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Review on Financial Sector Assessment Program (FSAP) and its Adoption of Proposed Islamic Financial Sector Assessment Program (IFSAP)

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Abstract

The Financial Sector Assessment Program (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 framework, and the infrastructures. There is an urgency to review to what extent FSAP has adopted Proposed Islamic Financial Sector Assessment Program (IFSAP) Template. This note will try to review the FSAP on some selected countries and analyse the influence of proposed IFSAP to the FSAP. Result of this review shows that, based on 2013 data, the IMF-World Bank has adopted in a limited way the proposed template by IRTI-IDB. Overall, there is a very limited significance of change in the of FSAP model.

Keywords*: Financial Sector Assessment Program; Financial Stability; Regulatory and Supervisory Framework; Financial system infrastructure*

A. INTRODUCTION

The Financial Sector Assessment Program (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 framework, and the infrastructures. The three pillars are:

Pillar I: Macroprudential Surveillance and Financial Stability
Pillar II: Regulatory and Supervisory Framework of the Financial System
Pillar 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. The pillars show the importance of FSAP. Realizing this importance, The IDB-World Bank Working Group on Islamic Finance (WGIF) initiated a study, after its first meeting in Jeddah during January 24-25, 2009. The purpose of the study is to review the methodology and procedures used in the Bank-Fund Financial Sector Assessment Program (FSAP) in order to identify the areas where additional guidance and benchmarks would be helpful to FSAP assessors in order to assess the development and stability of the Islamic Financial services Industry (IFSI). The result of the study is a paper titled "*Towards Developing a Template to Assess Islamic Financial Services Industry (IFSI) in the World Bank-IMF Financial Sector Assessment Program (FSAP)*" which is published on March 2010.

There is an urgency to review to what extent FSAP has adopted Proposed Islamic Financial Sector Assessment Program (IFSAP) Template. Thus, this study will try to review the FSAP on some selected countries and analyse the influence of proposed IFSAP to the FSAP based on 2013 data.

B. LITERATURE REVIEW

1. Brief about 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 the global financial stability by using a variety of assessment tools and methodologies.

The implementation of FSAP offers benefits in some areas (World Bank and IMF, 2005). First, it allows the government to analyse 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 resulted from external shocks possibly happen in the future.

In the very beginning, FSAP was not designed to cater the unique characteristics of Islamic Finance Industry. In its review on 2005, IMF-World Bank did not say anything related with Islamic Finance. Thus, the development of template to assess Islamic Financial Industry is needed, which we will discuss in the following section.

2. Development of IFSAP

Rapid growth in Islamic banking, and more recently Islamic capital market and *Takāful* (Islamic insurance) products has motivated policy makers to address the challenges of fostering orderly expansion of the industry and ensuring its stability. While the share of Islamic Finance in the global financial system is still small, it constitutes a significant and rising share of the financial sector in many countries and regions, providing an alternative to conventional finance, and competing with it. In addition, the global expansion of institutions offering Islamic financial services (IIFS) and their growing significance in several international and regional financial centers such as Singapore, London, Paris, and Hong Kong have also highlighted the need to facilitate regional and international integration of Islamic financial services industry (IFSI), and to help in developing an internationally competitive industry.

Total assets of Islamic banking industry is estimated to reach about $1 trillion by 2010, while total issuance of *Sukuk*–both global and national–could reach about $200 billion. The top 500 Islamic Financial Institutions listed by Banker's Magazine recorded total Shari'ah compliant assets of $639 billion by end November 2008, reflecting a growth of 27.6% from a year ago. (IFSAP).

Table 1 Islamic Finance Development, a Cross Country Comparison.

Country	Share of Islamic Banking in total Bank assets (%)	Size of Islamic Banking (as % of GDP)	Size of Muslim Population (in millions; % share of total population in parentheses, 2008)	Growth in IFSI bank assets (% per annum)
Saudi Arabia	35[5]	20[5]	24.1 (100)	33.4[2]
Bahrain	30[9]	47.5[9]	0.7(100)	
United Arab Emirates	12.6[10]		4.7(96)	37.6[4]
Qatar	31[13]		0.8 (99)	65.8[2]
Kuwait	29[9]		2.7 (100)	14.3 [2]
Malaysia	16[11]	26[11]	15.4(60)	20[12]
Indonesia	2[11]	1[11]	195.3(88)	44[7]
Brunei	35[11]	35[11]	0.27(67)	2[8]
Pakistan	5.0[13]	4.5[13]	157.5 (97)	16[7]
Bangladesh	6[3]		127.3 (88)	18[1]
Sudan	100[5]	17.1[5]	30.1(70)	33[6]
Jordan	10.3[9]		5.3 (94)	11.2[2]
Yemen	30.2		7.3(60)	22.7[2]

[1] 1988-97; [2] 2003-08; [3] 2002; [4] 2002-08; [5] 2008 (including widows); [6] 2003-07; [7] 2003-09; [8] 2004-08; [9] 2008; [10] 2006; [11] 2008; [12] 2008-09; [13] 2009 (including widows)

Source: FSAP reports, central bank publications, IMF, Regional Economic Outlook for Middle East and Central Asia, October 2009, Box 1.1, Pages 10/11; and www.islamicpopulation.com

The development of IFSAP cannot be separated from the Task Force on Islamic Finance and Global Financial Stability. The Task Force was formed in response to the recommendations of the Forum on the Global Financial Crisis and its Impact on Islamic Financial Industry, which was organised by the Islamic Development Bank (IDB) Group on 29 October 2008. The Task Force was headed by H.E. Dr. Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, and included international representations of eminent scholars and experts in Islamic finance.

The taskforce reviewed the on-going responses to the global financial crisis including the impact on IFSI, the current status of Islamic finance architecture and infrastructure and its readiness to cope with crisis, and the inherent features of the IFSI that could contribute to stability. The task force concluded that the inherent features of the IFSI deriving from Shari'ah principles, if properly realized, could contribute to global financial stability. But before that can happen significant reforms of the industry from within would be needed. In particular, regulatory architecture of the industry should continue to reinforce effective risk management, and genuine risk sharing. Initiatives are needed to improve existing models of financial intermediation in order to better represent the spirit and objectives of Islamic finance.

Another requirement is the key institutional infrastructure for IFSI, notably systemic liquidity infrastructure, and legal infrastructure for crisis management, including emergency lending, safety nets, and insolvency and creditor rights arrangements need strengthening, together with emphasis on macro prudential surveillance. In addition, greater inclusiveness should be pursued through a better integration of Islamic social institutions—*awqaf, qard, zakah*, forbearance, etc.—into Islamic finance and Islamic micro finance. In order to facilitate the needed coordination among stakeholders in undertaking such a wide-ranging agenda, the Taskforce proposed the formation of Islamic Finance Stability Forum, under the auspices of IFSB which shall, inter-alia, be a broad-based and constructive dialogue platform for IDB and IFSB members to address the following primary objectives:

- First, to build cross-border consensus and collaboration on the strategic direction for the IFSI for better alignment to the objectives of financial stability;
- Second, to support implementation of strategic and synergistic policies and mechanisms which will scale-up the role of IFSI from only the profit-based institutions to also cover social institutions

such as *zakat, awqaf* and private philanthropy; and

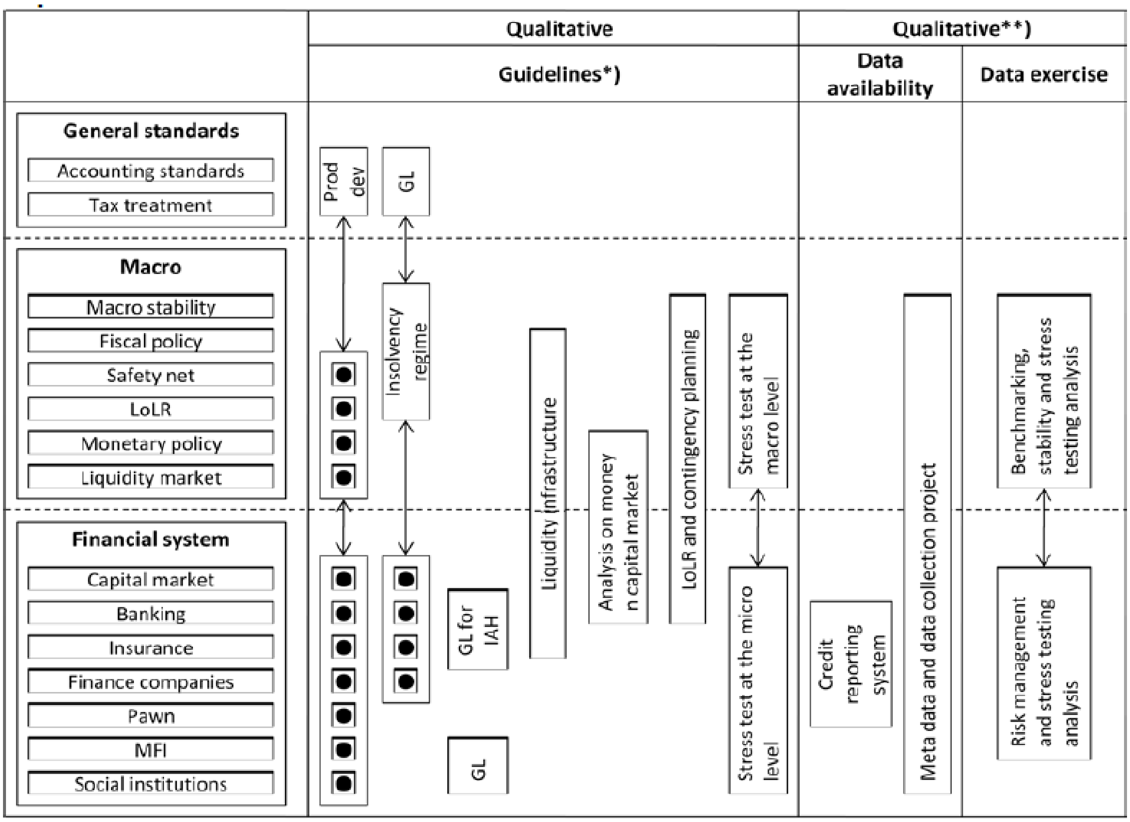
- Third, to encourage functional and operational relationships between Islamic standard-setting bodies and the relevant national authorities to facilitate adoption of relevant prudential and best practice standards.

3. IFSAP Studies

Senior representatives from the IFSB, IMF and IIFM have taken an initial step to discuss on the assessment methodology and to see the possible level of formality of the assessment process in country level agenda. 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 benchmark would be helpful to FSAP assessors in order to assess the development and stability of the Islamic Financial Services Industry (IFSI).

The last studies regarding the possible implementation of IFSAP has provided a bird eye view of gaps occur between the existing FSAP assessment methodology and the existing measures in the Islamic financial industry. There are three main areas discussed in the studies comprising general standards applied, macroeconomic and microeconomic analysis.

Table 2 Gaps Identified in FSAP initiatives for Islamic Finance



*) Assessment based on compliance *)

** Assessment based on the reliability of data and analysis

Source: Dadang Muljawan (2011)

The first issue discusses about the standards applicable for accounting system, financial reporting and tax treatment so that the industry can optimally achieve its operational efficiency, prudence and eventually level of playing field. The accounting standard applicable to the Islamic finance should show itself to be reliable to promote transparency and good governance besides 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 relation between the financial properties and solvency regime that relates the sharia properties into financial claims that link public funds to the bank capital and the financial safety net program. The studies found the needs to have adequate guideline on the tax treatment and accounting standard. This would lead to foster product innovation beneficial to all financial players, such as banking, capital market or even the government and central bank when it comes to sukuk issuance.

4. Stages in developing IFSAP

a. First stage: Document

The study was initiated in the framework of IDB-World Bank Working Group on Islamic Finance in 2009. The objective of the study was to review the methodology and procedures used in the joint World Bank-IMF Financial Sector Assessment Program (FSAP) in order to identify the areas where additional guidance and benchmarks would be helpful to FSAP assessors in order to assess the development and stability of the Islamic Financial Services Industry (IFSI). The content of document consisted of:

- The status and recent developments in Islamic Financial Services Industry.
- Background on recent developments in the methodology and processes of FSAP.
- Components of FSAP methodology from the perspective of how well they meet the needs of assessing Islamic Financial Services Industry.
- Proposed action plan

b. Second Stage: The templates

Following-up the first document, IRTI in 2011/2012 conducted further study and document that provides:

- A compilation of the international regulatory standards as the reference points for regulatory observance. This includes the compilation of the conventional and Islamic regulatory standards.
- Identification of potential adoption of the existing framework and the needs for the development of the Islamic regulatory framework at both micro and macro levels.
- Setting up templates to complement the current FSAP framework, particularly when it comes to the assessment of the Islamic financial industry.

  The survey covers 10 areas of information indicating the level of development and opinion of financial regulators towards further adoption of international standard and development. Those cover:

  - General information
  - Financial stability
  - Financial structure and development assessment
  - Evaluating financial supervision
  - Assessment of other financial intermediaries
  - Rural and microfinance institutions
  - Financial integrity
  - Legal structure for financial system
  - Information and governance infrastructure
  - Liquidity infrastructure

5. IFSAP and Macro Prudential Policy

FSAP exercises serve as a measure to help the countries identify potential weak points in the area of Islamic finance (particularly Islamic banking, takaful and Islamic capital market) and its links to the mainstream policies and conventional system. Further, IFSAP helps to ensure that the Islamic financial sector is equipped with sufficient infrastructure and policy when dealing with macroprudential issues, including financial stability and contribution to sustainable economic development in general.

Table 3 Macroprudential policy

	Immediate	Intermediate	Long-term
Monetary	Liquidity policy - Stat. reserve policy - Loan to value - Leverage		
Surveillance	Supervision - Individual and systemic surveillance covering banking, takaful and capital market	Sector analysis and development - Financial structure - Financial linkage - Financial outlook	Sustainable economic dev - Financial inclusion - Isl. Social Sector Dev
Payment system	Surveillance - Large value transaction		

3. HASIL DAN PEMBAHASAN

1. Recent FSAP and adoption of Proposed IFSAP Template

To review the adoption of IFSAP to FSAP, the study analyses FSAP documents from 8 selected countries. Based on those documents,

Table 4 Types and Year of Assessment Document (Summary) [1]

Country	FSA	FSSA	ROSC	SC	SI	Number of Docs	Number of pages
				Total	Total		
Pakistan	2005	2004	2005 (2)		2004 (1)	5	147
Indonesia		2010	2010	2010 (5)		7	486
Malaysia	2013	2013	2011	2013 (5)	2013 (2)	10	879
Saudi Arabia	2005/12	2006/12	2012	2011 (3)		7	339
Bahrain		2006				1	89
Sudan				2005	2005	2	189
Qatar			2008	2008 (2)		2	231
UAE		2003/7				2	115
						36	**2475**

The documents consist of several types of documents. They are:

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[1] For details, please see appendix

FSA **Financial Sector Assessment**

Evaluation of the condition of the financial sector as a whole and recommendations for reform

FSSA **Financial System Stability Assessment**

Evaluation of the condition of the financial sector by category and recommendations for reform

ROSC **Reports on the Observance of Standards and Codes**

Assessments of compliance with international standards and codes

SC **Detailed Assessments of the Observation of Standards and Codes**

Principle-by-Principle assessment

SI **Technical Notes**

Analysis of selected topics

SC has several types of documents;

SSS IOSCO Securities Settlement Systems
MP Monetary Policy
PSR IOSCO Objectives and Principles of Securities Regulation
PS Payment Systems
BCP Basel Core Principles
FMI CPSS-IOSCO Recommendations for Financial Market Infrastructures -
EDI Core Principles for Effective Deposit Insurance Systems
ICP Insurance Core Principles
SR IOSCO Objectives and Principles of Securities Regulation
AML anti-money laundering (AML) and combating the financing of terrorism

SI has several types of documents

TN Technical Notes
CBS Condition of Banking System
FI Financial Inclusion
BMD Bond Market Development

The result of the observation is as follows.

Table 5 Treatment of IFSI in FSAPs

Coverage of IFSI in FSAP	Pakistan	Indonesia	Malaysia	Saudi Arabia	Bahrain	Sudan*1	Qatar	UAE
Data of FSIs for IFSI is presented separately	No	No	Yes	No	Yes	N/A	No	No
State of Development of IFSI is described	No*2	Yes	Yes	Yes	Yes	N/A	Yes	Yes
Indicators of IFSI development presented	No	No	In a limited way*10	Yes	No	Yes	No	No

separately								
Unique characteristics and risks in IFSI is noted in BCP assessment or in FSSA	No*3	No	Some-what*7	In a limited way*11	Yes	Some-what	No	Yes
Impact of PSIA on Bank Capital discussed	No	No	No	No	Yes	No	No	No
IFSI development issues reviewed	No	Yes	In a limited way*8	In a limited way	In a limited way *4	Yes	No	In a limited way *6
Separate stress testing of IFSI in FSSA's	No	No	In a limited way*9	No	Yes	N/A	In a limited Way *5	Yes

This is the update of the table by IDB (2010), the change in data can be noticed in Indonesia, Malaysia, and Saudi Arabia.

*1 All Islamic financial system.

*2 For Pakistan, the share of Islamic finance – 0.5% of total Bank assets – is noted, number if IIFS stated, but not updated in the 2008 FSAP update

*3 BCP assessment mentions existence of a separate Islamic Banking Department – to supervise Islamic Banks – in state Bank of Pakistan, and there is no further analysis of its function.

*4 Importance of Islamic finance for the overall financial and economic development is noted, but not discussed.

*5 Stress test for Qatar did not take into account the role of Investment accounts in sharing risks due to data availability, although results of stress tests were shown separately for Islamic Banks.

*6 Importance of building sovereign Sukuk markets to provide systemic liquidity infrastructure for IFSI is emphasized

*7-11 will be discussed in next section.

In the next discussion, we will focus on FSAP of Indonesia, Malaysia and Saudi Arabia. There are two reasons for this. First, from 8 selected countries above, only Indonesia, Malaysia and Saudi Arabia who have FSAP report dated after the IFSAP template proposal. This will enable us to review whether the proposal has been implemented in FSAP or not.

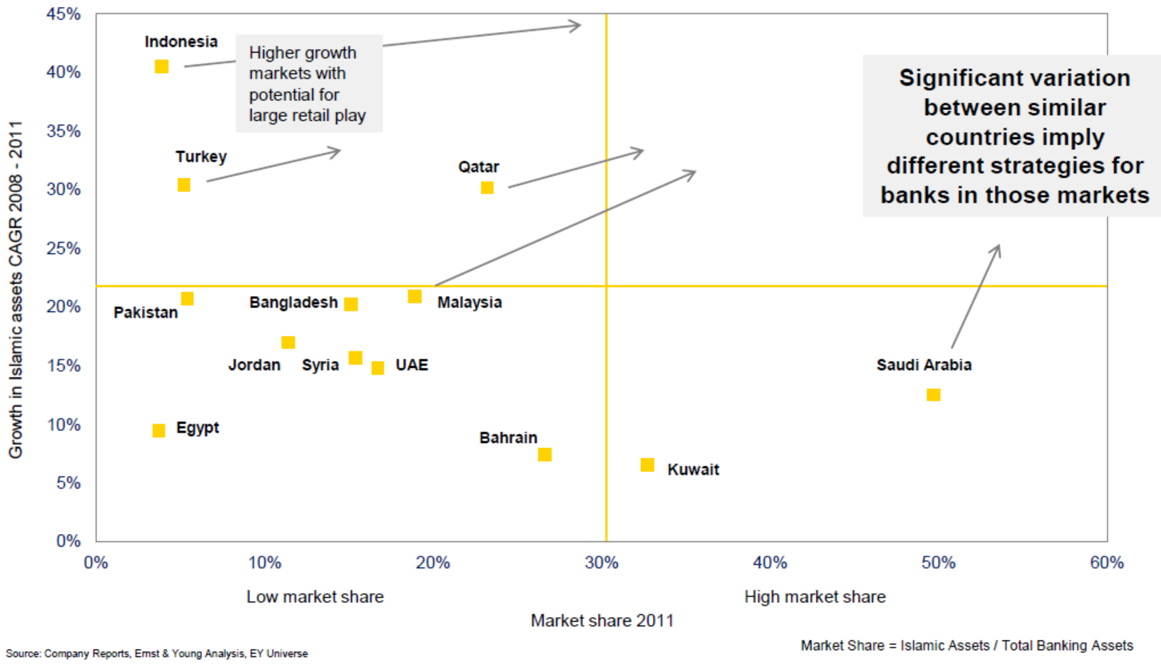

Figure 1 Growth Matrix of Islamic Finance in selected countries

Second, the three countries have been highlighted in recent development of the Islamic Finance Industry (Ernst & Young, 2013). Related to Islamic Financial Industry, Indonesia is the country with the highest growth, Malaysia has the highest banking asset penetration, and Saudi has the highest Islamic Banking share of total asset.

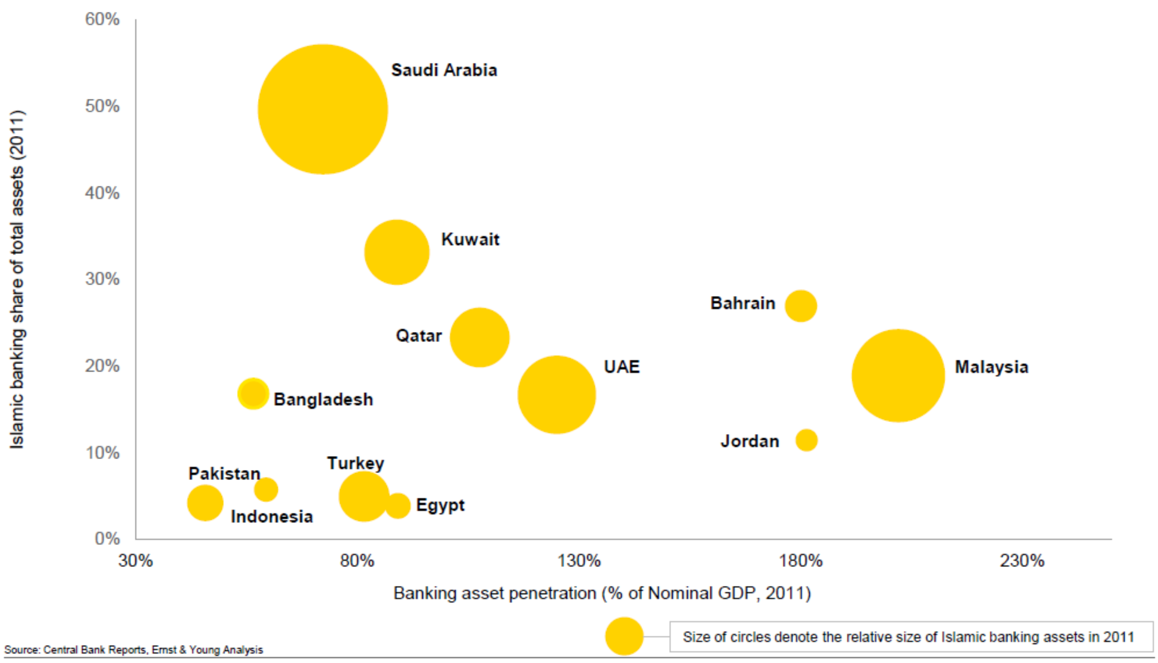

Figure 2 Banking asset penetration (% of Nominal GDP) and Islamic banking market share of total assets (%) in 2011

2. Review on FSAP of Indonesia

This study notes several statements in FSAP of Indonesia showing consideration of the potential significance of Islamic Finance Industry in Indonesia. In CPSS, Core Principles For Systemically Important Payment Systems, it is stated: "The main players in the payment system in Indonesia are banks who comprise state banks, private banks, regional development banks and sharia banks. Most of these banks have a deliberate policy to extend payment services by establishing branches throughout the country".

In the other section, *Enforceability of collateral arrangements;* the arrangements relating to assets used as collateral in the provision of the intraday credit facility for RTGS operations are clearly stipulated in the regulations and relevant circular letters. Specifically, the following regulations govern the enforceability of arrangements in this regard:

- Bank Indonesia Regulations 10/29/PBI/2008 and No. 7/24/PBI/2005) for Intraday Liquidity Facility for conventional and sharia banks respectively.
- BI Regulations No. 10/26/PBI/2008 and No. 5/3/PBI/2003 for Short Term Funding Facility for conventional and sharia banks

In BCP Documents, some statements explain the state of development of IFSI in Indonesia

The Indonesian financial sector comprises banks, multi-finance companies, capital market companies, insurance companies, and pension funds. The banking sector accounts for about 80 percent of the financial sector assets. It is dominated by 121 commercial banks, which account for about 98.6 percent of total banking assets (including 5 sharia banks accounting for 1.8 percent market share), with rural banks comprising the remainder of the banking system (about 1.4 percent market share). Bank Indonesia (BI), the central bank, is responsible for regulation and supervision of the banking system.

However, in view of the small share of sharia and rural banks, the assessment was confined to regulation and supervision as applicable to commercial banks. As stated in following paragraph. The assessment of compliance with the Basel Core Principles for Effective Banking Supervision (BCP) was carried out within the framework of the Financial Sector Assessment Program (FSAP) between September 29 and October 16, 2009. The assessment was conducted by a team comprising Damodaran Krishnamurti (senior financial sector specialist, World Bank), and William Ryback (consultant, International Monetary Fund). The team used the October 2006 Core Principles Methodology document of the Basel Committee on Banking Supervision (BCBS), but by agreement with BI the team limited its work to a study of the essential criteria. In view of the small share of sharia and rural banks, the assessment was confined to regulation and supervision as applicable to commercial banks.

3. Review on FSAP of Malaysia

Unique characteristics and risks in IFSI (*7) are in some extent noted in BCP assessment or in FSSA. This can be noted in the following paragraph which is quoted from FSAP, Core Principle 12: Public Awareness.

> "In order for a deposit insurance system to be effective it is essential that the public be informed on an ongoing basis about the benefits and limitations of the deposit insurance system. PIDM has a comprehensive public awareness program. PIDM's public awareness activities are guided by an Integrated Communications Plan or ICP. Member banks make extensive use of materials provided by IDM on its deposit insurance coverage. Member banks are required to disclose the status of insurability when an account is opened and any new deposit product must be submitted to PIDM for an insurability determination before its launch. PIDM makes use of the same public awareness materials concerning deposit insurance coverage for conventional and Islamic banks. **It may be that different disclosures concerning deposit insurance coverage are required for conventional versus Islamic banks**"

The recognition of unique characteristic also found in FSSA, Stress Test section.

"Some smaller Islamic banks are more vulnerable in the adverse scenarios, in part due to their lower starting capital. Islamic banks have a less diversified business—specifically, a greater credit concentration in retail lending activities. Lower starting capital and solvency deterioration of some smaller Islamic banks could manifest itself in reputational risks to the group in adverse scenarios".

However, in most cases, the unique characteristic is not recognized. In Core Principle 2: Mitigating moral hazard. It is stated,

"Moral hazard should be mitigated by ensuring that the deposit insurance system contains appropriate design features and through other elements of the financial system safety net. All appropriate design features are present in the PIDM framework. The PIDM has limited coverage in the amount of RM 250,000 per depositor per member institution, an amount that covers 99% of depositors in the system but only 36.9% of total conventional and Islamic bank deposits held by member institutions. PIDM also has in place a Differential Risk Premium System as authorized by Article 53 of its Act so that higher deposit insurance premiums are assessed against banks that fall into higher risk categories".

In a limited way, IFSI development issues is reviewed (*8). It is stated:

"An analysis of market development issues in Islamic Finance will be covered in the World Bank's Financial Sector Assessment report based on the FSAP".

In a limited way, there is Separate stress testing of IFSI in FSSA's (*9). FSSA states:

"Some smaller Islamic banks are more vulnerable in the adverse scenarios, in part due to their lower starting capital. Islamic banks have a less diversified business—specifically, a greater credit concentration in retail lending activities. Lower starting capital and solvency deterioration of some smaller Islamic banks could manifest itself in reputational risks to the group in adverse scenarios".

Also, in a limited way, indicators of IFSI development presented separately. (*10) We can see this by seeing following figure.

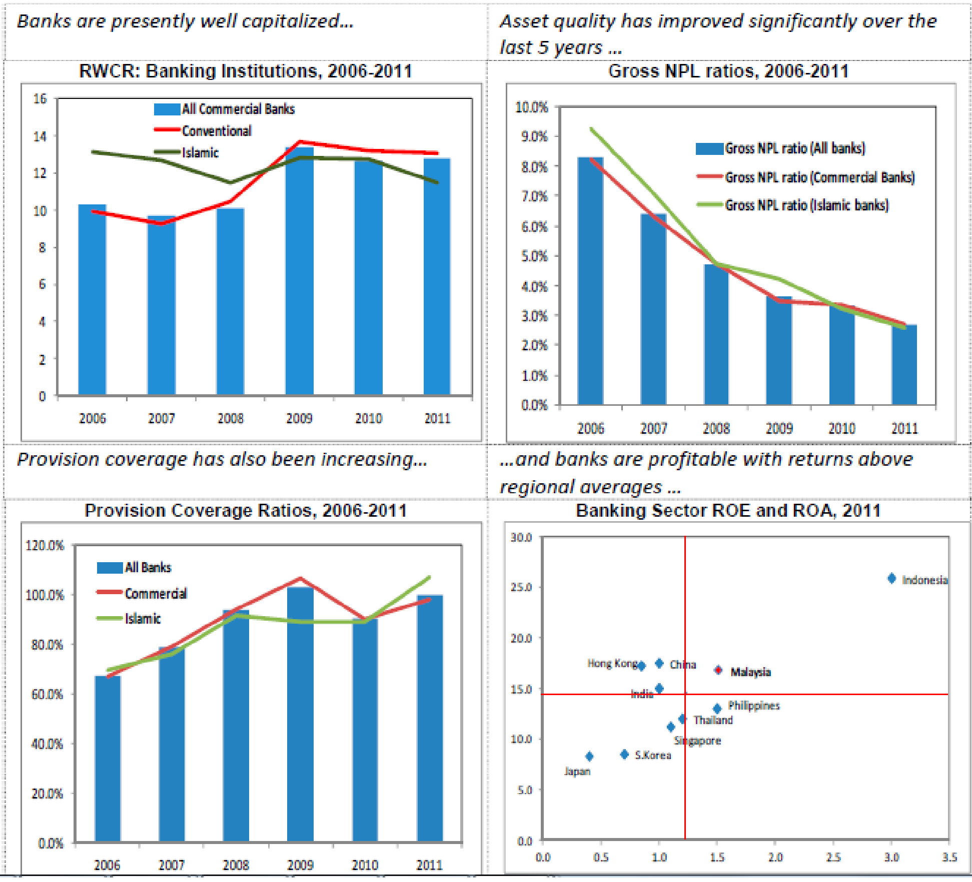

Figure 3 Banking soundness and Performance Indicators in Malaysia FSAP

4. Review on FSAP of Saudi Arabia

Unique characteristics and risks in IFSI is, in a limited way, noted in BCP assessment or in FSSA (*11). This can be seen in the following paragraph.

> **"In its design of regulation and supervision and in its implementation of the *Core Principles*, the SAMA makes no differentiation between conventional and Sharia compliant banking arrangements**. There is recognition, however, that some Sharia compliant instruments carry unique risks, e.g., commodity price risk in deferred-sale transactions and property price risk in Islamic housing finance. In this evolving area of supervision, the SAMA is an active member of the IFSB's working groups".

However, in other section,

> **"Despite significant Sharia-compliant banking activities, the SAMA does not differentiate in its implementation of the *Core Principles***. In general, there is no difference in treatment of conventional and Islamic banking in the Saudi supervisory approach. There are only two occasional exceptions, neither of which are material:
>
> • Banks are allowed to take certain risks in order to comply with Sharia principles, for example, potential commodity risk arising from the financing of trades.

Saudi Arabia has joined the FSAP program in 2005 and the report was updated in 2005. However, there is no significant increase of discussion related to IFSI in the updated version of FSSA and FSA.

5. CONCLUSION AND SUGGESTION

This review shows that, based on 2013 data, the IMF-World Bank has adopted in a limited way the proposed template by IRTI-IDB. Overall, there is a very limited significance of change in the of FSAP model. This study suggests IDB, IFSB, AAOIFI, and another of Islamic Industry Infrastructure Institutions (IIIIs) proactively promote the IFSAP template to be applied by FSAP. As FSAP reflects the significance of financial sector in the economy, increasing the size and the penetration of Islamic Finance, will also help to make FSAP put more consideration on assessing IFSI. Thus, all stakeholders in IFSI has responsibility to work harder to improve the performance of IFSI domestically and internationally. Since the data used in this research is mainly limited to 2013 data, further research on the issue based on more recent years data will be beneficial to observe the progress the adoption of the proposal year by year.

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APPENDIX

Types and Year of Assessment Document (Detailed)

Country	FSA	FSSA	ROSC	SC										SC	SI				SI	Number of Docs	Number of pages
				SSS	MP	PSR	PS	BCP	FMI	EDI	ICP	SR	AML	Total	TN	CBS	FI	BMD	Total		
Pakistan	2005	2004	2005 (2)													2004			2004 (1)	5	147
Indonesia		2010	2010	2010	2010	2010	2010	2010						2010 (5)						7	486
Malaysia	2013	2013	2011					2013	2013	2013	2013	2013		2013 (5)			2013	2013	2013 (2)	10	879
Saudi Arabia	2005/12	2006/12	2012				2011	2011				2011		2011 (3)						7	339
Bahrain		2006																		1	89
Sudan													2005	2005	2005				2005	2	189
Qatar			2008										2008	2008 (2)						2	231
UAE		2003/7																		2	115
																			TOTAL	**36**	**2475**