



YAOUNDE NOVEMBER - 2017

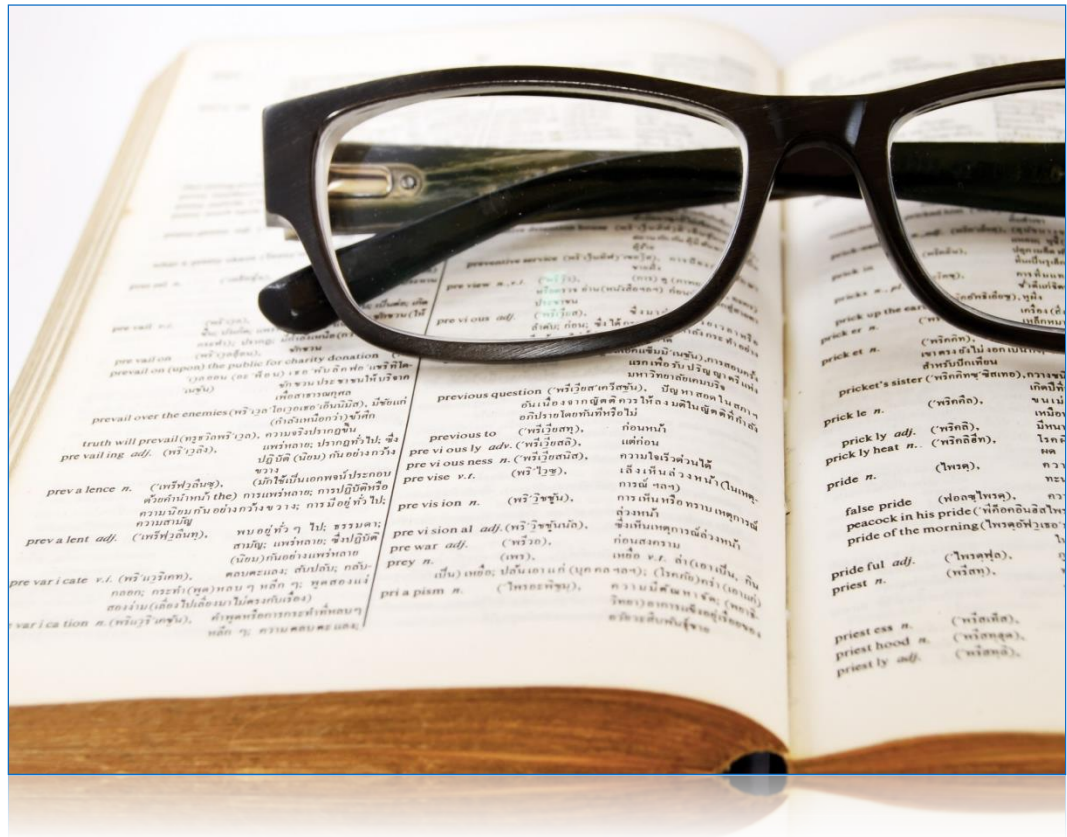
IFAAS

ISLAMIC FINANCE ADVISORY & ASSURANCE SERVICES

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# Islamic Finance regulatory framework in West Africa



# HISTORY OF ISLAMIC FINANCE IN WEST AFRICAN, WAMU COUNTRIES

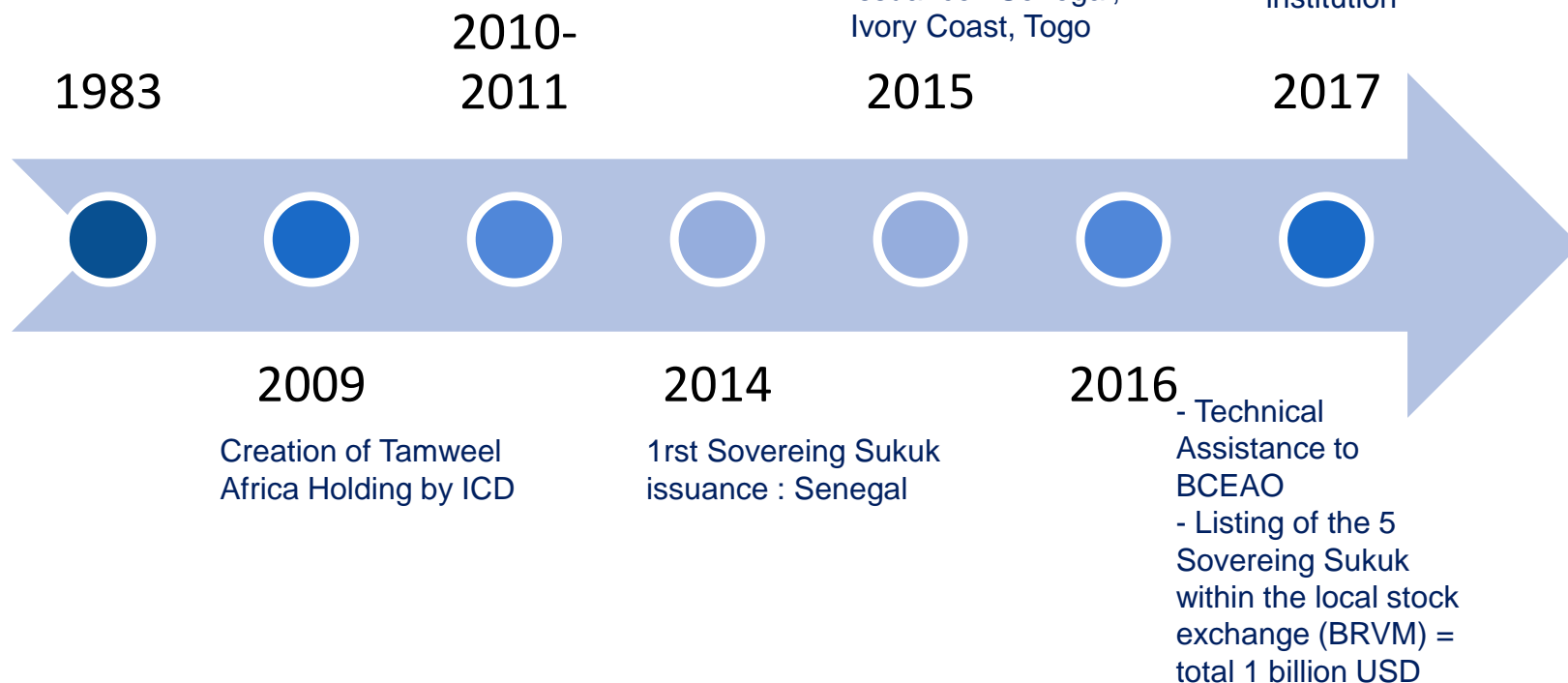
# ISLAMIC FINANCE IN WEST AFRICA

- Modification of the banking law : 2 new articles for banks that do not « use interest », practice : « merchand operations » and implement « profit sharing)  
- Set-up of the first local islamic banks in Senegal, Niger and Guine by Dar Al Maal Al Islami

2010- The President of Senegal annouced the interest of the country to promote Dakar as an IF hub  
2011 – first technical assistance provided by IDB to Senegal to analyse the regulatory framework for IF

Sovereign Sukuk issuance : Senegal, Ivory Coast, Togo

New regulatory framework for islamic bank and microfinance institution



# BCEAO PROJECT – OUR MISSION

- Define a regulatory framework allowing an adequacy between the activities of the Islamic finance and the conventional legal framework of the UMOA for :
  - Banks
  - Microfinance Institutions (SFD)
  - Islamic compliant financial instruments (Sukuk)
  - Monetary Policy
- Define the standards of:
  - Prudential framework
  - Accounting for Banks and microfinance institutions
  - Tax environment for Islamic financial products
- Conduct a regional workshop to present the draft of the new framework for Islamic finance and discuss it with all the regional authorities.

## **THE IMPORTANCE OF A CONTEXTUALIZED FRAMEWORK: "THINK GLOBAL, ACT LOCAL"**

- It was inappropriate to transpose existing mechanisms into other countries without taking into account the specificities, the legal framework and the local context of UEMOA.
- To this end, the first meeting (“REUNION DE CADRAGE”) allowed us:
  - To define clear and realistic objectives compliant with the legal, economic and financial context of the Union
  - To get all the stakeholders to a common of understanding of Islamic finance
- Collaboration with a dedicated working group of BCEAO was very important for us :
  - To involve them deeply in the process
  - To get the official and applicable regulation

# OUR METHODOLOGY FOR THIS PROJECT



1

**1<sup>er</sup> Meeting with BCEAO project team to :**

Define clear objectives  
Train the team to our understanding of islamic finance referential and concepts  
Define the Road Map  
Define clear deliverable



2

**Data collection**  
(official texts, bceao strategy, any previous work studies done on islamic finance)



3

**Analyses Research**  
Identifying obstacles  
Production of the first draft of the islamic finance regulatory framework



4

**Meeting with BCEAO team to challenge our proposition based on Seminars**  
Taking into account the observations of all the stakeholders and authorities of the 8 countries and IDB  
Production of the temporary final report



5

**Delivery of the final report**

# THE FIRST CHALLENGE : IDENTIFY THE PROPER ISLAMIC **PRACTICE** AND THE REFERENTIAL THAT CAN BE IMPLEMENTED WITHOUT MODIFYING THE LAW

2



Banking and  
microfinance law

3



Accountancy  
Prudential  
Tax

4



Interbank  
instruments  
Sukuk  
Monetary Policy

Transverse issues :

Which standard would be the best for the region and how to implement any Sharia Governance Framework within secular countries (AAOIFI and Maliki local culture)

1

# OUR APPROACH

- Focus on **instructions** that can be **adopted directly** by the BCEAO for financial institutions (without any law modification)
- **One instruction dedicated to the main Islamic compliant products :**
  - That can be used by several institutions (banks, microfinance...)
- Instructions dedicated to the conditions to be fulfilled by:
  - Banks including :
    - Stand alone Islamic banks
    - Islamic windows For the Sharia Governance Framework taking into account the secular context
  - Microfinance institutions (without modifying the law, microfinance institutions can, for the moment, only set-up Islamic windows).



# OUR APPROACH

- Regarding tax, propose a tax directive that will be supported by BCEAO and then transposed by each country
  
- Regarding Islamic finance compliant instruments:
  - Amend existing regulation regarding the issuance of Islamic compliant monetary instruments (BCEAO can solely take this measure)
  - Propose a regional regulation on Islamic compliant financial instruments (including Sukuk).
    - BCEAO can support some of this regulation



## MAIN ISSUES

# ISLAMIC LAW WITHIN SECULAR COUNTRIES

- In secular countries, the enforceability of Sharia can be challenged
- Our challenge based on the request of BCEAO :
  - Do not modify the current law nor create any new law for islamic products (implementation process would have been too complicated)
  - Refer to Islamic principles and rules as interpreted by national law
- **What we have not done:**
  - To identify the main gaps between Sharia and OHADA laws

# ISLAMIC FINANCE PRODUCTS

## ■ Our approach :

- To define the main characteristics of islamic finance products as *sui generis* products (no legal qualification as been given except for Ijara)
- Indeed, for ijara, it was possible to modify the law on leasing. Therefore Ijara is « legally » defined while the other products have only be described in the instructions.
- To open the door to innovation : other products can be proposed by financial institutions

## ■ Our proposition :

- A dedicated instructions for Islamic finance products
  - That describes the main Islamic operations and contracts and
  - Remain flexible for any new product validated by a Sharia Supervisory Board

# THE ISLAMIC PRODUCT INSTRUCTIONS

- The objective was to identify the main products that will be proposed by financial institutions and to :
  - Describe the main characteristics
  - Provide guidance on the main provisions to mandatory include in the contracts in order to promote harmonization of key practices in the UEMOA
  - Leave the flexibility to the product developers to propose new products while supervising the innovations by the SSB and the BCEAO

## OUR REFERENCE : AAOIFI STANDARDS

- AAOIFI standards have been validated by BCEAO as referential
  - Objective : harmonization of the practice in 8 countries
- In the Instruction we used the wording below (BCEAO asked for the translation in french of certain arabic terms):
  - Qardh ou Prêt Gracieux
  - Mourabaha
  - Mourabaha financement, Moussawama financement
  - Ijara et Ijara financement
  - Moudaraba and Mousharaka financement
  - Salam, Istisna
  - Compte d'investissement Moudaraba Général et Spécifique (Investment account)
  - Compte d'investissement Wakala (Investment account)
  - Arboun
  - Waad
  - hamish jiddiyah
  - Tawarruq has been limited to interbank and payment transactions

# SAMPLE OF ISSUES

- To avoid legal qualification of Islamic contracts (**sui generis contracts**) due to:
  - The fact that all Islamic contracts do not necessarily have a civil « equivalent »
  - and that our mission did not include an assessment of potential gaps with OHADA law
  
- One example is the Moudaraba that has no existing defined equivalent contract (it is not a « société en commandite » as a lot of people used to say)



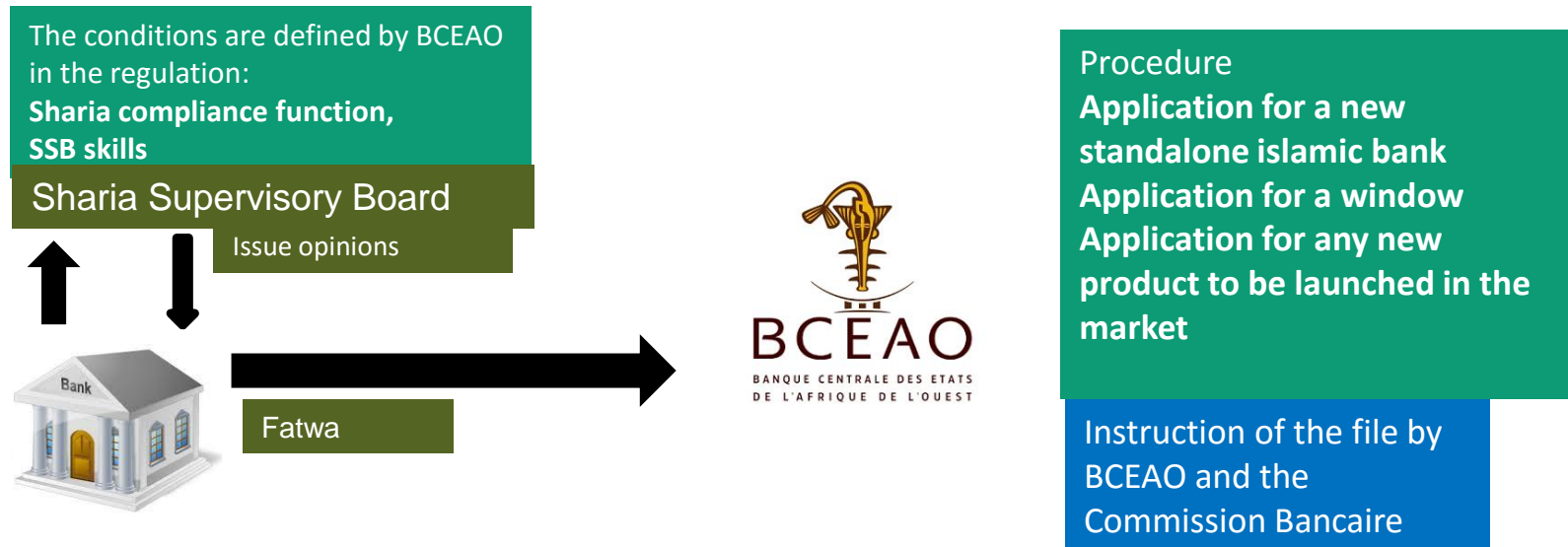
# **SHARIA GOVERNANCE FRAMEWORK**



# HOW TO IMPLEMENT SHARIA GOVERNANCE FOR ISLAMIC FINANCIAL INSTITUTIONS IN UMEOA

- For the moment, according to BCEAO a Central Sharia Board is not an option due to the secular context (even if some countries have more than 90% of Muslims)
  - This option may be reconsidered later by BCEAO
- At the same time, BCEAO should keep control and supervise the governance process
- BCEAO can't issue any opinion about the Shariah compliance of products but can define how to implement Sharia in the existing corporate governance framework by
  - Defining the selection criteria of SSB (experience, skill, knowledge, etc..), but each bank has to implement its own SSB
  - Having the possibility to consult a SB. In this case, the option of this scholar or expert will become enforcable in the market

# HOW TO INTEGRATE SHARIAH COMPLIANCE IN THE APPROVAL OF ISLAMIC FINANCIAL INSTITUTIONS?



## ■ The circular mentions :

- The obligation to set up a Shariah Supervisory Board (SSB)
- The SSB role
- The means of control
- Its nomination process
- Its composition
- Its revocation
- The setup of the function : Sharia compliance officer
- The annual sharia audit
- The map of the risk that includes the sharia non compliance risk

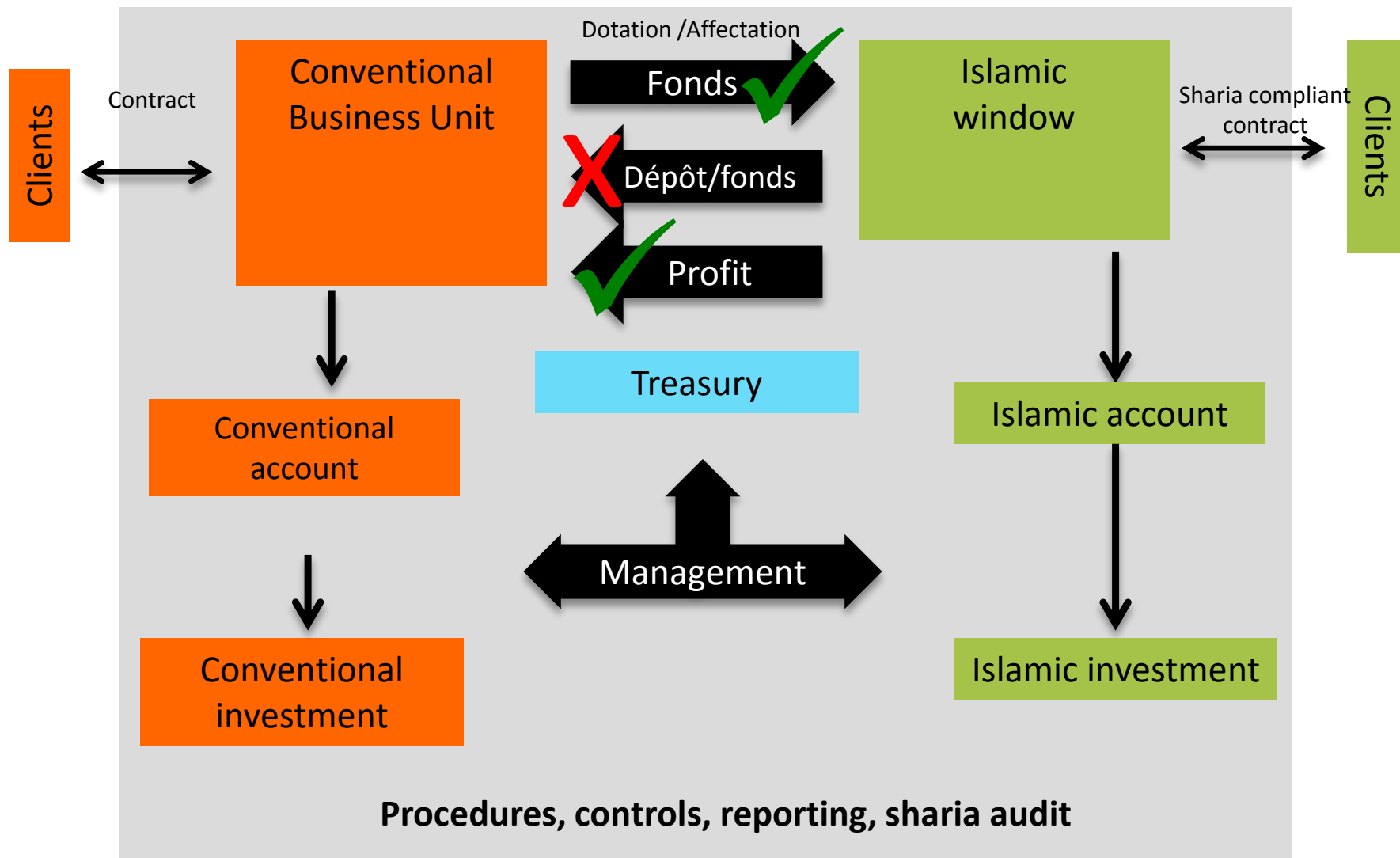


# **INSTRUCTION FOR ISLAMIC BANKS AND ISLAMIC WINDOWS**

# TWO CATEGORIES OF BANKS

- Type 1 : Standalone bank
  - Allowed to use the word « Islamic » in its commercial name
  
- Type 2 : Islamic window
  - Not allowed to use the word « Islamic » in its commercial name but only in the commercial documentation related to Islamic products

# ISLAMIC WINDOW : CATEGORY 2



# SOME IMPORTANT ISSUES

- The consequences of the prohibition of interest on the remuneration of deposits
  - How to qualify “legally” the profit sharing accounts. Are they a category of deposit?
  - “Funds received from the public and the obligation to refund in all case” (guaranteed)
    - Qard and Wadia
    - Moudaraba and Wakala :
      - General and Specific Investment Account
      - Loss and Profit Sharing Mechanism
- Limit this product only to sophisticated investors to protect clients (local context)
- The mitigation of the Displaced Commercial Risk

# APPLICATION REQUIREMENT FOR STANDALONE ISLAMIC BANK 1/2

- Minimum of capital is the same than for conventional banks
- Information to provide about the members of the SSB
  - CVs, experience
  - Term of reference of their assignement
  - Procedure and Sharia audit plan
- **Flow Chart/Organigram** showing the Sharia control and auditing functions
- Market Studies, Business Plan over 5 years etc...
- Human Ressources skills and their Islamic finance training program
- Management policy of the Investment account

# APPLICATION REQUIREMENT FOR ISLAMIC WINDOW 2/2

- Procedures showing:
  - Clearly the accountancy of the window and its balance sheet
  - The non-Sharia compliant income
  
- Human Resources :
  - Number
  - Which are fully dedicated to the window / which are not
  - Skills and their Islamic finance training program
  
- The visual identity dedicated to the window





# **CIRCULAR FOR MICROFINANCE INSTITUTIONS**

# THE MAIN ISSUE FOR MICROFINANCE INSTITUTIONS

- After having pointed out the limitations of the current law (art. 36), Islamic finance can only be launched under Islamic window as an ancillary activity
- Indeed, microfinance institutions have to offer deposits and remunerated loans to be approved by BCEAO.
- Having a standalone Islamic microfinance institution will be possible if the applicable law is modified :
  - By changing the definition of loan to include non-remunerated loan
  - Or by adding into the main activities of microfinance institutions Islamic compliant financing contracts.



# SUKUK AND OTHER INVESTMENT CERTIFICATES

# MAIN INSTRUMENTS USED IN UEMOA FOR THE MONETARY POLICY AND PUBLIC (STATE) FINANCING

- Conventional bonds
  - < 5 years under supervision of BCEAO
  - > 5 years under supervision of the CREPMF
  
- Conventional treasury bill
  - < 5 years under supervision of BCEAO

# MAIN INSTRUMENTS USED FOR SUKUK ISSUANCE – SECURITIZATION VEHICLE

- FCTC : « Fonds Communs de Titrisation et de Créances » (used as legal vehicle – SPV - for the Sovereign Sukuk issued in Senegal, Ivory Coast and Togo) :
  - The issue between « Créance » (receivable) as asset and the other type of tangible assets required by sharia
  - To trade receivable is not permissible by sharia

# OUR APPROACH – A NEW REGIONAL « REGLEMENT »

- As requested by BCEAO, the new financial market instrument has been created by using a dedicated « Reglement » which is not under its control but under CREPMF and UEMOA.
- This Reglement will define :
  - The islamic compliant financial instruments
  - The eligible Asset
  - The new vehicle (SPV) « FCT » instead of « FCTC »
  - The different type of islamic compliant financial instruments:
    - Islamic Treasury bills
    - Sukuk
    - Other Sharia compliant Certificates that can be :
      - Ownership certificat
      - Investment certificates
- The issuers of those islamic financial instruments (including securitization vehicle) and the originator (state, companies....)

# OUR APPROACH – A NEW REGIONAL « REGLEMENT »

- The new regional regulation will provide :
  - The features of all kind of islamic financial instruments
    - Can be used by different type of issuer/originator
  - The features of a new kind of SPV when securitization is required : FCT
  - The features of the Eligible Assets
  - The sharia compliance process applicable to the issuance of islamic financial instruments
  - The SSB requirements
  - The sharia audit process



# **INTERBANK MARKET MONETARY POLICY**



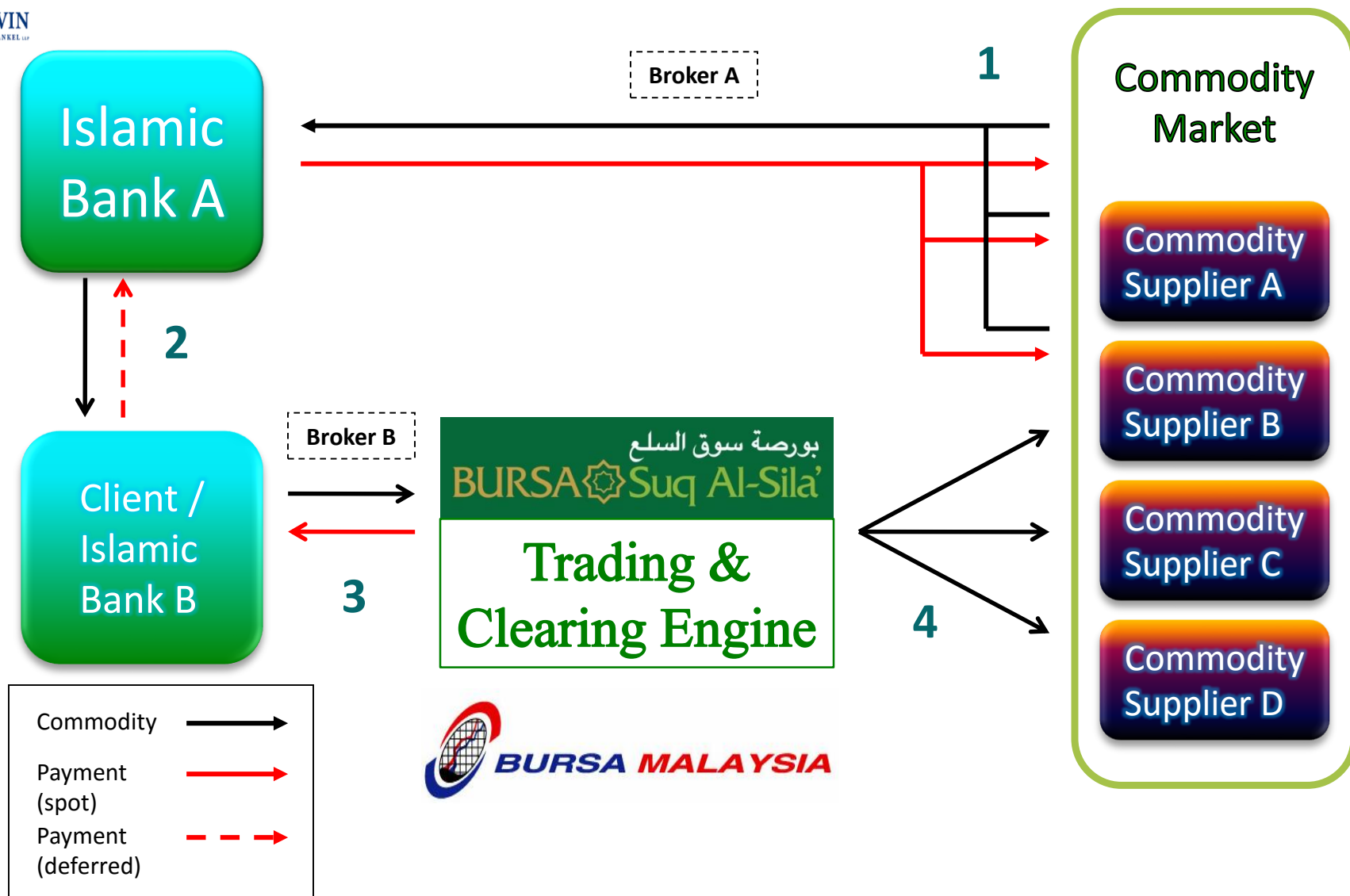
# THE MAIN ISSUES FOR ISLAMIC BANKS

- The liquidity management of financial institution is a key issue :
  - Needs of refinancing
  - Diversity for surplus
- Underlying assets are not necessarily (highly) liquid and used to structure short-term Islamic compliant instruments
- Debt trading is not permissible **VS** all conventional products need to be negotiable/tradable

# OUR APPROACH

- To keep the same organization of the Islamic liquidity market as the conventional one (auction, time horizon of instruments (one week, two years...))
- Creation of a dedicated desk (“Guichet”) within the BCEAO for liquidity need of Islamic financial institutions
- Proposal of “pragmatic” solutions (short-term and long-term):
  - Responding to the needs for absorption and injection of liquidity
  - Enabling tradability of certain securities (Certificate)

# SHORT TERM SOLUTION



# TWO SOLUTIONS

- First and short-term option :
  - To have recourse to an electronic platform such as Bursa Malaysia Suq Al Sila'
  
- A second and long-term solution:
  - Islamic Refinancing funds that has the status of a bank (already available in the local market for mortgage loan) : CAISSE ISLAMIQUE DE REFINANCEMENT

BANK STATEMENT FOR THE MONTH ENDED JULY 31	
DEPOSITS AND CREDITS	CHECKS AND DEBITS
10.00	
0.00	
3.60	
77	
	1,100.00
	415.20
	10.00
	400.00
	2.00
	6,095.75
	85.00
	6,088.38

# THE ACCOUNTING FRAMEWORK

# OUR APPROACH

- First, based on the discussions with the BCEAO, it was agreed that we should propose amendments in the current accounting referential for banks and microfinance institution accounting to include the main AAOIFI standards
- It was raised that:
  - Some AAOIFI standards required legislative adaptations for the banks
  - In the same time, The UEMOA is currently upgrading to IFRS international standards
  - For the microfinance, it was possible to adopt AAOIFI standards

# OUR APPROACH

- Therefore the adopted approach :
  - Providing a local framework that takes into account the main trends of the AAOIFI but respecting the current UEMOA framework and to add notes to the appendices
  - Creating sub-account with modifying the main accounting structure
  
- In this regard, the proposed amendments should :
  - Takes into account the accounting schemes of the main financing contracts of Islamic financial institutions
  - Be reflected in the standards and format of the financial statements of Islamic financial service providers

# THE DELIVERABLE

- Accounting schemes has been provided for all products that have been defined in the instruction for bank and microfinance institutions
  - Asset and Liability side
  - For the banks :
    - Special treatment for deposit
    - Ijara remain similar than conventional treatment
- Regarding the PER & IRR (reserves)
  - As it was not possible to create a « mezzanine account » in the current system as required by AAOIFI and as it's actually done in many countries we recommended :
  - The banks should manage the displaced commercial risk internally by adapting the profit distribution ratio to market conditions
  - In this context, no adjustment of the law or regulatory minimum capital would be necessary



# THE DELIVERABLE

- Regarding the accounting of IJARA :
  - For the banks based on the new law that has been adopted in 2016 (during our mission), we decided to stay in line with this new law (IFRS) instead of the AAOIFI standard but remain in line with the majority of the practice in the Islamic finance industry
    - Depreciation is on lessee's balance sheet
    - Insurance and maintenance cost remain on lessor's balance sheet
    - For microfinance : Ijara accounting treatment is AAOIFI compliant



## PRUDENTIAL REGULATION

# THE CHALLENGES

- Islamic banking intermediation is a different model than the conventional one:
  - Commercial contracts based on assets
  - With several phases
- Depositors may be treated as investors (profit sharing accounts)
- Receivables are not tradable
- Highly liquid Islamic assets will not be available in a short-term horizon
- Monetary creation is forbidden
- Specific risks not defined in BASEL II or III exist

# INTERNATIONAL BENCHMARK

- According to the IMF (2014 - 39 countries)
  - 11 countries have not taken any specific measures (eg : Kenya, Saudi Arabia, EAU, UK)
  - 10 countries have implemented some specific measures into the conventional prudential regime (Jordan, Kazakhstan, Qatar, Turkey)
  - 3 countries have implemented a specific prudential regulation for Islamic financial institutions (Bahrain, Iraq, Kuwait)
  - 7 have a common regulation for Islamic and conventional financial institutions and dedicated guidelines for each category (Indonesia, Lebanon, Malaysia, Syria)

*Source IMF working Paper 14/220 : **Islamic Banking Regulation and Supervision: Survey Results and Challenges** by Inwon Song and Carel Oosthuizen*

# THE CONTEXT

- During the mission, the BCEAO was in the process of going from a Basel II regulation to a Basel III compliant regulation (with the standard approach)
- However it was not possible for us to insert into the new regulation any amendments
- Accordingly, BCEAO will issue dedicated instructions or guidelines to adapt some provisions to the constraints of Islamic finance
- We have prepared a report on the issues that BCEAO will need to clarify for islamic finance institutions based on IFSB standards

# OUR APPROACH

- Based on the discussions with BCEAO, in the report :
  - we have identified the risks and their mitigation for all islamic product (defined in the instruction) using the IFSB standard
    - Credit Risk, Market Risk, Operational Risk, Liquidity Risk + Specific risks
  - We have explained the risk assesment islamic contract per islamic contract
  - We have proposed
    - For the Tier 1 and Tier 2
      - how to define the Capital Adequacy Ratio
      - How to define the « Alpha » for the Investment account
      - The different approach to manage the Displaced Commercial Risk
    - For the Tier 3: the approach about the communication of the profit Ratio



## TAX FRAMEWORK

# TERMS OF REFERENCE

- Draft a tax framework to ensure a better adequacy between Islamic finance and the legal framework in the UMOA for banks, microfinance institutions and other Sharia compliant financial instruments such as Sukuk
- Expected deliverables
  - The tax rules relating to the Islamic finance activities



# OUR APPROACH

## ■ Initial diagnostic :

- Research on actual tax treatment of Islamic finance products ;
- In-depth analysis of the documentation collected.
- To identify clearly and precisely the non-compliance of the operationality of the Islamic finance in the UEMOA.
- Identify best practices in the different countries of UEMOA;
- Comparative assessment of practices:
- To identify the gains in taxation applicable to Islamic finance, particularly in Senegal, and analyze if
  - It could be consolidated
  - It could be used in other countries
  - There is not any distortion risk between conventional finance and Islamic finance

# OUR APPROACH

- Without ever hiding 3 fundamental principles:
  - The Tax administration applies the rule according to its economic reality,
  - the Tax administration is not bound either by the agreement between the parties or by the legal status of the contractor in the transaction
  - In principle the Tax Administration is motivated by defending the interests of the Treasury and should ensure that any due tax is always paid

# OUR DELIVERABLE

- One draft of « **Directive Fiscale** » that takes into account :
  - VAT
  - Stamp Duties
  - Profit are considered as Interest (for financing and deposit product)
  - Sukuk are considered as Conventional bonds
  - Donation to charity
  - Etc..
- But each country should transpose the Directive in its context and it will remain some differences between the countries because the tax is not harmonized

# THANK YOU FOR YOUR ATTENTION

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