Integrating Islamic Finance to Global Financial System: the Role of the Islamic Financial Services Board (IFSB)

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Abstract

A prudential framework is an important element in facilitating the successful integration of Islamic financial services to the global financial system. In recognition of this need, various stakeholders decided to establish the Islamic Financial Services Board (IFSB) to spearhead the development of a uniform set of prudential, supervisory and disclosure standards for the Islamic financial services industry internationally. Over the last decade, the IFSB has made laudable progress in developing prudential standards, facilitating the development of liquidity infrastructure, and creating awareness of Islamic finance. These have been a step toward strengthening the Islamic financial services industry. With the globalization of Islamic finance and beyond this decade, it will be important for the IFSB to maintain the momentum of

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strengthening the industry and at the same time building closer and effective coordination with relevant stakeholders in the global financial system.

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1. Introduction

A prudential framework is an important element in facilitating the successful Islamic financial services industry in the global financial system. It is imperative that high quality of prudential standards be developed and implemented by institutions offering Islamic financial services (IIFS). The Islamic Financial Services Board (IFSB), established in 2003 and based in Kuala Lumpur, Malaysia, plays an important role in the development and promotion of these standards. This paper highlights the establishment of the IFSB in developing prudential standards and promoting awareness of Islamic finance. The financial crisis and globalization of Islamic finance have accelerated these significant roles of the IFSB with respect to the prudential development in an effort to integrate the IIFS to the global financial system.

2. Prudential Framework for the Islamic Financial Services

2.1. Background of the Industry

Islamic banking and finance is ascending to greater prominence in the global financial system and has fast extended beyond the traditional predominantly Muslim economies to major industrial economies. This growing significance is a manifestation of the viability of Islamic banking as a financial intermediation channel that supports economic growth and development of nations. While initially developed to fulfill the needs of the Muslims, Islamic banking and finance have now gained universal acceptance. This appreciation of its potential has prompted interest amongst conventional financial institutions to venture into this fast expanding market. In essence, Islamic banking and finance can expect to evolve into an increasingly important component of the global financial system.

An indication on the absence of international standards designed to address the specificities of institutions offering Islamic financial services (IIFS) is evident in the vast spectrum of control seen in the supervision and regulation of the industry in the various countries and jurisdictions, varying from specific guidelines for Islamic banks on the one end, to the application of the same prudential policies governing conventional banks on the other. Such differences in approach have raised concerns that compliance with multiple supervisory and regulatory regimes would impose additional costs on IIFS, impeding the industry's growth and consequently acting as a hindrance towards full integration into the mainstream global financial system. The two fundamental challenges facing the Islamic financial services industry are to ensure that the industry operates (1) as an integral part of the international financial system; and (2) on a sound and stable basis.

The growth in the Islamic financial services industry following 11 September 2001, which seems to be fueled by very high demand for Sharī`ah compliant products and facilitated by the availability of excess liquidity in the majority of countries that host the IIFS, poses a major challenge to regulatory authorities and international inter-governmental organizations entrusted to monitor the soundness and stability of the global financial system. These organizations need to deepen their understanding and awareness of Islamic finance in order to promote sound regulatory framework and suitable jurisprudence, among other parameters of the financial architecture, that allow for efficient financial intermediation.

In addressing such challenges, the industry requires the pre-conditional establishment of basic infrastructures, one of which is prudential standards that cater for the specificities of Islamic financial products and services.

2.2. Islamic Financial Services Board

In recognition of this need, a proposal was made in the late 1990s to establish an organization to spearhead the development of a uniform set of prudential, supervisory and disclosure standards for the Islamic financial services industry internationally. This proposal was discussed in various consultative meetings among a group of Central Bank Governors, and officials from the Islamic Development Bank (IDB), the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the International Monetary Fund (IMF).

The establishment of the IFSB reinforces the necessary pillar for stability in the financial system. As a global authority for setting standards for Islamic banking and finance, the IFSB recommends that IIFS incorporate international best practices and standards for the supervision and regulation of Islamic financial transactions, that is not only consistent with Islamic rules and principles, but is also based on prudential standards that are at par with those observed in conventional banking. The subsequent improvements in supervisory standards of Islamic financial institutions will enhance the credibility of IIFS in the financial world. All these point toward an important role for the IFSB in enhancing the development of Islamic banking and finance to be an integral part of the international financial system.

The IFSB, which is based in Kuala Lumpur, was officially inaugurated on 3rd November 2002 and started operations on 10th March 2003. The IFSB founding members comprise Central Bank of Bahrain (formerly known as Bahrain Monetary Agency), Bank Indonesia, Bank Markazi Jomhouri Islami Iran, Central Bank of Kuwait, Bank Negara Malaysia, State Bank of Pakistan, Saudi Arabian Monetary Agency, Central Bank of Sudan (formerly known as Bank of Sudan) and Islamic Development Bank. Malaysia, the host country of the IFSB, has enacted a law known as the Islamic Financial Services Board Act 2002, which gives the IFSB the immunities and privileges that are usually granted to international organizations and diplomatic missions.

The IFSB serves as an international-standard setting body of regulatory and supervisory agencies that have stake in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and insurance. The IFSB will liaise and collaborate with other international standard setting bodies to achieve the common goal of international financial stability.

In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with Islamic Shari'ah principles, and recommend them for adoption. The IFSB focuses on the development of sound risk management and supervisory practices and facilitates the implementation of robust risk control mechanisms in Islamic financial institutions through research, training and technical assistance. This would encompass the adoption of international best practices as well as the development of new techniques in conformity with Shari'ah rules and principles.

2.3. Objectives of the IFSB

The objectives of the IFSB are:

- To promote the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing, international standards consistent with Shari'ah principles, and recommending these for adoption.
- To provide guidance on the effective supervision and regulation of institutions offering Islamic financial products and to develop for the Islamic financial services industry the criteria for identifying, measuring, managing and disclosing risks, taking into account international standards for valuation, income and expense calculation, and disclosure.
- To liaise and cooperate with relevant organizations currently setting standards for the stability and the soundness of the international monetary and financial systems and those of the member countries.
- To enhance and coordinate initiatives to develop instruments and procedures for efficient operations and risk management.
- To encourage cooperation amongst member countries in developing the Islamic financial services industry.
- To facilitate training and personnel development in skills in areas relevant to the effective regulation of the Islamic financial services industry and related markets.
- To undertake research into, and publish studies and surveys on, the Islamic financial services industry.
- To establish a database of Islamic banks, financial institutions and industry experts.
- Any other objectives which the General Assembly of the IFSB may agree from time to time.

In December 2005, one of the significant developments took place at the IFSB where the Council approved amendments to its Articles of Agreement. These amendments opened the door to the securities and insurance regulatory and supervisory authorities to join the IFSB as Full Members similar with the banking supervisory members. This is in line with the mandate of the IFSB to set standards for all segments of the industry. To this end, the work of the IFSB complements the work of the International Organization for Securities Commission (IOSCO) and the International Association for Insurance Supervision (IAIS).

As at April 2013, the 187 members of the IFSB comprise 57 regulatory and supervisory authorities, eight international inter-governmental organizations and 122 market players, professional firms and industry associations operating in 43 jurisdictions.[1]

The IFSB finances its activities from the proceeds of annual subscriptions fees, waqf (endowment), donations, grants, technical assistance and other sources.

2.4. Structure of the IFSB

The IFSB structure comprises the following constituent organs:

General Assembly

The representative body of all the members of the IFSB namely, Full Members, Associate Members and Observer Members

Council

Council is the senior executive and policy-making body of the IFSB. It consists of one representative from each Full Member who shall be the senior executive officer of that Full Member or such other senior person nominated to represent him from time to time.

1. The data is updated at the time of publication.

Technical Committee

This is the body responsible for advising the Council on technical issues within its terms of reference (as determined by the Council). It consists of up to fifteen persons selected by the Council and shall have a term of office of three years.

In selecting the members of the Technical Committee due consideration shall be given to:

- The relevant technical expertise and skills of the candidates;
- Ensuring equitable distribution between the specific technical skills required by the Technical Committee and geographical and required sector composition; and
- Ensuring continuity of the committee's work.

Working Group

The Working Group is the committee responsible for drafting standards and guidelines. It will report to the Technical Committee.

Secretariat

Secretariat is the permanent administrative body of the IFSB. It is headed by a full-time Secretary-General appointed by the Council on such terms and conditions determined by the Council.

2.5. Communication with the industry

The IFSB standards are developed in close communication with the industry. The standards prepared by the IFSB follow a lengthy due process including issuance of exposure draft and public hearing. This will allow the views of various stakeholders in the industry to be heard from an early stage (that is, the discussion and the drafting stage).

In line with the IFSB Articles of Agreement, 21 (d), the IFSB has prepared a process that shall be followed by the concerned individuals in preparing the standard/guideline and the process of commenting on and issuance of exposure drafts. The project manager and the consultant together with the working group members that are assigned to a standard/guideline shall prepare and discuss an initial study highlighting, among others; (a) issues that require to be addressed in the standard/guideline; (b) how these issues are addressed in existing international standards/guidelines; (c) the reasons why a different treatment is required; (d) the possible alternative treatments of the identified issues; (e) the pros and cons of each proposed alternative treatment, and; (f) the basis for conclusion.

As part of the due process, the Working Group (WG) shall refer the document to the Shari'ah Board (of the IDB) to endorse the compliance of the document with Shari'ah rules and principles, and the Technical Committee for discussion, amendment, and approval. The WG shall amend the draft of the exposure draft (ED) accordingly.

The ED shall be posted on the website of the IFSB for comments by all interested parties for a stipulated period. The WG shall attend the public hearing and receive the comments of the participants on the ED and respond to their queries. After the public consultation period, the WG shall discuss the comments on the ED after taking into consideration the suggestions of the project manager and the consultant(s) and revise the ED accordingly. The revised draft will then be presented to the Shari'ah Board and subsequently to the TC before it is finally adopted by the Council.

3. Changing Landscape of Global Financial Regulation

The financial crisis in 2008 and ongoing economic uncertainty around the world gave rise to challenging regulatory and supervisory environment internationally.

The 2007-2008 financial crises in particular became a turning point for changing landscape of global financial regulation and supervision. There are many factors that led to the buildup of the crisis. At the top of the list is excess liquidity, resulting in too much credit and weak underwriting standards. The vulnerability of the banking sector to this buildup of risk in the system was primarily due to excess leverage, too little capital of insufficient quality, and inadequate liquidity buffers. In addition, there were major shortcomings around risk management, corporate governance, market transparency, and the quality of supervision. When it comes to both risk management and supervision, there was too much of a firm-specific focus and an insufficient understanding of how broader system-wide risks could play out under stress.

The crisis has extended to become an economic crisis and some financial institutions are still struggling to meet their obligations. The crisis has shown the regulatory authorities the importance of shifting to a new paradigm in the macro financial stability framework as well as in the international financial order. In particular, a broad consensus in the international community has developed on the necessity to design various regulatory tools, including macro prudential policies, to counter the heightened mood of anxiety now seen everywhere concerning systemic risk. As a result, leaders of the G20 countries mandated Financial Stability Board to address these issues.

3.1. Financial Stability Board (FSB)

The FSB was established in April 2009 as the successor to the Financial Stability Forum (FSF). The FSF was founded in 1999 by the G7 Finance Ministers and Central Bank Governors following recommendations by Hans Tietmeyer, President of the Deutsche Bundesbank.

In November 2008, the Leaders of the G20 countries called for a larger membership of the FSF. A broad consensus emerged towards placing the FSF on stronger institutional ground with an expanded membership - to strengthen its effectiveness as a mechanism for national authorities, standard setting bodies and international financial institutions to address vulnerabilities and to develop and implement strong regulatory, supervisory and other policies in the interest of financial stability. As announced in the G20 Leaders Summit of April 2009, the expanded FSF was re-established as the Financial Stability Board (FSB) with a broadened mandate to promote financial stability.

4. The Development of Prudential Framework by Basel Committee

In addressing the challenges in the global financial system on banking sector, the Basel Committee on Banking Supervision (BCBS) developed a new framework called Basel III, comprising micro prudential and macro prudential measures. Clearly, micro and macro prudential reforms are closely related, as greater resilience at the individual bank level reduces the risk of system wide shocks.

First, the Basel Committee has substantially raised the quality of capital, especially a much greater focus on common equity to absorb losses. Credit and market value losses come directly out of retained earnings and therefore common equity. During the crisis, it was the tangible common equity ratio that market participants focused on to assess bank resilience. This is also the reason why regulatory deductions are taken from this common equity component of capital. In the Basel III, the Committee has fully harmonized all aspects of the definition of capital and these must be fully disclosed in the financial statements.

Second, Basel III has substantially improved the coverage of the risks, especially related to capital markets activities. Among other things, trading book exposures will be subject to a stressed value at risk requirement. Banks must hold appropriate capital for less liquid, credit sensitive assets with much longer holding periods. Securitization exposures will be subject to capital charges more consistent with those for the banking book. The Committee is also working to ensure that these are appropriately managed and capitalized, so that no new concentrations of systemic risk are created.

Third, the Basel III is requiring much higher levels of capital to absorb the types of losses associated with crises. This includes an increase in the minimum common equity requirement from 2% to 4.5% and a capital conservation buffer of 2.5%, bringing the total common equity requirement to 7%.

Fourth, Basel III has introduced a global liquidity standard to supplement the capital regulation. While capital is a necessary condition for bank resilience, it is of course not sufficient. Northern Rock had one of the highest capital ratios in the UK when it failed. There were extremely high levels of liquidity across asset markets, even in the first half of 2007. Liquidity risk was not priced into many banking activities or even considered to be a key risk at the system level. The Basel III therefore will require banks to be able to withstand a 30 days system-wide liquidity shock as well as maintain a more robust structural liquidity profile. No doubt, this will raise the cost of funding in normal times and have an impact on business models. Banks will have to do more to self-ensure against periods of stressed liquidity, just as they need to hold capital to absorb unexpected losses. Going forward, liquidity should not be viewed as a free good and therefore needs to be priced appropriately.

Fifth, Basel III is also addressing systematically important financial institutions (SIFIs) through various frameworks. The issues of domestic as well as regional SIFIs are also currently being discussed at the Committee level.

The Basel Committee also addresses the weaknesses through macro prudential measures in its current work. An effective macro prudential regime must employ tools that increase the resilience of the financial system to shocks that originate not only from external sources, but also from within the financial markets. In this respect, the Committee highlights two approaches to the application of macro prudential tools—a variable approach and a fixed approach. The variable approach uses tools, such as countercyclical capital buffers, with flexible parameters that adjust either automatically or change in response to business cycle developments. On the other hand, a fixed approach uses tools, such as gross leverage ratios and core funding ratios that are not adjusted during the course of the economic cycle in an attempt to make the financial system more resilient to systemic risk at all points in the cycle. The use of both variable and fixed tools is necessary to achieve the goal of a more resilient and stable financial system, less prone to severe upswings and downturns.

5. Prudential Development Activities in the Islamic Financial Services Industry

As the financial crisis continues to unfold, its consequences have affected all asset classes across the financial markets; Islamic finance is no exception. As an international standard-setting organization for Islamic financial services industry, the IFSB is committed by its mandate to develop prudential standards that promote soundness and stability of the Islamic financial system. Application of such standards by regulatory and supervisory authorities will go a long way towards ensuring not only that the financial system is in good health, but that its stakeholders, including the providers of development finance, reach their full potential.

In addition, the IFSB now is expected to move faster to cope with the development within the Islamic financial services industry as the Islamic finance is becoming more globalized. Many Islamic banks are planning to expand their operation outside their home jurisdictions and they are potentially exposed to risks inherent in the global financial system. However, prudential framework for Islamic finance remains within its jurisdictional boundary. Hence, there is a need for even further cooperation among the authorities that regulate and supervise the IIFS at regional and international levels.

5.1. Prudential Standard Development

Among the earliest standards issued by the IFSB; the IFSB-2: Capital Adequacy Standard is the standard that has been widely implemented by the IFSB member countries. To complement this standard, a number of Guidance Notes (GN) have also been developed and published in order to provide additional guidance needed by the Islamic banks to calculate capital adequacy requirements. The additional standard that had been issued is Capital Adequacy Requirements for Sukûk, Securitizations and Real Estate investment. The GN that were issued to support this standard are GN on Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on Shari'ah-Compliant Financial Instruments; GN on Commodity Murâbahah Transaction; and GN on the Determination of Alpha in the Capital Adequacy Ratio.

With the development taking place in the Basel Committee following the crisis, the IFSB has started the due process of revising the IFSB Capital Adequacy Standard since January 2011. The revision of capital adequacy document not only provides an update to the previous standard, but also taking into account recent development and requirements requested by BCBS in the Basel III. Overall, the document tries to provide a more comprehensive guidance to supervisory authorities on application of capital adequacy regulations for IIFS. The revised capital adequacy standard is expected to be adopted by the IFSB Council in late 2013.

5.2. Liquidity Infrastructure

Due to the importance of a sound liquidity risk management framework, the IFSB has been addressing this subject in a number of its initiatives and publications. A major initiative involved the setting up of the International Islamic Liquidity Management Corporation (IILM) in November 2010 to issue high-quality benchmark inter-governmental sukūk that can be traded globally and bring about regional and global integration of Islamic money and capital markets in sovereign issues. The industry is expecting to witness IILM’s first global Shari'ah-compliant dollar bills in the near future.

In terms of publications, the IFSB has published several documents in the area of liquidity management, the latest being the IFSB-12: Guiding Principles on Liquidity Risk Management, issued in March 2012. This standard provides a set of principles for the robust management of liquidity risk by IIFS and vigorous supervision and monitoring by the supervisory authorities. The IFSB is also currently working on the preparation of a separate Guidance Note on quantitative tools for the measurement and monitoring of liquidity risk in IIFS.

Given the international efforts to make regulatory reforms at a broader level, the review and drafting of the IFSB’s existing standards and guidance notes is currently being conducted to align the Islamic financial services industry with global best practices issued by, inter alia, the BCBS, the Committee of European Banking Supervisors and the IOSCO – many of which were revised after the financial crisis.

5.3. Systemic Stability

Financial stability issues are also key areas for further work. The question remains on how well IIFS can absorb stresses and shocks that are more specific to the Islamic financial market. This implies an approach to stress testing that differs in some respects from that applicable to conventional institutions.

In its earlier standards, the IFSB mentioned the significance of using stress testing for both IIFS and supervisory authorities. However, recognizing that stress testing for risk management requires active involvement of supervisory authorities and market players, the IFSB has issued the IFSB-13: Guiding Principles on Stress Testing also in March 2012. Taking into account the specificities of IIFS in terms of their risk exposures, the Guiding Principles are expected to contribute to the soundness and stability of the IIFS particularly, and the IFSI as a whole.

6. Coordination of Regulatory Approaches with Basel Committee

With the current trends towards globalization of Islamic financial services, it becomes increasingly important for the Basel Committee and the IFSB to work more closely together in order to facilitate the integration of the Islamic financial services industry within the overall financial system.

The participation of the IFSB in the Basel Consultative Group provides both the Basel Committee and the IFSB with an opportunity to observe and benefit from each other's work and experience on issues of mutual interest, particularly in ensuring the success of the complementary role played by the IFSB in addressing the prudential issues of the Islamic financial services industry.

First, the BCG's broad and open linkages with the international financial community provides a significant channel for the Basel Committee to engage with supervisors around the world on a broader range of issues, including financial stability and prudential issues in which all members are able to interact fully and openly. The IFSB's participation as one of BCG members acts as a bridge between supervisors of conventional banks and Islamic financial institutions and their supervisors.

Second, it is also equally important for Basel Committee to understand the development of Islamic Finance and ensure that the risk management, corporate governance and accounting issues faced by IFSB are handled in a consistent manner and at the same time in compliance with the Shari'ah rules and principles. Indeed, several financial stability issues may arise in the rapidly changing international scene which may require both the Basel Committee and the IFSB to deliberate and address these issues in the forum such as the BCG.

Third, BCG provides a unique and effective effort to promote the intrinsic benefits of meeting face-to-face among banking regulatory authorities as it builds trust and relationships, and develops an effective exchange of ideas among the regulatory authorities. This is especially important during the crisis involving cross border matters, where the regulators would need urgent response from their other counterparts.

7. Implementation of the IFSB Standards

Similar to other international standard setting organizations, the IFSB does not have enforcing power towards its standards. One key question following the development of the standards is on the implementation of the IFSB Standards. In terms of implementation, members of the IFSB are expected to implement the Guiding Principles on Liquidity Risk Management and the Guiding Principles on Stress Testing in their jurisdictions from 2013 onwards. The challenge will be in terms of implementing and applying these Guiding Principles to commensurate with the nature, size and complexity of relevant IIFS in the respective jurisdictions, without serious risk of compromising the desired effects.

The Council of the IFSB has so far approved the issuance of fifteen standards, which are available online. The current projects focus on three aspects, namely, revised capital adequacy standard, revised supervisory review process and risk management for takāful undertakings.

In an effort to provide interactive learning tool for authorities supervising Islamic financial services, the IFSB is in the process of developing e-learning tutorials, which can be used by staff of the authorities to gain a broad understanding of the IFSB standards, and to refresh or expand their knowledge in a particular prudential area such as risk management, capital adequacy and supervisory review process.

8. Creating Awareness on the Prudential Issues in Islamic Finance

Apart from developing the standards, the IFSB is actively involved in promoting the awareness of issues that are relevant or have an impact on the regulation and supervision of the Islamic financial services industry. This mainly takes the form of international conferences, seminars, workshops, trainings, meetings and dialogues staged in many countries and publications.

8.1. Awareness Programme

Among the events organized by the IFSB are:

- legal seminar
- interactive session
- challenges seminar
- lecture on financial policy and stability
- IFSB summit
- European challenges

Some seminars or forums are jointly organized with other organizations, international inter-governmental agencies such as The World Bank, Islamic Development Bank and IDB-IRTI and supervisory authorities of member countries. These events may not be on a regular basis, but more to fulfilling the current industry needs.

8.2. Publications

All IFSB standards are published both in print and portable document format as means of information dissemination. The portable document format may be downloaded from the IFSB website.

Every year, the IFSB organizes an interactive session, which discusses the future prospects of the Islamic financial services industry. The session followed the meetings of The Council and the General Assembly of the IFSB. The session that is attended by many industry representatives highlights some of the major challenges that have to be addressed by the industry.

The event generally follows with an International Seminar on Challenges Facing the Islamic Financial Services Industry. The Seminar generated sets of policy recommendations on the developments of human capital, products and markets, and legal framework for the Islamic financial services industry. These recommendations will be applied towards the formulation of various policies to support the development of the industry. The Seminar is restricted to the IFSB member countries and generally attended by senior representatives of central banks, monetary agencies and international inter-governmental financial organizations, chief executive officers of financial institutions and other relevant organizations, partners of international accounting firms and law firms, and academics. For instance, one of the challenges affecting the financial architecture, which the IFSB has begun to address, is the legal infrastructure. Legal risk is perhaps one of the major risks to which IIFS could be exposed, particularly as all their transactions are based on Shari'ah contracts, which may or may not be compatible with local laws.

9. Conclusion

The last ten years have been an eventful period for financial services industry. The Islamic financial services industry has managed to weather the challenges well since it was not directly exposed to derivatives. However, as the financial crisis led to economic crisis, the industry is no exception. Prudential regulation needs to adapt to new circumstances and, where necessary, the IFSB also has to tighten up its standards to be consistent with other international standards.

During this period, the IFSB has developed its mandates, by carrying out fundamental prudential banking activities that complemented Basel II framework, supporting necessary infrastructure on liquidity and promoting dialogues on legal issues. While significant milestones have been reached in the development of the IFSI, there remains much more to be accomplished by both the regulatory and supervisory authorities as well as the industry players if the noble goal is to fully integrate Islamic finance in the global financial system.

The IFSB will be celebrating its 10th year anniversary in 2013. The future facing the IFSB beyond this stage depends towards facilitating the needs of the Islamic financial services industry and enhancing closer and effective cooperation with international standard setters by actively participating in the development of prudential regulatory framework. Implementation of the standards specific to IIFS remains a key issue, and it is about time for perceptive change among relevant regulatory authorities to pay more attention to this aspect.

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