COPING WITH THE INTERNATIONAL STANDARDS OF BASEL COMMITTEE ON CORE PRINCIPLES ON EFFECTIVE BANKING SUPERVISION (BCBS): ANALYSIS AND REFORM FOR ISLAMIC BANKING

Hakimah Yaacob
Sultan Sharif Ali Islamic University

Ruzian Markom♣
Universiti Kebangsaan Malaysia

Asma Hakimah
Universiti Kebangsaan Malaysia

ABSTRACT

Coping with international standards is not an easy task for Islamic banking. Surviving for years under the umbrella of Basel Committee on Banking Supervision (BCBS), opens comprehensive avenues for Islamic banking to adopt conventional Core banking as a generic platform. Islamic finance, which spurns activities outlawed by Islam, is considered a viable ethical alternative to conventional financing. In order to be accepted and recognized as part of players in the industry, Islamic banking riding over the Banking Core Principles to guide businesses and operations. Eventually, this may leads to unpleasant legal and Shari'ah issues. Therefore, Islamic Financial Services Board (IFSB) has so far issued their own Core Principles in Islamic banking operations in addition to the BCBS Core Principles. The methodology chosen for this study is to undertake the direct observation from operations, legal and regulatory perspectives. The study finds that there is a pressing need of the consolidation of the existing bodies rather than duplicating efforts in the establishment of recognised international Standards for Islamic Banking. This paper aims to analyses the viability of the Core Principles applied in Islamic banking and proposes several proposals for considerations and direction for future research. The recommendations put forward for this study are expected to help enhancing the Islamic banking systems and operations and to uphold Shari'ah. It is hoped that this research brings a new way out for Islamic banking regulatory systems and operations.

Keywords: Banking core principles; Basel committee; Islamic banking; Shari'ah compliance; Shari'ah board; Islamic Financial Services Board (IFSB)

1. INTRODUCTION

The Core Principles for Effective Banking Supervision (Core Principles) are the de facto minimum standard for sound prudential regulation and supervision of banks and banking systems. The rule was issued by the Basel Committee on Banking Supervision in 1997 to supervise conventional banking. As of to date they have issued 29 Core Principles on Banking Supervision. The Standards

♣ Corresponding author, Associate Professor at Faculty of Laws, Universiti Kebangsaan Malaysia: ruzian@ukm.edu.my

are used as a benchmark for assessing the quality of banking operations and regulators supervisory systems for conventional banking to ensure financial stability (Morisson, 2002)

The Core Principle is an instrument to assess the effectiveness of countries' banking supervisory systems by the International Monetary Fund (IMF) and the World Bank through the Financial Sector Assessment Programme (FSAP). The principles allows the banking systems to offer a wide range of products or services and with the general aim of catering to different financial needs (Barr & Miller, 2006). To accommodate this breadth of application, a proportionate approach is adopted, both in terms of the expectations on supervisors for the discharge of their own functions and in terms of the standards that supervisors impose on banks. Consequently, the Core Principles acknowledge that supervisors typically use a risk-based approach in which more time and resources are devoted to larger, more complex or riskier banks (Jarrow, 2007). In the context of the standards imposed by supervisors on banks, the proportionality concept is reflected in those Principles focused on supervisors' assessment of banks' risk management, where the Principles prescribe a level of supervisory expectation commensurate with a bank's risk profile and systemic importance (Decamps et al., 2004).

The Core Principles, such as those issued by the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) for securities and the International Association of Insurance Supervisors (IAIS) for Insurance and Takaful, have become a standard tool to guide regulators and supervisors in developing their regulatory regimes and practices. They also serve as the bases for regulatory and supervisory authorities (RSAs) themselves, or external parties such as the multilateral agencies, to assess the strength and effectiveness of regulation and supervision (Young, 2012). This paper focuses on the BCBS Core Principles for banking only. The objectives of this article are twofold:

i. To analyse the viability of Islamic banking applying the 29 Core Principles issued by the BCBS
ii. To propose viable Shari'ah Compliance Principles for Islamic banking operations to be applied in the Islamic banking system.

Based on the mandate given to Islamic Financial Services Board (IFSB) is of high importance to ensure the International Core Principles are followed and at the same time upholding Shari'ah in all aspects of Islamic banking and Takaful businesses. Islamic Financial Service Board (IFSB) was mandated to ensure the operations of Islamic banking are in line with the required Core Principles and some amendment to the Principles have added values to Islamic finance industries. On 12 December 2012 at Islamic Development Bank headquarters in Jeddah, Kingdom of Saudi Arabia, IFSB Council approved the preparation of a set of IFSB Core Principles for Islamic Finance Regulation (hereinafter referred to as "CPIFR") and the setting up of a Core Principles for Islamic Finance Regulation Working Group (CPIFRWG) for this purpose.

The present Core Principles issued by the BCBS consist of 29 Core Principles for Conventional Banking supervision and regulation. Indeed the Principles are silent on the operations in Islamic Finance such as Takaful, Shari'ah governance, Islamic capital market, and Shari'ah. These sectors triggers different issues hailed from Shari'ah principles.

2. THE IMPORTANCE AND THE EFFECTS OF BCBS CORE PRINCIPLES ON THE BANKING REGULATORS

The Core Principles set out the powers that supervisors and regulators should have in order to address safety and soundness concerns. It is equally crucial that supervisors use these powers once weaknesses or deficiencies are identified. The principles applicable for all banks be it conventional or Islamic banks. Adopting a forward-looking approach to supervision through early intervention can prevent an identified weakness from developing into a threat to safety and soundness. This is particularly true for highly complex and bank specific issues (e.g. liquidity risk) where effective supervisory actions must be tailored to a bank's individual circumstances (Wignall & Atkinson**,** 2010**)**. Bear in mind, that the Core Principles are conceived as a voluntary framework of minimum standards for sound supervisory practices; national authorities are free to put in place supplementary measures that they deem necessary to achieve effective supervision in their jurisdictions. This is where the IFSB comes with the authority and liberty to add more principles to the lists given by the BCBS.

3. FUNCTIONS AND ROLE OF ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

In order to understand the banking principles followed by Islamic Financial Institutions around the world, it is important to understand the standards setting body established for IFI to ensure financial stability are observed and complied with. The role to ensure this task was given to the Islamic Financial Services Board (IFSB).

The Islamic Financial Services Board (IFSB), which is based in Kuala Lumpur, was officially inaugurated on 3rd November 2002 and started operations on 10th March 2003. It serves as an international standard-setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and insurance. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with Sharî'ah principles, and recommend them for adoption (Yaacob, 2010).

The establishment of Islamic Financial Services Board in Malaysia was based on the Article of Agreement executed by all member countries from different parts of the world. As at April 2016, the 189 members of the IFSB comprise 66 regulatory and supervisory authorities, eight international inter-governmental organizations, and 115 market players (financial institutions, professional firms and industry associations) operating in 48 jurisdictions.

4. APPLICATION OF BASEL CORE PRINCIPLES IN MALAYSIA

In September 2010, the Basel Committee on Banking Supervision (BCBS) endorsed a package of reforms to strengthen global capital standards and introduce global standards for liquidity known as Basel III. The reforms represents the core components of the global financial reform agenda aim to improve the banking sector's ability to absorb financial and economic shocks, thus reducing the risk of spill over from the financial sector to the real economy. All major elements of the Basel II capital framework including the Internal Ratings-Based approach for credit risk as well as the Pillar 2 and Pillar 3 components – have been incorporated into the guidelines issued by Bank Negara. Below are several examples of guidelines issued by Bank Negara based on the BCBS Core Principles.

4.1. Guideline BNM/RH/GL 001- 22 - Capital Adequacy Framework (Basel II – Risk Weighted Assets)

Capital Adequacy Framework (Basel II - Risk-Weighted Assets) issued by the Prudential Financial Policy Department of Malaysian Central Bank indicates that the computation of the risk-weighted assets is consistent with Pillar 1 requirements set out by the Basel Committee on Banking Supervision (BCBS) and the Islamic Financial Services Board (IFSB) in their respective documents - “International Convergence of Capital Measurement and Capital Standards: A Revised Framework” issued in June 2006 and the “Capital Adequacy Standard (CAS)” issued in December 2005. There are areas of National Discretion summarises the options that could be exercised by the Bank in areas where national discretion is provided by the BCBS to the national supervisory authority. This is written in the Guideline Capital Adequacy Framework (Basel II - Risk-Weighted Assets) BNM/RH/PD 032-5. In terms of regulations for International Islamic Bank, the requirements stipulated in the guidelines provided by Bank Negara are the minimum standards that need to be observed. However, an International Islamic Bank is allowed to observe higher regulatory and prudential standards and ensure that the observed standards are in line with internationally accepted standards and best practices. The framework is applicable to;

1. all Islamic banking institutions licensed under Islamic Financial Services Act 2013; and
2. all banking institutions licensed under the Financial Services Act 2013 (FSA) approved under section 15(1)(a) of the FSA to carry on Islamic banking business in accordance with the Guidelines on Skim Perbankan Islam (SPI);
3. all financial holding companies (FHCs) approved under the Islamic Financial Services Act 2013 (IFSA) which are engaged predominantly in banking activities. The requirements for FHCs are set forth in part G.

4.2. Capital Adequacy Framework for Islamic Banks (Capital Components) issued on 13 October 2015

The Capital Adequacy Framework for Islamic Banks sets out the approach for computing regulatory capital adequacy ratios, as well as the levels of those ratios at which an Islamic financial institution is required to operate. The framework has been developed based on internationally-agreed standards on capital adequacy promulgated by the Basel Committee on Banking Supervision (BCBS) and Islamic Financial Services Board (IFSB). The policy for Capital Adequacy Framework for Islamic Banks (Capital Components) document sets out the general requirements concerning regulatory capital adequacy, and the components of eligible regulatory capital. It shall be read together with the Capital Adequacy Framework for Islamic Bank (Risk Weighted Assets) which details out the requirements for computing risk weighted assets.

4.3. Guideline BNM/RH/NT 007-25 - Implementation of Basel III

In December 2010, the Basel Committee on Banking Supervision ("Basel Committee") finalised a package of measures to strengthen global capital and liquidity rules with the goal of strengthening the resilience of the global banking system. The rules are detailed out in the documents Basel III. A global regulatory framework for more resilient banks and banking systems and Basel III: International framework for liquidity risk measurement, standards and monitoring1 (collectively referred to as Basel III). From time to time, the Basel Committee publishes additional documents detailing out individual components of the Basel III reform package. For the purpose of implementation in Malaysia, the Basel III reform package is defined to also include enhancements to the Basel II framework made by the Basel Committee in July 2009, as well as other remaining components of the Basel II framework which have yet to be implemented in Malaysia.

4.4. Guideline BNM/RH/GL 002-22- Capital Adequacy Framework for Islamic Banks – Internal Capital Adequacy Assessment Process (Pillar 2)

Pillar 2 of the Capital Adequacy Framework for Islamic Banks (CAFIB) aims to ensure that Islamic banking institutions have adequate capital to support their operations at all times. It also promotes the adoption of a more forward looking approach to capital management and encourages Islamic banking institutions to develop and employ more rigorous risk management techniques.
Under Pillar 2, the adequacy of an Islamic banking institution's capital will be assessed by both the Islamic banking institution and Bank Negara Malaysia (the Bank). This encompasses: 1. An Internal Capital Adequacy Assessment Process (ICAAP) to be carried out by the Islamic banking institution in accordance with these Guidelines; and 2. Supervisory review and evaluation of the Islamic banking institution's ICAAP, including an assessment of the quality of the control environment within which the ICAAP is implemented.

4.5. Guideline BNM/RH/GL 007-18-Capital Adequacy Framework for Islamic Banks (CAFIB) - Disclosure Requirements (Pillar 3)

The Guidelines forms part of the Capital Adequacy Framework for Islamic Banks (CAFIB) that specifies the disclosure requirements for: (1) credit risk under the standardised and internal rating based (IRB) approach; (2) market risk under the standardised and internal models approach; and (3) operational risk under the basic indicator or standardised approach. The Pillar 3 disclosure requirements aim to enhance transparency by setting the minimum requirements for market disclosures of information on the risk management practices and capital adequacy of Islamic banks. This will enable market participants to obtain key information on risk exposures, risk assessment processes, the capital structure and capital adequacy of Islamic banks.
The core Principles issued by Islamic Financial Services Board on April 2015 reflects the need of incorporating the international requirements of BCBS into the Islamic banking operations. The Guideline issued by IFSB serves as guidelines for banking operations.

5. SIMILARITIES AND DIFFERENCES OF BCBS CORE PRINCIPLES ON BANKING SUPERVISION WITH CORE PRINCIPLES OF ISLAMIC BANKING REGULATION

The BCBS Core Principles on Banking Supervision consist of two parts i.e. supervisory powers, responsibilities and functions and the Prudential regulations and requirements. The divisions are explained in Table 1 as follows.

Table 1: BCBS Core Principles on Banking Supervision

BCBS Core Principles on Banking Supervision	
Supervisory Powers, Responsibilities and Functions	**Prudential Regulations and Requirements.**
Principle 1: Responsibilities, objectives and powers	Principle 14: Corporate governance.
Principle 2: Independence, accountability, resourcing and legal protection for supervisors	Principle 15: Risk management process
	Principle 16: Capital adequacy
Principle 3: Cooperation and collaboration	Principle 17: Credit risk
Principle 4: Permissible activities	Principle 18: Problem assets, provisions and reserves
Principle 5: Licensing criteria	
Principle 6: Transfer of significant ownership	Principle 19: Concentration risk and large exposure limits
Principle 7: Major acquisitions	
Principle 8: Supervisory approach	Principle 20: Transactions with related parties
Principle 9: Supervisory techniques and tools	Principle 21: Country and transfer risks
Principle 10: Supervisory reporting	Principle 22: Market risk
Principle 11: Corrective and sanctioning powers of supervisors	Principle 23: Interest rate risk in the banking book
	Principle 24: Liquidity risk 56
Principle 12: Consolidated supervision	Principle 25: Operational risk
Principle 13: Home-host relationships	Principle 26: Internal control and audit 60
	Principle 27: Financial reporting and external audit
	Principle 28: Disclosure and transparency
	Principle 29: Abuse of financial services

Source: http://www.bis.org/publ/bcbs230.pdf

Principle 1 is generic in nature. It requires an effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups. A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to authorize banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns. This is when the banking laws, regulations and prudential standards are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices. These are subject to public consultation, as appropriate. There are other Principles that are generic in nature and retained and unamend. However, there few Principles which is not in conformity with Shari'ah requires amendment and additional Principles to suit financial stability of Islamic Financial Institutions (IFI).

Table 2: Similarities and Differences of CPIFR Approach: Revised CPs in the form of CPIFR Reflecting the Specificities of IIFS

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

Source: www.ifsb.my

6. ADDITIONAL PRINCIPLES TO ENSURE FINANCIAL STABILITY OF ISLAMIC FINANCIAL SERVICES

Principle 29 requires the supervisory authority to determine adequate internal control frameworks to establish and maintain a properly controlled operating environment for the conduct of their business taking into account their risk profile. These include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the IIFS, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the IIFS's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations. In this regard, IFSB has added the supervisory authority provides and enforces guidelines on internal Shari'ah audits. The supervisory authority determines that IIFS undertake a Shari'ah compliance review at least annually, performed either by a separate Shari'ah control department or as part of the existing internal and external audit function by persons having the required knowledge and expertise for the purpose. When assessing the effectiveness of the control (including internal audit) and compliance functions of the IIFS and its external audit, the supervisory authority holds discussions with the IIFS's compliance function to assess its role, authority and effectiveness, and with its internal and external auditors and its Audit Committee regarding the audit scope and recent audit findings.

For BCBS Core principles No 27, IFSB has added the supervisory authority to determine the IIFS and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisory authority also determines that IIFS and parent companies of banking groups have adequate governance and oversight of the external audit function.

This includes the supervisory guidelines or local auditing standards determine that audits cover areas such as the financing portfolio, financing loss provisions, non-performing assets, asset valuations, trading and other securities activities, *sharī`ah*-compliant hedging instruments, asset securitizations, consolidation of and other involvement with off-balance sheet vehicles, and the adequacy of internal controls over financial reporting.

7. ISLAMIC WINDOWS

In addition, IFSB added CPIFR Principle No 32 to include Islamic windows into the operations of Islamic banking. Supervisory authorities define what forms of Islamic "windows" are permitted in their jurisdictions. The supervisory authorities review Islamic windows' operations within their supervisory review process using the existing supervisory tools. The supervisory authorities in jurisdictions where windows are present satisfy themselves that the institutions offering such windows have the internal systems, procedures and controls to provide reasonable assurance that (a) the transactions and dealings of the windows are in compliance with Shari'ah rules and principles; (b) appropriate risk management policies and practices are followed; (c) Islamic and non-Islamic business are properly segregated; and (d) the institution provides adequate disclosures for its window operations. Laws, regulations or the supervisory authority determine, with appropriate definitions, what forms of Islamic window operation are permitted to operate in the jurisdiction. Below are the principle requirements to be observed by the Islamic Financial Institutions when they operate “windows”. The supervisory authority determines that an Islamic window has, both initially and on an ongoing basis, a minimum amount of funding from the conventional parent as required by the laws and regulations of the jurisdiction, including its capital adequacy and liquidity requirements.

The supervisory authority determines that an institution with Islamic windows has a system such that the separation of Islamic assets and funds from non-sharī`ah-compliant assets and funds is made transparent. The system should act both to prevent the window from investing in non-sharī`ah-compliant assets, and from channeling investors' funds back to the conventional parent entity. Supervisory authorities in jurisdictions where windows are present satisfy themselves that the institutions offering such windows have the internal systems, procedures and controls to provide reasonable assurance the following;

(a) the transactions and dealings of the windows are in compliance with Shari’ah rules and principles; and
(b) appropriate risk management policies and practices are followed.

The supervisory authority requires a window to apply Shari’ah governance arrangements comparable to those of a full-fledged IIFS. If the supervisory authority permits any variation to those arrangements (in respect of the institution’s Islamic business), it should have clear reasons for doing so. In such cases, the supervisory authority should satisfy itself that pertinent *Shari’ah Fatāwa* and resolutions are complied with by the financial institution’s management in their offering of Islamic financial services. The supervisory authority takes account of the *Sharī`ah*-compliant assets of the window, as well as the risk-bearing nature of the *Sharī`ah*-compliant funds that are invested in these assets, in assessing the capital adequacy of the conventional financial institution concerned. The IFSB’s *Revised Capital Adequacy Standard* provides a measurement approach that may be used for this purpose, although in general the overall capital regulatory requirement is embodied in the regulatory requirement at the main institutional level, irrespective of whether the parent is in the same jurisdiction or in another jurisdiction. The supervisory authority determines and understands the manner in which capital and liquidity are to be made available to Islamic windows, and how losses generated by the windows will eventually be absorbed.

The additional Principles add values to cases where a conventional bank offers Islamic operations through Islamic windows, supervisory authorities fully evaluate the liquidity risk management framework at both the group/parent level and Islamic entity level. The supervisory authority also determines that senior management of a conventional bank operating Islamic operations in the form of an Islamic window is aware of the differences, complexities and constraints in managing liquidity in the Islamic operations vis-à-vis at the bank level. A particular issue arises when the parent entity of an Islamic window operation is situated in another jurisdiction and there are restrictions on, or impediments to, fund transfers between the parent and the window. If the supervisory authority has a policy requiring Islamic windows to be converted into Islamic banking subsidiaries, the criteria for requiring conversion are clearly specified (e.g. in terms of asset size of the window in absolute terms or as a percentage of the parent’s balance sheet, years of operation, etc.). Such criteria are clearly grounded in the overall legal and regulatory framework in the jurisdiction as well as its overall strategic plan for the Islamic banking industry, if any.

The supervisory authority determines that IIFS have a robust Shari'ah governance system in order to ensure an effective independent oversight of Shari'ah compliance over various structures and processes within the organizational framework. The Shari'ah governance structure adopted by an IIFS is commensurate and proportionate with the size, complexity and nature of its business. The supervisory authority also determines the general approach to Shari'ah governance in its jurisdiction, and lays down key elements of the process.
Laws, regulations or the supervisory authority determine that the IIFS are under an obligation to ensure that their products and services comply with Shari`āh rules and principles. The supervisory authority further determines that in all aspects of IIFS operations, including products and services, a governance structure, policies and procedures exist to ensure that the Shari`āh rules and principles are adhered to at all times.

Laws, regulations or the supervisory authority ensure that a financial institution is not allowed to represent itself as "Islamic", either expressly or by implication, without having such a governance structure, policies and procedures.

The supervisory authority determines that the Shari'ah board of an IIFS plays a strong and independent oversight role, with adequate capability to exercise objective judgment on Sharī`ah-related matters. The supervisory authority also determines that IIFS has in place an appropriate and transparent process for resolving any differences of opinion between the BOD and the board. This process may include having direct access (after duly informing the supervisory authority) to the shareholders as a "whistle-blower". IFSB added a Shari'ah board can only be deemed "independent" when none of its members has a blood or intimate relationship with the IIFS, its related companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of independent judgment in the best interests of the IIFS by the Shari'ah board. In the case of Shari'ah advisory firms, such a firm can only be deemed independent from the IIFS if they are not related parties, such as in terms of having common shareholders or common directors.
The supervisory authority requires that each IIFS has a properly functioning Shari'ah governance system in place, which clearly demonstrates, among other things:

i. clear terms of reference regarding the Shari'ah board's mandate, reporting line and responsibility;
ii. well-defined operating procedures and lines of reporting; and
iii. good understanding of, and familiarity with, professional ethics and conduct

The supervisory authority determines that the Shari'ah board or comparable body is provided with complete, adequate and timely information prior to all meetings and on an ongoing basis on any product or transaction on which a pronouncement is sought, including having its attention drawn to any areas of possible difficulty identified by the IIFS's management. The management of an IIFS has an obligation to supply the Shari'ah board with complete, accurate and adequate information in a timely manner. The supervisory authority also determines that the Shari'ah board has free access to the company's senior management for all the information it needs.
The supervisory authority determines that the following elements in the Shari'ah governance mechanism have been reflected by IIFS:

a. Issuance procedures of relevant Shari'ah pronouncements/resolutions and dissemination of information on such Shari'ah pronouncements/resolutions to the operative personnel of the IIFS who monitor day-to-day compliance with the Shari'ah pronouncements/resolutions;

b. An internal Shari'ah compliance review/audit for verifying that Shari'ah compliance has been achieved; and

c. An annual Shari'ah compliance review/audit for verifying that the internal Shari'ah compliance review/audit has been appropriately carried out and its findings have been duly noted by the Shari'ah board.

8. DIFFERENCES OF SHARI'AH OPINION

The supervisory authority requires IIFS to have in place an appropriate mechanism for obtaining rulings from Shari'ah scholars, applying Fatāwa (i.e. Shari'ah pronouncements or resolutions) and monitoring Shari'ah compliance in all aspects of their business operations. This refers to a juristic opinion on any matter pertaining to Shari'ah issues in Islamic finance, given by the appropriately mandated Shari'ah board.

The supervisory authority requires an IIFS's Shari'ah governance system to cover the relevant ex-ante and ex-post processes. Ex-ante processes cover those for:
(a) The issuance of *Shari'ah* pronouncements/resolutions; and
(b) Compliance checks before the product is offered to the customers. Ex-post processes cover internal and external *Shari'ah*review66 and *Shari'ah* governance reporting. The supervisory authority also determines that IIFS engage appropriate experts, including a *Shari'ah* adviser or *Shari'ah* board, to review and ensure that new financing proposals that have not been proposed before or amendments to existing contracts are *Sharī`ah*-compliant at all times.

9. SHARI'AH COMPLIANCE

Shari'ah compliance requires the supervisory authority to ensure the Shari'ah governance system applies in ex-ante and ex-post processes. As required under the IFSB, ex-ante requirement are as follows;

(a) The issuance of Shari'ah pronouncements/resolutions; and
(b) Compliance checks before the product is offered to the customers.

Ex-post processes covers internal and external Shari'ah review and Shari'ah governance reporting. The supervisory authority also determines that Islamic banking engage appropriate Shari'ah experts or other baking related experts or Shari'ah board, to review and ensure that new financing proposals that have not been proposed before or amendments to existing contracts are Sharī`ah-compliant at all times (*IFSB-10*, December 2009; and *IFSB-16*, March 2014). In addition, the IFSB imposes supervisory authority to allow Shari'ah board a free access to the internal Shari'ah compliance unit/department (ISCU) and internal Shari'ah review/audit unit/department (ISRU). This is to ensure the internal control and compliance procedures are followed and complied with the applicable rules and regulations.

The missing element of Shari'ah governance in BCBS Principles was added to reflect the operation in Islamic banking as follows:

a. Issuance procedures of relevant Shari'ah pronouncements/resolutions and dissemination of information on such Shari'ah pronouncements/resolutions to the operative personnel of the IIFS who monitor day-to-day compliance with the Shari'ah pronouncements/resolutions;
b. An internal Shari'ah compliance review/audit for verifying that Shari'ah compliance has been achieved; and
c. An annual Shari'ah compliance review/audit for verifying that the internal Shari'ah compliance review/audit has been appropriately carried out and its findings have been duly noted by the Shari'ah board.

This measures adopted by the IFSB member countries On 12 December 2012 at Islamic Development Bank headquarters in Jeddah, Kingdom of Saudi Arabia, IFSB Council approved the preparation of a set of IFSB Core Principles for Islamic Finance Regulation (hereinafter referred to as "CPIFR"). In order to ensure the continuous professional development of persons serving on its Shari'ah board or Shari'ah committee (Malaysia refer Shari'ah committee as Shari'ah adviser. Unlike other countries, Shari'ah committee referred to as Shari'ah Board), the training policies are required to be established. This is to safeguards compliance with the operational and internal control policies and procedures, and all applicable legal and regulatory requirements. Formal assessment on the effectiveness of the Shari'ah Board are required through process for assessing the effectiveness of the Shari'ah board as a whole, as well as the contribution by each individual member to its effectiveness. The performance assessment report is submitted to the BOD for its review. Malaysia adopts strict requirement for performance assessment. Shari'ah committee is regarded as one of the 'Key Responsible Person' equal to Board of Directors and Directors of the Banks. Refer to BNM Guideline on Key Responsible Person.

The supervisory authority determines that risk management strategies, policies, processes and limits:

i. are properly documented;
ii. comply with Shari'ah rules and principles as interpreted by its Shari'ah board or other relevant authority;
iii. provide for adequate and timely identification, measurement, monitoring, control and mitigation of the risks posed by its financing, investing, trading, securitisation, off-balance sheet, fiduciary and other significant activities at the business line and IIFS-wide levels;
iv. clearly delineate accountability and lines of authority across the IIFS's various business activities, and ensure there is a clear separation between business lines and the risk function;
v. are regularly reviewed and appropriately adjusted to reflect changing risk appetites, risk profiles, and market and macroeconomic conditions; and
vi. are communicated within the IIFS.

10. ANALYSIS AND PROPOSAL FOR REFORM

The BCBS Core Principles are generic in nature. It has been adopted by all banks in many jurisdictions. The objective is to ensure the banking financial stability besides effectiveness of its supervision system. The regulators like Central Banks from various jurisdictions are required to observe and adopt the minimum Standards imposed. However, they are at full liberty to add values to the Principles to ensure the financial needs adequately addressed by the different needs of different countries. However, with the growth of Islamic banking around the world, it is timely for BCBS to recognize additional principles proposed by IFSB as part of BCBS Core Principles. Optional Protocol for specific Shari'ah supervision should be established to safeguards financial stability for those who believe in 'banking in faith'. IFSB, being a Standard Setting body should not be isolated from its member countries by not having a binding impact to its standards. The efforts by IFSB in issuing the additional Protocol may seem worthless if it is merely for voluntary adoption. May be it is not too ambitious to submit that IFSB should stand as high as BCBS. Having member countries of more than 148 countries is an accelerated route to ensure Islamic Banking Principles are adhered to. The BCBS Principles brings a ready-made dimension to Islamic banking. The principles have been adopted since the inception of Islamic banking. However, the adoption remains until today and regarded as generic adoption for Islamic banking. For countries like Malaysia, the full adoption as generic banking system triggers legal consequences. By virtue of Islamic Financial Services Act 213, breach of Shari'ah means breach of laws. Consequently, imposes dual compliance in banking systems. Despite of non bindingness of the IFSB Principles, Malaysia imposes strict compliance on Shari'ah. Islamic financial institutions are to ensure the Shari'ah compliance in its affairs, aims, objectives, operations and businesses (Jamal et al., 2011). This paper submits that Basel III requirements should not be imposed on Islamic banking as propounded by the Basel Committee. These cause difficulties for Islamic banking to seek for more capital and liquidity to meet the ratio required under the Basel III. The way Islamic banking operates should be different for the Core Principles imposed. Based on the above submission, this paper concludes with some proposal for reform as follows;

i. It is highly encouraged for Islamic banking to adopt their own Core Principles to ensure its operation, business, affairs, aims and objectives are Shari'ah compliance (Colon, 2011).
ii. The generic application of core banking system may be suitable in some areas of consumer protection (Harland, 1991), dispute resolution (Lim, 1998; Oseni, 2009; Oseni, 2011; Othman 2005; Raihanah, 2005; Rashid 2004), etc.; however, the recognized Shari'ah accounting system, Shari'ah audit system, Shari'ah governance system should be adopted by all countries applied Shari'ah banking .
iii. IFSB should not leave as merely a self-regulating body. This body should be accepted as an international standards setting organization at par with BCBS (Deshpande, 1989).
iv. It is timely to recognize the principles, standards, guidelines issued by IFSB are of high values and Shari'ah emphasize.
v. Voluntary adoption in IFSB Standards may lead to inconsistency its application. The regulators are merely concerns with the Core Principles issued by the BCBS which seems to be minimum standards rather than IFSB added Shari'ah values which is voluntary based. Should this practice continues, Shari'ah may be seen as secondary

issues when disputed in international court. This is evident from the cases decided in English Courts as well as Malaysian courts (Yaacob, 2011).

vi. It is timely for Islamic Banking Core Principles issued by IFSB to be recognized, adopted and binded to all jurisdictions that applies Islamic banking.

vii. It is timely for 'banking in faith' to be regarded as commercial banking systems and the acceptance is to be made compulsory for the countries that applies Islamic banking.

viii. Eventually, Islambarric banking requires an international standards setting body that is recognized globally and Standards issued in upholding Shari'ah are mandatorily adopted.

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