



IMF POLICY PAPER

THE CORE PRINCIPLES FOR ISLAMIC FINANCE REGULATIONS AND ASSESSMENT METHODOLOGY

May 2018

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its May 9, 2018 consideration of the staff report.
- The **Staff Report**, prepared by IMF staff and completed on April 6, 2018 for the Executive Board's consideration on May 9, 2018.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

Electronic copies of IMF Policy Papers
are available to the public from
<http://www.imf.org/external/pp/ppindex.aspx>

International Monetary Fund
Washington, D.C.



INTERNATIONAL MONETARY FUND



Press Release No. 18/193
FOR IMMEDIATE RELEASE
May 24, 2018

International Monetary Fund
700 19th Street, NW
Washington, D.C. 20431 USA

IMF Executive Board Adopts Decisions to Formally Recognize the Core Principles for Islamic Finance Regulation (CPIFR) for Banking

The Executive Board of the International Monetary Fund (IMF) today endorsed a proposal on the use of the Core Principles for Islamic Finance Regulation (CPIFR), which were developed by the Islamic Financial Services Board (IFSB) with the participation of the Secretariat of the Basel Committee on Banking Supervision. The CPIFR are intended to provide a set of core principles for the regulation and supervision of the Islamic banking industry and are designed to take into consideration the specificities of Islamic banks, as explained in the IMF Staff Paper, *“The Core Principles for Islamic Finance Regulations and Assessment Methodology.”*

The CPIFR will complement the international architecture for financial stability, while providing incentives for improving the prudential framework for Islamic banking industry across jurisdictions.

The CPIFR and their associated methodology will be applied in financial sector assessments undertaken in fully Islamic banking systems and, as a supplement to the Basel Core Principles for Effective Banking Supervision (BCP), in dual banking systems where Islamic banking is systemically significant.

Executive Board Assessment¹

Executive Directors welcomed the opportunity to consider the staff’s proposals to strengthen the Fund’s engagement on promoting financial stability in countries with Islamic banking. They noted that the Islamic finance sector continues to grow and evolve in size and complexity, with Islamic banking offered in more than 60 countries. Directors concurred that the growth of Islamic finance presents important opportunities to strengthen financial inclusion, deepen financial markets, and mobilize funding for development by offering new

¹ An explanation of any qualifiers used in the summing up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

modes of finance and attracting “unbanked” populations that have not participated in the financial system.

Directors noted that Islamic banks (IB) undertake distinct operations with risk profiles and balance sheet structures that differ in important respects from conventional banks, with associated financial stability implications. In this regard, they called for stronger efforts to strengthen the regulatory and supervisory frameworks to take into consideration the specificities of IB to promote financial stability and sound development, particularly in countries where IB have become systemically important. The approach to regulating and supervising IB should reflect the nature of risks to which IB are exposed and the financial infrastructure needed for effective regulation and supervision, which requires additional or different regulation and supervisory practices to address risks inherent in the Islamic banking operations.

Directors broadly endorsed the use of the “Core Principles for Islamic Finance Regulation” (Banking Sector) (CPIFR) and their assessment methodology for the purposes of undertaking financial sector assessments and preparing Reports on the Observance of Standards and Codes (ROSCs) initiated after January 1, 2019 regarding the effectiveness of regulation and supervision of IB. The CPIFR, which was developed by the Islamic Financial Services Board (IFSB) with the participation of the Secretariat of the Basel Committee on Banking and Supervision (BCBS) for assessments of the banking regulatory and supervisory regimes for countries where Islamic banking is systemically significant, will complement the international architecture for financial stability, while simultaneously providing incentives for improving the prudential framework for the Islamic banking industry across jurisdictions.

Directors saw merit in maintaining close cooperation between the IFSB and the BCBS to ensure their respective standards remain consistent.

Directors noted that the CPIFR standard and assessment methodology will be used in fully Islamic banking systems and as a supplement to the Basel Core Principles for Effective Banking Supervision (BCP) in dual banking systems where IB has a significant market share (of 15 percent or more). Where a jurisdiction has both significant Islamic banking and significant conventional banking sectors, the Fund will assess both sectors at the same time using the CPIFR and BCP standards and assessment methodologies respectively, which would also reveal the relevant linkages between the IB and its conventional counterpart, and their implications for financial stability. Directors noted that the use of CPIFR would help strengthen evenhandedness and consistency in surveillance, program design and technical assistance. They considered that the outcome of these assessments would be useful for the Fund in formulating policy recommendations and addressing specific country circumstances.

Directors welcomed staff’s proposal for countries where the IB system is below the 15 percent threshold. They considered that adoption of the CPIFR could be supported

through technical assistance to help nascent IB financial systems develop in a safe and sustainable way. For these countries, Islamic finance plays a complex developmental role including in meeting the United Nations' sustainable development financing goals in terms of providing access to investment and equity finance and inclusion for large parts of their unbanked populations where conventional finance may have less acceptance. Directors encouraged the Fund to continue developing alternative criteria to determine the significance of the IB sector in a country, beyond the simple market share in the financial market. A number of Directors saw merit in future work on developing comprehensive standards for Islamic financial services.

Directors emphasized the importance of close cooperation between the Fund and relevant key institutions on IB issues. In order to avoid duplication of efforts, they saw merit in a clear division of labor between standard-setters and international organizations.



April 6, 2018

THE CORE PRINCIPLES FOR ISLAMIC FINANCE REGULATIONS AND ASSESSMENT METHODOLOGY

EXECUTIVE SUMMARY

This paper provides a proposal to incorporate the Core Principles for Islamic Finance Regulation (Banking Sector) (CPIFR) issued by the Islamic Financial Services Board (IFSB),¹ as part of the standards used in assessing the banking regulatory and supervisory regimes of relevant member jurisdictions under the Financial Sector Assessment Program (FSAP) and the Reports on Observance of Standards and Codes (ROSCs). The CPIFR largely reflects the order of the Basel Core Principles on Effective Banking Supervision (BCP), with five additional principles that are specific to Islamic banking operations. Thus, for countries that have systemically significant Islamic banking sector, the assessment of the banking regulation and supervision regime of the jurisdiction would be against the CPIFR (for fully Islamic banking systems) or BCP and the five additional core principles under the CPIFR (for dual banking systems). The Fund staff is seeking the endorsement of the Executive Board on this proposal.

¹ The Islamic Financial Services Board (IFSB) serves as an international standard-setting body of regulatory and supervisory agencies that promotes the soundness and stability of the Islamic financial services industry, which include banking, capital market and insurance. See Appendix I for further details.

Approved By
Aditya Narain (MCM),
Ross B. Leckow (LEG),
and Aasim M. Husain
(MCD)

Prepared by IMF and World Bank: a staff team led by Nor Shamsiah Yunus, Nigel Jenkinson (IMF), and Abayomi Alawode (World Bank) comprising Mohamed Norat (AFR), Nadia Rendak, Julianne Ams, Arz Murr, Chady El Khoury, Elsie Addo Awadzi (LEG), Phil de Imus, Alison Holland, Padamja Khandelwal, Inutu Lukonga (MCD), Rachid Awad, Abdullah Haron, Alejandro Lopez-Mejia, Shamloo Maral and Ghiath Shabsigh (MCM), Artak Harutyunyan and Samah Torchani (STA). Administrative support was provided by Natalia Naryshkina.

CONTENTS

Glossary	3
INTRODUCTION	4
OVERVIEW OF THE CPIFR	5
APPLICATION OF THE CPIFR	7
PRINCIPLES SPECIFIC TO ISLAMIC BANKS IN CPIFR	9
A. Treatment of PSIA/IAHs (CPIFR 14)	9
B. Shari`ah Governance Framework (CPIFR 16)	10
C. Equity Investment Risk (CPIFR 24)	11
D. Rate of Return Risk (CPIFR 26)	11
E. Islamic “Windows” Operations (CPIFR 32)	12
TECHNICAL ASSISTANCE	13
RESOURCE IMPLICATIONS	13
BOX	
1. Islamic Finance—Key Principles Governing Islamic Banking	6
APPENDICES	
I. The Islamic Financial Services Board	15
II. The Fund’s Involvement in Islamic Finance	17
III. Mapping the BCPs and CPIFR Approach	18
IV. List of Countries with Islamic Banking Assets	19
V. Key Unique Risks in IBs	20
VI. Summary of the Unique CPIFR and the Corresponding Methodology	23

Glossary

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AC	Additional Criteria
AsDB	Asian Development Bank
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BOD	Board of Directors
CAGR	Compounded Annual Growth Rate
COI	Cooperating Institution
CPIFR	Core Principles for Islamic Finance Regulation (Banking Sector)
DCR	Displaced Commercial Risk
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
IAH	Investment Account Holders
IAIS	International Association of Insurance Supervisors
IB	Islamic Banks
IFSB	Islamic Financial Services Board
IIFS	Institutions Offering Islamic Financial Services
ILD	Investment-Linked Deposit
IOSCO	International Organization of Securities Commissions
IRR	Investment Risk Reserve
IsDB	Islamic Development Bank
ML/TF	Money Laundering and Terrorism Financing
PER	Profit Equalization Reserve
PLS	Profit and Loss Sharing
PSIA	Profit Sharing Investment Accounts
RIA	Restricted Investment Account
ROR	Rate of Return
ROSC	Reports on Observance of Standards and Codes
RSA	Regulatory and Supervisory Authorities
RTACs	Regional Technical Assistance Centers
SDG	Sustainable Development Financing Goals
TA	Technical Assistance
UFR	Use of Fund Resources
URIA	Unrestricted Investment Account

INTRODUCTION

1. The Islamic finance sector continues to grow and evolve. Global Islamic financial assets have reached about US\$2 trillion, with the banking sector accounting for about 85 percent of the total assets. Islamic banking exists in more than 60 countries and the industry has become systemically important in 13 jurisdictions,² while the domestic market share of Islamic banks (IB) increased in 18 countries in 2016. The rapid growth of Islamic finance reflects both supply-push and demand-pull factors, including strong economic growth in core markets, competitive pressures, regulatory advancements, and facilitative environment provided by governments.³ Several countries are recognizing the segment's potential, with authorities encouraging Islamic finance to improve financial inclusion. The industry's potential contribution to the United Nation's sustainable development financing goals (SDGs) are also likely to help the industry to progress in coming years. Reflecting the importance of Islamic finance for many of its members, the IMF has had a long-standing interest in its implications for macroeconomic and financial stability.⁴

2. The growth of Islamic finance presents important opportunities. Islamic finance can deepen financial markets and inclusion by offering new modes of finance and attracting “unbanked” populations that have not participated in the financial system. Its products and services have the potential to facilitate the “bailing-in” of stakeholders (for example, investment account holders who bear losses on their invested capital) of banks in resolution. Islamic finance also provides the discipline that strengthens the link between finance and the real economy through its emphasis on risk-sharing. Thus, IBs generally are less leveraged than conventional banks.

3. However, IB generates distinct operations with risk profiles and balance sheet structures that differ in important respects from conventional banks, with associated financial stability implications. These include equity investment risk, displaced commercial risk, rate-of-return (ROR) risk, and Shari`ah non-compliance risk. In addition, some of the traditional risks such as credit, concentration, and liquidity risks can be amplified as transactions in financial derivatives to hedge risks and the availability of Shari`ah compliant liquidity instruments are limited. In many countries, the industry is still largely operating in an environment that is governed by a legal, tax, and regulatory and supervisory framework developed for conventional banks; financial safety nets and central bank liquidity framework are either absent or, if available, do not appropriately consider the special characteristics of Islamic banks.

² IFSB's Financial Stability Report 2016, published in May 2016 specified that an Islamic banking system is classified as systemically important if it accounts for 15 percent or more of the domestic banking system assets.

³ “Islamic finance ... is growing rapidly, with \$2.2 trillion in assets and strong capitalization. This is a 10 percent increase from 2015, and assets are expected to grow by 9.4 percent CAGR to reach \$3.8 trillion in 2022.” State of the Global Islamic Economy 2017/18, Thomson Reuters.

⁴ See Appendix II on the Fund's involvement in Islamic finance.

4. On February 3, 2017, the Executive Board of the IMF adopted a set of proposals on the role of the Fund in promoting financial stability in countries with Islamic banking.⁵

Executive Directors expressed support for staff's proposed approach to developing and providing policy advice on Islamic banking-related issues in the context of Fund surveillance, program design, and capacity development activities. They also called for staff's continued support to the work of the relevant international standard setters and other international bodies to help address current gaps in the international regulatory framework for Islamic banking. Directors saw merit in considering a proposal to formally recognize the CPIFR prepared by the IFSB, to supplement BCP assessments under the Fund/Bank Standards and Codes Initiative.

5. The purpose of this paper is to seek endorsement from the Executive Boards of the World Bank and the IMF on the use of the CPIFR and its assessment methodology.

Due to differences in the Bank and Fund Board procedures, this paper is being submitted by the Bank staff to its Board for information purposes only, advising the Board that the CPIFR and assessment methodology developed by the IFSB will be used as outlined in paragraphs 10 and 11 of this paper. In the case of the IMF, Fund staff is seeking the endorsement of its Board for the use of the CPIFR to supplement BCP standards assessments of the banking regulatory and supervisory regimes for countries where Islamic banking is systemically significant based on the 15 percent threshold proposed in this paper, and to use the CPIFR for assessments conducted in countries that have wholly Islamic banking systems.

OVERVIEW OF THE CPIFR

6. The CPIFR are intended to provide a set of core principles for the regulation and supervision of the Islamic banking industry.

They are designed to take into consideration the specificities of Islamic banks where the provision of financial services must be in accordance with Shari'ah (Islamic jurisprudence) principles pertaining to Islamic finance and underpinned by real economic activities (Box 1). Shari'ah bans *riba*,⁶ products with excessive uncertainty (*gharar*), gambling (*maysir*), short-sales, as well as the financing of prohibited activities that are deemed harmful to society.

7. The CPIFR will complement the international architecture for financial stability, while simultaneously providing incentives for improving the prudential framework for Islamic banking industry across jurisdictions.

Many regulatory and supervisory authorities (RSAs), including those new to the regulation and supervision of IB, face challenges in identifying and applying appropriate principles and benchmarks for assessing the gaps in the existing structures

⁵ Board paper SM/17/3 "Ensuring Financial Stability in Countries with Islamic Banking," February 3, 2017.

⁶ In Islamic finance, money is not a commodity to be traded; thus, the acceptance of deposits and payment of interest, or lending of money and the charging of interest, without any underlying trading and exchange of real assets or services are deemed as *riba* and is therefore prohibited.

Box 1. Islamic Finance—Key Principles Governing Islamic Banking

- Principle of equity:** This is the rationale for the prohibition of predetermined payments (riba), with a view to protecting the weaker contracting party in a financial transaction and promoting fair treatment. The term riba, which means “hump” or “elevation” in Arabic, is an increase in wealth that is not related to engaging in a productive activity. The principle of equity is also the basis for prohibiting excessive uncertainty (gharar) as manifested by contract ambiguity or elusiveness of payoff. Transacting parties have a moral duty to disclose known information before engaging in a contract, thereby reducing information asymmetry; otherwise, the presence of gharar would nullify the contract.
- Principle of participation:** Although commonly known as interest-free financing, the prohibition of riba does not imply that capital is not to be rewarded. Investment return has to be earned in tandem with participation in the productive activity and not with the mere passage of time, which is also the basis of prohibiting riba. Thus, return on capital is legitimized by risk taking and determined ex post based on asset performance or project productivity, thereby ensuring a link between financing activities and real activities. The principle of participation lies at the heart of Islamic finance, ensuring that increases in wealth accrue from productive activities.
- Principle of ownership:** The rulings of “do not sell what you do not own” (for example, short-selling) and “you cannot be dispossessed of a property except on the basis of right” mandate asset ownership before transacting. Islamic finance has, thus, come to be known as asset-based financing, forging a robust link between finance and the real economy. It also requires preservation and respect for property rights, as well as upholding contractual obligations by underscoring the sanctity of contracts.

Balance Sheet of an IB

	Assets	Liabilities	
Peculiar to IB	Inventories Real Estates/Automobiles	Demand Deposits Wadiah/Custodian	Currents and Savings Accounts in Conventional Banks
Loans in Conventional Banks	Receivables from: Murabahah/Ijarah/Istisna'/Salam	General Investment Accounts Mudarabah	Peculiar to IB
Peculiar to IB	Profit Sharing Transactions Mudarabah/Musharakah	Specific Investment Accounts Mudarabah	Investment-Linked Deposit (ILD) Accounts in Conventional Banks
	Fixed Assets	Equity	

and policies in their jurisdictions. The approach to regulating and supervising IB needs to reflect: (a) the nature of risks to which IB are exposed; and (b) the financial infrastructure needed for effective regulation and supervision, which will result in additional or different regulation and supervisory practices to address risks inherent in the Islamic banking operations. A detailed discussion of the relevant concepts and the issues faced by Islamic banks was provided in SM/17/3 (2/3/17).

8. As in the case of the BCP, the CPIFR set out “preconditions” (i.e., necessary conditions) for effective banking supervision. These preconditions are broadly and equally relevant for the Islamic banking industry, but several of the preconditions need to be approached in ways that recognize the specificities of IB. Examples include the frameworks for recovery and resolution (e.g., creditor hierarchy) and the tools for systemic protection.

9. The CPIFR is largely modeled after the BCP as revised in September 2012, with modifications to address Islamic banking-specific issues in regulation and supervision. Each CPIFR is supported by assessment criteria. These are divided between essential and additional criteria. The Secretariat of the Basel Committee on Banking Supervision participated as a member of the working group in the development of the CPIFR together with 18 country authorities, the AsDB, the IsDB, the IMF, and the World Bank. **Appendix III** provides a mapping between the BCP and the CPIFR.

- Nine BCP are retained un-amended in the CPIFR in view of their common applicability to both conventional and Islamic banking;⁷
- Nineteen BCP have been amended at the level of the assessment criteria rather than the Principles themselves;⁸ and
- Five additional principles of CPIFR and their corresponding methodology have been developed by the IFSB. These are listed in **Appendix V**.

APPLICATION OF THE CPIFR

10. The CPIFR and their assessment methodology will be applied in fully Islamic banking systems and, as a supplement to the BCP, in dual banking systems where Islamic banking is significant. Where a jurisdiction has both significant Islamic banking and significant conventional banking sectors, it would be prudent to assess both sectors at the same time. This reflects the fact that the CPIFR and the BCP cover much of the same territory, and many issues will therefore need to be considered only once. A dual assessment of this kind will also be able to assess the relevant

⁷ The CPIFR on abuse of financial services including anti-money laundering and combating the financing of terrorism (AML/CFT) (CPIFR 33) is similar to CP29 as the money laundering/terrorism financing (ML/TF) risks in Islamic banking would be addressed by the BCP. However, although there is no evidence that the ML/TF risks in IBs are any different from those posed by conventional banks, there is currently no common understanding of ML/TF risks associated with Islamic banking, including those due to: (i) the complexity of some Islamic banking products; and (ii) the nature of the relationship between the IB and their clients. The Fund is collaborating with the IFSB to analyze these risks and assess the degree to which they are covered by measures of the Financial Action Task Force (FATF) standard. A joint paper may be developed to that effect.

⁸ IBs are also exposed to credit, market, and operational risks; but these risks could be heightened by the complexity of the way the products are structured (see Appendix V). The detailed application of these BCP to IB requires RSAs and assessors to consider Shari'ah rules and principles and the different product characteristics (see list of amended BCP in Appendix III).

linkages between the IB and its conventional counterpart, and their implications for financial stability.

11. For assessments in a Reports on the Observance of Standards and Codes (ROSCs)⁹, staff propose to use the threshold adopted by the IFSB for determining countries where Islamic banking is significant. Staff is proposing to align the market share threshold with that used by the IFSB at 15 percent to determine the significance of Islamic banking sector in a country.¹⁰ In addition, until a more comprehensive and risk-based methodology is established, Islamic banking may be considered significant, and the use of the CPIFR may be recommended where staff assesses that the rapid growth rate of the Islamic banking sector in a given country may pose risks to the domestic financial system.¹¹ Staff will continue refining the risk-based methodology.

12. In countries where the IB system is below this threshold, the adoption of the CPIFR could be supported through TA (when requested by the member) to help nascent financial systems to develop in a safe and sustainable way. For these countries, Islamic finance plays a complex developmental role including in meeting UN SDGs in terms of providing access to investment and equity finance and inclusion for large parts of their unbanked populations where conventional finance has less acceptance. For this reason, the TA would support the strengthening of supervisory and regulatory framework in those countries.

13. Countries with Islamic banking assets that account for 15 percent or more of the respective domestic banking system as at end-December 2016 are listed in Appendix IV. If a detailed assessment is conducted in these countries, it would then be expected to cover the 5 additional CPIFR mentioned in **Appendix VI** in addition to the 29 BCP. In case the macrofinancial approach to supervisory standards assessments is taken,¹² the 2 CPIFR principles on Shari`ah governance framework and treatment of profit-sharing investment accounts and investment account holders would be deemed as relevant from a macrofinancial standpoint in addition to the 11 BCP principles. These two principles are relevant for macrofinancial stability purposes, as weakness in managing Shari`ah compliance risks and risks associated with profit-sharing investment accounts (which is one of the significant funding source for Islamic banks) may result in financial and reputational risks that may, in turn, affect the safety and soundness of an Islamic bank.

14. An assessment of a jurisdiction's compliance with the CPIFR would be a useful tool in the jurisdiction's implementation of an effective system of banking supervision for Islamic banks. To achieve objectivity and comparability of compliance with the CPIFR in different jurisdictions, RSAs and assessors would refer to the CPIFR assessment methodology, which requires

⁹ ROSCs may either be conducted on a stand-alone basis or as part of a Financial Sector Assessment Program.

¹⁰ Staff will rely on the IFSB's annual list of countries where Islamic banking exceeds this threshold or statistics published by authorities where available.

¹¹ For example, in Oman, Islamic banking assets accounts for only 12.7 percent but it has been growing at 44 percent in 2017.

¹² Board paper SM/14/249, August 18, 2014

both parties to use their judgment in assessing compliance. Such an assessment should identify weaknesses in the existing system of supervision and regulation, and form a basis for remedial measures by government authorities and RSAs.

15. Graded assessments of compliance with CPIFR will remain voluntary. Similar to other standards developed by standard-setting bodies (Basel Committee on Banking Supervision (BCBS), International Association of Insurance Supervisors (IAIS) and International Organization of Securities Commissions (IOSCO)), the CPIFR standard will be either assessed in full, resulting in grades, or used as the basis for a deeper analysis of selected elements of the oversight framework in a focused review, without grades. The Board paper (FO/DIS/17/79) “Use of Supervisory Standards in the Financial Sector Assessment Program—Understandings with Standard-Setting Bodies,” June 2017, will be used as the basis about the understandings on this issue and the way decisions on selective assessments of the standards to be made.

16. The IFSB will not make assessments of its own to maintain the current division of labor between the IFSB’s standard-setting and the international financial institutions’ assessment functions (i.e., conducted primarily by the IMF and the World Bank). However, the IFSB, together with its partners would assist in other ways—for example, by providing “Facilitating the Implementation of Standards” workshops and training to interested countries.¹³

PRINCIPLES SPECIFIC TO ISLAMIC BANKS IN CPIFR

A. Treatment of PSIA/IAHs (CPIFR 14)

17. Profit Sharing Investment Account (PSIA) is a contract by which an investor/depositor opens an investment fund with an Islamic bank mainly under the terms of Muḍārabah contract. The bank could have restricted (restricted investment account (RIA)) or full discretionary power in making investment decisions (unrestricted investment account (URIA)). Both parties agree on a ratio of profit sharing, which must be disclosed and agreed upon at the time of opening the account. Profits generated by the IBs are shared with the PSIA holder in accordance with the terms of the Muḍārabah agreement while losses are borne solely by the PSIA holder up to the amount invested, unless they are due to IB’s misconduct, negligence, or breach of the contract terms.

18. Since the investor/depositor bears the risk of losing their funds invested by the bank, the management of PSIA raises issues of governance, disclosure, and risk-absorbency features in assessing capital adequacy become paramount. The (credit and market risk-weighted) assets financed by the funds of the UIAH can be excluded from the denominator of the standard capital adequacy formula and where there is risk absorbency by the investors. The IB as Muḍārib owe a fiduciary duty to the IAH under the Muḍārabah contract. The fact that capital and return on investment for PSIA depend on the IB’s profitability indicates that transparency in the IBs should go beyond the requirements in the conventional banking sector to include profit calculation and

¹³ Paragraph 47 of the IFSB “Core Principles for Islamic Finance Regulation (Banking Segment) (CPIFR),” April 2015.

distribution, and investment strategies and risk exposures. A supervisory authority, therefore, has a role in reinforcing market discipline by requiring timely and relevant information disclosures, including clear guidelines on the use of smoothing mechanisms such as a profit equalization reserve (PER) or investment risk reserve (IRR), and specifying prudential limits on the percentage of UIAHs' funds that may be invested in real estate and large exposure limits. Supervisory authorities should assess the significance of IAH as a source of funds for IBs, the risk characteristics of such accounts, and the unique fiduciary duties that they entail for the IB as Muḍārib under the terms of Muḍārabah contract. These, eventually entail regulatory implications in term of appropriate governance (including Shari`ah governance), capital adequacy requirement, disclosure, and resolution framework.

19. When managing the investments of the IAH, the IB as Muḍārib should 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 IAHs' assets are safeguarded, and that the IB as Muḍārib has operated within the objectives agreed with the IAHs.

B. Shari`ah Governance Framework (CPIFR 16)

20. Shari`ah compliance is central to ensuring legality of contracts and integrity and credibility of IBs. This is one of the key responsibilities of IB boards, hence, a mechanism needs to be in place to obtain rulings from Shari`ah scholars and monitor Shari`ah compliance. The risk of Shari`ah non-compliance can lead to non-recognition of an IB's income or losses.¹⁴ It may also manifest itself as reputational risk, leading to loss of future business, or even the withdrawal of deposits and investments placed with the IB. In the operational risk domain, IBs need to follow all requirements as written in the contractual agreement between the IB as Muḍārib (an entrepreneur) or Wakīl (agent) and the investment account holders (IAHs), including any declared policies for the use of smoothing mechanisms such as a profit equalization reserve or investment risk reserve. Thus, the Shari`ah governance arrangement (policies and effectiveness of implementation) is important to ensure its compliance with Shari`ah rules and principles.

21. The supervisory authority should assess that IBs comply at all times with Shari`ah rules and principles. The Shari`ah compliance oversight role of Shari`ah Supervisory Board (SSB) intersects with the overall oversight role of IBs' Board of Directors (BOD), given that the latter includes ensuring that appropriate policies, systems, and processes are in place to manage risks, including compliance risks. As SSBs are mainly advisory boards, the level of fiduciary obligation is much higher in the BOD than the SSBs. IBs therefore are expected to have Shari`ah governance framework in place, which effectively manages and ensures Shari`ah compliance in all aspects of their business operations, covering both ex-ante and ex-post processes. At the minimum, the framework should (i) define the role(s) of the board oversight, the SSB, senior management, internal

¹⁴ Non-compliance with Shari`ah can result in a fall in the value of the asset or credit losses that may adversely affect IB's earnings when these contracts are deemed invalid in the court of law, either in a foreclosure or other court rulings.

Shari`ah review and audit; and (ii) establish formal reporting channel(s) among the key functions to ensure that the reporting on Shari`ah matters are carried out effectively and in a timely manner. Assessment of Shari`ah governance does not imply that the RSA has to make Shari`ah judgments by itself.

22. Supervisory authorities should also require effective and timely remedial action by an IB to address material deficiencies in its Shari`ah governance policies and practices. The supervisory authorities should also satisfy themselves that the IB's BOD approves and oversees implementation of the IB's strategic direction, risk appetite, and strategy. The supervisory authority also determines that the SSB has the capability to exercise objective and independent judgment on Shari`ah related matters. Supervisory authorities are expected to have either in-house or external experts to assist them in discharging these responsibilities.

C. Equity Investment Risk (CPIFR 24)

23. Investments made via profit-and-loss sharing instruments may contribute substantially to IB's earnings, but they entail significant market, liquidity, credit, and other risks—potentially giving rise to volatility in earnings and capital. The capital invested through these instruments may be used to purchase shares in a publicly traded company or privately held equity or invested in a specific project, portfolio or through a pooled investment vehicle. In the case of a specific project, IBs may invest at various stages of the project. In addition, the delays and variation in cashflow patterns and possible difficulties in executing a successful exit strategy may pose a challenge. The capital invested by the provider of finance does not constitute a fixed return, but is explicitly exposed to capital impairment risk in the event of losses.

24. IBs therefore need adequate policies and procedures, appropriate strategies, risk management, and reporting processes for equity investment risk management. The supervisory authority should, therefore, ensure that the IBs have in place appropriate and consistent valuation methodologies; define and establish the exit strategies in respect of their equity investment activities; and have sufficient capital when engaging in equity investment activities, and that rules or guidelines are in place for measuring, managing, and reporting the risk exposures when dealing with nonperforming equity investments and providing provisions.

D. Rate-of-Return Risk (CPIFR 26)

25. IBs are exposed to rate-of-return (ROR) risk in the banking book. IBs are funded primarily by shareholder's equity, deposits and profit-sharing investment accounts (PSIA). On the asset side, IBs do not engage in "conventional lending," but in cost plus financing or sales with deferred payments, leases, profit- and loss-sharing financing, and fee-based services. ROR risk has some parallels with interest rate risk in the banking book in conventional banks as defined by the BCBS, but it differs from interest rate risk in that IBs are concerned with the returns on their investment activities at the end of the investment holding period and the impact on net income and cash flow after the sharing of returns with IAHs. IBs also face uncertainty in the returns it may earn

on their assets when an increase in benchmark rates results in expectations of higher rates of return on investment accounts.

26. A consequence of ROR may be displaced commercial risk (DCR), which entails the IBs and their shareholders foregoing part of their profits to attract or retain investors. IBs may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by IAH when the return on assets is under-performing as compared with competitors' rates. IBs may decide to waive their rights to part or their entire Muḍārib share of profits in order to satisfy and retain their fund providers and dissuade them from withdrawing their funds. The decision of IBs to waive their rights to part or all of their Muḍārib share in profits in favor of IAH is a commercial decision, the basis for which needs to be subject to clear and well-defined policies and procedures approved by the IBs' BOD. IBs therefore have to build reserves against losses and this has implications for the calculation of regulatory capital. IBs are expected to have systems and capacity in place to mitigate and manage the ROR risks and any resultant DCR in the banking book on a timely basis considering IBs' risk appetite, risk profile, IAHs' behavioral and maturity profiles and market and macroeconomic conditions.

E. Islamic "Windows" Operations (CPIFR 32)

27. Islamic windows heighten Shari`ah governance issues because of the risk of commingling of funds and regulatory arbitrage, thus there is need for IBs to establish appropriate firewalls and disclosures. An Islamic window operation is part of a conventional financial institution (which may be a branch or dedicated unit of that institution, but not a separate legal entity) that provides both fund management (investment accounts) and financing and investment that are Shari`ah compliant. Islamic windows raise supervisory issues beyond those posed by full-fledged IB, because of the potential for commingling of funds and regulatory arbitrage. In addition, supervisory practices for regulating Islamic windows, relating to capital requirements, vary considerably across jurisdictions. The supervisory issues raised by such operations are substantially the same as those faced by full-fledged IB, but include issues on the legitimacy of the generated profits and risk management in respect of the Shari`ah-compliant assets and liabilities.

28. Operating an Islamic window requires conventional banks to establish the appropriate firewalls to avoid the commingling of Islamic and conventional assets and liabilities.

Conventional banks operating windows therefore need to have internal systems, procedures, and controls to provide reasonable assurance that (a) the transactions and dealings of the windows are in compliance with Shari`ah rules and principles; (b) Islamic and non-Islamic business are properly segregated; and (c) the institution provides adequate disclosures for its window operations.

TECHNICAL ASSISTANCE

29. The IMF and the World Bank have been providing some TA to member countries on strengthening the supervision and regulation of Islamic banks. Staff have encouraged standard setters to reach out to a broader range of their member countries to increase awareness of the CPIFR. The IFSB has adopted strategies to promote standards implementation, including outreach activities, as well as coordinating training to non-IFSB-member countries. The World Bank and the IMF are also collaborating with such efforts including with other institutions like the Islamic Development Bank which also provide funding support.

30. The wider adoption of the CPIFR may generate additional requests for TA from member jurisdictions. The principles have raised the bar in terms of the scope and depth of regulatory requirements and supervisory practices and, in many cases, require higher effort and greater resources from supervisory authorities to achieve compliance. Jurisdictions might need assistance to enhance their capabilities to identify and monitor emerging risks, to understand the linkages that might exist with other sectors, and to ensure effective supervision with a risk-based approach, which involves a systemic and macroprudential dimension.

RESOURCE IMPLICATIONS

31. The increase in resources required to conduct assessments of compliance with the CPIFR is not expected to be significant. There are only 2 countries with fully Islamic banking systems and another 12 currently deemed systemic with IB assets that accounts for 15 percent or more of their respective total domestic banking system. In addition, the assessment on IB regulatory and supervisory system includes only assessment of compliance with an additional 4 core principles (as CPIFR on rate-of-return risk replaces CP23 on interest rate risk) and expansion of assessment criteria in 19 BCP to take into account Shari'ah dimensions. Given the scheduling of FSAPs, it is expected that on average only one country would be assessed every two years.

32. The Cooperating Institution's (COI) list will be reviewed to take on board more experts from relevant supervisory authorities to participate in missions to undertake and support the quality of the assessments. This will complement Fund staff (from functional and area departments) with expertise in or sufficient knowledge of Islamic banking.

33. A note to provide guidance to the IMF staff on the inclusion of Islamic finance issues in surveillance, will be prepared jointly by MCM, LEG, STA, and Area Departments in the 2018/19 fiscal year. The preparation of this paper is expected to require two staff full-time equivalents (FTE), which will be made available from internal resources. They have already been allocated to Islamic banking work; specifically, one FTE from MCM and another jointly from MCM, LEG, STA, and Area Departments. The Area Departments will continue to provide policy advice to relevant countries on Islamic banking issues in the context of Article IV surveillance and program design, while MCM, STA, and LEG will provide capacity development services and engage with relevant standard setters in their respective mandates.

Proposed Decision

The following decision, which may be adopted by a majority of the votes cast, is proposed for adoption by the Executive Board:

The Fund takes note of the Islamic Financial Services Board's Core Principles for Islamic Finance Regulation (CPIFR) and their assessment methodology.

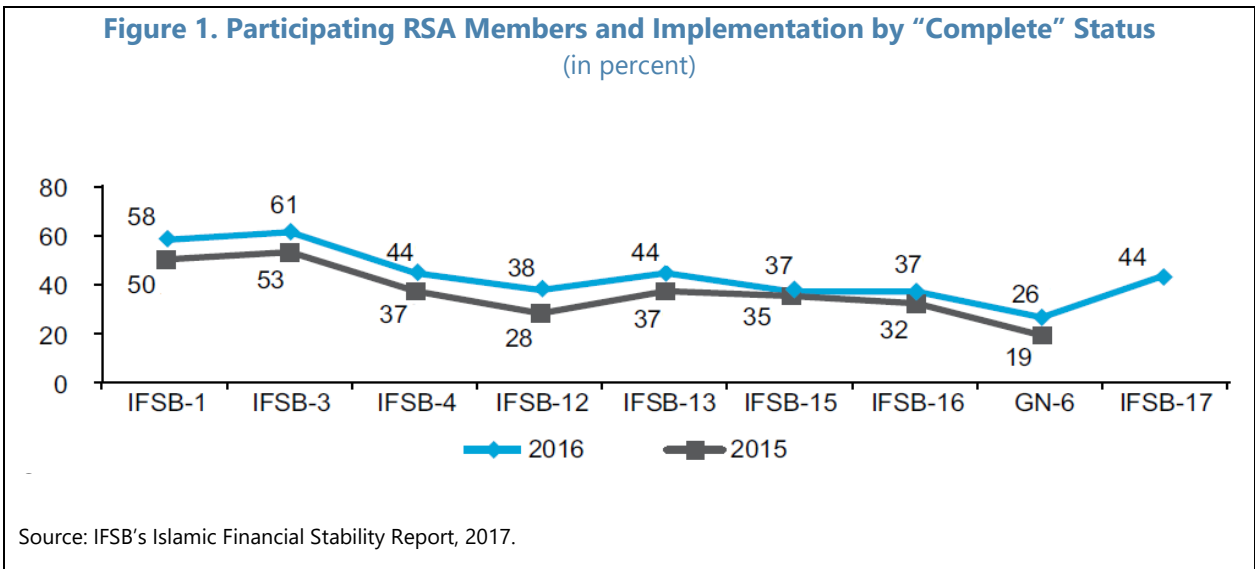
The Fund endorses the use of CPIFR and their assessment methodology for the purposes of undertaking assessments and preparing Reports on the Observance of Standards and Codes (ROSCs) regarding the effectiveness of regulation and supervision in fully Islamic banking systems and, as a supplement to the Basel Core Principles, in dual banking systems where Islamic banking is significant, as defined in paragraph 11 of SM/18/76.

The CPIFR standard and assessment methodology will be used in relevant assessments and ROSCs initiated after January 1, 2019.

Appendix I. The Islamic Financial Services Board

1. **The Islamic Financial Services Board (IFSB), which is based in Kuala Lumpur, was officially inaugurated on November 3, 2002 and started operations on March 10, 2003.** The IMF is one of the founding members of the IFSB. The IFSB serves as an international standard-setting body of regulatory and supervisory agencies that promotes the soundness and stability of the Islamic financial services industry, which includes banking, capital market, and insurance. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new or adapting existing international standards to be consistent with Shari'ah principles and recommends them for adoption. Thus, the work of the IFSB complements that of the BCBS, the IOSCO, and the IAIS. As at December 2017, the members of the IFSB comprise 75 regulatory and supervisory authorities and 8 international intergovernmental organizations including the IMF, the World Bank, and the BIS. Collectively, these members operate in 57 jurisdictions. The Governor of the Central Bank of Kuwait is currently the Chairman of the IFSB Council. The Council consists of governors from 23 countries.¹
2. **There are also currently 102 market players** (e.g., financial institutions, professional firms, industry associations, and stock exchanges) who are observer members who can participate in IFSB awareness programs on priority basis and at special members' rates. They are not involved in the formulation of standards and receive complimentary copies of exposure drafts.
3. **Since its inception, the IFSB has issued 27 Standards, Guiding Principles, and Technical Notes for the Islamic financial services industry.** The standards prepared by the IFSB follow a lengthy due process which involves, among others, the issuance of exposure draft that is posted on the website of the IFSB and, where necessary, the holding of a public hearing. The IFSB Secretariat conducted a survey among its members that are regulatory and supervisory authorities (RSA) about the implementation status of selected IFSB standards in 2017 and the result is indicated in Figure 1 below.

¹ Bahrain, Bangladesh, Brunei, Djibouti, Egypt, Indonesia, Iran, Iraq, Jordan, Kazakhstan, Kuwait, Morocco, Malaysia, Mauritania, Mauritius, Nigeria, Pakistan, Qatar, Saudi Arabia, Singapore, Sudan, Turkey, the United Arab Emirates, and Islamic Development Bank



Appendix II. The Fund's Involvement in Islamic Finance

1. Fund engagement in Islamic banking issues dates to the mid-1980s. In the decade since the mid-1980s, the Fund has not provided TA or policy advice, but Fund staff published a number of important conceptual working papers that helped shape views on Islamic banking. The Fund started providing TA on IB in the second half of 1990s, mostly in countries with relatively established Islamic banking practices (e.g., Iran, Pakistan, Sudan, etc.) and focused primarily on central banking operations and developing local government funding markets. The Fund did not provide any significant TA on legal and regulatory aspects of IBs until about 2005/06, after the IFSB began to issue its standards.

2. Fund staff involvement on Islamic banking issues is rising. Fund staff have been increasingly encountering Islamic banking-related issues in surveillance work (FSAPs and Article IV missions, e.g., Malaysia, Saudi Arabia, Turkey) and in Use of Fund Resources (UFR) cases (e.g., Afghanistan, Pakistan, and Yemen). In addition, the number of Islamic banking-related TA requests has risen considerably in recent years, particularly, from new Islamic banking jurisdictions (e.g., Djibouti, Kenya, Mauritania, and Tanzania), on topics, such as regulation, supervision, and development of *Sukuk* markets. For regulation and supervision TA, our TA advice have been based on the measures needed to comply with the CPIFR (e.g., Mauritania, Djibouti). Fund staff have also participated in training and outreach as part of IMF Regional Technical Assistance Centers (RTACs) jurisdictions (e.g., Djibouti, Mauritania, Kenya, and Tanzania, etc.).

3. The Fund has been collaborating closely with other international organizations and standard setters on Islamic banking issues. The Fund has carried out over the years, joint activities (TA, conferences, working groups, etc.) with organizations like the World Bank, the Arab Monetary Fund, and the Islamic Development Bank (IsDB)¹, as well as the standard setters for industry (IFSB and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)) and various national central banks. Fund staff conducts training and outreach work as part of the IMF RTACs and contributing to G20 and other international conferences on Islamic banking matters. Finally, Fund staff continue to be called on to contribute to various international initiatives on Islamic banking-related issues (e.g., contributing to the working group developing CPIFR and commenting on drafts of various technical standards in Islamic finance).

4. The Fund played a catalyst and central role in the establishment of the IFSB. By the end of the 1990s, the need to ensure that international prudential standards adequately capture the unique features of Islamic financial and banking products became increasingly evident. A meeting of central banks on the side of a conference on the regulation of IBs (Bahrain, February 2000) organized jointly by the IMF and AAOIFI called for international action to facilitate the development of relevant prudential standards. The Fund facilitated the subsequent consultation process culminating in the establishment of the IFSB in November 2002, as an international organization to develop the necessary prudential standards. The Fund provided significant TA support to the IFSB in its early years and remains an associate member.

¹ The IsDB has been supporting part of the IMF's TA program to IsDB member countries in developing their financial markets, with focus on IB and finance issues.

Appendix III. Mapping the BCP and CPIFR Approach

BCP	CPIFR Approach: Revised CPs in the Form of CPIFR Reflecting the Specificities of IIFS
Supervisory Powers, Responsibilities and Functions	
CP 1: Responsibilities, objectives and powers	Retained unamended: CPIFR 1
CP2: Independence, accountability, resourcing and legal protection for supervisors	Retained unamended: CPIFR 2
CP3: Cooperation and collaboration	Retained unamended: CPIFR 3
CP4: Permissible activities	Amended: CPIFR 4
CP5: Licensing criteria	Retained unamended: CPIFR 5
CP6: Transfer of significant ownership	Retained unamended: CPIFR 6
CP7: Major acquisitions	Amended: CPIFR 7
CP8: Supervisory approach	Retained unamended: CPIFR 8
CP9: Supervisory techniques and tools	Amended: CPIFR 9
CP10: Supervisory reporting	Amended: CPIFR 10
CP11: Corrective and sanctioning powers of supervisors	Amended: CPIFR 11
CP12: Consolidated supervision	Amended: CPIFR 12
CP13: Home-host relationships	Amended: CPIFR 13
Prudential Regulations and Requirements	
CP14: Corporate governance	Amended: CPIFR 15
CP15: Risk management process	Amended: CPIFR 17
CP16: Capital adequacy	Amended: CPIFR 18
CP17: Credit risk	Amended: CPIFR 19
CP18: Problem assets, provisions and reserves	Amended: CPIFR 20
CP19: Concentration risk and large exposure limits	Amended: CPIFR 21
CP20: Transactions with related parties	Amended: CPIFR 22
CP21: Country and transfer risks	Retained unamended: CPIFR 23
CP22: Market risks	Amended: CPIFR 25
CP23: Interest rate risk in the banking book	N.A., but CP 23 replaced with CPIFR 26
CP24: Liquidity risk	Amended: CPIFR 27
CP25: Operational risk	Amended: CPIFR 28
CP26: Internal control and audit	Amended: CPIFR 29
CP27: Financial reporting and external audit	Retained unamended: CPIFR 30
CP28: Disclosure and transparency	Amended: CPIFR 31
CP29: Abuse of financial services	Retained unamended: CPIFR 33
Additional Core Principles	
Treatment of PSIA/IAHs	New: CPIFR 14
<i>Shari`ah</i> governance framework	New: CPIFR 16
Equity investment risk	New: CPIFR 24
Rate of return risk [replacing CP 23]	New: CPIFR 26
Islamic "windows" operations	New: CPIFR 32

Appendix IV. List of Countries with Islamic Banking Assets

Country	Islamic Banking Market Share (percent)*	FSAP
1. Iran	100.0	2000
2. Sudan	100.0	2018 (development module)
3. Brunei	64.0	N.A.
4. Saudi Arabia	63.0	2017
5. Kuwait	40.0	2019
6. Yemen	30.0	2000
7. Malaysia	30.0	2012
8. Qatar	25.4**	2007
9. Mauritania	21.4***	2014
10. United Arab Emirates	20.4	2007
11. Bangladesh	19.8	2010
12. Djibouti	16.9	2008
13. Jordan	15.5	2020

Source: National authorities; IMF staff calculations.
 * 2017 data
 ** 2016 data
 *** 2015 data

Country	Growth of Islamic Banking Assets (percent)****
1. Oman	43.9
2. Nigeria	24.8
3. Iran	19.5
4. Bangladesh	16.0
5. Pakistan	12.7
6. Qatar	12.7
7. Indonesia	12.0
8. United Arab Emirates	10.8
9. Jordan	10.1

Source: IFSB
 **** Calculated on year-on-year basis, comparing figures at end of 2016: Q2 and end of 2015: Q2.

Appendix V. Key Unique Risks in IBs¹

Credit Risk

1. IBs are exposed to credit risk when using debt-type contracts for financing. In Murabahah transactions (cost plus contract), IBs are exposed to credit risks when the bank arranges the delivery of the underlying goods to the client but does not receive payment from the client in time. In other more complex Murabahah transactions, the ownership of the real asset can change multiple times between the bank, other intermediary agents, or the final receiver of the assets. This means that any simple assessment as to the degree of credit risk exposure by the IB can vary at different times in executing the Murabahah contract. In a Mudarabah contract, where an IB enters into the contract as “principal” with an external “agent,” the IB is exposed to an enhanced credit risk on the amounts advanced to the agent. The bank is not in a position to know or decide how the activities of the agent can be monitored accurately, especially if losses are claimed.

2. Credit risk management for IBs is complicated further by additional factors. Especially in the case of default by the counterparty, IBs are generally prohibited from charging any accrued interest or imposing any penalty. During this delay, the bank’s capital is stuck in a nonproductive activity, and the bank cannot earn income. Part of this risk could be mitigated through better collateralization and in the pricing of contracts. For example, the bank might ask the client to post additional collateral before entering into *Murabahah* transactions. In addition to collateral, personal and institutional guarantees are also accepted to minimize credit risks.

Market Risk

3. IBs are exposed to market risk due to the volatility in the value of tradable, owned, or leasable assets. Market risk is the risk that a bank may experience loss due to unfavorable movements in market prices. In the absence of hedging instruments, IB have traditionally tried to minimize open positions and speculative transactions, but have in general, smaller off-balance sheet structures. The prudential measures used for conventional banks such as position limits and stop loss provisions are also used by IB to manage market risks effectively. However, market risks have heightened in IB in recent years by the complexity of some products and increased reliance on commodities to structure some operations.

Operational Risk

4. IBs are more likely to be exposed to operational risk than comparable conventional banks. Operational risk is defined as “the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events.” Operational risks are likely to be significant for IBs reflecting the nature of their financing that is closely tied to real transactions, specific contractual features (e.g., buy and sell back), and the general legal environment that may not be

¹ Reproduced from Board paper SM/17/3 “Ensuring Financial Stability in Countries with Islamic Banking,” February 3, 2017.

adequately adapted to the IB model. Additionally, IBs face two unique operational risks: “Shari`ah non-compliance risk” arising from not having in place adequate systems and controls to ensure compliance, and “fiduciary risk” arising from not having in place mechanisms to safeguard the interests of IAH, especially when their funds are comingled with the bank’s own funds.

5. The Shari`ah compliance is critical to IBs’ operations, and such compliance requirements must permeate throughout the organization and their products and activities.

Depositors’ perception regarding IBs’ compliance with IF principles is of great importance to their sustainability. Non-compliance could risk transactions being cancelled and income generated from them as illegitimate.

6. Fiduciary risk is the risk that arises from IBs’ failure to perform in accordance with explicit and implicit standards applicable to their fiduciary responsibilities. As a result of losses in investments, IBs may become insolvent and, therefore, unable to meet the demands of current account holders for repayment of their funds and safeguard the interests of their IAH. IBs may fail to act with due care when managing investments resulting in the risk of possible forgone profits to IAH.

Liquidity Risk

7. The idiosyncrasies of traditional IB seem to reduce its liquidity risks, albeit at the expense of profitability, but this profile is changing rapidly. IBs have not been able traditionally, to raise wholesale funding (given IF restrictions on direct interest-based borrowing and repo), relying instead, almost exclusively, on more stable deposits (current and investment) as a source of funding. However, IBs in recent years have been increasingly able to access wholesale funding through commodity Murabahah markets, exposing them to new risks. On the assets’ side, IBs have generally faced a dearth of acceptable and tradable assets, especially HQLA like sovereign Sukuk; instead they often resorted to holding excess cash reserves. This situation has been exacerbated for IBs by the slow progress in adopting standing facilities and other central banks liquidity management instruments suitable for IB.

Rate-of-Return Risk

8. The IBs is generally exposed to rate-of-return risk, which is associated with overall balance sheet exposures where mismatches arise between assets and balances from fund providers. Rate of return risk differs from interest rate risk in that IBs are concerned with the result of their investment activities at the end of the investment-holding period. Such results cannot be pre-determined exactly. It also stems from uncertainty in the returns earned by IBs on their assets when an increase in benchmark rates results in expectations of higher rates of return on investment accounts.

Displaced Commercial Risk

9. A consequence of rate of return risk may be displaced commercial risk resulting in the IBs and their shareholders to forego part of their profits. IBs may be under market pressure to pay a return that exceeds the rate that has been earned on assets financed by IAH when the return on assets is under-performing as compared with competitors' rates. IBs may decide to waive their rights to part or their entire Muḍārib share of profits in order to satisfy and retain their fund providers and dissuade them from withdrawing their funds. Displaced commercial risk derives from competitive pressures on IBs to attract and retain investors (fund providers). The decision of IBs to waive their rights to part or all of their Muḍārib share in profits in favor of IAH is a commercial decision, the basis for which needs to be subject to clear and well-defined policies and procedures approved by the IBs' board of directors.

Appendix VI. Summary of the Unique CPIFR and the Corresponding Methodology

CPIFR 14: Treatment of Investment Account Holders (IAHs)¹

The supervisory authority determines how (IAHs are treated in its jurisdiction. The supervisory authority also determines the various implications (including the regulatory treatment, governance and disclosures, and capital adequacy and associated risk-absorbency features, etc.) relating to IAHs within its jurisdiction.

(Reference documents: *IFSB-1*, December 2005; *IFSB-4*, December 2009; *IFSB-10*, December 2009; *GN-3*, December 2010; *GN-4*, March 2011; *IFSB-15*, December 2013; *IFSB-13*, March 2012; and *IFSB-16*, March 2014.)

Essential Criteria

1. The supervisory authority determines, from a prudential perspective, how UIAHs are treated by the IIFS² in the jurisdiction. In this respect, UIAHs are treated in any one of the following ways:
 - (a) As 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 UIAH are excluded from the denominator of the standard capital adequacy formula;
 - (b) As a liability of the IIFS, which therefore bears the risk of the assets funded by UIAHs;³ or
 - (c) As partially risk absorbent so that the IIFS bears part of the earnings volatility of the assets funded by the UIAH. In such a case, IIFS include a corresponding proportion (known as “alpha” (α) factor) of the credit and market risk-weighted assets financed by UIAH in the denominator of the standard capital adequacy formula.⁴

¹ Various aspects of CPIFR 14 are developed further in the principles dealing with “Corporate Governance” (CPIFR 15), “Capital Adequacy” (CPIFR 18), “Rate-of-return risk” (CPIFR 26), and “Transparency and Market Discipline” (CPIFR 31).

² The term “IIFS,” as defined in Section 1, is used throughout this document, except where the term “bank” has been used for clarification.

³ In the opinion of the *Shari`ah* board of the IsDB, this approach is not *Shari`ah*-compliant.

⁴ Whether the IIFS engages in practices designed to smooth returns or principal risk to IAH will be evidence as to whether the IAH are being treated as risk absorbent. 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 addition to determining whether smoothing arrangements exist, the supervisory authority may take into account whether the IIFS may come under market pressure to increase returns to avoid investors withdrawing their funds (DCR).

2. The supervisory authority requires that initial risk disclosures to IAHS are consistent with the prudential treatment of their accounts.
3. The supervisory authority requires IIFS to apply the appropriate treatment of IIFS in all capital adequacy matters, including their own determinations of their capital needs, and internal models where these are permitted for capital adequacy purposes.
4. The supervisory authority determines that investment accounts are managed by the IIFS within the parameters of the given mandate, including all requirements as written in the contractual agreement between the IIFS as *Muḍārib* or *Wakīl* and the IAHS, and any declared policies for the use of smoothing mechanisms such as a profit equalization reserve (PER) or investment risk reserve (IRR).

The supervisory authority also determines that IAHS are adequately advised by the IIFS of their contractual rights and risks in regard to investment account products, including primary investment and asset allocation strategies and the method of calculating the profit/loss made from their investments.

5. The supervisory authority determines that an IIFS, when managing the investments of the IAHS, clearly displays the level of competence necessary to fulfil its fiduciary duties as *Muḍārib* or *Wakīl* and that adequate policies and procedures are in place.⁵
6. The supervisory authority prescribes formal guidance for IIFS to ensure they fulfil their fiduciary duties towards their IAHS (whether UIAHS or RIAHS).
7. The supervisory authority determines that IIFS clearly indicate the existence of various practices of smoothing the profit payout to IAHS that are employed, due to various internal and regulatory considerations, to mitigate the risk of withdrawal of funds by IAHS (withdrawal risk). Where supervisory authorities have approved various techniques of smoothing in their respective jurisdictions, they provide a policy (or written guideline) to IIFS with respect to these practices, with particular reference to the criteria or procedures used by them to assess an IIFS' exposure to DCR in assessing the IIFS's capital adequacy.⁶
8. In jurisdictions where real estate investment is permissible, supervisory authorities provide prudential limits on the percentage of UIAHS' funds that may be invested in real estate and a limit to single exposures within the jurisdiction.⁷ In this respect, the supervisory authority reviews

⁵ Refer to CPIFR 15, Essential Criterion 2.

⁶ GN-3 gives examples of smoothing practices used by IIFS.

⁷ Some supervisory authorities adopt a combined approach in limiting the risks to which the IIFS or its IAHS are exposed through restricting the total amount of exposures in the sector, restricting the usage of unrestricted investment accounts, or applying specific risk weights for this investment.

IIFS' operations to ensure that they have adequate resources and capabilities for undertaking real estate investment activities through UIAHs' funds.

9. The supervisory authority determines that stress testing conducted by the IIFS takes account of the risks associated with investment accounts and the position of IAHS as providers of risk-absorbent funds.⁸ The supervisory authority also determines that the Governance Committee (or equivalent) is actively involved in the development of the scenarios with respect to IAHS, particularly in the context of unrestricted PSIA.
10. Where the supervisory authority determines the capital adequacy treatment of IAHS on a case-by-case basis, rather than for all IIFS in its jurisdiction, it requires IIFS to implement a sound and robust measurement methodology for DCR based on adequate and reliable data. The supervisory authority also assesses and evaluates the reliability and accuracy of the methodology as a basis for measuring the proportion of the risk that is effectively borne by IIFS in the form of DCR.
11. The supervisory authority determines that IIFS provide timely and relevant continuing disclosures to IAHS (including profit calculation and distribution, and investment strategies and risk exposures).
12. The supervisory authority determines that an IIFS maintains separate accounts in respect of the IIFS's operations undertaken for RIAHS and ensures proper maintenance of records for all transactions in investments.
13. The supervisory authority's approach to IAHS, including its prudential approach, is in accordance with the authority's best understanding of the contractual rights of the parties, including UIAHs, according to applicable law during the insolvency or liquidation of the IIFS.

CPIFR 16: *Shari`ah* Governance Framework⁹

The supervisory authority determines that IIFS have a robust *Shari`ah* governance system in order to ensure an effective independent oversight of *Shari`ah* compliance over various structures and processes within the organizational framework. The *Shari`ah* governance structure adopted by an IIFS is commensurate and proportionate with the size, complexity and nature of its business. The supervisory authority also determines the general approach to *Shari`ah* governance in its jurisdiction and lays down key elements of the process.

(Reference documents: *IFSB-10*, December 2009; and *IFSB-16*, March 2014.)

⁸ See IFSB-13, and in particular the narrative to Principle 3.10.

⁹ The IFSB's guiding principles on *Shari`ah* governance (IFSB-10) address the components of a sound *Shari`ah* governance system, especially with regard to the competence, independence, confidentiality, and consistency of *Shari`ah* boards. Given the *Shari`ah* governance needs and requirements of different types of IIFS, IFSB-10

(continued)

Essential Criteria

1. Laws, regulations, or the supervisory authority determine that the IIFS are under an obligation to ensure that their products and services comply with *Shari`ah* rules and principles. The supervisory authority further determines that in all aspects of IIFS operations—including products and services—a governance structure, policies, and procedures exist to ensure that the *Shari`ah* rules and principles are adhered to at all times.
2. Laws, regulations, or the supervisory authority ensure that a financial institution is not allowed to represent itself as “Islamic,” either expressly or by implication, without having such a governance structure, policies, and procedures.
3. The supervisory authority determines that the *Shari`ah* board of an IIFS plays a strong and independent¹⁰ oversight role, with adequate capability to exercise objective judgment on *Shari`ah*-related matters. The supervisory authority also determines that IIFS has in place an appropriate and transparent process for resolving any differences of opinion between the BOD and the *Shari`ah* board. This process may include having direct access (after duly informing the supervisory authority) to the shareholders as a “whistle-blower.”¹¹
4. The supervisory authority requires that each IIFS has a properly functioning *Shari`ah* governance system in place, which clearly demonstrates, among other things:
 - (a) clear terms of reference regarding the *Shari`ah* board’s¹² mandate, reporting line and responsibility;
 - (b) well-defined operating procedures and lines of reporting; and
 - (c) good understanding of, and familiarity with, professional ethics and conduct.

acknowledges that there are various *Shari`ah* governance structures and models that have been adopted in different jurisdictions where IIFS are present, suggesting a no “single model” or “one-size-fits-all” approach. For instance, in some jurisdictions, there is a national body (e.g. a national *Shari`ah* Council) that has the authority to issue *Fatāwa* (i.e. *Shari`ah* pronouncements/resolutions) that are mandatory for IIFS in that jurisdiction, while—in the majority of jurisdictions—it is an IIFS’s *Shari`ah* board that issues *Fatāwa* applicable to that IIFS.

¹⁰ A *Shari`ah* board can only be deemed “independent” when none of its members has a blood or intimate relationship with the IIFS, its related companies, or its officers that could interfere—or be reasonably perceived to interfere—with the exercise of independent judgment in the best interests of the IIFS by the *Shari`ah* board. In the case of *Shari`ah* advisory firms, such a firm can only be deemed independent from the IIFS if they are not related parties, such as in terms of having common shareholders or common directors.

¹¹ In some jurisdictions the supervisory authority may be involved in this process of resolving differences without compromising the binding nature of the pronouncements/resolutions of the *Shari`ah* board.

¹² A reference to *Shari`ah* board in this essential criterion includes clear terms of reference for a *Shari`ah* adviser reporting to a national *Shari`ah* Council (where one exists), and to firms that are allowed to use the services of an external *Shari`ah* consultancy, in their jurisdictions.

5. The supervisory authority determines that an IIFS ensures that the key members of its *Shari`ah* governance system fulfil acceptable “fit and proper” criteria.¹³
6. The supervisory authority determines that IIFS comply at all times with the *Shari`ah* rules and principles as determined by the relevant body in the jurisdiction in which they operate with respect to their products and activities.
7. The supervisory authority requires IIFS to have in place an appropriate mechanism for obtaining rulings from *Shari`ah* scholars, applying *Fatāwa* (i.e., *Shari`ah* pronouncements/resolutions),¹⁴ and monitoring *Shari`ah* compliance in all aspects of their business operations.
8. The supervisory authority determines the requirement and criteria for the establishment of a *Shari`ah* board or equivalent body in an IIFS’ governance structure. The supervisory authority also determines that the qualifications of the members of the *Shari`ah* board are subject to review, and makes available evaluation criteria¹⁵ for the assessment of the qualifications and reporting responsibilities of the *Shari`ah* board.
9. The supervisory authority determines that the *Shari`ah* board or comparable body is provided with complete, adequate, and timely information prior to all meetings and on an ongoing basis on any product or transaction on which a pronouncement is sought, including having its attention drawn to any areas of possible difficulty identified by the IIFS’ management. The management of an IIFS has an obligation to supply the *Shari`ah* board with complete, accurate, and adequate information in a timely manner. The supervisory authority also determines that the *Shari`ah* board has free access to the company’s senior management for all the information it needs.
10. The supervisory authority requires an IIFS’ *Shari`ah* governance system to cover the relevant ex-ante and ex-post processes. Ex-ante processes cover those for: (a) the issuance of *Shari`ah* pronouncements/resolutions; and (b) compliance checks before the product is offered to the customers. Ex-post processes cover internal and external *Shari`ah* review¹⁶ and *Shari`ah* governance reporting. The supervisory authority also determines that IIFS engage appropriate experts, including a *Shari`ah* adviser or *Shari`ah* board, to review and ensure that new financing proposals that have not been proposed before or amendments to existing contracts are *Shari`ah*-compliant at all times.
11. The supervisory authority determines that the IIFS’ *Shari`ah* board has free access to the internal *Shari`ah* compliance unit/department (ISCU) and internal *Shari`ah* review/audit unit/department (ISRU), respectively, to check whether internal control and compliance procedures have been

¹³ Appendix IV to IFSB-10 gives examples of competence criteria for members of a *Shari`ah* board.

¹⁴ This refers to a juristic opinion on any matter pertaining to *Shari`ah* issues in Islamic finance, given by the appropriately mandated *Shari`ah* board.

¹⁵ Commonly referred to as “fit and proper criteria for members of the *Shari`ah* board.”

¹⁶ See IFSB-10, in particular paragraphs 3–6.

appropriately followed and that applicable rules and regulations to which the IIFS is subject have been complied with.

12. The supervisory authority determines that the following elements in the *Shari`ah* governance mechanism have been reflected by IIFS:
 - (a) issuance procedures of relevant *Shari`ah* pronouncements/resolutions and dissemination of information on such *Shari`ah* pronouncements/resolutions to the operative personnel of the IIFS who monitor day-to-day compliance with the *Shari`ah* pronouncements/resolutions;
 - (b) an internal *Shari`ah* compliance review/audit for verifying that *Shari`ah* compliance has been achieved; and
 - (c) an annual *Shari`ah* compliance review/audit for verifying that the internal *Shari`ah* compliance review/audit has been appropriately carried out and its findings have been duly noted by the *Shari`ah* board.
13. The supervisory authority determines that an IIFS facilitates continuous professional development of persons serving on its *Shari`ah* board, as well as its ISCU and ISRU, if any. The supervisory authority also determines that training policies are established with adequate consideration given to training needs to ensure compliance with the IIFS's operational and internal control policies and procedures, and all applicable legal and regulatory requirements to which the IIFS generally, and members of the *Shari`ah* board and internal *Shari`ah* officers particularly, are subject.
14. The supervisory authority determines that there is a formal assessment of the effectiveness of an IIFS's *Shari`ah* board as a whole and of the contribution by each member to the effectiveness of the *Shari`ah* board. The supervisory authority also determines that an IIFS' BOD specifies and adopts a process for assessing the effectiveness of the *Shari`ah* board as a whole, as well as the contribution by each individual member to its effectiveness. The criteria for this assessment should be established by the BOD in consultation with the SSB. The performance assessment report is submitted to the BOD for its review.
15. The supervisory authority has the power to have full access to the *Shari`ah* board and relevant staff and records in order to monitor compliance with relevant laws and regulations, and internal compliance with the pronouncements/resolutions of the *Shari`ah* board. This includes access to both internal and external *Shari`ah* audits, and to the assessment of the effectiveness of the *Shari`ah* board.

CPIFR 24: Equity Investment Risk¹⁷

The supervisory authority satisfies itself that adequate policies and procedures including appropriate strategies, risk management, and reporting processes are in place for equity investment risk management, including *Muḍārabah* and *Mushārah* investments in the banking book (i.e., financing on a profit-and-loss sharing basis), taking into account the IIFS' appetite and tolerance for risk. In addition, the supervisory authority ensures that the IIFS: have in place appropriate and consistent valuation methodologies; define and establish the exit strategies in respect of their equity investment activities; and have sufficient capital when engaging in equity investment activities.

(Reference documents: *IFSB-1*, December 2005; *IFSB-4*, December 2009; *IFSB-15*, December 2013; *IFSB-13*, March 2012; and *IFSB-16*, March 2014.)

Essential Criteria

1. Laws, regulations, or the supervisory authority determine that the IIFS define and set the objectives of—and criteria for—investments using profit-sharing instruments (e.g., *Muḍārabah* and *Mushārah* investments in the banking book), including the types of investment, tolerance for risk, expected returns and desired holding periods.¹⁸
2. The supervisory authority determines that the IIFS have—and 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. The supervisory authority ensures that proper infrastructure and capacity are in place to monitor continuously the performance and operations of the entity in which IIFS invest as partners.¹⁹
3. The supervisory authority determines that an IIFS ensures that its valuation methodologies²⁰ are appropriate and consistent, and that it assesses the potential impacts of its methods

¹⁷ The risks entailed by holding equity instruments for trading or liquidity purposes are dealt with under market risk in CPIFR 25.

¹⁸ For example, a *Mushārah* 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 *Mushārah*).

¹⁹ Where an IIFS invests as a partner (through *Muḍārabah* or *Mushārah*) with an entrepreneur or business, a critical consideration is the quality of the other partner. Due diligence on the risk profile of that partner is essential to the fulfilment of IIFS' fiduciary responsibilities as an investor of IAH funds on a profit-sharing and loss-bearing basis (*Muḍārabah*) or a profit-and-loss sharing basis (*Mushārah*). This risk profile includes the past record of the management team and quality of the business plan of, and human resources involved in, the proposed *Muḍārabah* or *Mushārah* activity.

²⁰ Valuation and accounting play an important role in measuring the quality of an equity investment, especially in a privately held entity, for which independent price quotations are neither available nor sufficient in volume to provide a basis for meaningful liquidity or market valuation. An appropriate and agreed method to be applied to determine the profit of the investment can be in the form of a certain percentage of either gross or net profit

(continued)

(mutually agreed between the IIFS and the *Muḍārīb* and/or *Mushārahah* partners) on profit calculations and allocations, taking into account market practices and liquidity features. The supervisory authority also determines that the IIFS assesses and takes measures to deal with the risks associated with potential manipulation of reported results leading to overstatements or understatements of partnership earnings.

4. The supervisory authority determines that an IIFS defines and establishes general criteria for exit strategies in respect of its equity investment activities, including extension and redemption conditions with the mutual consent of the parties for *Muḍārahah* and *Mushārahah* investments, alternative exit routes, and the timing of exit.
5. The supervisory authority sets rules or guidelines for measuring, managing, and reporting the risk exposures when dealing with nonperforming equity investments and providing provisions.
6. The supervisory authority determines that there is a systematic process for regularly reviewing and updating the *Mushārahah* and *Muḍārahah* policies, processes, and limits to take into account the risk appetite of the IIFS and changes that take place in the IFSI.
7. The supervisory authority determines that appropriate policies and procedures on stress testing for *Mushārahah*- and *Muḍārahah*-related exposures are clearly specified by the IIFS.

CPIFR 26: Rate-of-Return Risk²¹

The supervisory authority determines that IIFS have adequate systems to identify, measure, evaluate, monitor, report, and control or mitigate rate-of-return (ROR) risk in the banking book on a timely basis. These systems take into account the IIFS' risk appetite, risk profile, and market and macroeconomic conditions. The supervisory authority also assesses the capacity of an IIFS to manage the ROR risk and any resultant DCR, and obtains sufficient information to assess its IAHs' behavioral and maturity profiles.

(Reference documents: *IFSB-1*, December 2005; *GN-3*, December 2010; *GN-4*, March 2011; and *IFSB-16*, March 2014.)

earned by the *Muḍārahah* or *Mushārahah* business, or any other mutually agreed terms. In the case of a change of the partnership's shares in a *Mushārahah* (e.g., in a diminishing *Mushārahah*), the shares changing hands should be valued at fair value or on some other mutually agreed basis.

²¹ Wherever "rate-of-return risk" is used in this Principle, the term refers to rate of return risk in the banking book only.

Essential Criteria

1. Laws, regulations, or the supervisory authority require IIFS to have an appropriate ROR risk²² strategy and ROR management framework that provides a comprehensive IIFS-wide view of ROR risk. This includes policies and processes to identify, measure, evaluate, monitor, report and control or mitigate material sources of ROR. The supervisory authority determines that the IIFS' strategy, policies, and processes are consistent with the risk appetite, risk profile, and systemic importance of the IIFS; take into account market and macroeconomic conditions; and are regularly reviewed and appropriately adjusted, where necessary, with the IIFS' changing risk profile and market developments.
2. The supervisory authority determines that an IIFS's strategy, policies, and processes for the management of ROR have been approved—and are regularly reviewed—by the IIFS' board. The supervisory authority also determines that senior management ensures that the strategy, policies and processes are developed and implemented effectively.
3. The supervisory authority assesses the capacity of IIFS to manage ROR risk. The supervisory authority obtains sufficient information to assess the IAHS' behavioral and maturity profiles, and to satisfy itself as to the adequacy and quality of IIFSs' policies and procedures regarding the management of ROR risk. Where the supervisory authority has a policy of stating an expected rate of return to UIAH, the supervisory authority establishes a framework within which this is to be undertaken by the IIFS operating in its jurisdiction. The framework may include, among other methods, applicable periods and recognizable income and expenses, and other calculation bases relating to the use of funds. This framework should assist the supervisory authority to assess the efficiency of IIFS in terms of their profitability and prudent management.
4. The supervisory authority determines that IIFS are aware of the factors that give rise to ROR risk, and that they have in place appropriate systems for identifying and measuring the factors which give rise to ROR risk.²³ In assessing whether a potential threat is likely to have a material, likely, and imminent impact on a balance sheet position, IIFS will ensure that they understand the

²² 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. It 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 and cash flow after the sharing of returns with IAH. ROR risk leads to DCR if the IIFS absorbs all or part of any shortfall in the returns payable to IAH by reducing its *Muḍārib* share or by donation from the shareholders' share of income.

²³ The primary form of ROR risk to which the IIFS are exposed comprises increasing long-term fixed rates in the market. In general, profit rates earned on assets reflect the benchmark of the previous period and do not correspond immediately to changes in increased benchmark rates.

different characteristics of their balance sheet positions in the different currencies and jurisdictions within which they operate.²⁴

5. The supervisory authority ensures that IIFS consider ROR risk when setting and reviewing business and product strategies, and assess its impact on their balance sheet structure.
6. The supervisory authority determines that IIFS' policies and processes establish an appropriate and properly controlled ROR environment, including:
 - a. comprehensive and appropriate ROR measurement systems;
 - b. regular review and independent (internal or external) validation of any models used by the functions tasked with managing ROR (including review of key model assumptions);
 - c. appropriate limits, approved by the IIFS' boards and senior management, that reflect the IIFS' risk appetite, risk profile, and capital strength, and which are understood by, and regularly communicated to, relevant staff;
 - d. effective exception tracking and reporting processes that ensure prompt action at the appropriate level of the IIFS' senior management or boards where necessary; and
 - e. effective information systems for accurate and timely identification, aggregation, monitoring, and reporting of ROR exposure to the IIFS' boards and senior management.
7. The supervisory authority obtains from IIFS sufficient and timely information with which to evaluate their level of benchmark rate risk. This information should take appropriate account of the range of maturities and currencies in each IIFS' portfolio, including off-balance sheet items, as well as other relevant factors, such as the distinction between fixed-rate and variable-rate *Shari'ah*-compliant contracts. Supervisory authorities collect additional information from IIFS on those positions where the behavioral maturity is different from the contractual maturity.
8. The supervisory authority requires IIFS to have in place an appropriate framework for managing DCR, where applicable. This requires the IIFS to have in place a policy and framework for managing the expectations of their shareholders and IAHS. Where market rates of return of competitors' IAHS are higher than those of the IIFS' IAHS, the IIFS will evaluate the nature and extent of the expectations of their IAHS and assess the amount of the gap between competitors' rates and its own IAHS' expected rates. In this context, IIFS need to develop and maintain an informed judgment about an appropriate level of the balances of PER (or an equivalent reserve

²⁴ For example, in case of early repayment made by the customer (in *Murabahah* or *Ijarah* transactions) in certain jurisdictions, IIFS may accept full settlement but give rebates on subsequent transactions, while in other jurisdictions the IIFS may give rebates immediately at their discretion without any reference to this in the contract.

maintained by the IIFS), bearing in mind that its essential function is to provide mitigation of DCR.

9. The supervisory authority requires IIFS to include appropriate scenarios in their stress testing programs to measure their vulnerability to loss under adverse benchmark rate movements.

Additional Criteria

1. The supervisory authority obtains from IIFS the results of their internal ROR measurement systems, expressed in terms of the threat to economic value, including using a standardized benchmark rate shock on the banking book.
2. The supervisory authority should particularly assess whether the internal measurement systems of IIFS adequately capture the benchmark rate risks in their banking book.

CPIFR 32: Islamic “Windows” Operations

Supervisory authorities define what forms of Islamic “windows” are permitted in their jurisdictions. The supervisory authorities review Islamic windows’ operations within their supervisory review process using the existing supervisory tools. The supervisory authorities in jurisdictions, where windows are present, 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 *Shari`ah* rules and principles; (b) appropriate risk management policies and practices are followed; (c) Islamic and non-Islamic business are properly segregated; and (d) the institution provides adequate disclosures for its window operations.

(Reference documents: *IFSB-4*, December 2009; *IFSB-10*, December 2009; *IFSB-15*, December 2013; and *IFSB-16*, March 2014.)

Essential Criteria

1. Laws, regulations, or the supervisory authority determine, with appropriate definitions, what forms of Islamic window operation are permitted to operate in the jurisdiction.²⁵

²⁵ The term “window” may be used in two different senses. (A) An Islamic “window operation” is defined as being part of a conventional financial institution (which may be a branch or dedicated unit of that institution, but not a separate legal entity) that provides both fund management (investment accounts) and financing and investment that are *Shari`ah*-compliant. In principle, these windows are potentially “self-contained” (or “full windows”) in terms of *Shari`ah*-compliant financial intermediation, as the funds managed will be invested in *Shari`ah*-compliant assets, and segregation of assets (with separate accounting for profit and loss) is properly maintained between the Islamic window and its parent funds. (B) The term “window” is used in some jurisdictions to refer to an operation whereby an institution invests funds in *Shari`ah*-compliant assets (such as home purchase plans based on *Ijārah Muntahia Bittamlik*, diminishing *Mushārahah* or *Murābahah*) without such funds having been mobilised on a *Shari`ah*-compliant basis or specifically for *Shari`ah*-compliant investment purposes. Such operations clearly do not meet the definition of an Islamic window given in (A) above, but are referred to as “asset-side only windows.” Such

(continued)

2. The supervisory authority determines that an Islamic window has, both initially and on an ongoing basis, a minimum amount of funding from the conventional parent as required by the laws and regulations of the jurisdiction, including its capital adequacy and liquidity requirements.
3. The supervisory authority determines that an institution with Islamic windows has a system such that the separation of Islamic assets and funds from non-*Shari`ah*-compliant assets and funds is made transparent. The system should act both to prevent the window from investing in non-*Shari`ah*-compliant assets, and from channeling investors' funds back to the conventional parent entity.²⁶
4. Supervisory authorities in jurisdictions where windows are present 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 *Shari`ah* rules and principles; and (b) appropriate risk management policies and practices are followed.
5. The supervisory authority requires a window to apply *Shari`ah* governance arrangements comparable to those of a full-fledged IIFS. If the supervisory authority permits any variation to those arrangements (in respect of the institution's Islamic business), it should have clear reasons for doing so. In such cases, the supervisory authority should satisfy itself that pertinent *Shari`ah Fatāwa* and resolutions are complied with by the financial institution's management in their offering of Islamic financial services.
6. The supervisory authority takes account of the *Shari`ah*-compliant assets of the window, as well as the risk-bearing nature of the *Shari`ah*-compliant funds that are invested in these assets, in assessing the capital adequacy of the conventional financial institution concerned. The IFSB's *Revised 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 (consolidated²⁷ or parent) level, irrespective of whether the parent is in the same jurisdiction or in another jurisdiction.

operations may be carried out through either branches that offer current account facilities or other units of the institution. The supervisory issues raised by such operations are substantially different from those raised by full-fledged IIFS, but include issues of risk management in respect of the *Shari`ah*-compliant assets and of applying appropriate risk weightings to those assets for capital adequacy purposes.

²⁶ The window's share of profits from managing those funds may, of course, be channeled back to the parent. However, any losses of the parent conventional financial institution should not lead to a withdrawal of funds from the Islamic window, which would leave it unable to meet its capital adequacy and liquidity requirements.

²⁷ For the purpose of the principle on Islamic windows, the term "consolidation" refers to consolidation of the window with its parent conventional bank of which it is a branch or division. This term should not be confused with the group consolidation of a parent company and its subsidiaries at the banking group level.

7. The supervisory authority determines and understands the manner in which capital and liquidity are to be made available to Islamic windows, and how losses generated by the windows will eventually be absorbed.
8. In cases where a conventional bank offers Islamic operations through Islamic windows, supervisory authorities fully evaluate the liquidity risk management framework at both the group/parent level and the Islamic entity level. The supervisory authority also determines that senior management of a conventional bank operating Islamic operations in the form of an Islamic window is aware of the differences, complexities, and constraints in managing liquidity in the Islamic operations vis-à-vis at the bank level.²⁸ A particular issue arises when the parent entity of an Islamic window operation is situated in another jurisdiction and there are restrictions on, or impediments to, fund transfers between the parent and the window.
9. The supervisory authority requires the Islamic window to disclose information that is material in the sense that its omission or misstatement could influence a user relying on that information for the purpose of making economic and legitimate assessments or decisions in accordance with *Shari`ah* requirements. The supervisory authority requires the institution to publish a full separate set of financial statements for its window operation either: in the notes to the financial statements of the conventional financial institution of which the window is a part; or separately, in readily accessible form. In particular, the supervisory authority requires the institution to disclose publicly, among other things:
 - sources of funds to cover a liquidity deficit of the window, if any;
 - capital-adequacy-related disclosures;
 - risk management and governance;
 - appointment of a competent *Shari`ah* scholar or *Shari`ah* board; and
 - a *Shari`ah* compliance report covering, among other things, the mechanism established to provide *Shari`ah* oversight of the activities of an Islamic window.
10. The supervisory authority's approach to a window, including its prudential approach, reflects its best understanding of 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.
11. If the supervisory authority has a policy requiring Islamic windows to be converted into Islamic banking subsidiaries, the criteria for requiring conversion are clearly specified (e.g., in terms of asset size of the window in absolute terms or as a percentage of the parent's balance sheet, years of operation, etc.). Such criteria are clearly grounded in the overall legal and regulatory framework in the jurisdiction as well as its overall strategic plan for the Islamic banking industry, if any.

²⁸ Normally, in the case of Islamic window operations, a dedicated funding line is made available from the head office treasury to meet any liquidity shortfalls in normal and stressed times, on a *Shari`ah*-compliant basis.