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**Developing Islamic Capital Markets:
New Challenges and Opportunities for International and Islamic
Financial Centres**

Good morning ladies and gentlemen.

It is a great honour to be here today and to be a part of such a distinguished line-up of speakers. We have already had three presentations that have shed some real insight into some of the major issues facing Islamic finance and Islamic capital markets as they evolve during what are still early days in the industry.

However, before I proceed further, I would like to congratulate the organisers of The London Sukuk Summit. Although this is only the second year of this conference, it has already become an important date on the annual calendar for practitioners in the field.

And that this conference draws so many industry participants from across the globe is particularly important given the nascent, evolving and fast-growing nature of the industry. A gathering of this calibre is crucial in enabling professionals from around the globe to come together to discuss emerging trends and challenges, innovations and latest developments.

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The topic of my comments today is close to our collective hearts at the Dubai International Financial Centre. Not only do we have an ambition to be a major global financial centre, and not only are we committed to supporting the development of regional capital markets, but we also have identified Islamic finance as one of our key areas of focus. In fact, we have a team dedicated entirely to providing the infrastructure and

environment necessary to support the industry and attract the leading players in the industry to come to work or list in the DIFC

As part of my introduction to this subject, I also would like to note that we are having this discussion at a time when more and more, we are talking about how the centre of gravity in global capitals markets is shifting eastward.

Signs of this are everywhere:

- Senior decision-makers of major global banks and even headquarters of major Western corporations are relocating to cities like Dubai in the Middle East and Asia.
- There has been tremendous wealth accumulation, as reflected in the growth of both sovereign wealth funds and private wealth. In fact, private wealth in Asia grew 10.5% last year to 8.4 trillion US dollars, according to Capgemini.
- Multinational companies are emerging from the Middle East and Asia to become prominent players in their sectors globally. Examples include Orascom Group of Egypt, Dubai World and Emirates Airlines of the United Arab Emirates, ArcelorMittal and the Tata Group of India, and Lenovo of China.
- Asian economies are growing rapidly, with China and India now ranked by the IMF as the second and third largest behind the United States and ahead of Japan.
- And just last week, The Financial Times ran a story on how Hong Kong, Singapore and Dubai were all seeking to challenge Switzerland as centres of private banking.

Leading on from this last point, there is another sign of this shift, related to a gentlemanly competition among rising financial centre, primarily in Asia. While there is clearly no immediate threat to the supremacy of London and New York, there are distant rumblings. For example, in 2006, Hong Kong was the world's largest IPO market, ahead of both London and New York. Of course there are one-off reasons for this, but

the point is that such a result would have been inconceivable 10 years ago.

Now, added to this mix of competition is the rise of Islamic finance, the fastest growing segment of the global financial services industry, and an industry that has its heartland in emerging Asia and Middle East.

With the opportunities related to serving this industry almost unlimited – given the double-digit rate of growth and amount of capital flowing into the sector, it's a virtual gold rush, and for a city that could capture the title as a global financial capital of Islamic finance, the rewards would be tremendous.

In fact, the total size of the industry is estimated at between 700 billion and 1 trillion US dollars, with a global potential of 4 trillion US dollars. And, as I said, it is growing rapidly, at 15% to 20% per year.

Cities from London to Dubai, Kuala Lumpur, Bahrain and Qatar have all put their hats in the ring in acknowledgement of the value of this prize.

Now, I don't want to get into handicapping this race; rather I have raised this as another sign of the shift East in global capital markets and as one of the opportunities growth of this industry offers these centres.

This also helps me transition – after this introduction – to the heart of my comments today: The challenges and opportunities for financial centres in the context of a growing international Islamic capital market.

As I have noted, Islamic finance and its capital markets are still in their infancy. They also face numerous challenges, as we've just heard.

Such a scenario provides an opening for financial centres to play nurturing roles in building this industry.

And history teaches us that a city that offers the right infrastructure – legal, regulatory and physical – as well as the right environment for innovative thinking, will grow along with the markets that are established in that city.

Take the City of London. In 886 Alfred the Great made sure that there was suitable accommodation for merchants travelling from northwest Europe, an accommodation then extended to traders from the Baltic and Italy. The City then developed its own code of law for the mercantile classes, and the rest is history.

Across the Atlantic Ocean a thousand years later, Wall Street had its origins in the Buttonwood Agreement of 1792, when 24 traders gathered under a tree to set out the conditions and regulations for the speculative market, a nascent market that had all but been destroyed by ad-hoc rules and the unethical trading on insider information. The formalised rules they set and agreed to, set the foundation for the tremendous success of the New York Stock Exchange.

I might add that Dubai – like the City of London – had its commercial origins in a decision to provide an environment and infrastructure that was welcoming to merchants coming from across the Middle East, Asia and Africa.

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With these comments as an introduction, I now will turn to the main focus of my talk today. I will begin by briefly reviewing some of the challenges facing Islamic finance. Next I will look at the role that financial centres can play in developing Islamic capital markets, and then conclude with the specific example that the DIFC offers as a financial centre that is supporting the ongoing development and evolution of Islamic finance and Islamic capital markets.

Challenges

As we have just heard from the previous speakers, a number of challenges face the industry.

These include the need for greater innovation, standardisation and regulation.

We see that there are still many countries where the legal and institutional framework is not explicit and transparent about Islamic

finance, and the framework developed for conventional finance is being applied to Islamic institutions.

It is unclear whether such an approach is sufficiently flexible to address and supervise the unique mix of risks and special operational features of Islamic finance. In addition, this situation creates potential tensions between the architecture and reform priorities required for conventional finance and those required for Islamic finance.

Second, there needs to be more done in terms of setting supervisory and regulatory standards tailored to Islamic banks. This is necessary to support industry development. Indeed, some of the areas of weakness that currently prevail in many countries – in risk management, recognition of market and operational risks, information sharing and consolidated supervision – are particularly pertinent for effective supervision of Islamic banks, and so they need to be addressed right away.

Third, in order to aid the growth of the Islamic financial services industry, there needs to be greater streamlining and co-ordination of regulatory requirements across jurisdictions.

One example of this actually occurring is a mutual recognition arrangement concluded between the DIFC regulator and the regulator in Malaysia.

This arrangement itself has much potential, including providing a model for other jurisdictions and preparing the way for full 'passporting' arrangement of Islamic funds across the MENA region, and even across regions – similar to the system operating in Europe.

Fourth, significant weaknesses in the legal, governance and systemic liquidity infrastructure are impeding the spread of product innovations in Islamic finance and preventing effective supervision and risk management. The still underdeveloped state of the securities markets and insurance industry in many countries is affecting greater use of equity-based and asset-backed facilities by financial institutions.

Fifth, the weaknesses in insolvency and creditor rights regimes and in contract enforcement, as well as the limited adoption of AAOIFI

accounting standards for Islamic institutions and the weaknesses in content and scope disclosures, all affect further development of investment account management and impede an equity culture necessary to support a greater use of equity-based facilities in the sector.

Sixth, the problems with the systemic liquidity infrastructure have raised liquidity risks for Islamic banks and prevented the effective use of monetary operations with Sharia-compatible money market instruments as a means to manage market liquidity and set a benchmark rate of return.

The recent developments in Islamic asset securitisation, however, have opened up opportunities to strengthen systemic liquidity arrangements (by fostering national money markets for suitably designed securitized assets) and for greater use of markets for securitized assets as a tool of risk management.

Seventh, the need for greater standardisation in Islamic finance would help reduce costs and speed the issuance of Sharia-compliant products. One way to promote this is through standardisation of, or agreement on, a set of *fatwas* issued by Sharia scholars.

Although standardisation of fatwas would not alleviate the differences across schools of thought, it would at least provide some indication of what structures would be acceptable from a Sharia perspective.

Some jurisdictions are helping industry practitioners by collating fatwas issued in their markets to serve as a useful aid to those structuring Islamic financial transactions.

Collation of fatwa's also may facilitate innovation in the industry, particularly if there is a general understanding of how basic transactions should be structured.

The work of the IFSB and AAOIFI is important in encouraging and facilitating standardisation.

This is particularly crucial because of the differences in practices and standards between the two main centres of Islamic finance – Asia, led by

Malaysia, and the GCC, led by Dubai and Bahrain. While there has been more cooperation between the Gulf and Asia, particularly as cash-rich Gulf investors seek to diversify their holdings, a recent Reuters poll of bankers showed that nearly 70 percent cited differences in Islamic financial law as the main constraint on greater Islamic deals between the two regions. The main issue named was the prohibition on the trading of debt in the Gulf, something permitted in Malaysia.

Role of Financial Centres

These challenges provide great opportunities for financial centres, both international and Islamic. Many of the issues facing Islamic finance can be addressed through the steps taken by strong and proactive financial centres. Such centres can be characterised as having skilled regulators, a fair and transparent legal structure, a critical mass of knowledgeable professionals and scholars, supportive government policymakers and access to capital, investors and institutional players.

Early on, I mentioned the competition among cities to be the leading global centre of Islamic finance. This competition generally is a good thing as centres look to provide the legal and regulatory environment necessary for financial services; as they help develop the human capital necessary to populate the industry; as they drive the innovation that will produce the products and services the industry needs, and as they work collaboratively across jurisdictions to increase standardisation.

The relative success of one financial centre to achieve these goals will push other competitors to improve their offerings and so this virtuous cycle drives advancements across the global Islamic finance industry.

Attracting the best talent; developing the best legal and regulatory structures and attracting a critical amount of capital, by contrast, represent some of the main challenges.

As well, centres have the challenge of supporting product and service innovation, along with the growth and sophistication of the industry, while always remaining true to the tenets of Islam. A financial centre that ends up with a regulatory system on the wrong side of the line – assuming a

global consensus ultimately can be reached regarding what is, and what is not Sharia-compliant – would be at a major disadvantage.

DIFC

I now turn to the Dubai International Financial Centre as an example of what a financial centre can do. I will begin with an overview of the centre as a whole and then move into a more specific discussion of our efforts in the field of Islamic finance and capital markets.

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Our Regulatory Law is based on English Law, while the insurance regulations are taken from best practice FSA rules from the jurisdictions of Bermuda, Singapore, London, Guernsey and Jersey. Moody's has described our regulatory standards as "on a level with or better than those seen in more developed insurance markets".

The DIFC has worked very hard in recent years to create an ultra-modern, highly efficient and well-regulated financial centre to serve both our region and the world. Described by the City of London as the fastest emerging financial centre, in just four years the DIFC has attracted many of the world's leading institutions and professionals. More than 600 companies are now represented here, among them 150 multi-national companies of the Global 500, including the Top 10. We expect this number to rise further in the coming years.

Through our regulatory body, the Dubai Financial Services Authority, the centre has created a set of rules and regulations that ensure that everyone operating at the centre does so to the highest standards. The DFSA is created by statute and is entirely independent of the DIFC. While many regulatory bodies have been formed in response to financial crises, the DFSA was established as a world-class regulator from the outset. Its framework is free from the confines and complexities that can develop when old legacy systems are forced to fit new circumstances.

The DIFC has an independent court system that upholds the provisions of DIFC laws and regulations. The Courts provide legal redress in civil

and commercial matters within the DIFC and above all the Courts operate under Anglo-Saxon common law - again unique for this region - which offers institutions and companies legal clarity and predictability.

Two further examples of our commitment to best practice are our arbitration service, in a joint venture with the London Court of International Arbitration, offering dispute resolution services to all business and commercial sectors, and the Hawkamah Institute for Corporate Governance, created to advance corporate governance reform throughout the region.

With its international framework, facilities and standards the DIFC wants to act as the global gateway to an untapped and vibrant region of 2.1 billion people and a combined economy worth 2.3 trillion US dollars. Our regional footprint stretches from the western tip of North Africa to the eastern part of South Asia, comprising North and Eastern Africa, the Levant, the Caspian, the Indian Sub-continent and the GCC States.

DIFC's Islamic Finance Focus

The DIFC has six areas of focus:

- Banking & Brokerage
- Capital Markets
- Wealth Management
- Re-insurance and Captives
- Islamic Finance
- Ancillary Services

Our efforts to support the development of Islamic finance cover a wide range of issues discussed previously. I will begin by discussing the legal and regulatory regime.

Legal, regulatory environment

Central to the DFSA's approach to Islamic finance is its belief in risk-based regulation, the same theory that applies to conventional institution regulation at the centre. Many of the risks in Islamic finance have their

counterparts in conventional finance, and we believe they should be treated similarly.

The underpinning law is the Law Regulating Islamic Financial Business. Under this law, any firm that holds itself out as conducting Islamic financial business must have a special endorsement on its licence.

This may allow the firm to operate as a wholly Islamic firm, or to operate an Islamic window.

The key point here is that the DFSA is a 'Sharia *Systems* Regulator' not a 'Sharia Regulator'. Any firm that conducts Islamic financial business must put *systems* in place to ensure that the business is conducted in accordance with Sharia.

This includes the appointment of a Sharia Supervisory Board with at least three competent scholars. The firm must have systems in place to disseminate the board's rulings, conduct regular Sharia reviews and also conduct an internal audit.

The overall regulatory regime integrates and extends international standards to the fullest extent possible to all DFSA authorised firms, including wholly Islamic financial institutions and Islamic windows. An appropriate degree of modification to these standards has been made to provide an appropriate regulatory model for the specificities of Islamic finance, including but not limited to:

- Implementation of AAOIFI (including extension of AAOIFI's Sharia review process to Islamic windows)
- Modification of prudential requirements to reflect the specific prudential risks and Sharia risk mitigation techniques for Islamic finance
- Enhanced disclosure in respect of Sharia oversight, and periodic information in respect of products and services offered in accordance with Sharia.

By way of specific example, let me list some challenges facing the industry and then talk about how the DIFC is addressing them.

The need for greater product innovation:

As discussed, the DIFC provides a clearly defined legal and regulatory framework that facilitates innovation in the field of Islamic Finance. Another example of innovation is the creation of Waqf Trust Services - the first exclusive Islamic trust services provider in the world offering Sharia-compliant global trust services.

Greater liquidity in Islamic Finance

The DIFX provides a conducive framework for the listing and trading of Islamic securities. The Dubai International Financial Exchange is the largest and most liquid exchange for sukuks, or Islamic bonds, in the world, with a total value of nearly 17 billion US dollars.

Industry benchmarks

The DIFC, in collaboration with HSBC, has developed a series of industry benchmarks including the Sukuk Index

The Shortage of Talent

The DIFC has a well-defined education strategy, led by the Centre of Excellence. Our Centre of Excellence provides a platform for the world's best education facilities and programmes, including the International Bar Association, London Business School and Queens Business School.

At the DIFC we have established the world's first Executive MBA specialising in Islamic Finance and Energy in partnership with Cass Business School, and we provide numerous other workshops and opportunities.

Standardisation

The DIFC is seeking to provide an environment for Islamic finance forums to attract the best talent in Islamic finance in order to spearhead standardisation.

Passportability of Islamic Products

The DIFC has been leading in the move toward convergence and regulatory standardisation in the field. We are working with regional and international regulatory bodies and are entering into co-operation and information-sharing arrangements with other regulators and counterparties.

We have signed over 27 bilateral MoUs with various regulatory authorities around the world, including the Mutual Recognition model with Malaysia noted previously.

Conclusion

We are in the exciting early days of the Islamic finance industry and the development of its capital markets. We also are seeing the shift in the global capital market's centre of gravity. These trends provide tremendous opportunities – and challenges – for both international and Islamic financial centres. These centres, and cities, will succeed or fail based on their ability to help the industry grow, innovate and develop the products and services that clients, investors and issuers require.

As a representative of an international financial centre that is committed to the development of this industry, I look forward to working with other centres, as well as other industry participants, to help grow Islamic capital markets and the Islamic finance industry in the years and decades ahead. This will by its nature be a collaborative effort, and I look forward to pursuing this journey together.

Thank you.

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