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Financial sector assessment program for Islamic financial system (iFSAP)

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Abstract - The FSAP, initiated by the IMF and the World Bank, has been implemented internationally including the IDB and IFSB member countries. The initiative is beneficial to further improve the quality of the financial industry as well as to contribute to global financial stability. The rapid growth of Islamic finance internationally poses new challenges to the supervisory authority particularly with the growing significance of the newly developed industry. Operationally, the development of the Islamic financial industry should fulfill certain criteria in promoting operational soundness and efficiency. The initiative on iFSAP is deemed very crucial for providing appropriate understanding on how the Islamic financial system can deliver benefits and how it is compatible with the international financial stability initiatives. The implementation of iFSAP in further instances may provide a developmental view to the financial authorities in particular countries operating by the Islamic financial system. To address this issue, the IRTI-IDB has been trying to formalize the contents of the iFSAP that are beneficial to complement the FSAP initiative so that the assessors of the FSAP would have a standard set of guidelines to carry out the initiative. This paper provides the methodology and the areas of the assessment in the iFSAP.

Keywords: Financial assessment, regulation and stability

JEL: G15, G18, G28 and H12

1. Introduction

The Islamic financial industry has developed rapidly in the last two decades. This has been taking place not only in the Muslim predominated countries, but also in the non-predominated Muslim countries (Mersch, 2010). The presence of the Islamic financial industry can be seen in African countries, Middle Eastern countries, South Asian, Southeast Asian countries, and some European countries. The Islamic financial industry has become more significant than its predecessors and starts to play a significant role in economic development. The development has been taking place in terms of business volume, the variety of products offered, institutional development, and a regulatory framework. In most instances, Islamic financial institutions have started to complement the conventional products, i.e. banking products, capital markets, insurance (takaful), pawnshop, microfinance, and areas of the Islamic social sector (zakat, infaq, sadaqah and waqaf). The Islamic banking industry has even been offering technology intensive products to entertain the customers with the equally friendly and sophisticated products resembling those offered by its conventional counterpart. Despite a relatively smaller market share, in some countries, the Islamic financial industry provokes a relatively higher rate of growth, showing a potential of the industry to further develop in years to come. Some countries have put the development of the newly established industry within its national agenda, which could potentially complement the existing financial system, including the issuance of dedicated acts for Islamic banking, takaful and capital markets. Besides accommodating the demand of the local markets, some countries also look forward to benefiting from the growth of the industry internationally.

Besides offering benefits, the development of Islamic financial systems poses more challenges to the financial authority that is in the position to maintain stability in the financial system including the Islamic financial system stability. Islamic financial industry as a part of the global financial system requires a standardized and internationally recognized set of regulations. Many countries have tried to develop their own regulatory framework applied to the Islamic banking operation along side the conventional counterpart. The development may vary from one country to others since they have to accommodate its operational characteristics resulting from

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different interpretations of Shariah issues. One country may have a set of permissible products, which may not be acceptable to other countries. The operational differences will then lead to different permissible Shariah financial products (Jobst, 2007).[1] That has been the main reason for having a number of international initiatives seeking for a higher level of compatibility of the Islamic financial operation and eventually the international regulatory framework. An international initiative has established a number of international institutions to help the industry achieve a higher level of regulatory convergence. There are AAOIFI, IFSB, IIFM and IILM, all dealing with accounting standard, prudential regulations, financial product development and liquidity market development, respectively. Internationally, the development of the regulatory framework should also be convergent with the international initiatives aimed at achieving a required level of financial soundness like the Financial Sector Assessment Program (FSAP).

The paper proceeds as follows. Section 2 reviews the existing FSAP initiative by the IMF and the World Bank. Section 3 reviews the relevance of the FSAP to the Islamic finance and the initiatives for the Islamic financial industry. Section 4 discusses the areas of the assessments. Section 5 discusses the implementation of iFSAP. Section 6 concludes the paper.

2. A brief about the FSAP

The FSAP initiative is a joint program developed by the IMF and the World Bank to help strengthen the financial system. The pilot program was launched in 1999 and has gone through reviews and updates until the formal document was launched in 2005. The objective of the FSAP program is to achieve an integrated analysis of stability and development issues in the financial system at the country level that will contribute to global financial stability by using a variety of assessment tools and methodologies.[2] The implementation of FSAP offers benefits in some areas (World Bank and IMF, 2005). First, it allows the government to analyze issues relating to the stability and development of the financial system by using a standardized method of assessment. Second, as the result of assessment process, the government can identify the points of vulnerability of the financial system. Third, the government can also detect the weakness of the financial system. Lastly, based on the identification and analysis conducted, the result of the assessment process serves as the basis for policy formulation aiming at strengthening the infrastructure needed for improving the financial stability in the long run including its capability to withstand any adverse effect resulting from external shocks that could possibly happen in the future. The FSAP states that a sound and well functioning financial system is supported by three pillars to sustain orderly financial development and stability, which relate to the macroeconomic factors, regulatory and supervisory frameworks, and the infrastructures.

Pilar I : Macroprudential Surveillance and Financial Stability
Pillar II : Regulatory and Supervisory Framework of the Financial System
Pilar III : Financial System Infrastructure

The three assessment pillars are consolidated into the final assessment reflecting the overall stability of the financial system, and current financial structure and stage of development.

Based on the assessment process, the document will also offer the recommendation and follow-up actions (see **Exhibit 1**). As illustrated in the **Exhibit 2**, the FSAP is conducted by the IMF and the bank to compliment the reports put forward for the board presentation under the ROSCs binder. As the follow-up, the assessment committee will suggest programs, which generally cover continuous country dialogue, technical assistance and lending operations, as well as capacity building and policy reforms. The technical assistance program would accommodate country specifics that are unique. With the growing significance, the assessment of the soundness of the Islamic financial system becomes more important than the previous since the new system provides benefits to sustain the economic

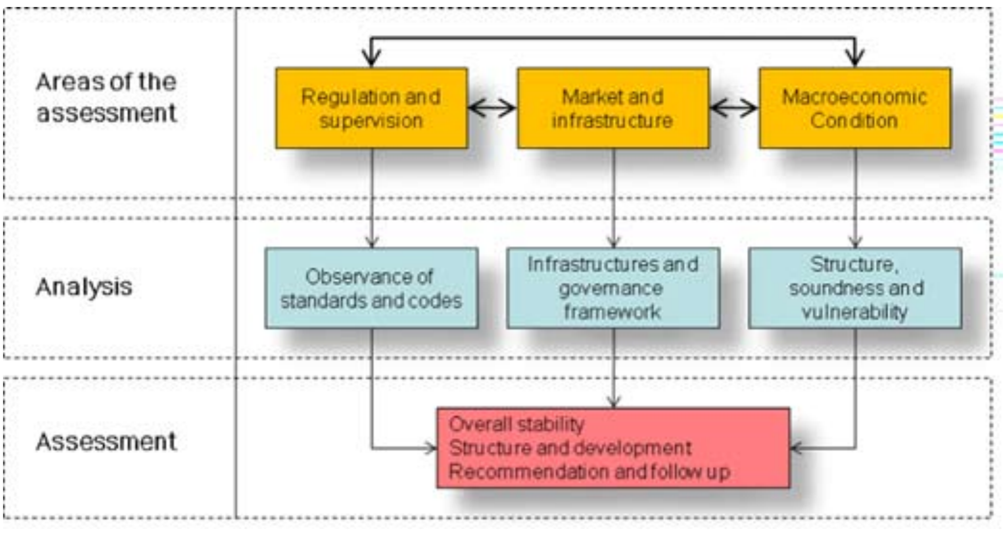
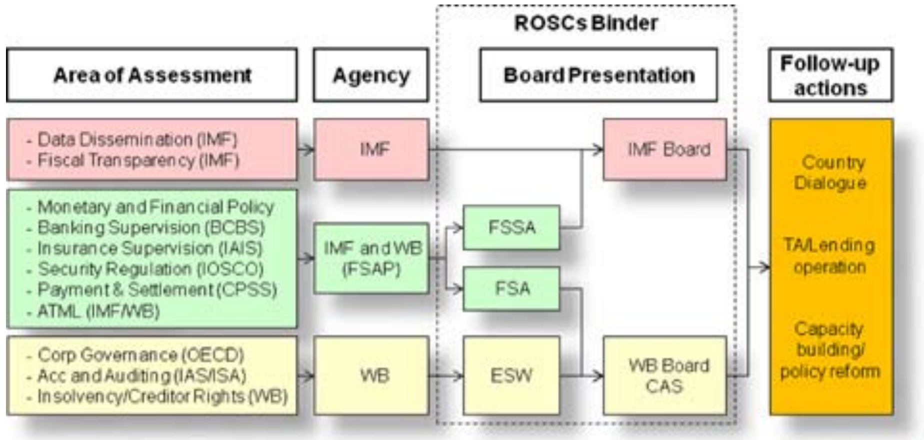


Exhibit 1. The assessment framework.



Notes: ROSCs: Reports on the Observance of Standards and Code
FSSA: Financial Sector Stability Assessment
FSA: Financial Sector Assessment
ESW: Economic and Sector Work
CAS: Country Assistance Strategy

Exhibit 2. FSAP and ROSCs.

development and potential risk in the case of operational failures. The inclusion of the assessment of the Islamic financial system within the 3 pillars of the assessments could help the financial authority assure that the Islamic financial system fulfills the essential requirements to contribute to financial stability in general. Those requirements for the Islamic financial system are supposed to be compatible with the existing financial assessment framework in order to arrive at an accurate consolidated picture.

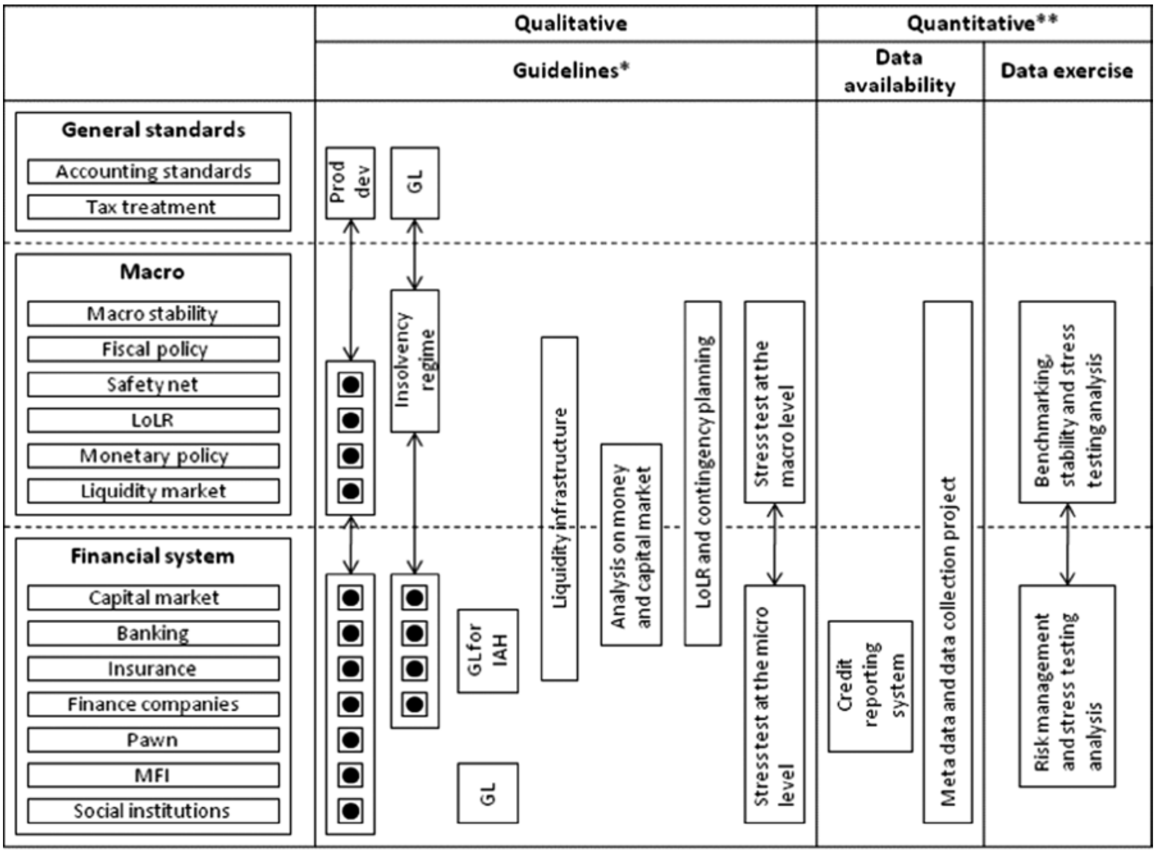
This assessment process can also be considered as the step to integrate the Islamic financial system into the global financial system by assuring the compliance with international prudential measures and the Shariah principles at the same time.

3. The iFSAP studies

The prudential regulatory framework has been one of the central themes after the recent financial crises. Most of the countries have participated in the Bank-Fund Financial Sector Assessment Program (FSAP) in order to create a comprehensive assessment process considerate of financial stability and development needs of the within financial systems around the world. The governments allowing the Islamic financial institutions to operate need to assure this new system operates within the prudential corridor. Senior representatives from the IFSB, IMF and IIFM have taken an initial step to discuss the assessment methodology and to see the possible level of formality of the assessment process in country-level agenda.[3] The initial discussion is followed-up by the IRTI-IDB study to review the methodology and procedures used in the Bank-Fund FSAP in order to identify the areas where additional guidance and benchmarking would be helpful to FSAP assessors in order to assess the development and stability of the Islamic Financial Services Industry (IFSI).[4]

The last studies regarding the possible implementation of iFSAP has provided a birds-eye view of gaps occuring between the existing FSAP assessment methodology and the existing measures in the Islamic financial industry (see **Exhibit 3**). There are three main areas discussed in the studies comprising general standards applied, macroeconomic and microeconomic analysis. The first issue discusses the standards applicable to accounting systems, financial reporting and tax treatments so that the industry can achieve its optimal operational efficiency, and, eventually, a level playing field. The accounting standard applied to Islamic finance should show itself to be reliable and to promote transparency and good governance besides being capable of accommodating its operational peculiarities. There is a need to translate those characteristics into clear financial profiles properly so that the financial authority can provide appropriate treatments. One of the important examples is the relationship between financial properties and solvency regimes that relate the Shariah properties into financial claims that link public funds to the bank capital and financial safety net programs. The studies found the need to have adequate guidelines set in place around tax treatment and accounting standards. This would foster product innovation beneficial to all financial players, such as banking, capital market or even the government and central banks, when it comes to sukuk issuance.

At the micro level, an international initiative, led by IFSB, has been trying to fill the gaps in the field of prudential standards, in terms of promoting modifications on capital adequacy standards applicable to Islamic banks, risk management, good governance, codes of business conducts, etc. However, the implementation is not on a compulsory basis. It allows some modifications based on national discretion around what was considered to best fit its condition. Despite its efforts to keep on achieving its target to better equip the market, much still remains to be done. The standards issued require more technical notes so that they can achieve their practical benefit. The technical notes should serve to explain how the prudential measures describe financial conditions precisely in terms of liquidity figures and potential risk faced by the financial institutions.



* Assessment based on compliance

** Assessment based on the reliability of data and analysis

Exhibit 3. Gaps identified in the FSAP initiatives for Islamic finance.

Since the Islamic financial institutions face different frontiers of transactional modes, there is a need to develop suitable methodologies applicable for risk identification, measurement, mitigation techniques, and monitoring. At the macro level, the challenges are largely based on the capability to interpret the financial figures resultant from the risk assessment process and to consolidate the financial figures of the Islamic financial sector into that which would be interpretable by the mainstream. The analysis would cover the areas of liquidity markets, lender of the last resort facility, stress-testing analysis and financial robustness against any possible shocks.

Having the initial iFSAP study in hand, the phase II study explores 2 major areas: potential absorbance of international best practices set in the regulatory standards and the prudential measures allowing the supervisors to always maintain financial soundness (see **Exhibit 4**). In the area of regulatory standards, the study focuses on the compilation process of the main documents according to the international regulatory standards issued by the conventional bodies and the international standards set for Islamic finance. This compilation process is aimed at identifying the existing gaps that should be filled by the Islamic regulatory setting bodies so that it could offer reference points when any financial supervisor refers to it. The regulatory framework covers the banking industry, capital market, insurance, social sector, accounting standards and other aspects relating to infrastructural development.

The compilation of prudential measures involves the analysis of the financial indicators at the micro level as well as at the macro level. The financial indicators at the micro level concern the operational sustainability of the financial institutions. The indicators at the macro level concern the financial stability and systemic costs, particularly when encountering an adverse condition. In addition to the stability issues that are the main focus of the FSAP, the study also presents developmental issues, since most of the Islamic financial system is still in the developing stage. In this follow-up stage, the initiative also elaborates on the assessment methodology that combines the issues of the absorbance of the regulatory framework and the issues of financial stability, which involve the quantitative aspects.

The study serves as a continuation of the previous one, seeking possible steps to fill up the gaps. The steps will cover the followings:

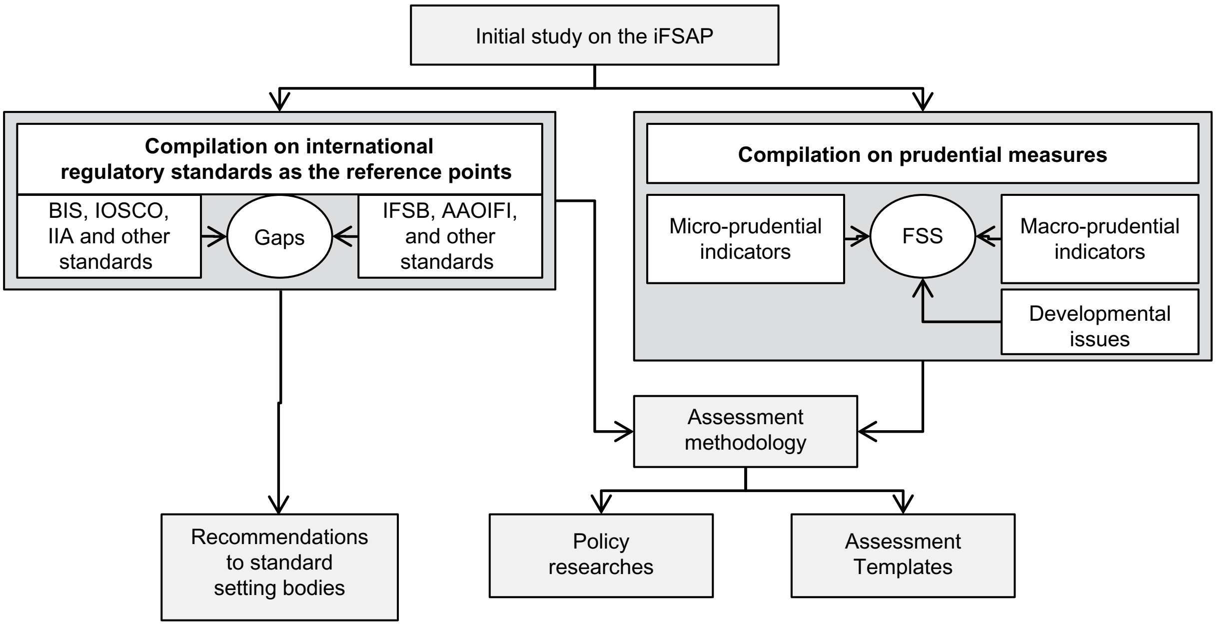


Exhibit 4. Flow of the analysis.

1. The compilation of the international regulatory standards as the reference points for regulatory absorbance – this includes conventional and Islamic regulatory standards
2. Identification of possible indicators applicable for Islamic finance prudential measures, at both micro and macro levels

The study aims at providing a comprehensive picture of Islamic finance architecture, adding value on several fronts as follows:

1. It provides a bird-eye view of the Islamic financial system within the global financial market – this describes the potential differences as well as the common ground between the regulatory framework of the two systems
2. It provides a converged view on how Islamic finance could contribute to financial robustness on whole, particularly when it comes to the assessment process
3. It provides some analytical grounds for the governments that wish to develop Islamic finance within their jurisdictions, while maintaining their financial soundness and operational efficiency

4. The areas of the assessment

Financial stability assessment

Financial stability assessment involves the analysis on macroeconomic and financial market development, macro prudential framework, macro financial linkage and key policy issues supporting financial stability. The involvement of the Islamic financial system in macroeconomic analysis depends upon the level of significance of the Islamic finance in one particular country. Other issues specific to the country may also be folded into the analysis to arrive at wider perspectives and understanding of various stages and dynamics of national development.

Macroeconomic and financial development

A dedicated analysis of the vulnerability of the Islamic financial system would be important to complement the overall analysis, assuming that the Islamic financial system would manifest different dynamics in particular response to the financial disturbance at hand. A dedicated reporting system compiling Islamic financial data and information would be important for the analysis since it enables the authority to look into the Islamic financial system independently before it is integrated into the national financial analysis. The dedicated reporting system is expected to have the same level of operational reliability in terms of data accuracy and time lag.

Macro-prudential surveillance framework

Financial stability indicators

The IFSB has initiated the establishment of internationally compatible Islamic financial indicators (IFSB, 2007)[5]. The financial data and information complements the IMF Financial Stability Indicators (FSI) (IMF, 2006) arriving at better understanding of the dynamics of the Islamic financial system. The financial authority identified the Islamic financial data, which was compiled from the market through a dedicated reporting system. The prudential data set represents the potential financial disturbance directly caused by the lack of operational soundness, as produced by the financial institutions. Some of the data set is totally the same as its conventional counterpart, whilst some of those represent necessary adjustments, like capital adequacy standard and prudential reserves allocated to the profit sharing investment account holders. Like the IMF-FSI data set, the IFSB financial data set focused more attention on the three major financial industries: Islamic banking, takaful industry and Islamic capital market (particularly sukuk). The analysis should also include the role of sukuk in supporting debt sustainability of the government as another pillar providing financial resources for development. The Islamic financial industry should be able to set a proper methodology for stress testing representing the level of the system robustness to withstand any possible and unexpected financial shock in the future. The result of the stress testing should also be compatible and complimentary to the stress testing process of the financial system as a whole. Complementing the existing dominating institutions, there is also one segment of the Islamic financial industry that is supposed to play a significant role in the development of the Islamic financial industry, i.e. the Zakat-Infaq-Sadaqah and Waqaf (ZISW) systems. As mentioned earlier, the ZISW system could enhance the outreach of the system by providing low-cost funds and infrastructure so that the system can serve the low-income society more effectively. An efficient informational system allowing cross-sector information exchange could even leverage the benefit of the ZISW funds when the facilities are combined with other facilities provided by other Islamic financial sectors.

5. System-focused stress testing

The implementation of stress testing may adopt two different approaches: top-down and bottom-up. The stress test at the aggregate level may also involve variety techniques and toolboxes (Blaschke et al., 2001). Top-down approach estimates the effect by using aggregate data, whilst bottom-up approach estimates the effect by using individual institutions' portfolios. Having proposed by its member countries, the IFSB has also come up with a set of principles outlining the essential components in conducting stress testing at both the institution level and systemic level. This helps the supervisory authority assure the Islamic financial industry operates within the acceptable prudential corridor, which involves variables having different intensity from those of the conventional. Bottom-up stress testing would allow financial authority to capture specificities in Islamic finance.

6. Analysis of macro-financial linkages

Effect of FS on macroeconomic development

An analysis on specific sector where Islamic banking starts to show its significance may be done to see the potential effect of the Islamic banking problems on those particular economic sectors. A second linkage can be found in trade finance, which showed a dramatic fall during the period of financial crisis, which eventually affected the pace of economic development. The magnitude of the impact linked to the lack of insurance when it was needed, to herd behavior (among banks, official export credit agencies, and private insurers), and to weaknesses in domestic banking systems. This encourages the analysis of takaful industry when its presence becomes financially significant. Another linkage comes from the function of banking institutions as monetary transmission channels by the central bank. If there is any significant problem occurs in the banking industry, it could disrupt its capacity of the central bank to perform its function effectively. The analysis would have to take account of financial structure, including the relative importance of market and bank financing, the role of foreign banks in financial intermediation, and the central bank operating procedures. As a part of the banking industry, Islamic banking may also be used as a channel of monetary transmission. The analysis involves the innovation of Islamic monetary instruments and its effectiveness in supporting efficient monetary policy.

7. Effect of FS on debt sustainability

Debt servicing problem in Islamic finance might take a different shape since there exist share-based instruments besides fixed-income instruments. If the share-based instruments are more dominant, debt-servicing problems will be less intensive. However, the choice is up to the market players depending upon the level of transparency and market discipline in the market. Debt servicing problems in the government are caused by deterioration of the government's balance sheet and unsustainable debt ratio, which could create a severe impact on the whole financial system since government securities play a key role as risk-free assets, as stores of collateral and as liquid assets.

Macroeconomic variables such as interest rate and exchange rate may also be significant factors causing problems in debt sustainability. Therefore, the government and the monetary authorities should make concerted and credible efforts to assure these since debt sustainability and macroeconomic sustainability are mutually reinforcing. The assessment of debt sustainability and monitoring the two-way linkages between financial system soundness and financial soundness of nonfinancial sectors are keys to fostering financial stability. In a separate analysis, debt sustainability is analyzed on the sukuk market for countries that have used sukuk as one of the fiscal instruments globally as well as domestically. Assuming that the level of demand could be different, the government should have sufficient knowledge about the market to come up with the planning for an efficient composition of issuance government sukuk and bonds.

8. Effect of FS on growth and financial development

Financial soundness gives positive effect to the economic growth. The soundness of financial systems involves stability and the development of the market to facilitate the real economic activities. To that extent, Islamic finance assures that all the financial transactions have direct links to the economy. In many countries, the development involves the size of the banking system and the liquidity of stock markets, which each positively linked with economic growth which lower external financing constraints impeding corporate and industrial expansion. The last financial crises proves that although financial development can foster general development, the financial authorities should assure the prudential part of this development since fast growth of the financial market can make it vulnerable to shocks and putting constraints on the economic output. Specifically, the financial regulatory authorities need to distinguish to what extent a rapid financial sector growth reflects improvements in access to finance and to what extent the growth reflects a loosening in risk management practices and supervision. Islamic finance may have a greater chance to reduce the market volatility since it does not involve the speculative transactions that do not have direct link to the economy.

9. Other topics relevant to the financial stability analysis

International financial centers (IFC) and offshore financial centers (OFC).

Islamic banking and finance may also be a part of financial services offered in the IFC and OFC. The objective of offering Islamic finance is similar to the conventional, i.e. providing more flexibility to the global players. The presence of the IFC and OFC may offer economic benefits, but it may be an additional source of instability for the host economy. The hosting countries should have a financial surveillance that is capable of conducting analysis covering the complex structure of the key financial institutions operating in an IFC and the operations in which those institutions are engaged so people can understand the sources of the risks and the transfers of risks within and from the IFC.

10. Capital account liberalization

The choice of capital control regime has a significant effect on the way that external shocks are transmitted to the domestic financial system (including the Islamic financial industry) and to the macro-economy. Some evidences show how capital account liberalization can provide the economy with natural adjustment and minimize the potential of having speculative attacks. However, the liberalization process requires a thorough consideration and process on the capital account on domestic financial stability.

11. Key policy issues and policy priorities to support financial stability

The policy actions cover four key areas: macroeconomic, institutional, regulatory or supervisory, and structural. The financial authorities of related jurisdictions are in a position to formulize policy tools with appropriate mix and timing to address the vulnerability, which combines the analysis of risks and vulnerabilities with the assessment of various financial policy responses and policy frameworks. Priorities in financial policy development need to be put to the Islamic financial industry. The rapid growth of Islamic financial institutions in several countries needs to be facilitated by proper regulatory and supervisory frameworks. The new financial industry also needs to be supported by infrastructure, including efficient settlement systems and safety nets.

12. Financial structure and development assessment

The Islamic financial system is also expected to deliver efficient financial services to all market segments and sectors of the economy. Technically, the scale and the scope of activities affect the level of operational efficiency. Since the Islamic financial industry is relatively new, different paces of development may occur in different subsectors. In most cases, Islamic banking is usually the most developed followed by the Islamic capital market, takaful industry and other subsectors.

13. Quantitative benchmarking

Quantitative benchmarking for the Islamic financial industry may use the structure of IFSB prudential data for financial data comparison. Some of them already use the GDP for unit of comparison. Quantitative benchmarking normally takes three main areas for comparison, i.e. business volume as the measure of efficiency as a function of economic of scale, operational sustainability and efficiency in terms of profitability, and net-worth level (solvability) in terms of capital. This quantitative benchmarking analysis may also be used to measure of the level of significance of the Islamic banking operations in one particular financial jurisdiction.

14. Review of legal, informational, and transactional technology infrastructures for assessment and development

The Islamic financial industry needs to translate its internationally accepted standards within its operations so that the integration into the global financial markets contribute to global financial stability. Islamic finance embraces sharing in some of the financial transactions that may be considered less appropriate in the conventional system. The supervisory authority needs to define those transactions in the operating regulations at micro and macro level effectively. This adoption would bring legal consequences to other legal aspects like bankruptcy law. The recognition of Islamic financial operations needs to take place in some relevant legal structures like company law, trade law besides directly related laws like banking act, capital market acts and insurance acts.

The existence of informational infrastructures is aimed at reducing asymmetric information between borrowers and lenders. The information required covers transparency in borrowers' financial statements and enables lenders to assess borrowers' creditworthiness on present and past financial and operational performance, and readily available credit information on borrowers enables lenders to assess borrowers' creditworthiness according to their past performance within the financial system.

The effectiveness of financial reporting should also be supported by sufficient accounting and auditing rules and practice, as well as the legal and organizational requirements for public or private credit registries and property registries. In addition to that, the presence of rating agency may be relevant in more-advanced, middle-income countries. The Islamic financial system is even in a deeper need for this informational infrastructure to minimize potential moral hazards in the shared based financial contracts. In some countries, the Islamic financial system uses the same credit information exchange facility with some slight modifications in the financial data structure to make the transparency and market discipline work. Development assessment includes evaluating the effectiveness of the check and money transfer system in terms of time and cost, and access to the financial systems. The payment system should be flexible to facilitate the transaction within the whole financial system including the Islamic financial system. A reliable payment system is also critical to sustain the function of central bank in conducting monetary policy and performing its function as Lender of the Last Resort (LOLR) for both the conventional and the Islamic banks by using appropriate instruments.

15. Sectoral development review

Banking

The banking industry plays a significant role in economic development, particularly in most developing countries through an intermediation process. An effective banking system is normally characterized by considerable depth and breadth in terms both of customer base and of product range and and efficiency. Similarly, the development of the Islamic financial industry is normally led by a significant development of Islamic banking industry. Some financial indicators like overhead costs, income spreads, and profit margins may also indicate the level of operational efficiency.

Quantitative benchmarking

Comparison is made between Islamic banks and conventional banks, and cross-country analysis. It should be able to explain not only the level of operational efficiency but also the decomposing factors pointing out on the roots of the deficiencies in the system. One indicator must be able to be decomposed into other factors, such as profit margin is decomposed by overhead cost, loan-loss provision, reserve requirements, taxes and the profits. The level of access to banking services may be assessed by physical presence (geographical spread of branch offices and ATM) and virtual presence (level of internet access and the availability of mobile banking services to the community).

Scope of activities

An assessment of the scope of activities is aimed at assuring the synchronization between risk-taking activities and the regulatory framework applied (a level of playing field). Each country may adopt different operational segmentation of Islamic banking operation e.g. whether adopting a universal banking framework or segmenting the investment banking and commercial banking criteria. This assessment also identifies the existence of near-banking activities, which potentially magnify the financial disturbance within the system. Different financial institutions may converge to provide similar financial products as the result of stiff business competition. The assessment should also consider the competition between conventional and Islamic banking.

Competition and market segmentation

The level of competition may be indicated by the number of the players operating within the market. However, relating to the analysis of scope of activities, the level of competition may also come not only from the banking institutions but also from other financial companies offering almost the same financial products like insurance companies or other institutions that used to be the outsiders before the financial innovation become advanced. The level of competition, in turn, would determine the behavior of the banking institution particularly in composing its investment portfolio. High competition would lead the players to become more aggressive in approaching the market.

Taxation issue

The taxation issue covers direct and indirect taxation impacts on the operational efficiency. The direct taxation issue is relating to the deduction of taxable income by the provision of earning asset losses and possible double taxation problems to the trade-based assets. This requires sufficient understanding on the Islamic financial transactions when it is implemented in the tax law. Indirect taxation issue is relating to reserve requirement determined by the central bank.

Near banking institutions

There are financial institutions operating in the society to provide alternative financing. These financial institutions can take the form of finance companies that can be seen as an annex to the commercial banking system, and some smaller scale near-banks may have sufficient development importance to call for special treatment. Some smaller near-bank institutions consist of specialized microfinance firms, cooperative credit unions, specialized mortgage banks, and government sponsored specialized development intermediaries. This calls for a special regulatory framework due to its financial characteristics particularly when the activities involve the deposit taking activities. Some of the institutions are operating for non-profit motif and some of them operate in very small business activities.

16. Takaful and collective funds

Takaful companies provide risk-reduction instruments on the liabilities side and conduct long-term funds management. Some investments of the takaful industry are placed in terms of bank deposits or in terms of unit trust; therefore, it is necessary to have a cross-sector review to assess inter-relation among the possible connected sectors. Takaful and collective investment funds operations often overlap in the area of pension fund management. Takaful companies may sell pension policy or manage pension funds and so do the fund managers. The assessment process may also cover the available range of products and its pricings, and its relation to the regulatory framework, level of competition, organizational capacity, and existing skills in the industry.

17. Securities market

The assessment of the Islamic capital market needs to look at the quantitative measures describing the depth and liquidity of the market. The depth and liquidity are fundamentally affected by the variety of Islamic financial instruments available in the market (i.e., fixed income and equity types of instruments, including any possible Shariah compatible derivative products) and transaction cost. In most countries, the domestic sukuk market is often less developed than the Islamic equity market due to some weaknesses. Active issuance of government sukuk can have a significant influence on the functioning of the sukuk market by helping provide the benchmark needed to price more risky securities and can be beneficial to the monetary policy management. An efficient capital market requires a cost-effective infrastructure including proper design of the trading platform and the regulatory burden. The ultimate goal of the capital market should be providing an optimal way of giving local firms and investor access to liquid securities markets.

18. The demand-side reviews and the effect of finance on the real sector

The demand-side review is conducted to assess the demand for, and access to, financial and credit services by listed companies, including corporate and micro entrepreneurs – ideally from different economic sectors and business lines. An analysis on the demand side may be conducted for Islamic financial system to indicate the development trend and its sustainability. The financial authority may need to assess the awareness level of the public towards the Islamic financial system.

Evaluating financial sector supervision: Banking, insurance and securities market

The soundness of the financial system depends upon the effectiveness of the financial sector supervision. The FSAP framework emphasizes legal, institutional and policy frameworks of the three sectors, i.e. banking, securities markets and insurance. Besides the implementation of the relevant regulatory framework, effective supervision requires some preconditions covering the provision and consistent enforcement of business laws, good corporate governance (including adoption of sound accounting), auditing, and transparency procedures that carry wide international acceptance and that promote market discipline, appropriate systemic liquidity arrangements, and adequate ways to minimize systemic risk. As part of the overall financial system, the analysis of the Islamic financial system has also come into view covering the same aspects of the assessment.

Legal and institutional framework for financial supervision

Financial sector supervision is one of the center points of the assessment process of financial soundness. The supervisory framework should be able to maintain systemic stability by providing a safe mechanism of exit for the Islamic financial institutions that do not meet the soundness criteria. Effective supervisory activities for Islamic financial institutions require proper legal frameworks that empower supervisors to ensure that rules and regulation are effectively implemented by the market players. The key laws governing the central bank, banking and financial institutions, capital market laws, and insurance laws are backed by adequate provisions on the efficient and reliable payment system infrastructure. Those key laws should clearly recognize Islamic financial operations. The legal and institutional framework should cover: the identity of the supervisor; the authority and the process behind the issuance of regulations and guidance (including the governance around Shariah fatwa issuance); the authority and tools to monitor and verify compliance with the regulations and principles of safe and sound operations; the authority and actions to remedy, enforce, take control, and restructure the procedures to de-license and liquidate problem institutions that cannot be restructured. It should define the roles and responsibilities of institutions involved in supervision activities. They are regulatory governance, regulatory practices, prudential, and financial integrity and safety net arrangements.

In order to maintain the soundness and robustness systematically, the Islamic financial system needs proper designed safety nets that cover efficient liquidity support, deposit insurance schemes, investor protection schemes and crisis management protocols. The Islamic financial industry faces almost the same challenges when entertaining its customers. There are risk-averse customers and risk-neutral customers. At the customer side, the implementation of deposit insurance schemes and investor protection could reduce the potential liquidity crunch resulted from deposit runs. Although, in concept, Islamic banking depositors are supposed to share the profit as well as the loss, in reality they still wish to have sufficient financial assurance. Some countries have included deposit protection schemes with both systems: the conventional and the Islamic. However, some further development should take place to improve the mechanism that confirms Shariah principles. There are two distinctive features that should appear in the Islamic deposit insurance scheme. First, the protection does not directly link to the deposit but is in place more to relieve potential loss of the Islamic banking business activities. Secondly, the investment activities by the deposit insurance corporation should be on the Shariah-compliant financial instruments in order to justify the income. The financial authorities for Islamic banking system have to prepare the required infrastructure required, particularly where the Islamic banking operations is still far below the critical mass to achieve its operational sustainability. The legal interpretation can also be an issue – to interpret the liabilities around the customers when the guarantee is given to the instrument that is supposed share contracts according to Shariah principles. This issue is addressed implicitly, in terms of capital, according to an adequacy standard by the IFSB, which introduces the alpha factor as the proxy to estimate the potential liabilities levied to the Islamic banks that eventually will apply to the deposit's insurance corporation. In some Islamic finance operating countries, the deposit insurance scheme has been a standard practice; although, some adjustments need to take place. In conventional practices, the banks pay premiums to the Deposit Insurance Company (DIC) and then the DIC invest that premium in some investment portfolios. There exist two conflicting problems when it comes to Islamic banking:

i. In order to minimize adverse selection problems, the authority sets a ceiling premium rates for the deposit (in case of a flat-rate scheme). The banks that entertain the customers with deposit rates higher than the ceiling rates will be excluded from the deposit protection scheme. On the other hand, the returns given by the Islamic banking systems are based on the actual financial performance. The higher the financial performance of an Islamic bank, the higher the return given to the investors. There is a need to set out a risk-sensitive premium rate applied for the Islamic banking so that the system can still minimize the potential adverse selection problem and at the same time provides incentives to the bank to perform well.
ii. The deposit insurance scheme needs to separate the Islamic assets from the conventional. It will allow the DIC to invest the premium taken from the Islamic banking to the Islamic compatible instruments.

On resolution process, the Islamic banking should also be equipped with adequate procedures to deal with problem banks and sound exit mechanism that is capable of minimizing contagion effect to other Islamic banks.

Liquidity has become very important to improve its operational efficiency and the confidence of the customers as the ultimate points of the financial services. To anticipate the unexpected but plausible event, the Islamic financial system should also be equipped with proper set of crisis management protocols outlining the mandates of the related financial authorities to formulize inter sector emergency financial policy in an extreme financial condition. The policy actions could be set out of the existing regulations. However, the protocol should define the criteria, fulfilling the extreme financial conditions agreed by other related institutions, including even the parliament.

Aspects of financial safety nets

Financial safety net arrangement is aimed at preventing potential failure of individual financial institutions, which would lead to systemic financial disruption and broader economic problems. The arrangement covers 3 important areas: a framework for liquidity support, deposit insurance plus investor and policyholder protection schemes, and crisis management policies.

Frameworks for liquidity support

Liquidity is one of key elements to support the operational sustainability of the financial system. Normally, the central bank provides emergency liquidity facility in terms of lender-of-the-last-resort (LOLR), applicable for conventional and Islamic banks as the systemic financial buffer against temporary disturbance in the financial market.

Deposit insurance

Deposit insurance schemes can serve as the last line of defense for customers in the financial market. In an adverse condition, the customers of the banks assume the first come first serve basis providing a better chance for the customers who withdraw their money earlier. Normally, a deposit protection scheme does not cover the whole value of the public funds deposited in the banking system. The Basel Committee and International Association of Deposit Insurers (2009) have released a set of core principles for effective deposit insurance systems. The concept of deposit insurance has to also cover Islamic banking since it is also vulnerable to experience deposit runs because of idiosyncratic disturbance. Practically, an effective deposit insurance scheme for Islamic finance needs to be supported by clearly defined concept of solvency regime.

Investor and policy holder protection scheme

The investor and policy holder protection scheme becomes more important in Islamic finance with the presence of share based instruments. Most of the protection schemes are designed to provide compensation due to fraudulent practices or other malfeasance in absolute terms, as a proportional of the loss incurred. In most cases, investor protection schemes have become as statutory and set as separate companies administered by the regulator of the market. The scheme should promote good governance practice and minimize the potential of having moral hazard problems. Ultimately, this protection scheme helps to level the playing field across different sectors. In order to address this issue, the IOSCO (2003) has issued objectives and principles of securities regulation that put this protection scheme in context.

Crisis management

Financial policies should be set based on two possible conditions: normal business and periods of crisis. The financial crisis may be caused by natural disaster or other idiosyncratic failures that can adversely affect the financial system. Islamic financial institutions are not immune and could adversely be affected by the crisis. The CMP covers the steps to identify potential threats to the financial stability which are sourced from problems in the general banking industry, currency vulnerability, interest rate and other possible indicators leading to the financial crisis. The CMP should be equipped with threshold function in defining the financial crisis since each country would have its own structure and characteristics that determine the level of financial resilience when facing a significant turmoil. In general, the establishment of CMP is aimed at two objectives. First, the CMP serves as the anticipatory action to maintain the operational soundness of the financial system even if it operates under significant financial pressure so that the intermediary function can always be performed. Second, the CPM should promote possible prompt corrective actions to stabilize the system whenever necessary. In order to make the CMP effective, there are a few steps that are worth considered to be taken as follows: business continuity plan (BCP), framework for coordination, early warning system, and stress test.

Islamic banking supervision

The Islamic banking industry has IFSB as its international regulatory standard setter to equip the industry with sufficient standards. Technically, the Islamic banking industry can benefit from the current development that has taken place in conventional industry. The majority of the regulatory framework can still be applicable to Islamic banking operations like the 25 BCPs that have been internationally adopted.

Group 1 – principle 1 – the standards needs to address the position of fatwa authority within the banking industry contributing to the legal certainty in a case of dispute. There should be clear definitions around the banking authority that governs the whole range of Islamic banking issues, including Shariah compliance. The dispute settlement mechanism needs to involve a proper process that is pro-efficiency and that avoids unnecessary cost per transaction. Group 2 (principles 2–5) the standards need to define Islamic banking permissible activities that in some particular areas might be incompatible with their conventional counterpart. Islamic banks allow the operation of mutual funds within the banking activities while theirs are classified as a capital market activities. On the licensing activities, the Islamic banking authority needs to consider sufficient knowledge of Shariah banking by the top management and the shareholders of the bank to minimize the operational risk (particularly regarding the Shariah compliance aspect) besides the general banking activities like financing, money transfer, maintaining deposits, etc. Like any other companies, Islamic bank ownership is transferable through an acquisition process. Therefore, the transfer of ownership needs to go through a thorough examination process. The authority should also assure that competent persons having high integrity are in place to run the business. Group 3 (principles 6–18): Islamic banking can follow the Capital Adequacy and Risk Management Standards set by the IFSB. The standards have to accommodated the Islamic financial instruments in the Risk Weighted calculation and set out the definition of capital applicable to the Islamic banking operations.

Although, it still adopts the standardized approach using a risk-slotting menu in determining the level of credit risks. In the prudential measures, particularly in the risk management standard, the Islamic banking industry can follow the standards set by the BIS. The Risk Control System (RCS) applies both to Islamic banking and conventional banking. The differences mostly take place in the product interpretation process. Islamic banking has different types of products that translate into the same payoff curves and risk building blocks. For example, the assessment of the credit risk on the mudharaba contract requires a correct understanding on the contractual arrangement to define the state of default, the probability of default and the residual value, which eventually determines the price of the product. The same approach goes to other types of risk, i.e. market risk, liquidity risk and operational risk.

The Islamic banks may not have a direct impact on the interest rate risk since they do not have interest based instruments that adjust the price of the instruments contractually like interest based derivatives. However, the changes of interest rates in the market may cause a demand of the instruments since the investment vehicles do not differentiate the segment of the market. On the liabilities side, the changes in interest rate may also influence the appetite of the investors to put their money in the Islamic banks. In order to maintain the liquidity, the Islamic bank may adjust the returns to the investors to keep them loyal to the bank. Group 4 (principles 19–21): the supervisors of Islamic banks may use the BIS standards in formulating a proper supervision strategy that consists of reporting systems, techniques and approaches. The on-site and off-site supervision have been standard practice involving comprehensive reporting systems to reflect the actual financial soundness of the Islamic banking institutions. The supervisors use the on-site supervision to verify the information reported through the off-site reporting system and to have a closer look on the particular problem in a more focused way. The Islamic banking system may complement the reporting system with Shariah compliant aspects in assuring the Islamic banks operate within the Shariah principles. Group 5 (principle 22): Islamic banking uses the internationally recognized accounting standards (IAS) and financial reporting (IFRS) complemented by the AAOIFI standards to capture the Islamic financial transaction more appropriately. As a matter of fact, the AAOIFI standards were developed in compatibility with the IAS standards. Group 6 (principle 23): Islamic banking may use the BIS standards in formulating corrective and remedial power of supervisors. Group 7 (principles 24 to 25) Islamic banks may be a part of conglomerate business and conduct international operations. The supervisory activities should be able to perform consolidated supervisory activities capable of capturing potential risks resultant from financial and non-financial activities within the same business group. Besides, the supervisory framework applied should be able to define responsibilities shared between home and host countries when it comes to the cross border banking activities.

Assessment of insurance supervision

Similar to the Islamic banking industry, the takaful industry may also benefit from the current development in the insurance industry by adopting relevant principles of the insurance supervisory framework. The table summarizes the areas peculiar to the takaful practices taking assumption that almost international insurance standards are applicable to the general takaful industry.

Group 1 (principles 1 to 4) the standards need to address the position of fatwa authority issuing the Shariah standards applicable to the takaful activities. At the operational level, the supervisors have also a responsibility to assure the Shariah compliance besides the prudential issues. Group 2 (principles 5 to 8) the standards need to define the scope of business activities that are Shariah compliant. The scope covers the takaful contribution collecting process, investment process and operational management. Consequently, the persons running the business activities should have an adequate capacity in terms of prudential measures and Shariah compliant issues, and integrity. This includes the possible transfer of controlling parties that could potentially change the policy direction of the companies. The existence of tabarru pools is unique to the takaful industry; hence, the takaful operators need additional guidance in managing the funds to minimize potential moral hazards in the usage of the funds. Group 3 (principles 9 to 12) the standards need to address the corrective actions taken in the area of Shariah compliance to minimize the violation of Shariah rules. One of the possible corrective measures is to combine the suasion and the financial penalty as one enforcement factor since the deterioration of the public confidence may result in financial loss. The same as the insurance industry, the takaful authority should have a sound exit policy allowing an exit process without causing unnecessary contagion effect to the system as a whole. Group 4 (principles 13 to 17): operationally, takaful operators may have different products and structure (like tabarru funds). The takaful industry may apply the same prudential standards to achieve operational soundness, contributing to the operational sustainability at the institution level and systemic stability such as the use of solvency ratio (capital adequacy) and other methods relevant to the risk assessment process. Group 5 (principles 18 to 21) the takaful industry may use the same principles plus additional items on the disclosure material containing additional Shariah compliance reports and additional business conducts. The IFSB has issued a standard guidance on the conduct of business for Islamic financial institutions, including takaful operators. The implementation of conduct of business is supposed to be borne by the commitment of the industry. It does not have punitive action at the event of violation. Group 6 (principles 22) the industry may implement the same ICPs standards in the area of anti-money laundering and combating the financing for terrorism since there is no Shariah issue involved in the analysis. A full adoption of this standard would improve the profile of the takaful industry in terms of financial integrity internationally. Group 7 (principles 23 to 24): the main issue on the group wide supervision and macro-prudential surveillance is the compatibility in the reporting system so that the consolidated figure represents financial position and performance accurately. A financial conversion process may be required to facilitate the consolidation process to converge the interpretation. Group 8 (principles 25 to 26) the takaful supervisor would need to develop cooperation domestically (with other financial supervisory agency within the country) and to achieve mutual understanding between host and home countries particularly in the area of Shariah interpretation. In some cases, different interpretation on the Shariah aspect may lead to different assumptions in the Islamic financial contract such as an insolvency regime in the Islamic financial transaction.

Assessment of securities market regulation

Islamic capital market basically plays the same function as the other capital market except for with Shariah compliant issues. The Shariah compliant issues restrict certain prohibited business activities and financial instruments containing interest-bearing concepts and speculation. The Islamic capital market serves as melting point facilitating the investment activities between the investors and the capital holder efficiently. A review has been done resulting in the conclusion that IOSCO principles are applicable to the Islamic securities market with some recommendation. Generally the recommendations touch the areas that recognize Shariah principles with formal regulation, giving the authorities the power to deal with Shariah compliance issues. These recommendations are to minimize the Shariah compliance risk that may disrupt public confidence regarding the Islamic segment of capital markets. The recommendations cover regulatory instruments relating to the prudential measures, reporting frameworks and entry policy ensuring the intermediary has the relevant competencies in Islamic finance.

Group 1 – The principles relating to the regulator (1–8) set out the status and the position of the regulator. The principles state the importance of having the operational competence and independence to arrive at the highest professional standards. Like other financial regulators, the capital market regulators should also be supported by a clear defined legal framework to assure its effectiveness of the regulatory process. The relevance to the Shariah issues covers the regulatory power over the Shariah compliance aspect, the consistency over the Shariah interpretation and the capacity of the regulators to understand the Shariah principles. Group 2 – The principle for self-regulation (9) sets out the framework of self-regulatory organization involving some direct oversight responsibility and observing standards of fairness and confidentiality. The same principle is applicable to the Islamic system. Group 3 – The principles for enforcement of securities regulation (10–12) set out comprehensive supervisory tools to ensure the enforcement of securities regulation covering inspection, investigation and surveillance. The regulators should be able to ensure the sufficient level of compliance of the companies to the regulatory framework set by the regulator in order to achieve sufficient level of investor protection including the inspection over Shariah compliance issue and the power to rectify any possible incompliance problem. Group 4 – The principles for cooperation in regulation (13–15) set out the framework for cooperation with other domestic regulators and other regulator in foreign countries in the areas of information exchange and operational assistance in the discharge of their function and exercise of their powers. However, different jurisdictions may have different interpretation over Shariah principles that give different implication to the application technically. Therefore, mutual recognition by home and host supervisor is very important. Group 5 – The principles for issuers (16–18) set out the basic requirement should be fulfilled by the issuers. The requirements include accurate and timely financial reports for disclosure purposes, adherence to the international accounting and auditing standard so that the investors are treated fairly and in equitable manner. All types of risks should be represented objectively in the financial report. In order to achieve a sufficient level of compatibility, the convergence of financial reporting system between the conventional and Islamic financial reporting is important. Group 6 – The principles for auditors, credit ratings agencies, and other information service providers (19–23) set out the regulatory requirements for adequate level of oversight on the auditing companies, credit rating agencies and other entities offering financial analysis services. The requirements are meant to assure that the investors have unbiased and accurate information about the market arriving at greater confidence over the market. These institutions are subject to registration and periodic review by the supervisory authority. Group 7 – The principles for collective investment scheme (24–28) set out the regulatory requirements for collective investment activities. The requirements include the legal foundation, structure of collective investment scheme, disclosure, asset valuation redemption process and assurance that the companies invest in Shariah compatible instruments. Group 8 – The principles for market intermediaries (29–31) set out the regulatory guidance for market intermediaries in order to protect the interests of the clients. There is a need to prescribe prudential requirement reflecting the level of risk undertaken by the intermediary companies and its responsibility, particularly when dealing with failure of the market intermediary containing systemic risk that could possibly creating instability. Operationally, the intermediary companies should also sufficient knowledge about Islamic finance to minimize reputation risk and to ensure that the intermediary companies apply Shariah compliant risk management techniques. Group 8 – The principles for secondary market (33–38) set out the regulatory guidance for the establishment of the secondary market. The regulatory principles should be able to promote transparency minimizing the potential of having manipulative practices and unfair trading activities. Besides prohibiting usury, the Islamic finance also prohibits unproductive speculative activities which try to gain financial profit out of speculative transactions which do not reflect the real economic activities. Operationally, the liquidity in the Islamic financial market is also important which may offer benefits to the market players to gain more efficiency in the liquidity management. However, excessive liquidity can also built out of speculative financial transactions that may make the financial market more vulnerable against market disturbance. The Islamic financial authority may prescribe an alternative mechanism to facilitate the financial transactions that are compliant with Shariah principles.

The guiding principles also cover the oversight of large exposures and the settlement of securities transactions to ensure fairness, effectiveness and efficiency. All the prudential frameworks set to the capital market are expected to reduce the systemic risk and promote sustainable economic development. The link between the observance of the 38 principles and market development and stability is very important. The implementation of the 38 principles needs some preconditions to be met including company law, established contract law, clear tax law, bankruptcy law, banking law, competition law and an efficient judicial system.

19. Assessing the supervision of other financial intermediaries

Non-bank islamic financial institutions

Conceptually, standalone-low-leveraged finance companies do not need an intensive supervisory framework since they operate with their own financial sources. Any operational failure of this financial institution will not create systemic implications, and any transactional disputes fall under common commercial law. There is no immediate impact on financial stability, although some significant impact on the productions can also trouble other production sectors within their production chains. Currently, the ability of the financial authority to expand its supervisory activities to the non-bank financial institutions is very important when it comes to the assessment of the cross-sector wide conglomerate financial activities. The risk-based capital adequacy assessment takes into account the financial conditions of any financially related companies capable of influencing the financial soundness of the Islamic banks, takaful and other highly supervised institutions. Islamic financial institutions should address the same importance for conducting consolidated supervision to minimize the myopia when assessing a group-wide financial soundness.

ZISW institutions

In most Muslim countries, the development of Islamic social institutions has just reached the infancy stage. Currently, almost no regulatory framework exists in a comprehensive way to optimize its presence in supporting the economic development. However, some countries have started to equip the institutions with stronger legal foundations by ratifying Zakat and Waqaf acts as the basis for their operations. So far, there has not been an international effort to set out guiding principles for zakat and waqaf operators as well as the supervisory authority to operate soundly.

Zakat-infaq-sadakah institutions

Despite the slow pace of development, some countries have taken serious steps to establish the legal foundation for zakat operators. The areas of regulation cover the objectives of the establishment that emphasize the development roles in the economic development, the activities of the institutions, reporting system and possible punitive actions taken in the case of violations to the zakat regulations. Financially, the operational failure of any zakat institutions will not create systemic disturbance since the funds collected by the zakat institutions is non-claimable. However, the Islamic financial system succeeds in mobilizing the zakat funds, the outreach of the system will improve very much since it is low cost and can sustain the basic consumption of the poor even in the period of economic downturn. The purpose of the regulatory and supervisory framework is to minimize the potential misuse of the funds and improve the public confidence in performing one of the important religious duties at the economic front. At the macroeconomic level, the presence of zakat system can dampen the economic volatility since the consumption level can always be maintained, providing opportunity to the production sector to still operate during a period of recession. The zakat system can equip the financial system with effective measures for financial inclusion programs. Some human capital development programs need to be developed to achieve operational effectiveness in distributing the funds, which is beneficial to the poverty alleviation program. In some countries, the zakat fund is also used for working capital of the poor when they start up the business. Some of the fund is also allocated to sustain health programs for the poor in terms of free medication and the development of health facility like small hospitals.

Waqaf institutions

Different from zakat, infaq and sadaqah institutions, the management of waqaf funds needs to maintain the value of the funds, and all the assets managed should be allocated according to the statements of the waqaf providers when it was submitted to the management. As mentioned earlier, types of waqaf may vary from fixed asset waqaf (like lands, houses and buildings) to cash waqaf. The designation of waqaf can also be time infinite or fixed-term, which is notable when the period ends. Some countries have already ratified the waqaf act to provide a stronger legal foundation for waqaf management to allocate usage of waqaf assets effectively. The waqaf act defines the basic activities of the waqaf funds and all the relating parties engaged. The waqaf institution is set up as an independent body that is free from vested interest and audited externally to assure that the institutions are well-managed. The asset of the waqaf institutions should be properly registered and managed so that the value of the funds managed will not be looted or mismanaged that could result in the decrease of the net value of the waqaf funds.

Rural and microfinance institutions

Despite the simplicity of the regulatory framework, the regulation applied for microfinance institutions may include legal registration, regular financial reporting representing its financial performance, regular reporting of conduct in business operations, and securing proper license. An international initiative has been done to address the issue on possible standard guidance applicable to micro finance institutions under the Consultative Group to Assist the Poor (CGAP). The initiative has been successful to release guiding principles on regulation and supervision of microfinance institutions. Generally, the guidelines consist of two types of regulations: non-prudential regulations and prudential regulations.

Non-prudential regulations set out the basic requirements supporting the environment, supporting efficient microfinance activities, particularly non-banking microfinance institutions, which have very limited regulatory frameworks. The non-regulatory regulations cover the legal foundation, allowing the companies to extend their facilities legally, good governance and business conducts, support on the macroeconomic policy (including interest rate ceiling and special tax treatments), and transformation mechanism.

Islamic microfinance institutions may benefit from the current development in the microfinance regulatory framework. Like the Islamic banking industry, Islamic microfinance institutions, particularly to those collecting public deposits, need to always maintain its solvability level high. The depositors of the Islamic microfinance behave like the banking depositors. However, due to its size, the prudential regulation should be kept as simple as possible to minimize the regulatory 'cost' without sacrificing the prudential measures. Most of Islamic microfinance institutions operate under cooperative frameworks opening up wide opportunities for the public to participate as shareholders besides collecting public deposits. Besides Shariah related aspects, Islamic microfinance industry can still adopt the CGAP regulatory framework. The peculiarities to the Islamic microfinance lie upon the recognition of Islamic modes of finance, the adoption of the Islamic accounting standards and the price limit set whilst the rest can still be adopted fully.

Non-bank microfinance institutions, in much simpler structure, resemble the banking institutions; therefore, some of the prudential regulations are similar to those of the banking industry. The prudential regulations put much of emphasize on solvency level and the quality of the exposures. The solvency level is indicated by the minimum capital and capital adequacy ratio. The regulations relating to the quality of exposures cover provisioning, documentation, governance structure (supported by monitoring and reporting), concentration risk, and liquidity position. The guideline principles also put one pillar to state the importance of deposit insurance schemes for the microfinance industry. In order to simplify the supervision process, the guideline provides an alternative supervisory process by using a well-managed commercial bank as the apex to assure the business activities are conducted efficiently as well as prudently. Like its conventional counterpart, Islamic microfinance can adopt the prudential standards for Islamic banking but according to a simpler version, which puts emphasize on the solvability level and the quality of exposures. Islamic microfinance can adopt the existing regulatory framework relating to the quality of exposures that cover provisioning, documentation, governance structure (supported by monitoring and reporting), concentration risk, and liquidity position. The monitoring system should also contain the Shariah compliance aspect to assure public confidence is maintained as high.

20. Assessing financial system integrity – anti-money laundering/combating the financing of terrorism

Anti money laundering and combating terrorism are both considered part of good governance, which is beneficial in strengthening financial sector supervision and promoting better integrity of the international financial system. The AML/CFT tries to minimize the illegally obtained money and investments activities through an outside party to conceal the true source. The AML/CFT is mutually complementing with a wide range of United Nations conventions and resolutions promoting international cooperation in preventing and containing drug trafficking, organized crime, corruption, and efforts to finance terrorism. It covers all financial institutions, including bureau of change, wire remittance transfer, cash couriers, insurers, brokers and traders and also nonfinancial business and professions like lawyers, accountants, and trust and company service providers. Operationally, the financial institutions should practice core principles to enhance know-your-customers (KYC) rules, suspicious transactions reporting, and other due diligence requirements helping to support the AML/CFT regimes. The AML/CFT has been an international initiative and adopted in the various international standards like Basel Committee on Banking Supervision (BCBS), International Association of Insurance Supervisors (IAIS) and International Organization of Securities Commissioners (IOSCO). The BCBS has recognized the money laundering issue in 3 documents: statement on prevention of criminal use of the banking system for the purpose of money laundering, 25 BCPs and customer due diligence for banks. The IAIS has issued guidance paper 5 regarding AML notes for insurance supervisors and insurance entity. Parallel with the 2 standard setters, the IOSCO has also issued a resolution on money laundering to be implemented by the securities regulators in each individual country. The adoption of the AML/CFT is considered important to improve the financial stability since the money laundering activities could create an adverse impact to the country macroeconomic performance, national reputation and cross-border externalities.

A country with a strong indication of money laundering activities may have less potential to attract foreign investment and be more volatile to international capital flows and exchange rates. Internally, money laundering may also distort resource allocation and distribution of wealth. In most cases, it is costly and time consuming to eradicate the money laundering activities. After all, all economic and financial transactions are based on trust wherein the government needs to keep its integrity at all times. The government should ensure that the existing legal foundation provides legal power to exercise necessary actions such as freezing, seizing and confiscating the proceeds of crime and terrorist funding on the widest range of institutions (financial and non financial institutions). The law and measures also need to assure the international cooperation. Some preconditions that need to be in place in order to make the implementation of the AML/ACT effective include among others: the implementation of transparency and good governance, sound financial sector policy and infrastructure, appropriate measure for combating corruption, high ethical and professional requirement of the supporting institutions such as court system, and AML/CFT culture.

21. Assessing the legal infrastructure for a financial system

The operational soundness and sustainability of the financial system heavily depends upon the legal foundation assuring legal rights, predictability, and fair and impartial enforcement of rules and regulations. In general, the legal infrastructures covers the central banking operations and the law regulating banking, non-banking operations and the markets. From the financial sector perspective, the financial regulation cover central banking law, banking law, capital market law, etc. In a broader term, those regulations also cover insolvency regime and creditor rights, financial safety nets, ownership, contracts, contract enforcement, accounting and auditing, disclosure, formation of trusts and asset securitization, etc.

Financial sector legal infrastructure

When establishing a legal foundation, the Islamic financial system may need to establish new acts like an Islamic banking act, a takaful act, and a zakat and waqaf act. In some particular areas, the Islamic financial system may still use the existing legal infrastructure with some modifications or amendments like the central bank act, payment system act, governing law for government debt management, capital market act and financial safety net act. One of the main objectives of establishing new governing acts is to provide more space and flexibility for development where Islamic finance has some operational distinctive features.

1. Central banking law should define the mandate of the central banks to conduct monetary policy by using Islamic instruments and channels. The mandate should also allow the central bank to facilitate the Islamic financial institutions to get a Lender of the Last Resort facility when the market is struck by an unexpected liquidity crunch.
2. The recognition of the Islamic banking activities is stated either in the existing banking act or separate Islamic banking act. The banking act should define the operational activities of the Islamic banks, including its products and services, the power to regulate and to supervise according to prudential guidelines and well translated Shariah principles.
3. The payment system act should state the mandate to facilitate financial transactions of the conventional markets and Islamic financial market, and to develop necessary infrastructure for Islamic financial markets whenever necessary.
4. The governing law on government debt management should state the mandate to issue government fiscal instruments both conventionally as well as through Islamic instruments. Regular issuance of local government bonds (sukuk) can also be used as one of liquidity and monetary instruments.
5. The capital market act (facilitating Islamic instrument and conventional or separate Islamic capital market) should state the Islamic capital market operations covering the Islamic capital market products, modes of transactions and Shariah related governance besides the common regulatory framework generally applicable.
6. The recognition of the takaful industry is stated either in the existing insurance act or separate takaful. The act should define the operational activities of the takaful institutions including the products and services, and the regulatory powers.
7. The governing law of a financial safety net should formally include the Islamic financial system allowing the related authorities to react against unexpected financial shock.

Just like its conventional counterpart, the Islamic financial system requires other supporting laws including commercial laws, creditor right and insolvency systems, access to credit and land rights, and supporting judicial system.

1. Commercial laws normally facilitate general commercial business transactions, which inspire other business-related laws such as company law, etc. The amendment is aimed at recognizing Shariah-based transactions formally as another acceptable basis of commercial contracts.
2. The adoption of profit and loss sharing contracts, including their derivatives such as hybrid contracts, has to be accommodated when defining the creditor rights and insolvency regimes. This will be the basis of the bankruptcy concept, solvency regime and deposit insurance scheme.
3. Judicial system refers to the efficiency and effectiveness of a dispute settlement system, which also recognizes the Shariah principles.

22. Assessing information and governance infrastructure

The assessment on the information infrastructure covers 3 main areas. They are the framework for monetary and financial policy transparency; the accounting and auditing framework that helps to define and validate the information that is disclosed to the public and the regulatory authorities, and the arrangements to compile, process, and share information on financial conditions and credit exposures of borrowers and other issuers of financial claims.

Monetary and financial policy transparency

The central bank plays its function as the monetary authority controlling (i) the money supply, (ii) availability of money, and (iii) cost of money in order to attain a set of objectives oriented toward the growth and stability of the economy. The policy-making rests on the relationship between the cost of money in an economy and the total money supply. Through a variety of controlling instruments, the central bank tries to influence and optimize the economic outcomes covering economic growth, inflation, exchange rates with other currencies and unemployment. The central bank holds a monopoly of money issuance and has all power to alter the money supply and thus influence the interest rate and eventually achieve the ultimate economic goals. In order to perform this function, the central bank as the monetary authority must have a credibility in the market that makes private agents believe that these announcements will reflect actual future policy.

If the monetary authority believes that private agents anticipate the low inflation, it will provide incentives to the market by adopting an expansionist monetary policy and vice versa. Besides the technical capabilities, the central bank should be able to show its independence and transparency, since lack of clarity can serve to lead policy away from what is believed to be the most beneficial. The IMF has issued a document providing guidelines to the monetary authorities to gain credibility from the public. As a part of the financial industry, Islamic financial institutions may also be used as channels for monetary transmission by using Shariah compatible financial instruments, particularly when the size of the business of the Islamic financial system becomes significant. The central bank might use Shariah compatible central bank certificates in order to complement the existing central bank certificate used with conventional banking institutions or other instruments, which have the potential to be used as Islamic monetary instruments, like government sukuk.

Pillars no 1 to 4 describe the clarity of roles, responsibilities and objectives of central banks for monetary policy that should be well-defined in the legal documents; the openness to the public about the process for formulating and reporting monetary policy decisions in order to gain public confidence; the level of information dissemination to the public about the monetary policy; and, the methods to set criteria of the accountability and assurance of integrity by the central bank. The laws should explicitly give mandate to the central bank to conduct monetary policies using 2 possible channels of monetary transmission, resulting in clear monetary signals to the market effectively. Pillars no 5 to 8 mention the requirements for other financial agencies supporting the effectiveness of the monetary operations. Just as with the monetary authority, there is a need to have clarity of roles, responsibilities and objectives among the financial agencies; openness in formulating and reporting of financial policies; publicly available information on financial policies, and accountability and assurance of integrity by financial agencies. The positions of regulatory authorities of the Islamic financial system should be clearly defined. Each country may have different approaches towards the supervisory structure. Some may adopt the single peak approach (the combination of the supervisory functions under one single roof) and some may separate the supervisory authority for bank and non-bank institutions (including securities market). The Islamic financial institutions report their financial position in a compatible structure to the conventional so that the consolidation process can be done easily. In order to fulfill the requirements as one of the monetary instrument, the government sukuk should be issued regularly in the local currency and traded with a sufficient level of liquidity.

Accounting and auditing assessments

The assessment of the financial soundness is based on the financial assumptions and standards set in the accounting standards. Therefore, a core component of good corporate governance is an accurate disclosure based on high quality accounting and auditing standards. The assessment process reflects the adoption of such accounting standards, which serve as a precondition to support effective supervisory frameworks. Moreover, financial disclosure is very important for informed financial decisions, effective resource allocation and effective functioning of the market. Inability to implement such accounting standards very well can reduce the ability of the supervisory authority to filter the sound financial institutions from the unsound ones. This becomes important especially when the conglomeration exists, which requires consolidated supervision in place.

These accounting and auditing standards, which have been developed by the International Accounting Standards Board (IASB), evolve over time. Currently, there are 36 effective IAS–IFRS standards, with 11 interpretations, addressing the general-purpose financial statements designed to meet the needs of shareholders, creditors, employees, government agencies, and the public at large for information about a public entity's financial position, performance, and cash flows. Some of the standards of IASs and IFRSs are very important in the financial sector assessment process. The IAS 1 deals with the content of financial statements generally. The IAS 30 sets out requirements to the disclosures by banks and other similar institutions of their income statement, balance sheet, and contingencies and commitments, including other off-balance sheet items. The IAS 32 and IAS 39 set out requirements on the recognition, measurement, and disclosure of financial instruments.

For the auditing purposes, there are 33 ISAs, accompanied by a "Code of Ethics for Professional Accountants" and other related engagement standards. Some auditing standards relevant to the financial industry include ISA 220, 230, 240 400, 520 and 700 setting out the quality control, documentation, responsibility to consider fraud and error, risk assessments of internal control, analytical procedures, and the auditor's report on financial statements respectively. Like the accounting standards, the IASB and the IFAC's IAASB constantly revise and update the standards to reflect current trends and issues in financial reporting and auditing, which reflect globalization, capital flows, regionalization, technology changes, and so forth. In order to promote the global adoption of the standards, the World Bank has developed a program relating to the FSAP-ROSC focusing on the institutional framework, comparability of national and international standards, compliance with national standards, and action plan by the respective countries. The Islamic financial institutions need to adopt internationally recognized accounting and auditing standards as well as accommodating the transactional uniqueness of the Islamic finance. The AAOIFI has issued a number of documents covering accounting standards, auditing standards, governance standards and Shariah.

The AAOIFI has already issued 26 accounting standards covering the very basic objectives of the financial statements of the Islamic financial institutions, which are compatible with conventional international accounting standards. Some countries have already adopted the AAOIFI accounting standards into their national accounting standards for the adoption by the industry besides keeping the IASB accounting standards wherever required. Each country may decide different level of adoption towards the AAOIFI standards depending upon their readiness of the country to really translate and harmonize the AAOIFI standards into their existing accounting standards. The accounting standards have also been complemented by the auditing standards. The auditing standards put emphasize on the Shariah aspects besides common auditing process. The AAOIFI standards on governance put more emphasis on the roles of Shariah supervisory board which distinguish the Islamic financial institutions from other financial institutions.

The AAOIFI have also issued documents relating to the Shariah standards which serve as underlying principles for Islamic financial instruments. However, the adoption of Shariah standards is subject to the approval of the ulama council in each country whether the standards confirm their Shariah interpretation. Eventually, the financial authorities operating Islamic financial system should be able to declare the accounting regime adopted in the system to avoid misconception when interpreting financial reports particularly when it comes to group wide consolidated figures.

Credit reporting system and financial information services

The credit reporting system has become a formidable tool to minimize adverse selection problems. It provides high-quality credit information about the credit customers. Ideally, the system is fueled by data from banks, other financial intermediaries, private firms, retailers and others. They share certain accurate and reliable information, which is exchangeable through rapid access systems that support a well-functioning credit market. In order to maintain the quality of the information, the credit reporting system should meet certain technical criteria: the system must be open, the data collection covers positive and negative information, data maintenance is kept for a reasonable timeframe, and the data should be updated in real time. Practically, the data reporting system should be governed by several legal foundations covering law on bank secrecy, data protection law, consumer protection, fair credit and consumer credit regulation, and provision with respect to privacy and personal or corporate secrets in existing laws. It is used to support both onsite and offsite supervision, ultimately facilitate macro prudential surveillance since the supervisor has access to individual data. Islamic financial systems would need the credit reporting system as a mean to minimize the adverse selection problem. The Islamic financial system can use the existing information systems, employing slight modifications relating to the data fields describing the classification of the Islamic financial products. In a wider horizon, efficient informational exchange among the Islamic financial institutions and conventional financial system can avoid the loophole potentially used by unsound customers to maximize their own benefits.

Corporate governance

Good Corporate Governance (GCG) provides positive impact to the operational efficiency of the companies since it harmonizes the relationship among the management, its boards, shareholders and other relevant stakeholders (including the communities). Operationally, the GCG can bridge the gaps between the management who runs the companies and the shareholders. To a broader degree, the implementation of GCG contributes to financial stability and promotes market confidence and fosters market disciplines. The harmonization of the relationship covers the property rights of shareholders, the mechanisms of exercising and protecting those rights, and the way of ensuring a fair return. Those relationships are set based on proper incentive mechanisms and effective monitoring activities. The GCG serves as one of the preconditions in achieving effective supervision, which is mutually reinforcing with other financial prudential standards such as BCPs, IOSCO and other standards. To address this importance, the OECD has issued OECD Principles of Corporate Governance outlining the four fundamental principles covering responsibility, accountability, fairness and transparency. The principles have been adopted as one of the 12 key standards for sound financial systems by the Financial Stability Forum. The IFSB and the AAOIFI have issued documents relating to the practice of the Good Corporate Governance (GCG) although the emphasis is put more on the role of Shariah boards. This confirms that the Islamic financial institutions may adopt the common standards of Good Corporate Governance for general use, complemented by the Shariah board related standards. The same goes for the disclosure regime where Islamic financial industry should promote more market power to objectively govern the industry. For the Islamic financial industry, which promotes the use of sharing based financial transaction, the transparency becomes very essential to reduce agency problem.

Disclosure regime for financial institutions

Market forces is very essential in supporting self-regulatory regime in the financial market and has become one of the important pillars in the international prudential standards such as Basle Standards and other supervisory standards although standard element of the financial disclosures have been covered in the IFRS standards. At the national level, disclosure standards are outlined in the banking laws, listing requirements of the securities regulations and applicable company laws. Practically, market discipline serves as an effective tool to limit excessive risk taking behavior by banks covered by the safety net. Market discipline is important when the supervisory approach has shifted from the compliance-based supervision to the risk based supervisory review. In particular, pillar III of Basle II provides 13 templates to facilitate the financial disclosure issue. The templates cover scope of application, capital structure, capital adequacy, credit risk (general), credit risk (standardized approach), credit risk (IRB approach), equity (banking book) positions, credit risk mitigation, securitization, market risk (standardized approach), market risk (internal models approach), operational risk, and interest rate risk in the banking book. The Islamic financial industry should encourage the convergence between IFRS and Islamic financial reporting.

Systemic liquidity infrastructure

Systemic liquidity is the setting of institutional and operational arrangement that provide first liquidity effect to the market players in achieving effectiveness and efficiency. This arrangement includes central banking, banking and other financial institutions. The market infrastructure involves the design and operation of payment systems and securities settlement systems; the design of monetary policy instruments and procedures for money and exchange markets operations; public debt and foreign exchange reserves management strategies and operations and microstructure of money, exchange, and securities markets.

The Islamic financial industry heavily relies on an efficient and reliable liquidity infrastructure consisting of payment systems, securities settlements, monetary and foreign exchange settlements, government market securities and foreign exchange reserve management. It can benefit from the existing infrastructure, which is already able to support operational efficiency. Technically, the newly established

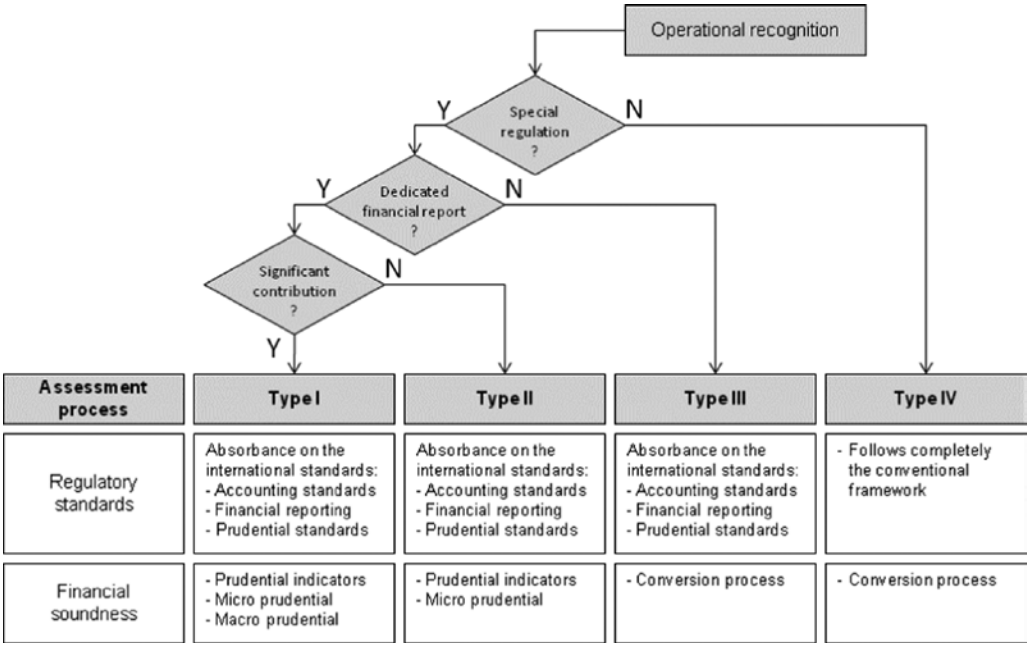


Exhibit 5. The level of presence.

industry can use the Real Time Gross Settlement (RTGS) to provide the customers and the companies with a more efficient payment system. The Islamic financial system may need the Delivery Versus Payment (DVP) type of settlement more than to the PVP (Payment Versus Payment) to facilitate the exchanges of underlying Islamic underlying assets. The industry needs to also develop liquidity market that trades securities (including government securities). In most instances, Islamic financial market needs liquidity and flexibility to let the market participants achieve its operational efficiency.

23. Implementation

The degree of presence and operation of the Islamic financial industry varies in every country. In some countries, the industry has just reached an introductory phase, whilst in others the industry may have played a significant role in the economic development. There are possibly four ways to adopt the Islamic financial system, as illustrated in **Exhibit 5**. Type I represents the countries that allow the Islamic financial institutions to operate with full adoption of the conventional regulatory and supervisory framework. Type II represents the countries that adopt dedicated regulatory standards for the Islamic financial industry without having dedicated financial reports that accommodate the operational differences of the Islamic financial transactions. In type I and II countries, the financial authorities need to have conversion programs that translate financial information into conventional reporting standards so that the financial figures can fit all the existing financial ratios and analysis. Type III represents the countries that already developed dedicated financial reports representing the actual Islamic financial transactions based on particular Shariah contracts besides adopting dedicated regulatory standards.

Since the share of the Islamic financial industry is still small, dedicated macro analysis is not exercised to compliment the nation wide financial analysis. Type IV represents the countries that already have dedicated financial reporting, regulatory framework and significant contribution of Islamic financial industry within their national financial industry. The issue of financial stability should also cover the Islamic financial industry as the complementary part of the macroeconomic analysis. The adoption of the regulatory framework depends upon national discretion. The implementation of the iFSAP initiative should also consider the conditionality of the assessed countries based on the optimality criteria in developing the regulatory structure and the infrastructure.

Conclusion

In order to achieve operational soundness, the development of the Islamic financial system requires concerted efforts by the stakeholders internationally. The efforts may take place in several areas as follows:

1. It would be required to develop further international regulatory standards by the international Islamic standard setters – in most instances, the development of an Islamic regulatory framework may still use the existing regulatory framework wherever it still relevant. The development of the regulatory standards needs to also involve the conventional counterparts in order to build up mutual understanding between the two systems.
2. The development of appropriate tools for complementing the existing assessment framework is also needed since the assessment process should cover the whole financial system including the conventional and the Islamic. Therefore, the assessors should be equipped with sufficient knowledge of Islamic financial systems, particularly when they relate to the financial stability issues involving financial ratios and infrastructures.

3. The implementation of the assessment process needs to consider the conditionality of the Islamic financial system. The Islamic financial system that significantly presents in one particular country needs a full range assessment process. On the contrary, a limited assessment process may be adopted for countries that operate the Islamic financial system at the very early stage.

Notes

1. Different interpretation would somehow lead to the legal uncertainty in the area of cross-border Islamic financial activities.
2. By year 2009, 40 countries, which are IDB and IFSB member countries, have completed the assessment process with more members are underway.
3. The IDB-World Bank Working Group on Islamic Finance (WGIF) met in Jeddah during January 24–25, 2009, to initiate the discussion with other stakeholders of the IFS industry.
4. IRTI-IDB, in collaboration with Centennial Group, has produced an initial document titled Towards Developing a Template to Assess Islamic Financial Services Industry (IFSI) in the Bank-IMF Financial System Assessment Program (FSAP).
5. During the development of the compilation guide, the IFSB technically collaborated with the IMF to assure the compatibility. The IFSB had been a member of CCE reference group who are responsible for developing the metadata.

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