

MFSA

MALTA FINANCIAL SERVICES AUTHORITY

FEEDBACK STATEMENT

ISLAMIC FINANCE IN MALTA

APPLICATION TO BANKING & SECURITIES

October, 2008

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1 Introduction

This Feedback Statement reports on the main issues arising from MFSA's Consultation Document entitled: ISLAMIC FINANCE IN MALTA - APPLICATION TO BANKING & SECURITIES.

The MFSA carried out a review of the conventional Islamic Funding Structures and Financing Vehicles vis a vis Malta's regime applicable to collective investment schemes, investment services providers, credit institutions and financial institutions. The MFSA issued a consultation document on this topic in May 2008 on this topic to stimulate debate and receive views by July 2008.

This Feedback Statement summarises the comments on issues raised in the Consultation Document.

MFSA's Consultation Documents proposed a number of amendments to the local Banking Act and Financial Institutions Act, and expressed views on the use of Professional Investor Fund, Non UCITS Retail Funds and UCITS Funds for the purposes of setting up Sharia compliant funds under Maltese law.

All respondents were in agreement on Malta's possible potential in the field of Sharia Finance. Most respondents were also in agreement with the main proposals and recommendations made in the Consultation Document.

Most respondents also raised a number of considerations which go beyond the recommendations referred to in the Consultation Documents. These considerations revolve around the various operational challenges associated with Sharia Institutions and Sharia Funds.

2 Islamic Banks and Financial Institutions

Islamic Banking Products and Services

As indicated in the Consultation Document, the Banking Act provides the statutory basis for regulating credit institutions constituted in or operating in or from Malta whilst the Financial Institutions Act provides the statutory basis for regulating certain activities that are of relevance to Sharia Institutions.

The Consultation Document covered the following Islamic Products and Services:

1. Musharaka: Joint Ventures/ Equity Participation
2. Mudaraba: Profit Sharing
3. Murabaha: Cost plus contracts
4. Bai' muajjal: Deferred payment contracts
5. Ijara: Leasing
6. Bai'Salam: Pre-Paid Purchases of Goods
7. Bank Accounts
8. Other Services

Most of the respondents provided a detailed description of the principal features of the various Islamic Products and Services referred to in the Consultation Document. A number of respondents also analysed other Islamic Products not referred to in the Consultation Document such as the 'Istisna'.

All respondents in general agreed with most of MFSA's recommendations included in the Consultation Document. Most respondents pointed out that further work needs to be carried out in this area to ensure all stumbling blocks – not limited to the revisions to Banking Act/ Financial Institutions Act – are adequately reviewed and assessed and the necessary revisions implemented.

A number of respondents expressed the view that the MFSA has the duty to ensure that the relevant institutions satisfy the applicable Sharia principles. The MFSA would like to clarify that it will **not** be assuming responsibility for ensuring that its licensees satisfy the applicable Sharia principles. It is the view of the MFSA that this responsibility should be borne and assumed by the Board of Directors of the Institution concerned.

Bank Accounts and the definitions of ‘Deposits’ and ‘Business of Banking’

A number of respondents explained that there are two important considerations which need to be addressed within the context of the Banking Act, when one considers the typical Islamic Banking Model. These are (1) the definition of ‘Business of Banking’ and (2) the definition of ‘Deposit’, both within the Banking Act.

A respondent explained that the current definition of ‘Business of Banking’ implies that the risk of loss relating to the investment of deposited funds rests with the relevant institution and is not shared with the depositor. This requirement does not tally with the risk sharing principle synonymous with Sharia compliant transactions. The same respondent pointed out that the Investment Services Act is the law which regulates the investment of assets belonging to clients and that further work needs to be undertaken to clarify the interaction between the Banking Act and the Investment Services Act within this context.

A number of respondents highlighted the fact that the definition of ‘deposit’ in the Banking Act implies a requirement on the Bank to repay the amount deposited in full – as long as the Bank remains solvent. This again does not tally with the general risk sharing principles referred to above. This respondent referred to the approach adopted by the UK FSA and suggested that the MFSA should follow the same model.

3 Sharia Funds

Collective Investment Schemes

All respondents agreed with the views of the MFSA in connection with the setting up of Sharia compliant funds as:

1. Equity Funds
2. Ijarah Funds
3. Commodity Funds
4. Murabaha Funds

A respondent explained that the investors in a Sharia Fund should be given the right to object if the Fund is not Sharia compliant. The MFSA is of the view that Sharia Funds, irrespective of whether they are set up as Professional Investor Funds, UCITS Funds or Non UCITS Retail Funds, should be regulated in the same manner as non Sharia Funds.

A respondent expressed concerns on the use of Professional Investor Funds, UCITS Funds or Non UCITS Retail Funds for the purposes of setting up Sharia Funds, but did not elaborate on these concerns.

A respondent highlighted the role of MFSA in ensuring that where a fund claims to be Sharia compliant, it actually does satisfy the relevant Sharia principles and requirements. Here again, the MFSA wishes to clarify that it will **not** be assuming responsibility for ensuring that licensed collective investment schemes which claim to be Sharia compliant effectively do satisfy the relevant Sharia requirements. The MFSA is of the view that this responsibility should be borne and assumed by the managing body (such as the Board of Directors) of the fund concerned. It will notwithstanding request promoters of such funds to provide the necessary explanations and confirmations in support of their claim that the fund being set up is Sharia compliant.

4 Other Comments

A number of respondents also raised additional issues not covered by the Consultation Document including:

1. the use and role of the Sharia Supervisory Board in Islamic Institutions and the contents of the Constitutional Documents of these Institutions – which should be extended to cater for these Boards;
2. Corporate Governance concerns within Sharia Institutions;
3. Risk Management within the context of Islamic Products and Services;
4. The use of Islamic Accounting Standards by Sharia Institutions;
5. The role of the Sharia Supervisory Board in Sharia Funds;
6. The relationship between the Fund Manager and a Sharia Fund;
7. Governing Law of documentation for Sharia compliant transactions;
8. Interpretational disagreements between Sharia Scholars.

A respondent pointed out that there should be a joint effort with the Maltese Tax Authorities to analyse the taxation associated with the Islamic Services and Products referred to above.

The above areas relate the internal operational arrangements of Islamic Institutions were thus outside the scope of the Consultation Document (which focused exclusively on the revisions required to the Banking Act and Financial Institutions Act to attract Islamic Institutions to Malta as well as on the use of MFSA's regime for collective investment schemes to set up Sharia Funds).

The matters referred to above will, however, be taken into account when formulating any ad hoc rules applicable to Islamic Institutions and Sharia Funds.

5 Way Forward

In view of the positive feedback received from all respondents, the MFSA will be taking this project forward and will in the coming weeks be seeking further advice from Sharia experts in connection with the implementation of the matters raised in the Consultation Document, including the additional matters raised by the various respondents as summarised in Section 4 above.

The MFSA will be announcing the setting up of an Expert Group to identify, in further detail, the necessary regulatory changes – at Level 1 (i.e. legislative revisions), Level 2 (revisions to Regulations) and Level 3 (drafting new or revising Rules for Sharia Institutions) – relating to Sharia Institutions and Sharia Funds, as applicable; and to assist in the proper implementation of the proposed revisions.

The ultimate goal of this Expert Group will be to ensure that Malta has a regulatory and legislative system that appreciates and recognises the specific needs of Sharia Institutions such that Malta becomes a domicile of choice for the setting up of Sharia Institutions.

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