The Islamic Financial Services Board: Setting Standards for Islamic Finance

The IAASB Consultative Advisory Group Meeting

Date : 7-8 March 2017
Venue : New York, USA

www.ifsb.org
We were established in 2003. Visit by IMF’s Deputy Managing Director, Mr. Mitsuhiro Furusawa last week.

Sasana Kijang, Bank Negara Malaysia, where the IFSB is based.
IFSB PROMOTES SOUNDNESS AND STABILITY

- Serves as an international standard-setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and *Takāful*

**OBJECTIVES**

- Develop standards & recommend implementation
- Provide guidance on effective supervision and regulation & develop risk management & disclosure criteria
- Establish cooperation with international standard-setting bodies & member countries
- Enhance and coordinate initiatives to develop instruments & procedures for efficient operation & risk management
- Encourage cooperation among member countries
- Facilitate capacity-building & development of human capital
- Undertake research
- Establish database

- To this end, the work of the IFSB complements those of BCBS, IOSCO and IAIS
The IFSB’s members have increased from 9 in 2003 to 188 members as of December 2016

<table>
<thead>
<tr>
<th>Membership Type</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Full Members</td>
<td>31</td>
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<tr>
<td>Associate Members</td>
<td>22</td>
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<tr>
<td>Observer Members</td>
<td>125</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>188</strong></td>
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By organisational demarcation:

<table>
<thead>
<tr>
<th>Organisational Demarcation</th>
<th>Total</th>
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<tbody>
<tr>
<td>Regulatory/ supervisory authorities</td>
<td>70</td>
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<tr>
<td>Inter-gouvernmental organizations</td>
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<tr>
<td>Financial institutions &amp; professional firms</td>
<td>106</td>
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<tr>
<td>Self-regulatory organizations</td>
<td>4</td>
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</tbody>
</table>

Bank of England joined the IFSB as an Associate member. Second supervisory authority from Europe after Banque Centrale du Luxembourg.
IFSBI’S KEY GOAL: CONSISTENCY IN REGULATION AND SUPERVISION

Unifying Themes

New Standards supporting **orderly development of Islamic finance** at national level benchmarked against comparators

Implementation of harmonised or common set of prudential Standards for **resilient cross border growth**

Facilitating Islamic finance’s **integration into the global economy** and global financial stability surveillance framework
COLLABORATION WITH GLOBAL COUNTERPARTS

• **IFSB Is a member of the Basel Consultative Group**
  o Provides feedback on global regulatory developments
  o Submitted Note on Impact of Liquidity Reforms on IIFS on LCR (2012); NSFR (2014); Credit Risk (2016)

**BCBS’ participation in the IFSB’s Working Groups**
  o Special Issues in Capital Adequacy (2008-2009)
  o Core Principles for Islamic Finance Regulation- Banking (2012-2014)

• A **joint paper** with IAIS on Insurance Core Principles and the *Takāful* Sector (2006)
• A **joint project** on *Microtakāful* published in November 2015

• An ongoing **joint collaboration** with IOSCO on transparency and disclosure in Islamic capital markets launched in 2012

• IFSB collaborating with IFAC on raising awareness of Islamic finance
• IFSB is an active member of CAGs of IAASB and IESBA
IFSB & AAOIFI: COMPLEMENTARY MANDATES

**IFSB’s Mandate**

- Prudential standard setter across three sectors – Islamic banking, Takaful (Islamic insurance) and Islamic Capital Market
- Facilitate Implementation of Standards and Capacity Building: Workshops, Technical Assistance and Annual Implementation Surveys
- Promote Cross Border Cooperation on stability and resilience issues: Publications and awareness building
- IFSB & AAOIFI have issued complementary standards on transparency, disclosure and consumer protection for risk sharing investment account holders

**AAOIFI’s Mandate**

- Development of accounting and auditing Standards relevant to Islamic Finance activities
- Dissemination of accounting and auditing standards through trainings, seminars and certificate programmes
- Prepare Shari’ah standards on Islamic finance products

Both IFSB & AAOIFI are members of IASB’s Consultative Advisory Group on Islamic Finance.
WIDENING INTEREST IN ISLAMIC FINANCE IN RECENT YEARS

Sovereign Sukūk issuances by UK, Luxembourg, Hong Kong, South Africa etc.


Press Release 21 February 2017: Board will consider adopting IFSB Core Principles as a global standard under IMF/WB Standards and Codes Review

IMF External Advisory Group (EAG) on Islamic Finance *(IFSB is a member)*.
REFLECTS RAPID GROWTH OF ISLAMIC FINANCE …

Islamic Banking Assets by Region

Sukuk Market Growth Trend

Takāful Gross Contributions

Note: The Islamic banking sector expanded at a CAGR of 14.4% during 2008-2014. The annual growth rate in 2009 is particularly high as many new Islamic banks / subsidiaries were set up at this time.

Note: Sukūk outstanding grew at a CAGR of 16.1% during 2008-2015.

Islamic Financial Assets by Region (USD bln)

<table>
<thead>
<tr>
<th>Region</th>
<th>Banking Assets</th>
<th>Sukūk Outstanding</th>
<th>Islamic Funds Assets</th>
<th>Takāful Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asia</td>
<td>209.3</td>
<td>174.7</td>
<td>23.2</td>
<td>5.2</td>
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<tr>
<td>GCC</td>
<td>598.8</td>
<td>103.7</td>
<td>31.2</td>
<td>10.4</td>
</tr>
<tr>
<td>MENA (exc. GCC)</td>
<td>607.5</td>
<td>9.4</td>
<td>0.3</td>
<td>7.1</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>24</td>
<td>0.7</td>
<td>1.4</td>
<td>0.5</td>
</tr>
<tr>
<td>Others</td>
<td>56.9</td>
<td>2.1</td>
<td>15.2</td>
<td>--</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,496.5</strong></td>
<td><strong>290.6</strong></td>
<td><strong>71.3</strong></td>
<td><strong>23.2</strong></td>
</tr>
</tbody>
</table>

Note: Data for banking and Takāful is as of 1H2015 while Sukūk and funds as of 11M15.

EMERGENCE OF SYSTEMIC IMPORTANCE IN SOME VERY DIVERSE ECONOMIES

Increasing number of economies in which IB is more than 15% of assets

Indonesia and Turkey: far reaching plans to integrate Islamic finance into public sector goals

ISLAMIC FINANCE: REAL ECONOMY, ETHICAL CONDUCT, SOCIAL RESPONSIBILITY

Overarching Principles (Islamic Law)

- Towards achieving the objectives of:
  - High ethical values - justice, fairness, trust, honesty and integrity
  - More equitable distribution of wealth
  - Principle of stewardship

Materiality and Validity of Transactions

- Economically productive underlying activities
- Avoidance of interest-based transactions
- No involvement in illegal and unethical activities
- Avoidance of gambling, and excessive uncertainty and speculation

Materiality and Validity of Transactions

- Entitlement of profit contingent upon risk taking
- Sharing of risks – emphasis on equity
- Honouring both substance and form of contract

Source: Islamic Finance and Global Financial Stability 2010
A distinctive approach serves financial and social stability.

Profit sharing, loss bearing investment accounts in banks

Risk sharing financing infrastructure + housing

Insurance based on risk sharing, not premiums

Voluntary exclusion from formal interest based financial system
NEW BASEL REQUIREMENTS FOR HIGH QUALITY CAPITAL SIMILAR TO IF. BUT BASEL STANDARDS FOR HIGH QUALITY LIQUID ASSETS (HQLA) FOLLOWING GLOBAL FINANCIAL CRISIS (LCR, NSFR) POSE CHALLENGES TO IF BECAUSE OF UNDERDEVELOPED MARKETS AND LACK OF TRADABLE SECURITIES.

NEED FOR REGULAR SOVEREIGN Sukūk ISSUANCES + BY CENTRAL BANKS – WOULD PROVIDE MORE Shari‘ah-compliant short-term liquid instruments; interim options under BASEL ALTERNATIVE LIQUIDITY APPROACHES (ALA) - CENTRAL BANK LINES OF CREDIT.
KEY LEGAL & REGULATORY CHALLENGES

Overarching issue: IF contracts involve both Islamic and secular law: ramifications for introduction of IF + its regulation and supervision; sources of law and governing law will shape strategy

Applying capital and liquidity standards to Islamic banks: numerous IFSB standards

Investment accounts – systemic challenges: IFSB standards covering transparency, measurement, calibration; need for consistent application

Shari’ah governance: IFSB standard is a benchmark; but leaves room for differences of view on law

Financial safety nets; LOLR + SCDIS; Insolvency law and its application to Islamic finance
ADDRESSING THE CHALLENGES: THE IFSB’S STANDARDS + RESEARCH

1. Banking sector Standards first; gradual expansion to other sectors
2. Post crisis: alignment with Basel III + Core Principles + Soundness Indicators
3. New programme of 8 standards for 2016-18
4. Research to support key issues: Safety Net + Resolution/AMLFT/Macroprudential
IFSB STANDARDS: INITIAL FOCUS ON BANKING THEN EXPANDED COVERAGE

**Banking**
- IFSB-1: Risk Management
- IFSB-2: Capital Adequacy
- IFSB-3: Corporate Governance for IIFS
- IFSB-4: Transparency & Market Discipline
- IFSB-5: Supervisory Review Process
- IFSB-7: Special Issues in Capital Adequacy
- IFSB-12: Liquidity Risk Management
- IFSB-13: Stress Testing
- IFSB-15: Revised Capital Adequacy Standard
- IFSB-16: Revised Supervisory Review Process
- IFSB-17: Core Principle for Islamic Banks
- GN-6: Quantitative Measures for Liquidity Risk

**Capital Market**
- IFSB-6: Governance of Islamic CIS
- GN-6: Quantitative Measures for Liquidity Risk

**Takaful**
- IFSB-8: Corporate Governance for Takaful
- IFSB-11: Solvency for Takaful Undertakings
- IFSB-14: Risk Management for Takaful
- IFSB-18: Guiding Principles on Retakaful

**Cross-sector**
- IFSB-9: Conduct of Business
- IFSB-10: Shari’ah Governance System

**Expected New Standards**
- Disclosure Requirements ICM Products
  - Apr-2017
MAJOR FOCUS ON CAPITAL, IAH + NEW ISSUES

### Published Guidance Notes

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<tr>
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<tr>
<td>Mar 2008</td>
<td>GN-1: Capital Adequacy (Credit Ratings Assessments)</td>
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<tr>
<td>Dec 2010</td>
<td>GN-2: Capital Adequacy (Commodity <em>Murabahah</em> Transactions)</td>
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<td>Mar 2011</td>
<td>GN-3: Smoothing the Profits Payout to IAH</td>
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<td>GN-4: Capital Adequacy (Determination of Alpha Factor)</td>
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<td>GN-5: Takaful and <em>Retakaful</em> (Credit Ratings Assessments)</td>
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<td>April 2015</td>
<td>GN-6: GN on Quantitative Measures for Liquidity Risk</td>
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### Published Technical Notes

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<tr>
<td>Dec 2016</td>
<td>TN-2: Stress Testing for Institutions Offering Islamic Financial Services (IIFS)</td>
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### Published Research

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<td>April 2014</td>
<td>WP-01: WP on Strengthening the Financial Safety Net: Role of SLOLR Facilities</td>
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<td>Nov 2014</td>
<td>WP-02: WP on Evaluation of Core Principles Relevant to IF Regulation</td>
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<td>Oct 2015</td>
<td>WP-03: WP on Financial Consumer Protection in Islamic Finance</td>
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<td>Mar 2016</td>
<td>WP-04: Comparative Study on the Implementation of Selected IFSB Standards</td>
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<td>WP-05: WP on <em>Shari‘ah</em> Non-Compliance Risk in the Banking Sector</td>
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<td>WP-06: WP on Strengthening the Financial Safety Net: The Role of SC DIS</td>
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**Cross-sector:**
- Banking
- Takaful
ACCELERATING THE EFFECTIVE IMPLEMENTATION OF IFSB STANDARDS

Implementation Is Accelerating – Challenge And Opportunity…

IFSB Standards as benchmark to promote consistent regulatory and supervisory practices + Helps identify constraints and challenges through Implementations Surveys, QIS etc.

A sustained framework to support an orderly growth of IFSI globally

IFSB’s Transition Challenge

Moving from achieving ex-ante consistency in understanding to ex-post consistency in implementation in diverse jurisdictions
### Review of the FIS Workshops Initiatives (2007 –2016)

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<td>Countries</td>
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<td>Number of Workshops</td>
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<td>Number of Participants</td>
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**STRATEGY**

- **Technical Assistance**
- **FIS Workshops**
- **E-Learning**
- **Working with Partners**
The overall implementation status is consistent with 2015 survey with minor differences in completion.

- Jurisdictions indicating they have ‘Completed’ implementation is higher by 9% and while those that indicate they are in the ‘Planning’ stages has increased by 2%
- Those that indicate they ‘Do Not Plan’ to implement has decreased by 6% and those that are ‘In Progress’ has reduced by 4%
STANDARDS COMPLETED BY TIMELINE

- Earliest standards have highest implementation rate
- Basel III related standards have strong pickup in recent years

Average Rate of RSA Implementation Per 1 Year

<table>
<thead>
<tr>
<th>IFSB 1</th>
<th>IFSB 2</th>
<th>IFSB 3</th>
<th>IFSB 4</th>
<th>IFSB 5</th>
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<td>7</td>
<td>8</td>
<td>9</td>
<td>10</td>
<td>16</td>
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</table>
CHALLENGES IN IMPLEMENTATION

- The lack of staff with detailed knowledge of Islamic finance for implementation of standards is identified as a major challenge faced by RSAs.
- The need for changing or adapting existing statutory/legal frameworks was also identified as the major constraint hindering standards’ implementation.

Human Resources and Capacity Building

Implementation needs a detailed knowledge of Islamic finance, which few staff of our organisation have

Our supervisory staff do not have the capability to supervise the compliance with Islamic finance related regulations, once issued

Other Factors

- Existing statutory/legal framework hinder the Standards’ implementation as the framework needs to be changed or...
- Process of standards implementation is too time intensive or requires an excessive administrative effort for RSA
- Lack of or poor quality of available industry data to support implementation of the Standards
- Number of Islamic finance institutions/ size of industry (in terms of market share) is too small to make implementation viable
- Process of standard implementation is financially prohibitive for RSA (budgetary constraints)
Most RSAs require more FIS Workshops with 24% of the respondents finding it extremely significant and 36% finding it very significant.

Preparation of more Technical Notes and providing direct Technical Assistance (TA) to RSAs were ranked second and third respectively in terms of their significance.

Secretariat to organize more “Facilitating the Implementation of IFSB Standards (FIS)” Workshops, allowing stakeholders to attend and enhance their knowledge

Secretariat to prepare more technical notes/explanatory notes on various standard to facilitate and clarify the implementation process

Providing direct Technical Assistance (TA) i.e. staff missions of limited duration sent from IFSB to RSAs to review existing legal & regulatory framework and advise on the steps required to implement IFSB Standards.

To offer a self-study e-learning platform for RSA training and implementation skill enhancement as an alternative to the FIS Workshops

To prepare Comparative Studies or Case studies to assess level of standard implementation and assist RSA countries in pinpointing implementation gaps

To introduce Regulatory Consistency Assessment/Evaluation across RSAs to benchmark and guide RSAs on their current performance vis-à-vis the RSA community
KEY ASPECTS OF NEW STRATEGY

- The findings of the implementation survey feeds into the IFSB’s future Strategy and work

  ✓ **Greater engagement** with jurisdictions in the Middle East, as well as with other regions, to help new jurisdictions to build awareness about Islamic finance from the stability, resilience and regulatory perspective

  ✓ A **membership drive**, combined with a prioritisation of the needs of our members and of the wider set of stakeholders in the IFSI.

  ✓ Ramp up **support for the implementation** of the IFSB existing standards
    - E-Learning Modules and longer-term engagement with members

  ✓ **Working with global partners** and enhanced collaboration on areas of common interest
    - Integrating Islamic finance into global surveillance framework (Core Principles)
OUTLINE

1. Overview of the IFSB and its Mandate
2. Recent Developments in Islamic Finance
3. Islamic Finance: Regulatory Challenges
4. Implementation of IFSB Standards
5. IFSB Strategic Performance Plan 2016-2018
6. Going Forward: New Challenges

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THE IFSB’S NEW STRATEGIC PERFORMANCE PLAN 2016-2018

To provide greater coverage of the needs of its key stakeholders, the IFSB has identified four Strategic Key Result Areas (SKRAs) over the 2016-2018 period.

<table>
<thead>
<tr>
<th>SKRA</th>
<th>Outcome</th>
</tr>
</thead>
</table>
| **SKRA 1: Formulation and Issuance of Prudential Standards and Studies for the Regulation of the IFSI** | **Outcome 1 (OC1):** Enhanced Guidance on Prudential Supervision of IFSI  
**Outcome 2 (OC2):** Expansion of Coverage of IFSI issue areas |
| **SKRA 2: Facilitating the Implementation of Prudential Standards and Capacity Development** | **Outcome 3 (OC3):** Increased implementation of the IFSB standards in member jurisdictions  
**Outcome 4 (OC4):** Enhanced Capacity of Member Jurisdictions to Understand the Enabling Factors for an Effective Regulatory and Supervisory System |
| **SKRA 3: Increased Awareness and Knowledge Sharing** | **Outcome 5 (OC5):** Improved awareness of stakeholders on the growth and soundness of the IFSI  
**Outcome 6 (OC6):** Enhanced knowledge sharing through the dissemination of information |
| **SKRA 4: Enhancing Cooperation with the Islamic Finance Stakeholders** | **Outcome 7 (OC7):** Improved Cooperation with Members’ of the IFSB  
**Outcome 8 (OC8):** Increased satisfaction of Members’ with the services provided by the IFSB |
## TARGETS FUTURE STANDARDS DEVELOPMENT 2016 - 2018

<table>
<thead>
<tr>
<th>No</th>
<th>Project</th>
<th>Sector</th>
<th>Development Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.</td>
<td>Core Principles for Islamic Finance Regulation (Islamic Capital Market Segment)</td>
<td>ICM</td>
<td>2016 – 2019</td>
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<tr>
<td>3.</td>
<td>Disclosure to Promote Transparency and Market Discipline in Islamic Banking (Revised IFSB-4 with focus on Consumer Protection)</td>
<td>Banking</td>
<td>2016 – 2019</td>
</tr>
<tr>
<td>7.</td>
<td>Operational Risk, Market Risk, Revised Approach to Credit Risk, Rate of Return Risk and Leverage Ratio (Revised IFSB-15 with group of topics undertaken as a single project)</td>
<td>Banking</td>
<td>2018 – 2020</td>
</tr>
<tr>
<td>8.</td>
<td>Core Principles for Islamic Finance Regulation (Takāful Segment)</td>
<td>Takāful</td>
<td>2018 – 2021</td>
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</table>
## SUPPORTED BY RESEARCH 2016 - 2018

<table>
<thead>
<tr>
<th>No</th>
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<th>Development Period</th>
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</thead>
<tbody>
<tr>
<td>1.</td>
<td>Issues Arising from Changes in <em>Takāful</em> Capital Requirements (surplus, capital instruments, etc)</td>
<td><em>Takāful</em></td>
<td>2016 – 2017</td>
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<tr>
<td>2.</td>
<td>Systemic Links and Macroprudential Issues for Islamic Banks</td>
<td>Banking</td>
<td>2016 – 2018</td>
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<tr>
<td>3.</td>
<td>Resolution and Recovery</td>
<td>Cross-Sectoral</td>
<td>2016 – 2018</td>
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<td>5.</td>
<td>Capital Market Intermediaries</td>
<td>ICM</td>
<td>2017 – 2018</td>
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<tr>
<td>7.</td>
<td>Consumer Protection in <em>Takāful</em></td>
<td><em>Takāful</em></td>
<td>2017 – 2019</td>
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<tr>
<td>10.</td>
<td>Islamic Hedging Instruments</td>
<td>Cross-Sectorial</td>
<td>2018 – 2019</td>
</tr>
</tbody>
</table>
SUMMARY OF IFSB PERFORMANCE AND FUTURE WORK

- A Range of cross sectoral standards that aim to provide a consistent and robust prudential framework comparable to international standards issued by global comparators.

- Major programme to align Islamic finance with new global regulatory architecture.

- Sustained effort to assist implementation of IFSB standards across countries.

- Launch of Core Principles for Islamic Finance Regulation to facilitate integration into global surveillance framework.
Thank you

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