

10th Islamic Financial Stability Forum

**Preserving the Soundness and Stability
of the Islamic Financial Services Industry:
The Development of a Financial Safety Net Infrastructure**

Kuala Lumpur, Malaysia

In conjunction with the 25th Meeting of the Council of the IFSB

Organised By:



Hosted By:



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

10th IFSF : Speakers & Discussants

Speakers:

- ❖ *Jaseem Ahmed, Secretary-General, Islamic Financial Services Board*
- ❖ *Zahid ur Rehman Khokher, Assistant Secretary-General, Islamic Financial Services Board*

Discussants:

- ❖ *Greg Cavanagh, Counsel and Vice President, Legal Group, Federal Reserve Bank of New York*
- ❖ *Rafiz Azuan Abdullah, Executive General Manager, Malaysia Deposit Insurance Corporation*



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10th Anniversary 2003 - 2013

THE DEVELOPMENT OF A FINANCIAL SAFETY NET INFRASTRUCTURE FOR THE ISLAMIC FINANCIAL SERVICES INDUSTRY

PRESENTED AT:

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Jaseem Ahmed
Secretary-General

Zahid ur Rehman Khokher
Assistant Secretary-General

AGENDA

- ❖ **Financial Safety Nets and Islamic Financial Services Industry**
- ❖ **Lender of Last Resort (LOLR) Facilities**
 - ❖ **Doctrines of LOLR**
 - ❖ **Structuring *Shari'ah* Compliant LOLR- Challenges and insights**
- ❖ **Deposit Insurance Schemes (DIS)**
 - ❖ **Role of Deposit Insurance in Financial Stability**
 - ❖ ***Shari'ah* Compliant DIS- Challenges and insights**
- ❖ **Conclusions and Moving Forward**

FINANCIAL SAFETY NETS AND ISLAMIC FINANCIAL SERVICES INDUSTRY

ELEMENTS OF FINANCIAL STABILITY

NORMAL MONITORING

EARLY WARNING

FINANCIAL SAFETY NET

1. Crisis Management & Contingency Planning

4. Bank Resolution

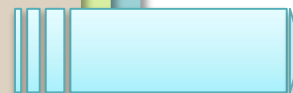
2. Lender of last resort

3. Explicit deposit insurance

Stable and Sound
Banking System

Depositors'
Protection

Financial
Stability



OBJECTIVES OF POLICY DURING FINANCIAL CRISIS



Restoration of confidence



Restoration of liquidity, solvency and, ultimately, profitability



Other supporting actions: restructuring of balance sheets, NPL removal, recapitalisation



Goal of shortening the duration of the credit crunch and restoration of credit growth

RECENT FINANCIAL SECTOR CRISES

Asian + Global Financial Crisis

Focus on restoring liquidity early



Addressing the emergency

Liquidity support

- The central banks provided liquidity under various emergency lending and **lender-of-last-resort facilities** to financial institutions to offset the withdrawal of deposits and credits

Deposit insurance

- To stabilise banks' funding and prevent bank runs, central banks strengthened deposit insurance through **blanket guarantees** to provide full protection for depositors and creditors.

BANKS DURING CRISIS OF 2007




Excessively leveraged banks



Over reliance on wholesale funding of short duration (and currency mismatch)



Decline in loss absorption of capital



Decline in quality/ quantity of liquid assets

ISLAMIC BANKS – DIFFERENT BUT STILL VULNERABLE

- High capital adequacy, 95% common equity Tier 1
- Lower leverage and higher solvency
- Flush with cash, But....
- Risk sharing – the return on PSIA is not guaranteed and depends on the bank's performance
- Higher exposure to consumer sector, which usually has a higher default rate
- Limited access to HQLA or to interbank markets
- Uncertainty over central bank support and adequacy of financial safety nets

IFSB 2010 HIGH LEVEL TASK FORCE REPORT FINANCIAL INFRASTRUCTURE

Eight Building Blocks

Comprehensive set of cross-sectorial prudential standards

Development of a liquidity management infrastructure

Strengthening financial safety nets

Effective crisis management and resolution framework

Accounting, auditing and disclosure standards

Macro-prudential surveillance

Strengthening rating processes

Capacity building and talent management

Strengthen the foundations of the Islamic financial system

CAPABILITIES FOR MONETARY OPERATIONS: IMPROVING WITH A LAG FOR IF

Tools for Monetary Operations	Available for Conventional Banks		Adopted for Islamic Banks	
	Yes	Base	Yes	Base
Open market operations (OMOs)				
Buying and selling money market instruments through Repo or outright sale in the secondary market	20 (80%)	25	5 (23%)	22
Issuance of Central Bank or Government Securities				
Primary market issuance of central bank or government securities for monetary policy purposes	18 (72%)	25	6 (29%)	21
Standing facilities				
Discount window or Short-Term Deposit facilities	20 (84%)	24	4 (20%)	20

Source: IFSB Survey, 2013

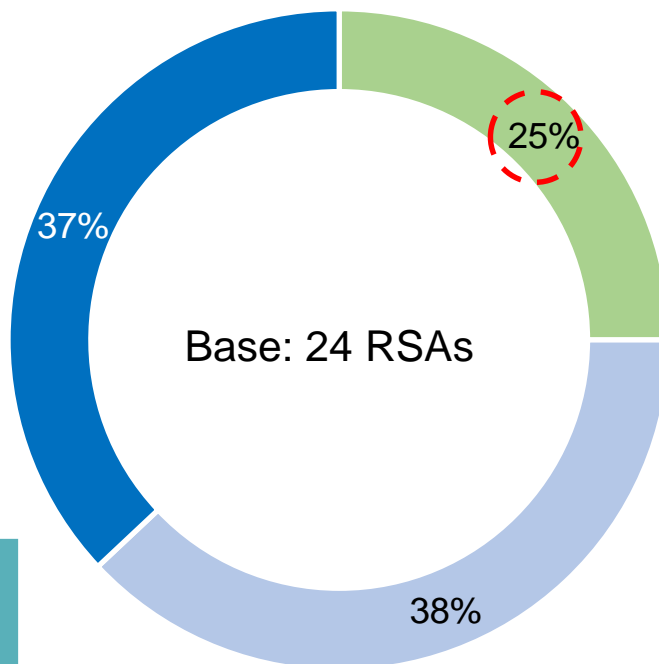
Availability of monetary policy tools in the form of OMOs, primary market issuances and standing facilities demonstrate relative progress in the capabilities of central banks and monetary authorities.

...REFLECTS RELATIVE PROGRESS ON LEGAL FRAMEWORK FOR LOLR/SLOLR

Nine RSAs have not offered an SLOLR to-date but they **place a high importance on developing SLOLR facilities** due to the increasing IIFS market share in the banking system

LOLR facility is legally embedded in the scope of the respective central bank/monetary authority

Yes	23	85%
No	4	15%
TOTAL	27	100%



Six RSAs confirmed that SLOLR facilities **have been developed** for the IIFS in their jurisdictions.

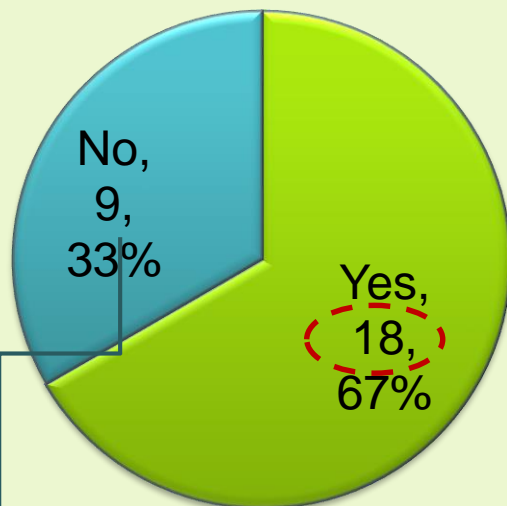
Nine RSAs revealed that SLOLR facilities **have not been developed** in their respective jurisdictions, as they **do not differentiate** between conventional and IIFS when it comes to providing LOLR facilities

Note: Approximate timeframe for the development of SLOLR facilities ranges from 1-3 years

Source: IFSB Survey, 2013

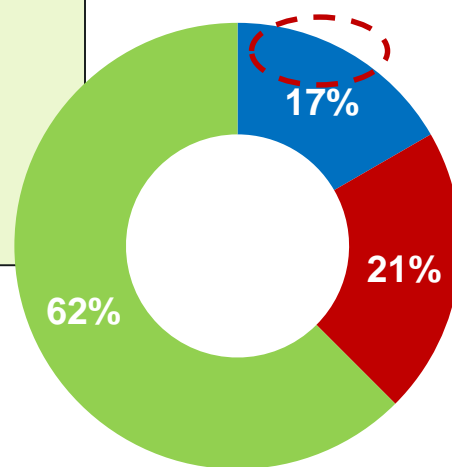
SIMILARLY, PROGRESS ON DEPOSIT INSURANCE SCHEMES WITH LAG

Availability of Conventional Deposit Insurance Scheme



Out of 9 Jurisdictions:
=> 5 Jurisdictions: DIS Under Development/Under Consideration
=> 1 Jurisdiction: No Conventional Banks

Availability of Shari'ah -Compliant DIS



- An SCDIS has been developed and implemented
- An SCDIS has not been developed and implemented
- Considers important to develop and implement an SCDIS

***SHARĪAH* COMPLIANT LENDER-OF-LAST-RESORT (SLOLR) FACILITIES**

DOCTRINES OF LOLR (1)

OBJECTIVE

To Prevent, or mitigate, financial instability through the provision of liquidity support by monetary authorities either to individual financial institutions or to the market as a whole, in response to an adverse shock that causes increase in the demand for liquidity which cannot be met by an alternative source.

Henry Thornton (1802) & Walter Bagehot (1873)

Classic Doctrine of LOLR

- 1. Central bank, acting as LOLR, **should prevent temporarily illiquid but solvent banks from failing** [Exclude insolvent banks]
- 2. Central bank should accommodate **any private bank with good collateral**, valued at pre-panic prices
- 3. Lend, but **at a high penalty rate**
- 4. This **policy should be clearly communicated**. Uncertainty about central bank actions can itself contribute to panic

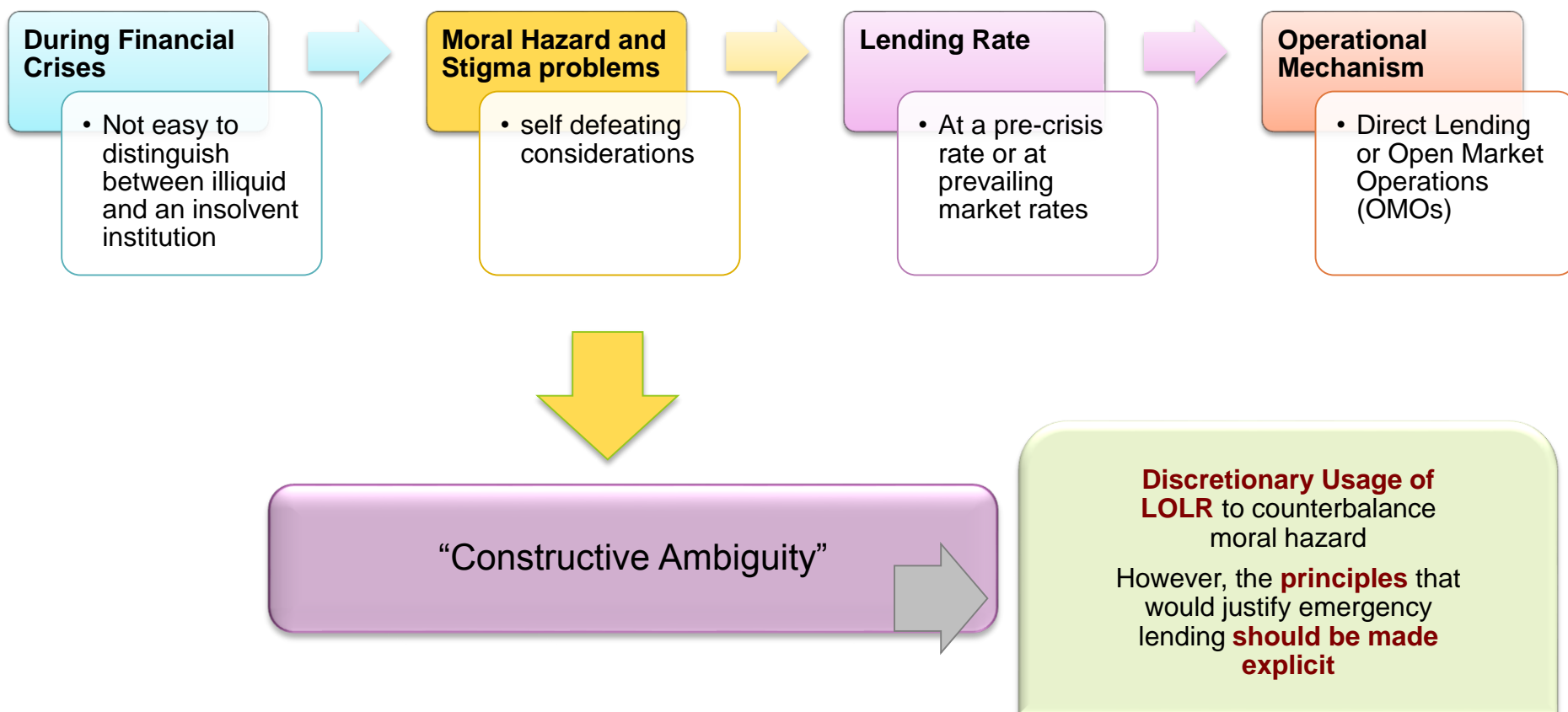
Two Operating Principles

LOLR role is discretionary, not mandatory

Systemic implications by contagion due to failure of one bank

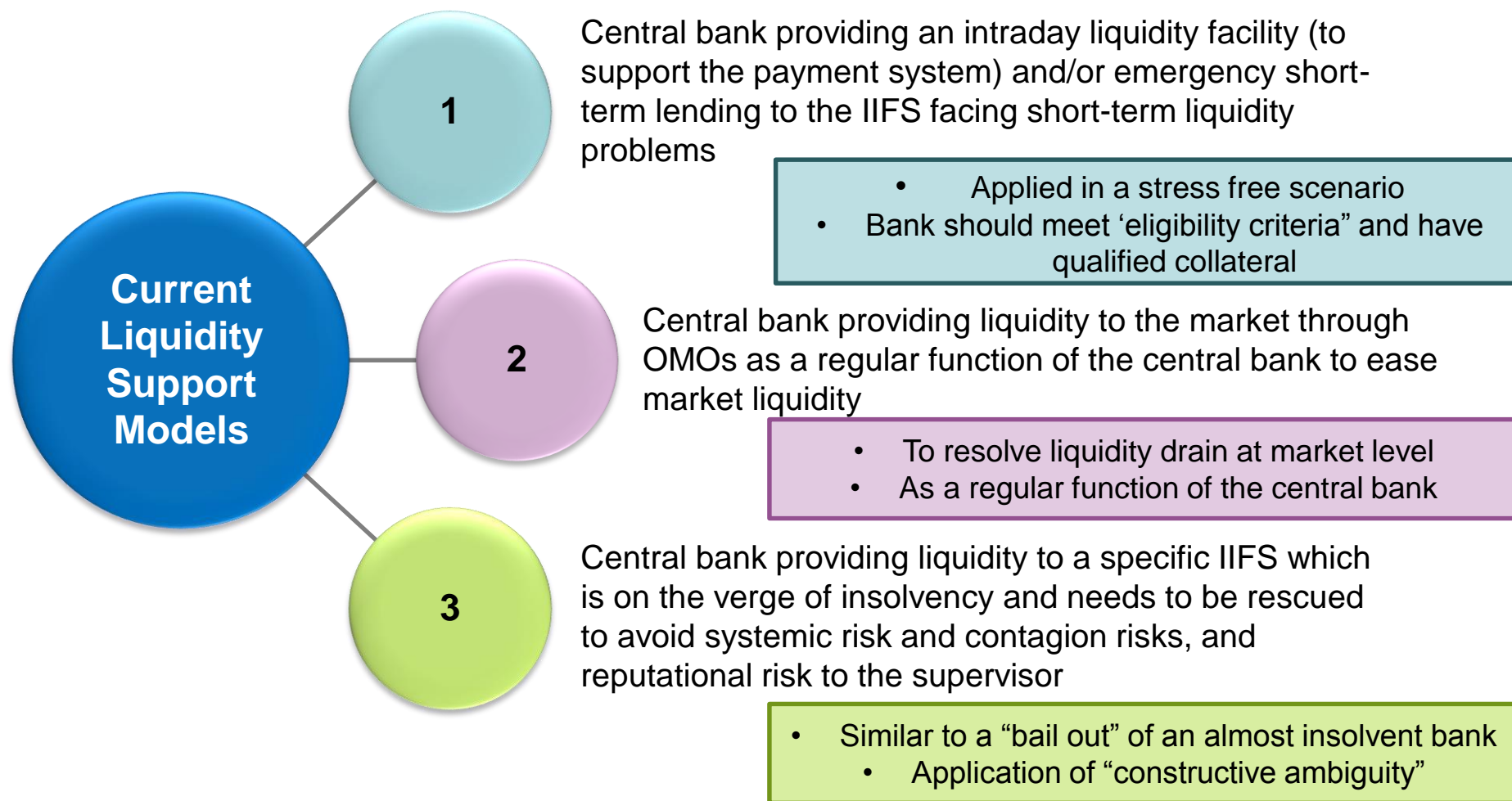
DOCTRINES OF LOLR (2)

Critique



DOCTRINES OF LOLR (3)

At present, central banks utilise a variety of mechanisms to provide liquidity support to banking institutions, such as:



STRUCTURING SHARI'AH COMPLIANT LOLR FOR IIFS – SOME PERTINENT QUESTIONS

Questions

1. What are the *Sharī'ah* and operational issues with regard to providing SLOLR facilities to IIFS?
2. What is the status of pre-conditions for the development of SLOLR facilities?
3. How are existing SLOLR mechanisms structured by RSAs?
4. Have the monetary tools used by the RSAs been adapted to cater to the specificities of IIFS?
5. What is the qualifying criteria and conditions for providing SLOLR facility?
6. What are the key challenges and supervisory considerations in developing SLOLR?

1. ISSUES IN STRUCTURING SLOLR FACILITY

Sharī`ah issues

LOLR as an interest-bearing loan

The SLOLR to be structured and developed must be **free from interest-bearing elements**.

Collateral in LOLR

A security is permissible, provided that the **collateral is a Sharī`ah-compliant asset**.

LOLR and high penalty rate

A “high profit rate” may be applied to the SLOLR facility, provided that the conditions imposed by the *Sharī`ah* in connection with the principle of **mutual willing consent (Tarāḍī)** are fulfilled. The acceptability of such rate also depends upon the use of a suitable underlying **Sharī`ah-compliant contract and benchmark rates**.

Role of Central Banks

- The central bank, acting as an LOLR, should prevent temporarily illiquid banks from failing, including IIFS
- The central bank should make clear its readiness to providing liquidity support well in advance of crises, so that the market knows exactly what to expect, and thus removing uncertainty

2. PRE-CONDITIONS FOR THE DEVELOPMENT OF SLOLR FACILITIES

Pre-conditions	Ranking
It is necessary to have a robust supervisory framework in place first (i.e. in terms of setting out relevant controls on the SLOLR) before developing the SLOLR facility	1
A central bank will need to obtain appropriate regulatory and remedial powers , and backing of a suitable legal framework before developing and offering the SLOLR facility to IIFS	2
A central bank will have to assess the suitability of the SLOLR facility in relation to the prevailing Sharī'ah interpretations in its jurisdiction	3
A central bank will have to first have in place proper Sharī'ah governance mechanism before developing the SLOLR facility	4
A central bank will need to consider the cross-border implications in the development of SLOLR facilities	5
The development of SLOLR facility would require the central bank to commit to a substantial resource (e.g. IT and manpower)	6
Due to lack of eligible collaterals, there is a need for the central bank to broaden the scope of eligibility to include lower-rated securities and acceptance of bank/IIFS bills in overnight facility of SLOLR	7

3. SHARIAH-COMPLIANT LIQUIDITY MECHANISM

Six (out of 26) RSAs indicated that they have in place a **structured mechanism for providing liquidity to IIFS**

1. Intraday credit (*Rahn*)
2. Standing facility – sell and buy-back transaction (*Bay` al-`Inah*)
3. Standing facility – collateralised *Murābahah* (*Rahn* and *Murābahah*)



1. The authority (central bank) government short-term *Sukūk Al-Ijārah* (*Al-Ijārah*)

1. *Tawarruq* and Reverse *Tawarruq* (*Murābahah*)
2. Exchange of deposits (*Qarḍ*)

1. Liquidity management (Commodity *Murābahah*)

1. Interest-free loans (*Qarḍ al-Hasan*)
2. Floating speculation (deposits) (Floating *Muḍārabah*)
3. Restricted speculation (deposits) (Restricted *Muḍārabah*)
4. Partnership (*Mushārah*)

1. Islamic certificates of deposit (Commodity *Murābahah*)
2. Islamic FX swaps (Islamic swaps)
3. Collateralised *Murābahah* facility

Name of facility
Underlying structure

4. TOOLS FOR MONETARY OPERATIONS OF THE CENTRAL BANK (i)

It is essential to look at the **existing mechanisms** available for RSAs for monetary operations and how they are adapted to **cater to Islamic finance**. This will lead to **evaluating the challenges** in developing SLOLR facilities.

The development of OMOs using “repos and outright” sale or purchase is considered “important” for efficient monetary operations by the RSAs

	Existence of tools for monetary operations		Tools adapted to meet <i>Sharī'ah</i> requirements	
	Yes	Base	Yes	Base
Open market operations (OMOs)				
Buying and selling money market instruments outright on the secondary market	80%	25	23%	22
Buying and selling assets under repurchase agreement (repo and reverse repo operations) in a secondary market to inject or absorb liquidity into or from the banking system	84%	25	23%	22
Buying and selling of foreign exchange swaps	64%	25	15%	20

4. TOOLS FOR MONETARY OPERATIONS OF THE CENTRAL BANK (ii)

The use of primary market issuance of central bank or government securities is considered important among the categories

	Existence of tools for monetary operations		Tools adapted to meet <i>Sharī'ah</i> requirements	
	Yes	Base	Yes	Base
OMO-type operations (conducted using specific central bank instruments)				
Lending and borrowing on an auction basis against underlying assets as collateral	44%	25	14%	21
Primary market issuance of central bank or government securities for monetary policy purposes	72%	25	29%	21
Auctions of term deposits	25%	24	5%	20
Foreign exchange auctions (as a tool for both banking system's liquidity management and foreign exchange)	28%	25	0%	20

4. TOOLS FOR MONETARY OPERATIONS OF THE CENTRAL BANK (iii)

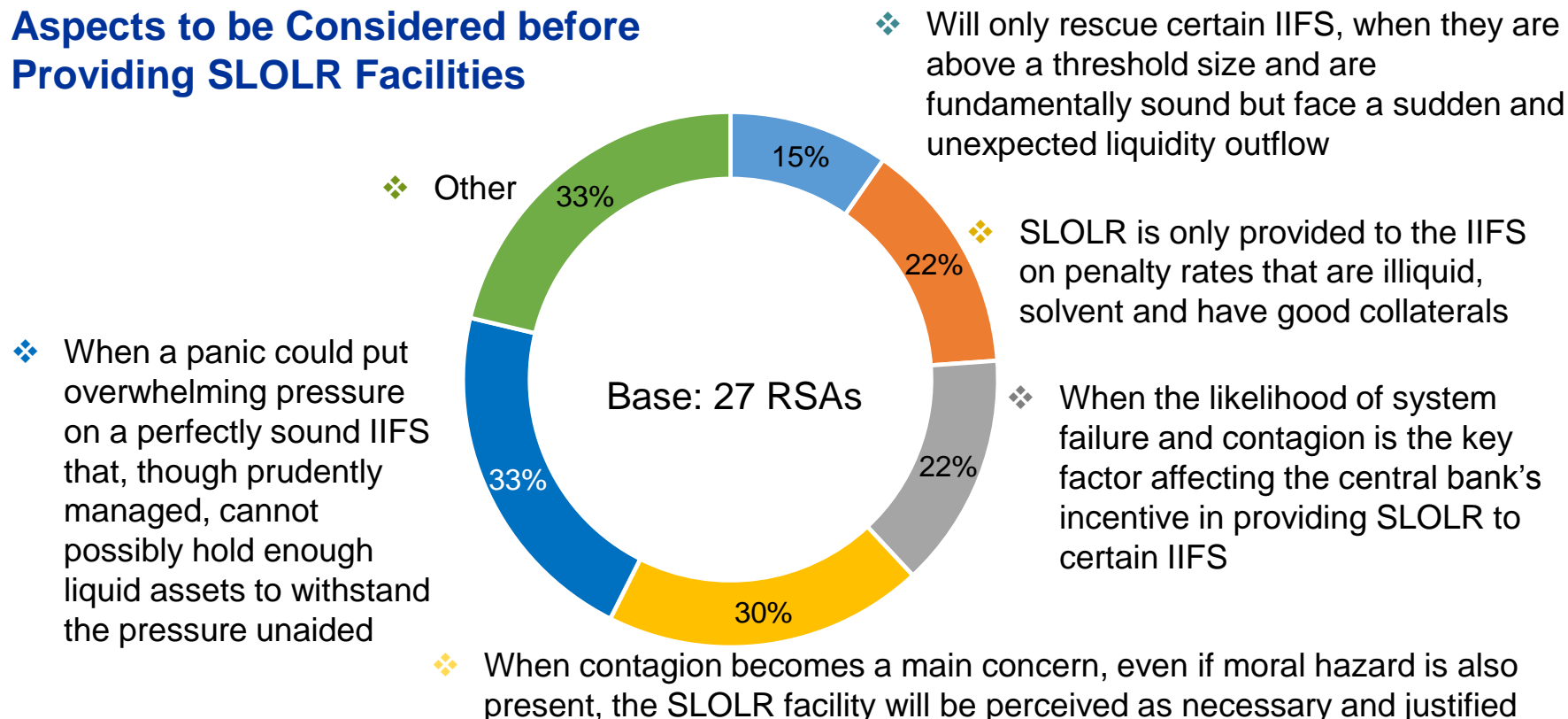
The findings suggest the need to develop new such facilities, or to adapt existing facilities, in line with the specificities of Islamic finance

	Existence of tools for monetary operations		Tools adapted to meet <i>Shar'ah</i> requirements	
	Yes	Base	Yes	Base
Standing facilities (i.e. discretionary end-of-day lending or deposit facilities to provide or absorb overnight liquidity)				
Discount window or re-finance facilities (i.e. short-term borrowing of funds from central banks secured against government bonds or central bank securities as collateral, providing a ceiling for market interest rates)	88%	24	10%	20
Deposit facilities (i.e. short-term placement of banks' funds with central banks), providing a floor for market interest rates	79%	24	25%	20
Fully collateralised Lombard facilities, secured against government bonds and loans on deeds, providing a ceiling for market interest rates	29%	24	0%	19

Source: IFSB Working Paper on Strengthening the Financial Safety Net: The Role of Shar'ah-compliant Lender-of-last-resort Facilities as an Emergency Financing Mechanism, April 2014

5. QUALIFYING CRITERIA AND CONDITIONS FOR PROVIDING AN SLOLR FACILITY

Aspects to be Considered before Providing SLOLR Facilities



Access to the SLOLR facility should be **at the discretion of the central bank** i.e. each request should be **properly evaluated** before deciding whether or not to extend the SLOLR facility to the requesting IIFS

6. KEY CHALLENGES IN DEVELOPING SLOLR

Important aspects to be considered by the RSAs in the development of SLOL facilities (by order of significance)

1

Availability of a range of eligible *Sharī`ah*-compliant collateral - a shortage of high-quality *Sharī`ah*-compliant liquid assets

2

Procedures and guidelines for SLOLR - developing a process to ensure *Sharī`ah* compliance of SLOLR operations

3

Supporting infrastructure (e.g. human resources, an effective *Sharī`ah* governance mechanism, adaptation of integrated payment and settlement systems addressing *Sharī`ah* concerns)

4

Valuation techniques for the underlying *Sharī`ah*-compliant assets or collateral

5

Prohibition of “penalty rate/discount rate/interest rate” and development of Islamic benchmark as an alternate for an SLOLR facility

6

Differing interpretations of *Sharī`ah* rulings, or *Fatāwa*, on financial matters across the jurisdiction (i.e. interpretations among *Sharī`ah* boards of the IIFS) *

7

Re-financing or roll-over facilities for the SLOLR facility

**Most of the IIFS which have cross-border operations believe that this would be a significant challenge to them*

SUPERVISORY CONSIDERATION ON POTENTIAL STRUCTURES FOR LOLR

Key supervisory considerations

Identify the appropriate
Sharī'ah-compliant
financial contract to
be employed

Address risk
management
issues in providing
a SLOLR, such as
credit, reputational
and legal risk

Establish the
necessary
frameworks to
mitigate the
incidence of moral
hazard problem

Identify the merits
and weaknesses of
the potential
structures when
developing SLOLR
facilities



Recommendations

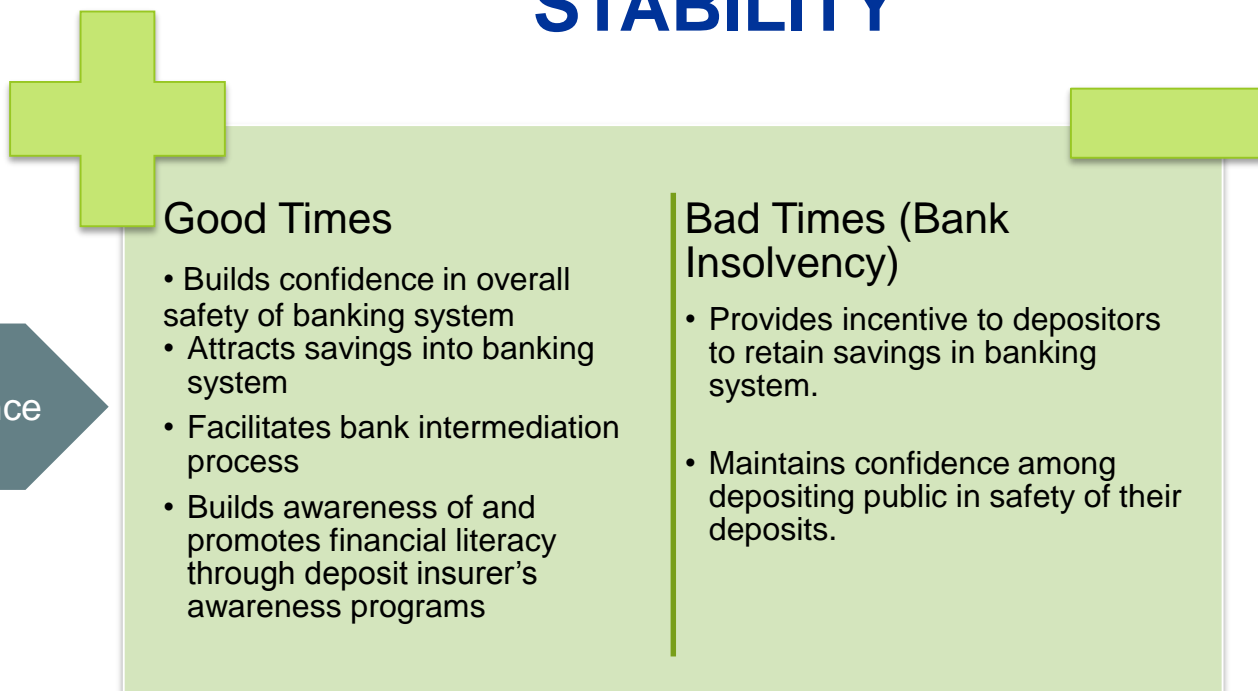
Qarḍ to be used for
overnight funding

Collateralised CMT to be
used for intraday and
short-term funding

Muḍārabah or *Wakālah* to
be used for longer-term
liquidity provision

***SHARĪAH*-COMPLIANT DEPOSIT INSURANCE SCHEME**

ROLE OF DEPOSIT INSURANCE IN FINANCIAL STABILITY



Role of Deposit Insurance Provider

In good times, to establish credibility

In bad times, to build confidence by effective bank resolution procedures and speed of deposit insurance repayment

Incentives for banks to improve risk management

Banks with riskier profile pay higher premiums

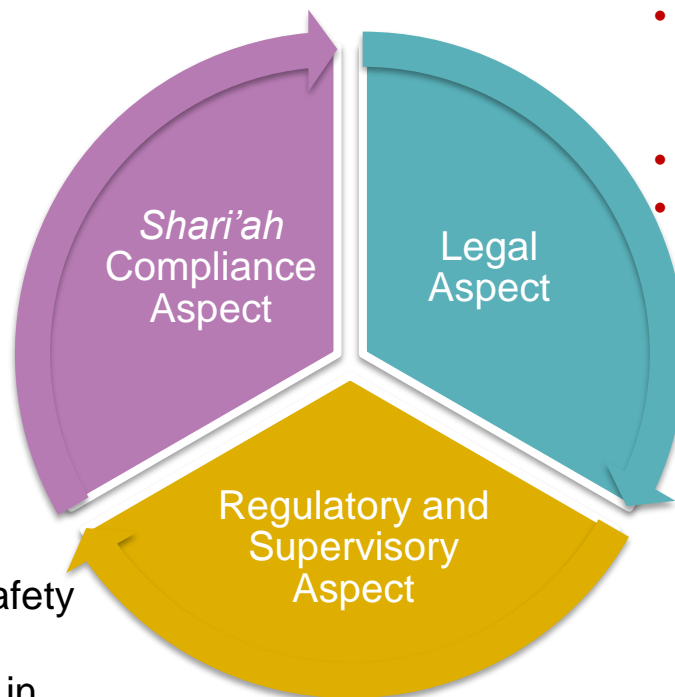
Reduces moral hazard issues

DI components are indicators of sound risk management framework.

provides financial incentive to resolve deficiencies on timely basis.

POLICY PARAMETERS FOR STRUCTURING A SCDIS FRAMEWORK

- **Insurability** of Islamic banks' deposits
- **Who** guarantees?
- **How** is it funded?
- **Choice** of *Shari'ah* Compliant Model
- **Treatment** of Islamic Deposits and PSIA, including Restricted accounts



- **Amendments to current statute** or a separate law on Islamic bank deposits
- **Insolvency Regime**
- **Resolution Frameworks**

- **Interaction** with other safety net mechanisms
- **Role of Deposit Insurer** in Bank Resolution
- **Funding Mechanism** of Deposit Insurer
- **Compulsory membership** in a Kafalah (guarantee) structure

INSTITUTIONAL APPROACHES

- In a Survey undertaken by the IFSB in 2014, **67% of the RSAs** (18 out of 27) indicated that a Conventional Deposit Insurance System (CDIS) facility exists in their banking institutions.
- With respect to *Sharī'ah*-compliant deposit insurance schemes (SCDIS), only 17% (four) RSAs confirm that SCDIS facilities have been developed and implemented for the IIFS in their jurisdictions.

Protecting Islamic Deposits: Three Approaches

Protecting Islamic deposits under a conventional deposit insurance system

Developing a SCDIS alongside a conventional system

Developing an SCDIS in a fully-Islamic banking environment

SELECTED MODELS FOR SCDIS

Choice for Appropriate Model for *Shari'ah* Compliant Deposit Insurance and Insurability of Profit Sharing Investment Accounts (PSIA) Pose Primary Challenge for Jurisdictions

Features	Kafalah Bil Ujr (Guarantee with Fee) [Malaysia]	Takaful (Joint Guarantee) [Sudan]
Parties to the Contract	IIFS and Deposit Insurance Provider	IIFS, IAH, MOF and/or Central Bank
Funds for guarantee of Islamic deposits and PSIA	One Fund covers both Islamic Deposits and PSIA. Fund is separate from conventional fund.	Separate Takaful Funds for the guarantee of Islamic deposits and PSIA*
Contribution to Fund	Made by the IIFS	Islamic Deposits: Contribution by the IIFS and/or MoF/Central Bank PSIA: IAH and/or MoF/Central Bank
Fund Ownership	Deposit Insurance Provider	Respective Contributors
Role of Deposit Insurance Provider	Guarantor	Agent to Manage Takaful Funds
Reimbursement	Made by Deposit Insurance Provider's Fund	Made from the Takaful Funds

*Footnote: One Takaful Fund with two portfolios: One each for Islamic deposits and PSIA (Jordan)

DIFFERENT TREATMENT OF INSURABILITY OF PROFIT SHARING INVESTMENT ACCOUNTS

- Regulatory and *Shar'iah* Treatment of PSIA had an impact on insurability.

	Treatment of PSIAs	No.	%
a.	IAHs are treated <u>like investors</u> who bear all the earnings volatility and risks of losses on their investment (absent misconduct or negligence in the part of the IIFS) - Therefore, the (credit and market risks weighted) assets financed by the funds of the IAHs are excluded from the denominator of the capital adequacy formula.	2	7
b.	IAHs are treated like a <u>liability of the IIFS</u> , which therefore bears the risk of the assets funded by IAH.	12	44
c.	IAHs are only <u>partially risk absorbent</u> so that the IIFS bears part of the earnings volatility on their investment. Therefore IIFS include a proportion of credit and market risks (known as Alpha (α)) related to the assets financed by PSIA, in the denominator of the CAR	7	26
d.	Others	6	22
Base/Total		27	

	Aspect A		Aspect B
	Types of Account	Underlying contract	account is protected under the SCDIS?
RSA 1	Current accounts	Qard	Yes
	Investment accounts	Mudarabah	Yes
RSA 2	Saving Account	Wadiah, Qard, Mudarabah	Yes
	Current Account	Wadiah, Qard, Mudarabah	Yes
	Commodity Murabahah Account	Murabahah	Yes
	Unrestricted Investment Account (UIA)	Mudarabah, Wakalah	Yes
	Restricted Investment Account (RIA)	Mudarabah, Wakalah	Yes
	Money market deposit	Murabahah, Wakalah, Mudarabah	No
	Negotiable Instrument of Deposit/Islamic Negotiable Instrument	Wadiah, Mudarabah	No
	Investment Linked to Derivatives Offered/ Structured Product	Murabahah, Wakalah, Mudarabah	Yes
	Gold investment account	Qard	No
RSA 3	Islamic repurchase agreement	Mudarabah	No
	Unrestricted investment accounts	Mudarabah	Yes
RSA 4	Restricted investment accounts	Mudarabah	No
	Demand Deposit	Qard	Yes
	Savings	Wadiah	Yes
	Investment account	Mudarabah	Yes

- In one case, restricted PSIA are not covered by SCDIS.

COVERAGE OF ISLAMIC WINDOWS

IFSB Survey Findings

95% of the RSAs (19 out of 20) agreed that Islamic windows' clients should be given similar protection to clients of fully-fledged Islamic banks.

- Consistency in protection is necessary

- Necessary to have a level-playing field between Islamic windows and fully-fledged Islamic banks

Challenges and Issues in Covering Islamic Windows

1. Requirement to “ring-fence” the contributions made by parent bank for its conventional and Islamic deposits
2. Implementation of a differential premium system – categorising banks into a few categories based on their respective risk profiles for premium collection purposes
3. Priority of payments upon liquidation of assets should a conventional bank with Islamic window fail
4. Treatment of windows if conventional bank goes under resolution and is taken over by other bank
5. Reputational Risk between Islamic and conventional arms

ASSESSMENT OF THE ARRANGEMENTS FOR THE DEVELOPMENT OF SCDIS

Assessment of the Existing Arrangements for the Development of SCDIS Facilities	Yes		No		Total	
	No.	%	No.	%	No.	%
The necessary legal, tax and regulatory aspects have been studied to accommodate the development of SCDIS	5	33	10	67	15	100
The necessary legal, tax and regulatory framework has been created, but has not yet been put into operation	2	13	13	87	15	100
The operational procedures and processes have been set out under which the SCDIS would function	0	0	15	100	15	100
<i>Shar'ah</i> constraints and other challenges on the introduction of SCDIS have been assessed	4	27	11	73	15	100

RSAs who do not have sufficient experience in regulating and dealing with Islamic finance activities may find the development of an SCDIS facility a more challenging task

Note: Approximate timeframe for the developing SCDIS facilities ranges from 1-5 years

KEY CHALLENGES IN THE DEVELOPMENT OF A SCDIS

Challenges encountered in developing and implementing a SCDIS	Ranking
Legal issues – formulating the necessary changes to existing laws, regulations etc.	1
Sharī'ah issues – such as differing interpretations of <i>Sharī'ah</i> rulings, or <i>fatawa</i> , on financial matters across the jurisdiction	2
Legislative issues – securing the necessary approvals from your legislative body, Ministers, etc.	3
Supporting infrastructure – human resources including skills and expertise, etc.	4
Investment tools or schemes – limitations on appropriate <i>Sharī'ah</i> -compliant instruments for SCDIS to invest in	5
Setting procedures and guidelines on SCDIS (including developing a process ensuring <i>Sharī'ah</i> compliance of SCDIS operations)	6

Not addressing these challenges would obstruct the development and implementation of the SCDIS

SUMMARY: SCDIS ISSUES

SCDIS is relatively new

Coverage to IIFS is provided by
CDIS in many countries

Different operational models – but
possibility of clear choices emerging

Treatment of IAH critical issue

Convergence on need to develop
SCDIS

OVERALL CONCLUSIONS AND MOVING FORWARD

The question for Islamic finance - not whether financial safety nets are required, but **how they should be structured to be Sharī'ah compliant**. Leaving IIFS without a safety net is too high a risk for the soundness and stability of the financial system.

Key aspects of evolving strategies

- **Capacity building** of supervisors and deposit insurance providers
- **Sharing of experiences** by the stakeholders
- Research papers and standards to provide **policy guidelines** in order to define the structures, mechanisms and specific criteria for developing these facilities
- Having in place a **robust banking supervisory framework**
- Cooperation between various supervisory agencies within a jurisdiction for effective **cross-sector oversight**, information sharing and timely decision making

Moving forward

- The IFSB has issued its first Working Paper on SLOLR in 2014. The second Working Paper on SCDIS is nearing completion.
- Future IFSB work programme - providing prudential guidance or standards on this subject Consultations with IFSB TC and Council.
- Institutionalising policy coordination/sharing of experiences

**THANK YOU FOR
YOUR ATTENTION**