



ISLAMIC FINANCIAL SERVICES BOARD

**GUIDANCE ON
KEY ELEMENTS IN THE SUPERVISORY REVIEW PROCESS OF
INSTITUTIONS OFFERING ISLAMIC FINANCIAL SERVICES
(EXCLUDING ISLAMIC INSURANCE (*TAKĀFUL*) INSTITUTIONS
AND ISLAMIC MUTUAL FUNDS)**

December 2007

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The IFSB is an international standard-setting organisation that 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.

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ACRONYMS

DCR	Displaced commercial risk
IAH	Investment account holders
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IIFS	An institution (or institutions) offering only Islamic financial services (excluding (a) Islamic insurance (<i>Takāfu</i>) institutions and (b) Islamic mutual funds)
IRR	Investment risk reserves
PER	Profit equalisation reserve
PSIA	Profit-sharing investment accounts
REIT	Real Estate Investment Trusts

Bismillahirrahmanirrahim
Allahumma salli wasallim 'ala Sayyidina Muhammad wa'ala ālihi wasahbihi

1. INTRODUCTION

1.1 Background

1. The overall aim of this document is to set forth guidance on key elements in the supervisory review process for authorities supervising institutions offering only Islamic financial services (IIFS) (excluding (a) Islamic insurance (*Takāful*) institutions and (b) Islamic mutual funds). This document represents the views of the Islamic Financial Services Board (IFSB) on (a) the IFSB standards that the IIFS are expected to observe; and (b) the practices that supervisory authorities are expected to apply. In this context, the supervisory review process covers capital adequacy, risk management, internal controls and corporate governance. This document takes a risk-based approach¹ to the process of supervisory review. Accordingly, later in the document the supervisory implications of the various categories of risk that IIFS face in their operations will be examined.

2. The emergence of institutions that provide a wide range of Islamic financial services has resulted in some supervisory authorities prescribing additional requirements in order to address elements that are specific to Islamic finance, including risk characteristics and issues relating to *Sharī'ah* compliance. The requirements include (among others) guidelines or frameworks relating to fit and proper requirements for *Sharī'ah* scholars, rate of return calculation methodology and the scope of *Sharī'ah* audits.

3. Therefore, in view of the development that is taking place in the industry, the IFSB has reviewed and taken note of best practice as applied by various authorities supervising IIFS. This document is intended to foster convergence towards best practice among authorities supervising IIFS, enabling such supervisory authorities to meet their requirements when carrying out the roles expected of them in the light of IFSB standards. This convergence should lead to the establishment of a common approach to the minimum review process to be followed by authorities supervising IIFS.

1.2 General Principles

4. **The supervisory authority shall satisfy itself as to the adequacy of various compliance aspects, including the *Sharī'ah* rules and principles, with reference to the IFSB standards including those on capital requirements, risk management, governance structure and processes, transparency and market discipline.**

5. While the primary responsibility for compliance with applicable *Sharī'ah* rulings rests with the management of IIFS, supervisory authorities have to satisfy themselves that IIFS have an appropriate control environment, with policies and procedures in place to ensure compliance.

¹ The term "risk-based approach" as used in this document refers to the supervisor's approach to a supervised institution being based on its assessment of the risks to which the institution is exposed and of the institution's capability to manage these risks.

6. Four internationally agreed principles underpinning supervisory review in the Basel II Pillar 2 are equally applicable in a broader sense for IIFS. They are as follows:

- (i) Institutions should have a process for assessing their overall capital adequacy in relation to their risk profile, and a strategy for maintaining their capital levels.
- (ii) Supervisors should review and evaluate institutions' internal capital adequacy assessments and strategies, as well as their ability to monitor themselves and ensure their compliance with regulatory capital ratios. Supervisors should take supervisory action if they are not satisfied with the result of this process.
- (iii) Supervisors should expect institutions to operate above the minimum regulatory capital ratios and should have the ability to require them to hold capital in excess of the minimum.
- (iv) Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular institution and should require rapid remedial action if capital is not maintained or restored.

7. The risks that IIFS assume vary according to, *inter alia*, the types of financing contracts used; therefore, the supervisory authority shall satisfy itself that IIFS (a) understand and control the risks at every contract stage; and (b) have systems and controls in place to ensure compliance with *Shari'ah* rules and principles. The supervisory authority may consider developing a set of guidelines when reviewing the operations of IIFS, including evaluating their management systems for investment programmes and asset allocation practices in order to safeguard various stakeholders' interests, particularly those of the Investment Account Holders (IAH).

8. In a situation where systems are not properly set up, the supervisory authority may direct the IIFS concerned to take corrective actions so that the IIFS is managed in a prudent manner.

9. In addition to the four principles mentioned in paragraph 6 above, supervisory authorities need to address carefully the investor protection issues raised by the IIFS' role as managers of funds placed with them by the IAH.

10. In assessing the risks relevant to capital requirements as per the IFSB's *Capital Adequacy Standard*, the supervisory authority has the option to require an IIFS to employ either the Standard Formula or the Supervisory Discretion Formula to measure its minimum capital requirement.²

11. Supervisory authorities need to apply an appropriate capital adequacy approach that reflects the extent to which the IAH bear the risks of the assets in which their funds are invested, the existence of reserves within the equity of IAH to absorb periodic losses and within their equity and that of shareholders to smooth profits, and the implications of the formula used for the overall financial system. In the case of the Standard Formula, the IAH are treated as investors rather than as depositors. Hence, the supervisory emphasis would need to be on issues of investor protection and firewalls³, rather than on capital requirements in respect of the assets financed by IAH funds.

12. It is important to note the notion of balance between the minimum capital adequacy requirements, supervisory review process, transparency and market discipline in the regulation of IIFS and the supervisory review programme employed in this context.⁴ Each aspect is important, but none alone is sufficient for achieving the objectives of supervision of the IIFS industry sector.

² Refer to IFSB, *Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services*, December 2005, Appendix A.

³ The supervisor will need to consider which type of firewall is appropriate, particularly where IAH funds are commingled with the IIFS's own and current account holders' funds.

⁴ This is similar to the pillar structure, on which the Basel II framework is based.

13. Accordingly, within the existing infrastructures in their jurisdictions, the supervisory authorities will have to exercise judgement regarding the appropriate weights and balance to be given in the application of qualitative and quantitative measures in their policies on capital adequacy, risk management, corporate governance and disclosure requirements.

1.3 Scope and Application

14. The scope and application of this guidance will be determined by reference to the adoption of the other applicable IFSB standards and guiding principles.

15. The IFSB aims to encourage the authorities supervising IIFS to include measures (qualitative and quantitative) relating to elements in this document in their regulatory policy and/or supervisory review programme

16. The supervisory review process culminates in a formalised and structured supervisory strategy, which staff will follow when conducting off-site surveillance and on-site examination. The supervisory authority needs to assess the risk profile and evaluate the appropriateness and adequacy of the risk management processes. Based on these assessments, the supervisory authority may determine the extent of on-site transaction testing. The IIFS with the highest risks shall be expected to undergo the most rigorous scrutiny, analysis and transaction testing by the supervisory authority.

17. IIFS are setting up branches and subsidiaries in other countries, and investing in activities not traditionally undertaken by conventional financial intermediaries. In this context, and where separate supervisory agencies are responsible for certain regulatory requirements, coordination and cooperation among these authorities are expected in order to ensure effective consolidated supervision and stability of the financial system.

2. KEY ELEMENTS IN THE SUPERVISORY REVIEW PROCESS OF IIFS

2.1 Necessary Conditions for Effective Supervision

18. In jurisdictions where IIFS operate alongside conventional institutions, the supervisory authority needs to recognise the requirement for a framework that is both consistent with Islamic precepts and able to meet internationally acceptable prudential requirements as well as providing a level playing field for both IIFS and conventional institutions.

19. The revised Basel Core Principles⁵ document sets out “pre-conditions” (that is, necessary conditions) for effective banking supervision. In principle, the broad pre-conditions are equally relevant for the IFSI; however, they need to be properly adapted to provide a basis for effective supervision of Islamic financial services institutions. In particular, the conditions that provide a context for such a supervisory regime for IIFS in a jurisdiction include a well-developed public infrastructure comprising the following elements, *inter alia*:

- (i) 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;
- (ii) comprehensive and well-defined accounting principles and rules that command wide international acceptance;
- (iii) a system of independent audits for companies of significant size, 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;
- (iv) an efficient and independent judiciary, and well-regulated accounting, auditing and legal professions;
- (v) well-defined rules governing, and adequate supervision of, other financial and non financial markets and, where appropriate, their participants;
- (vi) a secure and efficient payment and clearing system for the settlement of financial transactions where counterparty risks are controlled;
- (vii) a form of legal entity for investment funds that provides one alternative to the use of a *Muḍārabah* contract without any separate legal entity for funds management by an IIFS; and
- (viii) a mechanism for providing an appropriate level of systemic protection (public safety net).

20. In addition to the above, the Basel Core Principles document also states a) soundness and sustainability of macroeconomic policies, and b) effective market discipline as being “preconditions for effective banking supervision”. The latter issue is addressed in the IFSB Standard on Transparency and Market Discipline. With regard to the soundness and sustainability of macroeconomic policies, it is acknowledged that these are not within the scope of authority of banking supervisors, but the latter will need to react if they perceive that existing policies are undermining the safety and soundness of the banking system.

⁵ Bank for International Settlements, *Revised Core Principles*, April 2006, paragraph 13.

21. While IIFS have a right to practice various *Sharī'ah-compliant* types of activities, as well as to hold instruments of conventional institutions that do not conflict with *Sharī'ah* rules and principles, it is advisable that the regulatory authorities provide a framework for a *Sharī'ah* compliance mechanism within IIFS.. Accordingly, the framework established by the supervisory authority may include, among other things:

- (i) appropriate requirements when applying IIFS licensing; and
- (ii) a broad framework governing applicable Islamic financial transactions, including appropriate governance in place to ensure compliance with *Sharī'ah* rules and principles.

22. Insofar as IIFS cannot obtain funds from conventional lender of last resort facilities or discount windows, because these involve the payment of interest, contingency plans to obtain funds (*Sharī'ah-compliant* financial instruments) are highly desirable and are feasible, as is evident from their existence in several countries.

23. The fact that capital and return on investment for profit-sharing investment accounts (**PSIA**) depend on the IIFS's profits indicates that transparency is even more crucial in the IFSI than in the conventional sector. Applicable international accounting and auditing standards are the underlying supports for risk management, control systems and market discipline. Accordingly, if these standards are applied and enforced, the information should be accurate, relevant, timely and accessible, to meet the needs of various stakeholders. Implementation of such standards would make it easier to compare financial statements of IIFS, particularly in terms of income recognition and profit calculation. This would enable the IAH to assess the type of investment and risk characteristics, based on IIFS's disclosure of their investment strategies and risk exposures. A regulatory authority therefore has a role in reinforcing market discipline by requiring timely and relevant information disclosures.⁶

2.2 Regulatory Capital Requirements

24. Supervisory authorities recognise the need to satisfy themselves that their regulated entities meet the applicable minimum capital adequacy requirements. Assessment of the appropriate level of the capital adequacy requirements for IIFS should be based on an analysis of the underlying asset portfolio⁷ and the results of the supervisory review process, taking into account rate-of-return risk and other risks that may give rise to displaced commercial risk.⁸ If the IIFS are required by the supervisory authority to set aside additional capital over and above the normal minimum requirement, the supervisory authority should set out the factors that are the basis for such an additional capital requirement.⁹

25. The supervisory authority should require each IIFS to demonstrate that its capital is commensurate with the level of its overall risk exposures, including assets such as real estate or commodities not made as part of the process of financial intermediation, whether these activities are carried out by the IIFS itself or through a subsidiary. The supervisory authority should adopt an approach that is proportionate to the nature, scale and complexity of the IIFS's activities.

26. The IFSB's *Capital Adequacy Standard* covers only the standardised approach to credit risk measurement; however, supervisory authorities, at their discretion, may authorise the use of other approaches (for example, based on internal ratings) for regulatory capital requirement purposes. In any case, the supervisory authorities need to reflect in the capital adequacy

⁶ Refer to the IFSB, *Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services (excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds)*, December 2007.

⁷ IFSB, *Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services*, December 2005.

⁸ For further reading on rate of return risk, please refer to the IFSB, *Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services*, December 2005. Note that rate of return risk for an IIFS may be compared to interest rate risk in the banking book for conventional banks.

⁹ Any additional capital charge therefore needs to be made on clearly stated and non-arbitrary basis subject to any legal constraints. It is a necessary condition of effective supervision that legal constraints do not prevent a supervisor from taking effective action.

requirement for IIFS the way in which IIFS carry out their business within their respective jurisdictions. Factors include the differing risks to which the IIFS are exposed for various contracts, at different contract stages, the different ways in which risks are managed by the IIFS (in view of the limited availability of risk mitigation techniques) and the sharing of risks between IIFS and the IAH (with particular reference to displaced commercial risk).

27. In some jurisdictions, IIFS are required to get approval from the supervisory authority or national *Sharī'ah* Board to develop instruments for risk mitigation. The broad framework for considering appropriate mitigation techniques may be embodied in the requirement for the *Sharī'ah* Board's approval and, in certain cases, the supervisory authority will only receive a copy of such approval. For the purpose of prudential supervision, the supervisory authority may satisfy itself as to the suitability of these instruments for mitigating risks in the portfolio so as to be recognised as risk mitigants in the capital adequacy requirement. The supervisory authority may need to be aware that the use of risk mitigants may not be very effective (leaving some residual risks) and can also be subject to operational risk.

28. In the case of *Mushārah* or *Muḍārah* (financing) contracts, the supervisory authority may provide specific guidance on the slotting method (as an alternative to the simple risk-weight method) for specialised financing based on various factors.¹⁰ While from a purely commercial perspective such contracts may be appropriate for the Islamic financial services industry, some may pose a prudential concern. Therefore, the supervisory authority needs to consider in its review the relevance for the IIFS of such prudential concerns. Such a review should take into account, among other matters, restrictions (for example, legal, tax, rights of shareholders' and IAH's interests, foreign exchange), significant exposure to risks, or influence by virtue of the IIFS's participation as *Mushārah* partner.

29. The supervisory authority has discretion to impose additional capital charges for operational risk, as the authority deems fit, to cater for the *Sharī'ah* non-compliance risk. This may lead the supervisory authority to judge that, although operational risk may cover similar non-compliance risk such as regulatory non-compliance and legal risk, an IIFS's inappropriate conduct may endanger the reputation of the institution, leading to withdrawal of funds. If *Sharī'ah* non-compliance is considered a significant portion of operational risk, the supervisory authority should assess appropriate measures that may need to be taken.

2.2.1 Treatment of IAH

30. An emerging issue for supervisory authorities is the treatment of IAH. In many cases, the treatment of IAH in the calculation of a regulatory capital requirement may lead the supervisory authority to judge that a full exclusion of the credit and market risk exposures from assets funded by the IAH may not be appropriate, and that there is a need to provide regulatory capital in respect of the proportion of such risks that is in effect borne by the IIFS's own capital (known as displaced commercial risk (**DCR**)). IIFS are expected to implement a sound and robust measurement methodology based on reliable data. For the purpose of computing the capital adequacy requirement, the supervisory authority would therefore assess and evaluate the reliability and accuracy of the methodology as a basis to measure the risk absorbed by the IIFS. The supervisory authority will need to exercise its judgement regarding the proportion of such risks that is subject to DCR, either for a particular IIFS or for all of the IIFS in its jurisdiction.

¹⁰ Refer to the criteria set out in Appendices B and C in the IFSB's *Capital Adequacy Standard for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services*, December 2005.

31. In certain jurisdictions, IIFS may be able to establish that there is no DCR because they are not under any pressure to forgo profits in order to “smooth” returns to IAH. The supervisory authority may provide guidance as to such circumstances. In such cases, the IAH may be considered to be restricted IAH or mutual fund investors. Therefore, the supervisory authority must be satisfied that the IIFS have adequate controls, which are similar to the general framework for mutual fund management.¹¹

2.3 Risk Management and Corporate Governance

32. Supervisory authorities need to place significant emphasis on the adequacy of an IIFS’s management of risks, including its systems of controls, when reviewing the condition of the IIFS. In view of the significant influence of *Sharī`ah* rules and principles throughout its operations, an IIFS’s failure to adequately identify, monitor and control *Sharī`ah* non-compliance that potentially applies to the entire spectrum of operations would be considered as making it vulnerable to eventual loss of income, as well as to reputational risk and possible insolvency. When evaluating the quality of internal controls of an IIFS, the supervisory authority should give due consideration to reviewing the key elements set out in the IFSB guiding principles on risk management and corporate governance.

2.3.1 Risk Management Processes¹²

33. Risk management processes are systems to manage various categories of risk, which must fit in with the IIFS’s practices and its (and its IAHs’) appetite for risk. The supervisory authority should evaluate the IIFS’s profiles under the different risk categories in the various modes of financing and investment, as well as the concentration of such risks, and should assess the appropriateness and quality of the IIFS’s risk management system.¹³ In evaluating such risks, the supervisory authority should require IIFS to adopt forward-looking stress testing that identifies possible events or changes in market conditions that could adversely affect the institution’s financial performance. The evaluation should also include the controls in place to mitigate such risks, both qualitative and quantitative. This will enable the supervisory authority to tailor its approach to individual IIFS and, in case of deficiency, to require the IIFS to improve its risk management process. In addition, the evaluation should encompass the IIFS’s capital adequacy and its internal systems for determining its economic and regulatory capital needs. Determination of the capital adequacy requirements for the IIFS, as set out in the IFSB’s *Capital Adequacy Standard*, differs technically in some respects from the determination of those of a conventional institution. However, the assessment process will in principle be the same as that of a conventional institution, except that attention would be given to matters such as (a) *Sharī`ah* compliance, (b) risk of real estate assets, and (c) certain aspects of operational risk that may not be applicable to conventional institutions.

34. Traditionally, fund management has been associated primarily with regulation under the securities market regulator. However, in practice, the IIFS may offer to investors, based on *Muḍārabah* or *Wakālah* contracts, investment funds that have specific purposes, such as real estate funds. (In the IIFS, this type of account is generally termed a restricted investment account.) The supervisory authority is concerned with assessment of the risks that arise from the fact that the operations of these restricted investment accounts are not carried out through a separate legal entity (as they are in conventional fund management). Given the risks arising from the operation of such investment accounts, the regulatory authority should require the IIFS to have adequate internal controls, risk management practices and risk disclosures to IAHs.¹⁴

¹¹ In cases where fund management rests separately with the securities market regulatory authority, the authority that supervises the IIFS will remain the front-line supervisor and is responsible for the day-to-day supervision of the IIFS’s activities. However, this arrangement between the authority that supervises the IIFS and securities market may vary from one jurisdiction to another.

¹² IFSB, *Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services*, December 2005.

¹³ IFSB, as in note 8, Appendix A, which explains the role of the supervisory authority on various risk categories.

¹⁴ See also: (a) 2.2.1 Treatment of IAH; and (b) 2.5 Transparency and Market Discipline.

2.3.2 Corporate Governance¹⁵

35. The IFSB's guiding principles on corporate governance address the relevant aspects of corporate governance from the perspective of IIFS. The general elements of governance in IIFS include:

- (i) compliance with Islamic *Sharī`ah* rules and principles;
- (ii) the role of the *Sharī`ah* Board in the governance, the role of auditors in terms of independence and accountability, and the extent to which supervisory authority can rely on third parties;
- (iii) the rights of the IAH: processes and controls in IIFS (such as a Governance Committee) for protecting their rights; and
- (iv) transparency of financial reporting in respect of investment accounts.

36. There is no "single model" of corporate governance that works well in every institution or country. The supervisory authority needs to review the controls and the quality of internal governance that have been put in place to ensure that the IIFS's control environment is (a) consistent with the general framework; and (b) commensurate with the size, complexity and nature of the business. Through a "comply or explain" approach, the supervisory authority needs to tailor its review to the individual IIFS and require the IIFS to improve its internal governance in a manner commensurate with its business.

37. The supervisory review is in no way intended to replicate the roles of the IIFS's Board and senior management, or of the internal, external and *Sharī`ah* audits, or of the *Sharī`ah* Board. The Board and senior management have the ultimate responsibility for understanding the fiduciary duties concerning various stakeholders, risks and exposures facing the IIFS. Supervisory authorities need to be satisfied that the IIFS are able to demonstrate that they have adequate corporate governance. Supervisory authorities are expected to provide broad, general guidance that includes "fit and proper" tests, and allocation by the Board of Directors of responsibilities to various members of management and organs of governance (such as an Audit Committee and Internal Audit, as well as a *Sharī`ah* Board). This is in order to ensure that the operation is in compliance with sound and prudent principles, as well as with those of the *Sharī`ah*, and that there are clear and well-defined reporting lines of responsibility. This is essential in order for the supervisory authority to ensure effective and prudent management of the IIFS.

38. When managing the investments of the IAH, the IIFS as *Muḍārib* shall clearly illustrate to the supervisory authority and external third parties that it has the level of competence necessary to fulfil its fiduciary duties and that adequate policies and procedures are in place. This is to ensure that the IAH's assets are safeguarded, and that the IIFS as *Muḍārib* has operated within the objectives agreed with the IAH.

2.3.3 Audit and Compliance

39. When assessing the effectiveness of the control (including internal audit) and compliance functions of the IIFS and of its external audit, the supervisory authority should hold discussions with the IIFS's compliance function to assess its role and effectiveness, and with its internal and external auditors and its Audit Committee regarding the audit scope and recent audit findings. Such discussions will give the supervisory authority the opportunity to assess the adequacy of the control and compliance function, the scope of the audits, and the degree of reliance to be placed on the audit findings.

¹⁵ IFSB, *Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (excluding Islamic Insurance (Takāful) institutions and Islamic Mutual Funds)*, December 2006.

2.4 Related Party Transactions

40. The supervisory authority needs to satisfy itself that the IIFS's related party transactions are conducted on an arm's-length basis. The definition of related party transaction is similar to that given in international accounting standards¹⁶, where the transaction in question relates to the transfer of resources, services or obligations.

41. A related party is defined as a member of the Board of Directors or senior management or a *Sharī'ah* advisor, or an external auditor of the institution, major shareholders, or other related interests with whom the institution has business transactions which may be for the benefit of that party rather than the institution's shareholders and IAH. In order to be included in the above definition of related party, *Sharī'ah* advisors would need to be members of the *Sharī'ah* Supervisory Board, which has the authority to approve or disapprove of products and operations. A family member or close associate of a member of the Board of Directors or senior management, or of a *Sharī'ah* advisor or external auditor, may also be considered to be a related party.

42. As part of its review process, the supervisory authority needs to satisfy itself, through auditors or on-site inspection, as to appropriate evidence of the accounting for and disclosure of any material transactions with related parties.

2.5 Transparency and Market Discipline¹⁷

43. The supervisory authority needs to consider that disclosures reinforce (a) discipline; and (b) fiduciary duties towards various stakeholders, particularly the IAH, with regard *inter alia* to IIFS's compliance with *Sharī'ah* rules and principles. Insofar as the IAH bear their own risk, it is important that IIFS's financial reporting should include information about their investment performance in a form that they can readily understand. Such information, provided accurately and reliably and on a timely basis, is vital not only for protecting the interests of the IAH but also for promoting systemic stability. The information is likely to enhance incentives for the IIFS as the *Muḍārib* to operate prudently in order to maintain the IAH's confidence.

44. At present, most IAH are generally not able to undertake regular monitoring of the IIFS. In addition, the IAH do not have the power to enforce any requirements on financial institutions, or to call for corrective action, except by withdrawing their investment from the IIFS. Thus, an important role of supervisory authorities is to ensure that adequate systems and processes are in place to protect the interests of the IAH.

45. Additionally, the supervisory authority may collaborate with the IIFS industry and consumer associations to advocate and promulgate best practices regarding controls and risk management systems. While each group may be geared primarily to the interests of its members, the advantage of such a suggestion is the "peer pressure" approach it takes to compliance.

46. Insofar as the IAH bear their own risks, the supervisory authority should satisfy itself with regard to appropriate and timely disclosure of information on risks and returns and, where appropriate, the receipt of the reports from IIFS that, among other things, provide early warnings where necessary.

47. In this regard, the supervisory authority may need to ensure that the IIFS disclose key accounting and prudential information, as proposed in the IFSB's *Standard on the Disclosure Principles to Promote Transparency and Market Discipline for Institutions (other than Insurance Institutions) Offering Only Islamic Financial Services*. It is important to differentiate the scope and type of information to be disclosed by the categories of users, including regulators, existing and potential shareholders, and other parties dealing with the IIFS.

¹⁶ For example, the currently applicable international accounting standard is IAS 24 *Related Party Transactions*.

¹⁷ IFSB, *Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services (excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds)*, December 2007.

2.6 Consolidated¹⁸ and Home-host Supervision

48. A general framework of arrangements relating to the power of supervisory authorities to share information is viewed as consistent with international standard practice, which emphasises arrangements for better information sharing and coordination to improve prudential supervision and crisis management. This framework may include, among other things, consistency in the application of different confidentiality requirements, reciprocal undertakings in relation to information sharing, right contacts and competent persons, and help with language and interpretation of terms.

49. In the context of home-host relationships, the supervisory authorities are expected to consider implications relating to competing pressures within the financial sectors, own countries' best interests, national *Shari'ah* interpretations, legal and tax systems, crisis management and the benefits of international cooperation. On one hand, the authorities should provide a regulatory environment for the IIFS to operate seamlessly across jurisdictions. On the other hand, crisis management would be undertaken on a national basis and involve separate asset pools. Since not all countries have deposit insurance schemes (especially schemes that are *Shari'ah*-compliant), supervisory authorities need to consider the potential of IIFS to undertake riskier activities depending on whether IAH are fully or largely protected from the risks.

2.6.1 Consolidated and Cross-sector Supervision

50. The IIFS may have a range of activities that cross supervisory boundaries. The supervisory authority needs to assess the risks on a consolidated basis. The restricted investment accounts, for example, are akin to fund management, normally supervised by the securities market supervisor. Another example relates to having *Takaful* as a separate line of business within the IIFS. In jurisdictions where these activities are supervised by a separate regulatory entity, close cooperation with other supervisory authorities is crucial. To facilitate coordination between the authorities, frequent dialogues or memoranda of understanding may be needed to assign clearly their respective roles and responsibilities, and to establish a central point of contact.

51. This central point of contact is crucial in fulfilling the objective of risk-focused supervision. The central point of contact should be knowledgeable about the IIFS's activities, remain up to date, and share information specific to an IIFS, where appropriate, with any interested supervisory authority.

52. For unregulated entities and/or non-financial entities that are subsidiaries of a regulated IIFS, the authority supervising the parent IIFS may assess whether the risks are transferred from regulated to unregulated entities, or vice versa. Where a regulated IIFS has significant influence over, and exposure to the risks of, such subsidiaries, the supervisory authority may apply to the investments in the subsidiaries in the consolidated balance sheet approaches to capital adequacy and disclosure that would be appropriate in the case of similar activities of a regulated entity. In addition, the authority may need to satisfy itself that appropriate *Shari'ah* compliance systems are in place across the group.

2.6.2 Home-host Cooperation

53. There are diverse approaches with respect to regulation and supervision of *Shari'ah* matters in various jurisdictions. In some cases, there may be a national *Shari'ah* Board, whereas another jurisdiction may mainly require applicable *Shari'ah* systems to be in place. In some arrangements, the prior consent of the home supervisory authority may be an integral part of the products and services authorisation process. In other cases, there may be simply a notification requirement or no formal authorisation or approval requirement. Irrespective of the approaches,

¹⁸ Consolidated supervision is generally defined as a comprehensive approach to banking supervision which seeks to evaluate the strength of an entire group, taking into account all the risks which may affect a bank, regardless of whether these risks are carried in the books of the bank or of related entities.

the host supervisory authority has primary responsibility to ensure that the IIFS under its supervision comply with its national rules and regulations, including on *Shari`ah* matters.

54. For consolidated supervision, the home supervisory authority is expected to have the need for and access to a range of information pertaining to the foreign branches and subsidiaries of an IIFS group under its supervision. The home supervisory authority needs to assess the impact of any development in the structure of the supervised IIFS group and to make appropriate adjustments to its supervisory approach. To facilitate the review process, the home supervisory authority should obtain information from IIFS groups under its supervision about the objectives, business activities and risk management practices applicable to their foreign branches and subsidiaries as well as other issues of supervisory concern.¹⁹

55. While the extent of cooperation and information sharing is also relevant with regard to the IIFS group operations, the selected structure of cooperation, such as a supervisory college,²⁰ bilateral or multilateral, should reflect both the group's structure and the supervisors' requirements. Specific home-host information access and/or sharing involving IIFS groups with cross-border and cross-sectoral structures may include, among others and where applicable, licensing criteria, background of foreign institutions, "fit and proper" information, issues of supervisory concern such as verification of risk management methodology, validity of *Shari`ah* compliance, and findings regarding *Shari`ah* non-compliance.

¹⁹ There are many existing arrangements in place relating to information exchanges. The suggestion set out in this document is not intended to replace such existing arrangements.

²⁰ "College" refers to a group of supervisory authorities that have come together in order to pursue a common purpose of sharing information and coordinating activities on a cross-border basis.

3. SPECIFIC ISSUES

3.1 Islamic Window Operations (“Windows”)

56. For the purpose of this Standard, an Islamic window operation is defined as part of a conventional financial institution (which may be a branch or dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are *Sharī`ah*-compliant. In principle, these windows are potentially self-contained in terms of *Sharī`ah*-compliant financial intermediation, as the funds managed will be invested in *Sharī`ah*-compliant assets. They thus raise a number of issues of supervision that are substantially the same as those raised by a fully-fledged IIFS.

57. The term “window” is used in some jurisdictions to refer to an operation whereby an institution invests funds in *Sharī`ah*-compliant assets without such funds being mobilised specifically for *Sharī`ah*-compliant investment purposes. Such operations may be carried out through either branches that offer current account facilities or other units of the institution. In this context, the operations do not meet the definition of an Islamic Window given in paragraph 56 above. The supervisory issues raised by such operations are substantially different from those raised by fully-fledged IIFS, but include issues of risk management in respect of the *Sharī`ah*-compliant assets and of applying appropriate risk weightings to those assets for capital adequacy purposes. Supervisory authorities should be guided by the IFSB standards on risk management and capital adequacy in supervising such operations.

58. The institution should have a system such that the separation of Islamic assets and funds from non-*Sharī`ah*-compliant assets and funds is made transparent.²¹ As such, windows need to be differentiated from (a) *Sharī`ah*-compliant mutual funds that are separate legal entities; and (b) providers of *Sharī`ah*-compliant financing products (for example, for house purchase) which do not mobilise funds with the assurance that they will be invested in *Sharī`ah*-compliant assets.

59. In view of the widespread trend towards windows over the past few years in several jurisdictions, the supervisory authorities in these jurisdictions need to satisfy themselves that the institutions offering such windows have the internal systems, procedures and controls to provide reasonable assurance that (a) the transactions and dealings of the windows are in compliance with *Sharī`ah* rules and principles; and (b) appropriate risk management policies and practices are followed.²²

60. In supervising a window operation, the supervisory authority needs to bear in mind the specific characteristics of the *Sharī`ah* compliance as well as the fact that it is part of a conventional institution. This is true of capital adequacy, corporate governance, risk management and disclosure. A window operation should in the first instance be considered separately as a branch of the entity of which it is a part; the latter will then be considered on a consolidated basis.

3.1.1 Internal Controls

61. A window is expected to provide evidence that it has appointed a competent *Sharī`ah* scholar or *Sharī`ah* Board of such scholars, which will provide assurance that the products and operations comply with *Sharī`ah* rules and principles. The scholars should be independent and free to give their opinion on the proposed contracts and transactions. The scholars may provide continuous supervision of *Sharī`ah* compliance in the contracts, transactions and procedures.

²¹ The supervisory authority may require the institution to publish a full separate set of supplementary financial statements for its window operation in the notes to its financial statements (see the IFSB's *Disclosures to Promote Transparency and Market Discipline*).

²² Refer to retail investor disclosure in the IFSB, *Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services (excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds)*, December 2007.

62. In cases where the institution does not appoint a *Sharī`ah* scholar or Board, the supervisory authority needs to seek explanation of the reasons for not doing so. In addition, the supervisory authority should satisfy itself that pertinent *Sharī`ah fatāwa* and resolutions are complied with by the financial institution's management, in implementing the Islamic financial services that the financial institution offers.

3.1.2 Regulatory Capital Requirement

63. A supervisory authority will need to take account of the *Sharī`ah*-compliant assets of the window, as well as the risk-bearing nature of the *Sharī`ah*-compliant funds that are invested in these assets, in assessing the capital adequacy of the conventional financial institution concerned. The IFSB's *Capital Adequacy Standard* provides a measurement approach that may be used for this purpose, although in general the overall capital regulatory requirement is embodied in the regulatory requirement at the main institutional level. In some countries, the amount of the entity's own regulatory capital that is required to provide capital adequacy to the window operation is clearly identified and segregated from the regulatory capital available for the conventional operations. The use of this approach for a window operation is subject to considerations of materiality.

64. For a window operation defined in paragraph 56, its capital requirement may be calculated by first calculating the amount of the denominator of the CAR (as explained in Appendix A of the IFSB CAS), and then by calculating the amount of capital needed in the numerator of the CAR in order to meet the regulatory capital requirement. This amount may then be deducted from the bank's eligible capital in the numerator of the CAR (for example, 50% from Tier 1 and 50% from Tier 2). However, a supervisory authority may at its discretion employ a different approach with the same economic effect.

65. For a window as defined in paragraph 57, all that is required is the calculation of the appropriate risk weightings for its *Sharī`ah*-compliant assets.

3.1.3 Disclosure Requirements

66. In addition to some proposed disclosures as mentioned in paragraph 47, a supervisory authority may require the institution to disclose, among other things:

- (i) whether the institution commingles the funds relating to Islamic financial services with funds relating to conventional financial services; and
- (ii) sources of funds to cover a liquidity deficit of the windows, if any.

3.2 Real Estate Investments

67. Real estate investments by IIFS have been on the rise in many jurisdictions. The IIFS act as property developers and/or then owners, which is normally undertaken by real estate specialists. Such investments raise supervisory issues, particularly with respect to risk management and capital adequacy.

68. In some jurisdictions, IIFS may securitise these real estate investments. While the investment constitutes a collective investment scheme in real estate and as such is generally classified under securitised restricted investment accounts, there are some differences where the supervisors need to make an assessment and, if necessary, provide guidance.²³

²³ In some jurisdictions, the authority supervising capital markets (for example, the Securities Commission) may provide similar guidance. This issue may be an area for discussion in terms of cross-sector supervision.

DEFINITIONS

The following definitions are intended to give a general understanding of the Arabic terms used in this document. The list is by no means exhaustive.

Islamic window	Islamic window is part of a conventional financial institution (which may be a branch or dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are <i>Shari`ah</i> -compliant
<i>Muḍārabah</i>	A <i>Muḍārabah</i> is a contract between the capital provider and a skilled entrepreneur, whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur as the <i>Muḍārib</i> (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the <i>Muḍārabah</i> agreement, while losses are to be borne solely by the capital provider unless the losses are due to the <i>Muḍārib</i> 's misconduct, negligence or breach of contracted terms.
<i>Mushārah</i>	A <i>Mushārah</i> is a contract between the IIFS and a customer to contribute capital to an enterprise, whether existing or new, or to ownership of a real estate or moveable 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>Mushārah</i> agreement, while losses are shared in proportion to each partner's share of capital.