

Frequently Asked Questions (FAQs) on: IFSB-26: Core Principles for Islamic Finance Regulation (Financial Market Infrastructure)

Q1. How does IFSB-26 differ from “Principles for Financial Market Infrastructures” issued by CPSS-IOSCO?

Answer: IFSB-26 complements the PFMI (CPSS-IOSCO Principles for Financial Market Infrastructures). Particularly, it is built on the CPSS-IOSCO’s PFMI and its associated Disclosure Framework and Assessment Methodology (collectively referred to as “the CPSS-IOSCO Documents”), to address areas in which the existing CPSS-IOSCO Documents either do not deal, or deal inadequately, with the specificities of Islamic finance. It has also taken into account some lessons learned from the COVID-19 pandemic, particularly in areas relating to the operational resilience of FMIs (Financial Market Infrastructure).

Q2. Is implementing IFSB-26 mandatory to IFSB members?

Answer: To encourage consistency in implementation of IFSB standards across jurisdictions, it is recommended that RSAs implement the standard in their jurisdictions effective from January 2024 onwards. This should take into account an adequate pre-implementation period starting from the issuance date of this standard, for the standard to be embedded into national regulations and guidelines, and where applicable, implemented into supervisory practices. RSAs are encouraged to implement the standard earlier than this date, where they are able to do so. RSAs should consider proportionality in applying this standard by taking account of the size, nature, and complexity of the FMIs and the characteristics of the ICM environment in which they operate.

Q3. What are the advantages of implementing IFSB-26 for the regulatory and supervisory authorities (RSAs)?

Answer: The IFSB envisages that the CPIFRFMI will be used by jurisdictions as a benchmark for assessing the quality of their regulatory and supervisory systems, and for identifying future work to achieve a baseline level of sound regulations and practices for Islamic FMIs. Furthermore, it enables self-assessment of the effectiveness of the jurisdictions existing regulatory and supervisory regime for Islamic FMIs. The development of CPIFRFMI is also intended to promote further integration of Islamic finance with the international architecture for financial stability and operational efficiency, especially in the area of securities clearing and settling, payment, and data recording in the FMIs.

Q4. What is the purpose of the set of questions (titled as Questions by Key Consideration) that follows each Principle presented in IFSB-26?

Answer: These questions are part of the assessment methodology that an assessor (during a self-assessment or a third-party assessment) may ask, in order to assess whether the minimum benchmarks listed in the key considerations have been implemented in the jurisdiction being assessed.

The questions outlined are intended to inform and guide the judgment of assessors, not to replace it. The assessment methodology provided in IFSB-26 is intended to assist assessors in correctly applying the principles to both private and public sector FMIs, taking into account differences in ownership structures and organisational forms.

Q5. What is the difference between Islamic financial market infrastructure and Islamic capital market?

Answer: FMI (Financial Market Infrastructure) is defined as a multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities or other financial transactions. FMIs typically establish a set of common rules and procedures for all participants, a technical infrastructure, and a specialised risk management framework appropriate to the risks they incur. FMIs provide participants with centralised clearing, settlement, and recording of financial transactions among themselves or between each of them and a central party to allow for greater efficiency and reduced costs and risks.

Meanwhile, Islamic capital market (ICM) comprises Sharī'ah-compliant stocks, sukūk (Islamic bonds), Islamic collective investment schemes (ICIS) and Islamic risk management products. The ICM plays the same fundamental role as conventional capital markets; that is, it is used to raise funds in the form of securities and to provide savers with an outlet for their capital. These fundamental aims are supported by mechanisms for trading, whether on- or off-exchange, and for risk management.

Q6. In the components of financial market infrastructure, what is the difference between the Central Securities Depositories (CSD) and Central Counterparties (CCP)?

Answer: A central securities depository (CSD) provides securities accounts, central safekeeping services, and asset services, which may include the administration of corporate actions and redemptions, and plays an important role in helping to ensure the integrity of securities issues. Meanwhile, a central counterparty (CCP) interposes itself between counterparties to contracts traded in one or more financial markets, becoming the buyer to every seller and the seller to every buyer and thereby ensuring the performance of open contracts.

Q7. Why do Central Counterparties (CCP) have the highest number of issues related to shariah non-compliance risk?

Answer: A CCP becomes a party to every trade and has the fundamental role of ensuring that trades can be settled even if a party defaults. To do this, it will hold substantial financial resources, either its own funds or collateral deposited by participants, or both. The types of asset that can be accepted, and the way in which resources can be held, will raise Sharī'ah issues. So will the way these resources can be deployed. Moreover, there will typically be a default fund, and the way in which this fund is structured and used may also raise Sharī'ah issues. Additionally, the processes for dealing with a default may also raise Sharī'ah issues, where the defaulting party acts on behalf of many clients.

A common aim will be to protect their clients and transfer their trading positions to another, non-defaulting, member, but this may not be straightforward. A CCP from a Sharī'ah

perspective undertakes the settlement of transactions by delivery of assets and payments and is not a buyer or a seller in the transaction's origin. Regulations should be in line with this reality. If a seller defaults in delivery of the asset, the CCP will, on the buyer's behalf, buy an asset and deliver to the buyer using in the first instance the collateral deposited by the seller to the CCP. If the buyer defaults, the CCP will make the payment on the buyer's behalf from the collateral he has deposited to the CCP. If the participant's funds are not sufficient, a CCP will use its own financial resources to settle a default and claim them back from the defaulting participant. If financial resources provided by other participants are used, the defaulting participant will remain liable until he pays them back (with no interest).

Q8. Why is applying haircuts necessary in valuing a collateral?

Answer: To ensure the operation of the market is not disrupted during a highly volatile market environment arising from a crisis, an FMI may consider accepting broader forms of collaterals and imposing a lenient approach towards haircuts on any collateral accepted, while being mindful of the risk associated with such arrangement.

Q9. Why are collateral issues (e.g. calculation) more critical for a CCP compared to other FMIs?

Answer: CCPs become a buyer to every seller and seller to every buyer and therefore takes on counterparty credit risk. CCPs utilise risk management and counterparty credit mitigation tools that, among other things, incentivize their market participants to effectively manage their risks. These tools include the collection of collateral (initial margin) and other tools, that implement a "defaulter pays" model through which market participants are incentivised to manage their risks and meet their obligations to the CCP.

A CCP should cover its credit exposures to its participants for all products through an effective Shari'ah-compliant collateral system that is risk-based and regularly reviewed. A CCP should adopt initial collateral models and parameters that are risk-based and generate collateral requirements sufficient to cover its potential future exposure to participants in the interval between the last collateral collection and the close out of positions following a participant default. Initial collateral should meet an established single-tailed confidence level of at least 99 percent with respect to the estimated distribution of future exposure.

For a CCP that calculates collateral at the portfolio level, this requirement applies to each portfolio's distribution of future exposure. For a CCP that calculates collateral at more-granular levels, such as at the subportfolio level or by product, the requirement must be met for the corresponding distributions of future exposure. The model should (a) use a conservative estimate of the time horizons for the effective hedging or close out of the particular types of products cleared by the CCP (including in stressed market conditions), (b) have an appropriate method for measuring credit exposure that accounts for relevant product risk factors and portfolio effects across products, and (c) to the extent practicable and prudent, limit the need for destabilising, procyclical changes.

Q10. What is the best practice for treating the interest received on settlement accounts held at a central bank?

Answer: If an FMI has access to central bank accounts, payment services, securities services, or collateral management services, it should use these services, where practical, to enhance its management of liquidity risk. An FMI that has such access should also seek arrangements

with the central bank to ensure that it neither receives nor pays interest and complies with other Sharī'ah requirements.

Q11. What are the differences between individual and omnibus accounts in terms of structure, cost, and level of protection to participant's customers?

Answer: CCP should employ an account structure that enables it readily to identify positions of a participant's customers and to segregate related collateral. A CCP should maintain customer positions and collateral in individual customer accounts or in omnibus customer accounts.

A CCP should disclose its rules, policies, and procedures relating to the segregation and portability of a participant's customers' positions and related collateral. In addition, a CCP should disclose any constraints, such as legal or operational constraints, that may impair its ability to segregate or port a participant's customers' positions and related collateral. The degree of protection achievable for customer collateral will depend on whether customers are protected on an individual or omnibus basis and the way initial collateral is collected (gross or net basis) by the CCP.

Each of these decisions will have implications for the risks the CCP faces from its participants and, in some cases, their customers. The CCP should understand, monitor, and manage these risks. Similarly, there are advantages and disadvantages to each type of account structure that the CCP should consider when designing its segregation regime.

Q12. How does operational risk differ from general business risk?

Answer: General business risk refers to the risks and potential losses arising from an FMI's administration and operation as a business enterprise that are neither related to participant default nor separately covered by financial resources under the credit or liquidity risk principles. General business risk includes any potential impairment of the FMI's financial position (as a business concern) as a consequence of a decline in its revenues or an increase in its expenses, such that expenses exceed revenues and result in a loss that must be charged against capital. Such impairment can be caused by a variety of business factors, including poor execution of business strategy, negative cash flows, or unexpected and excessively large operating expenses. Meanwhile, business-related losses also may arise from risks covered by other principles, for example, legal risk (in the case of legal actions challenging the FMI's custody arrangements), investment risk affecting the FMI's resources, and operational risk (in the case of fraud, theft, or loss). In these cases, general business risk may cause an FMI to experience an extraordinary one-time loss as opposed to recurring losses.

Q13. What does "fit and proper criteria" mean in the context of shariah board members?

Answer: The IIFS should ensure its Sharī'ah board has suitable qualifications, training, skills, practical experience and commitment to effectively discharge its role and responsibilities. Members of the Sharī'ah board may be required to follow certain behavioural standards, particularly in regard to the protection of confidential information, as well as other measures such as abiding by, where available and at the discretion of the regulator, specific codes of conduct, governance standards, and restrictions in place on the number and types of Sharī'ah boards they may sit on concurrently.

Q14. What is the main criteria that must be used by authorities in classifying an FMI (e.g. payment system, CCP, CSD, etc) as systemically important?

Answer: Systemically important payment systems, CSDs, SSSs, CCPs, and TRs are typically subject to regulation, supervision, and oversight because of the critical role that they play in the financial system. Criteria that are often considered in determining the need for or degree of regulation, supervision, and oversight for various types of FMIs include (a) the number and value of transactions processed, (b) the number and type of participants, (c) the markets served, (d) the market share controlled, (e) the interconnectedness with other FMIs and other financial institutions, and (f) the available alternatives to using the FMI at short notice.

Authorities may also want to designate FMIs as systemically important on the basis of other criteria relevant in their jurisdictions for the purposes of applying the CPSS-IOSCO Principles for financial market infrastructures.

Q15. Annex A provides assessment methodology for the principles related to financial market infrastructure. How can this be helpful to the authorities?

Answer: Annex A is prepared to guide FMIs, authorities and IFIs in assessing an FMI's observance of the PFMI. This assessment methodology is designed to cover all the types of FMIs to which the principles apply – that is, systemically important payment systems, CSDs, SSSs, CCPs and TRs. In conducting an assessment of an FMI's observance of the principles, assessors should take into account a number of considerations, including but not limited to:

- a. Customisation of the assessment for each FMI
- b. Applicability of the assessment methodology to public-sector-owned FMIs
- c. General instructions for completing an assessment of the principles

There are the six steps involved in an assessment of the principles: (1) determine the appropriate scope of an assessment; (2) gather facts on each applicable key consideration; (3) develop key conclusions for each principle; (4) assign a rating for each principle; (5) indicate an appropriate time frame for addressing each identified issue of concern, if any, including a discussion of priorities; and (6) prepare an assessment report.
