



Islamic Financial Services Board

Implementation of the IFSB Standards

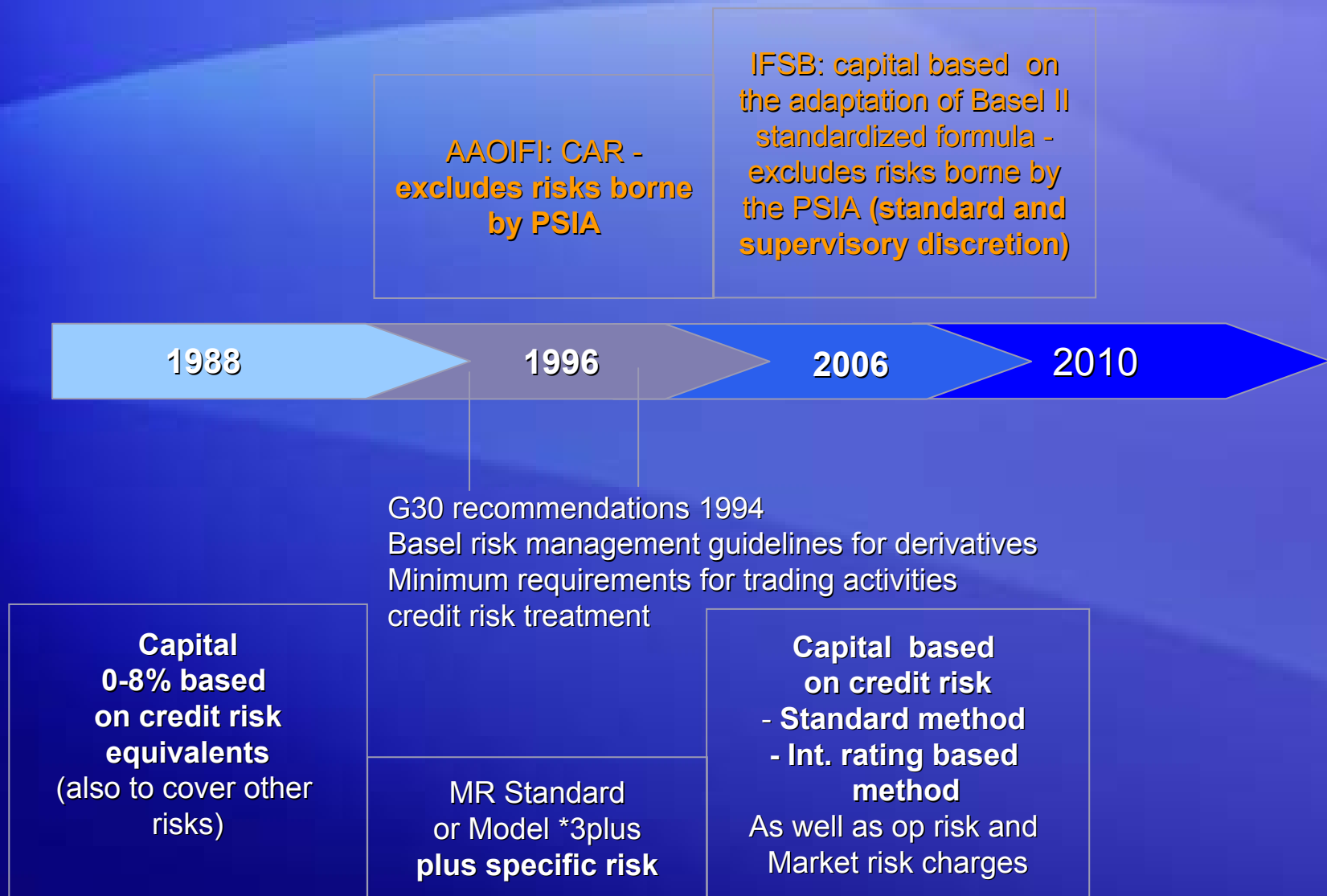
**Financial Regulators Forum on Islamic Finance
In conjunction with IFSB Annual Meetings
29 March 2007**

Abdullah Haron
Assistant Secretary-General

Agenda

- Introduction
- The IFSB standards
- Impact of the IFSB standards on regulatory capital of IIFS
- Challenges in the implementation of the IFSB standards
- Facilitating the implementation of the IFSB standards

Introduction: capital regulatory framework



Introduction: capital regulatory framework *cont'd*

Basel I	Basel II	IFSB Standard
Focus on a single risk measure	More emphasis on banks' internal methodologies, supervisory review and market discipline	Focus on a single risk measure, supervisory review and disclosure
One size fits all	Flexibility, menu of approaches. Provides incentives for better risk management	One size fits all and, in certain area, supervisory discretion
Operational risk not considered	Introduces approaches for credit risk and operational risk in addition to market risk introduced earlier	Incorporates credit, market and operational risks

The IFSB Standards

The IFSB standards



Article 4 of the Articles of Agreement outlines the objectives of the IFSB, which include, among others:

To promote the development of a prudent and transparent Islamic financial services industry by introducing new, or adapting existing, international standards consistent with *Sharī`ah* principles, and recommend them for adoption.

To provide guidance on the effective supervision and regulation of institutions offering Islamic financial products and to develop the criteria for identifying, measuring, managing and disclosing risks, taking into account international standards for valuation, income & expense calculation and disclosure.

Development of the IFSB standards

Standard	Commencement of preparation	Issuance
Risk management	2003	2005
Capital adequacy	2003	2005
Corporate governance	2004	2006
Supervisory review process	2005	2008
Transparency & market discipline	2005	2008

Development of the IFSB standards *cont'd*

Standard	Commencement of preparation	Issuance
Special issues in capital adequacy	2006	2008 (ED)
Governance of investment fund	2006	2008 (ED)
Governance of Takaful operator	2006	2008 (ED)
<i>Sharī`ah</i> governance	May 2007	2009 (ED)
Market conduct	May 2007	2009 (ED)

Guiding Principles of Risk Management

High level overview

Guiding principles of risk management

- Approach
- Key objectives
- Guiding principles for the management of risk on specific features of IIFS products and services, amongst others:
 - Equity investment risk
 - Rate of return risk (Displaced commercial risk)
 - Operational risk (*Sharī`ah* noncompliance risk and Fiduciary risk)

Definition

Type of Risks	Definition
Equity Investment Risk	The risk arising from entering into a partnership for the purpose of undertaking or participating in a particular financing or general business activity as described in the contract, and in which the provider of finance shares in the business risk. This risk is relevant under <i>Muḍārabah</i> and <i>Mushārah</i> contracts.
Rate of Return Risk	The potential impact on the IIFS' returns caused by unexpected change in the rate of returns.
Displaced Commercial Risk	The risk that the IIFS may confront commercial pressure to pay returns that exceed the rate that has been earned on its assets financed by investment account holders. The IIFS forgoes part or its entire share of profit in order to retain its fund providers and dissuade them from withdrawing their funds.
<i>Sharī`ah</i> Noncompliance Risk	Risk arises from the IIFS' failure to comply with the shariah rules and principles.

Approach

- Rather than prescriptive procedures, the approach that has been taken by the IFSB is principle-based approach, applied to accommodate continuous improvement in the infrastructures, methodologies and system as theory and technology permit.
- In identifying the risks to which IIFS are exposed, as an initial step is to identify inherent risks which include the following two risks.
 - primary risks, i.e. the exposures deliberately entered into for business reasons when an IIFS decides to offer a certain type of service; and
 - consequential (or operational) risks, i.e. the exposures that are not actively taken but which are incurred as a result of business undertaken by the IIFS

Key objectives

- The IIFS are expected to view the management of these risks from a holistic perspectives
- The guiding principles define a common terminology of key risk categories to which IIFS are exposed, acting as a common language for further development of regulatory financial requirements and seen as a stimulant to the progress of risk management practices required in Islamic financial services industry
 - The rate of return risk (as opposed to interest rate risk) is essentially the risk with regard to the result of an investment at the end of the investment-holding period.
 - Displaced commercial risk could be the consequence of the rate of return risk whereby IIFS may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by IAH.

Key objectives *cont'd*

- At present, in many jurisdictions, the consequence of the rate of return risk is considered as part of the strategic risk, hence is left to the individual IIFS to decide. In some jurisdictions, guidelines on the rate of return risk including on the use of profit equalization reserve (PER) exist.

Principles of risk management

General Requirement

Comprehensive risk management and reporting process, including appropriate Board and senior management oversight; ensuring adequate holding of capital against risks; and complying with *Sharī'ah* rules and principles.

Credit Risk	Equity Investment Risk	Market Risk	Liquidity Risk	Rate of Return Risk	Operational Risk
<ul style="list-style-type: none"> • Strategy for financing which includes overall level of risk appetite. • Due diligence review in respect of counterparties and engage appropriate expert for <i>Sharī'ah</i> compliance. • Methodology for measuring and reporting credit risk for each financing instrument. • Appropriate credit risk mitigating techniques for each financing instrument. 	<ul style="list-style-type: none"> • Strategy, risk management and reporting process for equity investments, including <i>Mushārah</i> and <i>Muḍārah</i> investments. • Appropriate and consistent valuation methodologies. • Define and establish exit strategies. 	<ul style="list-style-type: none"> • Appropriate framework for market risk management in respect of all assets held, including those that do not have a ready market and/ or are exposed to high price volatility. 	<ul style="list-style-type: none"> • Liquidity management framework for overall and each liquidity exposures in respect of each category fund providers. • Undertake liquidity risk commensurate with ability to have sufficient recourse to <i>Sharī'ah</i>-compliant funds. 	<ul style="list-style-type: none"> • Comprehensive risk management and reporting process to assess potential impacts of market factors on rates of return on assets in comparison with the expected rate of return for investment account holders. • Appropriate framework for managing displaced commercial risk and maintaining appropriate level of balances of Profit Equalization Reserve (PER). 	<ul style="list-style-type: none"> • Adequate systems and controls to ensure compliance with <i>Sharī'ah</i> rules and principles. • Appropriate mechanisms to safeguard the interest of all fund providers.

Capital Adequacy Standard (CAS)

High level overview

Capital adequacy standard

- Approach
- Key objectives
- Principles for the measurement of capital adequacy standard on specific features of IIFS products and services:
 - Credit (including exposures made under profit sharing modes that are not made for trading)
 - Market
 - Operational
 - Profit sharing investment account (PSIA)

Approach

- Since the structure and activities of IIFS are influenced by the *Shari`āh* rules and principles, the approach undertaken by the working group is analysing the intrinsic characteristics of each contract. For this reason, the CAS is structured in a matrix format
- The CAS does not represent an exhaustive list of products
 - Principles for minimum capital adequacy requirements for credit and market risks arising from a given type of financial instrument
 - Financing and investment instruments

Key objective

- The standard on Capital Adequacy sets out a common structure for the assessment of IIFS capital adequacy requirements, which will support transparency and consistent methodology for all IIFS
 - This will bring the benefits of a common approach without compromising *Sharī`ah* rules and principles by substantially enhancing the transparency of true obligations within IIFS operations
 - The standard promotes a level playing field at a global level as far as common assessment is concerned especially for the minimum capital requirement in respect of both credit and market risks arising from each financing mode at different stages of a contract
 - Recognition of investment account holders (IAH) as partners in IIFS operations should result in a more effective use of capital. According to the Quantitative Impact Study (QIS) conducted by the IFSB, the capital base of IIFS is more than sufficient to meet their true liabilities, in contrast to critics about them being undercapitalized

General principles of capital adequacy

IIFS are required to use the substance of the *Sharī`ah* rules and principles governing the contracts to form the basis for an appropriate treatment in deriving their minimum capital adequacy requirements

Some IIFS may use different product names or contract titles as part of their market differentiation or a commercial expression.

General principles of capital adequacy *cont'd*

(a) *Murābahah* and Non-binding MPO

Applicable Stage of the Contract	Credit RW	Market Risk Capital Charge
Asset available for sale (asset on balance sheet)*	Not applicable	15% capital charge (187.5% RW)
Asset is sold and delivered to a customer, and the selling price (accounts receivable) is due from the customer	Based on customer's rating or 100% RW for unrated customer (see paragraphs 88 to 89)	Not applicable
Maturity of contract term or upon full settlement of the purchase price, whichever is earlier	Not applicable	Not applicable

* Also includes an asset which is in possession due to cancellation of AP by a non-binding MPO customer. Any HJ taken, if any, is not considered as eligible collateral and shall not be offset against the value of the asset.

Capital adequacy requirements vary according to the transformation of risks at different contract stages

For example: In *Murābahah* or *Ijārah*, rather than lending money, an IIFS has to acquire a physical asset and then sell it back on credit or on lease. The risk to which the IIFS is exposed transforms from the market risk of physical assets at the time of acquisition to credit risk at the time of sale on deferred payment or on lease. To see all the commands again, double-click the active tab again to bring back the groups.

General principles of capital adequacy *cont'd*

On basis of either *Muḍārabah* or *Wakālah* contract, credit and market risks of the investment made by the IAH shall normally be borne by themselves, while the operational risk is borne solely by the IIFS (unless proven negligence, mismanagement or fraud)

As opposed to the emphasis of Basel II Capital Accord on depositors' protection, the IFSB Standard on Capital Adequacy stresses the importance of investors' protection mechanisms (with no guarantee of capital). As such, assets financed by IAH do not affect risk-bearing capital of IIFS since they bear their own commercial risk.

Comparison of the approach: credit risk

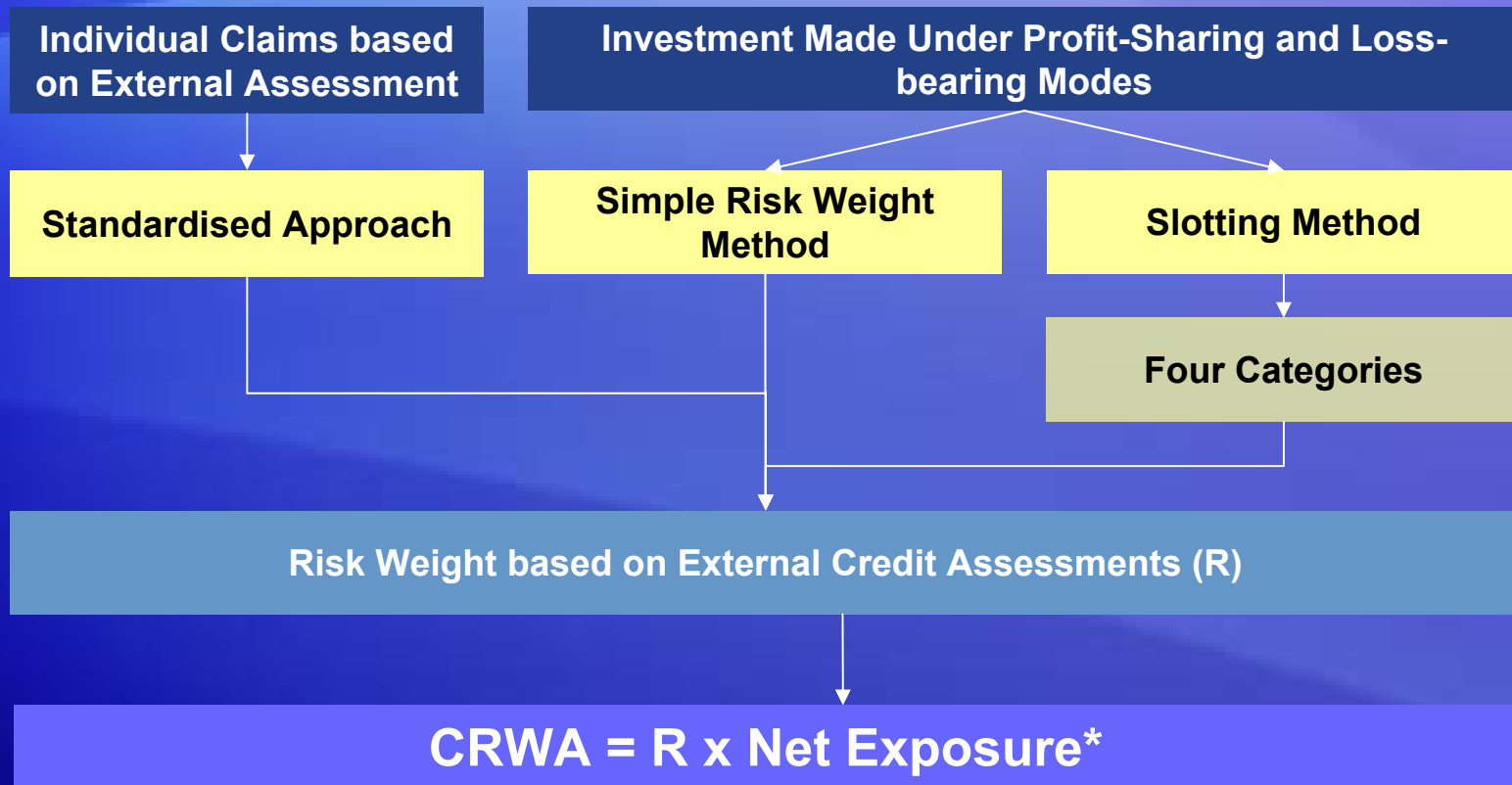
Criteria	Basel II Standardised	IFSB CAS Standardised
Risk weight	Calibrated on the basis of external ratings by the BASEL committee.	Calibrated on the basis of external ratings by the BASEL committee. <i>Vary according to contract stage and financing mode.</i>
Treatment of equity in the banking book	≥ 150% for venture capital and private equity investments	Simple risk weight method (RM300% or 400%) or supervisory slotting method (RW 90%-270%)
Credit Risk Mitigation Techniques	Includes financial collateral, credit derivatives, guarantees, netting (on and off balance sheet).	Includes <i>hamish jiddiyyah</i> , <i>urbun</i> , PSIA or cash on deposit with IIFS, guarantees, financial collateral, pledge assets

Principles of credit risk

Credit risk is measured according to the Standardised Approach of Basel II, except for certain exposures arising from investments by means of *Mushārah* or *Muḍārah* contracts in assets that are not held for trading

Until adequate historical data are available, the IFSB employs Basel's risk weights

Measurement of Credit Risk



*Amount of exposure less eligible collateral (Net exposure)

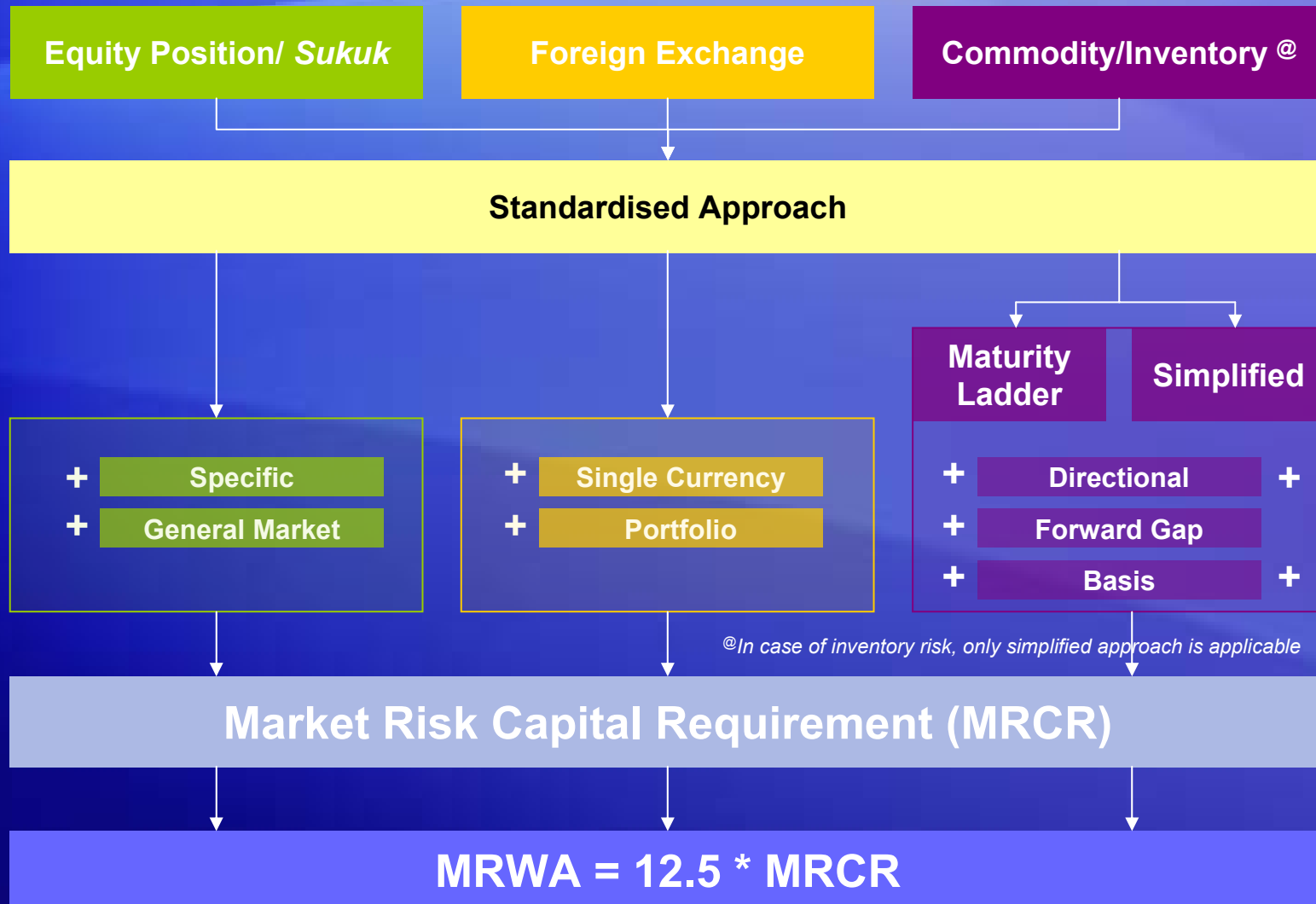
Comparison of the approach: market risk

Criteria	Basel II Standardised	IFSB CAS Standardised
Category	Equity, FX, Interest rate risk in the trading book, commodity	Equity, FX, benchmark risk in the trading book, commodity, <i>Inventory</i> <i>Silver falls under foreign exchange risk</i>
Measurement	1996 market risk amendments (standardised and internal model)	1996 market risk amendments (<i>standardised measurement method</i>)

Principles of market risk

- Apart from market risk exposures arising from equity, foreign exchange, commodities, the exposures also include trading positions in *sukuk* and inventory risk, which results from IIFS holding assets with a view to re-selling or leasing them
- In the case of equity investment made by means of *Mushārah* or *Muḍārah* contract where the underlying assets are commodities held for trading, market risk provisions for commodities are applicable
- For inventory risk, only simplified approach is applicable

Measurement of Market Risk



Principles of market risk *cont'd*

- Apart from market risk exposures arising from equity, foreign exchange, commodities, the exposures also include trading positions in *sukuk* and inventory risk, which results from IIFS holding assets with a view to re-selling or leasing them
- In the case of equity investment made by means of *Mushārah* or *Muḍārah* contract where the underlying assets are commodities held for trading, market risk provisions for commodities are applicable
- For inventory risk, only simplified approach is applicable

Comparison of the approach: operational risk

Criteria	Basel II Basic Indicator	IFSB CAS
Gross income	Annual average gross income (previous three years)	Annual average gross income (previous three years) <i>excluding PSIA's share of income</i>

Principles of operational risk

- *Sharī`ah* noncompliance risk is a type of operational risk facing the IIFS which can lead to non-recognition of income and resultant losses
- The extent of losses from non-compliance with *Sharī`ah* rules and principles cannot be ascertained owing to lack of data
 - Supervisory authorities have discretion to impose a RW higher than 15% as they deem fit to cater for the *Sharī`ah* noncompliance risk of a particular IIFS.

Measurement of Operational Risk

Annual Average Gross Income
(previous three years)

X 15%

Gross income is defined as:

Net income from financing activities (e.g. selling price less purchase price) which is gross of any provisions and operating expenses; plus
Net income from investment activities; plus
Fee income (e.g. commission and agency fee)

Less:

Investment account holders' share of income

Operational Risk Capital Requirement (ORCR)

ORW = 12.5 * ORCR

CAR relating to assets financed by PSIA

The IIFS assumes the role of economic agent or *Muḍārib* in placing such funds in income-producing assets or economic activities, and as such is entitled to a share (the *Muḍārib* share) in the profits (but not losses) earned on funds managed by it on behalf of the IAH, according to a pre-agreed ratio specified in the *Muḍārabah* contract

The commercial risk on assets financed by PSIA do not represent risks for the IIFS' own (shareholders') capital and thus would not entail a regulatory capital requirement for the IIFS

Treatment of investment account

- Standard formula
 - 100% of credit & market risk of risk-weighted assets financed by IAH is borne by IAH
 - 100% of operational risk of managing these assets is borne by IIFS

This implies that assets funded by either unrestricted or restricted PSIA would be excluded from the calculation of the denominator of the capital ratio

CAR: Standard formula

**RWA of PSIA
(CR + MR)**

Treatment of investment account *cont'd*

- Supervisory discretion formula
 - Some proportion α (decided by supervisor) of credit & market risk of risk-weighted assets financed by IAH is deemed to be borne by IIFS
 - 100% of operational risk of managing these assets is borne by IIFS

In practice, the IIFS (a) may forgo its rights to some or all of its *Muḍārib* share of profits in order to offer its IAH a more competitive rate of return on their funds, or (b) may be treated as constructively obliged to do so by the supervisory authority as a measure of investor protection and in order to mitigate potential systemic risk resulting from massive withdrawals of funds by dissatisfied IAH

CAR: Supervisory discretion formula

RWA funded by restricted PSIA (CR+MR)

**(1- α) RWA funded by
unrestricted PSIA
(CR+MR)**

**α RWA funded
by unrestricted
PSIA (CR+MR) –
PER and IRR**

**α RWA funded by
PER and IRR of
unrestricted PSIA
(CR+MR)**

**RWA funded
by
non-PSIA
(CR+MR+OR)**

Impact of the IFSB standards on regulatory capital of IIFS

CAR: Standard formula

Standard Formula

Capital amount of PSIA is not guaranteed by the IIFS and any losses arising from investments or assets financed by PSIA are to be borne by the IAH, unless losses are due to the IIFS's negligence, misconduct or breach of investment mandate.

ELIGIBLE CAPITAL

TOTAL:
RWA (CR + MR) +
ORW

LESS

FUNDED BY PSIA:
RWA (CR + MR)

Example:

EL = 8, CRWA = 40, MRWA = 40, ORW = 20 and assets funded by PSIA is 70% of total on- and off-balance sheets

$$8 / [100 - 56] = 8 / 44 = 18.2\%$$

CAR Supervisory Discretion Formula

Supervisory Discretion Formula

Applicable in jurisdiction where supervisory authority considers the IIFS is obligatory to smooth income for IAH as part of a mechanism to minimise withdrawal risk and is concerned with systemic risk.

$$\begin{aligned}
 & \text{ELIGIBLE CAPITAL} \\
 & \text{TOTAL RWA (CR+MR+OR)} \\
 & \quad \text{less} \\
 & \quad \text{RWA funded by restricted PSIA (CR+MR)} \\
 & \quad \text{less} \\
 & \quad (1-\alpha) \text{ RWA funded by unrestricted PSIA (CR+MR)} \\
 & \quad \text{less} \\
 & \quad \alpha \text{ RWA funded by PER and IRR (CR+MR)}
 \end{aligned}$$

	Restricted PSIA (20%)	Unrestricted PSIA (50%)	All other funds (30%)	Total (100%)
CRWA	8	20	12	40
MRWA	8	20	12	40
ORWA	0	0	20	20
Total	16	40	44	100

CAR Supervisory Discretion Formula *cont'd*

ELIGIBLE CAPITAL <hr/> TOTAL RWA (CR+MR+OR) less RWA funded by restricted PSIA (CR+MR) less (1-α) RWA funded by unrestricted PSIA (CR+MR) less α RWA funded by PER and IRR (CR+MR)	$\frac{8}{40+40+20 - (8+8) - (1-30\%)(20+20) - 30\%(2+2)} = 14.60\%$
--	--

	Restricted PSIA (20%)	Unrestricted PSIA (50%)	All other funds (30%)	Total
CRWA	8	20	12	40
MRWA	8	20	12	40
ORWA	0	0	20	20
Total	16	40	44	100

Comparison of using different formula

	Standard formula	Supervisory discretion formula	Basel formula
Capital adequacy ratio	18.2%	14.6%	8%

Challenges in the implementation of the IFSB standards

Challenges in the implementation

In general, both national authorities and IIFS may face some of the following challenges in implementing these standards. On the other hand, the IFSB is not empowered to enforce its proposed standards and guidelines. Therefore, the IFSB relies solely on the voluntary adoption of standards by its members and IIFS.

Challenges in the implementation *cont'd*

- The obligation on national authorities to ensure that they have sufficient infrastructures, skills and domestic guidelines in order to effectively supervise IIFS operations. The prerequisites to implement these standards imply sound understanding by supervisors and regulators of the risks involved in *Sharī`ah* compliant transactions and how such risks are managed.

First, supervisory authorities should review their current systems and procedures, assess whether a good baseline supervisory system is in place, and consider the appropriate phasing and sequencing of various regulatory, supervisory, and legislative measures – and IIFS should correspondingly modify their systems and procedures for risk measurement and controls, with the view to implement the IFSB standards over a reasonable time frame. The timeframe should be broadly consistent with the envisaged timeframe for conventional banks.

Challenges in the implementation *cont'd*

- Absence of adequate risk-mitigating tools and infrastructure for IIFS or even risk management culture among IIFS.

The development process will continue to evolve.

Challenges in the implementation *cont'd*

- Assurance that the implementation of these standards will not put IIFS at a competitive disadvantage in particular in terms of huge cost implications, lengthy product development process etc.

IIFS should keep in mind that implementing these standards will help them having a better understanding of their risk appetite in sourcing their funds and in pricing new businesses in order to determine risk profiles of their fund providers.

Challenges in the implementation *cont'd*

- Although enhanced disclosure of information is generally perceived as beneficial by the public, its benefit to IAH, given their level of understanding of their rights and obligations, has yet to be proven.

In practice, the IAHs behave similar to fixed depositors in conventional institutions but, contractually, they share the profits and bear their own losses.

Facilitating the implementation of the IFSB standards

Rationale to facilitate the implementation

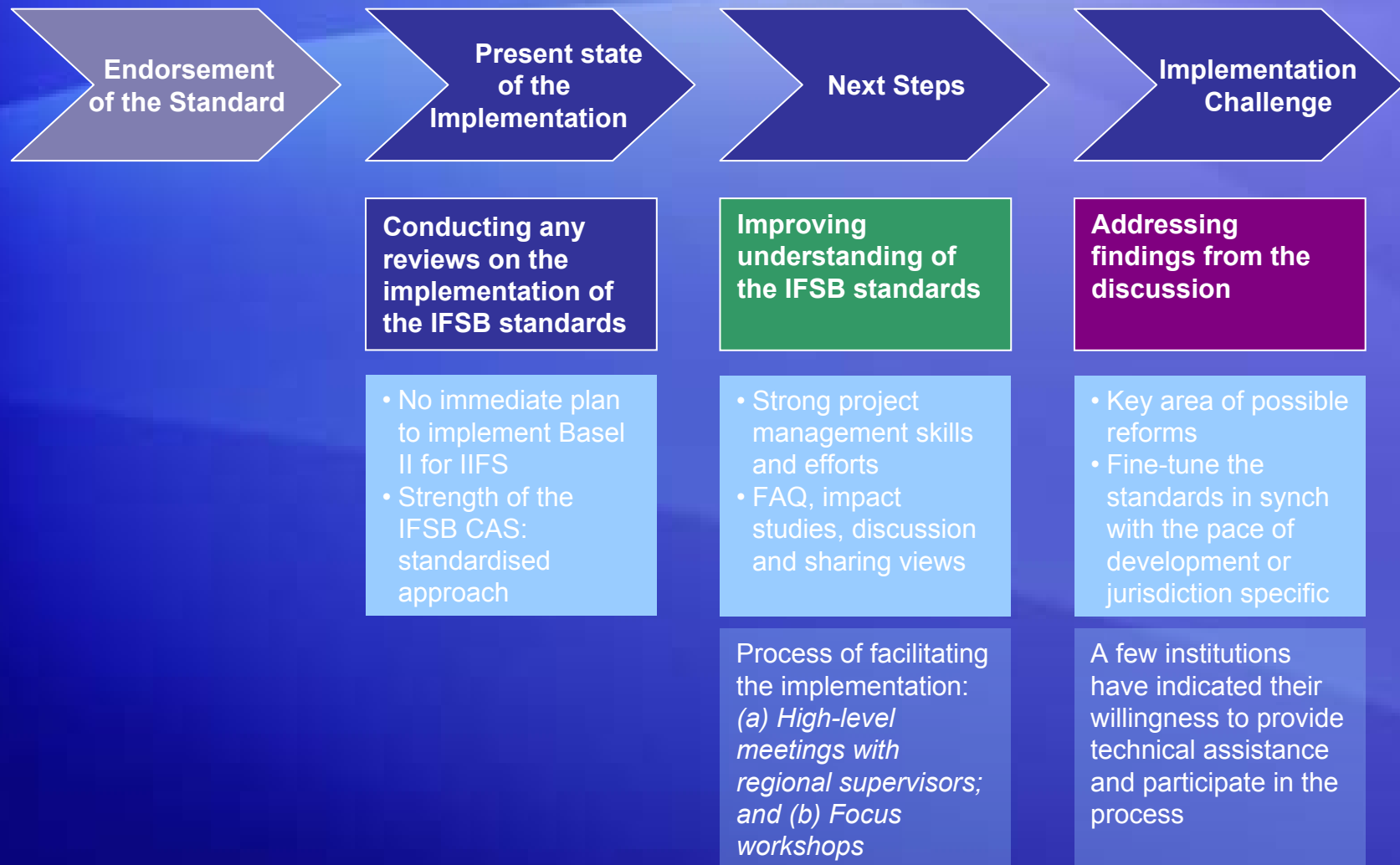
- The IFSB standards, together with additional guidance notes (from IFSB) being developed on specific aspects of these standards constitute the Basel II equivalent for Islamic finance.

Many countries with IIFS are already planning a phased implementation of basic approaches to Basel II for conventional banks, and hence implementation of Basel II equivalent standards for IIFS is essential to ensure a level playing field and effective competition

Broad direction of the strategic plan

- Three main questions:
 - How is the implementation going on at the present stage?
 - What are the next steps?
 - How will the IFSB be able to facilitate the implementation?

Action plan to facilitate the implementation



Strengthen and add coherence to the mission and commitment of the IFSB to the industry

Setting the milestones

Dec 2005	Standards on the risk management and capital adequacy
Feb 2006	Workshop on rating
Nov 2006	Strategy to facilitate the implementation of the standards
Dec 2006	Standards on the corporate governance
Dec 2006	Exposure draft: supervisory review process and disclosures
Jan 2007	Seminar in promoting the understanding of the IFSB standards in Riyadh
Feb 2007	Workshop on profit equalisation reserves
Mar 2007	Compilation guide on statistics of IIFS

Forthcoming

Dec 2007	Seminar in promoting the understanding of the IFSB standards in Frankfurt
End 2007	Standards on the supervisory review process and disclosures
Early 2008	Exposure draft: real estate investment and securitisation
2008 onwards	a) Issuance of specific guidance note; b) Module trainings in promoting the understanding of the IFSB standards; and c) Regional dialogues on issues of implementation among the regulatory authorities

Thank you for your attention