Islamic Financial Services Board

IFSB Standards for Institution Offering Islamic Financial Services (IIFS)

Lecture in the IRTI DL Course
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About the IFSB

Introduction

- Based in Malaysia, officially inaugurated on 3 November 2002, and started its operation on 10 March 2003
- Serves as an international standard-setting body of regulatory and supervisory agency that have vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and takaful
- To this end, the work of the IFSB complements BCBS, IOSCO and IAIS

About the IFSB *cont'd*

Objectives

- Develop of standards & recommend its implementation
- Provide guidance on effective supervision and regulation & develop risk management & disclosure criteria
- Establish cooperation with standard international setting bodies & member countries
- Enhance & coordinate initiatives to develop instruments and procedures for efficient operation and risk management
- Encourage cooperation among member countries
- Facilitate capacity building and development of human capital
- Undertake research
- Establish database
- Miscellaneous objectives agreed by the General Assembly

About the IFSB *cont'd*

191 members

By membership type

Full Member	29
Associate Member	22
Observer Member	140

By organisational demarcation

Regulatory / supervisory authorities	54
Inter-governmental organisations	7
Financial institutions and professional firms	130

Membership as at March 2011

About the IFSB *cont'd*

General Assembly

The representative body of all the members of the IFSB namely, Full Members, Associate Members and Observer Members.

Council Members

The senior executive and policy making body of the IFSB. It shall consists of one representative from each Full Members who shall be the senior executive officer of that Full Member or such other senior person nominated to represent him from time to time.

Secretariat

The permanent administrative body of the IFSB. It is headed by a full-time Secretary-General appointed by the Council on such terms and conditions determined by the Council. The Secretariat is based in Kuala Lumpur, Malaysia.

Technical Committee

The body responsible for advising the Council on technical issues within its terms of reference (as determined by the Council). It shall consists of up to 15 persons selected by the Council and shall have a term of office of three years.

Working Group / Task Force

- Working Group is a committee established to be responsible for drafting standards and/or guidelines.
- Task Force is a committee established to be responsible for undertaking ad-hoc tasks.

About the IFSB *cont'd*

The IFSB is actively involved in the promotion of awareness of issues that are relevant or have an impact on the regulation and supervision of the Islamic financial services industry. This mainly takes the form of international conferences, seminars, public lectures, dialogue sessions, forums and meetings staged in many countries.

- Summit
- Conference
- Seminar
- Forum
- Interactive Session
- Public Lecture

Website

www.ifsb.org is the main communication tool for the IFSB to disseminate information to members and stakeholders.

Agenda

- Nature of the regulated IIFS
- The IFSB standards
  - *Risk Management*
  - *Corporate and Sharī`ah Governance System*
  - *Capital Adequacy*
- Challenges in the implementation of the IFSB standards
- Facilitating the implementation of the IFSB standards

Nature of the regulated IIFS

Stylised Balance Sheet of an IIFS

ASSETS	LIABILITIES
Cash & cash equivalents	Current accounts
Sales receivables	Other liabilities
Investment in securities	
Investment in leased assets	**Equity of Profit Sharing Investment Accounts (PSIA)**
Investment in real estate	Profit Sharing Investment Accounts (PSIA)
Equity investment in joint ventures	Profit equalization reserve
Equity investment in capital ventures	Investment risk reserve
Inventories	
Other assets	
Fixed assets	**Owners' Equity**

IIFS: A one-stop shopping model

Unlike the predominantly borrowing and lending operations performed by conventional banks, the stylized balance sheet of an IIFS suggests that its business activities resemble a "one-stop shopping" model that includes, among others, the following operations:

- Source of funds (commercial banking, funds management and investment banking)

- Application of funds (buying of 'physical' assets and selling them on credit, direct equity investments in transactions based joint ventures and capital ventures, leasing, trading in real estate, commercial and agricultural inventories held for resale)

Risks: IIFS vis-à-vis conventional banks

The nature of risks to which an IIFS is exposed is not necessarily the same as those of a conventional bank.

- For example, rather than lending the money, an IIFS has to acquire a physical asset and then either sell it on credit or lease it.
- This means that the IIFS is exposed to market risk of physical assets at time of acquisition which then transforms to credit risk when the asset is sold on deferred payment or leased.
- The nature of the risk associated with assets held for leasing, real estate, inventories (commercial and agricultural) etc., is different from that to which conventional banks are normally exposed.
- These require different risk management approaches and different regulatory capital requirements.

Risks: IIFS vis-à-vis conventional banks *cont'd*

IIFS do not have the option to sell at a discount or to repackage and sell off their financial assets (e.g. receivables) as securities, which represent a high percentage of total assets, in order to take the risk off their balance sheet

- This would limit the options of an IIFS to diversify or to avoid concentration by spreading its risks at times when an individual institution is vulnerable to shocks
- IIFS, therefore, have to hold on to their receivables until maturity and manage the risk associated with them, which could mean that IIFS have to carry more of the overall credit risk than their conventional counterparts

The IFSB Standards

The IFSB standards

Article 4 of the Articles of Agreement outlines the objectives of the IFSB, which include, among others:

To promote the development of a prudent and transparent Islamic financial services industry by introducing new, or adapting existing, international standards consistent with *Sharī`ah* principles, and recommend them for adoption.

To provide guidance on the effective supervision and regulation of institutions offering Islamic financial products and to develop the criteria for identifying, measuring, managing and disclosing risks, taking into account international standards for valuation, income & expense calculation and disclosure.

The IFSB standards *cont'd*

It is important to note the **notion of balance in the regulatory requirements of IIFS and the supervisory review programme** employed in this context.

The supervisory authorities will have to exercise judgement regarding the **appropriate weights and balance to be given in the application of qualitative and quantitative measures** in their policies on capital adequacy, risk management, corporate governance and disclosure requirements.

Guiding Principles of Risk Management

Guiding principles of risk management

- Approach
- Key objectives
- Guiding principles for the management of risk on specific features of IIFS products and services, amongst others:
  - Equity investment risk
  - Rate of return risk (Displaced commercial risk)
  - Operational risk (*Sharī`ah* noncompliance risk and Fiduciary risk)

Definition

Type of Risks	Definition
Equity Investment Risk	The risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk. This risk is relevant under *Muḍārabah* and *Mushārakah* contracts.
Rate of Return Risk	The potential impact on the IIFS' returns caused by unexpected change in the rate of returns.
Displaced Commercial Risk	The risk that the IIFS may confront commercial pressure to pay returns that exceed the rate that has been earned on its assets financed by investment account holders. The IIFS forgoes part or its entire share of profit in order to retain its fund providers and dissuade them from withdrawing their funds.
Sharī`ah Noncompliance Risk	Risk arises from the IIFS' failure to comply with the shariah rules and principles.

Approach

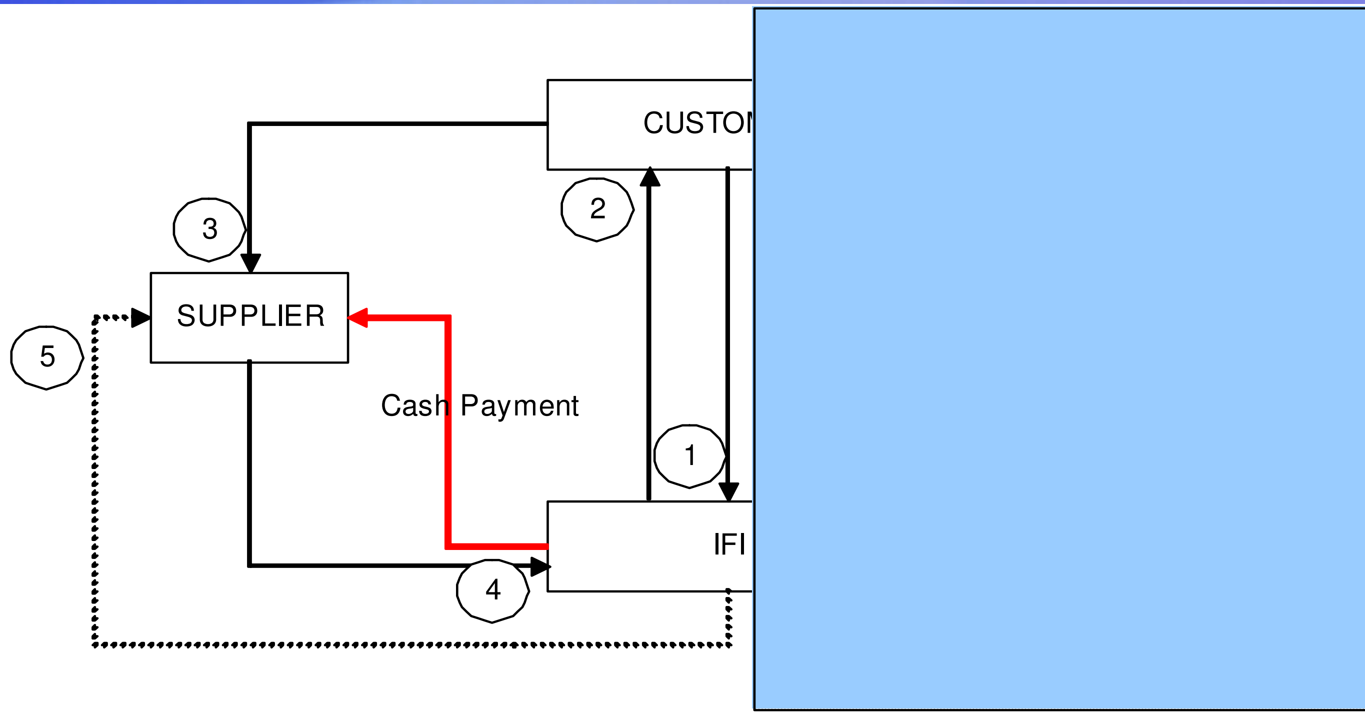
- Rather than prescriptive procedures, the approach that has been taken by the IFSB is principle-based approach, applied to accommodate continuous improvement in the infrastructures, methodologies and system as theory and technology permit.

- In identifying the risks to which IIFS are exposed, as an initial step is to identify inherent risks which include the following two risks.

  – primary risks, i.e. the exposures deliberately entered into for business reasons when an IIFS decides to offer a certain type of service; and

  – consequential (or operational) risks, i.e. the exposures that are not actively taken but which are incurred as a result of business undertaken by the IIFS

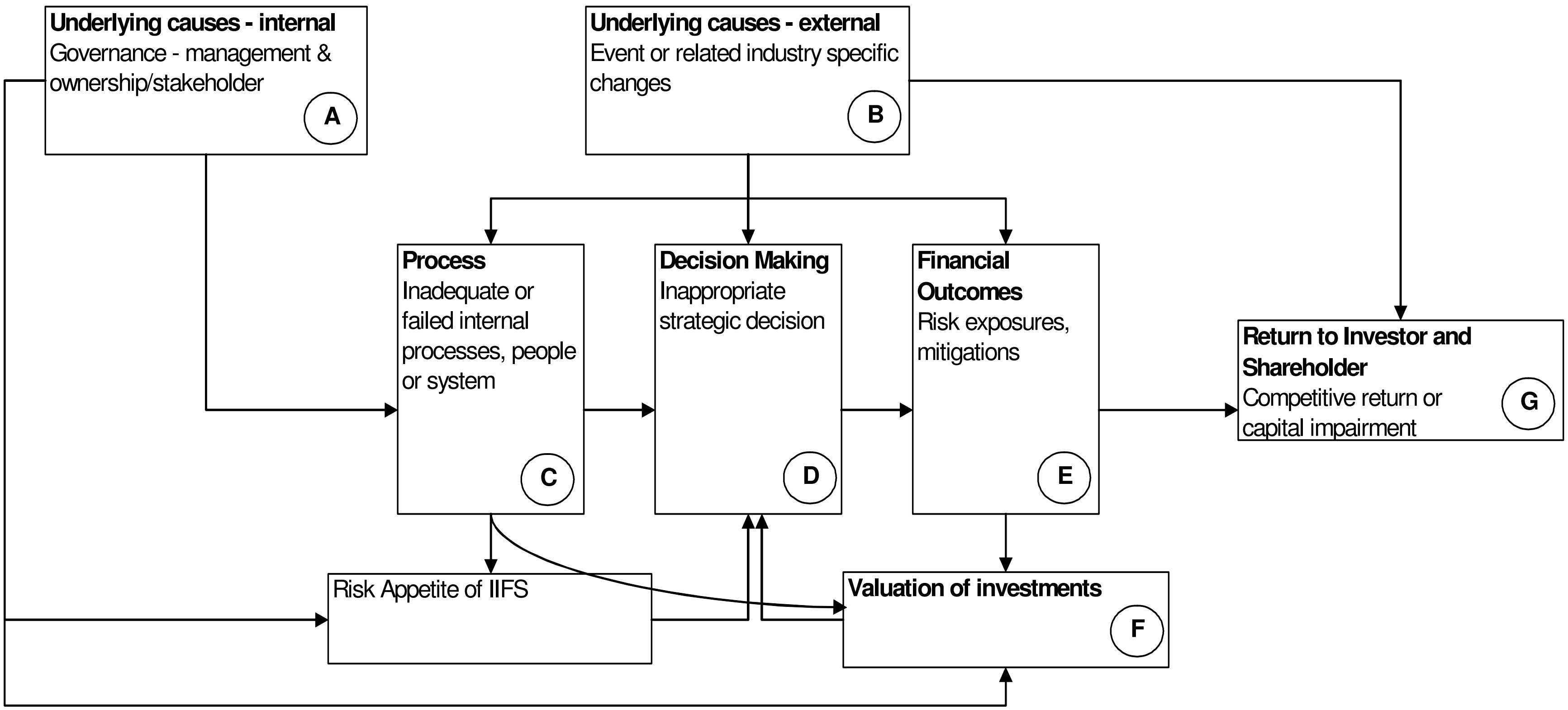
Analysis of risk: Each financing mode



PROCESS FLOW

1 Promisor/Promisee relationship
2 Under the Principal/Agent relationship, IFI appoints the Customer as Agent
3 Agent will identify specific asset from a specific supplier
4 The IFI will purchase the asset from the supplier
5 Sale or return basis
6 The IFI will sell the asset to the customer through Murabaha contract
7 The customer will settle the sale price on deferred payment over a specific tenor
8 For prompt payment, IFI can obtain guarantee from the customer

Analysis of risk: Cause effect analysis



Key objectives

- The IIFS are expected to view the management of these risks from a holistic perspectives
- The guiding principles define a common terminology of key risk categories to which IIFS are exposed, acting as a common language for further development of regulatory financial requirements and seen as a stimulant to the progress of risk management practices required in Islamic financial services industry
  - The rate of return risk (as opposed to interest rate risk) is essentially the risk with regard to the result of an investment at the end of the investment-holding period.
  - Displaced commercial risk could be the consequence of the rate of return risk whereby IIFS may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by IAH.

Key objectives *cont'd*

- At present, in many jurisdictions, the consequence of the rate of return risk is considered as part of the strategic risk, hence is left to the individual IIFS to decide. In some jurisdictions, guidelines on the rate of return risk including on the use of profit equalization reserve (PER) exist.

Principles of risk management

General Requirement					
Comprehensive risk management and reporting process, including appropriate Board and senior management oversight; ensuring adequate holding of capital against risks; and complying with *Sharī`ah* rules and principles.					
Credit Risk	**Equity Investment Risk**	**Market Risk**	**Liquidity Risk**	**Rate of Return Risk**	**Operational Risk**
• Strategy for financing which includes overall level of risk appetite. • Due diligence review in respect of counterparties and engage appropriate expert for *Sharī`ah* compliance. • Methodology for measuring and reporting credit risk for each financing instrument. • Appropriate credit risk mitigating techniques for each financing instrument.	• Strategy, risk management and reporting process for equity investments, including *Mushārakah* and *Muḍārabah* investments. • Appropriate and consistent valuation methodologies. • Define and establish exit strategies.	• Appropriate framework for market risk management in respect of all assets held, including those that do not have a ready market and/ or are exposed to high price volatility.	• Liquidity management framework for overall and each liquidity exposures in respect of each category fund providers. • Undertake liquidity risk commensurate with ability to have sufficient recourse to *Sharī`ah*-compliant funds.	• Comprehensive risk management and reporting process to assess potential impacts of market factors on rates of return on assets in comparison with the expected rate of return for investment account holders. • Appropriate framework for managing displaced commercial risk and maintaining appropriate level of balances of Profit Equalization Reserve (PER).	• Adequate systems and controls to ensure compliance with *Sharī`ah* rules and principles. • Appropriate mechanisms to safeguard the interest of all fund providers.

Definition: Credit risk

- Credit risk is generally defined as the potential that a counterparty fails to meet its obligations in accordance with agreed terms. This definition is applicable to IIFS managing the financing exposures of receivables and leases (for example, *Murābahah*, Diminishing *Mushārakah* and *Ijārah*) and working capital financing transactions/projects (for example, *Salam*, *Istisnā*` or *Muḍārabah*).

- IIFS need to manage credit risks inherent in their financings and investment portfolios relating to default, downgrading and concentration.

- Credit risk includes the risk arising in the settlement and clearing transactions.

Credit risk: Principle 2.1 *cont'd*

Principle	Objective	Tools
IIFS shall have in place a strategy for financing, using the various Islamic instruments in compliance with Sharī`ah, whereby it recognises the potential credit exposures that may arise at different stages of the various financing agreements.	To set the desired overall level of appetite for type of applicable Islamic financing modes	A list of all types of applicable and approved Islamic financing modes Review restriction on some Islamic financing modes
	To set appropriate limits and Sharī`ah permissible granting extensions, rescheduling or early settlement	A set of limits for selected Islamic financing modes Review exit and extension strategy
	To understand the existence of and triggers for the commencement of exposures to credit risk	Policy and procedures to address changes or triggering events that affect responsible parties
	To be aware of the binding nature where credit risks associated with underlying asset under different agreement	Policy and procedure to address interdependent contracts where rights and obligations of certain parties in one contract may lead to defaults in other contracts

Credit risk: Principle 2.2 *cont'd*

Principle	Objective	Tools
IIFS shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.	To have adequate initial due diligence evaluation as first line of defense against counterparty risk	Sufficient information for assessment of the customer's risk profiles Forward-looking analysis on the legal and economic substance of the proposed project
	To be aware of the preference made by the customer where there are choices of financing modes	Policy and procedure to address eligible counterparties and the nature of approved financings
		Engagement of the appropriate experts including Sharī`ah scholars

Credit risk: Principle 2.3 *cont'd*

Principle	Objective	Tools
IIFS shall have in place appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.	To improve the IIFS ability to analyse the risks and look for early warning or trigger signals in different financing modes	Risk analysis based on the result of appropriate methodology relevant to each financing mode
		Appropriate and adequate reporting system and resources in place

Credit risk: Principle 2.4

Principle	Objective	Tools
IIFS shall have in place *Sharī`ah*-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.	To take preventive or corrective action against potential failure where the IIFS may be affected in view of limited use of penalties	Administrative and financial measures
	To assess possibility of consequential risks in parallel transaction that may trigger IIFS to honour	Establishment of specialised department Appointment of specialist
	To assess consequential risks of permanent impairment of Ijarah asset	Sufficient takaful coverage

Role of the Supervisory Authority

Role of Supervisory Authority

May decide to **develop Shariah guidelines or minimum documentations** in respect of agreements between IIFS and counterparties for the financing instruments used in their jurisdiction.

Undertake initiatives to **harmonise standard documentation** in areas including clauses covering notices, grace periods etc.

Establish **criteria and procedures for dealing with non-willful defaulters** (in jurisdictions where non-willful defaults are recognized by practice)

Maintain a **detailed description of each financing instrument** used by the IIFS in their jurisdiction and the risk exposures to which each instrument gives rise.

Review the **adequacy of the policies and procedures** implemented by IIFSs in its jurisdiction to **mitigate risks in compliance with Shariah**.

Develop **information sharing procedures to assess the counterparty credit profiles**, while maintaining adequate confidentiality

Definition: Equity investment risk

- The type of equity investment risk dealt with in this section may be broadly defined as the risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk.

Equity investment risk: Principle 3.1

Principle	Objective	Tools
IIFS shall have in place appropriate strategies, risk management and reporting processes in respect of the risk characteristics of equity investments, including Muḍārabah and Mushārakah investments.	To ensure that the IIFS understands exposure to equity investment risks, which may risk losing its entire invested capital	Analysis of three risk components – partner, operation and business
	To understand the risks affecting variable cashflow	Analysis of possible risk factors affecting the expected volume and timing of cash flows for both capital and returns

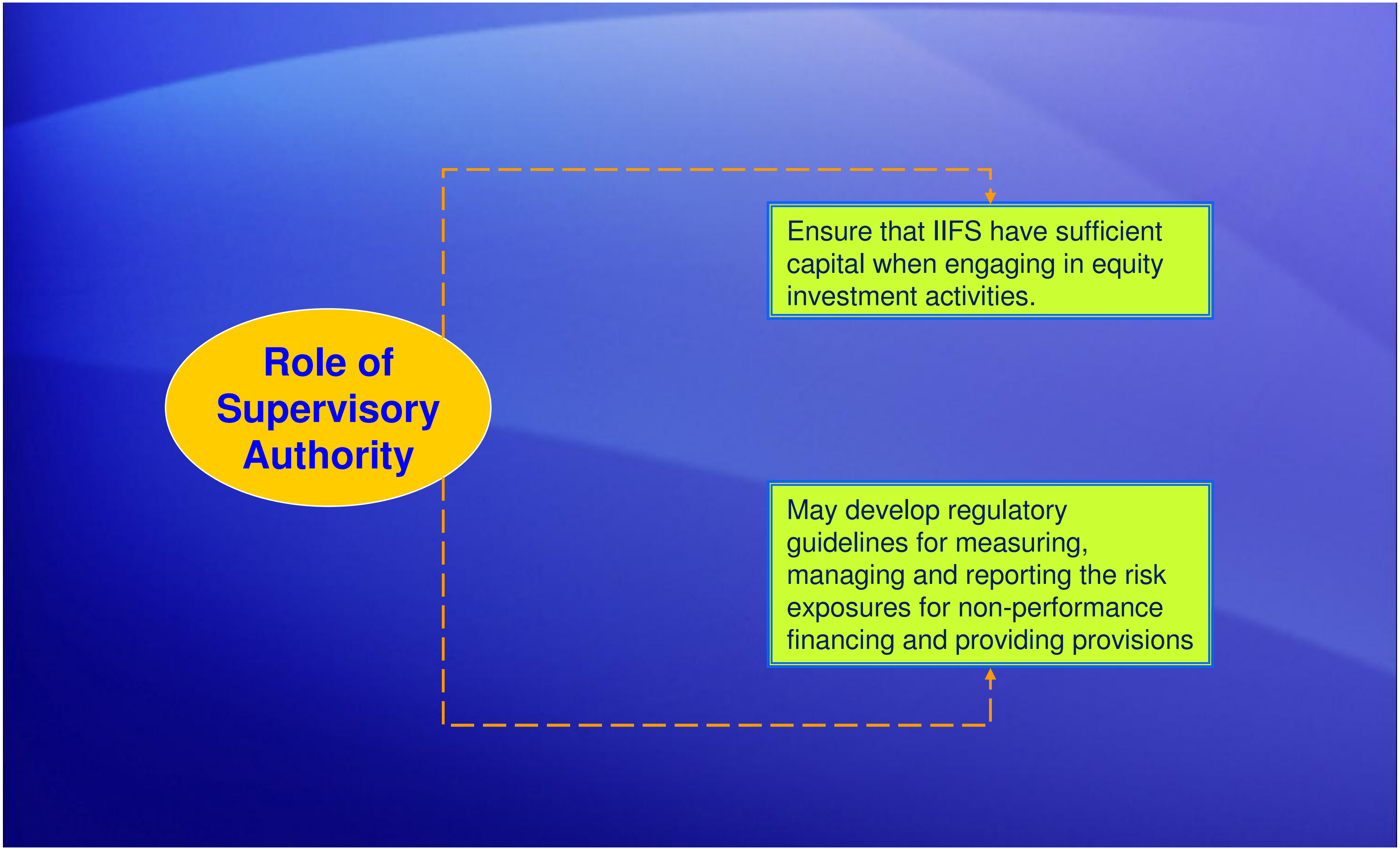
Equity investment risk: Principle 3.2

Principle	Objective	Tools
IIFS shall ensure that their valuation methodologies are appropriate and consistent, and shall assess the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IIFS and the Muḍārib and/or Mushārakah partners.	To agree and ensure clear and appropriate valuation	Framework in place on the agreement of appropriate methodology taking into account market practices and liquidity features
	To carry out objective assessment of the performance	Use of independent party to carry out audit and valuation of book values

Equity investment risk: Principle 3.3

Principle	Objective	Tools
IIFS shall define and establish the exit strategies in respect of their equity investment activities, including extension and redemption conditions for Muḍārabah and Mushārakah investments, subject to the approval of the institution's Sharī`ah Board.	To ensure that the IIFS has established agreeable criteria for liquidation or extension	Policy and procedure to address the liquidation or extension criteria including related issues such as treatment of delayed profits
		Policy and procedure to address possible alternative exit routes and timing of exit under certain unexpected circumstances

Role of the Supervisory Authority



Definition: Market risk

- Market risk is defined as the risk of losses in on- and off-balance sheet positions arising from movements in market prices i.e fluctuations in values in tradable, marketable or leaseable assets (including *sukūk*) and in off-balance sheet individual portfolios (for example restricted investment accounts). The risks relate to the current and future volatility of market values of specific assets (for example, the commodity price of a *Salam* asset, the market value of a *sukūk*, the market value of *Murābahah* assets purchased to be delivered over a specific period) and of foreign exchange rates.

Market risk: Principle 4.1

Principle	Objective	Tools
IIFS shall have in place an appropriate framework for market risk management (including reporting) in respect of all assets held, including those that do not have a ready market and/or are exposed to high price volatility.	Tradable assets – to emphasise similar approach employed by Basel	Basel 1996 Amendment
	Illiquid assets - to ensure appropriate framework is available for both marketable/ tradable and illiquid assets where the IIFS is exposed to fluctuation in prices	Incorporate best effort basis in the product programme Reserves and contractual agreement
	To ensure appropriate treatment for portfolio of restricted investment account	Appropriate framework for pricing, valuation and in accordance with investment agreement

Role of the Supervisory Authority

Role of Supervisory Authority

Supervisory authority shall satisfy itself on the **adequacy of IIFS' internal systems and controls and internal limits set by IIFS on their market risk** management in relation to the activities undertaken

Require IIFS in their jurisdictions to **develop guidelines for acceptable valuation techniques** where direct market prices are not available, and should approve such guidelines.

Alternatively, the **supervisory authorities may themselves** develop such guidelines.

Definition: Liquidity risk

- Liquidity risk is the potential loss to IIFS arising from their inability either to meet their obligations or to fund increases in assets as they fall due without incurring unacceptable costs or losses.

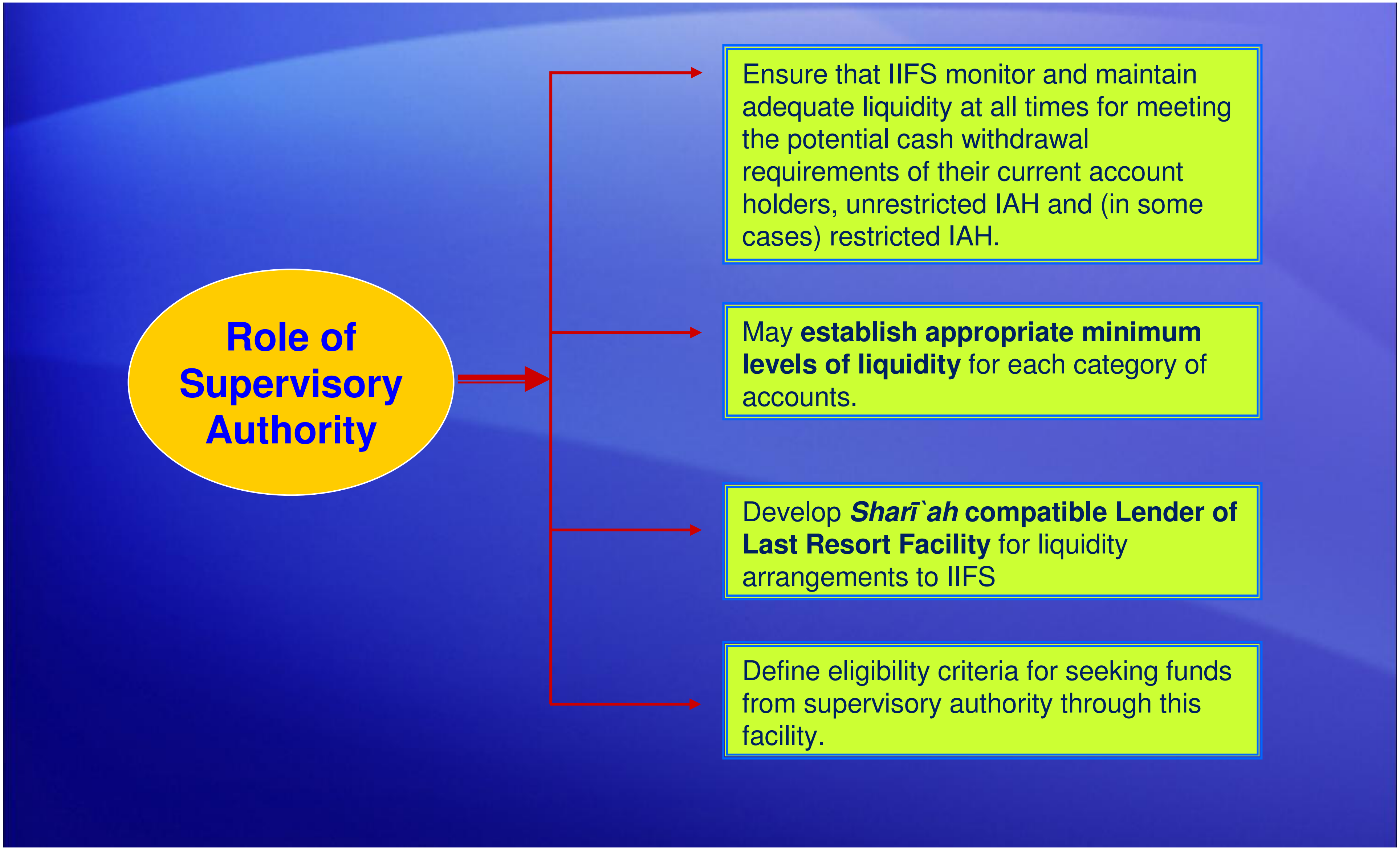
Liquidity risk: Principle 5.1

Principle	Objective	Tools
IIFS shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts, unrestricted and restricted investment accounts.	To maintain adequate liquidity to meet withdrawal demand for each fund provider	Analyse liquidity profiles of each fund provider as effect of liquidity shortages may vary according to risk appetite
		Limits in place to maintain adequate liquidity at all times to meet obligations

Liquidity risk: Principle 5.2

Principle	Objective	Tools
IIFS shall assume liquidity risk commensurate with their ability to have sufficient recourse to Sharī`ah-compliant funds to mitigate such risk.	Sufficient recourse to funds will help the IIFS to have some form of orderly liquidation procedure without having to liquidate assets at an unfavourable price	Policy and procedure to address orderly liquidation to an extend that IAHs' capital erosion can be avoided, including but not limited to the use of investment risk reserves Establish appropriate trigger points that require management actions
		Employ cash flow analysis under various market condition based on plausible assumption to project the dependence of reserves Establish cooperation agreement
		Requirement to disclose key risk indicators (including asset liquidity exposures) on a timely basis

Role of the Supervisory Authority



Definition: Rate of return risk

- IIFS are exposed to rate of return risk in the context of their overall balance sheet exposures. An increase in benchmark rates may result in IAHs' having expectations of a higher rate of return. Rate of return risk differs from interest rate risk in that IIFS are concerned with the result of their investment activities at the end of the investment-holding period. Such results cannot be pre-determined exactly.

Rate of return risk: Principle 6.1

Principle	Objective	Tools
IIFS shall establish a comprehensive risk management and reporting process to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for investment account holders (IAH).	To understand and recognise the factors in the relationship between (a) the impact of variability of cash inflows, and (b) the importance of managing investment account holders' expectation	Review other risks, plausible events, market trends and/or expectation of IAH that may affect the cashflow patterns
	To achieve greater accuracy of aligning return on assets and IAH's expected rate of return	Dynamic testing of balance sheet exposure Assess potential threat that is like to have material impact on the balance sheet
	To minimise divergence between return on assets and IAH's expected rate of return	Balance sheet hedging strategy

Rate of return risk: Principle 6.2

Principle	Objective	Tools
IIFS shall have in place an appropriate framework for managing displaced commercial risk, where applicable.	To assess IAH's expected rate of return	Assess future IIFS's cashflow and appropriate benchmarks
	To determine level of comfort and quickness of reserves, which is used to mitigate displaced commercial risk	Establishment of trigger limit that forms the basis to frame and initiate discussion for action plans

Role of the Supervisory Authority

Role of Supervisory Authority

Obtain **sufficient information to assess the IAHs' behavioral and maturity profiles** and satisfy itself as to the adequacy and quality of IIFS' policies and procedures regarding the rate of return risk management

Establish a framework which may include amongst others, methods, applicable periods and recognizable income and expenses, and other **calculation bases relating to the use of funds.**

This framework shall assist the supervisory authority to assess the efficiency of IIFS in terms of their profitability and prudent management of funds.

Definition: Operational risk

- IIFS shall consider the full range of material operational risks affecting their operations, including the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. IIFS shall also incorporate possible causes of loss resulting from *Sharī`ah* non-compliance and the failure in their fiduciary responsibilities.

Operational risk: Principle 7.1

Principle	Objective	Tools
IIFS shall have in place adequate systems and controls, including Sharī`ah Board/ Advisor, to ensure compliance with Sharī`ah rules and principles.	To ensure adherence to the decision or fatwa issued by Sharī`ah board or any other higher fatwa authority	Prepare a full set of procedure manuals for all products and services before launching (ex-ante)
		Perform, at least annually, on Sharī`ah compliance (ex-post)

Operational risk: Principle 7.2

Principle	Objective	Tools
IIFS shall have in place appropriate mechanisms to safeguard the interests of all fund providers. Where IAH funds are commingled with the IIFS's own funds, the IIFS shall ensure that the bases for asset, revenue, expense and profit allocations are established, applied and reported in a manner consistent with the IIFS's fiduciary responsibilities.	To establish appropriate basis against possible fiduciary failures where investment account holders may be affected	Policy and procedure on appropriate basis for assets and profits to be allocated
		Disclosure of timely information for market's and IAHs' investment performance assessment

Role of the Supervisory Authority

Place a **comprehensive and sound framework for developing and implementing a prudent** control environment for the management of operational risks arising from their activities

Satisfy that IIFS have **adequate *Sharī`ah* compliance mechanisms** in place.

(a) well-defined and adequately **qualified and staffed organisational** structure

(b) **Clear lines of authority and accountability**

(c) Policies and procedures pertaining to the approval of products and activities. May require IIFS to have an independent and **regular review of *Sharī`ah* compliance** in this regard

Role of Supervisory Authority

Prescribe formal **guidance to ensure IIFS fulfill their fiduciary duties** towards IAH

Satisfy that the applicable **auditing standards** relevant to IIFS **are being implemented correctly** in respect of appropriateness of allocations, distributions and reporting of profits to IAH

Guiding Principles on Corporate Governance

Guiding principles on corporate governance

- Understanding the motivating factors
- Defining ‘corporate governance’ (CG) and ‘stakeholders’ in the context of IIFS
- Corporate governance issues specific to IIFS
- Guiding principles of corporate governance for IIFS

Understanding the motivating factors

Separation of ownership & control

- Agency problems occur when the principal (investors) lacks the necessary power or information to monitor and control the agent (managers) and when the incentive of the principal and agent is not aligned.
- When contracts are incomplete and managers possess more expertise than investors, managers typically end up with the residual rights of control, giving them enormous latitude for self-interested behaviour.
- The challenge for good CG is in ensuring how the providers of capital can influence the managers to meet such wider obligations as may in the circumstances be pertinent.

Understanding the motivating factors *cont'd*

Information asymmetries

- In the case of financial institutions there are particular issues - the ability of 'outsiders' to monitor and in particular evaluate the performance and conduct of the managers may well be difficult.
- This opaqueness makes it easier and more likely for managers and large investors to manipulate board of directors and exploit the private benefits of control.
- In such circumstances suspicions of insider dealing and abuse may be detrimental not only the institution in question and those responsible for management, but the market as a whole.

Understanding the motivating factors *cont'd*

Balancing stakeholders' protection

- The conventional approach - Anglo-American model vs. Franco-German model.
- In the context of IIFS, their duties and responsibilities as *Muḍārib* are set out not only in contracts and residual contracts but ultimately accountability to God.
- IIFS must carefully manage potential conflicts of interest between its various stakeholders, particularly between its shareholders and the investment account holders (IAH), bearing in mind the parameters set by the *Sharī'ah*.
- Concerns of anti-money laundering, fraud and misconduct.

Understanding the motivating factors *cont'd*

Transparency and Market Discipline

- Transparency in providing timely and adequate information to IIFS investors, for example in the calculation of *Muḍārib* share and profit allocation, is not only important for protecting the interest of investors but to enforce market discipline on IIFS.
- Furthermore, it would contribute in bringing about systemic stability.
- It is necessary therefore, to enhance transparency and comparability of IIFS through suitable disclosures.

Defining Corporate Governance

A defined set of relationships between a company's management, its Board of Directors, its shareholders and other stakeholders which provides the structure through which:

- the objectives of the company are set; and
- the means of attaining those objectives and monitoring performance are determined.

Defining Corporate Governance *cont'd*

In the context of IIFS, good CG should encompass:

- a set of organisational arrangements whereby the actions of the management of IIFS are aligned, as far as possible, with the interests of its stakeholders;
- provision of proper incentives for the organs of governance such as the Board of Directors, SSB and management to pursue objectives that are in the interests of the stakeholders and facilitate effective monitoring, thereby encouraging IIFS to use resources more efficiently; and
- compliance with *Sharī`ah* rules and principles.

Defining Stakeholders

BCBS paper:

- ‘Stakeholders’ include employees, customers, suppliers and the community. Due to the unique role of banks in national and local economies and financial systems, supervisors and governments are also stakeholders [of banks].

From Islamic financial services perspective:

- ‘Community’ should particularly connotes the Muslim *Ummah*.
- ‘Customers’ does not refer to conventional depositors and borrowers but to Investment Account Holders (IAH) and Current Account Holders.

Islamic viewpoints on good governance

The concept of vicegerency - Accountability to God as well as to others. Ethics of IIFS are set out not only in contracts and residual contracts but ultimately accountability to God.

Amongst the code of ethics set out in the Qur'an:

- Honest fulfilment of all contracts (*Al-Māidah*:1)
- Prohibition against betraying any trust (*Al-Anfāl*:27)
- Prohibition against deriving income from cheating, dishonesty or fraud (*Āli Imrān*:29)
- Prohibition against bribery to earn unfair advantage (*Al-Baqarah*:188)
- Prohibition against concealing evidence (*Al-Baqarah*:283), for e.g. to manipulate prices

Specificities of IIFS

In addition to general banking matters, organs of governance of IIFS also need to attend to:

- *Sharī`ah* compliance
- Ethics & social responsibility (in line with the concept of vicegerency)
- Interests of IAH, especially unrestricted
- Potential conflicts of interest between shareholders and unrestricted IAH especially where the funds are commingled - issues of asset allocation and risk appetite
- Transparency in financial reporting, e.g. calculation of *Muḍārib* share (especially where funds are commingled) and profit distribution

CG issues in IIFS

Protection of Investment Account Holders ("IAH")

- Like investors in Collective Investment Schemes (CIS), IAH are exposed to potential conflict of interest with the management of an IIFS, which may look after the interest of shareholders at the expense of IAH.
- As in the case of securities regulators, this requires more emphasis on fiduciary responsibility or establishment of detailed regulations designed to monitor potential conflicts of interest.
- Furthermore, adequate disclosure of relevant information about the IIFS' investment objectives and policies, operational guidelines that govern the relationship between the IIFS and IAH, etc. should be made available.
- Albeit IAH may have no representation in the organs of governance such as the Board of Directors or *Sharī`ah* Supervisory Board, they have every right to expect accountability and transparency on investment made on their behalf.

CG issues in IIFS *cont'd*

Sharī`ah Supervisory Board ("SSB")

– SSB is a specific organ of governance. It should be concerned with monitoring *Sharī`ah* compliance and not just issuing edicts (*fatāwa*).

– Since SSB members may lack monitoring skills, auditors and audit committee should act in concert to assist the SSB.

Transparency in financial reporting

– The current financial reporting practices of IIFS do not provide adequate information to their IAH regarding the revenues and expenses accruing to their particular investment fund.

– IAH is rightfully entitled to transparency, e.g. calculation of *Muḍārib* share and profit allocation.

Current status of CG awareness amongst IIFS

IFSB Survey (2004) highlights:

- Strong awareness amongst IIFS on the importance of good governance.
- Majority IIFS offer only unrestricted IA, and even for those offering restricted IA they do not address the IAH's risk appetite.
- "Smoothing of returns" has not been proven as a widespread practice, however it is appropriate that the practice be accepted with caution in order to avoid it being used to mislead the IAH on the performance of the IA.
- SSB have become almost a compulsory feature of Islamic finance. However their cost and efficiency continue to be a major concern.

Scope of CG in IIFS: filling the gaps

CG aspects already covered	OECD	BCBS	IOSCO	FRC/FSA
Companies				
Directors/The Board	√	√		√
Remuneration/Compensation	√	√		√
Accountability and Audit	√	√		√
Relations with Shareholders	√	√		√
Shareholders				
Rights and Key functions	√			√
Equitable Treatment	√			√
Other Stakeholders				
Employees/Manager	√	√		
Regulator/Supervisor	√	√	√	
Disclosure and Transparency	√		√	√

The issue of IIFS' accountability and transparency to its customers, particularly IAH , as well as *Sharī`ah* compliance, have not been covered or contemplated in any of the above documents.

Scope of CG in IIFS: filling the gaps *cont'd*

The standard aims to cover these aspects:

Organs of governance

- safeguarding interests of IAH, especially the unrestricted
- adequate monitoring of *Sharī`ah* compliance

Information environment and transparency

- specifying and enforcing appropriate disclosure requirements
- fostering auditors independence and enforce the relevant and applicable auditing standards
- the focus is very specifically on protection of the IAH's interests – not to overlap with general transparent reporting which would be covered by the Transparency and Market Discipline Standard

Overview: Principles of corporate governance

General Governance		
• IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing their accountabilities to various stakeholders. • IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards which are in compliance with *Sharī`ah* rules and principles and are applicable to the Islamic financial services industry as recognized by the supervisory authorities of the country.		
Rights of AH	**Compliance with *Sharī`ah* Rules and Principles**	**Transparency of financial reporting in respect of IAH**
• IIFS shall acknowledge IAHs' right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised. • IIFS shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted IAH), and be transparent in smoothing any returns.	• IIFS shall have in place an appropriate mechanism for obtaining rulings from *Sharī`ah* scholars, applying *fatāwā* and monitoring *Sharī`ah* compliance in all aspects of their products, operations and activities. • IIFS shall comply with the *Sharī`ah* rules and principles as expressed in the rulings of the IIFS' *Sharī`ah* scholars. The IIFS shall make these rulings available to the public.	• IIFS shall make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage.

Principles of corporate governance *cont'd*

General governance

Principle 1.1: IIFS shall establish a comprehensive governance policy framework which sets out the strategic roles and functions of each organ of governance and mechanisms for balancing their accountabilities to various stakeholders.

Main recommendations

- The adoption of OECD and BCBS recommendations through comprehensive governance policy framework.
- Establishment of a 'Governance Committee' to implement the governance policy framework.

Principles of corporate governance *cont'd*

General governance *cont'd*

Principle 1.2: IIFS shall ensure that the reporting of their financial and non-financial information meets the requirements of internationally recognized accounting standards which are in compliance with *Sharī`ah* rules and principles and are applicable to the Islamic financial services industry as recognized by the supervisory authorities of the country.

Main recommendation

- Establishment of an 'Audit Committee' to ensure good implementation of internationally recognized accounting standards.

Principles of corporate governance *cont'd*

Rights of IAH

Principle 2.1: IIFS shall acknowledge IAHs' right to monitor the performance of their investments and the associated risks, and put into place adequate means to ensure that these rights are observed and exercised.

Main recommendation

- Establishment of an internal guideline that sets out adequate protection of the IAH investments, including the disclosure of relevant and material information to the IAH such as on profit allocation and investment policies.

Principles of corporate governance *cont'd*

Rights of IAH *cont'd*

Principle 2.2: IIFS shall adopt a sound investment strategy which is appropriately aligned to the risk and return expectations of IAH (bearing in mind the distinction between restricted and unrestricted IAH), and be transparent in smoothing any returns.

Main recommendations

- Distinguishing between "profits earned" and "actual dividends payout" through appropriate disclosure.
- The Governance Committee to oversee the utilization of any reserves for these purposes.

Principles of corporate governance *cont'd*

Compliance with *Sharī`ah* Rules and Principles

Principle 3.1: IIFS shall have in place an appropriate mechanism for obtaining rulings from *Sharī`ah* scholars, applying *fatāwā* and monitoring *Sharī`ah* compliance in all aspects of their products, operations and activities.

Main recommendations

- Emphasis on ex-post and ex-ante roles of *Sharī`ah* scholars – beyond just issuing edicts.
- Ensuring appropriate qualifications and accountability of *Sharī`ah* scholars.

Principles of corporate governance *cont'd*

Compliance with *Sharī`ah* Rules and Principles *cont'd*

Principle 3.2: IIFS shall comply with the *Sharī`ah* rules and principles as expressed in the rulings of the IIFS' *Sharī`ah* scholars. The IIFS shall make these rulings available to the public.

Main recommendations

- Encouraging transparency in the process of issuing, applying or abandoning of fatāwa through appropriate disclosure and publications.
- Check on the activity of fatāwa-shopping.

Principles of corporate governance *cont'd*

Transparency of financial reporting in respect of IAH

Principle 4: IIFS shall make adequate and timely disclosure to IAH and the public of material and relevant information on the investment accounts that they manage.

Main recommendation

- Making adequate and timely public announcement in annual report, website and in mainstream media organs in respect of profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any) in respect of the investment accounts that the IIFS manage.

Expected outcome

- Adoption of OECD and BCBS recommendations will improve IIFS' Board of Directors' and management's awareness of the importance of good governance, at par with international best practices
- Due recognition of IAH's rights and risks as residual claimants will lead to appropriate protection of IAH
- More professional approach for *Sharī`ah* compliance will mitigate compliance and reputational risks of IIFS
- Increased transparency in financial and non-financial reporting by IIFS will inculcate better risk management structure and discipline culture amongst IIFS

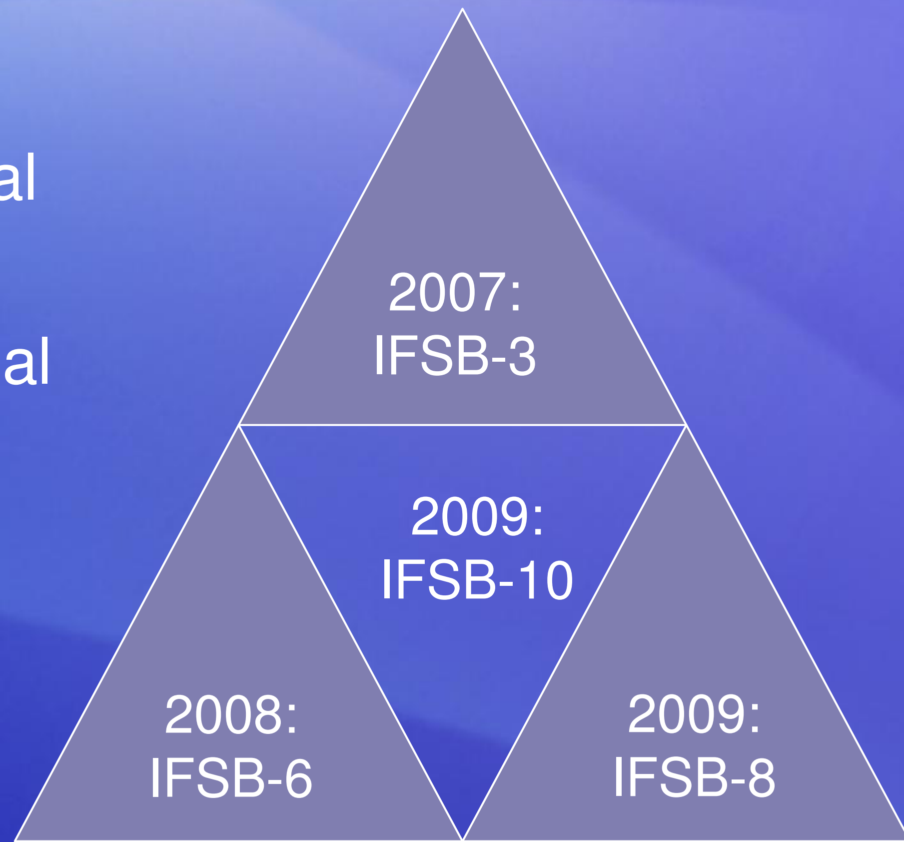
Guiding Principles on *Sharī`ah* Governance System

Guiding Principles on *Sharī`ah* Governance System

- Background and objectives
- Definition and scope
- Insight into issues to be addressed
- Recommended best practices

Background and objectives

- Guiding Principles for Governance for Institutions offering only Islamic Financial Services (IIFS – excluding Islamic insurance/*takāful* institutions and Islamic mutual funds) – IFSB3;
- Guiding Principles on Governance for Islamic Collective Investment Schemes – IFSB6;
- Guiding Principles on Governance for *Takāful* (Islamic Insurance) Operations – IFSB8.



- Guiding Principles on the *Sharī'ah* Governance System

Background and objectives *(cont'd)*

- **Complement** other prudential standards issued by the IFSB
- **Facilitate** better understanding of *Sharī`ah* governance issues
- Provide **an enhanced transparency** in terms of issuance, and audit/review process for compliance with *Sharī`ah* rulings
- Provide **greater harmonisation** of *Sharī`ah* governance structures and procedures across jurisdictions

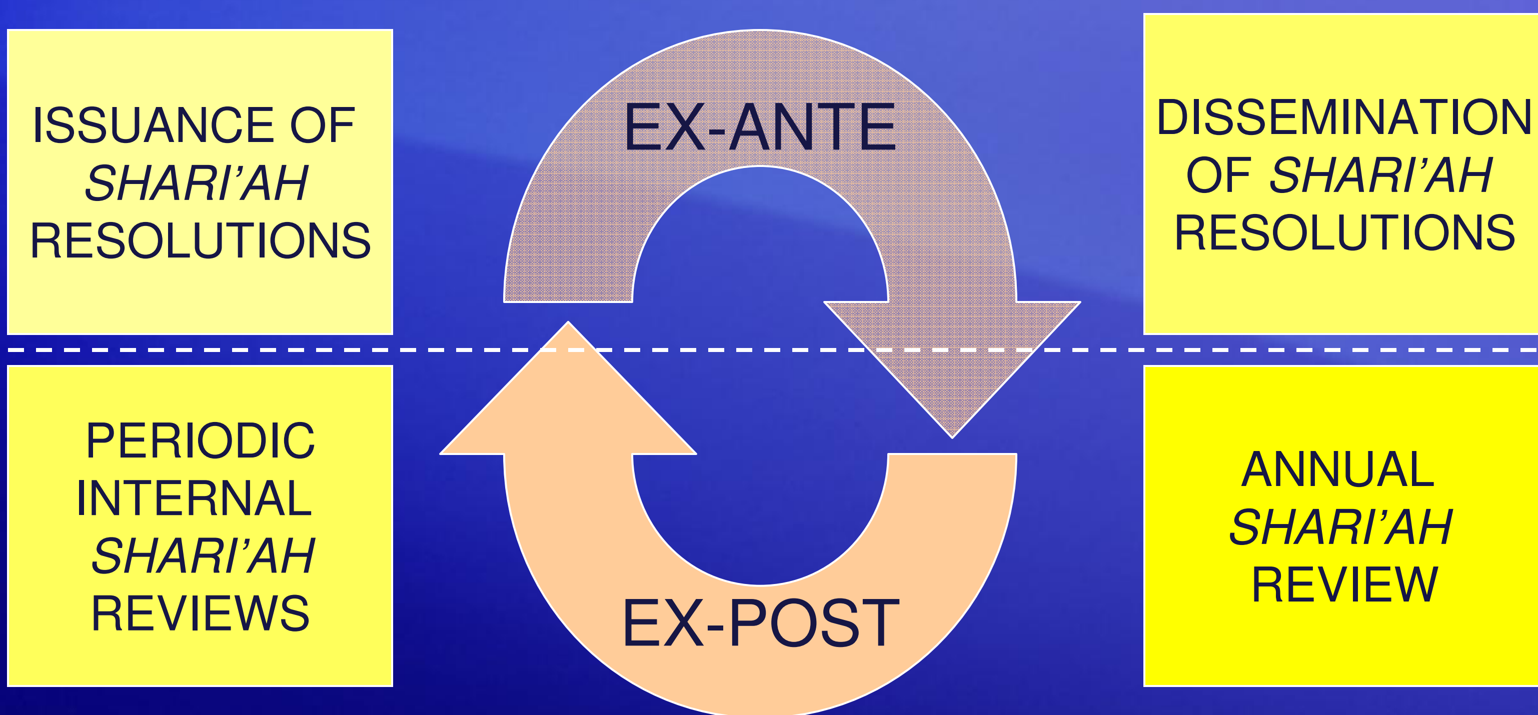
Highlighting the components of a sound *Sharī`ah* governance system

Focus on competence, independence, confidentiality and consistency of *Sharī`ah* boards

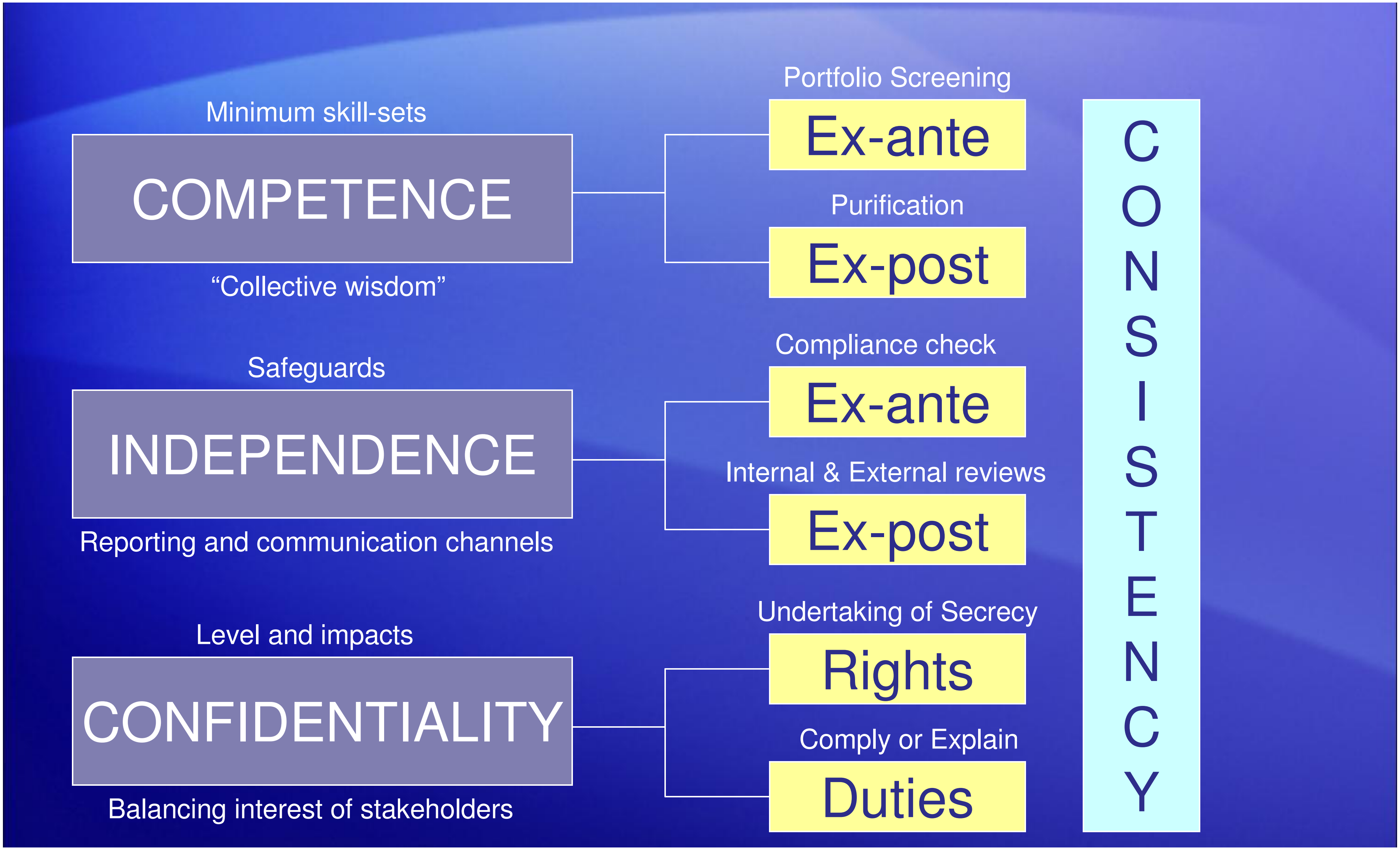
Stakeholders should satisfy themselves that an appropriate and effective *Sharī`ah* governance system is in place

Definition & Scope of *Sharī’ah* Governance System

“*Sharī`ah* Governance System” refers to the set of institutional and organisational arrangements through which an IIFS ensures that there is effective independent oversight of *Sharī`ah* compliance over each of the following structures and processes:



Sharī'ah Governance System



Sharī'ah Governance System *(cont'd)*

- **Scope**
  - Defining "*Sharī'ah* Governance System" and other key terminologies.
  - Covers all types of IIFS including banks, collective investment schemes, fund management companies, *Takāful* undertakings and Islamic windows.
  - Instead of repeating *structures and processes* that govern relationship between *Sharī'ah* Board and IIFS, the ED focuses on four elements required for an effective *Sharī'ah* Governance System.
- **Structures and Processes**
  - Competence – Terms of Reference, "Fit & Proper" criteria, "Code of Ethics"
  - Independence – Management of conflicts of interest
  - Confidentiality – Authorised/unauthorised disclosures
  - Consistency – Drive towards convergence

Sharī'ah Governance System *(cont'd)*

MAIN PREMISES

COHERENCE	The IFSB standards and guiding principles shall draw upon and complement one another, and form a coherent prudential framework. The requirements and recommendations in this document do not, in any manner, contradict or supersede the requirements and recommendations relating to the *Sharī`ah* Governance System that may have been mentioned in other IFSB standards and guiding principles.
NO SINGLE/ONE-SIZE-FITS-ALL MODEL	It is perfectly understandable that supervisory authorities may tailor the *Sharī`ah* Governance System adopted by IIFS in their respective jurisdictions to suit market realities and the stage of development of their IFSI. Each model may have its pros and cons, and supervisory authorities should have a clear understanding of these and justification as to which model would suit their requirements.
SHARING RESPONSIBILITY	The burden of ensuring a sound and effective *Sharī'ah* Governance System should not be left to members of the *Sharī'ah* board alone. Every stakeholder in the IFSI, including the clients, management, shareholders and the supervisory authorities, should also play a part in sharing the responsibility.

Sharī'ah Governance System *(cont'd)*

Part I	relates to the **general approach to a *Sharī'ah* Governance System,** whereby various *ex-ante* and *ex-post* processes considered as essential parts of good governance practices in other internationally recognised governance standards, such as the precise terms of reference for *Sharī'ah* boards, appropriate alignment of incentives, proper record-keeping, adoption of a professional code of ethics, etc., are adapted in order to strengthen the *Sharī'ah* Governance System.
Part II	in the area of competence, suggests various measures to ensure reasonable expertise and skill-sets in *Sharī'ah* boards, and to evaluate their performance and professional development.
Part III	aims at safeguarding the independence of *Sharī'ah* boards, particularly from the management of IIFS, by highlighting various issues arising from potential conflicts of interest and recommending how they should be managed.
Part IV	emphasises the importance of observing and preserving confidentiality by the organs of *Sharī'ah* governance.
Part V	focuses on improving consistency in terms of the professionalism of members of the *Sharī'ah* board, which would be crucial in enhancing their credibility and confirming their integrity through a set of best practices.

General *Sharī'ah* Governance Approach

Principle 1.1: The *Sharī'ah* governance structure adopted by the IIFS should be commensurate and proportionate with the size, complexity and nature of its business.

- Sets out the *ex-ante* and *ex-post* considerations before an IIFS chooses it *Sharī'ah* Governance structure

Ex-Ante	**Ex-Post**
•to appoint a reputable and credible *Sharī`ah* board; •to support the *Sharī`ah* board by appointing an ISCU or an individual *Sharī`ah* officer; and •for the *Sharī`ah* board to have at least three members, possibly of different nationalities, or trained in different schools of jurisprudence, and to have a mix of more experienced and less experienced members of the *Sharī`ah* board. Members of the *Sharī`ah* board should possess some exposure in the areas of commerce or finance.	•ensuring that the *Sharī`ah* board is more focused, with more time spent on each assignment and conflicts of interest adequately managed; •letting the *Sharī`ah* board mandate and delegate some of its functions to the ISCU; •hiring and nurturing young members of the *Sharī`ah* board with promising potential to expand the talent pool in the profession; and •engaging other professionals such as lawyers, accountants and economists to assist and advise the *Sharī`ah* board, especially on legal and financial issues.

General *Sharī'ah* Governance Approach *(cont'd)*

Principle 1.2: Each IIFS must ensure that the *Sharī'ah* board has:

- a clear terms of reference regarding its mandate and responsibility;
- well-defined operating procedures and lines of reporting; and
- good understanding of, and familiarity with, professional ethics and conduct.

Complemented by terms of reference, meeting procedures and basic code of ethics (see Appendix in the Standard)

Competence

Principle 2.1: The IIFS shall ensure that any person mandated with overseeing the *Sharī`ah* Governance System fulfils an acceptable fit and proper criteria.

Criteria when assessing the fitness and propriety of individuals to serve on the Sharī`ah board as well as officers of Internal Sharī`ah Compliance Unit (ISCU) and Internal Sharī`ah Review Unit (ISRU):

•Good character, i.e. honesty, integrity, fairness and reputation	•Competence, diligence, capability and soundness of judgment

Competence *(cont'd)*

Principle 2.2: The IIFS shall facilitate continuous professional development of persons serving on its *Sharī`ah* board, as well as its ISCU and ISRU, if any.

Training policies shall be established with adequate consideration for training needs, to ensure compliance with the IIFS's operational and internal control policies and procedures, and all applicable legal and regulatory requirements to which the IIFS generally, and members of the *Sharī`ah* board and internal *Sharī`ah* officers particularly, are subject.

- Orientation and induction program
- Mentoring program i.e. more experienced members of the *Sharī`ah* board and internal *Sharī`ah* officers provide guidance and tutelage to less experienced counterparts
- Tailor-made training on industry-specific knowledge
- Giving in-house training to other officers

Competence *(cont'd)*

Principle 2.3: There should be a formal assessment of the effectiveness of the *Sharī`ah* board as a whole and the contribution by each member to the effectiveness of the *Sharī`ah* board.

IIFS shall decide how the *Sharī`ah* board's performance may be evaluated and propose objective performance criteria. Such performance criteria, which allow for comparison with industry peers, should be developed together and in consultation with the *Sharī`ah* board and may include, for example, how the *Sharī`ah* board enhances long-term shareholders' value.

- Performance criteria should not be arbitrarily or unilaterally changed by the IIFS; onus should be on the IIFS, through the BOD, to justify any changes.
- Appendix 5 recommends assessments criteria.

Independence

Principle 3.1: The *Sharī`ah* board should play a strong and independent oversight role, with adequate capability to exercise objective judgment on *Sharī`ah*-related matters. No individual or small group of individuals shall be allowed to dominate the *Sharī`ah* board's decision making.

- In order to uphold the integrity and credibility of the *Sharī`ah* board, its members must not only be able to exercise independent judgement without undue influence or duress, especially from the management of the IIFS, but also to be seen to be truly independent.
- Sets out the position deemed to be "in conflict".

Independence *(cont'd)*

Principle 3.2: In order to fulfil their responsibilities, the *Sharī`ah* board should be provided with complete, adequate and timely information prior to all meetings and on an on-going basis.

•*Sharī`ah* boards should have separate and independent access to the ISCU and ISRU, respectively, to check whether internal control and compliance procedures have been appropriately followed and that applicable rules and regulations to which the IIFS is subject have been complied with.

•Where the *Sharī`ah* board has its own secretariat, the appointment and removal of members of the secretariat should be appropriately carried out in consultation with the *Sharī`ah* board.

•IIFS shall have a procedure for the *Sharī`ah* board, either for each individual member or as a group, in the furtherance of their duties, to take independent professional advice, such as on legal, accounting, financial or valuation issues, if necessary, at the IIFS's expense.

Confidentiality

Principle 4.1: *Sharī`ah* board members should ensure that internal information obtained in the course of their duties is kept confidential.

- Example 1: In case of leakage of confidential or market-sensitive information to inappropriate parties, IIFS should at least have appropriate risk management and control processes in place to limit the damage of such leakage.
- Example 2: Wherever possible, the IIFS should establish a process for taking disciplinary and/or other administrative actions against the *Sharī`ah* board or its members to ensure absolute accountability and appropriate remedy.

Consistency

Principle 5.1: The IIFS should fully understand the legal and regulatory framework for issuance of *Sharī`ah* pronouncements/resolutions in the jurisdiction where it operates. It should ensure that its *Sharī'ah* board strictly observes the said framework and, wherever possible, promotes convergence of the *Sharī`ah* governance standards.

Ex-Ante	Ex-Post
•In countries where there is a central authority issuing the *Sharī`ah* pronouncements/ resolutions, the *Sharī'ah* board at the IIFS is usually required to follow and adopt such *Sharī`ah* pronouncements/ resolutions as are issued by that central *Sharī`ah* authority. •If no such body, the *Sharī'ah* board should follow and adopt the *Sharī`ah* pronouncements/ resolutions issued by the OIC Fiqh Academy. •Otherwise, the *Sharī'ah* board should exercise its best efforts in documenting and publishing its *Sharī`ah* pronouncements/resolutions so that they can be openly assessed by the industry's stakeholders (subject to the appropriate observance of confidentiality).	•From time to time, members of the *Sharī`ah* board should participate in meetings of *ulama* specialised in *fiqh al-muamalat* to present and debate *Sharī`ah* pronouncements/resolutions. They must also expect to answer questions from shareholders and the public in a general assembly or similar forum. It would be helpful if they were to produce in the annual reports a section on *Sharī`ah* compliance by the IIFS, including clarifying the process of how the *Sharī`ah* board reached its decisions. •The IIFS should ensure that the *Sharī`ah* board adopts a specified process for changing, amending or revising any *Sharī`ah* pronouncements/ resolutions.

Capital Adequacy Standard (CAS)

Capital adequacy standard

- Approach
- Key objectives
- Principles for the measurement of capital adequacy standard on specific features of IIFS products and services:
  - Credit (including exposures made under profit sharing modes that are not made for trading)
  - Market
  - Operational
  - Profit sharing investment account (PSIA)

Introduction: capital regulatory framework

AAOIFI: CAR -
excludes risks borne by PSIA

IFSB: capital based on the adaptation of Basel II standardized formula - excludes risks borne by the PSIA **(standard and supervisory discretion)**

1988 | **1996** | **2006** | 2010

G30 recommendations 1994
Basel risk management guidelines for derivatives
Minimum requirements for trading activities
credit risk treatment

Capital
0-8% based
on credit risk
equivalents
(also to cover other risks)

MR Standard
or Model *3plus
plus specific risk

Capital based
on credit risk
- **Standard method**
- Int. rating based method
As well as op risk and Market risk charges

Introduction: capital regulatory framework *cont'd*

Basel I	Basel II	IFSB Standard
Focus on a single risk measure	More emphasis on banks' internal methodologies, supervisory review and market discipline	Focus on a single risk measure, supervisory review and disclosure
One size fits all	Flexibility, menu of approaches. Provides incentives for better risk management	One size fits all and, in certain area, supervisory discretion
Operational risk not considered	Introduces approaches for credit risk and operational risk in addition to market risk introduced earlier	Incorporates credit, market and operational risks

Approach

- Since the structure and activities of IIFS are influenced by the *Shari`āh* rules and principles, the approach undertaken by the working group is analysing the intrinsic characteristics of each contract. For this reason, the CAS is structured in a matrix format
- The CAS does not represent an exhaustive list of products
  - Principles for minimum capital adequacy requirements for credit and market risks arising from a given type of financial instrument
  - Financing and investment instruments

Key objective

- The standard on Capital Adequacy sets out a common structure for the assessment of IIFS capital adequacy requirements, which will support transparency and consistent methodology for all IIFS
  - This will bring the benefits of a common approach without compromising *Sharī`ah* rules and principles by substantially enhancing the transparency of true obligations within IIFS operations
  - The standard promotes a level playing field at a global level as far as common assessment is concerned especially for the minimum capital requirement in respect of both credit and market risks arising from each financing mode at different stages of a contract
  - Recognition of investment account holders (IAH) as partners in IIFS operations should result in a more effective use of capital. According to the Quantitative Impact Study (QIS) conducted by the IFSB, the capital base of IIFS is more than sufficient to meet their true liabilities, in contrast to critics about them being undercapitalized

General principles of capital adequacy

IIFS are required to use the substance of the *Sharī`ah* rules and principles governing the contracts to form the basis for an appropriate treatment in deriving their minimum capital adequacy requirements

Some IIFS may use different product names or contract titles as part of their market differentiation or a commercial expression.

General principles of capital adequacy *cont'd*

(a) *Murābahah* and Non-binding MPO

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Asset available for sale (asset on balance sheet)*	Not applicable	15% capital charge (187.5% RW)
Asset is sold and delivered to a customer, and the selling price (accounts receivable) is due from the customer	Based on customer's rating or 100% RW for unrated customer (see paragraphs 88 to 89)	Not applicable
Maturity of contract term or upon full settlement of the purchase price, whichever is earlier	Not applicable	Not applicable

* *Also includes an asset which is in possession due to cancellation of AP by a non-binding MPO customer. Any HJ taken, if any, is not considered as eligible collateral and shall not be offset against the value of the asset.*

Capital adequacy requirements vary according to the transformation of risks at different contract stages

For example: In *Murābahah* or *Ijārah*, rather than lending money, an IIFS has to acquire a physical asset and then sell it back on credit or on lease. The risk to which the IIFS is exposed transforms from the market risk of physical assets at the time of acquisition to credit risk at the time of sale on deferred payment or on lease.To see all the commands again, double-click the active tab again to bring back the groups.

General principles of capital adequacy *cont'd*

On basis of either *Muḍārabah* or *Wakālah* contract, credit and market risks of the investment made by the IAH shall normally be borne by themselves, while the operational risk is borne solely by the IIFS (unless proven negligence, mismanagement or fraud)

As opposed to the emphasis of Basel II Capital Accord on depositors' protection, the IFSB Standard on Capital Adequacy stresses the importance of investors' protection mechanisms (with no guarantee of capital). As such, assets financed by IAH do not affect risk-bearing capital of IIFS since they bear their own commercial risk.

Comparison of the approach: credit risk

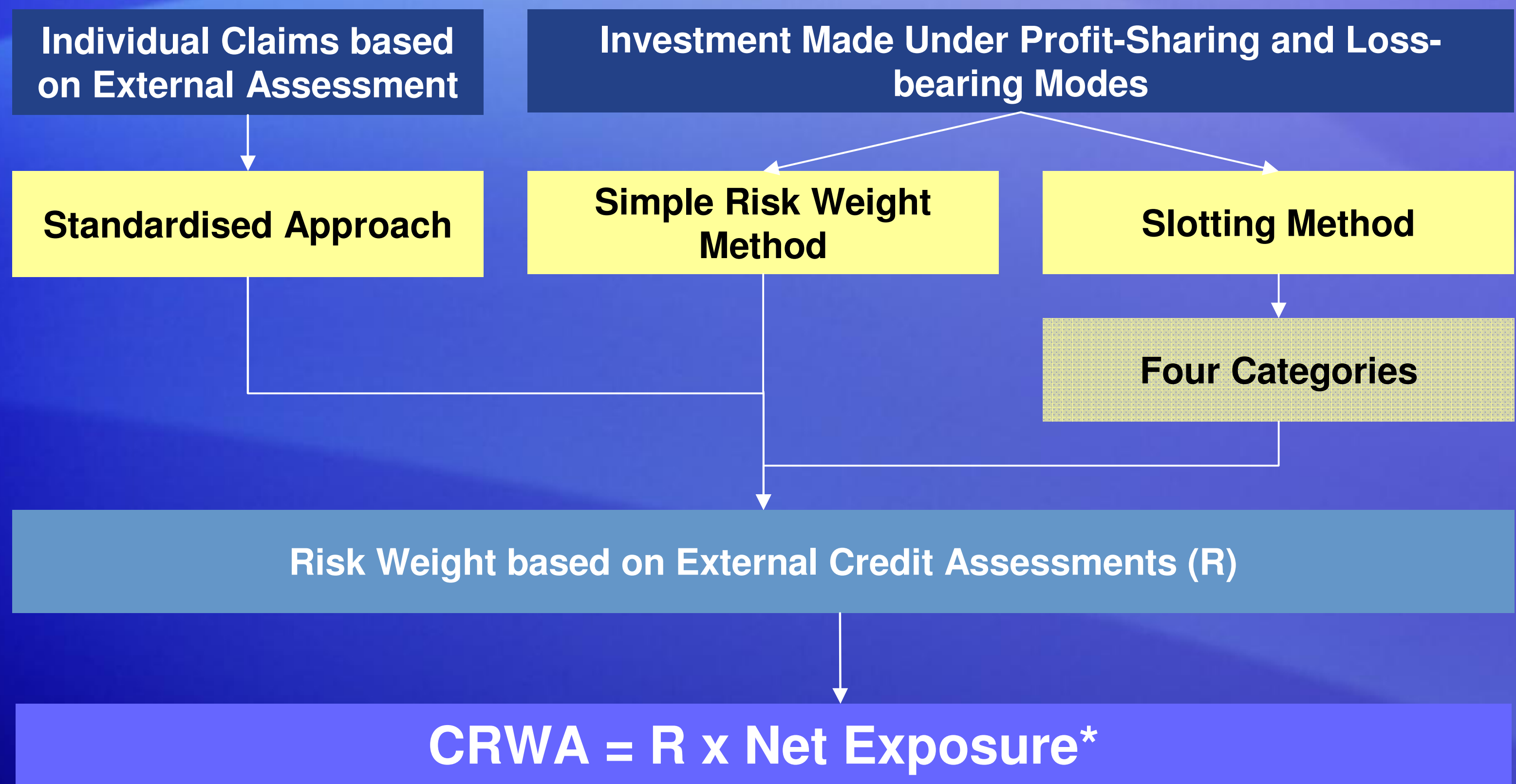
Criteria	Basel II Standardised	IFSB CAS Standardised
Risk weight	Calibrated on the basis of external ratings by the BASEL committee.	Calibrated on the basis of external ratings by the BASEL committee. *Vary according to contract stage and financing mode.*
Treatment of equity in the banking book	$\geq$ 150% for financing of venture capital and private equity investments	Simple risk weight method (RW300% or 400%) or supervisory slotting method (RW 90%-270%)
Credit Risk Mitigation Techniques	Includes financial collateral, credit derivatives, guarantees, netting (on and off balance sheet).	Includes *hamish jiddiyyah, urbun*, PSIA or cash on deposit with IIFS, guarantees, financial collateral, pledge assets

Principles of credit risk

Credit risk is measured according to the Standardised Approach of Basel II, except for certain exposures arising from investments by means of *Mushārakah* or *Muḍārabah* contracts in assets that are not held for trading

Until adequate historical data are available, the IFSB employs Basel's risk weights

Measurement of Credit Risk



*Amount of exposure less eligible collateral (Net exposure)

Comparison of the approach: market risk

Criteria	Basel II Standardised	IFSB CAS Standardised
Category	Equity, FX, Interest rate risk in the trading book, commodity	Equity, FX, benchmark risk in the trading book, commodity, ***Inventory*** *Silver falls under foreign exchange risk*
Measurement	1996 market risk amendments (standardised and internal model)	1996 market risk amendments ***(standardised measurement method)***

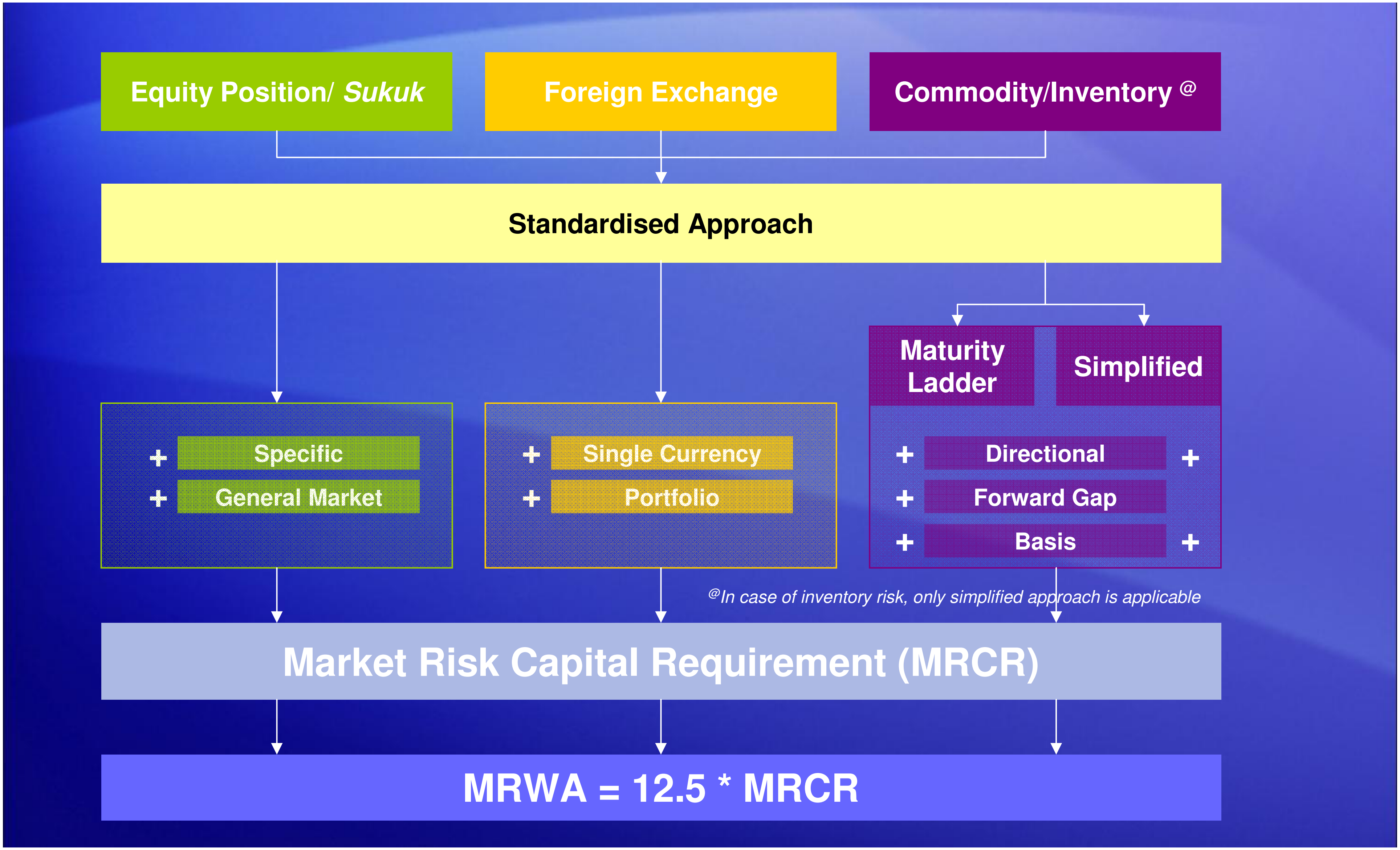
Principles of market risk

- Apart from market risk exposures arising from equity, foreign exchange, commodities, the exposures also include trading positions in *sukuk* and inventory risk, which results from IIFS holding assets with a view to re-selling or leasing them

- In the case of equity investment made by means of *Mushārakah* or *Muḍārabah* contract where the underlying assets are commodities held for trading, market risk provisions for commodities are applicable

- For inventory risk, only simplified approach is applicable

Measurement of Market Risk



Principles of market risk *cont'd*

- Apart from market risk exposures arising from equity, foreign exchange, commodities, the exposures also include trading positions in *sukuk* and inventory risk, which results from IIFS holding assets with a view to re-selling or leasing them
- In the case of equity investment made by means of *Mushārakah* or *Muḍārabah* contract where the underlying assets are commodities held for trading, market risk provisions for commodities are applicable
- For inventory risk, only simplified approach is applicable

Comparison of the approach: operational risk

Criteria	**Basel II** **Basic Indicator**	**IFSB CAS**
Gross income	Annual average gross income (previous three years)	Annual average gross income (previous three years) ***excluding PSIA's share of income***

Principles of operational risk

- *Sharī`ah* noncompliance risk is a type of operational risk facing the IIFS which can lead to non-recognition of income and resultant losses

- The extent of losses from non-compliance with *Sharī`ah* rules and principles cannot be ascertained owing to lack of data

  – Supervisory authorities have discretion to impose a RW higher than 15% as they deem fit to cater for the *Sharī`ah* noncompliance risk of a particular IIFS.

Measurement of Operational Risk

Annual Average Gross Income (previous three years) **X 15%**

Gross income is defined as:

Net income from financing activities (e.g. selling price less purchase price) which is gross of any provisions and operating expenses; plus
Net income from investment activities; plus
Fee income (e.g. commission and agency fee)

Less:

Investment account holders' share of income

↓

Operational Risk Capital Requirement (ORCR)

↓

ORW = 12.5 * ORCR

CAR relating to assets financed by PSIA

The IIFS assumes the role of economic agent or *Muḍārib* in placing such funds in income-producing assets or economic activities, and as such is entitled to a share (the *Muḍārib* share) in the profits (but not losses) earned on funds managed by it on behalf of the IAH, according to a pre-agreed ratio specified in the *Muḍārabah* contract

---

The commercial risk on assets financed by PSIA do not represent risks for the IIFS' own (shareholders') capital and thus would not entail a regulatory capital requirement for the IIFS

Treatment of investment account

- Standard formula
  - 100% of credit & market risk of risk-weighted assets financed by IAH is borne by IAH
  - 100% of operational risk of managing these assets is borne by IIFS

This implies that assets funded by either unrestricted or restricted PSIA would be excluded from the calculation of the denominator of the capital ratio

CAR: Standard formula

RWA of PSIA
(CR + MR)

Treatment of investment account *cont'd*

- Supervisory discretion formula
  - Some proportion α (decided by supervisor) of credit & market risk of risk-weighted assets financed by IAH is deemed to be borne by IIFS
  - 100% of operational risk of managing these assets is borne by IIFS

In practice, the IIFS (a) may forgo its rights to some or all of its *Muḍārib* share of profits in order to offer its IAH a more competitive rate of return on their funds, or (b) may be treated as constructively obliged to do so by the supervisory authority as a measure of investor protection and in order to mitigate potential systemic risk resulting from massive withdrawals of funds by dissatisfied IAH

CAR: Supervisory discretion formula

RWA funded by restricted PSIA (CR+MR)

(1- α) RWA funded by unrestricted PSIA (CR+MR)

α RWA funded by unrestricted PSIA (CR+MR) – PER and IRR

α RWA funded by PER and IRR of unrestricted PSIA (CR+MR)

RWA funded by non-PSIA (CR+MR+OR)

CAR: Standard formula

Standard Formula

Capital amount of PSIA is not guaranteed by the IIFS and any losses arising from investments or assets financed by PSIA are to be borne by the IAH, unless losses are due to the IIFS's negligence, misconduct or breach of investment mandate.

$$\frac{\textbf{ELIGIBLE CAPITAL}}{\text{TOTAL: RWA (CR + MR) + ORW} \quad \textbf{LESS} \quad \text{FUNDED BY PSIA: RWA (CR + MR)}}$$

Example:
EL = 8, CRWA = 40, MRWA = 40, ORW = 20 and assets funded by PSIA is 70% of total on- and off-balance sheets

8 / [100 – 56] = 8 / 44 = 18.2%

CAR Supervisory Discretion Formula

Supervisory Discretion Formula

Applicable in jurisdiction where supervisory authority considers the IIFS is obligatory to smooth income for IAH as part of a mechanism to minimise withdrawal risk and is concerned with systemic risk.

$$\frac{\textbf{ELIGIBLE CAPITAL}}{\begin{array}{c}\textbf{TOTAL RWA (CR+MR+OR)}\\ \textbf{less}\\ \textbf{RWA funded by restricted PSIA (CR+MR)}\\ \textbf{less}\\ \textbf{(1-}\alpha\textbf{) RWA funded by unrestricted PSIA (CR+MR)}\\ \textbf{less}\\ \alpha\textbf{ RWA funded by PER and IRR (CR+MR)}\end{array}}$$

	Restricted PSIA (20%)	Unrestricted PSIA (50%)	All other funds (30%)	**Total (100%)**
CRWA	8	20	12	**40**
MRWA	8	20	12	**40**
ORWA	0	0	20	**20**
Total	**16**	**40**	**44**	**100**

CAR Supervisory Discretion Formula *cont'd*

$$\frac{\text{ELIGIBLE CAPITAL}}{\begin{array}{c}\text{TOTAL RWA (CR+MR+OR)}\\ \text{less}\\ \text{RWA funded by restricted PSIA (CR+MR)}\\ \text{less}\\ (1-\alpha)\text{ RWA funded by unrestricted PSIA (CR+MR)}\\ \text{less}\\ \alpha\text{ RWA funded by PER and IRR (CR+MR)}\end{array}}$$

$$\frac{8}{\begin{array}{c}40+40+20\\ \text{less}\\ (8+8)\\ \text{less}\\ (1-30\%)\ (20+20)\\ \text{less}\\ 30\%\ (2+2)\end{array}} = 14.60\%$$

	Restricted PSIA (20%)	Unrestricted PSIA (50%)	All other funds (30%)	**Total**
CRWA	8	20	12	**40**
MRWA	8	20	12	**40**
ORWA	0	0	20	**20**
Total	**16**	**40**	**44**	**100**

Comparison of using different formula

	Standard formula	Supervisory discretion formula	Basel formula
Capital adequacy ratio	**18.2%**	**14.6%**	**8%**

Sukuk and securitisation

Sukuk and securitisation: background *(cont'd)*

Sukuk (plural of *sakk*), frequently referred to as "Islamic bonds", are certificates with each *Sakk* representing a proportional undivided ownership right in tangible assets, or a pool of predominantly tangible assets, or a business venture (such as a *Muḍārabah*). These assets may be in a specific project or investment activity in accordance with *Sharī`ah* rules and principles.

Sukuk and securitisation: background *(cont'd)*

Differences

	Sukuk	Bonds	Shares
Nature	Not a debt issuer but undivided ownership share in specific assets, projects or services	Debt of issuer	Ownership share in a corporation
Asset-backed	A minimum of certain percentage of tangible assets	Generally not required	Not required
Claims	Ownership claims on the specific assets/ project/ service and so on	Creditors claim on the borrowing entity, and in some cases liens on assets	Ownership claims on the company
Security	Secured by ownership rights in the underlying assets or projects in addition to any additional collateral enhancement structure	Generally unsecured debentures except in cases such as first mortgage bonds, equipment trust certificates and so on	Unsecured

Sukuk and securitisation: background *(cont'd)*

Differences *(cont'd)*

	Sukuk	Bonds	Shares
Principal and return	Not guaranteed by issuer	Guaranteed by issuer	Not guaranteed by company
Purpose	Must be issued only for Shari`ah compliant purposes	Can be issued for any purpose	Can be offered for any purpose
Trading of security	Sale of ownership interest in a specific asset/ project/ service and so on	Sale of a debt instrument	Sale of shares in a company
Responsibility of holders	Responsibility for defined duties relating to the underlying assets/ projects limited to the extent of participation of in the issue	Bondholders do not have any responsibilities for the circumstances of the issuers	Responsibility for the affair of the company limited to the extent of holding in the company

Adam, Nathif and Abdulkader Thomas, Islamic Bonds, Euromoney 2004, page 54

Sukuk and securitisation: background *(cont'd)*

For the purposes of the standard, *Sukuk* is generally defined as certificates with each *sakk* representing a proportional or undivided ownership interest in tangible assets, pool of assets or in the assets of a specific project or investment activity:

a) Investment in specified assets

b) Income must be related to the purposes for which the funding is used

c) Rights are transferred for a fixed period

Sukuk and securitisation: standard *(cont'd)*

The Standard covers:

- *Sukuk* structure
- Parties in a *Sukuk* structure
- Risk exposures from various perspectives
- *Shari`ah* & operational requirements pertaining to assets, transfer of rights (i.e. assets de-recognition criteria) and credit enhancement
- Capital requirements:
  - Risk weights for IIFS (as an originator, sponsor, issuer or servicer) and for eligible liquidity facility
  - Treatment of credit risk mitigation

Sukuk and securitisation: standard *(cont'd)*

Two *Sukuk* structures covered in the standard:

- **An asset-based *Sukūk* structure with a repurchase undertaking (binding promise) by the originator: the issuer purchases the assets, leases them on behalf of the investors and issues the *Sukūk*. Normally, the assets are leased back to the originator in a sale-and-leaseback type of transaction. The applicable credit risk is that of the originator, subject to any *Sharī`ah*-compliant credit enhancement by the issuer. The recognised ECAI will put weight, in determining the rating, on the payment schedule of the repurchase undertaking and the capability of the originator to make the scheduled payments to the issuer. Such structures are sometimes referred to as "pay-through" structures, since the income from the assets is paid to the investors through the issuer.**

Sukuk and securitisation: standard *(cont'd)*

Two *Sukuk* structures covered in the standard:

- **An asset-based *Sukūk* structure where a separate issuing entity purchases the underlying assets from the originator, packages them into a pool and acts as the issuer of the *Sukūk*. This issuing entity requires the originator to give the holders recourse, but provides *Sharī`ah*-compliant credit enhancement by guaranteeing repayment in case of default by the originator.**

Sukuk and securitisation: standard *(cont'd)*

Sukuk transaction lifecycle:

Phase 1: Issuance of the *Sukuk*	**Phase 2: Servicing of the *Sukuk***	**Phase 3: Repayment to the *Sukuk* holders**
Availability of qualifying assets	Mechanism to ensure that the *sukuk* holders received profit dividends on a timely basis	Determination of asset value at a time of repayment
Any restriction in the asset pool	Impact of bankruptcy of the issuer	Redemption of certificate
Transfer of rights		Mechanism for transfer of sukuk pool on maturity
Credit enhancement		

Adam, Nathif and Abdulkader Thomas, Islamic Bonds, Euromoney 2004, page 56

Shari`ah requirement should be taken into account in all phases in addition to legal, regulatory, tax and accounting considerations.

Real estate investment

Real estate investment: background

Conventional institutions in general cannot engage in real estate investments unless they obtain consent from the regulatory authority. These institutions are required to comply with applicable capital standards and the authority determines that the activity poses no significant risk to the depositors.

Real estate investment: background *(cont'd)*

Regulatory and/or supervisory authorities in a number of jurisdictions permit institutions offering Islamic financial services (IIFS) to invest their and/or unrestricted IAH funds in real estate (on their balance sheets), and/or may allow investment via subsidiaries or through restricted IAH (off-balance sheet).

Real estate investment

Definition

- Real estate assets include various types of completed and under-construction properties, as well as land used for such purposes. Real estate activity involves, among other things, the purchase, sale and development of land, and residential and non-residential buildings.
- Investment in real estate refers to the IIFS investing its own and/or customers' funds directly in real estate assets or in real estate projects (or in partnerships in real estate or real estate projects) for commercial purposes to achieve profits from property development, or to benefit from asset price appreciation. However, the investment does not include assets held by a lessor under an IMB contract – that is, Islamic financing.

Real estate investment

Definition *cont'd*

- Therefore, the key criterion in distinguishing between real estate investment and financing is the existence of a regular cash flow due or receivable from a customer in respect of the asset. The existence of such a cash flow signifies that the IIFS is providing financing to the customer for the asset, while the absence of such a cash flow indicates that the IIFS has invested in the asset on its own account (or in its own and its unrestricted IAH accounts). The national supervisory authority will determine the precise criteria that will govern real estate investment within its jurisdiction. In this context, the supervisory authority will provide a set of detailed criteria to which IIFS will pay attention.

Real estate investment

Definition *cont'd*

- In the context of this document, a real estate investment (as opposed to a real estate financing transaction) may fall into one of three broad categories:
  - The activity of holding real estate at any stage of the development process, or even completed properties, where such a holding is not part of a financing transaction for a third party (such as IMB or *Murābahah*).
  - An asset holding where there is no binding promise from a third party to acquire (by *Murābahah*) or to lease the asset (by IMB), and the holding period has exceeded a relatively short period such as six months (at supervisory discretion) and based on evidence of management intention.
  - Operating *Ijārah*.

Real estate investment

Risk weight

- Referring to the three categories of real estate investment, the applicable risk weights of a single investment exposure for each category are as follows:
  - The treatment for single investment exposure is a 187.5% risk weight;
  - The treatment for an exposure due to a holding for financing purposes during the non-binding stage of the transaction is a 187.5% risk weight; and
  - The treatment of an exposure resulting from Operating *Ijārah* is the risk weights as mentioned in the next slide.

Real estate investment

Risk weight *cont'd*

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Asset available for lease (prior to signing a lease (Ijarah) contract)	Binding PL* Asset acquisition cost less (a) market value of asset fulfilling function of collateral (net of any haircuts) and (b) any *'hamish jiddiyyah* multiply with the customer's rating or 100% RW for unrated customer.	Non-binding PL 15% capital charge (equivalent to 187.5% RW) until lessee takes possession
Upon consigning a leasing contract and the lease rental payments are due from the lessee	Total estimated value of lease receivables for the whole duration of leasing contract shall be risk-weighted according to the lessee's rating. 100% RW for an unrated lessee. less recovery value of the leased asset	The residual value will be risk weighted at 100%
Maturity of contract term and the leased asset is returned to the IIFS	Not applicable	15% capital charge of the carrying value of the asset

Challenges in the implementation of the IFSB standards

Challenges in the implementation

In general, both national authorities and IIFS may face some of the following challenges in implementing these standards. On the other hand, the IFSB is not empowered to enforce its proposed standards and guidelines. Therefore, the IFSB relies solely on the voluntary adoption of standards by its members and IIFS.

Challenges in the implementation *cont'd*

- The obligation on national authorities to ensure that they have sufficient infrastructures, skills and domestic guidelines in order to effectively supervise IIFS operations. The prerequisites to implement these standards imply sound understanding by supervisors and regulators of the risks involved in *Sharī`ah* compliant transactions and how such risks are managed.

First, supervisory authorities should review their current systems and procedures, assess whether a good baseline supervisory system is in place, and consider the appropriate phasing and sequencing of various regulatory, supervisory, and legislative measures – and IIFS should correspondingly modify their systems and procedures for risk measurement and controls, with the view to implement the IFSB standards over a reasonable time frame. The timeframe should be broadly consistent with the envisaged timeframe for conventional banks.

Challenges in the implementation *cont'd*

- Absence of adequate risk-mitigating tools and infrastructure for IIFS or even risk management culture among IIFS.

The development process will continue to evolve.

Challenges in the implementation *cont'd*

- Assurance that the implementation of these standards will not put IIFS at a competitive disadvantage in particular in terms of huge cost implications, lengthy product development process etc.

IIFS should keep in mind that implementing these standards will help them having a better understanding of their risk appetite in sourcing their funds and in pricing new businesses in order to determine risk profiles of their fund providers.

Challenges in the implementation *cont'd*

- Although enhanced disclosure of information is generally perceived as beneficial by the public, its benefit to IAH, given their level of understanding of their rights and obligations, has yet to be proven.

In practice, the IAHs behave similar to fixed depositors in conventional institutions but, contractually, they share the profits and bear their own losses.

Facilitating the implementation of the IFSB standards

Rationale to facilitate the implementation

- The IFSB standards, together with additional guidance notes (from IFSB) being developed on specific aspects of these standards constitute the Basel II equivalent for Islamic finance.

Many countries with IIFS are already planning a phased implementation of basic approaches to Basel II for conventional banks, and hence implementation of Basel II equivalent standards for IIFS is essential to ensure a level playing field and effective competition

Broad direction of the strategic plan

- Three main questions:
  - How is the implementation going on at the present stage?
  - What are the next steps?
  - How will the IFSB be able to facilitate the implementation?

Action plan to facilitate the implementation

Endorsement of the Standard → **Present state of the Implementation** → **Next Steps** → **Implementation Challenge**

Present state of the Implementation

Conducting any reviews on the implementation of the IFSB standards

- No immediate plan to implement Basel II for IIFS
- Strength of the IFSB CAS: standardised approach

Next Steps

Improving understanding of the IFSB standards

- Strong project management skills and efforts
- FAQ, impact studies, discussion and sharing views

Process of facilitating the implementation: *(a) High-level meetings with regional supervisors; and (b) Focus workshops*

Implementation Challenge

Addressing findings from the discussion

- Key area of possible reforms
- Fine-tune the standards in synch with the pace of development or jurisdiction specific

A few institutions have indicated their willingness to provide technical assistance and participate in the process

Strengthen and add coherence to the mission and commitment of the IFSB to the industry

Thank you for your attention