



January 5, 2017

ENSURING FINANCIAL STABILITY IN COUNTRIES WITH ISLAMIC BANKING

EXECUTIVE SUMMARY

Islamic banking (IB) continues to grow rapidly, in size and complexity, posing a challenge to supervisory authorities and central banks. While accounting for a small share of global financial assets, IB has established a presence in more than 60 countries and has become systemically important in 14 jurisdictions. Islamic Finance (IF) principles underpin IB and involve operations, balance sheet structures, and risks that differ from their conventional banking counterparts. The current framework governing IB contains many gaps that need to be closed through the development of a more comprehensive enabling environment that ensures IB financial stability and sound development.

The legal environment within which Islamic banks (IBs) operate can be complex and challenging and may have implications for financial stability. IBs operate in diverse legal environments, some of which are more evolved than others in providing strong legal underpinnings for IB. Legal clarity and certainty for IB are important to promote confidence in the industry, as well as to mitigate the potential risk of regulatory arbitrage and strengthen supervision.

International governance standards apply to IB but need to be customized to take into account IBs' distinct governance features. These relate to decision-making structures, *Shari'ah* compliance, and the rights of investment account holders (IAH).

Significant progress has been achieved in developing prudential standards for IB, although broader implementation and more consistent application are needed. Prudential standards for conventional banks generally apply to IB but gaps exist reflecting the specific features of IB and their associated risks. Prudential standards for IB have been developed to complement international standards, including, inter alia, on capital adequacy, "Core Principles of Islamic Finance Regulation for Banking," and the supervisory process. The adoption of these standards has progressed albeit at different speeds across jurisdictions.

International guidance is needed to address the limited progress that has been achieved in developing resolution and financial safety net frameworks for IB. The international principles for deposit insurance, lender-of-last-resort (LOLR), and effective bank resolution regimes, are broadly relevant for IB but require modification to address

IB-specific issues. Country practices in this regard, have diverged on several important fronts, including, the insurability of investment accounts, the priority of claims, the role of deposit insurance in resolution, and the adequacy of IB instruments and collateral.

Progress has been slow in developing IB's liquidity management and money markets. A dearth of high quality liquid assets (HQLA), including, most importantly, government *Sukuk*, have undermined IBs' capacity to manage liquidity, interact with central banks, and develop money markets. This situation has given rise to IB practices that may achieve some liquidity management objectives but are inefficient and present risks. The lack of progress in this area has also impeded efforts to strengthen financial safety nets specific to IBs. International guidance and the active participation by relevant authorities, particularly, in countries where IB is systemically important, are needed to accelerate the issuance of *Sukuk* and other liquid instruments.

In recent years, hybrid financial products in IB have emerged that replicate aspects of conventional finance in an IB context, raising financial stability concerns. This trend is spurred by opportunities for profit in a rapidly growing IB sector, coupled with slow progress in developing adequate infrastructure for traditional IB. However, the growth of hybrid products raises a number of concerns, including the emergence of new complex risks, the applicability of existing prudential regimes, governance and consumer protection issues, and reputational risk.

The Fund has played an important role in promoting financial stability in IB jurisdictions, working closely with IB standard setters, and international organization to shape IB standards and promote best practices. Fund staff are increasingly encountering IB related issues in surveillance, program, and technical assistance (TA) work. A more comprehensive Fund policy framework will help to support the Fund's work in this area going forward.

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Glossary

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BCBS	Basel Committee on Banking Supervision
CAMELS	Capital Adequacy, Asset Quality, Management Quality, Earnings Efficiency, Liquidity, and Sensitivity
CAR	Capital Adequacy Ratio
CPIFR	Core Principles for Islamic Finance Regulation for Banking
DCR	Displaced Commercial Risk
DGS	Deposit Guaranteed Scheme
DIS	Deposit Insurance Scheme
D-SIBs	Domestically Systemically Important Banks
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicators
FTE	Full Time Equivalent
GFC	Global Financial Crisis
HQLA	High Quality Liquid Assets
IA	Investment Account
IADI	International Association of Deposit Insurers
IAH	Investment Account Holders
IB	Islamic Banking
IBs	Islamic Banks
ICAAP	Internal Capital Adequacy Assessment Process
IDIS	Islamic Deposit Insurance Scheme
IDWGIF	Interdepartmental Working Group for Islamic Finance
IF	Islamic Finance
IFC	International Finance Corporation of the World Bank
IFIs	Islamic Financial Institutions
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IILM	International Islamic Liquidity Management Corporation
IOSCO	Securities Commissions and the International Association of Insurance Supervisors
IMF	International Monetary Fund
IRR	Investment Risk Reserve
IsDB	Islamic Development Bank
LCR	Liquidity Coverage Ratio
LOLR	Lender-of-Last-Resort
ML/FT	Money Laundering and Financing of Terrorism
NPL	Nonperforming Loans
OIC	Organization of Islamic Cooperation
P&A	Purchase and Assumption
PER	Profit Equalization Reserve
PLS	Profit-and-loss Sharing
PSIA	Profit-sharing Investment Account

RIA	Restricted Investment Account
RWA	Risk-weighted Assets
SDN	Staff Discussion Note of the IMF
SSB	<i>Shari'ah</i> Supervisory Board
TA	Technical Assistance
U.A.E.	United Arab Emirates
UFR	Use of Fund Resources
URIA	Unrestricted Investment Account
U.K.	United Kingdom
US\$	United States Dollar
WB	World Bank

INTRODUCTION

1. Islamic Banking (IB) has grown rapidly in value and geographical reach, and has become an important and integral part of the financial systems in many countries.¹ Though IB accounts for less than 2 percent of global finance, IBs currently operate in more than 60 countries and the industry has become systemically important in 14 jurisdictions.² While the assets are concentrated in the Middle East and South East Asia, IB has expanded to sub-Saharan Africa and Central Asia, reflecting both supply-push and demand-pull factors, including economic, competitive pressures, regulatory advancement, and the Global Financial Crisis (GFC).³ Most major financial centers around the world (e.g., London, Luxemburg, Singapore, and Hong Kong) have also opened up their markets to IF products including insurance and “*Sukuk*” investments.⁴

2. The growth of IB presents opportunities but also has important financial stability and regulatory implications. IB can deepen financial markets and inclusion by offering new modes of finance and attracting “unbanked” populations that have not participated in the financial system, including for religious reasons. Its products (Appendix I) have the potential to facilitate the “bailing-in” of stakeholders of banks in resolution. However, the principles underpinning IF generate distinct operations and risk profiles and corporate and balance sheet structures that differ in important respects from conventional banks (Appendix II). The international prudential and accounting standards that apply to conventional banks are, in significant measure, relevant for IB but require modification in some areas to address the specific features of IB. In particular, adaptation is needed in the areas of the governance, anti-money laundering and combat the financing of terrorism (AML/CFT), and the financial safety net.

3. Standards for the IB industry have been developed to complement international standards. The establishment in 2002 of the Islamic Financial Services Board (IFSB)⁵ (based in Kuala Lumpur, Malaysia) with a mandate to develop prudential standards for IB and financial products, marked a milestone in the development of industry standards. The IFSB has established a number of important standards for IB, including for capital adequacy, governance, risk management, and the supervisory process to complement the standards issued by the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO), and the

¹ More detailed information can be found in the April 2015 Staff Discussion Note (SDN) “Islamic Finance: Opportunities, Challenges, and Policy Options,” (SDN/15/05).

² Consistent with the definition in the “Financial Stability Report, 2016,” IFSB May 2016, IB is classified as systemically important if it accounts for 15 percent or more of the domestic banking system assets.

³ While the IB industry was negatively affected by the global recession that followed the GFC, the crisis itself left the industry largely unscathed. See “The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study,” Hasan, Maher and Dridi, Jemma, IMF Working Paper No. 10/201, 2010.

⁴ *Sukuk* are “certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs, and services or (in the ownership of) the assets of particular projects or special investment activity” (AAOIFI, 2008).

⁵ The IFSB currently has 188 members, including regulatory and supervisory authorities, international organizations and market players, operating in 57 jurisdictions (source: IFSB: <http://www.ifsb.org/membership.php?id=1>).

International Association of Insurance Supervisors (IAIS). In addition, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has issued a broad range of accounting, auditing, governance, ethics, and *Shari'ah* standards for IBs.⁶

4. The Fund plays an important role in promoting financial stability in jurisdictions with Islamic banking sectors (Appendix III). The Fund facilitated the establishment of the IFSB and has been working closely with international organizations such as the World Bank (WB), the Arab Monetary Fund, the Islamic Development Bank (IsDB), and other IB standard setters (e.g., AAOIFI), to shape international standards on IB. Several important publications by Fund staff on IB have contributed to the international discourse on IB. The growth of IB has also led to increased demand for the Fund to provide policy advice in the context of surveillance and program work, and for TA to strengthen regulatory, supervisory and monetary frameworks for IBs. An interdepartmental working group on IF Interdepartmental Working Group for Islamic Finance (IDWGIF) was established in 2014 to take stock of the lessons learned in these areas and to identify policy issues that bear further consideration. Its work has benefited from the guidance of an external advisory group.

5. Building on this work, this paper provides a basis for a first formal discussion by the Executive Board on Islamic banking, and on the role that the Fund should play in this area.⁷ It examines the principal features of Islamic banking models, the risks they present, and the approaches that member countries have taken in addressing them. It discusses the key elements of the relevant international standards, the progress that has been made in their development, and the gaps that remain to be addressed. It describes the work that the Fund has done with members and international standard setters in strengthening regulatory and supervisory frameworks and the work that the Fund staff proposes to do in future. Further, it seeks Board guidance on staff's assessment of the current international frameworks for ensuring IBs' financial stability, and staff's work program moving forward. The paper's analysis has been guided by Fund staff's previous work, including the 2015 SDN that benefited from inputs by the external advisory group, the results of Fund-administered survey of country practices in 2016,⁸ and an accompanying paper on cross-country experiences. The paper will guide the development of assessment tools and staff advice that can be used in countries where IBs operate or are about to be introduced.

6. The remainder of the paper is structured as follows: Section II discusses the key features of IB and risk implications. Section III discusses legal and corporate governance frameworks. Section

⁶ AAOIFI was established in 1991 in Bahrain, to supplement international accounting and auditing standards by developing, interpreting and disseminating accounting, and auditing standards for IFIs. AAOIFI at present has 200 members from 45 countries, including central banks, financial institutions, and other participants from the international IB and finance industry, worldwide (source AAOIFI: <http://www.aaofii.com/aaofii/TheOrganization/Overview/tabid/62/language/en-US/Default.aspx>).

⁷ This paper will focus on IB only and will not cover other IF products and institutions (e.g., insurance).

⁸ The survey covered general IB information, legal, regulatory and supervisory framework, liquidity management and central banking, resolution regimes and deposit insurance. 31 countries responded to the survey: Afghanistan, Algeria, Bahrain, Bosnia and Herzegovina, Botswana, Djibouti, Guinea, Hong Kong, Indonesia, Iraq, Jordan, Kenya, Kazakhstan, Kosovo, Kuwait, Kyrgyzstan, Lebanon, Luxembourg, Malaysia, Morocco, Oman, Pakistan, Palestine, Qatar, Saudi Arabia, South Africa, Sudan, Tunisia, Turkey, United Arab Emirates (U.A.E.), and the United Kingdom (U.K.).

III evaluates the regulatory, supervisory, and AML/CFT frameworks currently governing IB operations and identifies remaining gaps. Section IV covers resolution and financial safety net frameworks and highlights areas where additional work is needed. The last section presents the conclusions and lays out the Fund’s strategy for engaging with its membership and international counterparts. The IB terms used in the paper are elaborated in Appendix I.

KEY FEATURES OF ISLAMIC BANKING MODEL AND RISK IMPLICATIONS

A. Islamic Finance Principles and Risk Implications

7. IF refers to the provision of financial services in accordance with Islamic jurisprudence (*Shari’ah*). *Shari’ah* bans interest (*Riba*), products with excessive uncertainty (*Gharar*), gambling (*Maysir*), short-sales, as well as the financing of prohibited activities that it considers harmful to society (Box 1). It also requires parties to honor principles of fair treatment and the sanctity of contracts. In addition, transactions must be underpinned by real economic activities, and there must also be a sharing of risks in economic transactions.

Box 1. Islamic Finance—Key Guiding Principles and Implications for Islamic Banking

- Financial transactions involving interest payment are strictly prohibited. The ramifications of this principle go beyond the obvious prohibition of conventional interest-bearing lending, as it tends to limit certain aspects of financial market development (e.g., fixed income markets).
- All financial transactions must be representations of: (a) sales of goods, services or benefits, or (b) profit-and-loss sharing (PLS) arrangements, all of which give rise to the “assets-backed” characteristic of IF (Appendix I). Sales-based financial transactions give rise to debt contracts (as a result of deferred payment terms), while PLS arrangements give rise to equity-like instruments. Lease transactions generate financial obligations but they are not considered debt instruments.
- Financial returns are generated through the assumption of risk (e.g., ownership risk, profit-and loss etc.). As a result, capital-guaranteed instruments (e.g., conventional loans) cannot earn return.
- Risk management under IF emphasizes risk sharing versus risk transfer in conventional finance, which significantly restricts IF investors from using derivatives and other conventional hedging mechanisms.
- The prohibition against “short-sale” usually curtails speculative trading in financial instruments, although the principle also applies to transactions in real assets.
- Other guiding principles of IF include: (i) emphasis on the minimization of disputes, deception, and unfair trade practices (*Gharar*); and (ii) market determination of prices.

8. The provision of banking services in line with Islamic jurisprudence results in operations and balance sheet structures that are distinct from conventional banks. IBs, like conventional banks, play a financial intermediary role, mobilizing deposits and channeling them to investors and undertaking maturity transformation. However, IB activities can extend beyond the traditional role of financial intermediation, as IBs can act as partners in property ownership, trade in

tangible assets, and provide equity financing for customers. Given the prohibition of interest, IBs are funded primarily by noninterest-bearing current accounts and profit-sharing investment accounts (PSIA).⁹ On the asset side, IBs do not engage in “lending,” but in sales (with deferred payments), leases, PLS financing, and fee-based services. Risk management in IB emphasizes risk-sharing (as compared to risk transfer in conventional banking) which significantly restricts the use of conventional hedging mechanisms (Box 2), as all financial transactions are either profit-and-loss sharing (PLS) arrangements or must be underpinned by transactions in real assets.

Box 2. Risk-sharing and Risk Transfer	
Islamic Banks Risk-sharing	Conventional Banks Risk Transfer
<p>Sources of funds: (a) Current accounts, where deposits are guaranteed by the bank but earn no income; and (b) PSIA, where depositors share the risk and return with the bank, as the returns are not guaranteed and depends on the bank’s performance.</p>	<p>Sources of funds: The bank takes all the risks and guarantees the deposits and a pre-specified return.</p>
<p>Uses of funds: The bank shares the earning risk in <i>Mudarabah</i> and <i>Musharakah</i> contracts and take credit and transaction risks on other contracts, without the use of conventional hedging instruments.</p>	<p>Uses of funds: Financing is debt-based. Borrowers are required to pay interest on loans, independent of the return on their project. The Bank transfers or otherwise, mitigate the credit risk through securitization or hedging.</p>

9. IBs’ balance sheet structures can strengthen IBs’ resilience if risks are managed well.

Two important characteristics have defined traditional IB: (a) IF principles significantly limit IBs’ capacity to engage in speculative financial transactions (e.g., short-selling, derivatives, etc.), and (b) balance sheets risks are managed through risk-sharing. IBs have less capacity than conventional banks to actively manage their balance sheets but, through risk-sharing and the resultant loss-absorbing capacity of their balance sheets, may be more resilient than conventional banks. These characteristics, combined with IB unique risks, have defined the industry’s prudential and risk management standards.

⁹ Investment accounts can be compared to collective investment schemes (CIS), in which participants have mandated their fund managers to manage their investments. Both IAH and CIS participants:

- (i) entrust their money to be invested and managed by a fund manager (that is, the Islamic bank in the case of IAH and the CIS operator in the case of CIS participants);
- (ii) bear the risk of losing the capital of their investment; and
- (iii) have minimal rights in controlling the conduct of the fund manager; more often they would have to vote with their feet—that is move their investment away if they find the fund manager’s performance is unsatisfactory.

However, in most cases, CIS participants stand in a better position than the IAH, since securities regulation usually ensures that CIS operators meet stringent requirements before they can operate a CIS. CIS participants enjoy more rights—in particular, concerning their access to information. Furthermore, CIS participants often know the net asset value of their investments, which would allow them to dispose of the investments swiftly in a secondary market.

10. Shari'ah compliance for IB raises unique challenges.¹⁰ An inadequate Shari'ah compliance function could give rise to a number of risks that are in the public interest domain, including, fraudulent activities affecting consumers, bank solvency and liquidity risks if depositors and IAH lose confidence in the bank's Shari'ah compliance framework, or even systemic risk if the bank is sufficiently large and connected.

B. Islamic Banking Industry Practices

11. IBs vary in scale and structures but they are generally more complex than conventional banks. The banks range from small banks that focus on niche markets to domestically systemically important banks (D-SIBs) with complex conglomerate structures that include nonfinancial corporations.¹¹ Facing increasing competition in domestic markets, some larger IBs have sought business opportunities abroad. When coupled with investments in nonfinancial corporations, the result has been a complex web of interrelated affiliate companies with cross ownership linkages between IBs, non-banking financial institutions, nonfinancial corporations, and conventional banks. Such complexity has created significant challenges for regulators.

12. The assets of IBs are comprised largely of financing items (e.g., Murabahah), although PLS contracts have increased to significant levels in some countries (Figure 1). Financing items (i.e., sales and lease-based contracts) account for about 70 percent of total assets with *Murabahah* and *Ijarah* representing, respectively, the largest items. PLS contracts only account for about 5 percent of the IBs aggregate assets, and comprise mostly "*Musharakah*" contracts, but there are important differences across countries. A number of countries (e.g., Indonesia, Iran, Pakistan, and Sudan) feature much higher levels of PLS contracts. In Iran and Indonesia, *Musharakah* contracts account for 29 and 63 percent respectively, while Pakistan and Sudan are 11 and 13 percent respectively. *Mudarabah* contracts average around 5 percent in Indonesia, Iran, and Sudan.

13. PSIA are, on aggregate, the single largest source of funding for IBs. At end-2015, PSIA were estimated to account for 40 percent of IBs' aggregate liabilities, of which 29 percent were deposits and 11 percent were interbank placements (PLS contracts). Other important sources of funding are commodity "*Murabahah*" (14 percent), which has grown rapidly in recent years (see below discussion), and current deposit accounts (12 percent). As with the asset side, there are significant variations across countries in the magnitudes of the funding instruments. In a number of countries (Indonesia, Iran, and Jordan) the share of PSIA ranges between 53 and 70 percent. IBs in Saudi Arabia exhibit greater reliance on current deposit accounts while Malaysia, Pakistan, and the U.A.E. shows greater reliance on fixed term-like deposit structures (Figure 1).

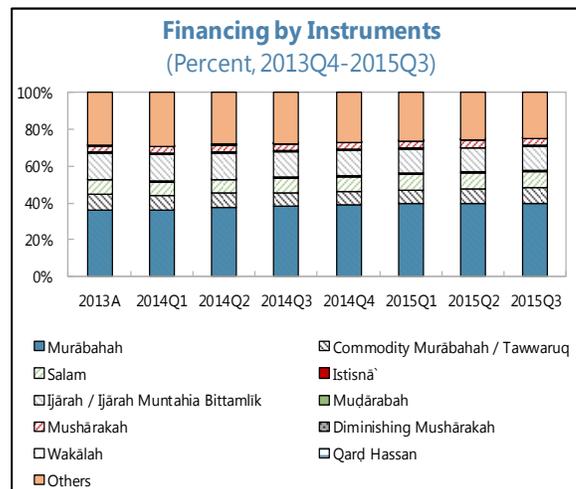
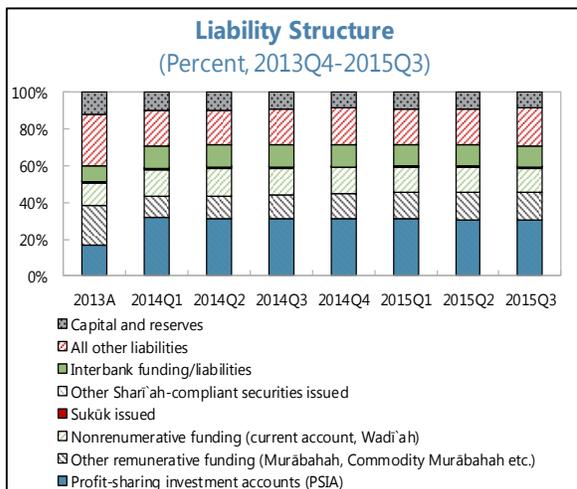
¹⁰ Issues related to the Shari'ah compliance function are discussed in paragraphs 25–27 below.

¹¹ Some IBs have an extensive networks of subsidiaries, associate companies and joint ventures in a broad range of sectors, insurance, leasing, schools, aircraft leasing, textiles, labor services, hospitals, hotels, computers, infrastructure.

Figure 1. Balance Sheet Structure of Islamic Banks

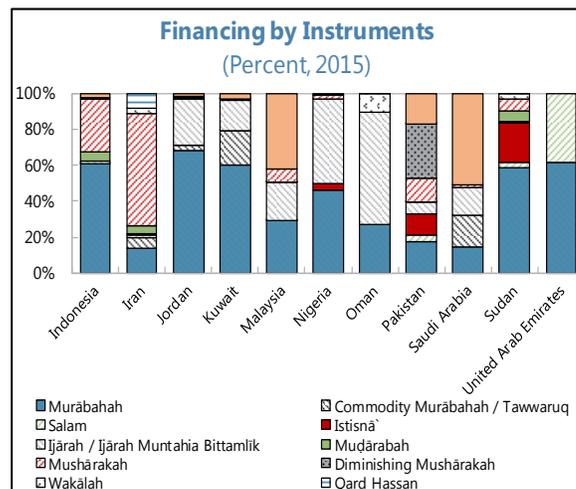
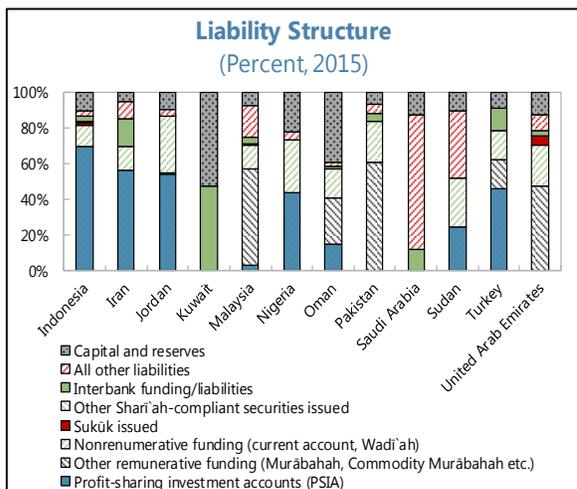
IBs are largely funded by PSIA comprising investment accounts of customers and interbank deposits based on Mudarabah.

The assets comprise mostly of debt-like products, such as Murabahah and Ijarah, although some countries do offer the equity-like risk-sharing products, Musharakah.



The liability structures, however, differ across regions and countries, with some showing very large shares of PSIA and others relying more on fixed term-like products.

On the asset side, while most offer debt-like products, there are a number of countries for which equity-like products are of material importance.



Source: IFSB.

14. Divergent market environments and regulatory approaches have shaped the evolution of IB practices and their balance sheet structures across jurisdictions.¹² Larger and more established IBs seem to offer broader range of financing options, including PLS contracts, bringing their balance sheet structure closer to the traditional model. Smaller or newly established banks, on

¹² It is important to note that factors such as low income levels or underdeveloped financial market in some of the countries where IB operates will create broader difficulties, such as lack of HQLA or underdevelopment of money or bond markets, for all banks, Islamic and conventional.

the other hand, seem to focus primarily on debt-type financing (e.g., *Murabahah*). Differences in the regulatory approaches to IB have been an important factor in shaping IB. For example, the application of conventional regulatory norms to IBs, without adaptation, may have contributed to restricting the growth of IB and limited the scope of their product offerings (particularly, PLS financing). The lack of a supportive market infrastructure for IF products or the availability of HQLA has given rise to non-traditional IB practices, including hybrid Islamic and conventional finance products. Finally, the divergent environments for IB may have created macroprudential challenges in some cases, as the bias of IBs in some jurisdictions towards real estate investments, trade and commodity finance may create concentration risk and may make IBs more procyclical than conventional banks. These variations in IB practices need to be assessed and addressed (whether by regulatory reforms or market development) to ensure financial stability.

15. Profit equalization reserves (PER) and (to a lesser extent) investment risk reserves (IRR) constitute important innovations in traditional IB. Largely driven by competitive pressure, many IBs (especially the smaller ones) have sought to stabilize the returns on PSIA by smoothing profit payouts to IAH through the use of PER. Under the PER process, profits accrued to PSIA above a certain threshold are transferred to the PER and used later to offset lower returns during less profitable periods. The IRR operates in a similar manner but is intended to cushion the effects of future investment losses on IAH. In essence, the PER and the IRR acts as countercyclical buffer, albeit funded by IAH instead of shareholders.

16. The rise of hybrid financial products, where aspects of conventional finance are melded with those of IB, is transforming the risk profile of IB, with potentially significant financial stability implications. Opportunities for profit in an environment where the enabling infrastructure for traditional IB is not yet fully developed, have, at times, spurred IB products that replicate aspects of conventional banking products, creating in the process new risks. For example, some new IBs have adopted a business model that is different from traditional IB and, in many ways, mimics attributes of conventional banking (e.g., IBs operating solely on the basis of *Murabahah* on the assets side, and reverse *Murabahah* on the liabilities side creating a balance sheet structure that closely resembles that of conventional banks). These models make it difficult to assess whether the associated risks are comparable to those typical of Islamic or conventional banking, or to determine how they should be managed. Similarly, relatively new instruments such as commodity *Murabahah* (Box 3), that effectively produce the outcome of conventional finance, have substantially expanded some IBs' exposure to liquidity, market and interest rate risks.

17. These hybrid IB operations offer some benefits but significantly raise regulatory and supervisory concerns. The key advantage of hybrid IB products is their capacity to utilize conventional banking infrastructure to rapidly grow their balance sheets. However, in the process, a number of important challenges have emerged, that would need to be addressed by standard setters and regulators, with respect to monitoring the new complex hybrid risks, the applicable prudential regime that is needed to prevent systemic externalities, disparities in the accounting and legal treatments of products, governance structure, consumer protection, and reputational risk.

Box 3. Commodity Murabahah

- Commodity *Murabahah* facilitates cash advances to a customer for a term (usually up to one year) at a fixed markup, through the use of commodity contracts traded on a commodity exchange. On the assets side, the bank purchases a commodity contract and sells it to its customer (or another bank in the case of interbank transaction) on a deferred payment basis with an agreed upon fixed profit. The customer uses the same bank as its agent to resell the contract immediately and receives the cash. A reverse transaction is used to create a deposit or fund the bank in the interbank market.
- The use of commodity *Murabahah* as a short-term money market and liquidity management instrument has spread rapidly in recent years,¹ facilitated by its reliance on existing financial infrastructure—i.e., international and local commodity markets. The practice remains controversial within the IF community with majority of scholars allowing the practice out of necessity, given the dearth of Islamic HQLA.
- The commodity *Murabahah* exposes IBs to several interrelated risks that could potentially disrupt the markets and transmit systemic risk.² These risks include: (a) market risk from commodity price fluctuations if the bank ends up holding the commodity for a period of time; (b) counterparty risk, which includes additionally the commodity brokers; (c) liquidity mismatch risk; (d) rate of return risk, especially when the instrument is used on the liability side creating, unlike the PSIA, contractually fixed return ex-ante; and (e) operational risk arising from the complexity of structuring the instrument itself. Finally, commodity *Murabahah* provides IBs with an opportunity to significantly increase leverage that might not have been possible under more traditional IB instruments.

¹ According to the 2016 IB survey, there is a domestic currency interbank commodity *Murabahah* market between IBs in 35 percent of the countries that answered the survey. The maturities of the contracts range from overnight to one year.

² IFSB "Guidance Note In Connection With The Risk Management And Capital Adequacy Standards: Commodity Murabahah Transactions."

C. Performance and Soundness of the Islamic Banking Industry

18. The IB industry has performed relatively well with very limited incidences of bank distress. Countries for which data was available report aggregate capital adequacy ratios above the statutory limits, although the ratio of nonperforming loans (NPL) is relatively high in some countries (See Box 4 on the treatment of Islamic financial instruments in macroeconomic statistics). IBs also remain profitable on aggregate and are generally liquid, though both profit margins and liquidity indicators have been trending down (Figure 2). Incidences of stress have been limited and occurred mostly in the smaller banks during the real estate downturn following the GFC. Strong economic growth and the recovery of real estate markets in countries where IBs are concentrated have provided a favorable environment that has spurred higher profits and the internal generation of capital. Some of the larger IBs that are implementing Basel III have tapped international *Sukuk* markets to build-up tier II capital. The deteriorating macroeconomic environment due to lower oil prices has exacerbated risks for IBs whose assets are concentrated in oil-exporting economies. Moreover, IBs in a number of countries exhibit significant exposures to cyclically sensitive sectors, such as real estate, construction, and manufacturing.

Box 4. Treatment of Islamic Financial Instruments in Macroeconomic Statistics

The IMF's Monetary and Financial Statistics Manual and Compilation Guide provides guidance on the classification of Islamic financial institutions (IFIs) and instruments in the context of compiling monetary statistics.¹ This manual updates the current guidance followed by countries with IFIs that report monetary data to the IMF, and includes a discussion on additional Islamic financial instruments such as *Sukuk* and *Takaful*.

Annex 4.3 of the above-referenced manual focuses on various types of Islamic financial instruments in comparison with the conventional ones in the context of macroeconomic and financial statistics:

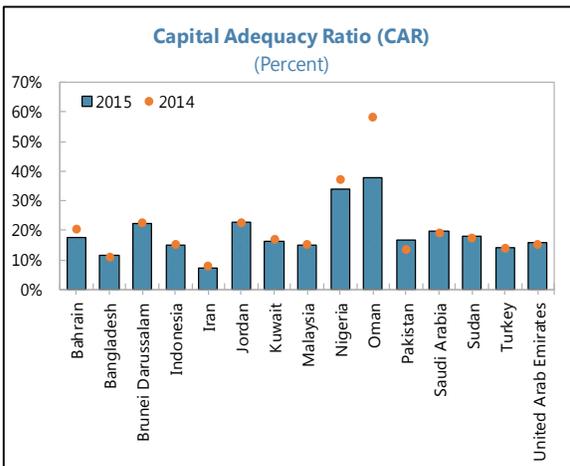
- **Islamic financial instruments are mapped to the 2008 System of National Accounts classification of financial instruments based on the nature of underlying transactions.** For the majority of Islamic financial instruments, the mapping to the 2008 SNA classification is relatively straightforward. For those Islamic financial instruments that have somewhat ambiguous characteristics, specific guidance is provided for statistical compilers.
- **Consistent treatment of Islamic financial transactions across countries is essential to ensure cross-country comparability of data.** Even though the Islamic financial standard setting bodies such as the AAOIFI and the Islamic Financial Services Board (IFSB) have made efforts to develop accounting standards and a regulatory framework for IFIs, these standards are not always fully implemented by IFIs when preparing their financial statements. This is why the provision of international guidance on the treatment of IFIs in macroeconomic and financial statistics is important for achieving cross-country comparability.

The growing trend of IF across the world calls for an increased attention to the proper statistical treatment of Islamic financial instruments to underpin effective macroeconomic management. For analytical purposes, it is recommended that countries with dual banking systems compile separate aggregate data for IBs, in addition to standard monetary statistics, to allow monitoring of specific indicators for the IB system such as growth in financing (credit) and sources of funding (deposits). Furthermore, guidance is also being developed for the compilers of financial soundness indicators (FSIs) in countries with IFIs in the context of updating the IMF's *Financial Soundness Indicators Compilation Guide*.

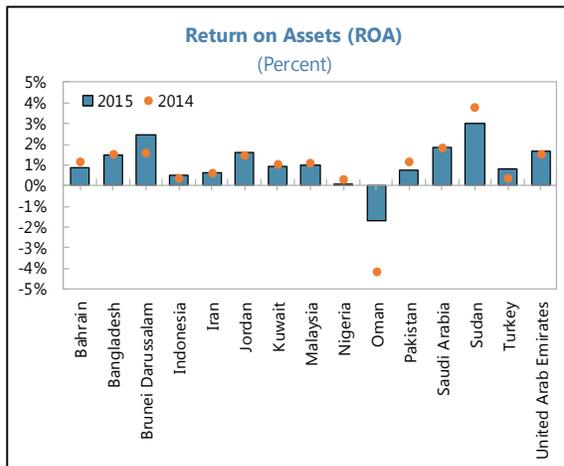
¹ See *Monetary and Financial Statistics Manual and Compilation Guide*—Prepublication Draft, Annex 4.3 (http://www.imf.org/~media/Files/Data/Guides/mfsmcg_merged-web-pdf.ashx).

Figure 2. Performance of Islamic Banks in Selected Countries

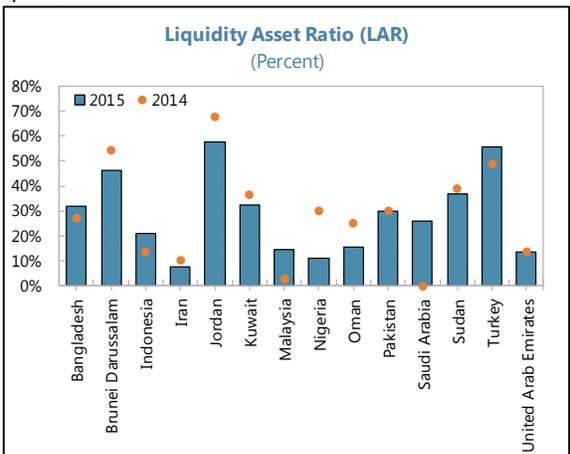
IBs are, with few exceptions, well capitalized...



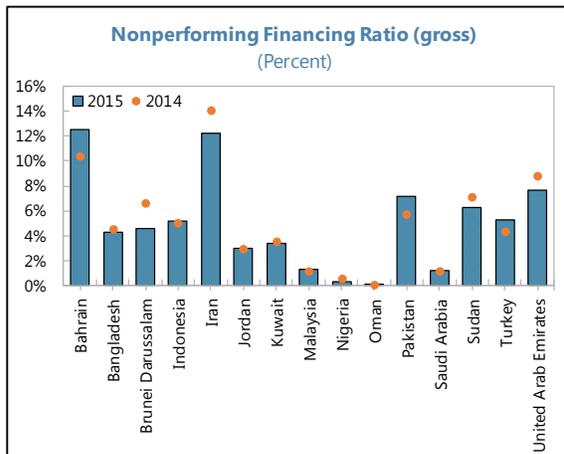
...and profitable, though margins are tightening in some countries.



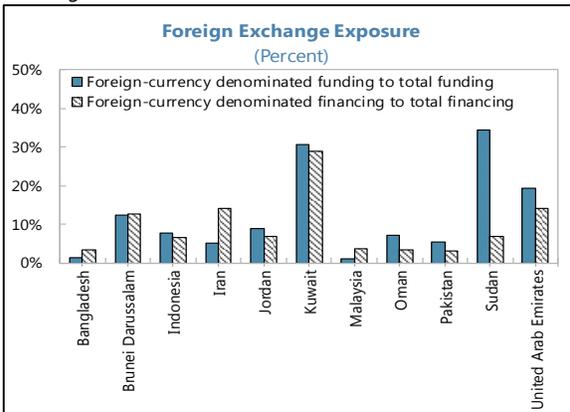
Liquidity ratios are high, but trending down in a number of countries.



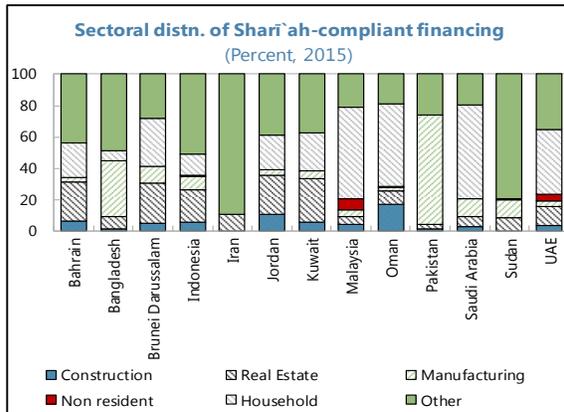
...While nonperforming financing remains high in several countries.



...selected countries exhibit notable exposure to foreign exchange risk.



...and concentration in cyclical sensitive sectors is high.



Source: IFSB.

LEGAL AND GOVERNANCE FRAMEWORKS

A. The Legal Landscape

19. Islamic jurisprudence for IF has evolved in recent years to accommodate modern financial intermediation. The cornerstone of IF is the adherence to, and compliance with, the relevant rules and principles of *Shari'ah* under the broader collective reasoning of prominent scholars and jurists. Historically, a number of schools emerged in Islamic jurisprudence reflecting variations in methodology, approach, and local conditions. Modern Islamic jurisprudence pertaining to IF cuts across the traditional schools in an effort to provide (to the extent possible) a harmonized framework of principles that is relevant for modern banking and finance. Based on this work, AAOIFI's "*Shari'ah Standards for IFIs*" have sought to broadly articulate a harmonized version of principles to guide IF institutions (including banks).¹³

20. The legal environment within which IBs operate can be complex and challenging, with implications for financial stability. IBs operate in diverse legal environments some of which have strong legal underpinnings for IB while others do not. In many cases, the applicable legal frameworks were established before IB emerged and, therefore, do not adequately support the conduct of IB operations (Box 5). The evolutionary nature of IB practices, variations in the application of IF principles, and their interaction with secular laws, have created additional layers of complexity to the legal landscape. Many countries have put in place legal frameworks that provides clarity and certainty on permissible IB practices, products and institutions. However, there are other countries, including some with systemically important IBs, that have not yet done so.¹⁴

21. Jurisdictions that allow IB will need to have in place an effective legal framework that supports IB operations. In many countries, further work is necessary to ensure that their legal frameworks fully take into account IB models, including the nature of their balance sheets, corporate structures, and governance arrangements.

¹³ These standards and the body of related rulings (including those of the *Fiqh* (jurisprudence) Academy of Organization of the Islamic Conference (OIC) countries) are collectively referred to as "Islamic finance principles."

¹⁴ Background Paper on Ensuring Financial Stability in Countries with Islamic Banking Sectors: Country Case Studies.

Box 5. Legal Environment Complexities for Islamic Banking

- **The degree of interaction between Islamic jurisprudence and secular law.** Depending on the extent to which Islamic jurisprudence is incorporated in the law of an IB jurisdiction, challenges may arise as to how to recognize the IF principles that IBs are subject to, and how those interact with secular law such as contract, banking, and related laws. There are jurisdictions where Islamic jurisprudence is incorporated into secular law (e.g., contracts law, banking law, and bankruptcy law etc.). In others whose legal systems are not fundamentally based on *Shari'ah* as a source of law, the authorities do not necessarily take Islamic jurisprudence into account in the application of secular law.¹ In other jurisdictions, the bank regulatory framework does not contain any separate prescriptions on IB's compliance with IF principles.
- **Contract enforceability for IB transactions can be challenging in purely secular jurisdictions.** In some jurisdictions, courts have held that "specific black letter provisions of the *Shari'ah*" are not to be deemed as incorporated into contracts. As a result, the enforceability of such contracts is not determined in accordance with Islamic jurisprudence in such jurisdictions. However, as a result of increased global penetration of IF, a trend has emerged since early 2000 in a number of key secular jurisdictions in which legislation has been enacted to recognize certain IF products.² Moreover, in some cases, the legal framework may provide for the recognition and enforcement of relevant IF principles, if they can be "precisely and effectively incorporated" into IF contracts.³ In some jurisdictions, arbitration processes have been established to enforce Islamic jurisprudence provisions underpinning IF contracts.⁴

¹ See Abed Awad & Robert E. Michael, Iflas and Chapter 11: Classical Islamic Law and Modern Bankruptcy, 44 Int'l Law. 975 (2010), available at <http://digitalcommons.pace.edu/lawfaculty/749/>.

² For example, France, Hong Kong, Japan, Singapore, and the U.K. all enacted specific legislation recognizing *Sukuk* as financial products and requiring supervisory approval for their origination by IBs.

³ See: "Enforceable in Accordance with its Terms: A Proposal Pertaining to Islamic Shari'ah;" Michael J.T. McMillen, presentation at the Islamic Financial Services Board meeting in Bali, Indonesia, April 2, 2004.

⁴ For example, "*Shari'ah* courts" have been newly organized in London under the Arbitration Act and have jurisdiction over Islamic financial disputes. Decisions issued by such "*Shari'ah* courts" can be legally enforceable in a U.K. court.

B. Governance

22. International corporate and bank governance principles generally apply to IB.¹⁵

Variations in governance arrangements between jurisdictions generally relate to the approach of the underlying legal framework (e.g., Anglo-American vs. French-German approaches), and local circumstances. Furthermore, the on-going debate on how to address the weakness in traditional bank governance structures that were exposed by the GFC (e.g., roles and duties of bank boards, etc.) are equally relevant for IBs.

¹⁵ This broader applicability of international governance norms to IBs has been acknowledged by the IFSB 2006 "Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services."

Corporate Structure

23. IB services are normally provided separately from conventional banking, through dedicated stand-alone IBs,¹⁶ or through IB subsidiaries or windows¹⁷ of conventional banks (Box 6). The need for the separation of IB from conventional banking arises for two main reasons:

- (a) *The perceived need to guard against the comingling of funds that are raised separately for Islamic and conventional banking activities:* IB depositors and investors need to be assured that income earned on their deposits and investments are generated from banking activities that are compliant with IF norms.
- (b) *The risk of regulatory arbitrage:* the risk that banks offering conventional and IB products may engage in regulatory arbitrage between the two types of products (e.g., undue risk transfers given IB emphasis on risk-sharing, possible differences in capital and other reserve requirements on IB products, etc.).

Box 6. Islamic Window Vs. Fully-fledged Islamic Bank

The Case for Islamic Windows

- IB benefits from the established operations of conventional banks (e.g., liquidity management, back office support, etc.), potentially improving service quality and lowering cost.
- Windows enhance competition in the market, which may lower the cost of IB products.
- For countries with limited demand for IB services, opening an Islamic window could be the only feasible way of providing IB services, thus enhancing financial inclusion.

The Case Against Islamic Windows

- Windows increase reputational risk as depositors and IAH might withdraw their money if they have concerns about potential commingling. It also raises issues related to consumer protection.
- Windows could weaken IB governance and risk management. The management and Board of a conventional bank may not be attuned to IB risks and *Shari'ah* Boards may also be unable to adequately verify compliance.
- Windows could lead to regulatory arbitrage between a bank's conventional and Islamic operations. Windows could also hinder prudential oversight by making it difficult to monitor prudential ratios that are specific to IB, and to prepare proper financial statements for mixed banking operations.
- Bank resolution could be further complicated for an Islamic window operating within a conventional bank. An orderly resolution of a distressed conventional bank (with an Islamic window) may be more challenging as to whether it will adhere to IF principles.
- Given the current limitations on the availability of liquidity management instruments for IB, the conduct of monetary operations could potentially be more complicated.

¹⁶ From the 2016 survey results, there are 141 stand-alone Islamic banks operating in 18 of the 27 respondent countries with stand-alone banking assets totaling US\$602 billion.

¹⁷ The total size of IB assets that belong to windows in 17 respondent countries (140 conventional banks had Islamic windows), amounted to US\$188 billion, with Saudi Arabia accounting for US\$175.4 billion (2011: US\$80 billion).

24. Country experiences vary with respect to the choice of the corporate form and are shaped by the legal and regulatory framework in a given jurisdiction, tax, and other considerations.¹⁸ Nonetheless, the majority of jurisdictions with IB have either not permitted Islamic windows or required conventional banks to establish separate IB units in their corporate structures.¹⁹

Shari'ah Compliance Function

25. The Shari'ah compliance function is a unique feature of IB governance, and is central to the integrity of IBs and their operations. *Shari'ah* standards have been developed by IFSB (framework) and AAOIFI (products). According to the IFSB,²⁰ the *Shari'ah* governance system refers to the set of institutional and organizational arrangements through which IBs ensure that there is effective independent oversight of *Shari'ah* compliance. This function assures the bank's stakeholders, including shareholders, customers and depositors, and IAH, that the bank is operating according to IF principles. This function plays a specialized risk management role, enhances consumer and investor protection, and provides assurances of IB ethical conduct.

26. The Shari'ah governance framework involves compliance oversight functions carried out by a Shari'ah Supervisory Board (SSB), internal control, external audit, and reporting functions, which form the basis of the SSB's reports to stakeholders (Box 7).²¹ The mandate of SSBs is sometimes established in contract or statute, and typically includes reviewing and supervising the activities of IBs to ensure that they are in compliance with IF principles. Under different national frameworks, SSBs may review transactions on an *ex-ante* or *ex-post* basis, and approve them from an IF perspective. However, they do not assess the business merits of particular activities.

27. There is some ambiguity between the governance role of SSBs and that of IBs' Board of Directors. The *Shari'ah* compliance oversight role of SSBs intersects with the overall oversight role of IBs' Board of Directors, given that the latter includes ensuring that appropriate policies, systems, and processes are in place to manage risks, including compliance risks. The extent to which the Board of Directors may be held liable for shortcomings in the *Shari'ah* compliance oversight role is somewhat unclear. Moreover, SSB members appear to have fiduciary duties related to their role, but the precise nature of these duties and the stakeholders to whom they are owed are unclear in many jurisdictions.

¹⁸ Background Paper on Ensuring Financial Stability in Countries with Islamic Banking Sectors: Country Case Studies.

¹⁹ Nearly all international banks, such as HSBC, Standard Chartered, Deutsche Bank, Citibank, and others, have engaged in Islamic banking and finance activities, through investment, private, and retail banking. They adapted their services to meet their business objectives and accommodate local requirements, including through locally incorporated subsidiaries (e.g., Citi Islamic Investment Bank in Bahrain, and HSBC) or through windows (Standard Chartered in Tanzania and Citibank in Malaysia).

²⁰ IFSB Guiding Principles on *Shari'ah* Governance Systems for Institutions Offering Islamic Financial Services—December 2009.

²¹ See AAOIFI Governance Standards on *Shari'ah* Supervision and Compliance and IFSB Guiding Principles on Governance Systems, which makes a distinction between compliance and control functions. SSBs may alternatively be called *Shari'ah* Committees or SSBs.

Box 7. Shari'ah Supervisory Boards for Islamic Banks

Structure: There are two types of SSBs: (a) centralized SSBs that provide guidance for all IBs in a particular jurisdiction, and are either set up by the central bank, regulatory authorities, or by other state authorities; and (b) internal SSBs that are established by individual IBs to ensure compliance, and are often appointed by shareholders (e.g., Turkey, Jordan, Qatar, and Lebanon). Centralized SSBs offer the advantage of harmonizing *Shari'ah* rulings across the IB sector, while reducing compliance costs to IBs, and compensating for the lack of a sufficient number of qualified scholars particularly in new IB jurisdictions.

Legal Underpinnings: In about half of the countries surveyed, legislation requires the establishment of internal SSBs. These include Afghanistan, Bahrain, Djibouti, Indonesia, Jordan, Kazakhstan, Kuwait, Kyrgyzstan, Luxembourg, Malaysia, Pakistan, Sudan, Tunisia, and the U.A.E. In others, (e.g., Kenya and the U.K.), there is no legal requirement for the existence of SSBs.

Status: Internal SSBs operate (i) as subsidiary organs of the general assembly of shareholders in some countries (e.g., Bahrain and Jordan); (ii) as free-standing organs of the IB (Afghanistan, Kazakhstan, Kuwait, Lebanon, Malaysia, and the U.A.E.); or (iii) as a subsidiary organ of the Board of Directors (Kyrgyzstan).

Mandate: SSBs advise on compliance with IB principles. Their specific mandates differ from jurisdiction to jurisdiction, but generally include directing, reviewing, and supervising the activities of IBs to ensure that they are in compliance with relevant IF principles.

Reporting Authority: In some countries (e.g., Bahrain, Djibouti, Jordan, Kuwait, Lebanon, Malaysia, Palestine, Sudan, and the U.A.E.), SBs report to IB shareholders, and in others, to the Board of Directors (e.g., Afghanistan, Djibouti, Indonesia, Kyrgyzstan, Lebanon, Malaysia, Palestine, and Saudi Arabia) or management of the IB (Djibouti, Malaysia, and Palestine). Others report to national or central *Shari'ah* boards (e.g., Djibouti, Indonesia, and Sudan), or to general public (e.g., Palestine).

Governance of Investment Accounts

28. Investment accounts offered by IBs present additional governance challenges, given the potential divergence of interests between shareholders and IAH. IAH have the right to value maximization similar to that of IB shareholders, in line with the PLS feature of PSIA. There may be situations, however, where value maximization for IAH may not be fully aligned with shareholders' long-term interests (i.e., different risk preferences). However, IAH cannot claim shareholders' rights (e.g., voting on key corporate actions) under company law. This presents a governance dilemma that does not exist in conventional banking, namely, how to protect IAH interests without impinging on shareholders' rights.

29. IAH have a direct stake in IBs performance, and their interest is increasingly acknowledged in IB governance structures. In line with the IFSB 2006 guiding principles on governance, some jurisdictions acknowledge the rights of IAH to monitor the performance of their investments and associated risks, and also require IBs to disclose investment policies and the performance of the bank to facilitate monitoring by IAH. Some jurisdictions also require the establishment of a "governance committee" to protect the interests of stakeholders other than shareholders (primarily IAH), and to monitor the implementation of governance policies. The governance committee, which reports to the Board of Directors, may comprise, at a minimum, a member of the audit committee, a *Shari'ah* expert, and a non-executive Director.

30. Enhanced disclosure and the establishment of governance committees will strengthen IAH protection, but important gaps may still need to be addressed. It may be impractical and costly for IBs to provide IAH (of unrestricted PSIA in particular) with ex-ante information similar to an “investment prospectus.” In any event, investment policies are usually too broad to inform IAH of the risks facing the bank. Furthermore, as the governance committee reports directly to the bank’s Board and not IAH, it is not clear to what degree IAH would ever be informed of any divergence of interest between shareholders and IAH. While IAH have the option of terminating their participation in the bank if they feel dissatisfied with the level of protection they enjoy, this may be a suboptimal option for enforcing discipline within the bank.

Outstanding Issues

31. Additional efforts are needed by IB jurisdictions to ensure full and consistent implementation of IFSB and AAOIFI governance standards, which would enhance IBs stability. IB jurisdictions should continue to take the necessary measures (including, where appropriate, legal reforms) to bring their legal and regulatory frameworks in conformity with existing IB governance standards, and to ensure their consistent application. International guidance is still required for IB jurisdictions, on: (a) the precise design of SSBs (e.g., centralized and/or internal SSBs); (b) the responsibilities of SSBs relative to those of the IB Board of Directors; and (c) mechanisms for the better alignment of the interests between IAH and shareholders.

REGULATION, SUPERVISION, AND AML/CFT

A. Regulatory Framework

32. Effective prudential regulation is as necessary for IB as it is in conventional banking to ensure the stability of the financial system and to protect the interests of depositors and other stakeholders. The necessity of applying prudential regulation and supervision over financial activities and intermediation by IBs is driven by concerns broadly similar to those of conventional banks, to safeguard their proper management and to prevent any failure from having systemic repercussions.

33. The prudential standards developed by the BCBS are relevant for IB, but some modification is needed. Prudential exposure requirements, such as large exposure and related lending limits, and consolidated and cross-border supervision are, in principle, applied in the same way on conventional banks and IBs, as the underlying regulatory concerns are broadly the same. Similarly, when IBs use debt-type instruments in their financing activities, traditional loan classification and provisioning requirements are applied on the basis of the same concepts of degree of credit risk and impairment that apply for conventional banks. However, given the unique characteristics of IB, the application of international standards to IBs without adjustments, may not address the full spectrum of IB-specific risks (Appendix II). This approach may give rise to regulatory gaps that could either increase IBs’ vulnerability, or inappropriate over-regulation that will stifle the growth of the industry.

34. The application of IFSB and BCBS standards together create a comprehensive prudential framework for IB. The unique features of IB call for special regulation and supervision that effectively address their special characteristics. In this regard, initiatives have been undertaken in recent years to ensure the coherence and consistency of IB standards with international norms, including the publication in 2015 of the *Core Principles for Islamic Finance Regulation for Banking (CPIFR)*, which was built on the BCBS core principles.²² The CPIFR can be used to undertake a self-assessment of IB regulatory and supervisory framework.

35. While there is broad recognition of the relevance of the IFSB standards, their formal incorporation into legal and regulatory frameworks has been progressing, albeit at different speeds. About 60 percent of countries surveyed in 2016 have modified their domestic frameworks to accommodate IB. Nonetheless, progress in adapting the standards has been uneven across countries.²³ Only eight countries (Bahrain, Djibouti, Jordan, Kyrgyzstan, Oman, Palestine, Qatar, and Sudan) have mandated AAOIFI accounting standards while four others (Afghanistan, Guinea, Luxembourg and Saudi Arabia) have allowed AAOIFI standards as a second option. Ten countries (Bahrain, Bosnia and Herzegovina, Djibouti, Guinea, Jordan, Kyrgyzstan, Palestine, Qatar, Saudi Arabia, and Sudan) have mandated IFSB standards for IBs, and six others (Afghanistan, Kazakhstan, Kuwait, Lebanon, Oman, and Pakistan) have only incorporated certain aspects of IFSB standards in their frameworks. The lack of consistent application of standards remains a concern, particularly in the countries with systemically important IB.

36. The emergence of hybrid IB institutions and products is a regulatory challenge. Existing prudential standards for IB are premised on traditional IB model, with well understood characteristics and risks. However, the hybrid IB activities straddle the regulatory line between conventional banking regulations and traditional IB regulations, creating potential regulatory gaps, complex new risks, and heightened financial stability concerns.

B. Selected Regulatory Issues

Licensing

37. Robust licensing procedures are necessary to ensure that IBs are managed in a sound and safe manner. Many basic elements of a conventional licensing process are fully applicable also in an IB framework, although modifications are needed to take into account certain specific features of IB (Box 8).

²² CPIFR was developed with the Fund's TA support.

²³ Background Paper on Ensuring Financial Stability in Countries with Islamic Banking Sectors: Country Case Studies.

Box 8. Modifications to Licensing Requirements

- **Business Plan.** The plan should include, inter alia, details on the IB's strategy to attain and maintain profitability, including the funding plan and the management of the PSIA.
- **Capital Requirements.** Minimum levels (both in absolute and as a proportion of risk-weighted assets), composition and quality of initial capital should be ensured and prescribed (as per the IFSB standards) to reflect the business model envisaged by the bank.
- **Fit and Proper Requirements.** The suitability of significant shareholders should be ensured. Bank managers are also required to be fit and proper, and to be trained and experienced in IB operations. A significant number of Board members should also be familiar with the nature of IB and its associated risks. An area that has yet to receive greater attention by jurisdictions, but which is important, is the application of fit and proper requirements to *Shari'ah* Board members and staff in IBs responsible for *Shari'ah* compliance. Only a few jurisdictions apply such fit and proper requirements to these individuals.
- **Corporate Governance.** The governance structure of the IB, and the structure of any group to which the bank belongs should be transparent and should not hinder effective supervision. The supervisory authority should ensure that appropriate governance structure and process are in place as discussed above.
- **Internal Control.** The supervisor should ensure that administrative and internal control systems are adequate. The supervisory authority should have an adequate understanding of the wide array of risks undertaken by the IB and satisfy itself that an adequate risk management and reporting process is in place.
- **Transparency.** Criteria and requirements for an IB license should be published and applied in an even-handed way.

Concentration Limit

38. Concentration limits and norms as applied to conventional banks will require modifications to accommodate IB activities. IBs rely on the acquisition of and direct investment in commodities and real assets, sometimes in the context of a partnership or joint venture with the customer. Where IBs invest their own and/or IAH funds directly in assets or projects to benefit from asset price appreciation, IBs act as property developers and business owners. Such investments raise supervisory issues, particularly, with respect to risk management and capital adequacy. In considering whether to establish limits on such investment activities, supervisors should assess the impact of these activities on the risk profile of the bank and require additional capital requirements in case of excessive exposures in the activities that are not well managed (this applies particularly in the context of pillar 2 of Basel II for countries that are already applying it).

Capital Requirements

39. While the computation of capital adequacy ratios is similar to BCBS' formula, there are important variations in the recognition of sources of funds, risk-weighted assets, and eligible capital. A major difference between IBs and conventional banks relates to PSIA loss absorbency. As discussed above, IAH are expected to bear the loss of earnings or investments that were made with

their funds.²⁴ This capacity to pass-through low returns or losses to IAH provides IBs with an additional buffer to limit the impact of adverse shocks on IBs' solvency. The higher the share of IA as a source of funds and the lower their sensitivity to changes in return, the higher the solvency of IBs compared to conventional banks.²⁵

40. The calculation of risk-weighted assets needs to take into account the transformation of risks. The complexity involved in profiling the risk in IBs may further evolve from one type of risk to another at the various stages of the business transaction. For example, in a diminishing *Musharakah* contract, the IB initially acts as a joint-owner of the asset, but the asset ownership will be transferred fully to the customer at the conclusion of the contract. In this regard, the IB is exposed to market and impairment risks at the initial part of the transactions compared with the exposure during the later stages of the contract. At the same time, repayment obligations by customers give rise to credit risk.

41. In reality, IB practices differ across the world with respect to upholding the pass-through principle to IAH. Many IBs (especially smaller or new banks) face market pressure to pay competitive rates of return to IAH to avoid withdrawal risk. Other IBs have built their business model around providing stability of earnings to IAH. These banks have engaged in income smoothing operations (and sometimes investment guarantees) by using PER and/or IRR for this purpose.²⁶ Some IBs have simply opted to compensate IAH from shareholders' profits' as needed instead of establishing a PER.

42. The presence of income or investment smoothing practices gives rise to "displaced commercial risk (DCR)" with implication for IBs' capital adequacy that regulators should take into account. DCR is defined as the risk arising from assets managed on behalf of IAH which is effectively transferred (displaced) to the IBs own capital because the bank forgoes part or all of its profit share in these assets. The bank may consider this necessary as a result of commercial pressure in order to increase the return that would otherwise be payable to IAH (IFSB-1, 2005). In December 2005, the IFSB issued the first Capital Adequacy Standard to cater to the specification of IBs, which includes a risk weights matrix and capital calculation formulas that capture the DCR of IBs. The IFSB revised its capital adequacy standard in December 2013 to incorporate many elements of Basel III.

43. For the calculation of capital adequacy ratio (CAR), the IFSB standard provides two formulas: standard and discretionary. In the standard formula, capital is divided by risk-weighted assets excluding the assets financed by IAH. The second formula, referred to as the discretionary

²⁴ Unless there is evidence of negligence or misconduct on the part of the bank.

²⁵ Heavy early withdrawals penalties that are usually imposed on IA would lessen the impact on the IB solvency in the case of significant and unexpected IA deposits' withdrawals in response to low profits or losses.

²⁶ Survey results shows that 11 responded countries have allowed PER and six allowed IRR.

formula, is designed to account for DCR as determined at the supervisor's discretion.²⁷ Such supervisory discretion can give rise to wide variations in the alpha factor (Box 9),²⁸ and, together with rules and regulations regarding PER and IRR, can result in widely different calculations of capital adequacy. In turn, this poses challenges for cross-country comparisons of solvency and may provide scope for regulatory arbitrage. Accordingly, in line with IFSB guidelines, Fund staff support the view that supervisors, when determining the value of alpha, need to carefully assess the risk profiles of IBs, develop robust models, decide whether to adopt it for each bank or for the entire system, and disclose their approach to determining alpha.

Box 9. Islamic Financial Services Board Capital Ratio Calculation for Islamic Banks

Standard Formula

- IAH bear 100 percent of credit and market risks of assets funded by IAH and the IB bears 100 percent of operational risk

$$\frac{\text{Eligible capital}}{\text{Total RWA (credit + market risks) + Op. risk- RWA funded by IA (credit + market risks)}}$$

Supervisory Discretion Formula

- IB bears a proportion (α) of credit and market risks of assets funded by IAH and 100 percent of operational risk. If $\alpha=0$, this indicates a complete pass through of credit and market risks to IAH. If $\alpha=1$, IA are practically guaranteed as in conventional banks.

$$\frac{\text{Eligible capital}}{\text{Total RWA (credit + market risks) + Op. risk- RWA funded by RIA (credit + market risks) - (1 - \alpha)(RWA funded by URJA (credit + market risks)) - \alpha (RWA funded by PER and IRR of URJA (credit + market risks))}}$$

C. Supervisory Process

44. Effective prudential supervision is as necessary in an IB framework as in conventional banking to ensure the safety and soundness of individual IBs and help reduce risks to the stability of the financial system. Compliance with the Basel Core Principles (BCP) is important for effective banking supervision for IB, but needs to be supplemented with the CPIFR and the IFSB standard on "Risk Management." The conduct of banking supervision needs to be undertaken in a manner that addresses the special characteristics of IBs, including understanding the challenges inherent in IB, its unique risks, the implications of the interactions between IBs and conventional banks, and the potential for regulatory arbitrage. The supervisory review process for IBs should be risk-based and culminate in a formalized and structured supervisory strategy similar to conventional

²⁷ Malaysia does not require general assets financed by investment accounts to be converted into risk-weighted assets, while Sudan and Kuwait require 50 percent, Bahrain and Jordan requires 30 percent only and Afghanistan 12 percent. These variations reflect the supervisors' views of local IB practices.

²⁸ The alpha factor identifies the proportion of losses which are due for pass-through to IAH. Specifically, alpha determines the proportion of credit and market risk-weighted assets funded by PSIA.

banks, which supervisors will follow when conducting off-site surveillance and on-site examination.²⁹ Supervisors may also need to adapt rating methodologies, such as the capital adequacy, asset quality, management quality, earnings efficiency, liquidity, and sensitivity (CAMELS) system for IBs and implement the IFSB standards and technical guidance on stress testing.

45. The frameworks for risk-based supervision and cross-border and consolidated supervision of IBs remain underdeveloped. Approaches to risk-based supervision of IBs are being developed (including *Shari'ah* compliance, corporate governance, internal control, and transaction testing), but progress is tempered by a broader weakness in the application of risk-based supervision to banking within many IB jurisdictions. Gaps in the acceptability and application of IB prudential standards can have consequences for capital and liquidity adequacy across countries. These issues need to be considered in any approach to cross border and consolidated supervision of IBs. Diverse approaches to the treatment of *Shari'ah* matters across jurisdictions also complicate cross-border supervision of IBs.³⁰

46. On and off-site supervision of IBs has generally been integrated into the broader supervisory process, but a more nuanced approach is necessary.³¹ In some jurisdictions, IBs and conventional banks are subject to a uniform off-site and on-site supervision involving similar supervisory risk-based approaches, manuals, systems, processes, and procedures. However, there is broad recognition, particularly, in jurisdictions where IB is systemically important, of the need to adapt the supervisory process to capture the unique risks of IB. For example, on-site examination would place greater focus on operational risk and verification of underlying real transactions.

47. IBs may need to review reputational risk arising from inadequate *Shari'ah* compliance more carefully. Many countries apply Pillar 2 of Basel II, which could be extended to capture reputational risk in the internal capital adequacy assessment process (ICAAP). For example, in the case of Jordan, the supervisor can ask for higher capital adequacy requirements in part to account for reputational risk. In Malaysia, any uncaptured risks can be covered by special risk management control measures or additional capital. For this purpose, the central bank regards that stress testing is very crucial and stress test assumptions try to capture these factors.³²

²⁹ The 2014 IFSB guideline on the Supervisory Review Process also recommends that supervisory authorities ensure, inter alia, that supervisors fully address *Shari'ah* governance and coverage of Islamic windows, banks practices on meeting capital requirements, ICAAP, and risk management.

³⁰ In some cases, there may be a national *Shari'ah* board, whereas, other jurisdictions may mainly require applicable *Shari'ah* systems to be in place. In some arrangements, prior consent of the home supervisory authority may be an integral part of the product and service authorization process. In other cases, there may be simply a notification requirement or no formal authorization or approval required.

³¹ Discussions continue on whether to establish separate supervisory functions for conventional and IBs or integrate them into one function. The trend seems to be moving toward the latter to eliminate duplication, as significant part of the supervisory process is also applicable to IB.

³² IFSB 16—Supervisory Review Process.

48. Given the unique challenges posed by *Shari'ah* compliance (as noted in paragraph 10), it is important for the bank supervisor to have a clear supervisory policy in place. The supervisor will need to have a view irrespective of whether the relevant laws of the jurisdiction recognizes the *Shari'ah* or are purely secular. At a minimum, the supervisor should ensure that the IBs in its jurisdiction have adequate *Shari'ah* compliance function in place without the need to have views on the merits of the resulting rulings.³³

Outstanding Issues

49. Full implementation and the consistent application of IFSB standards, and the strengthening of the supervisory framework are required, particularly, in jurisdictions with systemically important IB. International cooperation and additional efforts by relevant international bodies and standard setters are needed to broaden the adoption and the consistent application of the IB prudential standards. Additional efforts are also needed to ensure that an adequate supervisory process is in place to identify, assess, measure, and monitor the risks specific to IBs and evaluate the potential impact on IBs' capital adequacy and solvency.

50. International guidance is needed to address concerns regarding hybrid IB institutions and products. Work is needed, by relevant international bodies and standard setters, to fully understand the structures of these activities to delineate how they can be effectively regulated.

D. Anti-Money Laundering and Countering the Financing of Terrorism

51. The standards for anti-money laundering and countering the financing of terrorism (AML/CFT) were developed mainly with the conventional financial sector in mind,³⁴ without giving consideration to potential money laundering, terrorist financing (ML/TF) risks specific to IB.³⁵ There is no evidence that the ML/TF risks in IB are any different from those posed by conventional banks, although very little work has been done by the international community to examine this issue. At the same time, some features of IB could alter the exposure to ML/TF risks, and require a reassessment of vulnerabilities and adequacy of AML/CFT regimes in addressing such risks. Features of IB warranting further study include the implications of the partnership relationship between an IB and its customers and the complexity of certain IB products and transactions.

52. Going forward, the international community needs to develop a better understanding of the ML/TF risks in IF, including through an enhanced dialogue with supervisors, Islamic

³³ This has been the approach, for example, of many purely secular jurisdictions including, for example, the U.K. and Hong Kong.

³⁴ ML/TF and the related predicate crimes can undermine the stability of a country's financial system or its broader economy. The Financial Action Task Force (FATF), the standard setter on AML/CFT, calls for countermeasures against countries where there is a high risk of money launder or terrorist financing.

³⁵ See "Islamic Finance and anti-money laundering and combating the financing of terrorism" Nadim Kyriakos-Saad, Manuel Vasquez, Chady El-Khoury, Arz El Murr, IMF Working Paper, 2016 Working Paper No. 16/42, 2016.

finance institutions, and practitioners.³⁶ Regulators, in consultation with the Fund, FATF, and other interested parties, should also seek to understand whether the current recommendations set out in the FATF standard are sufficient to effectively mitigate ML/TF risks or require further adaptation to mitigate any ML/TF risks that are specific to IBs.

RESOLUTION AND FINANCIAL SAFETY NET

A. Resolution

53. Establishing a clear and well-designed framework for resolving failed IBs, is important to help maintain financial stability in jurisdictions where they operate. While certain characteristics of IBs may reduce the overall risk of failure (e.g., risk-sharing, and a conservative approach to investment), IBs are as vulnerable to crises as conventional banks. Jurisdictions should be able to resolve IBs in an orderly manner. This would entail taking official control of a failing IB, and applying a broad range of legal powers and tools to restructure its assets and liabilities or liquidate it if required, in a manner that minimizes disruptions to the financial system. The legal and policy frameworks for bank resolution in many countries with IB systems are, as a general matter, not well developed, whether for conventional or IB. Very few of these countries have put in place specialized resolution frameworks for IB,³⁷ thereby, leaving unaddressed potential risks for financial stability.

54. International standards for the design of effective bank resolution regimes need to be adjusted to address specific features of IB. The Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions* which is the prevailing non-binding international standard in this area, may resonate strongly with relevant IF principles (e.g., risk-taking and loss-sharing). Many features of conventional resolution regimes appear to be broadly appropriate for IBs. Given the unique features of IB, however, a customized approach to the design of an effective resolution regime for IBs is called for (Box 10).³⁸ Among other things, the applicability of conventional resolution powers and tools and triggers for placing an IB in resolution are unclear, as is the role (if any) of the SSB in ensuring *Shari'ah* compliance in resolution. Inconsistencies in the legal and accounting status of IB transactions in jurisdictions may render the design of creditor hierarchies and the practical application of certain resolution tools challenging, particularly in the cross-border context.

³⁶ This could be done in the context of the ongoing round of assessment of the effectiveness of AML/CFT regimes.

³⁷ With the exception of Malaysia (Islamic Financial Services Act (Act 759) of 2013), IB jurisdictions do not provide for IB-specific resolution regimes addressing their unique features.

³⁸ See "Resolution Frameworks for Islamic Banks" Addo Awadzi, E., Carine Chartouni, and Mario Tamez, IMF Working Paper, 2015 Working Paper No. 15/247, 2015.

Box 10. Key Resolution Issues for Islamic Banking

Legal and Accounting Status of Transactions: Some IB contracts are not treated as debt contracts from a legal or accounting stand point, and this could have implications for the practical application of resolution tools such as purchase and assumption (P&A), and bail-in—which assumes the existence of loss-absorbing debt on the bank’s balance sheet.

Creditor Hierarchy and Treatment of “Deposits”: For IBs, the ranking of demand deposits is similar to those in conventional banks, but differences exist in the treatment of PSIAAs. Some jurisdictions rank URIA ahead of creditors in the creditor hierarchy but they differ in the ranking of (RIAs). The IFSB’s guidelines on corporate governance envision that “shareholders and IAH rank *pari passu* as residual claimants in regard to assets financed by funds commingled in the same asset pool.”¹ These differences reflect divergent views on the nature of RIAs and could pose challenges for IB resolution, particularly, in the cross-border context.

Resolution Tools: IF principles could make the application of certain resolution powers and tools problematic. For example, while the concept of loss absorption by claimants is not foreign to IF, the extent of permissible debt write-downs is unclear. The prohibition of interest may affect the use of the P&A tool for the transfer of loan assets below face value and the bail-in tool for mandatory debt write-downs or conversion of debt into equity. While loss-absorbing IB contracts could, in principle, be used to facilitate bail-in, the availability of qualifying IF-compliant loss-absorbing instruments and the prohibition against subordination of unsecured claims in relation to others of the same class, could be challenging. Under the relevant IFSB standard (IFSB-15), IBs can issue loss-absorbing *Musharakah Sukuk* similar to common equity and backed by their own assets, as part of additional Tier 1 or Tier 2. For the purpose of Tier 2 capital, IBs can issue *Muḍarabah* or *Wakalah Sukuk*, the underlying assets of which would be convertible into equity shares at the point of non-viability or insolvency. It is, however, unclear how these contractual arrangements would be viewed by SSBs, especially in the absence of effective legal frameworks for IB resolution.

Resolution Triggers: Triggers for activating resolution powers for IBs are unclear. Identifying appropriate indicators of non-viability for a business model that relies less on lending and more on partnerships and other PLS, sales, and leasing, could be challenging. Legal frameworks should clarify indicators of non-viability of IB or risks to the interests of depositors and other claimants (e.g., IAH) as well as the financial system as a whole.

Institutional Arrangements: The *Shari’ah* compliance function in resolution could have implications for the design of institutional arrangements (in particular, the role of SSBs in resolution, if any).

¹ According to the IFSB’s guideline on corporate governance, shareholders and IAH rank *pari passu* as residual claimants in regard to assets financed by funds commingled in the same asset pool. Where current account funds are also commingled in the same pool, the current account holders rank as creditors in regard to the shareholders’ portion of the assets, but not in regard to the IAH’s portion.

55. International guidance is needed for the design of legal regimes for the effective resolution of IBs. Further analytical work on the complexities and uncertainties in this regard, should be undertaken by relevant international bodies. Greater harmonization of relevant *Shari’ah* bankruptcy principles and the legal and accounting treatment of various assets and liabilities between jurisdictions would help strengthen national and cross-border resolution frameworks. The international financial community should also provide guidance on the design of institutional arrangements for resolution and mechanisms for allocation of losses in resolution to stakeholders.

B. Deposit Insurance

56. The design principles of deposit insurance are broadly applicable to IBs, but require some adaptation (Box 11).³⁹ Four key questions arise in the context of Islamic Deposit Insurance Scheme (IDIS) namely, (a) whether the PSIA should be treated as deposits, notwithstanding some of their equity-like features; (b) what priority should be assigned to different types of IB deposits; (c) what role the deposit insurance fund should play in resolution;⁴⁰ and (d) to what degree IDIS is consistent with IF principles. With many of these questions unresolved, there is significant heterogeneity among jurisdictions in this area. Only one country (Sudan) has a full-fledged IDIS, two countries (Bahrain and Malaysia) have a dual deposit insurance scheme, with premiums from IBs managed according to IF principles, and twelve countries have a deposit guarantee scheme that covers both systems, with premiums managed in a single, indivisible account. Overall, international guidance is needed on adapting international principles for IDIS.

Box 11. Islamic Deposit Insurance—Challenges

Standards: The IFSB has not adopted a standard or guideline on deposit insurance. The Islamic Deposit Insurance Group of the (IADI) has concluded that *Shari'ah* compliance is a key challenge for an IDIS.¹

Governing Framework: Although governments could take several alternative approaches to implementing an IDIS, the legal enforceability of each approach would need to be ensured.

Insurability of Islamic “Deposits:” There seems to be a consensus regarding the insurability of current accounts but there remains uncertainty in the definition and treatment PSIA.²

Risk-based Fees: In jurisdictions that apply risk-based fees for funding deposit insurance, IB's risks would need to be quantified, implying the development of requisite analytical capacities and underlying data.

Availability and Liquidity of Investments: To ensure a quick payout to depositors, deposit insurance funds need to be liquefied on short notice, which would mean that IDIS funds would, in turn, need to be invested in liquid instruments. The dearth of IF liquid instruments is a key impediment.

Co-existence with Conventional Banking: Islamic deposits can be covered by either conventional deposit insurance or an IDIS, which can be housed either in a separate agency or a single agency that manages both schemes. Each option will have its own governance, legal, and operational implications.

Priority of Claims: Conventional deposit insurance rank depositors (at least insured depositors) *pari passu* with each other. Under an IDIS, a distinction is made between current deposits and PSIAs, and between URIA and RIAs.

Role in Resolution: There is growing support for authorizing a DIS to fund bank resolution. *Shari'ah* compliance of such resolution activity by the DIS is unclear.

¹ See also Arshad, “Implementation of an IDIS for the Islamic Financial Services Industry,” (IFSB 2011).

² Al-Ja'Fari and Walker, “Deposit Insurance in the MENA Region,” (Washington: WB, 2011).

³⁹ The Core Principles for Effective Deposit Insurance adopted (November 2014) by the International Association of Deposit Insurers (IADI), <http://www.iadi.org/docs/cprevised2014nov.pdf>, and the “Handbook for the Assessment of Compliance with the Core Principles for Effective Deposit Insurance Systems” (March 2016): http://www.iadi.org/docs/IADI_CP_Assessment_Handbook_FINAL_14May2016.pdf. Blanket guarantees and implicit deposit protection schemes are not covered in this paper.

⁴⁰ Similar issues were identified by the 2010 “Survey on Islamic Deposits Insurance” prepared by IADI.

C. Liquidity Management and Lender-of-Last-Resort

57. IBs, like conventional banks, are exposed to liquidity risks and need robust liquidity management capacity to mitigate these risks and exploit investment opportunities. As financial intermediaries, IBs transform short-term liquid liabilities into long-term illiquid assets, while providing liquidity to demand deposits and borrowers. This process creates exposure to liquidity risks, that could be bank-specific (e.g., unexpected large withdrawals, negative news, etc.) or market-related (e.g., shallow money market, market disruption, etc.). An IB should be able to access and hold sufficient levels of HQLA and have the capacity to raise funds in money markets to use in the event of a liquidity shortage or to fund new profitable investment (Box 12).

Box 12. Key Liquidity Management Instruments

Interbank *Mudarabah* Placements. A structured interbank transaction used by surplus IBs to deposit funds in shortage IBs on *Mudarabah* basis for returns based on agreed profit-sharing ratio and formula for profit computation. The terms of these facilities are often proscribed by central banks.

Commodity *Murabahah*. Is used to facilitate short-term interbank lending using transactions in commodities (mostly metal, and often through the London Metals Exchange or Malaysia “Bursa Suq Al-Sila”) to structure a loan between two IBs. A variety of this transaction is the Salam *Sukuk*, which uses forward commodity contract to generate longer term loans (usually three months).

Central Bank *Wadiah* (Trust) Certificate/Deposit. Is issued against funds placed by IBs at the central bank for various maturities. Remuneration is at the central bank’s discretion given the debt nature of the facility. Central banks may pay a bonus at maturity that is usually tied to a domestic financial benchmark (including the average return on Interbank *Mudarabah* investments).

Central Bank Paper. There are two forms of these papers: (a) *Musharakah* Certificates issued against the central bank ownership of a pool of income earning assets; or (b) *Sukuk* issued against the central bank ownership of real fixed assets. These papers are freely tradable with maturities of less than one year.

Government paper. Similar to central bank papers, these instruments can be issued as *Musharakah* Certificate against government ownership of a pool of income earning assets, or as *Sukuk* issued against the government ownership of real assets. These instruments are freely tradable with maturities that can be structured (particularly for *Sukuk*) similar to those of domestic government securities.

Islamic Repurchase Agreements or sale and buyback. Usually involves two separate contracts, an outright sale of security at an agreed price and a forward purchase of security at a specified price and future date. *Shari’ah* and operational issues have significantly limited the use of this instrument.

58. Efforts to develop Islamic liquidity management instruments and money markets have traditionally faced a number of obstacles, but some progress has been achieved in recent years. Obstacles have included: a chronic sector-wide excess liquidity in some jurisdictions, the very slow pace of issuance of sovereign *Sukuk* in most jurisdictions, and lack of alternatives to repo-like transactions, which are viewed as replicating an interest-bearing loan. Some progress has been achieved in developing instruments and markets (Box 12), mostly in countries with a substantial IB presence or with more developed money and sovereign *Sukuk* markets (e.g., Bahrain, Malaysia, and Sudan). According to the IMF IB survey results of 2016, the principal Instruments used by IBs to

manage liquidity are central bank deposits, the interbank *Mudarabah* market, and increasingly commodity *Murabahah* markets.

59. Progress has been achieved in developing central bank instruments to manage structural liquidity, but progress has been modest in developing shorter term liquidity management instruments.⁴¹ The lack of an adequate supply of sovereign *Sukuk* and the tendency of central banks not to engage in transactions (including issuing central bank instruments) involving real assets have been important factors in the underdevelopment of central banks' IB operations. Despite these difficulties, 40.9 percent of central banks in IB jurisdictions, according to 2016 IB survey, engage in regular liquidity operations with IBs. Of these central banks, 27 percent issue their own securities (with maturities usually ranging from one week to one year) and 24 percent use government securities or *Sukuk* in their liquidity operations with IBs.

60. Most central banks apply reserve requirements to IBs (86 percent of the respondents according to the survey). Reserve requirements are applied to domestic currency denominated demand deposits and to domestic currency PSIA's, as well as to foreign currency deposits. However, only 27 percent of central banks surveyed remunerate the reserve requirements for IBs, reflecting the lack of a mechanism for reserves remuneration that complies with IF principles.⁴² Where reserve requirements are not remunerated, high reserve required ratios create distortions. increase the cost of IB credit, and constrain growth.

61. The LOLR function is an important tool for central banks to safeguard financial stability, including in the context of IB.⁴³ The broad principles that govern the LOLR framework for conventional banks apply also to IBs, provided that the LOLR structure and the collateral used complies with the relevant IF principles. Several central banks are currently adapting their frameworks to accommodate LOLR needs from IBs. According to the IFSB, 25 percent of the regulatory and supervisory authorities have developed a LOLR framework for IBs using different types of instruments (*Mudharabah*, *Musharakah*, and *Murabahah*).⁴⁴ Adapting conventional LOLR to cover IBs would require central banks to consider:

- (a) The availability for central banks of alternatives to interest-bearing loans, which in turn depends on whether existing mechanisms available for regular liquidity management have been adapted for IBs or whether new instruments need to be created.

⁴¹ Given that the primary focus of this paper was financial stability (including the discussion on liquidity management), issues related to monetary policy (effectiveness, monetary transmission, etc.) are not covered in the paper.

⁴² In cases where IBs' required reserves are remunerated, the proceeds are usually used by to pay licensing fees and taxes or distributed for charitable purposes.

⁴³ In practice, the application of these principles varies across jurisdictions and a number of important questions continue to be debated (e.g., coverage: bank vs. nonbank, liquidity vs. solvency issues, and triggers for the provision of government guarantees, etc.).

⁴⁴ Chattha and Abdul Halim (2014).

- (b) The definition of “penalty rate” will need to take into account the type of central bank regular liquidity management used with IBs. For example, in some countries (e.g., Sudan), central banks sometimes use a PLS *Mudarabah* facility to extend funding to IBs, often with a preannounced profit-sharing rate (i.e., lower profit-sharing rate compared to the rate used in standing facility).
- (c) Bilateral LOLR is usually provided against broader and less liquid collateral than central banks’ regular liquidity management operations. Many of the issues that are traditionally covered in collateral policies (e.g., asset quality and marketability, haircut, etc.) are also relevant in the case of IBs. However, additional issues warrant further consideration, including whether or not to accept PLS assets as collateral.

Outstanding Issues

62. Robust financial safety nets that comply with IF principles and reflect international best practices are essential for IB jurisdictions. International guidance is needed for the design of IB resolution frameworks drawing on the key attributes. Such frameworks should *ex-ante*, clarify institutional arrangements for resolution, the legal and accounting status of IB transactions for resolution purposes, creditor hierarchies for IB claims, and cross-border issues. Furthermore, international standards are required for the design of IB deposit insurance schemes to help address the issue of insurability of Islamic “deposits,” fund management arrangements, and the potential for resolution funding.

63. The orderly development of Islamic money and sovereign *Sukuk* markets is important for financial stability in countries with systemically important IB and for the sustainable development of the IB industry. Faced with the lack of HQLA, IBs are increasingly relying on complex instruments to manage liquidity (e.g., commodity *Murabahah*), which has also allowed them to rapidly increase their access to wholesale funding in recent years. This, in turn, is transforming the risk profile of these institutions and increasing their vulnerability to liquidity shocks. A number of factors hinder the development of deep *Sukuk* markets, including subjugating issuance of government *Sukuk* to the fiscal position irrespective of market development needs, weak public debt management, and reliance on complex designs. These need to be addressed with international guidance.

CONCLUSIONS AND ISSUES FOR BOARD CONSIDERATION

64. Significant progress has been achieved in developing prudential standards for IB, but progress has been limited in developing resolution, financial safety net, and liquidity management frameworks. The IFSB standards, in conjunction with the BCBS, provide a comprehensive framework for regulating and supervising IBs. Further strengthening of the implementation and the consistent applications of these standards are needed, particularly, in jurisdictions where IB has become systemically important. The emergence of hybrid institutions and

products is a regulatory challenge, with potential implications for financial stability. There has been limited progress in the development of resolution, financial safety net, and liquidity management frameworks, in particular, because the lack of HQLA; active international collaboration is needed to address these gaps. International guidance is required on a number of key issues as highlighted in paragraphs 31, 49, 50, 52, 55, 62, and 63.

65. To address these issues, Fund staff propose to implement a work plan involving several initiatives. Staff will propose, in 2017, that the Board formally recognize the CPIFR as the international standard for the supervision and regulation of IBs so that these standards can be formally used and assessed under the ROSC program (together with the World Bank) and in financial surveillance and TA. MCM will focus on developing further the methodology for the CPIFR, as well as stress testing tools and financial stability analysis framework for IB. A guidance note on IB will be prepared jointly by MCM, LEG, and MCD. Taken together, this work is expected to require two staff full-time equivalents (FTE), which will be made available from internal resources that have already been allocated to IB work; specifically, one FTE from MCM, and another jointly from MCM, LEG, and MCD. MCD and other area departments will continue to provide policy advice to relevant countries on IB issues in the context of Article IV surveillance and program design, and MCM and LEG will provide capacity development services and engage with relevant standard setters in their respective mandates.

66. Given the above:

- (a) Do Directors agree with staff's proposed approach in providing policy advice on IB-related issues as described above, and on areas where further work is needed?
- (b) Do Directors agree that the Fund should provide such advice in the context of surveillance, program design, and capacity development activities?
- (c) Do Directors agree that Fund staff continue to support work streams of the relevant international standard setters and other international bodies to help address current gaps in the international regulatory agenda for IBs?
- (d) Do Directors agree that staff should propose formal recognition of the CPIFR, to be included in a forthcoming paper to the Board in FY 2018?
- (e) Do Directors agree with the estimated resource implications for IB-related Fund work?

Appendix I. Islamic Banking: Financing and Mobilizing Funds

Islamic Financial Instruments

1. Islamic financial instruments fall into three broad categories: profit-and-loss sharing, debt, and quasi-debt instruments. While each category covers a wide variety of instruments, this appendix gives a brief description of the main contracts that are most frequently used by IBs.

Profit-and-loss Sharing Instruments

2. *Musharakah* (equity financing) contract is an agreement whereby the IB and a customer contribute capital to an enterprise, whether existing or new, or to the ownership of real estate or a moveable asset, either on a permanent basis or on a diminishing basis where the customer progressively buys out the share of the IB (“diminishing *Musharakah*”). Profits generated by the enterprise or the asset/real estate are shared in accordance with the terms of the *Musharakah* agreement, while losses are shared in proportion to the respective contribution to capital.

3. A *Mudarabah* (participation or trust financing) is a contract that refers to an agreement whereby the bank contributes capital to an enterprise or activity which is to be managed by the customer. Profits generated by that activity are shared in accordance with the terms of the *Mudarabah* agreement, while losses are to be borne solely by the bank unless they are due to the customer misconduct, negligence, or breach of the contract terms. *Mudarabah* could be restricted to a specific transaction, or unrestricted.

Debt Instruments

4. *Murabahah* (cost-plus financing) contract refers to an agreement whereby the Islamic bank sells to a customer, at acquisition cost plus an agreed profit margin, a specified asset that is already in its possession (such as a manufactured good). Following delivery of the asset, a credit risk in respect of the amount receivable from the customer arises. The main features of this contract are: (a) the cost and the mark-up must be both known to the bank and the client; (b) the bank must assume the ownership of the goods prior to reselling them to the client (bearing all the ownership risks in the interim); (c) the client’s promise to buy the goods purchased on his order by the bank may or may not be binding (in most jurisdictions it is binding); (d) no interest is levied for late payments but the bank could require a collateral; and (e) the *Murabahah* contract cannot be sold except at par.

5. *Salam* (purchase with deferred delivery) is a purchase contract with deferred delivery of goods (opposite to *Murabahah*) and is mostly used in agriculture finance. The contract is used to purchase, at a predetermined price, a specified kind of commodity which is to be delivered on a specified future date in a specified quantity and quality (such as an agricultural or a manufactured product). As the buyer, the bank makes full payment of the purchase price upon execution of the *Salam* contract. To mitigate price risk (as a debt contract it cannot be sold to a third-party except at par), the bank enters, in certain cases, into a “Parallel *Salam*” to sell a commodity with the same

specification as the purchased commodity under a Salam contract to a party other than the original seller.

6. **Qard Hasan** is an interest-free loan contract.

Quasi-debt Instruments

7. **Ijarah (lease)** contract refers to an agreement whereby the bank leases to a customer an asset (such as a ship, aircraft, or telecom equipment) for an agreed period against specified installments of lease rental. The contract commences with an agreement to lease that is binding on the part of the potential lessee and requires the bank to purchase or lease an asset prior to entering into the contract. An *Ijarah* contract could offer the lessee the option to purchase the asset either at the end of the lease period by means of a gift or a token consideration, or by installments of a specified amount. During the lease period, the bank, as the owner of the asset bears all the risks associated with ownership. The *Ijarah* contract can be sold at a negotiated market price, effectively resulting in the sale of the leased asset.

Mobilizing Funds by Islamic Banks

8. **Current accounts** are similar to non-interest paying call or demand deposits. They are set up on the basis of: (a) interest free loan (*Qard Hasan*) contract between the depositor (lender) and the bank (borrower); or (b) A *Wadiah* (safe keeping) contract between the depositor and the bank (custodian), with explicit permission given to the bank to utilize the funds. The bank guarantees these deposits and in return depositors are not entitled to any share in the bank's profits. If the bank utilizes the deposits, it will be at its own risk; all profits and losses will be borne by the bank.

9. **Savings and time accounts** are similar to current accounts in the right of customers to withdraw their deposits on demand. However, to encourage depositors to commit their deposits for longer periods (e.g., three months), the bank may, at its sole discretion, reward depositors by sharing part of its profits with them from time to time, the depositors can share in the bank's profits on the basis of a minimum balance that is maintained within a specified period of time. More recently, a number of IBs started offering these accounts based on commodity *Murabahah* contracts.

10. **Profit Sharing Investment Account (PSIA)** is a contract by which an investor/depositor opens an investment fund with an Islamic bank on the basis of *Murabahah*. 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 IB are shared with the PSIA holder in accordance with the terms of the *Murabahah* agreement while losses are borne solely by the PSIA holder, unless they are due to IB's misconduct, negligence, or breach of the contract terms. Often, the bank capital is invested in the same income-producing assets or economic activities and accordingly bear a share in the outcome.

Stylized Balance Sheet of Islamic and Conventional Banks	
Balance Sheet of an Islamic Bank	Balance Sheet of a Conventional Bank
Assets	Assets
Cash and cash equivalents Investment in securities sales receivables Investments in leased assets Investments in real estate Financing assets (e.g., <i>Murabahah</i>) Equity/profit-sharing financing Investment in subsidiaries fixed assets Other assets	Cash and cash equivalents Investment in securities Loans and advances Investment in Subsidiaries Fixed assets Other assets
Liabilities	Liabilities
Current accounts Saving and time deposits Other liabilities	Current accounts Saving and time deposits Other liabilities
Equity of PSIA	
PSIA (unrestricted) Profit equalization reserve Investment risk reserve	
Owner's Equity	Owner's Equity
PSIA (restricted) Off-balance sheet Letters of credit, guarantees	Off-balance sheet Letters of credit, guarantees, derivatives
Source: IMF Staff.	

Appendix II. Key Unique Risks Exposed to Islamic Banks

Credit Risk

1. IBs are exposed to credit risk when using debt-type contracts for financing. In *Murabahah* transactions (the most common debt contract used in IB), 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.¹ 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.”² Operational risks are likely to be

¹ Grenning and Iqbal (2008), pp. 120–127.

² Basel Committee: “Principles for the Sound Management of Operational Risk,” BIS, June 2011.

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 adequately adapted to the IB model.³ 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.⁴

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,⁵ 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, rapidly increasing their leverage and 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.⁶

³ See also Grenning and Iqbal (2008), pp. 174–176.

⁴ IFSB: “Guiding Principles of Risk Management for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services,” December 2005.

⁵ See “The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study,” Hasan, Maher and Dridi, Jemma, IMF Working Paper No. 10/201, 2010.

⁶ The central banks of Indonesia, Iran, Kuwait, Luxemburg, Malaysia, Mauritius, Nigeria, Qatar, Saudi Arabia, Sudan, Turkey, the U.A.E., and the IsDB established in October 2010 the Kuala Lumpur-based International Islamic Liquidity Management Corporation (IILM), to create and issue short-term *Shari’ah*-compliant financial instruments to facilitate effective cross-border Islamic liquidity management.

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 III. International Monetary Fund's Involvement in Islamic Banking and Finance

1. Fund engagement in IB issues dates back 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 IB. The Fund started providing TA on IB in the second half of 1990s mostly in countries with relatively established IB practices (e.g., Sudan, Iran, Pakistan, 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 around 2005/06 after the IFSB began to issue its standards.

2. Fund staff involvement on IB issues is rising. Fund staff have been increasingly encountering IB related issues in surveillance work (FSAPs and Article IV missions) and in Use of Fund Resources (UFR) cases (e.g., Afghanistan, Pakistan, and Yemen). In addition, the number of IB-related TA requests has risen considerably in recent years, particularly, from new IB jurisdictions (e.g., Djibouti, Mauritania, Kenya, and Tanzania, etc.), on topics, such as regulation, supervision, and development of *Sukuk* markets. 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.). The Fund did not provide any significant TA on legal and regulatory aspects IBs until around 2005/06 after the IFSB began to issue its standards.

3. The Fund has been collaborating closely with other international organizations and standard setters on IB issues. The Fund has carried out over the years, joint activities (TA, conferences, working groups, etc.) with organizations like the WB, the Arab Monetary Fund, the and the IsDB,¹ as well as the standard setters for industry (IFSB and AAOIFI). Fund staff are undertaking training and outreach work as part of the IMF RTACs and contributing to G20 and other international conferences on IB matters. Finally, Fund staff continue to be called on to contribute to various international initiatives on IB-related issues (e.g., contributing to the working group developing Core Principles for Islamic finance regulation 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 IV. World Bank Group Involvement in Islamic Banking and Finance

- 1. The WB has accelerated in recent years its involvement in IF issues.** In 2009, the WB established the Islamic Economics and Finance Working Group (part of the Financial Systems Practice), bringing together expertise in this area from across the WB.¹ The Group has focused on: (a) strengthening the legal, regulatory, and institutional foundations for the sustainable development of the IF industry; and (b) knowledge sharing and capacity building. The WB also established in October 2013, the Global IF Development Center in Istanbul with the aim to contribute to the development of IF globally, through research, training and advisory services.
- 2. The WB has established working partnerships with the IFSB and AAOIFI.** The WB has been working closely with the IFSB and AAOIFI in the design of a wide range of standards (e.g., Principles of Insolvency and Creditor Rights) and is currently engaged in efforts to expand the implementation of these standards in individual jurisdictions. Work is also underway with AAOIFI to develop accounting standards that are fully compliant with international accounting standards while taking into consideration the special features of IFI.
- 3. The WB is in the process of finalizing the Supplemental Corporate Governance Guidelines for IFI.** These provide guidance on how to improve the governance of these institutions and are expected to provide the basis for the WB's FSAP assessment of corporate governance in member countries.
- 4. The WB's International Finance Corporation's (IFC) involvement in IF issues have been rising in recent years.** The IFC has formed an interdepartmental task force in 2008 to share knowledge and develop a more systematic approach to IF activities. Furthermore, the IFC has been engaged in a number of joint ventures and funding activities using IF instruments.

¹ Initial work has also commenced within the Global Capital Markets Practice, which covers securities markets and nonbank financial institutions, on *Sukuk* and *Takaful* (insurance) issues, but presently have limited capacity.