

## TECHNICAL ASSISTANCE COMPLETION REPORT

Division: SEGF

TA No., Country and Name		Amount Approved: \$400,000	
TA 6182-REG : Development of International Prudential Standards for Islamic Financial Services		Revised Amount: \$400,000	
Executing Agency: ADB		Source of Funding: ADB's TA Funding Program Co-Financing from the Islamic Development Bank	Amount Undisbursed: \$16,867.27
			Amount Utilized: \$383,132.73
TA Approval Date: 27 July 2004	TA Signing Date: 27 July 2004	Fielding of First Consultants: July 2005	TA Completion Date Original: 31 August 2005
			Actual: 31 March 2007
			Account Closing Date Original: 31 August 2005
			Actual: 30 June 2007

### **Description.**

In recognition of the size and fast paced growth of Islamic finance in Asia, and potential impact on financial sector development, in December 2003, the Asian Development Bank (ADB) joined the Islamic Financial Services Board (IFSB), the standard setter for the Islamic finance sector. Islamic financial institutions (IFI) face a unique mix of risks that arise from the contractual design of instruments based on Shariah (Islamic law) principles and the overall legal, governance and liquidity infrastructure for Islamic finance. For example, many Shariah products are sold by banks and are based on the use of equity-like instruments (profit sharing investment accounts) – however these products are not regulated as securities. To promote sound and stable development of these products and a level playing field in terms of competition with conventional products, additional legal and regulatory standards are needed for IFI. Many jurisdictions have not adopted an explicit legal and institutional framework for IFI. Moreover, legal infrastructure for finance generally in many countries that offer Islamic financial products – particularly laws governing insolvency and creditor rights, contract enforcement, formation of trusts and securitization - are often not robust and not well adapted to support the requirements of Islamic finance. A key concern in developing effective financial policy making and supervision for Islamic finance is the absence of reliable data on IFI and markets. This data is incomplete and not comparable among countries nor among firms within a country due to differences in accounting standards, and weak accounting and auditing environments. Cross border trading of Islamic financial products is also limited by the lack of compatibility of Islamic instruments across borders. To address many of these concerns, ADB agreed to provide a TA to IFSB.

### **Expected Impact, Outcome and Outputs**

The TA aim is to develop Islamic finance as a viable, sustainable finance model that can catalyze economic development and reduce poverty. To achieve this goal, the TA supports (i) the development of international prudential standards for IFI; (ii) strengthening of the legal framework for IFI; (iii) increased transparency in Islamic financial markets and comparability of IFI data and transactions; and (iv) development of harmonized standards and practices among jurisdictions. TA outputs include: (i) draft international prudential standard for market transparency and discipline for IFI, taking into account the special characteristics and risks of Islamic finance (disclosure standards); (ii) analysis and assessment of IFSB member data and recommendations for final draft international prudential standards for capital adequacy, risk management and corporate governance; (iii) identification of key principles for the development of an appropriate legal framework (focus on trust law and contract law) for IFSB to use in promoting harmonized legal systems across diverse legal jurisdictions; and (iv) compilation guidelines for obtaining information for a public database on IFI and markets (database).

### **Delivery of Inputs and Conduct of Activities**

The project was well formulated but ambitious in terms of inputs based on timing and resource constraints. Consultants were actively involved in the preparation of the disclosure standards, which adapt Pillar 3 of the New Basel Capital Accord (Basel II) to the specific features of Islamic finance and closely complement the objectives and procedures of the evolving capital adequacy (Pillar 1) and supervisory review (Pillar 2) standards for IFI. Consultants participated in working group meetings and international workshops to discuss various drafts of this standard. The standard is expected to be adopted by IFSB later this year – an exposure draft is posted on the IFSB website ([www.ifsb.org](http://www.ifsb.org)). Consultants assisted IFSB to develop a survey of data requirements and compilation practices in IFSB countries. The database of cross border banking statistics of the BIS and the work on the compilation guide on financial soundness indicators by the IMF provided the broad background for the design of the survey questionnaire. The consultants helped IFSB revise and administer the questionnaire and prepared a draft outline of a compilation and dissemination framework for discussion and consultation. Based on time and resource constraints, it was agreed that this TA component would not include the actual collection of data and setting up of the database. An initial draft of the guide was sent for comment to all IFSB members, International Monetary Fund (IMF), Bank for International Settlements (BIS), World Bank, ADB, Islamic Development Bank (IDB) and other concerned organizations. The Compilation Guide was approved in March 2007 and issued as an IFSB Guide. This guide supplements the IMF's Financial Sector Indicators Compilation Guide and is the first step toward compilation and dissemination of internationally comparable Islamic finance statistics. IFSB expects to publish the Guide on its website later this year.

With respect to clarifying the need for other Islamic prudential standards, the consultants gathered information from IFSB members to clarify the following issues: (i) current status of supervision of Islamic banks (extent of observance with Basel Core Principles); (ii) plans for Implementing Basel II by IFSB members, including plans to implement related IFSB standards; (iii) information on product innovations that could strengthen risk mitigation in Islamic finance; and (iv) current status of risk management and governance practices in IFI. Due to resource constraints and the fact that the current availability of this information is inadequate and incomplete, requests to IFSB members to address some of these information gaps were included in the data survey questionnaire (discussed above). More comprehensive data gathering and analysis is needed and may need to be deferred until the database has been operationalized. Based on information gathered, a technical background note, along with an analysis to design the critical follow up exercise was prepared. With respect to the legal framework for Islamic finance, consultants focused on issues relating to Islamic asset securitization in different jurisdictions. Consultants gathered background information and conducted a comparative analysis of country experiences in trust and contract laws from an Islamic finance perspective. Report findings were presented at an international legal seminar in London in March 2006. The focus of the seminar was on sukuk (Islamic bonds) and insolvency. A paper on comparative analysis of trust laws and contract laws from an Islamic finance perspective and of Islamic asset securitization was drafted based on the seminar discussion. The final report on the guidelines on legal framework and asset securitization in Islamic Finance was prepared in June 2006 and presented at an IFSB Legal Seminar in March 2007 (in connection with the IFSB annual meeting).

Several changes were made during TA implementation to (i) extend the TA completion date to reflect the delay in finalizing co-financing arrangements and recruiting consultants and based on the IFSB extensive consultation process in approving the new standards, and (ii) hire a firm vs. individual consultants to promote greater efficiency in oversight. While consultant performance was excellent, ADB oversight was not. The performance of the consulting team's team leader was especially strong, with authoritative experience and an excellent international network of key contacts. IFSB was closely involved in TA implementation. The consultants met regularly with the IFSB and ADB. IFSB and ADB comments were incorporated into consultant deliverables. Based on staff movements within and out of ADB, there were three Project Managers overseeing the project. The change in ADB staff did not diminish the success of the project but did increase the level of effort required to oversee the project. In September 2006, SEGF organized a brown bag seminar to present the TA findings and provide background information on Islamic finance to bank staff – the workshop was well attended.

#### **Evaluation of Outputs and Achievement of Outcome**

Consultants submitted high quality (comprehensive and well prepared) reports on a timely basis: (i) the inception report was submitted in August 2005; (ii) the mid term report was submitted in December 2005; (iii) the interim report was submitted in April 2006; (iv) a draft final report was submitted in October 2006; and (v) a final report was submitted in March 2007. Key performance targets were met. New international prudential standards for market transparency and discipline will be issued shortly. Key principles for the development of an appropriate legal framework for asset securitization have been prepared. While the foundation for developing a comprehensive public database on IFI and markets has been adopted, due to resource and time constraints, collection of such data has not yet started. Although consultants prepared recommendations for additional IFSB prudential standards to address perceived gaps, a more thorough analysis depends on more comprehensive data collection.

#### **Overall Assessment and Rating**

Highly successful.

**Major Lessons:** Internal procedures for finalizing project outputs within Implementing Agencies should be reflected in project design – the need for extensive consultation and related international workshops on draft standards and compilation guidelines, and attendant delays, were not effectively factored into project design. Better understanding of the related delays and costs may have resulted in more focused inputs and less ambitious outcomes. To ensure the sustainability of TA reforms, greater synergies with ongoing financial sector projects in DMCs that are members of the IFSB should be promoted. While in several DMCs (Pakistan, Indonesia) policy reform dialogue includes reforms related to Islamic finance, in other DMCs where ADB is helping to promote financial sector development, there is a lack of awareness of Islamic finance (e.g. Philippines). IFSB members include DMCs in several operational departments – more effective internal coordination within ADB is needed to ensure that all DMCs benefits from related TA reforms. Based on the ADB's new Disclosure Policy (adopted after TA was approved), TA design should include the delivery of a report that can be publicly disseminated vs. an internal discussion document. Provided that the Executing or Implementing Agency does not request an exemption from ADB's disclosure policy based on confidentiality or other concerns, the TA should designate funds and level of effort for this purpose.

#### **Recommendations and Follow-up Actions**

To help catalyze the growth of Islamic financial products, both to expand access to financial services and as part of wide ranging capital market reforms, it is recommended that ADB work jointly with the IFSB in conducting studies on various aspects of Islamic finance, with a focus on strengthening the legal framework for Islamic asset securitization and developing a medium term work plan on designing and building consensus on an effective legal infrastructure. To ensure the sustainability of TA reform initiatives, it is recommended that ADB help facilitate implementation of IFSB standards at the country level in DMCs that are participating in ADB financial sector programs, supported by development of additional guidelines and technical studies and new standards, as needed, and assist in compilation and dissemination of Islamic finance statistics through the pilot database exercise (outreach program, compilation and dissemination exercise, and development of a standard reporting template for data submission and related information technology infrastructure). It is also recommended that in DMCs that are participating in ADB financial sector reform initiatives that have not yet prepared a strategy to develop Islamic finance, ADB discuss the development of related masterplans that identify key milestones and key actions needed to address impediments to such development, and where requested, help develop and implement such plans.