An Islamic mortgage, for instance, often has a straightforward linear or annuity-type financial structure in combination with a complicated ownership structure. The *Sharia* aspects and the complicated contract forms heighten the risk of misselling. The risk of misselling can be subdivided into the following aspects:

- *Adequate information*: the complexity of the contract forms gives rise to new and different types of risks than the consumer is accustomed to with conventional financial products. In addition, the *halal* element is an extremely important product characteristic of Islamic financial products. A consumer buys an Islamic financial product precisely because it is *halal*. There is the risk that the product is not *halal*, e.g. because no *fatwa* has been issued or because the business processes are not set up in a *halal* manner. The consumer must therefore be adequately informed about the *halal* element in a broad sense as well as the risks attached to the Islamic contract forms. Alongside general product information, other types of relevant information include whether a *fatwa* has been issued for the product, the names of the members of the *Sharia* review board and e.g. whether the contracts can be cancelled;
- *Quality of advice*: a consumer often buys a financial product with the aid of an adviser. The role of the adviser is to tailor his advice to a customer profile so that he can make an appropriate recommendation. A customer profile contains information on the financial position, knowledge and experience, objectives and risk propensity of the consumer. The adviser can only tailor his advice to a customer profile if he also has specific knowledge of Islamic financial products. This is extremely important in view of the frequent legal complexity of this type of products and the attendant risks;
- *Knowledge*: providers, advisers and consumers lack knowledge of this type of

products. These products are relatively new, not just in the Netherlands but also elsewhere in the world. In the Netherlands, only a few providers have studied (the structures for) Islamic financial products in any depth. So the available knowledge is still very limited. The limited availability of this type of product means that consumers, too, lack knowledge.

The product that seems to be attracting the most interest is the Islamic mortgage. Though this product is not yet available in the Netherlands, it is interesting to establish what protection the consumer would have under the current market conduct supervision. Below we have outlined the protection the Wft gives consumers in the Netherlands for conventional mortgages and Islamic mortgages.

Duty of care with conventional mortgages
As noted earlier, unlike Islamic mortgages, conventional mortgages fall within the scope of the Wft. Financial companies that provide conventional mortgages must adhere to specific rules of conduct (also known as duty of care). Among other things, these oblige the financial company to provide relevant product information (such as quotation, credit prospectus, financial information leaflet, risks, etc.) prior to the conclusion of an agreement so that consumers are able to adequately assess the product and make a well-founded decision.

The product that an adviser recommends should link up with the customer profile. He does this by seeking relevant information from the consumer in relation to his financial position, knowledge, experience, objectives and risk propensity (customer profile). In addition, the provider of the loan (mortgage) or adviser must also seek to avoid excessive borrowing.

Application of duty of care with Islamic mortgages
In the case of Islamic mortgages, the adviser or provider would not be subject to the duty-of- care rules. Consumers therefore have less protection with Islamic mortgages than with conventional mortgages, even though both types of mortgage are designed to meet the same consumer need. In other words, under the current market conduct supervision system there is no level playing field between Islamic and conventional mortgages.

One way to bring Islamic mortgages within the scope of the Wft would be to adjust the Wft definition of 'commodity credit'. This definition is currently restricted to movable goods; if it were widened to include immovable goods, Islamic credit agreements (mortgages) would also fall within the scope of the Wft. Another alternative would be to designate Islamic mortgages as a financial product.

Nevertheless, the question remains whether the Wft rules of conduct are sufficient to mitigate the risk of misselling when it comes to Islamic financial products. The rules of conduct, which are laid down in the Wft, the Decree on Conduct of Business Supervision of Financial Undertakings (*Besluit gedragstoezicht financiële ondernemingen* / Bgfo) and the Further Regulations on Conduct of Business

Supervision of Financial Undertakings (*Nadere regeling gedragstoezicht financiële ondernemingen* / Nrgfo) were drawn up to facilitate the supervision of conventional financial products and services. These rules of conduct also seem applicable to Islamic mortgages because the norms in the Wft and accompanying laws are largely defined in an open manner. It should be noted here that terms such as commission and interest are used in, for instance, the Nrgfo. These terms bear no relation to Islamic financial products, so that provisions containing these terms are by definition not applicable to Islamic mortgages.

For instance, the obligation to provide adequate information prior to the conclusion of an agreement has been included in the Wft as an open norm: the product information must enable the consumer to make a well-informed decision. In applying this norm to an Islamic mortgage, this implies that, apart from general product information, a mortgage provider must also provide specific information about e.g. the *halal* element in a broad sense. Among other things, this may include information on the presence of a *fatwa* and the composition of the *Sharia* review board (members and Islamic schools of thought to which the members belong). After all, the *halal* element is the (most important) reason for a consumer to opt for an Islamic mortgage instead of a conventional mortgage. As a result, the *halal* element is a key determinant in the consumer's purchasing decision.

It is also important to ensure that consumers are informed of the specific risks or complexities of the legal contract forms that are applied in concluding Islamic mortgages. One major difference compared to conventional mortgage contracts is that an Islamic contract cannot be cancelled. This restriction and its consequences must be clearly explained to the consumer who must, for instance, be made aware of the consequences if he moves house before the contract expires. Depending on the contract form (*Murabaha*, *Musharaka* or *Ijara*) and/or the provisions in the contract, a consumer cannot sell the house before the end of the contract without the permission of the co-owner, in this case the mortgage provider. In addition, the consumer may be saddled with a residual debt in the case of 'premature' sale, the reason being that on signing the contract the consumer undertakes to pay the price of the house plus the charged profit mark-up for the entire duration of the contract. It is up to the mortgage provider to determine whether he waives payment of the outstanding purchase sum in the event of a 'premature' sale.

If a consumer asks an adviser to provide guidance on the best mortgage for his circumstances, the adviser is obliged to obtain all relevant information on his financial position, knowledge, experience, objectives and risk propensity (customer profile) in order to give the most suitable recommendation. To provide advice on an Islamic mortgage (product must meet the customer profile), an adviser must have specific knowledge of the various Islamic products and contract forms so he can inform the customer of the specific risks attendant on these products. For, as we have seen, these often differ from the risks that customers and advisers are used to with conventional products. One example concerns the fact that an Islamic mortgage contract cannot be cancelled (see section 2.4).

The open norms of the Wft on the duty of care are also applicable to Islamic financial products. This means that a level playing field can be created between Islamic and conventional mortgages as regards consumer protection. However, it is still necessary to establish whether these norms are adequate for offering consumers sufficient protection. It is conceivable that specific supplementary rules on e.g. the provision of specific types of information need to be set, as is also the case with life insurance products. This can be studied in greater detail once the Islamic mortgage products have been developed and all product and contract specifications are known.

5 Conclusion

Islamic finance is a niche market that is growing rapidly around the world. There also appears to be a substantial potential demand for Islamic financial products in the Netherlands. Various Islamic investment products are already on the market and providers show interest in Islamic mortgages, which are probably the most important financial products. Key aspects that need to be considered in the development and successful launch of Islamic mortgages are tax legislation and the financial supervision. This study analyses the implications of Islamic financial products for financial supervision and assesses whether the current supervisory framework is adequate. On the one hand, the supervisory framework can be applied to Islamic finance because the Wft norms are largely formulated in open terms. On the other hand, certain financial supervision issues still need to be addressed in the fields of market entry, conduct of business, capital adequacy and provision of information.

Regarding market entry, not every Islamic financial product falls within the scope of the Wft, therefore the required financial supervision is not always in place. Not all new Islamic financial institutions seeking to engage in banking business meet the criteria to qualify as a bank. This is because the most common Islamic commodity finance contracts cannot be interpreted as credit. Finance lease contracts are interpreted as credit for prudential supervision purposes, but this is usually not the case with operating lease or hire-purchase contracts.

In the case of Islamic mortgages, which is the financial product currently attracting the most interest, the existing market conduct supervisory framework does not provide consumers with the same level of statutory protection as with conventional mortgages. This is because these products cannot be grouped under the Wft definitions of a financial product in general or credit in particular. In addition, companies seeking to provide mediation or advisory services for these products could not qualify for an AFM licence for the provision of financial services – for the simple reason that such advisory or mediation services only qualify for a licence if these services concern financial products that fall within the scope of the Wft.

A second financial supervision issue concerns the conduct of business. Among other things, adequate administrative records are necessary to ensure transparency on the cash flows relating to obligatory alms (the *zakat*) so that it is always possible to trace what amounts have been transferred to whom. Other financial supervision issues concern the co-mingling of funds, the checks and balances in respect of the assessment of financial products by the *Sharia* scholars, and *Sharia* compliance as a whole. Adequate administrative records and transparency can also mitigate the integrity risks arising in this respect.

Regarding capital adequacy, the specific risk profile of an Islamic bank requires attention. The credit, operational, liquidity and financing risks differ from those of a conventional bank. In addition, Islamic banks are also exposed to the 'displaced commercial risk'. By contrast, Islamic banks run no interest rate risk, which is a risk-mitigating factor compared to conventional banks. Despite these differences, the new Basel II capital adequacy framework provides a sufficient basis for managing the specific financial risks, though particular attention must be devoted to the market, liquidity, operational and displaced commercial risks. Several other difficulties arise in relation to the calculation of the capital adequacy requirement for credit risk purposes, but these are not insurmountable. If the capital maintained is found to be insufficient on the basis of the collected data, this can be remedied by bringing the capital buffers in line with this risk profile.

Regarding the provision of information, the risk of misselling requires attention. Islamic products appear to involve a heightened risk of misselling compared to conventional products because providers, intermediaries and advisers, on the one hand, and consumers, on the other, still have little knowledge of these products. Given the specific risks and legal design of these products, both the financial company and the consumer need to have more knowledge so as to reduce the risk of misselling and the resulting reputation and legal risks. This risk can be reduced by providing more transparency on the specific risks relating to Islamic contracts and the *halal* element of the product. Among other things, information could be provided on the members of the *Sharia* review board, the functioning of the review board and the issued *fatwa*. To achieve this, Islamic financial products must be brought within the scope of the Wft.

Given the open definition of provision of information, the current market conduct requirements offer a sufficient basis for the supervision of Islamic financial products. However, certain adjustments to the terminology (e.g. interest, commission) must be made in the current laws and regulations. It is also worth considering adding supplementary and more specific requirements regarding the provision of information on Islamic financial products and the conduct of business of financial companies in order to offer consumers the same level of statutory protection as with conventional products.

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Notes

1 One important problem in discussing the term Sharia is the existence of many – sometimes strongly divergent – interpretations of this term in the Islamic world. Due to the absence of a uniform interpretation, we cannot really speak of *the* Sharia. However, for the sake of convenience and readability, we have done so in this exploratory analysis.

2 Arabic has no written vowels, so that 'rb' can be interpreted in two ways.

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