

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

CONSULTATION DOCUMENT

ISLAMIC FINANCE IN MALTA

APPLICATION TO BANKING & SECURITIES

May, 2008

Contents

1. Introduction.....	3
2. The Malta Financial Services Authority.....	4
3. Sharia Principles and the Islamic Economic Model.....	6
<i>Sharia is based on the principle of fairness.....</i>	<i>6</i>
<i>Absence of interest.....</i>	<i>7</i>
<i>The principle of profit-sharing and equity participation.....</i>	<i>7</i>
<i>Halal Investment.....</i>	<i>7</i>
4. Islamic Banks and Financial Institutions.....	8
<i>The Banking Act.....</i>	<i>8</i>
<i>The Financial Institutions Act.....</i>	<i>9</i>
<i>Islamic Banking Products and Services.....</i>	<i>11</i>
5. Sharia Funds.....	17
<i>Collective Investment Schemes.....</i>	<i>17</i>
<i>Malta based Funds.....</i>	<i>18</i>
<i>Sharia Funds.....</i>	<i>22</i>
6. MFSA's approach to authorisation.....	25
<i>The Fit and Proper Test.....</i>	<i>26</i>
7. Consultation Period.....	27

1 Introduction

Over the past decade, Islamic finance has grown rapidly across the world in general and Europe in particular. According to information released by the General Council for Islamic Banks and Financial Institutions (“CIBAFI”)¹, the Islamic Financial Services Industry includes 284 Institutions offering Islamic Financial Services operating in some 38 countries. The entities are estimated to manage USD250 billion. These figures do not however include assets managed by Islamic window operations of conventional banks (CIBAFI estimates a further USD200 billion managed by these operations), non-banking Islamic Institutions, *takaful* and *re-takaful*, and institutions involved in the capital market activities.

The Malta Financial Services Authority has been closely monitoring developments in this field. In this respect, there are a number of opportunities for the setting up of Malta based Islamic Institutions as either full fledged Banking Institutions in terms of the Banking Act or Financial Institutions. There are also a number of opportunities for the setting up of Sharia compliant funds in Malta.

The consultation document analysis will analyse conventional Islamic Funding Structures and Financing Vehicles vis a vis Malta regime applicable to collective investment schemes, investment services providers, credit institutions and financial institutions.

The Malta Financial Services Authority intends to continue its work on Islamic finance by issuing a consultation document on Islamic Bonds (Sukuk) by the end of 2008 and Sharia Insurance early in 2009.

¹ CIBAFI Ten-Year Master Plan, June 2005.

2 The Malta Financial Services Authority

The Malta Financial Services Authority (MFSA) was established in 2002. It is a fully autonomous public institution and reports to Parliament on an annual basis. The MFSA has taken over supervisory functions previously carried out by the Central Bank of Malta, the Malta Stock Exchange and the Malta Financial Services Centre and is the single regulator for financial services. The sector incorporates all financial activity including banking, investment and insurance. The MFSA also manages the Registry of Companies and has also taken over responsibility as the Listing Authority.

The organisational structure of the MFSA ensures that the regulatory and operational functions of the Authority are exercised within strict legal demarcations. The Board of Governors, presided by the Chairman, sets out policy and general direction and is assisted by the Legal and International Affairs Unit. The Supervisory Council, headed by the Director General, is exclusively responsible for issuing licenses and regulation and is composed of the Directors responsible for Banking, Securities, Pensions, Insurance, Company Compliance and Corporate Services.

Over the past decade, Malta has moved from being an offshore corporate services centre to an onshore financial services jurisdiction. It has completed a programme of reforming all its finance sector legislation in line with international best practice and was, in 2000, one of the first six countries in the world to reach an advanced accord on fiscal matters with the Organisation for Economic Co-operation and Development (OECD). As a result of this agreement Malta is not considered to be a tax haven. Furthermore, the currently applicable tax regime was agreed with the European Union under State Aid Rules and Code of Conduct during 2006.

Malta is actively involved with the OECD and the European Union in modelling global regulatory policy. The finance industry has benefited significantly from the country's national policy of moving to the mainstream. Financial services is the fastest growing sector of the Maltese economy and one of the most important employers of trained professional staff.

Creating the MFSA as a single regulator was a structured part of Malta's long term strategy to create a mainstream finance centre in the country. Malta is a jurisdiction that follows and helps develop international best practice.

Financial services companies have benefited from a reduction in bureaucracy, streamlined procedures, lower fees and compliance costs and a more consistent implementation of standards.

The MFSA is also responsible for consumer education and consumer protection in the financial services sector. This function is vested in the Consumer Complaints Manager. The MFSA has a staff of over 130 people, consisting of specialist regulators, lawyers, accountants and support staff who are involved in communications and organisational administration.

The consumer therefore has one single point of decision making and policy creation. More importantly, the founding of the MFSA means that Malta now has one skilled, experienced and powerful body seeking to protect consumers whilst encouraging fair and open competition in the financial services sector.

The International Tax Unit of the Inland Revenue Department and the Companies Registry are also housed at the MFSA's offices and have the task of ensuring that all taxation and company registration matters relating to international activity are dealt with swiftly and effectively. The International Tax Unit is also responsible for issuing advance revenue rulings which give certainty to the tax treatment of all international undertakings.

3 Sharia Principles and the Islamic Economic Model

The Arabic word 'Islam' simply means 'submission', and is derived from a word meaning 'peace'. In a religious context it means complete submission to the will of God. For a fifth of the world's population, Islam is not only a religion but also a complete way of life. The teachings of Islam reflect all aspects of a believer's life, determining the basis of his faith and his relationships with God, and with other human beings.

Islamic law or Sharia – as revealed in and derived from the Qur'an and Sunnah (the sayings and practices of the Prophet Muhammad) – governs all economic and social activities and undertakings. The Islamic economic model is based on the rulings of Sharia on commercial and financial transactions. Islam does not require its followers to keep their funds idle, on the contrary, it encourages people to use money in Islamically legitimate ventures. Effectively, money is treated as a means of exchange and not a commodity for speculation.

An Islamic economic model is effectively the study of man and his behaviour in the acquiring and using of resources. The Islamic economic model places emphasis on the need for human and social considerations when making economic decisions. It dictates that all economic activity should have an ethical and moral dimension.

Sharia is based on the principle of fairness

The Islamic economic model is based on the principle of fairness. Uncertainty, Risk or Speculation (also referred to as Gharar) are all prohibited as contracting parties should have perfect knowledge of the transactions to be entered into. There is a specific emphasis on social justice and the economic prosperity of the whole community based on the principle of just distribution of resources, while recognising the principle of wealth creation

Absence of interest

The best known feature of the Islamic economic model is the prohibition of interest. Adherents to the Islamic faith are prohibited from taking or giving interest (*riba*) regardless of the purposes for which such loans are made. Any pre-determined payment over and above the actual amount of principal is strictly prohibited.

Modern Islamic banking has developed mechanisms to allow interest income to be replaced with cash flows from productive sources such as Joint Ventures and profit sharing arrangements as well as income from the provision of services such as wealth management, investment advice, spot foreign exchange transactions and fund transfers.

The principle of profit-sharing and equity participation

The Islamic economic model is based on the principle of risk sharing. The lender must effectively share in the profits or losses arising out of the venture for which the money was lent. In view of the above, Islamic transactions are very similar to equity-based transactions in that the cash-flows are dependent on the profitability or otherwise of joint ventures.

Halal Investment

Under the Islamic economic model only halal investments are permissible. A halal investment is one that adheres to Sharia principles. There are two categories that an investment instrument has to fulfil in order to be deemed a permissible investment. Firstly, it has to be free of interest. Secondly, the business model of the target investment should not be involved in forbidden activities (*haram*). Forbidden investments include companies involved in the liquor industry, tobacco companies, companies involved in pork-related products, the armaments industry, the gaming industry, conventional banks and credit institutions, the entertainment industry and the pornographic industry. Companies that do not engage in the above activities are deemed permissible investments.

4 Islamic Banks and Financial Institutions

The Banking Act

The Banking Act (Chapter 371) provides the statutory basis for regulating credit institutions constituted in or operating in or from Malta. Article 5 of the Act provides that no business of banking shall be transacted in or from Malta except by a company which is in possession of a licence granted under this Act by the MFSA. It further provides that a credit institution licensed or holding an equivalent authorisation outside Malta may not open a branch, agency or office or set up any subsidiary in Malta unless it is in possession of a licence granted under this Act by the Competent Authority. Notwithstanding the above, a credit institution licensed or holding an equivalent authorisation in an EU or EEA state shall be entitled to exercise their rights under European Community Law.

Subarticle 5(1) makes it illegal for any Credit Institution, to operate in or from Malta without having a licence. Subarticle 5(2) in turn makes it illegal for a Credit Institution established outside Malta, to operate in or from Malta without having a licence unless in exercise of a passport right in terms of the EU Banking Directive.

The Act further defines a “bank” or “credit institution” as any person carrying on the business of banking. The business of banking is deemed to include:

- the acceptance of deposits of money from the public withdrawable or repayable on demand or after a fixed period or after notice; or
- borrowing or raising money from the public (including the borrowing or raising of money by the issue of debentures or debenture stock or other instruments creating or acknowledging indebtedness), in either case for the purpose of employing such money in whole or in part by lending to others or otherwise investing for the account and at the risk of the person accepting such money.

The business activities of a Credit Institution licensed under the Act may, besides the business of banking, include any or all of the additional activities:

- i. Financial leasing;
- ii. Money transmission services;
- iii. Issuing and administering means of payment (credit cards, travellers' cheques and bankers' drafts and similar instruments);
- iv. Guarantees and commitments;
- v. Trading for own account or for account of customers in²:
 - a. money market instruments (cheques, bills, certificates of deposit, and similar instruments);
 - b. foreign exchange;
 - c. financial futures and options;
 - d. exchange and interest-rate instruments;
 - e. transferable securities.
- vi. Participation in securities issues and the provision of services related to such issues;
- vii. Advice to undertakings on capital structure, industrial strategy and related questions and advice as well as services relating to mergers and the purchase of undertakings;
- viii. Money broking;
- ix. Portfolio management and advice³;
- x. Safekeeping and administration of securities⁴;
- xi. Credit reference services;
- xii. Safe custody services⁵.

A prospective applicant for a licence as a Credit Institution shall have own funds of not less than the value of €5,000,000. The business of a Credit Institution should be directed in Malta by at least two individuals. Furthermore, all qualifying shareholders, controllers and all persons who will effectively direct the business of the Credit Institution should be fit and proper such that they are suitable persons to ensure the prudent management of the institution.

The Financial Institutions Act

The Financial Institutions Act (Chapter 376) provides the statutory basis for Financial Institutions constituted in or operating in or from Malta. Article 2 defines a "Financial Institution" as any person who regularly or habitually acquires holdings or undertakes the carrying out of any of the following activities for its account:

²⁻⁵ This activity may be carried out without prejudice to any requirements included in the Investment Services Act (Chap 370), 1994.

- i. Lending (including personal credits, mortgage credits, factoring with or without recourse, financing of commercial transactions including forfaiting);
- ii. Financial leasing;
- iii. Venture or risk capital;
- iv. Money transmission services;
- v. Issuing and administering means of payment (e.g. credit cards, travellers' cheques and bankers' drafts);
- vi. Guarantees and commitments;
- vii. Trading for own account or for account of customers in:
 - a. money market instruments (cheques, bills, Certificates of deposits, etc.);
 - b. foreign exchange;
 - c. financial futures and options;
 - d. exchange and interest rate instruments;
 - e. transferable instruments;
- viii. Underwriting share issues and the participation in such issues;
- ix. Money broking.

The Act specifically provides that in order for a Financial Institution to qualify as such, the activities outlined above should not be funded through the taking of deposits or other repayable funds from the public as defined in the Banking Act. In view of the fact that there is a clear overlap between the activities regulated under the Financial Institutions Act and the Investment Services Act, the Financial Institutions Act specifically provides that it shall not apply to persons regulated under the Investment Services Act which carry on one or more of the activities outlined above by virtue of their authorisation.

Article 3 of the Act provides that no business of a Financial Institution shall be transacted in or from Malta except by a company which is in possession of a licence granted under this Act by the MFSA. It further provides that a person shall not be deemed to be a Financial Institution by reason of the fact that the person either:

- a. belongs to a group of companies and provides any of the activities listed above to companies which are not banks or financial institutions and which belong to the same group of companies; or
- b. draws and issues trade bills in the normal course of business under hire purchase agreements, or under sales on credit where trade bills are drawn in respect of the price due.

Subarticle 3(1) makes it illegal for any Financial Institution, to operate in or from Malta without having a licence.

A prospective applicant for a licence as a Financial Institution shall have own funds as may be specified by the MFSA as appropriate for the activities to be undertaken by the applicant. The business of a Financial Institution should be directed in Malta by at least two individuals. Furthermore, all qualifying shareholders, controllers and all persons who will effectively direct the business of the Financial Institution should be fit and proper such that they are suitable persons to ensure the prudent management of the institution.

Islamic Banking Products and Services

Products/ Services

This activity may be undertaken by:

1. *Musharaka: Joint Ventures/ Equity Participation*

Under a musharaka contract a Sharia Institution, jointly with other partners, uses its capital, through an equity participation – generally of limited duration – to potentially generate a profit. In this manner, profits or losses are shared amongst all partners (including the Sharia Institution) depending on their respective equity participation.

Credit Institutions⁶ and Financial Institutions

Participation in a musharaka can either be in a new project or by providing additional funds for an existing project.

Article 15(1)(d) of the Banking Act provides that a credit institution may not acquire or hold directly or indirectly any significant or qualifying shareholding in any company which is not another credit institution, or a financial institution licensed in terms of the Financial Institutions Act, or any other company carrying out an activity which is supervised on a consolidated basis by the MFSA. The original cost of this holding shall not exceed fifteen per centum (15%) of the credit institution's own funds or its consolidated own funds, as the case may be. In view of the above, the *Joint Venture/ Equity Participation* entered into/ held by the credit institution would need to be supervised by the MFSA (as part of the supervision of the credit institution).

⁶ A Credit Institution may enter into these Joint Ventures/ Equity Participations subject to the current restrictions included in Article 15(1)(d) and (e) of the Banking Act.

Products/ Services***This activity may be undertaken by:***

Furthermore Article 15(1)(e), provides that where such shareholding exceeds 5% of the issued shares of the Joint Venture, MFSA's prior approval is required.

The MFSA is proposing to review and assess these requirements in order to determine whether they should be retained/ revised in view of the above operational structure of a Sharia Institution provided that any amendment conforms with EU Directive 2006/48/EC.

2. Mudaraba: Profit Sharing

Under a mudaraba contract a Sharia Institution would generally be the owner of the capital i.e. the lender (*rabbul-mal*), and lends money to a borrower (*mudarib*). The return on the loan would generally be linked to the performance of the borrower. In this manner, the Sharia Institution, as the owner of capital, shares in the profits earned by the entrepreneur (the borrower or *mudarib*). The Sharia Institution will also be fully exposed to any losses suffered by the entrepreneur. The Sharia Institution generally acts as a *quasi* sleeping partner.

Credit Institutions⁷ and Financial Institutions

In a mudaraba contract, the division of profit between, the Sharia Institution and the borrower would generally be on a proportional basis and cannot be a lump sum or guaranteed return. The extent of the potential loss to the Sharia Institution depends on the mode of the funding to the *mudarib*.

Where such contracts are entered into by a Credit Institution/ Financial Institution, the bank lends money to its client – to finance a business – in return for which the

⁷ A Credit Institution may enter into Mudaraba contacts subject to the limitations included in Article 15(1)(b) of the Banking Act.

Products/ Services

This activity may be undertaken by:

institution will get a pre agreed percentage of the business' net profit every year for a pre agreed period of time. The amount paid to the institution represents both the principal as well as the return/ profit attributable to it. Should the business lose money, the institution, the borrower and, where applicable, the depositors all jointly suffer losses.

Where the transaction is entered into by a Credit Institution, part of the profit would be generated by such transactions and would generally be forwarded to certain depositors. In these transactions, the Credit Institution effectively operates a two tier mudaraba system in which it acts both as the borrower (*mudarib*) with respect to the deposits on the savings side and as the lender (*rabbul-mal*) on the investment side of the transaction.

The MFSA is proposing to review the provisions of the Banking Act and the Financial Institutions Act to ensure that they accommodate the operational structure of a Sharia institution

3. Murabaha: Cost plus contracts

In a murabaha contract, the Sharia Institution finances the purchase of goods or assets by buying these goods/ assets on behalf of its clients and adding a mark up before reselling it to the client on a "cost-plus" basis. The profit to be made by the Sharia Institution is also known to buyer.

Credit Institutions and Financial Institutions

The Sharia Institution therefore assumes certain risks between the purchase and the resale as it takes responsibility for the good before it is safely delivered.

Products/ Services

This activity may be undertaken by:

4. Bai' muajjal: Deferred payment contracts

In a deferred payment contract (*Bai' muajjal*) the Sharia Institution would generally purchase and resell immovable property on a deferred payment basis. This type of transaction is not considered to be a lending transaction but rather a trading transaction. These contracts are very similar to the murabaha.

Credit Institutions⁸ and Financial Institutions

Article 15(1)(f) implies that the acquisition of immovable property by a credit institution under a deferred payment contract would be subject to the prior approval of the MFSA. This requirement imposes extensive operational restrictions to a Sharia Institution offering these arrangements.

Another issue in respect of Bai' muajjal contracts involving immovable property is the fact that these contracts presently attract double stamp duty, both on the purchase of the property by the Sharia Institution and on the transfer of the property by the Sharia Institution to the customer. The UK addressed this matter via the Finance Act of 2003, which introduced a relief to prevent multiple payment of Stamp Duty Land Tax on Islamic mortgages.

The MFSA is proposing that Article 15(1)(f) of the Banking Act be reviewed in order to determine whether it should be retained/ revised and also consult with the Government in respect of the double stamp duty.

5. Ijara: Leasing

In an Ijara contract, the Sharia Institution buys the machinery or equipment and then leases it out to its clients via an

Credit Institutions and Financial Institutions

⁸ A Credit Institution may enter into Bai' muajjal contacts subject to the limitations included in Article 15(1)(f) of the Banking Act.

Products/ Services***This activity may be undertaken by:***

operating or finance lease. The clients would generally be given the right to acquire the machinery or equipment (financing lease). If clients are given this option, the monthly payments would consist of two components; rent, for the use of the equipment and an instalment towards the purchase price of the machinery or equipment.

In order for the Ijara to be valid under Islamic Law, the leased item should be used productively and in ways permitted by Islamic Law.

6. Bai'Salam: Pre-Paid Purchases of Goods

In a Bai'Salam agreement, the Sharia Institution effectively finances the production of a counterparty. The manufacturer sells his goods to the Sharia Institution at a price agreed in advance. The Sharia Institution pays the manufacturer an agreed price at the time of the contract. Delivery would effectively take place at a future date. This technique is very similar to a futures or forward purchase contract.

*Credit Institutions and Financial Institutions***7. Bank Accounts**

Sharia Institutions generally offer three principal types of bank accounts as follows:

Credit Institutions

The **current account** offered by a Sharia Institution does not pay any Interest which is prohibited under Islamic Law. The Sharia Institution effectively acts as a safekeeper (*al wadiah*) of the depositors' money. Depositors are generally also given a cheque book facility. Depositors may withdraw their money at any time. The Sharia Institution may in turn use the depositors' money as a mode of financing.

The **savings account** would generally not pay any specific return. The Sharia Institution may however, at its absolute discretion, pay depositors a periodic positive return linked to the profitability of the Sharia Institution. The periodic return,

Products/ Services

This activity may be undertaken by:

if any, is not a condition for lending by the depositors as it is neither guaranteed nor pre-determined. Depositors may withdraw their money at any time and are generally issued with a savings book. The Sharia Institution may, naturally, in turn use the depositors' money as a mode of financing.

The **investment account** is equivalent to a term deposit that cannot be withdrawn before maturity. Investment Accounts are used to finance projects based on the principle of mudaraba. The profit sharing ratios would generally vary from an Institution to another and depend on demand and supply. In theory, the rate of return could be positive or negative. However, in practice, the returns on investment accounts are generally positive and comparable to rates conventional banks offer on term deposits.

8. Other Services

Besides the services outlined above, Islamic Institutions also provide the following traditional fee based banking services which naturally do not involve any interest payments:

- Spot forex transactions
- Fund transfers
- Letters of credit
- Travellers' cheques
- Safe deposit boxes
- Securities safekeeping
- Investment management
- Investment advice.

Credit and Financial Institutions.

Provided that in the case of Portfolio Management and Investment Advice these institutions are required to be authorised under the Investment Services Act, 1994.

5 Sharia Funds

Collective Investment Schemes

The Investment Services Act (Chapter 370) provides the statutory basis for regulating collective investment schemes constituted in or operating in or from Malta and defines “Collective Investment Schemes” as any scheme or arrangement which has as its object or as one of its objects the collective investment of capital acquired by means of an offer of units for subscription, sale or exchange and which has the following characteristics:

- i. the scheme or arrangement operates according to the principle of risk spreading; and either
- ii. the contributions of the participants and the profits or income out of which payments are to be made to them are pooled; or
- iii. at the request of the holders, units are or are to be repurchased or redeemed out of the assets of the scheme or arrangement, continuously or in blocks at short intervals; or
- iv. units are, or have been, or will be issued continuously or in blocks at short intervals.

Article 4 of the Act provides that:

- “4 (1) *Subject to the provisions of subarticle (3), no Collective Investment Scheme shall issue or create any units or carry on any activity in or from within Malta unless there is in respect of it a valid Collective Investment Scheme licence.*
- (2) *Subject to the provisions of subarticle (3), no Collective Investment Scheme formed in accordance with or existing under the laws of Malta shall issue or create any units or carry on any activity in or from within a country, territory or other place outside Malta unless there is in respect of it a valid Collective Investment Scheme licence.*
- (3) *No Collective Investment Scheme shall be precluded by the provisions of subarticle (1) from issuing or creating such units or from taking such steps as*

may be necessary for the incorporation or, as the case may be, the establishment of the scheme or from taking such steps as may be necessary for securing the authorisation of the scheme by the competent authority.”

Subarticle 4(1) makes it illegal for any Scheme, to operate in or from Malta without having a licence. Subarticle 4(2) in turn makes it illegal for a Scheme, to use Malta as a base without having a licence.

Subarticle 4(3) permits the initial steps in establishing a Scheme, to be taken before a Licence has been obtained but the Scheme may not deal with investors before it is licensed.

Under Article 12(1)(i) of the ISA, certain exemptions have been granted from the requirement to obtain a Collective Investment Scheme licence.

Malta based Funds

The MFSA’s regulatory regime for collective investment schemes caters for two principal classes of schemes, namely, Retail Schemes and Professional Investor Funds (PIFs).

Retail Schemes are further sub-divided into two principal categories: Maltese non-UCITS Schemes and Maltese UCITS Schemes. Similarly, Professional Investor Funds are further sub-divided into three principal categories: Experienced Investor Funds, Qualifying Investor Funds and Extraordinary Investor Funds.

A Maltese Scheme may be set up as an investment company with variable share capital (SICAV); an investment company with fixed share capital (INVCO); a limited partnership divided into shares; a unit trust or a contractual fund.

MFSA’s regime applicable to Retail Schemes is set out to in the Investment Services Rules for Retail Collective Investment Schemes, whilst MFSA’s regime applicable to Professional Investor Funds is set out in the Investment Services Rules for Professional Investor Funds.

Maltese non- UCITS Schemes

A Maltese non-UCITS Scheme may be set up as an open ended or closed ended Scheme and may market its units to the general public in Malta without any limitation. The marketing of Maltese non-UCITS Schemes to investors outside Malta is subject to compliance with the relevant authorisation or other regulatory requirements applicable in the jurisdiction where such investors are based.

A Maltese non-UCITS Scheme is required to appoint an Investment Manager unless it is set up as a self managed Maltese non-UCITS Scheme. The Custodian or depositary of a Maltese non-UCITS Scheme should be based in Malta and licensed by the MFSA. The Custodian of a Maltese Non UCITS Scheme is required to keep under custody the asset of the Scheme and to carry out a monitoring function over the activities of the Investment Manager. The Administrator of a Maltese non-UCITS Scheme should be based in Malta.

Maltese UCITS Schemes

A Maltese UCITS Scheme is an open ended Scheme and is subject to the requirements of the EU UCITS Directive (Directive 85/611/ EEC). Like Non UCITS Schemes, Maltese UCITS Schemes may also market their units to the general public in Malta without any limitation

A Maltese UCITS Scheme is required to appoint a Maltese UCITS Management Company as its designated Investment Manager unless it is set up as a self managed Scheme. The Custodian or depositary of a Maltese UCITS Scheme should also be based in Malta and licensed by the MFSA. The Custodian of a Maltese UCITS Scheme is required to keep under custody the assets of the Scheme and to carry out a monitoring function over the activities of the Investment Manager. The Administrator of a Maltese UCITS Scheme should preferably be based in Malta, although the MFSA may accept in exceptional circumstances a foreign based Administrator provided that the said Administrator is regulated in a Recognised Jurisdiction.

Unlike a Maltese non-UCITS Schemes, a Maltese UCITS Scheme is automatically eligible for marketing its units to the general public in any EEA State (other than Malta) provided that it follows the notification procedure stipulated in the UCITS Directive.

Professional Investor Funds promoted to Experienced Investors

An “Experienced Investor”, is a person having the expertise, experience and knowledge to be in a position to make his own investment decisions and understand the risks involved. The minimum investment threshold is €15,000 or equivalent in another currency and applies to each individual “Experienced Investor”.

Before an Experienced Investor Fund may accept any investment, it should obtain a completed “Experienced Investor Declaration Form” in which the investor confirms that he/she has read and understood the mandatory risk warnings and describes why he/she is an “Experienced Investor”. PIFs promoted to Experienced Investors are not subject to any investment restrictions. Whilst borrowing on a temporary basis for liquidity purposes

is permitted and not restricted, borrowing for investment purposes or leverage via the use of derivatives is restricted to 100% of NAV (same as Maltese UCITS Schemes).

A PIF promoted to Experienced Investors may appoint any Service Provider as it may deem necessary provided that a PIF promoted to Experienced Investors should always appoint a Custodian responsible for safekeeping the assets of the Fund and carrying out a monitoring function over the activities of the Investment Manager. Ordinarily, Service Providers of a PIF may include, amongst others, a Manager, an Administrator, an Investment Adviser and/or a Custodian/Prime Broker. All Service Providers appointed by an Experienced Investor Fund are not required to be based in Malta provided that they are established and regulated in a Recognised Jurisdiction.

Professional Investor Funds promoted to Qualifying Investors

A “Qualifying Investor”, is required to meet one or more of the following criteria:

- i. a body corporate which has net assets in excess of €750,000 or which is part of a group which has net assets in excess of €750,000;
- ii. an unincorporated body of persons or association which has net assets in excess of €750,000;
- iii. a trust where the net value of the trust’s assets is in excess of €750,000;
- iv. an individual, or in the case of a body corporate, the majority of its Board of Directors or in the case of a partnership its General Partner who has reasonable experience in the acquisition and/or disposal of :-
 - a. funds of a similar nature or risk profile;
 - b. property of the same kind as the property, or a substantial part of the property, to which the PIF in question relates;
- v. an individual whose net worth or joint net worth with that person’s spouse, exceeds €750,000;
- vi. a senior employee or Director of Service Providers to the PIF;
- vii. a relation or close friend of the promoters limited to a total of 10 persons per PIF;
- viii. an entity with (or which are part of a group with) €3.75 million or more under discretionary management, investing on its own account;
- ix. the investor qualifies as a PIF promoted to Qualifying or Extraordinary Investors;
- x. an entity (body corporate or partnership) wholly owned by persons or entities satisfying any of the criteria listed above which is used as an investment vehicle by such persons or entities.

The minimum initial investment applicable to Qualifying Investor Funds is €75,000, or equivalent in another currency. Prior to accepting any investment, the PIF should be in receipt of a completed “Qualifying Investor Declaration Form” in which the investor

confirms that he/she has read and understood the mandatory risk warnings and describes why he/she is a “Qualifying Investor”. PIFs promoted to Qualifying Investors are not subject to any investment or borrowing (including leverage) restrictions other than those which may be specified in their Offering Document.

Professional Investor Funds promoted to Extraordinary Investors

An “Extraordinary Investor” is required to meet one or more of the following criteria:

- i. a body corporate, which has net assets in excess of €7.5 million or which is part of a group which has net assets in excess of €7.5 million;
- ii. an unincorporated body of persons or association which has net assets in excess of €7.5 million;
- iii. a trust where the net value of the trust’s assets is in excess of €7.5 million;
- iv. an individual whose net worth or joint net worth with that person’s spouse, exceeds €7.5 million;
- v. a senior employee or Director of Service Providers to the PIF;
- vi. the investor qualifies as a PIF promoted to Extraordinary Investors;
- vii. an entity (body corporate or partnership) wholly owned by persons or entities satisfying any of the criteria listed above which is used as an investment vehicle by such persons or entities.

Minimum initial investment is €750,000, or equivalent in another currency. Prior to accepting any investment the PIF should be in receipt of a completed “Extraordinary Investor Declaration Form” in which the investor confirms that he/she has read and understood the mandatory risk warnings and describes why he/she is an “Extraordinary Investor”. PIFs promoted to Extraordinary Investors are not subject to any investment or borrowing (including leverage) restrictions other than those which may be specified in their Offering Document/ Marketing Document.

PIFs promoted to Extraordinary Investors are subject to the minimum level of supervision for a Fund regulated in Malta

Sharia Funds

A Sharia or Islamic Investment Fund is generally referred to as a joint pool wherein the investors contribute their surplus money for investment purposes to earn halal⁹ profits in strict conformity with the principles of Islamic Sharia.

Units in a Sharia compliant fund are required to satisfy two basic conditions as follows:

- instead of a fixed return tied up with their face value, they must carry a pro-rated profit actually earned by the fund. This implies that a Sharia compliant fund can never be capital guaranteed.
- the portfolio of assets of the fund should be invested in a business acceptable to Sharia.

The more common investment styles of Sharia compliant funds are:

Equity Funds

Equity Funds generally invest a large portion of the assets in listed and/ or unlisted equity securities. The returns of Equity Funds are generally derived from capital gains and dividends. The Manager of a Sharia compliant equity fund must ensure that the main business of a target company is lawful in terms of Sharia. If the business of the target company is not lawful in terms of Sharia law, the fund will be precluded from holding such equity securities as it will entail the direct involvement of the fund in that prohibited business. In view of the above, Sharia compliant equity fund are generally subject to extensive limitations with respect to the nature of equity securities they may hold.

The MFSA is of the view that Sharia compliant equity funds may be set up as Maltese UCITS Schemes, Maltese non-UCITS Schemes¹⁰ or Professional Investor Funds.

⁹ Halal in this context refers to “lawful” profits in terms of the Qur'an

¹⁰ Subject to compliance with the restrictions relating to investment in unlisted equities set out in the MFSA's Investment Services Rules for Retail Schemes

Ijarah¹¹ Funds

The proceeds from the issue of units in Ijarah Funds are generally utilised to purchase real estate, motor vehicles, or other equipment. These assets are generally leased to the fund's client. The fund retains the ownership of these assets and receives rental income from its clients. Rental income, which is generally distributed to investors in the fund, is the principal source of revenue.

The MFSA is of the view that since Ijarah Funds generally invest in non conventional asset classes, these may only be licensed in Malta under the Professional Investor Funds Regime.

Commodity Funds

Commodity Funds generally acquire different commodities for the purpose of the resale. The profits generated by the sale represents the income of the fund. These profits of these funds are generally also distributed to investors. In order for the fund to be deemed to be Sharia compliant, all the rules governing the transactions in commodities outlined above should be fully compliant with Sharia principles. To illustrate, the commodity must be fully owned by the fund at the time of sale (as short sales are not allowed in Sharia). The commodities dealt in by the fund should be lawful in terms of Sharia. Thus the fund will be precluded from dealing in wines, pork, or other prohibited materials.

The MFSA is of the view that as Commodity Funds generally invest in non conventional asset classes similar to Ijarah Funds, these can be licensed in Malta under the Professional Investor Funds Regime.

Murabaha Fund

In a "Murabaha" contract, the fund finances the purchase of goods or assets by buying them on behalf of its clients and adding a mark up before reselling the same to the client on a "cost-plus" basis. The profit to be made by the fund will generally be known to both

¹¹ Ijarah means leasing

the buyer and the fund. The Fund naturally assumes certain risks between the purchase and the resale as the fund takes responsibility for the good before it is safely delivered.

Murabaha contracts are widely used by contemporary Islamic banks as a mode of financing. Assets are sold on the basis of deferred payment arrangements at an agreed margin of profit added to the cost. Effectively a Murabaha fund does not own any tangible assets, as its assets represent amounts receivable from the clients of the fund.

The MFSA is of the view that Murabaha Funds can only be licensed in Malta under the Professional Investor Funds Regime.

6 MFSA's approach to authorisation

When processing applications for a licence in terms of the Investment Services Act, the Banking Act and the Financial Institutions Act, the MFSA takes account of:

- i. the degree of protection to the investors;
- ii. the protection of the reputation of Malta taking into account Malta's international commitments; and
- iii. the promotion of competition and choice.

MFSA recommends that the promoters arrange to meet representatives of the MFSA to describe their proposal. This preliminary meeting should take place well in advance of submitting an Application for a Licence. Although guidance will be given on the applicable regulatory requirements and on the completion of the Application documents, responsibility for the formulation of the proposal and the completion of the Application documents will remain with the Applicant. It is essential that the Applicant submits a comprehensive (written) description of the proposed activity before the meeting.

The next stage is that the promoters submit an Application Form, together with supporting documents. The draft Application and the supporting documentation will be reviewed and comments provided to the Applicant. The MFSA may ask for more information and may make such further enquiries as it considers necessary. The "fit and proper" checks, which entail following up the information which has been provided in the Application documents, begin at this stage.

Once the review of the Application and supporting documents has been completed and the ongoing requirements have been agreed, the MFSA will issue its "in principle" approval for the issue of a licence. At this stage, the Applicant will be required to finalise any outstanding matters, such as incorporation of Company, submission of signed copies of the revised Application form together with supporting documents in their final format, and any other issues raised during the Application process. The Licence will be issued as soon as all pre-licensing issues are resolved.

The Applicant may also be required to satisfy a number of post-licensing matters prior to formal commencement of business.

The Fit and Proper Test

The “fit and proper” test is one which an Applicant and a Licence Holder must satisfy on a continuing basis. Each case is assessed on the basis of the relevant circumstances. The onus of proving that it meets the required standards is on the Applicant and Licence Holder. It is not the task of the MFSA to prove that an Applicant is “fit and proper” either on licensing or thereafter. The MFSA’s approach is cumulative that is to say the Authority may conclude that a Licence Holder has failed the test on the basis of considering several situations, each of which on its own would not lead to that conclusion. An open and honest relationship with the MFSA is essential. When arriving at its decision as to whether a Licence Holder is “fit and proper” the MFSA will take account both of what is said and of what is not said.

In general terms, there are three criteria which must be met, to satisfy the “fit and proper” test:

- i. integrity;
- ii. competence; and
- iii. solvency.

Integrity involves the Licence Holder and its employees being of good repute and acting honestly and in a trustworthy fashion in relation to its clients and other parties.

Competence means that those people carrying on the business of the Licence Holder must be able to demonstrate an acceptable amount of knowledge, professional expertise and experience. The degree of competence required will naturally depend upon the job being performed.

Solvency means ensuring that proper financial control and management of liquidity and capital is applied. The business should have sufficient Own Funds to meet not only the financial demands on the business but also to satisfy the applicable MFSA requirements.

7 Consultation Period

Interested parties are invited to express their views on the introduction of Islamic Finance in Malta as applicable to Banking and Securities by the 31st July 2008.

Replies should be addressed to:

The Director
Strategic Development Unit
Malta Financial Services Authority
Notabile Road,
Attard

E-mail: sdu@mfsa.com.mt

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

Notabile Road, Attard

Tel: +356 21 441155

Fax: +356 21 441188

Website: www.mfsa.com.mt

E-mail: sdu.mfsa.com.mt