

## FAQs on IFSB-21:

### Core Principles for Islamic Finance Regulation [Islamic Capital Market Segment]

#### Q1. What are the CPICM?

**Answer:** Core principles for regulation of the financial sector issued by international standard setters such as the IOSCO, BCBS, IAIS and others are standard tools to guide regulatory and supervisory authorities (RSAs) in developing their regulatory regimes and practices. They also serve as a basis for RSAs or external parties such as the multilateral agencies, to assess the strength and effectiveness of regulation and supervision in jurisdictions as part of financial sector assessment programmes conducted by the World Bank and IMF or self-assessments conducted by RSA's themselves.

The CPICM are core principles for the Islamic capital market that are set out in IFSB-21 Core Principles for Islamic Finance Regulation (ICM segment) standard issued by the IFSB in December 2018. The CPICM provide a set of core principles for the regulation and supervision of the Islamic Capital market taking into consideration the specificities of Islamic finance, while complementing IOSCO Principles.

(Paragraphs 2, 9 and 10)

#### Q2. What are the major changes that the CPICM makes to the IOSCO Principles in order to address Islamic finance specificities?

**Answer:** Two entirely new core principles have been developed for CPICM, which are not part of the IOSCO Principles. The two new core principles concern Sharī'ah governance in the ICM (CPICM 10) and the issuance of Şukūk (CPICM 20).

Two IOSCO Principles are omitted from the standard which are IOSCO Principles 28 and 38. The deletion of Principle 28 on hedge funds reflects the fact that Sharī'ah restrictions on, for example, short selling and the use of derivatives make it generally impossible within the Islamic capital market to structure a hedge fund as they are commonly understood. The deletion of Principle 38 on clearing and settlement is for two reasons. Firstly, because it is currently not assessed as part of IOSCO's Principles; any assessment in this area is against the Principles for Financial Market Infrastructures (PFMI), to which Principle 38 refers. In addition, the IFSB plans to develop a separate Core Principles for Financial Market Infrastructure that complements the PFMI, but takes into consideration the specificities of Islamic finance.

(Paragraph 12 and Appendix)

**Q3. Are there any modifications or amendments to the IOSCO Principles that have been retained within the CPICM?**

**Answer:** In addition to the major changes mentioned above, some IOSCO Principles have been amended at the level of the supporting text and Key Questions rather than the Principles themselves. In two areas significant amounts of text have been omitted from IOSCO Principles. Some of this concerns derivatives, which are for Sharī'ah reasons, not a feature of Islamic capital markets. In addition, the IOSCO Principles deal with stable net asset value money market funds for which there are also strong Sharī'ah reasons for why such funds are not a feature of the Islamic capital market, as opposed to variable net asset value funds, whose establishment is not impossible provided they adhere to Sharī'ah rules and principles. However, many of the IOSCO Principles have been retained in view of their common applicability to both conventional and Islamic finance and for consistency and harmonisation of regulation as well as financial sector assessments across both.

(Appendix)

**Q4. What issues are addressed in the new CPICM 10 that are specific to Islamic capital markets?**

**Answer:** CPICM 10 sets out the Sharī'ah governance mechanisms and processes that regulatory frameworks should require to have in place for products and services that claim Sharī'ah-compliance as well as entities operating in the Islamic capital markets. CPICM 10 addresses Sharī'ah governance mechanisms that are specific to the Islamic capital markets sector which have not been addressed in prior standards.

(Paragraph 244)

**Q5. What issues are addressed by CPICM 20 that are not addressed by conventional standards?**

**Answer:** CPICM 20 sets out the specific disclosure requirements for Şukūk that take into account, the specific nature and risk characteristics of Şukūk and transparency in all aspects related to compliance with Sharī'ah requirements. Şukūk can often have significantly different underlying structures that may introduce different risk characteristics from those of conventional instruments, which need to be addressed within disclosures. Sharī'ah-compliance is also an important part of what Şukūk offer and hence require sufficient disclosures about the Sharī'ah aspects of the Şukūk to allow an informed judgment as to initial and ongoing Sharī'ah compliance of the Şukūk to be made. The differences in the structure of Şukūk from that of bonds also require regulators to ensure that there are adequate disclosures

on structure-related aspects of Şukūk in clear and understandable language which is particularly important because of the complexities involved and the use of terminology that may not be familiar to some investors.

(Paragraphs 438-441)

**Q6. What are the specific provisions in the CPICM for regulators that are responsible for regulation of Islamic capital market activities in their jurisdiction?**

**Answer:** CPICM 2 addresses the regulator's accountability on matters of Sharī'ah compliance where the regulator has functional responsibility and power in relation to the aforementioned. The CPICM however does not prescribe a specific structure for the regulator nor do they prescribe a particular Sharī'ah governance model at the level of the regulator. Ideally, the regulator is expected to have an approach to Sharī'ah governance in order to be assessed under the CPICM.

In relation to the above, CPICM 2 includes additional provisions that the functions and powers of the regulator, and resulting accountability, regarding any centralised Sharī'ah board to be explicitly stated, particularly in cases where the regulator requires consultation with, or approval by, the centralised Sharī'ah board. In particular, it includes the provisions that if a Sharī'ah board is embedded within the regulator, then a regulator should be accountable for ensuring that the Sharī'ah board is adequately resourced and serviced; is competent by way of having the relevant skills and expertise; and measures are in place to address any potential conflicts of interest of the Sharī'ah board members.

CPICM 3 also factors in sufficiency of the powers, resources and competence of the regulator on matters of Sharī'ah compliance where the regulator has functional responsibility and accountability in relation to the aforementioned.

(Paragraph 97, CPICM 2 and 3)

**Q7. Are there any additional regulatory considerations for Islamic Collective Investment Schemes addressed by the CPICM?**

**Answer:** CPICM 26 sets out additional requirements for the eligibility criteria for ICIS operators to ensure that it takes into account certain minimum requirements that ICIS operators should meet if they are to operate in the ICM, including possession of an adequate level of knowledge in Islamic finance to ensure the fund's operations adhere to Sharī'ah principles. In addition, it also includes additional provisions for the regulatory framework, to require ICIS operators to have in place appropriate and effective systems and mechanisms for monitoring ex-ante and ex-post Sharī'ah-compliance.

CPICM 28 also requires the regulatory framework to include additional disclosures that take into account the specificities of ICIS, in line with IFSB-19, including but not limited to, sufficient disclosures about the ICIS's Sharī'ah governance arrangements as well as their ongoing compliance with Sharī'ah; continuing disclosures about operational matters and their compliance with Sharī'ah principles, and; adequate disclosures for special types of ICIS that reflect their specific structures, operational considerations and risks.

(CPICM 26 and 28)

**Q8. Are there any additional considerations addressed by the CPICM for credit rating agencies in the Islamic capital market?**

**Answer:** CPICM 24 sets out an additional requirement that regulatory frameworks ensure credit ratings assigned through different methodologies are consistent and comparable across conventional and Islamic securities. It means that credit rating agencies (CRA) should take into account essential differences and characteristics distinguishing Islamic securities and a CRA must therefore, rate an Islamic security based on its nature, taking into account the differences from conventional securities in terms of its underlying structure. For example, if it represents debts only, as in the case of murābahah ṣukūk, it cannot be traded unless at par; whereas if it represents shares of undivided ownership in assets, it can be traded based on an agreed-upon price between the two parties. Such basic financial, credit, risk or other characteristics must be taken into consideration when rating Islamic securities, since the violation of such characteristics would result in Sharī'ah non-compliance risk, which should in turn impact the rating. As a result, if CRAs' methodologies neglect the specificities of Islamic securities and their characteristics this will result in the issuance of defective ratings. Thus, CPICM 24 sets out specific requirements for regulatory frameworks concerning credit rating agencies to require that the differences between Islamic and conventional securities be taken into account when issuing ratings.

However, it also specifies that if a CRA applies the same methodology to both conventional and Islamic securities, regulators should ensure that Islamic and conventional products which are similarly rated are equivalent enough in terms of their features and risk characteristics to be rated using the same methodology and that there are no material risks (for example, arising from the structure of the product) that the methodology does not capture. On the other hand, where CRAs claim to undertake rating services that are specific for Islamic securities or use a separate methodology, regulators are also expected to ensure that the methodologies used are clearly defined, consistent and comparable with ratings for conventional securities.

(Paragraphs 487 and 488)

**Q9. What are the additional requirements that regulators should have for capital market intermediaries operating in the Islamic capital market?**

**Answer:** CPICM 30 addresses specific considerations in relation to authorisation or licensing requirements for market intermediaries involved in Islamic capital market activity. It requires that if a market intermediary claims Sharī'ah compliance in any of its activities, relevant regulatory requirements should be present to ensure that such claims are being upheld. This includes provisions within the minimum standards or criteria that applicants for licensing must meet, including but not limited to knowledge of Islamic capital markets and Sharī'ah principles, as well as the presence of adequate sharī'ah governance processes and mechanisms within the internal processes or functions of the market intermediary.

The standard does not specify any additional considerations for capital adequacy requirements for market intermediaries, since this has not been well-studied thus far, from an Islamic capital market perspective at this time.

CPICM 32 includes additional considerations for market intermediaries in the Islamic capital market, particularly in relation to the fact that regulatory frameworks should require intermediaries to have internal functions that ensure adherence to internal procedures including continuing compliance with the rulings of a Sharī'ah board or similar body, where a market intermediary makes a claim of Sharī'ah-compliance in relation to itself or specific products or services that it is marketing.

(CPICM 30 and 32)

**Q10. Does the CPICM address cross border issues for regulation of Islamic capital market activities?**

**Answer:** Specific to ICM, issues may arise in relation to cross-border activities, such as the issuance of cross-border sukūk, which may require cooperation between regulators in terms of, for example, additional records of underlying assets to support sukūk structures, and to ensure compliance with respective laws and regulations, including on matters of Sharī'ah. In this respect, IFSB -21 notes the importance of international cooperation between regulators for the effective regulation and supervision of domestic markets. In the context of the ICM in particular, it notes that cross-border issuances and listing of securities may require international cooperation to gauge any differences in interpretation of Sharī'ah, which may impact the Sharī'ah compliance status of securities in the respective markets.

In relation to the aforementioned considerations, CPICM 10 requires the regulator to have in place cooperation arrangements to manage cross-border activities in ICM in the light of differing Sharī'ah interpretations.

In addition, CPICM 16 requires domestic regulators to be able to offer effective and timely assistance to foreign regulators in obtaining, among other things, reports from a competent Sharī'ah board/authority as to whether the asset/project backing a security sold/listed/issued cross-border is Sharī'ah-compliant.

These provisions are in addition to the cross border issues addressed by the IOSCO principles which are equally applicable and retained within the CPICM.

(Paragraphs 310, 318, and CPICM 10)