



ISLAMIC FINANCIAL SERVICES BOARD

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**IFSB-16**

**REVISED GUIDANCE ON KEY ELEMENTS  
IN THE SUPERVISORY REVIEW PROCESS  
OF INSTITUTIONS OFFERING ISLAMIC FINANCIAL  
SERVICES (EXCLUDING ISLAMIC INSURANCE  
(*TAKĀFUL*) INSTITUTIONS AND ISLAMIC  
COLLECTIVE INVESTMENT SCHEMES)**

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March 2014

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The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, among others, the issuance of exposure drafts, holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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## ACRONYMS

AMA	Advanced measurement approach
ASA	Alternative standardised approach
AT1	Additional Tier 1
BCBS	Basel Committee on Banking Supervision
BOD	Board of directors
CAR	Capital adequacy ratio
CCR	Counterparty credit risk
CET1	Common Equity Tier 1
CMF	Commodity <i>Murābahah</i> Financing
CMLF	Commodity <i>Murābahah</i> for Liquid Funds
CMT	Commodity <i>Murābahah</i> transactions
CRO	Chief risk officer
DCR	Displaced commercial risk
D-SIBs	Domestic Systemically Important Banks
EAD	Exposure at default
ECAI	External credit assessment institution
ERM	Enterprise risk management, also known as firm-wide risk management (FRM)
FSB	Financial Stability Board
GC	Governance Committee
GN-1	<i>IFSB Guidance Note on Recognition of Ratings by External Credit Assessment Institutions on Sharī'ah-Compliant Financial Instruments</i> , March 2008
GN-2	<i>IFSB Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity Murābahah Transactions</i> , December 2010
GN-3	<i>IFSB Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders</i> , December 2010
GN-4	<i>IFSB Guidance Note in Connection with the IFSB Capital Adequacy Standards: The Determination of Alpha in the Capital Adequacy Ratio</i> , March 2011
HQLA	High quality liquid assets
IAH	Investment account holder of PSIA – see PSIA, below
IAIS	International Association of Insurance Supervisors
ICAAP	Internal capital adequacy assessment process
IFSB	Islamic Financial Services Board
IFSB-1	<i>IFSB Guiding Principles of Risk Management</i> , December 2005
IFSB-2	<i>IFSB Capital Adequacy Standard</i> , December 2005
IFSB-3	<i>IFSB Guiding Principles on Corporate Governance</i> , December 2006
IFSB-4	<i>IFSB Disclosure to Promote Transparency and Market Discipline</i> , December 2007
IFSB-5	<i>IFSB Guidance on Key Elements in the Supervisory Review Process</i> , December 2007
IFSB-7	<i>IFSB Guiding Principles on Capital Adequacy Requirements for Sukūk, Securitisations and Real Estate Investment</i> , January 2009
IFSB-9	<i>IFSB Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services</i> , December 2009
IFSB-10	<i>IFSB Guiding Principles on Sharī'ah Governance System</i> , December 2009
IFSB-12	<i>IFSB Guiding Principles on Liquidity Risk Management for IIFS</i> , March 2012
IFSB-13	<i>IFSB Guiding Principles on Stress Testing for Institutions offering Islamic Financial Services</i> , March 2012
IFSB-15	<i>IFSB Revised Capital Adequacy Standard</i> , December 2013
IFSI	Islamic financial services industry
IIFS	An institution (or institutions) offering Islamic financial services in the banking segment [other than Islamic insurance ( <i>Takāful</i> ) institutions and Islamic collective investment schemes]
ILAAP	Internal liquidity adequacy assessment process
IOSCO	International Organization of Securities Commissions
IRB	Internal ratings-based
IRR	Investment risk reserves
ISCU	Internal <i>Sharī'ah</i> compliance unit
ISRU	Internal <i>Sharī'ah</i> review unit
KYC	Know-Your-Customer

LCR	Liquidity coverage ratio
LGD	Loss given default
LOLR	Lender of last resort
MOA	Memorandum of agreement
MOU	Memorandum of understanding
NFSR	Net stable funding ratio
OTC	Over-the-counter
PD	Probability of default
PER	Profit equalisation reserve
PSIA	Profit-sharing investment accounts
RIAH	Restricted investment account holders
ROR	Rate of return
RSA	Regulatory and supervisory authority
RSRPWG	Revised Supervisory Review Process Working Group
RWA	Risk-weighted assets
SAG	Standards and Guidance Notes
SLRP	Supervisory liquidity review process
SM	Senior management
SNCR	<i>Sharī'ah</i> non-compliance risk
SLOLR	<i>Sharī'ah</i> -compliant lender of last resort
SPE	Special-purpose entity
SSB	<i>Sharī'ah</i> Supervisory Board
TSA	The standardised approach
UIAH	Unrestricted investment account holder
UPSIA	Unrestricted profit-sharing investment accounts
VaR	Value at Risk

## **Bismillahirrahmanirrahim**

*Allahummasalliwasallim 'alaSayyidina Muhammad wa'alaalihiwasahbihi*

### **SECTION I: INTRODUCTION**

#### **1.1 Background**

1. The Islamic Financial Services Board (IFSB) issued its *Guidance on Key Elements in the Supervisory Review Process of Institutions offering Islamic Financial Services (IIFS) [excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds]* (hereinafter referred to as IIFS-5) in December 2007. IIFS-5 took a risk-based approach to the process of supervisory review and addressed the supervisory implications of the various categories of risk that IIFS face in their operations.

2. The IFSB has issued several Standards and Guidance Notes (SAG) with respect to three segments of the Islamic financial services industry (IFSI) – namely banking, *Takāful* and capital markets – since the issuance of IIFS-5. Some of these SAG, with respect to the banking segment, have discussed a broad range of prudential issues, which have relevance to the need for revision of IIFS-5. Those SAG which may have relevance to the revision of IIFS-5 are indicated below.<sup>1</sup>

- (a) IIFS-15: *Revised Capital Adequacy Standard*, December 2013.
- (b) IIFS-7: *Capital Adequacy Requirements for Sukūk, Securitisations and Real Estate Investment*, January 2009.
- (c) IIFS-10: *Guiding Principles on Sharī'ah Governance System*, December 2009.
- (d) IIFS-12: *Guiding Principles on Liquidity Risk Management for IIFS*, March 2012.
- (e) IIFS-13: *Guiding Principles on Stress Testing for IIFS*, March 2012.
- (f) GN-1: *Guidance Note in Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on Sharī'ah-Compliant Financial Instruments*, March 2008.
- (g) GN-2: *Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity Murābahah Transactions*, December 2010.
- (h) GN-3: *Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders*, December 2010.
- (i) GN-4: *Guidance Note in Connection with the IFSB Capital Adequacy Standard: The Determination of Alpha in the Capital Adequacy Ratio*, March 2011.

3. Following the issuance of IIFS-5, a number of supervisory authorities have implemented this Standard in their respective jurisdictions.<sup>2</sup> The IFSB took feedback, through various platforms (such as seminars, supervisory and regulatory forums, roundtables and workshops) and from all its stakeholders (e.g. supervisory authorities, market players), on those areas which need to be updated in relation to the supervisory review process of IIFS. In particular, the “Facilitating the Implementation of the IFSB Standards” (FIS) workshops conducted in the member countries resulted in the identification of important supervisory issues which were not covered in IIFS-5 (see paragraph 6), thus calling for appropriate changes in the existing IIFS-5 to take into account the developments occurring internationally in the supervisory review process.

4. With the background of the financial and economic crisis (2008), the global regulatory landscape witnessed a number of developments and reforms which have resulted in the issuance of various publications by the Basel Committee on Banking Supervision (BCBS).<sup>3</sup> These developments and reforms included enhancements to Basel II resulting in Basel 2.5, which itself has now moved on to a new framework known as Basel III – comprising both micro- and macroprudential measures. Among other things, in July 2009, the BCBS made significant enhancements to its Basel II framework of the supervisory review process (referred to as Pillar 2). It also published, in March 2013, a draft Supervisory Framework for measuring and controlling large exposures.

<sup>1</sup> In addition to the above publications, the IFSB is also preparing *Guidance Note on Quantitative Measures for Liquidity Risk Management in IIFS*, which may be relevant during the course of revising IIFS-5.

<sup>2</sup> IIFS Standards Implementation Survey, July 2011.

<sup>3</sup> Section 7 of the Standard Operating Procedures of the IFSB indicates that the IFSB Secretariat *shall remain vigilant about any new developments and changes taking place in respect of the standards issued by other international bodies that may have an impact on the IFSB's Standards and Guidelines.*

5. Based on the above considerations, and in line with the IFSB mandate to develop prudential SAG to promote the soundness and stability of the IFSI, the Council of the IFSB, in its 19<sup>th</sup> meeting held on 17 November 2011 at the IFSB Headquarters, Kuala Lumpur, Malaysia, approved the revision of IFSB-5 and the formation of a Revised Supervisory Review Process Working Group (RSRPWG).

## 1.2 Main Premises and Objectives

6. The overall aim of this document is to revise and replace IFSB-5 in setting forth guidance on key elements in the supervisory review process for authorities supervising IIFS (excluding Islamic insurance (*Takāful*) institutions and Islamic collective investment schemes) taking into consideration the specificities of the IIFS, the lessons learned from the crisis, while complementing the existing international standards on the supervisory review process, in particular those of the BCBS. This document represents the views of the IFSB on (a) the IFSB Standards that the IIFS are expected to observe; and (b) the practices that supervisory authorities are expected to apply. The areas addressed by this guidance include, *inter alia*:

- (a) regulatory capital requirements;
- (b) internal capital adequacy assessment process (ICAAP);
- (c) risk management, including enterprise risk management;
- (d) corporate and *Shari'ah* governance;
- (e) securitisation exposures;
- (f) concentration risk and counterparty credit risk;
- (g) assessment of the rate of return risk in the banking book;
- (h) sound stress testing practices;
- (i) Islamic windows operations;
- (j) consolidated and home-host supervision, and supervisory colleges; and
- (k) transparency and market discipline.

7. This document takes a risk-based approach<sup>4</sup> to the process of supervisory review. Accordingly, later in the document the supervisory implications of the various categories of risk that IIFS face in their operations will be discussed.

8. The emergence of institutions that provide a wide range of Islamic financial services has resulted in some supervisory authorities prescribing additional requirements in order to address elements that are specific to Islamic finance, including risk characteristics and issues relating to *Shari'ah* compliance. The requirements include guidelines or frameworks relating to fit and proper requirements for *Shari'ah* scholars, rate of return calculation methodology and the scope of *Shari'ah* audits.

9. Therefore, in view of the developments that are taking place in the industry, the IFSB has reviewed and taken note of best practice as applied by various authorities supervising IIFS. This document is intended to foster convergence towards best practice among authorities supervising IIFS by establishing a minimum standard, enabling such supervisory authorities to meet their requirements when carrying out the roles expected of them in the light of IFSB standards.

10. The IFSB notes that the revision of IFSB-5 is necessary in order to ensure that the supervisory review process covering IIFS will be consistent with those for conventional institutions and relevant to the current state of the industry, while catering for the specificities of *Shari'ah*-compliant financial transactions and promoting the financial soundness of the IIFS. The document highlights the need for a broader focus in providing guidance to IIFS and supervisory authorities, as the Standard will strengthen the management of risks in IIFS and complement the IFSB's revised *Capital Adequacy Standard* (IFSB-15).

## 1.3 General Principles

11. **The supervisory authority shall satisfy itself as to the adequacy of various compliance aspects with reference to the IFSB Standards, including those on capital requirements, risk management, governance structure and processes, *Shari'ah* governance, transparency and market discipline, and stress testing.**<sup>5</sup>

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<sup>4</sup> The term "risk-based approach" as used in this document refers to the supervisor's approach to a supervised institution being based on its assessment of the risks to which the institution is exposed and of the institution's capability to manage these risks.

<sup>5</sup> Supervisory authorities will also need to supervise compliance with other provisions implemented in their own jurisdictions but not (or not yet) covered in the IFSB Standards. Some of the material in this Standard will also be relevant to such supervision.

12. While the primary responsibility for compliance with applicable *Sharī'ah* rulings rests with the management of IIFS, supervisory authorities have to satisfy themselves that IIFS have an appropriate internal compliance system, with policies and procedures in place to ensure compliance. In this respect, supervisory authorities should ensure that IFSB-10 (on *Sharī'ah* governance) is being adhered to in their respective jurisdictions.

13. With respect to ICAAP, four internationally agreed principles underpinning supervisory review in Basel II Pillar 2 are equally applicable in a broader sense for IIFS, and they are discussed in section 3.2.

14. The risks that IIFS assume vary according to, *inter alia*, the types of financing contracts used; therefore, the supervisory authority shall satisfy itself that IIFS (a) understand and control the risks at every contract stage; and (b) have systems and controls in place to ensure compliance with *Sharī'ah* rules and principles. The supervisory authority may consider developing a set of guidelines when reviewing the operations of IIFS, including evaluating their management systems for investment programmes and asset allocation practices in order to safeguard various stakeholders' interests, particularly those of the investment account holders (IAH) and especially the unrestricted IAH. Supervisory authorities need to carefully address the investor protection issues raised by the IIFS' role as managers of funds placed with them by the IAH.

15. In a situation where systems are not properly set up, the supervisory authority should require the IIFS concerned to take corrective actions so that the IIFS is managed in a prudent manner. Supervisory authorities should have the necessary authority, powers and procedures to ensure that they can enforce compliance of any remedial or corrective actions required of an IIFS.

16. In assessing the risks relevant to capital requirements as per the *Revised IFSB Capital Adequacy Standard* (IFSB-15), the supervisory authority has the option to require an IIFS to employ either the Standard Formula or the Supervisory Discretion Formula, depending on the circumstances, to measure its minimum capital requirement.<sup>6</sup>

17. Supervisory authorities need to apply an appropriate capital adequacy approach that reflects: (a) the extent to which the IAH bear the risks of the assets in which their funds are invested; (b) the existence of reserves within the equity of IAH to absorb periodic losses (investment risk reserves (IRR)); (c) the existence of reserves within their equity and that of shareholders to smooth profits (profit equalisation reserves (PER)); and (d) the implications of the formula used for the overall Islamic financial system. In the case of the Standard Formula, the IAH are treated as investors rather than as depositors. Hence, the supervisory emphasis would need to be on issues of investor protection, rather than on capital requirements in respect of the assets financed by IAH funds.

**18. It is important to note the notion of balance between the minimum capital adequacy requirements, supervisory review process, transparency, and market discipline in the regulation and supervision of IIFS.<sup>7</sup> Each aspect is important, but none alone is sufficient for achieving the objectives of supervision of the IIFS industry sector.**

19. Accordingly, within the existing infrastructures in their jurisdictions, 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 the areas mentioned in paragraph 6. Further, in supervising the IIFS under their jurisdiction, supervisory authorities should have an explicit focus on prudential risk, rather than being merely compliance oriented. In this respect, the key elements of the supervisory process should sufficiently cover identification of vulnerabilities, escalation of findings and decision making; deliver appropriate preventive and corrective actions; and, where necessary, contribute to appropriate resolution, recovery strategies and processes.

#### **1.4 Scope and Application**

20. In general, the scope and application of this guidance will be determined by reference to the adoption of the other applicable IFSB Standards and guiding principles. The guidance is primarily intended to guide the firm-level supervision of full-fledged banking IIFS with due consideration to "proportionality" taking account of their size, sophistication and complexity, and references to IIFS

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<sup>6</sup> For details on these formulas, refer to IFSB-15, *Revised Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services*, December 2013, Appendix A.

<sup>7</sup> This is similar to the pillar structure, on which the Basel II and III frameworks are based.

should be read in that light. These IIFS include, but are not limited to, commercial banks, investment banks and other fund mobilising institutions, as determined by the respective supervisory authorities, that offer services in accordance with *Shari'ah* rules and principles.

21. Supervisory authorities may, at their discretion, extend the application of this guidance to Islamic “window” operations that are self-contained, or to other IIFS that fall within their jurisdictions. Islamic “windows” are dealt with specifically in section 3.8, which covers in detail both the supervisory review process of “windows” and guidance on factors that supervisory authorities should consider with respect to extending certain IIFS SAG to “windows”.

22. The IFSB encourages authorities supervising IIFS to include measures (qualitative and quantitative) relating to elements in this document in their regulatory policy and/or supervisory review programme.

23. The supervisory review process culminates in a formalised and structured supervisory strategy, which staff will follow when conducting *off-site surveillance* and *on-site examinations* (see section 2.4 for more detail). The supervisory authority needs to assess the risk profile and evaluate the appropriateness and adequacy of the risk management processes. Based on these assessments, the supervisory authority may determine the extent of on-site transaction testing (i.e. *on-site examination* on specific areas, products and services). The IIFS with the highest risk exposures should be expected to undergo the most rigorous scrutiny, analysis and transaction testing by the supervisory authority.

24. IIFS are setting up branches and subsidiaries in other countries, and investing in activities not traditionally undertaken by conventional financial intermediaries. In this context, and where separate supervisory agencies are responsible for certain regulatory requirements, coordination and cooperation among these authorities are expected in order to ensure effective consolidated supervision and stability of the financial system.

25. Supervisors may have macroprudential as well as microprudential responsibilities. Assessment of macroprudential risks will be partly informed by trends seen in the course of firm-based supervision, but will also draw heavily on macroeconomic data. This is a developing field which is not treated in detail in this Standard.

## **1.5 Stock-taking Initiative**

26. In the course of revising IFSB-5, the RSRPWG carried out an industry-wide survey during the period from 24 October to 30 November 2012 in order to verify the understanding that the working group members had so far developed regarding the actual supervisory review process for IIFS.<sup>8</sup> The main rationale of the survey questionnaire was to assess the existing practices of the supervisory review process in different jurisdictions and to provide background information to the RSRPWG for the revision of IFSB-5. This guidance aims to reflect the best practices that were identified while addressing the notable gaps in the context of the supervisory review process.

## **1.6 Implementation Date**

27. The Revised Standard should be implemented by supervisory authorities in compliance with the legal framework of their respective jurisdictions. The IFSB will expect its members to apply this Standard from January 2015 (or later where the relevant application date of the substantive underlying provision is later), meaning that by this date the guidance should be transposed into national supervisory guidelines and be reflected in the national supervisory manuals/handbooks, where applicable, and implemented in supervisory practices.

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<sup>8</sup> The survey questionnaire was distributed between 24 October and 30 November 2012 to all 38 banking regulatory and supervisory authorities (RSAs), including central banks and monetary authorities, who are members of the IFSB. The IFSB received 35 responses out of the total of 38 RSAs, a response rate of 92%. These RSAs were geographically distributed across a number of important regions of the world.

## SECTION II: SUPERVISORY PRECONDITIONS, CRITERIA AND APPROACHES FOR EFFECTIVE SUPERVISION OF IIFS

### 2.1 Necessary Preconditions for Effective Supervision

28. In jurisdictions where IIFS operate alongside conventional institutions, the supervisory authority needs to recognise the requirement for a regulatory framework that is both consistent with Islamic precepts and able to meet internationally acceptable prudential requirements, as well as providing a level playing field for both IIFS and conventional institutions.

29. The revised Basel Core Principles<sup>9</sup> document sets out “preconditions” (i.e. necessary conditions) for effective banking supervision. These are generally matters that are outside the direct or sole jurisdiction of banking supervisors. Supervisors who have concerns that the preconditions could impact the efficiency or effectiveness of regulation and supervision of banks should make the government and relevant authorities aware of their concerns, and of the preconditions’ actual or potential negative repercussions for supervisory objectives. The preconditions include:

- (a) sound and sustainable macroeconomic policies;
- (b) a well-established framework for financial stability policy formulation;
- (c) a well-developed public infrastructure;
- (d) a clear framework for crisis management, recovery and resolution;
- (e) an appropriate level of systemic protection (or public safety net); and
- (f) effective market discipline.

30. In principle, the broad preconditions are equally relevant for the IFSI; however, they need to be properly adapted to provide a basis for effective supervision of Islamic financial services institutions.<sup>10</sup> In particular, a well-developed public infrastructure in the context of a supervisory regime for IIFS in a jurisdiction would include the following elements, *inter alia*:

- (a) a system of business laws, including corporate, bankruptcy, contract, consumer protection and private property laws, which is consistently enforced and provides a mechanism for the fair resolution of disputes;
- (b) comprehensive and well-defined accounting principles and rules that are accepted internationally;
- (c) a system of independent external audits, to ensure that users of financial statements, including banks, have independent assurance that the accounts provide a true and fair view of the financial position of the company and are prepared according to established accounting principles, with auditors held accountable for their work;
- (d) an efficient and independent judiciary;
- (e) availability of competent, independent and experienced professionals (e.g. accountants, auditors and lawyers), whose work complies with transparent technical and ethical standards set and enforced by official or professional bodies consistent with international standards, and who are subject to appropriate oversight;
- (f) well-defined rules governing, and adequate supervision of, other financial markets and, where appropriate, their participants;
- (g) secure, efficient and well-regulated payment and clearing systems (including central counterparties) for the settlement of financial transactions where counterparty risks are effectively controlled and managed;
- (h) efficient and effective credit bureaus that make available credit information on recipients of financing<sup>11</sup> and/or databases that assist in the assessment of risks; and
- (i) public availability of basic economic, financial and social statistics.

<sup>9</sup> BCBS: *Core Principles on Banking Supervision*, revised September 2012, paragraph 50.

<sup>10</sup> The IFSB Working Group is currently preparing *Core Principles for Islamic Finance Regulation*, which is expected to address what adaptations to the preconditions are necessary.

<sup>11</sup> The BCBS document *Core Principles on Banking Supervision*, revised September 2012, refers here to “borrowers”.

31. Of the other preconditions, effective market discipline is addressed in the IFSB's *Standard on Transparency and Market Discipline* (IFSB-4). With regard to the soundness and sustainability of macroeconomic policies, it is acknowledged that these are not within the scope of authority of banking supervisors, but the latter will need to react if they perceive that existing policies are undermining the safety and soundness of the banking system. Other preconditions, such as a clear framework for crisis management, recovery and resolution and an appropriate level of systemic protection (or public safety net), are under consideration by the IFSB.

32. Insofar as IIFS cannot obtain funds from conventional lender of last resort (LOLR) facilities or discount windows, as these involve the payment of interest, contingency plans to obtain funds (using *Sharī'ah*-compliant financial instruments) are necessary, and are feasible as is evident from their existence in several countries. It should be noted that liquidity problems in the financial markets across jurisdictions have tested supervisory authorities' ability to manage situations of stress, and highlight the need for effective LOLR facilities to support IIFS in situations of serious stress. The experiences have also indicated the need for supervisory authorities to provide greater clarity on their roles as providers of *Sharī'ah*-compliant liquidity support and *Sharī'ah*-compliant LOLR facilities to the IIFS in both normal and stressed times. (Please refer to IFSB Working Paper on *Strengthening the Financial Safety Net: The Role of Sharī'ah-Compliant Lender of Last Resort (SLOLR) Facilities as an Emergency Financing Mechanism*, April 2014.)

33. The fact that capital and return on investment for profit-sharing investment accounts (PSIA) depend on the IIFS's profitability indicates that transparency is even more crucial in the IFSI than in the conventional sector. Applicable international accounting and auditing standards are the underlying supports for risk management, control systems and market discipline. Accordingly, if these standards are applied and enforced in conjunction with IFSB-4, the information should be accurate, relevant, timely and accessible, to meet the needs of various stakeholders. Implementation of such standards would make it easier to compare financial statements of IIFS, particularly in terms of income recognition and profit calculation. This would enable the IAH to assess the type of investment and risk characteristics, based on IIFSs' disclosure of their investment strategies and risk exposures. A regulatory authority therefore has a role in reinforcing market discipline by requiring timely and relevant information disclosures.<sup>12</sup>

## **2.2 Criteria for Classifying the Institution as an IIFS or Window**

34. Supervisory authorities should outline in their laws and regulations the administrative structure within which they regulate and/or supervise IIFS (or may do so in the future). In this regard, supervisory authorities should indicate the criteria for approving or classifying an institution as an IIFS or an Islamic window in their respective jurisdictions. The supervisory review process and key issues relating to Islamic windows are discussed in section 3.8.

35. While IIFS have a right to practise various *Sharī'ah*-compliant types of activities, as well as to hold instruments of conventional institutions that do not conflict with *Sharī'ah* rules and principles, the supervisory authorities should provide a framework for an internal *Sharī'ah* compliance system within IIFS as proposed by IFSB-10. The framework established by the supervisory authority may include, among other things:

- (a) appropriate requirements when applying for licensing as an IIFS; and
- (b) a broad framework governing applicable Islamic financial transactions, including appropriate governance structure and procedures in place to ensure compliance with *Sharī'ah* rules and principles.

## **2.3 Additional Considerations in the Issuance of an IIFS Licence**

36. Given that the ultimate responsibility for granting a licence to an institution stays with the licensing authority, which has the power to set or apply criteria and reject applications for establishments that do not meet the criteria, the licensing process of the institution should take into account the specificities of IIFS (see paragraph 41). To ensure that the specificities of IIFS are taken into account, supervisory authorities should include additional factors when considering the

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<sup>12</sup> Refer to IFSB-4: *Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds)*, December 2007.



application of an institution seeking a licence as an IIFS compared to one seeking a licence as a conventional financial institution.

37. An institution applying for a licence as an IIFS must ensure that its business and activities are fully *Sharī'ah*-compliant, and establish and maintain effective systems and controls to ensure that it complies with all applicable *Sharī'ah* requirements at all times.<sup>13</sup> The institution must be prepared to implement an Islamic financial business policy and procedures manual and ensure that it complies with all the applicable additional regulatory requirements in respect of its conduct of business,<sup>14</sup> strategic and operating plan, internal controls, risk management and capital adequacy. Following licensing, as part of the supervisory review process, supervisory authorities should check the compliance of the IIFS with respect to its having effective systems and controls for ensuring *Sharī'ah* compliance in all its transactions and operations.<sup>15</sup>

## 2.4 Supervisory Approaches in the Supervision of IIFS

38. In many jurisdictions, IIFS are being supervised through existing arrangements or departments. Supervisory authorities need to ensure that they have the capacity and adequate skill sets (a) to formulate and issue regulations (guidelines); (b) to oversee the implementation in practice of *Sharī'ah* principles; and (c) to supervise the IIFS and Islamic windows through appropriate supervisory tools in their jurisdiction. Depending on the market share and systemic importance of IIFS in the jurisdiction, this may imply a dedicated department or specialist personnel assigned from various departments.

39. In their review, supervisory authorities can employ a wide range of supervisory tools such as *on-site examinations* and *off-site surveillance* to identify, assess, measure and mitigate risks in the IIFS and Islamic windows.

40. *On-site examination* involves detailed inspections of the IIFS conducted at appropriate frequencies and is used as a tool to (a) provide independent verification that adequate policies, procedures and controls exist in IIFS; (b) determine that information reported by IIFS is reliable; (c) obtain additional information on the IIFS and its related companies needed for the assessment of the condition of the IIFS; and (d) monitor the IIFS's follow-up on supervisory concerns, etc. On the other hand, *off-site surveillance* is used as a tool to (a) regularly review and analyse the financial condition of banks; (b) follow up on matters requiring further attention; (c) identify and evaluate developing risks; and (d) help identify the priorities, scope of further off-site and on-site work, etc.<sup>16</sup>

41. Supervisory authorities should conduct regular *on-site examinations* and *off-site surveillance* in providing risk assessment on the activities of the IIFS and evaluation of the adequacy of the IIFSs' risk management control function. The scope and frequency of both *on-site examination* and *off-site surveillance* methodologies should be determined by the respective supervisory authority in line with the specificities of IIFS which may require supervisory authorities to take account of additional considerations in the supervisory assessment of IIFS. These specificities may include, among others: (a) the impact of risk transformation in financing contracts (e.g. *Ijārah* and *Murābahah* financing contracts); (b) legal risks pertaining to the rights of each party in the documentations of the contracts used; (c) operational risk arising from the operationalisation of decisions of the *Sharī'ah* Supervisory Board (SSB); (d) inventory risk embedded within structures of financing such as *Ijārah* and Commodity *Murābahah*; (e) special requirements pertaining to the governance process for *Mushārahah* products; and (f) the development of tools for appropriate measurement of the rate of return risk.

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<sup>13</sup> Refer to IFSB-10: *Guiding Principles on Sharī'ah Governance Systems for Institutions offering Islamic Financial Services*.

<sup>14</sup> Refer to IFSB-9: *Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services*.

<sup>15</sup> As this document indicates, there are many other aspects of the review process apart from issues of *Sharī'ah* compliance.

<sup>16</sup> A reference is made to BCBS: *Core Principles on Banking Supervision*, revised September 2012.

## SECTION III: KEY ELEMENTS IN THE SUPERVISORY REVIEW PROCESS OF IIFS

### 3.1 Regulatory Capital Requirements

42. Supervisory authorities need to satisfy themselves that their regulated entities meet the applicable minimum capital adequacy requirements. Assessment of the appropriate level of the capital adequacy requirements for IIFS should be based on an analysis of the risk exposures arising from the underlying asset portfolio, as well as off-balance sheet exposures and the results of the supervisory review process, taking into account rate of return risk and other risks that may give rise to displaced commercial risk.<sup>17</sup> If the IIFS are required by the supervisory authority to set aside additional capital over and above the normal minimum requirement, the supervisory authority should set out the factors that are the basis for such an additional capital requirement (see paragraph 54).<sup>18</sup>

43. The IFSB's *Revised Capital Adequacy Standard* (IFSB-15) includes revised minimum regulatory capital requirements reflecting those of Basel III with the aim that all risk exposures of an IIFS – both on- and off-balance sheet – are to be adequately covered. The supervisory authority should require each IIFS to demonstrate that its capital is commensurate with the level of its overall risk exposures, including exposures to assets such as real estate or commodities not made as part of the process of financial intermediation, whether these activities are carried out by the IIFS itself or through a subsidiary. The supervisory authority should adopt an approach that is proportionate to the nature, scale and complexity of the IIFS's activities.

44. IFSB-15 covers only the standardised approach<sup>19</sup> to credit risk measurement; however, supervisory authorities, at their discretion, may authorise the use of other approaches (refer to section 3.1.5) for regulatory capital requirement purposes. In any case, supervisory authorities need to reflect in the capital adequacy requirements for IIFS the way in which IIFS carry out their business within their respective jurisdictions. Factors include the different risks to which the IIFS are exposed for various contracts at different contract stages, the different ways in which risks are managed by the IIFS (in view of the limited availability of risk mitigation techniques), and the sharing of risks between IIFS and the IAH (with particular reference to displaced commercial risk).

45. In some jurisdictions, IIFS are required to get approval from the supervisory authority or national *Shari'ah* board to develop instruments for risk mitigation. The broad framework for considering appropriate mitigation techniques may be embodied in the requirement for the *Shari'ah* board's approval and, in certain cases, the supervisory authority will receive a copy of such approval. For the purpose of prudential supervision, the supervisory authority should satisfy itself as to the suitability of these instruments for mitigating risks in the portfolio so as to be recognised as risk mitigants in the capital adequacy requirement. The supervisory authority will need to be aware that the use of risk mitigants may not be fully effective (leaving some residual risks) and can also be subject to operational risk.

#### 3.1.1 Components of Capital and Supervisory Discretion on Buffers

46. In their supervisory review process, supervisory authorities should ensure that IIFS demonstrate and take into account the applicable criteria for various components of capital (in particular, for components other than common equity), as well as regulatory adjustments and deductions attached to these components as reflected in IFSB-15.

47. The definition of (regulatory) eligible capital (i.e. the sum of Tier 1 and Tier 2 capital) for IIFS is provided in IFSB-15, and should be referred to by IIFS in determining the numerator to be used in calculating the capital adequacy ratio (CAR) formula. Tier 1 capital consists of Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1). In this respect, supervisory authorities should ensure that the eligible capital requirements for IIFS, in their respective jurisdictions, are not less than 8% of total risk-weighted assets (RWA) at all times (with CET1 capital of at least 4.5% of RWA at all times; Tier 1 capital (CET1 plus AT1) of at least 6.0% of RWA at all times; and total capital (Tier 1 capital plus Tier

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<sup>17</sup> For further reading on rate of return risk, please refer to IFSB-1: *Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services*, December 2005. Note that rate of return risk for an IIFS may be compared to interest rate risk in the banking book for conventional banks.

<sup>18</sup> Any additional capital charge therefore needs to be made on a clearly stated and non-arbitrary basis subject to any legal constraints. It is a necessary condition of effective supervision that legal constraints do not prevent a supervisor from taking effective action.

<sup>19</sup> The standardised approach of IFSB-15 sets out specific risk weights for certain types of credit risk. IIFS that decide to adopt the standardised approach must either rely on the ratings generated by external agencies or use the standardised risk weights.

2 capital) of at least 8.0% of RWA at all times).<sup>20</sup> Furthermore, IIFS identified as Domestic Systemically Important Banks (D-SIBs) by the supervisory authority will be required to hold additional CET1 capital.<sup>21</sup> In addition to D-SIBs, in their supervisory review process, supervisory authorities may take into account the possibility of regional systemically important IIFS (i.e. R-SIBs) or the potential emergence of globally systemic IIFS. In this respect, the framework for the assessment and additional regulatory requirements for these types of IIFS can be built on the D-SIBs framework with additional parameters.

48. In addition to Tier 1 (T1), Tier 2 (T2) capital consists of *Shari'ah*-compliant instruments and some reserves, as mentioned in IFSB-15. In this regard, supervisory authorities should outline the precise criteria (including the *Shari'ah* compliance requirements) to be met by IIFS operating in their jurisdiction.<sup>22</sup> Together with CET1, AT1 capital is considered as "going concern" capital which absorbs losses while the IIFS is solvent, while T2 capital is considered as "gone concern" capital, which absorbs further losses in the case of the non-viability of the IIFS and thus helps to protect the current account holders and other creditors of the institution.

49. Supervisory authorities should also cover the application of the capital conservation buffer, countercyclical capital buffer and leverage ratio for IIFS, keeping in mind IIFS' balance sheet structures and specificities in regard to these requirements. They should spell out capital buffer requirements and provide guidance, where applicable, on how the capital conservation buffer<sup>23</sup> and countercyclical capital buffer<sup>24</sup> requirements would be operationalised, including the approach to determining the weighted average of the countercyclical capital buffer requirements for cross-border exposures, elements subject to restrictions on distributions (e.g. cash dividends and other discretionary distributions) and the interactions of the buffers with other supervisory processes (e.g. the Pillar 2 Internal Capital Adequacy Assessment Process). The implementation of these buffers and leverage ratio should be made applicable across the industry for IIFS in line with IFSB-15.

### **3.1.2 Guidance on the Slotting Method**

50. It is noted that, among other things, the regulatory capital requirements<sup>25</sup> proposed by the IFSB under the simple risk-weight method applicable to *Musharakah* or *Mudharabah* (financing) contracts are perceived by some as being an obstacle to the use of these methods of financing. While it is the riskiness of these methods of financing, rather than the risk weights proposed by the IFSB, which would be a general obstacle to their more frequent use, the IFSB has already suggested in IFSB-15 the use, in appropriate cases, of a more risk-sensitive method, known as the supervisory slotting method, to risk-weight these exposures. However, lack of specific guidance on this method could be seen as a potential difficulty for IIFS in undertaking such exposures.

51. Accordingly, in the case of *Musharakah* or *Mudharabah* (financing) contracts, the supervisory authority should provide specific guidance on the slotting method (as an alternative to the simple risk-weight method) for specialised financing based on various factors.<sup>26</sup> While from a purely commercial perspective such contracts may be appropriate for the Islamic financial services industry, some may pose a prudential concern. Therefore, the supervisory authority needs to consider in its review the relevance for the IIFS of such prudential concerns. Such a review should take into account, among other matters, restrictions (e.g. legal, tax, rights of shareholders' and IAH's interests, foreign

<sup>20</sup> To the extent that jurisdictions adopt capital requirements superequivalent to those of IFSB-15, supervisory review will need to be based on the higher requirements.

<sup>21</sup> IFSB-15 provides a framework for the assessment and additional regulatory requirements for D-SIBs. Taking a non-prescriptive approach, the framework provides a broad outline to supervisory authorities for selecting the D-SIBs and outlining the requirements for higher loss absorbency as well as recovery and crisis management plans. In dual banking environments, the guidelines outlined in IFSB-15 on D-SIBs can be used by supervisory authorities for assessing and stipulating additional policy measures for all the banking institutions in the jurisdiction, including the IIFS.

<sup>22</sup> IFSB-15 highlights that the eligibility of various types of instruments for inclusion in AT1 or T2 is a matter for consideration by the supervisory authority in the light of the relevant criteria, notably with regard to loss absorbency.

<sup>23</sup> The capital conservation buffer is intended to encourage the build-up of capital buffers by IIFS during normal times that can be drawn down during stress periods.

<sup>24</sup> The countercyclical capital buffer is meant to protect the banking sector as a whole from systemic risk that is often developed during an economic upswing when aggregate credit growth tends to be excessive.

<sup>25</sup> The IFSB has made clear in IFSB-15 that higher capital requirements under the simple risk-weight approach are as per the BCBS approach and "apply" (i.e. the higher capital requirements) to the amount of exposure not covered by risk mitigation techniques and therefore fully exposed to the risk of capital impairment, without any recourse to the investee or another party. Hence, such exposure cannot be compared to a "commercial loan".

<sup>26</sup> Refer to the criteria set out in Appendices E and F in the IFSB's *Revised Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services*, December 2013.

exchange), significant exposure to risks, or influence by virtue of the IIFS's participation as a *Musharakah* and/or *Muḍārabah* partner.

52. Furthermore, referring to the criteria set out in Appendices E and F to IFSB-15, the supervisory authorities should provide guidelines clarifying these criteria to facilitate their application where IIFS take on *Musharakah* or *Muḍārabah* financing exposures. Supervisory authorities may also expand, at their discretion, the list of risk mitigation techniques (as presented in IFSB-15) which could be used by IIFS. As suggested in IFSB-15, any supervisory decision to suggest a lower RW than that suggested by the simple RW method should be subject to a robust supervisory review of the factors, including infrastructure and capacity of the IIFS to monitor the performance and operations of the financed entity, quality of collateral used, nature of business activities to be undertaken, legal and regulatory environment, adequacy of financial control and reporting system of the customer and the IIFS, information-sharing procedures, valuation methods and exit strategies.

### **3.1.3 Discretion to Impose Additional Capital Charges for Operational Risk**

53. The supervisory authority has discretion to impose additional capital charges for operational risk,<sup>27</sup> as the authority deems fit, to cater for *Sharī'ah* non-compliance risk. The supervisory authority may judge that, although operational risk may cover similar types of non-compliance risk such as regulatory non-compliance and legal risk, an IIFS's inappropriate conduct in respect of *Sharī'ah* compliance may adversely affect the reputation of the institution, leading to a risk of withdrawal of funds. If *Sharī'ah* non-compliance is considered to constitute a significant portion of operational risk, the supervisory authority should assess appropriate measures that may need to be taken.

54. In the above circumstances, the supervisory authority should specify and provide explanation of the methodology (i.e. factors that form the basis for such an additional capital requirement) from a supervisory perspective for operational risk. Such factors may include, *inter alia*: (a) any precedents of material *Sharī'ah* non-compliance; (b) the robustness of an IIFS's existing internal *Sharī'ah* governance systems to check (*ex-ante*) and monitor (*ex-post*) potential *Sharī'ah* non-compliance; (c) the presence of internal *Sharī'ah* audit and the enforcement of relevant *Sharī'ah* audit standards; and (d) the availability of a *Sharī'ah* review function, including the *Sharī'ah* reviewers responsible for assessment of the *Sharī'ah* compliance of transaction flows, as determined by the IIFS's *Sharī'ah* body or the relevant higher *Sharī'ah* body in the jurisdiction in which the IIFS operates. This assessment may be used as the basis for capital add-on estimation by supervisory authorities as part of the ICAAP. Supervisory authorities may allow IIFS to use a combination of qualitative and quantitative approaches that incorporate management experience and judgement to assess the *Sharī'ah* non-compliance risk in a broadly similar way to other aspects of operational risk.

55. While an additional capital charge could be imposed based on the specified factors, consideration should also be given by supervisory authorities to the infrastructure, risk management and governance process in mitigating any possible *Sharī'ah* non-compliance risk (included under operational risk), which may nullify the need for such additional capital.

### **3.1.4 Treatment of IAH and Displaced Commercial Risk – Income Smoothing and Alpha**

56. A salient issue for supervisory authorities is the treatment of IAH, and more particularly unrestricted IAH (UIAH). In the current practice, the treatment of UIAH, under a *Muḍārabah* contract, for the calculation of CAR varies from jurisdiction to jurisdiction.<sup>28</sup> (Similar considerations may apply if IAH assets are managed under a *Wakālah* contract.) In many cases, the treatment of IAH in the

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<sup>27</sup> Following the usage of the BCBS and IFSB-1, "operational risk" is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. This definition includes legal, fiduciary and *Sharī'ah* non-compliance risk, but excludes strategic and reputational risk.

<sup>28</sup> For instance, in some jurisdictions, UIAH are treated like investors who bear all the earnings volatility and risks of losses on their investment accounts (absent misconduct or negligence on the part of the IIFS). In such cases, the (credit and market risk-weighted) assets financed by the funds of the IAH are excluded from the denominator of the capital adequacy formula. By contrast, in some jurisdictions IAH are treated like a liability of the IIFS, which therefore bears the risk of the assets funded by IAH "(which in the opinion of the *Sharī'ah* Board of the IDB is not *Sharī'ah* compliant)"; while in other jurisdictions, IAH are only partially risk absorbent so that the IIFS bears part of the earnings volatility of the assets funded by their investment. In such a case, IIFS include a corresponding proportion (known as "alpha" ( $\alpha$ )) of the credit and market risk-weighted assets financed by UIAH in the denominator of the capital adequacy formula. Such smoothing practices are not normally employed in the case of restricted IAH (RIAH), but where they are, RIAH should be treated for capital adequacy purposes similarly to UIAH.

calculation of a regulatory capital requirement may lead the supervisory authority to judge that a full exclusion of the credit and market risk exposures from assets funded by the IAH may not be appropriate, and that there is a need to provide regulatory capital in respect of the proportion of such risks that is in effect borne by the IIFS's own capital (known as displaced commercial risk (DCR)). IIFS are expected to implement a sound and robust measurement methodology for DCR based on adequate and reliable data. For the purpose of computing the capital adequacy requirement, the supervisory authority would therefore assess and evaluate the reliability and accuracy of the methodology as a basis for measuring the proportion of the risk that is effectively borne by the IIFS in the form of DCR (see paragraphs 60 and 61). The supervisory authority will need to exercise its judgement regarding the proportion of such risks that is borne as DCR, either for a particular IIFS or for all of the IIFS in its jurisdiction.

57. The IFSB's GN-4 (*Guidance Note on the Determination of Alpha in the CAR for IIFS*) demonstrates how to measure the DCR – that is, the additional risk that IIFS shareholders assume in order to cushion the returns payable to IAH against variations in asset returns. It also provides a methodology to estimate the value of alpha to be used in the supervisory discretion formula in calculating the CAR of IIFS. An algebraic approach to the determination of DCR and alpha is provided in GN-4 and can be used by supervisory authorities to decide the appropriate level of alpha across the industry. Supervisory authorities should note that this approach entails data requirements for the accurate estimation of both DCR and alpha. This, in turn, will require supervisory authorities to assess the existing accounting frameworks, and requirements in their jurisdictions for reporting and disclosure to the supervisor.

58. In certain jurisdictions or circumstances, IIFS may be able to establish that there is no DCR because they are not under any pressure to forgo profits in order to “smooth” returns to IAH. The supervisory authority may provide guidance as to such circumstances. In such cases, the IAH may be considered to be restricted IAH or mutual fund investors. Therefore, the supervisory authority must be satisfied that the IIFS have adequate procedures and controls to protect the interests of the IAH in such circumstances (see paragraph 90).

59. The IFSB notes the existence of various practices of smoothing the profit payout to IAHs that are employed due to various internal and regulatory considerations to mitigate the risk of withdrawal of funds by IAH (withdrawal risk). In the case of internal considerations, IIFS face competitive pressures to pay IAH a market-related return to prevent withdrawal of funds by IAH; while in the case of regulatory considerations, some supervisory authorities, from a financial stability perspective, require the IIFS to maintain smoothing reserves and/or use other techniques to pay returns to IAH that take into account prevailing market rates. In their supervisory review process, supervisory authorities should refer to the IFSB's GN-3 (*Guidance Note on the Practice of Smoothing the Profits Payout to IAH*) which highlights the various issues (such as capital adequacy, corporate governance, disclosures, etc.) related to smoothing triggered by various techniques employed by the IIFS, including forfeiting of the *Muḍārib* share of profits, donation of profits by shareholders to IAH, maintenance of a PER to smooth the return for IAH and dividend for IIFS, and maintenance of IRR to solely cover the losses suffered by the IAH, etc.

60. Where supervisory authorities have approved various smoothing techniques in their respective jurisdictions, they should provide a policy (or written guideline) to the IIFS in their jurisdiction with respect to these practices, with particular reference to the criteria or procedures used by them to assess an IIFS's exposure to DCR in assessing the IIFS's capital adequacy.

61. The supervisory discretion formula under IFSB-15 is applicable where IIFS are required to hold regulatory capital in respect of DCR. In this approach, the credit and market risks of assets financed by unrestricted PSIA are considered to be borne proportionately by both the unrestricted IAH and the IIFS (i.e. the shareholders). Hence, a proportion of the (risk-weighted) assets funded by unrestricted PSIA, denoted by the Greek letter “alpha” ( $\alpha$ ), is required to be included in the denominator of the CAR, the permissible value of alpha being subject to supervisory discretion. In this respect, the main challenge facing IIFS and their supervisors is to assess the extent of risk-sharing between IIFS' own capital (shareholders' funds) and that of the IAH, and the resultant levels of DCR and alpha. A value of alpha near zero would reflect a view of IAH as like investors bearing most of the commercial risk, while a value of alpha close to 1 would reflect a view of IAH as like depositors effectively bearing virtually no commercial risk.

### 3.1.5 Advanced Approaches and Supervisory Discretion where Relevant

62. The credit risk component in the denominator of the capital adequacy ratio can be calculated in three different ways with varying degrees of sophistication, namely: (a) *standardised approach*; (b) *foundation internal ratings-based (IRB) approach*; and (c) *advanced IRB approach*.<sup>29</sup> Similarly, market and operational risk components in the denominator of the CAR can be calculated in different ways. It should be noted that IFSB-15 does not cover advanced approaches for the calculation of capital requirements, such as the *foundation and advanced IRB approaches* for calculation of credit risk capital requirements, and the *advanced measurement approach (AMA)* for the calculation of operational risk capital requirements. However, IFSB-15 expands (a) the scope of market risk valuation and measurement by including the use of *mark-to-market and mark-to-model methodologies* for the valuation of positions in the trading book of the IIFS and the *duration method* for the calculation of the capital charge for general market risk; and (b) the scope of operational risk measurement by including the *standardised approach (TSA)* and the *alternative standardised approach (ASA)*, which should be taken into account in the supervisory review process.

63. The IFSB is aware that in certain jurisdictions the supervisory authorities allow certain IIFS to use some of the advanced approaches, in view of their increasing size and sophistication in risk management practices. The IFSB is also aware that there has been concern that IIFS which are part of a group including conventional banks should be allowed to choose a risk measurement framework that is consistent with the approach used in their conventional banking business; otherwise, the group would need to maintain two different credit measurement systems, giving rise to inconsistencies in the capital requirements for the same counterparty, which if not addressed might give rise to capital arbitrage situations over time. In this respect, supervisory authorities, at their discretion, may allow the IIFS in their jurisdiction to migrate to the advanced approaches for regulatory capital requirement purposes provided that they are satisfied, *inter alia*, with: (a) the robustness of the internal models; (b) the availability of sufficient and reliable data; and (c) the fulfilment of other related requirements.

64. In circumstances where such approaches are to be used by IIFS and are approved by their respective supervisors, the latter should ensure that the risks associated with the various approaches are estimated accurately. Risks can be estimated by such means as: (a) providing guidance to the IIFS – in particular, specifying the qualifying criteria<sup>30</sup> for the use of such approaches, as discussed above; and (b) having in place a process for validating these approaches across the industry for consistency purposes. In addition, with respect to validation, supervisory authorities will need to ensure that they have the capacity and adequate skill set (e.g. expertise in quantitative modelling) to assess and meaningfully review an IIFS's internal approaches.

### 3.2 Internal Capital Adequacy Assessment Process

65. A thorough and comprehensive internal capital adequacy assessment process is a vital component of a strong risk management programme that produces a level of capital adequate to support the nature and level of an IIFS's risk exposures. It is the role of the supervisory authorities to evaluate the sufficiency of the bank's internal assessment and to intervene where appropriate. The supervisory review process for ICAAP is outlined in section 3.2.2.

66. Four internationally agreed principles underpinning supervisory review are included in Basel II Pillar 2. These principles, which are equally applicable in a broader sense for IIFS, are as follows:

- (a) Institutions should have a process for assessing their overall capital adequacy in relation to their risk profile, and a strategy for maintaining their capital levels.
- (b) Supervisors should review and evaluate institutions' internal capital adequacy assessments and strategies, as well as their ability to monitor themselves and ensure their compliance with regulatory capital ratios. Supervisors should take supervisory action if they are not satisfied with the result of this process.

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<sup>29</sup> The *foundation IRB approach* refers to a set of credit risk measurement techniques proposed under the Basel II capital adequacy rules for banking institutions under which the banks are allowed to develop their own empirical models to estimate the probability of default (PD) for individual clients or groups of clients. Under this approach, banks are required to use the regulator's prescribed loss given default (LGD) and other parameters required for calculating the risk-weighted assets. Total required capital is then calculated as a fixed percentage of the estimated RWA. Under the *advanced IRB approach*, the banks are allowed to develop their own quantitative models to estimate PD, LGD and exposure at default (EAD) and other parameters required for calculating the RWA.

<sup>30</sup> With reference to qualifying criteria, in particular for the use of TSA and ASA as outlined in IFSB-15, reference should be made to paragraphs 660–663 of BCBS: *International Convergence of Capital Measurement and Capital Standards*, June 2006.

- (c) Supervisors should expect institutions to operate above the minimum regulatory capital ratios and should have the ability to require them to hold capital in excess of the minimum.
- (d) Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular institution and should require rapid remedial action if capital is not maintained or restored.

### **3.2.1 ICAAP Framework for IIFS**

67. An IIFS's ICAAP should be conducted on a consolidated basis and, when deemed necessary by the appropriate supervisory authorities, at the legal entity level for each IIFS in the group. In assessing capital adequacy, the IIFS should be able to demonstrate that chosen internal capital targets are well founded and are consistent with its overall risk profile and current operating environment (i.e. the current business cycle in which the bank is operating). The five main features of a rigorous process are as follows:

- (a) board and senior management oversight;
- (b) comprehensive assessment of risks;
- (c) sound capital assessment;
- (d) monitoring and reporting; and
- (e) internal control review.

#### **Board and senior management oversight**

68. The board of directors (BOD) has responsibility for setting the IIFS's tolerance for risks – that is, risk appetite (see paragraph 109) – and capital management framework (which should include, *inter alia*, internal targets, internal controls, written policies and procedures, and methods for monitoring compliance with internal policies) for assessing the various risks. The board should ensure that senior management discharges its responsibilities for the development and effective implementation of the ICAAP. Senior management is responsible for understanding the nature and level of risk being taken by the IIFS and responsible for ensuring that the sophistication of the risk management processes is appropriate in the light of the risk profile and business plan.

69. The analysis of an IIFS's current and future capital requirements in relation to its strategic objectives is a vital element of the strategic planning process. The strategic plan should clearly outline the IIFS's capital needs, anticipated capital expenditures, desirable capital level and external capital sources. Senior management and the board should view capital planning as a crucial element in being able to achieve its desired strategic objectives. As part of capital planning, senior management should also ensure that comprehensive assessment of capital adequacy is conducted on a regular basis, with the view to determining whether internal capital targets continue to remain appropriate.

#### **Comprehensive assessment of risks**

70. All material risks faced by an IIFS should be addressed in the capital assessment process. In this context, an IIFS should review the nature of its basic activities and the external environment in which it operates in order (a) to identify a range of relevant material risks to which the IIFS is, or is likely to become, exposed, both at the business unit level and the IIFS level; and (b) to measure those risks that can be reliably quantified.<sup>31</sup> The following types of risk exposures, which by no means constitute a comprehensive list of *all* risks, should be considered:

- (a) **Types of risks captured under Pillar 1** – such as *credit risk, market risk and operational risk*.
- (b) **Types of risks not fully captured under Pillar 1** – such risks relate to *securitisation exposure risk* (see section 3.5) or underestimation of risks calculated under Pillar 1 and may include *model risk* (due to limitations of data inputs or weaknesses in model structures, under advanced approaches).
- (c) **Other types of risks not covered by Pillar 1** – covering risks which are not specifically addressed under Pillar 1, including *DCR, liquidity risk, credit concentration risk, rate of return risk in the banking book* and other types of risks that are more qualitative in nature and cannot

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<sup>31</sup> An IIFS should note that if the level of risk of a specific category is material enough to make the IIFS vulnerable, the IIFS has to take the risk into account when carrying out its ICAAP.

be measured exactly (i.e. *legislative risk, legal risk, Sharī`ah non-compliance risk, reputational risk, strategic business risk*).

- (d) **Changes in external factors** (e.g. regulatory, economic or business environment) that may affect their risk profile over time.

71. To address some of the key risks as presented above, IFSB-1: *Guiding Principles of Risk Management* provides guidance on risk management controls from the perspective of an IIFS. These principles are grouped in six categories according to risk, namely: *credit risk, equity investment risk, market risk, liquidity risk, rate of return risk* (including *displaced commercial risk*) and *operational risk* (including *Sharī`ah non-compliance risk and fiduciary risk*<sup>32</sup>). Section 3.3.4, on enterprise-wide risk management (ERM), provides more assessment on some of the above qualitative risks and other specificities of IIFSs that should be taken into account in ICAAP.

72. For each material risk identified, an IIFS should ensure that the risk assessments are supported by the following: (a) consistent and robust risk assessment approaches (i.e. quantitative and qualitative techniques) commensurate with the IIFS's size, nature of business and complexity of activities; and (b) quality data used for risk measurement in ICAAP. The assessments will need to cover the adequacy and robustness of the IIFS's internal controls for mitigating risks.

### **Sound capital assessment**

73. Based on material risks identified, the IIFS should assess its overall capital adequacy, and develop a strategy for maintaining adequate capital levels consistent with its risk profile and taking into account current and anticipated changes in the risk profile. This should be reflected in the IIFS's capital planning process and the setting of internal capital targets. Fundamental elements of sound capital assessment include: (a) policies and procedures designed to ensure that the IIFS identifies, measures and reports all material risks; (b) a process that relates capital to the level of risk; (c) a process that states capital adequacy goals with respect to risk, taking account of the IIFS's strategic focus and business plan; and (d) a process of internal controls, reviews and audit to ensure the integrity of the overall management process.

74. The capital planning process should be dynamic and forward-looking in relation to the IIFS's risk profile, and therefore rigorous forward-looking stress testing should form an integral part of the IIFS's ICAAP, enabling the institution to assess the impact on its capital adequacy arising from adverse events or changes in market conditions (see section 4.5 on stress testing). The results of these stress tests should be considered when evaluating the appropriateness of the IIFS's capital plans and internal capital targets, with remedial actions (e.g. review of earnings retention policies to gradually build up additional capital buffers, injection of additional capital by shareholders) identified to address any potential deficiencies in capital.

75. In assessing capital adequacy, an IIFS should also evaluate the quality and capacity of its capital to absorb losses. Supervisory authorities should expect the IIFS to state clearly the definition of capital used in any aspect of its ICAAP. Since components of capital have varying capacities to absorb losses, the IIFS should demonstrate how capital, as defined in its ICAAP, is able to absorb losses both on a going concern (Tier 1) and gone concern (Tier 2) basis, particularly when internal definitions are broader than that employed for regulatory capital purposes (see section 3.1.1). This should include an explanation of such differences, and analyses and reasons to support the use of any capital instrument not recognised for regulatory purposes.

### **Monitoring and reporting**

76. An IIFS should establish an adequate system for continuous monitoring and reporting of risk exposures and assessing how its changing risk profile affects the need for capital. Such a system should incorporate internal triggers to serve as early warning signals of deviations away from internal capital targets and breaches of regulatory capital requirements. The IIFS's senior management or board of directors should, on a regular basis, receive reports on the institution's risk profile and capital needs in a manner appropriate to facilitate the informed conduct of their responsibilities in:

- (a) evaluating the level and trend of material risks and their effect on capital levels;

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<sup>32</sup> Fiduciary risk will exist, in particular, in relation to IAH.



- (b) evaluating the sensitivity and reasonableness of key assumptions used in the process of assessing material risks and capital;
- (c) determining that the IIFS holds sufficient capital against the various risks and is in compliance with established (internal or regulatory) capital management policies; and
- (d) assessing and planning for the IIFS's future capital requirements and making necessary adjustments to its strategic plans as appropriate.

### **Internal control review**

77. The IIFS's internal control structure is essential to the capital assessment process. Effective management of the ICAAP includes an independent review and, where appropriate, the involvement of internal or external audits. Independent reviews should be performed by appropriately qualified persons or units who are not directly involved in the development or oversight of ICAAP. Reviews should be carried out at regular intervals with regular reporting of the results to the board and senior management of the IIFS. The board should regularly verify whether its system of internal controls is adequate to ensure well-ordered and prudent conduct of business.

78. The IIFS should conduct periodic reviews of its risk management and capital management processes relating to the ICAAP to ensure their integrity, reasonableness and consistent application. This review should cover, at least, an assessment of:

- (a) the appropriateness of the IIFS's ICAAP given the nature, scope and complexity of its activities;
- (b) identification of large exposures and risk concentrations;
- (c) the quality and completeness of data inputs to the ICAAP;
- (d) the reasonableness and validity of stress scenarios and assumptions used in the ICAAP;
- (e) the reasonableness and validity of inputs and methodologies (method/model to quantify capital for specific risks);
- (f) the robustness of the IIFS's ICAAP-related risk monitoring and reporting systems; and
- (g) performance and appropriateness of the use of third-party vendors and products, services and information, to the extent that they are employed within the ICAAP.

### **3.2.2 Supervisory Review Process in ICAAP**

79. For IIFS to achieve effective management of their capital taking into account the risks to which they are, or are likely to become, exposed, a successful integration of Pillar 2 ICAAP programmes will be critical. IIFS need to continue to assess how much capital is required to cover all of their material risks (including specific risks) and to generate estimates that utilise forward-looking stress scenarios. Given the new regime's inclusion of capital conservation, countercyclical and systemic buffers, IIFS will have to reconcile their current use of capital buffers with the buffers outlined in IFSB-15, and supervisory authorities will need to be mindful that certain risks which previously would have been assessed as part of Pillar 2 now attract specific capital requirements through the use of buffers.<sup>33</sup>

80. Supervisory authorities should require IIFS to follow the ICAAP as part of the Pillar 2 process, ensuring that they maintain an appropriate level of capital to support their operations at all times – that is, to absorb unexpected losses resulting from the risks incurred through the IIFS's business activities. Authorities should also provide an ICAAP document (i.e. suggested format submission). The purpose of the ICAAP document is to inform the supervisory authority and the board of the ongoing assessment of the IIFS's risks, how the IIFS intends to mitigate those risks, and how much current and future capital is necessary having considered other mitigating factors. This ICAAP document may cover an executive summary, background, current and projected financial and capital positions,

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<sup>33</sup> According to BCBS: *Guidance for National Authorities Operating the Countercyclical Capital Buffer*, December 2010, the countercyclical capital buffer incorporates elements of both Pillar 1 and Pillar 2. It is like a Pillar 1 approach in that it is a framework consisting of a set of mandatory rules and disclosure requirements. However, its use of jurisdictional judgement in setting buffer levels and the discretion provided in terms of how authorities explain buffer actions are more akin to a Pillar 2 approach.... In some jurisdictions, the implementation of Pillar 2 may need to be adapted to accommodate the existence of the countercyclical buffer regime. Specifically, it would make sense for authorities to ensure that a bank's Pillar 2 requirements do not require capital to be held twice for financial system-wide issues if they are already captured by the countercyclical buffer when the latter is above zero.... See BCBS: *Guidance for National Authorities Operating the Countercyclical Capital Buffer*, December 2010, for further details.

capital adequacy, capital planning, liquidity planning, aggregation and diversification, challenge and adoption of the ICAAP, and use of the ICAAP within the IIFS. Supervisory authorities may also adopt a mechanism to ensure that ICAAP documents are timely updated and submitted whenever IIFS undertake or plan to undertake certain actions that would materially impact their capital requirements.

81. The ICAAP requirements stipulated by the supervisory authority should particularly address the specificities of IIFSs, and its implementation should be proportionate to the nature, scale and complexity of an IIFS's activities. In addition, within the ICAAP process, there is a need to ensure that IIFS establish the risk appetite framework statement (see paragraph 109). It will also be important for supervisory authorities to ensure that the ICAAP is embedded within an IIFS's internal risk management framework, and is understood by all relevant parts of the IIFS, including, where appropriate, its *Sharī'ah* compliance mechanisms.

82. A supervisory authority should have in place a process for conducting regular reviews of the soundness of an IIFS's ICAAP against the expectations set out in the respective guidelines as part of the risk-based supervisory framework. The emphasis of the review should be on the quality of the IIFS's risk management and controls, and the periodic review may involve some combination of: (a) on-site examinations and off-site review (see section 2.4); (b) discussions with IIFS management; (c) review of work done by external auditors (provided it is adequately focused on the necessary capital issues); and (d) periodic reporting. Such a review should assess whether an IIFS is able to remain above the minimum required regulatory capital ratios at all times in the face of a severe but plausible stress event. There are several means available to supervisory authorities for ensuring that individual IIFS are operating with adequate levels of capital. Among other methods, the supervisory authorities may set trigger and target capital ratios or define categories above minimum ratios (e.g. well capitalised and adequately capitalised) for identifying the capitalisation level of the IIFS.

83. Based on the review and evaluation of the supervisory authority, the authority (if not satisfied with the IIFS's ICAAP) may require the IIFS, among other things, to take remedial actions to improve its capital and risk management processes. Supervisory authorities should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular IIFS and should require rapid remedial action if capital is not maintained or restored. Supervisory authorities should consider a range of options if they become concerned that an IIFS is not meeting the requirements embodied in the ICAAP. These actions may include intensifying the monitoring of the IIFS, restricting the payment of dividends,<sup>34</sup> requiring the IIFS to prepare and implement a satisfactory capital adequacy restoration plan, and requiring the IIFS to raise additional capital immediately. Supervisory authorities should have the discretion to use the tools best suited to the circumstances of the IIFS and its operating environment.

### **3.3 Governance and Risk Management**

#### **3.3.1 Corporate Governance**

84. Sound corporate governance is a vital element in ensuring that IIFS are soundly and prudently managed and comply with their regulatory obligations. It will therefore be an important focus of supervisory interest. This section deals with some aspects of the review of corporate governance that are specific to IIFS, and reference is made later to the governance of the risk management framework. This Standard does not, however, purport to be a comprehensive treatment of the subject.<sup>35</sup>

85. The IFSB's guiding principles on corporate governance<sup>36</sup> address the relevant aspects of corporate governance from the perspective of IIFS. The general elements of governance in IIFS include:

- (a) compliance with *Sharī'ah* rules and principles;

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<sup>34</sup> Where the Capital Conservation Buffer has been implemented in the jurisdiction, this will automatically restrict the payment of dividends once capital falls below the buffer level.

<sup>35</sup> For more detailed treatment, see in particular BCBS: *Principles for Enhancing Corporate Governance*, October 2010; and BCBS: *Core Principles for Banking Supervision*, revised September 2012.

<sup>36</sup> See IFSB-3: *Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds)*, December 2006.

- (b) the role of the *Sharī'ah* board in the governance, the role of auditors in terms of independence and accountability, and the extent to which supervisory authority can rely on third parties;
- (c) the rights of the IAH: processes and controls in IIFS (such as a Governance Committee) for protecting their rights; and
- (d) transparency of financial reporting in respect of investment accounts.

86. There is no “single model” of corporate governance that works well in every institution or country. The supervisory authority needs to review the controls and the quality of internal governance that have been put in place to ensure that the IIFS’s control environment is (a) consistent with the general framework; and (b) commensurate with the size, complexity and nature of the business. Through a “comply or explain” approach, the supervisory authority needs to tailor its review to the individual IIFS and require the IIFS to improve its internal governance in a manner commensurate with its business.

87. Supervisory authorities should require IIFSs to have in place an appropriate mechanism for obtaining rulings from *Sharī'ah* scholars, applying *Fatāwa* and monitoring *Sharī'ah* compliance in all aspects of their business operations. The establishment of an SSB or equivalent body in their governance structure is the usual step taken by IIFS to this end. The qualifications of the members of the SSB should be subject to the review of the respective supervisory authority. This requires supervisory authorities to outline and make available the evaluation criteria for the assessment of the qualifications and reporting responsibilities of the SSB.

88. Supervisory authorities should regularly perform a comprehensive evaluation of an IIFS’s overall corporate governance policies and practices and satisfy themselves that the IIFS has robust corporate governance policies and processes commensurate with its risk profile and systemic importance. In this respect, supervisory authorities should require effective and timely remedial action by an IIFS to address material deficiencies in its corporate governance policies and practices. The supervisory authorities should also satisfy themselves that the IIFS’s board of directors approves and oversees implementation of the IIFS’s strategic direction, risk appetite and strategy.

89. The supervisory review is in no way intended to replicate the roles of the IIFS’s BOD and senior management (SM), or of the internal, external and *Sharī'ah* audits, or of the *Sharī'ah* board. The BOD and SM have the ultimate responsibility for understanding the fiduciary duties concerning various stakeholders, and the risks and exposures facing the IIFS. Supervisory authorities need to be satisfied that IIFS are able to demonstrate that they have adequate corporate governance, including a clear statement that the BOD is ultimately responsible for the affairs of the IIFS – including the processes and effectiveness of its SSB. Supervisory authorities are expected to provide broad, general guidance that includes “fit and proper” tests, and allocation by the BOD of responsibilities to various members of management and organs of governance (such as an Audit Committee and Internal Audit, as well as a *Sharī'ah* board). This is in order to ensure that the operations are in compliance with sound and prudent principles, as well as with those of the *Sharī'ah*, and that there are clear and well-defined reporting lines of responsibility. In particular, supervisory authorities should ensure that the respective responsibilities of the BOD and the SSB are clearly articulated and that this articulation is followed in practice.

90. When managing the investments of the IAH, the IIFS as *Muḍārib* or *Wakīl* shall clearly illustrate to the supervisory authority and external third parties that it has the level of competence necessary to fulfil its fiduciary duties and that adequate policies and procedures are in place. This is to ensure that the IAHs’ assets are safeguarded, and that the IIFS as *Muḍārib* or *Wakīl* has operated within the objectives agreed with the IAH. One of the ways for supervisory authorities to check the safeguards for IAH is to refer to the Governance Committee (GC), which is another board committee, as recommended in IFSB-3, and specifically mandated to protect the interests of the IAHs. Supervisory authorities should note that the significance of IAH as a source of funds for IIFS, the particular risk characteristics of such accounts, and the unique fiduciary duties that they entail for the IIFS as *Muḍārib* or *Wakīl* under the principles of *Muḍārabah* or *Wakālah*, respectively, imply the need for the involvement of a committee such as the GC.<sup>37</sup> Another key aspect of governance is transparency and

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<sup>37</sup> While the establishment of a separate GC is highly recommended, depending on the organisational framework of an individual IIFS, the suggested role can be performed by some other BOD committee provided it is chaired by an independent

satisfaction of stakeholders' rights to information. From this perspective, in December 2007 the IFSB issued IFSB-4: *Disclosure to Promote Transparency and Market Discipline*. Supervisory authorities should require IIFS in their jurisdiction to implement both the requirements of IFSB-3 as regards the establishment and functioning of a Governance Committee (or some equivalent arrangement) and those of IFSB-4 as regards providing information relevant to the needs of IAHS.

91. Supervisory authorities should review the operating structure of the risk and compliance function, the performance metrics or performance indicators developed for the control function, the performance appraisal documents for control function personnel and the compensation policy, to ensure that the compensation of control function personnel is not determined by either the personnel or the financial performance of the business areas they oversee.

92. With regard to compensation, BCBS's *Compensation Principles and Standards Assessment Methodology* is relevant and useful for the IIFS and their respective supervisory authorities. This guidance on compensation and remuneration can be considered by supervisory authorities and entails the following requirements:<sup>38</sup> (a) the IIFS's BOD must monitor and review the compensation system to ensure it operates as intended; (b) with regard to disclosure, IIFS must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders; and (c) supervisors should have access to all information they need to evaluate the conformity of practice to the principles.

### **Audit and compliance**

93. Supervisory authorities should determine that IIFS have an independent, permanent and effective internal audit function charged with: (a) assessing whether existing policies, processes and internal controls (including risk management, compliance, and corporate and governance processes) are effective, appropriate and remain sufficient for the IIFS's business; and (b) ensuring that policies and processes are complied with.<sup>39</sup> The internal audit function should have reporting lines to the BOD or to an audit committee of the BOD, and should have sufficient status within the IIFS to ensure that SM reacts to and acts upon its recommendations. The IIFS's BOD has the ultimate responsibility for ensuring that SM establishes and maintains an adequate, effective and efficient internal control framework and internal audit function within the institution.

94. Supervisory authorities should issue guidelines on internal and/or external *Shari'ah* audits and seek to enforce relevant *Shari'ah* audit standards in their respective jurisdictions. While the IIFS's management is required to report to the supervisory authority on any material instances of *Shari'ah* non-compliance and to furnish a plan to rectify the non-compliance, the supervisory authorities can also require external auditors to report and communicate on any material *Shari'ah* non-compliance identified when auditing the IIFS. The other mechanisms for reporting *Shari'ah* non-compliance to the supervisory authority are as follows: (a) the SSB may report directly to the supervisory authority on any *Shari'ah* non-compliance cases; (b) disclosure by the IIFS of the SSB's report, included in its annual report, which reports on the compliance of the IIFS with *Shari'ah* rules and principles; (c) supervisory reviews and on-site inspections; (d) whistle-blowing by employees and other relevant individuals, including external auditors, who may become aware of non-compliance by the IIFS;<sup>40</sup> and (e) specific complaints reported by the customers.

95. When assessing the effectiveness of the control (including internal audit) and compliance functions of the IIFS and its external audit, the supervisory authority should hold discussions with the IIFS's compliance function to assess its role, authority and effectiveness, and with its internal and external auditors and its Audit Committee regarding the audit scope and recent audit findings. Such discussions will give the supervisory authority the opportunity to assess the adequacy of the control and compliance function, the scope of the audits, and the degree of reliance to be placed on the audit findings.

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BOD member and is explicitly mandated to monitor the governance policy framework of the IIFS and safeguard the interests of IAHS.

<sup>38</sup> For details, please see BCBS: *Compensation Principles and Standards Assessment Methodology*, January 2010.

<sup>39</sup> A reference is made to Principle 26 of BCBS: *Core Principles for Banking Supervision*, revised September 2012.

<sup>40</sup> Legislation will commonly provide protection for such persons against the risk of dismissal and will override any obligations of confidentiality they may owe to the IIFS.

96. Supervisory authorities should have regular annual discussions involving the BOD, the Audit Committee and the SSB, including a combined meeting with all parties present at the same time. Their supervisory review process should also include a review of the interaction between internal audit, risk management, external audit and other executive management areas, and of the assurance they provide. After the audit assessment, the supervisory authority should be prepared to take appropriate supervisory actions requiring SM and the BOD to remedy any identified deficiencies relating to the internal audit function within a specified time frame and to provide it with periodic written progress reports.

### **3.3.2 Sharī'ah Governance**

97. The IFSB's guiding principles on *Sharī'ah* governance (IFSB-10) address the components of a sound *Sharī'ah* governance system, especially with regard to the competence, independence, confidentiality and consistency of *Sharī'ah* boards. Given the *Sharī'ah* governance needs and requirements of different types of IIFS, IFSB-10 acknowledges that there are various *Sharī'ah* governance structures and models that have been adopted in different jurisdictions where IIFS are present, suggesting a *no "single model" or "one-size-fits-all" approach*. Supervisory authorities should require that each IIFS has a properly functioning *Sharī'ah* governance system in place, which clearly demonstrates, *inter alia*: (a) clear terms of reference regarding the SSB's mandate, reporting line and responsibility; and (b) well-defined operating procedures and lines of reporting.

98. The supervisory authority should satisfy itself that an IIFS's *Sharī'ah* governance system covers the relevant *ex-ante* and *ex-post* processes. While the former concerns: (a) the issuance of *Sharī'ah* pronouncements/resolutions; and (b) compliance checks before the product is offered to the customers (*ex-ante compliance*), the latter is about internal *Sharī'ah* review and *Sharī'ah* governance reporting (*ex-post compliance*).

99. Supervisory authorities should verify that the SSB or comparable body is provided with complete, adequate and timely information on any product or transaction on which a pronouncement is sought, including having its attention drawn to any areas of possible difficulty identified to the IIFS's management.

100. Supervisory authorities should also verify whether the following elements have been reflected by the IIFS in the *Sharī'ah* governance mechanism:

- (a) issuance procedures of relevant *Sharī'ah* pronouncements/resolutions and dissemination of information on such *Sharī'ah* pronouncements/resolutions to the operative personnel of the IIFS who monitor the day-to-day compliance with *Sharī'ah* pronouncements/resolutions;
- (b) an internal *Sharī'ah* compliance review/audit verifying that *Sharī'ah* compliance has been achieved; and
- (c) an annual *Sharī'ah* compliance review/audit verifying that the internal *Sharī'ah* compliance review/audit has been appropriately carried out and its findings have been duly noted by the *Sharī'ah* board.

101. Supervisory authorities should, at a minimum, enforce the implementation of IFSB-10 in their jurisdictions, and may wish to provide additional guidance on *Sharī'ah* governance to IIFS, to facilitate their understanding and performance of their roles in achieving *Sharī'ah* governance objectives, thereby promoting the soundness and stability of the IFSI.

### **3.3.3 Risk Management and Risk Management Process**

102. Supervisory authorities need to place significant emphasis on the adequacy of an IIFS's management of risks, including its systems of controls, when reviewing the condition of the IIFS. In view of the significant influence of *Sharī'ah* rules and principles throughout its operations, an IIFS's failure to adequately identify, monitor and control *Sharī'ah* non-compliance that potentially applies to the entire spectrum of operations would be considered as making it vulnerable to eventual loss of income, as well as to reputational risk and possible insolvency. When evaluating the quality of internal controls of an IIFS, the supervisory authority should give due consideration to reviewing the key elements set out in the IFSB guiding principles on risk management (IFSB-1), corporate governance (IFSB-3) and *Sharī'ah* governance (IFSB-10).

103. Risk management processes are systems to manage various categories of risk, which must fit in with the IIFS's practices and its (and its IAHS') appetite for risk. Supervisors should determine whether an IIFS has in place a sound firm-wide risk management framework that enables it to define its risk appetite and recognise all material risks, including the risks posed by concentrations, securitisation, off-balance sheet exposures, valuation practices and other risk exposures. The IIFS can achieve this by: (a) adequately identifying, measuring, monitoring, controlling and mitigating these risks; (b) clearly communicating the extent and depth of these risks in an easily understandable, but accurate, manner in reports to SM and the BOD, as well as in published financial reports; (c) conducting ongoing stress testing to identify potential losses and liquidity needs under adverse circumstances; and (d) setting adequate minimum internal standards for allowances or liabilities for losses, capital and contingency funding.

104. The supervisory authority should evaluate the IIFS's profiles under the different risk categories in the various modes of financing and investment, as well as the concentration of such risks, and assess the appropriateness and quality of the IIFS's risk management system.<sup>41</sup> In evaluating such risks, the supervisory authority should require IIFS to adopt forward-looking stress testing (as set out in IFSB-13) that identifies possible events or changes in market conditions that could adversely affect the institution's financial performance and financial position. The evaluation should also include the controls in place to mitigate such risks, both qualitative and quantitative. This will enable the supervisory authority to tailor its approach to individual IIFS and, in case of deficiency, to require the IIFS to improve its risk management process. When evaluating the stress testing practices of an IIFS, the supervisory authority should give due consideration to reviewing the key principles set out in IFSB-13.

105. In the supervisory review process, the quality, capability and effectiveness of the risk management functions of an IIFS should be assessed via different supervisory tools, using the risk-based supervisory framework. In particular, such assessment should include the following: (a) robustness of policy and procedures to facilitate the identification of existing and emerging risks and sources of vulnerabilities; (b) appropriate risk measurement methodology (e.g. risk grading methodologies, Value at Risk (VaR), stress testing); (c) adequacy of control measures to mitigate the risk (i.e. limit structure); and (d) comprehensiveness of risk monitoring and risk reporting (e.g. robustness of stress testing and granularity of information communicated to SM and the BOD). These elements are explained in section 3.3.4 on the enterprise risk management framework.

106. The evaluation should also encompass the IIFS's capital adequacy and its internal systems for determining its regulatory and ICAAP capital needs. Determination of the capital adequacy requirements for an IIFS, as set out in IFSB-15, differs technically in some respects from the determination of those requirements for a conventional institution. However, the assessment process will in principle be the same as that of a conventional institution, except that particular attention would be given to matters such as (a) *Sharī'ah* compliance, (b) risk of real estate assets, and (c) certain aspects of operational risk that may not be applicable to conventional institutions.

107. Traditionally, fund management has been associated primarily with regulation under the securities market regulator. However, in practice, IIFS may offer to investors, based on *Muḍārabah*, *Mushārah* or *Wakālah* contracts, investment funds that have specific purposes, such as real estate funds. (In IIFSs, this type of account is generally termed a restricted investment account.) The supervisory authority is concerned with assessment of the risks that arise from the fact that the operations of these restricted investment accounts are not carried out through a separate legal entity (as they are in conventional fund management). Given the risks arising from the operation of such investment accounts, the regulatory authority should require the IIFS to have adequate internal controls, risk management practices and risk disclosures to IAHS.<sup>42</sup>

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<sup>41</sup> When assessing and evaluating IIFSs' risk management activities, paragraphs 138–152 of IFSB-1 provide guidance on the role of the supervisory authority in various risk categories.

<sup>42</sup> See also sections 3.1.4 (on treatment of IAHS) and 3.6 (on transparency and market discipline).

### **3.3.4 Enterprise-wide Risk Management Framework**

#### **3.3.4.1 The General Framework for IIFS**

108. Recent market events underscore the importance of senior management taking an integrated, enterprise-wide perspective in considering an IIFS's risk exposures, in order to support its ability to identify and react to emerging and growing risks in a timely and effective manner. In the banking area, enterprise-wide (or firm-wide) risk management has been recognised as an important element in the process of maintaining an IIFS's economic stability and is regarded as a necessary tool to promote the effectiveness of banking supervision. A sound ERM framework consists of the following key features:

- (a) board and senior management oversight;
- (b) appropriate policies, procedures and limits;
- (c) comprehensive and timely identification, measurement, mitigation, controlling, monitoring and reporting of risks;
- (d) appropriate management information systems (MIS) at the business and firm-wide level; and
- (e) comprehensive internal controls.

In this context, well-managed firms will usually adopt, whether explicitly or implicitly, the so-called combined assurance<sup>43</sup> model, in which management, internal assurance and external assurance provide successive lines of defence against risk.

#### ***Board and senior management oversight***

109. It is the responsibility of the board of directors and senior management to define and approve the IIFS's risk appetite<sup>44</sup> and to ensure that the IIFS's risk management framework includes detailed policies that set specific IIFS-wide prudential limits on the IIFS's activities that are consistent with its risk appetite and capacity. In order to determine the overall risk appetite, the BOD and SM should first have an understanding of risk exposures on an IIFS-wide basis and possess sufficient knowledge of all major business lines.

110. SM should establish a risk management process that is not limited to credit, market, liquidity and operational risks, but incorporates all material risks. This includes reputational and strategic risks, as well as risks that do not appear to be significant in isolation, but when combined with other risks could lead to material losses.

111. To come out with a comprehensive ERM framework and appropriate implementation of that framework, an IIFS needs to have an internal risk function and a chief risk officer (CRO), or equivalent position whose expertise includes a good understanding of the specificities of Islamic finance. The risk function and CRO should be independent of the individual business lines and, while reporting to the chief executive officer (CEO), should also have direct and unimpeded access to the institution's BOD and in particular to its Risk Committee.<sup>45</sup> In addition to establishing the ERM framework, the risk function should highlight to SM and the BOD key risk management concerns such as risk concentrations and violations of risk appetite limits or internal position limits.

112. The establishment of an internal risk function and a CRO may be problematic for some IIFS, particularly small IIFS and newly established Islamic windows. Therefore, supervisory authorities should provide criteria to determine which IIFS are required to have a CRO or similar position, and what alternative arrangements are acceptable for smaller IIFSs or windows.

#### ***Policies, procedures, limits and controls***

113. The ERM framework of an IIFS should include detailed policies that set specific firm-wide prudential limits on the principal risks relevant to the IIFS's activities.<sup>46</sup> These limits should:

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<sup>43</sup> A coordinated approach to all assurance activities to ensure that assurance provided by management, internal assurance providers (such as internal audit) and external assurance providers (such as external audit) adequately address significant risks facing the IIFS, and that suitable controls exist to mitigate and reduce these risks.

<sup>44</sup> Such a definition is also referred to as a statement of direction, specifying the level of risk exposures that the organisation is willing to take on in defined circumstances. An effective risk appetite statement should consider the existing risk profile, and the capacity and willingness to assume each risk in respect of each segregated part of the IIFS.

<sup>45</sup> In a group, the CRO of a subsidiary may have a management reporting line to the group CRO, but he should nevertheless always have access to the BOD of the subsidiary.

<sup>46</sup> A reference is made to the Financial Stability Board's *Principles for an Effective Risk Appetite Framework*, November 2013.

- (a) be set at a level to constrain risk-taking within risk appetite, taking into account the interests of customers and shareholders, as well as capital and other regulatory requirements, in the event that a risk limit is breached and the likelihood that each material risk is realised;
- (b) be established for business lines and legal entities as relevant and generally expressed relative to earnings, capital, liquidity or other relevant measures (e.g. growth and volatility);
- (c) include material risk concentrations at the institution or group-wide, business line and legal entity levels as relevant (e.g. counterparty, industry, country/region, collateral type, product);
- (d) although referenced to market best practices and benchmarks, should not be strictly based on comparison to peers or default to regulatory limits;
- (e) not be overly complicated, ambiguous or subjective; and
- (f) be monitored regularly.

114. An IIFS should clearly document its risk policies and strategies within a risk management framework that is appropriate to the nature and scale of its activities. An IIFS's policies and procedures should provide specific guidance for the implementation of the IIFS's stated goals, objectives and broad business strategies and should establish, where appropriate, internal limits (in relation to the IIFS's capital, or total assets or earnings) for the various types of risk to which the IIFS may be exposed.

115. In this respect, an IIFS's policies, procedures and limits should, *inter alia*: (a) provide for adequate and timely identification, measurement, monitoring, control and mitigation of the risks posed by its financing, investing, trading, securitisation, off-balance sheet, fiduciary and other significant activities at the business line and IIFS-wide levels; (b) clearly delineate accountability and lines of authority across the IIFS's various business activities, and ensure there is a clear separation between business lines and the risk function; and (c) include a schedule and process for reviewing the policies, procedures and limits, and for updating them as appropriate.

***Identifying, measuring, monitoring and reporting of risk***

116. Risk identification is a qualitative process whereby an IIFS considers and records (through a risk register) all material risks and foreseeable events whose occurrence could have an impact on its financial condition. Following the risk identification, the risks should be properly measured through appropriate risk measurement tools (e.g. risk grading methodologies, VaR, stress testing), and the IIFS's management should understand the assumptions behind and limitations inherent in specific risk measures.

117. When implementing ERM, the BOD and SM of the IIFS should ensure that all the risks that are specific to IIFS, such as equity investment risk in the banking book, rate of return risk and DCR, as well as *Shari'ah* non-compliance risk (SNCR) and fiduciary risk (see paragraphs 119 to 121), have been incorporated in the ERM framework. The framework also needs to cover "transformation of risk" (see paragraph 118) at various stages of investment life cycles within the specific risks of the IIFS.<sup>47</sup> Rate of return risk and DCR are triggered by a number of factors in the IIFS's operation. Liquidity risk, market risk and credit risk may affect an IIFS's ability to meet the rate of return expected by its IAH,<sup>48</sup> and these risks together with other factors have to be incorporated by the IIFS in its ERM.

118. Transformation of risk is one of the specificities in IIFS. Transformation of risk occurs at various contractual stages for certain Islamic financing instruments. In this context, the IIFS may be exposed to market risk at a certain contractual stage and to credit risk at later stages. For instance, in a *Murabahah* transaction, the market risk "transforms" into credit risk, in the sense that the market risk exposure to the subject matter of the contract which is applicable when the latter is held by the IIFS prior to the sale is replaced after the sale by the credit risk exposure to the counterparty if the payment is on deferred terms.

119. SNCR is another specific risk that only exists in IIFS. According to IFSB-1, SNCR is treated as a component of operational risk in IIFS. Some major events in the industry include pronouncements and controversies related to SNCR; these have shown the increasing importance of ensuring *Shari'ah* compliance in IIFS' operations. Exposure to SNCR occurs not only on the assets side of an

<sup>47</sup> IFSB-1: *Guiding Principles of Risk Management*, December 2005.

<sup>48</sup> GN-3: *Guidance Note on the Practice of Smoothing the Profit Payout to Investment Account Holders*, December 2010.



IIFS's balance sheet (relating to financing products), but may also arise on the liabilities side (funding products – in particular, CMT-based deposits) and in connection with all activities of the institution (including securitisation). In this context, ERM can improve the risk identification and assessment process, through *ex-ante* and *ex-post* considerations (section 3.3.2), to capture exposures to SNCR in all operational aspects of IIFS.

120. There are in principle two aspects of SNCR. The first aspect is the risk of non-compliance resulting from the failure of an IIFS's *Sharī'ah* governance mechanism (implementation systems and personnel) to ensure its compliance with *Sharī'ah* rules and principles as determined by its SSB or other relevant body in the related jurisdiction. This risk can lead to non-recognition of an IIFS's income and resultant losses. It may also manifest itself as reputational risk, leading to loss of future business, or even the withdrawal of investments placed with the IIFS. The second aspect is the risk that the rulings given by the IIFS's SSB or other body come under criticism and are not generally accepted, again leading to the loss of current or future business. This risk is harder to mitigate (but see below).

121. In the operational risk domain, SNCR and fiduciary risk can be minimised through implementing a *Sharī'ah* governance framework (see section 3.3.2). IIFS should also follow all requirements as written in the contractual agreement between the IIFS as *Mudārib* or *Wakīl* and the IAHS, including any declared policies for the use of smoothing mechanisms such as a profit equalisation reserve or investment risk reserve. In this sense, ERM will (a) ensure that any deviation from the contracts is easily traced, as all activities are well documented and communicated across the silo; and (b) enhance the risk management function by overseeing risk from a wider perspective and on a consolidated basis.

122. To promote effective implementation of an ERM framework that covers the specificities of IIFS, a *Sharī'ah* governance mechanism should be incorporated into the framework. The important organs within an IIFS, such as an SSB, a GC, an internal *Sharī'ah* compliance unit (ISCU) and an internal *Sharī'ah* review unit (ISRU), where applicable, can provide input to the ERM process.

123. Another element of operational risk to be considered in the ERM is legal risk. As most IIFS have to operate within conventional legal environments, some aspects of an IIFS's specificities and operational aspects may not be adequately covered by the law, and this situation directly affects the risks to which IIFS are exposed, especially legal risk<sup>49</sup> faced by IIFS.<sup>50</sup> Legal risk is also particularly applicable to *Sukūk* structures (i.e. legal risk arising from the interaction between a *Sharī'ah* contract and civil law, particularly relevant to the issuance of certain *Sukūk* as a result of which various parties to the *Sukūk* issuance may be exposed to legal risk).

124. An IIFS should monitor the status of the risks that it has identified, through an adequate MIS. An IIFS's MIS should provide the BOD and SM, in a clear and concise manner, with timely and relevant information on the IIFS's aggregate risk profile, as well as the main assumptions used for risk aggregation. It should also be capable of capturing limit breaches, and there should be procedures in place for prompt reporting of such breaches to SM. Where breaches of policy, procedures and limits are identified, an IIFS should examine and consider the need to review those policies, procedures and limits.

125. An IIFS should maintain a comprehensive reporting process for all the risks of the organisation. The reporting process should cover all internal and external risk reporting requirements, including how relevant and reliable risk information is captured at the appropriate level of detail for each level of user, including operational management, the risk management committee (or equivalent body), the BOD, the *Sharī'ah* board, and any required public or regulatory reporting.

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<sup>49</sup> Legal risk includes, but is not limited to, exposures to fines, penalties or punitive damages resulting from supervisory actions, as well as private settlements. Such risk can arise from either (a) the IIFS's operations (i.e. legal risks common to all financial intermediaries); or (b) problems of legal uncertainty in interpreting and enforcing contracts based on *Sharī'ah* rules and principles. Legal risks also include the risk that a *Sukūk* structure in which an IIFS is originator, sponsor, manager or investor fails to perform as intended because of some legal deficiency.

<sup>50</sup> Several examples of court cases in the last decade in the IFSI can be categorised mainly as: (a) conflict of jurisdiction of a civil law or common law court *vis-à-vis* the *Sharī'ah* court; (b) applicability of civil law principles to decide on disputes in Islamic financial transactions; (c) legal recognition of the role of *Sharī'ah* scholars; and (d) defaults in *Sukūk* and the legal framework to protect investors.

### **Internal controls**

126. An IIFS's risk management processes should be frequently monitored and tested by independent control areas, and by both internal and external auditors. The aim is to ensure (a) that the information on which decisions are based is accurate so that processes fully reflect management policies; and (b) that regular reporting, including the reporting of limit breaches and other exception-based reporting, is undertaken effectively. The risk management function of an IIFS must be independent of the business lines in order to ensure an adequate separation of duties and to avoid conflicts of interest.<sup>51</sup>

#### **3.3.4.2 Supervisory Review Process for an IIFS's ERM Framework**

127. Risk management has emerged, in the light of recent developments (notably the financial crisis), as a key area that needs to be expanded. The different business models of IIFS, and new emerging products and risk mitigants employed by IIFS, have created new levels of risk and complexities that may lead to financial instability and other unintended economic consequences. This phenomenon in the IFSI has increased the role of supervisory authorities in ensuring the soundness of the banking system. In this respect, supervisory authorities should determine whether an IIFS has in place a sound ERM framework (as explained above) that enables it to define its risk appetite and recognise all material risks, including the risks posed by concentrations, securitisation, and off-balance sheet and other risk exposures. Where the IIFS is part of a group, it would be normal for ERM to be implemented at the group level, but it may also be appropriate for the IIFS to have its own ("solo-level") ERM.

128. To ensure the effectiveness of an IIFS's ERM framework, the supervisory authorities should (a) satisfy themselves that the framework is adequate and provides a comprehensive "business-wide" view of risk across all material risk types taking account of the risk profile and systemic importance of the IIFS; and (b) assess risks arising from the macroeconomic environment affecting the markets in which the IIFS operates and incorporate such assessments into their evaluation of the IIFS's risk management process. Where appropriate, supervisors should seek verification or demonstration of the BOD's role in approving the firm's risk appetite statement – for instance, by reviewing BOD minutes or through discussions with directors and management – to ensure that the BOD did not merely "rubber stamp" management's recommendation. They should also look for evidence in BOD papers and minutes, the risk appetite statement documents, metrics, reporting and other activities, that the BOD understands how management interprets and applies the risk appetite and risk limits. They may wish to review other material, such as strategy and planning documents and board reports, to ensure that risk-taking is aligned in practice with the board-approved risk appetite statement.

129. To review the implementation of ERM in an IIFS, supervisory authorities need to understand the overall structure of the banking group and be familiar with all the material activities (including non-banking activities) conducted by entities in the wider group, both domestic and cross-border. Supervisory authorities should also understand and assess how group-wide risks are managed, and take action when risks arising from the banking group and other entities in the wider group – in particular, contagion and reputation risks – may jeopardise the safety and soundness of the IIFS itself and the banking system as a whole. They will also need to understand the basis on which data and risks are aggregated across the group.<sup>52</sup>

130. In supervising an IIFS which is part of a corporate group, supervisory authorities need to consider the IIFS and its risk profile from a number of perspectives: (a) on a *solo basis* (but with both a micro and macro focus); (b) on a *consolidated basis* (in the sense of supervising the IIFS as a unit together with the other entities within the "banking group"); and (c) on a *group-wide basis* (taking into account the potential risks to the IIFS posed by other group entities outside of the banking group).<sup>53</sup>

131. Supervisory authorities should also ensure that an IIFS has incorporated the specific risks (including the effects of any capital market activities of the IIFS such as securitisation exposures or special-purpose entities (SPEs) leading to off-balance sheet exposures) in its ERM framework, and has undertaken a comprehensive analysis of the risks – not only within each risk type (*intra-risk analysis*), but also across the risk types (*inter-risk analysis*). Supervisory authorities should also

<sup>51</sup> Reference is made to BCBS: *Enhancements to the Basel II Framework*, July 2009.

<sup>52</sup> This is particularly significant in Islamic finance because of the possibility that aggregation will be based on interpretations of, for example, the status of IAH which may be different from those prevailing in the jurisdiction in question.

<sup>53</sup> A reference is made to BCBS: *Revised Core Principles for Banking Supervision*, September 2012.

satisfy themselves that an IIFS's ERM has the capacity to identify all types of risks in the IIFS's operations and is able to track transformation of risks at every contractual stage and across the IIFS.

132. The supervisory review process should cover business models, standardised contracts and product risk. Each product offered by IIFS has its specific risk characteristics, and supervisory authorities should consider issues such as profit or loss determination method, valuation, rescheduling of financing, *Shari'ah* non-compliance risk, legal risk and transformation risk. Furthermore, where *Shari'ah*-compliant risk mitigation instruments are used by IIFS, supervisory authorities will need to be sure that they fully understand the characteristics of such instruments, which are likely to differ in detail from those of their conventional counterparts.

133. Supervisory authorities should also satisfy themselves that an IIFS's ERM framework and its implementation are adequate from the standpoint of ensuring compliance with *Shari'ah* rules and principles (i.e. *Shari'ah* governance mechanism). Supervisory authorities should additionally satisfy themselves that there is an appropriate cooperation and communication mechanism between an IIFS's risk management unit and its *Shari'ah* governance system (i.e. SSB, ISCU and ISRU) to promote the effectiveness of ERM and minimise overlapping of work between the parties. If necessary and appropriate, some ISCU or ISRU members may also participate in the IIFS's risk management unit so as to minimise duplication of work between the units.

134. With respect to SNCR, in the supervisory review process, supervisory authorities should be guided by an examination manual (or section of a manual) that specifies how to assess the SNCR exposure of an IIFS and its management of that exposure. Supervisory authorities should use available remedial and, if necessary, enforcement tools for dealing with inadequate management of SNCR exposure by an IIFS.

135. Supervisory authorities should ensure that IIFS have MIS that are adequate (both under normal circumstances and in periods of stress) for measuring, assessing and reporting on the size, composition and quality of exposures on an IIFS-wide basis across all risk types, products and counterparties. They should also satisfy themselves that these reports reflect the IIFS's risk profile and capital and liquidity needs, and are provided on a timely basis to the bank's BOD and SM in a form suitable for their use. The risks covered by the ERM will naturally include those that have been considered within the ICAAP, and supervisors should satisfy themselves that the two are consistent.

### **3.4 Related Party Transactions**

136. A *related party* is defined as a person or entity that is related to the entity (the IIFS) as set out below:

- (a) A person or close member of that person's family is related to the entity if that person:
  - (i) has control (including joint control) of the entity;
  - (ii) has significant influence over the entity; or
  - (iii) is a member of the key management personnel of the entity or of a parent of the entity.
- (b) Another entity is related to the entity if any of the following applies:
  - (i) Both are members of the same group.
  - (ii) One entity is an associate or joint venture of the other entity or of a member of a group of which the other entity is a member.
  - (iii) Both entities are joint ventures of the same third party, or one is a joint venture of a third entity and the other is an associate of the third entity.
  - (iv) The entity is controlled or jointly controlled by the person identified in (a) above.
  - (v) A person identified in (a) (i) has significant influence over the entity or is a member of the key management personnel of the entity or of a parent of the entity.

137. Close members of the family of a person are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity and include, but are not limited to:

- (a) that person's parents, children or spouse(s);
- (b) children of that person's spouse(s);
- (c) dependants of that person or that person's spouse(s); and
- (d) that person's sibling(s).

138. Related parties thus include members of an IIFS's BOD, of its SM or of its SSB, an external auditor of the IIFS, the IIFS's major shareholders, and their close family members as defined in the previous paragraph.

139. A *related party transaction* is a transfer of resources, services or obligations between an entity (IIFS) and a related party, regardless of whether a price is charged. Related party transactions include on- and off-balance sheet credit exposures and claims, as well as dealings such as service contracts, asset purchases and sales, construction contracts, lease (*Ijārah*) contracts, financings, borrowings (through *Qard*) and write-offs. They also include transactions that are entered into in situations in which an unrelated party with whom the IIFS has an existing exposure subsequently becomes a related party.<sup>54</sup>

140. While these definitions of related parties and related party transactions are similar to those given in international accounting standards and by the BCBS,<sup>55</sup> supervisory authorities may take into account local specifics in prescribing what would constitute a related party or a related party transaction.

141. The supervisory authority should ensure that IIFS have policies and processes to identify individual exposures to and transactions with related parties as well as the total amount of exposures, and to monitor and report on them through an independent credit review or audit process. The supervisory authority also needs to satisfy itself that the IIFS's related party transactions are conducted on an arm's-length basis and that IIFS take appropriate steps to control or mitigate the related risks. In this context, as part of its review process, the supervisory authority needs to satisfy itself, through auditors or on-site inspection, as to appropriate evidence of the accounting for and disclosure of any material transactions with related parties.

### **3.5 Securitisation Risk and Related Off-balance Sheet Exposures**

#### **3.5.1 Risk Management Framework for Securitisation**

142. Where an IIFS undertakes or is otherwise involved in a securitisation, its own assessment of risk needs to be based on a comprehensive understanding of the structure of the transaction. It should identify the various types of triggers, credit events and other legal provisions that may affect the performance of its on- and off-balance sheet exposures and integrate these triggers and provisions into its funding/liquidity, credit and balance sheet management. All risks arising from securitisation, particularly those that are not fully captured under IFSB-15, should be addressed in an IIFS's ICAAP. These risks include: (a) the credit, market, liquidity and reputational risk of each exposure; (b) potential delinquencies and losses on the underlying securitised exposures; (c) exposures from credit lines or liquidity facilities to SPEs; and (d) exposures from guarantees provided by monolines and other third parties.

143. The BOD of an IIFS should play a central role in overseeing securitisation and off-balance sheet exposures. It should understand, and set the scope and purpose of, the involvement of the IIFS in such activities, and should be aware of the risks and other implications associated with the securitisation activities undertaken.

#### **3.5.2 Supervisory Review for Securitisation and Specificities of IIFS**

144. IFSB-7 (*Capital Adequacy Requirements for Sukūk, Securitisation, and Real Estate Investment*)<sup>56</sup> and IFSB-15 deal with minimum capital adequacy requirements in relation to: (a) IIFS' holdings of *Sukūk*; and (b) the exposures of an IIFS where it acts in the capacity of *originator*, or *issuer* or *servicer* or *provider of credit enhancement* to a *Sukūk* issuance. In line with these requirements, supervisory authorities should monitor, as appropriate, whether an IIFS has taken account of the economic substance of transactions for securitisation in its determination of capital requirements. Among other things, supervisory authorities may review, where relevant, an IIFS's own assessment of its capital needs and how this has been reflected in the capital calculation, as well as

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<sup>54</sup> A reference is made to Principle 20 of BCBS: *Core Principles for Banking Supervision*, revised September 2012.

<sup>55</sup> For example, the currently applicable international accounting standard is IAS 24: *Related Party Transactions*, revised December 2009.

<sup>56</sup> To be superseded by IFSB-15.

the documentation of certain transactions to determine whether the capital requirements are in accord with the risk profile of the IIFS.

145. Where an IIFS is a *Sukūk* holder, supervisory authorities should verify that it has taken adequate steps to verify the full economic and legal characteristics of the instruments in which it has invested. The *Sukūk* market, which started with “plain vanilla” *Sukūk* issues (using one structure or contract), has now seen complex issuances structured in the form of convertible and hybrid *Sukūk* (combining more than one contract/structure). IIFS holding such *Sukūk* will need to evaluate the risks underlying them and the nature of the contracts being combined in the structure, as well as any legal risks applicable to *Sukūk* structures, in their respective jurisdictions. Legal risk arising from the interaction between a *Sharī`ah* contract and civil law is particularly relevant. Other relevant issues may include: (a) whether the underlying assets comply with *Sharī`ah* principles; (b) recourse available to holders of securities – that is, against the assets backing the issuance or against an obligor such as the issuer or a guarantor, or the originator; and (c) valuation and provisioning required (where necessary) for mezzanine tranches held by IIFS.

146. As regards a securitisation undertaken by an IIFS, this may offer one or more of the following benefits: (a) *increased liquidity*, since a relatively illiquid asset is converted into cash paid by the investors in the *Sukūk*; and (b) *reduced capital requirements*, provided the securitisation meets the conditions under which assets may be derecognised for capital adequacy purposes. In order to provide capital relief to an IIFS under the second benefit, supervisory authorities should ensure that the treatment of the assets by the IIFS has met the applicable derecognition criteria (i.e. recognition of risk transference) outlined in IFSB-15.

147. Supervisory authorities should note that an IIFS may act in various capacities in *Sukūk* securitisations (as noted above) and its exposure to risks may be similar to that in a conventional securitisation. However, *Sharī`ah* rules and principles may add an extra dimension to the securitisation risk exposures; in particular, the possibility of implicit (or non-contractual) support being provided,<sup>57</sup> as opposed to contractual credit support (i.e. credit enhancement), raises various supervisory and *Sharī`ah* concerns, which should be taken into account by supervisory authorities in their supervisory review process.

148. Supervisory authorities may issue guidelines on how IIFS may participate in *Sharī`ah*-compliant securitisations. The guidelines should inform IIFS regarding the manner and extent to which they may have exposures in securitisation transactions, in addition to prudential issues including specific risks that may attach to the instruments and exposures. Furthermore, supervisory authorities should ensure that, where ratings issued by external credit assessment institutions (also known as rating agencies) on *Sharī`ah*-compliant financial instruments are relied upon for capital adequacy purposes, those ratings properly cover the specificities of the instruments. In this regard, reference can be made to IFSB GN-1, which highlights the criteria to be employed by ECAI.

149. Supervisory authorities should also ensure that the activities undertaken by IIFS in securitisations are compliant with applicable supervisory regulations and prudential requirements, including securities regulatory provisions such as prospectus requirements. They should also ensure that appropriate *Sharī`ah* governance arrangements are in place for the offer documentation (which should be written in a clear and precise manner to eliminate the risk of *Gharar* – i.e. contractual uncertainty – so as to manage *Sharī`ah* non-compliance risk),<sup>58</sup> as this may be crucial in case of insolvency or dispute resolution proceedings. In this context, reference should be made to IFSB-10 (on *Sharī`ah* governance).

150. In relation to the supervisory review process of securitisation activities and exposures, supervisory authorities should note that they may have to collaborate with other supervisory authorities or agencies within the same jurisdiction, with respect to relevant securitisation

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<sup>57</sup> In contrast to contractual credit exposures, such as guarantees, implicit support is a more subtle form of exposure. Implicit support arises when an IIFS provides post-sale support to a securitisation transaction in excess of any contractual obligation. Thus, implicit support might involve an IIFS taking on to its balance sheet assets that had been vested in an SPE, so that the IIFS is exposed to the risks and obligations relating to those assets. According to *Sharī`ah* rules and principles as generally understood, it is not permissible for the *Muḍarib* (investment manager), *Shārik* (partner) or *Wakil* (agent) to undertake in advance to repurchase assets from *Sukūk* holders or from one who holds them, for their nominal or par value, except on the basis of the net asset value, at the time of purchase.

<sup>58</sup> To manage the exposure to *Sharī`ah* non-compliance risk, an IIFS's SSB should be involved in giving approval when the IIFS intends to be a sponsor and/or an originator of a securitisation. In principle, the SSB should understand the objectives of such an exposure and be aware of the complexity as well as the possible risk exposures involved.

requirements that may have been set by other supervisory authorities or agencies. For example, activities of IIFS which are originators or issuers of *Sukūk* and *Sukūk*-related instruments may be regulated by a supervisory authority other than the banking supervisor – for instance, the Securities Commission or Capital Market Authority. This type of situation thus gives rise to a concern for cross-sector supervision and coordination, and needs to be taken into account in the supervisory review process.

151. One recent development has been the issuance of *Sukūk* by IIFS to raise capital which, under the terms of the *Sukūk*, would be eligible for inclusion in capital resources to meet the CAR prescribed in IFSB-15. Many of the considerations set out above in relation to securitisations by IIFS would be equally applicable to such issues, but supervisory authorities will need to focus in particular on whether the instruments have the necessary loss-absorbency characteristics to qualify as Additional Tier 1 or Tier 2 capital, as the case may be.

### **3.5.3 SPEs and Key Considerations in the Supervisory Review Process**

152. One of the important considerations for supervisory authorities with respect to securitisation is the use of SPEs specifically for the purpose of *Sukūk* issuance. The normal procedure is for an IIFS to establish an SPE to issue the securitisation instruments, and this raises supervisory issues. In asset-backed *Sukūk* structures, the SPE is established as a "bankruptcy-remote" independent entity, company or trust, so that following a "true sale"<sup>59</sup> of the securitised assets to the SPE the assets cannot be clawed back by the liquidator of the originator in the event of its liquidation.<sup>60</sup> SPEs may also be established for other reasons, and even when they are in principle bankruptcy-remote, there may be either commitments to support them (e.g. by providing liquidity) or informal, primarily reputational reasons for doing so.

153. Supervisory authorities should concern themselves with the complexity and economic risks of SPEs in addition to their governance structures to protect market participants. Their efforts can include:<sup>61</sup>

- (a) providing guidance and formats of reporting and notification arrangements that should be applied by an IIFS in relation to the establishment and operationalisation of SPEs;
- (b) assessing the risks associated with commitments to off-balance sheet SPEs and the possibility that the SPE's assets and liabilities will at any point be taken on to the IIFS's balance sheet, whether for reputational or other reasons;<sup>62</sup>
- (c) ensuring that market participants are aware of all economic risks and business purposes of an SPE;
- (d) satisfying themselves that the governance process of an SPE is commensurate with the degree of active intervention and discretion of the parties participating in the SPE;
- (e) examining the potential issues and deficiencies in risk management and exploring ways in which risk transfer can potentially be overestimated or underestimated by both originators and investors; and
- (f) overseeing and monitoring regularly the use of all SPE activity and assessing the implications for regulated IIFS of the activities of SPEs, in order to identify developments that can lead to systemic weakness and contagion or that can exacerbate procyclicality.

154. In addition to the above aspects, the supervisory authorities can also review additional aspects relating to the SPE's operations, such as information flow, governance set-up process, capital and loss absorbency, and key disclosures. If there is any doubt that the SPE is in all respects remote from the IIFS, the presumption should be that it should be consolidated with the IIFS for capital adequacy purposes.

<sup>59</sup> From a juristic perspective, subject to jurists' interpretations in the jurisdiction, there are four key criteria for a transaction to be considered as a "true sale" that transfers legal title to the SPE for the benefit of the *Sukūk* investors. For the features of "true sale", refer to section 5.2.4 of IFSB-15.

<sup>60</sup> In conventional securitisations, the SPE is a company or trust or other legal entity having no other business. By contrast, in a *Sukūk* securitisation, the SPE can be organised, for example, as a *Mushārahah*, *Muḍārabah* or *Wakālah*.

<sup>61</sup> A reference is made to the IOSCO-BCBS-IAIS Joint Forum *Report on Special Purpose Entities (SPEs)*, September 2009.

<sup>62</sup> This review can take into account assessing the size and soundness of an SPE relative to its own financial, liquidity and regulatory capital positions. This review can also include structural, solvency, liquidity and other risk issues, including the effects of covenants and triggers.

### 3.6 Transparency and Market Discipline

155. With respect to transparency,<sup>63</sup> supervisory authorities should satisfy themselves that IIFS and banking groups regularly publish both qualitative and quantitative information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies, and corporate governance policies and processes.<sup>64</sup>

156. In this regard, the supervisory authority may need to ensure that IIFS disclose key accounting and prudential information, as proposed in the IFSB's *Standard on Disclosures to Promote Transparency and Market Discipline for IIFS* (IFSB-4), and have appropriate governance over their disclosure policies and processes. It is important to differentiate the scope and type of information to be disclosed taking account of different categories of users, including regulators, existing and potential shareholders and IAH, and other parties dealing with the IIFS.

157. In addition to the disclosures proposed in IFSB-4, supervisory authorities may wish to expand the scope of such disclosures to enhance the disclosure regime in line with recent developments. In particular, from a capital framework perspective, IFSB-15 discusses additional issues (such as definition of capital, securitisation, etc.) which were not part of the IFSB-4 disclosure requirements.

158. Disclosures reinforce (a) discipline, and (b) fiduciary duties towards various stakeholders, particularly the IAH, with regard, *inter alia*, to IIFS's compliance with *Shari'ah* rules and principles. Insofar as the IAH bears its own risk, it is important that an IIFS's financial reporting should include information about its investment performance as manager of IAHs' funds in a form that the IAH can readily understand. Such information, provided accurately and reliably and on a timely basis, is vital not only for protecting the interests of the IAH but also for promoting systemic stability. The information is likely to enhance incentives for the IIFS as the *Muḍārib* or *Wakīl* to operate prudently in order to maintain the IAH's confidence.

159. At present, most IAH are generally not able to undertake regular monitoring of the IIFS. In addition, the IAH do not have the power to enforce any requirements on financial institutions, or to call for corrective action, except by withdrawing their investment from the IIFS. Thus, an important role of supervisory authorities is to ensure that adequate systems and processes are in place to protect the interests of the IAH.

160. Additionally, the supervisory authority may collaborate with the IIFS industry and consumer associations to advocate and promulgate best practices regarding controls and risk management systems. While each group may be geared primarily to the interests of its members, the advantage of such a suggestion is the "peer pressure" approach it takes to compliance.

161. Insofar as the IAH bear their own risks, the supervisory authority should satisfy itself with regard to appropriate and timely disclosure of information on risks and returns and, where appropriate, periodic reports from IIFS that, among other things, provide early warnings where necessary.

162. Supervisory authorities should also determine that the IIFS's BOD and SM know and understand the IIFS's and banking group's operational structure and its risks, including those arising from the use of structures that impede transparency (e.g. SPEs or related structures).

### 3.7 Consolidated and Home-host Supervision

163. It is a long-standing principle<sup>65</sup> that all international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision, and home country supervisors should expect to have access to information from all establishments of the banks they supervise. Supervisory authorities should in general not permit the creation of banking establishments which cannot be properly supervised under such principles. International best practice has recently placed still more emphasis on arrangements for information sharing and coordination among supervisory authorities to improve prudential supervision and crisis management. The

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<sup>63</sup> IFSB-4: *Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds)*, December 2007.

<sup>64</sup> A reference is made to Principle 28 of BCBS: *Core Principles for Banking Supervision*, revised September 2012.

<sup>65</sup> See BCBS: *Minimum standards for the supervision of international banking groups and their cross-border establishments*, July 1992.

framework within which this takes place may include, among other things, consistency in the application of different confidentiality requirements, reciprocal undertakings in relation to information sharing, right contacts and competent persons, and help with language and interpretation of terms.

164. In the context of home-host relationships, the supervisory authorities are expected to consider implications relating to competing pressures within the financial sectors, own countries' best interests, national *Sharī'ah* interpretations, legal and tax systems, crisis management and the benefits of international cooperation. On the one hand, the authorities should provide a regulatory environment for the IIFS to operate seamlessly across jurisdictions. On the other hand, crisis management would be undertaken largely on a national basis and involve separate asset pools. Since not all countries have deposit insurance schemes (especially schemes that are *Sharī'ah* compliant), supervisory authorities need to consider the potential of IIFS to undertake riskier activities depending on whether IAH are fully or largely protected from the risks.

### **3.7.1 Consolidated and Cross-sector Supervision**

165. Cross-sectoral exposures are particularly pertinent within the IFSI and hence raise concerns for authorities that supervise IIFS on a "silo" basis. In this respect, the IIFS may have a range of activities that cross supervisory boundaries. The supervisory authority needs to assess the risks on a consolidated basis. Restricted investment accounts, for example, are akin to collective investment schemes, which are normally supervised by the securities market supervisor. Another example relates to having *Takāful* as a separate line of business within the IIFS – for example, in a subsidiary. In jurisdictions where these activities are supervised by a separate regulatory entity, close cooperation with such other supervisory authorities is crucial. To facilitate coordination between the authorities, frequent dialogues or memoranda of understanding may be needed (see paragraph 172) to assign clearly their respective roles and responsibilities, and to establish a central point of contact.

166. This central point of contact is crucial in fulfilling the objective of risk-focused supervision. The central point of contact should be knowledgeable about the IIFS's activities, remain up to date, and share information specific to an IIFS, where appropriate, with any interested supervisory authority.

167. For unregulated entities and/or non-financial entities that are subsidiaries of a regulated IIFS, the authority supervising the parent IIFS may assess whether the risks are transferred from regulated to unregulated entities, or vice versa. Where a regulated IIFS has significant influence over, and exposure to the risks of, such subsidiaries, the supervisory authority may apply to the investments in the subsidiaries, as recorded in the consolidated balance sheet, the same approaches to capital adequacy and disclosure that would be appropriate in the case of similar activities of a regulated entity. In addition, the authority may need to satisfy itself that appropriate *Sharī'ah* compliance systems are in place across the group.

168. In their supervisory review process in terms of *Sharī'ah* compliance at the consolidated<sup>66</sup> level – in particular, in cases where the *Sharī'ah* is being interpreted differently across countries – the supervisory authorities should promote: (a) harmonisation of legal and *Sharī'ah* compliance frameworks; (b) the enhancement of collaboration between the SSBs of various jurisdictions; and (c) the sharing of the rulings and the basis of *Sharī'ah* rulings.

169. Consolidated supervision will normally be based, at least in part, on full or partial accounting consolidation at the group level. This may raise particular problems for the supervision of IIFS, where the treatment of different assets, liabilities and transactions may differ between jurisdictions. One example is whether unrestricted profit-sharing investment accounts (UPSIA) are treated as deposits, and thus as fully on the balance sheet of the group, or in some other way. Supervisory authorities should ensure that they understand the approach being taken, and its implications for the institutions they supervise, whether or not they are themselves the consolidating supervisor. Depending on the structures of cooperation involved, they may need to raise with other authorities the issues that arise.

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<sup>66</sup> "Consolidated supervision" is generally defined as a comprehensive approach to banking supervision which seeks to evaluate the strength of an entire group, taking into account all the risks which may affect a bank, regardless of whether these risks are carried in the books of the bank or of related entities.



### **3.7.2 Home-host Cooperation and Structures of Cooperation**

170. There are diverse approaches with respect to regulation and supervision of *Sharī'ah* matters in various jurisdictions. In some cases, there may be a national *Sharī'ah* board, whereas another jurisdiction may mainly require applicable *Sharī'ah* systems to be in place. In some arrangements, the prior consent of the home supervisory authority may be an integral part of the product and service authorisation process. In other cases, there may be simply a notification requirement or no formal authorisation or approval requirement. Irrespective of the approaches, the host supervisory authority has primary responsibility to ensure that the IIFS under its supervision comply with its national rules and regulations, including on *Sharī'ah* matters.

171. For consolidated supervision, the home supervisory authority is expected to have the need for and access to a range of information pertaining to the foreign branches and subsidiaries of an IIFS group under its supervision. The home supervisory authority needs to assess the impact of any development in the structure of the supervised IIFS group and to make appropriate adjustments to its supervisory approach. To facilitate the review process, the home supervisory authority should obtain information from IIFS groups under its supervision about the objectives, business activities and risk management practices applicable to their foreign branches and subsidiaries, as well as other issues of supervisory concern.<sup>67</sup>

172. The selected structure of cooperation, such as a supervisory college, bilateral or multilateral cooperation through a memorandum of understanding (MOU) or memorandum of agreement (MOA), should reflect both the group's structure and the supervisors' requirements. Specific home-host information access and/or sharing involving IIFS groups with cross-border and cross-sectoral structures may include, among others and where applicable, licensing criteria, background of foreign institutions, "fit and proper" information, issues of supervisory concern such as verification of risk management methodology, counterparty credit risk management and major counterparty exposures, validity of *Sharī'ah* compliance, and findings regarding *Sharī'ah* non-compliance.

### **3.7.3 Supervisory College and IIFS's Specific Issues**

#### **Overview of supervisory college**

173. The term "supervisory college" refers to a group of supervisory authorities that have come together in order to pursue a common purpose of sharing information and coordinating activities on a cross-border basis. The BCBS has issued detailed guidance on supervisory colleges entitled *Good Practice Principles on Supervisory Colleges*, October 2010.<sup>68</sup> According to the BCBS, the overarching objective of a supervisory college is to assist its members in developing a better understanding of the risk profile of the banking group and strengthening the supervision of the individual components of such a banking group through information exchange and cooperation between supervisors.

174. At the college level, the transparency and accountability of supervisors are important, both to enhance coordination among supervisory authorities and to provide information to the supervisees on the structure of, and requirements for, cross-border and cross-sector supervision.<sup>69</sup> Supervisory authorities should exchange information on prudential issues and risks which potentially endanger the institutions they oversee, particularly those that may have a systemic effect. In such exchanges of information, however, confidentiality should be a main consideration.

175. Supervisory dialogue is an important element to promote transparency and accountability in a college structure, as well as in consolidated, home and host supervision. The dialogue should be organised on a periodical basis embracing all aspects of business risks and internal governance including risk control, compliance and internal audit.<sup>70</sup> All supervisory authorities should ensure accountability, transparency and consistency of the dialogue, and provide other colleagues who are

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<sup>67</sup> There are many existing arrangements in place relating to information exchanges. The suggestion set out in this document is not intended to replace such existing arrangements.

<sup>68</sup> It is important to note that the supervisory colleges' initiative is also supported by the Joint Forum, the Financial Stability Board (FSB), the BCBS, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS), who have identified supervisory colleges as a major tool to improve supervisory coordination and cooperation.

<sup>69</sup> For example, the home supervisor should periodically notify host supervisors and relevant participants of any developments in college structures and activities, including variable and ad-hoc college sub-structures that may be used for specific purposes.

<sup>70</sup> A reference is made to CEBS's *Guidelines on Supervisory Review Process*, January 2006.

not included in the structure with particular opportunities for dialogue to provide input appropriately. The dialogue should also promote convergence of supervisory practices.

176. Supervisory disclosure is another important element in the college structure, as well as in consolidated and home-host supervision. Appropriate mutual disclosure by supervisory authorities is desirable to ensure proper accountability, which in turn helps to promote sound governance practices on the part of the supervisors themselves.

177. In the light of the expansion of domestic financial groups across borders, as well as the growing presence of foreign financial institutions (in particular, IIFS) operating in certain jurisdictions, the IFSB notes that some supervisory authorities have initiated more structured approaches to cooperation with other supervisory authorities. In particular, they have leveraged on the role of supervisory colleges in informing supervisory assessments, coordinating supervisory activities, and generally promoting more coherent supervisory frameworks for the cross-border operations of financial institutions. The discussions within the supervisory college have enabled the supervisory authorities to form a more comprehensive view of the financial groups and to validate their assessments of the extent to which the exposures of parent institutions to problems of subsidiaries (or, indeed, vice versa) and the centralisation of key functions present risks to regulated institutions in their jurisdictions.

178. While supervisory colleges are an important issue in the conventional banking industry, they may be a less immediate issue for the IFSI because the benefits of supervisory colleges are relevant specifically for internationally active banking groups. In this respect, the IFSB notes that the IFSI may not have the kinds of exposures that necessitate separate guidance on supervisory colleges with respect to its specificities.<sup>71</sup> Therefore, this Standard does not cover all aspects of supervisory colleges. These are well covered in the BCBS's *Good Practice Principles on Supervisory Colleges*, which should be referred to by supervisory authorities for more information.

179. Broadly, the scope of the engagement and an appropriate structure of the supervisory college would be guided through BCBS's *Good Practice Principles on Supervisory Colleges*; however, in particular, issues relating to the following should be included in the scope of the supervisory college: (a) the regulatory and legal framework for IIFS; (b) divergence of *Shari'ah* compliance practices and integration of SSBs; (c) key disclosures on IIFS' operations as indicated under IFSB-4 and confidentiality; and (d) cross-border insolvency of IIFS as part of a group operating in more than one jurisdiction.

180. While effective and efficient colleges are important, not only for consolidated supervision at the microprudential level, but also for the promotion of financial stability at the macroprudential level; nevertheless, they are not meant to replace wider bilateral or multilateral cooperation between supervisors, nor to impede existing national, bilateral or multilateral arrangements. In this respect, supervisory colleges should not be seen as a substitute for effective national supervision or as undermining the legal and prudential responsibilities of the respective supervisors.

#### ***Cross-border insolvency of IIFS in the supervisory college context***

181. Close collaboration between supervisory authorities guided by international standards and best practices is the most effective tool in dealing with cross-border insolvency of IIFS as part of a group operating in more than one jurisdiction. However, as part of the functioning of a supervisory college, with respect to supervisory coordination for such cross-border insolvencies of IIFS, the affected supervisory authorities may establish a crisis management group to undertake the following: (a) to identify all interlinkages and interdependencies between the IIFS and group members in other jurisdictions; (b) to identify legal impediments with respect to cross-border insolvency of IIFS; and (c) to understand the various national resolution frameworks and the processes involved, as well as the related legal arrangements. In addition, the above measures need to be further complemented by continuous sharing of information between the supervisory authorities.

182. In order to operationalise the above measures for supervisory coordination in case of such cross-border insolvencies of IIFS, the following recommendations can be considered: (a) an MOU should be signed between the supervisory authorities and should include a chapter on the procedures

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<sup>71</sup> While supervisory colleges aim at enhancing cooperation between supervisory authorities for cross-border supervision of banking groups operating in several jurisdictions, it is noted that some group members may or may not be IIFS.

to be taken by each in case of such cross-border insolvencies of IIFS; and (b) pre-approved procedures in case the parent bank becomes insolvent.

183. In particular, for cross-border insolvency of an IIFS, measures may be viewed from two perspectives: (a) the measures to be adopted by supervisory and other authorities (including developing resolution plans and in terms of information sharing and cooperation with other authorities, both domestic and cross-border, to coordinate an orderly restructuring or resolution of a troubled IIFS); and (b) those measures to be adopted by IIFS (including contingency funding plans and recovery plans) which should be subject to critical assessment by supervisors as part of their ongoing supervision. This requires that the supervisory review process by supervisory authorities should cover the availability of a sound institutional framework for crisis management and resolution of the IIFS, and clarity in the roles and mandates of the relevant agencies.

### **3.8 Islamic Window Operations (“Windows”)**

#### **3.8.1 Overview of Islamic Windows Operations**

184. Islamic windows are present in a majority of the IFSB member jurisdictions<sup>72</sup> where Islamic finance is operating, and the supervisory practices for regulating them – in particular, relating to capital requirements – vary considerably across jurisdictions. This diversity of windows’ operations raises a number of issues on supervision which are substantially the same as those raised by full-fledged IIFS.<sup>73</sup> Therefore, windows’ operations should be reviewed by the supervisory authorities within their normal supervisory review process using the existing supervisory tools as discussed in section 2.4.

185. For the purpose of this Standard, an Islamic window operation is defined as part of a conventional financial institution (which may be a branch or dedicated unit of that institution, but not a separate legal entity) that provides both fund management (investment accounts) and financing and investment that are *Shari’ah* compliant. In principle, these windows are potentially “self-contained (or “full windows”) in terms of *Shari’ah*-compliant financial intermediation, as the funds managed will be invested in *Shari’ah*-compliant assets, and segregation of assets (with separate accounting for profit and loss) is properly maintained between the Islamic window and its parent funds. They thus raise a number of issues of supervision that are substantially the same as those raised by a full-fledged IIFS.

186. The term “window” is used in some jurisdictions to refer to an operation whereby an institution invests funds in *Shari’ah*-compliant assets (such as home purchase plans based on *Ijārah Muntahia Bittamlik*, Diminishing *Mushārah* or *Murābahah*) without such funds having been mobilised on a *Shari’ah*-compliant basis or specifically for *Shari’ah*-compliant investment purposes. Such operations clearly do not meet the definition of an Islamic window given in paragraph 185, but are referred to in this Standard as “asset-side only windows”. Such operations may be carried out through either branches that offer current account facilities or other units of the institution. The supervisory issues raised by such operations are substantially different from those raised by full-fledged IIFS, but include issues of risk management in respect of the *Shari’ah*-compliant assets and the application of appropriate risk weightings to those assets for capital adequacy purposes. Supervisory authorities should be guided by the IFSB standards on risk management (IFSB-1) and capital adequacy (IFSB-15) in supervising such operations.

187. The institution should have a system such that the separation of Islamic assets and funds from non-*Shari’ah*-compliant assets and funds is made transparent.<sup>74</sup> The system should act to prevent the window not simply from investing in non-*Shari’ah*-compliant assets, but also from channelling investors’ funds back to the conventional parent entity.<sup>75</sup> The window’s share of profits from managing those funds may, of course, be channelled back to the parent. “Full” windows need to be differentiated from (a) *Shari’ah*-compliant mutual funds that are separate legal entities; and (b) providers of *Shari’ah*-compliant financing products (e.g. for house purchase) which do not mobilise funds with the assurance that they will be invested in *Shari’ah*-compliant assets.

<sup>72</sup> The RSRPWG Survey found 160 Islamic windows (comprising 50 windows from one jurisdiction alone and 24 in another jurisdiction). The majority of these Islamic windows have been in operation for over 15 years.

<sup>73</sup> In some cases, the absence of proper risk management and a *Shari’ah* compliance mechanism has resulted in closure of window operations. This indicates the need for satisfactory *Shari’ah* governance arrangements for the window.

<sup>74</sup> The supervisory authority should, subject to materiality, require the institution to publish a full separate set of supplementary financial statements for its window operation in the notes to its financial statements (see IFSB-4).

<sup>75</sup> Unless that entity has verifiable systems for the segregation of those assets and their deployment only in *Shari’ah*-compliant ways.

188. The supervisory authorities in jurisdictions where windows are present need to satisfy themselves that the institutions offering such windows have the internal systems, procedures and controls to provide reasonable assurance that (a) the transactions and dealings of the windows are in compliance with *Sharī'ah* rules and principles; and (b) appropriate risk management policies and practices are followed.<sup>76</sup>

189. In supervising a window operation, the supervisory authority needs to bear in mind the specific characteristics of the *Sharī'ah* compliance as well as the fact that it is part of a conventional institution. This is true of capital adequacy, corporate governance, risk management and disclosure. A window operation should in the first instance be considered separately as a branch of the entity of which it is a part; the latter will then be considered on a consolidated basis.

### **3.8.2 Internal Controls**

190. A window is expected to apply IFSB-10 on *Sharī'ah* governance. Where it does not do so, the supervisory authority needs to seek explanation of its reasons for not doing so. In such cases, the supervisory authority should satisfy itself that pertinent *Sharī'ah Fatāwa* and resolutions are complied with by the financial institution's management in their offering of Islamic financial services.

### **3.8.3 Regulatory Capital Requirement**

191. A supervisory authority will need to take account of the *Sharī'ah*-compliant assets of the window, as well as the risk-bearing nature of the *Sharī'ah*-compliant funds that are invested in these assets, in assessing the capital adequacy of the conventional financial institution concerned. The IFSB's *Revised Capital Adequacy Standard* provides a measurement approach that may be used for this purpose, although in general the overall capital regulatory requirement is embodied in the regulatory requirement at the main institutional (consolidated<sup>77</sup> or parent) level, irrespective of the parent, whether in the same jurisdiction or in another jurisdiction. In some countries, the amount of the entity's own regulatory capital that is required to provide capital adequacy to the window operation is clearly identified and segregated from the regulatory capital available for the conventional operations. The use of this approach for a window operation is subject to considerations of materiality.

192. The capital requirement for a window operation as defined in paragraph 185 may be determined by calculating first the amount of the denominator of the CAR (as explained in Appendix A to IFSB-15), and then the amount of capital needed in the numerator of the CAR in order to meet the regulatory capital requirement. This amount may then be deducted from the Common Equity Tier 1 (CET1) of the parent in the numerator of its CAR.<sup>78</sup> However, a supervisory authority may at its discretion employ a different approach with the same economic effect. Further, depending upon how the IAH are treated in the jurisdiction (see section 3.1.4), supervisory authorities should provide guidance to the window, subject to CAR or its parent, on the need for any adjustment in the calculation of the denominator of the CAR, to cater for any risk absorbency features of unrestricted PSIA, if offered by the window.

193. For an "asset-side only window" as defined in paragraph 186, all that is required is the calculation of the appropriate risk weightings for its *Sharī'ah*-compliant assets based on the guidance provided in IFSB-15.

194. In cases where supervisory authorities do not require "full" windows to maintain separate regulatory capital (irrespective of whether the parent is in the same or another jurisdiction), the supervisory authorities may consider applying separate minimum capital requirements in line with criteria set out in section 3.8.5. Thus, the supervisor may require the window to hold a certain minimum balance in its "head office account" – that is, the account that represents the parent's net investment in the branch. Such a requirement is particularly relevant when the parent entity is in another jurisdiction. Alternatively, in cases where the window is a foreign branch (i.e. its parent is in another jurisdiction), the host supervisory authority may require a guarantee from the parent entity, instead of stipulating minimum regulatory capital for the branch, to ensure that the branch operation receives appropriate capital support from the parent at all times. However, supervisory authorities

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<sup>76</sup> Refer to retail investor disclosure in IFSB-4.

<sup>77</sup> For the purpose of this sub-section on Islamic windows, the term "consolidation" refers to consolidation of the window with its parent conventional bank of which it is a branch or division. This term should not be confused with the group consolidation of a parent company and its subsidiaries at the banking group level.

<sup>78</sup> See IFSB-15 for more details on capital requirements for windows.

should note that this raises the issue of the extent to which such a guarantee may be relied upon in stressed conditions.

195. In line with the criteria set out in section 3.8.5, supervisory authorities, at their discretion, may also impose additional requirements (such as capital and risk management) on such windows, or may require them to be converted into full-fledged IIFS, if they are not fully satisfied with their risk profile, internal systems, procedures and controls. In some jurisdictions, supervisory authorities require Islamic windows to be converted into Islamic banking subsidiaries when they attain a significant size after several years of operations. A supervisory authority may stipulate certain criteria (e.g. in terms of asset size of Islamic windows in absolute terms or as a percentage of the parent's balance sheet) for such conversion, based on the overall legal and regulatory framework in the jurisdiction as well as the overall national strategic plan for the Islamic banking industry, if any.

#### **3.8.4 Disclosure Requirements**

196. In addition to some proposed disclosures as mentioned in paragraph 156, a supervisory authority may require the institution to disclose publicly, among other things:

- (a) sources of funds to cover a liquidity deficit of the window, if any;
- (b) capital adequacy related disclosures;
- (c) risk management and governance;
- (d) appointment of a competent *Sharī'ah* scholar or *Sharī'ah* board; and
- (e) a *Sharī'ah* compliance report covering, *inter alia*, the mechanism established to provide *Sharī'ah* oversight of the activities of an Islamic window.

197. Disclosure methodology, with respect to the disclosures suggested above, should be consistent with IFSB-4. Disclosures should be provided by any appropriate means approved by the supervisory authority (e.g. via the internet), or to the supervisory authorities for subsequent disclosure by those authorities. They should normally form part of the disclosure requirements associated with periodic financial reporting (i.e. a complete set of financial statements with notes for an Islamic window provided as part of the notes to the financial statements of the conventional financial institution of which the window is a part).

#### **3.8.5 Guidance Factors on the Application of IFSB Standards to Islamic Windows**

198. Most of the IFSB Standards and Guidance Notes are specifically not applicable to Islamic windows operations, and it is generally stated in these SAG that supervisory authorities may, at their discretion, extend the application of these standards to window operations that are self-contained ("full" windows). In this respect, certain supervisory authorities have expressed a wish for guidance on this issue. The applicability of standards to windows will vary depending on the subject matter of the standard. For example, market conduct standards may be readily applied to almost all windows, while governance standards will need to respect the fact that a window is not a separate legal entity with, for example, its own BOD. Nevertheless, the criteria presented below provide some indications of circumstances in which it may be appropriate to apply the IFSB standards to Islamic windows operations:

- (a) The total asset size (i.e. financing and investments) of the Islamic windows of one parent entity, irrespective of the total number of windows, is becoming reasonably significant within the parent's operations.
- (b) The Islamic windows have the potential to cause systemic risk to the industry.
- (c) Islamic windows have gained a sizeable market share of the total Islamic banking assets in the jurisdiction.<sup>79</sup>
- (d) The parent entity of the window is in a foreign jurisdiction.

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<sup>79</sup> The survey observed that, in some jurisdictions, quite a few Islamic windows are larger than some full-fledged IIFS in terms of total assets. In some other cases, the share of Islamic financing assets maintained by Islamic windows exceeds one-third of the total assets on the parent's balance sheet.

## SECTION IV: ADDITIONAL SPECIFIC ISSUES TO BE ADDRESSED UNDER THE SUPERVISORY REVIEW PROCESS OF IIFS

199. This section discusses some additional specific issues with respect to banking risks, which supervisory authorities should particularly focus on when carrying out the supervisory review process, including concentration risk (also covering real estate investment concentration), assessment of rate of return risk in the banking book, liquidity risk management and supervision, stress testing practices for IIFS and supervisory authorities, reputational risk, *Sharī'ah*-compliant hedging techniques, valuation practices, and supervisory transparency and accountability.

### 4.1 Risk Concentration

200. "Risk concentration" is defined as "any single exposure or group of similar exposures (e.g. to the same counterparty, including protection providers, geographic area, industry or other risk factors) with the potential to produce (i) losses large enough (relative to an IIFS's earnings, capital, total assets or overall risk level) to threaten an IIFS's creditworthiness or ability to maintain its core operations or (ii) a material change in an IIFS's risk profile".

201. The IFSB's GN-2 (*Guidance Note in connection with Risk Management and Capital Adequacy Standards: Commodity Murābahah Transactions*) notes the existence of high concentrations in various IIFS portfolios. Concentrated exposures in CMT and real estate activities (see sections 4.1.2 and 4.1.3 on real estate investment) are common in IIFS and can expose them to the various prudential risks and supervisory issues that need to be covered in the supervisory review process, especially when *Sharī'ah*-compliant hedging may not be available and risk transfer via *Sharī'ah*-compliant securitisation may be difficult to achieve. Therefore, supervisory authorities should assess the extent of an IIFS's credit and counterparty risk concentrations, how they are managed, and the extent to which the IIFS considers them in its ICAAP under Pillar 2. Such assessments should include reviews of the results of an IIFS's stress tests. (For concentration risk-related stress testing, both IIFS and supervisory authorities should be guided by IFSB-13.)

202. IIFS should have in place effective internal policies, systems and controls to identify, measure, monitor and control their credit risk concentrations in a timely manner. To mitigate concentration risk, IIFS should set limits to their exposures. In many jurisdictions, supervisory authorities provide and define a limit specific to a particular individual counterparty or group of related counterparties. This limit is commonly referred to as a "large exposure limit".<sup>80</sup> In addition to this limit, an IIFS may also establish an aggregate limit for the management and control of all of its large exposures as a group; however, limits should be defined in relation to the IIFS's capital, total assets or, where adequate measures exist, its overall risk level.

203. IIFS should also explicitly consider the extent of their credit risk concentrations in their assessment of capital adequacy under Pillar 2. It is also important for IIFS to capture the multidimensional, enterprise-wide threat from risk concentrations. Accordingly, identified concentrations should be measured in a number of ways (e.g. consideration of gross versus net exposures, use of notional amounts) through employing a number of techniques (such as stress testing with respect to shocks involving various risk factors; and the use of business-level and firm-wide scenarios and integrated stress testing and economic capital models), as appropriate, to measure the potential impact of risk concentrations.<sup>81</sup>

#### 4.1.1 Supervisory Review for Credit Concentration Risk

204. The following aspects can be considered by the supervisory authorities with respect to the supervisory review process regarding the concentration risk of an IIFS: (a) risk concentrations analysed at the level of an IIFS's legal entity and/or on a consolidated basis; (b) risk concentrations viewed in the context of a single or a set of closely related risk-drivers that may have different impacts on an IIFS; (c) the IIFS's compliance with defined limits for large individual exposures and for exposures in total; (d) a framework for managing credit risk concentrations that clearly documents and

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<sup>80</sup> A study conducted in 2012 for the RSRPWG indicated the variations in the definition of limits for single counterparty and/or an individual large exposure by the supervisory authorities. In most cases, the range of the defined limit was 10–35% of the IIFS's capital base.

<sup>81</sup> Not only should normal market conditions be considered, but also the potential build-up of concentrations under stressed market conditions, economic downturns and periods of general market illiquidity.

includes a definition of the credit risk concentrations relevant to an IIFS; and (e) different forms of credit risk concentrations to which an IIFS may be exposed, such as the following:

- (i) exposures to a single counterparty;
- (ii) exposures to a group of connected counterparties;
- (iii) significant amount of aggregate exposure to a small number of counterparties;
- (iv) industry or economic sectors, including exposures to both regulated and non-regulated financial institutions such as private equity firms;
- (v) geographical regions;
- (vi) exposures arising from credit risk mitigation techniques;
- (vii) exposures to counterparties through the execution or processing of transactions such as CMT;
- (viii) assets that are held in the banking book or trading book, such as financing, *Sharī'ah*-compliant hedging instruments and structured products (such as CMT); and
- (ix) off-balance sheet exposures, including guarantees, liquidity lines and other commitments.

205. In the supervisory review process, credit concentration risk management should be reviewed by supervisory authorities. The review should cover, at minimum, IIFS' internal policies, processes and procedures in identifying, measuring, monitoring and controlling (or mitigating) credit concentration risk. In certain circumstances, identifying risk concentrations may require looking through transaction structures to identify the underlying assets and assess any "hidden concentrations" that may emerge. In this respect, the supervisory authorities may want to look at models, scorecards, etc. used in the ICAAP for capital add-on, as well as at how the scorecards work as predictors of failure. To facilitate supervisory review of IIFS' ICAAP, the supervisory authorities should establish an internal capital add-on methodology for credit concentration risks to be used as a check on IIFS' reasonableness of capital computation for the risks.

206. If there is an indication of, or findings point out, a substantial concentration risk or lack of compliance with limits/caps in a specified sector/region, the supervisory authorities should take appropriate supervisory actions, such as: (a) warning the IIFS to reduce the concentration in that specific sector/region and diversify their investments in various sectors/regions; (b) incorporating an appropriate level of additional capital for risk concentrations in an IIFS' ICAAP (see section 3.2.1); and (c) deducting the excess amount from the IIFS's capital base.

207. Supervisory authorities should also assess the risk concentrations of IIFS in the context of domestic and cross-border banking groups. For this purpose, there should be appropriate discussions between consolidating and host supervisors to ensure coordination of supervisory activities relating to concentration risk. Supervisory authorities should also satisfy themselves that an IIFS has adequate capital and appropriate liquidity buffers in relation to its risk concentrations.

#### **4.1.2 Concentration Limits for Real Estate Investment**

208. "Real estate investment" (as opposed to a real estate financing transaction) 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.<sup>82</sup> Real estate investments by IIFS have been on the rise in many jurisdictions. The IIFS act as property developers and/or owners, roles which are normally undertaken by real estate specialists. Such investments raise supervisory issues, particularly with respect to risk management and capital adequacy. IFSB-15 outlines the three broad categories of real estate investment and the respective regulatory capital treatment that should be referred to by IIFS.<sup>83</sup>

209. The internal policies on real estate investment should be approved by the BOD, and at minimum should address the following: (a) a set of criteria on allowable exposures (i.e. risk limits) to

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<sup>82</sup> 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). (Refer to IFSB-15 for more detail on real estate activities.)

<sup>83</sup> Note that real estate financing will also expose the IIFS to risks from the real estate market in the jurisdiction, and these should be considered as part of the more general concentration risk assessment described above; the separate assessment for direct investment discussed here does not absolve the IIFS and supervisory authorities from their obligations to assess those more general risks.

real estate business based on the IIFS's business strategies; (b) assurance that the IIFS shall not engage in speculative activities involving land and properties; (c) internal limits to any individual developer, allowable investment limits, types of properties and overall sectoral exposure; (d) adequate guidance on the decision-making, monitoring and assessment process to ensure that the real estate business is permissible under *Shari'ah* principles. The policies should also provide appropriate measures to address potential non-compliance with *Shari'ah* requirements; and (e) clearly defined responsibility of internal audit in assessing the effectiveness of the internal control systems put in place to control risk.

210. In jurisdictions where real estate investment is permissible, some supervisory authorities adopt a combined approach in limiting the risks to which the IIFS or its IAH are exposed through restricting the total amount of exposures in the sector, restricting the usage of unrestricted investment accounts or applying specific risk weights for this investment.

211. Primarily, the supervisory authority needs to satisfy itself that the IIFS meets prudential requirements that allow it to engage in real estate investment activities on its own balance sheet or indirectly through a wholly or majority-owned subsidiary. The authority may, among other things, set the type of activity, the level of real estate investment suitable for the IIFS and the concentration level of risks. It may also set the financial conditions and managerial resources of the IIFS in order to ensure the IIFS's ability to support real estate investment activities, determine that the IIFS is adequately protected from litigation risk, and set robust risk management, stress testing and valuation processes, and appropriate practices with regard to the IIFS commingling its funds with those of the UIAH.

212. In this context and in line with paragraph 204, it is recommended that the supervisory authority include, *inter alia*, the following restrictions or prudential limits:

- (a) A limit on aggregate real estate investment exposures which are large in relation to regulatory capital, with a significantly lower limit on single real estate investment exposures. If an IIFS exceeds the limit set by the supervisor, it shall inform the supervisory authority and submit a corrective action to reduce the aggregate exposures to an amount within the limit.
- (b) As an alternative to the single limit based on regulatory capital as set out in (a) above, the supervisory authority at its discretion may apply separate limits to the investment of the IIFS's own funds and current accounts on the one hand and funds of UIAH on the other hand.

The former limit (an aggregate limit) should be a percentage of regulatory capital that is substantially lower than the aggregate limit mentioned in (a) above, while the latter limit would be a percentage of the UIAH funds that is greater than what would be implied by the aggregate limit as a percentage of regulatory capital mentioned in (a) above but low enough to limit appropriately the UIAHs' exposure to real estate (e.g. 15% of UIAH funds).

- (c) In the case of restricted investment accounts which are clearly for the purpose of real estate investment, there is no proposed limit on the percentage of such funds that may be invested in real estate. However, supervisory authorities may apply a limit to single exposures at their discretion.<sup>84</sup>

213. Notwithstanding the above recommendation on prudential limits, since different jurisdictions may have different macroeconomic, socio-economic and prudential objectives, the supervisory authority may at its discretion determine appropriate prudential limits and punitive capital requirements (such as deduction from capital) for over-concentration in real estate investment and financing.

#### **4.1.3 Supervisory Review Process for Concentration Limits of Real Estate Investment**

214. Broadly, the supervisory review process for credit concentration risk discussed in section 4.1.1 is also applicable for concentration limits of real estate investment. In line with the requirements outlined in paragraph 209, the supervisory authority should satisfy itself that: (a) the BOD and SM have carried out effective oversight over the bank's exposure to real estate business activities; and (b)

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<sup>84</sup> In the case of restricted investment accounts, the investors are informed about the asset allocation of their funds.



the IIFS has clear internal policies and procedures to manage exposures to real estate business that are consistent with the IIFS's business strategies, level of expertise and risk management capabilities.

215. Supervisory authorities should review IIFSs' operations to ensure that they have adequate resources and capabilities for undertaking real estate investment activities. They should satisfy themselves as to the criteria employed by IIFS for selecting joint ventures for the purpose of undertaking real estate investment activities. In addition, they should satisfy themselves as to the adequacy of the risk management frameworks of IIFS with respect to real estate investment and financing.

216. For valuation of real estate investments, the supervisory authority should ensure that active IIFS within its jurisdiction value their property investments on a consistent basis. The supervisory authority should satisfy itself regarding the appropriateness of valuations used to determine the carrying value of a real estate asset at which the asset is transferred from investment to financing, or vice versa (in the case of assets under *Murābahah* to the purchase order or *Ijārah* transactions).

217. For disclosure, supervisory authorities may require IIFS to disclose adequately all key information with respect to their real estate investment exposures, encompassing: (a) the total exposure amount and any material changes in the risk profiles; (b) the measurement basis used in determining the valuation of the properties; and (c) the basis for depreciation methodologies and policy for recognising impairment of the properties.

#### **4.2 Assessment of Rate of Return Risk in the Banking Book**

218. Rate of return (ROR) risk in the banking book of an IIFS (which is an analogue of interest rate risk in the banking book in conventional banks as defined by the BCBS) surfaces from the possible impact on the net income of the IIFS arising from the effect of changes in the market rates and relevant benchmark rates on the returns on assets and on the returns payable on funding. It differs from interest rate risk in that IIFS are concerned with the returns on their investment activities at the end of the investment holding period and with the impact on net income after the sharing of returns with IAH. ROR risk leads to displaced commercial risk if the IIFS absorbs all or part of any shortfall in the returns payable to IAH by reducing its *Muḍārib* share or by donation from the shareholders' share of income.

219. It is also notable that ROR risk arises because the rate of return on certain categories of assets based on sale-based contracts such as *Murābahah* is fixed (by virtue of the applicable *Sharī'ah* rules and principles), whereas the market benchmark rate of return moves up or down. Thus, if an IIFS raises funds via unrestricted PSIA or via CMT-based term deposits with maturities shorter than those of its *Murābahah* assets, it will be exposed to the ROR risk (in addition to the liquidity risk resulting from maturity mismatches when CMT-based deposits are used).

220. ROR risk is among the important elements in banking risk management and is dealt with in Pillar 2 instead of Pillar 1. Excessive ROR risk can pose a significant threat to an IIFS's earnings and capital base. Accordingly, an effective risk management process, covering the earnings and economic value perspectives, that maintains benchmark rates risk within prudent levels is essential to the safety and soundness of IIFS. The earnings perspective focuses on the impact of benchmark rate risk changes on an IIFS's near-term earnings, while the economic value perspective considers the potential impact of benchmark rate risk changes on the present value of all future cash flows. The economic value perspective also provides a more comprehensive view of the potential long-term effects of changes in benchmark rates than is offered by the earnings perspective.

221. For IIFS, sound benchmark rates risk management involves the application of four basic elements in the management of assets and liabilities: (a) appropriate BOD and SM oversight; (b) adequate risk management policies and procedures; (c) appropriate risk measurement, monitoring and control functions; and (d) comprehensive internal controls and independent audits. The specific manner in which an IIFS applies these elements in managing its benchmark rate risk will depend upon the complexity and nature of its activities, as well as on the level of benchmark rate risk exposure.

222. It is essential that IIFS have benchmark rate risk measurement systems. A number of generally accepted techniques (such as *gap analysis*,<sup>85</sup> *duration gap analysis*,<sup>86</sup> and *static and dynamic simulation techniques*<sup>87</sup>) are available for measuring the benchmark rates risk exposure of both earnings and economic value. Regardless of the measurement system, IIFS should note that the usefulness of each technique depends on the validity of the underlying assumptions and the accuracy of the basic methodologies used to model interest rate risk exposure.

223. Supervisory authorities should obtain from IIFS sufficient and timely information with which to evaluate their level of benchmark rate risk. This information should take appropriate account of the range of maturities and currencies in each IIFS's portfolio, including off-balance sheet items, as well as other relevant factors, such as the distinction between fixed rate and variable rate *Shari'ah*-compliant contracts. Supervisory authorities may want to collect additional information from IIFS on those positions where the behavioural maturity is different from the contractual maturity.

224. Supervisory authorities should particularly assess whether: (a) the internal measurement systems of IIFS adequately capture the benchmark rate risks in their banking book – in particular, that they are capable of measuring risk using both an earnings and an economic value approach; and (b) the standardised benchmark rates shock (expressed in percentage terms reflecting a stressful rate environment) as determined<sup>88</sup> by the respective supervisory authority has been properly incorporated into the systems.

225. The IFSB currently is not proposing mandatory capital charges specifically for benchmark rate risk in the banking book; nevertheless, all IIFS should have enough capital to support the risks they incur, including those arising from benchmark rate risk in line with ICAAP requirements. If supervisory authorities determine that an IIFS has insufficient capital to support its ROR risk, they should consider remedial action, requiring the IIFS either to make a reduction in the risk or to hold a specific additional amount of capital, or a combination of both. Supervisory authorities should be particularly attentive to the capital sufficiency of "outlier IIFS" – those whose ROR risk in the banking book leads to an economic value decline of more than 20% of the sum of Tier 1 and Tier 2 capital following a standardised benchmark rate shock or its equivalent.

### 4.3 Counterparty Credit Risk

226. Counterparty credit risk (CCR), a risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows, is an important element in the context of the supervisory review process under Pillar 2. In this respect, an IIFS should have CCR management policies, processes and systems that are conceptually sound and implemented with integrity relative to the sophistication and complexity of the IIFS's holdings of exposures that give rise to CCR.

227. In regard to CCR management by IIFS, the supervisory authorities should note that: (a) supervisory treatments of CCR for IIFS that calculate their capital adequacy using the standardised approach and advanced approaches (e.g. IRB) approach are different (see section 3.1.5 for details on advanced approaches); and (b) not all of the issues relating to CCR would appear to be of relevance to IIFS due to their limited use of *Shari'ah*-compliant hedging instruments and of advanced approaches for CAR. Nevertheless, recent CMT practices by IIFS, either over-the-counter (OTC) or through organised markets, may have important implications for supervisory authorities for CCR management and should be taken into account in the supervisory review process.

228. The IFSB's GN-2 discussed CCR from the IIFS perspective. It needs to be borne in mind that CMT may involve significant CCR exposures, either to an ultimate purchaser under asset-side

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<sup>85</sup> Simple maturity schedules can be used to generate simple indicators of the benchmark rates risk sensitivity of both earnings and economic value to changing benchmark rates. When this approach is used to assess the benchmark rates of current earnings, it is typically referred to as gap analysis.

<sup>86</sup> A maturity schedule can also be used to evaluate the effects of changing benchmark rates risk on an IIFS's economic value by applying sensitivity weights to each time band. Typically, such weights are based on estimates of the duration of the assets and liabilities that fall into each time band. Duration is a measure of the percentage change in the economic value of a position that will occur given a small change in the level of benchmark rates.

<sup>87</sup> In static simulations, the cash flows arising solely from the IIFS's current on-and-off balance-sheet positions are assessed. For assessing the exposure of earnings, simulations estimating the cash flows and resulting earnings streams over a specific period are conducted based on one or more assumed benchmark rates scenarios. In the dynamic simulation approach, the simulation builds in more detailed assumptions about the future course of benchmark rates and the expected changes in a bank's business activity over that time.

<sup>88</sup> Although the BCBS recommends a 200 basis point parallel rate shock, supervisory authorities can determine or make adjustments in the shock taking into account the local financial context in which IIFS and conventional banks are operating.

transactions, or to a broker under both asset- and liability-side transactions. CCR will be relevant in Commodity *Murābahah* for Liquid Funds (CMLF)<sup>89</sup> and Commodity *Murābahah* Financing (CMF)<sup>90</sup> on the asset side. In the cases of both CMLF and CMF on the asset side, the significance of CCR will depend on the size of the position, the quality of the counterparty and the available risk mitigants.

229. Supervisory authorities should ensure that an IIFS's CCR management framework includes the identification, measurement, management, approval and internal reporting of CCR, taking into account the market, liquidity, legal and operational risks, including *Sharī'ah* non-compliance risk, that can be associated with CCR and, to the extent practicable, interrelationships among those risks. They should also ensure that risks associated with CCR in the case of OTC transactions are correctly evaluated and managed by IIFS. Supervisory authorities should confirm that an IIFS has a rigorous programme of stress testing in place as a supplement to the CCR analysis based on the day-to-day output of the IIFS's risk measurement model. Additionally, they should ensure that IIFS manage the CCR by putting in place appropriate credit policies, applying *Takāful* coverage, securing the necessary collaterals, and setting authorised limits prior to entering into CMT.

#### 4.4 Liquidity Risk Management and Supervision

230. 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. The financial and economic crisis (2008) underscored the importance of assessing the potential impact of liquidity risk on capital adequacy in an IIFS's ICAAP. Liquidity risk can impact capital adequacy, for example, by forcing disposals of assets at prices below their carrying values, thus reducing the bank's capital.

231. An IIFS should both continuously manage its liquidity risk and maintain sufficient liquidity to withstand a range of stress events. A key element in the management of liquidity risk is the need for strong governance of liquidity risk, including the setting of an approved level of liquidity risk tolerance by the board. The IIFS is expected to be able to specify the structure of the liquidity risk management process and to thoroughly identify, measure, monitor, control, mitigate and report liquidity risks in compliance with *Sharī'ah* rules and principles and within the context of available *Sharī'ah*-compliant instruments and markets. This process should involve the ability to project cash flows arising from assets, liabilities and off-balance sheet items over various time horizons, and should ensure diversification in both the tenor and source of funding.

232. In March 2012, the IFSB published *Guiding Principles on Liquidity Risk Management for IIFS* (IFSB-12), which outlines a set of guiding principles for the robust management of liquidity risk by IIFS and their vigorous supervision and monitoring by supervisory authorities, taking into consideration the specificities of IIFS, while complementing relevant international standards and best practices. Apart from the guidance to IIFS in a number of key areas in their management of liquidity risk, the Standard also emphasises the importance of supervisory authorities assessing the adequacy of an IIFS's liquidity risk management framework and its level of liquidity, and suggests steps that they should take if these are deemed inadequate.

233. Supervisory authorities should ensure that, in line with IFSB-12, an IIFS has in place a sound and comprehensive liquidity risk management framework (including, *inter alia*, an appropriate governance process with board and senior management oversight), integrated into its enterprise risk process, in order to maintain sufficient liquidity to meet its daily funding needs and to cover both expected and unexpected deviations from normal operations for a reasonable time. In this respect, supervisory authorities should have a rigorous process for evaluating the overall liquidity positions and the liquidity risk management framework of an IIFS so as to ensure that it maintains an adequate level of liquidity at all times and can withstand a period of liquidity stress under defined scenarios.

234. Supervisory authorities should also outline important elements of the supervisory framework concerned with monitoring the liquidity positions and liquidity risk management framework of IIFS, including, *inter alia*, initiatives for the development of a robust national liquidity infrastructure,

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<sup>89</sup> CMT for interbank operations for managing short-term surpluses or deficits of liquidity (i.e. selling and buying of *Sharī'ah*-compliant commodities through *Murābahah* transactions), or where the counterparty is the central bank or monetary authority offering *Sharī'ah*-compliant liquidity support and/or a standing facility for effective liquidity management, is referred to as Commodity *Murābahah* for Liquid Funds.

<sup>90</sup> CMT for providing financing to a counterparty by a longer-term Commodity *Murābahah* where the counterparty immediately sells the commodities on the spot market is referred to as Commodity *Murābahah* Financing.

supervisors' contingency planning for IIFS, timely corrective actions, and supervisors' role as provider of *Sharī'ah*-compliant liquidity support to IIFS.

235. The quantitative liquidity framework introduced in Basel III has two components – the liquidity coverage ratio (LCR), and the net stable funding ratio (NSFR). The LCR ensures that banks have sufficient high-quality liquid resources to survive an acute stress scenario lasting a month. This is complemented by the NSFR, which is a structural ratio designed to address maturity mismatches over a longer-term horizon, and promotes resilience over that longer-term horizon by creating incentives for banks to fund activities with more stable sources of funding on an ongoing basis. The IFSB is working on the preparation of supplementary guidance to IFSB-12 on the quantitative elements of Basel III, namely the LCR and the NSFR, in the form of a separate Guidance Note.<sup>91</sup> In this connection, attention is drawn to the requirement for a Supervisory Liquidity Review Process (SLRP) in conjunction with an Internal Liquidity Adequacy Assessment Process (ILAAP) to be carried out by IIFS.

#### 4.5 Sound Stress Testing Practices

236. Stress testing is a key risk management tool within financial institutions and is an important part of the supervisory assessment under Pillar 2. The IFSB's *Guiding Principles on Stress Testing for IIFS* (IFSB-13), issued in March 2012, provides a comprehensive stress testing framework for both IIFS and supervisory authorities. The guiding principles are guidelines intended to complement the existing international stress testing framework,<sup>92</sup> taking into consideration the specificities of IIFS as well as the lessons learned from the financial crisis so as to contribute to the soundness and stability of IIFS, in particular, as well as the IFSI as a whole.

237. IFSB-13 outlines that stress testing should form an integral part of the overall governance of the IIFS. In particular, guiding principles provide a framework for IIFS with the aim of guiding them in assessing and capturing vulnerabilities under various stress testing scenarios, including extreme but plausible shocks, in order to achieve the following, *inter alia*:

- (a) to identify how different portfolios respond to changes in key economic variables (e.g. benchmark rates, foreign exchange rates and credit quality);
- (b) to assess the quality of assets, and identify existing and potential loss exposures;
- (c) to evaluate potential threats to the IIFS's ability to meet its financial obligations at any time arising from either funding or market liquidity exposures;
- (d) to estimate the impact of stress events on baseline profits (as profits normally act as the first line of defence before dipping into capital); and
- (e) to analyse an IIFS's ability to meet its capital requirements at all times throughout a reasonably severe economic recession.

238. The Standard also emphasises the importance of stress testing for supervisory authorities: (a) as a surveillance tool for periodically testing the safety and soundness of the financial system (including IFSI); (b) from a financial stability perspective, to identify "weaknesses" in the financial system and structural (systemic) vulnerabilities arising from the specific risk profiles of IIFSs individually and collectively; and (c) as a supervisory tool for designing macroprudential policies.

239. Regular supervisory review and comprehensive assessment of an IIFS's stress testing programme are crucial. Supervisory authorities should assess IIFS' compliance with sound stress testing practices, and in particular with the aspects outlined in Principles 3.1 to 3.22 in IFSB-13, taking into account the principles of "proportionality" and relevance. While undertaking regular assessment, supervisory authorities should evaluate the extent to which stress testing is embedded in an IIFS's risk management framework (i.e. verifying that stress testing forms an integral part of the IIFS's risk management framework). They should also ensure that stress testing conducted by IIFS has

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<sup>91</sup> Both the LCR and the NSFR are proving to be problematic to implement for conventional banks. The problem with the LCR is the definition of high quality liquid assets (HQLA), which constitutes the numerator of the ratio; the existing text was considered to be too restrictive, and some flexibility in the eligibility criteria applicable to assets for HQLA status was introduced by a revision in January 2013. With the NSFR, the problem is the restriction it places on banks' traditional ability to earn a spread between the lower yields on shorter-tenor liabilities and the higher yields on longer-tenor assets.

<sup>92</sup> In particular, two seminal documents dealing with stress testing have been published in response to the financial crisis. In May 2009, the BCBS published its *Principles for Sound Stress Testing Practices and Supervision*, and in August 2010 the CEBS issued its *CEBS Guidelines on Stress Testing*. The BCBS document sets out 15 "principles" for banks and 6 for supervisors, while the CEBS document contains 17 "guidelines" for banks and 5 for supervisors.

considered specific characteristics especially related to risk characteristics, capital adequacy and the position of IAHs as providers of risk-absorbent funds.

240. The ultimate responsibility for the overall stress testing programme of the IIFS should be with the BOD. BOD and SM involvement in the stress testing programme is essential for its effective operation. Supervisory authorities should consider whether the BOD and SM have been sufficiently involved in the stress testing programme in line with the expectations set out in IFSB-13. They should also verify that the roles of a Governance Committee (or an equivalent committee) and SSB are performed effectively so that they are involved in the stress testing programme, or at least are informed of the stress testing results and/or of the *Shari'ah* compliance of the remedial actions based on the stress testing outputs.

241. Supervisory authorities should engage in regular communication (i.e. ongoing dialogue) with SM to discuss their views on major macroeconomic and financial market vulnerabilities, as well as threats specific to the IIFS's operations and ongoing business model. Such discussions will also address the extent to which reverse stress testing is used as a risk management tool. In their reviews, supervisory authorities should consider all sources of information about stress testing programmes and methodologies, including IIFS' own internal assessments and validation as well as reviews undertaken by independent control functions.

242. Under the supervisory review process, supervisory authorities should examine an IIFS's stress testing results as part of a supervisory review of both the IIFS's ICAAP<sup>93</sup> and its liquidity risk management.<sup>94</sup> In particular, they should consider reviewing stress testing outputs in order to assess the resilience of individual IIFS to adverse economic conditions and whether they are able to maintain sufficient capital and liquidity. This assessment requires asking IIFS to submit IIFS-wide stress testing results to them on a regular basis, helping them to assess the extent of integration of stress testing outputs into decision-making throughout the IIFS, including the strategic business decisions of the BOD and senior management and the IIFS's capital assessment and liquidity needs.

243. Apart from reviewing IIFS' stress testing methodologies, supervisory authorities should also emphasise the evaluation of the inputs to the tests carried out within those methodologies. For instance, they can evaluate the period of time during which the data sample is taken (normal vs. crisis), sample size, proxy data (before a big enough sample size is accumulated for a new product), simulation of data, parameters used for simulation, etc. Supervisory authorities should question an IIFS's methodology when the impact of stress tests seems unrealistically low or when mitigating actions are unrealistic. In this context, the supervisory assessment of the robustness of the stress testing methodology is critical as part of the capital planning, as IIFS are expected to assess the appropriateness of capital targets under ICAAP.

244. In their evaluations, supervisory authorities should also review whether the IIFS uses output from stress testing results (obtained through stress testing methodologies such as sensitivity and scenario analyses) appropriately, shares results within the organisation (such as with risk managers and senior management), and properly acts upon the results (e.g. by taking remedial actions if sensitivity tests show large adverse outcomes or reveal model weaknesses).

245. Supervisory authorities should assess the feasibility of proposed management actions in stressed conditions, challenge their credibility and, if necessary, require stress tests to be re-run with a range of different mitigating management actions. In cases where material shortcomings are identified in the IIFS in regard to addressing the outputs of stress tests, supervisory authorities should require the IIFS to take further remedial actions to ensure its solvency during a stress scenario. With respect to reviewing the range of remedial actions envisaged by an IIFS in response to the results of the stress testing, supervisory authorities should be cautious and take a more holistic view of all the remedial actions and their impact on the IIFS, as corrective actions on an ad-hoc basis after each and every stress test may distort a holistic review of the IIFS's safety and soundness.

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<sup>93</sup> Supervisory authorities should satisfy themselves that IIFS have stress testing procedures that take account of the impact of IIFS-wide stress scenarios for capital planning on total capital and capital needs. Supervisory authorities should ensure that they have access to the details of the main assumptions and drivers of movements in capital and capital needs. They should also ensure that capital is available to absorb losses and increases in regulatory capital requirements.

<sup>94</sup> Supervisory authorities should have access to the information allowing them to examine the liquidity needs of IIFS under adverse scenarios and to consider the adequacy of liquidity buffers under conditions of severe stress. They should be in a position to review the use of stress test results to ensure that the potential impact on an IIFS's liquidity is fully considered and discussed at senior management level. Where deficiencies are noted, supervisory authorities should ascertain that senior management takes appropriate actions, such as increasing the liquidity buffer of the IIFS and strengthening its contingency funding plans.

## 4.6 Reputational Risk

246. Reputational risk is the risk arising from negative perception on the part of customers, counterparties, shareholders, investors or regulators that can adversely affect an IIFS's ability to maintain existing, or establish new, business relationships and continued access to sources of funding (e.g. through the interbank or securitisation markets). Reputational risk may originate from the lack of compliance with industry service and regulatory standards, failure to deliver on commitments, lack of fair market practices (e.g. unreasonably high costs, or a service style that does not harmonise with market benchmarks or customer expectations), inappropriate business conduct (see IFSB-9 on business conduct for more detail) and significant failures in *Shari'ah* compliance. Reputational risk is multidimensional and exists throughout the organisation.

247. Supervisory authorities should expect an IIFS to identify potential sources of reputational risk to which it is exposed and appropriate policies to manage such risk. These potential sources include the IIFS's business lines, liabilities, affiliated operations and failure to apply rigorous customer acceptance procedures (i.e. any deficiency in Know-Your-Customer (KYC) procedures and acceptance of customers with higher risk profiles or inadequate documentation), off-balance sheet vehicles (in particular, repurchase undertakings by IIFS at values other than the market value of *Sukūk* assets at the time of purchase, see footnote 57) and the markets in which it operates. With respect to potential sources, reputational risk can also arise through cross-sectoral exposures<sup>95</sup> – for instance, when an IIFS sponsors activities such as Islamic mutual funds or Islamic collective investment schemes, and in-house and real estate investment trusts. In these cases, an IIFS may decide to support the value of shares/units held by investors even though it is not contractually required to provide the support. A decision to support in this way would have an obvious financial consequence; thus, in such instances, reputational risk will be translated immediately into a direct financial impact.

248. Once an IIFS identifies potential exposures arising from reputational concerns, it should measure losses it might experience under adverse market conditions. In addition to the direct financial impacts mentioned in the previous paragraph, reputational risk can induce losses for an IIFS in the following ways: (a) loss of current or future customer base – resulting in a reduction in expected future revenues; (b) loss of employees within the organisation – resulting in an increase in hiring costs; and (c) increased costs of (i) financial funding via credit or equity markets; (ii) supervisory restrictions, fines or other penalties; (iii) court proceedings; and (iv) compensation or damages paid to customers.

249. Supervisory authorities should ensure that risks of this kind are incorporated into the IIFS's risk management processes and appropriately addressed in its ICAAP and liquidity contingency plans. In particular, an IIFS should develop methodologies to measure the effect of reputational risk in terms of other risk types (e.g. credit, liquidity,<sup>96</sup> market or operational risk) to which it may be exposed. This could be done by including reputational risk scenarios in regular stress tests – for instance, including non-contractual off-balance sheet exposures in the stress tests to determine the effect on an IIFS's credit, market and liquidity risk profiles.

250. Supervisory authorities should note some precedents involving certain *Sharī'ah*-compliant contracts where *Sharī'ah* non-compliance has led to legal and related reputational risk. This has shown the increasing importance of the reputational risk of IIFS' operations. Supervisory authorities should ensure that an IIFS has in place appropriate policies for the identification of potential sources of reputational risk to which it is exposed and appropriate policies and methodologies to manage such risk. The supervisory authorities may include the following indicators in their supervisory review process to check their exposure to reputational risk: (a) credit rating by an eligible ECAI recognised by the respective supervisory authority, and in particular the factors that have led to it; (b) evidence of internal fraud in individual IIFS; and (c) evidence of regulatory non-compliance, failure to meet commitments, penalties, negative public opinion on the IIFS's performance, and law suits by external parties.

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<sup>95</sup> As noted in section 3.7.1, cross-sectoral exposures are a particular feature of the IFSI and hence are raising concerns for authorities that supervise IIFS on a "silo" basis. Appropriate consideration should be given to the effective supervision of IIFS, as the failure of an IIFS could have systemic effects.

<sup>96</sup> An IIFS should pay particular attention to the effects of reputational risk on its overall liquidity position, taking into account both possible increases in the asset side of the balance sheet and possible restrictions on funding, should the loss of reputation result in various counterparties' loss of confidence.

#### 4.7 *Sharī'ah*-compliant Hedging Techniques

251. In general, the use of *Sharī'ah*-compliant hedging instruments, namely *Sharī'ah*-compliant alternatives to derivatives contracts, is still not a common practice among IIFS, owing to strict *Sharī'ah* prohibitions; however, there is evidence that IIFS are employing certain OTC hedging instruments on the basis that they are *Sharī'ah* compliant<sup>97</sup> in their operations for risk management.

252. IFSB-15 provides guidance on regulatory capital requirements for such instruments, and should be referred to by IIFS. In this context, supervisory authorities should require IIFS to undertake aggregated risk analysis and risk management (e.g. risk of counterparty credit risk through OTC)<sup>98</sup> from the use of such instruments in their operations and ensure they adhere to regulatory capital requirements as prescribed in IFSB-15. Supervisory authorities should monitor the exposure and concentration of risk through the use of *Sharī'ah*-compliant hedging instruments and ensure that IIFS are applying robust counterparty credit risk management arrangements, including requirements for all important counterparties to post eligible collateral to secure their obligations.

253. Supervisory authorities may set out various reporting and disclosure requirements for the use of *Sharī'ah*-compliant hedging instruments by IIFS to identify current or potential sources of risk. This will encourage greater transparency for *Sharī'ah*-compliant hedging instruments, as this issue may fall under cross-sectoral supervision (e.g. as such instruments could be issued by hedge funds, which in many cases are not supervised by banking regulators), in order to enhance cooperation and the fostering of information-sharing across the sectors and jurisdictions. In this way, the issuers and users of *Sharī'ah*-compliant hedging instruments (i.e. IIFS) would be subject to timely regular reporting to their supervisory authorities and this would allow supervisory authorities to monitor on an ongoing basis the appropriate capital requirements and related risk management implications.

#### 4.8 Valuation Practices

254. Prudent valuation policies and procedures form the foundation on which any robust assessment of market risk capital adequacy of the IIFS should be built. An IIFS is expected to have adequate governance structures and control processes for fair valuing exposures (including *Sukūk* and/or other *Sharī'ah*-compliant instruments) for risk management and financial reporting purposes. These should be embedded in the overall governance structure of the bank covering the role of the BOD and SM. The BOD should receive reports from the SM on the valuation oversight and valuation model performance issues that are brought to SM for resolution, as well as all significant changes to valuation policies.

255. Supervisory authorities should also ensure that IIFS have adequate systems and controls, with documented policies and procedures for the valuation process, for carrying out the valuation of positions in the trading book. These systems and controls should be integrated with the IIFSs' enterprise risk management processes (see section 3.3.4) and instil confidence in the supervisory authorities and SM regarding the reliability of the valuations. The authorities should satisfy themselves that the approvals of all valuation methodologies (along with their inputs) are well documented by IIFS.<sup>99</sup>

256. IFSB-15 provides guidance on various valuation methods such as mark-to-market and mark-to-model for instruments exposed to market risk, and should be referred to by IIFS. Mark-to-market valuation requires daily valuation of positions based on independently sourced current market prices. Marking-to-model is used in the case where an IIFS is unable to mark-to-market its positions as a result of certain limitations on the reliability of price estimates owing to the low volume and number of transactions or in distressed market conditions. This can be a particular issue for instruments such as *Sukūk*, which in practice are traded relatively infrequently and often over the counter. Marking-to-model may, however, lead to unreliable valuations (see footnote 99). In any case, supervisory authorities should include these valuation methods and practices in their supervisory review process.

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<sup>97</sup> A study conducted in 2012 for the RSRPWG showed that *Sharī'ah*-compliant hedging instruments (such as profit rate swaps, cross currency swaps, etc.) have been used by the IIFS in some jurisdictions.

<sup>98</sup> It should be noted that the underlying contracts for such instruments vary from one IIFS to another, and range from CMT to *Wa'd* and a combination of some other contracts.

<sup>99</sup> In the absence of a transparent price from a liquid and/or illiquid market, an IIFS would have to rely on models or proxy-pricing methodologies, as well as on expert judgement. Supervisory authorities should note that the outputs of such models are highly sensitive to the inputs and parameter assumptions adopted, which may themselves be subject to estimation error and uncertainty. This issue is dealt with in the IASB's International Accounting Standard No. 13, *Fair Value Measurement*, which contains a "fair value hierarchy" of fair value estimation techniques in terms of their reliability.

In addition, when the exposures are valued by IIFS using the marking-to-market model, the resulting values should be subjected to stress testing for risk management purposes.

#### **4.9 Supervisory Transparency and Accountability**

257. Supervisory transparency and accountability are important to promote strong relationships between banking supervisors and the stakeholders, and predictability of the supervisory authority, which is helpful in promoting the adherence of IIFS to the existing regulations. It should be kept in mind that discretionary elements in the supervision of IIFS are inevitable. In this respect, supervisory authorities must carry out their obligations in a transparent and accountable manner. They should make publicly available the criteria to be used in the review of IIFS' internal capital assessments (i.e. ICAAP) and decisions related to special treatments in supervision for IIFS.

258. If a supervisory authority chooses to set target or trigger ratios, or categories of capital in excess of the regulatory minimum, factors that may be considered in doing so should be publicly available. Where the capital requirements are set above the minimum for an individual IIFS, the supervisory authority should explain to the bank the risk characteristics specific to the supervised IIFS (including background and underlying criteria) which resulted in the necessity for such action.

259. From an operational perspective, there are a number of tools that can be used by supervisory authorities to promote supervisory transparency and accountability. Among the examples of such initiatives is the Financial Stability Review, an initiative undertaken by banking supervisors in various jurisdictions. Supervisory authorities can also issue periodic publications and disclosures, through appropriate mechanisms (such as the supervisor's website or newsletters, etc.), to provide information about relevant supervisory actions.



## DEFINITIONS

The following definitions are intended to assist readers in their general understanding of the terms used in this Standard. The list is by no means exhaustive.

Alpha ( $\alpha$ )	“Alpha ( $\alpha$ )” is a measure of the proportion of actual credit and market risk on assets financed by IAH funds that is transferred to shareholders – that is, the displaced commercial risk. The parameter “alpha” is dependent on the supervisory authority’s directive in the jurisdiction in which the institution offering Islamic financial services (IIFS) operates. The value of “alpha” varies from 0 to 1. GN-4 provides a methodology to estimate the value of “alpha” to be used when the supervisory discretion formula is applied in calculating the capital adequacy ratio of IIFS.
Commodity Murābahah	The term "Commodity <i>Murābahah</i> transactions as a tool for liquidity management (CMT)" refers to a <i>Murābahah</i> -based purchase and sale transaction of <i>Sharī'ah</i> -compliant commodities, whether on cash or deferred payment terms.
Displaced commercial risk (DCR)	An IIFS that undertakes the role of a <i>Muḍārib</i> for IAHs may donate a part of its profit to the IAHs, and taking the possibility of this donation into consideration it is called displaced commercial risk. This is because initially the risk is to be borne by <i>Rabb al-Māl</i> (IAHs) but it has been displaced to the IIFS as it volunteers to do so.
Governance Committee	The Governance Committee is another board committee, as recommended in IFSB-3, established by the board of directors, and specifically mandated to protect the interests of the investment account holders.
<i>Hamish al-Jiddiyyah</i> (HJ)	<i>Hamish al-Jiddiyyah</i> carries a limited recourse to the extent of damages incurred by the IIFS when the purchase orderer fails to honour a binding promise to purchase (PP) or promise to lease (PL). The IIFS has recourse to the clients in the PP/PL if the HJ is insufficient to cover the damages. If the amount was more than the recognised damages, the balance should be given back to the clients. Moreover, if the damage was not recognised, the whole amount should be returned to the client.
Investment risk reserves (IRR)	The amount appropriated by the IIFS out of the profit of investment account holders (IAHs), after allocating the <i>Muḍārib</i> 's share of profit, in order to cushion against future investment losses for IAHs.
<i>Muḍārabah</i>	A partnership contract between the capital provider ( <i>Rabbu al-Māl</i> ) and an entrepreneur ( <i>Muḍārib</i> ) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless they are due to the entrepreneur’s misconduct, negligence or breach of contracted terms. Various deposit (investment) products are structured using this concept.
<i>Mushārahah</i>	A partnership contract in which the partners ( <i>Shurakā'</i> , sing: <i>Shārik</i> ) agree to contribute capital to an enterprise, whether existing or new, or towards the ownership of an asset, on either a temporary or permanent basis. Profits generated by that enterprise or asset are shared in accordance with the percentage specified in the <i>Mushārahah</i> agreement, while losses are shared in proportion to each partner’s share of capital. Various products, such as financing imports, exports, working capital, project finance, etc., can be structured using this concept.
Profit equalisation reserve (PER)	The amount appropriated by the institution offering Islamic financial services out of the <i>Muḍārabah</i> profits, before allocating the <i>Muḍārib</i> 's share of profit, in order to maintain a certain level of return on investment for unrestricted investment account holders.

<i>Sharī'ah Supervisory Board</i>	Specific body set up or engaged by the institution offering Islamic financial services to carry out and implement its <i>Sharī'ah</i> governance system.
<i>Sukūk</i>	Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of assets that are <i>Sharī'ah</i> compliant.
<i>Sukūk</i> securitisation ( <i>Sharī'ah</i> -compliant securitisation)	Securitisation is the process of issuing <i>Sukūk</i> or certificates which represent a common share of certain assets; these <i>Sukūk</i> or certificates can be issued by the owners of such assets or another trusted body as fiduciary represented by a special-purpose entity.
<i>Takāful</i>	A contract whereby a group of participants ( <i>Mushtarikīn</i> ) agree among themselves to support one another by contributing a sum of money into a common fund, which will be used for mutual assistance of the members against specified loss or damage.
<i>Urbūn</i>	An amount to be taken during signing of the contract, and considered part of the price if the contract is executed, and as compensation in the event the contract is terminated.