

FAQs on IFSB-16:

Revised Guidance on Key Elements in the Supervisory Review Process of Institutions Offering Islamic Financial Services (excluding Islamic Insurance [Takāful] Institutions and Islamic Collective Investment Schemes)

- 1. Can you explain further the impact of risk transformation in Shari'ah-compliant financing contracts (i.e., Ijarah and Murabahah) as mentioned in paragraph 41? How does it affect on-site examinations and off-site surveillance conducted by RSAs?**

Answer: In conducting a risk assessment of the activities of the IIFS and evaluation of the adequacy of the IIFS's risk management control function, it is essential to consider the specificities of Islamic Banking. These specificities become particularly relevant when determining the scope and frequency of both on-site examination and off-site surveillance methodologies. One of these specificities, as mentioned in IFSB-16, is the impact of risk transformation in Shari'ah-compliant financing contracts (i.e., murābahah), which reflects that the risk transforms based on different stages of the financing or investing based on Shari'ah-compliant contract.

For example, under a murābahah contract, the IIFS must own the asset before being able to enter into a murābahah agreement with the customer. The IIFS is faced with market (price) risk concerning the assets in the IIFS's possession that are available for sale based on murābahah. Market risk is then transformed into credit risk after the sale of the asset to the customer. Therefore, credit risk refers to the risk of a counterparty not paying the purchase price of an asset to the IIFS.

Understanding and assessing these risk transformations is crucial for effective on-site examinations and off-site surveillance conducted by RSAs in ensuring the compliance and stability of Islamic financial systems.

- 2. What are key considerations for RSA in designing the minimum requirements regarding the Shari'ah governance framework for IIFS?**

Answer: In designing minimum requirements for the Shari'ah governance framework for Islamic Financial Institutions (IIFIs), the IFSB-16 explicitly references IFSB-10, which

addresses the components of a sound Sharī'ah governance system, especially regarding the competence, independence, confidentiality, and consistency of Sharī'ah boards.

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

For further details, refer to Section 3.3.2 of IFSB-16 and the comprehensive guidance provided in IFSB-10.

3. What are the key supervisory review processes in the Internal Capital Adequacy Assessment Process (ICAAP)?

Answer: ICAAP aims to inform RSAs and the board of the ongoing assessment of the IIFS' risks, how IIFS plans to mitigate and control the risk, and how much current and future capital is required to appropriately absorb potential losses.

In conducting ICAAP, RSAs are recommended to do the following:

- Provide the suggested format for ICAAP documents;
- Establish mechanisms to ensure ICAAP documents are updated promptly and submitted whenever IIFS undertakes or plans to undertake actions that may materially impact its capital adequacy requirements;
- The ICAAP requirements stipulated by RSAs should consider IIFS' specificities;
- Ensuring ICAAP is embedded within an IIFS's internal risk management framework and is understood by all relevant parties within the IIFS, including Shari'ah compliance mechanisms when appropriate;
- Ensuring IIFS establishes a risk appetite framework statement and is integrated into ICAAP;

- RSAs should conduct regular reviews with a combination of appropriate supervisory tools (e.g., on-site examination, off-site surveillance, reporting, etc). Reviews should focus on the quality of IIFS's risk management and controls;
- Based on reviews and evaluations, RSAs may intervene or require IIFS to do remedial actions; and monitor its follow-up actions, when deemed necessary.

For further details, refer to section 3.2.2.

4. What aspects of governance and risk management are important to be set out for IIFS, particularly to address Islamic finance specificities?

Answer: When reviewing the condition of the IIFS, supervisory authorities need to place significant emphasis on the adequacy of an IIFS's risk management, including its control system. Given the significant influence of Shari'ah rules and principles in potentially the entire spectrum of IIFS's operations, an IIFS's failure to adequately identify, monitor, and control Sharī'ah non-compliance poses risks resulting in eventual loss of income, reputational risk, and even insolvency.

In addition, when evaluating the quality of internal controls of an IIFS, the supervisory authority should also give due consideration to reviewing the key elements set out in the IFSB guiding principles on risk management (IFSB-1), corporate governance (IFSB-3) and Sharī'ah governance (IFSB-10).

For further details, refer to section 3.3.

5. When evaluating the quality of internal controls of an IIFS, what should supervisory authority consider?

Answer: Supervisory authorities should determine that IIFS have an independent, permanent, and effective internal audit function charged with (a) assessing whether existing policies, processes, and internal controls (including risk management, compliance, and corporate and governance processes) are effective, appropriate and remain sufficient for the IIFS's business; and (b) ensuring that policies and processes are complied with.

The internal audit function should have reporting lines to the BOD or an audit committee of the board of directors (BOD) and should have sufficient status within the IIFS to ensure that senior management (SM) reacts to and acts upon its recommendations. The IIFS's BOD has the ultimate responsibility for ensuring that SM establishes and maintains an adequate, effective, and efficient internal control framework and internal audit function within the institution.

For further details, refer to Paragraphs 93-96.

6. How can we promote the effective implementation of an Enterprise-wide Risk Management (ERM) framework in IIFS?

Answer:

Recent market events underscore the importance of senior management taking an integrated, enterprise-wide perspective in considering an IIFS's risk exposures, to support its ability to identify and react to emerging and growing risks in a timely and effective manner. Well-managed firms will usually adopt, whether explicitly or implicitly, the so-called combined assurance model, in which management, internal assurance and external assurance provide successive lines of defence against risk. For an IIFS, enterprise-wide risk management (ERM) has been recognised as an important element in the process of maintaining an IIFS's economic stability and is regarded as a necessary tool to promote the effectiveness of banking supervision.

A sound ERM framework consists of the following key features:

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

For further details, refer to Section 3.3.4.

7. What are the approaches concerning the regulation and supervision of Shari'ah matters in various jurisdictions?

Answer: RSAs play a crucial role in ensuring that IIFS comply at all times with the Shari'ah rules and principles as determined by the relevant body in each of the jurisdictions in which they operate. It implies that for IIFS operating in multiple jurisdictions, adherence to Shari'ah rulings is mandatory across all the jurisdictions in which they operate.

While most Shari'ah rulings across jurisdictions provide the same or similar guidance, some variations may arise due to differences in methodologies applied between jurisdictions in promulgating such rulings. In cases where the Shari'ah matters are different between jurisdictions in which IIFS operates – the supervisory authorities should promote (a) harmonisation of legal and Shari'ah compliance frameworks; (b) the enhancement of collaboration between the SSBs of various jurisdictions; and (c) the sharing of the rulings and the basis of Shari'ah rulings. Furthermore, regular reviews and updates to internal policies and procedures should be conducted to accommodate any changes in Shari'ah rulings across jurisdictions.

8. In the case of Mushārah or Muḍārah contracts, what prudential concerns do these contracts pose that supervisors need to consider in their review?

Answer: One of the key elements of the supervisory review process, particularly in the prudential aspect, is the imperative for supervisory authorities to review and verify that their regulated entities meet the applicable minimum capital adequacy requirements. This scrutiny extends to encompass profit-sharing instruments like Mushārah or Muḍārah. The identification and measurement of risks associated with these instruments, as well as the risk mitigation techniques employed by IIFS, should align consistently with relevant IFSB capital adequacy standards, namely IFSB-15 and IFSB-23.

9. What are the proper risk management process and Shari'ah compliance mechanisms in managing Islamic windows?

Answer: The supervisory authorities in jurisdictions where windows are present need to satisfy themselves that the institutions offering such windows have the internal systems, procedures, and controls to provide reasonable assurance that (a) the transactions and dealings of the windows comply with Shari'ah rules and principles, and (b) appropriate risk management policies and practices are followed.

The institutions that have Islamic Windows operations should have a system such that the separation of Islamic assets and funds from non-Shari'ah-compliant assets and funds is made transparent. The system should act to prevent the window not simply from investing in non-Shari'ah-compliant assets, but also from channeling investors' funds back to the conventional parent entity.

For further details, refer to Section 3.8.

10. As IFSB standards primarily aim to serve full-fledged IIFS, can you please describe what are the judgments/considerations/criteria to guide RSAs in implementing this standard to Islamic windows?

Answer: As outlined in Paragraph 185, in principle, Islamic windows -especially "full windows"- may raise several supervisory concerns and issues that are substantially the same as those raised by a full-fledged IIFS. In line with that, Islamic Windows' operations should be reviewed by the supervisory authorities within their normal supervisory review process using the existing supervisory tools as discussed in section 2.4 of the standard.

11. Liquidity management is essential to the sustainability of IIFS. However, the level of development across jurisdictions varies. What RSAs should be taken into consideration when regulating and supervising IIFS's liquidity management? What are the possible alternatives that IIFS can utilise to meet their liquidity needs, especially in the case where Shari'ah-compliant Lender of the Last Resort (LOLR) is not yet available?

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

Supervisory authorities should also outline important elements of the supervisory framework concerned with monitoring the liquidity positions and liquidity risk management framework of IIFS, including, inter alia, initiatives for the development of a robust national liquidity infrastructure supervisors' contingency planning for IIFS, timely corrective actions, and supervisors' role as provider of Sharī'ah-compliant liquidity support to IIFS.

For further details, please refer to section 4.4 of this standard and GN-7 Guidance Note on Sharī'ah-compliant Lender-Of-Last-Resort Facilities.

12. Profit-sharing Investment Account (PSIA) is distinctive to IIFS and may pose different risk exposures for both IIFS and PSIA Holders. What are the key elements in supervising this product, particularly to ensure customers' or investors' protection?

Answer: The supervisory authority may consider developing a set of guidelines when reviewing the operations of IIFS, including evaluating their management systems for investment programmes and asset allocation practices to safeguard various stakeholders' interests, particularly those of the investment account holders (IAH) and especially the unrestricted IAH. Supervisory authorities need to carefully address the investor protection issues raised by the IIFS' role as managers of funds placed with them by the IAH.