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**CONSULTATION PAPER NO. 53**

**FEBRUARY 2008**

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**PRUDENTIAL RULES FOR ISLAMIC FINANCE**

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#### **Why are we issuing this paper?**

1. This Consultation Paper seeks public comments on the DFSA's proposals to enhance the PIB regime with regards to the way Islamic Contracts should be treated for prudential purposes. The proposals involve changes to the following modules of the DFSA Rulebook:

PIB	Prudential – Investment, Insurance Intermediation and Banking Business (Appendix 1)
ISF	Islamic Financial Business (Appendix 2)
GLO	Glossary (Appendix 3)

#### **Who should read this paper?**

2. The proposals in this paper would be of particular interest to Authorised Firms Managing a Profit Sharing Investment Account but will also be of interest to Authorised Firms in Category 1, 2, 3 or 5 when investing in or holding Islamic Contracts when calculating Credit Risk or Market Risk in respect of such contracts.

#### **How is this paper structured?**

3. In this paper, we set out:
  - (a) the background and overview of the proposals (paragraphs 7 to 11); and
  - (b) a detailed description of the drafting (paragraphs 12 to 21).

#### **How to provide comments?**

4. All comments should be forwarded to the person specified below. You may, if relevant, identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments.

**What happens next?**

5. The deadline for providing comments on the proposals is by close of business on **9 March 2008**. Once we receive your comments, we will consider if any further refinements are required to these proposals. We will then proceed to enact the changes to the DFSA's Rulebook. You should not act on these proposals until the relevant changes to the DFSA Rulebook are made. We will issue a notice on our website telling you when this happens.

**Comments to be addressed to:**

**Peter Casey**  
**Director, Policy**  
**DFSA**  
**PO Box 75850**  
**Dubai, UAE**

**or e-mailed to: [pcasey@dfsa.ae](mailto:pcasey@dfsa.ae)**

## Definitions

6. Defined terms are identified throughout this paper by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in the Glossary (GLO) module. Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning. Some proposed changes to GLO are in Appendix 3.

## Background

7. Consultation Paper 52, issued on 4 December 2007, contains proposals to ensure the DFSA's regime is in line with the standards which prevail in advanced jurisdictions. Although the proposals in this paper are not specifically linked to any proposal in Consultation Paper 52, they form part of the overall key policy review currently being undertaken by the DFSA and were contemplated in that paper.
8. In order to ensure the DFSA's regime is in line with international standards, including the standards produced by the Islamic Financial Services Board (IFSB), the DFSA has examined its prudential regime for Islamic finance. We have also observed an increase in conventional firms investing in or holding Islamic instruments, and we consider that guidance may be required on the treatment of such instruments for capital purposes.

## Overview of the proposals

9. The main aim of the proposals is to enhance the PIB regime by providing more detail on the way Islamic Contracts should be treated for prudential purposes.
10. At present, the treatment of Islamic Contracts for prudential purposes is set out in PIB chapter 3. The proposed enhancements include:
  - amending Table 2 of PIB chapter 3 to be in line with the "Capital Adequacy Standard for Institutions (other than insurance institutions) Offering Only Islamic Financial Services" (CAS 1) issued by the IFSB, and to deal with a wider range of Islamic Contracts;
  - prescribing the treatment of Islamic Contracts financed other than by a PSIA, including those held by conventional institutions; and
  - providing Rules on treatment of Market Risk for Islamic Contracts held in a Trading Book, whether financed by a PSIA or otherwise.
11. The substantive provisions are based on CAS 1, the only changes of substance being those that are necessary to implement them in the context of the PIB regime.

### **Detailed description of the drafting**

12. PIB chapter 3 has been substantially enhanced with new Guidance on the treatment of Islamic Contracts, as well as new Rules relating to Market Risk.

#### **(a) Guidance on the treatment of Islamic Contracts**

13. Table 2 under PIB Rule 3.5.3 is proposed to be relocated as Guidance under PIB Rule 3.5.2. The table has been enhanced to include the provisions in CAS 1 dealing with the minimum capital requirements for Islamic Contracts, specifically relating to relevant risk weightings or applicable capital charges.
14. This table and the other Guidance under PIB Rule 3.5.2 are intended to assist Authorised Firms in calculating their PSIACOMcredit (see Rule 3.4.2).
15. It is also relevant to an Authorised Firm which invests in or holds Islamic Contracts, when calculating Credit Risk for such contracts. We have inserted Guidance to that effect under PIB Rule 4.1.1 and consequential amendments have also been made to PIB Rule 4.10.1.

#### **(b) Market Risk**

16. Proposed new PIB section 3.6 is based on provisions in CAS 1. This section has been inserted to assist Authorised Firms in calculating their PSIACOMmarket (see Rule 3.4.2), and is also relevant to an Authorised Firm when calculating its Market Risk Capital Requirement in respect of Islamic Contracts it invests in or holds. We have inserted Guidance to that effect under PIB Rule 5.1.1

#### **(c) Economic substance**

17. The proposed new Guidance under PIB section 3.2 emphasises that an Authorised Firm undertaking Islamic Financial Business or otherwise investing in or holding Islamic Contracts, should give due importance to the economic substance of the transaction, in addition to the legal form of the Islamic Contracts.

#### **(d) Management of PSIA's**

18. We have taken the opportunity to move PIB Rule 3.7.1 to the ISF module as Rule 4.3.1. This Rule prohibits an Authorised Firm from utilising funds of PSIA holders to finance its corporate activities. This Rule has been moved because it relates to systems and controls (as opposed to capital requirements) and is therefore more appropriately placed under chapter 4 of the ISF module which sets out rules relating to systems and controls.

**(e) Displaced Commercial Risk**

19. Consultation Paper 52 contains proposals which if implemented will enable Authorised Firms to offer Financial Services to a wider range of Clients. That paper, amongst other things, deals with enhanced disclosure requirements for PSIAs.
  
20. As this paper focuses on prudential requirements for Authorised Firms Managing a PSIA, the DFSA invites comments on whether the current ratio of 35% for Displaced Commercial Risk (please refer to PIB Rule 3.4.2) remains appropriate, in light of the proposed broader access set out in Consultation Paper 52.
  
21. The Displaced Commercial Risk ratio essentially measures the likelihood that an Islamic bank will feel obliged to support returns to its PSIA holders for commercial reasons, even though in principle those holders bear the full investment risk, with no guarantee of principal. Full support would imply a ratio of 100%; no support at all would imply a ratio of 0%.

**Issues for consideration**

Are the proposed amendments clear and unambiguous?

Do Authorised Firms see any practical difficulties with the new Guidance and Rules for the treatment of Islamic Contracts for prudential purposes? If so, what are they and how should they be addressed?

Does the 35% Displaced Commercial Risk ratio remain appropriate? If the changes proposed by CP 52 are implemented should the ratio be revised?