

IFSB WORKING PAPER SERIES

WP-02/11/2014

**EVALUATION OF CORE PRINCIPLES
RELEVANT TO ISLAMIC FINANCE
REGULATION**

**CORE PRINCIPLES FOR ISLAMIC FINANCE
REGULATION WORKING GROUP (CPIFRWG)**

November 2014



**ISLAMIC FINANCIAL
SERVICES BOARD**



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Note: This Working Paper should not be reported as representing the views of the Islamic Financial Services Board (IFSB). The views expressed are those of the authors and do not necessarily reflect those of the IFSB.

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ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, among others, the issuance of exposure drafts, holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

For more information about the IFSB, please visit www.ifsb.org.

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TABLE OF CONTENTS

ACRONYMS	VII
SECTION 1: INTRODUCTION	1
1.1 Background: The Need for Core Principles	1
1.2 Guidance Provided by the IFSB to Supervisory Authorities	4
1.3 Structure of the Report	4
SECTION 2: DETAILED GAP ASSESSMENT OF THE BCBS BANKING CORE PRINCIPLES FOR ISLAMIC BANKING SECTOR	6
2.1 Overview of Islamic Banking Sector: Growth to Resilience	6
2.2 IFSB's Publications: Banking Sector	8
2.3 BCBS Core Principles	9
2.4 Gaps Assessment and Relevance of BCBS Core Principles for IIFS	12
SECTION 3: DETAILED GAP ASSESSMENT OF THE IAIS CORE PRINCIPLES FOR <i>TAKĀFUL</i> (ISLAMIC INSURANCE) SECTOR	37
3.1 Industry Development: <i>Takāful</i> Sector	37
3.2 The IFSB's Role in the <i>Takāful</i> Sector	38
3.3 IAIS's Insurance Core Principles	38
3.4 Core Principles and Assessment Methodologies	39
3.5 Analysis of the ICPs for Islamic Finance	40
SECTION 4: DETAILED GAP ASSESSMENT OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION FOR ISLAMIC CAPITAL MARKET SECTOR	78
4.1 Industry: Islamic Capital Market	78
4.2 Islamic Capital Market Instruments	78
4.3 IFSB's Work on Islamic Capital Market Regulation	82
4.4 IOSCO's Objectives and Principles of Securities Regulations	83
4.5 Gap Analysis of IOSCO's Principles and Assessment Methodology	85
SECTION 5: GAP ASSESSMENT AND RELEVANCE OF THE OTHER CORE PRINCIPLES FOR ISLAMIC FINANCE	98
5.1 Core Principles for Deposit Insurance	98
5.2 Principles for Financial Market Infrastructures	107
5.3 Principles for the Supervision of Financial Conglomerates	113
APPENDICES	120
Appendix A: List of Definitions	120
Appendix B: List of Publications Studied for the Working Paper	123

ACRONYMS

ALM	Asset-Liability Management
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principle
BOD	Board of Directors
CAGR	Compound Annual Growth Rate
CAR	Capital Adequacy Ratio
CCP	Central Counterparties
CIS	Collective Investment Scheme
CMT	Commodity <i>Murābahah</i> Transactions
CPIFWG	Core Principles for Islamic Finance Regulation Working Group
CPIFR	Core Principles for Islamic Finance Regulation
CPSIPS	Core Principles for Systemically Important Payment Systems
CPSS	The Committee on Payment and Settlement Systems
CRA	Credit Rating Agency
CSD	Central Securities Depository
ECAI	External Credit Assessment Institution
ED	Exposure Draft
ED-17	IFSB Core Principles for Islamic Finance Regulation – Banking
ERM	Enterprise Risk Management
FMI	Financial Market Infrastructures
FSAP	Financial Sector Assessment Programme
GCC	Gulf Cooperation Council
GFC	Global Financial Crisis
IADI	International Association of Deposit Insurers
IAH	Investment Account Holders
IAIS	International Association of Insurance Supervisors
ICAAP	Internal Capital Adequacy Assessment Process
ICM	Islamic Capital Market
ICMTF	Islamic Capital Market Task Force
ICP	Insurance Core Principles
IDB	Islamic Development Bank

IDIS	Islamic Deposit Insurance System
IFSB	Islamic Financial Services Board
IFSI	Islamic Financial Services Industry
IIFS	Institutions offering Islamic Financial Services in banking segments [other than Islamic insurance (<i>Takāful</i>) institutions and Islamic collective investment schemes]
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
LCR	Liquidity Coverage Ratio
MENA	Middle East and North African
ML/FT	Money Laundering or Financing of Terrorism
MCR	Minimum Capital Requirement
MOU	Memoranda of Understanding
NSFR	Net Stable Funding Ratio
OTC	Over the Counter
ORSA	Own Risk and Solvency Assessment
PCR	Prescribed Capital Requirement
PER	Profit Equalisation Reserve
PIF	Participants' Investment Fund
PRF	Participants' Risk Fund
PSIA	Profit-Sharing Investment Account
RCCP	Recommendations for Central Counterparties
RSSS	Recommendations for Securities Settlement Systems
RTO	Reinsurer or <i>Retakāful</i> Operator
SGP	Standards and Guiding Principles
SLOLR	<i>Sharī'ah</i> -compliant Lender of Last Resort
SPE	Special-Purpose Entity
SRP	Supervisory Review Process (also referred as "Pillar 2")
SRO	Self-Regulatory Organization
SSB	<i>Sharī'ah</i> Supervisory Board
SSS	Securities Settlement System
TR	Trade Repository
WP	Working Paper

SECTION 1: INTRODUCTION

1.1 Background: The Need for Core Principles

1. The rapid growth of the Islamic financial services industry (IFSI) has been accompanied by its geographic spread into not only Muslim-majority countries but also non-Muslim economies (such as Singapore, the United Kingdom, Luxembourg, etc.). Accordingly, in various jurisdictions, the IFSI has gained significant market share and now constitutes an important building block of the financial systems in many jurisdictions. This cross-border development and growth has raised a number of challenges in respect of the resilience and stability of those financial systems where institutions offering Islamic financial services (IIFS) operate alongside their conventional counterparts. One tool that has been used to enhance financial system resilience is the development and application of core principles for regulatory and supervisory regimes. In this respect, **three major international standard-setters** – the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) – have each developed a set of core principles relating to their own sectors.¹
2. The global financial crisis (GFC) in 2008 and the ongoing sovereign debt crisis have emphasised the significance of a well-articulated micro- and macroprudential policy framework for ensuring financial sector stability, focusing on (a) assessment of risks to the financial sector; (b) the financial stability policy framework; and (c) capabilities for resolving crises. As Islamic finance is increasingly integrated into the global financial system, it is important to ensure that its regulation and supervision are subject to assessment (e.g. through the International Monetary Fund [IMF]/World Bank Financial Sector Assessment Programme [FSAP]). However, many supervisory authorities that are new to the regulation and supervision of Islamic financial services face challenges in identifying applicable principles and benchmarks for assessing the gaps in their existing structures and the policies in their jurisdictions, while addressing the specificities of Islamic finance. The differences in the operational and *Sharī'ah* characteristics of Islamic finance products in various regions highlight the need for international standardisation of the prudential framework.
3. With the growing significance of IFSI at the international level and in the majority of Islamic Financial Services Board (IFSB) member countries, the need has been recognised for minimum international standards which set out sound supervisory practices for the regulation and assessment of the

1 The Financial Stability Board also recognises other specialist or non-sectoral core principles – for example, those of the Financial Action Task Force on money-laundering and terrorist financing, and those of the Organisation for Economic Co-operation and Development on corporate governance.

various sectors of the industry at jurisdiction level. The IFSB continues to prepare prudential standards and guiding principles (SGP) for various sectors of the IFSI, so far covering the banking, Islamic insurance (*Takāful*) and Islamic capital markets sectors. It has therefore been proposed, in line with the core principles available for the sectors of the conventional financial system, that the IFSB prepare one or more principles documents for the IFSI to facilitate the review of this sector from the perspective of regulation and supervision.

4. The IFSB Council, at its 21st Meeting held on 12 December 2012 at the Islamic Development Bank (IDB) headquarters in Jeddah, Kingdom of Saudi Arabia, therefore approved the preparation of a new standard on *IFSB Core Principles for Islamic Finance Regulation* (hereinafter to be referred to as “CPIFR”) and setting up of a *Core Principles for Islamic Finance Regulation Working Group* (CPIFRWG) for this purpose.
5. At its second meeting, held in Istanbul, Turkey, on 16 September 2013, the CPIFRWG received an initial study report from the IFSB Secretariat. The report analysed the applicability to Islamic finance of the core principles of the three main sectoral standard-setters (the BCBS, IAIS and IOSCO). It also considered, in less detail, the following additional sets of principles:
 - Core Principles for Deposit Insurance;
 - Principles for Financial Market Infrastructures; and
 - Principles for the Supervision of Financial Conglomerates.
6. The CPIFRWG explored a number of possible options for the development of core principles for the IFSI, including both sectoral and cross-sectoral approaches.
7. In the event, the CPIFRWG, with the support of the IFSB Technical Committee, decided that it should begin by developing core principles for the Islamic banking sector, with the aim of subsequently developing core principles for the other sectors of the IFSI. This decision reflected three main considerations:
 - a. Assessments of regulatory and supervisory regimes tend to be conducted by assessors with detailed sectoral expertise. Also, in many jurisdictions, an assessment of the regime for the IFSI would be likely to be conducted in parallel with an assessment of the regimes for one or more conventional sectors. For both these reasons, a sectoral approach would be likely to be more useful to assessors than a cross-sectoral one.
 - b. The Islamic banking sector is at present by far the largest in the IFSI, accounting for perhaps 80% of assets.

- c. It is also the sector on which the IFSB has so far done most standards work, which facilitates the preparation of core principles, albeit that, in line with international practice, core principles are in general at a higher level.
8. Following this decision, and the subsequent work of the CPIFRWG, draft *Core Principles for Islamic Finance Regulation – Banking* are being published as an Exposure Draft (ED) contemporaneously with this document.² The Technical Committee considered, however, that it would be helpful to the Islamic finance community, and the regulatory community more generally, also to publish the substance of the initial study report. This would give an indication of the applicability of other core principles to Islamic finance, and also of the possible future work programme of the IFSB in this area. This is what the present Working Paper (WP) aims to achieve.
9. Thus, the present WGP provides background information on the core principles for banking, insurance and securities markets, respectively, and discusses in detail the key areas of the BCBS's and IAIS's core principles, as well as IOSCO's Objectives and Principles, and their applicability to supervision of the various sectors of the IFSI. In particular, the WGP presents a principle-by-principle gap analysis of specificities of IIFS-related issues. This gap analysis indicates whether: (a) the existing principle is fully applicable; (b) it requires modifications or adjustments; or (c) a new principle is needed. In addition, the analysis indicates the need to have additional principles for CPIFR to cater for the specificities of IFSI in the three sectors: banking, insurance (*Takāful*) and capital markets.
10. In line with ED-17, with respect to IAIS and IOSCO, this present WGP has also noted the assessments of gaps in core principles which have been conducted in the past, such as IFSB–IAIS *Issues in Regulation and Supervision of Takāful (Islamic Insurance)* (2006); IOSCO *Islamic Capital Markets Fact Finding Report* (July 2004) and *Analysis of the Application of IOSCO Objectives and Principles of Securities Regulation for Islamic Securities Products* (September 2008). The present analysis in this WGP builds on, and broadens the scope of, these previous exercises. As noted above, the IFSB has yet to work in detail on the application of core principles to sectors of the IFSI other than banking, and to produce Exposure Drafts on such topics. Therefore, the gap assessment provided here with regard to IAIS and IOSCO core principles for applicability to Islamic finance, with particular reference to the insurance and capital markets sectors, will be reviewed in the course of the future work of the IFSB.

² IFSB ED-17: *Core Principles for Islamic Finance Regulation – Banking*. It is intended that this Exposure Draft, as amended following public consultation, will eventually be adopted by the IFSB Council as the standard IFSB-17.

1.2 Guidance Provided by the IFSB to Supervisory Authorities

11. In addition to ED-17: *Core Principles for Islamic Finance Regulation*, it should be noted that a number of IFSB SGPs provide guidance to supervisory authorities on their application. For example, Section 4 of IFSB-12: *Guiding Principles on Liquidity Risk Management for IIFS* sets out eight guiding principles for supervisory authorities. Likewise, Section 4 of IFSB-13: *Guiding Principles on Stress Testing for IIFS* provides seven guiding principles for supervisory authorities. Also, IFSB-15: *Revised Capital Adequacy Standard* provides elements of macroprudential supervision for supervisory authorities. Thus, the IFSB provides guidance on supervision and regulation at three levels: at the technical level in various SGPs; at a more general level on key elements in the supervisory review process in IFSB-16; and in terms of core principles in ED-17. The proposed guidance in ED-17 has been aligned with that given at the technical level in other SGPs with respect to the banking sector of the IFSI. ED-17 will contribute to the promotion of financial stability by, *inter alia*, facilitating the process of assessment of institutions in the banking sector of the IFSI, through the provision of guidance to institutions in their self-assessment and their preparation for being assessed, as well as signposts to their assessors in the conduct of the assessment.

1.3 Structure of the Report

12. The remainder of the report is structured as follows. **Sections 2–4** provide background information on the core principles for banking, insurance and securities markets, respectively, and analyse in detail the relevance of these core principles for three sectors of the IFSI (Islamic banking, *Takāful* and Islamic capital markets). **Section 5** provides gap assessment of other international (core) principles issued for financial conglomerates, deposit insurance and financial market infrastructures, and their possible application to the IFSI.
13. The analysis was undertaken by the relevant subject matter specialists in the Secretariat, who presented their work to the CPIFRWG in slightly different formats. Because this research paper is based on the CPIFRWG material, and in the interests of time, the IFSB has not attempted fully to align these formats.
14. Note that whenever the term “IIFS” is used in this document, it covers all types of institutions offering Islamic financial services in the banking, *Takāful* and capital markets segments, except where the context requires a narrower interpretation. In contrast, the term “bank”, without further qualification, is used to refer to conventional banks as used by the BCBS and

in other regulatory documents issued by various central banks. Further, the terms “supervisory authorities” and “supervisors” are used interchangeably in the report. Similarly, the terms “board” and “board of directors (BOD)” are used interchangeably. In addition, the term “core principles” is used in this document to refer to principles or objectives issued by the BCBS, IAIS and IOSCO, respectively, while the term “CPIFR” is used to refer to the *Core Principles for Islamic Finance Regulation*.

SECTION 2: DETAILED GAP ASSESSMENT OF THE BCBS BANKING CORE PRINCIPLES FOR ISLAMIC BANKING SECTOR

15. This section focuses on identifying the pertinent issues in applying the latest Basel Core Principles (BCPs) to the Islamic banking industry. It also presents an overview of the development of the IFSI, and of the IFSB's efforts to bridge the gap between conventional financial sector regulation and Islamic finance regulation, taking into account the significant development in the Islamic finance industry. The section also provides detailed analysis of the BCPs' compatibility with Islamic finance and insight into potential amendments to capture the specificities of Islamic finance. Following the detailed analysis of the BCPs, some areas for the development of additional principles are proposed. As noted above, the analysis of the BCPs has been aligned retrospectively with that in ED-17.

2.1 Overview of Islamic Banking Sector: Growth to Resilience

16. Islamic banking in the early 2000s was a niche market in most jurisdictions, with only a few institutions offering basic depository and financing instruments. This was coupled with low awareness and demand for Islamic banking services, particularly in Asia Pacific and developed markets. Regulation was another area that was undeveloped in most jurisdictions until the mid-2000s, when various authorities began introducing and amending legislation to make it supportive of the Islamic banking industry's growth. Such amendments served to regulate, accommodate and incentivise *Shar'ah*-compliant transactions in a number of markets across the globe.³
17. The current global financial turmoil caused a fundamental rethinking of the global financial system. Basic assumptions regarding the role of banks, the responsibilities of supervisors, the stakeholder's perspective, and the rules of macroeconomic policy are being examined and revisited. The Islamic finance sector has not been immune to the current crisis. While several aspects of the Islamic banking model inherently provided insulation from the crisis, Islamic financial markets and institutions were clearly impacted by the global recession, particularly through second-round effects. Nevertheless, despite the turmoil across financial markets, Islamic banks remained relatively resilient and still able to grow at a significant pace.
18. According to the *IFSB Islamic Financial Services Industry Financial Stability Report, 2014*, the global IFSI has grown in size and geographic coverage, now encompassing new jurisdictions and more institutions. Total Islamic finance assets grew to an estimated USD1.8 trillion by the end

³ *IFSB Islamic Financial Services Industry Stability Report, 2013.*

of 2013, representing a compound annual growth rate of 17% between 2009 and 2013. Islamic banking remains the dominant sector within the IFSI with approximately 80% of the total Islamic financial assets. Islamic banking assets are concentrated in the Gulf Cooperation Council (GCC) and in Malaysia, but some non-GCC Middle East and North African (MENA) countries have experienced a rapid expansion or made a new entry (Jordan, Yemen, Tunisia, Libya and Morocco) last year. Despite slower growth post-GFC, the fundamentals of Islamic banks remain sound. Improving asset quality and a pickup in economic growth are expected to benefit the Islamic banking sector over the coming years.

19. In another study⁴ conducted by the IFSB, regulatory and supervisory authorities (RSAs) were asked for information on the **market share of IIFS** (in terms of assets⁵ as a percentage of total assets of financial institutions) in the respective jurisdiction with respect to total **banking, capital market and Takāful segments**. Table 2.1.1 indicates that, among these segments, the banking segment is the most developed among IFSB members – although the picture varies significantly by individual jurisdictions.

Table 2.1.1: Market Share of the IIFS

Market Share	Banking		Takāful		Capital Market	
	No.	%	No.	%	No.	%
Less than 5%	14	54	12	75	10	83
5–9%	3	12	1	6		
10–14%	1	4	1	6		
15–19%	1	4				
20–24%	2	8				
25–29%			1	6	1	8
30–34%						
35%+	5	19	1	6	1	8

Base: Banking – 26, *Takāful* – 16, Capital Market – 12

Source: IFSB SLOLR Survey June 2012.

20. From the study findings it is also evident that the majority of the respondents have less than a **5% market share** of Islamic finance assets in their respective jurisdictions in all three segments. Additionally, Table 2.1.1 demonstrates that the Islamic banking sector is becoming increasingly significant in certain jurisdictions, as **19% (5 out of 19) RSAs** have a market share of over 35% and 7 RSAs are in the range of 5–24%.

⁴ IFSB Survey on *Shari'ah-compliant Lender of Last Resort (SLOLR)*, June 2012.

⁵ Total assets comprise both on-balance sheet and off-balance sheet accounts of the IIFS, so as to get the consolidated figures of the total assets of the IIFS regardless of their reporting.

2.2 IFSB's Publications: Banking Sector

21. Apart from various global initiatives for the harmonisation of accounting, financial product development and liquidity infrastructure for Islamic finance by other international organisations, the IFSB has played an active role in strengthening the soundness and stability of the IFSI as the sole international standard-setting organisation issuing prudential SGP for this industry. In the past decade, the IFSB has issued 16 SGP, five Guidance Notes and one Technical Note that cover various prudential aspects of Islamic banking, *Takāful* and Islamic capital markets.
22. In the banking segment, the IFSB has been playing an active and complementary role to that of the BCBS and other standard-setting organisations so as to strengthen the supervisory framework for IIFS and safeguard the interests of stakeholders of the IFSI. The IFSB has so far issued the following SGP for the banking industry (Table 2.2.1). These publications will support the CPIFR.

Table 2.2.1: List of IFSB SGP – Final Issued

No.	Banking-related Standards	Issuance Date	Nature of Document	Sector
1	Risk Management (IFSB-1)	Dec 2005	Guiding Principles	Banking
2	Capital Adequacy (IFSB-2)	Dec 2005	Standard	Banking
3	Corporate Governance (IFSB-3)	Dec 2006	Guiding Principles	Banking
4	Transparency and Market Discipline (IFSB-4)	Dec 2007	Standard	Banking
5	Supervisory Review Process (IFSB-5)	Dec 2007	Standard	Banking
6	Special Issues in Capital Adequacy: <i>Sukūk</i> , Securitisation and Real Estate (IFSB-7)	Dec 2008	Standard	Banking/ Cross-sectoral
7	Conduct of Business (IFSB-9)	Dec 2009	Guiding Principles	Cross-sectoral
8	<i>Sharī'ah</i> Governance (IFSB-10)	Dec 2009	Guiding Principles	Cross-sectoral
9	Liquidity Risk Management (IFSB-12)	Mar 2012	Guiding Principles	Banking
10	Stress Testing (IFSB-13)	Mar 2012	Guiding Principles	Banking
11	Revised Capital Adequacy (IFSB-15)	Dec 2013	Standard	Banking
12	Revised Supervisory Review Process (IFSB-16)	Mar 2014	Banking	Banking
13	Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on <i>Sharī'ah</i> -Compliant Financial Instruments	Mar 2008	Guidance Note	Banking
14	Risk Management and Capital Adequacy Standards: Commodity <i>Murābahah</i> Transactions	Dec 2010	Guidance Note	Banking
15	Practice of Smoothing the Profits Payout to Investment Account Holders	Dec 2010	Guidance Note	Banking

16	The Determination of Alpha in the Capital Adequacy Ratio for IIFS	Mar 2011	Guidance Note	Banking
17	Issues in Strengthening Liquidity Management of Institutions offering Islamic Financial Services: The Development of Islamic Money Markets	Mar 2008	Technical Note	Banking
18	Revised Compilation Guide on Prudential and Structural Islamic Financial Indicators	Mar 2011	Statistical Guide	Cross-sectoral

2.3 BCBS Core Principles

23. The BCBS's *Core Principles for Effective Banking Supervision* ("Core Principles", or BCPs) were issued for the first time in September 1997. The methodology for the assessment of the Core Principles was issued in 1999. The Core Principles have been used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying the future work to be undertaken to achieve a baseline level of sound supervisory practices.
24. In 2006, the BCBS revised its original Core Principles along with its assessment methodology; following the GFC, it made further significant changes. The revised Core Principles and the associated methodology were issued for public consultation in December 2011, and the final version was issued in September 2012. The IFSB was represented in the group that carried out the 2011/2012 revision.

2.3.1 The Structure of the Revised Core Principles

25. Following the 2011/2012 revision, there are 29 core principles. Principles 1 to 13 address supervisory powers, responsibilities and functions, focusing on effective risk-based supervision, and the need for early intervention and timely supervisory actions. Principles 14 to 29 cover supervisory expectations of banks, emphasising the importance of good corporate governance and robust risk management, as well as compliance with supervisory standards.
26. Each principle is supported by assessment criteria. These are divided between essential and additional criteria. For the purposes of assessments, the essential criteria are the only elements on which to gauge full compliance with a core principle. The additional criteria are suggested best practices that countries having advanced banks should aim for, and assessment against them is voluntary.

2.3.2 Preconditions for Effective Banking Supervision

27. The Core Principles document also sets out preconditions for effective banking supervision. These are matters that have a direct impact on the effectiveness of supervision in practice, but are mostly outside the

direct or sole jurisdiction of banking supervisors. Accordingly, while any assessment against the BCPs should include the assessors' opinion on how weaknesses in the preconditions for effective banking supervision hinder effective supervision, and how effectively supervisory measures mitigate these weaknesses, this opinion should be qualitative rather than providing any kind of graded assessment. Note that the IAIS sets out very similar preconditions for insurance supervision; see section 3.4.

28. The BCBS preconditions include:
- sound and sustainable macroeconomic policies;
 - a well-established framework for financial stability policy formulation;
 - a well-developed public infrastructure;
 - a clear framework for crisis management, recovery and resolution;
 - an appropriate level of systemic protection (or public safety net); and
 - effective market discipline.
29. The concept of well-developed public infrastructure is further elaborated to include:
- a system of business laws, including corporate, bankruptcy, contract, consumer protection and private property laws, which is consistently enforced and provides a mechanism for the fair resolution of disputes;
 - an efficient and independent judiciary;
 - comprehensive and well defined accounting principles and rules that are widely accepted internationally;
 - a system of independent external audits, to ensure that users of financial statements, including banks, have independent assurance that the accounts provide a true and fair view of the financial position of the company and are prepared according to established accounting principles, with auditors held accountable for their work;
 - availability of competent, independent and experienced professionals (e.g. accountants, auditors and lawyers), whose work complies with transparent technical and ethical standards set and enforced by official or professional bodies consistent with international standards, and who are subject to appropriate oversight;
 - well-defined rules governing, and adequate supervision of, other financial markets and, where appropriate, their participants;
 - secure, efficient and well regulated payment and clearing systems (including central counterparties) for the settlement of financial transactions where counterparty risks are effectively controlled and managed;
 - efficient and effective credit bureaus that make available credit information on borrowers and/or databases that assist in the assessment of risks; and
 - public availability of basic economic, financial and social statistics.

30. In principle, the broad preconditions are equally relevant for the IFSI; however, they need to be properly adapted and interpreted to provide a basis for effective supervision of Islamic financial services institutions.

2.3.3 Assessment Methodology

31. The BCPs are mainly intended to help countries assess the quality of their systems and to provide input into their reform agenda. An assessment of the current situation of a country's compliance with the Core Principles can be considered a useful tool in a country's implementation of an effective system of banking supervision. According to the BCBS, the methodology can be used in multiple contexts: (a) self-assessments performed by banking supervisors themselves; (b) IMF and World Bank assessments of the quality of supervisory systems – for example, in the context of an FSAP; (c) reviews conducted by private third parties such as consulting firms; or (d) peer reviews conducted, for instance, within regional groupings of banking supervisors.
32. As already noted, the methodology includes a set of essential and additional assessment criteria for each principle. The additional criteria are suggested best practices that countries having advanced banks should aim for. For assessments of the Core Principles by external parties, the following four-grade scale will be used: compliant, largely compliant, materially non-compliant and non-compliant.
- **Compliant** – A country will be considered compliant with a principle when all essential criteria applicable for this country are met without any significant deficiencies. There may be instances, of course, where a country can demonstrate that the principle has been achieved by other means. Conversely, due to the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the principle, and therefore other measures may also be needed in order for the aspect of banking supervision addressed by the principle to be considered effective.
 - **Largely compliant** – A country will be considered largely compliant with a principle whenever only minor shortcomings are observed that do not raise any concerns about the authority's ability and clear intent to achieve full compliance with the principle within a prescribed period of time. The assessment "largely compliant" can be used when the system does not meet all essential criteria, but the overall effectiveness is sufficiently good, and no material risks are left unaddressed.
 - **Materially non-compliant** – A country will be considered materially non-compliant with a principle whenever there are severe shortcomings, despite the existence of formal rules, regulations and

procedures, and there is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance. It is acknowledged that the "gap" between "largely compliant" and "materially non-compliant" is wide, and that the choice may be difficult. On the other hand, the intention has been to force the assessors to make a clear statement.

- **Non-compliant** – A country will be considered non-compliant with a principle whenever there has been no substantive implementation of the principle, several essential criteria are not complied with or supervision is manifestly ineffective.

2.4 Gaps Assessment and Relevance of BCBS Core Principles for IIFS

33. The analysis which follows addresses the question whether the BCPs are adequate for IIFS in the banking sector, and, if otherwise, to identify the core principles framework required as well as the challenges involved in outlining such a framework.
34. Tables 2.4.1 and 2.4.2 set out detailed analyses of points where the current practices of the IIFS raise questions about the Core Principles or their application. Table 2.4.1 presents the applicability to IIFS of BCBS Core Principles 1 to 13, which focus on supervisory powers, responsibilities and functions. Table 2.4.2 presents gaps assessment and relevance of BCBS Core Principles 14 to 29, covering supervisory expectations of banks. In many cases, any issues that arise would be likely to be at the level of the supporting methodology, rather than the Core Principles themselves.
35. Following the above detailed analysis of the Core Principles, some additional principles are proposed.
36. In some cases, issues identified in this analysis have been dealt with in ED-17 under a different principle, because it has been convenient to group together, for example, those issues concerned with *Shari'ah* governance and the relevant powers of supervisory authorities.

**Table 2.4.1: Applicability of BCBS Principles to the IIFS
(Part A: Supervisory powers, responsibilities and functions)**

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
A. Supervisory powers, responsibilities and functions		
Principle 1: Responsibilities, objectives and powers	<ul style="list-style-type: none"> ■ An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups. ■ A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to authorise banks, conduct ongoing supervision, address compliance with laws, and undertake timely corrective actions to address safety and soundness concerns. 	<ul style="list-style-type: none"> ■ In general this principle is applicable to IIFS, with the amendments/ extensions noted below. ■ Clear position of <i>Fatawa</i> authority in the Islamic banking system. ■ The IIFS supervisor has full access to IIFS, and its group, boards, management, <i>Sharī'ah</i> supervisory board (SSB), staff and records in order to ascertain whether the IIFS has the necessary system of <i>Sharī'ah</i> governance to monitor compliance with <i>Sharī'ah</i> rules and principles, and with internal rules and external laws, and that material failings in <i>Sharī'ah</i> compliance are brought to the supervisor's attention (cf. Essential Criterion (EC) 5).
Principle 2: Independence, accountability, resourcing and legal protection for supervisors	<ul style="list-style-type: none"> ■ The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor. 	<ul style="list-style-type: none"> ■ This principle is equally applicable to IIFS.
Principle 3: Cooperation and collaboration	<ul style="list-style-type: none"> ■ Laws, regulations or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors. These arrangements reflect the need to protect confidential information. 	<ul style="list-style-type: none"> ■ This principle is equally applicable to IIFS.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 4: Permissible activities</p>	<ul style="list-style-type: none"> ■ The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined and the use of the word “bank” in names is controlled. 	<ul style="list-style-type: none"> ■ This principle is equally applicable to IIFS; however, the principle needs some modifications on the essential criteria as mentioned below to fit within the Islamic finance framework. ■ EC4 requires that “deposit taking” be restricted to institutions licensed as banks, where “deposits” are understood to be “capital certain”, which effectively excludes the <i>Muḍārabah</i>- or <i>Wakālah</i>-based unrestricted profit-sharing investment account (UPSIA) offered by many IIFS. While some Islamic banks do accept capital certain deposits under <i>Qard</i> or <i>Wadiah</i>, the requirement to be licensed as banks should be extended to include IIFS offering <i>Muḍārabah</i>- or <i>Wakālah</i>-based UPSIA. ■ Further, there may be scope for a new criterion here or elsewhere indicating that conditions are defined under which an institution may represent itself as “Islamic”.
<p>Principle 5: Licensing criteria</p>	<ul style="list-style-type: none"> ■ The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. ■ At a minimum, the licensing process consists of an assessment of the ownership structure and governance (including the fitness and propriety of Board members and senior management) of the bank and its wider group, and its strategic and operating plan, internal controls, risk management and projected financial condition (including capital base). ■ Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home supervisor is obtained. 	<ul style="list-style-type: none"> ■ Generally, this principle is applicable to IIFS but needs additional considerations as follows. ■ Nature or range of products and services to be offered by the IIFS, and overall <i>Shari’ah</i> compliance mechanism, should be captured in this principle. IFSB-16 delineates an additional criterion in the issuance of an IIFS licence. Overall <i>Shari’ah</i> compliance matters are dealt with in IFSB-10. ■ The licensing authority, at authorisation level, should evaluate the IIFS board members and senior management and SSB, and any potential for conflict of interest between shareholders and other stakeholders.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 6: Transfer of significant ownership</p>	<ul style="list-style-type: none"> ■ The supervisor has the power to review, reject and impose prudential conditions on any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties. 	<ul style="list-style-type: none"> ■ This principle is equally applicable to IIFS.
<p>Principle 7: Major acquisitions</p>	<ul style="list-style-type: none"> ■ The supervisor has the power to approve or reject (or recommend to the responsible authority the approval or rejection of), and impose prudential conditions on, major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and to determine that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision. 	<ul style="list-style-type: none"> ■ This principle is equally applicable to IIFS; however, a further essential criterion is needed in order to ensure that IIFS acquisitions are <i>Shari'ah</i>-compliant businesses.
<p>Principle 8: Supervisory approach</p>	<ul style="list-style-type: none"> ■ An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable. 	<ul style="list-style-type: none"> ■ This principle is equally applicable to IIFS.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 9: Supervisory techniques and tools</p>	<ul style="list-style-type: none"> ■ The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach and deploys supervisory resources on a proportionate basis, taking into account the risk profile and systemic importance of banks. 	<ul style="list-style-type: none"> ■ This principle is equally applicable to IIFS; however, some modifications are needed – in particular, to the breach of <i>Sharī'ah</i> requirements. ■ The supervisor evaluates the IIFS's <i>Sharī'ah</i> compliance system, and considers whether the <i>Fatawa</i> are being properly implemented (and perhaps whether the SSB is being given proper information on which to base them). ■ The supervisor requires an IIFS to notify it in advance of any significant changes in its activities, products, structure and overall condition, including breach of <i>Sharī'ah</i> requirements (see Essential Criterion 10).
<p>Principle 10: Supervisory reporting</p>	<ul style="list-style-type: none"> ■ The supervisor collects, reviews and analyses prudential reports and statistical returns from banks on both a solo and a consolidated basis, and independently verifies these reports through either on-site examinations or use of external experts. 	<ul style="list-style-type: none"> ■ This principle is equally applicable to IIFS; however, modification of EC1 is needed to reflect IIFS's specificities. ■ Under EC1, the supervisory authority has the power to require IIFS to submit information, on both a solo and a consolidated basis, on their financial condition, performance and risks, on demand and at regular intervals. However, these reports should provide information such as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, risk concentrations (including by economic sector, geography and currency), asset quality, financing loss provisioning, related party transactions, investment account holders (IAHs), equity investment risk, rate-of-return (ROR) risk including displaced commercial risk (DCR), and market risk.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
Principle 11: Corrective and sanctioning powers of supervisors	<ul style="list-style-type: none"> ■ The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. ■ The supervisor has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability to revoke the banking license or to recommend its revocation. 	<ul style="list-style-type: none"> ■ This principle is equally applicable to IIFS; however, some modifications are needed – in particular, to the windows activities, and a broad range of measures in which the interest of unrestricted investment account holders (UIAHs) are considered. ■ Under EC2, the supervisory authority should have available an appropriate range of supervisory tools for use when, in the supervisor’s judgement, an IIFS is not complying with laws, regulations or supervisory actions. In this respect, the interests of UIAHs should be considered in addition to those of depositors.
Principle 12: Consolidated supervision	<ul style="list-style-type: none"> ■ An essential element of banking supervision is that the supervisor supervises the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide. 	<ul style="list-style-type: none"> ■ The consolidated supervision principle is equally applicable to IIFS; however, one new essential criterion can be added, as well as modification of existing EC3 to reflect additional aspects as noted below. ■ For additional aspects of consolidated supervision, reference can be made to IFSB-16. In particular, there are issues concerned with <i>Shari’ah</i> compliance systems across the group and <i>Shari’ah</i> compliance at the consolidated level – for example, in cases where the <i>Shari’ah</i> is being interpreted differently across jurisdictions.
Principle 13: Home–host relationships	<ul style="list-style-type: none"> ■ Home and host supervisors of cross-border banking groups share information and cooperate for effective supervision of the group and group entities, and effective handling of crisis situations. Supervisors require the local operations of foreign banks to be conducted to the same standards as those required of domestic banks. 	<ul style="list-style-type: none"> ■ This principle is equally applicable to the IIFS; however, one new essential criterion is needed for effective supervisory oversight, as indicated below. ■ Home and host supervisory authorities provide each other with appropriate information regarding their treatment of IAHS, <i>Shari’ah</i> governance and <i>Shari’ah</i> issues, and, where appropriate, the treatment of Islamic windows. ■ More details are provided in IFSB-16. IFSB-16 highlighted various approaches with respect to home–host supervisory issues, basically in relation to home–host supervision, supervisory college and windows operations.

**Table 2.4.2: Applicability of BCBS Principles to the IIFS
(Part B - Prudential regulations and requirements)**

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
B. Prudential regulations and requirements		
<p>Principle 14: Corporate governance</p>	<ul style="list-style-type: none"> ■ The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organisational structure, control environment, responsibilities of the banks' Boards and senior management, and compensation. ■ These policies and processes are commensurate with the risk profile and systemic importance of the bank. 	<ul style="list-style-type: none"> ■ Generally, Principle 14, including the essential criteria and additional criterion, is applicable to IIFS. ■ The IFSB has issued IFSB-3: <i>Guiding Principles on Corporate Governance</i>, December 2006, which covers the specificities of IIFS – in particular, the role of the SSB and the Governance Committee to safeguard the interests of the IAHS. “Fit and proper” tests for the SSB are also relevant. ■ The general elements of governance taking into account the specificities of IIFS can be added as new essential criteria: <ul style="list-style-type: none"> ○ compliance with <i>Shari'ah</i> rules and principles and the role of the SSB in the governance ○ enforcements of relevant <i>Shari'ah</i> audits standards – internal audit and/or external <i>Shari'ah</i> audit ○ the rights of the IAHS: processes and controls in IIFS (such as a Governance Committee⁶) for protecting their rights ○ transparency of financial reporting in respect of investment accounts ■ In addition, the supervisory authority should hold regular discussions involving the BOD, the Audit Committee and the SSB, including a combined meeting with all parties present at the same time. This can be added as a new essential criterion, and reference to IFSB-16 can be made. ■ Existing Additional Criterion 1 can be extended to cover SSB members.

⁶ A Governance Committee is another board committee, comprising at least three members, as recommended in IFSB-3, and specifically mandated to protect the interests of the IAHS. Three members include: (i) a member of the Audit Committee; (ii) a *Shari'ah* scholar (possibly from the IIFS's SSB); and (iii) a non-executive director (selected based on the director's experience and ability to contribute to the process).

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 15: Risk management process</p>	<ul style="list-style-type: none"> ■ The supervisors determine that banks have a comprehensive risk management process, to identify, measure, evaluate, monitor, report, and control or mitigate all material risks on a timely basis and to assess the adequacy of the banks' capital and liquidity in relation to their risk profile and market and macroeconomic conditions. This extends to development and review of contingency arrangements (including robust and credible recovery plans where warranted) that take into account the specific circumstances of the bank. The risk management process is commensurate with the risk profile and systemic importance of the bank. 	<ul style="list-style-type: none"> ■ Generally, Principle 15, including the essential criteria and additional criterion, is applicable to IIFS. ■ In addition to adding a new essential criterion based on the analysis below, existing essential criteria can be extended and modified to cover the risk management process of the IIFS. ■ The IFSB has issued comprehensive guidance on risk management for IIFS in a document entitled <i>Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering Only Islamic Financial Services (IFSB-1)</i>. This document outlines a set of principles applicable to the following six categories of risks – namely, credit risk, market risk, equity investment risk, liquidity risk, rate-of-return risk (covering DCR), and operational risk (covering <i>Shari'ah</i> non-compliance risk, fiduciary risk). In addition to these risks, IFSB-1 also recommends IIFS to recognise and evaluate the overlapping nature and transformation of risks that exist between the above-mentioned risks. The document also outlines the role of the supervisory authority in respect of how the IIFS should manage these risks. ■ In addition to the common risks such as market, credit and operational risk, a number of risks associated with IIFS's operations such as <i>Shari'ah</i> non-compliance risk, fiduciary risk, DCR, etc., are relevant. ■ IFSB-16 has covered the new dimensions of the risk management process, including enterprise risk management (ERM), the requirement for a Chief Risk Officer, and sound stress testing practices within the IIFS. A reference to this document can be made in new essential criteria. ■ IFSB-13: <i>Guiding Principles on Stress Testing for IIFS</i>, March 2012, has also been issued.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 16: Capital adequacy</p>	<ul style="list-style-type: none"> ■ The supervisors set prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. ■ The supervisors define the components of capital, bearing in mind their ability to absorb losses. ■ At least for internationally active banks, capital requirements are not less than the applicable Basel standards. 	<ul style="list-style-type: none"> ■ Generally, Principle 16, including the essential criteria and additional criterion, is applicable to IIFS. ■ In addition to adding new essential criteria, existing essential criteria can be extended and modified to cover the capital adequacy approach that reflects the extent of risk-sharing between IIFS' own capital (shareholders' funds) and that of the IAHs, and the resultant levels of DCR and alpha factor. ■ Principle 16 covers both Pillar 1 and Pillar 2 aspects of capital adequacy. For Pillar 1, IFSB-15: <i>Revised Capital Adequacy Standard</i> captures the Basel II and Basel III requirements. For Pillar 2, reference to IFSB-16 can be made. ■ The following particular criteria can be discussed: <ul style="list-style-type: none"> ○ The components of capital (in particular, for components other than common equity), as well as regulatory adjustments and deductions attached to these components as reflected in IFSB-15, which comply with <i>Shari'ah</i> rules and principles. ○ Application of the capital conservation buffer, countercyclical buffer and leverage ratio for IIFS, keeping in mind IIFS' balance sheet structures and specificities in regard to these requirements. ○ The profit-sharing and loss-bearing nature of a profit-sharing investment account (PSIA) may call for a partial or complete deduction of risk-weighted assets funded by PSIA from the calculation of capital adequacy ratio (CAR). This is covered in IFSB-15. ○ Smoothing practices for PSIA can change the calculation formula for CAR, due to transfer of risk to shareholders. This is covered in IFSB GN-3 and GN-4. ○ The supervisors set prudent and appropriate requirements with regards to equity investment (<i>Mudārabah</i>, <i>Musharakah</i> and <i>Sukūk</i>) and its impact on IIFS' capital. ■ For a forward-looking approach to capital management, reference to IFSB-13: <i>Guiding Principles on Stress Testing for IIFS</i>, March 2012, can be made.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 17: Credit risk</p>	<ul style="list-style-type: none"> ■ The supervisors determine that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions. ■ This includes prudent policies and processes to identify, measure, evaluate, monitor, report, and control or mitigate credit risk (including counterparty credit risk) on a timely basis. ■ The full credit life cycle should be covered, including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios. 	<ul style="list-style-type: none"> ■ Principle 17, including the essential criteria, is applicable to IIFS with some modifications, as some of the issues (such as derivatives transactions, securities financing activities, types of collateral) do not apply to IIFS. There are additional aspects (as mentioned below) which can be added in existing essential criteria. ■ The detailed guidance on credit risk is provided in IFSB-1: <i>Guiding Principles on Risk Management</i>, issued in 2005. Four principles on credit risk covered in IFSB-1 capture in detail the unique aspects relating to IIFS, and IFSB-15 addresses the capital requirements for credit risk. ■ In existing essential criteria, the discussion can be included in the following aspects relating to credit risk: <ul style="list-style-type: none"> ○ A well-documented and effectively implemented strategy and sound policies and processes in compliance with <i>Sharī'ah</i> rules and principles for assuming credit risk, without undue reliance on external credit assessments. ○ Development and implementation of appropriate risk measurement and reporting methodologies relevant to each Islamic financing instrument in respect of managing their counterparty risks, which may arise at different contract stages (including counterparty performance risk in <i>Salām</i> and <i>Istisnā'</i> contracts). ○ The importance of <i>Sharī'ah</i>-compliant credit risk mitigating techniques (including permissible and enforceable collateral and guarantees) appropriate for each Islamic financing instrument. ■ In the credit risk, the risk assessment and measurement processes undertaken by IIFS shall also be applicable to profit-sharing assets (<i>Muḍārabah</i> and <i>Mushārah</i>) which are classified under equity investments. Rigorous risk evaluation (including due diligence) and controls of these investments are necessary in view of their exposure to capital impairment. ■ For additional aspects of stress testing relating to credit risk, reference to IFSB-13: <i>Guiding Principles on Stress Testing</i> can be made.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 18: Problem assets, provisions and reserves</p>	<ul style="list-style-type: none"> ■ The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves. 	<ul style="list-style-type: none"> ■ Principle 18, including the essential criteria, is applicable to IIFS with some modifications to existing essential criteria and further essential criteria to address some of the issues, such as setting appropriate measures for early settlements, which are permissible under their <i>Shari'ah</i> rules and principles, for each Islamic financing instrument. ■ Although this issue on problem assets is not discussed in IFSB-5, recent development of Islamic finance shows its importance to the IIFS operation. It is noted that some BCBS discussion may not be relevant to IIFS, such as credit derivatives as risk mitigants. However, other issues (such as policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves) seem to be necessary for the IIFS to address at an early stage. Therefore, these issues may be included in the CPIFR. ■ There are issues related to problem assets due to trading or discounting. Also, the right to claim the asset depends on the ownership of assets. ■ The IIFS have specific reserves, namely the profit equalisation reserve (PER) and investment risk reserve (IRR). These reserves are not directly concerned with credit risk exposures, which should be covered by loss provisions, but may cushion the effects on IAH when the loss provisions prove to be inadequate. ■ Both administrative and financial measures for early settlements, which are permissible under their <i>Shari'ah</i> rules and principles for each Islamic financing instrument, are outlined in Principle 2.4 of IFSB-1. ■ Referring to criterion 5 of the BCPs, the prohibition of <i>Riba</i> does not allow IIFS to refinance debts on the basis of renegotiated higher mark-up rates. Debt rescheduling or restructuring arrangements (without an increase in the amount of the debt) are allowed.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 19: Concentration risk and large exposure limits</p>	<ul style="list-style-type: none"> ■ The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report, and control or mitigate concentrations of risk on a timely basis. ■ Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties. 	<ul style="list-style-type: none"> ■ The principle is equally applicable to IIFS. However, one further essential criterion relating to significant risk concentrations within the assets financed through the UPSIAs can be added to the principle, as excessive risk concentration within the assets financed through UPSIAs might put the IIFS in breach of its fiduciary duties to IAH.
<p>Principle 20: Transactions with related parties</p>	<ul style="list-style-type: none"> ■ In order to prevent abuses arising in transactions with related parties and to address the risk of conflict of interest, the supervisor requires banks to enter into any transactions with related parties on an arm's-length basis; to monitor these transactions; to take appropriate steps to control or mitigate the risks; and to write off exposures to related parties in accordance with standard policies and processes. 	<ul style="list-style-type: none"> ■ Principle 20 is generally applicable to IIFS; however, members of the SSB should be included within the definition of related parties. ■ IFSB-5 and IFSB-16 provide recommendations on related party transactions. According to IFSB-5 and IFSB-16, the definitions of related parties and related party transactions are similar to those given in international accounting standards (such as IAS 24) and by the BCBS. ■ Specific to IIFS, <i>Sharī'ah</i> advisers/ members of the SSB of the IIFS are also recognised as related parties to an IIFS as they have the authority to approve or disapprove products and operations and have access to inside information. A family member or close associate of a member of the BOD or senior managements, or of a <i>Sharī'ah</i> advisor or external auditor, may also be considered to be a related party. ■ Related party transactions include on-balance sheet and off-balance sheet credit exposures and claims, as well as dealings such as service contracts, asset purchases and sales, construction contracts, lease (<i>Ijārah</i>) contracts, borrowings and write-offs.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 21: Country and transfer risks</p>	<ul style="list-style-type: none"> ■ The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate country risk and transfer risk in their international lending and investment activities on a timely basis. 	<ul style="list-style-type: none"> ■ This principle is applicable to IIFS.
<p>Principle 22: Market risk</p>	<ul style="list-style-type: none"> ■ The supervisor determines that banks have an adequate market risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions and the risk of a significant deterioration in market liquidity. ■ This includes prudent policies and processes to identify, measure, evaluate, monitor, report, and control or mitigate market risks on a timely basis. 	<ul style="list-style-type: none"> ■ The principle, including the essential criteria, is applicable to IIFS with some modifications. ■ Detailed guidance on market risk is provided in IFSB-1: <i>Guiding Principles on Risk Management</i>, issued in 2005. One principle on market risk covered in IFSB-1 discusses in detail the unique aspects relating to IIFS, and IFSB-15 addresses the capital requirements for market risk. ■ Within market risk, IIFS's policies and processes establish an appropriate and properly controlled market risk environment in compliance with <i>Shari'ah</i> rules and principles, including the impact of market risk on IAH. This includes guidelines governing risk-taking activities in different portfolios of restricted IAH and their market risk limits. ■ For additional aspects of stress testing relating to market risk, a reference to IFSB-13: <i>Guiding Principles on Stress Testing</i> can be made.
<p>Principle 23: Interest rate risk in the banking book</p>	<ul style="list-style-type: none"> ■ The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report, and control or mitigate interest rate risk in the banking book on a timely basis. These systems take into account the bank's risk appetite, risk profile, and market and macroeconomic conditions. 	<ul style="list-style-type: none"> ■ The BCBS treats interest rate risk in the banking book under Pillar 2 of the framework. However, it is important to underline that interest rate risk is not applicable to IIFS; rather, it is <i>rate-of-return risk</i> that is applicable. ■ In IIFS, there are two types of rate-of-return risk: ROR risk as a form of market risk on assets such as <i>Sukūk</i>; and ROR risk in the banking book, which affects longer-tenor assets with fixed returns while the liabilities side of the balance sheet (IH, etc.) requires returns reflecting current market rates – an ALM issue.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
		<ul style="list-style-type: none"> <li data-bbox="664 352 1115 504">■ In IIFS, ROR risk arises from the possible impact on the net income of the IIFS arising from the effect of changes in the market rates and relevant benchmark rates on the returns on assets and on the returns payable on funding. <li data-bbox="664 529 1115 681">■ ROR risk differs from interest rate risk in that IIFS are concerned with the returns on their investment activities at the end of the investment holding period and with the impact on net income after the sharing of returns with IAH. <li data-bbox="664 706 1115 1024">■ ROR risk in the banking book leads to DCR if the IIFS absorbs all or part of any shortfall in the returns payable to IAH by reducing its <i>Muḍārib</i> share or by donation from the shareholders' share of income. DCR refers to the magnitude of risks that are transferred to shareholders in order to cushion the IAH from bearing the effects of volatility of returns on the assets in which their funds are invested, to which they are contractually exposed in <i>Muḍārabah</i> funding contracts (see IFSB-1 for details). <li data-bbox="664 1049 1115 1328">■ Based on <i>Sharī'ah</i> principles, profit rate earned on assets, in particular for the assets through <i>Murābahah</i> or any sale-based contract, cannot be increased because the price has been fixed on the basis of the mark-up rates of the previous period under sale contracts. This means that any increase in new earnings has to be shared with IAH, but cannot be readjusted on the assets side by repricing the receivables at higher rates. <li data-bbox="664 1353 1115 1467">■ IFSB-5 did not cover this aspect; however, IFSB-16 has provided guidance on this issue, which can be referred to while establishing the essential criteria for IIFS. <li data-bbox="664 1492 1115 1645">■ In addition, it is proposed that this principle be replaced with <i>rate-of-return risk</i>, which can cover, <i>inter alia</i>, the issues relating to ROR risk in the banking book. This proposed principle is presented later in the section.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 24: Liquidity risk</p>	<ul style="list-style-type: none"> ■ The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements, or both) for banks that reflect the liquidity needs of the bank. ■ The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report, and control or mitigate liquidity risk over an appropriate set of time horizons. ■ At least for internationally active banks, liquidity requirements are not lower than the applicable Basel standards. 	<ul style="list-style-type: none"> ■ The principle is applicable to IIFS in its entirety, including the essential criteria and additional criterion. ■ IFSB-12: <i>Guiding Principles on Liquidity Risk Management for IIFS</i> outlines a set of guiding principles for the robust management of liquidity risk by IIFS and their supervision and monitoring by supervisory authorities, taking into consideration the specificities of IIFS. ■ Apart from the guidance to IIFS in a number of key areas in their management of liquidity risk, IFSB-12 also emphasises the importance of supervisory authorities assessing the adequacy of an IIFS's liquidity risk management framework. ■ For liquidity risk-related stress testing, a reference to IFSB-13: <i>Guiding Principles on Stress Testing</i> can be made. ■ The IFSB is working on the preparation of supplementary guidance to IFSB-12 on the quantitative elements of Basel III, namely the LCR and the NSFR, in the form of <i>Guidance Note on Quantitative Measures for Liquidity Risk Management in IIFS</i>. ■ With respect to <i>Sharī'ah</i>-compliant lender-of-last-resort facilities (SLOLR), the IFSB has prepared a Working Paper entitled <i>Working Paper on Strengthening the Financial Safety Net: The Role of Sharī'ah-compliant Lender-of Last-Resort (SLOLR) Facilities as an Emergency Financing Mechanism, April 2014</i>.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 25: Operational risk</p>	<ul style="list-style-type: none"> ■ The supervisor determines that banks have an adequate operational risk management framework that takes into account their risk appetite, risk profile, and market and macroeconomic conditions. ■ This includes prudent policies and processes to identify, assess, evaluate, monitor, report, and control or mitigate operational risk on a timely basis. 	<ul style="list-style-type: none"> ■ The principle is applicable to IIFS in its entirety, including the essential criteria and additional criterion. ■ There will be some additions to the essential criteria, as reflected below. ■ The detailed guidance on operational risk is provided in IFSB-1: <i>Guiding Principles on Risk Management</i>, issued in 2005. Two principles on operational risk covered in IFSB-1 address in detail the unique aspects relating to IIFS, and IFSB-15 addresses the capital requirements for operational risk. ■ According to IFSB-1, IIFS are required to consider the full range of material operational risks, including in particular possible weaknesses in internal systems for <i>Shari'ah</i> compliance and the failure in their fiduciary responsibilities. ■ Some of the further essential criteria under operational risk may include: <ul style="list-style-type: none"> ○ Supervisor determines that IIFS comply at all times with the <i>Shari'ah</i> rules and principles as determined by the relevant body in the jurisdiction in which they operate with respect to their products and activities. ○ Supervisor determines that IIFS keep track of income not recognised arising out of <i>Shari'ah</i> non-compliance and assess the probability of similar cases arising in the future. Based on historical reviews and potential areas of <i>Shari'ah</i> non-compliance, the IIFS may assess potential profits that cannot be recognised as eligible IIFSs' profits. ○ The supervisory authority should prescribe formal guidance for IIFS to ensure they fulfil their fiduciary duties towards their IAH. This matter is proposed under a new principle on IAHs later in the section. ○ Supervisor determines that an IIFS considers <i>Shari'ah</i> non-compliance risk as part of operational risk under ICAAP.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 26: Internal control and audit</p>	<ul style="list-style-type: none"> ■ The supervisor determines that banks have adequate internal control frameworks to establish and maintain a properly controlled operating environment for the conduct of their business taking into account their risk profile. ■ These include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations. 	<ul style="list-style-type: none"> ■ The principle is applicable to IIFS with some additions with respect to guidelines on <i>Shari'ah</i> compliance and internal and/or external <i>Shari'ah</i> audits. ■ IFSB-5 and IFSB-16 discuss the role of internal audit and compliance. Reference to these documents can be made while establishing additional criteria for IIFS. ■ Two new essential criteria can be added, as follows: <ul style="list-style-type: none"> ○ A <i>Shari'ah</i> compliance review to be undertaken at least annually by an IIFS, performed either by a separate <i>Shari'ah</i> control department or as part of the existing internal and external audit function by persons having the required knowledge and expertise for the purpose. ○ When assessing the effectiveness of the control (including internal audit) and compliance functions of the IIFS and its external audit, the supervisory authority to hold discussions with the IIFS's compliance function to assess its role, authority and effectiveness, and with its internal and external auditors and its Audit Committee regarding the audit scope and recent audit findings.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 27: Financial reporting and external audit</p>	<ul style="list-style-type: none"> ■ The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally, and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. ■ The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function. 	<ul style="list-style-type: none"> ■ The essential criteria and additional criterion outlined in the principle are broadly applicable to IIFS. ■ Accounting and auditing is not the mandate of the IFSB. Therefore, there is no document issued by the IFSB on this issue; rather, in many cases, a reference to international accounting standards is made in IFSB standards.

BCBS Core Principles Reference	Description of the BCBS Core Principles	Applicability to IIFS
<p>Principle 28: Disclosure and transparency</p>	<ul style="list-style-type: none"> ▪ The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies, and corporate governance policies and processes. 	<ul style="list-style-type: none"> ▪ The principle is equally applicable to IIFS with some modifications in the list of disclosure requirements as set out in IFSB-4: <i>Disclosures to Promote Transparency and Market Discipline</i> complementing Basel II Pillar 3. ▪ It is important that an IIFS's financial reporting should include information about its investment performance as manager of IAHS' funds in a form that the IAHS can readily understand. Such information, provided accurately and reliably and on a timely basis, is vital not only for protecting the interests of the IAHS but also for promoting systemic stability. The information is likely to enhance incentives for the IIFS as the <i>Muḍārib</i> or <i>Wakeel</i> to operate prudently in order to maintain the IAHS' confidence. ▪ IFSB-4 discusses the above and can be referred to as a key reference for establishing the essential criteria for IIFS.
<p>Principle 29: Abuse of financial services</p>	<ul style="list-style-type: none"> ▪ The supervisor determines that banks have adequate policies and processes, including strict customer due diligence rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities 	<ul style="list-style-type: none"> ▪ The issue of abuse of financial services is equally applicable to IIFS.

2.4.1 Gaps Summary and Relevance of Current IFSB Publications

Supervisory powers, responsibilities and functions

37. Table 2.4.1 delineated Core Principles covering supervisory powers, responsibilities and functions, and tested their applicability to Islamic banking supervisors and the potential areas that need more attention. It raised a number of important issues for the supervisory authorities. Areas of concern include licensing, methods for evaluating the quality of the supervisory system, supervisory techniques and tools, consolidated supervision and home–host relationships.
38. Since the last GFC, much attention has been focused on strengthening the role of supervisors. The same core principles are applicable to the supervisors in Islamic finance, since the role of supervisors is similar regardless of whether the system is Islamic or conventional; however, when it comes to detailed functions, the scope may differ in some issues that are unique to Islamic finance.
39. The IFSB SGPs have addressed some of the areas covered in this section, notably in IFSB-16: *Revised Supervisory Review Process Standard*. However, addressing other issues relevant to this section has not been a priority, partly because in this area there are relatively few specificities of Islamic finance.

Prudential and regulatory requirements

40. Table 2.4.2 discussed the Core Principles covering prudential requirements, and their application to IIFS. This segment dealt with supervisory expectations of banks and the type of prudential regulations and requirements to be adopted and complied with by banks. In this respect, the IFSB has issued a wide spectrum of SGPs covering regulatory requirements in relation to prudential aspects – namely, risk management, capital adequacy, liquidity risk management, stress testing, corporate governance, transparency and market discipline, and *Sharī'ah* governance. Moreover, the IFSB has issued a number of Guidance Notes, as presented in Table 2.2.1 above, dealing with technical issues such as risk management and capital adequacy standards specifically for commodity *Murābahah* transactions (CMT), and the practice of smoothing the profits payout to IAH.
41. The publications as outlined in section 2.2 will support the proposed standard by assessing the prudential framework of the IFSI in various jurisdictions, and will assist in strengthening the supervisory framework for IIFS and safeguarding the interests of stakeholders of the IFSI.

2.4.2 Additional Proposed Principles for IIFS

42. Following the above detailed analysis of the Core Principles, the following indicative drafts show how some of the issues identified might be embraced within additional principles.

Table 2.4.2.1: Additional Proposed Principles for IIFS

No.	Principle Area	Brief Description
1.	Principle 1: <i>Shari'ah</i> governance framework	<ul style="list-style-type: none"> <li data-bbox="405 605 1112 776">▣ IIFS are under an obligation to ensure that their products and services comply with <i>Shari'ah</i> rules and principles. For this purpose, IIFS rely on the governance process and internal controls. In all aspects of IIFS operations, including products and services, a governance structure, policies and procedures must exist to ensure that the <i>Shari'ah</i> rules and principles are adhered to at all times. <li data-bbox="405 805 1112 976">▣ This is one of the important issues and should be part of the proposed CPIFR. This principle will be widely applied to other principles, which would require cross-referencing the essential criteria within the CPIFR as the compliance with <i>Shari'ah</i> rules and principles would entail greater emphasis on the systematic assessment of the operations of the IIFS in order to avoid fiduciary risk and resultant reputational risk. <li data-bbox="405 1005 1112 1100">▣ The IFSB's guiding principles on <i>Shari'ah</i> governance (IFSB-10) address the components of a sound <i>Shari'ah</i> governance system, especially with regard to the competence, independence, confidentiality and consistency of <i>Shari'ah</i> boards. <li data-bbox="405 1129 1112 1252">▣ The supervisory authority should ensure that an IIFS has in place a comprehensive framework dealing with various issues such as hiring and dismissing <i>Shari'ah</i> scholars, checking accountability and integrity (fit and proper test), and any potential for conflicts of interest. <li data-bbox="405 1281 1112 1500">▣ The supervisory authority should satisfy itself that an IIFS's <i>Shari'ah</i> governance system covers the relevant <i>ex-ante</i> and <i>ex-post</i> processes. Furthermore, the role of the internal <i>Shari'ah</i> compliance unit/department and internal <i>Shari'ah</i> review/audit unit/department is also important to be highlighted, in order to check whether internal control and compliance procedures within an IIFS have been appropriately followed and that applicable rules and regulations to which the IIFS is subject have been complied with. <li data-bbox="405 1528 1112 1624">▣ The SSB should be provided with full information on any product or transaction on which a pronouncement is sought, including having its attention drawn to any areas of possible difficulty identified to the IIFS's managements.

2.	<p>Principle 2: Treatment of investment account holders</p>	<ul style="list-style-type: none"> ■ A salient issue for supervisory authorities is the treatment of IAH, and more particularly unrestricted IAH. The application of this principle is expected to be broadly applicable to other principles, which would require cross-referencing the essential criteria within the CPIFR. Various aspects of the IAH can be discussed in the essential criteria, and these aspects of IAH can be developed further in the principles dealing with corporate governance, capital adequacy, ROR risk, and transparency and market discipline. Some of the issues are reflected below. ■ In the current practice, the treatment of UIAH, under a <i>Muḍārabah</i> contract, for the calculation of CAR varies from jurisdiction to jurisdiction. For instance, in some jurisdictions, UIAH are treated like investors who bear all the earnings volatility and risks of losses on their investment accounts (absent misconduct or negligence on the part of the IIFS). In such cases, the (credit and market risk-weighted) assets financed by the funds of the IAH are excluded from the denominator of the capital adequacy formula. ■ By contrast, in some jurisdictions IAH are treated like a liability of the IIFS, which therefore bears the risk of the assets funded by IAH. ■ In other jurisdictions, IAH are only partially risk absorbent, so that the IIFS bears part of the earnings volatility of the assets funded by their investment. In such a case, IIFS include a corresponding proportion (known as “alpha” (α)) of the credit and market risk-weighted assets financed by UIAH in the denominator of the capital adequacy formula. Such smoothing practices are not normally employed in the case of restricted IAH (RIAH), but where they are, RIAH should be treated for capital adequacy purposes similarly to UIAH. ■ In some countries, IIFS maintain one or both of two types of prudential reserves, as part of their strategy for mitigating DCR, PER and IRR. If the use of such reserves is not adequately controlled by the supervisory authority, the consequence is an “intergenerational” problem for IAH, since the existing IAH are disadvantaged by appropriations from their share of profits (and hence reductions in their profit payouts) made in order to benefit future IAH by smoothing or enhancing their profit payouts. ■ For issues in relation to the smoothing mechanism of IAH’s returns, refer to IFSB’s GN-3: <i>Guidance Note on the Practice of Smoothing the Profits Payout to IAH</i>, which highlights the various issues (such as capital adequacy, corporate governance, disclosures, etc.) related to smoothing triggered by various techniques, including forfeiting of the <i>Mudārib</i> share of profits, donation of profits by shareholders to IAH, maintenance of a PER and IRR by the IIFS, etc. ■ From the above, the principle might embrace the governance issue for PSiAs as well as capital adequacy issues. Adequate guidance for IIFS to ensure they fulfill their fiduciary duties towards their IAHs is an important consideration. Also during the insolvency or liquidation of the IIFS, the contractual rights of the parties, including UIAHs, need to be understood and considered in the principle.
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		<ul style="list-style-type: none"> ■ Where real estate investment is permissible, supervisory authorities' role in imposing prudential limits on the percentage of a UIAH's funds that may be invested in real estate, and in stipulating single exposures within the jurisdiction, is also important to be captured within this proposed principle. ■ Other aspects of PSIAs (e.g. cross-sectoral issues): With respect to cross-sectoral issues, there are particular issues attached to the relationship between PSIAs in the banking sector, and Islamic collective investment schemes (ICIS) in the capital markets sector, which share some characteristics and to which similar principles might apply. Restricted investment accounts, for example, are akin to collective investment schemes, which are normally supervised by the securities market supervisor.
3.	<p>Principle 3: Equity investment risk</p>	<ul style="list-style-type: none"> ■ Issues pertaining to the management of risks inherent in the holding of equity instruments, including <i>Muḍārabah</i> and <i>Mushārah</i> investments in the banking book (i.e. financing on a profit-and-loss sharing basis), for investment purposes should also be captured in the CPIFR. ■ According to IFSB-1, IIFS shall define and set the objectives of, and criteria for, investments using profit-sharing instruments, including the types of investment, tolerance for risk, expected returns and desired holding periods. For example, a <i>Mushārah</i> structure may contain an option for redemption whereby the IIFS as financiers have a contractual right to require their partner periodically to purchase, under a separate contract, a proportion of the IIFS's share in the investment at net asset value or, if the contract so specifies, on some agreed basis (diminishing <i>Mushārah</i>). ■ There is a need for supervisors to ensure that IIFS keep under review policies, procedures and an appropriate management structure for evaluating and managing the risks involved in the acquisition of, holding and exiting from profit-sharing investments. IIFS shall ensure that proper infrastructure and capacity are in place to monitor continuously the performance and operations of the entity in which IIFS invest as partners. These should include evaluation of <i>Shar'ah</i> compliance, adequate financial reporting by, and periodical meetings with, partners, and proper record-keeping of these meetings. ■ The supervisory authority shall satisfy itself that adequate policies and procedures are in place for equity investment risk management, taking into account the IIFS's appetite and tolerance for risk. ■ In addition, the supervisory authority shall ensure that IIFS have sufficient capital when engaging in equity investment activities. This should be dealt with through the risk weightings and CAR calculation. The supervisor will check that minimum capital requirements are met. Furthermore, in the case of <i>Mushārah</i> or <i>Muḍārabah</i> contracts, the supervisory authority should provide specific guidance on the slotting method (as an alternative to the simple risk-weight method) for specialised financing.

		<ul style="list-style-type: none"> ▣ The supervisory authority may develop regulatory guidelines for measuring, managing and reporting the risk exposures when dealing with non-performance investments and providing provisions according to the <i>Shari'ah</i> rules and regulations.
4.	<p>Principle 4: Rate-of-return risk</p>	<ul style="list-style-type: none"> ▣ This additional principle is aimed to replace the existing BCP 23 (interest rate risk). Some detail on this proposed principle is provided in Table 2.4.2 above. ▣ According to IFSB-16, ROR risk in the banking book of an IIFS (which is an analogue of interest rate risk in the banking book in conventional banks as defined by the BCBS) arises from the possible impact on the net income and cash flow of the IIFS arising from the effect of changes in the market rates and relevant benchmark rates on the returns on assets and on the returns payable on funding. ROR risk leads to DCR if the IIFS absorbs all or part of any shortfall in the returns payable to IAH by reducing its <i>Muḍārib</i> share or by donation from the shareholders' share of income. ▣ IIFS tend to employ benchmark rates (e.g. LIBOR) to price their assets and investments. The yield of an IIFS's asset portfolio is mostly fixed; however, when the benchmark rates rise, the IAH tend to expect the rates of return on their investments to follow, giving rise to ROR risk. ▣ However, while IRR in the banking book typically has an impact on the fair values of a conventional bank's assets and liabilities, and hence on its capital, ROR risk in the banking book affects the yields of an IIFS's assets relative to the expected returns on its IAH funds, but does not directly impact its capital. Hence, the IFSB covered ROR risk in the banking book in its <i>Revised Capital Adequacy Standard</i> (IFSB-15) under the heading of "displaced commercial risk". In such a case, the supervisory approach is important because the effects of the IIFS's transactions tend to require an individual approach to review the IIFSs' portfolios, since they are exposed to market competition among themselves as well as the conventional banks, which leads to DCR. ▣ In this regard, a supervisory authority's assessment should be forward-looking by evaluating the possible factors in the risk profiles of an IIFS's portfolio over the coming period, and the extent to which control of DCR can help mitigate the ROR risk. ▣ The IFSB in its <i>Revised Supervisory Review Process Standard</i> (IFSB-16), under the heading of "Assessment of the Rate of Return Risk in Banking Book", has also outlined various implications, including a standardised benchmark rate shock on the banking book of this risk which can be included in CPIFR.

5.	<p>Principle 5: Islamic windows</p>	<ul style="list-style-type: none"> ■ The issue of Islamic banking “windows” is important. Islamic windows are present in a majority of the IFSB member jurisdictions⁷ where Islamic finance is operating, and the supervisory practices for regulating them – in particular, relating to capital requirements – vary considerably across jurisdictions. This diversity of windows’ operations raises a number of issues on supervision which are substantially the same as those raised by full-fledged IIFS. ■ As noted in the relevant IFSB standards, there are two types of window: “full” windows offering products on both sides of the balance sheet; and “asset-side only” windows offering <i>Shari’ah</i>-compliant financing products. Both of these fall under IFSB-5 on the supervisory review process, which has been revised (see IFSB-16). ■ The “full windows” raise issues of capital adequacy if the “parent” entity of which the window is essentially a branch is in another jurisdiction. There is also the issue of how IFSB-10 applies to such windows. ■ This principle can cover high-level requirements such as governance, risk management, internal controls, capital adequacy, etc. ■ How an Islamic window will be treated in liquidation or other insolvency, including the contractual rights of the window’s clients, including UIAHs, according to applicable law, is also an important consideration to be highlighted in CPIFR.
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⁷ A survey conducted by the IFSB found 160 Islamic windows (comprising 50 windows from one jurisdiction alone and 24 in another jurisdiction). The majority of these Islamic windows have been in operation for over 15 years in the respective jurisdiction.

SECTION 3: DETAILED GAP ASSESSMENT OF THE IAIS CORE PRINCIPLES FOR TAKĀFUL (ISLAMIC INSURANCE) SECTOR

3.1 Industry Development: *Takāful* Sector

43. *Takāful* remains the smallest segment of the IFSI despite notable developments in recent years. There were an estimated 133 *Takāful* operators in 2006, two-thirds of which are located in the GCC, South-East Asia and Africa. The number increased to 200 in 2012⁸ with new operators appearing in the GCC, the Levant and other jurisdictions.
44. Despite its relatively small market share as compared to its banking and capital market counterparts, the industry has witnessed growth since the first operator emerged in Sudan in 1979. In 2010, the global *Takāful* contributions reached USD8.3 billion.⁹ Although the actual to-date contribution is subject to uncertainty, the industry has estimated that the global total contribution increased to USD18.3 billion in 1H2013 with a CAGR of 18.06% between 2007 and 2012.
45. Presently, the *Takāful* market is highly concentrated across countries such as Malaysia and the GCC states. However, there are a number of other jurisdictions, such as Afghanistan, Azerbaijan and Kyrgyzstan, which are working to introduce regulatory frameworks to enable *Takāful* operators to set up operations in those jurisdictions.
46. Growth of the industry comes with its own set of challenges as the market evolves. While the demand side shows a significant expansion, the supply side faces continuing constraints. Issues regarding the solvency and risk management frameworks feature as key areas for attention by both market participants and regulators.
47. A specific issue for *Takāful* operators is the governance framework in place to accommodate the different incentives and interests of its disparate stakeholders for its Shareholders Fund (SHF) as well as Participants' Risk Fund (PRF)/Participants' Investment Fund (PIF). A clear separation of responsibilities towards each fund requires careful consideration to avoid any conflict of interest.
48. Another area of continuing debate is that of financial reporting of *Takāful* operators. Other issues derive from the structures commonly used within *Takāful* undertakings, and include the treatment of *Qarḍ*, as well as consolidation of both funds (SHF and PRF/PIF).

8 IFSB *Islamic Financial Services Industry Stability Report, 2014*.

9 Ernst & Young, *The World Takaful Report, 2012*.

3.2 The IFSB's Role in the *Takāful* Sector

49. The IFSB's role in promoting the stability of the *Takāful* sector was initiated in 2006, when both the IFSB as well as the International Association of Insurance Supervisors jointly issued a paper titled *Issues in Regulation and Supervision of Takāful (Islamic Insurance)*. This joint paper highlights the Insurance Core Principles (ICPs) produced by the IAIS in October 2003 and matched its relevance to the *Takāful* industry. The issues faced by the *Takāful* industry were consequently grouped into four major themes:
- Theme 1: Corporate Governance
 - Theme 2: Financial and Prudential Regulation
 - Theme 3: Transparency, Reporting and Market Conduct
 - Theme 4: Supervisory Review Process
50. The work of the IFSB for the *Takāful* sector has since followed the four major themes proposed by this joint paper with the issuance of:
- a) IFSB-8: *Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings* (December 2009);
 - b) IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings* (December 2010);
 - c) GN-5: *Guidance Note on the Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on Takāful and ReTakāful Undertakings* (March 2011); and
 - d) IFSB-14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings* (December 2013).
51. In addition, the Council in its 23rd meeting held on 10 December 2013 in Doha, Qatar, approved the formation of a working group to develop a standard on *ReTakāful* (Islamic reinsurance) undertakings.

3.3 IAIS's Insurance Core Principles

52. The International Association of Insurance Supervisors, established in 1994, represents more than 200 jurisdictions in almost 140 countries. Documents issued by the IAIS since then have been based on a set of insurance core principles which were first introduced in 2003.
53. In 2011, the IAIS undertook a revision of the ICPs. A further minor amendment, affecting ICP 9 only, was made in 2012. The revision brought into the ICPs essentially all the material from previous IAIS Standards and Guidance Papers. The *Insurance Core Principles, Standards, Guidance and Assessment Methodology* issued to date have the following hierarchical structure:
- ICP statement: numbered and presented in a box with bold font
 - Standards: linked to an ICP statement and presented in bold font

with the number of the applicable principle statement followed by the standard number. For example, the second standard under ICP 3 appears as 3.2.

- Guidance material: presented in regular font (e.g. the second paragraph of guidance under Standard 1.3 appears as 1.3.2).

54. There are also a set of preconditions for effective insurance supervision, similar but not identical to those in the BCP. The incorporation of the existing material has led to the current ICP document being substantially longer and more detailed than the corresponding documents from the BCBS and IOSCO.

3.4 Core Principles and Assessment Methodologies

Assessment Methodologies

55. The assessment methodology depends on assessing each of the individual standards. Each standard needs to be considered using five categories.
- Observed:** Supervisor has the authority to perform its tasks and it exercises this authority to a satisfactory level.
 - Largely Observed:** Only minor shortcomings exist which do not raise any concerns about the supervisor's ability to achieve full observance with the standard.
 - Partly Observed:** Despite progress, the shortcomings are sufficient to raise doubts about the supervisor's ability to achieve observance.
 - Not Observed:** No substantive progress towards observance has been achieved.
 - Not Applicable:** The standard does not apply given the structural, legal and institutional features of a jurisdiction.

The assessment at standard level then feeds into the assessment at principle level, as follows:

Assessment of Principles

- Observed:** All the standards under ICP have been observed OR all standards are observed except for some that are not applicable.
- Largely Observed:** Only minor shortcomings exists which do not raise any concerns about the supervisor's ability to achieve full observance with the ICP.
- Partly Observed:** Despite progress, the shortcomings are sufficient to raise doubts about the supervisor's ability to achieve observance.
- Not Observed:** No substantive progress towards observance has been achieved.
- Not Applicable:** Standards are not applicable.

3.5 Analysis of the ICPs for Islamic Finance

56. The next section will discuss the 2012 ICPs further to identify how far they may be applied to the supervision of *Takāful*, as well as the type of changes or additions that may be required to be done to the IAIS ICPs for this purpose, taking into consideration the specificities of *Takāful*.
57. There are four columns to Table 3.5.1. The first column provides the 2012 ICP numbers. The second column provides the numbering of the standard belonging to each ICP in the first column. The third column provides a description of each standard, while the fourth column provides an explanation on whether modification will be required for the *Takāful* sector.

Table 3.5.1: Applicability of the IAIS CPs to *Takāful*

ICPs and Standards		Assessment Criteria	
		IAIS	Applicability to <i>Takāful</i>
<p>ICP 1 Objectives, Powers and Responsibilities of the Supervisor</p> <p>The authority (or authorities) responsible for insurance supervision and the objectives of insurance supervision are clearly defined.</p>			
Standard	1	Primary legislation clearly defines the authority (or authorities) responsible for insurance supervision.	Applicable to <i>Takāful</i> .
	2	Primary legislation clearly defines the objectives of insurance supervision and the mandate and responsibilities of the supervisor and gives the supervisor adequate powers to conduct insurance supervision, including powers to issue and enforce rules by administrative means and take immediate action.	Applicable to <i>Takāful</i> .
	3	The principal objectives of supervision promote the maintenance of a fair, safe and stable insurance sector for the benefit and protection of policyholders .	Applicable to <i>Takāful</i> .
	4	Where, in the fulfilment of its objectives, the supervisor identifies conflicts between legislation and supervisory objectives , the supervisor initiates or proposes correction in legislation.	Applicable to <i>Takāful</i> .
<p>ICP 2 Supervisor</p> <p>The supervisor, in the exercise of its functions and powers:</p> <ul style="list-style-type: none"> ○ is operationally independent, accountable and transparent ○ protects confidential information ○ has appropriate legal protection ○ has adequate resources ○ meets high professional standards 			
Standard	1	The governance structure of the supervisor is clearly defined . Internal governance procedures, including internal audit arrangements, are in place to ensure the integrity of supervisory actions. There is effective communication and prompt escalation of significant issues to appropriate levels within the supervisor. The decision-making lines of the supervisor are structured in such a way that action can be taken immediately in the case of an emergency.	Applicable to <i>Takāful</i> . It may be worth considering whether the possibility of the supervisor's having a <i>Shari'ah</i> Advisory Body should be mentioned. If so, some of the following standards might also be applicable to members of that body.

2	There are explicit procedures regarding the appointment and dismissal of the head of the supervisor and members of its governing body , if such a governing body exists. When the head of the supervisor or members of its governing body are removed from office, the reasons are publicly disclosed.	Applicable to <i>Takāful</i> .
3	The institutional relationships between the supervisor and the executive and judicial authorities are clearly defined and transparent . Circumstances where executive overrides are allowed are specified.	Applicable to <i>Takāful</i> .
4	The supervisor and its staff are free from undue political, governmental and industry interference in the performance of supervisory responsibilities. The supervisor is financed in a manner that does not undermine its independence. The supervisor has discretion to allocate its resources in accordance with its mandate and objectives and the risks it perceives.	Applicable to <i>Takāful</i> .
5	There are clear and transparent regulatory requirements and supervisory procedures which are appropriate for the objectives they are intended to meet. The supervisor applies them consistently and equitably, taking into account the nature, scale and complexity of insurers. These regulatory requirements and supervisory procedures are published.	Applicable to <i>Takāful</i> .
6	Regulatory requirements and supervisory procedures are reviewed regularly. All material changes are normally subject to prior public consultation.	Applicable to <i>Takāful</i> .
7	The supervisor publishes information on the insurance sector, about its own role and how it performs its duties.	Applicable to <i>Takāful</i> .
8	There are processes to appeal against supervisory decisions , including using judicial review. These processes are specific and balanced to preserve supervisory independence and effectiveness. However, they do not unduly impede the ability of the supervisor to make timely interventions in order to protect policyholders' interests.	Applicable to <i>Takāful</i> .
9	The supervisor, including its staff and any individual acting on its behalf (presently or in the past), are required by legislation to protect the confidentiality of information in the possession of the supervisor , including confidential information received from other supervisors. The supervisor maintains appropriate safeguards for the protection of confidential information. Wrongful disclosure of confidential information is subject to penalties. The supervisor denies any request for confidential information, other than when required by law, or when requested by another supervisor who has a legitimate supervisory interest and the ability to uphold the confidentiality of the requested information.	Applicable to <i>Takāful</i> .

	10	The supervisor and its staff have the necessary legal protection against lawsuits for actions taken in good faith while discharging their duties, provided they have not acted illegally. They are adequately protected against the costs of defending their actions while discharging their duties.	Applicable to <i>Takāful</i> .
	11	The supervisor has adequate resources, financial or otherwise, sufficient to enable it to conduct effective supervision . Its staffing policies enable it to attract and retain highly skilled, competent and experienced staff. The supervisor provides adequate training for its staff. The supervisor has the ability to hire or contract the services of outside experts when necessary.	Applicable to <i>Takāful</i> . Staff competences and experience will need to include those relevant to <i>Takāful</i> .
	12	The supervisor and its staff act with integrity and observe the highest professional standards , including observing conflict-of-interest rules.	Applicable to <i>Takāful</i> .
	13	Where the supervisor outsources supervisory functions to third parties , the supervisor sets expectations, assesses their competence and experience, monitors their performance, and ensures their independence from the insurer or any other related party. Outside experts hired by the supervisor are subject to the same confidentiality rules and professional standards as the staff of the supervisor.	Applicable to <i>Takāful</i> .
ICP 3 Information Exchange and Confidentiality Requirements			
The supervisor exchanges information with other relevant supervisors and authorities subject to confidentiality, purpose and use requirements.			
Standard	1	The supervisor has the legal authority and power to obtain and exchange supervisory information in respect of legal entities and groups, including the relevant non-regulated entities of such groups.	Applicable to <i>Takāful</i> .
	2	The supervisor has the legal authority and power, at its sole discretion and subject to appropriate safeguards, to exchange information with other relevant supervisors. The existence of an agreement or understanding on information exchange is not a prerequisite for information exchange.	Applicable to <i>Takāful</i> .
	3	The supervisor proactively exchanges material and relevant information with other supervisors. The supervisor informs any other supervisor in its jurisdiction and the supervisors of insurance group entities in other jurisdictions or sectors in advance of taking any action that might reasonably be considered to affect those group entities. Where prior notification is not possible, the supervisor informs other relevant supervisors as soon as possible after taking action.	Applicable to <i>Takāful</i> .

	4	The supervisor has a legitimate interest and a valid purpose related to the fulfilment of supervisory functions in seeking information from another supervisor.	Applicable to <i>Takāful</i> .
	5	The supervisor assesses each request for information from another supervisor on a case-by-case basis.	Applicable to <i>Takāful</i> .
	6	The supervisor responds in a timely and comprehensive manner when exchanging relevant information and in responding to requests from supervisors seeking information.	Applicable to <i>Takāful</i> .
	7	Strict reciprocity in terms of the level, format and detailed characteristics of information exchanged is not required by the supervisor.	Applicable to <i>Takāful</i> .
	8	Before exchanging confidential information, the supervisor ensures that the party receiving the information is bound by confidentiality requirements.	Applicable to <i>Takāful</i> .
	9	The supervisor generally permits the information it exchanged with another supervisor to be passed on to other relevant supervisors or other bodies in that jurisdiction, provided that the necessary confidentiality requirements are in place.	Applicable to <i>Takāful</i> .
	10	The supervisor receiving confidential information from another supervisor uses it only for the purposes specified when the information was requested. Before using the information for another purpose, including exchanging it with other parties, the supervisor obtains agreement of the originating supervisor.	Applicable to <i>Takāful</i> .
	11	In the event that the supervisor is legally compelled to disclose confidential information it received from another supervisor, the supervisor promptly notifies the originating supervisor, indicating what information it is compelled to release and the circumstances surrounding the release. Where consent to passing this information on is not given, the supervisor uses all reasonable means to resist the demand and to protect the confidentiality of the information.	Applicable to <i>Takāful</i> .
ICP 4 Licensing			
A legal entity which intends to engage in insurance activities must be licensed before it can operate within a jurisdiction. The requirements and procedures for licensing must be clear, objective and public, and be consistently applied.			
Standard	1	To protect the interests of policyholders, a jurisdiction controls through licensing which entities are allowed to conduct insurance activities within its jurisdiction.	Applicable to <i>Takāful</i> .

2	<p>The insurance legislation:</p> <ul style="list-style-type: none"> o includes a definition of regulated insurance activities which are subject to licensing; o prohibits unauthorised insurance activities; o defines the permissible legal forms of domestic insurers; o allocates the responsibility for issuing licences; and o sets out the procedure and form of establishment by which foreign insurers are allowed to conduct insurance activities within the jurisdiction. 	<p>Applicable to <i>Takāful</i>. Specification of permissible legal forms will need to include the forms that <i>Takāful</i> insurers may take to preserve the principle of mutual guarantee.</p>
3	<p>Licensing requirements and procedures are clear, objective and public, and are consistently applied, requiring:</p> <ul style="list-style-type: none"> o the applicant's Board Members, Senior Management, both individually and collectively, Significant Owners and Key Persons in Control Functions to be suitable; o the applicant to satisfy capital requirements; o the applicant to have a sound corporate or group structure and governance framework that does not hinder effective supervision; and o the applicant to have sound business and financial plans. 	<p>For <i>Takāful</i>, the requirements should include appropriate <i>Sharī'ah</i> governance, and the suitability of <i>Sharī'ah</i> Advisory Board members.</p> <p>Financial projections should be made for a little more than three years for <i>Takāful</i> undertakings, considering the business strain within the first few years which might create a need for <i>Qard</i>. New <i>Takāful</i> operators (TOs) should be required to provide a projection on the tenure of a <i>Qard</i> period. However, this would imply a change at the level of guidance only.</p>
4	<p>Where an insurer is seeking to establish a branch or subsidiary in a foreign jurisdiction, the host supervisor concerned consults the home supervisor as appropriate before the issuance of a license.</p>	<p>Applicable to <i>Takāful</i>.</p>
5	<p>Where an insurer is seeking to conduct cross border insurance activities without a physical presence in the jurisdiction of the host supervisor, the host supervisor concerned consults the home supervisor as appropriate before allowing such activities.</p>	<p>Applicable to <i>Takāful</i>.</p>

	6	The supervisor assesses applications, makes decisions and informs applicants of the decision within a reasonable time which is clearly specified.	Applicable to <i>Takāful</i> .
	7	The supervisor refuses to issue a license where the applicant does not meet the licensing requirements. The supervisor has the authority to impose additional requirements, conditions or restrictions on an applicant where appropriate.	Applicable to <i>Takāful</i> .
	8	If the license is denied, conditional or restricted, the applicant is provided with an explanation .	Applicable to <i>Takāful</i> .
	9	A license clearly states its scope .	Applicable to <i>Takāful</i> .
<p>ICP 5 Suitability of Persons</p> <p>The supervisor requires Board Members, Senior Management, Key Persons in Control Functions and Significant Owners of an insurer to be and remain suitable to fulfil their respective roles.</p>			
Standard	1	Legislation identifies which persons meet suitability requirements .	Applicable to <i>Takāful</i> .
	2	The supervisor requires that in order to be suitable, Board Members, Senior Management and Key Persons in Control Functions possess competence and integrity to fulfil their roles. Significant Owners are required to have the financial soundness and integrity necessary to fulfil their roles.	Integrity and competence should take into consideration behaviour and code of conduct from a <i>Sharī'ah</i> perspective. The indicators should include <i>Sharī'ah</i> -compliant indicators. Those considered for suitability should include SSB members.
	3	The supervisor requires the insurer to demonstrate initially and thereafter, when requested by the supervisor, the suitability of Board Members, Senior Management, Key Persons in Control Functions and Significant Owners. The suitability requirements and the extent of review required depend on the person's position and responsibility.	Similar comments to those on the previous standard apply.
	4	The supervisor requires to be notified by insurers of any changes in Board Members, Senior Management, Key persons in Control Functions and Significant Owners , and of any circumstances that may materially adversely affect the suitability of its Board Members, Senior Management, Key Persons in Control Functions and Significant Owners.	Applicable to <i>Takāful</i> .

	5	The supervisor takes appropriate action to rectify the situation when board members, senior management and key persons in control functions or significant owners no longer meet suitability requirements.	Applicable to <i>Takāful</i> .
	6	The supervisor exchanges information with other authorities inside and outside its jurisdiction where necessary to check the suitability of board members, senior management, key persons in control functions and significant owners of an insurer.	Applicable to <i>Takāful</i> .
ICP 6 Changes in Control and Portfolio Transfers Supervisory approval is required for proposals to acquire significant ownership or an interest in an insurer that results in that person (legal or natural), directly or indirectly, alone or with an associate, exercising control over the insurer. The same applies to portfolio transfers or mergers of insurers.			
Standard	1	<p>The term “control” over an insurer is defined in legislation and it addresses, at a minimum:</p> <ul style="list-style-type: none"> ○ holding of a defined number or percentage of issued shares or financial instruments (such as compulsory convertible debentures) above a designated threshold in an insurer or its intermediate or ultimate beneficial owner. ○ voting rights attached to the aforementioned shares or financial instruments ○ power to appoint directors to the Board and other executive committees or remove them. 	Applicable to <i>Takāful</i> .
	2	The supervisor requires the insurer to provide notification of any proposed acquisitions or changes in control of the insurer. The supervisor grants or denies approval to person(s) (legal or natural) that want(s) to acquire significant ownership or a controlling interest in an insurer, whether directly or indirectly, alone or with an associate.	Applicable to <i>Takāful</i> .
	3	The supervisor approves any significant increase above the predetermined control levels in an insurer by person(s) (legal or natural), whether obtained individually or in association with others. This also applies to any other interest in that insurer or its intermediate or ultimate beneficial owners. The supervisor requires appropriate notification from insurers in the case of a significant decrease below the predetermined control levels .	Applicable to <i>Takāful</i> .
	4	The requirements in Standards 6.2 and 6.3 above also refer to the acquisition or change of control where the intermediate or ultimate beneficial owner(s) of an insurer is (are) outside the jurisdiction where the insurer is incorporated. In such cases, the supervisor coordinates, where relevant and necessary, with corresponding supervisors of those entities.	Applicable to <i>Takāful</i> .
	5	The supervisor is satisfied that those seeking control meet the same criteria as they would be required to meet if they sought a new license.	Applicable to <i>Takāful</i> .
	6	The supervisor requires insurers to provide appropriate information on their shareholders and any other person directly or indirectly exercising control.	Applicable to <i>Takāful</i> .

	7	The supervisor rejects applications of proposed owners to control insurers if facts exist from which it can be reasonably deduced that their ownership will be unduly prejudicial to policyholders . The supervisor is able to identify the intended beneficial owner.	Applicable to <i>Takāful</i> .
	8	To assess applications for proposed acquisitions or changes in control of insurers the supervisor establishes requirements for financial and non-financial resources .	Must demonstrate ability to provide <i>Qard</i> or financial assistance when needed.
	9	A change of a mutual company to a stock company , or vice versa, is subject to the supervisor's approval. The supervisor satisfies itself with the new constitution or governing organisational document of the company before giving approval.	Applicable to <i>Takāful</i> .
	10	The transfer of all or a part of an insurer's business is subject to approval by the supervisor , taking into account, amongst other things, the financial position of the transferee and the transferor. The supervisor satisfies itself that the interests of the policyholders of both the transferee and transferor will be protected.	Applicable to TOs.
<p>ICP 7 Corporate Governance</p> <p>The supervisor requires insurers to establish and implement a corporate governance framework which provides for sound and prudent management and oversight of the insurer's business and adequately recognises and protects the interests of policyholders.</p>			
Standard	1	The supervisor <i>requires</i> the insurer's Board to set and oversee the implementation of the insurer's business objectives and strategies for achieving those objectives, including its risk strategy <i>and</i> risk appetite, in line with the insurer's long term interests and viability.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. Principle 1.1 of IFSB-8: <i>Guiding Principles on Governance for Takāful Undertakings</i> mentioned the need to have a comprehensive governance framework in which clear segregation of strategic and operational roles and responsibilities are spelled out, including but not limited to the responsibilities of the BOD.

			<p>In addition, IFSB-14: <i>Standard on Risk Management for Takāful (Islamic Insurance) Undertakings</i> has specified a detailed listing of the functions of the BOD in ensuring continuity of <i>Takāful</i> undertakings in paragraph 72.</p>
	2	<p>The supervisor requires the insurer's Board to:</p> <ul style="list-style-type: none"> ○ ensure that the roles and responsibilities allocated to the board, senior management and key persons in control functions are clearly defined so as to promote an appropriate separation of the oversight function from the management responsibilities; and ○ provide adequate oversight of the Senior Management. 	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. IFSB-14: <i>Standard on Risk Management for Takāful (Islamic Insurance) Undertakings</i> has specified a detailed listing of the functions of the BOD in ensuring continuity of <i>Takāful</i> undertakings in paragraph 72.</p>
	3	<p>The supervisor requires the insurer's Board to have, on an on-going basis:</p> <ul style="list-style-type: none"> ○ an appropriate number and mix of individuals to ensure that there is an overall adequate level of knowledge, skills and expertise at the Board level commensurate with the governance structure and the nature, scale and complexity of the insurer's business; ○ appropriate internal governance practices and procedures to support the work of the Board in a manner that promotes the efficient, objective and independent judgment and decision making by the Board; and ○ adequate powers and resources to be able to discharge its duties fully and effectively. 	<p>Applicable to <i>Takāful</i>. IFSB-14 specified a detailed listing of the functions of the BOD in ensuring continuity of <i>Takāful</i> undertakings in paragraph 72.</p>

4	<p>The supervisor requires the individual members of the Board to:</p> <ul style="list-style-type: none"> ○ act in good faith, honestly and reasonably; ○ exercise due care and diligence; ○ act in the best interests of the insurer and policyholders, putting those interests of the insurer and policyholders ahead of his/her own interests; ○ exercise independent judgment and objectivity in his/her decisionmaking, taking due account of the interests of the insurer and policyholders; and ○ not use his/her position to gain undue personal advantage or cause any detriment to the insurer. 	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraph 72 of IFSB-14.</p>
5	<p>The supervisor requires the insurer's Board to provide oversight in respect of the design and implementation of sound risk management and internal control systems and functions.</p>	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraph 72 of IFSB-14.</p>
6	<p>The supervisor requires the insurer's Board to:</p> <ul style="list-style-type: none"> ○ adopt and oversee the effective implementation of a remuneration policy, which does not induce excessive or inappropriate risk taking, is in line with the identified risk appetite and long term interests of the insurer, and has proper regard to the interests of its stakeholders; and ○ ensure that such a remuneration policy, at a minimum, covers those individuals who are members of the Board, Senior Management, Key Persons in Control Functions and other employees whose actions may have a material impact on the risk exposure of the insurer (major risk-taking staff). 	<p>Applicable for TOs, with modification to include SSB</p>
7	<p>The supervisor requires the insurer's Board to ensure there is a reliable financial reporting process for both public and supervisory purposes which is supported by clearly defined roles and responsibilities of the Board, Senior Management and the external auditor.</p>	<p>This is applicable for TOs, since the financial reporting process, regardless of the type of information reported, will need to be reliable and based on the defined roles and responsibilities of the board, senior management and the external auditor.</p>
8	<p>The supervisor requires the insurer's Board to have systems and controls to ensure the promotion of appropriate, timely and effective communications with the supervisor and relevant stakeholders on the governance of the insurer.</p>	<p>Applicable for TOs, with modification to include SSB</p>

	9	<p>The supervisor requires the insurer's Board to have appropriate policies and procedures to ensure that Senior Management:</p> <ul style="list-style-type: none"> ○ carries out the day-to-day operations of the insurer effectively and in accordance with the insurer's strategies, policies and procedures; ○ promotes a culture of sound risk management, compliance and fair treatment of customers; ○ provides the Board adequate and timely information to enable the Board to carry out its duties and functions including the monitoring and review of the performance and risk exposures of the insurer, and the performance of Senior Management; and ○ provides to the relevant stakeholders and the supervisor the information required to satisfy the legal and other obligations applicable to the insurer or Senior Management. 	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. In IFSB-14: <i>Standard on Risk Management for Takāful (Islamic Insurance) Undertakings</i>, paragraphs 78–83 highlighted the terms of reference of the four main governance functions, which include the actuarial, risk management, internal audit and compliance functions.</p>
	10	<p>The supervisor has the power to require the insurer to demonstrate the adequacy and effectiveness of its corporate governance framework.</p>	<p>Applicable to <i>Takāful</i>.</p>
<p>ICP 8 Risk Management and Internal Controls</p> <p>The supervisor requires an insurer to have, as part of its overall corporate governance framework, effective systems of risk management and internal controls, including effective functions for risk management, compliance, actuarial matters and internal audit.</p>			
Standard	1	<p>The supervisor requires the insurer to establish, and operate within, effective systems of risk management and internal controls.</p>	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. Key Feature 6 of IFSB-11 mentioned the need to have an effective risk management framework. This has been addressed extensively in IFSB-14: <i>Standard on Risk Management for Takāful (Islamic Insurance) Undertakings</i>.</p>

2	The supervisor requires the insurer to have effective control functions with the necessary authority, independence, and resources.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. Paragraph 69 of IFSB-14 highlighted the main four control functions, being the actuarial, risk management, internal audit and compliance functions.
3	The supervisor requires the insurer to have an effective risk management function capable of assisting the insurer to identify, assess, monitor, manage and report on its key risks in a timely way .	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraphs 60–62 of IFSB-14.
4	The supervisor requires the insurer to have an effective compliance function capable of assisting the insurer to meet its legal and regulatory obligations and promote and sustain a corporate culture of compliance and integrity.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraph 82 of IFSB-14.
5	The supervisor requires that there is an effective actuarial function capable of evaluating and providing advice to the insurer regarding, at a minimum, technical provisions, premium and pricing activities, and compliance with related statutory and regulatory requirements.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraph 81 of IFSB-14.
6	The supervisor requires the insurer to have an effective internal audit function capable of providing the Board with independent assurance in respect of the insurer's governance, including its risk management and internal controls.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraph 83 of IFSB-14.
7	The supervisor requires the insurer to retain at least the same degree of oversight of, and accountability for, any outsourced material activity or function (such as a control function) as applies to non-outsourced activities or functions.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraph 34(vii) of IFSB-14.

ICP 9 Supervisory Review and Reporting

The supervisor has an integrated, risk-based system of supervision that uses both off-site monitoring and on-site inspections to examine the business of each insurer, evaluate its condition, the quality and effectiveness of its Board and Senior Management and compliance with legislation and supervisory requirements. The supervisor obtains the necessary information to conduct effective supervision of insurers and evaluate the insurance market.

Standard	1	The supervisor has the necessary legal authority, powers and resources to perform off-site monitoring and conduct on-site inspections of insurers, including monitoring and inspecting services and activities outsourced by the insurer. The supervisor also has the power to require insurers to submit information necessary for supervision.	Applicable to <i>Takāful</i> .
	2	The supervisor has a documented framework for supervisory review and reporting which takes into account the nature, scale and complexity of insurers. The framework encompasses a supervisory plan that sets priorities and determines the appropriate depth and level of off-site monitoring and on-site inspection activity.	Applicable to <i>Takāful</i> .
	3	The supervisor has a mechanism to check periodically that its supervisory framework pays due attention to the evolving nature, scale and complexity of risks which may be posed by insurers and of risks to which insurers may be exposed.	Applicable to <i>Takāful</i> .
	4	The Supervisor: <ul style="list-style-type: none"> o establishes documented requirements for the submission of regular qualitative and quantitative information on a timely basis from all insurers licensed in its jurisdiction; o defines the scope, content and frequency of those reports and information; o requires more frequent and/or more detailed additional information on a timely basis whenever there is a need; o sets out the relevant principles and norms for supervisory reporting, in particular the accounting standards to be used; o requires that inaccurate reporting is corrected as soon as possible; and o requires that an external audit opinion is provided on annual financial statements. 	Applicable to <i>Takāful</i> .
	5	In particular, the supervisor requires insurers to report: <ul style="list-style-type: none"> o off-balance sheet exposures; o material outsourced functions and activities; and o any significant changes to their corporate governance. <p>The supervisor also requires insurers to promptly report any material changes or incidents that could affect their condition or customers.</p>	Applicable to <i>Takāful</i> .

	6	The supervisor periodically reviews its reporting requirements to ascertain that they still serve their intended objectives and to identify any gaps which need to be filled. The supervisor sets any additional requirements that it considers necessary for certain insurers based on their nature, scale and complexity.	Applicable to <i>Takāful</i> .
	7	The supervisor monitors and supervises insurers on an ongoing basis, based on regular communication with the insurer, information obtained through supervisory reporting and analysis of market and other relevant information.	Applicable to <i>Takāful</i> .
	8	The supervisor sets the objective and scope for on-site inspections, develops corresponding work programmes and conducts such inspections.	Applicable to <i>Takāful</i> .
	9	The supervisor discusses with the insurer any relevant findings of the supervisory review and the need for any preventive or corrective action. The supervisor follows up to check that required actions have been taken by the insurer.	Applicable to <i>Takāful</i> .
<p>ICP 10 Preventive and Corrective Measures</p> <p>The supervisor takes preventive and corrective measures that are timely, suitable and necessary to achieve the objectives of insurance supervision.</p>			
Standard	1	The supervisor has the power to take action against individuals or entities that conduct insurance activities without the necessary licence.	Applicable to <i>Takāful</i> .
	2	The supervisor has sufficient authority and ability , including the availability of adequate instruments, to take timely preventive and corrective measures if the insurer fails to operate in a manner that is consistent with sound business practices or regulatory requirements. There is a range of actions or remedial measures which include allowing for early intervention when necessary. Preventive and corrective measures are applied commensurate with the severity of the insurer's problems.	Applicable to <i>Takāful</i> .
	3	There is a progressive escalation in actions or remedial measures that can be taken if the problems become worse or the insurer ignores requests from the supervisor to take preventive and corrective action.	Applicable to <i>Takāful</i> .
	4	If necessary, the supervisor requires the insurer to develop an acceptable plan for prevention and correction of problems . Preventive and corrective plans include agreed and acceptable steps to be taken to resolve the issues raised within an acceptable time frame. Once preventive and corrective plans have been agreed to or imposed, the supervisor periodically checks to determine that the insurer is complying with the measures.	Applicable to <i>Takāful</i> .

	5	The supervisor communicates with the Board and Senior Management and Key Persons in Control Functions and brings to their attention any material concern in a timely manner to ensure that preventive and corrective measures are taken and the outstanding issues are followed through to a satisfactory resolution.	Applicable to <i>Takāful</i> regulators, with slight modification to include the SSB
	6	The supervisor initiates measures designed to prevent a breach of the legislation from occurring , and promptly and effectively deals with non-compliance that could put policyholders at risk or impinge on any other supervisory objectives.	Applicable to <i>Takāful</i> regulators.
ICP 11 Enforcement The supervisor enforces corrective action and, where needed, imposes sanctions based on clear and objective criteria that are publicly disclosed.			
Standard	1	The supervisor has the power to enforce corrective action in a timely manner where problems involving insurers are identified. The supervisor issues formal directions to insurers to take particular actions or to desist from taking particular actions. The directions are appropriate to address the problems identified.	Applicable to <i>Takāful</i> regulators.
	2	The supervisor has a range of actions available in order to apply appropriate enforcement where problems are encountered. Powers set out in legislation should at a minimum include restrictions on business activities and measures to reinforce the financial position of an insurer.	Applicable to <i>Takāful</i> regulators.
	3	After corrective action has been taken or remedial measures, directions or sanctions have been imposed, the supervisor checks compliance by the insurer and assesses their effectiveness.	Applicable to <i>Takāful</i> regulators.
	4	The supervisor has effective means to address management and governance problems , including the power to require the insurer to replace or restrict the power of Board Members, Senior Management, Key Persons in Control Functions, significant owners and external auditors.	Applicable to <i>Takāful</i> regulators, with modification to include the function of SSB.
	5	Where necessary and in extreme cases, the supervisor imposes conservatorship over an insurer that is failing to meet prudential or other requirements. The supervisor has the power to take control of the insurer, or to appoint other specified officials or receivers for the task, and to make other arrangements for the benefit of the policyholders.	Applicable to <i>Takāful</i> .
	6	There are sanctions by way of fines and other penalties against insurers and individuals where the provisions of the legislation are breached. The sanctions are proportionate to the identified breach.	Applicable to <i>Takāful</i> .

	7	The legislation provides for sanctions against insurers and individuals who fail to provide information to the supervisor in a timely fashion , withhold information from the supervisor, provide information that is intended to mislead the supervisor or deliberately misreport to the supervisor.	Applicable to <i>Takāful</i> .
	8	The process of applying sanctions does not delay necessary preventive and corrective measures and enforcement.	Applicable to <i>Takāful</i> .
	9	The supervisor, or another responsible body in the jurisdiction, takes action to enforce all the sanctions that have been imposed.	Applicable to <i>Takāful</i> .
	10	The supervisor ensures consistency in the way insurers and individuals are sanctioned, so that similar violations and weaknesses attract similar sanctions.	Applicable to <i>Takāful</i> .
<p>ICP 12 Winding-up and Exit from the Market</p> <p>The legislation defines a range of options for the exit of insurance legal entities from the market. It defines insolvency and establishes the criteria and procedure for dealing with insolvency of insurance legal entities. In the event of winding-up proceedings of insurance legal entities, the legal framework gives priority to the protection of policyholders and aims at minimising disruption to the timely provision of benefits to policyholders.</p>			
Standard	1	The procedures for the winding-up and exit of an insurer from the market are clearly set out in legislation. A high legal priority is given to the protection of the rights and entitlements of policyholders. The procedures aim at minimising the disruption to the timely provision of benefits to policyholders.	This was briefly mentioned in IFSB-11: <i>Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings</i> in which procedures of winding-up should be stated in law to ensure priorities of payments for claims.
	2	The legislation provides for the determination of the point at which it is no longer permissible for an insurer to continue its business.	A standard on winding-up and exit from the market may need to be developed specifically for <i>Takāful</i> undertakings. There are substantial <i>Sharī'ah</i> and practical issues here, and much work is likely to be needed before appropriate standards can be developed.

ICP 13 Reinsurance and Other Forms of Risk Transfer

The supervisor sets standards for the use of reinsurance and other forms of risk transfer, ensuring that insurers adequately control and transparently report their risk transfer programmes. The supervisor takes into account the nature of reinsurance business when supervising reinsurers based in its jurisdiction.

Standard	1	<p>The supervisor requires that cedants have reinsurance and risk transfer strategies appropriate to the nature, scale and complexity of their business, and which are part of their wider underwriting and risk and capital management strategies. The supervisor also requires that cedants have systems and procedures for ensuring that such strategies are implemented and complied with, and that cedants have in place appropriate systems and controls over their risk transfer transactions.</p>	<p>In general applicable for TOs. However, it needs to take into consideration the authority and power of the <i>Sharī'ah</i> Advisory Board in making decisions with regards to the approval of reinsurance programmes as well as monitoring of reinsurers' performance.</p>
	2	<p>The supervisor requires that cedants are transparent in their reinsurance arrangements and the associated risks, allowing the supervisor to understand the economic impact of reinsurance and other forms of risk transfer arrangements in place.</p>	<p>Applicable for TOs in general. However, it needs to take into consideration the ceding of <i>Takāful</i> business to a conventional reinsurer.</p>
	3	<p>The supervisor takes into account the nature of supervision of reinsurers and other counterparties, including any supervisory recognition arrangements in place.</p>	<p>Applicable for TOs.</p>
	4	<p>The question of binding documentation requirements for reinsurance contracts is a question of jurisdictional contract law. However, the supervisor requires that parties to reinsurance contracts promptly document the principal economic and coverage terms and conditions agreed upon by the parties and finalise the formal reinsurance contract in a timely fashion.</p>	<p>Applicable to <i>Takāful</i>.</p>
	5	<p>The supervisor assesses whether cedants control their liquidity position to take account of the structure of risk transfer contracts and likely payment patterns arising from these.</p>	<p>Applicable for TOs; however, it may need to include the availability of <i>Qard</i> or financial assistance prior to arranging an accelerated payment option with a reinsurer or <i>Retakāful</i> Operator (RTO).</p>

	6	Where risk transfer to the capital markets is permitted , supervisors are able to understand the structure and operation of such arrangements and to assess issues which may arise.	This is an area worth considering since it has never been implemented in the <i>Takāful</i> industry. This standard made reference to the use of derivatives, which may raise issues of <i>Sharī'ah</i> compliance.
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ICP 14 Valuation

The supervisor establishes requirements for the valuation of assets and liabilities for solvency purposes.

Standard	1	The valuation addresses recognition, derecognition and measurement of assets and liabilities.	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered to a certain extent in IFSB documents. Paragraphs 23–26 of IFSB-11 briefly mentioned the valuation of assets and liabilities in which it includes the need to have the following criteria:</p> <ol style="list-style-type: none"> 1. Take account of suitability of assets for the purpose of backing the TO's liabilities. 2. Should be undertaken on a market-consistent basis. <p>As noted in earlier paragraphs, there are significant accounting issues in <i>Takāful</i>, and it is unclear without much further work whether any changes to the valuation standards are required.</p>
	2	The valuation of assets and liabilities is undertaken on consistent bases.	
	3	The valuation of assets and liabilities is undertaken in a reliable, decision useful and transparent manner.	
	4	The valuation of assets and liabilities is an economic valuation.	
	5	An economic valuation of assets and liabilities reflects the risk-adjusted present values of their cash flows.	
	6	The value of technical provisions and other liabilities does not reflect the insurer's own credit standing.	
	7	The valuation of technical provisions exceeds the Current Estimate by a margin (Margin over the Current Estimate or MOCE).	
	8	The Current Estimate reflects the expected present value of all relevant future cash flows that arise in fulfilling insurance obligations, using unbiased, current assumptions.	
	9	The MOCE reflects the inherent uncertainty related to all relevant future cash flows that arise in fulfilling insurance obligations over the full time horizon thereof.	
	10	The valuation of technical provisions allows for the time value of money . The supervisor establishes criteria for the determination of appropriate rates to be used in the discounting of technical provisions.	
	11	The supervisor requires the valuation of technical provisions to make appropriate allowance for embedded options and guarantees.	

ICP 15 Investment			
The supervisor establishes requirements for solvency purposes on the investment activities of insurers in order to address the risks faced by insurers.			
Standard	1	The supervisor establishes requirements that are applicable to the investment activities of the insurer.	Applicable to <i>Takāful</i> .
	2	The supervisor is open and transparent as to the regulatory investment requirements that apply and is explicit about the objectives of those requirements.	Applicable to <i>Takāful</i> .
	3	The regulatory investment requirements address, at a minimum, the <ul style="list-style-type: none"> ○ security; ○ liquidity; and ○ diversification of an insurer's portfolio of investments as a whole.	Applicable to <i>Takāful</i> .
	4	The supervisor requires the insurer to invest in a manner that is appropriate to the nature of its liabilities .	Applicable to <i>Takāful</i> .
	5	The supervisor requires the insurer to invest only in assets whose risks it can properly assess and manage .	Applicable to <i>Takāful</i> .
	6	The supervisor establishes quantitative and qualitative requirements , where appropriate, on the use of more complex and less transparent classes of assets and investment in markets or instruments that are subject to less governance or regulation.	Requires modification to suit specificities of <i>Takāful</i> , taking into consideration the various investable <i>Sharī'ah</i> -compliant instruments other than the ones listed in the guidance to this standard.
ICP 16 Enterprise Risk Management for Solvency Purposes			
The supervisor establishes enterprise risk management requirements for solvency purposes that require insurers to address all relevant and material risks.			
Standard	1	The supervisor requires the insurer's enterprise risk management framework to provide for the identification and quantification of risk under a sufficiently wide range of outcomes using techniques which are appropriate to the nature, scale and complexity of the risks the insurer bears and adequate for risk and capital management and for solvency purposes.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. In IFSB-14: <i>Standard on Risk Management for Takāful (Islamic Insurance) Undertakings</i> , paragraphs 51–55 as well as paragraphs 84–93 mentioned the need for risk identification and own risk and solvency assessment (ORSA).

2	The supervisor requires the insurer's measurement of risk to be supported by accurate documentation providing appropriately detailed descriptions and explanations of the risks covered, the measurement approaches used and the key assumptions made.	Applicable to <i>Takāful</i> . See the reference given under the previous standard.
3	The supervisor requires the insurer to have a risk management policy which outlines how all relevant and material categories of risk are managed, both in the insurer's business strategy and its day-to-day operations.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraphs 46–59 of IFSB-14.
4	The supervisor requires the insurer to have a risk management policy which describes the relationship between the insurer's tolerance limits, regulatory capital requirements, economic capital and the processes and methods for monitoring risk .	
5	The supervisor requires the insurer to have a risk management policy which includes an explicit asset-liability management (ALM) policy which clearly specifies the nature, role and extent of ALM activities and their relationship with product development, pricing functions and investment management.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraphs 66 and 67 of IFSB-14.
6	The supervisor requires the insurer to have a risk management policy which is reflected in an explicit investment policy which: <ul style="list-style-type: none"> ○ Specifies the nature, role and extent of the insurer's investment activities and how the insurer complies with the regulatory investment requirements established by the supervisor; and ○ Establishes explicit risk management procedures within its investment policy with regard to more complex and less transparent classes of asset and investment in markets or instruments that are subject to less governance or regulation. 	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraphs 36 and 37 of IFSB-14.
7	The supervisor requires the insurer to have a risk management policy which includes explicit policies in relation to underwriting risk .	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraph 35 of IFSB-14.
8	The supervisor requires the insurer to: <ul style="list-style-type: none"> ○ establish and maintain a risk tolerance statement which sets out its overall quantitative and qualitative risk tolerance levels and defines risk tolerance limits which take into account all relevant and material categories of risk and the relationships between them; ○ make use of its risk tolerance levels in its business strategy; and ○ embed its defined risk tolerance limits in its day-to-day operations via its risk management policies and procedures. 	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraph 48 of IFSB-14.

9	The supervisor requires the insurer's ERM framework to be responsive to changes in its risk profile .	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraph 91 of IFSB-14.
10	The supervisor requires the insurer's ERM framework to incorporate a feedback loop , based on appropriate and good-quality information, management processes and objective assessment, which enables it to take the necessary action in a timely manner in response to changes in its risk profile.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See section 1.4 of the Appendix to IFSB-14.
11	The supervisor requires the insurer to perform its own risk and solvency assessment (ORSA) regularly to assess the adequacy of its risk management and current, and likely future, solvency position.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraphs 84–97 and the Appendix to IFSB-14.
12	The supervisor requires the insurer's Board and Senior Management to be responsible for the ORSA.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraphs 85 and 87 of IFSB-14.
13	The supervisor requires the insurer's ORSA to encompass all reasonably foreseeable and relevant material risks, including, as a minimum, underwriting, credit, market, operational and liquidity risks and additional risks arising due to membership of a group . The assessment is required to identify the relationship between risk management and the level and quality of financial resources needed and available.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraphs 84–97 and the Appendix to IFSB-14.
14	The supervisor requires the insurer to: <ul style="list-style-type: none"> ○ determine, as part of its ORSA, the overall financial resources it needs to manage its business given its own risk tolerance and business plans, and to demonstrate that supervisory requirements are met; ○ base its risk management actions on consideration of its economic capital, regulatory capital requirements and financial resources, including its ORSA; and ○ assess the quality and adequacy of its capital resources to meet regulatory capital requirements and any additional capital needs. 	

	15	<p>The supervisor requires:</p> <ul style="list-style-type: none"> the insurer, as part of its ORSA, to analyse its ability to continue in business, and the risk management and financial resources required to do so over a longer time horizon than typically used to determine regulatory capital requirements; the insurer's continuity analysis to address a combination of quantitative and qualitative elements in the medium and longer-term business strategy of the insurer and include projections of its future financial position and analysis of its ability to meet future regulatory capital requirements. 	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. See the sections of IFSB-14 cited under the previous standards.</p>
	16	<p>The supervisor undertakes reviews of an insurer's risk management processes and its financial condition, including the ORSA. Where necessary, the supervisor requires strengthening of the insurer's risk management, solvency assessment and capital management processes.</p>	
<p>ICP 17 Capital Adequacy</p> <p>The supervisor establishes capital adequacy requirements for solvency purposes, so that insurers can absorb significant unforeseen losses, and to provide for degrees of supervisory intervention.</p>			
Standard	1	<p>The supervisor requires that a total balance sheet approach is used in the assessment of solvency to recognise the interdependence between assets, liabilities, regulatory capital requirements and capital resources, and to require that risks are appropriately recognised.</p>	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. Key Feature 1 of IFSB-11: <i>Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings</i> mentioned that "The solvency requirements for <i>Takāful</i> undertakings must adopt a total balance sheet approach to ensure that risks are appropriately recognised and consistently valued and to identify the interdependence between assets, liabilities, regulatory solvency requirements for <i>PRF</i> and the shareholders' funds of the TO. However, the total balance sheet approach must address the clear separation of <i>PRF</i> and the shareholders' funds of the TO."</p>
	2	<p>The supervisor establishes regulatory capital requirements at a sufficient level so that, in adversity, an insurer's obligations to policyholders will continue to be met as they fall due and requires that insurers maintain capital resources to meet the regulatory capital requirements.</p>	

3	<p>The regulatory capital requirements include solvency control levels which trigger different degrees of intervention by the supervisor with an appropriate degree of urgency and requires coherence between the solvency control levels established and the associated corrective action that may be at the disposal of the insurer and/or the supervisor.</p>	
4	<p>In the context of insurance legal entity capital adequacy assessment, the regulatory capital requirements establish:</p> <ul style="list-style-type: none"> ○ a solvency control level above which the supervisor does not intervene on capital adequacy grounds. This is referred to as the Prescribed Capital Requirement (PCR). The PCR is defined such that assets will exceed technical provisions and other liabilities with a specified level of safety over a defined time horizon. ○ a solvency control level at which, if breached, the supervisor would invoke its strongest actions, in the absence of appropriate corrective action by the insurance legal entity. This is referred to as the Minimum Capital Requirement (MCR). The MCR is subject to a minimum bound below which no insurer is regarded to be viable to operate effectively. 	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. See Key Feature 3 of IFSB-11.</p>
5	<p>In the context of group-wide capital adequacy assessment, the regulatory capital requirements establish solvency control levels that are appropriate in the context of the approach to group-wide capital adequacy that is applied.</p>	<p>Applicable to <i>Takāful</i>. However, the detailed implementation will be difficult, since no work has yet been done on group consolidation in <i>Takāful</i>.</p>
6	<p>The regulatory capital requirements are established in an open and transparent process, and the objectives of the regulatory capital requirements and the bases on which they are determined are explicit. In determining regulatory capital requirements, the supervisor allows a set of standardised and, if appropriate, other approved more tailored approaches such as the use of (partial or full) internal models.</p>	<p>Applicable to <i>Takāful</i>.</p>
7	<p>The supervisor addresses all relevant and material categories of risk in insurers and is explicit as to where risks are addressed, whether solely in technical provisions, solely in regulatory capital requirements, or, if addressed in both, as to the extent to which the risks are addressed in each. The supervisor is also explicit as to how risks and their aggregation are reflected in regulatory capital requirements.</p>	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. See Key Feature 5 of IFSB-11 and IFSB-14: <i>Standard on Risk Management for Takāful (Islamic Insurance) Undertakings</i>.</p>

8	<p>The supervisor sets appropriate target criteria for the calculation of regulatory capital requirements, which underlie the calibration of a standardised approach. Where the supervisor allows the use of approved more tailored approaches such as internal models for the purpose of determining regulatory capital requirements, the target criteria underlying the calibration of the standardized approach are also used by those approaches for that purpose to require broad consistency among all insurers within the jurisdiction.</p>	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. See paragraph 60 of IFSB-11.</p>
9	<p>Any variations to the regulatory capital requirement imposed by the supervisor are made within a transparent framework appropriate to the nature, scale and complexity, according to the target criteria, and are only expected to be required in limited circumstances.</p>	<p>Applicable to <i>Takāful</i>.</p>
10	<p>The supervisor defines the approach to determining the capital resources eligible to meet regulatory capital requirements and their value, consistent with a total balance sheet approach for solvency assessment and having regard to the quality and suitability of capital elements.</p>	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. See Key Feature 4 of IFSB-11.</p>
11	<p>The supervisor establishes criteria for assessing the quality and suitability of capital resources, having regard to their ability to absorb losses on both a going-concern and wind-up basis.</p>	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. See Key Feature 4 of IFSB-11.</p>

12	<p>Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor:</p> <ul style="list-style-type: none"> o establishes appropriate modelling criteria to be used for the determination of regulatory capital requirements, which require broad consistency among all insurers within the jurisdiction; and o identifies the different levels of regulatory capital requirements for which the use of internal models is allowed. 	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. Paragraph 64 of IFSB-11 mentioned that “Where the supervisory</p>
13	<p>Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor requires:</p> <ul style="list-style-type: none"> o prior supervisory approval for the insurer’s use of an internal model for the purpose of calculating regulatory capital requirements; o the insurer to adopt risk modelling techniques and approaches appropriate to the nature, scale and complexity of its current risks and those incorporated within its risk strategy and business objectives in constructing its internal model for regulatory capital purposes; o the insurer to validate an internal model to be used for regulatory capital purposes by subjecting it, as a minimum, to three tests: “statistical quality test”, “calibration test” and “use test”; and o the insurer to demonstrate that the model is appropriate for regulatory capital purposes and to demonstrate the results of each of the three tests. 	<p>regime may allow the use of approved more tailored approaches such as internal models for the purpose of determining solvency requirements, the target criteria should also be used by those approaches for that purpose to ensure broad consistency within the solvency requirements as compared to those entities using a standard approach. The appropriate parameters and target criteria for these elements in the solvency framework should be outlined to provide clearer guidance to determine regulatory solvency requirements. Importantly, the use of these internal models must have prior approval from the supervisory authorities to ensure that the internal models are appropriately adjusted to the standard solvency requirements.”</p>
14	<p>Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor requires:</p> <ul style="list-style-type: none"> o the insurer to conduct a “statistical quality test” which assesses the base quantitative methodology of the internal model, to demonstrate the appropriateness of this methodology, including the choice of model inputs and parameters, and to justify the assumptions underlying the model; and o that the determination of the regulatory capital requirement using an internal model addresses the overall risk position of the insurer and that the underlying data used in the model is accurate and complete. 	<p>However, this may need future enhancement to provide more detailed guidance on the use of internal models.</p>
15	<p>Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor requires the insurer to conduct a “calibration test” to demonstrate that the regulatory capital requirement determined by the internal model satisfies the specified modelling criteria.</p>	<p>However, this may need future enhancement to provide more detailed guidance on the use of internal models.</p>

16	<p>Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor requires:</p> <ul style="list-style-type: none"> ○ the insurer to fully embed the internal model, its methodologies and results into the insurer's risk strategy and operational processes (the "use test"); ○ the insurer's Board and Senior Management to have overall control of and responsibility for the construction and use of the internal model for risk management purposes, and ensure sufficient understanding of the model's construction at appropriate levels within the insurer's organisational structure. In particular, the supervisor requires the insurer's Board and Senior Management to understand the consequences of the internal model's outputs and limitations for risk and capital management decisions; and ○ the insurer to have adequate governance and internal controls in place with respect to the internal model. 	
17	<p>Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor requires the insurer to document the design, construction and governance of the internal model, including an outline of the rationale and assumptions underlying its methodology. The supervisor requires the documentation to be sufficient to demonstrate compliance with the regulatory validation requirements for internal models, including the statistical quality test, calibration test and use test outlined above.</p>	
18	<p>Where a supervisor allows the use of internal models to determine regulatory capital requirements, the supervisor requires:</p> <ul style="list-style-type: none"> ○ the insurer to monitor the performance of its internal model and regularly review and validate the ongoing appropriateness of the model's specifications. The supervisor requires the insurer to demonstrate that the model remains fit for regulatory capital purposes in changing circumstances against the criteria of the statistical quality test, calibration test and use test; ○ the insurer to notify the supervisor of material changes to the internal model made by it for review and continued approval of the use of the model for regulatory capital purposes; ○ the insurer to properly document internal model changes; and ○ the insurer to report information necessary for supervisory review and ongoing approval of the internal model on a regular basis, as determined appropriate by the supervisor. The information includes details of how the model is embedded within the insurer's governance and operational processes and risk management strategy, as well as information on the risks assessed by the model and the capital assessment derived from its operation. 	<p>Applicable to <i>Takāful</i>. The comments made on the previous group of standards are also applicable here.</p>

ICP 18 Intermediaries
The supervisor sets and enforces requirements for the conduct of insurance intermediaries, to ensure that they conduct business in a professional and transparent manner.

Standard	1	The supervisor ensures that insurance intermediaries are required to be licensed .	Applicable to <i>Takāful</i> , with modification to meet specificities of <i>Takāful</i> , especially in the areas where basic knowledge of <i>Shari'ah</i> is pertinent for appropriate representation of the TO or its customers.
	2	The supervisor ensures that insurance intermediaries licensed in its jurisdiction are subject to ongoing supervisory review .	
	3	The supervisor requires insurance intermediaries to possess appropriate levels of professional knowledge and experience , integrity and competence.	
	4	The supervisor requires that insurance intermediaries apply appropriate corporate governance .	
	5	The supervisor requires insurance intermediaries to disclose to customers, at a minimum: <ul style="list-style-type: none"> ○ the terms and conditions of business between themselves and the customer; ○ the relationship they have with the insurers with whom they deal; and ○ information on the basis on which they are remunerated where a potential conflict of interest exists. 	
	6	The supervisor requires an insurance intermediary who handles client monies to have sufficient safeguards in place to protect these funds .	
	7	The supervisor takes appropriate supervisory action against licensed insurance intermediaries , where necessary, and has powers to take action against those individuals or entities that are carrying on insurance intermediation without the necessary licence.	

ICP 19 Conduct of Business
The supervisor sets requirements for the conduct of the business of insurance to ensure customers are treated fairly, both before a contract is entered into and through to the point at which all obligations under a contract have been satisfied.

Standard	1	The supervisor requires insurers and intermediaries to act with due skill, care and diligence when dealing with customers.	Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents.
	2	The supervisor requires insurers and intermediaries to establish and implement policies and procedures on the fair treatment of customers that are an integral part of their business culture.	
	3	The supervisor requires insurers to take into account the interests of different types of customers when developing and marketing insurance products.	
	4	The supervisor requires insurers and intermediaries to promote products and services in a manner that is clear, fair and not misleading .	
	5	The supervisor sets requirements for insurers and intermediaries with regard to the timing, delivery, and content of information provided to customers at point of sale .	

	6	The supervisor requires insurers and intermediaries to ensure that, where customers receive advice before concluding an insurance contract, such advice is appropriate , taking into account the customer's disclosed circumstances.	<p>IFSB-9: <i>Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services</i> provides an insight on the types of conduct that are compliant with <i>Shari'ah</i> principles. These include the need to have the following principles:</p> <ul style="list-style-type: none"> ○ truthfulness, honesty and fairness; ○ due care and diligence; ○ capabilities; ○ information about clients; ○ information to clients; ○ conflicts of interest and of duty; and ○ <i>Shari'ah</i> compliance. 	
	7	The supervisor requires insurers and intermediaries to ensure that, where customers receive advice before concluding an insurance contract, any potential conflicts of interest are properly managed .		
	8	The supervisor requires insurers to: <ul style="list-style-type: none"> ○ service policies appropriately through to the point at which all obligations under the policy have been satisfied; ○ disclose to the policyholder information on any contractual changes during the life of the contract; and ○ disclose to the policyholder further relevant information depending on the type of insurance product. 		
	9	The supervisor requires that insurers have policies and processes in place to handle claims in a timely and fair manner.		
	10	The supervisor requires that insurers and intermediaries have policies and processes in place to handle complaints in a timely and fair manner .		
	11	Legislation identifies provisions relating to privacy protection under which insurers and intermediaries are allowed to collect, hold, use or communicate personal information of customers to third parties.		
	12	The supervisor requires insurers and intermediaries to have policies and procedures for the protection of private information on customers .		
	13	The supervisor publicly discloses information that supports the fair treatment of customers.		
<p>ICP 20 Public Disclosure</p> <p>The supervisor requires insurers to disclose relevant, comprehensive and adequate information on a timely basis in order to give policyholders and market participants a clear view of their business activities, performance and financial position. This is expected to enhance market discipline and understanding of the risks to which an insurer is exposed and the manner in which those risks are managed.</p>				
Standard	1	Insurers disclose, at least annually, appropriately detailed quantitative and qualitative information in a way that is accessible to market participants on their profile, governance and controls, financial position, technical performance and the risks to which they are subject.		Applicable to <i>Takāful</i> . The specificities of <i>Takāful</i> have been covered in IFSB documents.

		<p>In particular, information disclosed must be:</p> <ul style="list-style-type: none"> o decision useful to decisions taken by market participants; o timely so as to be available and up-to-date at the time those decisions are made; o comprehensive and meaningful; o reliable as a basis upon which to make decisions; o comparable between different insurers operating in the same market; and o consistent over time so as to enable relevant trends to be discerned. 	<p>Key Feature 7 of IFSB-11: <i>Standard on Solvency Requirements for Takāful Undertakings</i> as well as various sections of IFSB-14: <i>Standard on Risk Management for Takāful Undertakings</i> suggested disclosing key information on solvency requirements and provided an insight on the types of information that is pertinent to be disclosed to the stakeholders of the TOs.</p>
	2	<p>Disclosure about the financial position of the insurer includes appropriately detailed quantitative and qualitative information about the determination of technical provisions. Technical provisions are presented by appropriate segment. This disclosure includes, where relevant to policyholders and market participants, information about the future cash flow assumptions, the rationale for the choice of discount rates, and risk adjustment methodology where used or other information as appropriate to provide a description of the method used to determine technical provisions.</p>	<p>Applicable to <i>Takāful</i>. The specificities of <i>Takāful</i> have been covered in IFSB documents. Key Feature 7 of IFSB-11 mentioned the importance of disclosing key information on solvency requirements to the public.</p> <p>Modifications may be required for a full standard on disclosure, encompassing information specific to <i>Takāful</i> undertakings, such as types of models, resolutions, the disclosures appropriate for the different funds, etc. Substantial work still remains to be done on this.</p>
	3	<p>Disclosure about the financial position of the insurer includes appropriately detailed quantitative and qualitative information about capital adequacy. An insurer discloses information that enables users to evaluate the insurer's objectives, policies and processes for managing capital and to assess its capital adequacy. This information encompasses the generic solvency requirements of the jurisdiction(s) in which the insurer operates and the capital available to cover regulatory capital requirements. If an internal model is used to determine capital resources and requirements, information about the model must be provided, having due regard to proprietary or confidential information.</p>	

4	<p>Disclosure about the financial position of the insurer includes appropriately detailed quantitative and qualitative information about financial instruments and other investments by class. In addition, information disclosed about investments includes:</p> <ul style="list-style-type: none"> ○ investment objectives; ○ policies and processes; ○ values, assumptions and methods used for general purpose financial reporting and solvency purposes, as well as an explanation of the differences (where applicable); and ○ information concerning the level of sensitivity to market variables associated with disclosed amounts. 	
5	<p>Disclosure about the financial position of the insurer includes appropriately detailed quantitative and qualitative information about enterprise risk management (ERM) including asset-liability management (ALM) in total and, where appropriate, at a segmented level. At a minimum, this information includes the methodology used and the key assumptions employed in measuring assets and liabilities for ALM purposes and any capital and/or provisions held as a consequence of a mismatch between assets and liabilities.</p>	
6	<p>Disclosure includes appropriately detailed quantitative and qualitative information on financial performance in total and by segmented financial performance. Where relevant, disclosures must include a quantitative source of earnings analysis, claims statistics including claims development, pricing adequacy, information on returns on investment assets and components of such returns.</p>	
7	<p>Disclosure about the financial position of the insurer includes appropriately detailed quantitative and qualitative information on all reasonably foreseeable and relevant material insurance risk exposures and their management. This disclosure must include information on its objectives and policies, models and techniques for managing insurance risks (including underwriting processes). At a minimum, disclosures must include:</p> <ul style="list-style-type: none"> ○ information about the nature, scale and complexity of risks arising from insurance contracts; ○ how the insurer uses reinsurance or other forms of risk transfer; ○ an understanding of the interaction between capital adequacy and risk; and ○ a description of risk concentrations. 	<p>Key Feature 7 of IFSB-11 mentioned the importance of disclosing key information on solvency requirements to the public. Modifications may be required for a full standard on disclosure, encompassing information specific to <i>Takāful</i> undertakings, such as types of models, resolutions, etc.</p>
8	<p>Disclosure includes appropriately detailed information about the company profile, including the nature of its business, a general description of its key products, the external environment in which it operates and information on the insurer's objectives and the strategies in place to achieve them.</p>	
9	<p>Disclosures include the key features of the insurer's corporate governance framework and management controls including how these are implemented.</p>	

	10	Subject to the nature, scale and complexity of an insurer, supervisors require insurers to produce, at least annually, audited financial statements and make them available to market participants.	
ICP 21 Countering Fraud in Insurance			
The supervisor requires that insurers and intermediaries take effective measures to deter, prevent, detect, report and remedy fraud in insurance.			
Standard	1	Fraud in insurance is addressed by legislation which prescribes adequate sanctions for committing such fraud and for prejudicing an investigation into fraud.	Applicable to <i>Takāful</i> .
	2	The supervisor has a thorough and comprehensive understanding of the types of fraud risk to which insurers and intermediaries are exposed. The supervisor regularly assesses the potential fraud risks to the insurance sector and requires insurers and intermediaries to take effective measures to address those risks.	Applicable to <i>Takāful</i> .
	3	The supervisor has an effective supervisory framework to monitor and enforce compliance by insurers and intermediaries with the requirements to counter fraud in insurance.	Applicable to <i>Takāful</i> .
	4	The supervisor regularly reviews the effectiveness of the measures insurers and intermediaries and the supervisor itself are taking to deter, prevent, detect, report and remedy fraud. The supervisor takes any necessary action to improve effectiveness.	Applicable to <i>Takāful</i> .
	5	The supervisor has effective mechanisms in place , which enable it to cooperate, coordinate and exchange information with other competent authorities, such as law enforcement authorities, as well as other supervisors concerning the development and implementation of policies and activities to deter, prevent, detect, report and remedy fraud in insurance.	Applicable to <i>Takāful</i> .
ICP 22 Anti-Money Laundering and Combating the Financing of Terrorism			
The supervisor requires insurers and intermediaries to take effective measures to combat money laundering and the financing of terrorism. In addition, the supervisor takes effective measures to combat money laundering and the financing of terrorism.			
Standard	1	The supervisor has a thorough and comprehensive understanding of the ML/FT risks to which insurers and intermediaries are exposed and uses available information to assess the ML/FT risks to the insurance sector in its jurisdiction on a regular basis.	Applicable to <i>Takāful</i> .

	2	<p>The supervisor:</p> <ul style="list-style-type: none"> ○ issues to insurers and intermediaries enforceable rules on AML/CFT obligations consistent with the FATF Recommendations, for matters which are not in law or regulation; ○ establishes guidelines that will assist insurers and intermediaries to implement and comply with their respective AML/CFT requirements; and ○ provides insurers and intermediaries with adequate and appropriate feedback to promote AML/CFT compliance. 	Applicable to <i>Takāful</i> .
	3	The supervisor has an effective supervisory framework to monitor and enforce compliance by insurers and intermediaries with AML/CFT requirements.	Applicable to <i>Takāful</i> .
	4	The supervisor regularly reviews the effectiveness of the measures that insurers and intermediaries and the supervisor itself are taking on AML/CFT. The supervisor takes any necessary action to improve effectiveness.	Applicable to <i>Takāful</i> .
	5	The supervisor has effective mechanisms in place which enable it to cooperate, coordinate and exchange information with other domestic authorities, such as the financial intelligence unit, as well as with supervisors in other jurisdictions for AML/CFT purposes.	Applicable to <i>Takāful</i> .
	6	The supervisor is aware of and has an understanding of ML/FT risks to which insurers and intermediaries are exposed. It liaises with and seeks to obtain information from the designated competent authority relating to AML/CFT by insurers and insurance intermediaries.	Applicable to <i>Takāful</i> .
	7	The supervisor has effective mechanisms in place which enable it to cooperate, coordinate and exchange information with other domestic authorities, such as the financial intelligence unit, as well as with supervisors in other jurisdictions for AML/CFT purposes.	Applicable to <i>Takāful</i> .
ICP 23 Group Wide Supervision The supervisor supervises insurers on a legal entity and group-wide basis.			
Standard	1	The supervisor, in cooperation with other involved supervisors as necessary, identifies the scope of the group to be subject to group-wide supervision.	

2	<p>The identified group, regarded as an insurance group for the purpose of group-wide supervision by insurance supervisors, covers all relevant entities. In deciding which entities are relevant, consideration should be given to, at least:</p> <ul style="list-style-type: none"> ○ operating and non-operating holding companies (including intermediate holding companies); ○ insurers (including sister or subsidiary insurers); ○ other regulated entities such as banks and/or securities companies; ○ non-regulated entities (including parent companies, their subsidiary companies and companies substantially controlled or managed by entities within the group); and ○ special purpose entities. <p>taking into account, at a minimum, the following elements related to the insurance activities:</p> <ul style="list-style-type: none"> ○ (direct or indirect) participation, influence and/or other contractual obligations; ○ interconnectedness; ○ risk exposure; ○ risk concentration; ○ risk transfer; and/or ○ intragroup transactions and exposures. 	
3	<p>The supervisor does not narrow the identified scope of the group due to lack of legal authority and/or supervisory power over particular entities.</p>	
4	<p>The scope of the group for the purpose of group-wide supervision is flexible in order to take account of any (potential) material and relevant changes in or outside of the group, such as those regarding the structure, activities or macroeconomic environment.</p>	
5	<p>The supervisor requires insurance group structures to be sufficiently transparent so that group-wide supervision will not be hindered.</p>	
6	<p>The supervisor establishes an effective and efficient group-wide supervision framework.</p>	
7	<p>At a minimum, the group-wide supervision framework includes, as a supplement to legal entity supervision,</p> <ul style="list-style-type: none"> ■ extension of legal entity requirements, as applicable according to the relevant ICPs, on: <ul style="list-style-type: none"> ○ solvency assessment (group-wide solvency) ○ governance, risk management and internal controls (group-wide governance) ○ market conduct (group-wide market conduct) ■ requirements related to group-wide supervision on: <ul style="list-style-type: none"> ○ complexity of group structure ○ cross-border/cross-sectoral issues ○ interplay with legal entity supervision ○ non-regulated entities. 	<p>Modifications may be required to address the specificities of Islamic finance since some groups may contain a mixture of conventional and Islamic entities. In particular, insufficient work has as yet been done on group consolidation of even purely Islamic entities, and the issues are likely to be still more complex where mixed groups are concerned.</p>

	8	The supervisor provides for group-wide supervisory review and reporting of an insurance group's adherence to the group-wide regulatory requirements.	
	9	The supervisor requires that insurance groups have reporting systems in place that adequately meet the supervisory demands.	
<p>ICP 24 Macroprudential Surveillance and Insurance Supervision</p> <p>The supervisor identifies, monitors and analyses market and financial developments and other environmental factors that may impact insurers and insurance markets and uses this information in the supervision of individual insurers. Such tasks should, where appropriate, utilise information from, and insights gained by, other national authorities.</p>			
Standard	1	The supervisor identifies underlying trends within the insurance sector by collecting data on, but not limited to, profitability, capital position, liabilities, assets and underwriting, to the extent that it has information available at the level of legal entities and groups. The supervisor also develops and applies appropriate tools that take into account the nature, scale and complexity of insurers, as well as non-core activities of insurance groups, to limit significant systemic risk.	Applicable to <i>Takāful</i> .
	2	The supervisor, in performing market analysis, considers not only past developments and the present situation, but also trends, potential risks and plausible unfavourable future scenarios with the objective and capacity to take action at an early stage, if required.	Applicable to <i>Takāful</i> .
	3	The supervisor performs both quantitative and qualitative analysis and makes use of both public and other sources of information, including horizontal reviews of insurers and relevant data aggregation.	Applicable to <i>Takāful</i> .
	4	The supervisor uses market-wide data to analyse and monitor the actual or potential impact on the financial stability of insurance markets in general and of insurers in particular and takes appropriate action. The supervisor also makes sufficiently detailed aggregated market data publicly available.	Applicable to <i>Takāful</i> .
	5	The supervisor assesses the extent to which macroeconomic vulnerabilities and financial market risks impinge on prudential safeguards or the financial stability of the insurance sector.	Applicable to <i>Takāful</i> .
	6	The supervisor has an established process to assess the potential systemic importance of insurers, including policies they underwrite and instruments they issue in traditional and non-traditional lines of business.	Applicable to <i>Takāful</i> .
	7	If the supervisor identifies an insurer as systemically important, it develops an appropriate supervisory response , which is commensurate with the nature and degree of the risk.	Applicable to <i>Takāful</i> .

ICP 25 Supervisory Cooperation and Coordination

The supervisor cooperates and coordinates with other relevant supervisors and authorities subject to confidentiality requirements.

Standard	1	The supervisor takes steps to put in place adequate coordination arrangements with involved supervisors on cross-border issues on a legal entity and a group-wide basis in order to facilitate the comprehensive oversight of these legal entities and groups. Insurance supervisors cooperate and coordinate with relevant supervisors from other sectors, as well as with central banks and government ministries.	Applicable to <i>Takāful</i>
	2	Coordination agreements include establishing effective procedures for: <ul style="list-style-type: none"> o information flows between involved supervisors; o communication with the head of the group; o convening periodic meetings of involved supervisors; and o conduct of a comprehensive assessment of the group. 	Applicable to <i>Takāful</i>
	3	Involved supervisors determine the need for a group-wide supervisor and agree on which supervisor will take on that role (including a situation where a supervisory college is established).	Applicable to <i>Takāful</i> .
	4	The designated group-wide supervisor takes responsibility for initiating discussions on suitable coordination arrangements , including establishing a supervisory college, and acts as the key coordinator or chairman of the supervisory college, where it is established.	Applicable to <i>Takāful</i> .
	5	There is appropriate flexibility in the establishment of a supervisory college – both when to establish and the form of its establishment – and other coordination mechanisms to reflect their particular role and functions.	Applicable to <i>Takāful</i> .
	6	The designated group-wide supervisor establishes the key functions of the supervisory college and other coordination mechanisms.	Applicable to <i>Takāful</i> .
	7	The designated group-wide supervisor understands the structure and operations of the group . Other involved supervisors understand the structure and operations of parts of the group at least to the extent of how operations in their jurisdictions could be affected and how operations in their jurisdictions may affect the group.	Applicable to <i>Takāful</i> .
	8	The designated group-wide supervisor takes the appropriate lead in carrying out the responsibilities for group-wide supervision . A group-wide supervisor takes into account the assessment made by the legal entity supervisors as far as relevant.	Applicable to <i>Takāful</i> .

ICP 26 Cross-border Cooperation and Coordination on Crisis Management The supervisor cooperates and coordinates with other relevant supervisors and authorities such that a cross-border crisis involving a specific insurer can be managed effectively.			
Standard	1	The supervisor meets regularly with other relevant supervisors and authorities to share and evaluate information relating to specific cross-border insurers and to analyse and assess specific issues (including whether there are systemic implications) in non-crisis periods.	Applicable to <i>Takāful</i> .
	2	The supervisor develops and maintains plans and tools for dealing with insurers in crisis and seeks to remove practical barriers to efficient and internationally coordinated resolutions.	Applicable to <i>Takāful</i> .
	3	The group-wide supervisor coordinates crisis management preparations with involvement from other relevant supervisors and ensures that all supervisors in the relevant jurisdictions (at a minimum those where the insurer is of systemic importance) are kept informed of the crisis management preparations.	Applicable to <i>Takāful</i> .
	4	As far as legal frameworks and confidentiality regimes allow, the supervisor shares with other relevant supervisors, at a minimum, information on the following: <ul style="list-style-type: none"> ○ group structure (including legal, financial and operational intragroup dependencies), ○ interlinkages between the insurer and the financial system in each jurisdiction where it operates, ○ potential impediments to a coordinated solution. 	Applicable to <i>Takāful</i> .
	5	The supervisory regime requires that insurers be capable of supplying, in a timely fashion, the information required to manage a financial crisis.	Applicable to <i>Takāful</i> .
	6	The supervisory regime requires insurers to maintain contingency plans and procedures based on their specific risk for use in a going- and gone-concern situation.	Applicable to <i>Takāful</i> .
	7	The supervisor informs the group-wide supervisor as soon as it becomes aware of an evolving crisis. The group-wide supervisor coordinates such that this information and any other relevant information that it has become aware of on its own is shared among other relevant supervisors and other relevant authorities promptly.	Applicable to <i>Takāful</i> .
	8	Subject to legislative requirements and confidentiality regimes, the supervisor shares information with relevant supervisors and authorities and in a way that does not compromise the prospects of a successful resolution. The supervisor shares information with other relevant authorities or networks as well, whenever necessary, and subject to the same legislative and confidentiality requirements.	Applicable to <i>Takāful</i> .

	9	The group-wide supervisor analyses and assesses the crisis situation and its implications as soon as practicable and supervisors try to reach a common understanding of the situation.	Applicable to <i>Takāful</i> .
	10	The supervisor cooperates to find internationally coordinated, timely and effective solutions .	Applicable to <i>Takāful</i> .
	11	If a fully coordinated supervisory solution is not possible, the supervisor discusses jurisdictional measures with other relevant supervisors as soon as possible.	Applicable to <i>Takāful</i> .
	12	In a crisis situation, the group-wide supervisor coordinates public communication at each stage of the crisis .	Applicable to <i>Takāful</i> .

SECTION 4: DETAILED GAP ASSESSMENT OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION FOR ISLAMIC CAPITAL MARKET SECTOR

4.1 Industry: Islamic Capital Market

58. A well-functioning capital market is a core aspect of economic development. Its economic functions include bringing together the suppliers of capital (savers and/or investors) and those requiring capital (firms and issuers), offering savers methods of transferring surplus cash as well as offering firms methods of attracting investment funds, and risk allocation and re-allocation.
59. Like conventional capital markets, the Islamic capital market (ICM) is an integral part of Islamic finance and plays an important part in the Islamic financial structure. It enables the efficient mobilisation of resources, promotes optimal allocation of those resources and funds, and provides liquidity and investment vehicles for the Islamic financial institutions.
60. The ICM has developed significantly over the past decade in terms of both sophistication and size. The need to seek alternative funding sources has grown in tandem with the increasing number of corporates and public enterprises engaging in project and infrastructure finance undertaking activities in compliance with *Sharī'ah* principles.

4.1.1 Regulation of Islamic Capital Markets

61. Islamic capital markets are not generally segregated from conventional capital markets. Islamic financial products are often listed on the same exchanges as conventional securities, and in most jurisdictions they are regulated under the same set of rules and regulations that regulate conventional products. Unlike conventional markets, however, Islamic capital markets have to abide by restrictions on how the funds are raised, and the instruments are structured in such a way as to be in accordance with *Sharī'ah* rules and principles.

4.2 Islamic Capital Market Instruments

62. At present, the dominant ICM instruments are *Sukūk*, Islamic collective investment schemes, *Sharī'ah*-compliant stocks and Islamic indices.

4.2.1 Sukūk

63. *Sukūk* are defined as certificates with each *sakk* representing a proportional undivided ownership right in tangible and intangible assets, monetary assets, usufructs, services, debts or a pool of predominantly tangible assets, or a business venture.¹⁰ These assets, which must be clearly identifiable, may be in a specific project or investment activity in accordance with *Sharī'ah* rules and principles. Issuance of *Sukūk*, including the utilisation of funds raised through such issuance, should not involve any elements of *Riba*, *Gharar* and activities prohibited by *Sharī'ah*. In most cases, a *Sharī'ah* board would be required to advise on the *Sharī'ah* compliance aspects of the *Sukūk*.
64. The tradability of the *Sukūk* is dependent on its structure, as the *Sharī'ah* generally prohibits the sale of debt other than at par.
65. After Islamic banking, the *Sukūk* market is the second-fastest growing segment of Islamic finance. The instruments offer an alternative funding tool to conventional bonds that can be structured and utilised for a vast array of purposes. In recent years, *Sukūk* products have seen significant innovation with the introduction of hybrid, convertible, perpetual, retail and insurance-linked issuances. As such, *Sukūk* are being used to fund working capital requirements, and for liquidity management, risk management and investment purposes.
66. Since 2005, according to the *IFSB Islamic Financial Services Industry Financial Stability Report, 2014*, *Sukūk* issuances have increased at a Compound Annual Growth Rate (CAGR) of 41.6% until end-2012, from USD11.5 billion to USD119.7 billion. More critically, the popularity of *Sukūk* as a financing instrument rapidly gained momentum in the post-financial crisis period, with more than 61% y-o-y growth in global *Sukūk* issuances in 2010.

Sukūk Issuance Trend



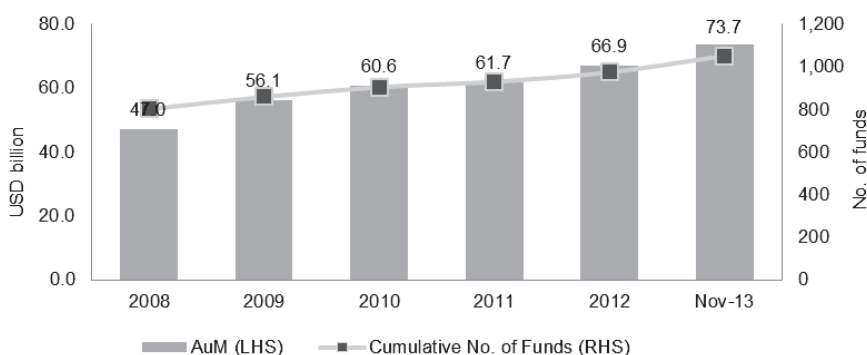
Source: *IFSB Islamic Financial Services Industry Financial Stability Report, 2014*

¹⁰ IFSB-15: *Revised Capital Adequacy Standard for Institutions offering Islamic Financial Services excluding Islamic Insurance and Collective Investment Schemes*, December 2013.

4.2.2 Islamic Collective Investment Schemes

67. An Islamic collective investment scheme can be any collective investment scheme (CIS) which is claimed to be established and managed in accordance with *Shari'ah* rules and principles. In general, ICIS follow similar structural approaches to conventional funds, and cover similarly broad classes of investment, including specialised fund types such as Islamic real estate investment trusts and Islamic exchange-traded funds. Assets must, however, be screened for their acceptability under *Shari'ah*. This may be done by a fund's (or its manager's) own *Shari'ah* advisers, or by using one of the commercially available screening methodologies. In addition, *Shari'ah* advisers will not generally allow an ICIS to sell short, and there are quite severe restrictions on the use of derivatives.
68. The *Shari'ah* governance system normally caters to the following processes:
- monitoring consistent compliance with the *Shari'ah* rules and principles in its daily operations;
 - portfolio screening to ensure its investment portfolios remain within *Shari'ah*-permissible assets/projects; and
 - purification of tainted income, whereby income that is contaminated by prohibited elements is removed from the ICIS and donated to charity.
69. As at end-2012, according to the *IFSB Islamic Financial Services Industry Financial Stability Report, 2014*, assets under management of Islamic funds grew to USD66.9 billion from USD47.0 billion in 2008, representing a CAGR of 9.4%. As of 11M13, the assets under management had reached an estimated USD73.7 billion, while the cumulative number of Islamic funds stood at 1052.

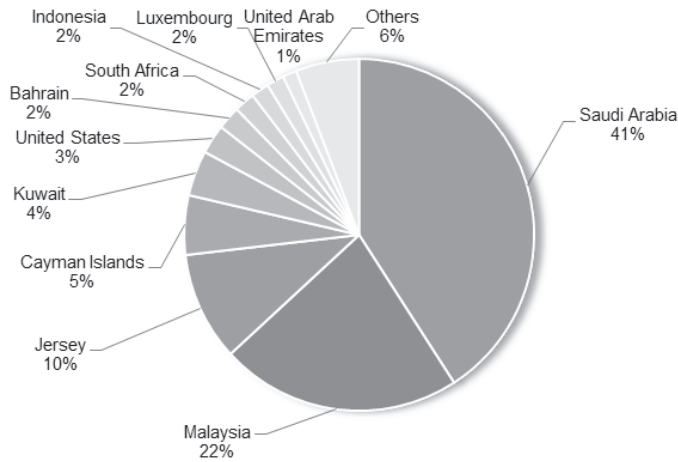
Growth in Assets under Management and Number of Islamic Funds



Source: *IFSB Islamic Financial Services Industry Financial Stability Report, 2014*

70. By domicile, Islamic funds are concentrated in Saudi Arabia and Malaysia, followed by Kuwait, the United States and the Cayman Islands, as at November 2013.

Islamic Fund Assets by Domicile (11M13)



Source: IFSB Islamic Financial Services Industry Financial Stability Report, 2014

4.2.3 Islamic Indices

71. An Islamic index is a financial index the constituents of which are *Sharī'ah*-compliant equities or *Sukūk*. Global Islamic index providers derive the base of constituent stocks for their Islamic indices from the universe of stocks for their respective conventional equity indices. Islamic indices offer benchmarks for the performance of Islamic investments as well as for those of conventional investments which are *Sharī'ah*-compliant. Islamic indices also necessitated the development of a *Sharī'ah* screening process to identify which companies are *Sharī'ah*-compliant and should be included in such indices. Screens may be used by investors as a proxy for their own assessment of the compliance of any particular instrument with *Sharī'ah* principles.
72. The first global Islamic index was the Dow Jones Islamic Market Index, introduced in March 1999, followed by the FTSE in October 1999. Globally, there are six major index providers that offer Islamic equity indices: Dow Jones Indices, FTSE, Morgan Stanley Capital International, Russell, Standard & Poor's and Thomson Reuters.

4.2.4 Sharī'ah-compliant Equity

73. Any equity security can be classified as a *Sharī'ah*-compliant equity security if the corporate's activities are not related to non-compliant

business activities and it does not fail financial ratio tests intended to exclude businesses receiving or paying substantial interest. The examples of prohibited non-compliant business activities, include:

- conventional financial services (because of interest);
- conventional insurance (because of uncertainty);
- alcohol or pork-related products (including producers, distributors and stores); and
- gambling or defence-related activities, etc.

74. Given the dominance of the interest-based conventional financial system, however, it is not practically feasible for most corporations to avoid transactions associated with interest or other kinds of prohibited activities, even though those are not part of their primary business activities. In this environment, finding an equity that is 100% *Shari'ah*-compliant could be difficult. Thus, In order to identify *Shari'ah*-compliant equity securities, various jurisdictions and institutions employ a *Shari'ah* screening process.
75. Two categories of *Shari'ah* screening process are generally used to ensure compliance with the requirements of *Shari'ah*: qualitative screening and quantitative screening. Qualitative screening is often called sector screening, and quantitative screening is called financial ratio screening. The former is the process through which companies' core business is examined in relation to the prohibited business activities. The latter refers to the process whereby companies involved in mixed activities and non-permissible financial practices are identified and excluded if those ratios exceed certain prescribed thresholds. The quantitative process also tests negotiability of shares from the *Shari'ah* perspective.
76. Islamic index providers conduct such screening as a matter of course, advised by *Shari'ah* scholars, and many ICIS operators rely on such screens. In some jurisdictions, however, another body (whether a regulator or an exchange) may operate a screening process of its own, and tag certain securities as *Shari'ah*-compliant.

4.3 IFSB'S Work on Islamic Capital Market Regulation

77. In January 2009, the IFSB published its IFSB-6: ***Guiding Principles on Governance for Islamic Collective Investment Schemes***, the first prudential standard developed by the IFSB in the area of Islamic capital markets. IFSB-6 has a specific aim of complementing the internationally recognised governance standards; therefore, it seeks to supplement and expand the relevant standards by focusing on the appropriate best practices by the IFSB.

78. The guidance given by IFSB-6 is categorised into four categories, namely: (a) general governance approach of ICIS; (b) transparency in disclosure; (c) compliance with *Sharī'ah* rules and principles; and (d) additional protections for ICIS investors. There are five guiding principles on governance for ICIS with recommended best practices for each principle.
79. In 2012, the IFSB co-organised a full-day Roundtable on Disclosure Requirements for Islamic Capital Market Products with the IOSCO and Securities Commission Malaysia, and subsequently published the proceedings of this Roundtable in September 2013. The publication was distributed during IOSCO's 2013 annual meeting, held in Luxembourg. The publication underlined:
- the importance of disclosure and transparency in the development of the ICM;
 - the role of disclosure in regulating and clarifying risk management, investor rights and *Sharī'ah* governance matters;
 - the application of IOSCO Core Principles on ICM products and areas not covered in these Core Principles; and
 - the role of regulation and disclosures in promoting investor confidence in ICM products.

4.4 IOSCO'S Objectives and Principles of Securities Regulations

4.4.1 Background

80. In May 1998, IOSCO resolved to adopt the *Objectives and Principles of Securities Regulation* as a source of information on principles that underlie effective securities regulation, and on the tools and techniques necessary to give effect to those principles. In May 2003, IOSCO members endorsed a revised set of *Objectives and Principles of Securities Regulation*, which included three main objectives and 30 core principles grouped into eight categories. In June 2010 a further revision added eight new principles (thus raising the total to 38), now grouped into ten categories. The supporting Assessment Methodology was released in September 2011. The new Objectives and Principles placed more emphasis on systemic risk, and covered additional topics such as the regulation of hedge funds.

4.4.2 Studies on ICM by IOSCO

81. Recognising the development of the IFSI, IOSCO has issued two studies on ICM. In July 2004, it issued the *ICM Fact Finding Report*, and in September 2008, the *Analysis of the Application of IOSCO Objectives and Principles of Securities Regulation for Islamic Securities Products*. Both papers explored the applicability of IOSCO's principles to

the ICM and **concluded that IOSCO's principles are compatible with and can be applied to the ICM.**

Islamic Capital Market Fact Finding Report (July 2004)

82. At the 2002 IOSCO annual conference held in Turkey, IOSCO mandated the formation of an Islamic Capital Market Task Force (ICMTF). ICMTF issued its report, *Islamic Capital Market Fact Finding Report*, in July 2004. The report explained the fundamentals and principles underlying Islamic finance, describing the landscape of IFSI and its individual components. The report also discussed the developmental and regulatory issues that have arisen from the survey and research.
83. According to the report, most jurisdictions, as well as market professionals, were of the view that ICM activities could be adequately regulated within the framework of the conventional financial market. Most survey respondents stated that their conventional domestic securities regulatory framework is equally applicable to the ICM, which suggests that IOSCO principles are applicable to the ICM. Further, the report stated: "Given that the ICM is primarily viewed as a segment of the conventional market (the main differences being in the structure of products, services and other activities) the IOSCO principles can be and should apply equally to the ICM. A significant finding from the survey was the consensus view that the conventional securities regulation framework and principles equally apply to the ICM, with the addition of some form of a *Shari'ah* approval or certification."

Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products (September 2008)

84. Subsequently, IOSCO considered it prudent to carry out further work in ICM and set a new mandate, narrower than that of ICMTF, to assess the compatibility of IOSCO's core principles with the product and practices of Islamic finance. In September 2008, IOSCO published *Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products*. The key findings of this report were consistent with those of the previous work. In addition, the report suggested the five recommendations.
85. Analysis of this report has not identified any concerns with respect to the compatibility of the IOSCO Core Principles, as they then stood, with the ICM. However, while the applicability of the IOSCO Core Principles was confirmed by this analysis, it was also found that the implementation of the principles may benefit from further consideration in some specific areas. This report highlighted a number of principles where some changes or additional guidance would be required.

4.5 Gap Analysis of IOSCO’S Principles and Assessment Methodology

86. IOSCO’s principles and the supporting assessment methodology are reviewed to see if there is any gap between the conventional and Islamic capital markets and to check their applicability to ICM. In general, all 38 principles are applicable to ICM. However, in practice, in order to establish a more effective regulatory system, certain specific characteristics of ICM need to be considered by regulators or reflected in the regulatory system. The results of this gap assessment are presented in Table 4.5.1.

Table 4.5.1: Applicability of IOSCO Objectives and Principles to the ICM

IOSCO Core Principles Reference	Description of the IOSCO Core Principles ¹¹	Applicability to the ICM
A. Principles relating to the regulator		
<p>Principle 1: The responsibilities of the Regulator should be clear and objectively stated.</p>	<p>The regulator’s responsibilities should be clearly and objectively stated, so that investors and market participants may not be uncertain about the degree to which the regulator is able to protect the market’s integrity through fair and effective oversight.</p> <p>The capacity of the regulator to act responsibly, fairly and effectively is assisted by a clear definition of responsibilities, preferably set out by law; and strong cooperation among responsible authorities through appropriate channels.</p>	<p>Principle 1, including the assessment methodology, is applicable to ICM with further consideration.</p> <p>Some jurisdictions may not yet have adopted a specific approach to dealing with ICM products and transactions. So, there may be a lack of clarity with regards to the regulator’s responsibilities and regulatory remit regarding ICM.</p> <p>To clarify and ensure investors’ confidence, regulators need to clearly state their responsibilities to the ICM services and products – in particular, their role in relation to <i>Sharī’ah</i> matters.</p>

11 Methodology For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation(IOSCO, September 2011)

IOSCO Core Principles Reference	Description of the IOSCO Core Principles ¹¹	Applicability to the ICM
<p>Principle 2: The Regulator should be operationally independent and accountable in the exercise of its functions and powers.</p>	<p>The regulator should be operationally independent from external political or commercial interference. Without such independence, investors and other market participants may come to doubt the regulator’s objectivity and fairness, with deleterious effects on the market’s integrity.</p> <p>Independence implies a regulator that operates independently of sectoral interest, with the ability to undertake regulatory measures and enforcement actions without external (political or commercial) interference.</p> <p>Accountability implies that the regulator is subject to appropriate scrutiny and review, including: periodic public reporting by the regulator on its performance; transparency of the regulator’s process and conduct; and a system permitting judicial review of licensing, authorising or enforcement-related final decisions of the regulator.</p>	<p>Principle 2, including the assessment methodology, is applicable to ICM.</p>
<p>Principle 3: The Regulator should have adequate powers, proper resources and the capacity to perform its functions and exercise its powers.</p>	<p>The regulator should have adequate powers, proper resources (including adequate funding) and the capacity to perform its functions and exercise its powers, both in regular and in emergency situations.</p> <p>This includes powers of licensing, supervision, inspection, investigation and enforcement. It also includes the capacity and resources to attract and retain appropriately trained, qualified and skilled staff to perform its functions and exercise its powers, while being able to provide ongoing training to this staff.</p>	<p>Principle 3, including the assessment methodology, is applicable to ICM.</p> <p>In the case where a capital market regulator performs the additional role of <i>Shari’ah</i> compliance or has regulations regarding the governance of the <i>Shari’ah</i> decision-making process, the regulator should also possess the appropriate powers and competence for dealing with <i>Shari’ah</i> compliance issues to discharge its responsibilities adequately.</p>
<p>Principle 4: The Regulator should adopt clear and consistent regulatory processes.</p>	<p>Clear, consistent, transparent procedures and processes are part of fundamental fairness and of a framework for developing regulatory decisions and for undertaking regulatory actions that assure accountability.</p> <p>Transparency policies must, however, balance the rights of individuals to confidentiality, and regulators’ enforcement and surveillance needs, with the objective of fair, equitable and open regulatory processes.</p>	<p>Principle 4, including the assessment methodology, is applicable to ICM with a possible addition to the assessment methodology:</p> <p>In the case where the regulator is directly involved in issuing decisions on <i>Shari’ah</i> issues, it should consider promoting the disclosure of decisions and their underlying rationale properly.</p>

IOSCO Core Principles Reference	Description of the IOSCO Core Principles ¹¹	Applicability to the ICM
<p>Principle 5: The staff of the Regulator should observe the highest professional standards, including appropriate standards of confidentiality.</p>	<p>This principle refers to the integrity, and the means for achieving and demonstrating the integrity, of the regulatory authority and its staff. Only the highest professional standards of conduct are appropriate to achieving the objectives of regulation.</p>	<p>Principle 5, including the assessment methodology, is applicable to ICM.</p>
<p>Principle 6: The Regulator should have or contribute to a process to monitor, mitigate and manage systemic risk, appropriate to its mandate.</p>	<p>The regulator should have or contribute to regulatory processes, which may be cross-sectoral, to monitor, mitigate and appropriately manage systemic risk.</p> <p>Capital market regulators should work with other supervisors to improve the overall understanding of the economics of the securities markets, their vulnerabilities, and the interconnections with the broader financial sector and the real economy.</p>	<p>Principle 6, including the assessment methodology, is applicable to ICM.</p>
<p>Principle 7: The Regulator should have or contribute to a process to review the perimeter of regulation regularly.</p>	<p>Regular review of the perimeter of regulation promotes a regulatory framework that supports investor protection, fair, efficient and transparent markets, and the reduction of systemic risk.</p>	<p>Principle 7, including the assessment methodology, is applicable to ICM.</p> <p>In the case where the regulator has regulations on <i>Sharī'ah</i> compliance, it should review the perimeter of such regulations regularly.</p>
<p>Principle 8: The Regulator should seek to ensure that conflicts of interest and misalignment of incentives are avoided, eliminated, disclosed or otherwise managed.</p>	<p>The regulator should identify and evaluate potential and actual conflicts of interests regarding regulated entities and misalignment of incentives for issuers and regulated entities providing analytical or evaluative services to investors and other users of those services within the securities market.</p> <p>The regulator should take steps so that conflicts of interest or misalignment of incentives among regulated entities are avoided, eliminated, disclosed or otherwise managed. Disclosure of potential conflicts of interest and misalignment of incentives should be made to or be accessible by investors and/or other users of the services or products.</p>	<p>Principle 8, including the assessment methodology, is applicable to ICM.</p>

IOSCO Core Principles Reference	Description of the IOSCO Core Principles ¹¹	Applicability to the ICM
B. Principles for self-regulation		
<p>Principle 9: Where the regulatory system makes use of Self-Regulatory Organizations (SROs) that exercise some direct oversight responsibility for their respective areas of competence, such SROs should be subject to the oversight of the Regulator and should observe standards of fairness and confidentiality when exercising powers and delegated responsibilities.</p>	<p>Self-regulation encompass the authority to create, amend, implement and enforce rules of trading, business conduct and/or qualification regimes with respect to the persons (i.e. legal and natural persons) subject to the SRO's jurisdiction and to resolve disputes through arbitration or other appropriate dispute resolution mechanisms.</p> <p>If self-regulation is used, the SROs should be subject to appropriate oversight by the regulator with regard to its authorisation, professional standards, management of conflicts of interests, etc.</p>	<p>Principle 9, including the assessment methodology, is applicable to ICM.</p>
C. Principles for the enforcement of securities regulation		
<p>Principle 10: The Regulator should have comprehensive inspection, investigation and surveillance powers.</p>	<p>This principle is designed to address whether a regulator has the powers to conduct surveillance, undertake inspections, obtain information, undertake investigations and take corresponding enforcement action in relation to regulated entities to ensure that they comply with relevant securities laws. It covers the circumstances where, and methods by which, the regulator may obtain information from those entities in the course of its inquiries.</p> <p>Principle 10, in particular, addresses the regulator's authority to conduct ongoing oversight and supervision of regulated entities as preventative measures.</p>	<p>Principle 10, including the assessment methodology, is applicable to ICM.</p>
<p>Principle 11: The Regulator should have comprehensive enforcement powers.</p>	<p>While Principle 10 is limited to regulated entities, Principle 11 is intended to have wider application. As in the case of powers, reflecting a broad definition of enforcement, Principle 11 deals with courses of action, including investigations and proceedings, available to the regulator where a breach of relevant securities laws by any person is suspected or identified.</p>	<p>Principle 11, including the assessment methodology, is applicable to ICM.</p>

IOSCO Core Principles Reference	Description of the IOSCO Core Principles ¹¹	Applicability to the ICM
<p>Principle 12: The regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program.</p>	<p>This principle requires the regulator to demonstrate how the regulatory system in place, and its own organisation, provides for an effective and credible use of supervisory and enforcement powers.</p>	<p>Principle 12, including the assessment methodology, is applicable to ICM.</p>
<p>D. Principles for cooperation in regulation</p>		
<p>Principle 13: The Regulator should have authority to share both public and non-public information with domestic and foreign counterparts.</p>	<p>The increasing internationalisation of financial activities and the globalisation of markets can put information beyond the immediate jurisdictional reach of one individual competent regulator. This puts an additional emphasis on the need for international cooperation.</p>	<p>Principle 13, including the assessment methodology, is applicable to ICM.</p>
<p>Principle 14: Regulators should establish information-sharing mechanisms that set out when and how they will share both public and non-public information with their domestic and foreign counterparts.</p>	<p>4. This principle addresses the power of the regulators to share public and non-public information within its files, or available to it through inspection and investigation, without other external processes.</p>	<p>Principle 14, including the assessment methodology, is applicable to ICM.</p>
<p>Principle 15: The regulatory system should allow for assistance to be provided to foreign Regulators who need to make inquiries in the discharge of their functions and exercise of their powers.</p>	<p>Securities regulators have long used Memoranda of Understanding (MoUs) to facilitate consultation, cooperation and the exchange of information in securities enforcement matters.</p> <p>These enforcement MoUs permit regulators who suspect there has been a violation of their laws and/or regulators to seek ad hoc assistance from their overseas counterparts when evidence of the possible violation may lie outside their jurisdictions.</p>	<p>Principle 15, including the assessment methodology, is applicable to ICM.</p>

IOSCO Core Principles Reference	Description of the IOSCO Core Principles ¹¹	Applicability to the ICM
E. Principles for issuers		
<p>Principle 16: There should be full, accurate and timely disclosure of financial results, risk and other information that is material to investors' decisions.</p>	<p>Issuers should disclose to investors current and reliable information necessary to make informed investment decisions on an ongoing basis.</p> <p>The principle of full, timely and accurate disclosure of current and reliable information material to investment decisions is directly related to the objectives of investor protection and fair, efficient and transparent markets.</p>	<p>Principle 16, including the assessment methodology, is applicable to ICM with further consideration.</p> <p>Additional disclosures might be relevant for investors in ICM products. These might include information on the <i>Sharī'ah</i> board, how the product meets <i>Sharī'ah</i> requirements, and details related to <i>Sharī'ah</i> compliance.</p> <p>As with conventional securities, the disclosure regime for ICM products should reflect the economic substance and risk profile of the product. For example, in the case of asset-based <i>Sukūk</i>, relevant information focusing on the originator should be disclosed.</p>
<p>Principle 17: Holders of securities in a company should be treated in a fair and equitable manner.</p>	<p>This principle requires that basic rights of shareholders should be protected, and shareholders within a class should be treated equitably.</p>	<p>Principle 17, including the assessment methodology, is applicable to ICM.</p>
<p>Principle 18: Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.</p>	<p>This principle requires that issuers should prepare financial statements in accordance with high-quality international financial reporting standards.</p> <p>Use of high-quality and internationally acceptable standards, in turn, seeks to ensure the information provided in financial statements is comprehensive, consistent, relevant, reliable and comparable, and so supports investors in making investment decisions, regardless of the geographic location of the entity concerned.</p>	<p>Principle 18, including the assessment methodology, is applicable to ICM.</p>

IOSCO Core Principles Reference	Description of the IOSCO Core Principles ¹¹	Applicability to the ICM
F. Principles for auditors, credit rating agencies, and other information service providers		
<p>Principle 19: Auditors should be subject to adequate levels of oversight.</p>	<p>Effective oversight of those performing audit services is critical to the reliability and integrity of the financial reporting process, and helps reduce the risks of financial reporting and auditing failures in the public securities market.</p> <p>The ultimate purpose of such oversight is to protect the interests of investors and further the public interest in the preparation of informative, true, fair and independent audit reports.</p>	<p>Principle 19, including the assessment methodology, is applicable to ICM.</p>
<p>Principle 20: Auditors should be independent of the issuing entity that they audit.</p>	<p>Independent auditors play a critical role in enhancing the reliability of financial information by attesting as to whether the financial statements prepared by management fairly present or provide a true and fair view of the financial condition and past performance of the issuer in compliance with accepted standards.</p>	<p>Principle 20, including the assessment methodology, is applicable to ICM.</p>
<p>Principle 21: Audit standards should be of a high and internationally acceptable quality.</p>	<p>High-quality auditing standards help safeguard the integrity of an issuer's financial statements. Auditing standards are necessary safeguards of the reliability of financial information, and such standards should be comprehensive, well defined, and of a high and internationally acceptable quality.</p>	<p>Principle 21, including the assessment methodology, is applicable to ICM.</p>
<p>Principle 22: Credit rating agencies should be subject to adequate levels of oversight. The regulatory system should ensure that credit rating agencies whose ratings are used for regulatory purposes are subject to registration and ongoing supervision.</p>	<p>Because credit rating agencies (CRAs) play an important role in helping market participants incorporate into their decision-making voluminous, diverse and highly complicated information about a particular investment, regulators, market participants and CRAs themselves have an interest in ensuring that CRAs carry out this role in an honest and fair manner.</p> <p>Therefore, CRAs should be subject to an adequate level of supervision.</p>	<p>Principle 22, including the assessment methodology, is applicable to ICM.</p>

IOSCO Core Principles Reference	Description of the IOSCO Core Principles ¹¹	Applicability to the ICM
<p>Principle 23: Other entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them.</p>	<p>Entities that provide analytical or evaluative services of various types to investors to assist them with assessing the desirability of a particular investment opportunity may need to be subject to regulation or oversight.</p> <p>An example of such an entity is “sell-side” securities analysts employed by full-service investment firms, who can face conflicts of interest that may compromise their ability to offer investors independent and unbiased opinions.</p>	<p>Principle 23, including the assessment methodology, is applicable to ICM.</p>
G. Principles for collective investment schemes		
<p>Principle 24: The regulatory system should set standards for the eligibility, governance, organisation and operational conduct of those who wish to market or operate a collective investment scheme.</p>	<p>CIS operators and CIS should meet clearly defined standards as set by the regulatory system, for both initial approval and continuing operation.</p> <p>The eligibility standards and operating conditions to act as CIS operators should seek to ensure that those who operate or market CIS are qualified to do so.</p>	<p>Principle 24, including the assessment methodology, is applicable to ICM with further consideration.</p> <p>Regarding eligibility of an ICIS operator, regulators may consider setting additional requirements such as a certain level of knowledge and experience in ICM and Islamic finance to ensure the fund's operations adhere to <i>Shari'ah</i> principles.</p> <p>Regulators may also wish to consider the <i>Shari'ah</i> governance/compliance arrangements to be applied to ensure that the fund is and remains <i>Shari'ah</i>-compliant.</p> <p>Also, special consideration needs to be given to PSIAAs of Islamic banks. As the 2008 IOSCO report noted:</p>

IOSCO Core Principles Reference	Description of the IOSCO Core Principles ¹¹	Applicability to the ICM
		<p>“There is as yet no consensus among regulators as to how unrestricted PSIAs should be regulated. Some regulators consider that in practice PSIAs are economically and functionally equivalent to bank deposits, and should therefore be regulated as such. This would mean that related issues would be more likely to fall within the remit of the BCBS than that of IOSCO. However, other regulators consider PSIAs to be distinct from bank deposits and treat them as such by, for example, requiring clear disclosure that neither principal nor return is guaranteed. In the latter case, it has been suggested that the principles applicable to CIS may also be of relevance in regulating PSIAs.”</p> <p>This core principle, and the others relating to CIS, are not easy to apply directly to PSIAs and there may be a need for a new core principle to cover them.</p>
<p>Principle 25: The regulatory system should provide for rules governing the legal form and structure of collective investment schemes and the segregation and protection of client assets.</p>	<p>The legal form and structure of CIS and the implications thereof for the nature of risks associated with the CIS should be disclosed to investors. Those risks to investors might be addressed either through statute, conduct rules or mandatory covenants in the constituent documents of a CIS.</p> <p>Also, the regulatory system should ensure adequate segregation and protection of client assets, including through use of custodians and/or depositories that are, in appropriate circumstances, independent.</p>	<p>Principle 25, including the assessment methodology, is applicable to ICM, subject to the point made above about PSIAs.</p>

IOSCO Core Principles Reference	Description of the IOSCO Core Principles ¹¹	Applicability to the ICM
<p>Principle 26: Regulation should require disclosure, as set forth under the principles for issuers, which is necessary to evaluate the suitability of a collective investment scheme for a particular investor and the value of the investor's interest in the scheme.</p>	<p>This principle is intended to ensure that matters material to the value of investing in a CIS are the subject of disclosure to investors and potential investors.</p> <p>Disclosure about a CIS should assist investors in understanding the nature of the investment vehicle and the relationship between risk and return, so that investors evaluating CIS performance do not focus solely on return, but also on the risk assumed to produce the return.</p>	<p>Principle 26, including the assessment methodology, is applicable to ICM with further consideration.</p> <p>To evaluate the suitability of ICIS more effectively, additional information related to specificities of Islamic finance, such as <i>Shari'ah</i> governance, the screening process and the possibility of purification, should be disclosed. This issue has been covered in IFSB-6.</p> <p>This analysis is also subject to the point made above about PSIA's.</p>
<p>Principle 27: Regulation should ensure that there is a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a collective investment scheme.</p>	<p>Proper valuation of CIS assets is critical to ensure investor confidence in CIS as a reliable and robust investment vehicle and for proper investor protection, especially in cases where a market price is unavailable.</p> <p>Regulation should seek to ensure that all of the property of a CIS is fairly and accurately valued and that the net asset value of the CIS is correctly calculated.</p>	<p>Principle 27, including the assessment methodology, is applicable to ICM with further consideration.</p> <p>There will be particular issues if PSIA's are considered as ICIS because of the use of smoothing mechanisms. In particular, PSIA's of an Islamic bank which use reserves such as PER/IRR or other means to smooth earnings should have proper asset valuation, pricing and redemption criteria and disclose this information appropriately.</p>
<p>Principle 28: Regulation should ensure that hedge funds and/or hedge funds managers/advisers are subject to appropriate oversight.</p>	<p>The regulatory system should set standards for the authorisation/ registration and the regulation and supervision of those who wish to operate hedge funds (managers/ advisers).</p>	<p>Principle 28, including the assessment methodology, is applicable to ICM. To the extent that hedge funds can operate within the ICM, the points made in relation to competence at Principle 24 and disclosure at Principle 26 will be relevant here also.</p>

IOSCO Core Principles Reference	Description of the IOSCO Core Principles ¹¹	Applicability to the ICM
<p>Principle 29: Regulation should provide for minimum entry standards for market intermediaries.</p>	<p>The licensing and supervision of market intermediaries, including its staff, should set minimum standards for them and provide consistency of treatment for all similarly situated intermediaries. It should also reduce the risk to investors of loss caused by negligent or illegal behaviour and/or inadequate capital.</p>	<p>Principle 29, including the assessment methodology, is applicable to ICM with further consideration.</p> <p>Where the regulator has responsibility for regulating <i>Sharī'ah</i> compliance, it should consider minimum entry standards for ICM intermediaries such as competency and resources to comply with <i>Sharī'ah</i> principles.</p>
<p>Principle 30: There should be initial and ongoing capital and other prudential requirements for market intermediaries that reflect the risks that the intermediaries undertake.</p>	<p>Establishment of adequate initial and ongoing capital standards also contributes to ensuring the protection of investors, and the integrity and stability of financial systems.</p> <p>A market intermediary should be required to ensure that it maintains adequate financial resources to meet its business commitments and to withstand the risks to which its business is subject.</p>	<p>Principle 30, including the assessment methodology, is applicable to ICM with further consideration.</p> <p>Regulators should consider the nature of Islamic products when applying capital adequacy and prudential requirements for market intermediaries. The methodology references more detailed IOSCO work on capital standards for market intermediaries, but these have not been studied as part of the present analysis.</p>
<p>Principle 31: Market intermediaries should be required to establish an internal function that delivers compliance with standards for internal organization and operational conduct, with the aim of protecting the interests of clients and their assets and ensuring proper management of risk, through which management of the intermediary accepts primary responsibility for these matters.</p>	<p>Regulation should require that market intermediaries have in place appropriate internal policies and procedures for observance of securities laws and appropriate internal organisation and risk management systems. Regulation should not be expected to remove risk from the marketplace, but should aim to ensure that there is proper management of that risk.</p>	<p>Principle 31, including the assessment methodology, is applicable to ICM with further consideration.</p> <p>The appropriate organisation and risk management systems will need to include those for ensuring continuing compliance with the rulings of any <i>Sharī'ah</i> supervisory board or similar body.</p> <p>If the regulator chooses to regulate <i>Sharī'ah</i> compliance, it may also wish to require that ICM intermediaries should apply <i>Sharī'ah</i>-compliant risk mitigation instruments where financial risks are involved.</p>

IOSCO Core Principles Reference	Description of the IOSCO Core Principles ¹¹	Applicability to the ICM
<p>Principle 32: There should be procedures for dealing with the failure of a market intermediary in order to minimize damage and loss to investors and to contain systemic risk.</p>	<p>The failure of a market intermediary can have a negative impact on clients and counterparties and may have systemic consequences. The regulator must have a clear and flexible plan in place to deal with the eventuality of failure by market intermediaries.</p>	<p>Principle 32, including the assessment methodology, is applicable to ICM.</p>
<p>H. Principles relating to the secondary markets</p>		
<p>Principle 33: The establishment of trading systems including securities exchanges should be subject to regulatory authorization and oversight.</p>	<p>The regulator's authorisation of exchanges and trading systems, including the review and approval of trading rules, helps to ensure fair and orderly markets. The fairness of markets is closely linked to investor protection and, in particular, the prevention of improper trading practices.</p>	<p>Principle 33, including the assessment methodology, is applicable to ICM with further consideration.</p> <p>Where an exchange has responsibility for determining whether a product is <i>Shari'ah</i> compliant or not, regulators should ensure that the exchange has the proper resources and competency to do so.</p> <p>Similarly, where an exchange permits non-equity Islamic products to trade (such as <i>Sukūk</i>), it should have sufficient knowledge properly to evaluate the product's design and other relevant features.</p>
<p>Principle 34: There should be ongoing regulatory supervision of exchanges and trading systems which should aim to ensure that the integrity of trading is maintained through fair and equitable rules that strike an appropriate balance between the demands of different market participants.</p>	<p>Orderly smooth functioning markets promote investor confidence. Accordingly, there should be ongoing supervision of the markets.</p>	<p>Principle 34, including the assessment methodology, is applicable to ICM with further consideration.</p> <p>Where the exchange has responsibility for determining the <i>Shari'ah</i> compliance of products, the exchange should review their status of <i>Shari'ah</i> compliance periodically and change the status in a timely manner if they are no longer listed or traded as <i>Shari'ah</i>-compliant.</p>

IOSCO Core Principles Reference	Description of the IOSCO Core Principles ¹¹	Applicability to the ICM
<p>Principle 35: Regulation should promote transparency of trading.</p>	<p>Transparency of trading is about the availability to the public of pre- and post-trade information.</p> <p>Pre-trade information concerns the posting of firm bids and offers, in both quote- and order-driven markets, as a means to enable intermediaries and investors to know, with some degree of certainty, whether, and at what prices, they can deal. Post-trade information is related to the prices and volume of all individual transactions actually concluded.</p>	<p>Principle 35, including the assessment methodology, is applicable to ICM.</p>
<p>Principle 36: Regulation should be designed to detect and deter manipulation and other unfair trading practices.</p>	<p>An effective market oversight program should have a mechanism for monitoring compliance with the securities laws, regulations and market rules, operational competence requirements and market standards.</p>	<p>Principle 36, including the assessment methodology, is applicable to ICM.</p>
<p>Principle 37: Regulation should aim to ensure the proper management of large exposures, default risk and market disruption.</p>	<p>Regulators should promote and allow for the effective management of risk and ensure that capital and other prudential requirements are sufficient to address appropriate risk-taking, allow the absorption of some losses and check excessive risk-taking.</p>	<p>Principle 37, including the assessment methodology, is applicable to ICM.</p>
<p>I. Principles relating to clearing and settlement</p>		
<p>Principle 38: Securities settlement systems and central counterparties should be subject to regulatory and supervisory requirements that are designed to ensure that they are fair, effective and efficient, and that they reduce systemic risk.</p>	<p>Because of the potential for disruptions to securities and derivatives markets and to payment and settlement systems, both domestic and non-domestic, securities settlement systems and central counterparties should be subject to effective regulation and oversight to ensure that they are fair, effective and efficient, and that they reduce systemic risk.</p> <p>Regulators should be prepared to cooperate with other relevant regulators, including central banks, both domestically and internationally, to address potential domestic and cross-border risks.</p>	<p>Principle 38 does not have its own assessment methodology, but refers to the <i>Principles for Financial Market Infrastructures</i>. These principles are discussed in Section 5.</p>

SECTION 5: GAP ASSESSMENT AND RELEVANCE OF THE OTHER CORE PRINCIPLES FOR ISLAMIC FINANCE

87. In addition to the discussion on several core principles covered in Sections 2–4, this section considers briefly the possible application to the IFSI of the principles issued for deposit insurance, financial market infrastructures, and the supervision of financial conglomerates.

5.1 Core Principles for Deposit Insurance

88. In July 2008, the BCBS and the International Association of Deposit Insurers (IADI) decided to collaborate to develop an internationally agreed set of core principles for deposit insurance using the IADI *Core Principles for Effective Deposit Insurance Systems* (February 2008) as a basis. A joint working group was formed to develop a set of core principles.
89. The consultative document, entitled *Core Principles for Effective Deposit Insurance Systems*, was completed in March 2009 and endorsed by the international community in June 2009. The document presented 18 core principles, each of which is augmented by supporting explanations and guidance. An accompanying set of preconditions addresses mainly external elements necessary to support effective deposit insurance systems.
90. According to this document, an effective deposit insurance system needs to be based on a number of external elements or preconditions. These preconditions, although mostly outside the direct jurisdiction of the deposit insurance system, have a direct impact on the system. The preconditions include: (a) an ongoing assessment of the economy and banking system; (b) sound governance of agencies comprising the financial system safety net; (c) strong prudential regulation and supervision; and (d) a well-developed legal framework and accounting and disclosure regime. The “assessment methodology” for compliance with these Core Principles was jointly issued by the BCBS and IADI in December 2010.
91. A summary of these Core Principles, and a gap assessment for their application for the IFSI, is provided in Table 5.1.2.
92. In order to study the potential issues in the application of deposit insurance principles to the IIFS, the IADI established an Islamic Deposit Insurance Group which issued its discussion paper titled “Deposit Insurance from the *Shari’ah* Perspective” in February 2010. Key differences between Islamic and conventional schemes are summarised in Table 5.1.1.

93. The paper observes that there are broadly three models of Islamic deposit insurance:
- a) protect Islamic deposits under a conventional deposit insurance system;
 - b) develop an Islamic deposit insurance system (IDIS) separately from a conventional system; or
 - c) develop a full-fledged IDIS.

The paper outlines that there are several issues and challenges in implementing an IDIS, as follows:

- First, given that Islamic deposit insurance is relatively new, there are no guiding principles available to aid in the development and establishment of an IDIS. Currently, only Malaysia and Sudan have set up an IDIS, while some other countries provide protection for Islamic deposits under their conventional systems.
- Second, the Islamic financial community is still debating whether profit sharing investment accounts (PSIA) should be treated as deposits or investments, and whether they should be protected under the deposit insurance system.
- Third, deposit insurers face the challenge of determining the insurability of deposit products and the priority of payment for each product. This issue is pertinent to Islamic banking given that some deposits are not accepted based on debtor-creditor relationship. Product innovation further escalates this challenge.
- Fourth, deposit insurers face difficulties in investing surplus deposit insurance funds, as there are limited Islamic instruments.
- Other issues include cross-border liquidation, liquidation of assets funded by restricted PSIAs and public awareness of the IDIS.

Table 5.1.1: Differences between Islamic and Conventional Deposit Insurance Systems

No.	Subject	Islamic Deposit Insurance System	Conventional Deposit Insurance System
1	Instruments covered	Islamic deposits (this may include PSIA's)	Interest-based deposits
2	Institutions covered	IBIs – i.e. Islamic banks and Islamic banking windows	Conventional banks
3	Premium payments	From the IBI's own funds. If the PSIA is protected, premiums may also be paid from returns on the PSIA's investments	From the conventional bank's own funds
4	Differential premium system	Key financial indicators for assessing risk profiles of IBIs (especially unique risks)	Key financial indicators for assessing risk profiles of conventional banks
5	Funds	Premiums received from IBIs maintained in Islamic deposit insurance fund (separate book if dual operation, and no commingling/cross-subsidisation)	Premiums received from conventional banks maintained in conventional deposit insurance fund
6	Expenses	Incurred for permissible activities only	Incurred for any activities
7	Investment	Investment in permissible business activities and instruments only	Investment in any business activity or instrument
8	Payments	Made from Islamic fund	Made from conventional fund
9	Priority of payments within deposit category	Payments for deposits and PSIA's are prioritised based on underlying contracts	There is no priority of payment for deposits
10	External funding (in case of deficit)	From the government or market based on <i>Shari'ah</i> principles	From the government or market
11	Liquidation	Assets funded by restricted PSIA's may be liquidated separately	Not applicable since there is no PSIA

Sources: IADI (2010), pp. 10–11; IFSB IFSI Stability Report (2013)

Table 5.1.2: Applicability of Core Principles for Effective Deposit Insurance Systems (2009) to IFSI

Reference	Description: Core Principle for Effective Deposit Insurance Systems	Applicability to IFSI
Principle 1: Public policy objectives	The first step in adopting a deposit insurance system or reforming an existing system is to specify appropriate public policy objectives that it is expected to achieve. These objectives should be formally specified and well integrated into the design of the deposit insurance system. The principal objectives for deposit insurance systems are to contribute to the stability of the financial system and protect depositors.	The principle is applicable to IFSI; however, public policy objectives have to be aligned with the core concepts of Islamic finance and should reflect the nature of the IIFS's operations.
Principle 2: Mitigating moral hazard	Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net.	The principle is equally applicable to the IFSI.
Principle 3: Mandate	It is critical that the mandate selected for a deposit insurer be clear and formally specified and that there be consistency between the stated public policy objectives and the powers and responsibilities given to the deposit insurer.	The principle is equally applicable to the IFSI.
Principle 4: Powers	A deposit insurer should have all powers necessary to fulfil its mandate and these should be formally specified. All deposit insurers require the power to finance reimbursements, enter into contracts, set internal operating budgets and procedures, and access timely and accurate information to ensure that they can meet their obligations to depositors promptly.	The principle is equally applicable to the IFSI.
Principle 5: Governance	The deposit insurer should be operationally independent, transparent, accountable and insulated from undue political and industry influence.	The principle is equally applicable to the IFSI. However, insofar as the assessment criteria (notably Essential Criterion 3) deal with competence, this should include competence in Islamic finance.
Principle 6: Relationships with other safety-net participants	A framework should be in place for close coordination and information sharing, on a routine basis as well as in relation to particular banks, among the deposit insurer and other financial system safety-net participants. Such information should be accurate and timely (subject to confidentiality when required). Information sharing and coordination arrangements should be formalised.	The principle is equally applicable to the IFSI.

Reference	Description: Core Principle for Effective Deposit Insurance Systems	Applicability to IFSI
Principle 7: Cross-border issues	<p>Provided confidentiality is ensured, all relevant information should be exchanged between deposit insurers in different jurisdictions and possibly between deposit insurers and other foreign safety-net participants when appropriate. In circumstances where more than one deposit insurer will be responsible for coverage, it is important to determine which deposit insurer or insurers will be responsible for the reimbursement process. The deposit insurance already provided by the home country system should be recognised in the determination of levies and premiums.</p>	<p>The principle is equally applicable to the IFSI. However, there may be a point to be made about a common understanding of coverage and permissible mechanisms. This would most naturally be dealt with at the assessment criterion level.</p>
Principle 8: Compulsory membership	<p>Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits from those deemed most in need of protection (e.g. retail and small business depositors) to avoid adverse selection.</p>	<p>This will depend on the model of the deposit insurance scheme and the respective guidelines from the supervisors. If it is not <i>Shari'ah</i> compliant, it will be problematic for IFSI to be members, even if they accept deposits (e.g. through the provision of chequing accounts).</p> <p>There are possibilities for <i>Shari'ah</i>-compliant mechanisms. For instance, <i>Takāful</i> is a kind of solidarity contract where potential beneficiaries (participants) jointly contribute to a risk pool out of which claims would be settled in cases of specified events such as the failure of a participating bank. In this case the pool would compensate claims of depositors of the failed bank. The contributions are classified as <i>Tabarru'</i> (conditional donations). The deposit insurance institution would act as the <i>Takāful</i> operator who manages the scheme, and the banks or the depositors would be the participants who contribute to the risk pool.</p> <p>The funds of the pool have to be invested in a <i>Shari'ah</i>-compliant manner. It is debatable whether the membership of a bank in a <i>Takāful</i> arrangement must be voluntary or can be enforced (e.g. by recourse to <i>Maslahah</i> arguments). This is something that needs to be studied in more detail.</p>

Reference	Description: Core Principle for Effective Deposit Insurance Systems	Applicability to IFSI
Principle 9: Coverage	<p>Polymakers should define clearly in law, prudential regulations or by-laws what an insurable deposit is. The level of coverage should be limited but credible, and be capable of being quickly determined. It should cover adequately the large majority of depositors to meet the public policy objectives of the system and be internally consistent with other deposit insurance system design features.</p>	<p>At the level of principle, this is also applicable to the IFSI. However, the major problem in relation to Islamic banking is that of PSIA investment account holders. It is arguable that to include them would fail to recognise the risk-sharing nature of PSIA's. However, if they are excluded it is arguable that Islamic banks would continue to be exposed to runs, and therefore the public policy objectives of promoting public confidence and financial stability (Essential Criterion 2) would not be met.</p>
Principle 10: Transitioning from a blanket guarantee to a limited coverage deposit insurance system	<p>When a country decides to transition from a blanket guarantee to a limited coverage deposit insurance system, or to change a given blanket guarantee, the transition should be as rapid as a country's circumstances permit. Blanket guarantees can have a number of adverse effects if retained too long, notably an increase in moral hazard. Polymakers should pay particular attention to public attitudes and expectations during the transition period.</p>	<p>The principle is equally applicable to the IFSI.</p>
Principle 11: Funding	<p>A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims, including a means of obtaining supplementary back-up funding for liquidity purposes when required. Primary responsibility for paying the cost of deposit insurance should be borne by banks, since they and their clients directly benefit from having an effective deposit insurance system.</p> <p>For deposit insurance systems (whether ex-ante, ex-post or hybrid) utilising risk adjusted differential premium systems, the criteria used in the risk-adjusted differential premium system should be transparent to all participants. As well, all necessary resources should be in place to administer the risk-adjusted differential premium system appropriately.</p>	<p>All the funding mechanisms have to be <i>Shari'ah</i>-compliant.</p> <p>As noted above, the protection of IAHS under PSIA's is problematic. Further, if the scheme is based on an external guarantee (<i>Kafalah</i>) to the IAHS, there remain issues as a majority of <i>Shari'ah</i> scholars insist that a guarantee is voluntary, and they reject the charging of a fee by the guarantor. Without a fee, a <i>Kafalah</i>-based deposit insurance scheme is commercially not viable.</p> <p>It would have to be <i>Takaful</i>-based with the UPSIA paying the contributions out of their share of profit (in lieu of appropriations to an IRR).</p> <p>In addition, in a mixed system, if separate deposit insurance schemes have to be provided for conventional and Islamic banks, this will make it more difficult to achieve an adequate level of funding for either.</p>

Reference	Description: Core Principle for Effective Deposit Insurance Systems	Applicability to IFSI
<p>Principle 12: Public awareness</p>	<p>In order for a deposit insurance system to be effective, it is essential that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system.</p>	<p>The principle is equally applicable to the IFSI.</p>
<p>Principle 13: Legal protection</p>	<p>The deposit insurer, and individuals working for the deposit insurer, should be protected against lawsuits for their decisions and actions taken in “good faith” while discharging their mandates. However, individuals must be required to follow appropriate conflict-of-interest rules and codes of conduct to ensure they remain accountable. Legal protection should be defined in legislation and administrative procedures and, under appropriate circumstances, cover legal costs for those indemnified.</p>	<p>The principle is equally applicable to the IFSI.</p>
<p>Principle 14: Dealing with parties at fault in a bank failure</p>	<p>A deposit insurer, or other relevant authority, should be provided with the power to seek legal redress against those parties at fault in a bank failure.</p>	<p>The principle is equally applicable to the IFSI.</p>
<p>Principle 15: Early detection and timely intervention and resolution</p>	<p>The deposit insurer should be part of a framework within the financial system safety net that provides for the early detection and timely intervention and resolution of troubled banks. The determination and recognition of when a bank is, or is expected to be, in serious financial difficulty should be made early and on the basis of well-defined criteria by safety-net participants with the operational independence and power to act.</p>	<p>The principle is equally applicable to the IFSI.</p> <p>Early detection and timely intervention and resolution require close monitoring of the <i>Shari’ah</i>-compliant deposit insurance scheme provider by the supervisor to ensure “going-concern” and “gone-concern” issues are dealt with – in particular, when the insurance scheme will be triggered. This requires clarity from the supervisory authorities.</p>

Reference	Description: Core Principle for Effective Deposit Insurance Systems	Applicability to IFSI
<p>Principle 16: Effective resolution processes</p>	<p>Effective failure-resolution processes should: facilitate the ability of the deposit insurer to meet its obligations including reimbursement of depositors promptly and accurately and on an equitable basis; minimise resolution costs and disruption of markets; maximise recoveries on assets; and reinforce discipline through legal actions in cases of negligence or other wrongdoings. In addition, the deposit insurer or other relevant financial system safety net participant should have the authority to establish a flexible mechanism to help preserve critical banking functions by facilitating the acquisition by an appropriate body of the assets and the assumption of the liabilities of a failed bank (e.g. providing depositors with continuous access to their funds and maintaining clearing and settlement activities).</p>	<p>The area of resolution of IFSI is a very difficult one requiring further study from a <i>Shari'ah</i>, as well as a practical, standpoint.</p> <p>In this respect, the IFSB and the World Bank published <i>Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance</i> in 2011. The book notes that uncertainty surrounding claims on the underlying assets of Islamic financial products, and differences in interpretation across jurisdictions of <i>Shari'ah</i> compliance, can potentially complicate resolution procedures and jeopardise creditors' confidence in Islamic financial services providers and products.</p> <p>In addition, the book highlights that there are no specific guidelines on the resolution regime for Islamic banks in the event of insolvency. Therefore, the immediate challenge is to establish a coherent system of insolvency rules and principles which are consistent with the philosophy of <i>Shari'ah</i> and benchmarked against international best practices.</p> <p>At this point it is difficult to say what, if any, change to this principle and its assessment criteria is needed.</p>

Reference	Description: Core Principle for Effective Deposit Insurance Systems	Applicability to IFSI
<p>Principle 17: Reimbursing depositors</p>	<p>The deposit insurance system should give depositors prompt access to their insured funds. Therefore, the deposit insurer should be notified or informed sufficiently in advance of the conditions under which reimbursement may be required and be provided with access to depositor information in advance. Depositors should have a legal right to reimbursement up to the coverage limit and should know when and under what conditions the deposit insurer will start the payment process, the time frame over which payments will take place, whether any advance or interim payments will be made as well as the applicable coverage limits.</p>	<p>The principle is equally applicable to the IFSI.</p>
<p>Principle 18: Recoveries</p>	<p>The deposit insurer should share in the proceeds of recoveries from the estate of the failed bank. The management of the assets of the failed bank and the recovery process (by the deposit insurer or other party carrying out this role) should be guided by commercial considerations and their economic merits.</p>	<p>While, at the level of principle, this is equally applicable to the IFSI, the assessment criteria contain provisions about the role and standing of the deposit insurer in insolvency proceedings which are subject to the same comments as for Principle 16. Without further research, it is impossible to know what, if any, changes are needed at the level of the criteria.</p>

5.1.1 Key Developments and Considerations

94. Deposit insurance is a key component of the financial safety-net arrangement for sustaining financial stability. The question for Islamic finance is not whether a deposit insurance scheme should be implemented, but how it should be structured to be *Shari'ah*-compliant.
95. The *Islamic Financial Services Industry Stability Report* issued by the IFSB in May 2013 outlines an initial study and analysis on *Shari'ah*-compliant deposit protection. The report concludes that a *Shari'ah*-compliant deposit protection scheme not only contributes to systemic stability and to consumer protection, but also helps to create a level playing field for Islamic and conventional banks. The majority of jurisdictions have not yet implemented a *Shari'ah*-compliant deposit insurance system, and those who have one in place follow very different operational models.
96. The IFSB is currently undertaking a study on the development of *Shari'ah*-

compliant deposit insurance schemes with the following objectives: (a) to understand the current status of *Shari'ah*-compliant deposit insurance; (b) to identify key challenges that are encountered by banking supervisory authorities in the implementation of *Shari'ah*-compliant deposit insurance schemes; and (c) to develop strategies for the operationalisation of such schemes in various jurisdictions.

97. In addition, the Core Principles refer to resolution processes. On this, the IFSB–World Bank publication already cited¹² notes that the uncertainty surrounding claims on the underlying assets of Islamic financial products, and differences in interpretation across jurisdictions on *Shari'ah* compliance, can potentially complicate resolution procedures and jeopardise creditors' confidence in Islamic financial services providers and products. In addition, the book highlights that there are no specific guidelines on the resolution regime for Islamic banks in the event of insolvency.
98. It is hoped that the findings of the study referred to above, and further work on resolution processes, will help the IFSB to develop core principles for this segment later.

5.2 Principles for Financial Market Infrastructures

99. Payment and settlement systems play a major role in the smooth functioning of any financial and payment system. With the increasing complexity and refinement of financial products, and the information systems used to trade such products, a number of initiatives were taken by global standard-setting bodies to provide a sound regulatory framework for these markets in the past decade. Some of the major developments in this area are summarised below:
- **January 2001:** The Committee on Payment and Settlement Systems (CPSS) published the *Core Principles for Systemically Important Payment Systems* (CPSIPS), which provided ten principles for the safe and efficient design and operation of systemically important payment systems.
 - **November 2001:** The CPSIPS were followed by the *Recommendations for Securities Settlement Systems* (RSSS), which were published jointly by the CPSS and IOSCO. This report identified 19 recommendations for promoting the safety and efficiency of securities settlement systems (SSSs).
 - **November 2002:** The accompanying assessment methodology for the RSSS was published.
 - **November 2004:** Building upon the recommendations established in the RSSS, the CPSS and IOSCO published the *Recommendations for Central Counterparties* (RCCP). The RCCP provided 15

¹² IFSB–World Bank (2011), *Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance*.

recommendations that addressed the main types of risks faced by central counterparties (CCPs). An assessment methodology was included in the report.

- **January 2009:** The CPSS and IOSCO established a working group to provide guidance on the application of these recommendations to CCPs that clear (over-the-counter) OTC derivatives products, and to develop a set of considerations for trade repositories (TRs) in designing and operating their systems. The reports of this working group, *Guidance on the Application of 2004 CPSS-IOSCO Recommendations for Central Counterparties to OTC Derivatives CCPs and Considerations for Trade Repositories in OTC Derivatives Markets*, were issued as consultative reports in May 2010.
- **February 2010:** The CPSS and the Technical Committee of IOSCO launched a comprehensive review of the three existing sets of standards for financial market infrastructures (FMIs) – the CPSIPS, RSSS and RCCP.
- **April 2012:** Based on the above review, the CPSS and IOSCO issued ***Principles for Financial Market Infrastructures***. These principles contain a unified set of standards that replace the CPSIPS, RSSS and RCCP standards insofar as they are directed specifically to FMIs. It is these principles that are analysed here.

100. FMIs play a critical role in the financial system and the broader economy. In this context, the term “financial market infrastructures” refers to systemically important payment systems (central securities depositories, SSSs), CCPs and TRs. These infrastructures facilitate the clearing, settlement, and recording of monetary and other financial transactions, such as payments, securities and derivatives contracts (including derivatives contracts for commodities). While safe and efficient FMIs contribute to maintaining and promoting financial stability and economic growth, FMIs also concentrate risk. If not properly managed, FMIs can be sources of financial shocks, such as liquidity dislocations and credit losses, or a major channel through which these shocks are transmitted across domestic and international financial markets.

101. With respect to the IFSI, this is still an evolving area where some further development is expected in the coming years. The tradable instruments specific to Islamic finance (mainly *Sukūk*) tend to be traded, if at all, through the OTC market. In addition, not all of the issues relating to counterparty credit risk appear relevant to IIFS, due to their limited use of hedging instruments and advanced approaches for capital adequacy. The principles for FMI are summarised and briefly analysed in Table 5.2.1. However, so little work has been done on this topic for Islamic finance that conclusions are difficult to reach.

Table 5.2.1: Applicability of Principles for Financial Market Infrastructures (FMI) to IFSI

Reference	Description: Principles for Financial Market Infrastructures	Applicability to IFSI
General organisation		
Principle 1: Legal basis	An FMI should have a well-founded, clear, transparent and enforceable legal basis for each material aspect of its activities in all relevant jurisdictions.	Applicable to IFSI.
Principle 2: Governance	An FMI should have governance arrangements that are clear and transparent, promote the safety and efficiency of the FMI, and support the stability of the broader financial system, other relevant public interest considerations, and the objectives of relevant stakeholders.	If the FMI is an Islamic institution, the governance arrangements will need to include <i>Sharī'ah</i> governance.
Principle 3: Framework for the comprehensive management of risks	An FMI should have a sound risk management framework for comprehensively managing legal, credit, liquidity, operational and other risks.	Applicable to IFSI.
Credit and liquidity risk management		
Principle 4: Credit risk	An FMI should effectively measure, monitor and manage its credit exposures to participants and those arising from its payment, clearing and settlement processes. An FMI should maintain sufficient financial resources to cover its credit exposure to each participant fully with a high degree of confidence. In addition, a CCP that is involved in activities with a more complex risk profile or that is systemically important in multiple jurisdictions should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the two participants and their affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions. All other CCPs should maintain additional financial resources sufficient to cover a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would potentially cause the largest aggregate credit exposure to the CCP in extreme but plausible market conditions.	Applicable to IFSI. IFSB-1 outlines the risk management framework, including credit risk for IIFS. IFSB-13 has set principles for stress testing, including the credit exposures of the IIFS.

Reference	Description: Principles for Financial Market Infrastructures	Applicability to IFSI
Principle 5: Collateral	An FMI that requires collateral to manage its or its participants' credit exposure should accept collateral with low credit, liquidity and market risks. An FMI should also set and enforce appropriately conservative haircuts and concentration limits.	Applicable to IFSI. IFSB-1 and IFSB-15 may be helpful by analogy in setting out <i>Shari'ah</i> -compliant collaterals which could be used by IIFS.
Principle 6: Margin	A CCP should cover its credit exposures to its participants for all products through an effective margin system that is risk-based and regularly reviewed.	Applicable to IFSI, subject to there being a <i>Shari'ah</i> -compliant basis for margining (presumably based on <i>Urbūn</i>).
Principle 7: Liquidity risk	An FMI should effectively measure, monitor and manage its liquidity risk. An FMI should maintain sufficient liquid resources in all relevant currencies to effect same-day and, where appropriate, intraday and multiday settlement of payment obligations with a high degree of confidence under a wide range of potential stress scenarios that should include, but not be limited to, the default of the participant and its affiliates that would generate the largest aggregate liquidity obligation for the FMI in extreme but plausible market conditions.	At the level of the principle, this appears applicable to the IFSI. However, the limited availability of <i>Shari'ah</i> -compliant liquid instruments may impact on FMIs as well as other IIFS. Insufficient work has as yet been done on IIFS to know whether any modifications would be necessary (presumably at the level of the Key Considerations).
Settlement		
Principle 8: Settlement finality	An FMI should provide clear and certain final settlement, at a minimum by the end of the value date. Where necessary or preferable, an FMI should provide final settlement intraday or in real time.	Applicable to IFSI. IFSB-12 has discussed payment and settlement issues. IFSB-13 has set principles for stress testing, including the credit exposures of the IIFS.
Principle 9: Money settlements	An FMI should conduct its money settlements in central bank money where practical and available. If central bank money is not used, an FMI should minimise and strictly control the credit and liquidity risk arising from the use of commercial bank money.	Applicable to IFSI.
Principle 10: Physical deliveries	An FMI should clearly state its obligations with respect to the delivery of physical instruments or commodities and should identify, monitor and manage the risks associated with such physical deliveries.	Applicable to IFSI.

Reference	Description: Principles for Financial Market Infrastructures	Applicability to IFSI
Central securities depositories and exchange-of-value settlement systems		
Principle 11: Central securities depositories	A CSD should have appropriate rules and procedures to help ensure the integrity of securities issues and minimise and manage the risks associated with the safekeeping and transfer of securities. A CSD should maintain securities in an immobilised or dematerialised form for their transfer by book entry.	Generally applicable to IFSI.
Principle 12: Exchange-of-value settlement systems	If an FMI settles transactions that involve the settlement of two linked obligations (for example, securities or foreign exchange transactions), it should eliminate principal risk by conditioning the final settlement of one obligation upon the final settlement of the other.	Applicable to IFSI. Further, it may be noted that it is not <i>Shari'ah</i> -compliant to make one contract conditional on another.
Default management		
Principle 13: Participant-default rules and procedures	An FMI should have effective and clearly defined rules and procedures to manage a participant default. These rules and procedures should be designed to ensure that the FMI can take timely action to contain losses and liquidity pressures and continue to meet its obligations.	Applicable to IFSI.
Principle 14: Segregation and portability	A CCP should have rules and procedures that enable the segregation and portability of positions of a participant's customers and the collateral provided to the CCP with respect to those positions.	Applicable to IFSI. IFSB-1 and IFSB-15 have outlined the list of <i>Shari'ah</i> -compliant collaterals that could be used subject to the <i>Shari'ah</i> supervisory board's endorsement.
General business and operational risk management		
Principle 15: General business risk	An FMI should identify, monitor and manage its general business risk and hold sufficient liquid net assets funded by equity to cover potential general business losses so that it can continue operations and services as a going concern if those losses materialise. Further, liquid net assets should at all times be sufficient to ensure a recovery or orderly wind-down of critical operations and services.	This is generally applicable to IFSI.
Principle 16: Custody and investment risks	An FMI should safeguard its own and its participants' assets and minimise the risk of loss on and delay in access to these assets. An FMI's investments should be in instruments with minimal credit, market and liquidity risks.	In addition to the criteria outlined in the principle, the investments in the assets are subject to the <i>Shari'ah</i> compliance criteria.

Reference	Description: Principles for Financial Market Infrastructures	Applicability to IFSI
Principle 17: Operational risk	An FMI should identify the plausible sources of operational risk, both internal and external, and mitigate their impact through the use of appropriate systems, policies, procedures and controls. Systems should be designed to ensure a high degree of security and operational reliability and should have adequate, scalable capacity. Business continuity management should aim for timely recovery of operations and fulfilment of the FMI's obligations, including in the event of a wide-scale or major disruption.	Applicable to IFSI.
Access		
Principle 18: Access and participation requirements	An FMI should have objective, risk-based and publicly disclosed criteria for participation, which permit fair and open access.	Applicable to IFSI.
Principle 19: Tiered participation arrangements	An FMI should identify, monitor and manage the material risks to the FMI arising from tiered participation arrangements.	
Principle 20: FMI links	An FMI that establishes a link with one or more FMIs should identify, monitor and manage link-related risks.	
Efficiency		
Principle 21: Efficiency and effectiveness	An FMI should be efficient and effective in meeting the requirements of its participants and the markets it serves.	Applicable to IFSI.
Principle 22: Communication procedures and standards	An FMI should use, or at a minimum accommodate, relevant internationally accepted communication procedures and standards in order to facilitate efficient payment, clearing, settlement and recording.	
Transparency		
Principle 23: Disclosure of rules, key procedures and market data	An FMI should have clear and comprehensive rules and procedures and should provide sufficient information to enable participants to have an accurate understanding of the risks, fees and other material costs they incur by participating in the FMI. All relevant rules and key procedures should be publicly disclosed.	At first sight this appears applicable to IFSI. However, the Key Considerations specifically reference the CPSS–IOSCO disclosure framework for financial market infrastructures, on which no analysis has been done.
Principle 24: Disclosure of market data by trade repositories	A TR should provide timely and accurate data to relevant authorities and the public in line with their respective needs.	

5.3 Principles for the Supervision of Financial Conglomerates

102. A financial conglomerate is defined as a group of entities with activities in more than one of the regulated banking, securities or insurance sectors, possibly combined with commercial (i.e. non-financial) activities.
103. The GFC highlighted the importance of financial conglomerates, due to the failure of some big institutions and complex interconnectedness between various portfolios within the same conglomerate. It also exposed the significant role that financial groups, including financial conglomerates, play in the stability of global and local economies. Due to their economic reach and their mix of regulated and unregulated entities (such as special-purpose entities and unregulated holding companies) across sectoral boundaries, financial conglomerates present challenges for sector-specific supervisory oversight.
104. The Joint Forum was established in 1996 under the aegis of the BCBS, IAIS and IOSCO to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates. It developed its first set of principles for the supervision of financial conglomerates in 1999, and published them in 2001. A substantially revised set of principles was published in September 2012. Their aim is to provide national authorities, standard-setters and supervisors with a set of internationally agreed principles that support consistent and effective supervision of financial conglomerates and, in particular, those financial conglomerates that are active across borders. They are cross-sectoral in their application and supplementary to the core principles of the BCBS, IAIS and IOSCO.

5.3.1 Core Principles: Structure and Analysis

105. The principles are grouped into five sections, as discussed below. Each principle is followed by a set of implementation criteria and explanatory comments, not quoted here. Implementation criteria are the steps which should be taken by authorities and supervisors to implement the principle. Explanatory comments are descriptive in nature, and are intended to help authorities, supervisors and assessors better understand the principle and implementation criteria to which they relate.
106. Table 5.3.1.1 sets out the core principles and offers a gap analysis indicating where they may need amendment for the IFSI.
107. Generally, all the financial conglomerates' core principles can be applied to the Islamic financial conglomerates. However, there are some key considerations worth mentioning here:

- A forward-looking assessment of the sources of risk to the financial conglomerates, specifically contagion risks, is important for conglomerates' supervision, but it is unclear how contagion works in Islamic finance with its different structures.¹³
 - Another key consideration is the commingling of funds between conventional activities and Islamic activities; this issue may have a negative impact on IFSI reputations, and the barriers to commingling are likely to be a significant supervisory issue.
 - Any consideration of human resource issues, both within conglomerates and within supervisors, must take account of the need for specific skills and knowledge relevant to Islamic finance.
 - Perhaps most importantly, financial conglomerates are often also cross-border, and may therefore be impacted by different approaches to Islamic finance and different understandings on issues such as the position of IAH, or the separation of funds in a *Takāful* undertaking.
108. All these considerations underline the significance of these core principles for the financial conglomerates for Islamic finance stability. However, it is not possible to address these considerations without greater knowledge of current practice in both Islamic and mixed conglomerates, and without more research than has so far been undertaken.

Table 5.3.1.1: Applicability of Principles of Financial Conglomerates to Islamic Finance

Area	Principle	Applicability to Islamic Finance
I. Supervisory powers and authority	Comprehensive group-wide supervision 1. The legal framework for the supervision of financial conglomerates should grant supervisors (including the Group-level Supervisor) the necessary powers and authority to enable comprehensive group-wide supervision.	The principle is fully applicable to Islamic finance. There may be merit in including SSB members in the list of those to whom supervisors should have access (see Implementation Criterion 1(e)).
	Cooperation and information sharing 2. The legal framework should grant the necessary power and authority to supervisors to enable efficient and effective cooperation, coordination and information sharing among supervisors in order to facilitate group-wide supervision.	The principle is fully applicable to Islamic finance.
	Independence and accountability 3. The legal framework should provide supervisors with operational independence while ensuring accountability for the discharge of their duties.	The principle is fully applicable to Islamic finance.
	Resources 4. Supervisors of financial conglomerates should be adequately resourced in a manner that does not undermine their independence.	The principle is fully applicable to Islamic finance.

13 One example of contagion risk is where a *Takāful* undertaking places liquid funds (e.g. as UPSIA) with an Islamic bank that is a member of the same financial group.

Area	Principle	Applicability to Islamic Finance
II. Supervisory powers and authority	<p>Group-level Supervisor</p> <p>5. Supervisors should ensure there is a clear process in place for coordinating various roles and responsibilities with clearly delineated responsibility for ensuring effective and comprehensive group-level supervision, including a coordination process to identify a group-level supervisor.</p>	<p>The principle is fully applicable to Islamic finance.</p>
	<p>Supervisory cooperation, coordination and information sharing</p> <p>6. Supervisors should establish a process to confirm the roles and responsibilities of each supervisor in supervising the financial conglomerate, and to ensure efficient and effective information sharing, cooperation and coordination in the supervision of the financial conglomerate.</p>	<p>The principle is fully applicable to Islamic finance.</p>
	<p>Prudential standards and coverage</p> <p>7. Supervisors should establish, implement and maintain a comprehensive framework of risk-based minimum prudential standards for financial conglomerates.</p>	<p>While the principle is fully applicable to Islamic finance, it would benefit from an additional implementation criterion along the following lines:</p> <ul style="list-style-type: none"> ○ There should be a clear, and clearly stated, prudential approach to the specific risks and structures of Islamic finance, including PSIAs, DCR and the structures of <i>Takāful</i> entities.
	<p>Monitoring and supervision</p> <p>8. Supervisors should develop and maintain a sound understanding of the operations of financial conglomerates through undertaking a range of appropriate supervisory activities.</p>	<p>The principle is fully applicable to Islamic finance.</p>
	<p>Supervisory tools and enforcement</p> <p>9. Supervisors should, when appropriate, utilise supervisory tools to compel timely corrective actions and/or enforce compliance of financial conglomerates with the prudential framework.</p>	<p>The principle is fully applicable to Islamic finance.</p>

Area	Principle	Applicability to Islamic Finance
III. Corporate governance	<p>Corporate governance in financial conglomerates</p> <p>10. Supervisors should seek to ensure that the financial conglomerate establishes a comprehensive and consistent governance framework across the group that addresses the sound governance of the financial conglomerate, including unregulated entities, without prejudice to the governance of individual entities in the group.</p>	<p>The principle should be extended to deal with Islamic finance by:</p> <ul style="list-style-type: none"> ○ modifying IC 10(a) to include <i>Shari'ah</i> compliance obligations among those to be met; and ○ including IAH among those in IC 10(d) whose interests should be respected.
	<p>Structure of the financial conglomerate</p> <p>11. Supervisors should seek to ensure that the financial conglomerate has a transparent organisational and managerial structure which is consistent with its overall strategy and risk profile and is well understood by the board and senior management of the head company.</p>	<p>The principle is fully applicable to Islamic finance.</p>
	<p>Suitability of board members, senior managers and key persons in control functions</p> <p>12. Supervisors should seek to ensure that the board members, senior managers and key persons in control functions in the various entities in a financial conglomerate possess integrity, competence, experience and qualifications to fulfil their role and exercise sound objective judgment.</p>	<p>The suitability requirements, notably those in IC 12(a), should be extended to SSB members.</p>
	<p>Responsibility of the board of the head of the financial conglomerate</p> <p>13. Supervisors should require that the board of the head of the financial conglomerate appropriately defines the strategy and risk appetite of the financial conglomerate, and ensures this strategy is implemented and executed in the various entities, both regulated and unregulated.</p>	<p>The principle is fully applicable to Islamic finance.</p>

Area	Principle	Applicability to Islamic Finance
	<p>Remuneration in a financial conglomerate</p> <p>14. Supervisors should require that the financial conglomerate has and implements an appropriate remuneration policy that is consistent with its risk profile. The policy should take into account the material risks that organisation is exposed to, including those from its employees' activities.</p>	<p>While the principle is fully applicable to Islamic finance, there is a case for extending IC 14(c) to include SSB members among those whose remuneration should "be determined in a manner that does not incentivise them to disregard the obligations they owe to the financial conglomerate or any of its entities, nor to otherwise act in a manner contrary to any legal or regulatory obligations".</p>
<p>IV. Capital adequacy and liquidity</p>	<p>Capital management</p> <p>15. Supervisors should require that the financial conglomerate:</p> <ul style="list-style-type: none"> (i) maintains adequate capital on a group-wide basis to act as a buffer against the risks associated with the group's activities; (ii) develops capital management policies that are approved and regularly reviewed by the board, and that include a clearly and formally documented capital planning process that ensures compliance with capital requirements on a group-wide and regulated entity basis; and (iii) considers and assesses the group-wide risk profile when undertaking capital management. 	<p>The principle is fully applicable to Islamic finance.</p>
	<p>Capital assessment</p> <p>16. Supervisors should require that the capital adequacy assessments undertaken by the financial conglomerate consider group-wide risks, including those undertaken by unregulated entities within a financial conglomerate, and that these assessments soundly address third-party participations and minority interests.</p>	<p>The principle is fully applicable to Islamic finance.</p>
	<p>17. Supervisors should require that capital adequacy assessment and measurement techniques consider double or multiple gearing.</p>	<p>The principle is fully applicable to Islamic finance.</p>

Area	Principle	Applicability to Islamic Finance
	18. Supervisors should require that capital adequacy assessment and measurement techniques address excessive leverage and situations where a parent issues debt and down-streams the proceeds in the form of equity to a subsidiary.	The principle should be extended to cover other non-equity issues by a parent, notably certain forms of <i>Sukūk</i> .
	19. Supervisors should require that assessment and measurement techniques evaluate any limitations on intragroup transfers of capital, taking into account potential impediments to executing such transfers that could constrain their suitability for inclusion in the assessment of group capital.	The principle is fully applicable to Islamic finance.
	<p>Liquidity</p> <p>20. Supervisors should require that the head of the financial conglomerate adequately and consistently identify, measure, monitor, and manage its liquidity risks and the liquidity risks of the financial conglomerate. Supervisors should require that liquidity be sufficient across the financial conglomerate to meet funding needs in normal times and periods of stress.</p>	The principle is fully applicable to Islamic finance, but might benefit from specific mention of the need to ensure that liquidity management impacting on IIFS within the group is achieved through <i>Sharī'ah</i> -compliant instruments.
V. Risk management	<p>Risk management framework</p> <p>21. Supervisors should require that an independent, comprehensive and effective risk management framework, accompanied by a robust system of internal controls, effective internal audit and compliance functions, is in place for the financial conglomerate.</p>	The principle is fully applicable to Islamic finance, but ideally <i>Sharī'ah</i> risk would be included among the examples given in IC 21(g).
	<p>Risk management culture</p> <p>22. Supervisors should require that the financial conglomerate have in place processes and procedures to engender an appropriate group-wide risk management culture.</p>	The principle is fully applicable to Islamic finance.
	<p>Risk tolerance levels and risk appetite policy</p> <p>23. Supervisors should require that the financial conglomerate establishes appropriate board approved, group-wide risk tolerance levels and a risk appetite policy.</p>	The principle is fully applicable to Islamic finance.

Area	Principle	Applicability to Islamic Finance
	<p>New business</p> <p>24. Supervisors should require that the financial conglomerate carries out a robust risk assessment when entering into new business areas.</p>	<p>The principle is fully applicable to Islamic finance.</p>
	<p>Outsourcing</p> <p>25. Supervisors should require that, when considering whether to outsource a particular function, the financial conglomerate carries out an assessment of the risks of outsourcing, including the appropriateness of outsourcing a particular function.</p>	<p>The principle is fully applicable to Islamic finance.</p>
	<p>Stress and scenario testing</p> <p>26. Supervisors should require, where appropriate, that the financial conglomerate periodically carries out group-wide stress tests and scenario analyses for its major sources of risk.</p>	<p>The principle is fully applicable to Islamic finance.</p>
	<p>Risk aggregation</p> <p>27. Supervisors should require that the financial conglomerate aggregate the risks to which it is exposed in a prudent manner.</p>	<p>The principle is fully applicable to Islamic finance.</p> <p>Because the structures of Islamic finance mean that aggregation at group level is often difficult (e.g. because risks fall in the first instance at least on <i>Takāful</i> contributors or IAH), there may be benefit in mentioning this point explicitly. This would, however, be likely to be at the level of guidance.</p> <p>This comment may also apply to Principle 28 below.</p>
	<p>Risk concentrations and intragroup transactions and exposures</p> <p>28. Supervisors should require that the financial conglomerate has in place effective systems and processes to manage and report group-wide risk concentrations and intragroup transactions and exposures.</p>	<p>See comment on Principle 27 above.</p>
	<p>Off-balance sheet activities</p> <p>29. Supervisors should require that off-balance sheet activities, including special-purpose entities, are brought within the scope of group-wide supervision of the financial conglomerate, where appropriate.</p>	<p>The principle is fully applicable to Islamic finance.</p>

APPENDICES

Appendix A: List of Definitions

The following definitions are intended to assist readers in their general understanding of the terms used in the Issues Paper. The list is by no means exhaustive.

Alpha (α)	“Alpha (α)” is a measure of the proportion of actual credit and market risk on assets financed by IAH funds that is transferred to shareholders – that is, the DCR. The parameter “alpha” is dependent on the supervisory authority’s directive in the jurisdiction in which the IIFS operates. The value of “alpha” varies from 0 to 1, and GN-4 provides a methodology to estimate the value of “alpha” to be used when the supervisory discretion formula is applied in calculating the CAR of IIFS.
<i>Commodity Murābahah</i>	The term “commodity <i>Murābahah</i> transactions as a tool for liquidity management (CMT)” means a <i>Murābahah-based</i> purchase and sale transaction of <i>Sharī’ah</i> -compliant commodities, whether on cash or deferred payment terms.
Displaced commercial risk (DCR)	Displaced commercial risk is the consequence of the rate-of-return risk. It refers to the magnitude of risks that are transferred to shareholders in order to cushion the IAH from bearing some or all of the risks to which they are contractually exposed in <i>Muḍārabah</i> funding contracts (see IFSB-1 for details).
Governance Committee	The Governance Committee is another board committee, as recommended in IFSB-3, established by the BOD, and specifically mandated to protect the interest of the IAHs.
<i>Hamish Jiddiyyah</i>	<i>Hamish Jiddiyyah</i> (HJ) carries a limited recourse to the extent of damages incurred by the IIFS when the purchase orderer fails to honour a binding promise to purchase (PP) or promise to lease (PL). The IIFS has recourse to the clients in the PP/PL if the HJ is insufficient to cover the damages.
<i>Ijārah</i>	An agreement made by an institution offering Islamic financial services to lease to a customer an asset specified by the customer for an agreed period against specified rental. An <i>Ijārah</i> contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the <i>Ijārah</i> contract.
Investment risk reserves (IRR)	The amount appropriated by the IIFS out of the profit of IAHs, after allocating the <i>Muḍārib</i> ’s share of profit, in order to cushion against future investment losses for IAHs.
<i>Istisnā`</i>	A contract of sale of specified objects to be manufactured or constructed, with an obligation on the part of the manufacturer or builder to deliver the objects to the customer upon completion.

<i>Kafālah</i>	A guarantee – for instance, when a person guarantees a liability or duty (especially debt) of another person.
<i>Maqāsid al-Sharī'ah</i>	The ultimate objective of the <i>Sharī'ah</i> , which is to promote the interests of all mankind and to protect them from harm.
<i>Mudārabah</i>	A partnership contract between the capital provider (<i>Rabb al-Māl</i>) and an entrepreneur (<i>Muḍārib</i>) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to the entrepreneur's misconduct, negligence or breach of contracted terms.
<i>Murābahah</i>	A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin.
<i>Mushārahah</i>	A contract between the IIFS and a customer whereby both would contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or movable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of the <i>Mushārahah</i> agreement, while losses are shared in proportion to each partner's share of capital.
Profit equalisation reserve (PER)	The amount appropriated by the IIFS out of the <i>Mudārabah</i> profits, before allocating the <i>Muḍārib's</i> share of profit, in order to maintain a certain level of return on investment for unrestricted IAHS.
<i>Qard</i>	A loan intended to allow the borrower to use the funds for a period with the understanding that this would be repaid at the end of the period, where it is not permissible for any increase in cash or benefit.
<i>Rahn</i>	A pledge or collateral.
<i>Salam</i>	A contract to purchase an asset (of which the price, quantity and quality are specified) to be delivered in the future.
<i>Sharī'ah-compliant</i>	A financial product or activity that complies with the requirements of the <i>Sharī'ah</i> .
<i>Sharī'ah Supervisory Board</i>	Specific body set up or engaged by the institution offering Islamic financial services to carry out and implement its <i>Sharī'ah</i> governance system.
<i>Sukūk</i>	Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of assets that are <i>Sharī'ah-compliant</i> .

<p><i>Sukūk</i> securitisation (<i>Sharī'ah</i>-compliant securitisation)</p>	<p>Securitisation in <i>Sukūk</i> is broadly referred to as a process of issuing <i>Sukūk</i> involving the following steps: (a) origination of assets (in conventional finance, these are normally loans or other receivables, while in Islamic finance they are <i>Sharī'ah</i>-compliant assets such as the subject matter of <i>Ijārah</i>); (b) transfer of the assets to a special-purpose entity which acts as the issuer by packaging them into securities (<i>Sukūk</i>); and (c) issuing the securities to investors. For details, see IFSB-7.</p>
<p><i>Takāful</i></p>	<p>A contract whereby a group of participants (<i>Mushtarikīn</i>) agree among themselves to support one another by contributing a sum of money into a common fund, which will be used for mutual assistance of the members against specified loss or damage.</p>
<p><i>Tawarruq</i></p>	<p>Reverse <i>Murābahah</i> for the purpose of acquiring cash through trade activities. It refers to buying of an item on credit (on a deferred payment basis) and then immediately reselling it for cash at a discounted price to a third party.</p>
<p><i>Urbūn</i></p>	<p>Earnest money held after a contract is established as collateral to guarantee contract performance. The '<i>Urbūn</i>' taken from a purchaser or lessee when a contract is established accrues to the benefit of the IIFS if the purchaser or lessee breaches the contract within the agreed-upon term.</p>
<p><i>Wadī'ah</i></p>	<p>Custody or safe-keeping, whereby the items are a trust for the safe-keeper. The items are not guaranteed by the safe-keeper, except in the case of misconduct, negligence or violation of the conditions. The safe-keeper may charge a fee for looking after the items or funds and may pay <i>Hibah</i> (gift) to the principal.</p>
<p><i>Wakālah</i></p>	<p>An agency contract where the customer (principal) appoints the IIFS as agent (<i>Wakīl</i>) to carry out the business on their behalf and where a fee (or no fee) is charged to the principal based on the contract agreement.</p>

Appendix B: List of Publications Studied for the Working Paper

No.	Title of the Document	Issue
1	BCBS – Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems	June 2011
2	BCBS – Basel III: International Framework for Liquidity Risk Measurement, Standard and Monitoring	Dec 2010
3	BCBS – Revised Core Principles for Effective Banking Supervision	Sep 2012
4	BCBS – Core Principles for Effective Banking Supervision	Sep 1997
5	BCBS – Enhancement to the Basel II Framework	July 2009
6	BCBS – International Convergence of Capital Measurement and Capital Standards	June 2006
7	BCBS and International Association of Deposit Insurers (IADI) – Core Principles for Effective Deposit Insurance Systems	June 2009
8	Committee on Payment and Settlement Systems (CPSS) and IOSCO – Principles for Financial Market Infrastructures	Apr 2012
9	Risk Management (IFSB-1)	Dec 2005
10	Capital Adequacy (IFSB-2)	Dec 2005
11	Corporate Governance (IFSB-3)	Dec 2006
12	Transparency and Market Discipline (IFSB-4)	Dec 2007
13	Supervisory Review Process (IFSB-5)	Dec 2007
14	Guiding Principles on Governance for Islamic Collective Investment Schemes (IFSB-6)	Jan 2009
15	Special Issues In Capital Adequacy: <i>Sukūk</i> , Securitisation and Real Estate (IFSB-7)	Dec 2008
16	Guiding Principles on Governance for <i>Takāful</i> (Islamic Insurance) Undertakings (IFSB-8)	Dec 2009
17	Conduct of Business (IFSB-9)	Dec 2009
18	<i>Sharī'ah</i> Governance (IFSB-10)	Dec 2009
19	Standard on Solvency Requirements for <i>Takāful</i> (Islamic Insurance) Undertakings (IFSB-11)	Dec 2010
20	Liquidity Risk Management (IFSB-12)	Mar 2012
21	Stress Testing (IFSB-13)	Mar 2012

22	Standard on Risk Management for <i>Takāful</i> (Islamic Insurance) Undertakings (IFSB-14)	Dec 2013
23	Revised Capital Adequacy (IFSB-15)	Dec 2013
24	Revised Supervisory Review Process (IFSB-16)	Mar 2014
25	Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on <i>Sharī'ah</i> -compliant Financial Instruments (GN-1)	Mar 2008
26	Risk Management and Capital Adequacy Standards: Commodity <i>Murābahah</i> Transactions (GN-2)	Dec 2010
27	Practice of Smoothing the Profits Payout to IAHS (GN-3)	Dec 2010
28	The Determination of Alpha in the Capital Adequacy Ratio for IIFS (GN-4)	Mar 2011
29	Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on <i>Takāful</i> and <i>ReTakāful</i> Undertakings (GN-5)	Mar 2011
30	Issues in Strengthening Liquidity Management of Institutions offering Islamic Financial Services: The Development of Islamic Money Market	Mar 2008
31	IFSB–World Bank – Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance	2011
32	IFSB Survey on <i>Sharī'ah</i> -compliant Lender of Last Resort (SLOLR)	June 2012
33	IFSB Working Paper on Strengthening the Financial Safety Net: The Role of <i>Sharī'ah</i> -compliant Lender-of Last-Resort (SLOLR) Facilities as an Emergency Financing Mechanism	Apr 2014
34	IFSB Islamic Financial Services Industry Financial Stability Report	May 2013, 2014
35	IAIS – Insurance Core Principles (ICPs)	2003, 2011
36	IOSCO – Objectives and Principles of Securities Regulation	1998, 2010, 2011
37	IOSCO – Islamic Capital Market Fact Finding Report	July 2004
38	IOSCO – Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products	Sep 2008
39	IADI – Deposit Insurance from the <i>Sharī'ah</i> Perspective	Feb 2010



ISLAMIC FINANCIAL SERVICES BOARD

Level 5, Sasana Kijang, Bank Negara Malaysia
No. 2, Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia
www.ifsb.org

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