

# International Regulatory Standards for Islamic Finance:

## Implementation Issues & Challenges

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# Introduction

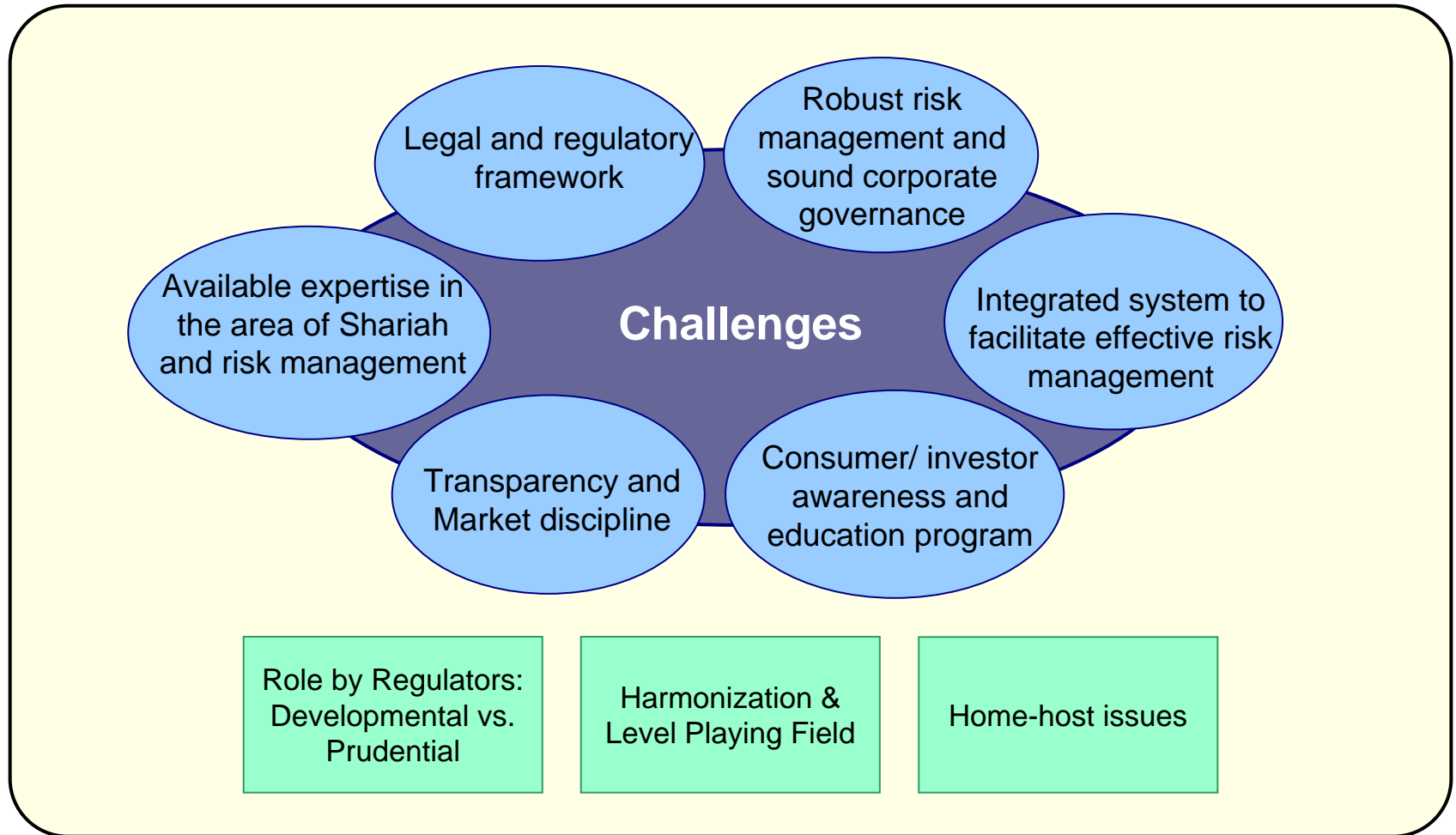
## Development of the IFSB standards

Standard on/Guiding Principles	Issuance Date
Risk Management	Guiding Principles issued in December 2005
Capital Adequacy	Standard issued in December 2005
Corporate Governance	Guiding Principles issued in December 2006
Transparency & Market Discipline	<i>ED 4 issued in December 2006</i>
Supervisory Review Process	<i>ED 5 issued in December 2006</i>

***“Rapid growth in Islamic finance necessitate the development of prudential standards aimed at addressing issues peculiar to Islamic financial transactions”***



***“Successful implementations of regulatory standards shall be supported by key enabling financial infrastructures”***



## Brief Introduction – focus on *Musharakah*

- ❖ *Musharakah* (profit and loss sharing) is partnership/joint venture agreement between two parties.
  - Both parties provide capital
  - Distribution of profits based on pre-agreed profit sharing ratio
  - Both parties share the losses according to equity participation
  
- ❖ Salient features:
  - Contractual relationship – partner relationship between IFI and their clients, not debtor-creditor relationship
  - Return – based on actual performance on business/joint venture, i.e. based on pre-agreed profit sharing ration as opposed to fixed return in nature
  - Risk profile – IFI exposed the risk of losing its capital invested and lending its name and reputation as a business co-partner



# “Higher Accountability – Transparency, Disclosure and Educating the Market”

a

Placement of fund by investment account holder (IAH) under profit sharing investment account (PSIA)

Applying best practices on transparency and disclosure requirements.

- Clear contract documentation indicating rights and obligation of IAH, i.e. IAH to bear losses under normal business operations.
- Application of PSIA into IFI’s activities i.e. financing, investment.
- Protecting IFI strategic interest.
- Issue of asymmetric information

Robust system that can monitor PSIA funding and its application.

Creating awareness and educating PSIA holders on risk and reward concept in Islamic banking – loss of investment is possible.

# “IFI Need to Have Robust Risk Management System ”

## b Entering into Musharakah Agreement – property development

Development of skill set and expertise.

Documentation.

- Clear terms and condition, rights of partners, project scope, timeframe, capital contribution, profit and loss distribution, capital repayment, event of default.
- Shariah compliant contracts e.g. terms & conditions

Comprehensive risk policies, system and internal controls.

- Identifying and measuring risk attached to musharakah.
  - Business risk, profit payout risk, reputational risk, withdrawal risk.
- Setting strategies, policies and procedures
- Exit strategies and mechanisms
- Valuation methodology and impairment policies.

Limits on concentration in musharakah financing/investment

**b** Entering into Musharakah Agreement – property development (cont'd)

Identify external factors affecting real estate – property development

Measuring and mitigate risk in property development/ real estate sector

Proper methodology in valuation of properties and income recognition.

***“Proper documentation to support effective liquidation process”***

**b** **Liquidation of Musharakah.**

The joint venture may not generate projected return or even worse making losses which IFI has to bear.

IFI may ended up with unsold properties which exposed them to market risk (asset price risk).

# “ Regulatory Capital Charge ”

c

Capital charge for PSIA and Musharakah financing.

PSIA having risk absorbent capacity (use of alpha for capital charge)

Measuring and managing risk associated with PSIA accounts.

- Rate of return risk
- Displaced commercial risk
- Liquidity risk.

Musharakah financing carry higher risk weight.

- Harmonization with Basle 2.

Real estate/ property development

- Inventory risk attract different capital charge.

# “Corporate Governance”

d

## Comprehensive and Effective Corporate Governance Framework

Board oversight function.

Rights of investment account holders (IAH).

Compliance with Shariah.

Robust Shariah review process.

Transparency of financial reporting on investment account

Related party transactions.

# “Supervisory Review Process”

e

## Effective Supervisory Role and Function

Regulatory capital requirement - treatment of investment account holder (IAH)

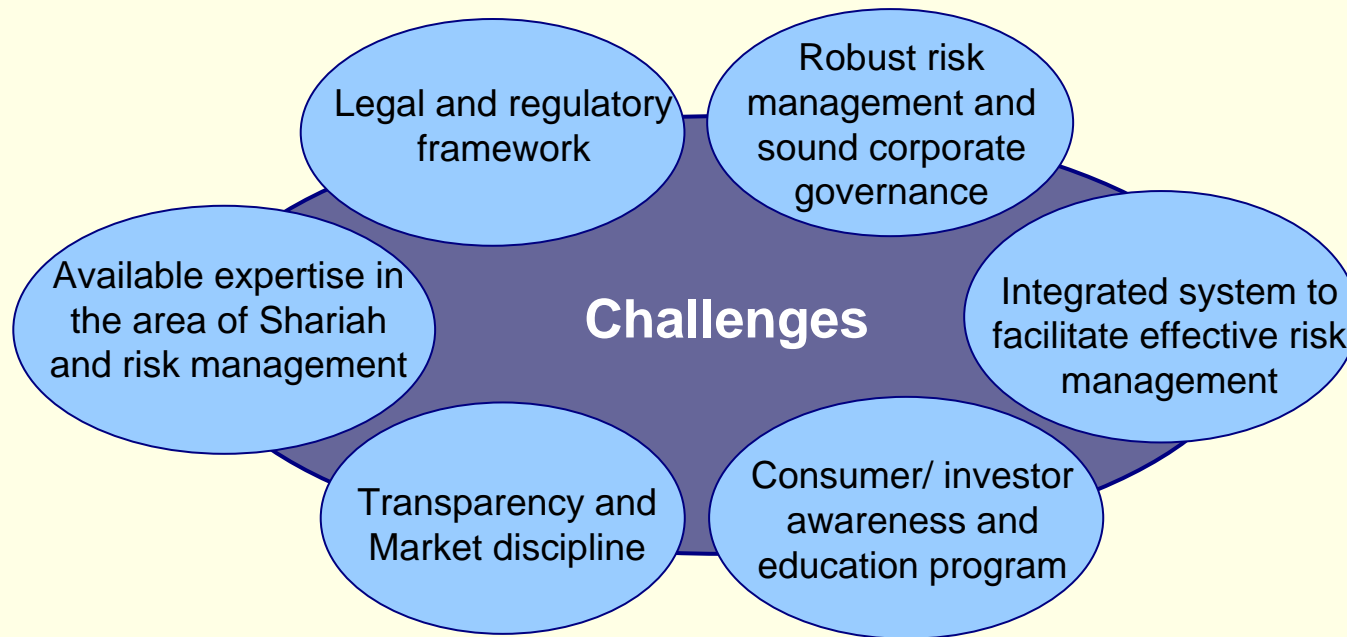
Risk management & corporate governance.

Transparency & market discipline.

Consolidated & home-host supervision.

***“Supervisors have to exercise judgment regarding the appropriate weights and balance to be given on the application of quantitative and qualitative measures for the above key elements ”***

***“Successful implementations of regulatory standards shall be supported by key enabling financial infrastructures”***



Role by Regulators:  
Developmental vs.  
Prudential

Harmonization &  
Level Playing Field

Home-host issues



*Thank you*

