ISLAMIC FINANCIAL SERVICES BOARD

ISLAMIC FINANCIAL SERVICES INDUSTRY STABILITY REPORT 2015

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May 2015

Published in 2015 by

Islamic Financial Services Board
Level 5, Sasana Kijang, Bank Negara Malaysia
2, Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia

ISBN 978-967-5687-42-6

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ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

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.

For more information about the IFSB, please visit **www.ifsb.org**.

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Bay' Bithaman al-`Ājil	Sale contract based on deferred payment at a certain price.
Bay' al-`Īnah	A contract involving the sale and buy-back transaction of assets by a seller. A seller sells an asset to a buyer on a cash basis and later buys it back on a deferred payment basis where the price is higher than the cash price. It can also be applied when a seller sells an asset to a buyer on a deferred basis and later buys it back on a cash basis, at a price which is lower than the deferred price.
Commodity *Murābahah* or *Tawarruq*	A *Murābahah*-based purchase and sale transaction of *Sharī'ah*-compliant commodities, whereby the buyer purchases the commodities on a deferred payment basis and subsequently sells them to a third party on a cash payment basis.
Diminishing *Mushārakah*	A form of partnership in which one of the partners promises to buy the equity share of the other partner over a period of time until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, after which buying and selling of the other partner's equity takes place at market value or the price agreed upon at the time of entering into the contract. The "buying and selling" is independent of the partnership contract and should not be stipulated in the partnership contract, since the buying partner is only allowed to promise to buy. It is also not permitted that one contract be entered into as a condition for concluding the other.
Hibah	A unilateral transfer of ownership of a property or its benefit to another without any counter-value from the recipient.
Ibrā'	Rebate/waiver of partial or total claim against certain right or debt.
Ijārah	An agreement made by an institution offering Islamic financial services to lease to a customer an asset specified by the customer for an agreed period against specified rental. An *Ijārah* contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the *Ijārah* contract.
Investment risk reserve	The amount appropriated by the institution offering Islamic financial services out of the income of investment account holders (IAHs), after deducting the *Muḍārib's* share, in order to cushion against future investment losses for the IAHs.
Islamic window	An Islamic window is part of a conventional financial institution (which may be a branch or dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are *Sharī'ah* compliant, with separate funds.
Istisnā`	A contract of sale of specified objects to be manufactured or constructed, with an obligation on the part of the manufacturer or builder to deliver the objects to the customer upon completion.
Kafālah bi-`Ājr	A guarantee with fee.
Maṣlaḥah	Public interest
Muḍārabah	A partnership contract between the capital provider (*Rabb-Al-Mal*) and an entrepreneur (*Muḍārib*) 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 the losses are due to the entrepreneur's misconduct, negligence or breach of contracted terms.
Murābahah	A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin.
Mushārakah	A contract between the institution offering Islamic financial services and a customer whereby both would contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or movable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/ asset are shared in accordance with the terms of the *Mushārakah* agreement, while losses are shared in proportion to each partner's share of capital.
Qarḍ	A non-interest-bearing loan intended to allow the borrower to use the funds for a period with the understanding that this would be repaid at the end of the period, where any increase in cash or benefit is not permissible.
Qarḍ al-Hassan	An interest-free loan given by a lender to a borrower with the stipulation that the latter pays back its equivalent only.
Rabb-Al-Mal	Capital owner/investor. In a *Muḍārabah* contract the person who invests the capital (the capital owner or financier).
Retakāful	*Retakāful* is conceptually similar to *Takāful*. The participants in a *Retakāful* undertaking are mainly *Takāful* Undertakings (TUs) and occasionally other *Retakāful* Undertakings (RTUs), in which case the term *Retrotakāful* is sometimes used to describe the activity. These participant TUs or RTUs, referred to as cedants, contribute a sum of money from their respective Participants' Risk Funds (PRFs) or cedant *Takāful* Operator's Risk Funds (TORFs) as a *TabarruÑ* into a common fund that is managed by the receiving RTO that will be used mutually to assist the cedants against a specified type of loss or damage.

Ribā	Any stipulated excess compensation without any corresponding counter-value. Such a practice is considered unlawful in the *Sharīʿah.*
Rahn	A contract to pledge a specified asset as security against a debt whereby the creditor (*Murtahin*) is entitled to hold custody of the asset. In the event of default by the debtor (*Rāhin*), the creditor may sell the asset.
Salam	An agreement to purchase, at a predetermined price, a specified kind of commodity not currently available to the seller, which is to be delivered on a specified future date as per agreed specifications and specified quality. The institution offering Islamic financial services as the buyer makes full payment of the purchase price upon conclusion of a *Salam* contract. The commodity may or may not be traded over the counter or on an exchange.
Sharīʿah	The practical divine laws deduced from their legitimate sources: the *Qur'ān, Sunnah*, consensus (*Al-Ijmā'*) and analogical reasoning (*Al-Qiyās*).
Sharīʿah board	An independent body set up or engaged by the institution offering Islamic financial services to supervise its *Sharīʿah* compliance and governance system.
Sukūk	Certificates that represent a proportional common ownership right in tangible assets, or a pool of assets that are *Sharīʿah*-compliant.
Takāful	The term "*Takāful*" is derived from an Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly against a defined loss. In a *Takāful* arrangement, the participants contribute a sum of money as wholly or partially *Tabarru*' (donation) into a common fund, which will be used for mutual assistance for the members against a defined loss or damage, according to the terms and conditions of the *Takāful*.
Waʿd	A promise to perform certain action(s) in the future.
Wadīʿah	An amount deposited whereby the depositor is guaranteed his/her fund in full.
Wakālah	An agency contract where the customer (principal) appoints the institution offering Islamic financial services as agent (*Wakīl*) to carry out the business on their behalf and where a fee (or no fee) is charged to the principal based on the contract agreement.
Waqf	A property that produces income and that may have been deeded to benefit a community.
Zakah	An obligatory contribution or tax which is prescribed by Islam on all Muslims having wealth above an exemption limit at a rate fixed by the *Sharīʿah*. The objective is to make available to the state a proportion of the wealth of the well-to-do for distribution to the poor and needy.

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AuM	Assets under management
ADB	Asian Development Bank
ALA	Alternative Liquidity Arrangements
ASA	Alternative Standardised Approach
ASF	Available stable funding
BAFIA	*Banking and Financial Institutions Act* 1989
BASEIND	Basic Social and Economic Indicators
BBA	*Bai' Bithaman al-Ājil*
BCBS	Basel Committee on Banking Supervision
BCG	Basel Consultative Group
BCPs	Core Principles for Effective Banking Supervision (or Basel Core Principles)
BCR	Basic Capital Requirements
BI	Business Indicator
BIA	Basic Indicator Approach
BIBF	Bahrain Institute of Banking and Finance
BIS	Bank for International Settlements
BNM	Bank Negara Malaysia
bps	Basis points
CAGR	Compound annual growth rate
CAR	Capital adequacy ratio
CBA	*Central Banking Act* 2009
CBB	Central Bank of Bahrain
CCE	Coordinated Compilation Exercise
CDC	United States Centers for Disease Control and Prevention
CDIS	Conventional Deposit Insurance Scheme
CDMs	Concentration and distribution measures
CGFS	Committee on the Global Financial System
CIS	Collective investment schemes
CMGs	Crisis management groups
COMCEC	OIC Standing Committee for Economic and Commercial Cooperation
ComFrame	Common Framework
CPs	Core principles
CPIFR	Core Principles for Islamic Finance Regulation
DFIs	Development financial institutions
DFSA	Dubai Financial Services Authority
DGI	Data Gaps Initiative
DIS	Deposit insurance scheme
DJIM	Dow Jones Islamic Market
D-SIBs	Domestic-systemically important banks
ECB	European Central Bank
ED	Exposure Draft
EMDEs	Emerging market and developing economies
FAS	Financial Accounting Standard
FDR	Financing-to-deposit ratio
FIS	Facilitating the Implementation of the IFSB Standards
FOMC	Federal Open Market Committee
FSA	*Financial Services Act* 2013
FSAP	Financial Sector Assessment Programme
FSB	Financial Stability Board
FSF	Financial Stability Forum
FSI	Financial Stability Institute
FSIs	Financial Soundness Indicators
FSIRG	Financial Soundness Indicators Reference Group
FSRs	Financial Stability Reports
FSSA	Financial System Stability Assessment
G-20	Group of Twenty
GB	Governing body
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GFC	Global Financial Crisis
GFSR	Global Financial Stability Report

GHOS	Governors and Heads of Supervision
GI	Gross income
GN	Guidance Note
G-SIBs	Global-systemically important banks
G-SIFIs	Global-systemically important financial institutions
G-SIIs	Global-systemically important insurers
HLA	Higher loss absorbency
HLGs	High-level goals
HNWI	High-net-worth-individuals
HQLA	High-quality liquid assets
IA	*Insurance Act* 1996
IA	Investment account
IADI	International Association of Deposit Insurers
IAG	Inter-Agency Group on Economic and Financial Statistics
IAHs	Investment account holders
IAIGs	Internationally Active Insurance Groups
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IBF	Islamic banking and finance
IBIS	Islamic Banks and Financial Institutions Information System
ICIS	Islamic collective investment schemes
ICM	Islamic capital market
ICMTF	Islamic Capital Market Task Force
ICPs	Insurance Core Principles
ICS	Insurance Capital Standard
IDB	Islamic Development Bank
IDIC	Indonesian Deposit Insurance Corporation
IFC	Irving Fisher Committee
IFDI	Islamic Finance Development Indicator
IFSA	*Islamic Financial Services Act* 2013
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IIFS	Institutions offering Islamic financial services
IILM	International Islamic Liquidity Management Corporation
IIMM	Islamic interbank money market
ILAAP	Internal liquidity adequacy assessment
IMF	International Monetary Fund
INCEIF	International Centre for Education in Islamic Finance
IOSCO	International Organization of Securities Commissions
IRB	Internal-ratings based
IRTI	Islamic Research and Training Institute
ISFD	Islamic Solidarity Fund for Development
ISLM	Islamic Finance Platform
ISRA	International *Sharī'ah* Research Academy
LCR	Liquidity coverage ratio
LNG	Liquefied natural gas
LOB	Lines of business
LOLR	Lender of last resort
MDBs	Multilateral development banks
MDIC	Malaysia Deposit Insurance Corporation
MENA	Middle East and North Africa
MiFID	Markets in Financial Instruments Directive
MMoU	Multilateral Memorandum of Understanding
MoU	Memoranda of Understanding
MTP	Medium-term plan
NBNI	Non-bank or non-insurer
NMPIs	Non-mainstream pooled investments
NPLs	Non-performing loans
NPFs	Non-performing financing/facilities
NSFR	Net stable funding ratio
NSOs	National Statistical Offices
NSSs	National Statistical Systems

OECD	Organisation for Economic Co-operation and Development
OIC	Organisation of Islamic Cooperation
OPEC	Organization of Petroleum Exporting Countries
OPHI	Oxford Poverty and Human Development Initiative
PER	Profit equalisation reserves
PGI	Principal Global Indicators
PRIIPs	Packaged Retail and Insurance-Based Investment Products
PSEs	Public-sector entities
PSIAs	Profit-sharing investment accounts
PSIFIs	Prudential and Structural Islamic Financial Indicators
QE	Quantitative Easing Programme
QIS	Quantitative impact study
RAM	Risk Assessment Matrix
RCAP	Regulatory Consistency Assessment Programme
REPI	Real Estate Price Index
ROA	Return on assets
ROE	Return on equity
ROSCs	Reports on the Observance of Standards and Codes
RPSIA	Restricted profit-sharing investment account
RSAs	Regulatory and supervisory authorities
RSF	Required stable funding
SALR	Short-term asset–liability ratio
SAPR	Self-Assessment and Peer Review
SBP	State Bank of Pakistan
SCDIS	*Sharīʿah*-Compliant Deposit Insurance Schemes
SDDS	Special Data Dissemination Standards
SESRIC	Statistical, Economic and Social Research and Training Center for Islamic Countries
SHF	Shareholders' Fund
SIBs	Systemically important banks
SIFIs	Systemically important financial institutions
SIG	Supervision and Implementation Group
SKRA	Strategic Key Result Area
SLOLR	*Sharīʿah*-compliant lender of last resort
SLRP	Supervisory liquidity review processes
SMC	SESRIC Motion Charts
SMEs	Small and medium enterprises
SNA	System of National Accounts of the United Nations
SPFO	Strategic Plan and Financial Outlook
SPP	Strategic Performance Plan
SRI	Socially responsible investing
STA	Statistics Department
TA	Technical assistance
TC	Technical Committee
TORF	*Takāful* Operators' Risk Fund
TSA	The Standardised Approach
TSM	Total Stock Market
UAE	United Arab Emirates
UCIS	Unregulated collective investment schemes
UCITS	Undertakings for Collective Investment in Transferable Securities Directive
UNDP	United Nations Development Programme
UNSD	United Nations Statistics Division
UPSIA	Unrestricted profit-sharing investment accounts
US	United States
USD	United States dollar
VE	Vulnerability exercise
WB	World Bank
WG	Working group
WHO	World Health Organization
UNWTO	World Tourism Organization
WP	Working Paper
XOF	CFA Franc

The issuance of the Islamic Financial Services Board's (IFSB) third *Islamic Financial Services Industry Stability Report* takes place against the background of a fragile and uneven global economic recovery. While global economic prospects appeared to brighten on the back of the economic recovery of the United States, and a shift to domestic demand-led growth in some key emerging markets, they remain uncertain in the Eurozone and in Japan. While the remarkable expansion in Islamic finance since the onset of the Global Financial Crisis in 2007 continues, as does the growth of *Sukūk* issuances, concern about the changing composition and increased volatility of capital flows points towards a new set of risks for the global economy. Against this backdrop the regulatory changes to the capital and liquidity framework initiated by the Group of Twenty and the Financial Stability Board have seen a sustained and comprehensive response by the IFSB through the issuance of a range of guiding principles, culminating in two standards in 2015, on liquidity management and on core principles, that set the stage for the integration of the Islamic financial services industry (IFSI) into the global economy and into the global surveillance mechanism for financial stability. Thus, in this report we take up the principal features of recent developments that affect Islamic finance through an assessment and evaluation of its growth, as well as of changes in the global regulatory and supervisory framework with its implications for the industry. As amply documented by the IFSB in recent times, the growth of Islamic finance is highlighting challenges to stability while also raising awareness of the issues that require a strong and sustained policy and regulatory response. The IFSI Stability Report 2015 seeks to illuminate these issues for the IFSB's wide membership, as well as for all those who have a substantive interest in the stability and resilience of Islamic finance.

Chapter 1 provides an overview of the IFSI as well as updates on trends and developments in the three sectors of the industry – Islamic banking, the Islamic capital market and *Takāful*. It also assesses the resilience of the Islamic financial system, which includes technical analysis of selected indicators as well as assessment of risks and vulnerabilities in the sectors. We also include box articles from the Central Bank of Bahrain, which examines the financial stability of the Islamic banking system in the jurisdiction, and from Bank Negara Malaysia, which shares its initiatives in modernising the legal and regulatory framework in the Islamic finance industry. I am deeply grateful for the inputs provided by the two central banks, both of which are members of the IFSB Council.

Chapter 2 examines the initiatives undertaken by international standard-setting bodies to further ensure the stability of the financial institutions and markets, as well as the implications of such reforms for institutions offering Islamic financial services (IIFS). It also reviews the progress of various projects and initiatives undertaken by the IFSB to enhance the supervisory framework so as to ensure stability and soundness of the IFSI. These initiatives include the development of new standards for the IFSI, namely *Guiding Principles for Retakāful* and GN-6: *Guidance Note on Quantitative Measures for Liquidity Risk Management in IIFS.*

Chapter 3 discusses the surveillance framework for the global financial system and identifies the gaps in the global surveillance framework in the absence of a set of core principles for Islamic finance, which eventually led to the development of an advanced approach to the assessment of supervisory and stability regimes for Islamic finance. It also tracks the implementation mechanisms undertaken by the global standards-setters, which provide a valuable reference for strengthening implementation efforts in the IFSI. This topic is selected in order to help create awareness of the importance of core principles for the industry – in particular, following the issuance of the *Core Principles for Islamic Finance Regulation* for the banking segment, which has been approved by the Council at its 26th meeting held in Jakarta, Indonesia, on 2 April 2015. The topic is also in line with the theme of the 12th IFSB Summit, held in Almaty, Kazakhstan, entitled *Core Principles for Islamic Finance: Integrating with the Global Regulatory Framework.*

Finally, **Chapter 4** addresses emerging issues in Islamic finance. Two issues discussed in the chapter are: (a) financial consumer protection in Islamic finance – in particular, in Islamic finance jurisdictions with growing systemic importance; and (b) the importance of having a global Islamic finance database for financial stability, focusing on the IFSB's initiative on the Prudential and Structural Islamic Finance Indicators. This chapter benefits from contributions from two international organisations that have provided box articles on their database initiatives. The International Monetary Fund provides an overview of its Financial Soundness Indicators initiative, while the Statistical, Economic and Social Research and Training Centre for Islamic Countries shares its initiatives in strengthening the statistical infrastructure of Islamic banking and financial services. We hope that this form of collaboration with other institutions will lead to the development of a global network of expertise that can help to increase awareness and understanding of emerging issues faced by the IFSI.

The *IFSI Stability Report 2015* was produced by a core team from the Technical and Research Division of the IFSB Secretariat, led by Mr Zahid ur Rehman Khokher, Assistant Secretary-General, and comprising Ms Noor Ashikin Ismail, who was the Project Leader, supported by Mr Abozer Majzoub, Mrs Kartina Md Ariffin, Mr Erdem Oz, Mr Dong Choon Yi and Mr Md Salim Al Mamun. The staff of the IFSB were responsible for preparing Chapters 2 and 3, as well as the important section of Chapter 4 on the global Islamic finance database for financial stability.

Mrs Baljeet Kaur Grewal, the then Managing Director of KFH Research, and her team were responsible for writing Chapter 1. Professor Volker Nienhaus authored the section on financial consumer protection in Islamic finance, included in Chapter 4. The report also benefited from constructive comments and feedback from Professor Volker Nienhaus and Mr Peter Casey. Mrs Siham Ismail, Head, and Ms Rosmawatie Abd Halim, of the Communications and Awareness Programmes at the IFSB, provided assistance in the formatting and publication of the final document.

We hope that the *IFSI Stability Report 2015* will serve not only as a useful complement to the better understanding of issues by the various stakeholders of the IFSB, but also contribute to a wider cross-border engagement on stability issues in Islamic finance, while helping to strengthen the building blocks needed for greater resilience.

Jaseem Ahmed
Secretary-General
Islamic Financial Services Board
May 2015

Assessment of Resilience

The growth of all segments of Islamic finance has continued, albeit with moderated growth rates. In seven jurisdictions with both a conventional and an Islamic finance sector, Islamic banking has achieved systemic importance, and in a few jurisdictions individual Islamic banks are approaching a domestic-systemically important bank (D-SIB) status. The resilience of Islamic banks has been analysed and confirmed for a sample of 59 prominent Islamic banks in 11 major Islamic banking jurisdictions.

- The *profitability* of Islamic banks has recovered but is still below the 2008 level. In general – that is, with notable exceptions – net profit margins declined and cost-to-income ratios increased.

- The lack of *liquidity management* tools is a continuing concern. The financing-to-deposit ratios of most banks remained under 90%, and the short-term asset–liability ratio was on average (with significant deviations of individual banks) about 80% of the liabilities payable within 90 days. The improvement of the liquidity position was partially due to new regulatory initiatives.

- The *financing exposure* of Islamic banks to private-sector businesses is predominant in jurisdictions with underdeveloped corporate securities markets. Where private businesses can get funding from the capital market, Islamic banks show a higher exposure to the household sector. The exposure to the real estate market is particularly significant in the Gulf Cooperation Council (GCC) states.

- The *asset quality* has improved and the number of non-performing loans decreased, which is largely due to the recovery of real estate prices. Risks remain in particular in the GCC, where banks have concentrated on a few large borrowers and are still strongly exposed to real estate. Political challenges in the region and the drop in oil prices may impact on asset quality in the future.

- The *capitalisation* of Islamic banks exceeds regulatory requirements by several percentage points across all jurisdictions. Challenges remain regarding the compliance of the capital structures with Basel III standards. High capital ratios indicate an underutilisation of capital. This inefficiency is caused by the need to keep higher capital buffers to compensate for the lack of effective interbank markets and *Sharīʿah*-compliant lender-of-last-resort facilities.

- The funding of Islamic banks is dominated by deposits. Profit-sharing and risk-bearing investment accounts (PSIA) were gradually replaced by sale-based fixed profit deposits (such as commodity *Murābahah* term deposits). As of 2013, the share of PSIA has slipped below the 50% mark across the Islamic banking sample. This reflects a demand for *Sharīʿah*-compliant capital- and profit-guaranteed term deposits. With such products (and profit smoothing for parts of the remaining PSIA), Islamic banks face the same risks from maturity mismatches as conventional banks.

- The *leverage multiple* of Islamic banks increased to 10.5 in 2013, but it is still lower than the average G-SIBs multiple of approximately 15 to 20. The lower leverage reflects the higher capitalisation.

Overall, the Islamic banking sector continues its robust recovery post-Global Financial Crisis (GFC), albeit with some vulnerabilities, and political as well as domestic and global economic risks.

The *Sukūk* market has become the fastest growing segment of the Islamic financial services industry (IFSI). Malaysia accounted for nearly one-third of all *Sukūk* issuances in 2014.

- The *Sukūk* market was quite resilient, with a default rate of 0.6% of total *Sukūk* tranches issued or 0.2% of the total issuance volume (from 1990 to November 2014). This may be explained largely by the fact that roughly 80% of all *Sukūk* were sovereign issuances.

- The trend away from risk-sharing and towards fixed-income and debt-creating contracts for the structuring of *Sukūk* continued: less than 7% of all new *Sukūk* issued in the first three quarters of 2014 were based on risk-sharing contracts (*Muḍārabah* or *Mushārakah*).

- The assessment of the resilience of the IFSI is completed by an examination of *Takāful* and *Sharīʿah*-compliant *equities and funds*. The overall stability of the IFSI remains healthy, albeit at different levels across jurisdictions. In the near future, the increased fragility of emerging financial markets and the sharp decline of oil prices may negatively impact the profitability and asset quality of Islamic banks, and the monetary policy of Western central banks can induce yield volatilities and may shake investors' confidence in emerging markets' financial assets, including *Sukūk*.

Global Financial Architecture

The global financial architecture is continuously changing, with implications for Islamic finance. This report focuses on initiatives to promote financial stability by the Financial Stability Board (FSB) and the sectoral global standard-setters for banking (Basel Committee on Banking Supervision, or BCBS), capital markets (International Organization of Securities Commissions, or IOSCO) and insurance (International Association of Insurance Supervisors, or IAIS). Of particular relevance for Islamic finance is a monitoring report by the FSB on the (unintended) impact of regulatory reforms on emerging markets and developing economies. Further, the Basel III capital and liquidity framework is still an issue – in particular, *Sharīʿah*-compliant high-quality liquid assets (HQLA). The BCBS issued its latest standard for the net stable funding ratio (NSFR) in October 2014. The Islamic Financial Services Board (IFSB) covered this in GN-6: *Guidance Note on Quantitative Measures for Liquidity Risk Management in Institutions Offering Islamic Financial Services (IIFS)* which suggests adjustments to global liquidity standards to meet the specificities of IIFS; it deals, among other things, with HQLA and the NSFR. In addition, the IFSB has established a working group for a standard *on Guiding Principles for Retakāful (Islamic Insurance) Undertakings.*

The IFSB conducted a survey on *Strengthening the Financial Safety Net: The Role of Sharīʿah-Compliant Deposit Insurance Schemes* (SCDIS) in which 27 regulatory and supervisory authorities (RSAs) participated. While conventional deposit insurance exists in 18 jurisdictions, only four have implemented a special SCDIS; some provide protection under their conventional system. Meanwhile, the IFSB's Standards Implementation Survey of 2014 indicated measurable progress in the implementation of some standards in 2014 as compared to 2013. Other IFSB initiatives include a joint IFSB-IAIS working group on regulatory issues of *microtakāful*, the preparation of new *Guiding Principles on Disclosure of Islamic Capital Market Products and a Technical Note on Stress Testing for IIFS.*

Core Principles for Islamic Finance Regulation

International standard-setters for conventional finance (in particular, BCBS, IOSCO and IAIS) have established core principles (CPs) to promote a consistent implementation of global prudential standards across countries. These CPs were updated following the GFC, and members of the FSB have agreed on regular assessments of their adherence to the CPs under the International Monetary Fund (IMF) – World Bank Financial Sector Assessment Programme (FSAP).

The Islamic financial services industry (IFSI) has become an important component of the financial system in an increasing number of jurisdictions. Regulatory and supervisory authorities have to understand the specific risks in the products and operations of institutions offering Islamic financial services (IIFS), as well as their impact on the stability and resilience of the financial system. These challenges can be addressed by an adaptation of existing CPs so that they cater for the unique characteristics of the IIFS. The IFSB has launched a programme to issue a set of Core Principles for Islamic Finance Regulation (CPIFR), and it started with banking as the largest segment of the IFSI with the greatest importance for systemic stability. The CPIFR will facilitate the assessment of the regulation and supervision of the Islamic banking sector (by self-assessments, peer reviews or other external assessments) and thereby contribute to the promotion of a resilient and stable financial system.

Islamic banking and conventional banking are regulated and supervised by the same authorities in dual systems. Therefore, it was decided to start from the BCBS CPs, and to adapt or supplement them to the extent necessary to deal with the unique aspects of Islamic finance. The CPIFR is intended to become an international minimum standard for the effective supervision of Islamic banks, to ensure a proper *Sharīʿah* compliance framework, safeguard systemic stability, and ensure that IIFS act in accordance with their fiduciary responsibilities, especially in regard to investment account holders (IAH).

An evaluation of the 29 BCBS CPs resulted in an amendment of 19, most commonly to the assessment methodology rather than the principle itself. Nine CPs were incorporated into the CPIFR essentially unchanged. One CP (on interest rate risk) was replaced (by a CPIFR on rate of return risk), and four new CPIFR have been added to cover the treatment of PSIA/IAH, *Sharīʿah* governance framework, equity investment risk and Islamic "window" operations. The CPIFR, like the CPs of other standard-setters, are published with an associated assessment methodology.

The CPIFR, as the highest level in the hierarchy of financial sector regulation, provide the overarching framework for the regulatory system and cover also the responsibilities, powers and legal protection of the supervisory authority itself. More detailed standards and guidance sit below them. These guidelines specify and explain in more detail, for example, prudential regulation related to risk management, corporate governance and transparency. The CPIFR may themselves help to identify new areas where standards or guidance are needed.

Emerging Issues: Consumer Protection and Stability Indicators

Two trends in global regulation and supervision are seen as emerging issues for Islamic finance: (a) the emphasis on financial consumer protection as a regulatory objective; and (b) the data requirements of quantitative stability analyses of an IFSI with growing systemic importance.

- In the aftermath of the GFC, financial consumer protection has become a concern of international institutions as well as national governments. Mandates of regulators were extended or separate new regulators were established. It was generally recognised that the actual behaviour of retail customers systematically deviates from what theories of efficient markets assume, and that additional information does not by itself ensure better consumer choices. Most consumer protection issues and instruments of conventional finance are also relevant for Islamic finance, but there are a few additional dimensions which emanate from more complex legal structures of *Sharīʿah*-compliant products and from the status of IAH as risk bearers. Savings and investment products of banks and investment-linked savings plans of family *Takāful* operators are very similar to collective investment schemes (CIS). Hence, elements of capital market regulations should be applied in banking in a way that prevents regulatory arbitrage.

- The IMF publishes Financial Soundness Indicators (FSIs) to measure the aggregate strength or vulnerability of a financial system. These indicators focus on systemic stability but do not reflect the specificities of Islamic finance, while specific Islamic finance data – as disseminated by commercial firms and international institutions – do not focus on systemic stability. Therefore, the IFSB launched a project to establish a global database of Prudential and Structural Islamic Financial Indicators (PSIFIs). The third phase of the project started in 2014 and deals with the methodology for data analysis, reporting formats, public access and a first collection, compilation and dissemination of data and indicators. Core prudential indicators capture capital adequacy, asset quality, earnings, leverage, liquidity and sensitivity to market risk; structural indicators measure the size and structure of the Islamic banking sector by information on volume of assets, liabilities, revenue and earnings, etc. PSIFIs shall facilitate an adequate and timely macroprudential surveillance of the Islamic finance industry.

1.0 DEVELOPMENT AND ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SERVICES INDUSTRY

1.1 Development of the Islamic Financial Services Industry

The global financial services industry has witnessed another challenging year in 2014, against the backdrop of a diverse range of macroeconomic and political factors affecting the financial sector. Following initial indications in mid-2013, the US Federal Reserve ultimately began cutting back its monthly stimulus bond purchases (known as Quantitative Easing Programme (QE)) in January 2014 and fully scaled back the programme in its Federal Open Market Committee (FOMC) meeting in October 2014. This has led to concerns within the global financial community that the era of record-low interest rates as an incentive to boost economic activity is nearing an end. Meanwhile, an improving US economy backed by a strengthening US dollar against the world's major currencies has indicated an improved outlook for the world's largest economy. This has triggered another round of sell-offs of emerging markets' assets, which has put depreciatory pressures on the currencies of those markets (including key Islamic finance jurisdictions), while causing considerable volatilities in their financial indicators.

Elsewhere, heightened geopolitical risks and conflicts (e.g. in the Middle East region and Eastern Europe) have led to growing concerns about the future growth trajectories of the global economy. Market sentiments were depressed further on fears of a potential recession in the Eurozone,[1] along with a slowdown in the Chinese economy[2] since the 3Q2014. This has been further exacerbated following an approximately 30% plunge in oil prices in the second half of 2014, as oil supplies in global markets increased while global demand for oil grew more slowly. As at 1 December 2014, oil prices had hit five-year lows, with the benchmark Brent crude falling as low as USD67.53 per barrel, the lowest level since October 2009. The oil price decline has been underpinned by a slowdown in manufacturing activity in China and Europe that led to a moderation in global oil demand; while from the supply side, the Organization of Petroleum Exporting Countries (OPEC) has chosen to maintain its oil output despite the stagnating demand. As a consequence of the above factors, the financial sector has experienced considerable volatility in equity prices and debt instrument yields. Moreover, financial institutions' increased focus on risk management has led to, at times, proportionately lower financing activity in the banking sector. Emerging market currencies, including the Indonesian rupiah, Malaysian ringgit and Turkish lira, have also witnessed fresh bouts of depreciatory trends. Overall, the IMF has cut its global growth forecast for 2015 to 3.3% in October, down from its 3.8% estimation earlier, citing stagnation in Europe and Japan and the slowdown in emerging economies.

The Islamic financial system, operating alongside the conventional sector, is also exposed to broadly the same systemic risk factors and volatilities as its conventional counterpart, despite its sustained growth momentum. The various sections of this chapter further analyse the growth momentum and structural shifts of the Islamic finance industry while assessing financial stability aspects in light of the evolving global macroeconomic and financial conditions.

1.1.1 Size of the Industry and Systemically Important Jurisdictions

The global Islamic finance industry has been in an upward trajectory, evidenced by its assets' double-digit compound annual growth rate (CAGR) of 17% between 2009 and 2013. The industry's assets are estimated to be worth USD1.87 trillion as at 1H2014, having grown from USD1.79 trillion as at end-2013.

Overall, Islamic finance assets are heavily concentrated in the Middle East and Asia, although the number of new markets is expanding. The GCC region accounts for the largest proportion of Islamic financial assets as the sector sets to gain mainstream relevance in most of its jurisdictions; the region represents 37.6% of the total global Islamic financial assets (see Table 1.1.1.1). The Middle East and North Africa (MENA) region (excluding GCC) ranks a close second, with a 34.4% share, buoyed by Iran's fully *Sharīʿah*-compliant banking sector. Asia ranks third, representing a 22.4% share in the global total, largely spearheaded by the Malaysian Islamic finance marketplace.

Table 1.1.1.1: Breakdown of Islamic Finance Segments by Region (USD billion, 2014 YTD*)

Region	Banking Assets	*Sukūk* Outstanding	Islamic Funds Assets	*Takāful* Contributions
Asia	203.8	188.4	23.2	3.9
GCC	564.2	95.5	33.5	9.0
MENA (exc. GCC)	633.7	0.1	0.3	7.7
Sub-Saharan Africa	20.1	1.3	1.8	0.6
Others	54.4	9.4	17.0	0.3
Total	**1476.2**	**294.7**	**75.8**	**21.4**

**Data for banking and Takāful as of 1H2014, while for Sukūk and funds as of 3Q2014.*
Source: Regulatory authorities, Bloomberg, Zawya, central banks, individual institutions, corporate communications, IFIS, The Banker, KFHR
Note: Where available, data are taken from primary sources (regulatory authorities, annual reports, etc.). Where primary data are unavailable, third-party data providers have been used. Where there were still information gaps, data were estimated based on historical growth trends and country-specific assumptions. Takāful contributions are used as a basis to reflect the growth in the Takāful industry. The breakdown of Islamic funds' assets is by domicile of the funds.

[1] The IMF warned in October 2014 that the outlook for the global economy has darkened, as it estimates a 4 in 10 chance that the Eurozone will slide into a third recession since the financial crisis.

[2] China's economy in the third quarter of 2014 grew at 7.3%, its slowest pace in five years as it battles a slumping real-estate market and weak domestic demand and industrial production.

The contribution from the other regions, particularly Europe and Sub-Saharan Africa, remains low, although the future growth prospects are promising on the back of recent developments and initiatives in several new and niche Islamic finance markets. In 2014, regulatory developments concerning the Islamic banking sector were witnessed in Afghanistan, Azerbaijan, Morocco, Tajikistan and Uganda, among other jurisdictions, each at a different stage of enacting its regulatory regime. Similarly, the *Sukūk* sector was of much stakeholder interest in 2014, with the primary sovereign *Sukūk* market debuts of Maldives, Senegal, South Africa and the Emirate of Sharjah, as well as sovereign debuts by conventional financial centres such as Luxembourg, Hong Kong and the United Kingdom. Developments elsewhere will very much depend on regulatory initiatives, clarity on legal aspects, and sustained policy support by the policymakers, particularly in nascent markets.

The Islamic finance industry is deepening its significance in key traditional markets, mainly concentrated in the GCC and select countries in Asia. Aside from Iran and Sudan, which operate fully *Sharī'ah*-compliant banking systems, Islamic banking has also now achieved systemic importance[3] in seven other countries as of 1H2014 – namely, Brunei, Kuwait, Malaysia, Qatar, Saudi Arabia, the United Arab Emirates (UAE) and Yemen (see Diagram 1.1.1.1). These markets operate an Islamic finance sector alongside the conventional finance sector within a dual financial system, and have achieved at least 15% market share of total banking assets for their Islamic banking and/or hold more than 5% of the total global Islamic banking assets.

Diagram 1.1.1.1: Islamic Finance Markets by Systemic Significance

Source: KFHR
Note: Islamic banking is used as the indicator, as the sector holds more than 80% of the total Islamic finance assets. Systemic importance in the above diagram refers to systemic importance under either or both of the criteria set out in footnote 3.

Chart 1.1.1.1: Islamic Banking Assets in Jurisdictions with an Islamic Finance Sector of Systemic Importance (1H2014)

Chart 1.1.1.2: *Sukūk* Outstanding in Jurisdictions with an Islamic Finance Sector of Systemic Importance (3Q2014)*

** Sukūk issuance domicile is based on domicile of issuers.*
Source: KFHR
Note: "Jurisdictions with an Islamic Finance Sector of Systemic Importance" refers to countries that have achieved at least 15% market share for their Islamic banking and/or hold more than 5% of the total global Islamic banking assets.

[3] This report considers the Islamic financial sector as being systemically important when the total Islamic banking assets in a country comprise more than 15% of its total domestic banking sector assets or hold at least 5% of the global Islamic banking assets. The report considers the Islamic banking segment as the criterion for systemic importance of Islamic finance, since about 80% of Islamic financial assets are held within the banking sector.

For instance, the Saudi Islamic banking sector represents 51.3% of the total domestic banking assets while also accounting for 18.6% of the global Islamic banking assets in 1H2014. In Malaysia, Islamic banking assets as a proportion of total banking assets represent 21.9% of the domestic banking sector while accounting for 9.6% of the global Islamic banking assets.[4] The UAE holds 17.4% of its total domestic banking sector assets in the Islamic banking system and accounts for nearly 7.4% of the global Islamic banking assets. Bangladesh's Islamic banking sector accounted for 17% of its domestic banking assets. The share of the Islamic banking sector as a proportion of the total domestic banking sector for the other systemically important jurisdictions is as follows: Brunei, 41%; Kuwait, 38%; Yemen, 27.4%; and Qatar, 25.1%.

Chart 1.1.1.3: Islamic Banking Share in Total Banking Assets by Jurisdiction (1H2014)

Source: Central banks and regulatory authorities, individual institutions, Bloomberg, Zawya, corporate communications, The Banker, KFHR

Chart 1.1.1.4: Shares of Global Islamic Banking Assets (1H2014)

Source: Regulatory authorities, Bloomberg, Zawya, central banks, individual institutions, corporate communications, The Banker, KFHR

Bahrain, Bangladesh, Jordan, Pakistan and Turkey are witnessing rapid growth. Based on the medium-term growth rates of these markets and their current domestic Islamic banking presence, these countries are deemed to be markets where Islamic finance may gain systemic importance. Their growth has been fuelled by various development efforts and firm regulatory support extended by their respective government agencies and regulatory bodies, including the formulation and implementation of strategic road maps that aim to achieve a wider market share for Islamic finance. For instance, the State Bank of Pakistan (central bank) has launched the Strategic Plan – Islamic Banking Industry of Pakistan, which aims to increase the domestic Islamic banking market share to 20% by 2018, up from 9.8% as of 1H2014. Moreover, the central bank has recently issued a revised *Sharī'ah* Governance Framework. The Government of Pakistan has constituted a high level Steering Committee for the Promotion of Islamic Finance in December 2013. The Steering Committee is working on strategic areas including legal, regulatory and taxation reforms, liquidity management, Islamic capital market and capacity building. Moreover, the Government and other corporate institutions have started tapping the local and international *Sukūk* markets in order to raise the required funding.

Similarly, the Government of Turkey has firmly supported the development of the participation finance sector[5] and aims to increase its market share to 15% by 2023, up from 5.7% in 1H2014. In Bahrain and Jordan, Islamic banking currently has domestic market shares of 12.7% and 11.7%, respectively, with significant potential for further growth. In Bangladesh, the Islamic banking sector currently accounts for 17% of the total domestic banking system's assets, with Islamic banking assets growing at a CAGR of 22.85% between 2010 and 2013 (total banking system assets CAGR at 18.11% during 2010–13). The country is poised to become a jurisdiction with a systemically important Islamic finance sector by 2018, based on the current growth momentum.

1.1.2 Islamic Banking: Development Review[6]

The Islamic banking sector is the largest segment of the global Islamic finance industry, with assets in full-fledged Islamic banks, subsidiaries and windows amounting to approximately USD1.48 trillion as at 1H2014.[7] The sector has expanded at a CAGR of 16.89% between 2008 and 2013, and grew by 16% in 2013 y-o-y. In comparison to the overall global banking growth, assets of the top 1000 global banks grew by only 4.9% in 2012 and 0.6% in 2013.[8]

4 *Source: Bank Negara Malaysia (BNM) Monthly Statistical Bulletin.* This figure excludes the Islamic banking assets of the development financial institutions (DFIs).

5 Islamic finance is known as "participation finance" in Turkey in line with constitutional requirements.

6 The figures reported in this section of the 2015 Financial Stability Report (FSR) are not fully comparable with FSR2014 on account of differences in samples of banks under study; availability of data across indicators between FSR2014 and FSR2015; differences between estimated figures as reported in FSR2014 and actual figures reported in FSR2015; exchange rate variations affecting reported values in USD terms between FSR2014 and FSR2015; and other factors.

7 The estimated figure for global Islamic banking assets as at end-2013 was reported as USD1.427 trillion in FSR2014. However, the actual figure for end-2013 is USD1.395 trillion, with many factors accounting for the change, including moderation in growth in the systemically important Islamic banking markets; the impact of emerging markets' volatilities on the financial system in those markets; and exchange rate depreciations leading to lower USD values of assets, particularly in emerging market countries such as Turkey, Indonesia and Malaysia, among others.

8 Total assets of the 1000 banks amounted to USD113 trillion. The list of 1000 banks, published by The Banker in July 2014, includes conventional and Islamic banks.

The potential for Islamic banking to sustain its gradual advancement by way of achieving wider geographical expansion and global market penetration is promising, as several new and niche markets are undertaking steps to enable *Sharīʿah*-compliant financial services in their jurisdictions. As already noted, key developments were witnessed in the nascent markets of Afghanistan, Azerbaijan, Morocco, Tajikistan and Uganda, where regulatory regimes are in the process of enactment. One of the fast-progressing Islamic banking markets is Oman, where the sector has already achieved more than 4% domestic market share in less than three years and has instituted several key frameworks to enable Islamic banking to flourish in the country. In order to further solidify its Islamic finance infrastructure, the Central Bank of Oman is in the process of finalising a framework for issuing short-term Islamic finance instruments that will help Islamic banks and *Takāful* institutions place their excess funds within the country. Moreover, Oman has also formed a national *Sharīʿah* board aimed at regulating Islamic banks and window operations of conventional banks.

In the more developed markets, Malaysia's Islamic Financial Services Act 2013 (IFSA 2013) has been in effect since 30 June 2014. The Act provides a legal foundation for the Islamic banking system to shift towards a regulatory framework which reflects the specificities of the various types of *Sharīʿah* contracts. In supporting the aspirations of the Act, Malaysia's central bank, Bank Negara Malaysia, is currently developing several standards for key Islamic contracts that set out the *Sharīʿah* and operational requirements of a particular contract. Among other things, the Act also distinguishes investment accounts from Islamic deposits, and prohibits principal and profit guarantees on investment accounts.

Box 1.1: Modernisation of Legal and Regulatory Framework in Malaysia's Islamic Finance Industry

By: Bank Negara Malaysia

The enactment of the *Islamic Financial Services Act* 2013 (IFSA) in consort with the *Financial Services Act* 2013 (FSA) marks an important milestone in modernising Malaysia's financial sector laws. Both the FSA and IFSA combine several separate laws to govern the financial sector under a single legislative framework for the conventional and Islamic financial sectors, respectively – namely, the *Banking and Financial Institutions Act* 1989 (BAFIA), *Islamic Banking Act* 1983, *Insurance Act* 1996 (IA), *Takāful Act* 1984, *Payment Systems Act* 2003 and *Exchange Control Act* 1953. These new laws are the culmination of more than six years of work which started concurrently with the review of the *Central Bank of Malaysia Act* 1958. IFSA, in particular, has reinforced Bank Negara Malaysia (BNM)'s financial stability mandate in the *Central Banking Act* 2009 (CBA), which codifies the existence of Islamic finance in a dual financial system in the country as well as places an emphasis on strong *Sharīʿah* governance through recognition of the *Sharīʿah* Advisory Council as the highest authority in *Sharīʿah*-related matters. The growing significance and role of Islamic finance in the domestic and international landscape was also the main factor that contributes to the further modernisation of Malaysia's legislation for Islamic finance. On the whole, the enactment of the new central bank legislation in 2009, the CBA, and the IFSA and FSA in 2013, completed the series of comprehensive legislative reforms that have been undertaken in the country.

Malaysia's commitment to institute a dedicated Act for Islamic financial business had begun as early as the enactment of the Islamic Banking Act 1983 and *Takāful* Act 1984, which enabled the first Islamic bank and *Takāful* operator to be established. Thereafter, various regulations and infrastructure developments have been fostered to stimulate steady growth of Islamic finance in the country. Malaysia's 30-year track record of building a successful domestic Islamic financial industry has given the country a solid foundation with financial bedrock of stability that adds to the richness, diversity and maturity of the overall financial system. Islamic financial regulation has therefore evolved to reflect the higher sophistication of the financial system and complexity of modern finance. As a result, IFSA serves as a forward-looking Act that not only enhances the current regulatory and supervisory framework but also lays down robust and comprehensive building blocks as the foundation for future Islamic finance developments.

The IFSA contains a two-pronged regulatory objective, with financial stability and compliance with *Sharīʿah* as the principal focus. Recognising the dual financial environment in which Islamic finance operates in Malaysia, regulatory parity is ensured for similar areas that are applicable across both the Islamic and conventional finance sectors. Hence, IFSA and FSA contain similar provisions to ensure regulatory and supervisory consistency and to minimise the possibilities of regulatory arbitrage. These provisions include the fundamental reorientation of the focus of financial supervision to take into account system-wide development and risks, in addition to the traditional focus on individual financial institutions. Beyond prudential regulation, focuses on consumer protection and financial inclusion have also become more prominent, driven by changing demographics, the increasing complexity of financial products, and public policy goals to alleviate poverty, improve equity and enhance growth. This leads to BNM's clear mandate for financial consumer protection and strengthened business conduct and consumer protection requirements.

In ensuring parity of regulatory treatment, Islamic windows in conventional banks are subject to prudential requirements that are on a par with those applied in full-fledged Islamic banks. These Islamic windows also need to observe similar *Sharīʿah* governance and end-to-end compliance. For example, IFSA reiterates the requirement for segregation of Islamic banking business whereby Islamic windows are required to ring-fence the capital of the Islamic banking business and conduct separation of accounts from conventional banking transactions. Such a requirement prevents commingling of funds and ensures that Islamic banking operations remain in compliance with *Sharīʿah* principles at all times. Given the level playing field between Islamic finance and conventional finance, IFSA not only enhances consistency in the regulatory treatment and legal position of Islamic financial transactions, but also recognises its uniqueness and maintains *Sharīʿah* compliance as the main pillar through modifications and additional provisions that cater to the Islamic finance sector.

Greater Legal and Operational Certainty through Contract-based Regulatory Framework

The introduction of IFSA offers a new dimension to the regulatory framework for Islamic finance as it accords greater prominence to the *Sharīʿah* contracts in Islamic finance transactions. The statutory foundation for a contract-based regulatory framework in IFSA has enabled the issuance of *Sharīʿah* standards that define the underlying *Sharīʿah* principles adopted by Islamic financial institutions and support the effective application of *Sharīʿah* contracts in the offering of Islamic financial products and services. This represents a significant step forward in aligning legal and regulatory principles with *Sharīʿah* precepts, and can serve as a useful benchmark for evolving more comprehensive regulatory frameworks globally that promote greater legal and operational certainty in Islamic finance. More importantly, the contract-based regulatory framework is developed in a manner that would facilitate the next level of Islamic banking business, transcending financial intermediation to include real economic sector participation. Such a distinctive regulatory approach seeks to realise further the value proposition of Islamic finance[9] as the industry advances towards a new level of maturity and sophistication.

To support the effective implementation of *Sharīʿah* standards, BNM also issues operational standards on *Sharīʿah* matters. Such operational standards address sound practice principles and BNM's expectations for effective risk management, governance, market conduct, and accounting treatments for key Islamic contracts that are necessary to ensure compliance with *Sharīʿah* under different Islamic contracts. To date, BNM has issued the final *Sharīʿah* and operational standards for *Murābahah* in December 2013, while the standards for the remaining contracts are currently being finalised, taking into account feedback received on the exposure drafts and concept paper issued. The current position on the development of standards for all 12 key Islamic contracts is shown in Table 1.

Table 1: Update on Development of Standards for Key Islamic Contracts

Status	12 Key Islamic Contracts	Issuance of Exposure Draft of *Sharīʿah* Standards	Issuance of Concept Paper of Operational Standards	Finalised Standards (Combining *Sharīʿah* and Operational Standards)
Completed	*Murābahah*	✓	✓	Issued in 2013
In Progress	*Muḍārabah*	✓	✓	To be issued by end-2015
	Mushārakah	✓	✓	
	Ijārah	✓	✓	
	Istisnā`	✓	✓	
	Wadī`ah	✓	✓	
	Tawarruq	✓	×	
	Wakālah	✓	×	
	Kafālah	✓	×	
	Bai` al-`Inah	✓	×	
	Wa`d	✓	×	
	Hibah	✓	×	

The emphasis on end-to-end *Sharīʿah* compliance for Islamic financial institutions under IFSA is also a key additional dimension of the regulatory framework for Islamic finance, specifically to elevate the level of transparency. The codification of *Sharīʿah* compliance as a regulatory objective of IFSA, alongside promoting financial stability, has enabled a clear focus on *Sharīʿah* compliance and governance in the Islamic financial sector. In particular, IFSA provides a comprehensive legislative framework that is fully consistent with *Sharīʿah* in all aspects of regulation and supervision, from licensing to the winding up of Islamic financial institutions (Diagram 1).

[9] Value propositions of Islamic finance include serving the real economy, promoting risk-sharing alternatives, subscribing to higher ethical ideals driven by *Sharīʿah* principles, and ensuring greater transparent governance.

Diagram 1: Contract-based Regulatory Framework

Over the years, BNM's expectations of the board and management of Islamic financial institutions and their *Sharīʿah* committees to ensure end-to-end compliance with *Sharīʿah* have been progressively raised in tandem with the increasing significance of Islamic finance business at the institutional, group and system-wide levels. Through IFSA, the roles and responsibilities of key functions in Islamic banks have been legislated, further strengthening the *Sharīʿah* Governance Framework, issued in 2010, that provided clear rules on the roles and responsibilities of the board, senior management and *Sharīʿah* committee of Islamic banks. Greater clarity on legal and regulatory requirements will enable industry players to align practices and expectations, with greater involvement by the senior management promoting a strong culture of *Sharīʿah* awareness and compliance within the organisation. Another important facet of the Act is the clarity of definition in the scope of assets and liabilities of the Islamic banking business based on the contractual features.

Liability Side: Recognition of Investment Account

On the liability side, among the key enhancements in IFSA is the recognition that Islamic banks can mobilise funds either through deposits or investment accounts (IA). The use of principal-guaranteed *Sharīʿah* contracts such as *Qarḍ*, *Wadī`ah* and *Tawarruq* in deposit-taking activities is clearly distinguished from principal non-guaranteed *Sharīʿah* contracts for IA such as *Muḍārabah* and *Wakālah*. Through this classification, IA enables the public to participate more effectively in profit- and risk-sharing investment to finance and foster entrepreneurship and the real economic sectors. The nominal value and profits of the IA would correspond to the level of risks assumed and performance of the account. Product transparency will also be enhanced by clearly differentiating IA from Islamic deposits, as well as clarifying their different implications for the rights and obligations of investors. This will ultimately allow investors to make informed decisions based on their risk appetite and financial needs.

To accommodate the orderly implementation of Islamic deposits and IA, a two-year transition period until 30 June 2015 has been accorded to Islamic banks. During this period, Islamic banks are expected to actively engage their customers in providing information and clarification on the differences between the two products, as well as the options available to them to place their money in the form of either Islamic deposit or IA.

Consequently, the introduction of IA in IFSA 2013 has led to the issuance of the Investment Account Framework to clarify rules when operationalising IA. The framework sets out the regulatory expectations of IA, and specifies key prudential requirements on aspects of risk management, governance, and transparency and disclosure as guidance to Islamic banks when offering IA. Collectively, these policy measures promote sound management to safeguard the interests of customers, to strengthen risk management and the governance process in managing funds and assets funded under IA, and to ensure transparent information disclosure to facilitate informed decision-making by customers.

In addition, the legislation brings the legal framework for the resolution of Islamic banks in line with distinctive elements of the relevant Islamic contracts (Diagram 2). Assets that are managed by Islamic banks on behalf of investors are legally ring-fenced from the assets of the Islamic banks to reflect the prohibition of any commingling of profits and losses attributed to the IA with other funds. A similar separation is applicable to Islamic windows within licensed commercial banks and investment banks, where Islamic assets and funds are ring-fenced from the conventional banking business. In the event of the resolution of an Islamic financial institution, payments to Islamic depositors are prioritised in a manner that is consistent with the guaranteed nature of contracts employed in Islamic deposit products.

Diagram 2: Priority of Payment Reflective of Underlying *Sharīʿah* Contracts

[1] Section 292(1) of Companies Act 1965
[2] Section 10 of Government Proceedings Act 1965
[3] Section 292(1)(a) & (f) of Companies Act 1965

Asset Side: Provision of Finance via Financing and Primary Model

On the asset side, IFSA allows Islamic financial institutions to provide financing based on Islamic contracts that are subject to a wider range of risks and potential returns. The scope of financing activities similarly draws on the distinctive features of Islamic contracts to include equity and partnership financing contracts under both "financing" and "primary" models.

The financing model essentially refers to the current credit intermediation role performed by Islamic banks that offer Islamic financial products with ultimate features that are comparable to conventional banks. In operationalising this model, Islamic banks have combined multiple principal *Sharīʿah* contracts – for example, the *Murābahah* contract, with other ancillary *Sharīʿah* contracts and arrangements such as *Wakālah* and *Wa`d*, which enables Islamic banking products to serve their intended purpose and limit the bank's exposure to financial risks. As an example, where the objective is for an Islamic bank to provide financing to a customer by purchasing an asset on behalf of the customer, *Wa`d* is used to effect the eventual transfer of the asset to the customer since the bank does not intend ultimately to own the asset purchased.

The primary model, on the other hand, includes investment intermediation activities that are driven by the customers' need to partake in risk-sharing deals. The objective of this transaction is completely different from the financing model. The banks may assume specific risks and responsibilities that not only relate to the financial sides but also encompass the business aspect of the transaction. Therefore, in addition to financial risks, Islamic banks may also assume and manage further risks such as business risk and risks associated with the holding and ownership of physical underlying assets. In operationalising this, a single *Sharīʿah* contract is adopted by applying its original features. The contracting parties either share the risks under risk-sharing contracts, as in the case of *Mushārakah* and *Muḍārabah*, or Islamic banks may undertake the role to assume specific risks under exchange-based contracts such as *Ijārah* and *Murābahah*.

These two models are grounded on the relationship between risk and return in Islamic finance that lay emphasis on the concept of "no risk, no return". The different attributes of the financing and primary models thus provide a broader range of product options for customers with customised levels of risk and differentiated pricing to meet their specific preferences and needs.

Changing Regulatory Expectations on Islamic Banks

The risks and obligations borne by Islamic banks under various *Sharī'ah* contracts will require significant modifications on the design of existing infrastructures in Islamic banks. Diagram 3 depicts the differentiated regulatory expectations for the operations of Islamic banks when offering products under the financing and primary models.

Diagram 3: Differentiated Regulatory Expectations on the Operations of Islamic Banks under Various *Sharī'ah* Contracts

Products under the primary model will require additional governance and risk management measures that are appropriate for the risks inherent in the contracts, in addition to existing arrangements for managing financial risks. Regulatory capital requirements should also reflect the types and level of risks involved to ensure that risk exposures of an Islamic bank are backed by an adequate amount of high-quality capital. This is to ensure that risks and infrastructure required are adequately considered in the business strategies of Islamic banks that offer such products.

The terms and conditions of each product have to clearly reflect the salient aspects of the contracts, in order for customers to be fully informed of their rights and obligations. Market conduct requirements, including disclosures, also vary based on the nature of products offered to ensure a high level of transparency that is commensurate with the risks borne by customers. Products must be structured to ensure that funds placed by customers are properly channelled in accordance with the agreed terms and conditions. These policies and infrastructure are important to ensure that the interests of customers and other stakeholders are protected, which in turn will promote confidence and trust in Islamic banks.

Islamic banks are now expected to conduct suitability assessments to ensure that products recommended, from among the different types of *Sharīʿah* contracts available, are the ones that best serve the needs and preferences of customers. The active participation of customers in seeking a clearer understanding of Islamic products, especially how these products may differ from those of conventional banks, is also important to ensure that the expectations of customers are met by the benefits acquired and obligations assumed under an Islamic financial transaction. Significant efforts are needed to educate and promote greater awareness among customers, including entrepreneurs, of the different options offered by Islamic banks.

IFSA as an Impetus for Stronger Engagement

With its holistic coverage that provides a strong legal foundation for Malaysia's comprehensive regulatory framework, IFSA lends support for increased adoption and implementation of the international prudential standards set by the Islamic Financial Services Board. Progression towards greater mutual understanding of initiatives taken by Islamic finance jurisdictions globally would foster greater interaction for increased collaboration in addressing issues and challenges faced by the industry. This shared wisdom would be crucial in strengthening the Islamic financial system, both domestically and internationally, which is vital in advancing the industry to the next level.

Elsewhere, the Pakistani central bank, State Bank of Pakistan (SBP), has launched a five-year strategic plan and is finalising details on an Islamic liquidity framework, consisting of an Islamic interbank money market (IIMM) and a *Muḍārabah*-based placement facility run by the central bank. Under the framework, banks would be required to settle their short-term liquidity needs through the IIMM, while surplus funds would be absorbed by the central bank.

Other notable Islamic banking developments include the planned establishment of a deposit insurance framework in Qatar which will also include a *Sharīʿah*-compliant variant, as part of the strategic plan to modernise the country's financial sector by 2016. Such financial safety net initiatives are critical in boosting the public's confidence in a country's financial system. In Turkey, three state-run banks have received regulatory approval to establish separate Islamic banking units, namely participation banks to offer *Sharīʿah*-compliant financial services. These banks are among the largest banks and likely to expand the use of Islamic financial services in Turkey. In the Eurozone, there are plans to establish the bloc's first full-fledged Islamic bank in Luxembourg aimed at offering *Sharīʿah*-compliant retail, corporate and private banking services in the region and with plans to open branches in Belgium, France, Germany and the Netherlands. In addition, a Turkish-based participation bank has applied for an Islamic banking licence in Germany. Meanwhile, the Sub-Saharan country of Burkina Faso is set to welcome its first Islamic banking window early in 2015. The initiative is being undertaken by a local conventional bank with support from an affiliate of the Islamic Development Bank (IDB), the Islamic Corporation for the Development of the Private Sector (ICD).

Overall, global Islamic banking assets are estimated to amount to approximately USD1.56 trillion by the end of 2014 (see Chart 1.1.2.1). The industry's assets remain heavily concentrated in the Middle East region and a select few Asian countries – the top ten Islamic banking jurisdictions account for almost 94% of the global Islamic banking assets. Critically, this makes the stability of the global Islamic banking system dependent upon the smooth functioning and viability of Islamic banks in such jurisdictions with an Islamic banking sector of systemic importance.

Chart 1.1.2.1: Islamic Banking Assets Growth Trend (2008–2014F)

Source: Regulatory authorities, Bloomberg, central banks, individual institutions, corporate communications, The Banker, KFHR

In the following subsection, an overview[10] of the Islamic banking growth patterns across 11 major Islamic banking domiciles (excluding Iran, due to data constraints) is presented using sample data from 59 prominent Islamic banks in these domiciles[11] (see Chart 1.1.2.2). The total assets of these sample banks amounted to USD567.8 billion as at end-2013, which represents 69.2% of the total Islamic banking assets in 2013 (if Iran is excluded). These 11 markets include Bahrain, Bangladesh, Indonesia, Jordan, Kuwait, Malaysia, Pakistan, Qatar, Saudi Arabia, Turkey and the United Arab Emirates.

[10] A detailed and analytical review of the financial performances of the Islamic banking sector in these markets is presented in the second part of the chapter.

[11] The Islamic banking sample comprises full-fledged and subsidiary banks. The analysis excludes Islamic windows, as there are data limitation issues with regards to Islamic windows in most jurisdictions. Where data on Islamic windows are available, there is an issue of limited financial disclosure of Islamic windows as a separate business. The list of banks is presented in the appendices section at the end of this report.

Chart 1.1.2.2: Islamic Banking Assets and Market Share (1H2014)

Source: Central banks and regulatory authorities, individual institutions, Bloomberg, Zawya, corporate communications, The Banker, KFHR

Islamic Banking Overview in Key Markets

The total Islamic banking assets across the sample 59 banks in 11 markets have expanded at a CAGR of 16.6% in the last five years (2008–13). However, notably, the growth has been moderating in recent years: the sample's assets grew 16% (CAGR 2011–13) as compared to 17.1% CAGR between 2008 and 2011 (see Chart 1.1.2.3). On a yearly basis growth has slowed from 2010 onwards. This moderation is attributable to several factors among which are: the gradual move by advanced domiciles towards more moderate growth rates (ranging between 10% and 15%); currency depreciations in certain emerging markets as a direct consequence of the US Federal Reserve's tapering concerns last year (the US dollar values of the assets have had downward revisions); and post-crisis balance sheet clean-ups by Islamic banks, removing non-performing financing assets (mostly in the real estate sector) from the financial crisis years or restructuring the same, leading to write-downs in the assets (as analysed in the *IFSI Stability Report 2014*).

Chart 1.1.2.3: Compound Annual Growth of Key Islamic Banking Statistics[12]

Source: Islamic banking sample, KFHR

A similar trend is also apparent in the growth of Islamic banking deposits over recent years. Although the five-year CAGR (2008–13) in Islamic banking deposits is recorded at 17%, the growth has been moderating recently – a 16.1% CAGR during 2011–13, as compared to a 17.6% CAGR in 2008–11. In contrast, Islamic financing across the sample witnessed growth variations over the last few years (see Chart 1.1.2.4). Following an apparent slowdown in 2009 (attributable to the knock-on effects of the GFC), Islamic financing growth experienced a resurgence in 2010 before slowing again in 2011, presumably on account of spillovers from the European crisis that had led to a contraction in financing activity in real economic sectors. This was followed by a revival in 2012 before the growth rate once again moderated in 2013.

Chart 1.1.2.4: Islamic Banking Global Average Annual Growth Trends

Source: Islamic banking sample, KFHR

A closer look at the growth patterns exhibited by 11 sample countries reveals that Islamic financing has experienced only moderate growth in nine out of those countries in the past few years, for various reasons (see Chart 1.1.2.5). The two countries with improved financing growth rates in 2013 are Pakistan and Turkey, where untapped demand for *Sharīʿah*-compliant financial services (these two countries have less than 10% Islamic banking share) is accompanied by firm governmental support. A maturing market and deeper penetration is likely to have been a factor in the slight moderation in growth of Islamic financing in developed Islamic banking markets such as Kuwait, Malaysia, Saudi Arabia and the UAE.

Chart 1.1.2.5: Financing Growth Trend by Country

Source: Islamic banking sample, KFHR

[12] The use of the term "deposit" in this section includes unrestricted profit-sharing investment accounts (UPSIAs), which are treated as equity in the financial statements of Islamic banks in some jurisdictions and as liabilities in others.

In terms of deposit mobilisation, two out of the 11 sample countries have experienced improved growth rates since 2011, Turkey and the UAE (see Chart 1.1.2.6). Islamic banks in the UAE appear to have benefited from a sustained demand (both from businesses and individuals), compared to the other Middle East countries.[13] On the other hand, the growth of Turkish participation banking deposits is supported by both demand and supply dynamics, with the domestic population increasingly favouring *Sharīʿah*-compliant banking services while the government itself is encouraging growth and expansion of the participation banking sector.

Chart 1.1.2.6: Deposit Growth Trend by Country

Source: Islamic banking sample, KFHR

Overall, the Islamic banking sector has continued the double-digit growth trajectory in its assets, financing and deposits, averaging nearly 14% y-o-y growth across the sample in 2013. As per earlier statistics, the Islamic banking sector is estimated to hold approximately USD1.56 trillion in assets by the end of 2014. Based on the various growth and developmental plans highlighted earlier across both new and existing markets, the sector is expected to surpass the USD2 trillion mark in assets by as early as 2018. Notwithstanding this statistical forecast, there are a number of pressing challenges that the industry stakeholders need to overcome in order for the sector to sustain its double-digit growth rates and increasing market penetration – in particular, when the global financial system is experiencing dynamic complexities based on evolving regulatory requirements, new risks are threatening the smooth functioning of the financial system, and more demanding customer segments are seeking newer, more innovative products. Consumers are also favouring newer means of availing themselves of financial services – for instance, through mobile and internet banking channels. Expectations surrounding these technological innovations require that Islamic banks become more "tech-savvy" in terms of the "banking experience" they offer, in order to appeal to the newer generation of banking service users who appreciate remote, online and mobile platforms for accessing financial services.

1.1.3 Islamic Capital Markets: Development Review

The Islamic capital market is the fastest growing component of the overall Islamic finance system, although it has been a late entrant into the industry, starting only in the mid-1990s. Notably, the sector has picked up positive momentum and is now attracting diverse investors and issuers from around the world, growing steadily in depth and size. Broadly, Islamic capital markets comprise three main sectors: the Islamic equities market facilitated by the availability of *Sharīʿah*-compliant indices, the *Sukūk* or Islamic bond market, and the Islamic funds market. These sectors, which are analysed in detail later in this report, have enabled investors to achieve ethical and *Sharīʿah*-compliant returns on their capital. Of the three sectors, the *Sukūk* market has garnered the most interest in recent years, and issuers in as many as 30 domiciles have now tapped into the *Sharīʿah*-compliant liquidity pool by issuing *Sukūk* instruments.

(a) *Sukūk*[14]

The *Sukūk* market has overtaken the Islamic banking sector (based on growth rates) as the most rapidly expanding Islamic finance sector in the last few years. The global *Sukūk* outstanding volume has expanded at a CAGR of 20.8% between 2008 and 2013 and stands at USD294.7 billion in volume as at end-3Q14 (see Chart 1.1.3.1). The market has been propelled by a heightened interest among various sovereign, quasi-sovereign and corporate issuers in tapping into the Islamic finance liquidity pool, particularly in the post-GFC period. Annual issuances have surpassed the milestone USD100 billion mark in each of the last three years, including 2014. As of the ten months ended October 2014 (10M14), global primary market *Sukūk* issuances amounted to USD102.94 billion (see Chart 1.1.3.2). Average annual *Sukūk* issuances volume amounted to USD19.8 billion between 2004 and 2009, compared with the USD95.3 billion average volume during 2010–13.

The increased volumes in recent years have also been supported by the debuts of several new markets in the *Sukūk* sector. In 2014 alone, the United Kingdom (£200 million issuance), Luxembourg (€200 million issuance), the Emirate of Sharjah (USD750 million issuance), Senegal (XOF100 billion issuance), Hong Kong (USD1 billion issuance) and South Africa (USD500 million issuance) have all entered the global primary *Sukūk* market. Several jurisdictions remain in the pipeline for debut issuances in the reasonably near future, including Jordan, Mauritania, Morocco, Oman and Tunisia among others. Kenya, Kyrgyzstan and Malta are among those jurisdictions deliberating on establishing Islamic capital markets, including a *Sukūk* segment.

[13] As per research from the Washington-based International Institute of Finance, the first-quarter data in 2014 from the leading UAE banks indicate that the banking system in that country has turned around, with a strong rebound in profitability and decline in non-performing loans (NPLs). The UAE banking sector is benefiting from a strong revival in the UAE's macroeconomic fundamentals and from its status as a safe haven since the Arab turmoil began in early 2011.

[14] *Sukūk* are certificates of investment in underlying assets, services or investment activities that generate fixed or floating returns according to Islamic principles. The instruments offer an alternative funding tool to conventional bonds that can be structured and utilised for a vast array of purposes. In recent years, *Sukūk* products have seen significant innovation with the introduction of hybrid, convertible, perpetual, retail and insurance-linked issuances. As such, *Sukūk* are being used for funding working capital requirements, liquidity management, risk management and investment purposes.

Chart 1.1.3.1: *Sukūk* Outstanding Trend

Source: Bloomberg, IFIS, Zawya, KFHR

Chart 1.1.3.2: *Sukūk* Issuance Trend

**Includes all government-related entities.*
Source: Bloomberg, IFIS, Zawya, KFHR

The *Sukūk* market post-GFC has increasingly been tapped by sovereign and government-related entity issuers. Since 2009, sovereign and quasi-sovereign *Sukūk* issuances have accounted for an average 80% of the total annual volume issued, as compared to approximately 29.4% average volume between 2004 and 2008 (see Chart 1.1.3.2). Several factors account for this trend:

- A surge in the regular supply of local-currency liquidity and capital management *Sukūk* by central banks occurred in Bahrain, Gambia, Malaysia and Qatar among other jurisdictions.
- An increasing preference by quasi-sovereign and government-linked agencies for tapping the *Sukūk* market in order to raise funds supported the government's ambitions to transform the jurisdiction into a major *Sukūk* hub (e.g. in Malaysia and the UAE).
- The drying-up of liquidity in the international financial markets encouraged sovereigns to tap into alternative funding sources (e.g. in Kazakhstan and Turkey).
- Jurisdictions aiming to gain traction in Islamic finance are strategically issuing sovereign *Sukūk* in order to send positive signals to market participants about the country's genuine interest in the sector (e.g. Luxembourg and the United Kingdom).
- Multilateral organisations, the Islamic Development Bank and the International Islamic Liquidity Management Corporation (IILM) have increased the frequency and volume of issuances.

These factors have been instrumental in driving the growth of the *Sukūk* sector across diverse geographical regions, as sovereign successes in the international markets, particularly by non-Organisation of Islamic Cooperation (OIC) issuers, generate publicity and raise the confidence of other issuers while giving them an encouraging example. In the longer term, interest is emerging from new domiciles in Central Asia, Europe, and North and Sub-Saharan Africa wanting to explore *Sukūk* as viable tools for fund-raising.

Meanwhile, the corporate *Sukūk* sector, although expanding, has experienced volatility in terms of issuance activities over the past few quarters. Predominantly, the US Federal Reserve's intended tapering of its quantitative easing programme had been a critical factor affecting corporate *Sukūk* issuances. In 3Q2013, corporate *Sukūk* issuances fell to all-time lows since 2010 as a direct consequence of the first indication by the US Fed of a potential taper in May 2013. A substantial rebound was witnessed in 4Q2013 following the decision by the Fed, at its September 2013, meeting to delay the taper. Since then, the gradual tapering has begun and the QE programme was fully scaled back by the Fed at its October 2014 meeting. Nonetheless, anxieties about the possible timing of US interest rate increases, along with other geopolitical factors in the Middle East region, have resulted in the widening of corporate spreads of emerging economies' bonds. This in turn has kept corporate issuers largely subdued in 2014 (see Chart 1.1.3.3).

Chart 1.1.3.3: Corporate *Sukūk* Issuance Trend

**Includes all government-related entities.*
Source: Bloomberg, IFIS, Zawya, KFHR

Overall, performance of the primary *Sukūk* market has been robust on the back of sovereign issuances that have seen volume reach USD102.94 billion for 10M2014, a 5.7% increase y-o-y on 10M2013's USD97.39 billion. Issuers originating from 19 different domiciles tapped the primary market in 10M2014, although the volume was concentrated in Malaysia, which accounted for 65.4% of the total volume issued (see Chart 1.1.3.4). The leading domiciles in the GCC were Saudi Arabia (11.2%) and the UAE (4.3%). However, the region has yet to see any issuances from Kuwait and Oman in 10M2014. Total GCC volume in 10M14 was approximately USD21.4 billion, accounting for 20.2% of the total global volume issued.

Chart 1.1.3.4: *Sukūk* Issuances by Domicile and Share (10M2014)

Source: KFHR
Note: Domicile is the location of the obligor.

In other markets, Indonesia sold its annual USD *Sukūk* tranche worth USD1.5 billion in October and, together with its local currency *Sukūk* tranches issued by the Ministry of Finance throughout the year, the jurisdiction accounted for 6% of the total volume as at 10M2014. The Turkish *Sukūk* sector represented 3% of the global volume in 10M2014 on the back of participation banks' *Sukūk* issuances, as well as the sovereign issuances by the government. Among the non-OIC domiciles tapping the market in 10M2014 were Hong Kong, Luxembourg, Singapore, South Africa and the United Kingdom. The corporate sector saw the first *Sukūk* issued by an American investment bank, and the success of this deal may trigger interest from more global investment banks in exploring *Sukūk* as a fund-raising instrument. In 2012, the bank had attempted to issue a *Sukūk*; however, following some debate on its *Sharī'ah* compliance, the issuance was cancelled. Nevertheless, the utilisation of *Sukūk* by investment banks is a positive trend, as *Sukūk* provides a *Sharī'ah*-compliant alternative for the financing of investment banking activity that is not necessarily linked to interest-based transactions (e.g. commodity trading).

Analysing the *Sukūk* market by sector (see Chart 1.1.3.5), the financial services industry recorded a notable increase in 10M2014, now accounting for 21.5% of the total volume issued (2013: 9.8%; 2012: 5.1%). The growth is underpinned by the issuances of *Sukūk* by Islamic banking institutions to comply with revised capital adequacy standards and regulations, as well as the short-term liquidity management *Sukūk* issued by the IILM. Moreover, 2014 also witnessed issuances from economic sectors that had not previously issued *Sukūk*. These included issuances by a *Takāful* company in Malaysia and a major fashion retailer in Saudi Arabia. A Japanese bank's subsidiary in Malaysia has also become the world's first issuer to raise *Sukūk* funds in Japanese yen, while also being only the second Japanese financial institution to tap into the *Sukūk* market. Apart from these milestones, the sovereign sector continued to account for the bulk of the new issuances volume (10M2014: 61.4%), while the other notable sectors included power and utilities (7.2%) and real estate (4.38%).

Chart 1.1.3.5: *Sukūk* Issuances by Sector (10M2014)

Source: Bloomberg, IFIS, Zawya, KFHR

The maturity profile of *Sukūk* issued over the years has become increasingly skewed towards the shorter-term maturity of a one-year tenure and less on the back of increased liquidity management *Sukūk* issuances by central banks and working capital *Sukūk* by corporates (see Chart 1.1.3.6). Approximately 47% of all *Sukūk* issued by volume had maturities of one year or less in 10M2014. Comparatively, the share of longer-term *Sukūk* (maturities of ten years and above) has contracted in 10M2014 (8% vs. 10.9% in 2013), on account of the rapid issuances of short-term *Sukūk* and careful consideration by issuers due to uncertainties surrounding future monetary policy directions. The three- to five-year maturity bracket increased, accounting for 16% of the volume raised in 10M2014 (2013: 11.6%), and the trend is plausible given that issuers do not wish currently to take long-term exposures while the level of future interest rates is uncertain.

Chart 1.1.3.6: *Sukūk* Maturity Trend of New Issuances

Source: Bloomberg, IFIS, Zawya, KFHR

Finally, in terms of the secondary market returns performances of *Sukūk* instruments, yields have generally declined across the key markets in 2014 since the upwards spiralling towards the second half of 2014 when the US Federal Reserve's tapering announcement came as an unexpected surprise to the financial community. Although the trajectory has generally been on a declining trend, the markets were not spared considerable volatility in 10M2014 (see Chart 1.1.3.7). The major factors impacting investors' required rates of returns were the US FOMC meetings, the geopolitical risks affecting the Middle East region, and the emerging markets' assets sell-off trends.

Chart 1.1.3.7: Selected USD *Sukūk* Yields vs. Five-year US Government Securities Yield

Source: Bloomberg, KFHR
Note: CBB = Central Bank of Bahrain, DOF = Dubai Department of Finance, SECO = Saudi Electricity Company, SoQ = State of Qatar, 1Mal = 1Malaysia Global Sukūk Wakālah, Hazine Varl = Hazine Mustesarligi [Turkish Under Secretariat], US 5Y = US 5 Year Generic Government Yield.

The market participants had been carefully scrutinising the FOMC's meeting minutes and announcements in search of possible signals as to the likelihood and timing of US interest rate increases. As such, prior to every meeting, yields on US dollar instruments would generally climb across the global markets, including on *Sukūk* instruments. Meanwhile, improving US economic indicators and a strengthening US dollar signalled a recovering trend in the US market, triggering a new round of sell-offs of emerging markets' assets that strained the exchange rates of those markets' currencies while causing volatilities in their financial markets, including on *Sukūk* and bond instrument yields. Furthermore, geopolitical conditions in the Middle East caused investors to reassess the risks of *Sukūk* instruments originating from the region, which in turn led to volatile *Sukūk* yields and weaker investor sentiment. Finally, *Sukūk* yields in certain countries were impacted by domestic conditions (e.g. high rates of inflation in Turkey), causing investors to demand higher rates of return. Going forward, *Sukūk* yields will be impacted by tighter global monetary policy conditions, as well as by emerging market and geopolitical risk factors.

Overall, the *Sukūk* sector has earmarked itself as one of the thriving sectors of the global Islamic finance industry in 2014 and surpassed the USD300 billion mark in 4Q2014. The *Sukūk* market is rapidly gaining traction across diverse geographical regions and its growth expands the number of economic sectors tapping into the sector to raise liquidity. In 2014 alone, new sectors include the *Takāful* industry, the fashion retailing industry and a surge in *Sukūk* issuances to comply with revised capital adequacy standards and regulations. A number of new and largely under-tapped sectors hold promising prospects going forward for *Sukūk* to fund their financing needs. They include the infrastructure financing market; the green and ethical investments market; the alternative Islamic structures (e.g. *Waqf, Zakah* institutions, etc.) market; and economic development initiatives by multilaterals. Furthermore, of late, potential has opened up for funding social causes through *Sukūk*. For instance, a landmark new addition to the multilateral sector is the proposed *Sukūk* to finance an immunisation programme by a World Bank affiliate, which opens up the possibility of more *Sukūk* issuances with a social cause. Meanwhile, the Securities Commission Malaysia launched a Socially Responsible Investments *Sukūk* (SRI *Sukūk*) framework during the Global Islamic Finance Forum 2014 which may spur *Sukūk* issuances for funding green and ethical financing projects in Malaysia and overseas.

The market has also experienced an increase in international *Sukūk* listings, with issuers tapping into the cross-border investors' base across global markets. This trend has resulted in an increase in the share of US dollar *Sukūk* papers being issued, since most international *Sukūk* instruments are structured using the US dollar. The US dollar represented a 21.2% share of the total new issuances volume in 10M2014 (2013: 15%). Overall, 16 currencies had been utilised by *Sukūk* issuers in 10M2014 to raise funds, including among the debuting currencies the Japanese yen, the West Africa CFA franc and the Maldivian rufiyya.

Nonetheless, despite the tremendous progress, there remain certain challenges that are likely to impact the sustainable growth and development of the *Sukūk* market as a mainstream fund-raising component of the global capital markets. A pressing challenge, in particular, is the lack of liquid and active secondary *Sukūk* markets in key Islamic finance domiciles, which limits investors' ability to trade *Sukūk* instruments. This also leads to other challenges, including lack of appropriate benchmarks to gauge the correct levels of yields on outstanding instruments. Often, *Sukūk* papers are benchmarked against the conventional instruments, adding a few basis points (bps) as premiums over and above the conventional yields. For this reason, *Sukūk* instruments are often priced at a premium, costing issuers

anywhere from 5bps to as much as 50bps more than the issuing conventional bond instruments. To date, a full-fledged secondary *Sukūk* market is only active in Malaysia, with the Malaysian *Sukūk* market remaining the only domicile with an outstanding volume in excess of USD100 billion.

The reasons cited for a lack of an active secondary market include differing *Sharī'ah* opinions on *Sukūk* tradability; the limited supply of *Sukūk* instruments, causing investors to hold them until maturity; and, in general, a lack of understanding of such instruments, leading to a limited universe of investors' base. However, *Sukūk* market stakeholders have already begun to implement efforts to address this limitation, both at the global and national levels. Various multilaterals and regulatory bodies have issued standards that support harmonisation of *Sukūk* structures in cross-border markets while providing guidelines for structuring instruments that are tradable while meeting *Sharī'ah* requirements. Harmonised *Sukūk* structures, along with tradable features, are an essential step forward towards achieving liquid and active domestic and cross-border secondary *Sukūk* markets.

(b) Islamic Indices

Islamic indices have played a pivotal role in building the global market infrastructure for the Islamic finance industry by facilitating Islamic investments in *Sharī'ah*-compliant equities. Today, they are supplied by all major global index providers, such as Dow Jones, Standard & Poor's, FTSE, MSCI and Russell Investments (see Diagram 1.1.3.1). Islamic equity indices are valuable to Islamic fund managers who have benefited from *Sharī'ah* screening methodologies and the expanded universe of *Sharī'ah*-compliant securities, as well as to those investors searching for alternative portfolio exposures and ethical products.

Diagram 1.1.3.1: Major Islamic Indices for Equity Markets

Source: Dow Jones, S&P, FTSE, MSCI, Russell Investments, KFHR

Considering the importance attached to Islamic equity indices in the Islamic financial system, it is of interest to see their historical comparative performance vis-à-vis conventional stock indices. For example, in the period from 2004 to mid-2008, the Dow Jones Global Total Stock Market Index (Dow Jones Global TSM Index) and the Dow Jones Islamic Market World Index (DJIM World Index) returned almost identical gains of 47.21% and 46.41%, respectively, despite varying compositions and methodologies. However, in the subsequent period until 10M2014, the Islamic index fared noticeably better, outperforming the conventional benchmark by 3.67% (see Chart 1.1.3.8).

Chart 1.1.3.8: Historical Performance of Selected Global Conventional and Islamic Equity Indices

Source: Bloomberg, KFHR

Chart 1.1.3.9: Number of Components

Chart 1.1.3.10: Market Capitalisation

Source: Dow Jones, KFHR

The divergence in performance is explained by the different performances of the indices' constituent stocks. The Dow Jones Global TSM Index's largest exposures are to the financial sector (22.62%) and the industrial sector (13.18%). In contrast, the top two sectors in the DJIM World Index, with a combined 39.31% share, are technology and health care (see Chart 1.1.3.11). The historical performance of these sectors from 2008 onward has been different, as is evident from the five-year annualised returns of the Dow Jones industry indices taken as proxies for the component sectors: a 10.94% average for "Financials" and "Industrials" versus a 16.53% average for "Technology" and "Health Care", as of 10M2014.

Chart 1.1.3.11: Sector Allocation (10M2014)

Chart 1.1.3.12: Regional Allocation (10M2014)

Source: Dow Jones, KFHR

(c) Islamic Funds

Islamic fund management remains a niche sector of the global Islamic finance industry. As a result of uncertain global macroeconomic circumstances as well as certain sector-specific challenges (such as smaller scale and limited distribution channels), its growth has moderated in the post-GFC period with *Sharīʿah*-compliant assets under management (AuM) recording a modest CAGR of 6.6% from 2009 to 2013. As of 3Q2014, the Islamic funds sector grew 4.6%, with their AuM reaching an estimated USD75.8 billion[15] (see Chart 1.1.3.13). The cumulative number of Islamic funds stood at 1161 in the same period.

Chart 1.1.3.13: Growth in Assets under Management and Number of Islamic Funds

Source: Zawya, Bloomberg, KFHR

[15] This figure includes all publicly available Islamic funds for which net asset value data are available.

By domicile, it is estimated that Islamic funds holding about 74% of total AuM are domiciled in just three jurisdictions – namely, Saudi Arabia, Malaysia and Jersey (see Chart 1.1.3.14). Saudi Arabia is home to a large number of Islamic investors who have a strong preference for domestic and regional allocations. As such, about 31% of global Islamic AuM is invested in Saudi Arabia on a geographical focus basis (see Chart 1.1.3.15). A similar pattern of predominantly domestic investing is noticeable in Malaysia, which appeals to Islamic fund managers as a domicile owing to its continuously improving and increasingly accommodative regulations. This makes Malaysia the second-largest geographical focus for allocations of Islamic AuM, with a 24% share. Other notable Islamic fund domiciles include Kuwait, the United States, Bahrain, South Africa, Indonesia and Pakistan. Globally focused Islamic funds, whose allocations have been simplified by the existence of numerous Islamic indices, account for 22% of *Sharīʿah*-compliant AuM.

Chart 1.1.3.14: Islamic Fund Assets by Domicile (3Q2014)

Source: Zawya, Bloomberg, KFHR

Chart 1.1.3.15: Islamic Fund Assets by Geographical Focus (3Q2014)

Source: Zawya, Bloomberg, KFHR

In terms of asset allocation, equity funds represent more than one-third of Islamic funds worldwide, reflecting Islamic investors' inclination for *Sharīʿah*-compliant stocks (see Chart 1.1.3.16). The money market is another prominent asset class in the Islamic investment universe, which caters to the requirements of the many Islamic investors across major Islamic finance markets with a high regard for capital preservation. Other significant asset classes include commodities, fixed income and real estate.

Chart 1.1.3.16: Islamic Fund Assets by Asset Class (3Q2014)

Source: Zawya, Bloomberg, KFHR

In the light of changing regulatory environments and intensifying competition, Islamic fund managers are being called upon to revise their fund management strategies. In this regard, from a supply perspective, amassing scale through the attraction of institutional investors is among the possible strategic paths for Islamic fund managers. In addition, attracting funds from high-net-worth investors – particularly from the Asia-Pacific region, which is expected to become the largest high-net-worth-individuals' (HNWI) wealth market, overtaking North America in 2014 – is another lucrative opportunity for the Islamic funds and assets management sector. The sector could also benefit had it managed to tap into the rich pool of funds seeking socially responsible investments in Europe and the Americas. Critically, the attraction of this mostly non-Muslim group of investors will require Islamic fund managers, among other stakeholders, to offer a competitive and diverse selection of *Sharīʿah*-compliant funds to these investors.

The industry's overall financial ecosystem – in particular, the availability of financial instruments and investment avenues for fund managers – is a determining success factor to support the evolution of the Islamic asset management sector in innovating sophisticated investment products. Likewise, the proliferation of Islamic wealth management solutions (in the form of Islamic pension funds, foundations and trusts) would also help Islamic funds to perform a greater role in the IFSI industry. In this regard, further developing Islamic capital market instruments and widening the potential sources of funds are necessary, as Islamic banks' interaction with financial markets will lead to the creation of a well-functioning financial ecosystem. In particular, advancements in the *Sukūk* and Islamic funds markets are pertinent to support the evolution of Islamic capital markets moving forward.

1.1.4 Development Trends in *Takāful*

The global *Takāful* (or Islamic insurance) industry has experienced strong double-digit growth rates in recent years with the global gross *Takāful* contributions amounting to an estimated USD21.4 billion as of 1H2014, representing a y-o-y growth of more than 15%. During the years 2008–13, global *Takāful* contributions grew at a CAGR of 15.8%, supported mainly by the growth of major *Takāful* regions such as the GCC, the Middle East (ex-GCC) and South-East Asia (see Chart 1.1.4.1). In other regions – for instance, South Asia and Africa – supportive legislation and regulatory developments are taking place that are likely to support the growth of the sector in the near future. In the GCC, Oman has become a new entrant in the *Takāful* market with the country's first *Takāful* company commencing operations starting 1 January 2014. Oman's presence in the sector is expected to fuel the growth of the *Takāful* sector in the GCC region.

Notwithstanding the above, the *Takāful* industry remains concentrated in Saudi Arabia and Malaysia,[16] and these two domiciles collectively generated approximately 43.7% of the global gross *Takāful* contributions in 2013. The Saudi *Takāful* market is served by more than 35 cooperative insurance providers[17] and these cumulatively contributed nearly USD6.4 billion in gross *Takāful* contributions as of end-2013. The Malaysian *Takāful* market is served by 11 *Takāful* operators, and the sector has maintained its growth momentum over the years (CAGR: 18.69% in 2009–13) with an estimated USD2.2 billion in gross *Takāful* contributions as at end-2013. The growth in these developed *Takāful* markets is mainly on account of an increasing awareness among the demographics regarding the benefits of insurance/*Takāful* products, combined with the population's growing preferences for *Sharīʿah*-compliant financial products.

Chart 1.1.4.1: Global *Takāful* Gross Contribution Trend

Source: World Islamic Insurance Directory 2014, central banks and regulatory authorities, individual institutions, KFHR

The GCC region is the largest *Takāful* market, with an estimated total of USD8.4 billion gross contributions as at end-2013. A total of 78 *Takāful* operators are known to be offering Islamic insurance services in the region in 2013 (see Chart 1.1.4.2). Recently, the Central Bank of Bahrain (CBB) in the GCC has released a new regulatory framework for *Takāful* as part of the regulator's efforts in overhauling standards as a means to attract new business in the industry. The CBB's new rules cover the operations and solvency of *Takāful* firms and are expected to increase their ability to distribute surpluses to policyholders and dividends to shareholders.

The South-East Asia region accounts for estimated total gross *Takāful* contributions of USD3.3 billion as at end-2013, with 42 *Takāful* operators offering Islamic insurance services in the region. Notable regulatory developments have recently taken place in Brunei and Malaysia. The central bank in Brunei, Autoriti Monetari Brunei Darussalam, announced in 2013 that it would move to implement new guidelines for *Takāful* and general insurance agents to instil good governance among agents and to standardise the commission rates for certain classes of business. One of the aims of the introduction of the new *Takāful* guidelines in 2013 was to increase the penetration rate of *Takāful* and insurance products in the market. In Malaysia, the *Takāful* industry is expected to witness notable changes in the coming years as the recently implemented *Islamic Financial Services Act* 2013 enforces separation of licences between the general and family *Takāful* businesses and gives a time period of five years for existing composite *Takāful* operators to separate the two businesses into different entities. This measure is expected to allow regulators to better assess prudential risks, given the different complexities and risk profiles of the respective products. Separately, the Republic of Philippines is anticipated to debut in the global *Takāful* industry in the near future, as the Insurance Commission of the Philippines is formulating *Takāful* regulations to enable *Takāful* services in the country.

Chart 1.1.4.2: Number of *Takāful* Operators (2013)

Source: Takāful Re, KFHR

Overall, the number of *Takāful* operators increased to 206 at end-2013, an increase from just 133 operators in 2006 (see Chart 1.1.4.2). A number of new markets are currently considering developing *Takāful* services in their jurisdictions which are likely to further support the growth and expansion of the sector. Among the countries in Africa that are exploring and expanding on Islamic finance (including *Takāful*) are Kenya, Morocco, Nigeria, South Africa and Tunisia. In Asia, countries such as Afghanistan, Azerbaijan, Maldives, Singapore, Sri Lanka, Thailand and others where Islamic finance remains a niche are also promising markets which could witness expansion in the number of *Takāful* operators during 2015 and beyond.

[16] Iran is excluded due to data limitation.
[17] International Cooperative and Mutual Insurance Federation Directory (2014).

In spite of the impressive double-digit growth rates, the global *Takāful* industry remains a small segment of the global Islamic finance industry as at 1H2014. On a y-o-y basis, overall growth in global *Takāful* contributions witnessed a slowdown from 2010 to 2011 and gradually registered increased y-o-y contribution growth thereafter (see Chart 1.1.4.3).

Chart 1.1.4.3: Global Year-to-year *Takāful* Contribution Growth

Source: World Islamic Insurance Directory 2014, KFHR

Nonetheless, the potential for the *Takāful* segment to expand rapidly and gain market share is promising given that large segments of the insurance market in key Islamic finance jurisdictions remain untapped and mainly dominated by conventional insurance providers. In addition, the leading *Takāful* regions are characterised by a young and growing middle-class population and solid long-term economic growth prospects. Based on the latest statistics available, the key Islamic finance jurisdictions in the GCC, South-East Asia and South Asia are characterised by low insurance penetration rates, averaging around 1% of the country's GDP, with the only exception being Malaysia which had an insurance penetration rate of around 5% as a percentage of GDP (see Table 1.1.4.1). These figures indicate that opportunities exist to expand the insurance services sector in these markets and that *Takāful* operators, capitalising on the general trend in these markets for favouring *Sharīʿah*-compliant financial solutions, have ideal opportunities to expand their market share.

Table 1.1.4.1: Insurance Penetration Rates as a % of GDP in Selected Asian and GCC Countries (2012)

Country	Insurance Penetration	Country	Insurance Penetration
Kuwait	0.5%	UAE	2.0%
Qatar	0.6%	China	3.8%
Pakistan	0.7%	Malaysia	4.8%
Saudi Arabia	0.8%	Thailand	5.0%
Bangladesh	1.0%	India	5.1%
Oman	1.0%	Singapore	6.0%
Turkey	1.4%	Japan	10.1%
Indonesia	1.8%	Hong Kong	13.7%

Source: MENA Insurance Market Review, Asia Insurance Market Review, EY, KFHR

By product segment, customer contributions in the *Takāful* market have been channelled mainly into the family and medical *Takāful* segment on the aggregate, though there are some variations across regions. Based on 2013 estimates, the motor *Takāful* and property and accident *Takāful* segments were also significant across these regions (see Chart 1.1.4.4). The marine and aviation business line, which requires substantial amounts of coverage in value, remains small, most likely due to the small-scale operations of most *Takāful* operators which somewhat limits their financial ability to provide full protection to larger-value projects.

Chart 1.1.4.4: Key *Takāful* Business Lines in Major Markets (2013)

**MENA includes Middle East (Non-Arab), North Africa, GCC and Levant.*
Source: World Islamic Insurance Directory 2014, KFHR

Overall, the main contributors to *Takāful* operators' income are family, medical and motor *Takāful*, which consist of mainly "plain vanilla" products designed to provide basic protection for households. More recently, *Takāful* operators in increasingly affluent Islamic finance markets have expanded products beyond traditional coverage to include segments as diverse as wealth management, educational planning schemes and retirement plans. These more complex products often include a savings or investment component, creating competition among *Takāful* providers to improve returns on customers' contributions. In this regard, the challenges and opportunities for *Takāful* operators arise from improving the penetration rate among new customers and new markets, as well as from innovating new products for increasingly sophisticated and affluent existing customers.

The commercial imperative of the *Takāful* sector to serve beyond low-risk sectors led to the need for a secondary market – *Retakāful*. The ability to provide protection for higher-value risks also depends on the strength of the *Retakāful* sector, apart from other organisational structural capacity and resources factors. Generally, *Takāful* operators in most jurisdictions have very limited financial resources as compared with long-standing international insurance groups; as such, *Retakāful* avenues are pertinent to support further growth as well as to safeguard their balance sheets and gain capacity.

Based on the historical growth rates of the sector, the forecasted gross *Takāful* contributions as at end-2014 will reach approximately USD23 billion. The growth prospects of the gross *Takāful* contributions in 2015 are promising on the back of growing awareness among demographics of the benefits of subscribing to insurance/*Takāful* products and the low insurance penetration rates in key Islamic finance markets. Moreover, the favourable regulatory environment created by various regulatory bodies and firm governmental support is driving the establishment of the *Takāful* sector in several new and niche markets. For instance, in the GCC's second-largest *Takāful* market, the UAE, a new law which makes it mandatory for all employers in the country to provide health insurance to employees is bound to boost the medical *Takāful* segment. Similarly, *Takāful* operators also have opportunities to expand their underwriting market share in the general *Takāful* business lines of fire, property, workplace

hazards and casualties, underpinned by a steady pipeline of construction and infrastructure-related projects taking place across the key *Takāful* markets of the GCC and Malaysia.

Retakāful plays an important role in spreading portfolio risk over different *Takāful* pools and provides underwriting capacity that would enable individual *Takāful* operators to cede larger risks. The shortage and competitiveness of *Retakāful* coverage may have led to a leakage to the conventional reinsurance market, causing a major constraint on the growth of *Retakāful*. Factors for this leakage include risk appetite, pricing, ratings, and long-standing relationships with reinsurers; as well as the lack of *Retakāful* capacity in some areas, mainly in general *Takāful*. The IFSB-IRTI Mid-Term Review of the Ten-Year Framework and Strategies[18] noted that *Retakāful* capacity in family *Takāful* is somewhat adequate, while gaps exist for general *Takāful* lines.

1.2 Assessment of the Resilience of the Islamic Financial System

Amid various economic, geopolitical and social challenges affecting the global economy, it is critical to assess the resilience and stability of the global financial system, on account of the transmission channels that exist between the financial and real sectors of the economy. A sound, stable and healthy financial system is essential to support the efficient allocation of resources and distribution of risks across the economy.

The global Islamic finance sector, although nascent compared to the world's total finance industry,[19] has achieved systemic importance in several markets (as highlighted in Section 1.1). The financial stability in these markets is now also dependent upon the smooth functioning and resilience of their domestic Islamic financial sectors. Although the governing principles of the Islamic finance sector are different from those of its conventional counterpart, with the former abiding by the rules of *Sharī'ah*, both systems are exposed to similar systemic risk factors and volatilities since the Islamic finance industry is operating as a subset of the entire global financial system.

1.2.1 Overview of the Global Economic and Financial Challenges

Since the onset of the Global Financial Crisis (GFC) of 2008–09,[20] the world's financial services sector has continued to face a challenging business environment, underpinned by a weakened global economic outlook; evolving economic and financial regulatory dynamics; central banks' monetary policy shifts; and other geopolitical, technological and social factors. The IMF has revised downwards its global economic growth expectations in 2014/15 as it forecasts a "weak and uneven" growth across the world economies. The IMF now estimates world economic growth at 3.3% in 2014 (July 2014 forecast: 3.4%) and at 3.8% in 2015 (July 2014: 4%).[21]

Factors driving challenges in the world's economic growth include a faltering recovery in the advanced markets, combined with slower-than-expected growth rates in the emerging markets. In Asia, the Japanese economy remains sluggish, with the country's GDP growth contracting by 1.6% (annualised) in the 3Q2014 (2Q2014: 7.3% annualised contraction), prompting the Japanese government to delay a second round of sales tax hikes while calling for snap general elections. Meanwhile, economic growth in China, the world's second-largest economy, slowed to 7.3% in 3Q2014 (3Q2013: 7.8%), its slowest pace in the past five years. According to the Organisation for Economic Co-operation and Development (OECD), a two-percentage-point decrease in the growth of Chinese domestic demand for two years would reduce world GDP by 0.3 percentage points a year.[22]

In Europe, there are growing concerns about a "triple-dip" recession in the Eurozone since the GFC of 2008–09 (see Chart 1.2.1.1). The 2014 economic growth forecast in Germany, the largest EU economy, has been reduced by the country's Economy Ministry to 1.2% from 1.8% earlier, and its 2015 prediction to 1.3% from 2%. Inflation in the Eurozone fell to 0.2% in December 2014, well below the European Central Bank's (ECB) target of almost 2%, prompting fears of a deflation in the region. Analysts estimate that approximately seven Eurozone countries have public debt-to-gross domestic product (GDP) ratios of over 100% in 2015, increasing the potential risks of a sovereign debt crisis akin to that experienced in 2011–12.[23]

Chart 1.2.1.1: Probability of Recession Q3-2014 to Q2-2015

Source: Financial Times, IMF WEO – October 2014

The muted global economic performance has also weighed on oil prices, with implications for the GCC economies and financial markets. In the second half of 2014, oil prices declined by 38% (see Chart 1.2.1.2). In the first week of December 2014, oil prices reached five-year lows of USD67.53 per barrel, the lowest since October 2009.[24] Amid a slowdown in global oil demand, global oil supply remained elevated, while OPEC reiterated its stance to maintain the group's oil production at 30 million barrels per day.[25] A prolonged period of weakness in oil prices is expected to

18 www.ifsb.org/docs/2014-06-17_IFSB-IRTI%20A%20MID-TERM%20REVIEW_FINAL.pdf
19 Various estimates and research reports indicate that the global Islamic finance sector represents a nascent 1% of the total world's financial industry.
20 The filing of bankruptcy by Lehman Brothers on 15 September 2008 is widely regarded as the eruption point of the GFC of 2008–09.
21 *IMF World Economic Outlook,* October 2014.
22 "The Impact of a China Slowdown", *The Economist,* 29 November 2014.
23 "Taking Europe's Pulse", *The Economist*, 14 November 2014.
24 "Oil Prices – Decline Turned Into Collapse", *Forbes*, 4 December 2014.

affect export incomes of the GCC economies, which would likely lead to lower budgetary revenues, state procurement budget cuts, subsidy removals, and slower progress or cancellations of major construction projects. Ultimately, these cuts in government spending would impact private-sector consumption and investment.

Chart 1.2.1.2: Brent Crude Oil (2013 – December 2014)

Source: Bloomberg, KFHR

At the same time, the global financial community is bracing itself for an imminent shift in US monetary policy, as the US FOMC voted in its round of meetings held on 28–29 October 2014 to end its monthly bond-buying stimulus programme. This officially marks the end of the quantitative easing programme 3 (QE3), which had been in place since September 2012. Although the US Fed left unchanged its pledge that rates would remain near zero for a "considerable time", it did acknowledge that if the economy improves faster than expected, then the first rate hike could come "sooner than anticipated". The US Fed particularly expressed confidence in the US economic recovery remaining on track, despite a slowdown in other regions, especially Europe. In addition, it downplayed the impact from the current low levels of inflation in the US economy,[26] indicating that labour market conditions had improved, with solid job gains and a lower unemployment rate; and that the official US unemployment rate in October was 5.8%, the lowest since 2008 (see Chart 1.2.1.3). Meanwhile, the ECB is in the midst of discussing QE measures[27] in light of continued weakness in the region's economic growth.

The global economy's uneven recovery and renewed uncertainties about oil prices have resulted in a dampened outlook for the world's economic growth. On the other hand, the US economy's better-than-expected performance compared to other advanced markets has led to a new wave of sell-offs of emerging markets' assets, sending their equity prices and fixed-instrument yields spiralling downwards. For instance, the MSCI Emerging Market Index declined by 12.3% in the three months ended 5. December 2014 (see Chart 1.2.1.4). Moreover, the US dollar has also sharply appreciated against a basket of the world's major currencies (see Chart 1.2.1.5), reaching its highest level in five years (2010–14), as investors seek to channel their funds into the jurisdiction on the back of its improved economic prospects vis-à-vis the other developed markets. For example, the Japanese yen depreciated by 5.9% month-on-month (m-o-m) to close at almost 120 per dollar on 5 December 2014. The IMF had earlier warned that the rise of the dollar against the Japanese yen could hurt prospects in emerging Asia.[28] The IMF had highlighted the risk of emerging financial market bubbles created by the stimulus money pumped in by the various central banks which have sent asset prices higher at a time when underlying economic growth remains weak.[29]

Chart 1.2.1.3: US Unemployment Rate – Seasonally Adjusted

**Shaded area represents recession.*
Source: Bureau of Labor Statistics (US)

Chart 1.2.1.4: MSCI Emerging Market Index

Source: Bloomberg, KFHR

Chart 1.2.1.5: Trade-weighted US Dollar Index*: Major Currencies**

** Chart date range: 28 November 2009 to 28 November 2014.*
*** Currencies include EUR, JPY, GBP, CAD, CHF and SEK.*
Source: Board of Governors of the Federal Reserve System (US), Bloomberg

25 As announced by OPEC in its 166th meeting held on 27 November 2014.
27 The US inflation rate was recorded as 1.7% (y-o-y) in October 2014, which is below the US Fed's target rate of 2%.
27 "ECB Weighs Bond Purchases up to 500 Billion Euros to Juice Economy", *Bloomberg*, 9 January 2015.
28 "IMF Warns of 'Mediocre' Growth", *Reuters*, 2 October 2014. Five out of the top 20 Islamic finance markets originate in the Emerging Asia Group.
29 Ibid.

Other risks in global markets include the geopolitical conflicts in Central Asia, Eastern Europe and the Middle East, which are threatening economic stability and the free flow of natural resources – for instance, gas supplies in Europe,[30] and oil production and sales in the Levant region. Moreover, the Ebola outbreak has further threatened the quality of human lives and affected economic growth in West Africa while requiring policymakers to divert more resources to counter its expansion.

The combination of these challenges has required intensified vigilance and pre-emptive measures by governments and regulatory authorities worldwide in order to ensure a sustainable growth trajectory of the global economy while protecting the financial system from another meltdown. The IMF, in its October 2014 *Global Financial Stability Report* (GFSR), notes that global economic recovery has relied heavily on accommodative monetary policies in advanced economies. However, prolonged monetary easing, as seen in the build-up to the 2008–09 crisis, may prompt and encourage excessive financial risk-taking[31] if left unaddressed or under-regulated. Going forward, national regulators need to intensify their efforts to maintain a sound financial system – for example, through stress tests of the financial institutions under their mandates.[32]

The various global downside risks also have implications for the major Islamic finance markets. The GCC region relies mainly on oil sales for its revenues; thus, declining oil prices are likely to have an impact on economic development expenditure in the region. Emerging market volatilities and the resulting currency depreciations will also weigh on Islamic finance prospects, since eight out of the top ten Islamic finance markets are classified as emerging markets by the world's major financial institutions/ financial services providers. Meanwhile, a persistent slowdown in oil prices going forward may also impact surpluses of petrodollars in the key Islamic finance markets in the GCC region.

1.2.2 Islamic Banking: Assessment of the Resilience

A resilient and well-regulated banking system is the foundation of financial stability, as banks are at the centre of the credit intermediation process between savers and investors. Instability in banking institutions can cause tremendous systemic effects across various productive economic sectors of a domestic economy, with the potential to spill over into regional and global economies. Banks provide critical financial intermediation services across all sectors of the real economy, including individual households, small and medium-sized enterprises (SMEs), large firms and government institutions.

Post-crisis, the global banking system is currently experiencing unprecedented structural changes, stemming from regulatory checks and limits being placed on banks' lending practices, financing exposures and levels of leveraging, while the banking capital structures and funding structures, among others, are being mandated to be shored up to enhance their resilience in the post-GFC period. The GFC has been an important learning experience for Islamic finance – in particular, regarding the contagion effects from financial instability of the conventional system. Similarly, regulation of Islamic banking has also evolved and taken into account these global changes, as well as risks that are unique to Islamic finance. Across most jurisdictions, the industry operates in a dual banking framework, which necessitates safeguards against contagion effects.[33]

This subsection provides a technical analysis of the performance of the global Islamic banking industry,[34] assessing indicators of profitability, liquidity, financing exposures, asset quality, capitalisation, funding structures and the leveraging in balance sheets of Islamic banks (as per Appendix 1), as well as vulnerabilities moving forward. Broadly, the Islamic banking industry's profitability has gradually recovered post-GFC with the average return on assets and on equity (ROA; ROE) across the Islamic banking sample recorded at 0.9% and 8.9%, respectively, in 2013. These returns, however, are still below those posted in 2008 (1.3% ROA and 9.9% ROE). A combination of global- and country-specific macroeconomic and political challenges have affected the general business environment in Islamic banking domiciles, which has led to relatively slower Islamic financing growth in 2013 at 13.5% (lowest rate since 2009); a decline in the net profit margin (2013: 0.96%; 2012: 1.03%); and an increase in the cost-to-income ratio of the industry (2013: 54.4%; 2012: 51.04%). Notable exceptions to this trend, however, are Islamic banks in Jordan, Kuwait, Saudi Arabia and UAE, where declining cost-to-income ratios on account of lower non-performing financing charges and improvements in the quality of balance sheet assets have enabled banks to improve their overall ROA and ROE.

Assessing the liquidity conditions of the Islamic banking industry through financing-to-deposit ratios (FDR) of sample banks, the Islamic banking sector appears to be comfortably positioned as the FDR has remained under 90% across the sample throughout the years 2008–13. Consistent with the IFSB's 2014 IFSI *Stability Report*, Turkey and Indonesia are the notable exceptions, having witnessed FDRs in excess of 100% during the last few years; while Pakistan has experienced a low FDR, ranging between 42% and 55% from 2009 to 2013. As a modified indicator to assess the

[30] State-controlled Russian gas giant Gazprom meets around one-third of Europe's gas demand, worth some USD80 billion a year, and it sends almost half of these supplies through Ukraine.

[31] As per the Global Financial Stability Report of October 2014, there is a broad consensus that excessive risk-taking by banks contributed to the Global Financial Crisis. Equally important were lapses in the regulatory framework that failed to prevent such risk-taking. In January 2015, at the World Economic Forum held in Davos, Switzerland, Bank of England Governor Mark Carney also warned that easy monetary policy could prompt excessive risk-taking in financial markets.

[32] For instance, as done by the ECB for 123 EU-wide banks in 2014 and the results of which found 24 European banks requiring capital enhancements to remain sound.

[33] Various estimates and research reports indicate that the global Islamic finance sector represents a nascent 1% of the total world's financial industry.

[34] The analysis is based upon a sample size of 59 full-fledged Islamic banks across 11 major Islamic banking domiciles (excluding Iran) as explained in Section 1.1.

short-term liquidity risk of Islamic banks, this IFSI stability report introduces the short-term asset–liability ratio (SALR),[35] which analyses the availability of liquid assets to meet liabilities payable within a 90-day period. Across the sample, Islamic banks on average had liquid assets to meet 81.18% of their total 90-day liabilities as at end-2013. Among the comfortably positioned Islamic banking domiciles in terms of short-term liquidity from this sample are the full-fledged Islamic banks in Bahrain and Pakistan. In contrast, the lowest levels of SALR recorded in 2013 were Malaysia (57.4%) and Qatar (50.6%).

The financing exposures of Islamic banks vary by jurisdiction; in the GCC region, a rapid recovery in real estate prices is causing some concern regarding another prospective property price bubble. On the other hand, high levels of household indebtedness need some check-and-balance measures and active monitoring by the relevant authorities in South-East Asia. The dampened economic outlook and emerging market turbulence are exposing Islamic banks to potential NPFs and defaults, requiring their risk management functions to undertake necessary checks and balances on exposures, particularly for those Islamic banks having high exposures to the SMEs sector.

In terms of capitalisation, consistent with the historical trend, Islamic banks have remained well capitalised, exceeding the regulatory benchmarks by several percentage points across all jurisdictions. As of 2013, the average total capital and Tier 1 capital adequacy across the Islamic banking sample were recorded as 16.8% and 15.5%, respectively, which exceed the capitalisation levels of some of the world's global-systemically important banks (G-SIBs). Challenges going forward would mainly be in terms of reorganising their capital structures to comply with the Basel III standards.

The following subsections present detailed analysis of the various indicators across the Islamic banking sample, along with analysis of the current performances and vulnerabilities going forward.

(a) Profitability

Profitability of the Islamic banking industry, although gradually recovering, is yet to revert to its pre-GFC levels. In 2013, the average ROA and ROE across the Islamic banking sample were recorded as 0.9% and 8.9%, respectively, which is lower than the 1.3% and 9.9% returns posted in 2008 (see Chart 1.2.2.1). Islamic banking returns had declined in 2009 when the financial crisis had hit the real economy, causing the ROA and ROE to contract to 0.7% and 6.3%, respectively.[36] Since then, the returns have constantly improved, although the pace stagnated between 2012 and 2013. A number of heterogeneous economic, geopolitical and general market factors contributed to this trend, varying across the different Islamic banking markets (see Chart 1.2.2.2).

Chart 1.2.2.1: Islamic Banking Average Return on Assets and Equity

Source: Islamic Banking Sample, KFHR

Chart 1.2.2.2: Islamic Banking Average Return on Assets by Country

Source: Islamic Banking Sample, KFHR

For instance, Turkish participation banks experienced their lowest ROA and ROE rates in 2013 (during the sample period 2008-2013) due to a slowdown in economic growth, tighter monetary and macro-prudential policies that squeezed the banking sector's margins while curbing financing growth. In the

[35] As disclosed in the annual reports of Islamic banks, the short-term asset liability ratio measures the amount of highly liquid assets held by financial institutions in order to meet short-term obligations payable within 90 days. The analysis in this section, however, does not address liquidity from the perspective of the Basel III liquidity coverage ratio (LCR). The LCR is designed to ensure that financial institutions have the necessary assets on hand to ride out short-term liquidity disruptions. Banks are required to hold an amount of highly liquid assets, such as cash or Treasury bonds, equal to or greater than their net cash over a 30-day period (having at least 100% coverage). The LCR has been endorsed as the global minimum standard for liquidity risk by the Basel Committee on 6 January 2013, with implementation to begin 1 January 2015, but the full 100% minimum will not be enforced until 2019. Basel has also, more recently, finalised plans for the net stable funding ratio, a measure which looks at liquidity over a one-year period. This is to become a minimum standard from 1 January 2018.

[36] The positive returns across the Islamic banking sample still compare favourably to the conventional banking system, where in 2009 the European banks generated ROA and ROE of 0.1% and 4%, respectively, and the US banks generated –0.05% and –1%, respectively. "Banks' Performance in US and Europe", Deutsche Bank, September 2013.

[37] "Moody's Retains Ba3 Rating Despite Hovering Political Uncertainty in Bangladesh", *The Daily Star*, 18 April 2014.

[38] Institute of International Finance, 11 May 2014.

[39] Moody's, "Malaysian Banking System Outlook Stable as Sector's Fundamentals Strong", 28 May 2014.

GCC region, the Bahraini banking system's outlook had been rated as "negative" by Moody's since 2009, underpinned by the challenging domestic operating environment, amid ongoing social unrest, which affected investor confidence and led to elevated levels of non-performing loans/financing (NPLs/ NPFs), thus affecting the banking sector's profitability. In Bangladesh, domestic political tensions as well as an industrial accident that led to depressed commercial activity in the garment sector has led to higher instances of NPFs and a slowdown in returns in the country's banking sector.[37]

On the other hand, stable returns were recorded in the comparatively more developed Islamic banking markets of Saudi Arabia (ROA: 1.84%; ROE: 12.75%), Malaysia (ROA: 0.76%; ROE: 10.84%), Kuwait (ROA: 0.93%; ROE: 7.94%) and the UAE (ROA: 0.97%; ROE: 6.55%). The recovery in real estate prices coupled with strong economic growth prospects, low interest rates and a relative safe-haven status since the Arab Spring turmoil began in early 2011 has helped the UAE banking sector post favourable returns in recent years.[38] The Kuwaiti banking system remains stable, underpinned by steady oil revenues and government spending on infrastructural development, which Moody's expects will support Kuwaiti banks' recovering profitability, robust capitalisation and ample liquidity. The Malaysian banking system had been relatively stable on the back of resilient asset quality and strong institutional capitalisation levels and funding profiles. In particular, the country's Islamic banking sector has been the main focus area for domestic business growth, and Islamic banks in the country are building up scale for sustainable growth. This trend is in line with the country's goal of expanding the proportion of Islamic financing to total domestic financing to 40% by 2020 (from 26.7% as at end-2013).[39]

The net impact of the various macroeconomic and political challenges highlighted above led to slower Islamic financing growth, a decline in the net profit margin, and an increase in the cost-to-income ratio of the sample Islamic banking industry in 2013. The Islamic financing portfolio across the sample grew at 13.5% in 2013, the slowest growth rate since 2009, while the net profit margin declined to 0.96% in 2013 (2012: 1.03%; 2008: 1.51%) on the back of squeezed profit margins and increasing costs in most jurisdictions (see Chart 1.2.2.3). The cost-to-income ratio across the Islamic banking sample increased to 54.4% in 2013 (2012: 51%; 2008: 50%) with only Islamic banks in Jordan, Kuwait, Saudi Arabia and UAE, (the countries that experienced improving ROA and ROE) on average slightly reducing their Islamic banking cost-to-income ratios. The reduction in levels of financing loss provisions, as well as an improvement in the NPF ratios in these markets, are key factors behind the improvements of the cost-to-income ratios of the sample Islamic banks.

Chart 1.2.2.3: Islamic Banking Average Net Profit Margin

Source: Islamic Banking Sample, KFHR

Chart 1.2.2.4: Islamic Banking Average Cost to Income

Source: Islamic Banking Sample, KFHR

Overall, in 2013 the profitability of Islamic banking remained fairly resilient in face of the effects of macroprudential risks originating from diverse factors in different Islamic banking markets, including jurisdiction-specific factors. Among the notable sources of profitability instabilities in the Islamic banking sector are various domestic factors such as political disturbances, social unrest, weakening domestic economic fundamentals, geopolitical risks dampening economic activity (leading to reducing financing activity and higher NPFs) and excessive risk exposures to one sector (e.g. to government securities in Pakistan – explained in the liquidity subsection below).

The performance of Islamic banking profitability in 2013, although positive and improved, indicates vulnerabilities to the various factors identified above. At a sample ROE of 8.9% in 2013, the Islamic banking profitability has performed weaker than the US banks, which generated an ROE of 10.44% in 2013, the highest level since 2007.[40] Moreover, the US banks also generated higher net-interest margins of 3.2%[41] in 2013, compared to the 0.96% of the Islamic banking sample. In contrast, in 2013, the Islamic banking sample fared better than the 2.2% ROE of the banks in the EU-28 region, which is currently facing threats of a third recession since the 2008 financial crisis.[42]

40 KPMG, "US Banking Outlook 2014".
41 Federal Reserve Bank of St Louis.
42 European Banking Federation, "Facts and Figures 2014".

Box 1.2: Financial Stability and Islamic Banking in the Kingdom of Bahrain

By: Central Bank of Bahrain

Importance of Financial Stability

Financial stability can be defined as a situation where the financial system is able to function prudently, efficiently and uninterrupted, even in the face of adverse shocks.

In a globalised world, financial problems may arise unexpectedly and spread faster than before. The Kingdom of Bahrain has one of the most open economies in the GCC and is known as a regional financial centre. The Central Bank of Bahrain (CBB), as a supervisory and regulatory authority of the financial institutions in the Kingdom, has the responsibility to adopt various crisis management measures to prevent financial crisis endangering the financial system.

As the single regulator for the Bahraini financial system, the CBB attaches utmost importance to fostering the soundness and stability of the financial system. The CBB recognises that financial stability is critical to maintaining Bahrain's position as a regional financial centre and ensuring that the sector continues to contribute significantly to growth, employment and development in Bahrain.

In pursuit of its objective of promoting financial stability, the CBB conducts regular financial sector surveillance, keeping a close watch on developments in individual institutions as well as in the system as a whole.

Financial Stability at the CBB

A key objective of the CBB is to ensure the continued soundness and stability of financial institutions and markets. The pursuit of this objective is the primary responsibility of CBB's Financial Stability Directorate, which conducts regular surveillance of the financial system to identify areas of concern and undertakes research and analysis on issues relating to financial stability.

Financial Stability Reports (FSRs) are prepared regularly for the CBB management, reviewing recent trends and identifying areas of concern which require supervisory and policy attention. Financial Soundness Indicators (FSIs) are used to monitor the financial sector on a continuous basis.

The FSR is one of the key components of CBB's financial sector surveillance framework. Produced semi-annually, its principal purpose is macroprudential surveillance, assessing the safety and soundness of the financial system as a whole (intermediaries, markets and payments/settlement systems). The ultimate objective of such macroprudential analysis is to identify potential risks to financial stability and mitigate them before they crystallise into systemic financial turbulence.

In December 2014, the banking sector in Bahrain was made up of 113 banking financial institutions, categorised as follows:

- 28 retail banks (including 6 Islamic retail banks); 13 locally incorporated and 15 branches of foreign banks;
- 76 wholesale banks (including 17 Islamic wholesale banks); and
- 10 banking rep offices (9 conventional and one Islamic).

There are also 291 non-banking financial institutions operating in Bahrain, including investment business firms, insurance companies (including *Takāful* and *Retakāful* firms), and specialised licences.

Islamic Banking in Bahrain

Over the past decades, Bahrain has emerged as a major regional financial centre, which has been essential to the development of its economy and the financial sector. Bahrain's financial sector is considered one of the most well-developed and diversified in the region. The financial sector accounts for almost 17% of Bahrain's GDP. It is the largest non-oil component of its economy. Bahrain has also developed an attractive, low-cost operating environment for regional and global institutions serving this region.

The CBB has established a comprehensive prudential and reporting framework, tailor-made for the specific concepts and needs of Islamic banking. The rulebook for Islamic banks covers areas such as licensing requirements, capital adequacy, risk management, business conduct, financial crime and disclosure/reporting requirements. Similarly, the insurance rulebook addresses the specific features of *Takāful* and *Retakāful* firms. Both rulebooks were the first comprehensive regulatory framework in the GCC that dealt with the Islamic finance industry.

The growth of Islamic banks in particular has been remarkable, with total Islamic assets increasing from USD1.9 billion in 2000 to USD24.8 billion in Q32014, an increase of over 13 times. The size of Islamic banks started seeing a notable increase from 2005. In 2006 the banking sector saw a 52.4% increase in size. The biggest increase in terms of value was in 2008 with an increase of over USD8.2 billion. It is notable that the size of Islamic banks continued to grow in Bahrain even during the international financial crisis. Despite a minor decline in 2011 followed by another one in 2013 (reaching the lowest level since 2008), the sector has since grown back, showing steady positive growth during 2014.

Chart 1: Aggregated Balance of Islamic Banking (USD billion)*

*Data is for Bahrain operations only.
Source: Central Bank of Bahrain

The share of Islamic banking assets has steadily increased in the last decade, from 1.8% in 2000 to 13% in September 2014.

Chart 2: Growth of Islamic Banking in Bahrain (% Share of Banking System)

Source: Central Bank of Bahrain

Financial Soundness Indicators (FSIs)

The FSIs assess the overall health of the financial system through regular monitoring of a set of indicators that gives us an overall picture of the financial condition and performance of the financial system.

These indicators are identified by the CBB to be tracked on a regular basis. The indicators relate to the financial condition and performance of the banking segments in Bahrain. Through regular tracking of these indicators the CBB can combine quantitative information and qualitative assessments to pinpoint any sources of financial sector vulnerability.

The FSIs are published quarterly for the four primary banking segments in the Kingdom of Bahrain. The tables below show select quarterly indicators of the Islamic retail banks and Islamic wholesale banks.

Table 1: Financial Soundness Indicators of Islamic Retail Banks

	2012		2013				2014		
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Capital Adequacy									
Capital Adequacy Ratio (%)	18.0	18.5	18.2	17.5	17.5	17.3	17.6	15.6	15.4
Tier 1 Capital Adequacy Ratio (%)	15.4	15.4	15.7	14.8	14.9	14.8	15.0	13.7	13.7
Asset Quality and Concentration									
NPFs (% of gross facilities)	21.7	15.0	13.8	13.4	13.1	12.1	12.3	14.1	12.6
Concentration of Facilities (% share of top 2 sectors)	34.8	40.6	39.3	35.4	36.1	36.3	33.7	32.3	34.3
Liquidity									
Liquid Assets (% of total assets)	10.7	11.8	12.8	12.3	13.7	13.2	14.1	13.9	13.5
Facilities/Deposit Ratio (x)	82.1	78.7	78.9	78.8	78.2	77.2	79.2	78.3	81.3
Profitability									
Return on Assets (%)	-0.3	-0.3	0.1	0.1	0.1	0.0	0.1	0.2	0.4
Return on Equity (%)	-2.5	-2.7	0.5	0.9	1.1	0.4	1.2	2.5	3.9

Source: Central Bank of Bahrain

Islamic retail banks showed strong balance sheets in 2012, with both capital adequacy ratio (CAR) and Tier 1 CAR well above 18% (Table 1). Since then, however, they have been trending slightly downward. Nonetheless, the ratios remain well above the regulatory requirement of the CBB. Asset concentration of Islamic retail banks remains well-diversified, with the top two sectors making up 34.3% of the total facilities in 3Q2014. The Islamic retail banks were profitable every quarter since 2013, with positive ROE and ROA.

The CAR and Tier 1 CAR ratios for Islamic wholesale banks have been strong and stable over the last three years, with slight changes from one quarter to another. On aggregate, all Islamic wholesale banks remain well capitalised above 20% (Table 2).

The non-performing facilities (NPFs) as a percentage of gross facilities for Islamic wholesale banks averaged 4.7% in the past three years, reflecting strong asset quality. Liquidity remains high among Islamic wholesale banks, with liquid assets ratios well above 20% over the last three years. The facilities-to-deposit ratio declined from 67.3 in Q3 of 2012 to 65.7 in Q3 of 2014. Islamic wholesale banks' profitability has been under pressure, with an ROE of approximately 3% in 2014.

Table 2: Financial Soundness Indicators of Islamic Wholesale Banks

	2012		2013				2014		
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Capital Adequacy									
CAR (%)	12.6	9.4	26.1	25.2	25.0	25.8	24.7	24.8	24.8
Tier 1 CAR (%)	11.1	7.7	25.2	23.8	23.6	24.8	23.7	23.3	23.3
Asset Quality and Concentration									
NPFs (% of gross facilities)	5.0	6.2	5.3	5.4	5.4	5.2	5.1	4.9	4.9
Concentration of Facilities (% share of top 2 sectors)	43.7	44.3	47.1	40.7	40.0	40.0	35.8	40.7	40.7
Liquidity									
Liquid Assets (% of total assets)	24.0	23.1	21.8	20.7	21.1	23.4	22.4	22.8	22.8
Facilities/Deposit Ratio (x)	67.3	69.8	67.6	71.5	71.2	67.2	67.2	65.7	65.7
Profitability									
Return on Assets (%)	0.4	0.3	0.3	0.5	0.6	0.8	0.2	0.5	0.5
Return on Equity (%)	5.1	7.1	1.7	3.1	3.6	5.1	1.3	3.1	3.1

Source: Central Bank of Bahrain

Stress Testing for Islamic Banks

The CBB conducts sensitivity stress testing exercises semi-annually for the domestic systemically important banks (D-SIBs). The tests are conducted for locally incorporated retail and wholesale banks in the Kingdom of Bahrain (both conventional and Islamic). The banks were carefully categorised as systemically important based on specific criteria such as size, interconnectedness, complexity and reputational risk. There are two Islamic banks among the D-SIBs.

The CBB identified (a) credit risks and (b) liquidity risks as the relevant challenges for the D-SIBs. Therefore, the focus is on these two areas.

In the credit risk scenarios, the banks are tested under various assumptions. Banks' balance sheets are stressed (e.g. an increase in the share of non-performing facilities) and the results are observed in the pre-shock and post-shock CAR. The aim of the exercise is to measure the impact on CAR and the corresponding capital shortfall for the banks to meet the CBB's minimum requirement.

Similarly, the banks' balance sheets are stressed under various assumptions in the liquidity risk scenarios. The liquidity exercises aim to measure the resilience of financial institutions in Bahrain if there were a sudden surge in withdrawals of deposits, the main determinant being the length of time before a bank runs out of liquid assets.

The CBB has utilised both top-down and bottom-up approaches in conducting its sensitivity stress testing exercises. Relevant data are collected from the banks and tested under several scenarios with varying degrees of shock (low, moderate, severe and very severe). The stress test model used is based on stress testing exercise tools developed by the IMF. The model was modified to fit the Bahraini banking system.

The CBB is currently working on further developing its stress testing strategy with plans that include developing other model-based stress tests to assess other risks and the involvement of banks in further exercises.

(b) Liquidity

Liquidity management has been a long-standing concern in the global Islamic finance industry as there is a general lack of tradable *Sharīʿah*-compliant instruments that can serve as high-quality short-term liquid assets. It is estimated that the Islamic finance industry is currently in need of at least USD400 billion of short-term, credible, liquid securities for capital management purposes.[43] At present, Islamic banks in most jurisdictions engage in bilateral investment-based (*Muḍārabah*) deposit placements with each other to settle liquidity surplus and deficit conditions. In some other jurisdictions, commodity-based mark-up sale (commodity *Murābahah*) is widely practised between Islamic banks to manage liquidity requirements. The challenge in both these types of liquidity management tools is that these placements/deposits are not tradable instruments, thus restricting secondary market tradability. Instead, high-quality *Sukūk* instruments were identified as key products that can potentially address liquidity management issues of Islamic banks. To date, only Malaysia has a fully functioning Islamic money market with an active secondary market that is very effective in addressing the domestic Islamic financial market's liquidity management issues.

A landmark innovation in the cross-border Islamic finance liquidity management context is the International Islamic Liquidity Management Corporation.[44] The IILM's short-term *Sukūk* programme is backed by sovereign assets of its shareholders and is rated as A-1 by Standard & Poor's, which falls under the upper-medium investment grade rating for short-term instruments. The programme is the first money market instrument globally to be backed by sovereign assets while being distributed through a diverse primary-dealer network of nine banks across different regions. To date, the IILM has issued a total of 11 tranches amounting to USD6.7 billion[45] out of which three remain outstanding as of 5 December 2014. The total value of the three outstanding *Sukūk* is USD1.85 billion.

Assessing the liquidity conditions of the Islamic banking industry through financing-to-deposit ratios of sample banks, the Islamic banking sector appears to be comfortably positioned as the FDR has remained under 90% across the sample throughout the years 2008–13 (see Chart 1.2.2.5). Consistent with the IFSB's IFSI Stability Report 2014, Turkey and Indonesia are the notable exceptions, having witnessed FDR in excess of 100% during the last few years, while Pakistan has experienced low FDR, in the range of 42% to 55% between 2009 and 2013.

[43] Ernst and Young, Global Competitiveness Report (2013).

[44] IILM is a global multilateral entity established by a group of central banks, monetary authorities and a multilateral organisation to create and issue short-term *Sharīʿah*-compliant financial instruments to facilitate effective cross-border Islamic liquidity management.

[45] The total asset base of IILM is less than the USD6.7 billion *Sukūk* issued, as the *Sukūk* are issued on a revolving basis, utilising the same assets for different issuances.

Chart 1.2.2.5: Islamic Banking Average Total Financing to Deposits

Source: Islamic Banking Sample, KFHR

Turkish participation banks had an FDR of 107.1% in 2013.[46] Financing by the Turkish participation banks has been consistently expanding faster than deposits mobilisation (2013: 36.3% financing growth and 29.1% deposits growth), resulting in the higher FDR ratios. In addition, Turkey is generally characterised by a low savings culture, with the Turkish gross national savings as a percentage of GDP recorded at 14.16% in 2013.[47] As a result, Turkish banks increasingly rely on bond issuances and foreign credit via syndicated loans (mainly in USD and EUR) to fund their assets expansion, as opposed to deposits. The risk of such a funding strategy lies in the adverse movements of rates and availability of liquid funds in the global funding markets that might expose the Turkish banking sector to potential liquidity risks. On the other hand, the share of wholesale external funding in the liabilities has not increased dramatically while there are some factors downsizing this risk as follows:

- The maturity of the funding has increased considerably.
- Banks' external foreign exchange (FX) funding rollover ratio remains above 100% and they have not experienced any difficulty rolling over their FX funding.
- In terms of prudential measures, there is a limitation on the net FX position of banks, which is 20% of own funds. Basel III-compliant LCR regulation is also in effect, with reporting having started in 2014 and enforcement in January 2015.

The Indonesian banking sector is also characterised by higher growth rates in loans/financing vis-à-vis deposits mobilisation over the past several years, which has led to the FDRs being in excess of 100%. The Indonesian banking sector's loans-to-deposit ratio increased to 90% in 2013, up from 38% in 2002.[48] In the Indonesian Islamic banking sample used in this report, total financing growth was recorded at 23.44% in 2013, compared with the 18.78% growth in sample Islamic banking deposits in the same year. Between 2006 and 2013, the total loan growth in the Indonesian banking sector outpaced deposit growth in six annual instances.[49] The Islamic banking sample, in particular, had a very high FDR of 130.9% in 2013,[50] which exposes them to a comparatively higher risk of financial instability given their greater reliance on funds markets to raise liquidity in order to support their portfolio of financing assets. As per a recent research report, the Indonesian banking sector is likely to witness more aggressive competition for local deposits going forward, since the country's domestic capital market is regarded by the banks as being too small to meet the liquidity needs of all financial institutions and currency volatility is restricting banks from tapping liquidity markets abroad.[51]

In contrast to Indonesia and Turkey, Pakistani Islamic banks have maintained low FDRs – in the range of 42% to 55% – between 2009 and 2013, declining from the relatively higher levels in the pre-financial crisis years. As of 2013, the Pakistani Islamic banking sample had an FDR of 49.11%, which is lower than the overall industry's loans-to-deposits ratio of 59.20% in the same year.[52] Pakistani banks have placed more funds as investments in government Treasury bills and bonds, and in stocks and other approved securities, thus achieving lower levels of FDRs in the balance sheets. However, this exposes the country's banking system to concentration risk, as high and increasing exposures to Pakistani government securities (rated Caa1 with negative outlook) have tied the solvency of the country's banking sector to sovereign event risk.[53] Nonetheless, Moody's also expects banks to sustain low-cost and stable deposit-funded profiles, partly mitigating these negative pressures. This might hold more importance for the country's Islamic banking sector where a regulatory push by the central bank is enabling market share gains for the *Sharīʿah*-compliant financing segment.

As previously discussed, this financial stability report introduces the short-term asset–liability ratio (SALR) to assess the short-term liquidity risk of Islamic banks. Across the sample, Islamic banks on average had liquid assets to meet 81.18% of the total 90 days' liabilities as at end-2013. There is clear heterogeneity in the SALR within the sample (see Chart 1.2.2.6). Among the comfortably positioned Islamic banking domiciles in terms of short-term liquidity on the basis of this survey are Pakistan and Bahrain, where the SALR is recorded at over 100% in both jurisdictions. In the case of Pakistan, the ratio is very high – at 149.4% in 2013 – which is plausible since Islamic banks in Pakistan actively place the mobilised funds as investments in government Treasuries, which are tradable in the secondary markets for cash, hence boosting the liquid assets portfolio of the Islamic banks in relation to liabilities.

46 The Turkish conventional banking sector had a loan-to-deposit ratio of 111% as at end-2013.
47 World Bank Development Indicators.
48 Standard Chartered Equity Research, "Indonesia Banks", 22 April 2014.
49 Bank Indonesia, Banking Statistics.
50 The Indonesian government's *Islamic Financial Development Report 2013* reported the FDRs for Indonesia's Islamic banking sector overall as reaching 100.32% as at end-2013. A possible reason for this difference is the limited sample used for this chapter.
51 Standard Chartered Equity Research, "Indonesia Banks", 22 April 2014.
52 State Bank of Pakistan, *Quarterly Bulletin,* December 2013.
53 Moody's, "Pakistan's Banking System Outlook Remains Negative", 6 March 2014.

In contrast, the lowest levels of SALR recorded in 2013 are in Malaysia (57.4%) and Qatar (50.6%), which is not necessarily a cause for alarm or concern about an imminent liquidity crisis in those countries' banking sectors. For instance, Malaysia has an active and liquid Islamic interbank money market that can serve to address the liquidity shortfalls of Islamic banks. Furthermore, the Malaysian central bank also operates a *Sharīʿah*-compliant liquidity programme while being available as a lender of last resort should the need arise in any Islamic bank. Similarly, in the case of Qatar, the banking sector liabilities are largely concentrated in the form of government-related deposits (42% of total deposits) that are stable and expected to be sustained going forward,[54] with potential risks emanating from a protracted weakness in oil and gas prices. The SALR in other jurisdictions generally ranges between 65% and 85%.

Chart 1.2.2.6: Islamic Banking Short-term Asset–Liability Ratio[55]

Source: Islamic Banking Sample, KFHR

The liquidity risk in the Islamic banking sector is contingent upon several factors, including availability of *Sharīʿah*-compliant liquidity management frameworks such as Islamic money markets and lenders of last resort. Currently, a number of jurisdictions are undertaking initiatives to enhance their Islamic liquidity frameworks. For example, as of end-2014, the State Bank of Pakistan is finalising details of an Islamic liquidity framework, consisting of an Islamic interbank money market and a *Muḍārabah*-based placement facility run by the central bank. In a relatively new Islamic banking jurisdiction, the Central Bank of Oman is in the process of finalising initial works for issuing short-term Islamic finance instruments for Islamic institutions to invest their excess funds within the country.

Among other factors, liquidity risk results from excessive assets and deposits concentration on few sectors/individuals, as well as from greater reliance on foreign short-term funding to shore up deposits. These two aspects are further explored in subsections 1.2.2(c) and 1.2.2(f). In general, the Islamic banking liquidity position has improved over the years, with several new regulatory initiatives and multilateral developments taking place to help address the challenges. There remain a few vulnerabilities – for instance, in Indonesia and Turkey, where the financing rates have outpaced deposit growth rates, or in Pakistan, where there are high levels of exposure to government securities, which stakeholders need to be wary of and take appropriate remedial measures against. Along these lines, the Central Bank of Republic of Turkey launched new macro-prudential policy to limit macro-financial risks where the required reserve ratios applied to non-core FX short-term liabilities of banks and financing companies were raised.

Meanwhile, efforts also need to be extended to create Islamic financial safety nets. Lender-of-last-resort (LOLR) facilities are a key element in maintaining stability and soundness in the financial system by enabling banks to manage short-term liquidity problems, but conventional LOLR facilities are founded on interest (*Riba*) and are thus not *Sharīʿah*-compliant. IFSB's Working Paper 01, published in 2014, recorded that six jurisdictions have *Sharīʿah*-compliant LOLR facilities in place for their Islamic banking sectors and indicated ways in which such facilities could be structured. The IFSB is currently working on a second component of the safety nets, *Sharīʿah*-compliant deposit insurance schemes. Such schemes, which already exist in at least four jurisdictions, serve not only to protect depositors but also to enhance financial stability by reducing the probability of a run on an Islamic bank.

(c) Financing Exposure

Most of the sample Islamic banking jurisdictions are characterised as markets where businesses normally rely on the banking sector to meet their financing needs, particularly in the South Asia and Middle East regions, where corporate bond markets are relatively underdeveloped and have only begun to expand in recent years.[56] As a result, the sample Islamic banking industry's business financing exposure generally is concentrated in private-sector businesses and may include funding their working capital needs, project financing and capital financing. Among the key Islamic banking markets with higher financing concentration in the private sector are Jordan (48%), Bahrain (63%), Kuwait (65%), Pakistan (69%), Bangladesh (78%) and Turkey (78%) (see Chart 1.2.2.7). These markets also host a large number of small and medium enterprises that rely on the bank funding channels for their financing needs, since tapping the bond markets is not feasible for SMEs due to the higher costs and lengthy processes involved in issuing debt instruments.[57] Although insufficient data are available to differentiate between sample Islamic banks' exposure to large corporations and SMEs, the risk concentration in the private sector could be building vulnerability in the Islamic banking sector should the general macroeconomic downturn worsen in the global economy, leading to weaker growth in emerging markets.

54 Moody's, "Stable Outlook for Qatar's Banking System", 2 June 2014.

55 The chart excludes Bangladesh and Indonesia, where relevant data are not available across all the years, The short term asset liability ratio measures the amount of highly liquid assets held by financial institutions in order to meet short-term obligations payable in a 90 days period. The ratios are based on disclosures as in the annual reports of Islamic banks.

56 For instance, as of June 2014, only a single corporate bond is listed on the Amman Stock Exchange in Jordan. In 2013, the Pakistani-listed corporate debt market represented less than 1% of the country's GDP, prompting the SBP Governor to call for a shift from a purely banking loans market to a vibrant debt and capital market. Similarly, the IMF highlighted in its *Global Financial Stability Report* (2008) that the Middle East and North Africa's capital structure was heavily skewed towards bank assets at 57%, while debt securities only represented a minute 6%; in contrast, the world's capital structure average recorded in the same year was 36% in the form of debt securities.

57 Based on recent estimates, SMEs make up 99% of total enterprises registered in Turkey, 98% in Jordan and about 90% in Pakistan.

Recent studies have demonstrated that SMEs tend to be more vulnerable during economic downturns, as dry-ups in credit sources (e.g. due to increased prudence in lending by banks) tend to be more significant for SMEs compared to larger corporations.[58] However, at the stabilising end, the lower oil prices could potentially lower operating costs for the private sector generally across the Islamic banking markets, while the depreciated exchange rates may help spur increased export sales, especially in predominantly export-oriented Asian economies, providing some cushion from any material declines in revenues and economic growth. These mitigating factors may act as a buffer for Islamic banks against the build-up of higher levels of NPFs, at least in the short term.

Chart 1.2.2.7: Islamic Banking Average Composition of Financing Exposures[59] (2013)

Source: Islamic Banking Sample, KFHR
Note: Financing exposures are based on reporting structure of Islamic banks, and variation of categorisation is expected. In particular, the fact that some jurisdictions report zero exposure to the real estate sector suggests that this exposure may be aggregated with another category.

In markets where the corporate bond markets are comparatively more developed, the exposure of the Islamic banks to the household sector is more significant. This cohort includes Malaysia, where Islamic banks' financing exposure to the households sector is recorded at 53%, the UAE with 50%, Indonesia with 50%, and Saudi Arabia with 41%.[60] The Malaysian household debt-to-GDP ratio reached a new record of 86.8% in 2013, the highest level in Asia. Earlier, in July 2013, the Malaysian central bank had introduced new measures to curb the rising household debt which included reducing the maximum tenure for personal loans to ten years, restricting home loans to no more than 35 years, and prohibiting offers for pre-approved personal loans. The central bank's pre-emptive measures seem to be taking effect as, ignoring sample differences, the Malaysian Islamic banking household debt exposure was contained to 53% in 2013, compared to 56% last year (as reported in IFSB FSR 2014). In contrast, the household debt exposure for Islamic banks in the other three markets has either expanded or remained consistent.

The level of household debt in the UAE remains elevated compared to pre-crisis times, standing at USD112,485 per household,[61] which is nearly double the nominal GDP per capita of USD58,000 in the country.[62] It is notable that personal financing is growing in the UAE, often for financing mortgage purchases, consumption and funding business projects; mortgages accounted for a third of total consumer debt in 2013, up from 15% in 2005. Although the UAE banking sector has recorded solid growth trends and profitability recently, underpinned by the overall economic revival and recovery in real estate asset prices, prolonged periods of elevated household debt pose vulnerability risks. An earlier study reported that 60% of UAE citizens are spending a quarter of their monthly income on debt repayment, while 48% have monthly loan repayment obligations that exceed their comfortable loan repayment thresholds.[63] Moreover, one-third of citizens now have three or more credit cards.[64]

In Saudi Arabia, the household debt-to-income ratio is about 50% as at end-2013, and mortgages account for a less than 6% share of the total consumer credit in the country.[65] The growth of household debt recently has been in the form of personal financing to fund investment opportunities.[66] Nonetheless, at a low debt-to-income ratio per household, average household debt levels remain manageable at the macro level.

In the Indonesian market, the increase in household debt funding by Islamic banks has increased the concentration risk of Islamic banks in the household sector (nearly 50% in 2013), potentially increasing the vulnerability of the Indonesian economy. The recent emerging market volatility, combined with depreciation of the Indonesia rupiah, may have a trickle-down effect on the incomes of the population, leading to potential repayment problems and an increase in NPFs. Notably, the overall Indonesian household debt-to-GDP ratio is among the lowest in the South-East Asian region at approximately 17% in 2013.[67] However, the sample banks under study appear to be increasingly focused on the household sector.

58 European Central Bank, "Box 6 – Small and Medium-Sized Enterprises in the Euro Area: Economic Importance and Financing Conditions", *European Central Bank Monthly Bulletin,* July 2013.
59 Classifications as disclosed in the financial statements of individual banks. In general, household exposure includes all forms of financing to individuals in addition to personal financing – for example, car financing. Government exposures include financing to government-related entities. Real estate exposures include direct holdings of property and investments in property companies and may also include individuals' home financing. Private sector includes all financing extended towards business enterprises.
60 The Malaysian corporate debt market as a percentage of GDP was 43.1% in 2013; while in Indonesia it accounted for 16.7% of the national GDP.
61 Samba Bank, "GCC Consumer Health Check", September 2014.
62 IMF 2013 data.
63 Strategic Analysis Research Centre, 2012 statistics.
64 Ibid.
65 Samba Bank, "GCC Consumer Health Check", September 2014. A new classification from SAMA has removed the renovation and furnishing component from the category of mortgage loans.
66 bid.
67 "Household Debt in Asia", *The Economist*, 2 November 2013.

Exposures to the real estate sector[68] remain material in the GCC markets and Jordan. The Islamic banking sector witnessed the first wave of defaults and the build-up of NPFs only when the financial crisis impacted on the real economy from 2009 onwards.[69] Since then, a gradual recovery in real estate asset prices has enabled Islamic banks to clean up their balance sheets from the NPFs dating from the financial crisis years (analysed further in subsection 3.2.4). For instance, approximately USD12 billion-worth of previously stalled construction projects have resumed in the UAE between 2013 and June 2014.[70] In Kuwait, real estate sales comprising residential, commercial and retail segments hit a new record, reaching KWD447 million (USD1.53 billion) in revenue y-o-y as of April 2014.[71] The real estate market is also booming in Jordan, where sales surged by 15% in 2013 to record revenues of JD5.6 billion (USD7.9 billion); notably, nearly 90% of the housing units were purchased by Jordanians,[72] thus protecting the market from risks of foreign buyers' flight to quality. Similarly in Qatar, real estate prices reached record highs in June 2014 with the average prices of land, commercial and residential properties 20% higher than in the previous peak of September 2008, as per the Real Estate Price Index (REPI) published by the Qatar Central Bank.

Nonetheless, the IMF warned in mid-2014 that the GCC markets remain susceptible to boom-and-bust cycles of credit and asset prices. In particular, the region's heavy reliance on volatile oil revenues, the concentration on real estate as a major asset class for investment, and the shortcomings in crisis resolution frameworks underline the importance of having a deep macroprudential policy to limit the potential systemic risk in the GCC financial system. As of end-2013, the average real estate exposure of the GCC and Jordanian Islamic banking sample numbers approximately 15%. In the event of excessive exposures to real estate, central banks may undertake macroprudential measures to guide the market – for example, the limits on loan concentration and real estate exposures of banks imposed by the Central Bank of the UAE.

Finally, in terms of exposure to public-sector financing, Islamic banks in Qatar and Jordan appear to have material exposures at 21% and 15%, respectively. The Qatari government and its related entities are deeply involved in the country's banking sector, placing sovereign and quasi-sovereign deposits as well as raising funding from the financial sector. Qatar is currently undertaking a huge infrastructural development plan as part of its efforts to host the World Cup 2022, which will see construction of new stadiums as well as hotels and other tourism facilities. Moody's, in its assessment of the Qatari banking system, notes that although the banking sector is heavily concentrated in the public sector, the government is also a source of stability in deposits.[73] In light of recent developments, there are risks to these deposits if oil prices remain low for a prolonged period.

In Jordan, the level of public indebtedness surged recently, after the kingdom was forced to expand borrowing domestically and externally to cover expenses incurred when the supply of Egyptian gas was disrupted following domestic political turbulence. The National Electricity Company's losses increased from JD1.1 billion (USD1.55 billion) in 2012, to JD1.3 billion (USD1.83 billion) in 2013. Moreover, the cost of hosting Syrian refugees in Jordan reached USD1.8 billion in 2013. The Jordanian government is currently planning a subsidy rationalisation programme, particularly in the electricity sector, in order to curb the levels of public indebtedness and protect the economy from any sovereign insolvency risks.

Overall, financing exposures of Islamic banks vary by jurisdiction. The exposures highlight sectoral concentration, which may lead to different sources of financial instability risks. In the GCC region, the rapid recovery in real estate prices raised concerns over another prospective property price bubble. On the other hand, the high level of household indebtedness requires proactive checks-and-balances measures and active monitoring by the respective authorities in South-East Asia. Dampened economic outlook and emerging market turbulence expose Islamic banks to potential NPFs and defaults, requiring their risk management functions to undertake the necessary checks and balances on exposures, particularly for those Islamic banks having high exposures to the SME sector.

(d) Asset Quality

The asset quality of Islamic banks continued to improve in 2013 with the average gross NPF ratio of the sample recorded at 4.12%, down from 4.86% in 2012 (see Chart 1.2.2.8). Nearly all countries in the sample have experienced improvements in the NPF, with some achieving levels lower than the pre-crisis ratio (see Chart 1.2.2.9). The recoveries in real estate sector prices have been instrumental in enabling the GCC Islamic banks to improve on their NPF ratios y-o-y. However, a number of countries in the sample still continue to be worse off in terms of asset quality compared to conventional banks.

The Islamic banking sample in the GCC region overall improved their asset quality, as the combined NPF declined to 4.87% in 2013, down from 5.81% in 2012 and the peak of 6.8% in 2010. Among the individual countries in the region, Qatar had the lowest Islamic banking sample NPF of 1.02% (2012: 1.44%), which is also lower than the overall industry's NPL of 1.9% in the country in 2013. The Qatari banking sector has benefited from a timely regulatory intervention post-GFC that saw the central bank place restrictions on easy credit expansion in the economy, while the government supported the economic environment by undertaking infrastructural and development projects, relying mainly on raising the required financing from the banking sector.[74]

68 Includes personal home financing.
69 See IMF Working Paper by Hasan and Dridi (2010), World Bank Working Paper by Beck, Kunt and Merrouche (2010), and IFSB FSR (2014).
70 MEED Projects, 2 June 2014.
71 National Bank of Kuwait, KUNA, State News Agency.
72 Department of Land and Survey, Jordan, January 2014.
73 Moody's, "Stable Outlook for Qatar's Banking System", 2 June 2014.
74 Moody's, "Stable Outlook on Qatar's Banking System", 2 June 2014.

Chart 1.2.2.8: Islamic Banking Average Gross Non-performing Financing to Total Financing

Source: Islamic Banking Sample, KFHR

Chart 1.2.2.9: Islamic Banking Average Gross Non-performing Financing to Total Financing by Country

Source: Islamic Banking Sample, KFHR

Recovering real estate prices and resumption of stalled projects have helped improve the asset quality of the Islamic banks in the UAE and Kuwait, although the relative NPF levels are still high. The UAE Islamic banking sample posted an NPF of 7.7% in 2013, which is a percentage point improvement since 2012 while also being lower than the overall industry's NPL of 8.4% in 2013. Similarly, the Kuwaiti Islamic banking sample had an NPF of 5.06% in 2013,[75] improving from the 6.9% peak in 2010, as the Islamic banks have made considerable progress in rehabilitating their balance sheets following the crisis. However, ratings agencies have raised concerns regarding the high credit concentrations and undisclosed levels of restructured loans in the Kuwaiti banking sector.[76]

The highest ratio of Islamic banking sample NPF remains in Bahrain at 9.23% in 2013 which, although declining from the 11.78% mark in 2012, is almost 3 percentage points higher than the 6.2% NPL of the overall banking sector in the country. The fundamental reason for the higher levels of NPF in the country's banking sector is regarded to be asset concentration on a few large borrowers that are under stress.[77] In contrast, the Saudi banking sector (both conventional and Islamic) remained resilient on the back of strong domestic economic conditions in 2013, supported by oil revenues; the NPF/NPL in the Islamic banking sample and overall industry were recorded as 1.33% and 1.30%, respectively, in 2013.

The Turkish participation banks' NPF increased slightly to 3.12% in 2013, which is higher than the overall industry's NPL of 2.6%. Apart from the domestic challenges in operating conditions, one participation bank has experienced a substantial increase in its NPF (doubling between 2012 and 2013) which has weighed down the overall sector's average in 2013. In the case of Pakistan, the Islamic banking sample NPF is calculated as 6.68% in 2013, which is remarkably lower than the conventional banking sector's NPL of 14.3% in the same year. The Pakistani Islamic banking sample's lower FDR in comparison to their conventional peers was mainly due to the former having more placements in government Treasury bills, *Sukūk* and other approved securities; and this resulted in them having limited exposures to NPF. Finally, the NPF ratios remain low in Malaysia, Indonesia and Jordan, in the range of 2% to 3%, all posting improvements since the financial crisis years.

Overall, the asset quality of Islamic banks has improved across the sample, although relatively more improvements are needed in the GCC countries of Bahrain, the UAE and Kuwait, where NPF levels remain above the 5% mark. The favourable and stable outlook of the banking sector in these countries by international ratings agencies creates expectations of a continued improvement trend going forward. Some of the remaining risks in terms of asset quality across the Islamic banking sample include concentration on a few large borrowers, continued material exposure to the real estate sector, and sovereign exposure as well as other domestic political challenges that may have an impact on the banks. Notwithstanding this, the Islamic banking system remained cushioned from major financial instability due to the asset-based nature of transactions as well as higher regulatory capital buffers maintained by the banks.

(e) Capitalisation

Consistent with the historical trend, Islamic banks have remained well capitalised, exceeding the regulatory benchmarks[78] by several percentage points across all jurisdictions. As of 2013, the average total capital and Tier 1 capital adequacy across the Islamic banking sample is recorded as 16.8% and 15.5%, respectively

[75] The reported NPF ratio for sample Kuwaiti Islamic banks is based on disclosures made in annual reports and when such disclosures are not made, the relevant data has been extracted from external databases (for e.g. Bankscope). The Central Bank of Kuwait, however, notes a NPF ratio of 3.56% in 2013 for the whole Kuwaiti Islamic banking market. The context remains same in the form of improved NPF ratios in the Kuwaiti Islamic banking market post financial crisis.

[76] Moody's, "Stable Outlook on Kuwait's Banking System", 2 July 2014.

[77] Moody's, "Outlook on Bahrain's Banking System Changed to Stable from Negative", 31 March 2014.

[78] While national regulatory requirements may vary, the Basel III minimum standards for total capital adequacy are 10.5% for total capital (including 2.5% capital conservation buffer) and 6% for Tier 1 capital (including up to 1.5% additional Tier 1 capital) and these limits are only fully applicable starting 1 January 2019. Note that the definitions of capital were materially tightened in Basel III, and Tier 1 capital under that definition cannot be directly compared with Tier 1 capital under the previous definition. In addition, different jurisdictions have implemented Basel III at different times. The figures that follow therefore need to be used with some caution.

(see Chart 1.2.2.10), which exceeds the capitalisation levels of some of the world's global systemically important banks (G-SIBs) (see Table 1.2.2.1). These higher ratios of regulatory capital had supported the resilience of Islamic banks during the GFC of 2008–09; no Islamic bank had required a major government bail-out as was the case for several large conventional banks across North America and Europe. Nonetheless, when the crisis entered the real economy in 2009, losses stemming from the building NPFs and increasing incidences of defaults, particularly in the real estate sector, did lead to a contraction in the Tier 1 capital ratios of the Islamic banking sample, where the overall industry ratio declined from 19.51% in 2008 to 16.81% in 2009.

Chart 1.2.2.10: Islamic Banking Average Capital Adequacy Ratios[79]

Source: Islamic Banking Sample, KFHR

Table 1.2.2.1: Average Tier 1 Capital Adequacy Ratios[80] (2013)

Banking Group	Average Tier 1 Ratio
Islamic Banking Sample	15.50%
Average US G-SIBs*	12.73%
Average non-US G-SIBs*	12.52%
EU-28 Banks	13.60%

**Data as of 1H2013*
G-SIBs = global-systemically important banks
Source: Islamic banking sample, Federal Deposit Insurance Corporation (US), European Banking Federation

The higher ratios of capitalisation in Islamic banks, while promoting greater financial stability, may also be a cause of inefficiency amid an underutilisation of capital to expand the financing portfolio. Over the years, the absence of well-functioning and healthy Islamic interbank money markets and a lack of LOLR facilities have compelled Islamic banks to maintain higher levels of regulatory capital to cushion and absorb any shocks and adversities in their balance sheets.

By region, the GCC and Jordanian Islamic banks hold the highest ratios of regulatory capital across the sample in 2013, averaging 20% for total capital and 18.6% for Tier 1 capital. The overall banking sector total capital adequacy in the GCC region averaged 18.04% in 2013.[81] The regulatory capital requirements as set by domestic authorities, in general, are higher for banks in this region and hence the ratios herein are highest across the sample for both total capital and Tier 1 capital adequacy during the sample years (see Charts 1.2.2.11 and 1.2.2.12).

Chart 1.2.2.11: Islamic Banking Average Total Capital Adequacy Ratio by Country

Source: Islamic Banking Sample, KFHR

Chart 1.2.2.12: Islamic Banking Average Tier 1 Capital Adequacy Ratio by Country

Source: Islamic Banking Sample, KFHR

On the other hand, the average capital adequacy ratios in the other five markets averaged 14.1% total capital and 12.1% Tier 1 capital, respectively, in 2013. Among this cohort, Malaysia held the highest ratio of total and Tier 1 capital; the Malaysian Islamic banking sample had a total CAR of 15.3% in 2013 vis-à-vis the overall banking system's 14.4%.[82] A number of new Malaysian Islamic banking subsidiaries were set up by parent conventional banks in 2008 and the injection of fresh capital had enabled these banks to post comparatively higher rates of CAR during the years 2008–10.

The Pakistani and Indonesian Islamic banking sample total capital ratios were higher than 25% in 2008 on account of the new entry of certain Islamic banks which, on commencement, had very high capitalisation levels against their low portfolio of risk-weighted assets. Gradually, expansions in the Islamic financing portfolio as well as losses stemming from the financial crisis years and other domestic economic challenges have led to a downward trend in the capital ratios. As of 2013, the Pakistani sample Islamic banks had a total capital ratio of 13.9%, while the Indonesian sample had 14.1%. In contrast, the overall banking sector in these two markets had higher total capital ratios at 14.9% in Pakistan and over 17.5%

79 The capital adequacy ratios are not adjusted as per Basel III standards and are taken as reported in the financial statements of Islamic banks.
80 The capital adequacy ratios are not adjusted as per Basel III standards and are taken as reported from the various sources.
81 including Islamic banks.
82 Including Islamic banks.

in Indonesia in 2013. These statistics indicate an opposite trend in these two markets where the Islamic banks held lower capital ratios as compared to the overall banking sector. Notwithstanding this, the current capital ratios are above the minimum regulatory requirements in each of these markets, although, going forward, the regulators may need to be more vigilant of developments particularly with the fast financing growth rates in Indonesia and the high exposure of the Pakistani Islamic banks to investments in various Islamic securities, including sovereign ones.

The lowest ratio of regulatory capital was held at the Bangladeshi Islamic banking sample: 13.3% total capital and 10.6% Tier 1 capital ratio. The Bangladesh Bank's *Financial Stability Report 2013* notes that the capital adequacy of the domestic banks is among the lowest in the South Asian region. The overall banking industry had a total capital ratio of 11.5% and a Tier 1 capital ratio of 9% in 2013, an improvement on the earlier year, partly on account of a relaxation of banks' provision charges by the regulator.[83] While the Islamic banks had comparatively better capital ratios, the regulator needs to be vigilant of any accumulating NPF in the banking sector balance sheets given domestic economic challenges stemming from political challenges.

Overall, the Islamic banking capitalisation remains resilient and the ratios rank among the highest in the global banking sector. Challenges going forward would mainly be in terms of reorganising their capital structures to comply with the Basel III standards. For instance, as per Basel III accords, total common equity must be stepped up to 4.5% of risk-weighted assets by January 2015 and total Tier 1 capital, which may also include additional Tier 1 capital, stepped up to 6%. Similarly, IFSB guidelines outlined that Islamic banks shall maintain total common equity capital of at least 4.5% of risk-weighted assets, and Tier 1 capital of at least 6%, of risk-weighted assets at all times.

(f) Structure of Funding

At times of adverse economic trends, exchange rate depreciations can strain a bank's ability to repay mobilised foreign currency deposits. Such an event was observed during the Asian financial crisis of 1997–98 when the banking sector in the affected Asian countries had relied on short-term foreign capital funding to expand their financing portfolios and the massive exchange rate depreciations during the crisis impeded their ability to repay, causing a systemic financial meltdown in the region.[84] Exposure to foreign currency deposits is a contributing factor that may impact profitability and funding strategy as well as deposit trends in the banking sector. This indicator, as such, is important particularly when the funds mobilised in foreign currencies are converted into local currency financing transactions.

In the sample Islamic banking sector, disclosures on foreign currency deposits are only available for five countries – namely, Jordan, Pakistan, Saudi Arabia, the UAE and Turkey. Among these, the share of Islamic banking deposits in foreign currency is less than 10% in Pakistan, Saudi Arabia and the UAE, while comparatively higher shares are recorded in the Islamic banking sample in Jordan and Turkey.

Chart 1.2.2.13: Islamic Banking Average Foreign Currency Deposit Share to Total Deposits[85]

Source: Islamic Banking Sample, KFHR

The Jordanian Islamic banking sample collectively held nearly 13% of their deposits in foreign currency. However, the Jordanian government maintains a pegged exchange rate to the US dollar which has been in place for several decades. Earlier in 2012, the Jordanian central bank had reaffirmed the continuity of the peg, amid speculation that several Middle East countries would consider abandoning the US dollar peg since, at that time, the US dollar was trading at lower values, causing these Middle Eastern currencies also to automatically depreciate vis-à-vis other global currencies. The ability of the Jordanian central bank to effectively maintain this peg going forward is the decisive factor in understanding the financial stability implications of the foreign currency exposure of the country's banking sector.

A unique funding structure available to Islamic banks is the profit-sharing investment account[86] that mobilises deposits with returns linked to actual performance of underlying investments. As such, the depositors are considered as investment account holders since they are expected to bear the risks of the assets funded from these accounts. In practice, however, most Islamic banks would smooth the returns provided to these IAHs by way of topping up additional returns in case of a weak performance by the underlying assets. This is done to mitigate the displaced commercial risk of PSIA, which arises when the actual returns generated by investments are below PSIA holders' expectations, usually benchmarked to the interest rates for deposits in similar accounts at conventional banks.

In the Islamic banking sample, the share of PSIA in the funding structure has gradually been declining over the years as most banks have started moving towards alternative sale-based fixed profit deposit products (e.g. commodity *Murābahah* term deposits) to be able to meet demands for capital- and profit-guaranteed term deposit solutions. As of 2013, the share has slipped below the 50% mark across the Islamic banking sample (see Chart 1.2.2.14). The biggest drop in composition of PSIA is witnessed in Malaysia, where the *Islamic Financial Services Act* 2013 prohibits Islamic banks from adding any facilities that would smooth the returns of the IAHs, thereby removing

83 Bangladesh Bank, *Financial Stability Report 2013*.
84 Corsetti et al., *What Caused the Asian Currency and Financial Crisis?* (1999).
85 Foreign currency deposits data are only available for five sample countries – namely, Turkey, Saudi Arabia, the United Arab Emirates, Pakistan and Jordan.
86 PSIA in this analysis includes saving and term deposits that are based on profit-sharing principles – that is, *Muḍārabah*.

the profit protection extended to these types of deposits.[87] The share of PSIA in the Malaysian Islamic banking sample declined from 48.4% in 2012 to 40.9% in 2013, and this trend is likely to continue before it stabilises once the law is in effect in 2015. On the other hand, Bangladesh had the highest share of PSIA in the country's Islamic banking sample, averaging between 87% and 91% over the past several years.

Chart 1.2.2.14: Average Profit-sharing Investment Accounts Share to Total Deposits[88]

Source: Islamic Banking Sample, KFHR

In general, the use of added facilities/clauses to achieve principal and profit protection for IAHs erodes some of the differentiation compared to the conventional banks' deposit products. Therefore, the Islamic banking sample also faces similar risks and the ability to roll over maturing deposits and prevent excessive withdrawals as being the fundamental factors to protect the banks' funding stability and operations as a liquid going concern. Although PSIA had the potential to ease the burden on a bank's capital on account of their risk-sharing and equity-like features, the shift in greater use of fixed profit rate contracts for structuring Islamic deposits places the Islamic banks at par with their conventional counterparts in terms of funding risks and capitalisation needs.

(g) Leverage

Excessive leverage by banks is widely believed to have contributed to the global financial crisis,[89] and in order to prevent such risks, the G-20 and the Financial Stability Board have proposed the introduction of a leverage ratio to supplement risk-based measures of regulatory capital. Prior to the GFC, some of the major global banks had leverage multiples[90] easily exceeding 25 times the banks' total equity base (see Chart 1.2.2.15). In contrast, the Islamic banking sample, due to their higher levels of capitalisation, have maintained modest levels of leverage exposure. Following a contraction during the crisis years 2008–10, the leverage multiple in the Islamic banking sample increased to 10.53 times in 2013 (see Chart 1.2.2.16). As a comparative indicator, the average US G-SIBs and non-US G-SIBs had leverage multiples of 14.75 and 19.81 times, respectively, in 1H2013 (see Table 1.2.2.2).

Chart 1.2.2.15: Average Bank Balance Sheet Leverage Multiples (1995–1H2008)

Note: Balance sheet leverage multiple (total assets divided by total equity) of individual bank weighted by asset size.
a. Bank of America, Citigroup, JpMorgan Chase, Wachovia Corparation, Washington Mutual, and Well Fargo & Company.
b. Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley.
c. Barclays, HSBC, Lloyds TSB Group and Royal Bank of Scotland.
d. Mitsubishi UFJ Financial Group, Mizuho Financial Gropu, and Sumitomo Mitsui Financial Group.
e. ABN AMRO Holding, Banco Santander, BPN Paribas, Commerzbank, Credit Agricole, Credit Suisse, Deutsche Bank, Société Générate

Source: World Bank: Note No. 11 – December 2009

Chart 1.2.2.16: Islamic Banking Average Bank Balance Sheet Leverage Multiples

Source: Islamic Banking Sample, KFHR

Table 1.2.2.2: Average Bank Balance Sheet Leverage Multiples (2013)

Banking Group	Average Leverage Multiple (times)
Islamic Banking Sample	10.53
Average US G-SIBs*	14.75
Average non-US G-SIBs*	19.81

**Data as of 1H2013.*
G-SIBs = global-systemically important banks.
Source: Islamic banking sample, Federal Deposit Insurance Corporation (US)

87 This will come fully into force starting 30 June 2015.
88 Excluding Kuwait and Indonesia, where data are not sufficiently available across all sample years.
89 IMF *Global Financial Stability Report* (2009).
90 Leverage multiple = total assets / total equity. This is not the same as the leverage ratio defined by the BCBS.

Consistent with the observations in the capital structures of the Islamic banking sample, the GCC Islamic banks had the lowest levels of balance sheet leverage multiples, at 7.25 times, in 2013, compared with 12.16 times in the remaining sample countries (see Chart 1.2.2.17). This indicates the higher levels of equity capital held by Islamic banks in the GCC which, while promoting greater financial stability, may be less efficient in terms of optimal utilisation of capital. The higher levels of balance sheet leverage multiples were recorded in Pakistan (14.7 times) and Malaysia (13.6 times). In the case of Pakistan, given the increased asset exposure in securities markets for Islamic banks, the financial instability risks are tied to the performance of the capital market, including the performance of government securities and sovereign risk events. In Malaysia, the availability of the LOLR facility from the central bank and an active Islamic capital and interbank money market reduces the risk profile of Malaysian Islamic banks running out of liquid funds in times of distress.

Chart 1.2.2.17: Islamic Banking Average Leverage Multiples by Country

Source: Islamic Banking Sample, KFHR
Note: Red lines indicate average leverage multiples of 7.25 and 12.16 for each cohort in 2013.

Finally, a number of Islamic banking institutions are gradually achieving D-SIB status.[91] At present, none of the 59 sample Islamic banks fall under the G-SIBs category of BCBS, although at least 31 of these banks satisfy the D-SIBs criteria used in this report (see Chart 1.2.2.18). Hence, these 31 banks have more relevance for the systemic stability of the global Islamic banking industry, as well as for the overall banking sector in their respective domicile country. The two largest Islamic banks (Al Rajhi and Kuwait Finance House) by total asset size (outside Iran) have shares of total domestic banking assets of 14.78% and 31.35%, respectively. The two largest banks by domestic Islamic banking share are Kuwait Finance House (68.96%) in Kuwait and Jordan Islamic Bank (63.62%) in Jordan.

Chart 1.2.2.18: Sample of Potential Domestic-Systemically Important Banks*

**Sample of Islamic banks with assets > 3% of total domestic banking assets (2013) and/or > 10% of total domestic Islamic banking assets (2013).*
Source: Islamic Banking Sample, KFHR

Overall, the Islamic banking sector continues its robust recovery post-GFC, albeit with some vulnerabilities and risks as have been identified above.

[91] Using criteria of Islamic banks with assets > 3% of total domestic banking assets (2013) and/or > 10% of total domestic Islamic banking assets (2013).

1.2.3 *Takāful*[92]

The expansion of the *Takāful* market is a necessary step to support the risk management of assets and savings/protection of individuals in the real economy. Nevertheless, the segment provides a critical service to the Islamic financial sector, as well as for the economy as a whole. Development of a *Sharīʿah*-compliant insurance sector provides the critical risk management supports needed in the banking and *Sukūk* sectors, as *Takāful* operators are able to provide a mechanism for reducing potential losses through defaults and for supporting long-term investment horizon activities via collateral enhancements and credit guarantees. Continued growth in the banking and capital markets sectors would lend support to the growth of the *Takāful* sector. On the other hand, the *Takāful* operators need to invest in Islamic financial assets to generate returns for their policyholders (for investment-linked accounts). This important synergy in ensuring a balanced growth, particularly from the perspective of risk management functions, places the *Takāful* sector at the locus of the financial stability objective. As reported in earlier analysis, the global *Takāful* industry recorded double-digit CAGR of 15.8% during 2008–13 with an estimated USD19.9 billion in gross *Takāful* contributions as at end-2013.

As is the case with other financial segments, the growth and performance of the insurance and *Takāful* sector are inextricably linked to the health of the global economy and financial system. In particular, demand for general *Takāful* products for motor and property are directly affected by the volume of car and property purchases/in-use, while protection for business-related transactions and assets depends on private investment activity. On the downside risk, throughout 2014, key interest rates in the advanced economies have remained low, while the emerging economies have continued to adopt accommodative monetary policies. The low interest rates, while accommodative to economic activity, have implications for the returns that *Takāful* operators can offer to policyholders of family *Takāful* with savings components, thus adding pressure to their pricing strategy. The expected unwinding of easy monetary policies in the advanced economies, especially the Federal Reserve's quantitative easing programme, may also lead to temporary volatility in financial market yields. Apart from the direct effects of interest rates, financial market sentiment remains vulnerable to exogenous events such as geopolitical crises and shocks to oil prices, which would also affect policyholders' returns via their impact on the financial market. Given that insurance and *Takāful* operators invest heavily in financial market instruments to generate returns for policyholders, the state of the financial system directly affects these returns. These volatilities would have an adverse impact on the equity and money markets, which are key investment instruments for insurance/*Takāful* firms. Notably, key *Takāful* markets operate in emerging economies, which in the recent past have been exposed to sell-offs during bouts of financial market volatility.

Drawing from the performance of the conventional insurance industry, a key theme going forward is increasing competition among insurance companies, spurred in part by the entry of more major players from advanced economies, where the insurance market is fairly saturated. In markets such as the GCC, where the markets are dispersed and consist of many small players, conventional insurers reported moderate returns in the past few years. Elsewhere, the Malaysian insurance industry recorded a sustained performance, supported by rising consumer awareness and income levels. Nevertheless, the insurance and *Takāful* industry in Malaysia is also anticipating the deregulation of motor tariffs by 2016, which would spur more competition in motor insurance/ *Takāful* rates. Meanwhile, the budding insurance markets in South Asia recorded steady growth over the last few years, supported partly by the expansion in distribution channels. A key challenge in South Asia is the distribution and marketing of insurance products; in recent years, insurers/*Takāful* operators have increasingly relied on links with banks (*bancassurance/ bancatakāful*).

In terms of the business profile of *Takāful* operators, most of the major *Takāful* operators conduct both family and general *Takāful* business, while a select few have chosen to specialise in either one[93] of these areas. By region, the leading domiciles of Malaysia and Saudi Arabia have continued to focus on the family *Takāful* market, as measured by the share of contributions for each segment. As at end-2013, the Malaysian *Takāful* operators generated approximately 70% of their gross contributions from the family *Takāful* sector (based on the sample of *Takāful* operators), underpinned by robust demand for medical-related *Takāful* products, as well as retirement and education savings. Motor *Takāful* accounts for about two-thirds of general *Takāful* contributions in Malaysia, reflecting high car ownership rates. Malaysia has one of the highest car ownership rates globally,[94] according to a recent market-based survey.

Similarly, around 60% of contributions in the Saudi Arabian *Takāful* market were channelled to the family *Takāful* segment, supported mainly by demand for medical *Takāful*. Other key business lines in the kingdom are motor and fire *Takāful*, while the marine/aviation *Takāful* market remains underserved. Overall, the Saudi market for *Takāful* and insurance remains dominated by compulsory health and motor coverage; while the voluntary take-up of personal health and life insurance/ *Takāful* remains small,[95] suggesting strong upside potential for *Takāful* operators in this segment. Another catalyst for the

[92] The financial performance of the global *Takāful* industry remains challenging to gauge, as information concerning *Takāful* operations is mostly irregular and scant for most operators. Where data are available, differences in reporting standards and accounting policies create hurdles in providing consistent performance analysis across a sample of operators. Nonetheless, annual reports of 30 *Takāful* operators across the two main *Takāful* markets of GCC (ex-Oman) and Malaysia, as well as South Asia, provided insights into the variability in the investment management and underwriting performances of the *Takāful* operators across the sample markets. The analysis in this section is based on financial statements for the years 2008–13. As the two largest markets, Malaysia and Saudi Arabia are reported as individual countries, while reporting for South Asia and the remaining GCC countries, or "GCC (ex-Saudi)", was done on a regional basis. See *Takāful* sample methodology in Appendix 1. The analysis excludes Iran (which has a sizeable *Takāful* sector) due to limited information from individual *Takāful* operators.

[93] Seven out of 30 *Takāful* operators in the study specialised in either family or general *Takāful*. These operators were from Malaysia, Saudi Arabia, the UAE, Qatar, Pakistan and Bangladesh.

[94] Nielsen survey (2014): Car ownership in Malaysia stands at 93% of households, the third-highest rate in the world. The country also has the highest incidence of multiple car ownership globally, with 54% of households having more than one car.

[95] Oxford Business Group (July 2014).

Saudi market is the 2012 Mortgage Law, which is expected to spur more home financing in a region that remains underserved due to the lack of legal clarity on the foreclosure process and other potential disputes. Demand for home financing has picked up very recently,[96] albeit from a low base, and is expected to open up more opportunities for the insurance/*Takāful* sector, such as *Takāful* cover for building materials and fixtures, fire risk protection, and life *Takāful* to cater for any eventuality arising before the expiry of the residential loan term.

Family *Takāful* comprised less than 15% of total contributions in the GCC (ex-Saudi) region, attributable to the generous welfare state provisions, as well as public-funded health and retirement schemes. In the UAE, for example, family *Takāful* accounts for more than 40% of contributions, while motor *Takāful* and "others" accounted for a 25% share each. Hence, there is less incentive for households to invest in private family *Takāful* schemes. The "others" category for UAE comprised mainly workmen's compensation and energy *Takāful* from one major *Takāful* operator.

In the GCC (ex-Saudi) region, Qatar stands out as the only country surveyed with a relatively high share of marine *Takāful*, which accords with developments in its conventional insurance sector. The marine *Takāful* sector is expected to expand further, in line with exports for liquefied natural gas (LNG).[97] There are very few compulsory insurance/*Takāful* schemes in Qatar, at present limited to third-party motor and professional liability for engineers. This is set to change with the ongoing roll-out of the Social Health Insurance Scheme, which will make health insurance/*Takāful* a mandatory requirement for all Qatari nationals and expatriates. The new health law could expand the market for *Takāful* operators in Qatar.

Elsewhere in South Asia, 44% of contributions were channelled to family *Takāful* and 56% for general *Takāful*. In terms of general *Takāful*, motor *Takāful* dominates the market in Pakistan, with a 38% share of contributions; while marine and aviation *Takāful* accounts for a 7% share. Going forward, competition is likely to intensify in Pakistan's *Takāful* market, spurred by a recent regulatory amendment to allow *Takāful* windows to operate in the country, which could lead to more product variety and better pricing for consumers (see Chart 1.2.3.1).

Generally, the marine *Takāful* segment offers ample opportunities, given the role of the GCC and Malaysia as major trading hubs, including for oil and gas activity which requires fairly sophisticated shipping services. However, across all the major *Takāful* regions, marine *Takāful* remains a relatively small industry, as *Takāful* operators have not reached the necessary scale to offer protection for these large and specialised risk business lines. Given the large value of contracts in this segment, *Takāful* operators would need to utilise *Retakāful* services to manage risks arising from these contracts (see Chart 1.2.3.2).

Chart 1.2.3.1: Key *Takāful* Business Lines in Sample Markets (2013)

Chart 1.2.3.2: Breakdown of Key General *Takāful* Business Lines in Sample Markets (2013)

Source: Takāful Operators Sample, KFHR
Note: Regulatory regimes commonly allow medical insurance to be underwritten by either general or life insurance providers. To the extent that a similar practice is applicable in the Takāful industry, the comparison between family and general Takāful segments across jurisdictions may be somewhat distorted by the effect of aggregating medical contributions into the family Takāful segment.

The risk retention ratios[98] suggest that Malaysian *Takāful* operators retain greater risks compared to GCC (ex-Saudi) and South Asian operators. Generally, higher risk retention ratios are an indicator of more sophisticated operational capabilities,[99] as these operators are better able to manage underwriting risks and do not rely heavily on *Retakāful* firms. Thus, as markets evolve and expand underwriting capabilities, the risk retention ratio is expected to increase. On another note, a greater business focus on family products would warrant a higher risk retention ratio, as operators invest a significant share of premiums to earn profit. In the general *Takāful* line, the use of reinsurance is more pronounced for large and specialised risks[100] in marine, aviation, oil and gas, and engineering products. Of the six Malaysian *Takāful* operators in the database, all showed high levels of risk retention ratios. Meanwhile, the risk retention ratio in Saudi Arabia has been on a consistent uptrend, averaging 83% in 2013. Of the ten *Takāful* operators surveyed, there was a significant variation across operators, with some recording retention rates of around 50% to 60%.

96 The IMF noted that demand for mortgages increased by 30% in the past year, albeit from a low base (September 2014).
97 In 2006, Qatar surpassed Indonesia as the world's biggest exporter of LNG, and has significantly ramped up LNG export capacity in recent years.
98 Risk retention ratio = net contributions / gross contributions.
99 Ernst & Young (2010).
100 IMF Country Report on Malaysia (March 2013): use of reinsurance is more pronounced for large and specialised risks in the aviation, oil and gas, and engineering classes of business, compared to the motor business.

Chart 1.2.3.3: Risk Retention Ratio in Sample Markets (2008–2013)

Source: Takāful Operators Sample, KFHR

By comparison, the GCC (ex-Saudi) and South Asia recorded lower risk retention ratios, averaging around 47% and 44%, respectively, in 2013, which reflects the more moderate operational capabilities compared to established markets such as Malaysia and Saudi Arabia, as well as the prominence of the general *Takāful* products in these markets (see Chart 1.2.3.3). Notably, the moderate risk retention rate for South Asia as a whole masks the relatively high retention rates among Bangladesh-based operators. Similar to practices in the conventional insurance industry, general *Takāful* products are exposed to underwriting risks, which thus necessitates *Retakāful* operators absorbing some of these risks. As such, the growth of *Retakāful* operators is particularly important in managing underwriting risks, especially from operators specialising in general *Takāful*. Nevertheless, it is important for general *Takāful* operators to expand and improve underwriting risks; if operators are highly dependent on *Retakāful*/reinsurance operators, they will also be exposed to price sensitivities and default risks from the *Retakāful*/reinsurance operator.

In terms of operating profits, profitability ratios differed substantially across the sample regions in 2013. By jurisdiction, Malaysian and South Asian *Takāful* operators have consistently recorded the highest return on assets, averaging above 6% throughout the sample period. Correspondingly, Malaysian operators also reported the lowest claims ratios and operating ratios among the sample countries. The operating ratio, in particular, is the industry benchmark[101] for the strength of underwriting operations. The Malaysian claims ratio averaged approximately 33% during 2008–13. Meanwhile, operating ratios averaged around 60% in the same period, but are on a rising trend, reflecting rising overhead costs. Elsewhere, South Asian operators reported higher return on assets in 2013, with the 2008–13 average at almost 6%. On average, the claims and operating ratios of South Asian operators are slightly higher than those of Malaysian operators, but well below those of the GCC operators (see Chart 1.2.3.4, 1.2.3.5 and 1.2.3.6).

Meanwhile, Saudi Arabian *Takāful* operators also reported rising overhead costs, with an average operating ratio of 97% between 2008 and 2013, as well as a notable increase in the claims ratio in the past three years. Thus, profitability was adversely affected, with the region recording a negative return on assets in 2013 (2008–12 average: 3.3%). Among the ten Saudi Arabian operators in the study, five operators recorded negative or zero returns. Similarly, the GCC (ex-Saudi) segment reported a small negative return on assets in 2013, after three years of small positive gains. Both the claims ratio and operating ratio increased in 2013. Overall, the profitability findings on the GCC as a whole are broadly comparable with industry reports[102] on moderating growth among Middle Eastern conventional insurers in 2013.

In the case of Saudi Arabia, the recent decline in return on assets is not reflective of the general strength of the country's operators, which have performed well in 2008–12. Industry reports point to intensifying competition in Saudi Arabia's insurance and *Takāful* market, due to the existence of many small players in the kingdom. The Saudi market, similar to other GCC markets, consists of a handful of operators accounting for up to 70% of premiums, with smaller businesses competing to win the remaining share, putting pressure on all participants in the sector.[103] In the medium term, this suggests the need for consolidation in the industry. In Malaysia, the new *Islamic Financial Services Act* 2013 (IFSA 2013) requires *Takāful* operators to legally separate their general and family businesses by 2018 to better manage prudential risks in the industry; these laws would drive consolidation among smaller operators with insufficient scale to justify the additional capital and investment in operations required due to the separation of licences policy.

Chart 1.2.3.4: Return on Assets (2008–2013)[104]

Source: Takāful Operators Sample, KFHR

Chart 1.2.3.5: Claims Ratio (2008–2013)[105]

Source: Takāful Operators Sample, KFHR

101 International Association of Insurance Supervisors (IAIS).
102 Swiss Re, Standard & Poor's (S&P).
103 Moody's (September 2013).
104 Return on assets = *Takāful* operating profit before distributions / total assets.
105 Claims ratio = net claims incurred / net contributions.

Chart 1.2.3.6: Operating Ratio (2008–2013)[106]

Source: Takāful Operators Sample, KFHR

Investment activity by *Takāful* operators reflects the different market conditions and instruments available across their respective regions. In the more established markets of Malaysia and Saudi Arabia, a significant share of investment funds was channelled to *Sukūk* and money markets. The more cautious market sentiment at end-2014, in light of the anticipated exit from easy monetary policies and the sharp decline in oil prices, will weigh on *Takāful* operators' investment income. Notably, the dependence on *Sukūk* and money market correspond to the status of Malaysia and Saudi Arabia as the leading domiciles for Islamic capital market activity, including both *Sukūk* and asset management. As at 11M2014, Malaysia dominated the *Sukūk* market, accounting for a 64.6% share of total issuances, while Saudi Arabia accounted for a 10.3% share (see Chart 1.2.3.7).

Chart 1.2.3.7: Investment Composition (2013)

Source: Takāful Operators Sample, KFHR

On the other hand, the more nascent markets in the GCC (ex-Saudi) and South Asia held more in the form of cash and deposits, funds and other investments. However, the figures for *Sukūk* for the *Takāful* operators in GCC (ex-Saudi) may be understated, as some operators did not disclose separate holdings for *Sukūk* and money market instruments. Interestingly, equities constitute a significant 29% of the investment composition in the GCC (ex-Saudi) region, the highest among the sample countries. The demand for equities is supported by fairly active and liquid stock markets in the region. Between January and November 2014, GCC equity indices generally recorded gains, but were affected by concerns of declining oil prices towards the end of the year. These developments may impact investment income and returns to policyholders in 2014.

Chart 1.2.3.8: GCC Equity Indices (indexed to January 2013)

Source: Bloomberg, KFHR

Elsewhere in South Asia, the *Takāful* operators held more than 60% of the investments in the form of cash and deposits, with a very minor share for funds and equities. This suggests that *Takāful* operators in the region are fairly risk-averse and reflects the lower share of family *Takāful* in the country. Generally, family *Takāful* products incorporate investment returns on top of protection coverage, which necessitates operators to invest in higher-risk assets such as equities. Between January and December 2014, the main stock exchanges in South Asia recorded a general uptrend, which is positive for *Takāful* operators with investment income components (see Chart 1.2.3.8). Nevertheless, profits from equity trading remain vulnerable to market volatilities in the short run, given renewed concerns about growth and sharp declines in oil prices.

In summary, the global *Takāful* sector has considerable market opportunities to gain traction going forward, supported by both demand and supply dynamics across the various markets offering Islamic financial services. Nonetheless, the industry is plagued by several internal challenges that require collaborated efforts by the industry stakeholders to mitigate them in order to sustain the competitiveness of *Takāful* in the global markets. The *Takāful* industry faces several pressing challenges going forward. Broadly, some challenges are similar to those faced by the overall Islamic finance industry, such as the lack of specialised human capital and the need for more research and development to develop products.[107] Collectively, these issues act as a constraint on product innovation, which is necessary for the industry to progress further. Regarding investment returns, *Takāful* operators are somewhat constrained by the lack of access to *Sharī'ah*-compliant investment products compared to conventional insurers,[108] though the growth of the Islamic capital markets may somewhat alleviate this challenge. On another note, the industry would benefit from a more robust ratings process, which would allow a better assessment of risks and support the expansion of highly rated *Takāful* operators in particular. *Takāful* operators also face operational issues on the relationship between *Takāful* participants' and shareholders' funds, which has implications for accounting treatment, among other matters. In this regard, the IFSB has issued a number of standards related to corporate governance, solvency and risk management issues, which also address the matter of shareholders' and contributors' interest.

[106] Operating ratio = claims ratio + expense ratio [overheads / net contributions].
[107] *IFSB-IRTI, Islamic Financial Services Industry Development: Ten-Year Framework and Strategies, A Mid-Term Review* (2014).
[108] Ibid.

1.2.4 Islamic Capital Market

(a) *Sukūk* Market

The *Sukūk* market has emerged as the fastest-expanding sector of the global Islamic finance industry (based on growth rates).[109] There are over 2300 *Sukūk* issuances outstanding, worth nearly USD295 billion as of 3Q2014, issued by approximately 400 issuers domiciled in more than 20 countries.[110] The issuers include diverse economic participants ranging from sovereign issuers to multilaterals, central banks and corporate institutions. In some countries, *Sukūk* issuances are gradually taking precedence over conventional bonds as the preferred instruments for fund-raising. For instance, in the Malaysian capital market, 76.1% of all corporate issuances in 2014 were *Sukūk*, with the remaining 23.9% being conventional bonds.[111] *Sukūk* have been used as tools for fund-raising and supporting the economic development process by issuers across as many as 30 jurisdictions (presently and in the past), consisting of both developed and emerging economies.

The interest in the *Sukūk* sector is also strong from the investors' side, as investments in *Sukūk* papers have been surging in recent years. Despite increased annual primary market issuances with volumes exceeding USD100 billion in the past three years, international *Sukūk* listings continue to be oversubscribed. Table 1.2.4.1 provides an overview of selected *Sukūk* papers issued in 2014 and their respective oversubscriptions, reaching as high as 13 times the offered amount. The demand for *Sukūk* papers therefore continues to outweigh issuances, backed by the tremendous expansion in other sectors of the Islamic finance industry (banking, funds and *Takāful*) where institutions actively seek investment opportunities in *Sukūk* to support their various needs. For example, Islamic banks demand high-quality *Sukūk* papers for their liquidity and capitalisation needs; *Takāful* operators invest in *Sukūk* to meet their lower risk and stable returns investment needs; and fund managers need to invest in *Sukūk* to support their *Sharīʿah*-compliant fixed-income products.

Table 1.2.4.1: Demand Comparison for Selected *Sukūk* Issued in 2014

Sukūk Name*	Issue Size (USD million)	Issuer Type	Tenure (Years)	Rating	Oversubscription (Times)
Al Hilal Bank Tier 1 *Sukūk*	500	Corporate	Perpetual	A + / (Fitch)	9.0
Damac *Sukūk* 4/19	650	Corporate	5	BB / (S&P)	4.2
Turkiye Finans 4/19	500	Corporate	5	BBB / (Fitch)	2.8
Dar Al Arkan *Sukūk* 5/19	400	Corporate	5	B + / (S&P)	2.5
Luxembourg Sovereign 10/19#	271.7	Sovereign	5	AAA / (S&P, Moody's, Fitch)	2.0
Hong Kong Sovereign 9/19#	1,000	Sovereign	5	AAA / (S&P)	4.7
Goldman Sachs 9/19#	500	Corporate	5	A / (Fitch)	3.0
DIP *Sukūk* Limited 2/19	300	Corporate	5	BB / (S&P)	13.0
UK Sovereign *Sukūk* 7/19	339.5	Sovereign	5	AAA / (S&P)	11.5
South Africa Sovereign 6/20#	500	Sovereign	5.5	Baa1 / (Moody's)	4.4
Investment Corp. of Dubai 5/20	700	Quasi-Sovereign	6	NR	6.0
Emaar Malls Group 6/24	750	Corporate	10	BBB - / (S&P)	7.2
Saudi Telecom *Sukūk* 6/24	533.2	Corporate	10	A1 / (Moody's)	2.0
Indonesia Sovereign 9/24	1,500	Sovereign	10	BBB - / (S&P)	6.8
Emirate of Sharjah 9/24	750	Sovereign	10	A / (S&P)	10.5
Dubai DOF *Sukūk* 4/29	750	Sovereign	15	NR	3.1

NR = not rated.
**Numbers in "Sukūk Name" indicate maturity date mm/yy.*
#Non-OIC origin Sukūk.
Source: Various references, Bloomberg, Zawya, KFHR

The surging demand in the *Sukūk* sector has also been supported by an expansion in the investors' base across diverse regions globally, including Asia, MENA, Europe and North America. In particular, there has been a substantial increase in the investor base originating from European-based accounts, as a low-interest rate environment in the Eurozone has encouraged regional investors to diversify their investments into higher-yielding opportunities available elsewhere (see Chart 1.2.4.1). The increase in availability of internationally rated *Sukūk* instruments has further encouraged non-traditional investors – for instance, global investment banks and asset management houses – to subscribe to *Sukūk* offerings suiting their risk appetites. In 2014, for example, various *Sukūk* instruments were subscribed to by diverse investor types, including central banks, sovereign wealth funds, pension funds, private banks, fund managers and banking institutions (see Chart 1.2.4.2).

[109] As has been aptly highlighted in Section 1.1 of this chapter.
[110] IFIS, KFHR.
[111] Securities Commission Malaysia: Annual Report 2014, page 146.

Chart 1.2.4.1: Geographical Distribution of Selected *Sukūk* Papers Issued (2014)

MENA = Middle East and North Africa; US = United States of America.
Source: Bloomberg, IFIS, Zawya, KFHR

Chart 1.2.4.2: Investors' Breakdown of Selected *Sukūk* Papers Issued (2014)

CBs / SWF = Central Banks / Sovereign Wealth Funds; Others = Pension Funds, Takāful/ Insurance Funds, etc.
Source: Bloomberg, IFIS, Zawya, KFHR

Despite the rapidly expanding issuances and investments in the market by a diverse group of issuers and investors, the *Sukūk* sector has performed quite resiliently. As of November 2014, less than 0.6% of total corporate *Sukūk* tranches issued to date have defaulted, while only 0.2% of the total issuance volume has defaulted (see Table 1.2.4.2). In contrast, the average annual global corporate bond default rate between 2002 (when the *Sukūk* market picked up) and 2013 is calculated at 1.62%.[112]

Table 1.2.4.2: Defaulted and Restructured *Sukūk* (1990 to November 2014)

	No. of *Sukūk* Tranches	No. of Issuers	Total Volume (USD billion)
Total issued	8621	679	781.2
Total defaulted	50	26	1.76
Total restructured	3	3	1.04

Source: IFIS, KFHR

The relatively better performance of the *Sukūk* market is often attributed to the mandatory requirement of underlying assets by *Sharīʿah* that acts to discourage overexposure of the financing beyond the value of the underlying assets. This results in reduced possibility of over-indebtedness in the *Sukūk* market, thus protecting its financial stability. The performance is also attributable to the domination of sovereign and quasi-sovereign issuances in the *Sukūk* market, representing 80.2% of all issuances in the 11 months ended November 2014. Notwithstanding this, the industry stakeholders need to be cautious, as the *Sukūk* market is still a relatively nascent industry and there are a number of vulnerabilities in the current performance trends of the *Sukūk* market that need to be considered.

Premium Pricing on New Issues

Sukūk issuances are priced with additional premiums at the point of issuance. The premiums have been offered as incentives to investors to compensate for the comparatively lesser liquidity of the *Sukūk* papers when compared with conventional instruments. Although the spread differentials have tightened over the years, nearly all international *Sukūk* (including both sovereign and corporate issuances) issued in 2014 offered premium returns to *Sukūk* investors when compared to identical bond instruments. For example, the South African sovereign *Sukūk* maturing June 2020 was priced at a profit rate 25.8bps higher than the South African sovereign bond maturing March 2020; adjusting for the three months' difference in maturity between these two instruments and allowing for a 5–10bps premium for a new instrument issuance, the *Sukūk* is regarded to offer investors an additional premium of 10–15bps over the conventional curve.[113] Similarly, the latest Indonesian government *Sukūk*, issued in September 2014, was priced at 26.3bps above the secondary market yield on the comparable Indonesian USD government bond with an identical maturity profile. In the corporate market, the recently priced *Sukūk* by Goldman Sachs is attributed to have incorporated a new issuance premium of 5–7bps, as compared to if a new conventional bond had been issued.[114] The premium returns on *Sukūk* issuances are additional costs of borrowings for the issuers that could discourage some potential issuers from tapping the market. Going forward, stakeholders need to address issues in the *Sukūk* market (e.g. liquidity and tradability of *Sukūk* instruments) that are causing investors to demand higher yields (see Charts 1.2.4.3 and 1.2.4.4).

112 Standard & Poor's, "Default, Transition, and Recovery: 2013 Annual Global Corporate Default Study and Rating Transitions" (2014).
113 KFHR, *Global Sukūk Weekly Report*, 18 September 2014.
114 Ibid.

Chart 1.2.4.3: *Sukūk* and Bond Yields Comparison – Malaysia (LCY Issue)

Chart 1.2.4.4: *Sukūk* and Bond Yields Comparison – Indonesia (USD Issue)

Source: KFHR

Declining Use of Risk-sharing Contracts in the Sukūk Market

In the past, *Mushārakah* and *Muḍārabah* contracts were frequently in evidence in the global *Sukūk* market. For instance, nearly one-fourth of all *Sukūk* outstanding in 3Q2014 is structured based on *Mushārakah* and *Muḍārabah* contracts (see Chart 1.2.4.5). However, this trend is on the decline, as less than 7% of all new *Sukūk* issued in the first three quarters of 2014 were structured on the basis of such contracts (see Chart 1.2.4.6).

Chart 1.2.4.5: Global *Sukūk* Outstanding by Structure (3Q2014)

Chart 1.2.4.6: Global New *Sukūk* Issuances by Structure (3Q2014)

Source: KFHR

Lack of Differentiation between Sukūk and Bonds

The greater use of sales-based contracts to structure *Sukūk* leads to a loss in differentiation of the *Sukūk* market vis-à-vis the bond market. *Sukūk* instruments are then treated by the market participants as being on a par with conventional bonds, using similar pricing strategies,[115] risk management principles, and so on, as with conventional bonds. As a result, any adversity in the global financial system, even if it originates in the conventional sector, has an impact on the financial stability of the *Sukūk* market. A case example is the volatility stemming from the US Federal Reserve's monetary policy meetings, which also affected *Sukūk* instruments identically. As *Sukūk* instruments are treated as financing instruments, the secondary market yields of outstanding *Sukūk* move in tandem with global interest rate expectations (see Table 1.2.4.3).

[115] Albeit with slight premiums to compensate for the lack of tradability.

Table 1.2.4.3: Yield Movements on Selected US Dollar Bond and *Sukūk* (June 2014*)

Instrument**	Yield Change (bps) 1 June to 18 June	Yield Change (bps) 18 June to 30 June
US Govt 5 Year Generic	+ 8.18	– 4.18
US Govt 10 Year Generic	+ 5.77	– 5.40
CBB 11/17	+ 9.50	– 5.10
DOF 5/17	+ 4.30	+ 1.70
SECO 4/22	+ 3.90	+ 1.10
SoQ 1/23	+ 7.30	– 2.10
Hazine Varl 3/18	+ 10.50	– 3.20
1Malaysia 6/15	+ 4.80	– 5.40

CBB = Central Bank of Bahrain; DOF = Dubai Department of Finance; SECO = Saudi Electricity Company; SoQ = State of Qatar; Hazine Varl = Hazine Mustesarligi (Turkish Under Secretariat); 1Malaysia = 1Malaysia Global Sukūk Wakālah.
**The US FOMC meeting held on the 17th and 18th of the month concluded that US interest rates will remain constant for a "considerable time" in future. Prior to the meeting, yields had been climbing on global US dollar instruments on expectations that the US Fed may signal an interest rates increase sooner than expected by the market.*
***Numbers in Sukūk instruments indicate their month and year of maturity.*
Source: Bloomberg, KFHR

Need for Robust Sukūk Pricing Benchmarks/Ratings

Most jurisdictions have an absence of appropriate *Sukūk* pricing benchmark curves (or even conventional pricing benchmark curves for countries with limited bond market activities) that can serve as initial guidance for prospective issuers across a wide range of maturities. Overcoming this challenge requires an active *Sukūk* market where instruments are available across a wide range of tenures, including short-, medium- and long-term maturities. In addition, *Sukūk* instruments need to be rated by rating agencies to establish benchmark curves across divergent credit qualities of the issuers. The issue of ratings is all the more significant, since a number of *Sukūk* defaults in the past were largely on account of the poor credit quality of the issuers as opposed to fundamental problems in the *Sukūk* designs and structures.

The Malaysian *Sukūk* market has made tremendous progress in this regard, led by the government and the central bank. *Sukūk* structured across a wide range of tenures (ranging from short three-month Treasury bills to the long-term 30-year government financing *Sukūk*) are available in the market to serve as pricing guidance for different tenures. In addition, the country has two rating agencies that rate locally issued papers, thus providing guidance on credit quality to potential investors. Based on this, Malaysia is one of the few countries in the world that has benchmark curves for corporate *Sukūk* across different ratings and maturities to serve as guidance to both issuers and investors (see Chart 1.2.4.7).

In contrast, the GCC *Sukūk* market is gradually catching up. For instance, the Dubai government issued a 15-year maturity sovereign *Sukūk* in 2014, the first long-dated sovereign *Sukūk* in the GCC region, thus setting price guidance for long-dated prospective issuers. Going forward, market stakeholders need to focus on developing appropriate pricing benchmarks across a range of tenures while enabling ratings to play an instrumental role in gauging the credit quality of *Sukūk* instruments.

Chart 1.2.4.7: Bloomberg-AIBIM Malaysia Corporate *Sukūk* Benchmark Curve

Source: Bloomberg, KFHR

In conclusion, the *Sukūk* market has achieved tremendous progress over the past decade and enjoyed relatively lower rates of default when compared to their conventional counterparts. However, as the sector gains market traction across regions, regulators need to focus on vulnerabilities in the market that could potentially have a destabilising effect. In particular, financial regulators need to focus on the macrofinancial linkages of the global *Sukūk* market and undertake greater research to better understand the impact of global economic conditions and potential financial instability risks, including immediate challenges such as potential emerging market outflows and sharp declines in oil prices. Meanwhile, markets that have achieved mainstream relevance in *Sukūk* – for instance, Malaysia, where *Sukūk* is the dominant financing instrument – need to be assessed in terms of the potential financial instability impact from adverse shocks in both the domestic and global *Sukūk* market.

(b) Islamic Equity and Funds Market

Over the past year, a number of new Islamic equity indices have been launched in several emerging and niche Islamic finance jurisdictions, with the goals of enhancing market liquidity and diversifying the investor base, as well as to cater to the allegedly strong demand for *Sharīʿah*-compliant investments.

In January 2014, Bangladesh's Dhaka Stock Exchange introduced the country's first Islamic index, which was designed and developed in accordance with the S&P Dow Jones Indices methodology. Later in October, another *Sharī'ah*-compliant index was launched at Chittagong Stock Exchange which accounted for 41.35% of the exchange's float-adjusted market capitalisation at the time. The country is also expecting to launch a *Sharī'ah*-compliant index catering for institutional investors in the near future. Elsewhere, in July 2014, Turkey's Participation 30 Index was joined by two new participation indices – the Participation 50 Index and the Participation Model Portfolio Index – which aim to facilitate the development of new *Sharī'ah*-compliant investment products in the domestic market. During 2Q2014, the Egyptian Islamic Finance Association started an Islamic index consisting of the 30 most liquid *Sharī'ah*-compliant stocks in the Egyptian Stock Exchange. The Philippine Stock Exchange is also planning to launch a *Sharī'ah*-compliant sub-index during 1H2015, having started screening of public companies for *Sharī'ah* compliance at the end of 2013.

In October 2014, the Securities Commission Malaysia issued its first set of *Sharī'ah* parameters for Islamic ETFs based on gold or silver as an underlying asset. The guidelines, which set forth *Sharī'ah* requirements on trading of *Ribawi* items and on the establishment of an Islamic ETF based on gold or silver, now serve as a reference for interested asset managers. Worldwide, Islamic ETF products are not yet in large supply; however, interest is picking up.[116] Also in October, the New York Stock Exchange listed the US market's first *Sharī'ah*-compliant ETF.

Chart 1.2.4.8: Price Returns of DJIM Developed Markets and DJIM Emerging Markets Indices (31 October 2014)

Source: S&P Dow Jones, KFHR

Analysing the performance of *Sharī'ah*-compliant indices, using the Dow Jones Islamic Market (DJIM) indices as proxies, those composed of stocks traded in developed market countries largely outperformed their peers from developing countries. The DJIM Developed Markets Index returned 11.49% in five-year annualised returns versus 2.13% for the DJIM Emerging Markets Index. As of 31 October 2014, the DJIM Emerging Markets Index performed marginally better than the DJIM Developed Markets Index, with 5.26% against 4.56%. This marks a major reversal for the former after 2013's dismal –2.16%. In contrast, the DJIM Developed Markets Index moderated from a high of 22.34% in 2013, reflecting to a greater extent the consecutive cuts to global economic growth forecasts. Conventional DJ indices witnessed similar trends: the DJ Emerging Markets Index improved from –0.73% in 2013 to 4.47% as of end-November 2014, while the DJ Developed Markets Index fell from 27.46% to 6.36% over the same period (see Chart 1.2.4.8).

Regionally across DJIM indices, the highest price returns were recorded by GCC stocks, which gained 15.16% as of end-October 2014 on the back of sustained economic activity and the migration of investment funds into this sub-region from the rest of MENA. DJIM Europe slipped into negative territory with –5.46% after having achieved a 19.35% return in 2013, as economic recovery decelerates and business confidence sags in the Eurozone. DJIM Greater China remained broadly consistent, returning 7.01% as of end-October 2014 and an annualised 7.51% over a three-year period. DJIM Asia Pacific rose by 4.65% and 4.06% respectively, over the same period (see Chart 1.2.4.9). Real GDP in Asia is estimated to have risen on average by 5.5% in 2014 – at the same rate recorded in 2013 – as economies rebounded after the slow first half of the year.

Chart 1.2.4.9: Price Returns of DJIM Markets Indices by Region (31 October 2014)

Source: S&P Dow Jones, KFHR
Note: Figures in { } are float-adjusted market capitalisation figures for the respective indices.

The Islamic funds sector has progressed, having expanded from USD29.2 billion in AuM in 2004 to USD75.8 billion as of 3Q2014. Still, it accounts for a tiny share of the global asset management industry, which reached USD68.7 trillion at end-2013,[117] having grown 13% year-on-year.

The historical performance of Islamic funds by asset class has been mixed and dependent to a large degree on prevailing economic, geopolitical and related financial market conditions. For example, during the recent recession, many Islamic fund managers altered their asset allocation patterns in favour of recession-proof commodity and secure money market investments. The performance of Islamic funds also tends to vary vastly among Islamic fund managers specialising in different geographical areas. The operational efficiency of asset management companies offering Islamic funds is another universal determinant. (see Chart 1.2.4.10 and 1.2.4.11)

[116] These index-tracking passive funds manage today USD2.76 trillion in assets globally, up from USD425 billion in 2005, and already account for about a quarter of all activity in the US stock market. As of October 2014, it was estimated that Islamic ETFs numbered 27 around the world, domiciled mostly in Ireland, Luxembourg, Malaysia and the US.

[117] Boston Consulting Group, *Global Asset Management Report* (2014).

Chart 1.2.4.10: Returns (%) of Islamic Funds by Asset Type (3Q2014)

Source: Zawya, Bloomberg, Eurekahedge, KFHR

Chart 1.2.4.11: Historical Returns of Islamic Funds by Asset Type

Source: Zawya, Bloomberg, Eurekahedge, KFHR

Asset Class Focus. The equities class of assets was a top performer in 2013 and 2014; as at the third quarter in 2014, Islamic equity funds returned an average of 11.31%, outperforming the comparative results of the DJIM Titans 100 Index (representing the largest *Sharī'ah*-compliant stocks traded globally) and the S&P 500 *Sharī'ah* Index (made up of large-cap *Sharī'ah*-compliant US stocks) (see Chart 1.2.4.12). Stock markets advanced cautiously in 2014. Idiosyncratic events throughout the year have not detracted significantly from the major stock markets. The outlook for global equities has been broadly favourable, reflecting a positive view of corporate profitability and continuing uncertainty around quantitative easing measures. There are views that the latter, and similar measures enacted across international markets in the aftermath of the Global Financial Crisis, might have driven the stock markets into a bubble.[118]

Chart 1.2.4.12: Historical Returns of Islamic Equity Funds and Benchmark Indices

Source: Zawya, Bloomberg, Eurekahedge, KFHR

Unsurprisingly in the current interest rate environment, the returns of Islamic money market funds have achieved only a meagre 1.53%. Globally, the market expects monetary conditions to remain broadly accommodative for the time being: the Federal Reserve is targeting a rate of 1.375% only by end-2015; the European Central Bank slashed the benchmark rate to 0.05% and initiated large-scale asset purchases in September 2014. This may continue to limit the midterm upside for Islamic portfolios, since Islamic money market funds hold about a third of *Sharī'ah*-compliant AuM.

Islamic commodity funds have recovered, with 4.78% as at 3Q2014, up from –8.50% in 2013, but the short-term prospects in commodities are unpromising and a substantial degree of uncertainty overshadows the long-term demand outlook. During 3Q2014, the Bloomberg Commodity Index dropped 11.83%, with double-digit declines recorded in the futures markets for energy, agricultural products and precious metals. Emerging market economies that rely heavily on commodity exports have felt the negative consequences of the oil price deflation which, to a large extent, drove the depreciation of their currencies against the US dollar. Prospectively, a prolonged drop in oil prices could add to financial instability through spillover effects from losses in related financial assets, especially in economies where the oil sector holds a major share.

Islamic real estate funds decelerated from last year's 6.08% to 4.08% as at 3Q2014. Most *Sharī'ah*-compliant AuM are invested in Asia-Pacific and MENA: money continues to flow into the former region's prime locations as prices remain strong; in the latter, the real estate market is displaying increasing signs of maturity, which have been welcomed by investors despite flatter returns. Finally, balanced Islamic funds have yielded a moderate 6.08% on average.

[118] Those who hold this opinion cite technical analysis showing almost uninterrupted persistence of a bull pattern in the US stock market post-2009 when the Federal Reserve began its monetary stimulus. Limited market volatility and a low-interest environment are said to have driven unreasonable investor interest in stocks. The IMF's *Global Financial Stability Report* of October 2014 also stated that the extended period of monetary accommodation and the accompanying search for yield are leading to credit mispricing and asset price pressures.

Chart 1.2.4.13: Returns of Islamic Funds by Geographical Focus (3Q2014)

Source: Zawya, Bloomberg, Eurekahedge, KFHR

Geographical Focus. The highest average returns as of 3Q2014 have been generated by Islamic funds operating in selected Gulf states and emerging Asian markets (see Chart 1.2.4.13). By 3Q2014, GCC stocks' combined value reached USD1.17 trillion, surpassing the pre-GFC level, which had been contributed to by the Dubai Financial Market (up 49.6% YTD), the Qatar Stock Exchange (32.3%), Tadawul (27.2%), and the Abu Dhabi Securities Exchange (19.4%). Well-performing Islamic funds with Asia-focused investments are also largely equity focused: the Jakarta Composite Index in Indonesia (which accounts for 2% of Islamic AuM by geographical focus) gained 22.9% as of end-September 2014 largely on optimism over structural economic reforms promised by the new government. In Pakistan (1.2% of Islamic AuM), equity indices in Islamabad, Karachi and Lahore rose in the nine months of 2014 boosted by relative political calm and encouraging earnings results. Elsewhere, India's benchmark BSE Sensex increased 26.8% as of 3Q2014; investors turned moderately bullish also on China and most Asia-Pacific markets (2.7% of Islamic AuM).

Returns from Islamic funds invested in developed geographies have moderated in the past year. As such, the US equity market has exhibited flat performance despite positive economic indications domestically, while equity fund returns elsewhere across developed markets have been affected partly by geopolitical events (primarily those concerning Ukraine and Russia in Europe) and partly by the strengthening of the US dollar against major currencies (e.g. the euro and the Japanese yen). The S&P 500, Stoxx Europe 600 and other benchmark indices across the US and Europe all posted returns below 10% in 2014 YTD.

In recent years, the Islamic funds industry is also witnessing a gradual process of internationalisation (emergence of UCITS-compliant and cross-border funds) with greater participation by the European and US fund managers, having started to offer *Sharī'ah*-compliant funds on their product shelves in order to attract a wider pool of investable funds, particularly from the GCC. While this is a positive development, it also pushes the existing small-scale Islamic fund managers into a more competitive domain. Moving forward, greater attention is needed in areas of market practices (including regulation), competitiveness and building scale.

Market Practices. In the wake of the financial crisis, the industry has been transforming in consideration of developments in the global investment environment. Although Islamic funds were affected by the crisis-driven performance pitfalls to a lesser extent than conventional funds, they are being equally challenged by resultant post-crisis changes. Primarily, these changes stem from increased market expectations on asset managers in the areas of risk management, monitoring and disclosure, as investors become more technically knowledgeable. In January 2014, the Financial Stability Board released a consultation paper[119] which raised the question of whether some asset managers needed to be designated "systemically important financial institutions" (SIFIs) – suggesting size should be a key classifying criterion – and should be subject to more stringent regulation, such as capital reserve requirements and contributions to a common liquidation pool. This important distinction serves to better focus supervision and regulatory efforts on key IFIs. The consultation by the FSB was undertaken considering that the financial distress or disorderly failure of a non-bank or non-insurer financial entity could potentially transmit to other financial firms and markets, leading to financial instability or contagion risks.

In the US, key financial regulation initiatives enacted post-GFC include the *Foreign Account Tax Compliance Act* (FATCA) and the *Dodd-Frank Wall Street Reform* and *Consumer Protection Act*. Of specific relevance to asset managers is Rule 2a-7, and recent amendments to it dated July 2014, which established a floating net asset value for institutional money market funds and introduced liquidity fees and redemption gates as new instruments to mitigate the risk of heavy redemptions. In 2014, the European Parliament adopted the Regulation on Key Information Documents for Packaged Retail and Insurance-Based Investment Products (PRIIPs) and the UCITS-related Directive 2014/91/EU, introducing new rules on fund depositories and remuneration principles for managers. This is in addition to the Alternative Investment Fund Managers Directive, the Markets in Financial Instruments Directive (MiFID) II, and the Undertakings for Collective Investment in Transferable Securities Directive (UCITS) IV, which have all been adopted over the past few years and centre on the themes of disclosure, distribution and depository rules.

These ongoing regulatory initiatives will lead to enhanced consumer protection and greater competition in the long run, while adding the need for greater compliance outlays at the initial adoption stage. Islamic fund managers, too, will be affected by the regulatory changes as the industry evolves on the global stage, although presently they are mostly of European and US origin. These regulatory benchmarks are also likely to be adopted in major domiciles for Islamic funds across Asia and the Middle East through a peer review process.

[119] The paper discussed three channels whereby financial distress of a non-bank or non-insurer (NBNI) financial entity is most likely to be transmitted to other financial firms and markets, and thereby pose a threat to global financial stability. These three channels are: (i) the exposures of creditors, counterparties, investors and other market participants to the NBNI financial entity (exposures/counterparty channel); (ii) the liquidation of assets by the NBNI financial entity, which could trigger a decrease in asset prices and thereby could significantly disrupt trading or funding in key financial markets or cause significant losses or funding problems for other firms with similar holdings (asset liquidation/market channel); and (iii) the inability or unwillingness of the NBNI financial entity to provide a critical function or service relied upon by market participants or clients (e.g. borrowers) and for which there are no ready substitutes (critical function or service/substitutability).

Competition. The asset management industry is also being redefined by changing customer expectations and profiles, which have put capital preservation into greater focus and have necessitated the exploration of more non-traditional distribution relationships. An emphasis on wealth preservation as an investment strategy is evident in global asset allocations: in 2013, cash and cash equivalents accounted for the largest share of investable assets held by high-net-worth-individuals (HNWIs), with 26.6% of the total, according to the World Wealth Report 2014; equities followed closely with 24.8%. At the same time, a divergent trend has been registered in the gradual shift of some investors towards alternative products, which gained 3.4 percentage points last year to attain a 13.5% share of the total. As such, during the first half of 2014, low volatility across most asset classes and restrained supply of corporate securities were believed to have incited the search-for-yield phenomenon among investors looking for private-sector securities, according to the Bank of England's Financial Stability Report of June 2014. The third quarter of the year, however, was characterised by a marked uptick in volatility as market participants received news in October of the Federal Reserve ending its quantitative easing programme.

Being a niche segment, the Islamic fund management industry must be adaptive to the need for rapid innovation and market awareness. The ongoing progress of Islamic finance globally, combined with the rising profile of ethical finance, could help Islamic fund managers establish a unique brand identity which could see a convergence of differentiation strategies from traditional and alternative managers. Smaller fund managers also need to build a niche strategy to cater for tailored potential clients' preferences, which tend to vary with geography and demography, as sustainability of these fund managers is a concern. In Asia-Pacific and the MENA, for example, HNWIs' preference for digitised delivery of asset management services is growing particularly strongly, driven by the younger generation of investors (aged under 40), 36.7% of whom globally favoured digital contact over direct contact in 2013 (2012: 29.1%). Investments driven by social impact are motivated principally by personal and family values in the Americas, while in Malaysia and Indonesia religion was cited among the top three reasons.[120]

Scale. Among other challenges specific to Islamic funds, the most pertinent is limited liquidity, given that about 43% of all Islamic funds manage less than USD25 million in assets individually (see Chart 1.2.4.14). At present, the majority of those investing in *Sharīʿah*-compliant funds are retail clients, while the assets of institutional investors remain largely untapped. It should be noted, however, that the asset management industry overall has come to be increasingly characterised by high concentration. Economies of scale in portfolio management and administration, as well as the growing prevalence of passive strategies, allow large asset management firms to offer most comprehensive and low-cost client solutions. For example, in the US – the world's largest mutual fund market – the top five mutual fund managers held 49% of domestic mutual fund assets in 2012, while the largest 25 mutual fund managers held 74% of the same.[121] From a financial stability perspective, such high industry concentration may increase the market impact of various firm-level risks.

Furthermore, the Islamic funds sector is reliant on a largely homogeneous base of investors, this being explained by mostly localised investing and marketing activities of Islamic fund managers. From a cost management perspective, operational efficiency of the Islamic fund business is being hampered greatly by the shortage of qualified talent at the fund managerial level.

Chart 1.2.4.14: Number of Islamic Funds by Asset Size (3Q2014)

Source: Zawya, Bloomberg, Eurekahedge, KFHR

Gradual internationalisation of *Sharīʿah*-compliant finance and liberalisation of cross-border capital flows among Islamic finance markets have contributed to substantial enhancement of Islamic investment portfolios and growth of asset volumes managed by Islamic collective investment schemes in recipient destinations across Asia, the MENA, Europe and the Americas. Nevertheless, in order to sustain the positive growth trend, the sector will likely need to undergo a number of structural and strategic changes.

Notably, some Islamic finance jurisdictions have been liberalising their financial markets which could be expected to boost useful cross-border activity in the fund management business. For example, Qatar has allowed non-GCC investors to own up to 49% of public companies, from the prior limit of 25%. In a major development, Saudi Arabian regulators announced in July the opening of the country's stock market – the MENA region's largest by market capitalisation – to direct foreign investment in the near future, with a possible ceiling of 20% on cumulative foreign ownership in any single listed company. To prepare Tadawul for integration with international markets, the Capital Market Authority is planning initiatives aimed at improving corporate governance standards for public companies which should make the market more transparent and less volatile. In the neighbouring UAE, the regulatory body for the Dubai International Financial Centre has created a new class of funds for small numbers of large professional investors. In Malaysia, foreign entities have been allowed to assume full ownership over unit trust management companies effective from June, which permitted foreign managers to start marketing funds to retail investors. These and similar regulatory directives across multiple Islamic finance markets are being welcomed by the industry.

[120] In the Global HNW Insights Survey 2014, 38.6% of respondents cited religion as an important reason for attaching the social impact value to investments.
[121] Office of Financial Research, US Department of Treasury, *Asset Management and Financial Stability Report* (September 2013).

Moving forward, the Islamic funds sector should develop organically through practical product innovation, strategic marketing outreach and effective resource management. This will help address some of the challenges straining the operational performance of Islamic asset managers at present, which relate chiefly to cost concerns stemming from intensifying competition from both within the sector and with conventional providers, higher standards of risk management and governance, as well as shifting investor preferences in asset allocation and distribution channels.

1.3 Overall Summary

The recent configuration of the world economy has led to growing concerns about the stability of the global financial markets. A dampened global economic outlook and increasing geopolitical crises (across the MENA and GCC regions and Eastern Europe) have added greater complexities to the volatilities expected from the normalisation of monetary policy in the United States. Furthermore, the vulnerability of emerging market economies has become more evident in the past year and necessitates careful and immediate remedies for managing potential financial vulnerabilities. As buoyancy returns to the US, investors are reallocating their assets out of emerging markets, sending their equity and bond market yields down. Coupled with emerging market economies' own specific issue of growing economic imbalances, emerging markets instability remains a key risk for the near future. In the final month of 2014, the stronger US dollar also steered the value of emerging market currencies to a 14-year low (as at 8 December 2014), taking the JPMorgan Emerging Market Currency Index[122] as a proxy. These entangled issues of global economic and financial stability, in many aspects, are relevant to the health and stability of the Islamic financial system, as Islamic financial institutions are characterised by the following structural concerns.

- ***Scale***
  Islamic banks are much smaller in size than conventional players (See Table 1.3.1 for a comparison of the average asset size of the Islamic banking sample vis-à-vis G-SIBs). Although size is not an important factor for banks to perform efficiently, conventional banks are aggressively tapping the Islamic banking potential, bringing healthy competition and an orderly consolidation process into focus as a means to achieve scale in the Islamic banking landscape.

Table 1.3.1: Average Size of Banking Group

Banking Group	Average Asset Size
Islamic Banking Sample	USD9.68 billion
Average US G-SIBs*	USD1.84 trillion
Average non-US G-SIBs*	USD1.68 trillion

**Data as of 1H2013.*
G-SIBs = global-systemically important banks.
Source: Islamic banking sample, Federal Deposit Insurance Corporation (US)

- ***Emerging market vulnerabilities***
  As deliberated in the chapter, eight out of the top ten Islamic finance markets are classified as emerging markets by the world's major financial institutions/financial services providers. These markets are characterised by rapid growth and the process of industrialisation, amid sensitivity to several risks such as political risks, sovereign risks, economic fundamental risks, regional conflict risks and systemic risks, among others.

- ***Peculiar risks***
  Islamic banks are also expected to manage new risks that are associated with Islamic banking's unique principles, which include the risks peculiar to profit-sharing contracts. This also underscores the imperative to gradually enhance their risk management capabilities.

Despite the challenging environment and structural limitations, the expansion of Islamic finance remains solid across jurisdictions, although performances of the stability factors analysed in this chapter are varied across jurisdictions. In terms of growth, the first section of this chapter has demonstrated encouraging trends seen in the ability of the global and domestic stakeholders to drive the industry to expanded frontiers across all key segments of the industry – namely, banking, *Takāful* and the Islamic capital markets. Global market infrastructures, cross-border liquidity activity and standardisation efforts are being pursued proactively, aimed at building an efficient market interaction across jurisdictions and sectors, given the limited scale and investment avenues available in the domestic markets. A notable example is the progress of the IILM, which has issued a total of 11 issuances as of 5 December 2014.

Based on analysis of the risk indicators discussed in this chapter, the overall stability of Islamic financial institutions remains healthy, albeit at different levels across jurisdictions. However, the increased fragility in financial markets, including the recent sharp decline in oil prices, is having a profound impact on the health of the economy, which may lead to potential deterioration of Islamic banks' profitability and asset quality moving forward. The *Sukūk* market will face yields volatility arising from the potential interest rates revision in the US, which will also largely depend on the sustainability of investors' confidence in emerging markets' financial assets. Rising competition and adaptation of Islamic banks to global reforms are expected to be the future-focused themes in the funding strategy of Islamic banks. Various legal and regulatory enhancements, which include *Sharīʿah* governance, are among the business and structural reorganisation aspects pertinent in supporting the transitions of the industry from being domestic-centric to becoming increasingly more globalised. The emerging challenges for various types of *Sharīʿah*-compliant institutions signify the need to foster product innovation, improve market awareness and build strategic marketing outreach.

[122] JPMorgan Emerging Market Currency Index, which measures the strength of a variety of developing country exchange rates against the US dollar, fell to its lowest level since it was created in 2000.

2.1 Global Initiatives to Promote Financial Stability

Together with the international standard-setting bodies the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS), the Financial Stability Board (FSB) has continued to publish policy papers and recommendations for the financial sectors to promote the stability of the financial services industry. The following sections highlight selected initiatives undertaken in the global financial industry since the publication of the *Islamic Financial Services Industry (IFSI) Stability Report 2014*, as well as the impact these may have on the IFSI.

2.1.1 Financial Stability Board

The Financial Stability Board continues to produce documents to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. The following are initiatives by the FSB which are also relevant to the IFSI.

(a) Standards and Processes for Global Securities Financing Data Collection and Aggregation[123]

In November 2014, the FSB published a consultative document entitled *Standards and Processes for Global Securities Financing Data Collection and Aggregation* which recommended that national/regional authorities collect aggregate data on securities financing markets such as repos, securities lending and margin lending, so as to detect financial stability risks and develop policy responses, as well as to allow the FSB to assess global trends in financial stability. The document also provided a list of proposed data elements for repos, securities lending and margin lending to be submitted by national/regional authorities for such purposes.

Institutions offering Islamic financial services (IIFS) are allowed in principle to engage in Islamic repos, securities financing, and margin financing or trading. However, they must do so in ways which comply with *Sharīʿah*, and the instruments they use are therefore not the same as those employed by their conventional counterparts. As the demand for such products increases, it is important for regulatory and supervisory authorities (RSAs) of Islamic finance to collect sufficient data on these markets to help detect financial stability risks and develop relevant policy responses. For example, IIFS Islamic margin financing or trading allows investors to borrow cash from IIFS to trade in the equity market. However, without sufficient regulation and monitoring by the central banks and/or capital market regulators, this practice could have system-wide effects during a market downturn.

In addition, given the increased importance of securities financing transactions in supporting price discovery and secondary market liquidity, the relevant RSAs may wish to enhance their data collection on Islamic securities financing markets so as to gather more information on, among other things, the types of *Sharīʿah* contracts, sectors, profit rate, underlying assets and amount traded, as well as to obtain timely and comprehensive insights into trends and developments in these markets. This will enable the RSAs to identify factors that could affect the stability of the sector and develop relevant policies to mitigate such risks. Once finalised, the Islamic Financial Services Board (IFSB) will review the FSB's document so as to determine whether there are any further or different data elements that need to be collected.

(b) Monitoring the Effects of Agreed Regulatory Reforms on Emerging Market and Developing Economies[124]

In 2012, a study was undertaken by the FSB, in collaboration with the International Monetary Fund (IMF) and the World Bank, on the unintended impact of regulatory reforms on the emerging market and developing economies (EMDEs). The recent follow-up monitoring report, which was published in November 2014, covered a range of regulatory reforms which include the Basel III capital and liquidity framework, policy measures for global-systemically important financial institutions (G-SIFIs) and resolution regimes, and structural banking reform initiatives, as well as their potential impact on EMDEs and measures undertaken by the FSB and its members to address some of the concerns. The following are some of the concerns raised by the EMDEs with regards to the Basel III capital and liquidity framework:

(i) Capital

- differences in the application of the framework across jurisdictions, which may result in differing risk weights applied to the same EMDE exposure between a parent bank located in an advanced economy and its EMDE subsidiary and could penalise that exposure in terms of capital requirements; and
- potential reduction in market-making and trading of EMDEs' sovereign debt securities by international banks as a result of the implementation of Basel 2.5.

(ii) Liquidity

- limited availability of high-quality liquid assets (HQLA) in certain markets and for certain types of market participants, which may lead to the hoarding of assets with adverse effects on domestic market liquidity and capital market development;
- differences in the recognition of HQLA across jurisdictions, which may penalise the treatment of certain local assets of bank subsidiaries operating in host EMDEs when calculating the liquidity coverage ratio (LCR) on a consolidated basis;
- the potential impact of liquidity requirements, combined with structural funding characteristics, on the availability and pricing of banks' long-term lending activities (e.g. infrastructure financing); and
- the intensified competition for deposits that may be prompted by the calibration of outflow rates for different types of liabilities and off-balance sheet commitments.

(iii) Potentially higher costs and reduced availability of credit and liquidity in financial markets in EMDEs.

[123] www.financialstabilityboard.org/wp-content/uploads/Global-SFT-Data-Standards-Consultative-Document.pdf
[124] www.financialstabilityboard.org/wp-content/uploads/Monitoring-the-effects-of-reforms-on-EMDEs.pdf

During the same month, the Basel Consultative Group (BCG) published a report[125] on the impact and implementation challenges of the Basel framework for EMDEs and small economies, of which the IFSB served as part of the committee. The report focuses on issues and recommendations with regards to the Basel capital and liquidity framework, over-the-counter (OTC) derivative market reforms, banks' sovereign exposures, domestic-systemically important banks (DSIBs) in EMDEs and small economies, and cross-border supervisory colleges. Table 2.1.1.1 highlights selected areas and recommendations put forward by the BCG:

Table 2.1.1.1: BCG's Selected Key Recommendations to EMDEs and Small Economies

Background	Key Recommendations
Basel capital framework	
Implementation of Basel III will generate a need for capital replenishment.	• To strengthen legal and institutional arrangements to enable issuance of capital instruments.
When adopting Basel II and Basel III, some banks may not reveal and recognise all potential risks associated with their balance sheets and could be tempted to put pressure on supervisors to approve internal-ratings based (IRB) approaches/ internal models when both the bank and supervisor are not ready.	• To set priorities for ensuring robustness, reliability and transparency in the adoption of Basel standards. • To communicate that (i) the pace of implementation should take into account particular characteristics of banks and banking systems, as well as supervisory constraints; and (ii) Basel II and Basel III standards are designed primarily for large internationally active banks in BCBS member jurisdictions.
Basel liquidity framework	
Implementation of the LCR will be challenging for many EMDEs and small economies.	• Quantitative impact study (QIS) for EMDEs and small economies; creation of a dedicated unit in a supervisory agency to facilitate LCR implementation.
Sovereign exposures	
The Basel III framework continues to provide for national discretion in giving preferential treatment to sovereign exposures, which could lead to an excessive build-up of such exposures.	• Request for BCBS to consider approaches that give due regard to sovereign exposure risks, preferably on a globally consistent basis.
Domestic-systemically important banks	
DSIBs could be perceived as "too big to fail".	• Host supervisors should consider bank-specific recovery and resolution plans.

Source: BCBS

As many Islamic finance jurisdictions are located in the EMDEs and small economies, it is expected that they will also face similar concerns with regards to the regulatory reforms. IIFS are already facing challenges in liquidity management, due to, among other things, a lack of liquidity management tools and highly liquid papers, the inexistence of secondary markets in most jurisdictions, and underdeveloped cross-border Islamic liquidity management. For IIFS, assets meeting the fundamental and market-related characteristics cannot automatically be recognised as HQLA, but must meet certain requirements as stipulated by the IFSB in GN-6: *Guidance Note on Quantitative Measures for Liquidity Risk Management in IIFS.* These requirements include *Sharī'ah* compliance of the structure and contracts underlying the liquid assets, and that their liquidity should be tested through sale or *Sharī'ah*-compliant alternatives of repurchase[126] (repo) transactions.

Nevertheless, the availability of *Sharī'ah*-compliant HQLA in many jurisdictions is improving.[127] In other jurisdictions where the *Sharī'ah*-compliant markets and instruments are expected to take some time to develop, the Alternative Liquidity Arrangements[128] (ALA) suggested in the LCR framework provide a way of meeting these requirements until such time as HQLA are available in sufficient supply, with deep and active secondary markets. RSAs, therefore, need to come up with their own guidance on the market-related characteristics of the *Sharī'ah*-compliant HQLA that is compatible with their jurisdiction-specific characteristics. However, as in the case of the EMDEs, differences in the recognition of HQLA across jurisdictions may penalise the treatment of certain local assets of bank subsidiaries operating in host EMDEs when calculating LCR on a consolidated basis. IIFS are also expected to face intensified competition for deposits – in particular, as IIFS that are heavily reliant on wholesale and government and public-sector entities as sources of funding begin to shift their focus to that of retail so as to meet the Basel Committee's net stable funding ratio (NSFR), which will become effective by 2018.

(c) Cross-Border Recognition of Resolution Action[129]

One of the main obstacles to the resolution of SIFIs that operate across borders is legal uncertainties about the cross-border effectiveness of resolution measures – in particular, with respect to stays on early termination rights under financial contracts and the write-down and conversion of debt instruments governed

125 https://www.bis.org/bcbs/publ/wp27.pdf

126 Some alternative structures of repos and securities borrowing used by IIFS are not widely accepted by *Sharī'ah* scholars. The LCR application on these instruments will thus be subject to the approval of the *Sharī'ah* board of the IIFS, and by the *Sharī'ah* board at the national level, if applicable.

127 The issuance of short-term *Sharī'ah*-compliant papers by the International Islamic Liquidity Management Corporation (IILM) is expected to help banks manage, in the interim, their short-term liquidity arrangements. However, the small amount of IILM *Sukūk* outstanding is still insufficient to address the current liquidity issue faced by the IFSI.

128 Alternatives include the use of central banks' "committed facilities" which can be provided at a fee, and the use of *Sukūk* denominated in foreign currency.

129 www.financialstabilityboard.org/publications/c_140929.pdf

by foreign law. The FSB consultative document, issued in September 2014, aims to address this issue by proposing: (a) a package of policy measures and guidance to be considered by jurisdictions so as to enhance the effectiveness of cross-border resolution; and (b) contractual approaches to cross-border recognition as an interim solution until comprehensive statutory regimes have been adopted in all relevant jurisdictions.

The growing internationalisation of Islamic finance over the years has resulted in heightened cross-border financial flows. The Global Financial Crisis illustrated that although IIFS were not directly impacted by the first round of the crisis, they were not totally sheltered from the adverse effects of the crisis. Hence, the greater financial and economic interlinkages arising from increased cross-border transactions of IIFS could pose a direct risk to the stability and resilience of the IFSI. Although the current international resolution tools are broadly applicable to Islamic finance, additional dimensions need to be explored, given: (i) IIFS operate based on Islamic law or *Sharīʿah*; (ii) the existence of Islamic banking windows; (iii) the complex nature of some of the Islamic finance transactions; (iv) the different interpretations of *Sharīʿah* across various *Sharīʿah* boards and scholars; (v) lack of harmonised legal approaches for Islamic finance and enforceability of legal instruments; and (vi) the different types of profit-sharing investment accounts (PSIAs) which would affect the disposal of assets and the distribution of proceeds from the liquidated assets to the liabilities of troubled or insolvent IIFS.

This signifies the importance of having in place an adequate and efficient cross-border resolution framework for the IFSI that takes into account the idiosyncrasies of Islamic finance. Key success factors for an efficient resolution framework include a close collaboration between the regulatory authority and the *Sharīʿah* board, and skilled resources in Islamic finance.

2.1.2 Basel Committee on Banking Supervision

Since the publication of the IFSI Stability Report 2014, the BCBS has finalised and issued a number of standards which were already in development at the time of the 2014 report and were discussed in that report. This section looks at selected new documents issued by the BCBS after the drafting and publication of the *IFSI Stability Report 2014.*

(a) Revised Good Practice Principles for Supervisory Colleges[130]

Following the GFC, the significance of colleges as an important component of effective supervisory oversight of international banking groups has been re-emphasised by the Group of Twenty (G-20). In 2010, the BCBS published *Good Practice Principles on Supervisory Colleges.*[131] To further clarity the relationship between home and host supervisors, and to describe how colleges typically function in practice, the BCBS issued in January 2014 a consultative document, *Revised Good Practice Principles for Supervisory Colleges*, to update the 2010 principles. Table 2.1.2.1 shows the key changes to the 2010 document.

Table 2.1.2.1: Good Practice Principles for Supervisory Colleges

Principle	Summary of 2010 Document	Key Changes in the 2014 Consultative Document
Principle 1: College objectives	To enhance information exchange and cooperation between supervisors; and enhance the mutual trust and appreciation of needs and responsibilities	Places greater emphasis on collaboration and information-sharing on an ongoing and confidential basis
Principle 2: College structures	To be structured in a way that enhances effective oversight of international banking groups, taking into account the scale, structure and complexity of the group and the corresponding needs of its supervisors	Provides greater clarity on the expectation to strike a balance between core college effectiveness and host involvement
Principle 3: Information sharing	To make their best efforts to share appropriate information with respect to the principal risks and risk management practices of the banking group	Includes the expectation that home and host supervisors will put in place appropriate mechanisms and sufficient resources for effective and timely information exchange
Principle 6: Interaction with the institution	Interaction between the college members and the banking group should complement the interaction that individual supervisors (both home and host) have with the specific entity they supervise	Encourages home and host supervisors to agree on the types of feedback provided to banks and ensure consistency in how such feedback is provided
Principle 7: Crisis management	The work of a banking group's supervisory college should serve as one of the building blocks for crisis management planning	Differentiates between banks that have established crisis management groups (CMGs) and those that do not have a CMG

Source: BCBS

While supervisory colleges are an important issue in the conventional banking industry, they may be a less immediate issue for the IFSI, given that the benefits of supervisory colleges are relevant specifically for internationally active banking groups. Currently, the presence of internationally active banking groups in Islamic finance is still limited. However, to the extent that they are present, their supervisory colleges are expected to be of interest to the supervisors of their Islamic activities.

130 www.bis.org/publ/bcbs276.pdf
131 www.bis.org/publ/bcbs177.pdf

For the present, the scope of the engagement and an appropriate structure of the supervisory college for the IFSI will continue to be guided through BCBS's *Revised Good Practice Principles on Supervisory Colleges.* However, as stipulated in IFSB-16: *Revised Guidance on Key Elements in the Supervisory Review Process of IIFS*,[132] issued in March 2014, certain aspects should be included in the scope of the supervisory college – in particular: (i) the regulatory and legal framework for IIFS; (ii) divergence of *Sharī'ah* compliance practices and integration of *Sharī'ah* supervisory boards; (iii) key disclosures on IIFS' operations[133] and confidentiality; and (iv) cross-border insolvency of IIFS as part of a group operating in more than one jurisdiction. IFSB-17: Core Principles for Islamic Finance Regulation (CPIFR) (Banking Segment) in the Essential Criteria under CPIFR 13: Home-host relationships, makes broadly similar points, including the need for clarity on the treatment of Islamic windows.

(b) Supervisory Guidelines for Identifying and Dealing with Weak Banks[134]

In light of the profound change in the global financial markets and global regulatory landscape following the 2007–09 GFC, the BCBS issued in June 2014 a consultative document, *Supervisory Guidelines for Identifying and Dealing with Weak Banks*,[135] to identify weak banks and ways to deal with them. Indeed, early identification of and intervention in weak banks is critical in order to minimise their occurrence, prevent the problem from escalating, and reduce the cost of resolving such banking problems. Diagram 2.1.2.1 highlights the guiding principles for RSAs when dealing with weak banks.

Diagram 2.1.2.1: Guiding Principles for RSAs when Dealing with Weak Banks

Source: BCBS

In a study undertaken by the IMF in 2010 entitled *The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study,*[136] it was observed that smaller investment portfolios, lower leverage and adherence to *Sharī'ah* principles helped to contain the initial impact of the GFC on Islamic banks. In fact, Islamic banks helped to contribute to financial and economic stability during the crisis. However, weaknesses in risk management practices had adversely affected the performance of some Islamic banks as the crisis moved to the real economy in 2009. Efforts have been undertaken since then by international standard-setting bodies, including the IFSB, as well as RSAs of Islamic finance jurisdictions, to strengthen the stability and resilience of IIFS and the IFSI as a whole.

Although the BCBS's guiding principles would help the RSAs to identify weak banks and contain the risk of failure, there are additional factors to be taken into account when dealing with the specificities of IIFS – in particular, in the areas of *Sharī'ah* governance, risk management and control, stress testing and resolvability assessment. For example, as highlighted in IFSB-13: *Guiding Principles on Stress Testing for IIFS*,[137] IIFS require a different approach to stress testing from that applicable to conventional institutions to ascertain how well IIFS will be able to absorb stresses and shocks that are more specific to the Islamic financial market, with regard to, for instance, credit, market and operational risks, rate of return risk and displaced commercial risk, and liquidity risks. For the RSAs, the stress testing can be used to, among other things, identify weaknesses in the financial system and structural (systemic) vulnerabilities arising from the specific risk profiles of IIFS individually and collectively.

(c) Review of the Pillar 3 Disclosure Requirements[138]

Effective disclosure is important to enhance market discipline and promote a safe and sound banking system. In June 2014, the BCBS issued a consultative document, *Review of the Pillar 3 Disclosure Requirements,*[139] which identified five guiding principles (see Diagram 2.1.2.2) and sought to address the shortcomings of the existing Basel framework Pillar 3 disclosure requirements – requirements that would enable market participants to assess more effectively key information relating to a bank's regulatory capital and risk exposures in order to instil confidence about its exposure to risk and overall regulatory capital adequacy. The review, which is the first phase of the proposed disclosure requirements, involved the following documents:

- Pillar 3 disclosure requirements for remuneration (July 2011);[140]
- composition of capital disclosure requirements (June 2012);[141]
- GSIBs: updated assessment methodology and the higher loss absorbency requirement (July 2013);[142]
- liquidity coverage ratio disclosure standards (January 2014, rev. March 2014);[143] and
- Basel III leverage ratio framework and disclosure requirements (January 2014).[144]

132 www.ifsb.org/standard/IFSB-16%20Revised%20Supervisory%20Review%20Process_March%202014%20(final-clean).pdf
133 As indicated under IFSB-4: *Disclosures to Promote Transparency and Market Discipline for IIFS.*
134 www.bis.org/publ/bcbs285.pdf
135 Defined as "one whose liquidity or solvency is impaired or will soon be impaired unless there is a major improvement in its financial resources, risk profile, business model, risk management systems and controls, and/or quality of governance and management".
136 www.imf.org/external/pubs/ft/wp/2010/wp10201.pdf
137 www.ifsb.org/standard/eng_IFSB-13%20Guiding%20Principles%20on%20Stress%20Testing%20(Mar2012).pdf
138 www.bis.org/publ/bcbs286.pdf
139 In conducting this review, the BCBS also considered the recommendations made by the *Enhanced Disclosure Task Force* (www.financialstabilityboard.org/publications/r_121029.pdf), a private-sector initiative facilitated by the FSB, which was established to improve banks' risk disclosures.
140 www.bis.org/publ/bcbs197.pdf
141 www.bis.org/publ/bcbs221.pdf
142 www.bis.org/publ/bcbs255.pdf
143 www.bis.org/publ/bcbs272.pdf
144 www.bis.org/publ/bcbs270.pdf

Diagram 2.1.2.2: Guiding Principles for Banks' Pillar 3 Risk Disclosures

Source: BCBS

The need for transparency is, above all, an important *Sharīʿah* consideration. Any form of concealment, fraud or attempt at misrepresentation violates the principles of justice and fairness in *Sharīʿah*. Following this, the IFSB published IFSB-4: *Disclosures to Promote Transparency and Market Discipline for IIFS*[145] in 2007. The standard specifies a set of key principles and practices to be followed by IIFS in making disclosures, with a view to achieving transparency and promoting market discipline. Key information to be disclosed includes: (i) the type of IIFS; (ii) capital structure and overview of capital adequacy; (iii) treatment of investment accounts; (iv) risk management process; (v) risk exposures by types of risk, and indicators of risk-sharing with investment account holders (IAH); (vi) key aspects of general governance and *Sharīʿah* governance; (vii) the scope of consumer-friendly disclosures concerning such risks and returns, *Sharīʿah* compliance and investment account products; and (viii) the role of Islamic windows.

The IFSB has already completed the revision of Pillar 1 and Pillar 2 through IFSB-15 and IFSB-16 by revising the earlier standards. As the IFSB expects that the BCBS document on Pillar 3 will have a major impact on IFSB-4, the IFSB will undertake a review of both documents, once the BCBS document is finalised, and make the necessary amendments to IFSB-4, if needs be, taking into account specific features of IIFS that are typically not well-captured in the existing guidelines and standards on transparency and disclosure for conventional banks. At this juncture, however, it is expected that the review will have an impact on the format, medium, frequency and timing of disclosure by IIFS.

(d) Operational Risk – Revisions to the Simpler Approaches[146]

In October 2014, the BCBS issued a consultative document, *Operational Risk – Revisions to the Simpler Approaches,* to address the weaknesses of the simpler approaches for operational risk – the Basic Indicator Approach (BIA) and The Standardised Approach (TSA), including its variant the Alternative Standardised Approach (ASA) – which stem mainly from the use of gross income (GI) as a proxy indicator for operational risk exposure, based on the assumption that banks' operational risk exposure increases linearly in proportion to revenue. Data from a wide range of banks, however, showed that the current non-model-based approaches for operational risk failed to correctly estimate the operational risk capital requirements of banks. Capital requirements for operational risk were found either to remain stable or to fall despite an increase in the number and severity of operational risk events during and after the financial crisis.

In the consultative document, Business Indicator (BI) has been identified as the most suitable replacement for GI, given its superior ability to capture a bank's exposure to the operational risk inherent in its mix of business activities. (Table 2.1.2.2 provides the macro-components of GI and BI items.) The BCBS also proposed a bucketing approach and coefficients that increase according to a bank's size. These are expected to better reflect banks' operational risk profiles and associated capital needs.

Table 2.1.2.2: BI and GI Decomposed by Macro-components

Components of a Bank's Income Statement	GI Items	BI Items
Interest	Interest income – Interest expense	Absolute value (Income – Expense)
Services	Fee income – Fee expense + Other operating income	Fee income + Fee expense + Other operating income + Other operating expense
Financial	Net P&L on trading book	Absolute value (Net P&L on trading book) + Absolute value (Net P&L on banking book)
Other	Dividend income	Not included

Source: BCBS

145 www.ifsb.org/standard/ifsb4.pdf
146 www.bis.org/publ/bcbs291.pdf

Operational risk[147] is significant in Islamic banks due to the specific contractual features of their mode of finance and the inadequate Islamic legal infrastructure. Its importance is also due to the nature of the business, which must be conducted as per *Sharīʿah* rules and principles. Under IFSB-15: *Revised Capital Adequacy Standard for IIFS*,[148] the proposed measurement of capital to cater for operational risk in IIFS is also based on similar approaches,[149] as shown in Table 2.1.2.3, which are in a continuum of increasing sophistication and risk sensitivity:

(i) BIA; and
(ii) TSA; or ASA.

Table 2.1.2.3: IFSB-15: Measurement of Capital to Cater for Operational Risk in IIFS

The Basic Indicator Approach (BIA)	Under this approach, the capital charge of an IIFS is equal to the average of a fixed percentage of 15% of positive annual GI over the previous three years. The GI is defined as: (i) net income from financing activities (which is gross of any provisions, operating expenses and depreciation of *Ijārah* assets); (ii) net income from investment activities, including the IIFS's share of profit from *Mushārakah* and *Muḍārabah* financing activities; and (iii) fee income (e.g. commission and agency fee); Less: (iv) share of income attributable to investment account holders and other account holders.
The Standardised Approach (TSA)	The activities of an IIFS are divided into eight lines of business (LOBs). Within each LOB, GI serves as a proxy for the likely operational risk exposure attributable to that particular business line. The total operational risk capital charge is calculated as the three-year average of the simple addition of the capital charges across the eight LOBs in each year. The capital charge for each LOB is calculated by multiplying the annual GI by the applicable percentage factor, which ranges from 12% to 18%, assigned to that business line.
The Alternative Standardised Approach (ASA)	IIFS may use ASA as an alternative to TSA, subject to supervisory approval. Under ASA, the operational risk capital charge is calculated in the same way as under TSA, except for two business lines – retail banking and commercial banking. For these two business lines, instead of using relevant GI, the amount of financing in each LOB is multiplied by a fixed factor of 0.035 to obtain the indicator of exposure.

Source: IFSB

Given the proposed change from GI to BI, upon finalisation of the BCBS document, the IFSB will commence to undertake a review of its IFSB-15 with respect to the measurement of capital to cater for operational risk in IIFS, to reflect the change from the use of GI to BI, and in particular, to cater for the specificities of IIFS. The IFSB is also collaborating with the International *Sharīʿah* Research Academy (ISRA) to undertake a study, *Capital Adequacy Requirement on Sharīʿah Non-compliance Risk*, to discuss the importance of such risk to Islamic banks, and to determine whether there is a need for additional capital charge for operational risk for Islamic banks due to *Sharīʿah* non-compliance.

(e) Corporate Governance Principles for Banks[150]

Given the importance of effective corporate governance to the proper functioning of the banking sector and the economy as a whole, the BCBS issued in October 2014 a consultative document, *Corporate Governance Principles for Banks,* which is a revision of the 2010 document, *Principles for Enhancing Corporate Governance.* Diagram 2.1.2.3 shows the main areas of change from the 2010 Principles. The document provides a framework within which banks and RSAs should operate to achieve robust and transparent risk management and decision-making. Adhering to the 13 Principles will help to promote not only public confidence but also the safety and soundness of the banking system.

147 According to IFSB-1 (2005), operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events, which includes but is not limited to legal risk and *Sharīʿah* compliance risk. This definition excludes strategic and reputation risk.

148 www.ifsb.org/standard/2014-01-28_eng_IFSB15%20Revised%20Capital%20Adequacy_(Jan%202014).pdf

149 IFSB-15 also mentions that RSAs, at their discretion, may allow the IIFS in their jurisdiction to migrate to the advanced approaches, such as the advanced measurement approach (AMA), provided that they are satisfied with, among other things: (a) the robustness of the internal models; (b) the availability of sufficient and reliable data; and (c) fulfilment of other related requirements. However, the IFSB surveys have shown that the use of this approach is almost non-existent in the Islamic finance jurisdictions.

150 www.bis.org/publ/bcbs294.pdf

Diagram 2.1.2.3: The Revised Document on Corporate Governance Principles for Banks: Areas of Emphasis

Source: BCBS

In December 2006, the IFSB issued IFSB-3: *Guiding Principles on Corporate Governance for IIFS*.[151] The document provides seven guiding principles which are divided into four main areas, namely: (i) general governance approach of IIFS; (ii) rights of investment account holders; (iii) compliance with *Sharī'ah* rules and principles; and (iv) transparency of financial reporting in respect of investment accounts. However, the Guiding Principles only address the specificities of IIFS, as the aim is to complement the existing internationally recognised standards of good corporate governance. For the present, therefore, the IFSB does not propose to undertake new work on corporate governance for IIFS in the banking sector, though it has taken into account some of the BCBS governance as it relates to governance of risk management in IFSB-16.[152] IIFS should therefore be guided by the BCBS standard when it is finalised. This suggests that they may need to give greater attention to the board's specific roles, qualifications, competency and compositions, as well as its structure and practices, given the critical role of the board and the board risk committees in strengthening the risk governance of an IIFS and overseeing the implementation of risk management systems. RSAs of IIFS should also provide guidance for and supervise and evaluate corporate governance at IIFS, evaluate the selection process of board members and senior management, and conduct regular interaction with the board and its risk and audit committees.

(f) Basel III: The Net Stable Funding Ratio[153]

In October 2014, the Basel Committee issued its latest standard for the net stable funding ratio (NSFR) which will require banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. The NSFR, which will become a minimum standard by 1 January 2018, is expected to reduce potential disruptions to a bank's regular sources of funding that would erode its liquidity position, increase the risk of its failure, and lead to broader systemic stress, as witnessed during the GFC. In essence, the NSFR limits over-reliance on short-term wholesale funding, encourages better assessment of funding risk across all on- and off-balance sheet items, and promotes funding stability. The NSFR also allows the RSAs to enforce their approach to liquidity risk management by requiring banks to change their funding structure.

$$\text{NSFR} = \frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} \geq 100\%$$

A study published by the IMF in June 2014, entitled *The NSFR: Impact and Issues for Consideration,*[154] highlighted the following concerns about the NSFR[155] raised by the industry:

(i) it may be too restrictive and undermine banks' traditional role in liquidity and maturity transformation, and could lead to a shortage in long-term lending with real consequences for economic growth;

(ii) it could make deposits less stable as banks compete for this scarce funding source;

(iii) it may encourage maturity transformation activities to migrate to the "shadow banking" sector and hence not address systemic risk;

(iv) it could have a more severe impact on EMDEs, which tend to have less developed capital markets and rely more on banks for long-term financing; and

(v) it could affect disproportionately those EMDEs that have large global bank presences, if these banks have a significant NSFR shortfall.

151 www.ifsb.org/standard/ifsb3.pdf

152 www.ifsb.org/standard/IFSB-16%20Revised%20Supervisory%20Review%20Process_March%202014%20(final-clean).pdf

153 www.bis.org/bcbs/publ/d295.pdf

154 www.imf.org/external/pubs/ft/wp/2014/wp14106.pdf

155 The study also concluded that most banks in Asia and a number of advanced countries have sufficient funding buffers to meet the 2018 deadline without having to significantly adjust their balance sheet. On the other hand, countries with larger gaps are expected to incur higher transitional costs, in particular should their systemically important banks (SIBs) suffer a shortfall.

Although some of the issues have been addressed in the final document, one of these concerns remains particularly relevant to Islamic finance jurisdictions, given that many are located in EMDEs with less developed capital markets where other parts of the economy rely more on banks for long-term financing. The shortage or unavailability of *Sharīʿah*-compliant securities/*Sukūk* compel IIFS to maintain a higher level of cash and non-earning liquid assets than their conventional counterparts. In jurisdictions where some *Sharīʿah*-compliant securities/*Sukūk* are available, the unavailability of an active trading or repurchase (repo) market remains an issue. In addition, although most IIFS rely on retail funds, there are IIFS in some Islamic finance jurisdictions who rely heavily on corporate funds or government and public-sector entities, and would be adversely affected under the new NSFR framework, unless they change the composition of their funding.

To provide a level playing field to the IIFS in the application of liquidity standards vis-à-vis their conventional counterparts, and to help promote the sound management of liquidity risk in IIFS, in April 2015, the IFSB Council at its 26th meeting held in Jakarta, Indonesia adopted GN-6: *Guidance Note on Quantitative Measures for Liquidity Risk Management in IIFS* which aimed to complement global liquidity standards with a number of additions and adjustments to meet the specificities of IIFS. These include a description of available and required stable funding under NSFR, as well as issues faced by IIFS in applying the NSFR. One such issue may be the absence of an SCDIS, which would result in all deposits or PSIA in IIFS being treated as less stable than their conventional counterparts. Details of the application, as well as the challenges of the NSFR, are provided in Section 2.2.1(b) of the report on GN-6.

2.1.3 International Organization of Securities Commissions (IOSC)

(a) Principles Regarding the Custody of Collective Investment Schemes' Assets[156]

Custodians play a key role in the safekeeping of collective investment schemes' (CIS) assets. Since the publication of the IOSCO's discussion paper, *Guidance on Custody Arrangements for CIS,* in 1996, custodians today are facing new challenges and risks – in particular, given that: (i) CIS managers now tend to invest more in complex instruments such as derivatives and index-based funds; (ii) the widespread use of electronic book entry to register and keep track of ownership changes in securities has resulted in a major change in market practices and processes; and (iii) a significant increase in the diversification and internationalisation of CIS portfolios now involves a growing number of foreign jurisdictions. Key risks identified are the risk of commingling or misuse of CIS assets or segregation, operational risk,[157] country risk, concentration risk, counterparty risk and reputational risk.

These developments, coupled with events arising from the GFC, have raised the need for the regulatory system to be equipped with rules governing the segregation and protection of client assets. In October 2014, IOSCO published a consultation paper, *Principles Regarding the Custody of CIS Assets*, which proposed nine principles (see Table 2.1.3.1) aimed at identifying the core issues that should be kept under review by the regulatory framework.

Table 2.1.3.1: Principles Regarding the Custody of Collective Investment Scheme Assets

Principle 1	The regulatory regime should make appropriate provisions for the custodial arrangements of the CIS.
Principle 2	CIS assets should be segregated from: • the assets of the responsible entity, its related entities and other schemes; • the assets of the custodian/sub-custodian throughout the custody chain; and • the assets of other clients of the custodian throughout the custody chain (unless CIS assets are held in a permissible omnibus account).
Principle 3	CIS assets should be entrusted to a third party custodian. In limited circumstances where the regulatory regime permits self-custody of CIS assets, additional safeguards should be put in place to ensure proper segregation and protection of CIS assets.
Principle 4	The custodian should be functionally independent from the responsible entity.
Principle 5	The responsible entity should seek to ensure that the custody arrangements in place are disclosed appropriately to investors in the CIS offering documents or otherwise made transparent to investors.
Principle 6	The responsible entity should use appropriate care, skill and diligence when appointing a custodian to safekeep CIS assets.
Principle 7	The responsible entity should, at a minimum, consider a custodian's legal/regulatory status, financial resources and organisational capabilities during the due diligence process.
Principle 8	The responsible entity should formally document its relationship with the custodian, and the agreement should seek to include provisions about the scope of the custodian's responsibility and liability.
Principle 9	Custody arrangements should be monitored on an ongoing basis for compliance with the terms of the custody agreement.

Source: IOSCO

[156] www.iosco.org/library/pubdocs/pdf/IOSCOPD454.pdf

[157] Risk of fraud or theft, information technology risk, inadequate record-keeping, holding non-standard assets, conflicts of interest, and legal and compliance risk.

In the IFSI, assets of Islamic CIS (ICIS) should be safely kept for the interest of investors and must not be subjected to any loss arising from inappropriate practices by ICIS operators or other responsible parties. The proposed IOSCO principles can generally be applied to the custody of ICIS assets. However, due to the level of development of the ICIS market which may vary from one jurisdiction to another, diverse approaches and practices can be seen in the ICIS market. Thus, given the development of their respective market infrastructure and regulatory environments, RSAs have to consider the impact of the implementation of such principles on the ICIS sector.

In this regard, IFSB-6: *Guiding Principles on Governance for ICIS* provides different structures of ICIS available in the market. In the case of depository models, the depository institutions are subject to the responsibility for proper custody of ICIS assets so that the IOSCO principles may be applied to those depository institutions.

(b) Report on Risk Identification and Assessment Methodologies[158]

Following the collapse of Bear Stearns & Co. Inc. and Lehman Brothers Holding Inc. in 2008, the G-20 and other international authorities agreed that securities regulators, and not just banking regulators, have a significant role in the identification of systemic risk. The IOSCO Committee on Emerging Risks prepared a report on risk identification and assessment methodologies as part of the organisation´s ongoing effort to identify, analyse and monitor systemic risk.

The IOSCO's report, *Risk Identification and Assessment Methodologies for Securities Regulators*, published in June 2014, provides a practical overview of the methods, approaches and tools that IOSCO and securities regulators have developed to identify and assess emerging and potential systemic risks.

Since securities markets are complex and involve a wide range of different types of intermediaries, products and investors, the report acknowledges that there is no one-size-fits all method for identifying trends, vulnerabilities and risks in these markets. Instead, it provides concrete examples of the different methods currently employed by the securities commissions that are members of the Committee on Emerging Risks. The report includes the definition of risk, identification methods used by securities regulators, and analytical framework for assessing systemic risks.

In order to assess systemic risk, the IOSCO uses impact factors refined into practical and concrete indicators, which are categorised into either the macro or micro level. In addition, the other factors, such as relative size or importance of the parts of the market that would be impacted by a risk, interconnectedness, and lack of substitutes/concentration, must also be considered in assessing systemic risks.

The IFSB is currently developing Prudential and Structural Islamic Financial Indicators (PSIFIs) as a tool for the identification of systemic risks in Islamic finance. Although the project only covers the banking sectors at the moment, it will also include the Islamic capital market (ICM) sector in the future. Thus it is expected to contribute to the overall financial soundness of Islamic financial systems.

2.1.4 International Association of Insurance Supervisors (IAIS)

(a) Strategic Plan and Financial Outlook, 2015–19

The IAIS adopted a new Strategic Plan and Financial Outlook (SPFO) in October 2014, during its 21st Annual Conference and General Meeting held in Amsterdam. This five-year plan (2015–19) aims to continue the Association's efforts in contributing to the financial stability of the insurance industry, such as the development of capital standards and a Common Framework (ComFrame).

Under this strategic plan, the IAIS is committed to pursuing seven high-level goals (HLGs) and strategies over the next five years. The seven HLGs are as follows:

HLG 1 : Assessing and responding to insurance sector vulnerabilities
HLG 2 : The IAIS as the global standard setter for insurance
HLG 3 : Contribution to financial stability in the insurance sector
HLG 4 : Enhancing effective supervision
HLG 5 : Enhancing implementation and observance of Insurance Core Principles
HLG 6 : Effective stakeholder outreach and external interaction
HLG 7 : Effective and efficient organisation and operations

A successful achievement of these HLGs will be a catalyst for the IFSB to adopt and implement a broadly similar approach in enhancing the stability and resilience of the *Takāful* industry. The IFSB has already indicated its intention in due course to produce a set of core principles for *Takāful*, and other elements of the IAIS's programme will be an important influence on the IFSB's forthcoming Strategic Performance Plan for 2016–18.

(b) Common Framework (ComFrame)

Since the revised Insurance Core Principles (ICPs) were adopted in October 2011 followed by the issuance of the first draft of the ComFrame for the Supervision of Internationally Active Insurance Groups (IAIGs) in July 2012, several key development initiatives by the IAIS have taken place.

[158] www.iosco.org/library/pubdocs/pdf/IOSCOPD443.pdf

In October 2014, the IAIS concluded the development of the first-ever global insurance capital standard – Basic Capital Requirements (BCR) for global systemically important insurers (G-SIIs). BCR is the first step of the IAIS initiative to develop capital requirements for group-wide supervision of G-SIIs. Under this regime, major categories of liability and asset risks that have an impact on G-SIIs as well as the on- and off-balance-sheet exposures of G-SIIs will be reflected in the computation of capital requirements. The BCR ratio is calculated by dividing total qualifying capital resources by required capital:

$$\text{BCR Ratio} = \frac{\text{Total Qualifying Capital Resources*}}{\text{Required Capital**}}$$

Notes:

* *Total qualifying capital resources are determined on a consolidated group-wide basis for all financial and material non-financial activities and are classified as either core or additional capital.*

** *Required capital is calculated on a consolidated group-wide basis for all financial and material non-financial activities.*

Reporting of BCR by G-SIIs to the group-wide supervisor is expected to take effect starting from 2015. This reporting period will be used by the IAIS to review its suitability and ensure that BCR remains fit. All G-SIIs are required to hold capital no lower than BCR plus higher loss absorbency (HLA) requirements. The combination of both BCR and HLA will provide a complete group-wide capital requirement that shall apply to G-SIIs only. This is to reflect the G-SIIs' systemic importance in the international financial system.

As a broader initiative, the IAIS is developing a risk-based group-wide global Insurance Capital Standard (ICS) which will be applied to IAIGs. Once the development of ICS is completed by end-2016, BCR's role to complement HLA is to be taken over by the ICS. This is due to be applied to IAIGs from 2019.

When the IFSB issued IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings*[159] in December 2010, this standard set out key principles for solvency requirements which are consistent with those set out by the IAIS. The standard, however, focuses only on the *Takāful* undertaking as a single entity and does not cover issues of group-wide supervision.

The most recent publication made by the IAIS with regards to capital requirement is the document issued for public consultation on the risk-based global ICS on 17 December 2014. This document covers issues of valuation and qualifying capital resources, and puts forward a standard method and other potential methods for determining the ICS capital requirement. While the ICS is intended initially for IAIGs and G-SIIs, there is merit in recognising the possibility that the standard will come to be applied more widely, including at individual entity level. In consequence of this, the IFSB may in the longer term need to review IFSB-11, and may also need to consider whether it needs to consider group-level capital requirements for groups containing one or more *Takāful* (or *Retakāful*) undertakings.

The issue of group consolidation in *Takāful* is likely to be a particularly relevant one, especially since the IAIS document pays little attention to the issues on consolidation when assets and liabilities are not effectively fungible between group members. This is significant for the *Takāful* industry, since the element of mutuality required by *Sharīʿah* requires clear segregation of funds between those belonging to the participants and those belonging to shareholders. In addition, since the participants will be different for each *Takāful* undertaking, the funds belonging to participants will not be fungible between different entities in the same group.

(c) Recovery and Resolution Planning for Systemically Important Insurers: Guidance on Identification of Critical Functions and Critical Shared Services[160]

In October 2014, the FSB, in consultation with the IAIS, issued a consultative document, *Recovery and Resolution Planning for Systemically Important Insurers,* to identify critical functions and critical shared services, and to provide guidance on the implementation of recovery and resolution planning requirements for systematically important insurers. The first part of the document provides a framework for identification of critical functions within an insurance firm, while the second part provides a framework for critical shared services.

At present, this document may be of relevance only to *Takāful* operators that are subsidiaries of systemically important insurers. As the *Takāful* industry grows, there may be a need for the IFSB to consider looking into issues of recovery and resolution for systemically important firms, and this IAIS work will be highly relevant to this.

2.2 Recent Initiatives Undertaken by the IFSB

This session discusses the initiatives undertaken by the IFSB over the last year which are in line with its Strategic Performance Plan (SPP) 2012–2015[161] approved by the Council in March 2012. The discussion focuses on Strategic Key Result Area (SKRA) 1, on the formulation, adoption and implementation of prudential standards for Islamic finance, which covers the development of new standards, adoption of IFSB standards by the member countries, and coverage of various issue areas for the IFSI.

2.2.1 Development of New Standards

(a) Guiding Principles for *Retakāful* (Islamic Reinsurance) Undertakings

Feedback obtained by the IFSB from the *Takāful* and *Retakāful* industry suggested the need to establish a working group to address issues pertaining to the *Retakāful* sector. Recognising the issues that the *Takāful* industry faces in relation to *Retakāful*, the Technical Committee (TC) of the IFSB, in its 31st meeting held in Kuala Lumpur in October 2013, recommended to the IFSB Council to approve

159 www.ifsb.org/standard/IFSB-11%20-%20Standard%20on%20Solvency%20Requirements%20for%20Takaful%20(Islamic%20Insurance)%20Undertakings.pdf
160 www.financialstabilityboard.org/publications/c_141016.pdf
161 www.ifsb.org/docs/IFSB-SPP-report_2013.pdf

preparation of a new standard in this area. Consequently, the Council of the IFSB, in its 23rd meeting held in Doha, Qatar, in December 2013, approved development of a standard named *Guiding Principles for Retakāful (Islamic Insurance) Undertakings.* In view of this, the IFSB has established a working group for the preparation of this standard. The standard, which is targeted to be completed in year 2016, is expected to address the following five broad areas:

(i) ***Governance*** of *Retakāful* undertakings may focus on the need for *Retakāful* operators to manage a comprehensive governance framework that is appropriate for their *Retakāful* business models, whereby the organs of governance within the institution are given appropriate powers to oversee, control and review the administration of the Shareholders' Fund (SHF) and the *Takāful* Operators' Risk Fund (TORF). This should be done with a view to ensuring the *Retakāful* operators' adherence to the objective of protecting the interests of cedant *Takāful* undertakings. In addition, governance of *Retakāful* undertakings calls for the need for *Retakāful* operators to adopt an appropriate code of ethics and conduct with the aim of achieving the highest standards of truthfulness, honesty and fairness in all its dealings.

(ii) ***Compliance with Sharīʿah principles*** may include topics on the acceptance of conventional risks by *Retakāful* operators, reliance on cedant *Takāful* operators' *Sharīʿah* committee in making decisions, as well as ceding of risks by *Takāful* operators to conventional reinsurers. This section may also cover areas that need the specific attention of a *Sharīʿah* committee, especially in ensuring that there are policies and procedures in place for *Sharīʿah* assessment of proposed *RetroRetakāful* arrangements, in particular where it is proposed that such arrangements are made with conventional reinsurers. The *Sharīʿah* committee may also need periodically to review the *Retakāful* model used by *Retakāful* operators to ensure compliance with *Sharīʿah* principles.

(iii) ***Prudential framework*** of *Retakāful* undertakings includes the need to meet regulatory capital requirements to ensure the funds' solvency in meeting claims from cedant *Takāful* operators, and this includes an elaboration on *Qarḍ* and the impact it has on the interests of the shareholders. In addition, the need to have a proper risk management framework in place, as well as to adopt and implement a sound investment strategy to prudently manage the assets and liabilities of *Retakāful* undertakings, is pertinent in ensuring the *Retakāful* operators' ability to manage the risks of cedant *Takāful* operators.

(iv) ***Transparency and disclosure*** for *Retakāful* operators may cover areas such as the disclosure of information pertaining to its operations. This may include the type of *Retakāful* model being used, the *Sharīʿah* governance arrangements, the basis of determination and attribution of underwriting and investment surplus, and the basis on which surplus will be distributed.

(v) ***Supervisory review of Retakāful/reinsurance arrangements*** may cover areas of supervision by regulatory authorities on the *Retakāful*/reinsurance programmes of *Takāful* undertakings and *RetroRetakāful*/retrocession programmes of *Retakāful* undertakings. The supervision not only covers the prudential standpoint but also ensures that *Sharīʿah* compliance is not compromised. This section also discusses the need for proper allocation of commissions, recoveries and distribution of surplus into the appropriate funds.

(b) Guidance Note 6: Guidance Note on Quantitative Measures for Liquidity Risk Management in IIFS *[Excluding Islamic Insurance (Takāful) Institutions and Islamic Collective Investment Schemes]*

The IFSB issued the expoure draft of GN-6 on 31 October 2014 for public consultation to adapt the Basel III liquidity standards for IIFS, which are the LCR and the NSFR.[162] On 2 April 2015, the IFSB Council at its 26th meeting held in Jakarta, Indonesia adopted GN-6 which includes appropriate calibration and necessary modifications for IIFS that fully take into consideration the nature and specificities of their operations in order to further strengthen the regulatory regime for the liquidity risk management of IIFS. It also complements other prudential standards issued by the IFSB, and supports the harmonised application of the international regulatory regime in the area of liquidity risk management, including related documents for LCR, NSFR and disclosure requirements issued by BCBS. The main objectives of GN-6 are as follows:

(i) to provide guidance on the application of global liquidity standards LCR and NSFR for the IIFS;
(ii) to provide guidance to supervisory authorities on the application of the liquidity standards in their jurisdictions and on their role in assessing the discretionary items specified in GN-6, including application of the ALAs; and
(iii) to delineate the disclosure requirements required alongside the application of LCR and NSFR.

GN-6 acknowledges that it is difficult for IIFS to find liquid instruments that can meet the criteria for HQLA. Limited supply of *Sharīʿah*-compliant instruments, and most importantly, the low level of trading in these instruments even during normal market conditions, as IIFS tend to hold most of these instruments up to maturity, are some of the important impediments for IIFS. Only a few jurisdictions have an active Islamic money market and capital market. Thus, Basel III requirements for the instruments to be traded in a large, active and deep repo market are effectively difficult, if not impossible, for the IFSI to meet. In addition, RSAs need to come up with their own guidance on the fundamental and market-related characteristics of the *Sharīʿah*-compliant HQLA that is compatible with their jurisdiction-specific characteristics. Lack of *Sharīʿah*-compliant lender-of-last-resort (SLOLR) and SCDIS schemes is another impediment highlighted in GN-6. These two schemes are important for IIFS to protect their soundness and stability in situations of serious liquidity stress, and deposits protected by a deposit insurance scheme (DIS) receive more favourable treatment within the NSFR regime.

[162] The final rules for LCR and NSFR were issued by BCBS in January 2013 and October 2014, respectively.

(i) Application of the LCR in IIFS

This section includes the components of the LCR which consist of *Sharīʿah*-compliant HQLA as the numerator and net cash outflows as the denominator, as well as the ALAs, which enable jurisdictions with insufficient HQLA to apply.

Components of the HQLA

HQLA are the assets that can be easily and immediately converted into cash, with no or little loss of value, during a time of stress. To be considered as HQLA, an asset must have fundamental and market-related characteristics particularly in terms of low risk, ease and certainty of valuation, and low volatility, as well as fulfil the operational requirements set by GN-6. The fundamental and market-related characteristics are calibrated according to specificities of assets in the IIFS' balance sheet.

HQLA should also be eligible for intraday and overnight liquidity facilities offered by the central bank or other relevant authority. GN-6 proposes that central banks should consider according HQLA status to *Sharīʿah*-compliant securities which they accept as eligible collateral, up to the limit of the liquidity facility that they would accord to the IIFS holding such securities on the basis of such collateral because of the unavailability of a well-established history of trading in liquid secondary markets. The eligibility criteria for HQLA are intended to ensure that an IIFS' HQLA stock endows the IIFS with the ability to generate liquidity in fairly short order, through sale or secured funding in a stress scenario.

Net cash outflows

The total net cash outflows are calculated as the total expected cash outflows minus total expected cash inflows in the specified stress scenario mentioned in GN-6, similar to the Basel III LCR's stress scenario for the subsequent 30 calendar days. The most important issue in this subsection is the treatment of PSIA – which may be unrestricted or restricted in nature – as they are currently a major source for generating funds for many IIFS. PSIA are mostly offered on the basis of *Muḍārabah* or *Wakālah* contracts. According to GN-6, treatment of PSIA depends on the withdrawal rights of the IAH. If IAH of a restricted profit-sharing investment account (RPSIA) does not have the right to withdraw funds before the contractual maturity date, the RPSIA is not exposed to run-off for LCR purposes, unless the contract maturity date falls within the next 30 days. Only in the case of RPSIA from which the IAH may withdraw funds at less than 30 days' notice without any "significant reduction of profit" is the IIFS exposed to run-off for LCR purposes. For UPSIA, if the withdrawal is permitted either on demand or at less than 30 days' notice, the RSA will need to apply the appropriate run-off factor as set out in GN-6. As in the case of *Muḍārabah*-based PSIA, run-off rates for *Wakālah*-based PSIA are again based on the contractual withdrawal rights of the IAH. RSAs, however, may apply different run-off factors for various components should the behavioural characteristics of these liabilities and PSIA components so suggest.

ALA treatments for IIFS

In most jurisdictions, IIFS face a variety of problems in meeting the LCR requirement. Considering the fact that the Islamic finance sector in many jurisdictions is still in an early stage of development, such jurisdictions experience a lack of supply of *Sharīʿah*-compliant HQLA. In order to meet the demand for *Sharīʿah*-compliant HQLA, RSAs may apply the ALA treatments. To conclude that there is an insufficiency of HQLA in its jurisdiction, an RSA should evaluate and be able to demonstrate the lack of supply of HQLA in the domestic and other major currencies used by the IIFS in the jurisdiction, taking into account all relevant factors affecting the supply of, and demand for, such HQLA.

The three ALA suggested by GN-6 for the jurisdictions with insufficient HQLA are as follows:

- **Option 1:** Contractual committed liquidity facilities from the relevant central bank with a fee can be applied to IIFS without a major *Sharīʿah* concern, given that the rules require that "a fee for this facility is charged regardless of the amount". The facility can be constructed by using a *Wakālah*, *Muḍārabah* or *Murābahah* contract, or any other or a combination of various *Sharīʿah*-compliant contracts.

- **Option 2:** Foreign currency HQLA to cover domestic currency liquidity needs will also provide a useful mechanism for the RSAs to permit IIFS in their jurisdictions to tap liquidity from outside the jurisdiction, if *Sharīʿah*-compliant HQLA are in short supply in the local market. *Sukūk* issued by multilateral development banks (MDBs), as well as other international Islamic infrastructure institutions such as the Islamic Development Bank (IDB) and the IILM, fall under this option.

- **Option 3:** Additional use of Level 2 assets with a higher haircut will be suitable for those jurisdictions where highly rated corporate *Sukūk* are available in good quantity, which can be used to fill the gap in the limited supply of Level 1 assets.

To govern the use of the above options by their IIFS, RSAs in jurisdictions with insufficient HQLA should be guided by the principles set out in the ED. These principles will be the main source of reference for RSAs for the assessments of their ALA treatment.

(ii) Application of the NSFR in IIFS

The purpose of the NSFR is to promote resilience over a longer time horizon by creating additional incentives for institutions to fund their activities with more stable sources of funding on an ongoing basis. The NSFR supplements the LCR and has a time horizon of one year. There are two components of the NSFR: available stable funding (ASF) and required stable funding (RSF). The amount of ASF is composed of the total amount of an IIFS's (i) capital, (ii) UPSIA with a maturity equal to or greater than one year, (iii) liabilities or *Sukūk* issued with effective or remaining maturities of one year or greater, and (iv) that portion of "stable" non-maturity deposits and/or term deposits or UPSIA with maturities of less than one year that would be expected to stay with the IIFS for an extended period in an idiosyncratic stress event. *Sukūk* issued with an effective maturity of one year or more would qualify for a 100% ASF. RPSIA do not count as ASF, but retail UPSIA may fall into either the 95% or the 90% category.

The amount of RSF is measured using supervisory assumptions about the broad characteristics of the liquidity risk profiles of a firm's assets and off-balance sheet exposures. A certain RSF factor is assigned to each asset type, with those assets deemed to be more liquid receiving a lower RSF factor and therefore requiring less stable funding. Under the current calibration, cash attracts a 0% RSF factor, while unencumbered financing to retail customers and small businesses with less than a year to maturity attracts an RSF factor of 85%.

The NSFR constrains the ability of IIFS as financial intermediaries to benefit from maturity transformation and the so-called yield curve – namely, the fact that they can normally raise short-term funds more cheaply than the rates of return they can earn by providing longer-term funding. For this reason, determining the parameters of the NSFR so as to strike a balance between achieving a maintainable maturity structure and overly constraining the ability of IIFS to benefit from the yield curve will remain a delicate task under the NSFR regime. The challenge for IIFS and their RSAs is to intensify their efforts to review the structure and tenure of current Islamic funding sources to achieve a more stable funding base.

The NSFR should help discourage IIFS' overreliance on short-term wholesale funding (less than one year) and encourage greater mobilisation of stable sources. The NSFR is a structural prudential measure of maturity transformation risk. While the NSFR does not impact IIFS more deeply than their conventional peers, given that IIFS generally rely on retail funding from individuals and small and medium (SME) customers, some IIFS may face the following difficulties in the application of the NSFR:

- In most IFSB member jurisdictions, the absence of an SCDIS is a major impediment to the IIFS that would result in a higher ASF factor. Because of the unavailability of such a scheme, all deposits or PSIA in IIFS have a 90% ASF factor.

- An ASF factor of 50% has been applied on the "funding with residual maturity of less than one year from sovereigns, public sector entities (PSEs), and multilateral and national development banks". Many IIFS in the IFSB member countries rely on wholesale deposits and PSIA provided by sovereigns and PSEs due to the high level of revenues from the commodities sector, such as oil and gas.

- The NSFR framework could also negatively affect the incentive for IIFS to provide longer-term financing due to the higher RSF factor. It could force IIFS to reduce the size of their long-term portfolio, such as project finance, and to channel funding to assets having a lower RSF.

(iii) Role of RSAs

This section includes the roles of RSAs in various issues related to the application of LCR and NSFR, including internal liquidity adequacy assessment (ILAAP) and supervisory liquidity review processes (SLRP), LCR by significant currency, frequency of monitoring, disclosure requirements and cross-border issues in applying LCR. The approaches are similar to those in the BCBS standard.

Cross-border issues in applying LCR requirements

To ensure consistency in applying the consolidated LCR in IIFS across jurisdictions, both RSAs and IIFS need further information for applying LCR in the following areas:

- ***Differences in home/host liquidity requirements, treatment of liquidity transfer restrictions and currencies.*** National differences in liquidity treatment may occur in those items subject to national discretion (e.g. deposit run-off rates, contingent funding obligations, treatment of PSIA, etc.) and where more stringent parameters are adopted by some RSAs.
- ***Treatment of liquidity transfer restrictions***. Liquidity transfer restrictions (e.g. ring-fencing measures, non-convertibility of local currency, foreign exchange controls, etc.) in jurisdictions in which a holding company or its subsidiaries operate will affect the availability of liquidity by inhibiting the transfer of HQLA and fund flows within the group.
- ***Currencies.*** RSAs and IIFS cannot assume that currencies will remain transferable and convertible in a stress period, even for currencies that in normal times are freely transferable and highly convertible.

2.2.2 The IFSB Surveys

(a) Strengthening the Financial Safety Net: The Role of *Sharī'ah*-Compliant Deposit Insurance Schemes

Recognising the rapid growth in market share of the IFSI in many jurisdictions and its potential significance for the systemic soundness and stability of the overall financial system, the Council of the IFSB, in its 20th meeting held on 29 March 2012 in Manama, Bahrain, approved the IFSB Strategic Performance Plan 2012–2015, which includes cross-border studies on the need for the development of financial safety nets, namely *Sharī'ah*-compliant lender-of-last-resort and *Sharī'ah*-compliant deposit insurance scheme (SCDIS), for the IIFS.

Following its first study on SLOLR which was undertaken and published by the IFSB in April 2014,[163] the IFSB has commenced a second study on SCDIS. The study involved a survey undertaken by the IFSB from July to August 2014 to determine the current status of SCDIS, identify countries' experiences in developing and implementing SCDIS, and ascertain the key issues and challenges faced by central banks/monetary authorities in the development and implementation of SCDIS. The following discussion illustrates the key findings of the survey, based on responses received from 27 RSAs[164] who are members of the IFSB.

Availability of a SCDIS Mechanism in the IFSI for IIFS

In general, 67% of the RSAs (18 out of 27) indicated that a Conventional Deposit Insurance Scheme (CDIS) facility exists in their respective jurisdictions and is granted universally to

[163] www.ifsb.org/docs/WP-01_(2014%20April)%20Working%20Paper%20on%20SLOLR.pdf

[164] The IFSB received in total 29 responses out of the total of 33 RSAs, a response rate of 88%. Two of these respondents indicated that they have no valuable information to contribute on this subject. Thus, there were 27 substantive responses in total. The survey was also sent to the Indonesian Deposit Insurance Corporation (IDIC) and Malaysia Deposit Insurance Corporation (MDIC) and their responses have been consolidated with their respective RSAs, therefore creating one response per jurisdiction.

conventional commercial banks and Islamic commercial banks licensed by a central bank/monetary authority.[165] However, the CDIS cannot be extended unchanged to IIFS, mainly because of their business model which calls for certain adjustments in the way the scheme is structured and operationalised.

On the liability side, certain categories of investment accounts such as PSIA are usually operated under the *Muḍārabah* contract, which, in principle, does not allow the guarantee of either capital (principal) or a fixed return on that capital by the *Muḍārib* (the IIFS). Thus, PSIA are based on participatory modes (sharing the profit/bearing the loss), and consideration needs to be given as to whether they should, or can, be eligible for depositor protection.

Meanwhile, for restricted PSIA, where monies are invested in specified assets or types of assets agreed in advance, they function similarly to CIS or discretionary asset portfolios and, as such, are not usually considered for depositor protection. However, the more widely used structure in Islamic banking is the unrestricted PSIA,[166] where a bank invests the funds in an asset pool, together with funds from (unremunerated) current accounts and shareholders' funds – which makes the IAH effectively a participant in the IIFS' general banking business – and is entitled to the profits and liable for the losses arising from the investments.

For capital adequacy purposes, some supervisors treat PSIAs as if they were deposits, while some others treat them as only partly risk-bearing. This raises important questions and issues for SCDIS on recognising the distinctive characteristics of PSIA, the protection mechanism (i.e. the contribution mechanism to the scheme), and how to reflect the interests of IAH during liquidation or insolvency. However, leaving the IAH without *Sharīʿah*-compliant protection may endanger the financial system, because of the risks of a run by IAH, and may not provide a level playing field for the customers of Islamic, as compared with conventional, banks.

In general, there are three broad approaches adopted by the RSAs: (a) protecting Islamic deposits under a conventional deposit insurance system; (b) developing an SCDIS alongside a conventional system; and (c) developing an SCDIS in a fully Islamic banking environment. However, the survey shows that only four RSAs (out of 24) – Bahrain, Malaysia, Nigeria and Sudan – have developed and implemented special SCDIS facilities for IIFS in their respective jurisdictions. Appendix 2 shows some of the important features of SCDIS facilities provided by the four jurisdictions.

Meanwhile, five RSAs (out of 24) revealed that SCDIS facilities have not been developed and implemented in their respective jurisdictions, as they have a CDIS available. Further, they do not differentiate between conventional institutions and IIFS when it comes to providing deposit insurance, due to prudential reasons. The small market share of Islamic banking assets, identical regulatory framework for conventional banks and IIFS, and absence of laws governing *Sharīʿah* compliance with the financial sector, are the key reasons for not having SCDIS in these jurisdictions.

Chart 2.2.2.1: Current Status of SCDIS Development

The remaining 15 RSAs (out of 24) that do not have an SCDIS consider it of high importance to develop and implement an SCDIS in the future, with the approximate time frame for developing SCDIS facilities ranging from one to five years. In this respect, a third of the total respondent RSAs indicated that they have assessed and studied the necessary legal, tax and regulatory changes to accommodate the development of SCDIS in their jurisdiction. Two jurisdictions have already created the necessary legal, tax and regulatory framework, although they are yet to be put into operation. Jordan expects its SCDIS to be fully operational within a period of one to two years.

Challenges to be Addressed

The IFSB survey also identified the following three main issues which currently hinder the progress of SCDIS in Islamic finance jurisdictions:

(i) *Sharīʿah* compliance perspective, such as differing interpretations of *Sharīʿah* rulings, or *Fatāwa*, on financial matters across the jurisdiction with respect to IIFS's operations, lack of clarity on the treatment of various deposits and types of deposits and investment accounts, and limitations on appropriate *Sharīʿah*-compliant instruments for SCDIS to invest in. In addition, defining the adequate level of guarantee in accordance with the principles of *Sharīʿah*, the conditions of providing a guarantee on Islamic deposits and investment accounts, and Islamic banks' investment operations of the IIFS, and developing a process ensuring the *Sharīʿah* compliance of SCDIS operations, represent important issues for consideration in the development of a SCDIS.

(ii) Regulatory and supervisory perspective, such as the dual banking system vs. a full-fledged Islamic banking system, the specific issues related to the existence of Islamic windows, the requirement for safety nets, including SLOLR and SCDIS under the preconditions for effective supervision outlined in the core principles documents of the IFSB and BCBS, the treatment of PSIAs and other deposit accounts, and supporting infrastructure, as well as lack of qualified resources with adequate skills and expertise are some of the major impediments.

(iii) Legal and legislative perspective, such as formulation of the necessary changes to existing laws and regulations, and securing the necessary approvals from legislative bodies and Ministers, as well as an insolvency regime for PSIA and other depositors.

[165] However, there is also evidence in certain jurisdictions which suggests that a CDIS is also provided to conventional and Islamic investment banks. Other types of financial institutions – conventional and Islamic rural banks, microfinance banks and merchant banks, finance companies, offshore banks, etc. – also qualify in many jurisdictions.

[166] In this section, references to PSIA should be taken to be to UPSIA unless otherwise specified.

Conclusion

The survey indicates that an SCDIS not only contributes to systemic stability and consumer protection, but also helps to create a level playing field for Islamic and conventional banks (if investment accounts are understood as "true" profit-and-loss sharing instruments). Given that Islamic deposit insurance is relatively new, the survey results highlighted that currently only a few jurisdictions have set up an SCDIS, while some other countries provide protection for Islamic deposits and PSIA under their conventional systems. Furthermore, those who have an SCDIS in place follow significantly different operational models due to legal and regulatory considerations and differences in funding products offered by the IIFS in their jurisdictions.

The results demonstrated that treatment of PSIA for the calculation of CAR in respondent RSAs varied from jurisdiction to jurisdiction; thus, the debate on the treatment of PSIA as deposits or investments continues to prevail internationally. Determining the insurability of deposit products of an IIFS and the priority of payments for each funding product is considered an important challenge for RSAs. In addition, deposit insurance providers face difficulties in investing surplus funds, as limited *Sharī'ah*-compliant liquid instruments are available. The question for Islamic finance, however, is not whether a deposit insurance scheme should be implemented, but how it should be structured to be *Sharī'ah*-compliant. Moving forward, these issues will be addressed in detail by the IFSB in its working paper on SCDIS.

(b) Implementation of the IFSB Standards

The IFSB members implement the IFSB's standards and guidelines[167] on a voluntary basis. Each member of the IFSB is entitled to determine its own timeline for implementation based on the market and industry dynamics in its territory/jurisdiction. In its SPP, 2012–2015, the IFSB identifies four strategic key result areas, which include SKRA 1: Formulation, Adoption and Implementation, Publicising and Promoting Prudential Standards for Islamic Finance; and SKRA 2: Technical Assistance and Capacity Building. These two SKRAs require the IFSB Secretariat to conduct an annual survey on the implementation of standards among its member RSAs with the aim of following up on the progress of implementation and assessing the support required by the authorities in implementing the standards. Following this, the IFSB undertook its third IFSB Standards Implementation Survey in 2014 (2014 Survey) to assess the implementation status of the IFSB standards, with a view to formulating policy recommendations for the implementation process over the medium to longer term.

Diagram 2.2.2.1: The IFSB's Strategic Performance Plan, 2012–2015

Source: IFSB Strategic Performance Plan, 2012–2015

In the 2014 Survey, the number of respondent RSAs was 30 from 22 countries, which consisted of 21 IFSB full members, seven associate members, and two observer members from Asia, GCC, North Africa and West Africa. As of end-December 2014, a total of 16 IFSB standards covering the three sectors of the IFSI – namely, Islamic banking, *Takāful* and the Islamic capital market – were assessed in the survey questions.

The key findings of the 2014 Survey are presented below.

(a) Banking Sector

All the IFSB standards in the banking sector, including those issued recently, have been implemented by one or more RSAs (Chart 2.2.2.2). Based on the assessment on 22 RSAs which are supervising the banking sector, a total of 12 RSAs (55% of respondents) have implemented one or more standards, two RSAs (9%) were in the process of implementing them ("in progress"), and six RSAs (27%) were planning to implement the IFSB standards.

[167] Refer to www.ifsb.org/published.php for a full list of IFSB standards.

Chart 2.2.2.2: Implementation Status of the IFSB Standards in the Banking Sector

Standards	IFSB -1	IFSB -2	IFSB -3	IFSB -4	IFSB -5	IFSB -7	IFSB -12	IFSB -13	IFSB -15	IFSB -16
Base	22	10	22	22	9	7	22	22	21	20

Source: IFSB Standards Implementation Survey, 2014

The chart shows that about one-third of respondent banking RSAs implemented IFSB-1: *Capital Adequacy, IFSB-3: Corporate Governance* and IFSB-4: *Disclosure to Promote Transparency and Market Discipline.* Another 15–20% of RSAs were in the process of implementing them, and about one-third of RSAs were planning to implement those standards. Of the recently issued IFSB standards, IFSB-15: *Revised Capital Adequacy* was already implemented by one-third (7 out of 21) of RSAs within a year after its issuance, and around 50% (11 out of 21) RSAs were in the process or planning to implement the said standard. More than one-fifth of RSAs had implemented IFSB-13: *Stress Testing* and IFSB-16: *Revised Supervisory Review Process,* and most of the RSAs indicated that they were planning to implement those standards. Only IFSB-12: *Liquidity Risk Management* has a low implementation rate (9%, or 2 out of 22 RSAs); however, another 41% RSAs (9 out of 22) were in the process of implementing the standard.

The two IFSB Capital Adequacy Standards for IIFS, IFSB-2 and IFSB-7, were completely implemented by 70% (7 out of 10 respondent RSAs) and 57% (4 out of 7 respondent RSAs), respectively. However, the results are not conclusive because of the low number of responses for these two standards. Since IFSB-2 and IFSB-7 are mainly based on Pillar 1 of Basel II, only banking RSAs that are adopting Basel II responded to these standards.

(b) *Takāful* Sector

Out of 10 RSAs supervising the *Takāful* sector, three respondents implemented at least one IFSB standard, three RSAs were in progress, and another two RSAs were planning to implement the standards.

Chart 2.2.2.3: Implementation Status of the IFSB Standards in the *Takāful* Sector (10 RSAs)

Source: IFSB Standards Implementation Survey, 2014

Chart 2.2.2.3 shows that overall, 20–30% of respondent RSAs had implemented IFSB standards in the *Takāful* sector, 30% of RSAs were "in progress", and 20–30% of RSAs were planning to implement the standards. IFSB-8: *Governance for Takāful Undertakings* and IFSB-11: *Solvency Requirements for Takāful Undertakings* were implemented by 30% (3 out of 10 respondent RSAs) and 20% (2 out of 10 respondent RSAs), respectively. The new *Takāful* standard, IFSB-14: *Risk Management for Takāful Undertakings*, published after the 2013 Survey, was implemented by two out of ten respondent RSAs within a year of its issuance.

(c) Capital Market Sector

In the capital market sector, the survey found that 36% (4 out of 11 RSAs) implemented IFSB-6: *Guiding Principles on Governance for Islamic Collective Investment Schemes (ICIS)* in 2014. However, one out of 11 respondent RSAs (9%) was in the "in progress" category, followed by 9% of RSAs in the "planning" category (Chart 2.2.2.4).

Chart 2.2.2.4: Implementation Status of the IFSB Standards in the Islamic Capital Market Sector (11 RSAs)

Source: IFSB Standards Implementation Survey, 2014

(d) Cross-sectoral

A total of six RSAs (out of 25 respondent RSAs) have fully implemented both the cross-sectoral standards – namely, IFSB-9: Guiding Principles on Conduct of Business for IIFS and IFSB-10: *Guiding Principles on Sharī'ah Governance Systems* for IIFS, which are applicable to all Islamic finance sectors – banking, *Takāful* and capital market. IFSB-9 and IFSB-10 were implemented by 29% (7 out of 24) and 36% (9 out of 25) of respondent RSAs, respectively (Chart 2.2.2.5).

Chart 2.2.2.5: Implementation Status of Cross-sectoral IFSB Standards

Standards	IFSB-9	IFSB-10
Base	24	25

Source: IFSB Standards Implementation Survey, 2014

Overall assessment

Overall, the 2014 Survey finds that 15 RSAs (54%) out of 28 respondent RSAs implemented one or more IFSB standards, four RSAs (14%) were already in progress, four RSAs (14%) planned to implement at least one standard, while five RSAs (18%) did not plan to implement any standard.

While analysing the implementation status of the IFSB standards, an important consideration is the market share of the Islamic segment of the respective sectors. Out of the total 28 respondent RSAs, 17 have more than a 5% market share in their respective sectors.

It is assumed that RSAs that are supervising an Islamic finance sector with more than 5% market share would have a higher incentive to implement the IFSB standards. Analysing the results based on this benchmark, the implementation of most of the IFSB standards was found to be much higher in jurisdictions with more than a 5% market share. Overall, with a minimum of 5% market share of total Islamic finance assets, the 2014 Survey finds that 11 RSAs (65%) out of 17 respondent RSAs implemented one or more IFSB standards. One RSA (6%) was in progress, and five RSAs (29%) planned to implement at least one standard (Chart 2.2.2.6).

Chart 2.2.2.6: Standards Implementation (Minimum One IFSB Standard) – Comparison of Overall Results with More than 5% Market Share

Table 2.2.2.1 summarises the implementation of IFSB standards with respect to all segments of the IFSI.

Table 2.2.2.1: Summary of Implementation of IFSB Standards by the Respondent RSAs

	IFSB-1	IFSB-2	IFSB-3	IFSB-4	IFSB-5	IFSB-6	IFSB-7	IFSB-8	IFSB-9	IFSB-10	IFSB-11	IFSB-12	IFSB-13	IFSB-14	IFSB-15	IFSB-16
1- Completed	8: (36)	7: (70)	8: (36)	7: (32)	6: (67)	4: (36)	4: (57)	3 :(30)	7: (29)	9: (36)	2: (20)	2: (9)	5: (23)	2: (20)	7: (33)	4: (20)
2- In progress	3: (14)	2: (20)	4: (18)	4: (18)	3: (33)	1: (9)	2: (29)	3: (30)	3: (13)	3: (12)	3: (30)	9: (41)	3: (14)	3: (30)	2: (10)	2: (10)
3- Planning	8: (36)	1: (10)	7: (32)	8: (36)	-: (-)	1: (9)	1: (14)	2: (20)	7: (29)	7: (28)	2: (20)	7: (32)	11: (50)	3: (30)	9: (43)	11: (55)
4- Do not plan to	3: (14)	-: (-)	3: (14)	3: (14)	-: (-)	5: (45)	-: (-)	2: (20)	7: (29)	6: (24)	3: (30)	4: (18)	3: (14)	2: (20)	3: (14)	3: (15)
Base	**22**	**10**	**22**	**22**	**9**	**11**	**7**	**10**	**24**	**25**	**10**	**22**	**22**	**10**	**21**	**20**

Legend:

1. Complete (i.e. implementation is complete)
2. In progress (i.e. implementation is in progress)
3. Planning (i.e. not yet commenced, but are planning to implement)
4. Do not plan to (i.e. do not plan to implement, e.g. because not relevant to the supervisory authority).

Source: IFSB Standards Implementation Survey, 2014
Note: Figures in parentheses indicate percent of implementation with respect to base RSAs.

There is an improvement in implementation of some standards in 2014 as compared to those in 2013. This comparison is confined only to those jurisdictions (19 respondent RSAs) that participated in both the survey periods. The implementation progress was seen particularly in IFSB-3, IFSB-4, IFSB-5, IFSB-6, IFSB-7 and IFSB-11, where the number of RSAs that implemented the standards in 2014 increased as compared to the year before (Chart 2.2.2.7).

Chart 2.2.2.7: Full Implementation of the IFSB Standards: Comparison between 2014 and 2013 Surveys

Source: IFSB Standards Implementation Survey, 2013 and 2014

Based on the information on market shares of total Islamic finance assets in the banking, *Takāful* or capital market sectors in each jurisdiction, this survey attempts to find the relationship between the market share and the standards implementation status. The summary of correlation between implementation status of IFSB standards and market share of IIFS under the respondent RSAs' jurisdictions is shown in Chart 2.2.2.8.

Chart 2.2.2.8: Implementation Status of the IFSB Standards and the Corresponding Market Share of Islamic Finance Assets in the Jurisdictions

Source: IFSB Secretariat's estimation based on Standards Implementation Survey, 2014

The above chart clearly shows that there is an upward trend in "completed" status of implementation of IFSB standards by the RSAs as the market share of Islamic assets in jurisdictions increases. For example, with a minimum of 5% or 10% market share of total Islamic finance assets in the jurisdictions, the RSAs implemented 35% of IFSB standards. The implementation was much improved in jurisdictions having 25% or more market share of total Islamic finance assets, where RSAs implemented about 70% of IFSB standards. On the other hand, there is a downward trend in the "do not plan to (implement)" category the higher the market share. For example, 17% of all RSAs which have Islamic finance do not plan to implement the standards, while an almost negligible percentage of RSAs with more than 25% market shares of Islamic finance assets fall under the "do not plan to" category. The correlation between the implementation status and the market share of the surveyed RSAs is found to be positive the higher the ratios of Islamic finance assets in the jurisdictions.

In terms of the time frame for the implementation of the IFSB standards, implementation plans are mostly scheduled to be undertaken over a period of one to three years (as shown in Chart 2.2.2.9). It is to be noted that, within one to three years, most RSAs will implement the recently issued IFSB standards for the banking sector – for instance, standards on liquidity risk management, stress testing, capital adequacy and supervisory review process – which are consistent with the timeline of implementation as stated in the standards.

Chart 2.2.2.9: Approximate Time Frame for Implementation of the IFSB Standards

Source: IFSB Standards Implementation Survey, 2014

In addition, the 2014 Survey gathered information on challenges faced by the RSAs in implementing the IFSB standards. Chart 2.2.2.10 indicates that ten RSAs considered that their most important challenge is the "need to change their regulatory and supervisory frameworks". Moreover, eight RSAs considered the "need to change legal framework" as the most important challenge they faced.

Chart 2.2.2.10: Challenges in Implementing the IFSB Standards

Source: IFSB Standards Implementation Survey, 2014

The 2014 Survey also compiled the rank of challenges and estimated a mean value against each of the challenges based on its level of importance. The lower the mean value, the higher is the importance level of any given challenge. Table 2.2.2.2 exhibits the ranking order of challenges based on the mean values and compares the results between the 2014, 2013 and 2011 surveys. The 2014 survey questionnaire included one new area of challenges – that is, on "the need to change legal framework", which was identified as the most important challenge to the RSAs. The results show that in 2014, the rankings of the other various challenges were mostly similar to those in the 2013 and 2011 surveys. The need to change the regulatory and supervisory framework, and a lack of personnel with relevant knowledge/experience/training, are the two other key challenges faced by RSAs, as depicted by the lower mean values. Although the biggest challenge was identified as very significant by the second-highest number of RSAs as depicted in Chart 2.2.2.10, the first two challenges are found to be similar. This reflects RSAs' utmost requirement for changes in both the legal and regulatory frameworks.

Table 2.2.2.2: Rank of Challenges in Implementing the IFSB Standards

Challenges	2014 Survey			2013 Survey			2011 Survey		
	Mean	Rank	Base	Mean	Rank	Base	Mean	Rank	Base
Need to change legal framework	2.36	1	28	-	-	-	-	-	-
Need to change regulatory and supervisory framework	2.52	2	28	2.4	1	29	2.7	1	25
Lack of personnel with relevant knowledge/experience/training	2.62	3	29	2.5	2	30	3.0	2	25
Cost of implementation	2.73	4	28	3.38	3	29	3.9	3	25
Lack/poor quality of data to support implementation of the Standards	2.79	5	28	3.6	5	30	4.1	4	25
Institution size and complexity	2.90	6	27	3.45	4	29	4.1	5	25

Source: IFSB Secretariat's estimation based on Standards Implementation Surveys, 2011, 2013 and 2014
Note: In the 2013 and 2011 surveys, the questionnaire did not include the challenge, "Need to change legal framework".

In addition to the challenges identified above, the survey compiled the responses from the RSAs on the challenges experienced by them to implement IFSB standards as compared to conventional standards. A total of 11 banking RSAs (48%), three capital markets RSAs (50%) and one *Takāful* RSA (20%) found the implementation of IFSB standards to be more challenging than the corresponding conventional standards (e.g. from the Basel Committee, IOSCO or the IAIS). Chart 2.2.2.11 shows the comparison of implementation challenges between the IFSB standards and the conventional standards.

Chart 2.2.2.11: Comparison of Implementation Challenges between the IFSB and Conventional Standards

Source: IFSB Standards Implementation Survey, 2014

To facilitate the implementation process of its standards, the IFSB took numerous initiatives which include "Facilitating the Implementation of the IFSB Standards (FIS)" workshops, public hearings, roundtables, seminars and conferences for RSAs and industry stakeholders over the years. The IFSB has also signed Memoranda of Understanding (MoU) with its strategic partners aimed at, among other things, achieving further penetration of its implementation efforts. The MoU partners' activities include providing technical assistance (TA) to facilitate the implementation of the IFSB standards and to promote the development of the IFSI (Diagram 2.2.2.2). The IFSB received TA from the Asian Development Bank (ADB) in 2012 extended to 2015 which focuses on facilitating the implementation of the IFSB standards in common member countries and developing an e-learning programme to disseminate the standard implementation initiative.

Diagram 2.2.2.2: The IFSB's MoU Partner Activities

Source: IFSB

To ensure wider dissemination of the IFSB standards, the IFSB plans to complement the FIS workshops with e-learning programmes. The programmes are expected to foster: (i) global awareness and understanding of regulators and supervisors, as well as market players and industrial experts, on the importance of the IFSB standards; and (ii) the implementation of the IFSB standards by the industry to promote the resilience and stability of the IFSI at the global level. Currently, a comparative perspective on challenges faced during the implementation of the IFSB standards has been integrated into the FIS programme through the participation of experts from key Islamic finance jurisdictions that have already implemented the standards.

A comparative study on four selected IFSB standards (IFSB-2, IFSB-4, IFSB-5 and IFSB-10) was conducted recently in selected Islamic finance jurisdictions to draw lessons from their implementation. Details on this study are provided in Section 2.2.3(c) below.

2.2.3 Other Initiatives

(a) Working Paper on the Role of *Sharīʿah*-Compliant Lender-of-Last-Resort Facilities

A lender-of-last-resort (LOLR) capability has emerged as a key aspect of the crisis prevention supervisory framework. However, the LOLR facilities, as they stand, cannot be extended to IIFS, due to, in particular, some *Sharīʿah* considerations (either in terms of their structure or the arrangement used to provide liquidity to the IIFS), even though, in substance, the *Sharīʿah*-compliant lender-of-last-resort (SLOLR) is not much different from the conventional one.

The rapid growth in terms of the market share of the IIFS in many jurisdictions and their potential significance for systemic soundness and stability of the overall financial system raises the need for SLOLR facilities as an emergency financing mechanism for the IIFS. It should be noted, however, that the SLOLR facilities are not designed by the RSAs for liquidity purposes under a normal setting; rather, they are a means to provide emergency liquidity to an eligible IIFS in stressed market conditions after the IIFS has examined other potential sources to tap in order to meet its demand for funds. Diagram 2.2.3.1 shows three types of LOLR that can be offered by central banks to IIFS who approach them for required funding in the presence of financial stress in the markets.

Diagram 2.2.3.1: Three Categories of LOLR for IIFS

As witnessed during the GFC, the associated drying up of liquidity in financial markets had tested the RSAs' ability to sustain financial institutions and markets, and highlighted the need for an effective mechanism for providing LOLR facilities at times of acute market stress. This has raised broader issues of the adequacy of RSA capabilities to address similar stress situations were they to apply to Islamic finance jurisdictions. The issues raised include:

- *Sharīʿah* perspectives and potential issues with regard to LOLR facilities;
- SLOLR mechanisms currently available for IIFS;
- current assessment of the development of SLOLR facilities as a safety net;
- structure of the existing SLOLR mechanisms;
- adaptation of the monetary tools used by RSAs to cater to the specificities of IIFS;
- key challenges and issues that need to be addressed before further developing the SLOLR facilities as a safety net; and
- development of an SLOLR facility by RSAs.

In order to explore these issues, in April 2014 the IFSB published a working paper entitled *Strengthening the Financial Safety Net: The Role of SLOLR Facilities as an Emergency Financing Mechanism,*[168] which focused on the role of well-designed SLOLR facilities as a financial safety net in Islamic finance to help promote the stability and resilience of the IFSI. The key objectives of the paper are to:

- examine the role of central banks/monetary authorities in the development of SLOLR facilities and emergency financing mechanisms;
- categorise the existing SLOLR facilities, practices and infrastructure across jurisdictions;
- identify significant challenges faced by the central banks/ monetary authorities in the development of SLOLR facilities; and
- review the *Sharīʿah* issues in LOLR and suggest strategies for developing SLOLR facilities.

[168] www.ifsb.org/docs/WP-01_(2014%20April)%20Working%20Paper%20on%20SLOLR.pdf

The paper, which benefited from an industry-wide survey[169] carried out in 2012 among 38 banking RSAs, showed that although a conventional LOLR facility is commonly available to a financial institution holding a banking licence and is legally embedded in the scope of RSAs, there is little evidence for SLOLR facilities being made available to IIFS. The survey showed that only six RSAs have developed SLOLR facilities for IIFS in their jurisdiction, using various *Sharīʿah*-compliant structures such as *Muḍārabah*, *Mushārakah*, *Murābahah*, commodity *Murābahah*, *Tawarruq*, and *Qarḍ* with *Rahn*.

Other potential structures for the SLOLR include the *Qarḍ al-Hasan* SLOLR Mechanism, Commodity *Murābahah* Transaction SLOLR Mechanism, *Muḍārabah* SLOLR Model and *Wakālah* SLOLR Mechanism. Another potential structure for SLOLR is the *Takāful* Mechanism and Partnership (*Mushārakah*) Contract, which is rather similar to a *Takāful* scheme. The former can be structured via setting up a mutual cooperative fund by the central bank to be participated in by the IIFS in their respective jurisdictions. The special fund aims at providing emergency liquidity assistance for the participating banks whenever needed. Meanwhile, in the partnership (*Mushārakah*) contract, the central bank, by providing emergency liquidity, is in substance entering into a partnership contract. The central bank as a partner can now dictate terms and conditions. The profit-sharing ratio could be suitably tipped towards the central bank so that it could also serve as a penalty and to discourage applications from other banks. A *Mushārakah* contract will not require the central bank to be the only party to bear losses. Both the IIFS that needs emergency funds and the central bank will share the losses. In this way, the problem that arises from the *Muḍārabah* contract, where the central bank as a *Sāhib al-Māl* would alone bear losses, is avoided.

In essence, basic requirements that need to be fulfilled for the purpose of developing an SLOLR facility for IIFS are: (i) loan free from interest or *Riba* (penalty rate); and (ii) *Sharīʿah*-compliant eligible goods/collateral. There are also key supervisory considerations that would influence the *Sharīʿah*-compliant structures for LOLR in a jurisdiction, as shown in Diagram 2.2.3.2.

Diagram 2.2.3.2: SLOLR – Key Considerations and Recommended Structures

The following are some of the main preconditions identified for the development of SLOLR facilities:

- to have in place a robust supervisory framework (i.e. in terms of setting out relevant controls on the SLOLR) before developing the SLOLR facility;
- to obtain appropriate regulatory and remedial powers, and backing of a suitable legal framework, before developing and offering the SLOLR facility to IIFS;
- to assess the suitability of the SLOLR facility in relation to the prevailing *Sharīʿah* interpretations in the jurisdiction; and
- to have in place a proper *Sharīʿah* governance mechanism before developing the SLOLR facility.

The paper also reiterates the recommendations made in IFSB-12: *Guiding Principles on Liquidity Risk Management for IIFS*, which states that RSAs should provide greater clarity of their roles in both normal and stressed times. For instance, RSAs can be more explicit regarding their response to a liquidity crisis, by defining the type of *Sharīʿah*-compliant collateral that can be pledged, the limits applicable to various types of eligible *Sharīʿah*-compliant collateral, and possible durations of the financing that would be provided.

The efforts by the RSAs to develop an SLOLR should involve the IIFS and other market participants at the development stage so that any solutions are tailored for the highest level of practicality and usefulness.

[169] Details of the survey findings were presented in the *IFSI Stability Report 2013*, www.ifsb.org/docs/IFSB%20-%20IFSI%20Stability%20Report%202013%20(Final).pdf

(b) IFSB-IAIS Joint Working Group on *Microtakāful*

In July 2013, the IFSB was invited to participate in the IAIS Financial Inclusion Subcommittee meeting held in Manila, Philippines. During the meeting, a presentation was made to the subcommittee focusing on the IFSB's *Takāful*-related work. Following this, the IFSB and the IAIS came to an understanding to work together on regulatory issues prevailing in the *Microtakāful* sector, and about the IFSB's role in enhancing financial inclusion.

Recognising the issues that the *Takāful* sector supervisors face in relation to enhancing and strengthening the role of *Microtakāful* institutions, the Technical Committee (TC) of the IFSB, in its 32nd meeting held in Basel, Switzerland, recommended to the IFSB Council to approve preparation of a research paper in this area. Consequently, the Council of the IFSB, in its 24th meeting held in Brunei in March 2014, approved the development of a research paper on *Microtakāful* to be part of the IFSB's 2014 Workplan. In view of this, the IFSB and IAIS have established the present Joint Working Group for the preparation of this research paper.

Taking into consideration the fact that there is currently a lack of studies on the operations of the *Microtakāful* sector and associated regulatory issues, this joint research will aim to identify the current practices and models used for offering *Microtakāful* products. Further, it will aim to review the current regulatory framework for the *Microtakāful* sector in various jurisdictions and suggest initiatives to strengthen the framework and thus enhance financial inclusion through the *Takāful* sector.

The proposed research paper is expected to cover four main areas: (i) corporate governance; (ii) financial and prudential regulation; (iii) transparency, reporting and market conduct; and (iv) the supervisory review process. All four areas aim to identify the functions of various stakeholders in the Islamic finance structure in ensuring the effectiveness of a *Microtakāful* system for the poor, whereby proper regulation is put in place to safeguard the interests of these participants. These regulations include ensuring the intended *Microtakāful* participants are well educated and aware of their rights, interests and the benefits of participation. In addition, the specific roles to be played by the supervisory authorities will be highlighted to ensure that the *Microtakāful* infrastructure is simplified for easier participation of the potential participants while warranting a safe and sound regulatory environment for the protection of all *Microtakāful* stakeholders.

(c) Comparative Study on the Implementation of Selected IFSB Standards

As part of a programme of technical assistance funded by the ADB, the IFSB has produced a comparative study on the implementation of the IFSB standards. It looked in particular at four standards relevant to the banking sector. Three of these – IFSB-2, IFSB-4 and IFSB-5 – correspond roughly to Pillars 1, 3 and 2, respectively, of the Basel regime;[170] the fourth is IFSB-10, on *Sharīʿah* governance. The study considered evidence from the Survey on Standards Implementation, which included some specifically targeted questions, and also at the experience in seven jurisdictions, four of which have a record of successful implementation of the IFSB standards and three of which are the intended targets of ADB technical assistance. It also drew on more general published work on standards implementation, and considered whether the IFSB standards were, or were not, more difficult to implement than their conventional counterparts.

The study found that the main predictor of successful standards implementation is a commitment to implement standards. That is, the successful implementers start with a presumption that international standards in general, and the IFSB standards in particular, will be implemented in their jurisdiction. Consultative processes are framed with that underlying assumption. In most cases, there is also an assumption that, because standards have been subjected to *Sharīʿah* review, scholars will be consulted only if specific issues are apparent. In the less successful implementers, there is a less strong presumption in favour of standards implementation which in some cases extends also to conventional standards, perhaps reflecting a weaker position of the regulator in relation to the industry it regulates. A consensus in favour of implementation therefore needs to be secured, as well as agreement on the details. In some cases, this consensus also needs to include national *Sharīʿah* bodies, whose members may not always be familiar with the issues.

There are, of course, also jurisdiction-specific issues in the less successful implementers. These may include particular features of the local industry – for example, a relatively high proportion of Islamic windows, or a lack of institutional capacity in the RSA. This can be a problem particularly where the RSA needs to communicate the rationale for a standard in order to build consensus. It was noteworthy that successful implementers often attached importance to their own participation in the standards process as a way of building their own understanding. There are, however, limitations as to how many jurisdictions can in practice participate in any Working Group, and a continuing issue as to how jurisdictions new to Islamic finance can acquire an understanding of the existing standards.

As regards the content of standards, there is some tension between jurisdictions that find them too detailed and technical and those that find they leave too much to the discretion of the relevant RSA. The latter view in part reflects an issue in the conventional world, where some RSAs find not only that they lack the data properly to exercise (for example) the national discretions within the Basel regime, but also that any exercise of discretion makes them subject to political and industry pressure. However, it also reflects a wish on the part of jurisdictions with well-developed Islamic finance industries for IFSB standards to cover the full scope of their conventional counterparts.

Work in the conventional world suggests that one approach to standards implementation, especially of the more technical standards, may be for jurisdictions not to implement their full provisions at once, but to do so in chunks. There may also be in some areas approaches to implementation structured more around core principles than around specific standards.

[170] IFSB-2 and IFSB-5 have recently been superseded by IFSB-15 and IFSB-16, respectively.

A number of more detailed points were made, including points about the timing of IFSB standards, their coverage and the way they are written.

The IFSB will be considering how this study should be reflected, both in standards development and in support for standards implementation, as part of its Strategic Performance Plan for 2016–2018.

(d) Core Principles for Islamic Finance Regulation

The cross-border development and growth of Islamic finance in various jurisdictions, including non-Muslim economies, has raised a number of challenges in respect of the resilience and stability of those financial systems where IIFS operate just like their conventional counterparts. As Islamic finance is increasingly integrated into the global financial system, it is important to ensure that its regulation and supervision are subject to assessment (e.g. through the IMF/World Bank Financial Sector Assessment Programme [FSAP]), and also to help RSAs to evaluate and develop their own regulatory systems. However, many RSAs that are new to the regulation and supervision of Islamic financial services face challenges in identifying applicable principles and benchmarks for assessing the gaps in their existing structures and the policies in their jurisdictions, while addressing the specificities of Islamic finance.

The three major international standard-setters – the BCBS, the IOSCO and the IAIS – have each developed a set of core principles for their respective sectors[171] as a tool for regulatory and supervisory regimes to enhance financial system resilience. However, the differences in the operational and *Sharīʿah* characteristics of Islamic finance products in various regions highlight the need for international standardisation of the prudential framework which sets out sound supervisory practices for the regulation and assessment of the various sectors of the industry at the jurisdiction level.

Hence, on 12 December 2012, the IFSB Council, at its 21st meeting held in Jeddah, Kingdom of Saudi Arabia, approved the preparation of a new standard on IFSB Core Principles for Islamic Finance Regulation. It was decided that the initiative should begin by developing core principles for the Islamic banking sector, with the aim of subsequently developing core principles for the other sectors of the IFSI – namely, *Takāful* and the Islamic capital market.

In October 2014, the IFSB issued an Exposure Draft – ED-17: *Standard on Core Principles for Islamic Finance Regulation (Banking Segment)* – for the regulation and supervision of the IFSI which was adopted on 2 April 2015 by the IFSB Council at its 26th meeting held in Jakarta, Indonesia . Further details on IFSB-17 are provided in Chapter 3 of this report.

In November 2014, the IFSB issued a *Working Paper on the Evaluation of Core Principles Relevant to Islamic Finance Regulation* which assessed in full the core principles issued by the BCBS, IOSCO and IAIS, and provided a principle-by-principle gap analysis of these core principles, explaining whether: (i) the existing principles are fully applicable; (ii) they require modifications or adjustments; or (iii) new principles are needed. It also considered, in less detail, the following additional sets of principles:

- Core Principles for Deposit Insurance;
- Principles for Financial Market Infrastructures; and
- Principles for the Supervision of Financial Conglomerates.

It is expected that following the finalisation and issuance of IFSB-17 in April 2015, the IFSB will commence the preparation of core principles for other segments of the IFSI.

(e) Guiding Principles on Disclosure of Islamic Capital Market Products

The GFC highlighted the need to ensure that investors and customers are also given adequate information about Islamic capital market (ICM) products and services. Having in place an effective disclosure regime for ICM products will help to widen the acceptability and global appeal of the products. This demands a closer look at the disclosure practices currently employed by issuers and other stakeholders in the industry, including the associated regulatory regime. Having in place a disclosure regime for ICM products will also serve as an important tool for investor protection and promote greater cross-border activity by facilitating transparency and a greater understanding of the nature of the investment and its related risks and rewards.

However, the IFSB standards produced to date do not reflect all aspects of disclosure requirements for ICM products such as *Sukūk*, Islamic collective investment schemes (ICIS) and *Sharīʿah*-compliant equities. Given the strong growth of the IFSI – in particular, the *Sukūk* market – there is a need to provide comprehensive guidance on disclosure requirements for products and services in this sector. This will not only encourage the development of the ICM, but also help to strengthen the regulatory and supervisory framework for this important sector, thus contributing to the soundness and stability of the IFSI.

As a background, in 2012, in order to deliberate on some pertinent issues with respect to disclosure, the IFSB co-organised a full-day Roundtable on Disclosure of Islamic Capital Market products in partnership with IOSCO and the Securities Commission Malaysia, in Kuala Lumpur. The proceedings of this roundtable were published in 2013 and underlined, among other things:

- the importance of disclosure and transparency in the development of the ICM;
- the role of disclosure in regulating and clarifying risk management, investor rights and *Sharīʿah* governance matters; and
- the role of regulation and disclosures in promoting investor confidence on ICM products.

Following this, the IFSB began preparing, in early 2015, the *Guiding Principles on Disclosure of Islamic Capital Market Products.* This guiding principles aim to address issues arising from the structure and market practices related to the specificities of *Sukūk*, Islamic collective investment schemes and *Sharīʿah*-compliant equity that differentiate them from their conventional counterparts.

[171] The FSB also recognises other specialist or non-sectoral core principles – for example, those of the Financial Action Task Force on money-laundering and terrorist financing, and those of the Organisation for Economic Co-operation and Development on corporate governance.

Sukūk are likely to be the main focus of the new standard, given their importance in the ICM and their material differences from conventional counterparts. Disclosures concerned with the *Sukūk* structure and any attendant risks – in particular, with the rights of investors over the underlying assets – need to be addressed. In addition, to the extent that *Sukūk* are beginning to move away from transactions which, in their economic substance, are similar to relatively simple conventional bonds and towards truly asset-backed transactions, there may be a case for attempting to enunciate disclosure principles which would be relevant to situations where the dominant economic risk is not simply that of default by the ultimate obligor.

Other issues related to *Sukūk* include *Sharīʿah* compliance aspects of the transaction. A ruling by *Sharīʿah* advisers will normally inform potential investors that the *Sukūk* is compliant with the principles of *Sharīʿah*. However, there are aspects that need further deliberations in the new standard, such as: (i) how the identity of the *Sharīʿah* advisers should be disclosed in the offering document; (ii) whether and how the details of the *Sharīʿah* ruling should be disclosed in the offering document; (iii) what continuing disclosures are necessary to cover the risk of change in the *Sharīʿah* compliance of the underlying activity; and (iv) whether the *Sukūk* will be treated as a debenture or equity in terms of financial recourse, foreclosure or financial claim.

For ICIS, IFSB-6: *Guiding Principles on Governance for Islamic Collective Investment Schemes*[172] requires fund managers to ensure that disclosure of material information is done not only with appropriate accuracy and timeliness, but also in an investor-friendly manner. It recommends specific disclosures, primarily concerned with governance, in the prospectus (or similar offering document) of ICIS. In addition to the principles and requirements in IFSB-6, the new standard may need to enhance the disclosure requirements to include information on screening methods of ICIS, such as exact criteria and authority for inclusion or exclusion, reliance on any external screen, *Sharīʿah* governance of the process, frequency of screening, etc.

With regard to the disclosure requirement for *Sharīʿah*-compliant equities, in addition to the standard disclosures applicable on equity securities, information that forms the basis for the claim of *Sharīʿah* compliance needs to be addressed. If a regulator or exchange publishes a list of such companies, the screening method and basis determination may also need to be disclosed. There is also a question as to whether similar disclosure principles should be applied to independent firms providing Islamic indices or other screens.

(f) Technical Note on Stress Testing for IIFS

Stress testing is a key risk management tool within financial institutions and an important part of the supervisory assessment under Pillar 2. In March 2012, the IFSB Council adopted IFSB-13: *Guiding Principles on Stress Testing for Institutions offering Islamic Financial Services.* The guiding principles are guidelines intended to complement the existing international stress testing framework,[173] taking into consideration the specificities of IIFS such as market risks in *Sharīʿah*-compliant instruments and risk mitigation techniques, the status of investment account holders, and the particular challenges of liquidity risk management. The document set out 29 guiding principles. Of those principles, 22 provide a framework for IIFS to guide them in assessing and capturing vulnerabilities under various stress-testing scenarios, including extreme but plausible shocks, in order to: (i) assess the quality of *Sharīʿah*-compliant assets and identify existing and potential loss exposures; (ii) evaluate potential threats to the IIFS's ability to meet its financial obligations at any time arising from either funding or market liquidity exposures; and (iii) estimate the impact of stress events on baseline profit and the IIFS's ability to meet its capital requirements. Seven of the guiding principles are for RSAs, to aid them in reviewing the stress testing of individual IIFS, and in conducting system-wide stress tests to ensure the safety and soundness of the financial system and to identify weaknesses and structural (systemic) vulnerabilities.

IFSB-13, however, does not provide detailed implementation guidance to IIFS on how to conduct stress testing. Both before and after the issuance of IFSB-13, a need for more detailed guidance for the operationalisation of IFSB-13 was articulated. Therefore, in its 23rd meeting held on 10 December 2013, the IFSB Council approved the preparation of a Technical Note on Stress Testing for IIFS and the setting up of an expert group for this purpose. The key objectives of the Technical Note on Stress Testing are as follows:

(i) to facilitate designing and simulating various stress tests for IIFS using a bottom-up approach, including establishing macrofinancial links, and running scenarios with variations of several assumptions and stress scenario parameters;
(ii) to facilitate designing and simulating various stress tests for supervisors through a top-down approach; and
(iii) to provide stylised numerical examples covering moderate to severe shocks.

The Technical Note will also help RSAs in assessing the safety and soundness of IIFS and the banking system. It will be complemented by the IFSB's other important project, Prudential and Structural Islamic Finance Indicators for IIFS, which is discussed in detail in Chapter 4.2. These indicators will also help RSAs to design stress scenarios for the IFSI in their respective jurisdictions. A range of PSIFIs can be used in stress tests to understand vulnerability to shocks and capacity to absorb the resulting losses. The health of the IFSI can be analysed by looking at levels and trends in PSIFIs, typically of capital adequacy, asset quality, profitability, liquidity, and exposure to market risks. It is envisaged that the outcome will be used by the member countries as a benchmark for conducting and assessing the stress testing practices under defined scenarios.

The key areas that will be covered in the proposed Technical Note, include, among others: (i) solvency stress testing; (ii) liquidity risk stress testing, which embedded the specificities of IIFS in credit, market and operational risks, including *Sharīʿah* non-compliance risk; and (iii) system-level stress testing. However, the Task Force established for preparing the Technical Note will discuss these key areas and agree on the most appropriate way to provide guidance on these areas.

[172] www.ifsb.org/standard/ifsb6.pdf

[173] 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 six for supervisors, while the CEBS document contains 17 "guidelines" for banks and five for supervisors.

3.1 Surveillance Framework for the Global Financial System

Weaknesses in the financial system of a jurisdiction can jeopardise financial stability both within the respective country and, more broadly, at the regional or international level. In order to assess the strength and effectiveness of regulation and supervision at the jurisdiction level, major global standard-setting bodies have issued sets of principles – commonly known as "core principles" – that provide a basis for making such examinations. These principles also act as a standard tool to guide regulatory and supervisory authorities (RSAs) in developing their supervision regimes and practices, thus promoting consistent implementation of global prudential standards across countries. Further strengthening these mutually reinforcing objectives, these principles help improve financial stability and act as a standard tool for the further development of effective supervisory systems.

The first set of core principles was issued by the Basel Committee on Banking Supervision (BCBS) in 1997, with the title *Core Principles for Effective Banking Supervision* ("Basel Core Principles", or BCPs). The methodology for the assessment of these core principles was issued two years later, in 1999. Core principles for the securities market sector were issued first in May 1998 by the International Organization of Securities Commissions (IOSCO), which adopted the Objectives and Principles of Securities Regulation as a source of information on principles that underlie effective securities regulation, and on the tools and techniques necessary to give effect to those principles. Subsequently, the global standard-setter for the insurance market, the International Association of Insurance Supervisors (IAIS), introduced its Insurance Core Principles (ICPs) in 2003.

These core principles have undergone a number of revisions in subsequent years. After the issuance of Basel II, the BCBS revised its original BCPs along with the assessment methodology in 2006. Following the Global Financial Crisis, at the behest of the Financial Stability Board (FSB),[174] all three sets of core principles were updated to reflect the lessons learned during the crisis, with a focus on raising the bar on financial sector supervision with respect to supervisors' resources and independence, as well as covering specific issues which had come to prominence during the crisis. Accordingly, the BCPs and their associated methodology went through another round of revision in 2011–12.[175] Similarly, IOSCO's core principles and assessment methodology, which had been revised in 2003, were further updated in 2010–11. Revised ICPs were issued in October 2011 and amended in October 2012 and October 2013.[176]

Core principles are not limited to the banking, insurance and securities market sectors. Global standard-setting bodies have issued other principles for many vital areas such as deposit insurance, financial market infrastructures,[177] and the supervision of financial conglomerates. Similar to the experience with other core principles, the aforementioned documents have also been revised and updated over time. The most recent revision is that of the *Core Principles for Effective Deposit Insurance Systems,* originally issued in 2009 by the International Association of Deposit Insurers (IADI). The revised version of these core principles was issued in 2014 with the aim of strengthening the deposit insurance standards in several areas, including reimbursement speed, coverage, funding and governance, the role of deposit insurer in crisis preparedness and management.[178]

The role of the FSB in this process has been very important. The FSB was established in April 2009 as the successor to the Financial Stability Forum (FSF). The FSF was founded in 1999 by the G-7 Finance Ministers and Central Bank Governors to bring together: (i) national authorities responsible for financial stability in significant international financial centres – namely, treasuries, central banks and supervisory agencies; (ii) sector-specific international groupings of regulators and supervisors engaged in developing standards and codes of good practice; (iii) international financial institutions charged with surveillance of domestic and international financial systems, and monitoring and fostering implementation of standards; and (iv) committees of central bank experts concerned with market infrastructure and functioning. In the midst of the GFC, the leaders of the G-20 countries met in November 2008 and called for a larger membership of the FSF. Consequently, it was agreed to place the FSF on stronger institutional ground with an expanded membership – to strengthen its effectiveness as a mechanism for national authorities, standard-setting bodies and international financial institutions to address vulnerabilities, and to develop and implement strong regulatory, supervisory and other policies in the interests of financial stability. In an April 2009 meeting of the G-20 Leaders Summit, the expanded FSF was re-established as the Financial Stability Board with a broadened mandate to promote financial stability. It is effectively the apex body for the financial sector standards framework.

The FSB has listed the Compendium of Standards, which identifies various economic and financial standards that are internationally accepted as important for sound, stable and well-functioning financial systems. The Compendium includes both key standards, which the FSB has designated as deserving of priority implementation depending on country circumstances, and other standards that are complementary in nature and cover particular functional areas.

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174 See report of the FSB to G20 leaders titled "Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability", November 2011, www.financialstabilityboard.org/wp-content/uploads/r_111104.pdf?page_moved=1

175 The IFSB was represented in the group that carried out the 2011–12 revision.

176 The FSB's update on "Insurance Core Principles, Standards, Guidance and Assessment Methodology", October 2013, www.financialstabilityboard.org/2013/10/cos_111001/

177 The Committee on Payment and Settlement Systems (CPSS) and IOSCO finalised in April 2012 an international standard for core financial market infrastructures. It contains a single, comprehensive set of 24 principles designed to apply to all systemically important payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories. The principles formed a new and more demanding standard, replacing the three earlier sets of CPSS and CPSS-IOSCO standards – namely: the "Core Principles for Systemically Important Payment Systems" (2001); the "Recommendations for Securities Settlement Systems" (2001); and the "Recommendations for Central Counterparties" (2004).

178 See link for further information: www.iadi.org/aboutiadi.aspx?id=105

The key standards come under the broad policy areas of Macroeconomic Policy and Data Transparency, Financial Regulation and Supervision, and Institutional and Market Infrastructure. The FSB's criteria for determining the list of key standards for sound financial systems includes a number of factors which require the standards to be: (i) relevant and critical for a stable, robust and well-functioning financial system, in order to impart a sense of prioritisation in implementation; (ii) universal in their applicability, by covering areas that are important in nearly all jurisdictions; (iii) flexible in implementation, by being general enough to take into account different country circumstances; (iv) broadly endorsed – namely, that such standards should have been issued by an internationally recognised body in the relevant area in extensive consultation with relevant stakeholders (in order to meet the last criterion, the standards are expected to have undergone a public consultation process, or to have been issued by a standard-setting body with wide representation, or to have been endorsed by the International Monetary Fund (IMF) and the World Bank); and (v) assessable by national authorities or by international organisations. The key standards include the core principles of the BCBS, IAIS, IOSCO and IADI, as well as other standards in areas including statistics, accountancy, auditing and corporate governance.

3.1.1 Hierarchy of Financial Sector Surveillance Framework

The various sets of core principles provide a globally accepted framework for the supervision of the respective sectors. The principles themselves represent the highest level in a hierarchy of supervisory material. They prescribe the essential elements that must be present in the supervisory regime in order to promote a financially sound sector and provide an adequate level of customer protection.

The hierarchy of supervisory material below the core principles is slightly differently articulated by each of the standard-setters, though many of the differences are more of terminology than of substance. The description that follows is based on the structure of the BCPs, which have been highly influential and the basis of the IFSB's own *Core Principles for Islamic Finance Regulation* (CPIFR).

As already mentioned, the BCPs themselves are accompanied by an assessment methodology. The core principles themselves can be implemented in a variety of ways appropriate to the situation of different jurisdictions, and the assessment methodology is intended to achieve objectivity and comparability of compliance with the core principles in the different assessments, whoever carries them out, though it does not eliminate the need for supervisors and assessors to use their judgment in assessing compliance. The methodology puts forward a set of essential and additional assessment criteria for each principle. Essential criteria set out minimum baseline requirements for sound supervisory practices and are of universal applicability to all countries. The additional criteria set out supervisory practices that exceed current baseline expectations but are suggested best practices that countries having advanced banks should aim for.

For assessments of the BCPs by external parties, a four-grade scale is used: compliant, largely compliant, materially non-compliant, and non-compliant.[179] A country will normally be considered compliant with a principle only when all essential criteria applicable for the country are met without any significant deficiencies, though some flexibility is possible depending on the circumstances of the country. A "not applicable" grading can be used when, in the view of the assessor, the principle does not apply given the structural, legal and institutional features of a country.

The essential criteria thus provide important detail to the BCPs, which is critical in any assessment. For example, while BCP 4, on permissible activities, says simply, "The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined and the use of the word 'bank' in names is controlled", Essential Criterion 5 to the same BCP adds the requirement that "the supervisor or licensing authority publishes or otherwise makes available a current list of licensed banks, including branches of foreign banks, operating within its jurisdiction in a way that is easily accessible to the public".

In some areas of the BCBS's interest, the BCPs and their assessment methodology represent the sum total of the Committee's supervisory standards. In others, the BCBS has done more detailed work, published as separate standards. In general, the high-level requirements of such standards are reflected in the BCPs and their essential criteria, and a cross-reference is given to the full standard. For example, the BCP on transfer of significant ownership refers to two separate documents on parallel-owned banking structures, and shell banks and booking offices. The well-known Basel regimes for capital and liquidity are formally second-level standards of this kind and are referred to at particular points – for example, under BCP 16 on capital adequacy and BCP 24 on liquidity risk.

In addition to their structural similarities, the core principles for various sectors inevitably have considerable overlaps in areas such as supervisory powers and independence, licensing criteria, corporate governance framework and abuse of financial services. These common features and overlaps suggest the need for harmonising various sets of core principles in terms of structure and assessment criteria. Currently, the FSB's regulatory convergence initiatives are mainly focused on accounting standards issued by the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board. However, it may well be that in the future it will seek further convergence on both substantive issues, such as those mentioned, and on structural issues.

3.1.2 Applicability of Proportionality Principle

The various sets of core principles are meant for application to the supervision of the respective financial sector in all jurisdictions regardless of the level of development or sophistication of the markets and the type of products or services being offered and supervised. However, any assessment of a country against the

[179] The scales used by the ICPs and IOSCO principles are different, though the approach broadly remains similar. The assessment methodology for ICPs uses the terms "largely observed", "partly observed", "not observed" and "not applicable". IOSCO Objectives and Principles assess compliance on the basis of core principles being "fully implemented", "broadly implemented", "partly implemented" and "not implemented".

essential criteria should recognise that its supervisory practices are expected to be commensurate with the risk profile and systemic importance of the financial institutions being supervised (whether small or large sized). Thus, in evaluating the implementation of core principles and associated standards in a jurisdiction, it is important to take into account the domestic context, industry structure and developmental stage of the financial system, and overall macroeconomic conditions. Supervisors need to tailor certain supervisory requirements and actions in accordance with the nature, scale and complexity of individual financial institutions and the potential risks they pose to the respective sector or the financial system as a whole.

3.2 Global Monitoring Framework for Core Principles and Prudential Standards

3.2.1 Role of Financial Stability Board and Other Standard-Setters in Monitoring Adherence to Core Principles and Other Standards

Following the GFC, the international regulatory community, led by the Financial Stability Board, placed new emphasis on strengthening adherence to international standards. Members of the FSB agreed to undergo regular appraisals under the IMF-World Bank Financial Sector Assessment Program (FSAP), and to publish the results, to undergo both thematic and country peer reviews, and to promote adherence by other jurisdictions to standards, especially the core principles issued by global standard-setters.[180] The FSB members have now committed to an annual reporting process on implementation.[181]

The FSB's framework on strengthening adherence to international financial standards is primarily carried out through the FSAP and the peer review process. This framework, announced in January 2010, outlined the leading role of its Standing Committee on Standards Implementation, which considers "encouragement from peers" as a primary motivating factor for all countries and jurisdictions to raise their level of adherence to international financial standards.[182] It was agreed by the FSB members that they will: (i) implement international financial standards; (ii) undergo an assessment under the IMF–World Bank FSAP every five years; (iii) disclose their degree of adherence to international standards, notably by publishing the detailed assessments prepared by the IMF and World Bank as a basis for the Reports on the Observance of Standards and Codes (ROSCs); and (iv) undergo periodic peer reviews, using, among other evidence, reports prepared as part of the FSAP.

The FSB also commenced in March 2010 an initiative to encourage the adherence by all countries and jurisdictions to regulatory and supervisory standards on international cooperation and information exchange.[183] To recognise the progress that most jurisdictions evaluated by the FSB under the current initiative have made towards implementing international cooperation and information exchange standards, and to incentivise improvements by those jurisdictions not cooperating fully, the FSB is publishing the names of all jurisdictions evaluated. The list includes those identified as non-cooperative jurisdictions.[184] Jurisdictions are identified as non-cooperative if they are participating in the FSB's evaluation process but are showing insufficient progress in addressing weak compliance; are not cooperating satisfactorily with the FSB's process for strengthening adherence; or are not engaged in dialogue with the FSB. So far, Libya and Venezuela have been identified as "non-cooperative jurisdictions" due to their lack of engagement in the dialogue process.[185] In order to carry out this assessment, the FSB has identified a set of principles included in the core principles issued by the BCBS, IAIS and IOSCO concerning international cooperation and information exchange.

Under the FSB's leadership, other standard-setters have also augmented their focus on implementation. The BCBS has adopted a Regulatory Consistency Assessment Programme (RCAP), which includes both implementation monitoring of the Basel standards and consistency assessments on a jurisdictional and thematic basis. It has also put new emphasis on the work of the Financial Stability Institute (FSI), a joint body of the BCBS and the Bank for International Settlements (BIS) created to support and assist supervisors in strengthening their financial systems.

The BCBS's RCAP, which was established in 2012 and revised in 2013, aims to monitor the adoption of Basel III standards, and to assess the consistency and completeness of the adopted standards and the significance of any deviations in the regulatory framework. This programme is seen as complementing the IMF/World Bank's FSAP. The RCAP focuses on implementation of the Basel regulatory framework in terms of consistency and completeness, while the assessment of the BCPs under the FSAP takes into account the full range of supervisory practices and is carried out in the context of a wider financial stability risk analysis.[186] Given the specialised nature of the subject matter, and to ensure sufficient rigour, the RCAP assessments are designed as "peer reviews" undertaken by technical experts from member jurisdictions. The entire process is closely supervised by the RCAP Peer Review Board, with feedback from the Committee's Supervision and Implementation Group (SIG), and the assessments are finalised by the Basel Committee based on consensus.[187]

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180 FSB, *Framework for Strengthening Adherence to International Standards, January 2010*, www.financialstabilityboard.org/wp-content/uploads/r_100109a.pdf

181 FSB Chairman's Report to G-20 leaders, *Financial Reforms: Completing the Job and Looking Ahead*, November 2014, www.financialstabilityboard.org/wp-content/uploads/FSB-Chair%E2%80%99s-Letter-to-G20-Leaders-on-Financial-Reforms-Completing-the-Job-and-Looking-Ahead.pdf

182 FSB, *Framework for Strengthening Adherence to International Standards,* January 2010, www.financialstabilityboard.org/wp-content/uploads/r_100109a.pdf?page_moved=1

183 See FSB, "Promoting global adherence to international cooperation and information exchange standards", 10 March 2010, www.financialstabilityboard.org/publications/r_100310.pdf and FSB, "Promoting global adherence to regulatory and supervisory standards on international cooperation and information exchange: Progress report", 29 April 2011, www.financialstabilityboard.org/publications/r_110429.pdf

184 While global standard-setters such as IAIS and multilateral bodies work to promote global adherence to international standards, the FSB's member international bodies' legal frameworks and policies preclude their participation in decisions regarding the listing of non-cooperative jurisdictions and the adoption of negative measures that are not in accordance with those frameworks and policies. See footnote 2 of FSB, 2011.

185 FSB Status Update, *Global Adherence to Regulatory and Supervisory Standards on International Cooperation and Information Exchange,* December 2014.

186 BCBS, Basel III Regulatory Consistency Assessment Programme (RCAP), October 2013.

187 The Peer Review Board consists of the Chairman of the BCBS, the Chairman of the Supervision and Implementation Group, and the Secretary General of the BCBS. The Board is supported by the Head of Basel III Implementation at the Basel Committee Secretariat.

IOSCO has created an Assessment Committee to conduct both country and thematic reviews of adherence to IOSCO core principles and standards, with technical assistance from the IOSCO Secretariat. Its implementation programme focuses on assisting securities regulators through organising and providing regular workshops and seminars to share expertise and enhance the supervisory and surveillance capacity of securities regulators; technical assistance, education, training and research; monitoring via annual surveys of the resources and capacity of its members; provision of guidance and Frequently Asked Questions on relevant IOSCO Recommendations and Principles; and other measures (e.g. joint projects with international organisations) to promote the development of domestic capital markets. Its implementation activities also lay special emphasis on supporting members from emerging markets. Similarly, adherence to core principles and standards has become a condition by IOSCO for granting membership and allowing the member to participate in its working groups.[188]

The IAIS has established a Coordinated Implementation Framework,[189] which in addition to self-assessments and peer reviews includes regional implementation plans and working with the Financial Stability Institute to develop training materials.[190] The focus of this framework is on the establishment of programmes for enhancing observance of the ICPs and improving insurance supervisory practices worldwide. Its Standards Observance Subcommittee plays an important role in this process and is tasked with developing self-assessment questionnaires and conducting thematic peer reviews of the ICPs, and preparing individual country reports as well as an aggregate report on the results of the assessment and peer review. This process is expected to provide an essential feedback loop on the results of the peer reviews, including to standard-setting working parties if ICPs are found to be unclear, incomplete or not well-understood; and to the Education Subcommittee on training needs, including regarding the self-assessment process, the substance of the ICPs, and participating members' areas of development identified in the reviews.

3.3 Major Operational Mechanisms to Track the Implementation of Core Principles

3.3.1 Self-Assessment by Supervisors

Almost all the standard-setting bodies have their self-assessment programmes which allow their members to identify adherence to respective core principles and prudential standards as well as providing them an opportunity to discover their strengths and weaknesses in their regulation and supervision regimes. This, in turn, helps them in developing, prioritising and implementing action plans that are necessary to improve the regimes. In addition, an FSAP mission is normally preceded by a self-assessment by the respective supervisory authority in the jurisdiction, which is submitted to the mission team for their study before the mission. In the majority of cases, self-assessments by supervisory authorities are not published but are used internally by the authority or by the FSAP team for identifying vulnerabilities in the system and exploring opportunities for improvement. However, in some cases self-assessments are made publicly available, as in the case of those published by the Dubai Financial Services Authority (DFSA) in 2006,[191] the Reserve Bank of India in 2009[192] and the US Treasury in 2014.[193]

To consider just one example, the US Treasury issued a 350-page self-assessment report on the implementation of BCPs by federal banking agencies, which not only provides a review of the individual assessment criteria for all the BCPs but also provides fairly comprehensive information on the regulation of the banking system in the US. This self-assessment was followed by an FSAP mission by the IMF.

As mentioned earlier, the RCAP introduced by the BCBS to monitor adherence to the Basel standards includes an in-built mechanism that relies on self-assessment by individual supervisory authorities and a peer review process. This process has now become a regular feature of its monitoring framework, which is also reported to the FSB and G-20 Governors and Heads of Supervision.

The IAIS programme of Self-Assessment and Peer Review (SAPR) is operationalised through identifying a set of ICPs that are assessed by the individual supervisory authorities and examined by a peer review process. The SAPR is conducted on a thematic basis, which assists jurisdictions in understanding whether they observe, largely observe, partly observe or do not observe the ICPs and the related individual standards. For example, in 2013, the IAIS launched its SAPR on ICPs related to corporate and risk governance, which is aimed at assessing observance and understanding of ICPs on licensing, suitability of persons, corporate governance, and risk management and internal controls (ICPs 4, 5, 7 and 8).

The self-assessment process begins with development of an online survey prepared by an Expert Team consisting of representatives from its subcommittees and the World Bank. A link to the online survey is circulated to all IAIS members. Once the survey period is closed, the Expert Team meets to review the survey results. Each IAIS member who participates in the SAPR receives a confidential jurisdiction-specific draft report containing the Expert Team's preliminary assessment of overall observance and each of the standards contained within the respective ICPs.[194]

188 Apart from adherence to core principles, applicants to become ordinary members of IOSCO are required to apply to become signatories to the IOSCO framework for information exchange – called the "Multilateral Memorandum of Understanding" (MMoU) – which has become a condition for being accepted as ordinary members of IOSCO. Securities regulators that are not signatories to the MMoU are permitted to apply for associate membership, which category of membership does not entitle holders to attend IOSCO committees or to vote. In addition, IOSCO has progressively introduced a series of measures in respect of those ordinary members who are not yet signatories to remove their rights to vote and to participate in IOSCO committees. FSB Status Update, *Global Adherence to Regulatory and Supervisory Standards on International Cooperation and Information Exchange,* December 2014.

189 IAIS, *Co-ordinated Implementation Framework,* October 2013.

190 www.iaisweb.org/index.cfm?event=getPage&nodeId=41633#

191 DFSA, *Self Assessment on Basel Core Principles,* 2007.

192 www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=543#COMP1

193 www.treasury.gov/resource-center/international/Documents/FSAP%20BCP%20Self%20Assessments.pdf

194 http://newsletter.iaisweb.org/newsletterlink-381?newsid=944&call=1

Once members receive their draft report, they are invited to provide comments and make corrections as necessary. The Expert Team then considers the comments and corrections before issuing a final report to the jurisdiction. Once individual jurisdiction reports are finalised, the Expert Team prepares an aggregate report of their overall findings, without details of members' survey responses or assessment. The process usually takes around one year.

3.3.2 Peer Reviews

Peer review can be described as the systematic examination and assessment of the performance of a jurisdiction by another jurisdiction or set of jurisdictions, with the ultimate goal of helping the reviewed jurisdiction improve its policymaking, adopt best practices, and comply with established standards and principles.[195] The examination is conducted on a non-adversarial basis, and it relies heavily on mutual trust among the jurisdictions involved in the review, as well as their shared confidence in the process. The effectiveness of peer review relies on the influence and persuasion exercised by the peers during the process, commonly termed "peer pressure". The peer review process can give rise to peer pressure through, for example: (i) a mix of formal recommendations and informal dialogue by the peer countries; (ii) public scrutiny, comparisons and, in some cases, even ranking among countries; and (iii) the impact of all the above on domestic public opinion, national administrations and policymakers. The impact is normally greater when the outcome of the peer review is made available to the public. Peer review is a means of soft persuasion, which can become an important driving force to stimulate the jurisdiction to improve, achieve goals and meet standards. The effectiveness of peer review can be enhanced with the presence of an objective set of assessment criteria and consistent approach as well as an adequate level of commitment and mutual trust between the parties involved.

Peer reviews are becoming a regular part of the toolkit used by global financial-sector standard-setting bodies to enhance the implementation of their standards.

The FSB's programme of country peer reviews of its member jurisdictions aims to examine the steps taken or planned by national authorities to address FSAP recommendations concerning financial regulation and supervision, as well as institutional and market infrastructure.[196] In comparison to FSB member jurisdictions' commitment to undergo an FSAP assessment every five years, peer reviews will be taking place typically around every two to three years following an FSAP, which will help to complement the assessment cycle.

A country peer review by an FSB team evaluates the progress made by the jurisdiction in implementing FSAP recommendations against the background of subsequent developments that may have influenced the policy reform agenda. It provides an opportunity for FSB members to engage in dialogue with their peers and to share lessons and experiences. Unlike the FSAP, a peer review does not comprehensively analyse a jurisdiction's financial system structure or policies, nor does it provide an assessment of its vulnerabilities or its compliance with international financial standards. As an example, a team comprising six representatives of FSB member jurisdictions led by Paul Rochon (Canada Department of Finance) conducted a peer review of Switzerland in 2011, which was based on the recommendations made by the FSAP team in 2006–07. The main purpose of the peer review mission was to assess Switzerland's progress in addressing the issues identified in the FSAP, which covered regulation and supervision of the banking, (re)insurance and pension sectors. The report provides a set of recommendations for addressing the issues identified during the peer review process.

The IAIS has been using peer reviews as a regular mechanism to support the adopting of ICPs and other standards. As mentioned earlier, it conducts thematic peer reviews of ICPs, and prepares individual country reports, as well as an aggregate report, on the results of the assessment and peer review exercise. This examination is expected to provide an essential feedback loop on the results of the peer reviews, including to standard-setting working parties if ICPs are found to be unclear, incomplete or not well-understood; and to support training needs, including regarding the self-assessment process, the substance of the ICPs, and participating members' areas of development identified in the reviews. For example, most recently in early 2015, the IAIS has initiated a Thematic SAPR Assessment on market conduct that covers ICPs 18 and 19 related to intermediaries and conduct of business, respectively. In the past it has conducted SAPR on selected ICPs related to corporate and risk governance,[197] supervisory measures[198] and inclusive insurance markets.[199]

3.3.3 Financial Sector Assessment Program

The IMF and the World Bank (WB) are mandated by their members to assist national governments and supervisory authorities through diagnostic, surveillance, policy guidance and capacity-building work. The approach of the IMF and WB involves identifying weaknesses in regulatory and supervisory frameworks through FSAP and ROSC assessments; tailoring the strategy and sequencing of implementing internationally agreed reforms given country circumstances; improving compliance with international financial sector standards; providing hands-on support to enhance supervisory capacity through technical assistance; mobilising financial resources to promote domestic finance, including by developing capital markets; and monitoring the effects of regulatory reforms. Since the financial crisis, the work of the IMF and WB has expanded considerably in relation to reviewing the adoption of global regulatory reforms with an added focus on identifying and controlling the systematic risk.

195 Fabrizio Pagani, *Peer Review: A Tool for Co-operation and Change* (OECD Secretariat, 2002).
196 FSB, *Peer Review of Switzerland: Review Report,* January 2012.
197 http://newsletter.iaisweb.org/newsletterlink-381?newsid=944&call=1
198 http://newsletter.iaisweb.org/newsletterlink-381?newsid=1318&call=1
199 A2ii Announcement: Self-assessment and Peer Review on Regulation and Supervision supporting Inclusive Insurance Markets. See https://a2ii.org/fileadmin/data_storage/documents/internal_documents/FINAL_A2ii_IAIS_Announcement_self_assessment.pdf

The FSAP, established in 1999, is an in-depth assessment of a country's financial sector. It is an important element of the IMF's surveillance and provides input to the Article IV consultations.[200] In developing and emerging market countries, FSAP assessments are usually conducted jointly with the WB and include two components: a financial stability assessment (the main responsibility of the Fund) and a financial development assessment (the main responsibility of the WB). Each FSAP concludes with the preparation of a Financial System Stability Assessment (FSSA), which focuses on issues of relevance to IMF surveillance and is discussed by the IMF Executive Board normally together with the country's Article IV staff report.[201]

The last review of the FSAP in 2009, in the aftermath of the GFC, introduced a number of far-reaching reforms. In 2010, the financial stability assessment under the FSAP in 25 jurisdictions – with financial sectors deemed by the Fund to be systemically important – became a mandatory part of Article IV surveillance, expected to take place every five years.[202] The list was expanded to 29 jurisdictions in 2013. For all other jurisdictions, FSAP participation continues to be voluntary. The reforms also included the introduction of the Risk Assessment Matrix (RAM);[203] expansion of stress tests to cover a broader set of risks, analysis of spillovers, and systematic coverage of macroprudential frameworks and financial safety nets. Overall, the FSAP's low frequency and narrower focus on financial stability and risks means that it can be seen as a complement to, rather than a substitute for, regular macrofinancial surveillance under Article IV. There are three components of the stability assessment under the FSAP: vulnerabilities and resilience; quality of the financial stability policy framework; and financial safety nets.

The 2009 FSAP review elevated the importance and defined the scope of financial safety nets. This third pillar of stability assessments under the FSAP involves an overview of the country's liquidity management framework (instruments, collateral policies); deposit protection/insurance and lender-of-last-resort arrangements; crisis preparedness and bank resolution frameworks; and possible spillovers from the financial sector to the sovereign balance sheet.

The involvement of the FSB and G-20 has helped cement the role of the FSAP and standards assessments. As mentioned earlier, following the G-20 commitment in 2008 to undertake FSAP assessments, the FSB members committed, in 2010, to undergoing FSAP assessments every five years and to publishing the detailed assessment of supervisory standards. The FSB also conducts peer reviews of its members two to three years after each FSAP assessment, including assessing members' progress in addressing FSAP recommendations. Both FSAPs and peer reviews have provided valuable input to IMF surveillance and subsequent FSAP assessments.[204]

Formal standards' assessment in the form of ROSC is another component that is fed into the financial stability analysis of FSAP. It provides a mapping of the quality of regulation, infrastructure or safety nets, and provides the IMF with insights on the authorities' capacity to use these systems effectively.

As mentioned earlier, self-assessment and FSAP process are in most cases closely aligned where the former precedes the latter. In a study carried out by the IMF,[205] a comparison has been made on the self-assessments with the review carried out by the IMF–WB. The study showed that half of the self-assessments were materially different from the assessment carried out by both the organisations, where in nearly all the cases the assessments by the IMF–WB were stricter. Only in 15% of the cases where the assessments were different did a country take a stricter view. Moreover, in 21 cases the self-assessment judged a core principle to be fully implemented, while in the IMF–WB assessment, the same core principle was graded as non-compliant – the lowest grade. The IMF believes this suggests that many self-assessments were based on a deficient understanding of the purpose behind the relevant core principles and the criteria for judging compliance. Similarly, self-assessments tended to focus more than the IMF–WB assessment on formal compliance with legislation, regulations and other written material. They did not take fully into account the need for comprehensive implementation, both by the supervisory authority and by the banks. Therefore, self-assessments are rarely used as a substitute for independent assessments. However, countries' self-assessments do provide benefits to countries not only in improving their understanding of the core principles, but also in facilitating the external assessment by focusing the discussions on appropriate laws, practices and other documentation.

It may be noted that the number of ROSCs has also increased significantly in recent years, especially the core principles issued by the BCBS and IAIS, which have become a standard feature of the FSAP process. The main reason for this phenomenon has been the compulsory FSAP assessment of core principles for the 25 countries identified by the G-20 as having systemically important financial systems, as exhibited in Chart 3.3.1.

200 Country surveillance by the IMF is performed under Article IV of the IMF's Articles of Agreement, hence the name "Article IV consultations". It is an ongoing process that culminates in regular (usually annual) consultations with individual member countries, with discussions in between as needed. During an Article IV consultation, an IMF team of economists visits a country to assess economic and financial developments and to discuss the country's economic and financial policies with government and central bank officials. IMF staff missions also often meet with parliamentarians and representatives of business, labour unions and civil society. The team reports its findings to IMF management and then presents them for discussion to the Executive Board, which represents all of the IMF's member countries. A summary of the Board's views is subsequently transmitted to the country's government. In this way, the views of the global community and the lessons of international experience are brought to bear on national policies. Summaries of most discussions are released in press releases and are posted on the IMF's website, as are most of the country reports prepared by the staff. For details, see www.imf.org/external/about/econsurv.htm.

201 IMF, *Review of the Financial Sector Assessment Program – Further Adaptation to the Post-crisis Era,* August 2014.

202 IMF, *Mandatory Financial Stability Assessments under the Financial Sector Assessment Program: Update,* November 2013.

203 The RAM presents in a tabular form the FSAP's assessment of the key risks facing the financial sector, the probability of realisation of each risk in the short to medium term, and the expected economic impact.

204 See Box 3 of IMF, *Review of the Financial Sector Assessment Program – Further Adaptation to the Post-crisis Era,* August 2014.

205 IMF, "Experience with Basel Core Principle Assessments", April 2000. https://www.imf.org/external/np/mae/bcore/exp.htm#II_B4

Chart 3.3.1: Recent Trends in Standards Assessments

Number of ROSCs increased, peaking in FY11…

Total Number of ROSCs per Fiscal Year By Type of Standard

….especially BCP, IAIS, and IOSCO standards per FSAP.

Average Number of ROSCs Conducted During FSAP Missions by Standard

…mainly driven by S-25 countries….

Total Number of ROSCs per Fiscal Year by S-25 and non-25 countries

…with a relatively higher increase in ROSCs per FSAP.

Average Number of ROSCs Conducted During FSAP Missions

Source: IMF, Review of the Financial Sector Assessment Program – Further Adaptation to the Post-crisis Era, August 2014

Similarly, the publication rates of FSSAs have increased over time, especially following the 2009 review, when the IMF's publication policy for the FSSA was aligned with that of the Article IV staff report. This was supplemented by the FSB's encouragement to its members to publish their FSSAs. As shown in Chart 3.3.2, since FY2009 all FSSAs in advanced countries have been published. Publication rates are lower for emerging market countries and low-income countries. On average, as well as in each country group, publication rates rose steadily in recent years, reaching 90% in FY2013.

Chart 3.3.2: Trends in Publication of FSSAs, FY2009–2014

Source: IMF, Review of the Financial Sector Assessment Program – Further Adaptation to the Post-crisis Era, August 2014

3.4 The Need for Core Principles for Islamic Finance Regulation

3.4.1 Use of Conventional Core Principles in FSAP

As mentioned earlier in this paper, the IMF–WB FSAP provides an in-depth assessment of a country's financial sector. It is an important element of the IMF's surveillance and provides input to the Article IV consultations. When FSAP assessments are conducted jointly with the World Bank, mostly in the case of developing and emerging market countries, they include two components: a financial stability assessment (the main responsibility of the IMF) and a financial development assessment (the main responsibility of the World Bank). The culmination of each FSAP is the preparation of an FSSA, which includes an evaluation of vulnerabilities and resilience, quality of the financial stability policy framework and financial safety nets.

In the past few years, a number of the IFSB member jurisdictions with the presence of Islamic finance have gone through FSAP. Some of these reports are publicly available. Similarly, a few Article IV reports for the IFSB member jurisdictions have also been published on the IMF website. A study of these reports provides an overview on how the assessors have dealt with the Islamic finance sector in these jurisdictions, especially Islamic banking.

The FSAP Reports for Bangladesh[206] and Kuwait[207] were published in 2010 in the months of February and July, respectively. In the former case, references to Islamic finance appear in the discussion on monetary policy instruments and statutory reserve requirements; however, formal assessment of BCPs does not include any discussion on Islamic finance. In the latter case, the Core Principle on Licensing Criteria makes a reference to Islamic banks. The assessment mentions that while Islamic banks' owners are submitted to "fit and proper" tests, conventional banks should also be required to submit the major shareholders to undergo the fit and proper test. The report also proposes that considering the size of Islamic banking in Kuwait and its rapid growth, the issuance of government *Sukūk* will benefit the market.

Two other reports, on Saudi Arabia[208] and Turkey,[209] were published in 2012. The former report is an update of a 2004 assessment, and was in a short form only. It mentions that *Sharīʿah*-compliant products are offered by commercial banks based on a single licence for commercial banks. It noted that while all banks provide *Sharīʿah*-compliant products, some banks provide only these products. The regulator considers the two types of banks as one system with different products. Apart from this, the assessment does not include any separate mention of Islamic finance. In the case of Turkey, while participation banks' data are included in some appendices, all banking regulation is treated as though it were conventional.

The assessment for Nigeria[210] was published in 2013. There is a note on Islamic banking in Appendix IV, on page 71, which tries to summarise the regulatory regime and some deficiencies, including by reference to the IFSB standards. However, the assessment does not go beyond this level.

Malaysia, with its significant market share in Islamic finance, went through an FSAP assessment for the banking, insurance, capital market and deposit insurance sectors in 2012, the findings of which were recorded in the ROSC published in February 2013.[211] These assessments made reference to Islamic finance components of the financial sector at a number of places. Separate sections on Islamic banking, *Takāful*, capital market and deposit insurance were also included in the report. On *Takāful*, the report indicates that "The ICPs were not specifically developed with Islamic insurance products in mind. Consequently, based on the agreed scope, details on the regulation, supervision and various workings of the Malaysian Islamic insurance market are included in this report, but do not form part of the ICP assessment ratings for Malaysia." Similarly, for the Islamic capital market, the report mentions that "there are two components to the capital markets in Malaysia, conventional and Islamic; but the latter has not been assessed separately in this review. The Assessment Methodology does not distinguish between conventional and Islamic markets with respect to expectations or standards." For the Islamic banking sector, the detailed FSAP report,[212] issued concurrently with ROSC, explicitly declares: "The regulatory framework specific to Islamic banking was not formally assessed, as separate assessment standards for Islamic banking have not yet been developed."

These references, and those noted earlier, demonstrate that assessors would have found core principles and the assessment methodology for various Islamic finance sectors helpful in making their assessments. These observations also suggest that an approach to produce a comparable set of Islamic finance core principles, benchmarked to the existing conventional core principles, will be the most suitable approach to facilitate the assessors in their evaluations.

3.4.2 Challenges in Regulation of the Islamic Financial Services Industry and the Role of the Core Principles

The development of the Islamic finance industry can be credited to an increase in the size and number of institutions offering Islamic financial services (IIFS), but also to an enhanced variety of products and services offered, improved legal and regulatory infrastructure, and new initiatives for international cooperation. Accordingly, the Islamic financial services industry (IFSI) has gained significant market share and now constitutes an important building block of the financial system in many jurisdictions. This development and growth has raised new challenges for regulatory and supervisory authorities in comprehending the underlying risks in the products and operations of these institutions, their impact on the stability and resilience of financial systems in which these institutions operate, as well as the protection of customers using financial services offered by them.

The increasing significance of the IFSI in various economies brings challenges for the supervision and regulation of the institutions that offer a variety of products and services on a *Sharīʿah*-compliant basis in various sectors, including banking, *Takāful*, fund and wealth management, private equity, microfinance and other areas. Many supervisory authorities that are regulating and supervising the IIFS sectors face challenges in identifying applicable principles and benchmarks for assessing the gaps in the existing policies and regulations in their jurisdictions, which can suitably accommodate the unique features of the institutional structure of the IIFS and unique elements in the products and services offered by them.

206 www.imf.org/external/pubs/ft/scr/2010/cr1038.pdf

207 www.imf.org/external/pubs/ft/scr/2010/cr10239.pdf. Apart from this FSAP Report, an Article IV Report for Kuwait was published in December 2014. The report acknowledges the importance of the Islamic banking sector in the jurisdiction and mentions various steps being taken by the Central Bank of Kuwait to improve the liquidity framework for the conventional and Islamic banking sector and commends newly issued regulations, including those related to capital adequacy for Islamic banks. Earlier, in November 2014, the IMF issued a Selected Issues Paper on Kuwait. While this paper covers a number of policy areas on macroeconomic management, a separate section is dedicated to Islamic banking in the jurisdiction. This section covers the structure of the industry, the regulatory framework, and financial stability issues facing the Islamic finance sector in the jurisdiction.

208 www.imf.org/external/pubs/ft/scr/2012/cr1292.pdf

209 www.imf.org/external/pubs/ft/scr/2012/cr12261.pdf

210 www.imf.org/external/pubs/ft/scr/2013/cr13140.pdf

211 www.imf.org/external/pubs/ft/scr/2013/cr1353.pdf

212 www.imf.org/external/pubs/ft/scr/2013/cr1352.pdf

These challenges are being met by amending the existing approach to the regulation and supervision of the conventional financial sector and adding new elements that are required to address the unique characteristics of the IIFS. Such an approach needs to ensure that the principles on which these institutions are based are fully appreciated, which will help the regulators to recognise the nature of risks to which IIFS are exposed. Further consideration will be needed on the financial infrastructure underpinning effective regulation and supervision, which could result in additional or distinctive sets of regulations and supervisory practices to address the unique nature and potential risks inherent in the IIFS' operations.

Similar to the core principles for other sectors, a set of core principles for Islamic finance will be naturally expected to prescribe the essential elements that must be present in the supervisory regime in order to promote a financially sound sector and provide an adequate level of customer protection for the users of financial services in various sectors, most of which might not be fully familiar with the features of the products. Being the highest level in the hierarchy of financial sector regulation, core principles should provide an overarching framework for the regulatory system in a jurisdiction that not only covers the prudential regulation aspects related to risk management, corporate governance and transparency of institutions, but also the broader and somewhat more fundamental issues such as responsibilities, powers and legal protection of the supervisory authority itself.

The core principles framework is supplemented by the discussion on the preconditions or building blocks on which a financial system is based. Though the main elements of these building blocks – such as macroeconomic policies, public infrastructure, crisis management and resolution framework, systemic protection and market discipline – are generally outside the direct or sole jurisdiction of supervisory authorities, supervisors are expected to be proactive and to explicate the role and interventions required from other public-sector bodies to achieve the objective of a stable and resilient financial system. Regulatory guidelines and policies – as the next level of hierarchy in financial sector regulation – are linked to specific core principles in the respective sectors, which outline key high-level and operational requirements for the financial institutions.

Thus, instead of a piecemeal approach to financial regulation that focuses on individual regulatory standards, a core principles framework provides necessary elements required in a supervisory regime in order to establish a financial sector that is sound and able to withstand system-wide shocks emanating from within and outside the jurisdiction. Similarly, the principal objectives of consumer protection and enhancing financial inclusion are also accounted for in a core principles framework.

In view of the above, the IFSB Council, in its 21st meeting held on 12 December 2012 at Islamic Development Bank (IDB) headquarters in Jeddah, Kingdom of Saudi Arabia, approved the preparation of IFSB CPIFR and the setting up of a working group (WG) for this purpose. The WG consisted of representatives of the multilateral bodies such as the BCBS, the IMF, the WB, the IDB and the Asian Development Bank (ADB), as well as the IFSB member authorities supervising the banking, insurance and capital market segments. The work of the WG has been facilitated by an in-depth issues paper and initial study report, as well as a survey of banking sector supervisory authorities in the IFSB member jurisdictions. This survey, and the deliberations of the WG, identified a number of areas in which existing core principles either do not deal, or deal inadequately, with the specificities of Islamic finance, thus confirming the need for a new set of core principles. The WG and the Technical Committee of the IFSB agreed that a sectoral approach would be most useful from the standpoint of practical assessment and, in view of the growth and significance of various sectors of the IFSI, it should focus initially on the banking sector.

While acknowledging the benefits a set of core principles can bring to the regulation of the financial system, it is equally important to appreciate that the core principles have not been the starting point of the work of any global standard-setting body. The BCBS was established in 1974 and focused on issuing standards on various aspects of the regulation and supervision of internationally active banks in the early years. For example, its framework for consolidated supervision and first capital accord (Basel I) were issued in 1979 and 1988, respectively. However, its first set of Core Principles for Effective Banking Supervision (BCPs) was issued in 1997, with its assessment methodology published two years later. The IAIS, established in 1994, issued its standard on solvency for the insurance sector in 2000, though its core principles (ICPs) were issued in 2003 for the first time. Thus the use of an incremental approach has been natural to the work of standard-setting bodies. Another reason for this phased approach has been the need for a body of standards which underlie various individual core principles and provide more detailed guidance on the respective areas of supervision. For this reason, global standard-setters have commonly embarked on the production of core principles only after a reasonable set of standards and guidelines have been produced in the respective sector.

3.5 Studies on the Application of Conventional Core Principles on Islamic Finance

3.5.1 Studies by the Conventional Standard-Setting Bodies

During 2004–08, a number of studies were conducted on the applicability of global core principles for the Islamic finance sector. These studies included: (i) *IOSCO Islamic Capital Markets Fact Finding Report,* July 2004; (ii) joint study by the IFSB and IAIS on *Issues in Regulation and Supervision of Takāful* (*Islamic Insurance*), 2006; and (iii) *Analysis of the Application of IOSCO Objectives and Principles of Securities Regulation for Islamic Securities Products*, September 2008. The studies provided the basis for the work of the IFSB WG on studying various sets of core principles for their application to Islamic finance.

The first such study – named *Islamic Capital Markets Fact Finding Report* – was conducted by IOSCO and published in July 2004. This report contained an explanation of the fundamentals and principles underlying Islamic finance, described the landscape of the IFSI, and discussed its individual components. Among key issues, the report discussed the applicability of the conventional regulatory framework to the ICM, including the IOSCO Objectives

and Principles of Securities Regulation. The report mentioned that the IOSCO Core Principles can be applied, and should apply, equally to the ICM.

After the issuance of the initial report by the Islamic Capital Market Task Force (ICMTF) in 2004, IOSCO carried out another more focused study to assess the compatibility of the IOSCO Core Principles with the regulation of Islamic finance. In September 2008 it published *Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products.* The key findings of this report were consistent with those of the previous work. While the applicability of the IOSCO Core Principles was confirmed by this analysis, it was found that the implementation of principles may benefit from further consideration in some specific areas. This report has highlighted a number of principles where some changes or additional guidance would be required.

On the application of ICPs, the IFSB and the IAIS jointly issued a paper entitled *Issues in Regulation and Supervision of Takāful* (*Islamic Insurance*). This paper studied the ICPs issued in October 2003 and provided an evaluation of their relevance to the *Takāful* industry. The issues faced by the *Takāful* industry were consequently grouped into four major themes: (a) corporate governance; (b) financial and prudential regulation; (c) transparency, reporting and market conduct; and (d) the supervisory review process.

The work of the IFSB on the *Takāful* sector has since followed the four major themes proposed by this joint paper with the issuance of IFSB-8: *Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings,* IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings,* and IFSB-14: *Risk Management for Takāful Undertakings.*

3.5.2 Working Paper on the Evaluation of Core Principles

The WG tasked with the preparation of CPIFR broadened the scope of earlier studies and not only reviewed the latest sets of core principles issued by the three main standard-setters after the financial crisis but also reviewed more briefly other core principles issued on deposit insurance, financial conglomerates and financial market infrastructures. The key objective was to analyse the applicability and relevance to the regulation and supervision of Islamic finance of the core principles of the conventional standard-setting bodies. For this purpose, the WG prepared a principle-by-principle gap analysis of three main core principles, which provided analysis on whether: (a) the existing principles are fully applicable; (b) they require modifications or adjustments; or (c) new principles are needed. The analysis indicated many areas of relevance, but it also underscored the importance of having additional principles to cater for the specific nature of products and the balance sheet structures of IIFS.[213]

The study also noted the differences in approach taken by various core principles. Some of these differences have been outlined above. It also noted some commonalities, including the fact that it is desirable to have a sufficient body of standards and guidelines in the respective area before any set of core principles is prepared. It noted that the broad objectives in each of the three sectors are to protect customers, whether these are investors, depositors or policyholders, and to ensure systemic stability. In the banking sector, systemic stability is considered the primary objective, though customer protection is, to a great extent, subordinated to the overall focus on stability. In the case of the insurance sector, the primary objective is to maintain efficient, fair, safe and stable insurance markets for the benefit and protection of policyholders. On the other hand, securities market principles focus on investor protection; fair, transparent and efficient market operations; and the reduction of systemic risk.

Based on this review, and as noted briefly above, the WG agreed that the exercise of preparing new core principles would be more meaningful and effective if it focused initially on BCPs for the Islamic banking sector. Other sectors of Islamic finance (principally, *Takāful* and Islamic capital markets) raise different issues, as indeed their conventional counterparts differ from conventional banking. They are at present substantially smaller in scale than Islamic banking. The body of global prudential standards issued for Islamic banking is also more widely available in comparison with the other sectors. The preparation of core principles for the Islamic banking sector will also create a feedback loop by way of experiences in their implementation and assessment through various mechanisms, including peer reviews and, potentially, the FSAP. This information will be helpful during the process of preparing a new set of core principles for other sectors such as *Takāful*, Islamic capital markets, Islamic deposit insurance, etc.

Based on these considerations, the current version of the CPIFR focuses on the Islamic banking sector. The Technical Committee of the IFSB nonetheless considered that it would be helpful for the Islamic finance community, and the regulatory community more generally, to publish the key findings of the WG study. This would give an indication of the applicability of other core principles to Islamic finance, and also of the possible future work programme of the IFSB in this area. It will also provide the background and wider context of the preparation of the IFSB CPIFR.

Consequently, the study was refined and published as an IFSB *Working Paper on the Evaluation of Core Principles Relevant to Islamic Finance Regulation* (WP-02), which was issued in November 2014 after the approval of the IFSB Technical Committee.[214] This paper expands gap assessment carried out by the IFSB as well as the IOSCO and the IAIS during the 2004–08 period, as discussed earlier in the chapter. The analysis in the paper builds on, and broadens the scope of, the previous exercises.

[213] www.ifsb.org/preess_full.php?id=277&submit=more
[214] The paper is accessible at: http://ifsb.org/docs/working%20paper-finalv2.pdf

The paper provides background information on the core principles for banking, insurance, the securities market, deposit insurance and other sectors, and discusses in detail the key areas of the core principles issued by the BCBS, IAIS and IADI, as well as IOSCO's objectives and principles, and their applicability to supervision of the various sectors of the IFSI. In particular, the paper presents a principle-by-principle gap analysis of unique considerations from the perspective of IIFS. This gap analysis indicates whether: (a) the existing principle is fully applicable; (b) it requires modifications or adjustments; or (c) a new principle is needed. In addition, the analysis indicates the need to have additional principles for CPIFR to cater for the unique risk faced by various sectors in the IFSI. This evaluation will be used as a foundation – and will be expanded further – for the future work programme of the IFSB when the Council approves the preparation of other sets of core principles at a later stage.

3.6 IFSB Core Principles on Islamic Finance Regulation for the Banking Sector

3.6.1 The Objectives and General Approach of CPIFR

The Working Group on CPIFR worked under the direction and guidance of the Technical Committee of the IFSB. The standard includes a set of core principles and associated assessment methodology. As a part of its due process, the WG conducted a number of studies and a survey of those RSAs that have supervisory responsibilities for Islamic banking in their jurisdictions. A total of 28 jurisdictions participated in the survey. This survey, and the WG's own deliberations, identified a number of areas in which existing core principles either do not deal, or deal inadequately, with the unique nature of supervisory practices and underlying risks facing Islamic banks and the sector as a whole. Consequently, and in line with the IFSB's normal approach, the CPIFR builds on the standards adopted by relevant conventional standard-setting bodies, in this case principally the BCBS, and adapts or supplements them only to the extent necessary to deal with the unique aspects related to Islamic finance. Apart from the representatives of RSAs in the banking, capital market and *Takāful* sectors, the participation of international organisations and multilateral development banks in the WG – such as the BCBS, IMF, World Bank, IDB and ADB – enriched the discussions, with valuable input from the WG members throughout the process. Additional feedback received by the IFSB during the public consultation phase, which included face-to-face public hearings and written comments from the IFSB member and non-member organisations as well as individuals, helped with further revisions and improvements in the standard.

The CPIFR endeavours to provide a set of core principles for the regulation and supervision of the Islamic banking sector, taking into consideration their specificities, lessons learned from the financial crisis, and complementing the existing international standards, principally the BCPs. In particular, the objectives of the CPIFR include:

- providing a minimum international standard for sound regulatory and supervisory practices for the effective supervision of the IIFS (Islamic banking sector);
- protecting consumers and other stakeholders by ensuring that the claim to *Sharīʿah* compliance made explicitly or implicitly by any IIFS is soundly based;
- safeguarding systemic stability by preserving the linkages between the financial sector and the real economic sector which underlie Islamic finance; and
- ensuring that IIFS act in accordance with their fiduciary responsibilities in all their operations, especially in regard to investment account holders (i.e. profit-sharing investment accounts, or PSIA).

In order to prepare the draft, the WG assessed the relevance of the BCPs and their associated methodology for application to Islamic finance, and retained them in their entirety where this seemed appropriate, while providing additional guidance where this was relevant. Each of the BCPs has been examined individually, and where needed, appropriate wording was introduced to reflect the unique features of Islamic finance. A total of four additional core principles were introduced, while one existing core principle was replaced in its entirety. Thus, against the 29 core principles issued by BCBS, the CPIFR includes 33 core principles. However, the most significant and far-reaching changes have been made to the detailed criteria that are proposed to facilitate the assessment of these core principles. Table 3.6.1.1 explains how the BCPs map into the CPIFR.

Table 3.6.1.1: Mapping the BCPs and CPIFR

Basel Core Principles (BCPs)	CPIFR Approach: Revised Core Principles in the form of CPIFR Reflecting the Specificities of IIFS
Supervisory powers, responsibilities and functions	
CP 1: Responsibilities, objectives and powers	Retained unamended: CPIFR 1
CP 2: Independence, accountability, resourcing and legal protection for supervisors	Retained unamended: CPIFR 2
CP 3: Cooperation and collaboration	Retained unamended: CPIFR 3
CP 4: Permissible activities	Amended: CPIFR 4
CP 5: Licensing criteria	Retained unamended: CPIFR 5
CP 6: Transfer of significant ownership	Retained unamended: CPIFR 6
CP 7: Major acquisitions	Amended: CPIFR 7
CP 8: Supervisory approach	Retained unamended: CPIFR 8
CP 9: Supervisory techniques and tools	Amended: CPIFR 9
CP 10: Supervisory reporting	Amended: CPIFR 10
CP 11: Corrective and sanctioning powers of supervisors	Amended: CPIFR 11
CP 12: Consolidated supervision	Amended: CPIFR 12
CP 13: Home-host relationships	Amended: CPIFR 13

Basel Core Principles (BCPs)	CPIFR Approach: Revised Core Principles in the form of CPIFR Reflecting the Specificities of IIFS
Prudential regulations and requirements	
CP 14: Corporate governance	Amended: CPIFR 15
CP 15: Risk management process	Amended: CPIFR 17
CP 16: Capital adequacy	Amended: CPIFR 18
CP 17: Credit risk	Amended: CPIFR 19
CP 18: Problem assets, provisions and reserves	Amended: CPIFR 20
CP 19: Concentration risk and large exposure limits	Amended: CPIFR 21
CP 20: Transactions with related parties	Amended: CPIFR 22
CP 21: Country and transfer risks	Retained unamended: CPIFR 23
CP 22: Market risk	Amended: CPIFR 25
CP 23: Interest rate risk in the banking book	Not applicable: Replaced with CPIFR 26
CP 24: Liquidity risk	Amended: CPIFR 27
CP 25: Operational risk	Amended: CPIFR 28
CP 26: Internal control and audit	Amended: CPIFR 29
CP 27: Financial reporting and external audit	Retained unamended: CPIFR 30
CP 28: Disclosure and transparency	Amended: CPIFR 31
CP 29: Abuse of financial services	Retained unamended: CPIFR 33
Additional Core Principles	
Treatment of PSIA/IAHs	New: CPIFR 14
Sharīʿah governance framework	New: CPIFR 16
Equity investment risk	New: CPIFR 24
Rate of return risk [Replaced CP23]	New: CPIFR 26
Islamic windows operations	New: CPIFR 32

Those BCPs which are equally applicable to both conventional and Islamic banking have been incorporated into the CPIFR essentially unchanged, in order to produce a single, complete set of principles. In these cases, a cross-reference has been made to the relevant BCP number for ease of reference. The detailed application may nevertheless be different as between conventional and Islamic finance.

In other cases, while the principle itself may have been changed only in minor ways or not at all, there may be key features of its application which have been reflected in the associated methodology. Space does not permit a full review of these changes here, but a few examples may serve to illustrate the approach that has been taken.

- Essential Criterion 4 to BCP 4, on permissible activities, limits deposit taking to firms that are licensed and supervised as banks. In the CPIFR, this limitation is extended to the offering of unrestricted PSIAs.
- BCP 7 deals with major acquisitions, largely from the point of view of the risks that may be imposed on the acquiring bank. Although CPIFR 7 does not change the text of the principle itself, it adds an important new essential criterion, that the supervisory authority determines that any business acquired by an IIFS should be *Sharīʿah*-compliant, or that there should be a valid plan to convert it to *Sharīʿah* compliance.
- CPIFR 31, on transparency and market discipline, largely covers the same territory as BCP 28. However, it specifies additional disclosures – for example, on the treatment of investment account holders (IAHs) and on *Sharīʿah* governance arrangements. It also mentions Islamic windows as material entities in the group structure about which disclosures should be made.

The new or replaced CPIFR, on the other hand, deal comprehensively with certain topics of particular relevance to Islamic finance, as explained in the following subsection. Where related topics are dealt with in different principles, the relationship has generally been indicated by a cross-reference rather than by repeating or restating material. This is to allow a focused approach to both assessment and implementation, and to avoid the confusion that may arise if similar concepts are expressed differently in the reference documents. It is also aimed at facilitating assessments where both the BCPs and the CPIFR are used in a jurisdiction that has both conventional and Islamic finance.

As explained earlier, and in line with the BCBS's practice, the CPIFR are intended as the highest level in the IFSB's standard-setting for the relevant sector. Where the IFSB has already published standards in a relevant area, these are reflected at a high level in the core principles. In some areas, the IFSB has done limited work, and the core principles are therefore its first definitive standards. (For example, there is limited work on Islamic windows.) In such areas, the IFSB may define standards in more detail in the future. Even where the IFSB does not produce a specific standard, the criteria in the assessment methodology provide additional guidance for RSAs on how the CPIFR can be applied and implemented in their jurisdictions. It is hoped that the CPIFR will contribute to the promotion of a resilient and stable Islamic financial system by, among other things, facilitating the process of assessment of the supervision of the Islamic banking system (whether by self-assessment or by external review), and also providing guidance to RSAs new to Islamic finance on the key components they should seek to incorporate in their regulatory and supervisory systems.

3.6.2 New Core Principles Introduced in the CPIFR

Table 3.6.1.1 exhibits that CPIFR has introduced four new core principles, which provide guidance and set out supervisory expectations on the treatment of IAHs, *Sharīʿah* governance framework, equity investment risk and regulation of Islamic window operations. One core principle has been replaced in full with rate of return risk in the banking book. Another 19 principles have undergone a revision in the text of the core principle itself and/or in the assessment methodology. Some others have been retained unamended.[215]

The regulation of profit-sharing investment accounts poses a number of challenges for a banking supervision regime that has evolved primarily for an interest-based banking sector where the funding side is denominated by the debtor–creditor relationship between a bank and its depositors. The new core principle (CPIFR 14) stipulates that the supervisory authority is expected to determine how IAHs are treated in its jurisdiction, and how various implications of the profit-sharing contract are considered in the regulatory framework. These unique features raise various considerations related to corporate governance, risk management, capital adequacy calculations and market discipline, all of which have been reflected in the assessment methodology.

The new core principle on the *Sharīʿah* governance framework (CPIFR 16) requires supervisory authorities to determine the general approach and to lay down key elements of the *Sharīʿah* governance framework in their jurisdictions. These elements include, among others, an effective independent oversight of *Sharīʿah* compliance over various structures and processes in the IIFS, which is commensurate and proportionate with the size, complexity and nature of its business. Moreover, the supervisory framework is expected to ensure that issuance procedures of relevant *Sharīʿah* pronouncements/resolutions and their dissemination to the operational staff is formalised. It also foresees the existence of an internal *Sharīʿah* compliance review/audit function for verifying that *Sharīʿah* compliance has been achieved. The principle further anticipates that a formal assessment of the effectiveness of an IIFS' *Sharīʿah* board, and of the contribution by each member to the effectiveness of the board, is conducted on a periodical basis as a whole. It may be noted, however, that this principle is a high-level reflection of the principal guidance provided in IFSB-10, rather than entirely new material.

Equity investment risk and rate of return risk are other areas where supervision of the IIFS has distinctive characteristics. The presence of profit-sharing contracts on both the asset and liability sides of the IIFS's balance sheet requires particular attention from a supervisory perspective. The new CPIFR 24 deals with asset-side risk and mentions that supervisory authorities should ensure the presence of adequate policies and procedures, including appropriate strategies, risk management and reporting processes. In addition, an IIFS should be able to demonstrate the appropriateness of its risk management framework and valuation methodologies, as well as define and establish the exit strategies in respect of its equity investment activities. The new principle on rate of return risk in the banking book (CPIFR 26) addresses the liability side of the balance sheet, which not only expects the supervisory authorities to ensure that IIFS have adequate systems to identify, measure and mitigate rate of return risk with a consideration of their risk appetite and risk management capabilities, but also stipulates that capacity of an IIFS to manage this risk and any resultant displaced commercial risk should be evaluated on a continuous basis.

Supervision of Islamic "window" operations is another unique feature. Such windows are now operating in a large number of the IFSB member jurisdictions. Supervisory practices for regulating these entities vary considerably across jurisdictions, which raises a number of issues on consolidation, capital adequacy treatment, transparency and disclosures, *Sharīʿah* governance and commingling of funds. While many considerations for their supervision are essentially similar to full-fledged IIFS, other issues need a careful policy stance and supervisory capacity to deal with them adequately. Therefore, supervisory authorities should not only define what forms of Islamic windows are permitted in their jurisdictions, but should also satisfy themselves that the institutions offering such windows have the internal systems, procedures and controls to provide reasonable assurance on the adequacy of *Sharīʿah* governance framework, risk management practices, segregation of funds and disclosures to stakeholders. All these points are covered in the new CPIFR 32.

3.6.3 Preconditions for Effective Supervision

The term "preconditions" or "necessary elements" of supervision refers to a set of key institutional and operational arrangements which can provide a facilitating environment in the regulation and supervision of financial institutions in that jurisdiction. Thus these elements are increasingly viewed as an essential component of both Islamic financial market development and overall financial system stability. These infrastructure components are largely institutional in nature and are commonly not within the sole mandate and scope of work of the supervisory authority. They cannot therefore be evaluated as part of an assessment of the RSA itself. This is why the CPIFR, in line with the BCP, treats them not as part of the core principles themselves, but as preconditions which an external assessor would comment on but not formally rate as part of the assessment. Nevertheless, supervisory authorities have a responsibility to communicate to the relevant state authorities and institutions the actual and potential negative repercussions of not providing a facilitating atmosphere to IIFS in managing their risk in an effective and competitive manner, which could ensure the soundness and stability of IFSI as well as of the financial sector as a whole. Supervisory authorities may also liaise with relevant state authorities and institutions by providing the necessary technical support and assisting in finding appropriate solutions for IFSI. They should also make the state authorities aware of the potential risks to the financial system posed by the absence of these mechanisms, and of their actual or potential negative repercussions for supervisory objectives. The preconditions relate to macroeconomic policies; the framework for financial stability policy formulation; public infrastructure; the framework for crisis management, recovery and resolution; systemic protection or public safety net; and effective market discipline.

[215] Except for purely technical changes, such as replacing "bank" with "IIFS".

While these preconditions are as applicable to the financial system in which IIFS are operating, as to a conventional one, there is a need for their proper interpretation and application in order to provide a basis for effective supervision of the IIFS. In particular, several preconditions need to be approached in ways that recognise the specificities of Islamic finance if they are to provide a level playing field to the IIFS and their conventional counterparts, such as public safety nets and recovery and resolution frameworks.

There are particular issues in relation to recovery and resolution in Islamic finance, including, for example, the correct contractual treatment of IAHs, *Sukūk* issued as capital instruments and the rights of their holders, and priorities among creditors of a failed IIFS. Similarly, while any decision on the appropriate level of systemic protection is a policy question to be addressed by the relevant authorities, including the government, particularly where it may result in a commitment of public funds, supervisory authorities will have an important role to play because of their in-depth knowledge of the financial institutions involved and their interconnections that may amplify systemic risk. The strengthening of financial safety nets comprises the establishment of a *Sharīʿah*-compliant version of the LOLR and deposit insurance scheme. An appropriate safety net mechanism can maintain the confidence of stakeholders in the financial system and deter any panic among IIFS' customers. The experiences have also indicated the need for supervisory authorities to provide greater clarity on their roles as providers of *Sharīʿah*-compliant liquidity support and LOLR facilities to IIFS in both normal and stressed times.

Finally, an effective market discipline is facilitated by: (i) adequate flows of information to market participants; (ii) appropriate financial incentives to reward well-managed institutions; and (iii) arrangements to ensure that investors are not insulated from the consequences of their decisions. These objectives are achieved by effective corporate governance, while ensuring that accurate, meaningful, transparent and timely information is provided to investors and creditors of an IIFS. Therefore, any role played by the governments or related entities to guarantee the financing provided by the IIFS should be appropriately disclosed. Similarly, the dependence of IAHs' capital and return on investment on the IIFS's profitability indicates that transparency is even more crucial in the IFSI. Therefore, the application of relevant international accounting and auditing standards, in conjunction with IFSB-4, would strengthen market discipline. Implementation of these standards would simplify the interpretation of financial statements of IIFS, particularly in terms of income recognition and profit calculation. Therefore, an appropriate disclosure of investment strategies and risk exposures by the IIFS would enable the IAHs to assess the type and risk characteristics of the investments made through their funds and make informed decisions.

In order to facilitate the introduction of financial safety nets in the member jurisdictions, the IFSB published its *Working Paper on The Role of Sharīʿah-compliant LOLR Facilities as an Emergency Financing Mechanism* in 2014 (WP-01). Currently, the IFSB is in the process of preparing two other WPs on *Sharīʿah*-compliant deposit insurance schemes and consumer protection. The future work programme will consider providing a more detailed guidance on these and other elements of regulatory infrastructure, such as recovery and resolution framework, crisis management and financial safety nets.

The CPFIR are intended to be applicable to both dual banking environments and fully Islamic banking environments. Where a jurisdiction has both significant Islamic banking and significant conventional banking sectors, it will normally be convenient to assess both at the same time. This reflects the fact that the CPIFR and the BCP cover much of the same territory, and many issues will therefore need to be considered only once. This is true not only of the core principles and their assessment criteria, but also of the preconditions for effective supervision. A dual assessment of this kind will also be able to assess the relevant linkages between the IFSI and its conventional counterpart, and their implications for financial stability. At what point in the development of Islamic finance in a jurisdiction an assessment against the CPIFR is appropriate will be a matter of judgment depending on both the significance of the sector and its projected development.

3.7 Conclusion and Going Forward

The CPIFR is aimed at providing a framework for the assessment of the quality of the regulatory and supervisory framework for the Islamic banking sector and for identifying future work to achieve a baseline level of sound regulations and practices related to this sector. It also endeavours to promote further integration of Islamic finance with the international architecture for financial stability, while simultaneously providing incentives for improving the prudential framework across jurisdictions so that it is harmonised and consistently implemented across the globe. As explained in this chapter, a number of mechanisms are being used by the global standard-setters and regulatory community to monitor the consistent implementation of the core principles and other international standards. These mechanisms are commonly used in combination with each other, instead of resorting to a single option in the toolkit. Most importantly, self-assessment and peer reviews are being increasingly utilised by the global standard-setters to track the standards' implementation.

The IFSB stands ready to encourage work at the national level to implement the core principles in conjunction with other supervisory bodies and interested parties. The IFSB invites the international financial institutions and other agencies to use the CPIFR in assisting individual jurisdictions to strengthen their supervisory arrangements, and it will continue to collaborate closely with those institutions and agencies, and remains committed to further enhancing its interaction with supervisors from the non-member as well as member jurisdictions.

The IFSB has produced its standards in a variety of areas related to the supervision of IIFS. The core principles have reflected, at a high level, the respective standards and guidelines already produced. In those areas where such standards are currently not available, the IFSB may work on producing the standards in more detail in the future. Revisions to existing IFSB standards and guidelines, and any new standard and guidance, will be designed to support the framework adopted in CPIFR.

4.1 Financial Consumer Protection in Islamic Finance

One of the root causes of the Global Financial Crisis (GFC) of 2007–09 was reckless lending practices in the retail market – in particular, sub-prime mortgages. These mortgages were securitised and became the basis of complex securities which were also sold off to retail clients,[216] who were unable to assess the high-risk structure of these papers (which were not fully understood even by professional rating agencies). Courts later found many financial institutions guilty of misconduct, and sometimes even of fraud, and some were sentenced to pay compensations and fines of an unprecedented size. The mistreatment of retail clients by financial institutions and the consequent need for protection of financial consumers gained prominence on political agendas in jurisdictions all over the globe.[217] It even escalated to the international level, with Finance Ministers and Central Bank Governors of the Group of Twenty (G-20) calling in early 2011 on the Organisation for Economic Co-operation and Development (OECD) and other international organisations to develop common principles on financial consumer protection. The first section of this chapter will briefly summarise these principles. The second section outlines the main instruments that are applied by different G-20 jurisdictions (in particular, the US, UK and EU) in their consumer protection policies for conventional finance. The third section discusses implications and adaptations for consumer protection in Islamic finance.

4.1.1 The Global Compass: G-20 Financial Consumer Protection

The G-20 initiative is not the first initiative aimed at formulating a comprehensive and consistent financial consumer protection policy globally,[218] but as a G-20 document it signals a global consensus of the governments of the jurisdictions with the most advanced financial industries. It will become the benchmark for consumer protection initiatives in other parts of the world, including Muslim countries.[219] The principles aim to prevent the mis treatment of consumers by financial institutions and to support informed consumer choices. In order to achieve this, the policy has to take into account behavioural peculiarities of the customers of financial institutions: empirical studies have found that the financial competencies of consumers are often very limited, and that they make persistently poor financial decisions. This has to be considered when designing financial consumer protection policies.

4.1.1.1 The G-20 High-level Principles of Financial Consumer Protection

The following summarises the ten *High-level Principles of Financial Consumer Protection* endorsed by the G-20 in October 2011:[220]

1. *Legal, Regulatory and Supervisory Framework:* Financial consumer protection should be an integral part of the legal, regulatory and supervisory framework and be adapted to the characteristics of the financial products and consumers. Strong and effective legal and judicial or supervisory mechanisms should protect consumers from financial frauds, abuses and errors.
2. *Role of Oversight Bodies:* There should be an explicit responsibility of oversight bodies for financial consumer protection with adequate powers, resources and capabilities.
3. *Equitable and Fair Treatment of Consumers:* Financial consumers should be treated equitably, honestly and fairly at all stages of their relationship with financial service providers.
4. *Disclosure and Transparency:* Financial service providers and agents should provide consumers key information on fundamental benefits, risks and terms of the product, conflicts of interest, and product alternatives they provide (including simpler ones). Promotional material and information provided should be clear, concise, accurate, reliable, understandable, comparable, easily accessible, not misleading, and timely.
5. *Financial Education and Awareness:* Financial education should give consumers knowledge, skills and confidence to understand risks and opportunities, and to make informed choices.
6. *Responsible Business Conduct of Financial Services Providers and Authorised Agents:* Financial service providers and agents should work in the best interests of their customers, be responsible for upholding financial consumer protection, and assess the consumer's financial capabilities, situation and needs before providing a product, advice or service. The remuneration structure of staff and agents should encourage responsible business conduct and fair treatment of consumers; it should not create conflicts of interest.
7. *Protection of Consumer Assets against Fraud and Misuse:* Consumers' deposits, savings and similar financial assets should be protected – in particular, against fraud, misappropriation and other misuse.
8. *Protection of Consumer Data and Privacy:* Consumers' financial and personal information should be protected, and consumers should be informed about data-sharing.

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216 The directive 2014/65/EU of the EU (the so-called MiFID 2 Directive) defines a retail client as a client who is not a professional client "who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs" (EU (2014), p. 483 [Annex II]). It is noteworthy that the ability to properly assess or manage financial risks has become a crucial criterion for the distinction between retail and professional clients and for the level of protection to be provided.

217 This does not mean that financial consumer protection is a totally new topic in politics. The need for consumer protection became apparent in the UK in the 1990s and led to regulatory initiatives in the late 1990s and early 2000s when elements of a "simple financial products" policy were implemented; see section 4.2.2.1.1, below.

218 For example, the Joint Forum of the BCBS released a report entitled *Customer Suitability in the Retail Sale of Financial Products and Services* in 2008 which focused on products with a significant investment component (including investment-based or investment-linked insurance products); the report presented a cross-sectoral comparison of suitability requirements. The World Bank launched its *Global Programme for Consumer Protection and Financial Literacy* in November 2010 and published in 2012 a detailed report on 39 good practices for financial consumer protection which were based on the experiences of 14 middle- and four low-income countries; see World Bank (2012).

219 For example, many elements of the G-20 package have been adopted or are on the agenda in Malaysia, where the authorities are implementing (step by step) far-reaching reforms of the mixed (conventional and Islamic) financial system.

220 See OECD (2011); all the following quotations are from this text (pp. 5-7).

9. *Complaints Handling and Redress:* Financial service providers and agents should have complaints-handling and redress mechanisms in place that are accessible and affordable to consumers, independent, fair, accountable, timely and efficient.
10. *Competition:* Competition should provide consumers with greater choices, stimulate innovation and ensure high service quality. Consumers should be able to search, compare and switch between products and providers easily and at a reasonable cost.

To support the implementation of the principles, the G-20 established a *Task Force on Financial Consumer Protection* that presented reports in 2013 and 2014.[221]

4.1.1.2 Capabilities and Consumer Behaviour in Finance

The GFC confirmed long-standing doubts about the explanatory power of neoclassical mainstream models of near-perfect financial markets. It also brought into discredit concepts of self-regulation and market discipline as the result of interactions of rational market players. Policymakers felt the need for a deeper understanding of financial decision-making, and gave their attention to alternative approaches for the explanation of adverse market phenomena – in particular, to models and insights of behavioural finance. Empirical studies on financial consumer behaviour were initiated by regulators, and their results were alarming. Consumers often do not understand financial products, are not well informed, and tend to choose, on the average, products and services that are not in their best interest. This weakness has been exploited by service providers who sold products that maximised their income (often from commissions).

The findings of empirical studies suggest a distinction between "retail investors" and "consumers" as two very different types of retail clients:

- The *retail investor* is not a professional, but a recurrent market participant with considerable experience and sophistication. He is aware of investment risks and can manage them reasonably well; he can also absorb occasional losses. The portfolio of risk-taking investors is diversified with significant investments in collective investment schemes (CIS) and direct investments in bonds and equity. The main problem of the investor is access to reliable information. The enforcement of better *disclosure* (i.e. more information in readily comparable format) would *empower* the investor-type retail client and facilitate better informed choices in pursuance of his individual preferences.
- The *consumer* has very little experience in and limited knowledge of financial markets. His income and wealth situation makes this type of retail client vulnerable, and he must avoid investment losses by all means. However, his understanding of complex products is poor, and he has difficulty in comparing investments and assessing their performance. If consumers make choices, these are often not in their own interest. Long lists of decision-making defects have been compiled,[222] and overall, consumers "simply tend to make bad decisions".[223] Better disclosure would not remove these defects. The appropriate policy approach for the consumer-type retail client would be *protection* – against mis-selling by financial service providers, but also against their own (systematic) mistakes.

An empowerment strategy for better information implies only minimal regulatory interventions, but decision-making defects are not reduced by more information.[224] Therefore, additional protective measures are deemed necessary. Some measures such as the creation of institutions for independent and unbiased generic advice are not "intrusive", but other instruments imply interventions into the financial markets which could be branded as "paternalistic". Examples are restrictions of the retail investors' access to particular instruments (e.g. closed-ended real estate funds) or the promotion of a suite of basic financial consumer products which are classified as "safe" by the regulator.

4.1.2 Instruments of Financial Consumer Protection

The instruments of financial consumer protection can be summarised in three main groups: (1) instruments for the empowerment of the consumers; (2) the regulation and supervision of financial products and service providers to implement good practice standards and fair treatment rules; and (3) a legal and judiciary framework for efficient complaints handling and dispute resolution, and mechanisms for damage containment such as deposit insurance schemes.

[221] The first report [OECD (2013)] covers disclosure and transparency, responsible business conduct of financial services providers and their authorised agents, and complaints handling and redress; while the second report [OECD (2014a)] covers the legal, regulatory and supervisory framework, role of oversight bodies, equitable and fair treatment of consumers, protection of consumer assets against fraud and misuse, protection of consumer data and privacy, and competition. An addendum [OEDC (2014b)] deals with financial education and awareness.

[222] "Rules of thumb are used to ease complex decisions and lead to poor decision-making. The status-quo bias, which means that decision-makers are reluctant to make changes and undervalue the risks of the status quo and the benefits of choice, leads investors to hold investments for too long and to a related tendency not to 'shop around'. The endowment effect, or the tendency to demand more to surrender an asset than its acquisition cost, leads to investors assessing risks in terms of loss aversion rather than in terms of final return. Cognitive conservatism also limits the extent to which investors change their decisions, even in the face of evidence that change is optimal. The framing effect means that investor vulnerability to marketing is significant; the way in which an investment choice is framed (in terms of the loss of an investment opportunity, for example) can drive the investment decision. The hindsight bias increases investor vulnerability to past performance information. The limitations of disclosure are borne out by the confirmation bias, which leads investors to rely on evidence or disclosures which reinforce their decisions, and by the availability shortcut, which leads investors to rely on information which is most easily brought to mind. Biases can also be contrarian. While loss aversion and the status quo bias suggest conservative decision-making, over-confidence is a particularly well-documented bias. It leads to investors being overoptimistic as to their skill, discounting the impact of chance (save with respect to losses), over-emphasizing positive returns and underestimating risk levels. Ultimately, poor decision-making based on over-confidence can lead to a wider misallocation of resources. Trend-chasing is also common, as is herding behaviour." Molony (2010), pp. 69–70, footnotes removed.

[223] Molony (2010), p. 70.

[224] This is a basic insight gained from behavioural economics and finance; see, for example, Altman (2008), Decision Technologies Ltd (2010), Baddeley (2013), Bavel et al. (2013), Lunn (2014).

4.1.2.1 Better-informed Choices

The starting point for consumer protection interventions is the fundamental information asymmetry between consumers and financial service providers. In the ideal world of *homo oeconomicus*, it would be in the self-interest of financial service firms to provide consumers "voluntarily" all the information of relevance for their rational decision. Hiding information is not a good idea in this competitive world because consumers will notice it and shy away. However, in the real world of human beings with limited information-processing capacities, it can be lucrative to be less than fully transparent and, for example, obscure information on fees, contractual restrictions or possible conflicts of interest. There is empirical evidence that such concealment practices were widespread in financial markets and went largely unnoticed by the consumers.

Disclosure requirements: relevant information in understandable form

Disclosure requirements are the least "intrusive" form of regulatory intervention, but (on their own) probably not very effective. It is crucial for a reasonably efficient financial retail market that the consumers get the information relevant for their choices in a format and language that not only clarifies the costs and features of a particular product but also facilitates comparisons with products of competing providers. Therefore, regulators may determine not only which information has to be provided but also in what format. It could be made obligatory to use plain English, to abandon fine print, to apply uniform templates for the presentation of data, etc. The regulator may require not only that an easy-to-understand summary of the relevant information is provided to the consumer at the point of sale, but also that a full disclosure of all product details is made on the provider's website. Although this may not be of much direct use for the individual consumer, financial advisers or consumer advocates could use the full disclosure for product analyses and recommendations. The media could also play a role, provided that qualified financial journalists exist (which cannot be taken for granted in emerging markets or developing countries).

If the typical consumer of financial products were a *homo oeconomicus*, then the provision of all relevant information would be sufficient to come to a market equilibrium that balances in a fair manner the interests of the supplier and the consumer. But if the typical consumer is a human being with limited average financial capabilities and information-processing capacities, this may not be enough. Mis-selling of financial products can be observed even in countries where rather strict disclosure requirements exist. Bad practices of service providers are persistent as long as particular incentive structures in imperfect markets are not changed by rather radical conduct regulation, such as the prohibition of commissions paid by product providers to financial advisers in the UK.

Comparable information (league tables)

A regulator could not only require the presentation of relevant information in a specific format; he could also compile and process the information in a way that encourages easy comparisons by consumers. The regulator may produce a huge "league table" or catalogue, probably as a web-accessible and searchable database, that "is likely to contain basic comparable information on price and other features of hundreds of individual financial products.... The provision of such comparative information is to be designed precisely to enable individuals to shop around effectively in the financial services marketplace – to act as more knowledgeable consumers and thus make competition work more effectively" (Johnson (2000), p. 9). A fundamental challenge for such a database is how to make products comparable which may have been designed intentionally to be different or even unique and then to identify those products which are most suitable for a particular customer.

Consumer awareness and education programmes

Financial retail products (such as capital-protected funds or whole life pension schemes) can be rather complex. Empirical studies in advanced economies have found a surprisingly low level of financial literacy of the average consumer of financial services. This means that many consumers are unable to make good use of available information even if it is worked up by the regulator. Hence, it is very important to raise the level of financial awareness, knowledge, and competency of consumers. Special attention should be given to people of small means, who are most harmed by poor financial choices (in relation to their limited financial resources).

Consumer education should be a high priority – in particular, in countries where the state reduces its involvement in health care and pensions and promotes market-based approaches for health insurance and retirement planning, as well as in countries where financial markets are just emerging. However, even if consumer education gets a high political priority, it may take not just a few years but a whole generation to achieve a significant rise in the financial literacy level.

Financial consumer advice institutions

Educational programmes may have been too ambitious in trying to teach the participants to find the solutions to their financial problems by themselves. It might have been better to teach only how to ask the right questions and then approach other people with the expertise to find the solutions. If consumers want to use the expertise of others, they must be able to communicate their financial needs. Trustworthy and permanently accessible institutions that provide comprehensive impartial generic advice for free could bring consumers to this level. The institutions should be able to offer comprehensive (financial) advice because financial problems can often be related to different segments of the financial market at the same time (e.g. investment funds and life assurance). The advice should be generic – that is, impartial and on basic features of different options only without any specific link to the products of particular providers. The recommendation of a specific product of a particular provider is beyond the scope of generic advice. This is a task for an adviser (agent, broker, sales staff, etc.) who knows the actual products in the market and can assume liability for his advice.[225]

[225] An example of such a permanently accessible institution that provides comprehensive impartial generic and free advice is the publicly funded Money Advice Service (MAS) under the supervision of the Financial Conduct Authority in the UK (see MAS (2014)). The rapidly increasing number of users indicates a growing acceptance of and trust in the services of this institution, as well as its usability and usefulness. But the example of MAS also shows that such an institution requires significant resources. It should be noted that the elaborate MAS model may not necessarily be suitable for other jurisdictions. The design of a financial consumer advice institution has to take into account national specificities of welfare, tax and pension systems, as well as the relevance of financial markets for individuals and households, in particular with respect to savings for health care and retirement. This means that, for some countries, less comprehensive and more specialised consumer advice institutions may be more appropriate than the "universal" MAS for the UK.

4.1.2.2 Regulation and Supervision of Financial Products and Providers

The regulation and supervision of financial products and financial service providers is the core business of regulatory authorities, but some regulations – in particular, in the field of conduct regulation – interfere with the freedom of contract and hence require backing by a legislative Act. Further, regulations that restrict the permissible range of products or product features require a solid justification in an economic order based on competitive markets and the freedom of contract.

Product regulation

Product regulations deal with restrictions regarding particular products or specific features of products. The intensity of the restriction of the freedom of contract can range from very moderate – in cases where the regulator makes product-related recommendations but leaves the implementation to the discretion of the financial service provider – to very strict in cases where the regulator prohibits or mandates the provision of particular products and services. For most cases, the intensity of the regulatory intervention lies between these extremes, such as obligatory minimum standards for product features deemed critical from a consumer protection perspective. Another common type of regulation requires the use of specific legal forms which have certain structural or governance features embedded (e.g. CIS, for which a custodian has to be separate from the manager).

A general justification for product regulations is the safety of the consumer – that is, the protection against damage resulting from the use of a product. This general argument has been applied in an analogy to the finance industry. A problem is that the potential damage depends very much on how or by whom a particular financial product is used. There are certain types of inherently risky financial products (from junk bonds to complex derivatives) that may meet the needs of advanced finance professionals and firms, but if inexperienced retail consumers buy such products, the probability of losses is very high. A total ban that would protect one group of customers but impair another group would not be an optimal solution. What looks more appropriate than a ban is a regulation of the access to "dangerous" products. A regulator could, for example, require a documented assessment of the financial knowledge and capacities of consumers who want to buy such a product, and it may only be offered to those who have sufficient knowledge and loss-bearing capabilities. Such a regulation would not alter the features of the product itself but restrict its distribution channels.

(i) Recommended standards and simple financial products

Recommended standards are intended to help consumers to make better choices. For example: There is a growing interest in socially responsible investing (SRI), and many financial service providers position themselves or some of their products in this field. There is a vast (and sometimes confusing) variety of different approaches and products all claiming to be SRI. National regulators may come forward with a set of best practice examples of what they consider good SRI products, or they may endorse and propagate principles for SRI products which have been established by international bodies or industry associations. By propagating and recommending them to domestic market players, the best practice examples and endorsed principles may gradually be adopted by more and more firms and finally become a de facto industry standard without compulsory measures by the regulator.

Another example of what may be considered as a "moral suasion policy" by the regulator (or the government) is the development of simple financial products. The underlying idea is to develop a suite of easily understandable financial products with standardised, and hence comparable, basic features which cover the typical financial needs of consumers with limited knowledge and capabilities. The initial focus in the UK was on simple savings products and simple protection (life insurance) products. The advantage for the consumers is that they cannot go wrong with these products: the products are structured in such a way that the consumers will not only not be exploited but will normally get a reasonable[226] deal. Products that meet all the criteria set by the regulator can be marketed under a special "quality label"[227].

(ii) Mandatory standards

Mandatory standards are typically minimum standards applicable to all products of a particular class. They are of particular relevance for products with long-term bindings such as assurance contracts with investment components. Minimum standards may require, for example, a capital protection or a minimum investment return, but they could also prescribe exit clauses or asset qualities. Minimum standards could set ceilings to product features – for example, a cap to interest on deposits.

A problem with such product regulations is that they may be circumvented if market participants find them too restrictive: new financial products that do not fall under the defining criteria of any restricted product class emerge (e.g. certificates of deposit at a time when savings deposits were restrictively regulated), or new types of financial institutions pop up (e.g. shadow banks), especially in legal systems where the freedom of contract allows all kinds of innovations unless they are explicitly prohibited.

(iii) Ban on products

The most severe form of product regulation is a ban on specific products. The general trend since the 1990s was not a tightening but the easing of regulatory restrictions. However, the trend was revered after the GFC of 2007–09. A "back to basics" movement set the tone for quite a while. Cost–benefit analyses of regulatory interventions were made to compare the microeconomic benefits of complex structures for individual market players with the macroeconomic costs of instabilities in the financial system. Seemingly, the balance

[226] See HM Treasury (2013).

[227] The expectation of the regulator is twofold: that the consumers will find these products appealing; and that these products are lucrative enough for the financial service providers so that they will offer them. The experience of the UK shows that both cannot be taken for granted, but some elements can enhance the likelihood of success, such as a product certification by a reputable institution which is well-known to the customers, and provisions for price transparency without price caps. A step beyond moral suasion could be tax benefits exclusively for financial products that meet the recommended minimum standards.

for some instruments was negative, and the financial services industry has experienced a partial ban on or temporary suspension of instruments with particularly destabilising potentials such as short selling. These instruments were not prohibited completely, but their use was restricted and banned from the retail market because they are considered too complicated and risky for the average consumer.

Conduct regulation

Over time the understanding of what is an "unsuitable product" has changed. The "traditional" view was that, for example, a loan is unsuitable if the debt service exceeds a certain percentage of the current income of the borrower, or an investment product is unsuitable if it freezes funds for a long period while the customer's need for an earlier access to liquidity is apparent. The problem was not the product as such, but its inappropriate use that could have been noted and prevented by the seller or adviser.

Another form of mis-selling is the sale of a product that is suitable in principle, but is not the best choice for the consumer. This "suboptimal" choice can result from a conflict of interest between the consumer and adviser in a commission-driven system. The adviser's income depends on the product he sells, and not on the optimality of the product for the consumer. The consumers' limited capacity to compare products facilitates "non-rational" consumer choices, and market forces alone are not strong enough to overcome these deficiencies. Hence, regulatory interventions may be needed to protect the consumers. These interventions can have very different intensities and may range from better information for the consumer to fundamental changes of the incentive structure of the sellers.

(i) Financial advice rules

It is said that complex financial products (such as unit-linked insurance plans) are not bought by the consumer but sold by the financial service provider, meaning that the provider (or broker, agent, adviser, etc.) plays the leading role in the decision process. Retail clients often rely on the advice of a provider, and a first step towards an effective consumer protection would be to ensure that the adviser or seller of a product gives the consumer unbiased advice based on a screening of the financial market – that is, of available alternatives that meet the needs of the consumer. Several countries have regulations in place which require an assessment of the financial needs and capabilities of the consumer, especially for long-term contracts, and this has to be documented in written form.

Regulators can go further and oblige financial advisers in the retail market to inform their customers explicitly on whether they give independent or restricted advice. Advice is restricted if the adviser advises only on certain types of products, or on products of only a few providers. Independent advisers have to "offer advice on a comprehensive range of retail investment products that might be suitable for … [their] clients, including: life policies, units in CIS, stakeholder and personal pension schemes, investment trust savings schemes, securities in investment trusts, investment companies, or other investment funds structured as special purpose vehicles, structured investment products".[228]

(ii) Restrictions on marketing and distribution channels

Although independent advisers must be able to provide advice on a wide range of products, they have to observe restrictions set by the regulator in the interests of consumer protection. Some "products are unlikely to be appropriate for the average retail investor. In particular, unregulated CIS (UCIS) and certain structured investment products, investment companies and other investment funds structured as special purpose vehicles are deemed to be non-mainstream pooled investments (NMPIs). NMPIs are subject to a marketing restriction … and generally speaking cannot be promoted to retail investors other than those who are certified as high net worth or sophisticated."[229]

(iii) Liability for advice

Regulators have to give teeth to their regulations. One possibility is significant penalties for the violation of rules. This may create a strong incentive for advisers to avoid the detection of a breach of a rule by the regulator, but not necessarily a strong incentive to observe the rule in the interests of the customer. The situation changes if the adviser becomes financially liable for losses suffered by a customer which are due to "wrong" advice. Disregarding the problem of the proof of a claim made by a consumer against an adviser, the liability for mis-selling is an important step towards a more incentive-compatible arrangement between consumer and adviser. If it is not too difficult for a consumer to prove that the adviser should have known that a product recommended was not suitable and caused financial damage, then it is in the genuine interest of the adviser to find at least a reasonably suitable product for the consumer.

(iv) Consumer-centred incentive structures

Neither product regulations nor disclosure requirements or rules for financial advisers eliminate the root cause of mis-selling – namely, commissions paid by the product provider to the distributor. This creates an incentive to advise or sell the products with the most attractive commissions, which may not be the products that are best suited for the customer. A radical solution for this problem is a complete change of the remuneration system for advisers: the adviser should not be paid by the seller of a product but by the buyer. With this incentive-compatible structure, it is in the genuine interest of the adviser and seller to find the best product for the customer. The ban on commissions for financial advisers in the UK is an example that such a fundamental change of a long-established incentive structure is possible if there is a political will.

4.1.2.3 Legal Matters, Disputes and Failure Cases

Decision support, as well as product and conduct regulation, should become effective in the pre-sales and sales phase. Legal issues, disputes and failures of financial service providers occur in the after-sales phase, which should also be covered by a comprehensive consumer protection system.

[228] Quoted from the FCA website: www.fca.org.uk/firms/firm-types/financial-adviser, last modified 14 November 2014, accessed 18 March 2015.

[229] Ibid.

Fair treatment of consumers

Regulators have received an increasing number of complaints about unilateral modifications of contract clauses by financial service providers on very short notice, harsh practices for the collection of overdue payments, lengthy procedures for the correction of mistakes, ignorance of complaints, etc.

(i) After-sales communication and contractual flexibility

In all these instances, consumers were not treated appropriately or were treated in an unfair manner. In response, regulators have implemented various instruments to ensure a fair treatment of consumers of financial services, including rules for after-sales communication (e.g. regular reports on the status of long-term investment plans or insurance contracts with saving schemes in understandable language), rules for a timely information on adjustments of contract clauses, regulations that prohibit or restrict unwanted direct sales practices (by phone or unrequested visits of sales persons), and cooling-off periods which give the buyer of a financial product time for second thoughts about a decision and the option of a cost-free cancellation of a contract.

Regulators have become aware that consumers consider contractual rigidity as a special form of unfair treatment. In times of financial turbulence and stagnating economies, increasing numbers of consumers have problems in meeting their regular payment obligations (for savings plans, mortgages, etc.) or want to get access to savings before the maturity of long-term contracts. Consumers are often disappointed with what they consider a lack of flexibility of financial service providers. However, one has to recognise that the financial service provider as the other contracting party has a legitimate interest that contracts are fulfilled. To avoid future hardships and to treat both sides fairly, model contracts with reasonable flexibility clauses (on a temporary suspension of payments, the freezing of a long-term savings plan, an early withdrawal of funds, etc.) could be developed.

(ii) Complaints handling: Internal and external (ombudsman)

Even with model contracts, disputes between the consumer and the financial service provider can occur. Therefore, internal complaint-handling procedures and external dispute resolution schemes are essential components of consumer protection regulations. The G-20 has called for financial service providers to institute accessible, fair, accountable and efficient complaints-handling and redress mechanisms.

If a complaint cannot be resolved by these internal routines, it may be transferred to an external mediator for an out-of-court settlement. A presently popular model is that of an ombudsman service.[230] Financial firms are obliged to give each consumer a final written response to a complaint, accompanied by a leaflet that explains how to access the ombudsman. If the final response is negative, the consumer may submit the complaint to the ombudsman service, where an adjudicator will look into the case and try to settle the dispute informally through mediation or conciliation. If the consumers and the firm accept the adjudicator's findings, the dispute is settled. If the dispute is not resolved, either side may ask for a final decision by the ombudsman. If the consumer accepts this decision, the consumer and the firm are bound by it. If the consumer does not accept the ombudsman's decision, the firm is not bound, and the consumer has the right to take court proceedings against the firm. The advantage of the ombudsman model is that the system is cheaper and usually resolves complaints faster than regular courts.

(iii) Court procedures

With an increasing complexity of financial products and financing structures with intricate special purpose vehicles on the one hand and a rapidly growing number of legal disputes in the retail market (where the challenge is not complexity but quantity) on the other hand, the establishment of specialised (benches of) courts could help to manage both complexity and quantity.

In recent years, courts became very actively involved in consumer protection. Following the GFC, many consumers filed lawsuits against their financial service providers for mis-counselling or mis-selling of financial products. In many cases the firms were sentenced to pay the consumers compensation, and in some countries, banks were also fined for violating existing laws and regulations.

Damage containment: Deposit insurance

Court decisions in mis-counselling and mis-selling cases which sentence financial service providers to pay customers compensations can also be seen as a form of ex post damage containment.

The consumer protection instruments so far assume that the provider of financial services stays in business. However, it happens that a financial service provider closes its business. This can be a voluntary and orderly, or an involuntary and unprepared, closure. Failure cases are of the latter type and can have a negative impact on assets which belong to customers of the failed firm. Today it is a widely shared view that bankruptcies of banks are dangerous events because they could trigger a bank run (in a fractional-reserve system). To prevent a systemic crisis, the regulatory systems of many jurisdictions protect depositors against losses caused by a bank failure by compensations from a deposit insurance scheme.

An argument against deposit insurance (without any retention) is that the depositors lose any incentive to monitor the activities of the bank's management and tolerate any level of risk taking by the bank. This argument presumes that the depositors would monitor the risk strategy of the management if there were no deposit insurance. In the light of behavioural economics, this argument is not very convincing.[231] Depositors would not only need regular and timely access to risk information, but also the

[230] For example, the UK set up a Financial Ombudsman Service (FOS) in 2001 as an "independent expert in settling complaints between consumers and businesses providing financial services" (FOS (2014), p. 1). The FOS clarifies: "We're not a regulator or an industry trade body. Nor are we a consumer champion or a government body. Our job is to settle individual disputes without taking sides" (ibid.). The procedure outlined in the text is that of the FOS.

[231] At least as regards retail depositors. Financial institutions depositing money in the interbank market are a different matter, and are commonly not protected by deposit insurance schemes.

capacity to process this information and the will to argue over the risk strategy with the management. Most depositors will not have these qualifications. The few who have the capability (and will) to monitor the risk strategy of the management can hardly claim to be representatives of "the" depositors: no individual depositor has access to the names and addresses of the other depositors to organise a "general assembly" of depositors where results of a risk monitoring could be discussed. In short, depositors would probably not be able to impose a market discipline on the management, even if their deposits would not be protected by a deposit insurance scheme.

4.1.3 Regulation in an Islamic Perspective

Since Islamic financial institutions are primarily financial institutions that operate in a dual financial system alongside conventional financial service providers, it is reasonable to suggest that, in principle, consumer protection regulations and initiatives implemented in conventional finance should also apply to them. However, the Islamic identity of Islamic financial institutions could call for additional regulations that do not have full equivalents in conventional finance, and it may require adjustments of conventional regulations to cater for the peculiarities of Islamic finance.

4.1.3.1 *Sharīʿah* Compliance as a Defining Product Feature

Conduct-of-business regulators in G-20 countries are in charge of all aspects of financial consumer protection. When it comes to Islamic finance, there is one obvious peculiarity with prime relevance for consumer protection in the Islamic sector which is absent in the conventional sector. For Muslim consumers of financial products, a feature of prime relevance is the *Sharīʿah* compliance of products and services. Islamic financial institutions claim that their products and services (as well as their internal operations) do have this quality, and it is consistent with a general mandate for consumer protection that a regulator takes a stance on how to ensure the correctness of this claim.[232]

IFSB-10 on Sharīʿah governance systems

A regulated screening for *Sharīʿah* compliance does not necessarily imply that the regulatory authority has to make *Sharīʿah* judgments by itself. The *Sharīʿah* compliance validation could be externalised, in principle, either by the establishment of a national *Sharīʿah* authority that has the final say in all matters related to the *Sharīʿah* compliance of financial products, or by a decentralised system of *Sharīʿah* boards on the level of the individual institutions that offer Islamic financial services.

In practice, variants of both approaches are applied by different jurisdictions. The IFSB has dealt with this topic in a standard-*Guiding Principles on Sharīʿah Governance Systems for Institutions Offering Islamic Financial Services* (IFSB-10), issued in 2009. It provides the following nine principles:

- Principle 1.1: The *Sharīʿah* governance structure adopted by the IIFS should be commensurate and proportionate with the size, complexity and nature of its business.
- Principle 1.2: Each IIFS must ensure that the *Sharīʿah* board has:
  - ◊ clear terms of reference regarding its mandate and responsibility;
  - ◊ well-defined operating procedures and lines of reporting; and
  - ◊ good understanding of, and familiarity with, professional ethics and conduct.
- Principle 2.1: The IIFS shall ensure that any person mandated with overseeing the *Sharīʿah* governance system fulfils acceptable fit and proper criteria.
- Principle 2.2: The IIFS shall facilitate continuous professional development of persons serving on its *Sharīʿah* board, as well as its ISCU (internal *Sharīʿah* compliance unit/ department) and ISRU (internal *Sharīʿah* review/audit unit/ department), if any.
- Principle 2.3: There should be a formal assessment of the effectiveness of the *Sharīʿah* board as a whole and of the contribution by each member to the effectiveness of the *Sharīʿah* board.
- Principle 3.1: The *Sharīʿah* board should play a strong and independent oversight role, with adequate capability to exercise objective judgment on *Sharīʿah*-related matters. No individual or group of individuals shall be allowed to dominate the *Sharīʿah* board's decision-making.
- Principle 3.2: In order to fulfil their responsibilities, the *Sharīʿah* board should be provided with complete, adequate and timely information prior to all meetings and on an ongoing basis.
- Principle 4.1: *Sharīʿah* board members should ensure that internal information obtained in the course of their duties is kept confidential.
- Principle 5.1: The IIFS should fully understand the legal and regulatory framework for issuance of *Sharīʿah* pronouncements/resolutions in the jurisdiction where it operates. It should ensure that its *Sharīʿah* board strictly observes the said framework and, wherever possible, promotes convergence of the *Sharīʿah* governance standards.

The implementation of these *Sharīʿah* governance principles should assure the consumers that products labelled as "Islamic" are indeed *Sharīʿah*-compliant.

The relevance of conventional financial consumer protection

Many initiatives of Western regulators and international organisations aiming at the prevention of mis-selling and the facilitation of better consumer choices could easily be transferred or adapted to Islamic finance: from basic disclosure requirements over reporting in "plain English" and a ban on hidden clauses in the fine print, to financial advice rules and dispute resolution mechanisms.[233] In some areas, adapted standards for IIFS have already been elaborated – for example, IFSB-4: *Disclosures to Promote Transparency and Market Discipline for Institutions*

[232] At first sight, this is somewhat similar to the claim of a conventional financial service provider to invest clients' funds, for example, only in socially responsible investments. However, while the meaning of "socially responsible investments" is framed in contemporary public debates, *Sharīʿah* compliance is more demanding. It requires the adherence to, or at least observance of, nominate contracts and maxims of a comprehensive but not codified legal system that evolved over centuries. Experts in Islamic law – traditional *Sharīʿah* scholars as well as specialised Western law firms – are working towards the compatibility of Islamic law and secular law that is in force in nearly all Muslim countries.

[233] The World Bank has compiled conventional "best practice" examples of consumer protection measures from middle- and low-income countries, and OECD reports instances from high-income countries; see World Bank (2014), OECD (2013).

Offering Islamic Financial Services (IIFS), issued in 2007. Even best-practice examples for awareness and education programmes could be adapted as far as the financial dimension is concerned. Whether and how such programmes should also incorporate the Islamic dimension – that is, the *Sharīʿah* compliance of products – is a different issue.

The adaptation of conventional models to Islamic finance becomes more complicated when a regulator wants to adapt initiatives for an easy comparison of financial products or to establish a body for generic advice on the suitability of different products, as most jurisdictions where Islamic finance is practised operate dual financial systems. Consumers – including Muslims – may not only want to compare conventional products with other conventional products and Islamic products with other Islamic products, but also conventional products with Islamic products, and vice versa.[234] Even Muslims who would not buy conventional products when Islamic alternatives are available may want to use conventional products as a benchmark for the performance of *Sharīʿah*-compliant products.

But there are more fundamental adaptation issues: Islamic banks – under the guidance of their *Sharīʿah* boards – have structured functional equivalents of contemporary financial products on the basis of traditional *Sharīʿah* nominate contracts to ensure the *Sharīʿah* compliance of their products. These contracts (in particular, *Murābaḥah, Salam, Istisnāʿ and Ijārah*) were never intended to be stand-alone *financing* contracts; instead, they are *sales* contracts with financing components – in particular, deferred payment clauses. These contracts in their stand-alone form either require the ownership of a real asset by the financier at the beginning, or the transaction ends with ownership of a real asset by the financier. However, financial institutions neither own a large variety of real assets, nor do they want to become owners of large pools of real assets. Their business is not trade but the *financing* of trade. Therefore, they had to combine traditional contracts with a second contract in the reverse direction[235] or with auxiliary contracts or unilateral promises *(Waʿd)*[236] in order to structure functional equivalents for conventional financial products. Not all modern combinations of traditional contracts are accepted by all *Sharīʿah* scholars so that different legal structures exist for the same financing purpose, or similar legal forms are filled with different commercial substance.

As a result, even basic products (such as *Sharīʿah*-compliant alternatives to conventional savings and term deposits or long-term loans) are more complex and can have different commercial characteristics depending on the practice of the banks. Major regulatory issues will be discussed in the following with the aid of an illustrative example each for the deposit business and for the financing business of IIFS.

4.1.3.2 Islamic Peculiarities in the Deposit Business

Until recently the predominant *Sharīʿah* nominate contract for the structuring of *Sharīʿah*-compliant equivalents of income-yielding savings and term deposits was *Muḍārabah*. In their abstract or legal form, *Muḍārabah* contracts are loss-bearing and profit-sharing arrangements,[237] known as unrestricted profit-sharing investment accounts (UPSIA). In contrast to the formal characterisation, *Muḍārabah*-based UPSIA are in practice often managed by Islamic banks in such a way that their substance resembles capital-protected fixed-income deposits. This is achieved by reference to prudent risk management techniques and by the application of profit-smoothing techniques which attune the actual profit payouts for investment account holders (IAHs) to the profits expected by them.[238] The abstract understanding of *Muḍārabah*-based UPSIA diverges significantly from the business practice of Islamic banks.

Smoothed investment accounts hardly look and feel like investments where a significant risk-taking justifies ex ante unknown returns for the capital provider. Instead, they resemble conventional interest-bearing deposits. This impression is reinforced by reference to a *Sharīʿah*-compliant "deposit" insurance scheme for investment accounts.[239] Both the formal characterisation and the practice of Islamic banks are backed by recognised *Sharīʿah* scholars and institutions such as the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

Better explanation and disclosure of smoothing practices

A consumer protection issue can arise if, for example, an Islamic bank follows the smoothing approach but uses promotional material with idealistic views by which it attracts clients to its UPSIA who would have gone for a different investment if they had fully understood the practice of the bank. There is a lot of enthusiasm for Islamic finance, especially among young people who subscribe to the view that only the productive investment of capital and its exposure to risk legitimises a return for capital owners. Smoothed investment accounts would not be the best choice for this group. "Unsmoothed" accounts or an investment in shares of an Islamic mutual fund or direct investments in capital market products might be more suitable for these risk-sensitive retail clients.

More detailed disclosure of smoothing practices would also support IAHs who, in principle, approve the smoothing approach but require more information to assess the past performance of their bank for informed choices on where to place their funds in the next period. For these clients, it is of particular interest to know how much of the profit payout was actual investment income

234 The persistence of dual financial systems and Islamic retail market shares of 20% or less mirror preferences of large parts of the population in Muslim countries. This behaviour may be considered morally or religiously wrong, but it is a fact of life.

235 For example, several *Murābaḥah* contracts constitute *Tawarruq*, *Salam* is applied as parallel or hybrid *Salam*, and *Istisnāʿ* is applied as parallel *Istisnāʿ*.

236 The combination of a single *Murābaḥah* contract with a promise of the customer to buy an asset at a mark-up from the bank is known as *Murābaḥah* to the purchase order(er).

237 One party (the *Rabb al-Māl*) entrusts his capital to another party with entrepreneurial skills *(the Muḍārib)* for profitable investments. Since only the *Rabb al-Māl* provides capital, all capital losses have to be borne by him, and the *Muḍārib* would receive no compensation for his efforts. Should the investment generate a profit, it is distributed among the *Rabb al-Māl* and the *Muḍārib* according to an agreed ratio.

238 The expectations of account holders are often formed by the advertisement of an expected rate of return by the Islamic bank. If no specific rates are advertised, account holders expect that their returns are in line with the prevailing deposit interest in the conventional sector.

239 The IFSB has recently completed a study on the role of *Sharīʿah*-compliant deposit insurance schemes for the strengthening of the financial safety net. The major findings are summarised in this report; see section 2.2.2(a).

and how much came from the release of profit equalisation reserves and other sources (in particular, adjusted *Muḍārib* profit shares or transfers from shareholders' funds). A high percentage of actual payouts taken from reserves and other sources could indicate that depleted reserves have to be replenished and that shareholders will look for a future compensation if actual payouts were beefed-up at their expense. Both will reduce the payout potential in good years, which may induce informed IAHs to switch to a competing bank with a stronger investment performance. Conventional finance regulators encourage consumers to "shop around for the best deal", and there is no reason why this should not also apply to Islamic finance, and disclosure should facilitate such a behaviour.

The urge for more disclosure on smoothing practices is not new. Major disclosure requirements regarding profit equalisation reserves were already spelled out in AAOIFI Financial Accounting Standard (FAS) No. 11, adopted in 1996 and addressing primarily the expert readers of balance sheets and income statements. The IFSB took a broader approach and issued IFSB-4 in 2007 with detailed disclosure requirements for UPSIA, including:

- written procedures and policies applicable to the investment accounts, including a synopsis of the following: range of investment products available from the IIFS; characteristics of investors for whom various investment accounts may be appropriate; purchase, redemption and distribution procedures; experience of portfolio managers, investment advisers and trustees; governance arrangements for the IAH funds; and procedures for trading and origination of assets;
- bases of allocation of assets, expenses and profit in relation to IAH funds;
- disclosure on the policies governing the management of IAH funds, which covers the approaches to the management of investment portfolio, establishment of prudential reserves, and the calculation, allocation and distribution of profits;
- disclosure on the major changes in the investment strategies that affect the investment accounts (including commingling of funds);
- method for calculation and distribution of profits;
- share of profits earned by unrestricted IAH, before transfers to or from reserves;
- share of profits paid out to unrestricted IAH, after transfers to or from reserves;
- rules governing the transfer of funds to or from investment risk reserves (IRR) and profit equalisation reserves (PER);
- disclosure of the utilisation of PER and/or IRR during the period; and
- profits earned and profits paid out over the past three to five years.

This information should be provided not only to professional clients but also in a form that is easily understood by retail clients.[240] The IFSB's GN-3: *Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders,* published in 2010, provides a survey of smoothing practices and explains in detail the use of and disclosures on IRR as well as PER and the underlying displaced commercial risk. The IFSB has placed disclosure on smoothing in the context of consumer protection and considers it not only an obligation to IAHs but also a matter of public concern and suggests that information on the use of IRR and PER be published in media that address the general public.[241]

Disclosure in analogy to collective investment schemes

If banks do not apply smoothing techniques but operate UPSIA as risk-bearing and profit-sharing products, other disclosure requirements become relevant with reference to the same consumer protection principles as quoted earlier. In this instance, investment accounts share basic characteristics with CIS. Islamic banks should explain to customers in some detail the differences between *Muḍārabah*-based investment accounts and (other) Islamic collective investment schemes (ICIS) – for example, exchange-traded Islamic funds for retail clients.

Since the IAHs are the ultimate risk bearers, banks should disclose, by analogy to CIS, details of the use of IAHs' capital and the bank's investment strategy. The risk/return profile is of particular interest, but also the valuation of assets. AAOIFI has adopted (in 2000) FAS 14 on investment funds with a comprehensive list of items for disclosure, including significant investment policies and the investment objectives; accounting policies adopted to value investments, receivables, financing and other assets; the accounting policy adopted to recognise income; the bases and terms that govern transactions that are jointly financed, wholly or partially, by resources of the *Muḍārib* and the investment fund; and non-*Sharīʿah* compliant earnings, if any, and how those amounts are disposed of.

The IFSB issued a specific standard on *Guiding Principles on Governance for Islamic Collective Investment Schemes* (IFSB-7) in 2009.[242] Based on IOSCO documents, the standard provides five principles with a number of recommended best practice examples:

- Principle 1: The ICIS's highest governing body (GB) shall establish a comprehensive governance policy framework which protects the independence and integrity of each organ of governance, and sets out mechanisms for proper control and management of conflicts of interest and duty.

240 "Retail investor-oriented disclosures for IAH … shall contain true, factual and balanced statements, and not projections or estimates of future performance of the funds. These disclosures shall include all explanations, qualifications, limitations and other statements that are necessary to prevent the performance information from misleading investors.… In addition to the current period's performance information, the disclosures shall contain information on historical returns for IAH and shareholders compared to general market and asset returns, and the underlying profit calculation and allocation method(s), which are consistent over a reasonable comparative period to enable IAH to make performance comparisons and to evaluate risks" (IFSB-4, paras 43, 45).

241 "An IIFS should be transparent to the IAH in respect of any smoothing practices. This is in due recognition of the rights of IAH as *Rabb-Al-Māl* to monitor the performance of IIFS as *Muḍārib*, which is crucial in preserving equitable treatment of investors and enhancing market discipline. As much as shareholders must be informed when a company utilises reserves to maintain a certain level of dividends distributions to them, similarly the IAH have a right to know when profits distributed to them are affected by appropriations to or releases from reserves. Indeed, a good track record of profit distribution is aimed not only at retaining IAH but also at enticing potential new investors. Smoothing should thus be treated as an issue of public concern. Therefore, it is reasonable for IIFS to publicise information about the aforementioned reserves in major media organs as well as in their annual reports" (IFSB GN-3, para. 73).

242 This standard explicitly classifies investment accounts as one form of an Islamic collective investment scheme (para. 7(v)).

- Principle 2: ICIS insiders shall ensure that disclosure of material information is not only done with appropriate accuracy and timeliness, but also presented in an investor-friendly manner.
- Principle 3: ICIS's GB shall ensure that appropriate systems and mechanisms for monitoring ex-ante and ex-post *Sharīʿah* compliance are in place, and are effective.
- Principle 4.1: The ICIS's GB shall ensure that any movement of the ICIS's funds or assets, to the extent that such is lawful, will be carried out in conformity with the ICIS's investors' objectives and their best interests and always supported by appropriate and objective valuations.
- Principle 4.2: ICIS insiders shall be transparent in the imposition of any fees, creation of any reserves and the smoothing of any dividend payments.

An area where detailed disclosure is required and most relevant for participants in "truly" profit-sharing structures is the determination of the profit that is to be shared and the formula for the calculation of the IAHs' profit share, as well as the terms for modifications during an investment period (including conditions for incentive profits, if any). AAOIFI FAS 6 (which has been transferred into the recently adopted FAS 27) explicitly addresses "Disclosure of Bases for Profit Allocation between Owners' Equity and IAHs". As in the case of smoothed investment accounts, this particular AAOIFI standard may become the basis of a consumer protecting regulation even in jurisdictions that otherwise do not apply AAOIFI standards. An even more elaborate alternative – with considerably more technical details – are the standards IFSB-4 and IFSB-10. Irrespective of whether regulators in dual systems refer to AAOIOFI or IFSB standards, both facilitate a regulation of Islamic finance that is at least equivalent to, if not more elaborate than, corresponding requirements for conventional CIS.

Quasi risk-free and quasi fixed-income term deposits on a Wakālah basis

Consumer protection by disclosure is the least interventionist method, but it can be effective only if the disclosed information is understood and processed adequately by the consumers. There are serious doubts whether this will be the case for *Muḍārabah*-based investment accounts, as these *Sharīʿah*-compliant investment accounts are inherently more complex and ambivalent in their practical utilisation than conventional counterparts. Furthermore, disclosure does not minimise the risk of a capital loss, and any risk exposure may be beyond the capabilities of financially vulnerable groups. UPSIA are probably not the most suitable savings vehicle for them, and it would be in their interest that Islamic banks provide simple risk-minimised products.

Wakālah-based accounts of a specific type could be a solution.[243] The commercial features of *Wakālah* accounts can come close to those of conventional savings or term deposits. The bank acts as the agent (*Wakīl*) of the customer and invests his money for a specified period of time in *Sharīʿah*-compliant businesses as agreed upon in the agency contract. To minimise the risk of capital losses, the contract could, for example, restrict the investments to asset-backed bank financings and top-rated *Sukūk*, and it may prescribe a minimum asset diversification. It could also specify an investment strategy (for pooled *Wakālah* accounts) which replicates capital protection strategies of conventional finance.[244] This does not eliminate the risk of capital losses completely,[245] but the remaining risk may be considered the lowest achievable for a *Sharīʿah*-compliant security that yields a regular income.[246] A voluntary guarantee against investment losses by a third party could eliminate even this residual risk. This makes the *Wakālah* account quasi risk-free.

As for the fixed-income feature, the bank and the account holder agree on an expected target profit from the investments. The resulting target rate of return is not guaranteed, but it can be calculated with high accuracy for a specified investment period. The bank does not have an incentive to set an unrealistically high target profit if the *Wakālah* contract stipulates that profits above the target will go to the *Wakīl* as an incentive fee. This should motivate the bank to meet and beat the target profit. If the extra profits go to the bank in total, the *Wakālah* account becomes a quasi fixed-income deposit.

The internal structure of such a product is all but simple.[247] Nevertheless, the commercial features are easy to understand by the consumer, and they should be particularly appropriate for financially vulnerable people with small savings who cannot afford losses but would like to earn a modest return on their capital in a *Sharīʿah*-compliant way. However, it is important to note that the *Wakālah* contract in itself does not imply a quasi risk-free investment.[248] It is the agency agreement on a particular investment strategy that can give the *Wakālah* account a quasi risk-free character. Without an explicit risk-minimising investment strategy, *Wakālah*-based accounts should be classified as a form of risk-taking investment accounts (with *Muḍārabah*-based accounts as another form).

Strict separation of risk-free Islamic deposits and risk-taking investment accounts

Most countries where Islamic finance is practised do not have a national *Sharīʿah* authority to decide on *Sharīʿah* compliance issues, and in many of these countries regulators painstakingly avoid authoritative comments on substantial *Sharīʿah* issues.

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243 This structure has gained popularity among Islamic banks in recent years. However, at present *Wakālah*-based accounts target mainly high-net-worth individuals instead of risk-averse low-income customers, but it should be possible to develop a standardised mass market version of this product (an analogy to the "simple products" approach in conventional finance).

244 For example, the bank could invest a sufficiently large part of the pooled funds of the *Wakālah* account holders in financial assets with non-negative returns and a guaranteed payment at maturity (e.g. in sovereign or top-rated corporate *Ijārah Sukūk*) that covers the nominal value of the initial deposit; the remaining funds could be used for investments with higher profit potentials but also higher risks.

245 Losses could occur, for example, in case of a default of the issuer of the *Ijārah Sukūk* that is used as the backup for the account holders' capital.

246 A "true" deposit with a capital guarantee by the accepting institutions could be based on *Sharīʿah* contracts such as *Qarḍ* and *Wadīʿah*, but these contracts do not allow a regular income for the capital provider (i.e. explicitly agreed or customarily expected payments of the deposit-accepting institution to the depositor).

247 There are contractual complexities to ensure *Sharīʿah* compliance, challenges for the investment manager, and liquidity management issues if withdrawals should be allowed on short notice or even at any time.

248 As in a *Muḍārabah* contract, the bank client is the capital owner under *Wakālah* and, as such, has to bear losses as long as the agent (bank) invests the capital within the limits defined by the agreement with the *Wakīl*.

This leaves the responsibility for the *Sharīʿah* compliance of products with the *Sharīʿah* boards of the financial institutions. As a result, different practices may prevail in the same jurisdiction, and the same name may be used for commercially very different products. This can create confusion and misunderstandings among retail clients regarding the risk profiles of investment accounts.

Malaysia has taken legal and regulatory steps to make a clear distinction between two fundamentally different types of Islamic accounts. The *Islamic Financial Services Act* 2013 differentiates between Islamic investment accounts and Islamic deposits, and Bank Negara Malaysia (BNM) released a policy document in 2014 on regulatory requirements of investment accounts (see BNM (2014)). The clear demarcation line is the existence of a legal obligation for the financial institution to repay money accepted from account holders in full. The obligation to repay in full is constitutive for an Islamic deposit (e.g. a current account or a savings account) that could be based on a *Qarḍ* or *Wadīʿah* contract. The Islamic depositors' claim for a full repayment can be covered by a deposit insurance scheme, and Islamic deposits are formally risk-free.

Money paid into an Islamic investment account is exposed to commercial risks. The accepting bank is not obliged to repay in full (notwithstanding a liability for misconduct and negligence); investment accounts can be based on *Muḍārabah*, *Mushārakah* or *Wakālah* contracts. Banks are obliged to point out unmistakably that money paid into investment accounts is exposed to market risks. BNM made it mandatory for financial institutions to place a disclaimer statement[249] and a risk warning[250] on all promotional material for investment accounts. In addition, BNM has stipulated that financial institutions have to provide a product disclosure sheet for each type of investment account offered to retail customers. This is very similar to what is common practice in capital markets (especially for CIS).

The product disclosure sheet has to contain, among other things, the following information: adopted *Sharīʿah* contracts (including details of the profit distribution policy, such as the application of the profit-sharing ratio and incentive fees, as well as the nature of losses that had to be borne by the IAH); the product structure, including investment objectives, strategies and proposed investment assets; fees and charges; and a risk disclosure statement highlighting risk factors; and an analysis of past and future performance (which not only presents best case scenarios and potential upside returns but also spells out downside risks of losses).

BNM has made rather detailed stipulations for a suitability assessment,[251] and only after the financial institution has satisfied itself that a client is eligible for investment products can it recommend the particular investment account (or another investment product) that it deems most suitable for the needs and capability of the retail client.

4.1.3.3 Islamic Peculiarities in the Financing Business

Let us assume that the regulator becomes aware of actual or potential financing practices in Islamic finance which are considered to be or to have the potential to become a serious threat to the interest of consumers. His possible reactions, and the issues involved, can best be illustrated by an example.

Product features: from recommended to mandatory

Islamic banks apply sales contracts for the long-term financing of consumer assets – for example, *Murābahah* or *Bayʿ Bithaman al-ʿĀjil* (BBA) contracts with tenures of 15 years or more for house financing. The bank and the customer agree on a selling price for the house that comprises the object's cost price (at which the bank acquires the house) plus the profit margin of the bank. The selling price is paid in instalments, and each instalment reduces (according to an agreed formula) the outstanding cost price and profit margin. If a customer wants to settle his debt before maturity, the *Sharīʿah*-compliant sales contract gives the bank the right to claim the full outstanding amount of the selling price, which includes a profit component that was calculated for instalments in the future. In an early settlement of a conventional loan, the bank (ignoring any charges, penalties, etc.) would claim the repayment of the outstanding loan amount – which is equivalent to the outstanding cost price in a sale-based Islamic financing – but no interest for future periods because there will be no more outstanding debt. Without modifications of the sale contract, the customer of the Islamic bank would be in a disadvantaged position, and his treatment could hardly be considered as fair.

A significant disadvantage for retail clients of Islamic banks should be a concern for regulators with a consumer protection mandate. If retail clients are familiar with conventional practices, and if an Islamic bank has presented the sale-based financing as a *Sharīʿah*-compliant equivalent to an interest-based loan financing without any exposition of early settlement issues, then the client was misguided by incomplete information. To avoid this outcome, Islamic banks and regulators have worked out the following solution. While the customer is contractually obliged to pay the full outstanding selling price, the bank has the right to waive all or part of it. Such a voluntary debt reduction or rebate is known in Islamic jurisprudence as *Ibrā*'. The bank, for example, may offer a rebate equivalent to all profit components of future instalments. By this means, the customer will pay the cost price of the object and the profit margin for only those periods in which he had used the resources of the Islamic bank. This is equivalent to what a customer of a conventional bank would have to pay.

The problem with this solution is that the granting of *Ibrā*' is at the discretion of the bank, and the customer cannot legally claim a rebate unless *Ibrā*' was explicitly mentioned (promised) in the financing contract. This may lead to a situation where some banks mention *Ibrā*', while others do not. Different practices create confusion and uncertainty among customers and may damage the reputation of banks that do not mention *Ibrā*' in the documents.

[249] BNM gives an illustration of such a statement, to be written in bold capital letters: "IMPORTANT/DISCLAIMER: THIS IS AN INVESTMENT ACCOUNT PRODUCT THAT IS TIED TO THE PERFORMANCE OF THE UNDERLYING ASSETS, AND IS NOT A DEPOSIT PRODUCT." (BNM (2014), p. 31).

[250] The illustration reads for such a warning, to be written in bold capital letters: "WARNING: THE RETURNS ON THIS INVESTMENT ACCOUNT WILL BE AFFECTED BY THE PERFORMANCE OF THE UNDERLYING ASSETS. THE PRINCIPAL AND RETURNS ARE NOT GUARANTEED AND CUSTOMER RISKS EARNING NO RETURNS AT ALL. IF THE INVESTMENT IS REDEEMED EARLY, CUSTOMER MAY SUFFER LOSSES IN PART OR THE ENTIRE PRINCIPAL SUM INVESTED. [WHERE THE INVESTMENT ACCOUNT IS NOT PROTECTED BY PIDM TO ADD: "THIS INVESTMENT ACCOUNT IS NOT PROTECTED BY PERBADANAN INSURANS DEPOSIT MALAYSIA."]" (BNM (2014), p. 32).

[251] The financial institution has to gather information on the investor's age, the annual income and number of dependants, his investment objectives, financial situation, risk profile and current portfolio, and his level of financial knowledge and experience which should correspond to the complexity of the product.

Regulators with a consumer protection mandate can take measures to come to a more unified fair treatment of customers of Islamic banks, The mildest form of product regulation would be a recommendation of an *Ibrā*' clause in sale-based financing contracts and an explication of the rebate policy. It remains at the discretion of each financial institution to follow the regulator's recommendation or not. However, the appellative approach does not ensure that all banks accede to the request and explicate *Ibrā*' in their contracts. If this were the goal, the regulator should require an *Ibrā*' clause as a mandatory product feature of sale-based financing contracts. The mere requirement of a clause does not ensure that all banks follow the same *Ibrā*' policy. Conditions and percentages for rebates may differ, and it can be difficult for consumers to find out which bank offers the best terms for different scenarios. To achieve a harmonised *Ibrā*' practice, the regulator has to make a particular method for the calculation of *Ibrā*' mandatory.[252]

Regulators who cannot take an explicit stance on *Sharīʿah* issues may be reluctant to prescribe an *Ibrā*' formula or to make an *Ibrā*' clause in contracts mandatory. Instead, they may follow a "comply-or-explain" approach.[253] The regulator recommends an *Ibrā*' clause (including, possibly, even an *Ibrā*' formula), but leaves the decision to adopt, modify or reject this proposal to the IIFS. Institutions that do not adopt the regulator's proposal are required to explain to their customers in written form and plain English why they have rejected or modified the regulator's proposal and what that means for customers who seek early settlement.

Specific product restrictions

Islamic finance has progressed not only in size but also in sophistication; the spectrum of instruments for medium- to longer-term consumer financing has become much wider. For example, banks today widely apply *Ijārah* or diminishing *Mushārakah* structures for house financing. These techniques are much less plagued by issues of transparency, fair treatment and flexibility than *Murābahah* or BBA when confronted with a demand for restructuring or early settlement.

If better alternatives are at hand, the regulator may consider a restriction of the use of a particular type of contract for specific purposes – for example, of *Murābahah* or BBA for long-term financing in general or home financing in particular. The restriction of the specific use of an instrument that is permissible from a *Sharīʿah* perspective but critical from a consumer protection point of view and substitutable in its functions by less conflict-prone instruments does not involve an explicit or implicit *Sharīʿah* argument. Instead, the rationale for the restriction is plainly technical – namely, the prevention of opacity, uncertainty, unfairness and unequal treatment of substantially equal cases. Restrictions on the use of a *Sharīʿah* nominate contract may raise questions from a *Sharīʿah* perspective, but they do not affect a regulator who deliberately does not refer to *Sharīʿah* but only to the technical implications of a *Sharīʿah* nominate contract for justification of his decision.

General suitability of products for retail clients

The protection of retail clients – in particular, of vulnerable individuals – against rigid and unfavourable instruments could also be achieved by an approach with no direct interventions by the regulator. In principle, *Sharīʿah* nominate contracts are not restricted in their use for any purpose, including sale-based contracts for house financing. However, it is a high-level principle of financial consumer protection that all products comply with the *suitability criterion*. All banks (Islamic or conventional) have to assess the suitability of a specific product for a particular retail client, taking into consideration the features of the product and the economic situation of the customer, as well as the features of alternative products for the same purpose. A product that creates an unreasonable financial burden for customers when changes of the original financing arrangement become necessary is seemingly not the most suitable one.

The suitability criterion can be framed in such a way that it gives financial consumers *enforceable rights* – for example, the right to be compensated for extra costs incurred that could have been avoided by the choice of a more suitable product. A long-term house financing contract based on *Murābahah* or BBA with no *Ibrā*' clause offered to a vulnerable household will hardly pass the test of suitability. It should be in the own interest of the bank to offer an alternative structure (*Ijārah* or diminishing *Mushārakah*) with more flexibility than a rigid sale contract.

The advantage for regulators with a neutral stance on Islamic finance is that the suitability approach leaves the responsibility for *Sharīʿah* compliance and fair treatment to the Islamic financial institution. What is required is a definition of "suitability" (and of the responsibilities of financial institutions) that creates enforceable consumer rights. The downside of the approach is that it does not ensure a uniform treatment of retail clients by different banks, and that it may evoke during a formative period a large number of cases that have to be decided by the dispute resolution bodies.

Ban on products and restriction of distribution channels

The regulator may screen the risk/return profile of more complex *Sharīʿah*-compliant structures. As in conventional finance, he may ban (temporarily or permanently) particularly risky products and contractual arrangements (such as *Sharīʿah*-compliant futures or short selling techniques) from the retail business. A milder version would be restrictions on marketing and distributions channels for high-risk products and structures that are analogous to conventional finance.

Conduct regulation

Major new conduct regulations in conventional finance were the implementation of stricter rules and regulations for financial advisers (including the liability for advice) and the radical change of the remuneration scheme for financial advisers in the UK. Malaysia has taken steps in this direction. If such reforms are considered for Islamic finance elsewhere, regulators with a neutral stance on

[252] Bank Negara Malaysia has taken this tougher approach and issued *Guidelines on Ibrā*' *(Rebate) for Sale-Based Financing* in 2011 (updated 2013) (see BNM (2013)). The objectives of the guidelines are to promote transparency and an equitable mechanism of the granting of *Ibrā*' by Islamic financial institutions. The guidelines explicate in detail for sale-based financings with fixed or variable rates and for different early settlement scenarios the method for the calculation of *Ibrā*'. The financial institutions have to apply this method and must, among other things, illustrate the application of the *Ibrā*' formula by a detailed payment schedule that can be easily understood by the customers.

[253] Although the regulator does not make an explicit *Sharīʿah* pronouncement by himself, he is not totally detached. By proposing an *Ibrā*' clause, he sides with those *Sharīʿah* scholars who deem *Ibrā*' permissible.

Sharīʿah could conceptually justify them by reference to the public good. The Islamic understanding of the public good (*Maṣlaḥah*) is not fundamentally different from the conventional one in this field. However, the empirical basis for an impact assessment in support of radical conduct regulations is at present very slim in most jurisdictions where Islamic finance is practised.

4.1.3.4 Fair Treatment in Disputes and Damage Containment for Islamic Consumers

There is no reason why initiatives in the conventional finance sector for improved after-sales communication, timely information on contractual changes, the prevention of unwanted direct sales practices, or the introduction of cooling-off periods should not be applied in the Islamic finance sector. The IFSB has underlined the great importance that Islamic law attributes to the overarching principle of fairness in financial transactions (in particular, if participatory elements such as those in UPSIA are involved).

Islamic specificities in dispute resolution

Like conventional banks, Islamic banks should implement a complaints-handling system. In cases where complaints are related to the *Sharīʿah* compliance of products or processes, the system should interact with the *Sharīʿah* governance bodies of the financial firm up to its *Sharīʿah* board.

In parallel to the strengthening of consumer rights, many jurisdictions have upgraded their systems for the settlement of legal disputes: from specialised courts for consumer-related cases to a variety of alternative dispute resolution systems (such as ombudsman models). Similar structures could also be applied in Islamic finance, and this topic (as well as the broader issue of the enforceability of Islamic finance contracts in secular jurisdictions) is well covered in the literature.[254]

Matters of dispute include the financial suitability of specific products for particular retail clients. This has some peculiarities in Islamic finance. The example of sale-based contracts for long-term house financing illustrates that there can be additional suitability dimensions in Islamic finance compared to conventional finance. Although disputes about suitability are not disputes about *Sharīʿah* compliance (but about "unfair" financial burdens due to "inappropriate" products), it would enhance the quality of consumer protection efforts if the members of dispute resolution institutions (judges, arbitrators, ombudsmen, etc.) have a good understanding of *Sharīʿah* concepts and contracts as well as Islamic finance products. If a complaint over an Islamic finance arrangement has not been settled internally by the mechanisms of the Islamic bank because it insists on a particular *Sharīʿah* interpretation, then the external institution for dispute resolution should be able to understand whether the *Sharīʿah* stance of the bank is serious or just a pretext. The judge, arbitrator or ombudsman should know (either by himself or with the help of advisers) about the peculiarities of Islamic contracts and possible alternatives that the bank should have considered before offering the disputed product. When it comes to a proposal for a solution of the dispute or, in the last instance, a sentence in favour of the customer, this should be sensible with respect to the *Sharīʿah* stance of the financial institution.

Damage containment in (near) failure cases

In conventional finance, savings deposits are financial claims against the bank. In a bankruptcy case, savers would have the status of unsecured creditors, and they could suffer losses if the total claims of all creditors exceed the value of the total assets of the bank. To prevent such an outcome, the capital of the savers can be protected by a deposit insurance scheme.

In Islamic finance, the legal status of the savers in respect of their funds can be rather different. If the underlying structure is a *Muḍārabah* or *Wakālah* contract, then the savers are not creditors of the bank but owners of their funds, and the bank is only the investment manager. The IAH have to bear all investment losses (except for misconduct and negligence). If the bank fails, a deposit insurance scheme can step in and pay out the net value of the accounts to the IAH. Such a support for IAH should not raise serious *Sharīʿah* concerns. This could be different if the deposit protection scheme also protects the IAH's capital against investment losses. A *Sharīʿah*-compliant loss protection – at least for cases of bank failures – may be structured on the basis of a third-party guarantee, and it could be justified by reference to public good considerations (*Maṣlaḥah*), as it protects systemic stability by preventing an imminent bank run. Details on *Sharīʿah*-compliant deposit insurance schemes and a survey of the practice in jurisdictions where Islamic finance is offered are presented in Chapter 3.

4.1.4 Concluding Remark

The first part of this chapter summarised the most important approaches and instruments of financial consumer protection in conventional finance. Most of them can be applied in Islamic finance directly or with minor modifications. Given the limitations of space, these minor modifications have not been spelled out in the second part on regulation from an Islamic perspective. Instead, the focus there is on the peculiarities of the *Sharīʿah* nominate contracts as the building blocks of the instruments of IIFS. Major savings and investment products of Islamic banks have participatory features that are very similar to (if not identical with) capital market products – namely, CIS. Investment-like savings plans of family *Takāful* operators also share many characteristics with CIS. A compartmentalised regulatory environment with separated and poorly coordinated regulators for banks, capital markets and insurance/*Takāful* (and in the worst case, each with a different consumer protection philosophy) will provide opportunities for regulatory arbitrage and undermine the effectiveness of financial consumer protection policies. The close cross-sectoral linkages of IIFS call for a cross-sectoral regulation, which is not the standard in all jurisdictions.

[254] See, for example, Abikan (2011), Yaacob (2012) and White (2012).

4.2 Towards a Global Islamic Finance Database for Financial Stability

4.2.1 Recent Global Financial Crisis and Data Gaps

Global financial markets in recent years have witnessed rapid innovation, product diversification, deregulation and integration across sectors. The recent financial crisis has highlighted the need for both microprudential and macroprudential data to support oversight of the financial industry, and market discipline over that industry, as well as the need for the data collected to be reviewed in the light of changes in the structure and activities of the industry.

In 2009, the Data Gaps Initiative (DGI) was formed under the auspices of the G-20, aimed at closing the information gaps highlighted by the crisis.[255] The G-20 Finance Ministers and Central Bank Governors Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets called for the International Monetary Fund (IMF) and the Financial Stability Board (FSB) to explore the information gaps and provide appropriate proposals for strengthening data collection. Widespread discussion and work under the DGI during the last five years has contributed significantly to improving the identification and monitoring of the build-up of risk in the financial sectors, international financial network connections, the vulnerability of domestic economies to shocks, and the communication of official statistics. A set of 20 recommendations has been set out, with a concrete plan and timeline for implementing each of the outstanding recommendations. The ultimate objective of the DGI is to create a global information system to monitor global financial and non-financial flows and positions comprehensively.

4.2.2 IMF's Financial Soundness Indicators and Data Gaps Initiatives

The IMF's Financial Soundness Indicators (FSIs) are measures of the aggregate strength or vulnerabilities of financial systems. They are macroprudential indicators of the condition of the entire system that supplement the traditional microprudential measures used by bank supervisors. In the existing framework for FSIs, reporting countries are to compile and report at least 12 core FSIs focusing on capital adequacy, asset quality, solvency, leverage and liquidity. Reporting countries are also encouraged to compile and submit data and metadata for some, if not all, of the 28 additional FSIs. In addition, countries are encouraged to provide information about the structure of their financial systems and the sectoral financial statements for dissemination along with their FSI data and metadata.

The DGI recommended the IMF to work on increasing the number of countries disseminating FSIs, including expanding country coverage to encompass all G-20 members, reviewing the list of FSIs, and other improvements to the FSI website. The FSI guide is in the process of being updated accordingly and is expected to be finalised by 2015.[256] The FSIs and their evolution are described in more detail in the following box article by the IMF.

Box 4.1: The IMF's Financial Soundness Indicators Initiative: An Overview

By: Statistics Department of the International Monetary Fund

Introduction

Financial soundness indicators (FSIs) were developed by the International Monetary Fund (IMF), together with the international community, with the aim of supporting macroprudential analysis and assessing the strengths and vulnerability of financial systems in the wake of the financial crises of the 1990s.[257] FSIs were conceived as a new area of statistics – *macroprudential statistics* – aimed at filling the gap between monetary/macroeconomic statistics and microprudential data in assessing the soundness of the financial sector as a whole. FSIs are indicators of the financial health and soundness of the financial institutions in a country and of their corporate and household counterparts. They include both aggregated individual institution data and indicators that are representative of the markets in which the financial institutions operate.

The Statistics Department (STA) of the IMF is responsible for developing methodologies and setting standards for compiling FSIs, for assisting countries in strengthening their capabilities for compiling and disseminating FSIs through technical assistance and training, and for disseminating FSI data and metadata provided by countries on the IMF's FSI website (http://fsi.imf.org) globally and free of charge. The current set of FSIs comprises 12 core and 38 encouraged indicators (Table 1). Currently, 98 countries across the world report their FSI data and metadata to STA on a regular basis for global dissemination.

A Brief History

FSIs are the outcome of sustained collective efforts that began in 1999, when the IMF launched its FSIs initiative and convened the first meeting of a reference group of FSI experts (FSIRG) from international/regional institutions and a broad range of countries.[258] Throughout the process of developing and fine-tuning the FSIs, STA has reached out to and extensively consulted with the FSIRG, national authorities, and other concerned departments of the IMF. In 2000, STA carried out a comprehensive survey of 122 countries to ascertain their views on the relative relevance of the various indicators and their availability. As a result, a list of 40 FSIs was presented to, and approved by, the IMF's Executive Board – 25 for the deposit takers sector and 15 for other parts of the economy crucial to deposit takers' soundness (Table 1).

[255] www.imf.org/external/np/g20/pdf/102909.pdf
[256] www.financialstabilityboard.org/wp-content/uploads/r_140923.pdf
[257] FSIs were originally called macroprudential indicators.
[258] The FSIRG includes 17 international and regional institutions, including the IFSB, and representatives from about 30 countries.

Table 1: Financial Soundness Indicators: The Core and Encouraged Sets[259]

Core Set	
Deposit takers	
Capital adequacy	Regulatory capital to risk-weighted assets Regulatory Tier 1 capital to risk-weighted assets Nonperforming loans net of provisions to capital
Asset quality	Nonperforming loans to total gross loans Sectoral distribution of loans to total loans
Earnings and profitability	Return on assets Return on equity Interest margin to gross income Noninterest expenses to gross income
Liquidity	Liquid assets to total assets (liquid asset ratio) Liquid assets to short term liabilities
Sensitivity to market risk	Net open position in foreign exchange to capital
Encouraged Set	
Deposit takers	Capital to assets Large exposures to capital Geographical distribution of loans to total loans Gross asset position in financial derivatives to capital Gross liability position in financial derivatives to capital Trading income to total income Personnel expenses to noninterest expenses Spread between reference lending and deposit rates Spread between highest and lowest interbank rate Customer deposits to total (noninterbank) loans Foreign-currency-denominated loans to total loans Foreign-currency-denominated liabilities to total liabilities Net open position in equities to capital
Other financial corporations	Assets to total financial system assets Assets to gross domestic product (GDP)
Nonfinancial corporations sector	Total debt to equity Return on equity Earnings to interest and principal expenses Net foreign exchange exposure to equity Number of applications for protection from creditors
Households	Household debt to GDP Household debt service and principal payments to income
Market liquidity	Average bid-ask spread in the securities market Average daily turnover ratio in the securities market
Real estate markets	Residential real estate prices Commercial real estate prices Residential real estate loans to total loans Commercial real estate loans to total loans

The IMF's Financial Soundness Indicators Compilation Guide

One particular challenge of compiling FSIs in the early stages of the initiative was the absence of a consensus or recognised best practice on key methodological aspects of the compilation of FSIs, such as the definition of economic sectors, appropriate accounting principles, possible consolidation bases, underlying data series (e.g. non-performing loans or liquid asset, etc.), which had made the development of harmonised indicators a difficult task to achieve, while exposing users to the risk of being misled by indicators that were not cross-country comparable. To meet this challenge, STA stepped up efforts at developing a robust methodology for FSIs.

[259] The list of FSIs is currently being revised in response to the Global Financial Crisis, the adoption of the Basel III Accord, and the G-20 Data Gaps Initiative's call to review the current FSI list.

The IMF's *Financial Soundness Indicators Compilation Guide (FSI Guide)* – published in 2006 – provides a framework for compiling cross-country comparable FSIs for the deposit takers sector, as well as other institutional sectors, the securities market, and the real estate market.[260] In order to assist countries in compiling FSIs in accordance with the *FSI Guide*, STA conducted a pilot project in 2004 – the Coordinated Compilation Exercise (CCE), in which 62 countries participated. The outcomes of the CCE led to refinements to the *FSI Guide*. The *FSI Guide* Amendment is also available on the IMF website.

The *FSI Guide* is currently being revised in response to recent international developments that have important implications for FSIs, such as the Global Financial Crisis and the adoption of the Basel III Accord.[261] The FSIRG met in November 2011 and discussed issues associated with revising the *FSI Guide*. Based on the conclusions of the FSIRG meeting, STA has formulated a work programme for producing a revised *FSI Guide* by the end of 2015.

Reporting and Dissemination of FSIs

With the completion of the CCE in 2007, participating countries gained substantive experience in compiling FSI data and metadata, strengthening their capabilities to compile and report FSIs to STA on a regular basis. Based on the experience gained with the CCE, the IMF Executive Board endorsed the regular reporting of FSIs by all member countries to the IMF, and the creation of a database to be used by Fund staff, as well as the public (policy makers, markets, academia). The first public release of regularly reported data on the IMF's website for about 50 countries was in July 2009.

The IMF continues to upgrade the publicly available FSI website. At present, the website contains FSI data and metadata for 98 countries. Since 2013, the number of FSI reporters has increased significantly (Figure 1) and periodicity has steadily improved. As of end-2014, over 85% of FSI reporters submit data on a monthly or quarterly basis, which improves the usefulness of the data for surveillance and analytical purposes. Much of the improvement is owed to a more regional approach to STA's delivery of capacity development activities (technical assistance and training), whereby methodology lectures are complemented by practical case studies and regional hands-on workshops involving multiple countries.

Figure 1: FSI Reporters by Year and by Region[262]

Source: IMF's Statictics Department

Enhanced Impetus from G-20 Data Gap Initiative

The recent Global Financial Crisis led to a call by the Group of Twenty (G-20) Finance Ministers and Central Bank Governors for the IMF and the Financial Stability Forum[263] "to explore gaps and provide appropriate proposals for strengthening data collection". This recommendation was endorsed by the IMF's International Monetary and Financial Committee in April 2009. In response, the IMF and FSB issued in October 2009 a report entitled *The Financial Crisis and Information Gaps: Report to the G-20 Finance Ministers and Central Bank Governors (G-20 Report),* which identified the main financial and economic information gaps and presented 20 recommendations for closing them (known as the G-20 Data Gaps Initiative).[264]

260 The *FSI Guide* can be found at http://fsi.imf.org (under the tab "Documents").
261 The background paper can be found at www.imf.org/external/np/pp/eng/2013/111313b.pdf
262 WHD stands for Western Hemisphere, MCD for Middle East and Central Asia, EUR for Europe, APD for Asia and Pacific, and AFR for Africa. The regional classification of countries follows that in the IMF's World Economic Outlook.
263 The predecessor of the FSB.
264 The *G-20 Report* can be found at www.imf.org/external/ns/cs.aspx?id=290.

Recommendation 2 of the *G-20 Report* called for the IMF to work on (i) increasing the number of countries disseminating FSIs, expanding the coverage to encompass all G-20 members; (ii) improving the FSI website, encouraging at least quarterly reporting of FSIs; and (iii) reviewing the list of FSIs to be reported by countries. The G-20 Data Gap Initiative gave impetus to STA's efforts to improve FSIs in all the above-mentioned areas. Some of the results have been mentioned above.

Moreover, Recommendation 3 of the *G-20 Report* called on the IMF "to investigate, develop, and encourage implementation of standard measures that can provide information on tail risks, concentrations, variations in distributions, and the volatility of indicators over time". The intention was that concentration and distribution measures (CDMs) may signal risk better than simple sector averages. With broad support, including from the FSIRG, STA launched in July 2014 a pilot project on compiling CDMs on selected FSIs (CDMs Pilot). The outcomes of the CDMs Pilot will contribute to assessing the feasibility of both calculating and reporting CDM data for selected FSIs for the deposit takers sector on a regular basis. The pilot project is expected to be completed in early 2015.

Uses of FSIs

The analysis of FSIs has become an integral part of Fund surveillance. FSIs are collected and analysed in the context of the IMF/World Bank's Financial Sector Assessment Program (FSAP) and are increasingly monitored as part of the Article IV process (country surveillance work). FSIs are used as inputs into the IMF's interdepartmental vulnerability exercise (VE). In addition, FSIs have been included as a new data category in the IMF's Special Data Dissemination Standards (SDDS). In more detail:

- FSAP reports routinely include tables on FSIs. These typically cover FSIs for deposit takers and other sectors to the extent available. FSI data are typically analysed using peer groups and in the context of stress tests.
- FSIs are increasingly included in Article IV staff reports (in a dedicated table or as part of the table on financial and external vulnerability). Coverage of FSIs has been generally commensurate with the coverage of financial sector issues more broadly, and has increased in line with the enhanced focus on financial sector issues in Fund surveillance.
- FSIs are monitored as part of the assessment of underlying vulnerabilities in the VEs. The VE methodology combines cross-country analysis of vulnerability indicators and judgment-based assessments for individual countries. FSIs used include selected indicators for deposit takers and for the nonfinancial corporations sector.
- The IMF's FSI database is used to produce the FSI tables associated with the *Global Financial Stability Report* (GFSR), one of the IMF's flagship publications. The GFSR-FSI tables have served as a valuable means to disseminate cross-country FSIs, which include six selected FSIs for over 110 countries, with annual time series spanning several years.[265]
- FSIs, as an additional data category, are included in IMF's data dissemination standards. In 2010, the IMF Executive Board approved the inclusion of seven FSIs in the SDDS on an encouraged basis with quarterly frequency.[266] In 2012, the Board further approved the inclusion of seven FSIs in the new upper-tier SDDS Plus.[267] Adherents to the SDDS Plus are required to disseminate these FSIs on a quarterly basis.

At the country level, one of the most noticeable signs of the increased focus on financial stability analysis has been the number of Financial Stability Reports published by national central banks. These reports typically use FSIs alongside a variety of other tools and indicators – reflecting efforts by member countries to refine the financial analysis toolkits – that are not dissimilar to those at the Fund. Greater availability through the Fund of internationally comparable FSIs would further support cross-country analyses by national authorities.

The Way Forward

STA is working on the revised FSI Guide based on the outcomes of the FSIRG meeting held in November 2011. In November 2013, STA presented an IMF Policy Paper on *Modifications to the Current List of Financial Soundness Indicators* to the IMF Executive Board.[268] The revised FSI list includes 19 new indicators to expand the coverage of the financial sector, including money market funds, insurance corporations and pension funds, nonfinancial corporations, and households. Five FSIs were dropped due mainly to very limited reporting and comparability. The revised FSI Guide will provide definitions and concepts for the revised list of FSIs.

Additionally, the revised *FSI Guide* will include an annex on FSIs for Islamic financial institutions, reflecting the growing importance of issues associated with Islamic banking in the Fund's work. The FSI data and metadata reporting templates used by countries for reporting purposes will also be revised accordingly in due course.

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265 The indicators included in GFSR FSI tables are: (i) regulatory capital to risk-weighted asset, (ii) capital to assets, (iii) nonperforming loans (NPLs) to total loans, (iv) provisions to NPLs, (v) return on assets, and (vi) return on equity.

266 The indicators included in SDDS are: (i) regulatory Tier 1 capital to risk-weighted assets, (ii) regulatory Tier 1 capital to assets, (iii) NPLs net of provisions to capital, (iv) NPLs to total gross loans, (v) return on assets, (vi) liquid assets to short-term liabilities, and (vii) net open position in foreign exchange to capital.

267 The indicators included in SDDS Plus are the same as SDDS FSIs except that real estate prices replace net open position in foreign exchange to capital.

268 The paper Modifications to the *Current List of Financial Soundness Indicators* can be found at http://fsi.imf.org (under the tag "Documents").

4.2.3 Collaboration among International Institutions and Data Gaps Initiatives

The DGI also recommended close collaboration among international institutions under the auspices of the Inter-Agency Group on Economic and Financial Statistics (IAG). The IAG was created in 2008 and comprises the Bank for International Settlements (BIS), European Central Bank (ECB), Eurostat, IMF, OECD, United Nations Statistics Division and the World Bank, to serve as a global facilitator and coordinator and to promote data provision and dissemination. It works in particular to facilitate coordination of activities among international organisations, and to identify the data gaps in the area of economic and financial statistics.

Another recommendation of DGI was to improve communication of official statistics. The Principal Global Indicators (PGI) website,[269] a product of IAG, serves as an important tool for improving communication of official statistics by providing a one-stop database centre with different indicators provided by BIS, ECB, Eurostat, IMF, OECD and World Bank. The PGI site now includes data for G-20 economies and ten non-G-20 economies with systemically important financial sectors. There is ongoing work by the international organisations to enhance the PGI website by further expanding the coverage in terms of datasets and reporting economies, improving the efficiency of data exchange, increasing timeliness, and reducing overlaps among data collections.

The DGI recommended that the FSB, in close consultation with the IMF, should work with relevant central banks, national supervisors, and other international financial institutions, to develop a common draft template for the systemically important global financial institutions for the purpose of better understanding the exposures of these institutions to different financial sectors and national markets. A common data template for global-systemically important banks (G-SIBs) was already approved by the FSB plenary to become operational in three phases. Phase 1 was completed in March 2013 and involved the launching of a data hub. Work is currently in progress for Phase 2 and Phase 3.

The BIS also publishes a number of financial statistics on various elements of the global financial systems. Diagram 4.2.3.1 shows the various areas of BIS statistics of different indicators on banking, securities, exchange rates, external debt, payment, property prices, credit to the private sector and liquidity conditions. On banking statistics, BIS collects and disseminates different sets of locational and consolidated data on cross-border lending and borrowing of internationally active banks in key financial centres, including offshore centres. Most, but not all, of the BIS statistics are provided by the banks.

Diagram: 4.2.3.1 BIS Statistics

Source: BIS website

The Committee on the Global Financial System (CGFS), which has a mandate to monitor international banking markets, is seeking further enhancements to the international banking statistics, in terms of both instrument and country coverage, and to the derivatives statistics, notably to better handle credit risk transfers. The DGI recommended that, as a first step, the BIS and the IMF should complete their work on developing measures of aggregate leverage and maturity mismatches in the financial system, drawing on inputs from the CGFS and the BCBS. More recently, the establishment of the Irving Fisher Committee (IFC), a forum of central bank economists and statisticians, under the auspices of BIS, provides yet another channel to address statistical issues of interest to central banks. It published its first report, on data-sharing issues and good practices, in January 2015.[270]

269 www.principalglobalindicators.org/
270 www.bis.org/ifc/events/7ifc-tf-report-datasharing.pdf

4.2.4 Islamic Financial Services Industry and Data Gaps

The IFSI has now become systemically important in a number of economies, including Brunei, Iran, Kuwait, Malaysia, Qatar, Sudan, Saudi Arabia, UAE, and Yemen.[271] Although the IFSI was resilient during and after the GFC, the industry is still vulnerable to the uncertainties in the overall macroeconomic environment.

Macro-level data and statistics for the Islamic financial services industry can contribute to a country's macrostatistics for overall macroprudential surveillance in the jurisdictions with significant Islamic finance shares. In addition, macrostatistics of Islamic finance provide the scope for cross-country comparison between jurisdictions as well as internal peer group benchmarking of individual institutions. The industry therefore needs to have a well-developed global database of Islamic finance for macroprudential oversight. Against this backdrop, the following questions need to be addressed:

(a) Do existing agencies provide sufficient data and statistics with respect to Islamic finance?
(b) What are the gaps relating to Islamic finance data and statistics that need to be identified and addressed to meet evolving needs and expectations from various stakeholders of the IFSI?
(c) Once the gaps are identified, how effectively can they be managed?

The development of collaboration among the international institutions, particularly those working with financial data and statistics, reinforces the need for cooperation among the agencies relating to Islamic finance, in particular given resource constraints and the risks of wasteful duplication.

4.2.5 Initiatives for Islamic Finance Statistics

Although the development of Islamic finance across various jurisdictions has been supported by key Islamic finance-related multilateral bodies and international agencies, little progress was actually achieved towards collection, compilation and dissemination of Islamic financial statistics. Most of the international institutions working with both public- and private-sector entities collect data from individual IIFS and disseminate them for public access at the individual bank level or in aggregate form. Some of the major developments include:

(a) The Islamic Development Bank's (IDB's) Islamic Research and Training Institute (IRTI) has developed an information system encompassing data of Islamic banks and financial institutions. The IRTI's Islamic Banks and Financial Institutions Information System (IBIS) provides various types of bank-level information to users, such as financial profiles, profit and loss accounts, and some ratio indicators on asset quality, capital adequacy, performance, liquidity and operational efficiency of individual Islamic banks.

(b) Bloomberg, as a global database platform, provides real-time and historical financial market and economic data covering all sectors. Bloomberg extended its coverage in 2011, launching a Bloomberg Islamic Finance Platform (ISLM), a comprehensive solution with the declared aims of increasing transparency, better connecting the Islamic finance sector, and providing analytical tools to maximise investment performance for *Sharīʿah*-compliant products and services.

(c) Bankscope is a global database of comprehensive banks' financial statements, rating and intelligence of both public and private banks. The categories in the Bankscope database also include data on individual Islamic banks' deposits, assets, costs, lending, customer and short-term funding.

(d) Thomson Reuters Zawya offers accessibility to business professionals interested in Islamic finance, providing information on *Sharīʿah*-compliant asset classes and instruments to conduct *Sharīʿah* compliance verifications and legal requirements. It also publishes an Islamic Finance Development Indicator (IFDI), which is a composite weighted index that measures the overall development of the Islamic finance industry of selected countries by assessing fundamentals such as qualitative development, knowledge, corporate social responsibility, governance and awareness of Islamic finance.

(e) The Statistical, Economic and Social Research and Training Center for Islamic Countries (SESRIC), a subsidiary organ of the Organisation of Islamic Cooperation (OIC), disseminates statistics in different socio-economic fields. It plans to launch a programme to compile Islamic banking and finance (IBF) statistics. Box 4.2 highlights recent developments of IBF statistics undertaken by the SESRIC.

(f) The IFSB's annual *IFSI Stability Report* also publishes analytical trends of several key indicators of Islamic finance. As can be seen in Chapter 1 of the report, there are data on the regional breakdown of Islamic financial assets in terms of Islamic banking assets, *Sukūk* outstanding, Islamic funds and *Takāful* contributions. For the Islamic banking sector, in particular, some indicators are provided on the size, share and growth trends of assets, financing and deposits, presented in charts and diagrams. There are also performance indicators of the Islamic banking sector, such as return on assets, return on equity, net profit margin and cost to income. To measure the health of capitalisation and liquidity levels of the Islamic banking system, some capital adequacy and liquidity indicators – for example, capital adequacy ratio, Tier 1 capital adequacy ratio, and leverage ratio – are also provided in the publication. However, the IFSB is not the primary source for those data, as they were collected from individual institutions, various publications and regulatory authorities, and compiled by different research and financial institutions, such as Bloomberg, Zawya, The Banker and KFHR.

Most of the institutions provide micro-level data/information on individual IIFS depending on their business and market strategies. Some institutions publish macro-level data aggregated from individual Islamic financial institutions; however, it does not include country-wide macroprudential indicators. Financial reporting of most of the IIFS is not standardised. Moreover, data and statistics from the private data providers are not complete for the Islamic finance sector in a jurisdiction.

[271] This report considers the Islamic financial sector as systemically important when the total Islamic banking assets in a country comprise more than 15% of its total domestic banking sector assets and/or hold at least 5% of the global Islamic banking assets (see Chapter 1).

Box 4.2: Strengthening the Statistical Infrastructure of the Islamic Banking and Financial Services

By: The Statistical, Economic and Social Research and Training Centre for Islamic Countries

The Statistical, Economic and Social Research and Training Centre for Islamic Countries (SESRIC) was founded as a subsidiary organ of the Organisation of Islamic Cooperation (OIC) and started its activities in Ankara in June 1978. The basic mandate drawn up for SESRIC includes collating and disseminating socio-economic statistics of OIC member countries; conducting research studies and proposing policy recommendations geared towards the development efforts of the member countries; and organising training programmes, with an aim to enhance cooperation and collaboration, based on the needs and capacities of member countries.

In addition to the implementation of the above-mentioned mandate, SESRIC assumes the role of focal point for the technical cooperation activities and projects with regional and international agencies. Furthermore, it acts as the major research arm of the OIC whereby it is assigned the task of preparing the main economic and social reports and background documents for the multitude of economic, social and technical cooperation meetings and conferences held at different levels under the umbrella of the OIC.

SESRIC also provides the Secretariat of the **OIC Statistical Commission (OIC-StatCom)**, which is the apex statistical body of the National Statistical Offices (NSOs) of member countries at OIC level. It organises the annual sessions of OIC-StatCom in collaboration with the Islamic Development Bank (IDB) to share and exchange knowledge, experiences and best practices for building more effective and efficient National Statistical Systems (NSSs) in member countries.

Accurate, timely, reliable, consistent, accessible, and high quality statistical data is of utmost importance for policymaking and setting out development strategies in any country. Despite this fact, many OIC member countries still have wide room to improve their statistical capacities in accordance with relevant international statistical norms and standards. In this regard, the Centre also devotes a large portion of its resources to statistical capacity development activities.

Initiated in early 2007, the **Statistical Capacity Building (StatCaB) Programme** is a large-scale capacity development project attempting to match statistical training needs and capacities of the NSOs of OIC member countries through the bi-annual StatCaB survey to organise efficient and to-the-point training activities by twinning beneficiary and provider countries. So far, 87 training courses have been organised in 35 OIC member countries with the technical support of 15 OIC member countries which provided trainers. SESRIC also actively cooperates with regional and international agencies to organise workshops and seminars on themes of common interest to OIC member countries.

SESRIC also considers the fields of interests demanded by a majority of OIC member countries. In this respect, SESRIC – in collaboration with relevant international agencies – develops and carries out projects with a focus on:

- **poverty statistics** together with OIC Standing Committee for Economic and Commercial Cooperation (COMCEC), Oxford Poverty and Human Development Initiative (OPHI), Islamic Solidarity Fund for Development (ISFD), and United Nations Development Programme (UNDP);
- **tourism statistics and tourism satellite accounts** together with COMCEC and World Tourism Organization (UNWTO);
- **health statistics** together with the World Health Organization (WHO), United States Centers for Disease Control and Prevention (CDC), and CDC Foundation.

SESRIC hosts the **Basic Social and Economic Indicators (BASEIND) Database** which serves as the online dissemination platform for 313 socio-economic indicators dating back to 1970 under 19 categories for the 57 OIC member countries (www.sesric.org/baseind.php).

The Centre is at the same time active in developing online statistical applications. One such tool is the highly appreciated **SESRIC Motion Charts (SMC) Module.** SMC is an interactive and dynamic online application that generates data visualisations from multiple indicators available in the BASEIND Database (www.sesric.org/smc.php). It allows users to dynamically explore the trends of several indicators over time in an animated form.

Islamic Banking and Finance (IBF) Statistics

Islamic finance is emerging as an alternative source of finance in addressing the major development challenges faced by many OIC member countries. OIC member countries continue to be the main actors in the industry's impressive growth story.

Building a well-functioning Islamic banking and finance infrastructure is imperative for providing the industry with a level playing field. Moreover, policymakers, regulators and standard-setters in OIC member countries should ensure that the supervisory and legal infrastructure for IBF remain relevant to the rapidly changing financial landscape and global developments. Infrastructure development efforts should also interface with the global financial reform agenda. Policymakers require high-quality data to come up with adequate, sound and effective structural policies regarding the sectoral infrastructure.

Yet, there are key challenges related to the collection, collation, processing and dissemination of IBF data. The first major challenge is the **lack of incorporation of IBF statistics into the National Statistical Systems in most of the OIC member countries, which prevents official collection and dissemination of related data.** Secondly, for the member countries where IBF statistics are covered in their NSSs, **there is no adequate level of coordination and communication mechanism among the agencies of the NSSs** on this matter. Thirdly, **there is lack of harmonisation and convergence in terms of definitions of IBF instruments and transactions.** This prevents the adoption of a generally accepted standardised methodology for the collection, processing, and dissemination of relevant statistical data in the member countries.

Mindful of these shortcomings, and because it provides the **Secretariats of both the OIC-StatCom and Annual Meetings of Central Banks of OIC Member Countries**, SESRIC brought forward the issue of filling the data gap in the IBF industry in these platforms. The last Annual Meeting of Central Banks of OIC Member Countries in Surabaya, Indonesia, in November 2004 acknowledged this challenge and trusted SESRIC by stating in its Final Communiqué that:

> *"We recognise the importance of the collection, collation, processing and dissemination of data on Islamic Banking and Finance, and express our support to SESRIC to coordinate the efforts in this context, in collaboration with relevant international organisations, including IFSB, World Bank Global Islamic* Finance Development Centre and Islamic Development Bank (IDB)."

In accordance with the relevant resolutions of the OIC-StatCom, SESRIC has taken active steps on the subject and organised **Expert Group Meetings and Workshops on Islamic Banking and Finance Statistics (IBFStat)** in collaboration with its international partners. These meetings have not only acted as a platform to exchange views on defining the scope of IBF statistics and the requirements for new financial indicators specific to OIC member countries, but also highlighted the need for the launch of a comprehensive database on the subject. SESRIC endeavours to bring about sustainable partnerships with relevant stakeholders to support and encourage OIC member countries to produce comparable IBF statistics. The availability of high-quality data will enable policymakers and researchers to analyse the sector more accurately from a comprehensive perspective as well as to better understand the emerging trends.

In line with the vision of OIC-StatCom, SESRIC plans to concretise the intents and efforts in this field by focusing on **wider collaboration with relevant international organisations including the IFSB, World Bank Global Islamic Finance Development Centre and IDB Group** which will pave the way for introducing a set of standards and methodological documents to produce reliable, comprehensive and timely IBF statistics, and establishing a comprehensive database of IBF statistics to make the relevant indicators available to data users. In doing so, SESRIC aims at promoting the currently available IBF indicator frameworks; such as the IFSB's Prudential and Structural Islamic Financial Indicators (PSIFIs) initiative, and through the aforementioned collaboration, further contributing to the efforts for strengthening the statistical infrastructure of the IBF sector.

SESRIC is also planning to increase the statistical capacities of OIC member countries in the compilation, production and dissemination of IBF statistics by implementing capacity building and training programmes under its relevant programmes in the future. This concerted effort is expected to improve the technical knowledge of staff in NSOs, central banks and relevant public agencies in the area of IBF statistics and also to provide the impetus for the expansion of the IBF industry in the global financial markets.

4.2.6 The IFSB's Efforts to Establish an Islamic Finance Database

In December 2004, the IFSB Council passed a resolution to establish a global database of Prudential and Structural Islamic Financial Indicators (PSIFIs), which are the measures of the aggregate strength or vulnerabilities of the Islamic financial system. One of the main objectives of PSIFIs is to document the structural development and soundness of Islamic finance, which are broadly similar to the IMF's FSIs. In 2008, the IFSB also conducted a pilot survey on compilation of data and preparation of PSIFIs in which four members – Indonesia, Malaysia, Pakistan and Sudan – participated. The survey attempted to get feedback and to identify practical challenges or issues emerging from the data compilation process. Major challenges identified include difficulties in expanding data coverage to new jurisdictions, inaccuracy of data in certain cases, and difficulties in collecting a full set of indicators. To address the challenges, participating countries requested the IFSB Secretariat to extend the training workshop so that the participants could have better understanding of each of the required items in the Compilation Guide and indicators.

The PSIFI indicators on Islamic finance would focus on macroprudential indicators covering a wider range of countries collecting data from regulatory authorities. The data set for the IFSI would be equivalent to the IMF's FSIs in terms of macroprudential oversight for the industry. A number of FSI reporting countries have IIFS in their jurisdictions and they are supposed to include the data of IIFS as part of the banking industry. However, the question relating to the IFSI is how it is linked to FSIs. The IMF identified in its FSI Compilation Guide (2006)[272] that the prohibition of interest (usury) and the promotion of trade through established *Sharī'ah* rules and principles set IIFS apart from conventional financial institutions in numerous ways. For example, the Guide noted that the balance sheets and accounting practices of IIFS can be different from those of conventional banks. The specificities of Islamic finance – in particular, its unique profile of financial risks – would fundamentally affect the definition of FSIs. Therefore, the prevailing statistical practices of FSIs did not attempt to link to the specific accounting series used by IIFS. As an international standard-setting body for the IFSI working with public-sector and financial regulators in its member countries, the IFSB therefore would be in a better position to contribute

[272] www.imf.org/external/pubs/ft/fsi/guide/2006/

effectively to providing a financial soundness database which takes into consideration the specificities of IIFS. It is envisaged that data would be published only at a level of aggregation which does not allow individual institutions to be identified.

The IFSB developed its project on PSIFIs in three different phases with an ultimate objective to document the structural development and soundness of Islamic finance, and thus contribute to the overall financial soundness of the countries' financial systems. Phases I and II of the IFSB's PSIFI project went through a series of background activities dedicated to preparing a compilation guide, and conducting workshops and surveys in order to establish the global Islamic finance database.

4.2.7 Compilation Guide on PSIFIs

The IFSB published its Compilation Guide on PSIFIs in 2007. The Compilation Guide attempts to:

(a) standardise the adoption of conceptual frameworks and relevant measurement principles that support the reporting structure and system so as to promote international data comparability; that is, to provide uniform guidance to national data compilers in particular on the concepts, definitions, techniques and any other aspects related to the compilation and dissemination practice, and hence provide an internationally comparable set of indicators; and

(b) encourage the compilation and dissemination, at the national level, of core and encouraged indicators, expressed in percentage or ratio terms, as well as to facilitate the eventual transmission of these internationally comparable indicators (together with their underlying data series) to the IFSB.

The Compilation Guide draws upon compilation and dissemination efforts at the national level, and is intended to be a comprehensive document in explaining how to compile core and encouraged indicators, as well as detailed information on their underlying data, to assist data suppliers and compilers and the PSIFI users.

The Compilation Guide intends to serve as a supplement to the IMF's FSIs. The idea is for the PSIFIs to be consistent with the IMF's FSIs, but adapted appropriately to cater for the specificities of IIFS and enhanced by some structural indicators. Moreover, for the purpose of financial soundness analysis, the underlying data of PSIFIs are required to be compiled on a domestically controlled, cross-border basis, a concept consistent with the recommendations specified for the IMF's FSIs and similar to the method used by the BIS to consolidate international banking statistics.

The PSIFIs and their underlying data series constitute a set of macroeconomic statistics, or macrostatistics. Other macrostatistics may include statistics drawn from national accounts – balance of payments systems, government finance, and monetary and financial statistics, among others. In general, the underlying purpose of the PSIFIs is to provide data on homogeneous categories and to maximise the benefits of internationally comparable statistics.

To minimise the statistical burden on national data compilers (as well as data suppliers), the Compilation Guide recommends using the existing statistical systems, especially in their reporting to other international organisations such as the BIS and the IMF. For the PSIFIs to be reasonably coherent and integrated with existing macrostatistical systems, their concepts, definitions, classifications, and accounting principles and frameworks shall be relatively consistent with each other. Consistency between different systems will enhance the analytical usefulness of all the macrostatistics involved, by providing more useful and relevant information for macroprudential analysis. The Compilation Guide gives special attention to the harmonisation of PSIFIs with other related statistical systems, and especially with the System of National Accounts of the United Nations 1993 (SNA 1993), which serves as a coordinating framework from both conceptual and accounting perspectives for all macrostatistics.

In principle, micro-data sets can be compiled at any level of aggregation, even at an individual institutional unit. As such, it would appear that macrostatistics for sectors or the whole economy could be obtained directly by aggregating corresponding data for individual units. However, in practice, macrostatistics may not be built up by simply aggregating the relevant micro-data, since accounting conventions and valuation methods at a micro level typically differ from those required at a macro level, or the concepts deemed appropriate at a micro level may prove to be unsuitable at a macro level. The Compilation Guide recommends standard benchmarks to consolidate Islamic finance statistics.

4.2.8 Pilot Study on PSIFIs

The pilot survey of Phase II attempted to: (i) get feedback on the Compilation Guide and to identify practical challenging issues; (ii) develop a standard reporting template for the transmission of PSIFIs and underlying data to the IFSB; (iii) develop a questionnaire for metadata compilation; and (iv) develop an outreach programme by organising workshops in which experts from supervisory authorities, international organisations, market players and other interested parties can have structured discussions.

In 2011, a taskforce comprising representatives from nine jurisdictions and the Asian Development Bank (ADB), IDB and IMF reviewed the experience of the pilot and contributed to a revision of the Compilation Guide,[273] which also reflected developments in international practices and global regulatory developments including Basel II.

4.2.9 Phase III on PSIFIs

In 2014, the IFSB started its third phase of PSIFI covering a number of components – such as country selection, selection of indicators, collaboration and interaction with other international agencies, revision of the Compilation Guide, capacity building, and data collection, compilation and dissemination – with an aim to complete the phase by 2016 under a medium-term plan (MTP). The main objectives of the third phase of the PSIFI project are to:

(a) formulate a methodology to analyse the reported cross-country data and any adjusted data to identify key characteristics and trends;

[273] www.ifsb.org/docs/2011-12-23%20PSIFI%20Compilation%20Guide%20(Final%20Clean).pdf

(b) provide recommendations for reporting formats and a management information system for sustainable IFSB database to support public access as well as internal reporting; and

(c) start collection, compilation and dissemination of data and indicators along with revising the Compilation Guide in line with the developments of Basel III.

Overall, 16 regulatory and supervisory authorities (RSAs) have already agreed to participate in the project. They are from Afghanistan, Bahrain, Bangladesh, Brunei, Egypt, Indonesia, Iran, Jordan, Kuwait, Malaysia, Nigeria, Oman, Pakistan, Saudi Arabia, Sudan and Turkey. The countries are key economies in respect of Islamic banking activities worldwide.

For the PSIFIs project, a revised set of indicators was agreed (19 core, 8 additional, 7 structural), taking into account the existing PSIFIs, Basel III innovations, modification of the IMF's FSIs, and analytical needs of the IFSB's *IFSI Stability Report*. The indicators are mainly classified into two groups: core prudential indicators and structural indicators. The core prudential indicators have been chosen to best capture the strengths and vulnerabilities of the sector, focusing primarily on capital adequacy, asset quality, earnings, leverage, liquidity and sensitivity to market risk. Some core indicators are listed as additional prudential indicators; in this category, countries may choose not to compile individual indicators depending on the degree of importance of Islamic banking in the country, difficulty in obtaining data, or methodological or statistical problems. The structural indicators are the indications of the size and structure of the Islamic banking sector, providing information on volume of assets, liablities, revenue and earnings, etc. (see Table 4.2.10.1). A supplement to the PSIFIs, Compilation Guide was prepared, which describes changes to the indicators, their formulas and statistical methodologies. Excel forms were constructed for reporting PSIFIs and their underlying data, and a second form for metadata was also completed. Metadata codes for the forms were developed and instructions to complete the forms prepared.

A task force comprising two coordinators from each of 16 banking RSAs finalised the indicators and their definitions through participating in meetings, workshops and coordinated compilations exercises of the PSIFI project. Finally, the IFSB collected data/metadata on the revised indicators from the RSAs based on the end period 2013. The IFSB launched its PSIFIs data in 2013, on the IFSB website in April 2015.

4.2.10 PSIFIs: A Global Islamic Finance Database and Its Implications

The PSIFI database aims to be a global platform of Islamic finance statistics reflecting *Sharīʿah*-compliant accounting practices and regulatory standards. PSIFIs have 19 core and 8 additional core indicators, as compared to IMF's 12 core and 8 additional core indicators. PSIFIs data are also aggregated banking sector data of an individual country, similar to FSI. The indicators will be compiled on a quarterly basis; however, the choice of frequency – for example, indicators on a half-yearly basis – is left to the banking RSAs. Two platforms for dissemination of PSIFIs are currently being considered: (i) online data with most current data, available historical series, and metadata describing compilation methods and country-specific information; and (ii) periodic volumes with a comprehensive review of PSIFIs. Online access is expected to be used most often.

The main implication of these indicators is that the database would not only provide information about the soundness or vulnerabilities of a global Islamic financial system but also allow RSAs, market players and policymakers to better understand the relation to, and impact of Islamic finance on, the overall financial system of the country.

Table 4.2.10.1 shows the comparison between the PSIFIs and the FSI indicators, where *Sharīʿah*-compliant specifications are made to the PSIFI indicators. On capital adequacy, for example, PSIFI indicators are in line with both Basel III and the corresponding IFSB standard (IFSB-15). Both versions of indicators do not show significant differences in numerator sides. However, the IFSB has specific guidance on how to measure risk-weighted assets in the denominator sides to address the issue of profit- and loss-sharing activities. (For details, please see IFSB-15: Revised Capital Adequacy Standard for IIFS and GN-4: *Guidance Note in Connection with the IFSB Capital Adequacy Standard*, available at www.ifsb.org.)

Indeed, to a certain extent, each PSIFI has its equivalent in the list of FSIs for deposit takers – in particular, in the core set. However, the PSIFIs have a number of additional and structural indicators on top of their equivalents in the FSIs for deposit takers, to reflect specific features of Islamic finance, as well as to provide an insight into the structure of a country's IFSI. Moreover, the structural and access indicators are crucial to support the interpretation of core and additional indicators.

Table 4.2.10.1: Comparison of PSIFIs and FSIs

PSIFIs	FSIs
PSIFIs for Islamic banks and Islamic windows	**FSIs for deposit takers**
Capital adequacy	
(a) CAR (Basel standard)	Regulatory capital to risk-weighted assets
(b) Tier 1 capital to RWA (Basel standard)	Regulatory Tier 1 capital to risk-weighted assets
(c) Common equity Tier 1 capital to RWA (Basel standard)	No equivalent
(d) CAR (IFSB standard)	No equivalent
(e) Tier 1 capital to RWA (IFSB standard)	No equivalent
(f) Common equity Tier 1 capital to RWA (IFSB standard)	No equivalent

PSIFIs	FSIs
PSIFIs for Islamic banks and Islamic windows	**FSIs for deposit takers**
Asset quality	
(a) Gross non-performing financing (NPF) ratio	NPLs to total gross loans
(b) Net non-performing financing (net NPF) to capital	NPLs net of provisions to capital
(c) Provisions for net NPF	Not in the current FSI list; however, the indicator is moving to the modified list.
Earnings	
(a) Return on assets (ROA)	Return on assets
(b) Return on equity (ROE)	Return on equity
(c) Net profit margin	No equivalent
(d) Cost to income	Non-interest expenses to gross income
Leverage	
(a) Capital to assets	Capital to assets
(b) Leverage	Not in the current FSI list; however, the indicator is moving to the modified list.
Liquidity	
(a) Liquid assets ratio	Liquid assets to total assets
(b) Liquid assets to short-term liabilities	Liquid assets to short term liabilities
(c) Liquidity coverage ratio (LCR)	Not in the current FSI list; however, the indicator is moving to the modified list.
(d) Net stable funding ratio (NSFR)	Not in the current FSI list; however, the indicator is moving to the modified list.
Sensitivity to market risk	
(a) Net foreign exchange open position to capital	Net open position in foreign exchange to capital
(b) Large exposures to capital	Large exposures to capital
(c) Growth of financing to the private sector	Not in the current FSI list; however, the indicator is moving to the modified list.
Additional core indicators	
(a) Income distributed to investment account holders (IAH) out of total income from assets funded by PSIA	No equivalent
(b) Total off-balance-sheet items to total assets	No equivalent
(c) Foreign-currency-denominated funding to total funding	Foreign-currency-denominated liabilities to total liabilities
(d) Foreign-currency-denominated financing to total financing	Foreign-currency-denominated loans to total loans
(e) Value of *Sukūk* holdings to total capital	No equivalent
(f) Value (or percentage) of *Sharīʿah*-compliant financing by economic activity	No equivalent
(g) Value (or percentage) of gross NPF by economic activities	No equivalent
(h) Value (or percentage) of returns by major type of *Sharīʿah*-compliant contract	No equivalent
Structural indicators	
(a) Number of Islamic banks	No equivalent
(b) Number of employees	No equivalent
(c) Total assets	No equivalent
(d) Total funding/liabilities	No equivalent
(e) Total revenues	No equivalent
(f) Earnings before taxes and Zakah	No equivalent
(g) Value (or percentage) of financing by major type of *Sharīʿah*-compliant contract	No equivalent

Source: IFSB, Supplement to Compilation Guide (2014); and IMF, Modifications to the Current List of Financial Soundness Indicators (13 November 2013)

These PSIFI indicators would also facilitate comparisons between conventional banks and IIFS and illustrate the effective impacts of application of the IFSB capital adequacy formula. In standard FSIs covering all banking institutions in a country (conventional and Islamic), the IIFS will be included in the FSIs by applying the risk-weighted assets (RWA) rules for conventional banks. This may lead to a capital adequacy ratio (CAR) different from that obtained by applying the IFSB Capital Adequacy Standard.

Countries now compiling FSIs already have data on the capital adequacy of IIFS using the Basel RWA rules. Countries can be encouraged to construct a peer group for IIFS to examine the influence of the IIFS on the overall CAR FSI of the country. For example, in a country with 23 banks of which seven are IIFS, the IIFS can be placed under a separate peer group[274] and their CAR calculated per the Basel RWA rules. This will permit a like-to-like comparison of the CARs of the conventional banks versus IIFS.

[274] Or two peer groups can be created comprising, respectively, the 16 conventional banks and seven IIFS.

Table 4.2.10.1 also shows that all of the PSIFIs core indicators are equivalent to FSIs, with the exception of net profit to margin, which is only applicable for interest-free banks. With this indicator, it is possible to measure the health of the Islamic financial system by indicating the ability of banks to attract new capital, build capital and grow. Since all other core indicators on asset quality, earnings, leverage, liquidity and sensitivity to market risks are similar to FSIs, the indicators would exhibit comparison with FSIs for the country's entire financial system.

Basel III also introduced liquidity indicators, the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). Adapting the Basel III liquidity standards, the IFSB also issued GN-6: *Quantitative Measures for Liquidity Risk Management for IIFS* in April 2015, to provide guidance to the RSAs on the application of the LCR and NSFR in their jurisdictions, and on their role in assessing the discretionary items. PSIFIs for LCR and NSFR reflect the IFSB Guidance Note in providing the state of the liquidity infrastructure, in line with *Sharīʿah* principles.

Finally, the IFSB's capacity-building efforts, such as technical assistance, workshops and task force meetings, will help to improve data quality, address data weaknesses, and update the methodologies for data compilation. The IFSB will also evaluate the PSIFIs to explore the demand for data and statistics among the industry's stakeholders and ascertain whether the indicators meet the industry's requirement. The IFSB will also examine, from time to time, whether the PSIFIs database is user-friendly and easily accessible for external stakeholders. The IFSB will also review the steps going forward to extend the number of RSAs in new jurisdictions and in other sectors, namely *Takāful* and Islamic capital markets. The continued collaboration between the IFSB and RSAs will ensure regular reporting of PSIFIs as well as the high quality of data.

Islamic finance continues to grow and has proven its resilience in times of financial turbulence. Its overall performance is remarkable, but there is room for improvement. In most jurisdictions, institutions offering Islamic financial services still lack *Sharīʿah*-compliant lender-of-last-resort facilities and instruments (in particular, *Sukūk*) for short-term liquidity management and long-term capital formation. With a growing systemic relevance of Islamic finance in a number of jurisdictions, other gaps in the regulatory architecture gain in importance. For example, *Sharīʿah*-compliant deposit insurance schemes are implemented in only a few countries, and indicators for a macroeconomic stability surveillance that captures the specificities of Islamic finance are not yet in general use.

Furthermore, the analysis of developments in Islamic banking and *Sukūk* markets revealed some trends that are at odds with the view that risk-sharing should be the distinctive feature of Islamic finance. Risk-sharing and loss-bearing profit-sharing investment accounts (PSIA) are gradually replaced by deposits with capital guarantees and predetermined returns. The share of PSIA dropped below 50%, and a substantial portion of the remaining PSIA is factually shielded against risks by smoothing techniques. With risk-averse depositors, Islamic banks lack funding for risk-sharing contracts in the financing business. They are exposed to the same risks from maturity transformation as conventional banks. The situation is no better for the Islamic capital market: the share of *Muḍārabah* and *Mushārakah Sukūk* has continuously dropped to less than 10% of the new issuances of 2014, meaning that direct financing is predominantly done in bond-like structures without participation of the investors in the business risks of the issuers.

The demarcation lines between risk-free and risk-bearing instruments have become blurred, and clarity is lacking. This is a challenge for regulatory authorities that try to account for the unique conceptual features of Islamic finance. One jurisdiction took decisive steps to stop this trend in banking: Malaysia's 2013 *Islamic Financial Services Act* makes a clear distinction between capital-guaranteed deposits and risk-bearing investment accounts for which smoothing practices are prohibited and risk disclosures mandatory. The Act will become fully effective in mid-2015, and bank customers have to adjust to the new setting by switching from the actual smoothed investment accounts to Islamic deposits, or to "real" investment accounts with an explicit consent to risk-sharing (e.g. the use of these funds for the financing of businesses on the basis of risk-sharing contracts).

Not all jurisdictions will follow the Malaysian example, but all have to add provisions for the regulation and supervision of the Islamic financial services industry to their regulatory system. Many face challenges in identifying the applicable principles and benchmarks for assessing the gaps in their existing structures. The *Core Principles for Islamic Finance Regulation* (CPIFR) (Banking sector) fills this gap and represent an advanced approach to the assessment of regulatory and supervisory regimes. These overarching principles provide both a set of minimum requirements for Islamic finance regulation and a framework for a coherent regulatory system that is compatible with the regulation of the conventional finance industry. With the CPIFR on the top level, existing and future IFSB standards set out key high-level requirements that are fundamental to the implementation of a core principle, and guidance or technical notes provide details on how to implement a core principle or standard.

The IFSB has conceptualised the CPIFR as an adapted version of the BCBS core principles for banking supervision that caters for the unique features of Islamic finance. This approach brings the regulatory architecture of Islamic finance in line with that of conventional finance. For a regulatory authority that has to regulate and supervise both the conventional and the Islamic finance industry, this coherence is of high importance: on the one hand, it keeps the workload to a manageable level; on the other hand, it helps to combat regulatory arbitrage.

Regulatory arbitrage may become an issue if the competition between Islamic and conventional finance intensifies. Customers for whom *Sharīʿah* compliance is not a fundamental concern can switch between products of Islamic and conventional providers. Market shares of Islamic financial institutions in a range of 25% or less in most jurisdictions imply that even in Muslim countries large numbers of customers still use conventional products. Islamic banks may consider them as a large pool of potential new customers to whom they have to offer products that are close to their actual preferences (which seemingly are not risk-sharing, but risk-avoidance). The competition for customers may induce a further approximation of Islamic products to the commercial features of conventional products. This poses a challenge to a regulatory system that has made some modifications of existing requirements in view of specificities of Islamic banks. It becomes increasingly important to verify that these specificities are not only conceptual ("on paper"), but do materialise in the actual practice of the Islamic banks. Otherwise, regulatory arbitrage may be encouraged. For example, it is reasonable to reduce capital requirements for Islamic banks if they treat investment account holders (IAH) as actual risk bearers and refrain from smoothing PSIA, but a concession becomes debatable when PSIA are smoothed and IAH are treated like depositors. Such a constellation creates incentive for cross-sectoral arbitrage between Islamic and conventional banking.

Another form of regulatory arbitrage could emerge as intra-sectoral and cross-segmental – that is, within the Islamic finance sector between the banking and capital market segment. Unsmoothed PSIA share essential characteristics of collective investment schemes, but the regulatory requirements may differ. It may be necessary to apply some elements of the capital market investor protection tools in banking regulation, or to achieve a closer cooperation of banking and capital market regulators, in order to prevent this type of regulatory arbitrage.

Market discipline can support systemic stability, but it requires sufficient information for informed choices of market players. The IFSB had already recommended more detailed disclosures particularly on smoothing techniques and risk profiles of PSIA. These recommendations are particularly relevant in a setting where the demarcation lines between conventional and Islamic finance have become blurred but should be sharpened in the interest of the protection or advancement of a distinct economic profile of Islamic finance.

Islamic and conventional finance may be similar in the actual practice, but there are important legal differences. While in conventional finance the typical contract for financing is a loan contract, it is a sales (or rental) contract with a financing component such as a deferred payment clause in Islamic finance. This legal difference implies some rigidity when a customer requests an early settlement or a debt rescheduling. If sales contracts were executed as concluded, the resulting treatment of customers may be considered unfair. Unfair treatment of customers and the mis-selling of financial products to customers with limited financial knowledge led to substantial revisions of regulatory regimes in the Western world. Financial consumer protection became a high-level objective, and in countries such as the United Kingdom and the United States, separate regulatory bodies with a financial consumer protection mandate have been established.

Not all regulators in jurisdictions where Islamic finance is practised have consumer protection mandates, but there are linkages between consumer protection and systemic stability. For example, *Sharī'ah*-compliant deposit insurance schemes prevent bank runs and protect consumers' capital, and disclosure in an understandable language is a precondition for market discipline in support of systemic stability and better consumer choices. Even without an explicit consumer protection mandate, regulators may be concerned about persistently "bad" choices of consumers because they are a challenge to the effectiveness of Basel Pillar 3 (market discipline). A large number of cognitive biases and limitations have been identified by behavioural economics in Western countries. Unfortunately, there is a lack of empirical studies on financial consumer behaviour of Muslims. Regulators may initiate such studies, especially if they want to promote a concept of Islamic finance which is based on risk-sharing. Its viability requires solutions for information asymmetries, moral hazard and adverse selection issues. The effectiveness of institutional arrangements depends on the cognitive capacities and behavioural peculiarities of those people who are expected to deliberately choose risk-sharing modes of finance and investment. Better empirical knowledge could enhance the chances of success.

Appendix 1: Sample Methodology

Islamic banking

Sample data were collected for 59 full-fledged Islamic banks in Bahrain, Bangladesh, Indonesia, Jordan, Kuwait, Malaysia, Pakistan, Qatar, Saudi Arabia, Turkey and the United Arab Emirates. These countries were chosen due to the importance of Islamic banking in their respective banking systems as well as data availability. Total assets of the sample Islamic banks amounted to USD567.8 billion in 2013, or 69% of global Islamic banking assets (excluding Iran). Data collected covered a period from 2008 to 2013.

List of Islamic Banks Selected for the Sample	
Bahrain	
ABC Islamic Bank	KFH Bahrain
Al Baraka Islamic Bank	Khaleeji Commercial Bank
Al Salam Islamic Bank	Ithmaar Bank
Bahrain Islamic Bank	
Bangladesh	
Al-Arafah Islami Bank	Islami Bank Bangladesh
First Security Islami Bank	Shahjalal Islami Bank
Indonesia	
Bank BRISyariah	Bank Syariah Mandiri
Bank Muamalat Indonesia	Bank Syariah Mega Indonesia
Bank Syariah Bukopin	
Jordan	
Islamic International Arab Bank	Jordan Islamic Bank
Kuwait	
Ahli United Bank	Kuwait Finance House
Boubyan Bank	Kuwait International Bank
Malaysia	
Affin Islamic Bank	Hong Leong Islamic Bank
Alliance Islamic Bank	HSBC Amanah Malaysia
AmIslamic Bank	KFH Malaysia
Asian Finance Bank	Maybank Islamic Bank
Al Rajhi Bank (Malaysia)	OCBC Al-Amin
Bank Islam	Public Islamic Bank
Bank Muamalat	RHB Islamic Bank
CIMB Islamic Bank	Standard Chartered Saadiq
Pakistan	
Al Baraka Bank (Pakistan)	Dubai Islamic Bank (Pakistan)
BankIslami	Meezan Bank
Qatar	
Barwa Bank	Qatar Islamic Bank
Masraf Al Rayan	Qatar International Islamic Bank
Saudi Arabia	
Alinma Bank	Bank AlBilad
Al Rajhi Bank	Bank AlJazira
Turkey	
Al Baraka Turk Participation Bank	Kuveyt Turk Participation Bank
Bank Asya Participation Bank	Turkiye Finans Participation Bank
United Arab Emirates	
Abu Dhabi Islamic Bank	Emirates Islamic Bank
Ajman Bank	Sharjah Islamic Bank
Dubai Islamic Bank	

Takāful

Sample data were collected for 30 full-fledged *Takāful* operators in Bahrain, Bangladesh, Kuwait, Malaysia, Pakistan, Qatar, Saudi Arabia, Sri Lanka and the United Arab Emirates. These countries were chosen due to the relative importance of *Takāful* in their respective insurance markets and, more importantly, data availability. Total gross contributions of the sample *Takāful* operators amounted to USD403.9 million in 2013. Data collected covered a period between 2008 and 2013.

List of *Takāful* Operators Selected for the Sample	
Bahrain	
Takaful International Co.	
Bangladesh	
Islami Insurance Bangladesh	Padma Islami Life Insurance
Kuwait	
Gulf Takaful Insurance Co.	Wethaq Takaful Insurance Co.
Malaysia	
Etiqa Insurance & Takaful	Prudential BSN Takaful
Great Eastern Takaful	Takaful Ikhlas
Hong Leong MSIG Takaful	Takaful Malaysia
Pakistan	
Dawood Family Takaful	Pak Qatar Family & General Takaful
Pak Kuwait Takaful Co.	
Qatar	
Doha Insurance	Qatar Islamic Insurance Co.
Saudi Arabia	
Al-Ahli Takaful Co.	Gulf Union Insurance and Risk Management Co.
Allianz Saudi Fransi	SABB Takaful Co.
Allied Cooperative Insurance Group	Saudi Arabian Cooperative Insurance Co.
Al Sagr Cooperative Insurance Co.	Saudi United Co-operative Insurance Co.
BUPA Arabia for Cooperative Insurance	The Company for Cooperative Insurance (Tawuniya)
Sri Lanka	
Amana Takaful	
United Arab Emirates	
Abu Dhabi National Takaful Co.	Islamic Arab Insurance Co. Salama
Dar Al Takaful	

Appendix 2: Selected Features of *Sharīʿah*-Compliant Deposit Insurance Schemes

	Bahrain	Malaysia	Nigeria	Sudan
Year established	**2011**	**2005**	**2011**	**1996**
Rationale for establishment	To develop the current post-funded scheme and replace it with a new prefunded scheme to bring deposit protection more closely in line with international best practices	To allow the depositors of Islamic member banks to enjoy the same protection accorded to the depositors of conventional member banks	To cater for the (potential) depositors of IIFS that was about to be licensed, then by the central bank	To participate in the stability and soundness of the banking system by protecting depositors
Governance structure	Established under specific legislation and administered by the central bank or an existing government-owned entity	Established under specific legislation and administered by a government-owned deposit insurer	Not established under specific legislation but is administered by a government-owned entity	Established under specific legislation and administered by a government-owned deposit insurer
Categories of IIFS covered	Full-fledged Islamic commercial banks	Full-fledged Islamic commercial banks and Islamic windows	Full-fledged Islamic commercial banks, Islamic windows, and Islamic microfinance banks	Full-fledged Islamic commercial banks and Islamic investment banks
Types of accounts protected	Unrestricted investment account (*Muḍārabah*)	• Savings account *(Wadīʿah, Qarḍ, Muḍārabah)* • Current account *(Wadīʿah, Qarḍ, Muḍārabah)* • Commodity *Murābahah account (Murābahah)* • Unrestricted *investment account (Muḍārabah, Wakālah)* • Restricted investment account *(Muḍārabah, Wakālah)* • Investment linked to derivatives offered/ structured product *(Murābahah, Wakālah, Muḍārabah)*	• Demand deposit (*Qarḍ*) • Savings *(Wadīʿah)* • Investment account (*Muḍārabah*)	• Current account (*Qarḍ*) • Investment account (*Muḍārabah*)
Who is covered	Individuals (local customers) and foreign customers	Individuals (local customers), corporates (businesses), foreign customers and others	Individuals (local customers), corporates (businesses), foreign customers and others	Individuals (local customers), corporates (businesses) and foreign customers
Underlying principle	An Islamic fund was established to cover eligible accounts, and investments made from the Islamic Fund must comply with *Sharīʿah* principles	*Kafālah bi al-ʿAjr* (guarantee with fee)	*Kafālah bi al-ʿAjr* (guarantee with fee)	*Takāful* mechanism whereby the banks, the government (represented by the Ministry of Finance), the central bank and the investors participate to provide protection to deposit holders

Year established	Bahrain 2011	Malaysia 2005	Nigeria 2011	Sudan 1996
***Sharīʿah* advisers at SCDIS**	Yes	No, but it seeks resolutions from the *Sharīʿah* Advisory Council of BNM on any *Sharīʿah* issues relating to its SCDIS operations	No	Yes
Nature of the scheme (pre-funded, post-funded, or mixed)	Pre-funded	Mixed	Pre-funded	Pre-funded
Investment strategy	Invest only in liquid safe financial instruments such as the country's sovereign *Sukūk*, or GCC sovereign *Sukūk*, including those issued by government-owned bodies	Invest in (a) ringgit-denominated securities issued or guaranteed by the government or BNM or of high investment grade as rated by a reputable rating agency, (b) deposits with BNM or any financial institution, or (c) any other investment as approved by the Minister, upon the recommendation of the board	The funds are invested only in safe and liquid instruments to enable easy access when the need arises. Currently, government and central bank instruments are the only eligible and available instruments	Invest in government securities and any investment opportunities to be proposed by the fund and approved by the board
Back-up guarantees from government should the fund be insufficient	No. The board may cover the shortfall by arranging *Sharīʿah*-compliant financing which shall be reimbursed by future contributions from IIFS	Yes. A *Sharīʿah*-compliant way of deploying those guarantees have been devised	Yes. A *Sharīʿah*-compliant way of deploying those guarantees has not been devised	Yes. A *Sharīʿah*-compliant way of deploying those guarantees has been devised
Trigger for payments	The board shall commence its responsibilities by following the compensation process for the eligible depositors and/or investors upon: (a) any bank being put under administration by the CBB; or (b) any bank being put into liquidation in each case, such bank hereinafter referred to as a "defaulting bank"	PIDM shall make payments to depositors in respect of any deposit insured by the SCDIS when a winding-up order has been issued by the court in respect of an Islamic member bank	Revocation of the banking licence of the failed bank	The central bank decides to liquidate the bank in question, then the fund is asked to reimburse depositors. An amendment in the BDSF Act was proposed in which the central bank will appoint the fund to be the official liquidator of the bank in question
Marketing awareness to the SCDIS' customers	All advertisements or other promotional publications issued by IIFS contain an invitation to make deposits or open UIAH and refer, directly or indirectly, to the regulation protecting deposits and UIAH	Undertaken via advertising, publicity and education programmes, as well as public/community relations, stakeholder engagement and media relations	Provision of informational materials (e.g. stickers) by the SCDIS, to be displayed in strategic positions in their branches	Undertaken via public awareness programmes using various media channels such as newspapers and television

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ISBN978-967-5687-42-6

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