ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a comprehensive due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, but is not limited to, the issuance of exposure drafts, the holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

For more information about the IFSB, please visit www.ifsb.org
ASSUMPTIONS AND CONVENTIONS

In this IFSI Stability Report 2021, the following conventions are used:

- **IFSI Stability Report “2021”** implies that the report covers activities for the year 2020 and is published in the year 2021.
- “1H20” means first half of the year 2020.
- “3Q20” means quarter 3 of the year 2020.
- “Billion” means a thousand million.
- “Trillion” means a thousand billion.
- “IFSB secretariat workings” means figures indicated in the corresponding table are based on IFSB staff estimates or calculations.
- “PSIFIs” implies that the data used in a corresponding table are obtained from the IFSB’s Prudential and Structural Islamic Financial Indicators database.
- The data and analysis in the IFSI Stability Report are compiled by IFSB staff from various sources and are assumed to be correct as at the time of publication. The data analysed correspond to the latest data available to the IFSB.
- Data for sukūk outstanding and Islamic funds are for full-year 2020. Data for Islamic banking are as at the end of September 2020 (3Q20). Data for takāful are mainly for full-year 2019 and as per the available indicated data period in 2020.
- In all cases, where data for the periods indicated above are not available to the IFSB Secretariat, the latest data available to the IFSB Secretariat have been used.
- Data used are mainly from primary sources (regulatory authorities’ statistical databases, annual reports and financial stability reports, official press releases and speeches, etc.), as well as from the IFSB’s Prudential and Structural Islamic Financial Indicators (PSIFIs) database and IFSB surveys.
- Where primary data are unavailable, third-party data providers have been used.

As much as possible, the data used and charts and figures provided in the IFSI Stability Report 2021 have been checked for accuracy, completeness and timeliness. Discrepancies in the sums of component figures and totals shown are likely due to the rounding-off effect. Where errors are observed, corrections and revisions will be incorporated in the online version of the report. The IFSB appreciates feedback on the report, which is available for free download at [www.ifsb.org](http://www.ifsb.org)
# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)</td>
<td>iii</td>
</tr>
<tr>
<td>ASSUMPTIONS AND CONVENTIONS</td>
<td>iv</td>
</tr>
<tr>
<td>PREFACE</td>
<td>v</td>
</tr>
<tr>
<td>LIST OF ABBREVIATIONS</td>
<td>vii</td>
</tr>
<tr>
<td>GLOSSARY</td>
<td>viii</td>
</tr>
<tr>
<td>FOREWORD</td>
<td>1</td>
</tr>
<tr>
<td>EXECUTIVE SUMMARY</td>
<td>4</td>
</tr>
</tbody>
</table>

## 1.0 DEVELOPMENTS IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

1.1 IFSI: Sustained Growth Despite Challenges arising from the Global Pandemic 6
1.2 Islamic Banking Sector: Increasing Prominence, Changing Structure 11
1.2.1 Overview of Islamic Banking in Key Markets 14
1.3 Islamic Capital Market: Sustained despite Market Volatility 18
1.3.1 Ṣukūk 18
1.3.2 Islamic Funds 23
1.3.3 Islamic Equity Markets 24
1.4 Takāful: Sustained Growth and Contribution 28
1.4.1 Overview of the Global Insurance Sector 28
1.4.2 Takāful contributions in 2019 29

## 2.0 ASSESSMENT OF THE SOUNDNESS AND RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

2.1 Islamic Banking: Rebound Amid Uneven Recovery 39
2.1.1 Profitability 40
2.1.2. Liquidity 48
2.1.3 Funding structure 57
2.1.4 Financing Exposure 58
2.1.5 Asset Quality 61
2.1.6 Capital Adequacy 69
2.1.7 Leverage 77
2.2 Islamic Capital Market Resilience and Stability 82
2.2.1 Ṣukūk 82
2.2.2 Islamic Funds 87
2.2.3 Islamic Equity Markets 88
2.2.4 Islamic Capital Market Stability Outlook 2021 90
2.3 Takāful: assessment of resilience 93
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.0</td>
<td>THE ROLE OF ISLAMIC SOCIAL FINANCE IN A POST- COVID-19 FINANCIAL</td>
<td>100</td>
</tr>
<tr>
<td></td>
<td>SYSTEM STABILITY</td>
<td></td>
</tr>
<tr>
<td>4.0</td>
<td>GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES</td>
<td>118</td>
</tr>
<tr>
<td>4.1</td>
<td>Global Developments and Impacts on the IFSI</td>
<td>119</td>
</tr>
<tr>
<td>4.1.1</td>
<td>Financial Stability Board</td>
<td>119</td>
</tr>
<tr>
<td>4.1.2</td>
<td>International Organization of Securities Commissions</td>
<td>120</td>
</tr>
<tr>
<td>4.1.3</td>
<td>International Association of Insurance Supervisors (IAIS): 2021-2022</td>
<td>113</td>
</tr>
<tr>
<td>4.2</td>
<td>IFSB Standards, Research and PSIFIs Activities</td>
<td>122</td>
</tr>
<tr>
<td>4.2.1</td>
<td>Update on Standards under Development</td>
<td>122</td>
</tr>
<tr>
<td>4.2.2</td>
<td>Synopsis of IFSB Research Projects</td>
<td>123</td>
</tr>
<tr>
<td>4.2.3</td>
<td>Final Review of the IsDB-IFSB Ten-Year Framework and Strategies</td>
<td>125</td>
</tr>
<tr>
<td>4.3</td>
<td>Facilitating the Implementation of IFSB Standards (FIS) Initiatives</td>
<td>126</td>
</tr>
<tr>
<td>4.3.1</td>
<td>Impact and Consistency Assessment Program (ICAP)</td>
<td>126</td>
</tr>
<tr>
<td>4.3.2</td>
<td>Train the Trainer Programme</td>
<td>127</td>
</tr>
<tr>
<td>4.3.3</td>
<td>Implementation Guidelines (IG)</td>
<td>128</td>
</tr>
<tr>
<td>4.3.4</td>
<td>Highlights of IFSB Implementation Survey 2020</td>
<td>128</td>
</tr>
<tr>
<td></td>
<td>LIST OF BOXES, TABLES, CHARTS AND FIGURES</td>
<td>132</td>
</tr>
<tr>
<td></td>
<td>IFSB MEMBERSHIP BENEFITS</td>
<td>135</td>
</tr>
<tr>
<td></td>
<td>IFSB MEMBERSHIP LIST</td>
<td>136</td>
</tr>
</tbody>
</table>
PREFACE

The Islamic Financial Services Board’s (IFSB) Islamic Financial Services Industry (IFSI) Stability Report provides recent updates on the trends and developments, as well as insights on the soundness and resilience of various sectors, in the global IFSI. The report also shares a selection of results of the IFSB’s internal research and surveys so as to achieve a broader and common understanding of critical issues in Islamic finance. Finally, the report provides an in-depth study on emerging issues in Islamic finance that have implications for regulation and supervision of this fast-growing industry.

The analysis and information in the IFSI Stability Report 2021 have been provided by a core team from the Technical and Research Department of the IFSB Secretariat comprising Dr. Abideen Adeyemi Adewale (Project Manager) and Ms. Aminath Amany Ahmed. External contributors and consultants are Mr. Peter Casey and Prof. Habib Ahmed. Other contributors include: Mr. Tarig Mohamed Taha Abdelgadir, Mr. Mohammad Arif Hassan, Mr. Esam Osama Al- Aghbari, Ms. Ainaz Faizrakhman, Mr. Ahmed Barakat, and Mr. Jhordy Kashoogie Nazar. Both Dr. Dauda Adeyinka Asafa and Ms. Mardhiah Muhsin assisted with compiling the Takāful data. Mrs. Ida Shafinaz Ab. Malek, Ms. Fadhila Izzati Mokhtar and Ms. Nur Khairunissa Md Zawawi of the IFSB Secretariat provided support in circulating the preliminary draft of the report to IFSB member institutions, while Mrs. Hazelinda binti Mazlan and Ms. Rosmawatie Abdul Halim, also from the IFSB, provided assistance in the editing, formatting and publication of the final document. The overall project coordination was done by Dr. Rifki Ismal (Assistant Secretary General, Technical and Research). Finally, it is worth acknowledging that the report has benefited immensely from comments and suggestions by the IFSB Regulatory and Supervisory Authority (RSA) members.

The analysis in this issue of the IFSI Stability Report is based on Islamic banking data obtained from the IFSB Prudential and Structural Islamic Financial Indicators (PSIFIs) database as at 3Q20, and on Islamic capital market data obtained from the Thomson Reuters Refinitiv Eikon and Bloomberg financial databases for 2020. The takāful data are mainly for 2019; however, in some instances, data up to 2Q20 have been obtained from a number of jurisdictions’ RSAs, Swiss Re and various company annual reports.
**LIST OF ABBREVIATIONS**

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAOIFI</td>
<td>Auditing Organization for Islamic Financial Institutions</td>
</tr>
<tr>
<td>AuM</td>
<td>Assets Under Management</td>
</tr>
<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
</tr>
<tr>
<td>CAGR</td>
<td>Compound Annual Growth Rate</td>
</tr>
<tr>
<td>CAR</td>
<td>Capital Adequacy Ratio</td>
</tr>
<tr>
<td>CIS</td>
<td>Collective Investment Scheme</td>
</tr>
<tr>
<td>CPIFR</td>
<td>Core Principles for Islamic Finance Regulation</td>
</tr>
<tr>
<td>ECL</td>
<td>Expected Credit Losses</td>
</tr>
<tr>
<td>FDR</td>
<td>Financing-to-Deposits Ratio</td>
</tr>
<tr>
<td>GCC</td>
<td>Gulf Cooperation Council</td>
</tr>
<tr>
<td>GFC</td>
<td>Global Financial Crisis</td>
</tr>
<tr>
<td>IAIS</td>
<td>International Association of Insurance Supervisors</td>
</tr>
<tr>
<td>IBs</td>
<td>Islamic Banks</td>
</tr>
<tr>
<td>ICM</td>
<td>Islamic Capital Market</td>
</tr>
<tr>
<td>IFRS</td>
<td>International Financial Reporting Standards</td>
</tr>
<tr>
<td>IFSB</td>
<td>Islamic Financial Services Board</td>
</tr>
<tr>
<td>IIFS</td>
<td>Institutions offering Islamic Financial Services</td>
</tr>
<tr>
<td>IILM</td>
<td>International Islamic Liquidity Management Corporation</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IOSCO</td>
<td>International Organisation of Securities Commissions</td>
</tr>
<tr>
<td>LCR</td>
<td>Liquidity Coverage Ratio</td>
</tr>
<tr>
<td>M&amp;A</td>
<td>Mergers and Acquisitions</td>
</tr>
<tr>
<td>MENA</td>
<td>Middle East and North Africa</td>
</tr>
<tr>
<td>MESA</td>
<td>Middle East and South Asia</td>
</tr>
<tr>
<td>NPF</td>
<td>Non-Performing Financing</td>
</tr>
<tr>
<td>NPL</td>
<td>Non-Performing Loans</td>
</tr>
<tr>
<td>NSFR</td>
<td>Net Stable Funding Ratio</td>
</tr>
<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
</tr>
<tr>
<td>OIC</td>
<td>Organisation of Islamic Cooperation</td>
</tr>
<tr>
<td>PSIA</td>
<td>Profit Sharing Investment Account</td>
</tr>
<tr>
<td>PSIFIs</td>
<td>Prudential and Structural Islamic Financial Indicators</td>
</tr>
<tr>
<td>ROA</td>
<td>Return on Assets</td>
</tr>
<tr>
<td>ROE</td>
<td>Return on Equity</td>
</tr>
<tr>
<td>RRP</td>
<td>Resolution and Recovery Plan</td>
</tr>
<tr>
<td>RSA</td>
<td>Regulatory and Supervisory Authority</td>
</tr>
<tr>
<td>RWA</td>
<td>Risk-Weighted Assets</td>
</tr>
<tr>
<td>SEA</td>
<td>South East Asia</td>
</tr>
<tr>
<td>SME</td>
<td>Small and Medium Enterprises</td>
</tr>
<tr>
<td>SRI</td>
<td>Social Responsible Investment</td>
</tr>
<tr>
<td>TO</td>
<td>Takaful Operator</td>
</tr>
<tr>
<td>TOR</td>
<td>Terms of Reference</td>
</tr>
<tr>
<td>Glossary Term</td>
<td>Description</td>
</tr>
<tr>
<td>----------------------------</td>
<td>------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Commodity Murābahah or Tawarruq</td>
<td>A <em>murābaḥah</em> transaction based on the purchase of a commodity from a seller or a broker and its resale to the customer on the basis of deferred <em>murābaḥah</em>, followed by the sale of the commodity by the customer for a spot price to a third party for the purpose of obtaining liquidity, provided that there are no links between the two contracts.</td>
</tr>
<tr>
<td>Ijārah</td>
<td>A contract made to lease the usufruct of a specified asset for an agreed period against a specified rental. It could be preceded by a unilateral binding promise from one of the contracting parties. An <em>Ijārah</em> contract is binding on both contracting parties.</td>
</tr>
<tr>
<td>Islamic window</td>
<td>That part of a conventional financial institution (which may be a branch or a dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are Shari‘ah-compliant, with separate funds. It could also provide <em>takāful</em> or <em>retakāful</em> services.</td>
</tr>
<tr>
<td>Maqāṣid al-Sharī‘ah</td>
<td>The fundamental principles of Shari‘ah, which aim to promote and protect the interests of all human beings and avert all harm that impairs their interests.</td>
</tr>
<tr>
<td>Muḍārabah</td>
<td>A partnership contract between the capital provider (<em>rabb al-māl</em>) and an entrepreneur (<em>muḍārib</em>) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms.</td>
</tr>
<tr>
<td>Murābahah</td>
<td>A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin.</td>
</tr>
<tr>
<td>Mushārakah (Sharikat al-‘Aqd)</td>
<td>A partnership contract in which the partners agree to contribute capital to an enterprise, whether existing or new. Profits generated by that enterprise are shared in accordance with the percentage specified in the <em>mushārakah</em> contract, while losses are shared in proportion to each partner’s share of capital.</td>
</tr>
<tr>
<td>Retakāful</td>
<td>An arrangement whereby a <em>takāful</em> undertaking cedes a portion of its risks on the basis of treaty or facultative <em>retakāful</em> as a representative of participants under a <em>takāful</em> contract, whereby it would contribute a portion of the contribution as <em>tabarru‘</em> into a common fund to cover against specified loss or damage.</td>
</tr>
<tr>
<td><strong>Sharī‘ah</strong></td>
<td>The practical divine law deduced from its legitimate sources: the Qur’ān, Sunnah, consensus (Ijmā‘), analogy (Qiyās) and other approved sources of the Sharī‘ah.</td>
</tr>
<tr>
<td><strong>Sharī‘ah board</strong></td>
<td>An independent body set up or engaged by the institution offering Islamic financial services to supervise its Sharī‘ah compliance and governance system.</td>
</tr>
<tr>
<td><strong>Sharī‘ah non-compliance risk</strong></td>
<td>An operational risk resulting from non-compliance of the institution with the rules and principles of Sharī‘ah in its products and services.</td>
</tr>
<tr>
<td><strong>Ṣukūk</strong></td>
<td>Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of tangible assets and other types of assets. These assets could be in a specific project or specific investment activity that is Sharī‘ah-compliant.</td>
</tr>
<tr>
<td><strong>Takāful</strong></td>
<td>A mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the participants' risk fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.</td>
</tr>
<tr>
<td><strong>Tawarruq</strong></td>
<td>A <em>murābaḥah</em> transaction based on the purchase of a commodity from a seller or a broker and its resale to the customer on the basis of deferred <em>murābaḥah</em>, followed by the sale of the commodity by the customer for a spot price to a third party for the purpose of obtaining liquidity, provided that there are no links between the two contracts.</td>
</tr>
<tr>
<td><strong>Wadī‘ah</strong></td>
<td>A contract for the safekeeping of assets on a trust basis and their return upon the demand of their owners. The contract can be for a fee or without a fee. The assets are held on a trust basis by the safekeeper and are not guaranteed by the safekeeper, except in the case of misconduct, negligence or breach of the conditions.</td>
</tr>
<tr>
<td><strong>Wakālah</strong></td>
<td>An agency contract where the customer (principal) appoints an institution as agent (wakīl) to carry out the business on his behalf. The contract can be for a fee or without a fee.</td>
</tr>
<tr>
<td><strong>Zakāh</strong></td>
<td>An obligatory financial contribution disbursed to specified recipients that is prescribed by the Sharī‘ah on those who possess wealth exceeding a minimum amount that is maintained in their possession for one lunar year.</td>
</tr>
</tbody>
</table>
The ninth edition of the Islamic Financial Services Board's (IFSB's) *Islamic Financial Services Industry (IFSI) Stability Report* is being published at a time when the global financial system is still faced with the impact of the COVID-19 pandemic. The duration and full extent of the damage brought about by the pandemic, as well as the span and form of future economic recovery, remain unclear. Various fiscal and monetary measures were introduced by governments and regulatory authorities to stimulate the economy and reduce the burden on citizens. The implementation of the various Basel reforms has either been suspended or extended across jurisdictions. As many countries were preparing to enter the recovery phase of the earlier wave(s) of the pandemic and gradually further ease restrictions, new mutations of the virus were discovered, further fuelling uncertainties around the speed and pattern of economic recovery.

Notwithstanding, the total worth of the IFSI increased to an estimated USD 2.70 trillion in 2020 (from USD 2.44 trillion in 2019). The IFSI sustained its growth momentum in 2020, recording a growth rate of 10.7% year-on-year (y-o-y) based on significant improvement, especially in the Islamic banking and Islamic capital markets segments. The financial stability indicators remained satisfactory, especially when compared with previous years' performance, conventional peers, and assessment criteria used by international standard-setting bodies.

In many cases and across many financial soundness indicators and jurisdictions, the impact of the challenging economic conditions due to COVID-19 and oil price and volume volatility became manifest right from 1Q20. Although a rebound was recorded, recovery has been very uneven due to jurisdictional pre-pandemic levels of prudential buffers, economic conditions and political stability, the extent and duration of COVID-19 lockdown measures, and structural peculiarities, including the effect of volatility in the oil and gas sector on some prominent Islamic finance jurisdictions.

Generally, in terms of outlook, improvements in financial soundness and resilience are likely in the Islamic finance industry in many jurisdictions, but perhaps not a full recovery to their pre-pandemic levels. This will depend on, among other things, timely access to, and the efficient roll-out of, COVID-19 vaccines; jurisdictions' capital flows, fiscal and monetary policy spaces and capacity to recover from recession; their digital transformation process; and the extent of contact-intensiveness of key economic sectors.

The IFSB closely monitors developments in the global financial system generally, and specifically in its member jurisdictions. In line with its core mandate, and in addition to issuing statements on measures to mitigate the impact of COVID-19 in the IFSI, the IFSB has published a compendium of policy responses across its member jurisdictions and issued a paper on the impact of COVID-19 on the IFSI. Prior to the outbreak of the pandemic, the IFSB issued several standards, guidance/technical notes and research papers that generally complement the work of other international standard setters but, most importantly, cater for the specificities of the IFSI. In this regard, since the publication of the *IFSI Stability Report 2020*, the IFSB has issued three new standards across the three main segments of the IFSI, along with five working papers, and has conducted numerous workshops on the implementation of its standards. Presently, the IFSB is working on nine standards and guidance/technical notes across the three segments, as well as on five research working papers that focus specifically on various aspects of the recovery phase of the COVID-19 pandemic in the IFSI.

The analysis conducted on the Islamic banking segment in this report is based on the IFSB's PSIFIs database. The IFSB has extended coverage of the database to both the Islamic capital market and takāful segments from 2020 onwards. The *IFSI Stability Report 2021*, as a flagship publication of the IFSB, examines the implications for the soundness and resilience of the global IFSI of recent economic developments and changes in the global financial
system, with a particular focus on the COVID-19 pandemic. It also includes a dedicated chapter on pertinent emerging issues, with a focus on the role of Islamic social finance in the post-pandemic recovery phase. There are box-article contributions from some IFSB members, including Central Bank of Bahrain, Central Bank of the UAE, Saudi Central Bank, and the State Bank of Pakistan. Other contributors are the Insurance and Private Pensions Regulation and Supervision Agency of Turkey, International Islamic Liquidity Management, and Moody’s Investors Services.

As always, it is my fervent hope that the IFSI Stability Report 2021 will provide a better understanding of trends and developments in the IFSI across jurisdictions and sectors, of the workings of the IFSB, and of both the extant and emerging issues that affect the stability and resilience of the IFSI.

Dr. Bello Lawal Danbatta
Secretary-General
Islamic Financial Services Board

July 2021
ISLAMIC FINANCIAL SERVICES INDUSTRY STABILITY REPORT 2021

KEY IFSI HIGHLIGHTS-

Islamic Financial Services Industry (IFSI) Development Review

Downside Risks of the Global Economy in 2021:
- Magnitude and duration of COVID-19 pandemic
- Uneven distribution of vaccine
- Oil price volatility
- Foreign exchange rate volatility
- Long-term funding disruption
- Weakened real sector productive capacity
- Geopolitical impasse, social unrest

Global IFSI Maintains Positive Growth in 2020:
The total assets of the global IFSI grew by 10.7% (y-o-y) with a total worth estimated at USD 2.70 trillion (2020).
The overall growth was achieved despite the prolonged depreciation of several emerging markets' currencies from 1Q20 towards 3Q20, which led to declines in the dollar values of assets.
The downside risks are expected to affect the projected sense of optimism for 2021

SECTORAL ANALYSIS

Growth (y-o-y): 4.3%
Share of IFSI: 68.2%
Islamic Banking

Growth (y-o-y): 26.9%
Share of IFSI: 30.9%
Islamic Capital Markets

Growth (y-o-y): -14.8%
Share of IFSI: 0.9%
Takāful

Islamic finance assets are still concentrated in the GCC region (48.9%), Middle East and South Asia region (24.9%), South-East Asia region (20.3%), Africa region (1.7%), and “Others” (4.3%).

Islamic banking is considered as systemically important in 15 IFSB jurisdictions

92.4% of Islamic banking assets are concentrated in jurisdictions where Islamic banking is of systemic importance

82.7% of sukūk outstanding in 2020 were in jurisdictions where Islamic banking is of systemic importance

STYLISED FACTS

Islamic banking data as at end-3Q20.
Islamic capital market share comprises sukūk and Islamic funds assets as at end-2020.
Takāful data as at end-2019. The apparent negative growth is primarily due to a change in the exchange rate used for Iran.
The Islamic Financial Services Board’s (IFSB’s) *Islamic Financial Services Industry (IFSI) Stability Report 2021* presents an assessment of the key vulnerabilities, resilience and future outlook of the global IFSI in general, and in the IFSB member jurisdictions in particular, across three key segments: Islamic banking, Islamic capital market (ICM) and Islamic insurance (also referred to as takāful). Since the publication of its maiden edition in 2013, the report has attracted interest beyond the IFSB’s member jurisdictions. Its broad coverage and in-depth analysis of pertinent issues are based mainly on data extracted from the IFSB’s Prudential and Structural Islamic Financial Indicators (PSIFIs) database. The report provides an indicative outlook for the IFSI, which makes it a prime reference for key information on the stability and resilience of Islamic finance globally and across jurisdictions.

Similar to its previous editions, the *IFSI Stability Report 2021* is divided into four chapters. It is worth noting that, in addition to a rearrangement of the chapters, the period of coverage for Islamic banking data is extended to the third quarter of 2020; ICM data are for the entire 2020; while takāful data are mainly for 2019, though where later information is available it is used in the discussion.

Chapter 1 of the report, as in previous editions, provides updates on the key trends in growth and development, and analytical and structural outlooks, across the Islamic banking, ICM and takāful sectors since the *IFSI Stability Report 2020*. The Islamic banking segment retains the highest share of asset worth in the IFSI, with two additional jurisdictions becoming systemically significant and thus increasing the number to 15. However, such dominance of the Islamic banking segment is waning, as the Islamic capital market remains the fastest growing segment and further entrenched its prominence for the fourth year running. The takāful segment’s share of the IFSI’s asset worth remains marginal. This chapter also contains a box article contributed by Moody’s Investors Service.

Chapter 2 provides a detailed assessment of the resilience of the three sectors of the IFSI based on technical analyses and interpretation of the likely implications of selected stability indicators. These indicators are compared with the previous year’s report, with conventional financial institutions in the respective jurisdictions, and with international benchmarks. Cognition is given to the effectiveness of policy measures adopted in various jurisdictions to ensure the stability and resilience of the IFSI amid the COVID-19 pandemic. In addition, this chapter includes box-article contributions from Central Bank of Bahrain (CBB), Saudi Central Bank (SAMA), Central Bank of the United Arab Emirates (CBUAE) and State Bank of Pakistan. Others are International Islamic Liquidity Management Inc. (IILM) and Insurance and Private Pensions Regulation and Supervision Agency (SEDDK) of Turkey.

Chapter 3 covers emerging issues in the IFSI, with a particular focus on the role of Islamic social finance in ensuring a stable post-COVID-19 financial system.

Chapter 4 tracks initiatives and developments in the other international financial standard-setting bodies with an emphasis on aspects that relate directly to the complementary role played by the IFSB. In addition, the various initiatives of the IFSB since the last report are highlighted, including a synopsis of the IFSB Standards Implementation Survey, standards development, research and working papers, and various industry collaborations.
DEVELOPMENTS IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY
The year 2020 was characterised by significant economic impacts globally as a result of the widespread public health measures triggered by the global pandemic. However, extraordinary and timely policy support measures helped to ease financial conditions and to mitigate any potential financial stability risks for the financial sector. The global risk appetite remained relatively resilient, and financial conditions improved over the year, although with significant differences across countries. Reinforced by policy actions, financial conditions remained favourable and continued to be supportive of growth for a large number of countries. The International Monetary Fund (IMF) projects, albeit with a cautious optimism, an improved global economic recovery with a predicted 6% growth in 2021.

The global IFSI maintained its growth momentum in 2020 despite the global pandemic and is estimated to be worth USD 2.70 trillion in 2020 (see Table 1.1.1), marking a growth of 10.7% year-on-year (y-o-y) in assets in USD terms [2019: USD 2.44 trillion]. The Islamic banking, and Islamic capital markets sectors contributed to the increase in total worth of the global IFSI, while takāful contributions experienced a slight contraction. Remarkably, the IFSI demonstrated overall growth in 2020 despite many jurisdictions experiencing economic recessions as a result of lockdowns and heightened uncertainty due to the COVID-19 pandemic.

Table 1.1.1 Breakdown of the Global IFSI by Sector and Region (USD billion) (2020*)

<table>
<thead>
<tr>
<th>Region</th>
<th>Islamic Banking Assets</th>
<th>Sukūk Outstanding</th>
<th>Islamic Funds Assets</th>
<th>Takāful Contributions</th>
<th>Total</th>
<th>Share %</th>
</tr>
</thead>
<tbody>
<tr>
<td>GCC</td>
<td>979.7</td>
<td>280.4</td>
<td>46.3</td>
<td>12.3</td>
<td>1,318.7</td>
<td>48.9</td>
</tr>
<tr>
<td>South-East Asia (SEA)</td>
<td>258.2</td>
<td>366.4</td>
<td>41.9</td>
<td>4.1</td>
<td>670.6</td>
<td>24.9</td>
</tr>
<tr>
<td>Middle East and South Asia (MESA)</td>
<td>499.0</td>
<td>18.9</td>
<td>22.8</td>
<td>5.5</td>
<td>546.2</td>
<td>20.3</td>
</tr>
<tr>
<td>Africa</td>
<td>43.1</td>
<td>1.7</td>
<td>1.5</td>
<td>0.6</td>
<td>46.9</td>
<td>1.7</td>
</tr>
<tr>
<td>Others</td>
<td>61.8</td>
<td>22.1</td>
<td>31.3</td>
<td>0.6</td>
<td>115.8</td>
<td>4.3</td>
</tr>
<tr>
<td>Total</td>
<td>1,841.8</td>
<td>689.5</td>
<td>143.8</td>
<td>23.1</td>
<td>2,698.2</td>
<td>100.0</td>
</tr>
<tr>
<td>Share%</td>
<td>68.3</td>
<td>25.6</td>
<td>5.3</td>
<td>0.9</td>
<td>100.0</td>
<td></td>
</tr>
</tbody>
</table>

Source: IFSB Secretariat Workings

* Data for sukūk outstanding and Islamic funds are for full-year 2020; for Islamic banking, they are as at 3Q20; and for takāful, they are as at end-2019.

Notes: (a) Data are mostly taken from primary sources (regulatory authorities’ statistical databases, annual reports and financial stability reports, official press releases and speeches, etc.) and from the IFSB’s PSIFI database.
(b) Where primary data are unavailable, third-party data providers have been used, including Thomson Reuters.
(c) Takāful contributions are used as a basis to reflect the growth in the takāful industry.
(d) The breakdown of Islamic funds’ assets is by domicile of the funds, while that for sukūk outstanding is by domicile of the obligor.
(e) The regional classification is different from that used in the previous IFSI stability reports. Other than the GCC and South-East Asian region, a new classification – Middle East and South Asia (MESA) – is used to capture other jurisdictions in Asia. The African region now includes both North Africa and Sub-Saharan Africa. Jurisdictions not belonging to any of the four regions are classified as “Others”, specifically countries located in Europe, North America, South America and Central Asia.

2 The figure quoted here is, in fact, a composite made up by adding assets in the banking sector and Islamic funds to the value of sukūk outstanding and takāful contributions. The latter is a measure of income, rather than assets, and elsewhere there may be elements of double counting – for example, if a bank holds sukūk. The figure is nevertheless the best measure we can offer in the current state of data availability.
3 This is due mainly to change in the exchange rate used for Iran.
4 For the purposes of regional classification, Iran is included in “MESA”, North African countries are included in “Africa”, and Turkey is included in “Others”.
Regionally, GCC (the Gulf Cooperation Council countries) retained its position as the largest domicile for Islamic finance assets in 2020. The region accounted for 48.9% of global Islamic finance market share, increasing from 45.9% in 2019. The Middle East and South Asia (MESA) region constituted the second-largest share, accounting for 24.9% of global IFSI assets, remaining consistent with the previous year. The South-East Asia (SEA) region’s share shrank slightly to 20.3% in 2020 from 23.8% in 2019, while that of the Africa region remained small, with a share of 1.7%. The “Others” region, comprising Turkey, the UK and countries from the Commonwealth of Independent States (CIS) region, accounted for 4.3% of total global IFSI assets.

The global Islamic banking industry in 2020 experienced growth of assets by 4.3% y-o-y, slowing down from the momentum gained a year earlier [2019: 12.4%], with total assets as at 3Q20 amounting to USD 1.84 trillion [3Q19: USD 1.77 trillion]. Section 1.2 of this report provides a detailed analysis of the growth and development of the Islamic banking sector across jurisdictions in 2020.

As at 3Q20, tracking a list of 34 jurisdictions (see Chart 1.1.1), the Islamic banking sector experienced an increase in domestic market share in 21 countries [3Q19: 27 countries] while remaining unchanged in three others (including Iran and Sudan, which both have 100% domestic market shares). On the other hand, the number of jurisdictions with declining market shares increased from two in 2019 to 10 as at 3Q20.

Notably, the number of jurisdictions where Islamic banking has achieved domestic systemic importance5 increased to 15 as at 3Q20 [3Q19: 13 jurisdictions]. Oman and Pakistan are the latest additions to the list of systemically important jurisdictions, with the Islamic banking share in the total value of the domestic banking market amounting to 16.0% in Pakistan and 14.2% in Oman [see note (b) of Chart 1.1.1]. Aside from Iran and Sudan, where Islamic banking constitutes 100% of the domestic market, Saudi Arabia and Brunei continue to be the only two jurisdictions that have a domestic Islamic banking share of over 50%. Saudi Arabia's Islamic banking share stood at 68.0%, while Brunei's share stood at 61.9%, as at 3Q20, both showing a marginal decline from the previous year. Kuwait and Malaysia6 recorded slight increases in their market shares as at 3Q20, standing at 42.0% and 28.9%, respectively. Improvements in market share were also made across other systemically important jurisdictions, including Bangladesh (21.9%), Djibouti (25.0%), Jordan (17.9%), Palestine (16.5%), Qatar (27.7%) and the UAE (19.0%).

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5 This report considers the Islamic financial sector as being systemically important when the total Islamic banking assets in a country comprise more than 15% of its total domestic banking sector assets. The report uses the Islamic banking segment as the criterion for systemic importance of Islamic finance, since about 68% of Islamic financial assets are held within the banking sector.

6 Based on Islamic banks regulated by the Central Bank of Malaysia and excluding development financial institutions (DFIs) regulated by the Ministry of Finance, Malaysia. The share for Islamic banking in Malaysia is approximately 30% if DFIs are also included in the banking sector pool of assets.
Chart 1.1.1 Islamic Banking Share in Total Banking Assets by Jurisdiction (3Q20)

Notes:
(a) The countries shown by dark blue-coloured bars satisfy the criterion of having a more than 15% share of Islamic banking assets (indicated by the vertical red dotted lines) in their total domestic banking sector assets and, hence, are categorised as systemically important.
(b) A recognition of systemic importance is considered for a jurisdiction that is within one percentage point of the 15% benchmark, provided it has active involvement in the other two sectors of the IFSI – Islamic capital markets and takāful (e.g. Oman).

Collectively, the 15 systemically important Islamic banking jurisdictions comprise a 92.4% share of the global Islamic banking assets as at 3Q20 [3Q19: 91.4%]. These jurisdictions also account for 82.7% of global ṣukūk outstanding (see Charts 1.1.2 and 1.1.3), indicating the availability of high-quality liquid assets.

Chart 1.1.2 Islamic Banking Assets in Jurisdictions with an Islamic Banking Sector of Systemic Importance (3Q20)

Chart 1.1.3 Ṣukūk Outstanding in Jurisdictions* with an Islamic Banking Sector of Systemic Importance (4Q20)

*Based on the domicile of obligors.
Source: IFSB Secretariat Workings

USD 139.3 bn. 7.6%
USD 1.702.6 bn. 92.4%
USD 119.1 bn. 17.3%
USD 570.4 bn. 82.7%

Systemic importance Others
Systemic importance Others
In terms of the top jurisdictions for Islamic banking assets, Saudi Arabia accounted for 28.5% [3Q19: 24.9%], increasing its relative share, while Iran accounted for 22.1% [3Q19: 28.6%], Malaysia 11.4% [3Q19: 11.1%], the UAE 9.2% [3Q19: 8.7%] and Qatar 6.5% [3Q19: 6.1%], making up the top five jurisdictions in 2020. The other countries in the top 10 Islamic banking jurisdictions, in order of size, are Kuwait, Bahrain, Turkey, Bangladesh and Indonesia (see Chart 1.1.4).

Supported by a flurry of policy actions, the ṣukūk sector ended 2020 with a total outstanding asset size of USD 689.5 billion [2019: USD 543.4 billion], thus recording a growth of 26.9% y-o-y. The volume of ṣukūk outstanding, on its own, accounted for 25.6% of the global IFSI as at end-2020 [2019: 22.3%], with a compound annual growth rate (CAGR) of 26% over the last 16 years (similar to that recorded in 2019). The ICM segment therefore continues to be a significant component of the global IFSI. Section 1.3 of this report provides a detailed analysis of Islamic funds and the Islamic equities market.

The Islamic equity markets experienced significant volatility in 2020 due to the COVID-19 pandemic, but recovered strongly, ending the year on a record high, due to improved investor sentiment and vaccine optimism. Islamic funds remained largely unaffected by the pandemic and saw a growth of 33.1% y-o-y, to close at USD 143.8 billion as at end-2020 [2019: USD 108 billion].

The takāful sector’s market share in the global IFSI stood at 0.9%, with a total asset size of USD 23.1 billion, as at end-2019. Section 1.4 of this report provides a detailed country-level analysis of the size and growth of the takāful sector.

Given the presence of several potential downside risks, particularly with the COVID-19 pandemic still ongoing, global growth projections for 2021 remain...
highly uncertain. While the projections for economic recovery have remained positive, the recovery in emerging markets is expected to be slower than in advanced economies. The impact of a more prolonged COVID-19 crisis than expected and the need for continued lockdown in many countries have significant implications for the global economy, although its full impact has not been seen yet due to the wide-ranging policy measures. The measures may also have unintended consequences, such as stretched valuations and growing financial vulnerabilities, among other things.

In addition, the effect of the pandemic is likely to increase government financing needs, particularly for emerging markets. This change could support an increase in sovereign șukūk issuances from more jurisdictions, although some jurisdictions could face challenges if financing conditions tighten going ahead. The debt levels in the corporate sector have also increased in many countries, which could have potential implications for the banking and ICM segments. Concerns about profitability, and about the credit quality of borrowers that have been more badly affected by the pandemic, are likely to have an impact on the risk appetite of banks. For the ICM segment, downgrading of issuers and possible defaults or restructurings are potential concerns.

The remainder of Chapter 1 provides a detailed analysis of growth and developments across the three key sectors of the global IFSI, while Chapter 2 provides further analyses from a stability and resilience perspective.
1.0 DEVELOPMENTS IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

The Islamic banking industry registered a slower growth rate of 4.3% y-o-y to end 3Q20 at USD 1.84 trillion [3Q19: USD 1.77 trillion] compared to the 12.4% y-o-y recorded in 2019. The apparent slow growth in USD terms was due mainly to the change in the exchange rate used for the Iranian data, but the dual shock of the COVID-19 pandemic and a dip in oil prices and production output in the first quarter of 2020 will also have played a part, especially in some jurisdictions with systemically important Islamic banking sectors. Without prejudice to the effectiveness of a flurry of policy responses put in place by regulatory and supervisory authorities (RSAs) and governments, the pervasiveness of the pandemic and its consequential effect on economic activities have also seen Islamic banks in many jurisdictions focused more on asset preservation than on asset growth in anticipation of a prolonged pandemic and gradual suspension of forbearance and other support measures. Some jurisdictions also faced economic turbulence, resulting in a high rate of inflation and exchange rate depreciation, especially those with low reserves and a high dependence on foreign currencies. Conversely, countries with huge foreign currency reserves and whose currencies are pegged against the USD were less affected. Other factors include political and economic sanctions, as well as national calamities.

The Islamic banking sector across jurisdictions nonetheless generally registered structural improvements. This change is based on the remarkable growth of assets y-o-y, especially in some emerging economies and in some with a systemically important Islamic banking sector. For example, Saudi Arabia registered a growth of 17.0% y-o-y, compared to 10.6% y-o-y registered as at end-3Q19. During the same period, Pakistan registered a growth of 19.9% y-o-y in 3Q20, a rebound from the –3.2% y-o-y recorded in 3Q19. Bangladesh, Brunei, Kuwait, Qatar and the

Chart 1.2.1 Islamic Banking Assets (USD) and Market Share (%) [3Q20]

Source: IFSB Secretariat Workings

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7 A notable example in this regard is Iran with a fully Sharī‘ah-compliant Islamic banking system and which faced economic sanctions, resulting in high inflation and local currency depreciation.
8 Lebanon is a notable example in this regard.
9 This is based on IFSB’s WP-18, which provided a preliminary analysis of the early effect of the pandemic on the resilience and stability of the global Islamic banking industry, as well as on analysis contained in Chapter 2 of this report.
UAE are other jurisdictions that registered increased Islamic banking assets over the period. Specifically, Bangladesh recorded asset growth of 12.6% y-o-y compared to 11.2% y-o-y in 2019, Qatar recorded 12.0% y-o-y compared to 10.6% y-o-y in 2019, Kuwait recorded 7.9% y-o-y, Qatar recorded 15.2%, Brunei rebounded to 4.8% y-o-y compared to −7.5% y-o-y in 2019, while the UAE’s Islamic banking assets increased by 9.5% y-o-y compared to −2.3% y-o-y in 3Q19. Other non-systemically significant banking jurisdictions that recorded y-o-y improvements in assets included Afghanistan [25.5%; 3Q19: 6.1%], Jordan [13.5%; 3Q19: 9.4%], Libya [16.1%; 3Q19: 14.8%] and Palestine [18.4%; 3Q19: 13.9%].

The systemically significant jurisdictions that registered a decline during the period included Malaysia, which registered asset growth of 7.8% y-o-y compared to 9.0% y-o-y in 3Q19, Oman [5.5%; 3Q19: 12.7%] and Sudan [28.1%; 3Q19: 56.5%]. Indonesia and Turkey registered slow growth during the period. The former recorded 9.0% y-o-y as at end-3Q20 compared to 12.7% y-o-y, while the latter recorded asset growth of 20.5% y-o-y as at end-3Q20 compared to 28.9% a year earlier. Nigeria and Lebanon, non-systemically significant Islamic banking jurisdictions, registered a decline in asset growth. While the former registered a slower but positive asset growth of 38.0% [3Q19: 50.6%] y-o-y, the latter registered a negative growth of −6.5% as at end-3Q20 compared to 0.5% y-o-y (see Chart 1.2.1).

The number of jurisdictions with a systemically important Islamic banking sector increased from 13 to 15, Pakistan and Oman being the new additions. The former increased its Islamic banking market share by 1.1 percentage points y-o-y to 16.0% in 3Q20. The latter increased its share by 0.6 percentage points to end 3Q20 with a 14.2% share. Saudi Arabia registered a slight 1 percentage point decline in its share of Islamic banking assets to 68.0% at end-3Q20 [3Q19: 69.0%]. With assets worth USD 522.3 billion, Saudi Arabia is now the biggest Islamic banking jurisdiction. This feat was due to, among other reasons, a higher penetration of Islamic banking windows, and a supportive regulatory environment that aligns with the economic diversification vision of the Saudi government.

Other systemically important Islamic banking jurisdictions that registered a decline in asset share of domestic banking assets are Brunei and Bahrain. The former’s Islamic banking now accounts for 61.9% [3Q19: 62.8%] of total domestic share and is worth USD 8.1 billion as at 3Q20. The Islamic banking sector in Bahrain, worth USD 31.6 billion, accounted for 15.3% as at end-3Q20 compared to its 15.5% share of the domestic banking system a year earlier. Both Brunei and Bahrain have been affected by the dual shocks of COVID-19 and (as oil-exporting economies) the dip in the oil and gas sector, especially up to 2Q20. Other non-systemically important jurisdictions that recorded a decline in their domestic asset share include Kenya [1.0%; 3Q19: 1.4%] and Sri Lanka [0.87%; 3Q19: 0.9%] (see Chart 1.2.1).

The banking sectors of both Iran and Sudan remain at 100%, although the Central Bank of Sudan (CBS) recently announced that it will commence a dual banking system in order to attract international banking corporations to Sudan. The sector was worth USD 14.38 billion as at end-3Q20. Iran is now the second-largest Islamic banking market after Saudi Arabia, after having been the largest since the initial issuance of the IFSI Stability Report in 2013. The sector was worth USD 405.31 billion as at end-3Q20 compared to the USD 504 billion reported in SR 2019.10

In the GCC, although the economies have been affected by the impact of the price and output volatility of the downstream sector, the Islamic banking sectors in Kuwait, Qatar and the UAE all recorded increased asset size relative to domestic banking assets. Specifically, Kuwait’s Islamic banking asset share increased from 41.6% in 2019 to 44.0% as at 3Q20, while that of Qatar and the UAE increased from 26.1% and 18.5% to 26.9% and 19.0%, respectively.

In contrast, with the exception of Sri Lanka, countries in the MESA region recorded an increased share of Islamic banking assets as at 3Q20 compared to a year earlier. Specifically, Bangladesh recorded an increased share of Islamic banking assets [21.9%; 2019: 20.1%]. Prudential policy support and increasing demand for Islamic banking has fuelled the growth of the sector, which has

10 To ensure consistency across sectors in this report, the exchange rate used for Iran is that stated by the Securities and Exchange Organization (SEO) in its Iran quarterly fact sheet, available on its website. An average exchange rate of IRR/USD =165,484 for the four quarters 4Q19-3Q20 was used.
seen further penetration into the domestic market especially through rural banking operations and the provision of remittances services. Jordan [17.9%; 2019: 16.2%] and Palestine [16.5%; 2019: 15.9%] both sustained their systemically significant Islamic banking jurisdiction status amid challenging economic conditions. Afghanistan's Islamic banking sector, with a share of 12.4% [2019: 9.1%], hinges closer to becoming a systemically significant jurisdiction status; while the Maldives also recorded an improved domestic share of Islamic banking assets [6.5%; 2019: 5.6%].

The Islamic banking industry in both Malaysia and Indonesia grew in assets on the back of a supportive regulatory environment and strong government support to sustain its growth momentum, albeit modestly, in the year to 3Q20. Malaysia remains the biggest market in the SEA region with a worth of USD 210.0 billion and accounts for 28.9% [3Q19: 28.4%] market share of the Malaysian commercial banking system. Indonesia's Islamic banking sector was worth USD 37.7 billion and accounted for a 6.1% share as at end-3Q20, a slight increase from 5.8% a year earlier. The growth outlook for the Islamic banking sector in both jurisdictions remains strong on the back of an increased drive towards digitalisation.

Also, while Malaysia's well-established infrastructure, deep customer penetration and commencement of digital Islamic banking are the key driving forces behind its growth, Indonesia's Islamic banking sector is expected to increase its market share based on the merger of three of the four largest banks in the country. Thailand completes the SEA countries that recorded an increased Islamic banking asset share, accounting for 0.5% [3Q19: 0.4%] of domestic banking share in the country.

Within the Central Asia region, the Islamic banking sector in Kazakhstan constitutes 70% of the region's total Islamic banking assets. However, domestically (and as in 2019), Islamic banking assets still account for less than 1% of the total Kazakhstan banking industry as at end-3Q20. Digitalisation is providing a major boost to Islamic banking, as well as strong government support. Attention to the development of a regulatory framework for Islamic banking has also been a key focus in the Kyrgyz Republic. Improvements in the legal and regulatory frameworks, such as in areas of risk management and corporate governance, have endeavoured to support the growth of Islamic banking assets. Such developments contribute to a positive outlook in the Republic for stable growth of the Islamic banking sector to improve its existing 1.5% market share.

In Turkey, the share of the participation banks continued to grow. As at end-3Q20, the sector's worth of USD 54.98 billion [3Q19: USD 45.57 billion] represents 7.10% [3Q19: 6.3%] of the total domestic banking assets. Notwithstanding the pandemic, it seems the change in the Banking Law [Article Nr. 77] that granted permission for development and investment banks to provide interest-free finance has yielded a positive outcome in helping to grow the share of Islamic finance in Turkey.

The share of Islamic banking assets in Africa is relatively low, although it is also increasing. The region has witnessed several developments highlighting its significant potential for the Islamic banking industry. While new full-fledged Islamic banks are being licensed to commence operation, a few notable conventional banks have also established Islamic banking windows. Currently, there are over 80 institutions offering Islamic financial services in Africa. Specifically, Djibouti's Islamic banking sector's asset share improved to 25.0%, maintaining its status as the second African country, after Sudan, to have attained systemic significance.

Egypt's Islamic banking sector also increased its market share by 2 percentage points to 4.03% and was worth USD 16.4 billion as at end-3Q20. Nigeria also increased its Islamic banking share to 0.7% from the 0.3% recorded a year earlier, due to the commencement of operation of another full-fledged Islamic bank, Taj Bank, in addition to the existing Jaiz Bank. The operation of Islamic banking windows is also building momentum in the country. Islamic banking in other African countries maintained its previous year's share of total domestic banking assets. Those countries are Algeria [2.4%], Tunisia [5.1%], Tanzania [0.8%] and South Africa [0.1%].

The GCC countries' Islamic banking assets share remains substantial and improved by 14.7% y-o-y to end 3Q20 with a value of USD 979.9 billion [3Q19: USD 854.0 billion]. The region accounts for 53.2% [3Q19: 48.4%] of global Islamic banking assets.

The MESA region's worth of Islamic banking assets declined by –14.6% y-o-y, due mainly to the lower value of Iran's Islamic banking assets following the depreciation of the Iranian Rial. Nonetheless, the region's Islamic banking asset worth of USD 499.0 billion [3Q19: USD 584.34 billion] accounts for 27.1% [3Q19: 33.1%] of global Islamic banking assets.

The SEA region's Islamic banking assets grew by 7.4% y-o-y to reach USD 258.2 billion [3Q19: USD 240.5 billion]. The region's share of global Islamic banking assets as at end-3Q20 was 14.0% [3Q19: 13.6%].

The Africa region recorded the highest improvement in asset worth: 27.1% y-o-y to end 3Q20 at USD 43.1 billion [3Q19: USD 33.9 billion]. Nonetheless, the region still accounts for the lowest share of global Islamic banking assets, at 2.3% [3Q19: 1.9%].

Turkey and the countries from Europe and the CIS region have been classified as “Others”. This group registered a growth of 16.4% y-o-y in Islamic banking assets, worth USD 61.8 billion [3Q19: USD 53.1 billion], and accounted for 3.4% [3Q19: 3.0%] of global Islamic banking assets (see Chart 1.2.2).

1.2.1 Overview of Islamic Banking in Key Markets

In USD terms, the compound annual growth rate (CAGR) for Islamic banking assets between 3Q18 and 3Q20 is slower by –0.5% y-o-y, at 6.1% as at end-3Q20 (see Chart 1.2.1.1). Specifically, among the 18 countries tracked for the computation of the CAGR in this year's report, 10 registered declining asset growth, including six that are also systemically significant Islamic banking jurisdictions. Nonetheless,
the majority of the countries included in the analyses displayed reasonable growth levels in key Islamic banking indicators. Further assessments of the fundamentals and resilience of the Islamic financial services industry are covered in Chapter 2 of this report.

Analysis of country-level growth rates\(^\text{12}\) shows 12 jurisdictions, including six that are systemically important, out of 19 for which data were available whose CAGR achieved double-digit asset growth rates in the year up to 3Q20. This growth can be attributed, in at least nine out of 17 of these countries, to financing growth that was also in the double digits. Deposits, on the other hand, grew by at least two digits in nine countries, out of 13 for which data were available (see Charts 1.2.1.2, 1.2.1.3 and 1.2.1.4).

\(^{12}\) The term “deposits” in this section includes remunerative funding (murābahah, commodity murābahah, etc.), non-remunerative (current accounts, wād‘ah), and unrestricted profit-sharing investment accounts (UPSIAs), which are treated as equity in the financial statements of Islamic banks in some jurisdictions and as liabilities in others.

\(^{13}\) This analysis is performed using the corresponding USD value for assets, financing and deposit for each jurisdiction to capture the impact of exchange rate fluctuations.
Among the GCC countries, the Islamic banking sectors of both Saudi Arabia and the UAE registered improved performance in terms of CAGR of assets, financing and deposits. Specifically, the Saudi Islamic banking sector registered double-digit performance in asset growth, which increased to 17.0% [3Q19:10.6%], due mainly to increased Shari‘ah-compliant financing and ṣukūk holdings. The sector's total financing also rose to 16.5% compared to 5.8% a year earlier, while deposits reached 14.0% compared to 1.8% recorded in 3Q19. The Islamic banking sector in the UAE, on the other hand, registered a rebound from −2.3% growth in assets to 9.4% in 3Q20. Also, the sector recorded improved financing to reach 7.3% in 3Q20 [3Q19: −0.6%], due mainly to Shari‘ah-compliant financing.
1.0 DEVELOPMENTS IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

and interbank financing activities. Deposits also improved, from –1.3% in 3Q19 to 5.0% as at end-3Q20, due to an increase in remunerative deposits.

In contrast, the Islamic banking sector in Oman registered a y-o-y decline in terms of assets, financing and deposits from the double-digit growth of a year earlier to single-digit growth as at end-3Q20. Specifically, the sector’s assets declined from 12.7% in 3Q19 to 5.5% in 3Q20, while financing also dropped to 5.5% compared to the 13.2% registered a year earlier. The decline in both remunerative and non-remunerative deposits is reflected in the dip in deposit growth from 10.3% in 3Q19 to 7.8% as at end-3Q20. While the Bahraini Islamic banking sector recorded a decline in assets from 6.8% a year earlier to 5.1% in 3Q20, financing growth declined from 13.8% in 3Q19 to –4.4% as at end-3Q20. The Islamic banking sector in both Kuwait and Qatar also recorded a decline in assets growth to reach 12.2% [3Q19: 13.3%] and 10.7% [3Q19: 11.9%] respectively in 3Q20. The former, however, registered improved financing to reach 11.1% in 3Q20 [3Q19: 10.8%].

In the SEA region, the Bruneian Islamic banking sector registered a rebound in asset growth, from –7.5% in 3Q19 to 4.8% in 3Q20. On the other hand, financing declined to 2.6% from the 4.5% registered a year earlier. Malaysia’s Islamic banking assets registered a decline to 7.8% compared to 9.0% in 3Q19. This is notwithstanding an improvement in financing growth from 7.0% a year earlier to 10.2% as at end-3Q20. However, the sector’s deposits slowed to 5.4% in 3Q20 compared to 10.9% registered a year earlier. Although the Indonesian Islamic banking sector recorded the highest growth rates in the SEA region in terms of both assets and deposits, the sector registered a y-o-y decline in terms of both, including for financing. Specifically, assets growth dropped to 9.0% in 3Q20 compared to 12.7% in 3Q19, while financing dropped to 3.5% from 16.3% recorded a year earlier. Deposits followed the same trend, dropping from a double-digit rate of 17.7% a year earlier to 7.2% as at end-3Q20.

In the MESA region, the Islamic banking sector in both Afghanistan and Bangladesh registered improved performance in terms of the growth of assets, financing and deposits. Afghanistan recorded an asset growth to reach 25.5% in 3Q20 [3Q19: 6.1%], while also registering a rebound in financing from –24.2% a year earlier to 7.2% as at end-3Q20. Deposits also increased from 11.4% to 27.4% from 3Q19 to 3Q20. Bangladesh grew its assets from 11.2% to 12.6%, while financing also improved from 10.1% to 12.0%, in 3Q20 compared to a year earlier. Deposits also rose from 11.1% to 19.7% over the same period. In 3Q20, the Pakistani Islamic banking sector registered a rebound with a growth in assets of 27.2% [3Q19: 21.8%], financing 28.9% [3Q19: 12.7%] and deposits 26.0% [3Q19: 20.1%].

All-round improvements were also registered by the Jordanian Islamic banking sector. Specifically, assets rose from 9.4% in 3Q19 to 13.5% in 3Q20. A similar performance is recorded in terms of financing, which rose to 13.9% [3Q19: 7.8%], and deposits, which rose to 10.6% [3Q19: 9.4%]. Palestinian Islamic banks also improved in terms of assets growth, which rose to 18.4% [3Q19: 13.9%], and financing growth, which rose to 15.0% [3Q19: 14.3%]. Due to worsening economic conditions in Lebanon on account of its sovereign default and the explosion at the port of Beirut, the country’s Islamic banking sector recorded a decline in assets growth to –6.5% [3Q19: 0.5%], and in financing from 11.1% a year earlier to –30.5% at end-3Q20.

In the Africa region, the Libyan Islamic banking sector recorded asset growth from 14.8% in 3Q19 to 16.1% in 3Q20. On the other hand, the non-interest banking (NIB) sector in Nigeria registered a decline from 50.6% in 3Q19 to 38.0% in 3Q20. However, the sector recorded further improvements in terms of financing, from 15.8% to 50.0%, and in deposits, from 56.8% to 154%, between 3Q19 and 3Q20. The NIB also registered the highest growth rate in both financing and deposits among the countries in the sample due to the relatively small size of the sector that benefited from the establishment of a new Islamic bank in the country. The Sudanese banking sector also recorded a decline in asset growth from 56.5% in 3Q19 to 49.2% in 3Q20, financing from 62.8% in 3Q19 to 32.0% in 3Q20, and deposits from 53.3% a year earlier to 49.2% in 3Q20.

14 The growth rate for assets, deposits and financing for the Islamic banking sector in Sudan, and the NIBs in Nigeria are not shown in Charts 1.2.1.2 to 1.2.1.4 in order to make the growth rates registered in the other jurisdictions visible on the charts.
1.0 DEVELOPMENTS IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

Unlike in the previous year when it recorded an asset growth rate of 28.9%, Turkish participation banks registered slower positive growth of assets of 20.5% in 3Q20. Similarly, the deposit growth of 33.8% reported in 3Q19 is higher than the 23.5% recorded in 3Q20. However, financing growth improved from its sluggish 6.9% in 3Q19 to 28.2% as at end-3Q20.

1.3 Islamic Capital Market: Sustained Growth despite Market Volatility

1.3.1 Ṣukūk

The ṣukūk market proved to be fairly resilient in 2020 despite the unprecedented and wide-ranging impact of a global pandemic. Ṣukūk outstanding continued its growth trend to reach USD 703 billion in 2020 (see Chart 1.3.1.1). Notwithstanding the initial shock of the pandemic on financial markets early in the year, ṣukūk markets recovered quickly, with the impact of the crisis manifesting unevenly across countries. The overall ṣukūk issuances by the end of 2020 proved to be relatively strong, with total issuances worth USD 163.4 billion. While this represents a 4% drop from the USD 171.1 billion of issuances in the previous year, the ṣukūk market has remained relatively robust, with higher total annual issuances than in the years prior to 2019 (see Chart 1.3.1.1).

Conditions for issuers improved over the year, although unevenly for different countries. The overall volume of issuances in 2020 was boosted by an increase in overall issuances from the GCC region, including Saudi Arabia, Kuwait, the UAE, Bahrain, Qatar and Oman, as well as by an increase in issuances from Iran compared to the previous year. On the other hand, there was a slight drop in overall issuances from the major issuers in Asia. In general, risk aversion of investors decreased over the year due to increased global liquidity resulting from policy measures to minimise the impact of the pandemic.

While emerging markets experienced initial fund outflows, global policy actions resulted in a flow of funds back into emerging market debt and hence into ṣukūk. Global monetary policy actions pushed rates lower, while the pandemic also drove investors to look for safety, which pushed Treasury yields and many other rates sharply lower. The resulting search for yield drove funds back into corporate and emerging market debt. This encouraged issuers with strong fundamentals to reopen ṣukūk or to continue issuance through established programmes.

Sovereign issuances, which continue to dominate the ṣukūk market, saw a slight drop in 2020. Sovereign issuances made up about 53% of all issuances [2019: 56%], followed by 37% from

Data for 2018 onwards include Iran

Source: IFSB Estimates based on data from Refinitiv and Regulatory Authorities
1.0 DEVELOPMENTS IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

Chart 1.3.1.2 Šukūk Issuances by Issuer Type (2020)

In a reversal from 2019, Saudi Arabia was the biggest sovereign issuer in 2020, followed by Indonesia, Malaysia and Kuwait (see Chart 1.3.1.3(a)) [2019: Malaysia 23%, Indonesia 21%, Saudi Arabia 20%, Kuwait 11%]. This reversal reflects a drop in sovereign issuances from Malaysia as well as Indonesia, while issuances from Saudi Arabia and Kuwait remained largely consistent with the previous year. There was also an increase in sovereign issuances from Bahrain, Turkey, the UAE and Iran compared to the previous year, while Oman and Nigeria returned to the Šukūk market in 2020 with sovereign issuances. Conversely, there were no sovereign issuances from Qatar in 2020, and Brunei and Bangladesh experienced a slight drop in issuances.

Source: IFSB Estimates based on data from Refinitiv and Regulatory Authorities
The contraction in sovereign issuances during the year reflected the economic shock and deep recession brought about by the COVID-19 pandemic in all core Islamic finance jurisdictions, which was further exacerbated in some jurisdictions by low oil prices. Nevertheless, a more severe impact on the market, including a liquidity strain, was mitigated by the swift and wide-ranging policy measures taken by central banks, including those in core Islamic finance markets, which helped to boost liquidity and produced more accommodative conditions for issuers. However, sovereign issuances remained more muted in some jurisdictions, while others relied on the bond market rather than the ṣukūk market for financing in 2020. At the same time, the economic challenges produced higher financing needs for sovereigns, particularly oil-exporting countries, due to a drop in oil prices. This helped to temper the drop in issuances, with some sovereign issuers tapping into all available financing avenues.

Corporate issuance volume was robust but slightly lower than 2019, due to the uncertain environment and the greater reliance on other forms of financing supported by government policy measures. Liquidity support and monetary policy measures by central banks allowed the banking system to meet corporates’ financing needs at preferential rates, which in turn reduced the incentive for some corporates to issue ṣukūk. The uncertain environment also made corporates more conservative in their capital expenditures, pushing back investments and projects, which in general also reduced corporates’ financing needs. However, some Islamic banks increased their issuances in 2020 to take advantage of the supportive market conditions and lower interest rates created by the policy measures, with issuances intended to meet capital adequacy requirements or to extend their debt maturity profiles.

Malaysia continues to be the largest corporate issuer in terms of overall volume of issuances, followed by the UAE, Saudi Arabia and Turkey (see Chart 1.3.1.3(b)) [2019: Malaysia 59%, Turkey 14%, UAE 14%, Saudi Arabia 5%]. However, issuances by Malaysian corporates were lower than those of 2019. There was also a general decrease in corporate issuance across many of the regular issuers. On the other hand, corporate issuances from the UAE, Saudi Arabia, Qatar and Iran increased despite the challenging year. While debut issuances were rare in 2020, there was a debut corporate issuance from Egypt by a real estate developer.

Chart 1.3.1.3 (b) Corporate ṣukūk Issuances by Jurisdiction of the Originator (2020)

Source: IFSB Estimates based on data from Refinitiv and Regulatory Authorities
Regionally, the GCC accounted for about 41% of the total volume of issuances in 2020, representing an overall increase in issuances from the region. The South-East Asia region (specifically, Malaysia, Indonesia and Brunei) accounted for about 42% of issuances, albeit with a drop in number compared to the previous year [2019: SEA 51%, GCC 33%]. The two regions collectively represented around 83% of issuances in 2020, consistent with the previous trend (2019: 84%).

Overall, Malaysia remains the largest issuers, followed by Saudi Arabia and Indonesia (see Chart 1.3.1.4) [2019: Malaysia 37%, Saudi Arabia 14%, Indonesia 14%]. This was supported by significant corporate participation in the sukūk market (consisting of 66% of total volume of issuances from Malaysia in 2020), compared to other jurisdictions, albeit with a drop from the previous year. However, notably, much of this activity is currently based in the active domestic sukūk market in Malaysia, which is relatively deep and liquid, with fewer international issuances.

On the other hand, Saudi Arabia, which was the second-largest overall issuer, increased its issuances compared to 2019. This was supported by a high volume of sovereign issuances (68% of the country’s total volume of issuances in 2020), although all these issuances were denominated in the local currency. Out of the total volume of corporate issuances from Saudi Arabia, about 55% were USD-denominated international sukūk. The third-largest issuer was Indonesia, dominated by sovereign issuances, which made up about 97% of total issuances from Indonesia.

While this overall sukūk market structure is expected to remain the same in the near term with respect to the major issuers, these core markets are likely to see further growth as their economies recover. It is also expected that the volume of issuances from jurisdictions that have so far remained as smaller issuers will continue to grow gradually, along with new entrants to the market.

There are several expected new entrants to the market in the coming years, including Egypt, Uzbekistan, Algeria and Mauritius. Egypt recently approved a new sovereign sukūk bill to facilitate a sukūk debut sovereign issuance, while Uzbekistan, Algeria and Mauritius are all actively working on adapting their legislation and regulations to enable sukūk issuance. In addition, the UK recently returned to the sukūk market,16 while South Africa also has plans to do so.

Investment-grade sukūk17 issued in 2020 made up about USD 25.9 billion of total issuances (16%) and were predominantly USD-denominated international issuances. These were diverse in terms of the issuing domiciles, issuer types and sukūk structures used. There were also a number of high-yield international issuances, comprising USD 6.9 billion, or 4%, of the total volume of issuances in 2020.

![Chart 1.3.1.4 Total Sukūk Issuances by Domicile* (2020)](chart)

Source: IFSB Estimates based on data from Refinitiv and Regulatory Authorities

Note: *Excludes issuances by multilaterals.

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16 UK Government. UK Bolsters Islamic Finance Offering with second sukūk. www.gov.uk
17 These are sukūk that receive higher ratings by rating agencies and, as such, are believed to have a lower rate of default.
The sectoral distribution remains concentrated in the government and financial sectors, consistent with the previous trend. Together, the two sectors accounted for slightly over 90% of the total volume of issuance (see chart 1.3.1.5). Sectors that were more impacted by the COVID-19 containment measures saw a decline in issuance activity.

Green and SRI (socially responsible investment) sukūk continued its growth trajectory in 2020 (see chart 1.3.1.6), which included issuances from Indonesia, Saudi Arabia, the UAE and Malaysia. They included green issuances from the Indonesian government, Saudi Electricity Company and Malaysian corporates, as well as environmental, social and governance (ESG) linked sukūk from the Islamic Development Bank (IsDB) and Etihad Airways. Green sukūk issuances in 2020 also included investment-grade USD-denominated sukūk that provided attractive investment opportunities for investors. Green and ESG-linked sukūk issuances are expected to grow moderately in the coming years, supporting the transition agenda as well as the pandemic recovery efforts.
The COVID-19 pandemic may also increase the issuance of social ṣukūk that target social needs in countries to finance economic recovery. Ṣukūk issuances in 2020 for this purpose included the IsDB’s USD 1.5 billion sustainability ṣukūk, the proceeds of which will go towards helping the IsDB’s member countries cope with the impact of the pandemic. Another example is the Malaysian government’s ṣukūk Prihatin, the proceeds of which will be used to help restart the economy. The latter was targeted not only at institutional investors, but also at retail investors, and was the first digital ṣukūk in the country. Innovative instruments such as social ṣukūk and digital and blockchain-based issuances are likely to support an increase in ṣukūk issuances with a retail investor focus, which are currently limited.

1.3.2 Islamic Funds

The total assets under management (AuM) of Islamic funds grew by 31.9% in 2020 despite the pandemic (see chart 1.3.2.1). While total AuM grew significantly, the total number of funds increased at a slower rate, which is a positive indication of growth in the average size of funds. The increase in scale of funds may be an indication of the flow of funds into emerging markets' fixed-income funds as a result of the search for yield and increased global liquidity. Contrasting with the previous year, about 47% of funds now hold AuM of USD 1 billion or more each, while only 1% of funds hold AuM of less than USD 10 million (2019: only 2% held AuM of more than USD 1 billion each).

Chart 1.3.2.1 Growth in Assets under Management and Number of Islamic Funds (2008–20)

Source: IFSB Estimates based on data from Refinitiv and Regulatory Authorities for 2019 and 2020.18 Data for the years 2008–18 are from the Bloomberg database as per previous Stability Reports.

18 Islamic funds data exclude pension funds and insurance funds.
Islamic funds continue to remain concentrated by domicile in three core markets – Saudi Arabia, Malaysia and Iran – constituting around 81% of total AuM (see Chart 1.3.2.2) [2019: Saudi Arabia 38.5%, Malaysia 28.1%, Iran 14.9%]. Industry impact from COVID-19 varied widely across countries, with the funds sector as a whole sustaining less damage than some other sectors. Revenues for investment management firms remained largely intact. At the same time, market volatility and price movement significantly accelerated at the industry sector and asset class levels. On the whole, notwithstanding the initial shock experienced in early 2020, inflows into Islamic funds in many countries picked up in the latter part of 2020, enabling the overall growth trend to continue into 2020.

1.3.3 Islamic Equity Markets

Global equity markets rebounded strongly from pandemic lows, with notable differentiation across countries depending on the spread of the virus, the scope of policy support and sectoral composition. Overall, 2020 was an exceptional year for the equity markets, with a bull market at the beginning of the year, followed by a steep crash from the initial market shock of the pandemic and a short-lived bear market, before once again entering a bull market (see Chart 1.3.3.1).

Thus, while the Islamic equity market experienced significant volatility in 2020 due to the COVID-19 pandemic, it ended the year on record highs due to fiscal and monetary support from governments, which, coupled with optimism about successful vaccine trials in tackling COVID-19, improved investor sentiment. This positive trajectory is expected to continue into 2021, barring the materialisation of any downside risks.

The technology sector, to which Islamic equities tend to have a relatively high exposure, outperformed the other sectors, as companies in this sector benefited the most from the “new normal” of remote work and increased time spent at home as a result of lockdowns. An improvement in investor risk sentiment and stocks from the strongest sectors led the market out of bear territory into a record high by the middle of 2020. However, notably, it also led to a distortion in the market, with growth stocks outperforming value stocks by the widest margin in decades. Although the drop that followed in September nearly qualified as a market correction, the equity market rallied again, reaching an all-time high at the end of 2020. This was also accompanied by a gradual shift back into value stocks from growth stocks.
Islamic indices, while moving similarly to the conventional market, continued to outperform their conventional counterparts in 2020 in keeping with the past trend, but with a growing differential (see Chart 1.3.3.2). The performance of Islamic indices, while parallel to that of conventional indices, has tended to surpass those, with this difference growing increasingly more pronounced (see Chart 1.3.3.1).

**Chart 1.3.3.1 Ten-Year Historical Performance (2011 – February 2021)**

![Chart 1.3.3.1 Ten-Year Historical Performance (2011 – February 2021)](chart1.png)

*Source: Bloomberg, Eikon Refinitiv and IFSB*

**Chart 1.3.3.2 Performance of Islamic Indices vs. Global (2020)**

![Chart 1.3.3.2 Performance of Islamic Indices vs. Global (2020)](chart2.png)

*Source: Bloomberg, Eikon Refinitiv and IFSB*
1.0 DEVELOPMENTS IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

The superior performance of Islamic equity indices compared to their conventional counterparts may be due to a number of factors. First, the Sharī‘ah screening process screens out firms carrying substantial percentages of conventional debt; this tends to provide hedging benefits during market downfalls. Second, the Sharī‘ah screening tends to skew the composition of Islamic indices towards greater exposure to the technology sector, which was one of the strongest sectors in 2020 (see Charts 1.3.3.3 and 1.3.3.4). Third, the screening process results in Islamic indices having a smaller subset of constituents, which, on average, have larger market capitalisations and stronger fundamentals than the larger set of constituents making up the equivalent conventional indices.

In terms of sector performance, the information technology sector was the strongest overall, with the top-performing companies being those that acted as enablers to remote working and e-commerce. Internet retail companies therefore performed particularly well, while the shift towards e-commerce also benefited the freight and logistics sector. The consumer discretionary sector was the second-highest performer in 2020. This was followed by materials, which gained during the latter part of the year while technology stocks reversed, with gold hitting an all-time high and copper reaching an eight-year high. Optimism regarding economic recovery also drove a rebound in prices for commodities such as oil and industrial metals. This trend is likely to continue as companies begin to rebuild after the economic collapse, with increased orders for materials such as lumber, copper and zinc.

The rebound in shares in the materials sector is an indication that the economy is recovering enough to also drive growth in the other sectors that underperformed in 2020, such as industrials and financials. Gains in the materials sector offer a better indication of the state of the broader economy than the performance of the technology sector, since the rising prices for materials, including lumber and steel, reflect rising orders in industries such as housing and automotives, which will eventually drive more activity and extend to growth in sectors such as energy and financials.

The worst-performing sector in 2020 was oil and gas, which had been affected pre-COVID-19 due to price wars and was further exacerbated by lockdowns and the shutdown of non-essential travel. Apart from the energy sector, predictably, the travel industry and airlines were also significantly affected by COVID-19 containment measures. The
1.0 DEVELOPMENTS IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

Chart 1.3.3.4 S&P 1200 Sector Performance (2020)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Performance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Information Technology</td>
<td>44.45</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>28.67</td>
</tr>
<tr>
<td>Materials</td>
<td>23.11</td>
</tr>
<tr>
<td>Communications Services</td>
<td>22.41</td>
</tr>
<tr>
<td>Health Care</td>
<td>13.14</td>
</tr>
<tr>
<td>Industrials</td>
<td>11.49</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>8.14</td>
</tr>
<tr>
<td>Utilities</td>
<td>5.72</td>
</tr>
<tr>
<td>-2.37 Financials</td>
<td></td>
</tr>
<tr>
<td>-30.21 Energy</td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg and Eikon Refinitiv

travel and airlines sector may continue to be weaker even after COVID restrictions are lifted, if a general cultural shift occurs towards increased remote working and online meetings, which will reduce passenger numbers and business travel going forward.

On the whole, the Islamic equities segment was one of the least affected with the exception of the initial volatility, having shown a stronger rebound than the other two segments. This performance was supported by the fact that Islamic indices have exposure to a larger proportion of sectors that were less affected by COVID-19. The exceptional performance of equity markets at the end of the year also points to a general resilience of the equities markets, boosted by increasingly positive investor sentiment regarding successful vaccine trials and economic recovery, and confidence of investors that policy support by governments will continue.

1.3.4 Growth Outlook in 2021

The growth outlook for 2021 will depend on a number of factors, including how soon countries are able to lift their pandemic containment measures and return to normal, the speed of economic recovery, and the continuation of government policy measures to aid recovery. In 2020, many of the core Islamic finance countries experienced a deep recession as a result of the COVID-19 pandemic. While government policy measures to mitigate the impact of the pandemic have tempered its impact on the ṣukūk, Islamic funds and equities markets thus far, some of the main risks for the growth of the Islamic capital market in 2021 include how effectively COVID-19 can be controlled and the length of time emerging markets would take to recover from the economic recession created by the pandemic.

Nonetheless, if the abundant liquidity and accommodative market conditions created by policy support continue, ṣukūk issuances in 2021 could either sustain current levels or see a modest increase. Issuances in 2021 are likely to include issuers that need to meet refinancing needs, with USD 65.9 billion maturing in 2021, as well as sovereigns needing to fund budget deficits as countries try to recover from the recession. Sovereign issuers in core Islamic finance jurisdictions are expected to remain major contributors to overall ṣukūk volumes. Issuances from financial institutions and corporates could also rise if the current low cost of funding continues. In particular, greater activity is expected from the GCC, including Qatar, as a result of the easing of restrictions against Qatar and the reopening of its access to the GCC market. In addition, as economies recover from the pandemic and lockdowns, it is expected that there will be a resurgence in ṣukūk issuances across all jurisdictions as economic activity increases. Innovative issuances such as green, digital and social ṣukūk are also likely to continue to attract investor demand.
The Islamic funds sector remains small but shows positive signs of increasing the scale of funds. Islamic funds, unlike the other segments, have tended to be more geographically diverse, with more participation from non-core Islamic finance markets than, for example, in the śukūk segment, which represents high potential for growth and expansion. Islamic funds are therefore expected to continue their growth trajectory, with participation from both core Islamic finance markets and other non-core markets.

1.4 Takāful: Sustained Growth and Contribution

1.4.1 Overview of the Global Insurance Sector

This section provides a general overview of developments in the global insurance sector, and of specific developments in the takāful market across countries and regions. It is based mainly on data for 2019; hence, the data exclude developments resulting from the COVID-19 pandemic. However, these developments are discussed in the narrative where information is available, as are potential developments for 2021.

The year 2019 is the first for which takāful data have been included in the IFSB’s PSIFI system. This system provides a standardised set of data, submitted by RSAs following a set of agreed definitions. In this report, PSIFI data have been used where available even though this inevitably means some discontinuity in data series. This transition towards the use of PSIFI data will continue in future years. In addition, better non-PSIFI data have become available for some countries – for example, Pakistan, where the available data now include takāful windows. As a general policy, this report uses what the IFSB judges to be the best and most complete available data, noting discontinuities where necessary.

Global insurance markets were experiencing solid growth before the COVID-19 pandemic, with total direct written premiums in 2019 up by some 3% from the year before. The key growth drivers were non-life insurance in advanced markets, and both life and non-life insurance in China. On the life side, premium growth in advanced markets slowed to 1.3%, though with wide divergences by country; whereas in the emerging markets it increased to 5.6%, after a fall of 2% in 2018 – in both years driven by developments in China. Life insurers in advanced markets have also felt pressure on profitability as a result of persistently low rates of return in the investment markets. As a result, they have increased their investments in alternative assets and lower-rated corporate bonds.

On the non-life side, premium growth in advanced markets also slowed modestly to 2.7%, but in the emerging economies growth strengthened to 7.7%, broadly in line with the 10-year average for those economies. China was again the major driver, and accident and health insurance performed strongly, while motor insurance was weaker, as a result of competitive pressures in a number of markets. Worldwide economic losses from natural and man-made disasters were well down, in relation both to the previous year and to the 10-year average, as were the losses falling on insurers. This mainly reflects an absence of large hurricanes in a single country (the USA) but will have had a global effect in reducing pressure on reinsurance/retakāful rates.

It was against this background that COVID-19 struck. The most useful analysis of its impact on the global insurance industry comes from the International Association of Insurance Supervisors (IAIS). While the IAIS analysis does not have complete data on the overall impact, it does contain very useful information some of which, on the industry’s resilience, is discussed in the next chapter. In general, however, the

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19 In this report, “takāful” refers to various Islamic insurance models that are adjudged to be Shari’ah-compliant. These include the Cooperative Insurance model in Saudi Arabia, the Mutual Insurance model (ta’awun) in Sudan, the Insurance model in Iran, and the Participation Insurance model in Turkey.

20 There are a number of data issues. Aggregate data are not always consistent as to whether takāful windows, or retakāful, are included, and in some cases it may not be clear what the position is. Where possible, takāful windows are included and retakāful is excluded, to give the clearest picture of the size of the primary market. Although, in general, Gregorian calendar year data are used, Iranian and Egyptian undertakings follow different accounting years, and the closest available year end has been used. In some cases, primary data from an RSA or insurance federation are not available, and secondary sources (e.g., press reports) have had to be used. Even where PSIFIs’ data have been submitted, there are in some cases problems and inconsistencies arising from the novelty of the return. There are also some takāful markets for which no data are available; these include Sudan, the UK (where a small amount of commercial lines business is written), and the financial free zones of Qatar and the UAE, which undertake primarily reinsurance/retakāful. In the case of Sudan, because of its significance, an IFSB estimate has been used.

21 One specific discontinuity arises from the exchange rate used to convert Iranian data from national currency to USD. In the past, the official exchange rate has been used. However, since 2017 this has diverged markedly from the parallel market rate, which the authorities report separately. For the 2019 data, this report uses the same (parallel market) figure as the Iranian authorities have used in reporting data for other sectors.


1.0 DEVELOPMENTS IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

Impact on premiums has been a modest reduction across the advanced markets. The impact on claims has been highly variable, with the impact on health insurance was actually mildly positive in some areas, perhaps contrary to immediate expectations. There have been reductions in claims also in transport sectors (especially aviation) as a result of reduced travel. Unsurprisingly, the large increases in claims have come in areas such as business interruption, event cancellation, travel insurance and credit. Some of this, especially business interruption and event cancellation, tends to be placed with insurers specialising in these lines of business, often on an international basis.

Early results for 2020 from global reinsurers have shown substantial pandemic claims provisions, in some cases leading to significant overall losses. This suggests that direct insurers for the most part had established prudent reinsurance programmes to protect them against extreme accumulations of risk (e.g. from event cancellation).

Data are not yet available to be certain how far this pattern was replicated in the takāful sector, or what the impact on retakāful undertakings will have been. However, the data available from a limited number of countries suggests that the global pattern has indeed been maintained for takāful. Where 2020 data are available, there do not appear to be any substantial declines in contributions, nor substantial increases in claims. In particular, the health insurance category has not suffered badly, and motor claims have declined. In addition, the main takāful markets are not ones in which business interruption insurance is a substantial feature of commercial life, and large-scale event cancellation business (such as for international sporting events or conferences) tends to be written in the conventional market. It thus seems likely that takāful undertakings will not have suffered materially on the underwriting side of the business, and this appears to be borne out by the limited data.

The investment side of the business is harder to gauge. While investment risks from the savings component of family takāful are passed on to participants, this is not true in the same way of the protection element or in general takāful. However, information on the impact of the pandemic on takāful undertakings’ investments is not yet widely available and will also depend on the economic responses made to the pandemic in each jurisdiction. Where evidence does exist, it does not suggest a major financial impact.

Some takāful operators, like their conventional counterparts, are known to have extended payment holidays of various kinds to participants. In some cases, this has been the result of regulatory pressure, but no systematic information is available on such practices internationally. To the extent that contribution deferrals relate to the risk protection rather than savings elements of takāful, there is a potential for adverse impact on the takāful undertaking’s finances if the deferred contributions are not caught up. However, such impacts seem likely to be marginal.

There is also some evidence\(^\text{24}\) that, as in other financial services sectors, the pandemic will accelerate digitalisation in insurance, though the precise technologies that will benefit will vary by country and region. There is not, however, a reliable basis for distinguishing between takāful and conventional insurance in relation to this effect.

1.4.2 Takāful Contributions in 2019

Overall, takāful contributions are estimated at USD 23.1 billion in 2019. Because of the data limitations explained in footnote [23], this is likely to be a slight underestimate. It represents an apparent decline from the figure reported for 2018, but this is entirely attributable to the change in the exchange rate used for the Iranian data, explained in footnote [24]. If Iran were excluded, the figure would have shown an overall increase.

In takāful, as in conventional insurance, the ratio between life and non-life business varies greatly between countries. This largely reflects the way individuals in those countries choose to save for the future and is driven by history, and by social and cultural factors, rather than by the economic situation.\(^\text{25}\) The discussion of individual countries will therefore, where possible, discuss general and family takāful separately.

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\(^{24}\) See, for example, Deloitte (2021). “2021 Insurance Industry Outlook” | Deloitte Insights

\(^{25}\) To give an example from conventional insurance, France and the Netherlands are physically close and have similar levels of insurance penetration. However, in France some 65% of the business is life, while it is only 17% in the Netherlands.
1.0 DEVELOPMENTS IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

Since Saudi Arabia and Iran are the largest takāful markets by a considerable margin, and both are entirely Islamic, it is sensible to discuss these countries individually, before turning to other regions and countries.

The Saudi market is going through a period of regulatory and structural change as part of the Kingdom’s “Vision 2030”. The reforms include new conduct-of-business measures, including measures relating to consumer protection, bancassurance and insurance aggregation activities. More significantly from the structural viewpoint, the regulator has been increasing capital requirements, has suspended some companies with unsatisfactory capital and solvency positions from accepting new business, and has required insurance companies to review and restructure their businesses, if necessary, through mergers and acquisitions. This has triggered merger negotiations involving 10 companies, as a result of which two mergers came to fruition in 2020, between Wala’aa and Metlife-AIG-ANB Cooperative Insurance Company, and between Gulf Union and Alahlia Cooperative Insurance Company. A further merger, between Aljazira Takaful and Solidarity, was concluded in February 2021. Saudi Arabia has also, for the first time, permitted foreign insurers to establish new branches there, and the first of these, from an insurer based in the UAE, began operations in 2020. These changes are likely to lead to a stronger industry overall.

At the same time, demand for its products has been driven by other regulatory changes, notably the Health Ministry’s project to provide 100% health insurance cover for all Saudi nationals within five years. This development led to a 13% increase in health insurance premiums in 2019 and, since health accounts for over half of total premiums, this drove the overall 8% increase in gross written premiums. General insurance increased only modestly (by 1.8%) in money terms, and its share of overall premiums fell from 40.1% in 2018 to 37.7% in 2019. This decline reflected a fall in motor premiums by 8.7%. Although there were increases in other classes, in some cases (e.g. engineering) very substantial ones, the importance of motor in the overall figures led to the modest growth already mentioned. The year 2019 was the third successive year in which motor premiums had fallen, presumably due to a more competitive environment.

Life/savings policies also displayed modest growth and their share of the market decreased slightly to 3.0%. Insurance penetration, the ratio of GWP (gross written premiums) to GDP, increased modestly but not...
sufficiently to reverse the decline over the three previous years. Net written premiums increased by less than GWP (5.4%).

Figure 1.4.2.1 on retention ratios is included here because of its bearing on the prospects for growth. It shows very high ratios for motor and health, but very low ratios in some other classes. In some of those classes, ratios have been falling, though it is always possible that a few very large contracts may have been responsible for this. In this situation, industry growth can continue to be driven for a few years by an increase in health cover. Thereafter, and leaving aside broader economic developments – for example, an increase in the number of major projects – the best prospect for growth on the non-life side lies in the possibility that stronger companies will be able to achieve higher retention ratios in some commercial lines. For life/investment business, growth will depend on broader social and policy developments, including the degree of dependence on government for social safety-nets and the ways in which individuals choose to save.

In the case of Saudi Arabia, 2020 data are now available. This allows some analysis of the impact of COVID-19 on growth. For general insurance, gross contributions for 2020 were 2.3% up on 2019. Health insurance grew at 1.6%, slower than in recent years. This change was driven by a decline in the number of non-Saudis insured, particularly from low-income workers leaving the country as a result of the economic pressures caused by COVID-19. Motor premiums showed a decline of 2.9%, partly as a result of the two-month free coverage offered to retail policyholders as a gesture of goodwill to reflect reduced vehicle usage during lockdown. Other areas of general insurance increased, with some evidence that this may have been driven by major commercial projects. The figures for protection and saving products were up by 3.3%, though they are a small part of the overall total. Net claims incurred in health insurance fell by 1.9% due to the government taking over responsibility for the treatment of COVID-19 patients, while others deferred non-urgent treatments. Motor claims fell by 13.8%, for several reasons of which reduced use in lockdown was one. With these two classes dominating the general insurance sector, overall claims and the loss ratio both fell. Mainly because of this improved underwriting performance, the overall profitability of the sector increased (see Chapter 2). The takāful industry in Saudi Arabia has thus not suffered significantly from the effects of the pandemic.

The available data on Iran are very sparse. Reports indicate that contributions in 2019–20 increased by 35.8% in national currency, while claims increased by 18.2%. Nine companies account for over 80% of contributions, with the largest, Iran Insurance Company, more than three times the size of its nearest rival. The market has been substantially isolated from international insurance and reinsurance markets in recent years as a result of sanctions, and risk will therefore be retained nationally, with investments also being made on a national basis.

The countries of the GCC other than Saudi Arabia have seen some significant developments. On the
In the GCC in general, levels of insurance penetration are low. The growth of takāful has been driven largely by health insurance, with increased regulatory requirements for cover, including for migrant workers. Takāful has not been a primary method for long-term savings, though there are some signs of growth in that area. The UAE has seen insurance growth well ahead of the global average in recent years, but in 2019 gross written premiums grew by only 1%. Takāful premiums, on the other hand, grew by 3.8%, raising the takāful share of the market to 16%. It is in health insurance, in particular, that takāful has taken market share from conventional companies, though it has also done so in life business, particularly group credit life. Retention ratios have also increased and are generally higher than those of conventional companies, even on a class-by-class basis. This may, however, reflect a greater emphasis on high-frequency, low-severity business.

In Bahrain, overall gross insurance premiums increased by just over 1% in 2019, but within this a massive increase of 32% in long-term business disguised a fall in general business, particularly engineering. Takāful firms saw an increase in market share, from 28.0% to 31.7%, partly reflecting a more than doubling of their previously small family takāful business but also their limited shares of those classes of general business where premiums have declined.

Besides Iran, the countries of the Middle East and South Asia group are a diverse set. The most significant in absolute terms are Jordan, Pakistan and Bangladesh. In Jordan, total takāful contributions rose to USD 100.1 million, comprising USD 87.7 million of general business and USD 12.3 million of family business. This represented an increase of 5.2% for general business and 11.3% for family business over the previous year – a market share of 11.7% for general business (up from 11.3% in 2018) and of 10.2% for family (up from 9.1%).

Data for Pakistan are incomplete mainly because one company, whose licence is currently suspended, has been unable to file accounts for 2019. The data available, however, show a market where takāful has been growing rapidly since takāful windows were permitted. Total takāful contributions in 2019 were USD 265 million, representing 11.7% of the total market, with 71% of these contributions coming from windows. Both the overall market and the takāful market are dominated by life (family) insurance, which makes up 73% of the total market and 68% of takāful. Windows are marginally less dominant in this sector than in general takāful.

Data for 2019 for Bangladesh are incomplete. While an overall premium figure is available, figures are not available for all takāful operators. However, those for which figures are available accounted for 93% of takāful contributions in 2018. It was therefore considered reasonable to estimate figures for the remaining operators. The market is dominated by family takāful, accounting for almost 93% of contributions in 2018.

In Africa, the overall takāful data are dominated by Sudan, Egypt, Tunisia and Kenya. There are smaller presences in Nigeria, Senegal, South Africa, the Gambia, Mauritania, Zambia and Algeria. For some of these countries, data were not available for inclusion in this report. Data for Sudan were also not available, but
because Sudan is material to the overall total, 2017 data have been used, solely for the purpose of arriving at that total. **Takāful** is expected to launch in Morocco, following the passage of legislation in 2019, but this has taken longer than was hoped.

The Egyptian insurance market is dominated by the state-owned company Misr Insurance, which has some 45% of the market. There are 11 **takāful** undertakings, with an overall stronger presence in the non-life sector of the market. These undertakings include the Misr group’s **takāful** subsidiary, Misr Takāful. In 2020, Misr was in the process of establishing a new family **takāful** company with external partners. This will provide a strong basis for the development of the family **takāful** sector in a country where life insurance business accounts for almost half the market.

Nigeria has a very low insurance penetration, even by the standards of economies with similar GDP per head. In recent years, the growth in premiums has not kept up with inflation. The sector is also undergoing major restructuring, following new capital requirements announced by the regulator to come into effect originally from 31 December 2020. As a result, six insurers announced their intention to merge and a further seven announced that they would raise new capital. There are four **takāful** companies, all with composite licences, but these account for less than 1% of the insurance sector. This is a somewhat lower percentage than in Kenya, where there is just one **takāful** company but a larger insurance market overall.

In South-East Asia, the key **takāful** jurisdictions are Malaysia, Brunei Darussalam and Indonesia. In Malaysia, gross contributions for general **takāful** were USD 809 million. This represented approximately a 20% increase on 2018, despite a slight decline in the exchange rate, and an 18.6% share of general business premiums. The Malaysian market is, however, dominated by family business, at USD 2.103 billion, representing approximately a 15% increase on 2018. Family **takāful** accounts (coincidentally) for 18.6% of total life business.

In the case of Malaysia, 2020 data are also available. They show a continuing, though modest, growth in contributions for both general and family **takāful**, implying that, although growth has slowed in the COVID-19 environment, there has been limited damage to business. (This picture is broadly consistent with that for the conventional industry.)

In Brunei Darussalam, general **takāful** contributions were USD 75.2 million and family **takāful** contributions were USD 20.1 million. The total represents a further decline of 9.4% after the decline reported last year. We do not, however, have data to locate this in the context of the insurance industry as a whole.

The Indonesian **takāful** market is dominated numerically by windows. At the end of 2019, there were 12 full-fledged **takāful** companies and one retakāful company, but 47 **takāful** and two retakāful windows. Some of the windows are small, and it is the policy of the Indonesian authorities to move them to full-fledged status (though possibly as subsidiaries within a group). **Takāful** business has been growing marginally faster than its conventional counterpart but is still only around 6% of the direct insurance market. The Indonesian market is dominated by life insurance, and family **takāful** has a slightly higher market share of its market than that of general **takāful**, with a somewhat greater growth rate. There were, unfortunately, two defaults by (conventional) life insurers in 2020, and it is possible that a loss of confidence as a result may spill over to the **takāful** market.

In Turkey, the new Insurance and Private Pension Regulation and Supervision Agency (IRSA) was established by Presidential decree in 2019 and began operation, based in Istanbul, in June 2020. There have also been major changes in the structure of the insurance industry, with the merger of six formerly bank-owned insurers into a single insurer majority-owned by the Turkish Wealth Fund.

In Turkey, **takāful** is referred to as “participation insurance” and, although it had operated before, it became the subject of a specific regulation in 2017. A further regulation, adopted in 2020, makes important changes, no longer requiring a **tabarru**-based contractual relationship. The Islamic insurance market has grown rapidly in recent years, to account for some
5% of the total in 2019. This involved a remarkable increase in contributions in 2019, up by 54% in national currency terms and 37% in USD terms. There are currently two full takāful undertakings and five takāful windows offering general takāful and two full undertakings and three windows offering family takāful. It is, however, general business that is dominant in financial terms, as it is in conventional insurance.

Retakāful is largely a global business and is therefore discussed separately in this paragraph. Retakāful companies have generally struggled over the last few years. Some have been started and closed to new business (e.g. Takāful Re), while Emirates Re (previously Al Fajer Re) has also become a discontinued business specialist. The reasons for this are disputed, particularly whether some decisions by takāful operators to place reinsurance with conventional reinsurers can be justified. However, it is common ground that retakāful, like its conventional counterpart, involves highly volatile books of business. As a result, it is very dependent on being able to maintain a high level of capital and a diversified book of business, together with high levels of underwriting expertise in specialist areas. These requirements have been difficult to achieve in stand-alone companies. Some have strong local positions, in some cases with regulatory support, but these often retrocede significant amounts of the contributions received. The recent tendency has therefore been for retakāful operations to be established as windows of conventional reinsurers. So, for example, 2019 marked the first year of operation of the retakāful window of the Pakistan Reinsurance Company. A retakāful window was also established by the Labuan branch of Allied World Assurance.
Islamic banks’ financing asset growth will moderate but still outpace conventional counterparts in 2021

Despite difficult operating conditions in most countries amid the global pandemic and related economic downturn, growth in Islamic banks’ financing assets remained steady in 2020, outpacing conventional asset growth in the core Islamic banking markets (which include the Gulf Cooperation Council (GCC), Malaysia, Indonesia and Turkey). As a result, Islamic assets’ market share of total financing assets in these core markets expanded to 32.8% in September 2020, from 31.4% in December 2019.

The GCC and Malaysia remain the key markets and driving force behind this dynamic. Penetration in the GCC has accelerated in the past decade to reach 45.7% in September 2020 from 32% in 2009, with Saudi Arabia, the world’s largest Islamic banking market, being the main contributor. Similarly, the industry has flourished over the years in Malaysia, making its Islamic finance industry the second largest globally. Overall, the core Islamic finance markets benefited from increased consumer demand, which powered strong financing growth of around 8.1% in compound annual terms in the last three years, compared with a 6.2% increase in conventional bank financing.

Regulatory pushes to develop Islamic finance in Pakistan and Bangladesh continue to support the industry in these countries. Numerous initiatives by the government and State Bank of Pakistan, which include by introducing a Shari`ah-compliant regulatory framework and Pakistan’s National Financial Inclusion Strategy, led to a significant growth in Islamic finance market share in Pakistan which now constitutes around 17% of total banking assets compared to 9% in 2013. In Bangladesh, the central bank has approved the conversions of three conventional banks into Islamic banks since the start of 2020, bringing the total number of Islamic banks in Bangladesh to six.
1.0 DEVELOPMENTS IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

of fully-fledged Islamic banks to 11. This indicates a growing willingness of the regulator to allow conversions, given that it had not approved any in the prior 10 years. In addition, the maiden issuance of Bangladesh’s sovereign sukuk (totaling BDT80 billion or $930 million) in December 2020 will pave the way for a greater supply of liquid instruments, which will in turn help improve Islamic banks’ liquidity management.

In Turkey and Indonesia, the penetration of Islamic banking remains relatively low at 5%-10%. To promote Islamic banking, the authorities in both countries have significantly increased their involvement over the past few years and adopted comprehensive policies to develop the sector. Given their large Muslim populations and government support, we expect Islamic financing to expand in these two countries.

Islamic banking is also likely to expand significantly in Africa in the next 5-10 years given the continent’s vast financing needs, underpinned by strong demographic and economic growth in Muslim-majority countries, low starting base and growing government interest in the sector. Across the continent, Moody’s has identified six countries that will lead the growth in Islamic banking in the coming years: Egypt, Morocco, Sudan, South Africa, Nigeria and Senegal. Most of these countries have large Muslim populations, a history of sukuk issuance and have made, or are making, the legal adjustments required to accommodate Shari’ah-compliant finance.

In addition to customer demand, proactive government legislation and mergers and acquisitions (M&A) have driven growth in Islamic banking assets. While we have seen regulators encouraging M&A activity in Southeast Asia, the trend has been consistently strong in the GCC, where a flurry of M&A activity has been announced or executed in the past few years and accelerated in 2020 amid lower oil prices and deteriorating economic conditions. In several cases, Islamic banks are acquiring conventional banks and emerging as the surviving entity, substantially adding to their asset base.

Sukuk issuance likely to stabilise after a record year in 2020 – but retains strong long-term growth potential

Sukuk issuance reached a record high of $205 billion in 2020, marking yet another strong year, up nearly 15% from 2019. The GCC region was a key driver behind this growth. Faced with increased budget deficits on the back of lower oil prices and the spread of the coronavirus, issuance in the region increased by almost 63% to $91 billion. Sovereigns were the largest contributors to this, through issuance in local currency, particularly Saudi Arabia. Conversely, issuance volumes in Southeast Asia declined slightly in 2020 to $97.5 billion, a 4% drop compared to 2019. Lower short-term sukuk issuance volumes by the Indonesian government drove the decline, while Malaysia’s issuance activity remained fairly stable around $66.7 billion. Issuance also dropped in Turkey, by almost 24% to $15.4 billion amid volatile market conditions.

In 2021, Moody’s expects sukuk issuance to consolidate around the $190-$200 billion mark. The GCC will continue to support issuance, albeit at a lower
level due to higher oil prices. We also expect issuance volumes in Southeast Asia to recover, with sovereigns remaining the largest issuers in this region as their funding needs remain elevated. Additionally, although the pandemic may have driven Southeast Asian sovereigns to favor conventional bonds in 2020, improved operating conditions going forward may help recover sukūk issuance volumes to their pre-pandemic levels. In Turkey, we also expect issuance levels to resume their positive trajectory as market volatility eases. Finally, a limited supply of highly rated sukūk and demand from Islamic banking should support market access for MDBs.

Moody's expects the pickup in issuance volumes from financial institutions to continue in 2021 as new issuers enter the market. Corporate issuers that could not enter the market in 2020 because of the pandemic may potentially support issuance activity in 2021 driven by improvements in operating conditions. Finally, the market for green and sustainable sukūk also offers potential as investor demand for such instruments continues to grow.

Growth prospects for Islamic insurance (takāful) remain buoyed by demand, digitalisation and improving regulations

Driven by large Muslim populations and relatively low insurance penetration (gross written premiums as a proportion of GDP), growth prospects for takāful remain strong in the GCC, Africa and Southeast Asia. Despite the pandemic-induced economic downturn, we expect takāful premiums to continue to grow at a moderate pace in the next 2-3 years, propelled by higher demand, the continued digitalisation of insurers’ processes and conducive regulatory improvements.

In the GCC region, the largest market for Shari'ah-compliant insurance, Moody's expects takāful insurers' to be supported by the widening of compulsory medical in Oman, Saudi Arabia and Kuwait, and by similar measures in motor in Saudi Arabia. We expect these measures to be particularly beneficial for takāful operators as these players focus on retail lines of business and are therefore more focused on health and motor insurance than some of their competitors who are also active in commercial lines. Similarly, expansion of compulsory health insurance coverage will drive growth in Southeast Asia and Africa.

Governments across the target regions are also starting to encourage a shift in mindset to individual savings and protection, which will raise growth prospects for family takāful products. In Southeast Asia there is already considerable uptake of family takāful products whilst in GCC and Africa we expect that the awareness of these products will increase only gradually. Regulatory changes that ease the licensing process for takāful operators will also support an expansion of takāful insurance.

Sources: Thomson Reuters Eikon, Bloomberg, IFIS and Moody's Investors Service
ASSESSMENT OF THE SOUNDNESS AND RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM
This chapter focuses on an assessment of the soundness and resilience of the IFSI, with specific attention paid to each of the three segments: Islamic banking, the Islamic capital markets and takāful. The IFSI SR2020 projected a sense of optimism about the outlook for the global IFSI, especially in the short term, but also noted that the implications of the COVID-19 pandemic cannot be discounted. In the sections that follow, a number of prudential and structural indicators are used in the analysis of the soundness and resilience of the various segments, especially due to the impact of the pandemic. The effectiveness of the various policy measures adopted by the RSAs, as well as plausible reasons for the outcomes and their likely implications, are also explained.

2.1 Islamic Banking: Rebound Amid Uneven Recovery

This section of the chapter assesses the soundness and resilience of Islamic banking for the period 3Q19 to 3Q20 across IFSB member jurisdictions, especially since 1Q20 when the COVID-19 pandemic became pervasive and most economies went into social and economic lockdown. Buffered by gains from the implementation of various comprehensive banking reforms post the GFC of 2007–8, Islamic banks entered the pandemic better equipped to withstand its impact through being more highly capitalised, more profitable and more liquid, especially since 1Q20. This strong position was aided by a flurry of swift policy measures by various RSAs that helped to ease the financial conditions and enhance the financial soundness and resilience of the Islamic banking industry from 2Q20 onwards. In many cases, across many financial soundness indicators and jurisdictions, a rebound was recorded but recovery has been uneven due to jurisdictional pre-pandemic economic conditions and political stability, the extent and duration of COVID-19 lockdown measures, and other prudential and structural peculiarities.

The resurgence in COVID-19 infections following the gradual relaxation of movement restriction orders in many jurisdictions, especially throughout the summer and autumn of 2020, led to the reintroduction of personal and economic restrictions. The roll-out of COVID-19 vaccines and the commencement of inoculation across many jurisdictions offer some hope that the worst of the economic lockdown due to the pandemic may be over. In the interim, the eased monetary policies, regulatory forbearances, liquidity provisions, credit guarantees and payment moratoria have generally proven to be effective, in many instances, in providing temporary relief to Islamic banks from liquidity as well as regulatory capital requirement pressures. Asset quality deterioration and a likely consequential increase in expected credit losses have also been masked by forbearance measures put in place across jurisdictions.

Nonetheless, it remains uncertain just how resilient the Islamic banking sector will prove to be across jurisdictions, especially as the pandemic has been more prolonged than initially expected and monetary, fiscal and other measures have had to be extended or modified, as the case may be. However, as these policy measures are gradually being withdrawn or are nearing their suspension date, the effect of the COVID-19‐induced financial disruptions, and the deterioration in both corporate financial performance and households’ financial conditions, will become manifest. This could lead to an increase in non‐performing financing, contraction in funding, and a decline in profitability and capital adequacy.

Generally, a further rebound, but not full recovery to pre-pandemic levels, is likely in many
jurisdictions. The path and speed of recovery will depend on timely access to, and efficient roll-out of, COVID-19 vaccines, capital flows, fiscal and monetary policy spaces, the extent of contact-intensiveness of the key economic sectors in a jurisdiction, etc. For those jurisdictions that entered the pandemic period with a high capital and liquidity buffer, and that also have broader fiscal space and a greater capacity to speed up the procurement and roll-out of the COVID-19 vaccine, the positive rebound recorded in 2020 across various soundness indicators is expected to strengthen in 2021. The converse is also expected in jurisdictions faced with pre-pandemic structural problems, declining growth rates, limited fiscal space and a weak capacity to recover from recession.

The following subsections present a global analysis, as well as country-by-country analyses, of the soundness of the Islamic banking industry across IFSB member jurisdictions. The analysis is based on various key profitability, liquidity, asset quality and capital adequacy indicators, which are mainly based on the IFSB PSIFIs. Other assessment indicators based on IFSB PSIFIs include leverage, and Islamic banking exposures to foreign currency (in both funding and financing) and to certain economic sectors, especially those that have been significantly affected by lockdowns due to the COVID-19 pandemic. Figure 2.1.1 highlights the key ratios and indicators used throughout this section.

2.1.1 Profitability

The profitability level of the global Islamic banking industry rebounded in 3Q20 but remains below its pre-pandemic level. Specifically, on average, the stand-alone Islamic banks recorded a rate of 1.3% as at 3Q20 (3Q19: 1.6%) for return on assets (ROA) and 14.9% as at 3Q20 (3Q19: 16.5%) for return on equity (ROE) (Chart 2.1.1.1). These rates represent a decline of –22.3% y-o-y and –9.9% y-o-y in ROA and ROE, respectively. Notwithstanding, both the average ROA and ROE of global Islamic banks compare favourably with those of conventional banks in the various IFSB jurisdictions, as well as with banks in the advanced economies. As at end-3Q20, the ROA of banks in the United States fell to 0.3% (3Q19: 0.4%), and ROE to 2.7% (3Q19: 3.5%). The ROA of banks in the United Kingdom increased slightly to 0.5% (3Q19: 0.4%), and ROE to 8.0% (3Q19: 6.6%).

For the country-by-country analysis, four indicators were used to assess the aggregate profitability performance of the Islamic banks across jurisdictions. These include: ROA and ROE for the full-fledged Islamic banks only, and net profit margin (NPM), and cost-to-income (CTI) ratio for the entire Islamic banking sector (see Charts 2.1.1.2 to 2.1.1.5).

Figure 2.1.1 Key Indicators for the Assessment of Islamic Banking Resilience

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36 In a few instances, data from respective RSAs have been used where available and more current. Due to non-availability, some key jurisdictions such as Iran, Kuwait, Qatar and Sudan are not included in the assessment.

37 “Stand-alone Islamic banks” refers to full-fledged Islamic banks and Islamic subsidiaries of conventional banks, but excludes Islamic windows of conventional banks.

38 This comparison does not control for the likely effects of whether profit-sharing investment accounts (PSIAs) are treated as on-balance-sheet or off-balance-sheet, as well as for the effects of applying the IFSB alpha on the equity of Islamic banks on the required equity capital as the denominator in the computation of the ROE. For the sake of further clarity, in general, restricted profit-sharing investment accounts (RPSIA) are off-balance-sheet because they are not considered an element of the Islamic bank’s financial position since the Islamic bank does not have an unconditional right to use or dispose of these funds. However, in accordance with new consolidation standards in IFRS 10, RPSIA that are controlled by institutions offering Islamic financial services (IFS) and which affect the income of the IFS as a result of that control should be treated as on-balance-sheet. IMF Financial Soundness Indicators, https://data.imf.org/?sk=51B096FA-2CD2-40C2-8D09-0699CC1764DA&slid=1485372949569
In Bahrain, all four profitability indicators worsened in 1Q20 on account of net loss recorded. A rebound was recorded in 2Q20 and sustained in 3Q20, to end the period under review with an ROA of 0.4% and an ROE of 4.3%. Both NPM and CTI ratio also followed the same trend to end 3Q20 at 16.6% and 83.4%, respectively. Despite the rebound, all four profitability indicators remained below their pre-pandemic levels. This profitability performance could be linked to the corporate demand for financing, which remained muted over the period. The Islamic banks also restricted their financing activities to honouring existing credit lines to which they were committed prior to the pandemic.

In addition to effect of COVID-19 policy measures by the Central Bank of Bahrain (CBB), such as policy rate cuts and fee waivers on profitability, there was loss on modification due to the difference between the net present value of credit exposure on deferred payment and the carrying amounts on the modification date. The profitability performance is expected to improve due to the resumption of economic activities, high COVID-19 vaccine rollout, and improving oil prices. Furthermore, Islamic banks in Oman are faced with limited investment options due to for instance, regulations that prevent the placing of funds with conventional banks as well as the offering of products based on tawaruq for interbank funding or personal financing. Moreover, Omani Islamic banks have not been able to boost profitability by taking part in huge government and public enterprise projects due to the relatively small size of their capital base relative to their conventional counterparts. Nonetheless, it is expected that profitability will improve gradually based on the positive effects of enhanced market penetration due to digital transformation activities, economic reopening, COVID-19 vaccine roll-out, and stability in the oil and gas sector.

40 This performance reflects that of the entire banking sector in the country, where both the ROA and ROE also declined while the cost-to-income ratio increased in response to the effect of the challenging economic conditions from 1Q20.

41 In March 2020, the CBB urged that any impacted borrower or credit card holder must be offered six months’ deferral of instalments with no fee, and no increase in the percentage of profit rate unless the customer agreed for a short period. This deferral was later extended for a further four months until the end of 2020

Islamic banks in Saudi Arabia registered a decline in profitability up to 2Q20 but rebounded in 3Q20. This was due to increased provisioning for NPF, as well as waivers on various fees and charges by the Saudi banks following the request by SAMA to support certain sectors that have been highly impacted by the pandemic. As economic activity started to pick up in 3Q20 on account of the effectiveness of the various economic stimulus measures put in place in the Kingdom by SAMA to stimulate credit extension, the country's Islamic banks recorded improved profitability in their profitability indicators. Both the ROA and ROE increased in 3Q20, reaching 2.2% and 16.7%, respectively. The CTI improved in 3Q20 to end at 49.9%.

The profitability rebound was driven mainly by the retail focus of the Saudi Islamic banks, which reduced their susceptibility to the impact of the economic downturn. Improvement in profitability could also be linked to the impact of growth in financing activities by 48% q-o-q as at 3Q20, especially in the rapidly expanding mortgage financing sector, as a key aspect of the Kingdom's “Vision 2030” initiatives to increase home ownership among the Saudis. Earnings were also supported by the 55% q-o-q growth recorded in fee-based income, notwithstanding the numerous fee waivers requested by SAMA. The decline in the CTI of Saudi Arabia’s Islamic banks was due to the strict approach to cost optimisation, especially in relation to administrative and travel expenses during the lockdown, as well as to gains on pre-pandemic investment in digitalisation, especially among the big Islamic banks in the Kingdom.

The Islamic banking sector in the UAE recorded mixed profitability performance amid challenging economic conditions in 2020. After a streak of improvements in return on assets ROA over the previous three quarters, UAE Islamic banks' ROA declined from 2Q20 and ended 3Q20 at 1.0%. In terms of return on equity ROE, after an initial decline in 1Q20, improvement was recorded in the subsequent quarters, with 3Q20 ending at 17.5%. During the period, both the NPM and CTI worsened slightly in 2Q20 but rebounded in 3Q20 to reach 23.6% and 76.4%, respectively. In addition to the effect of policy rate cuts and fee waivers under the Targeted Economic Support Scheme (TESS) programme, the UAE Islamic banking sector recorded increasing impairment losses on both financial and non-financial assets during the year. Deteriorating asset quality needed higher provisioning, lower profit rates affected funded income margins, and lower transactions volume was reflected in muted credit demand.

The profitability indicators for the Islamic banks in both Kuwait and Qatar were adversely affected by the dual shock of COVID-19 and the sharp decline in oil prices, especially in 2Q20. Despite recording a rebound in 3Q20, the Islamic banks in Kuwait and Qatar registered ROA of 1.0% and 1.2%, and ROE of 9.8% and 12.5% respectively. With both jurisdictions' NPM ratio of 21.1% and 38.2%, and CTI ratio of 26.4% and 13.2% respectively, all four profitability performance indicators were lower compared to their pre-pandemic levels. Nonetheless, the profitability of the Islamic banking sector in both Kuwait and Qatar is expected to improve on account of the gradual recovery recorded in both economies amid COVID-19 de-escalation measures, and a favourable pick-up in downstream activities.

In Brunei, all four profitability indicators dipped in 1Q20, but a positive rebound was recorded in 3Q20, albeit still below pre-pandemic levels. Specifically, at end-3Q20, the ROA and ROE of Brunei's Islamic banking sector were 1.9% and 13.0%, respectively; while the NPM and CTI were 60.6% and 42.6%, respectively. Brunei's Islamic banks were impacted to a large extent by low oil prices (being an oil-dependent economy), as well as by the outbreak of the COVID-19 pandemic, in terms of their economic growth and condition, and, by extension their profitability, especially in 1Q20.

Profitability performance was also affected by a decline in income from both fee-based and investment-based activities during 1Q20 on account of the low demand for new financing from households and corporates, which adopted a precautionary disposition in the face of the prevailing economic uncertainty and, instead, drew down on existing credit lines. Moreover, as part of the measures to offer assistance to individuals and corporates affected by the pandemic, the Brunei Darussalam Central Bank (BDCB) urged banks in
Brunei to grant an exemption on fees and charges arising from the deferment and restructuring of existing financing obligations. In agreement with the Brunei Association of Banks (BAB), waiver was also granted for online interbank transfer fees for six months until 30 September 2020 and later extended for another six months until March 2021. Generally, the profitability of the Islamic banking sector in Brunei is expected to improve on account of the recovery recorded in the economy due to COVID-19 de-escalation amid a gradual but stable increase in global oil prices.

The initial impact of the pandemic on the profitability of the Indonesian Islamic banking sector became apparent in 2Q20, and even earlier (1Q20) for the ROA. Both the ROA and ROE ended 3Q20 below their pre-pandemic levels, at 1.4% and 12.4%, respectively. The NPM also registered a decline to end 3Q20 at 24.4%, while the improvement streak in CTI ended in 2Q20, although a slight improvement was recorded to end 3Q20 at 75.6%. Profitability was affected by the revenue of the Islamic banking segment that dipped during the period on account of lower investment returns, as well as increased provisions for NPFs. The exposure of the Indonesia Islamic banks to the real estate sector, which contracted in 2020 due to lower transaction volumes in residential property, also affected profitability. This is in addition to policy rate cuts as a measure to reduce the impact of the pandemic on individuals and businesses, as directed by the Otoritas Jasa Keuangan (OJK), the financial services authority in Indonesia.

Notwithstanding, the profitability of the Indonesian banking sector is expected to strengthen in the quarters ahead. This is due to, among other factors, the strengthened regulation, enhanced corporate governance, wider outreach, increased market penetration, further human capital development, etc., that will accrue from the five-year financial road map for the Islamic banking sector being promoted by the OJK. Moreover, subsequent benefits are expected to accrue from the consequential operational efficiency of the sector on account of increased digitalisation and enhanced competitiveness, and increased market share from the expected merger among subsidiaries of three of the four largest state-owned banks in the country.

Despite the challenging economic conditions, the Malaysian Islamic banking sector remained profitable. This was on account of the banks’ concentrated exposure to retail financing, which is less vulnerable to economic downturns than corporate financing. This was manifested in the improvements in all profitability indicators as at end-3Q20, with an ROA of 0.8% and an ROE of 10.9%. While the Islamic banking sector’s ROA is less than the 1.2% recorded for the entire Malaysian banking system as at 2H20, the former’s ROE is higher than the latter’s 9.2% during the same period. The NPM and CTI also followed a similar trend. NPM recorded a back-to-back decline up to 2Q20 due to the downward repricing of floating rate financing before recording a rebound in 3Q20 to reach 33.2%. CTI, on the other hand, worsened in 2Q20 but recorded a rebound to end 3Q20 at 41.5%.

Profitability performance could be linked to an increase in both fee-based and financing-based income in 3Q20. Moreover, some of the largest Islamic banks that are also subsidiaries of the largest domestic banking groups were able to leverage on their group’s infrastructure to drive down operating costs. There are also ongoing digitalisation efforts which, while having an initial impact on the profitability of the Islamic banks in the interim, would nonetheless subsequently enhance their operational efficiency. The profitability indicators are envisaged to strengthen, given that provisions have been frontloaded by Islamic banks. This is in addition to improving economic conditions and the fiscal measures put in place to assist both borrowers and businesses to cope with the challenging economic situation. No significant mark-to-market losses were recorded on the Islamic banks’ financial instruments, as the domestic market remains orderly despite volatility experienced during the period.

Afghanistan’s Islamic banking sector’s profitability indicators remained in the negative and declined further after 1Q20, reaching –2.1% for ROA and –32.6% for ROE in 3Q20. The NPM also recorded a decline to reach –65.1%, while the CTI increased to 390.7% over the same period. This is notwithstanding the growth in revenue from financing, investments in sukūk and fee-based income. In addition to the challenging economic situation due to COVID-19, the losses incurred could be linked to the increase in
provisions and the loss on foreign exchange revaluation which affected net profit, especially during 2Q20. Although no significant negative effect on profitability was reported, there was a waiver of administrative fees and penalties, and without the possibility of retrospective applications for non-compliance, which has since been suspended by the Da Afghanistan Bank (DAB).

While it is encouraging that strong economic growth of 4.0% is projected for Afghanistan,
 the fact that the profitability indicators are moving further from their break-even point is of concern. High operating costs will remain a challenge on account of the low state of digitalisation and the low level of market penetration of Islamic banking in the country, due mainly to security issues which have confined Islamic banking operations to Kabul.

The full-fledged Islamic banks in Bangladesh recorded a fluctuating profitability performance during the period. Both the ROA and ROE recorded their highest improvement in 1Q20, only to later decline subsequently to end 3Q20 at 0.5% and 10.4%, respectively. While the NPM recorded improvements throughout the period to end 3Q20 at 33.5%, the CTI as a measure of efficiency worsened over the period to reach 51.1% in 3Q20. The decline recorded in the profitability indicators could be linked to the eroded debt servicing capacity of borrowers due to the COVID-19 crisis. Moreover, banks’ profitability was on a decline due to increased provisioning and the various waivers on fees and charges as part of the measures by the Bangladesh Bank (BB) to ease the burden of the pandemic on borrowers.

The profitability indicators of the Islamic banking sector in Iraq registered ROA and ROE of 0.7% and 1.1%, respectively in 3Q20. The NPM of 5.0% recorded by the Islamic banking sector in Iraq were lower than those reported by all countries in the MESA region except for Afghanistan. The CTI of 52.9% recorded was also higher than all MESA countries except for Afghanistan and Pakistan. The profitability performance was affected by the challenging economic situation in the country. Another reason was the Central Bank of Iraq (CBI) directives to the banks in the country to suspend charges on deferred payments, especially to SMEs. Moreover, to encourage the use of electronic payment systems as a means to flatten the curve of the pandemic, commissions on such payments were suspended for six months. Nonetheless, the reopening of the economy and a gradual improvement in the price of oil present a favourable outlook for the country’s Islamic banking sector.

The Jordanian Islamic banking sector recorded fluctuating profitability performance during the period under review. Specifically, the sector recorded a rebound in both ROA and ROE in 2Q20 and ended 3Q20 at 1.7% and 17.8%, respectively. The NPM and the CTI also deteriorated in 1Q20. The former thereafter grew at a decreasing rate to end 3Q20 at 50.2%, while the latter improved further to end 3Q20 at 49.9%. The fluctuating profitability can be explained by the decline in net income, over the four quarters from 4Q19 to 3Q20. Revenue generation from both fee-based and financing-based income also fluctuated, while investment income declined throughout the period. As part of the measures to mitigate the impact of COVID-19 on both individuals and businesses, the Central Bank of Jordan (CBJ) also directed banks to waive charging any commission or fees on deferred payment instalments. While the measures taken to stimulate economic activity and recovery are commendable, the fact that no significant increase in provisioning was observed during the period may impact negatively on the profitability of the Islamic banks when the repayment deferrals and waivers for fees and commission are gradually unwound and impairment losses start to build.

The Islamic banking sector in Lebanon registered a decline in both ROA and ROE throughout the period under review. Specifically, the declining streak in both profitability indicators continued into 3Q20 to end at 0.6% and 4.9%, respectively. The economic impact of COVID-19 compounded the challenging macroeconomic condition that the country has been faced with due to the sudden cessation of capital inflows, a weakening exchange rate, and the aftermath of the explosion at the port of Beirut. Moreover, the consistently increasing NPF of the Islamic banking sector raises profitability concerns. This also adds to the pre-existing profitability challenges, as the Banque Du Liban (BDL) expects banks in Lebanon to make

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44 International Monetary Fund (2021). Regional Economic Outlook Update. Middle East and Central Asia.  

45 While it is encouraging that progress is being made to reconcile the government and the Taliban, the implications of the announced withdrawal of US forces add to the political impasse in the country.
provisions to the value of the NPFs. Revenue also declined on account of a considerable dip in both investment income and financing income. Being a very dollarised economy faced with a foreign exchange shortage, exchange market pressure impeded cross-border trade and interrupted supply chains, thus severely impairing the banking system.  

The Islamic banking sector in Pakistan recorded improved profitability performance during the period under review. This was despite reduced demand for advances following economic lockdown and a dip in the weighted average financing rate due to an unprecedented policy rate cut. However, a retraction was recorded in 3Q20, and all profitability indicators deteriorated. Specifically, the ROA and ROE before tax of the full-fledged Islamic banks in Pakistan improved before registering a decline to end 3Q20 at 2.5% and 41.3%, respectively. The sector recorded the least NPM performance in 3Q20 to end the period at 47.7%, while the CTI improved in 3Q20 to end the quarter at 71.8%. Compared to the entire domestic banking sector in Pakistan that recorded an ROA before tax of 1.9% and an ROE before tax of 25.3% as at end-3Q20, the full-fledged Islamic banks seem more profitable. The improved profitability performance was accounted for largely by increased q-o-q revenues from investing, financing and fee-based activities as at end-3Q20. Islamic banks in Pakistan have also participated actively in the Government of Pakistan sovereign sukūk issued during the period under review, which amounted to PKR 360 billion.

In 3Q20, the Islamic banking sector in Palestine registered a rebound after a streak of declining q-o-q profitability performance due to the socio-economic consequences of COVID-19. Specifically, the ROA and ROE increased to reach 0.6% and 6.9%, respectively. The NPM followed a similar trend with a rebound to end 3Q20 at 17.1%. The CTI, on the other hand, recorded a continuous improvement until 3Q20 to reach 45.7%. Revenue from both financing and investing activities, as well as fee-based income, declined, especially in 1Q20 due to the impact of the pandemic on economic activity. The Palestine Monetary Authority (PMA), as part of the measures to ease the impact of the pandemic, urged banks to suspend all collection of fees, commissions and charges on deferred payment on existing financing. While increased provisioning by the Palestine Islamic banks would help mitigate a possible increase in credit risk, there are also implications for profitability.

The Islamic banking sector in Libya registered fluctuating profitability throughout the period under review. The ROA and ROE rebounded in 2Q20 and were sustained up to 3Q20, ending the year at 0.8% and 12.5%, respectively. Both the NPM and CTI worsened until 3Q20, reaching 47.0% and 53.0%, respectively. All four profitability indicators deteriorated compared to their pre-pandemic levels. The initial impact of the pandemic, declining oil prices, and a pre-existing challenging situation due to the country’s political instability and civil war, proved devastating to the Libyan economy. The profitability performance of the Libyan Islamic banking sector is expected to record a significant positive rebound. This is hinged on the expected positive impact of the commencement of vaccination, the gradual improvement in oil prices, and the political truce that produced a consensus government in March 2021.

The non-interest banking (NIB) sector in Nigeria sustained the rebound recorded in 2Q20 in all profitability indicators. The country has been severely hit by the dual shock of COVID-19 and the fall in global oil prices and production output. The rebound recorded in 2Q20 in both ROA and ROE was sustained and ended 3Q20 at 2.6% and 29.9%, respectively. The NPM and CTI also rebounded to end 3Q20 at 86.4% and 47.7%, respectively. The Central Bank of Nigeria (CBN) policy rate cut of 200 basis points could also have affected profitability, especially the market yield of government securities as investment activities accounted for 38.2% of NIB’s income. Although provisioning has been increasing since 2Q20, this should not pose any significant threat to the profitability of the NIBs in the near term, given that the NPF was also on the decline, reflecting the prospects of increasing oil prices and gradual economic reopening and recovery.

The ROA of the Islamic banking sector in Sudan remained flat at 3.2% throughout the period under review. The ROE on the other hand rebounded in 2Q20 and was sustained up to 3Q20, ending the year at

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47 On average, the Pakistani banking sector recorded a before-tax ROA and ROE of 1.9% and 25.2%, respectively, and a CTI of 48.9%, as at end-2Q20.
37.4%. Both the NPM and CTI worsened until 3Q20, reaching 50.8% and 50.0%, respectively. All four profitability indicators deteriorated compared to their pre-pandemic levels.

Following a slight decline in 1Q20, the participation banks in Turkey recorded improved profitability performance in the subsequent quarters of the period under review. Specifically, the ROA and ROE improved after 2Q20 to end 3Q20 at 1.4% and 17.5%, respectively. The participation banking sector’s profitability performance was higher than that of the entire banking sector in Turkey, which recorded an ROA of 1.1% and an ROE of 9.1% as at 3Q20. The NPM of the participation banking sector also improved further in 3Q20, although at a decreasing rate, to reach 23.1%, while the CTI recorded a rebound in 3Q20 to end the quarter at 34.9%. The positive rebound in the subsequent periods could be linked to the reopening of the economy and to the effect of various policy measures introduced by the regulatory authorities in the country. These include the policy rate cut by 300 basis points, forbearance measures to reduce the impact of the depreciation of the Turkish Lira, and a dip in securities prices, as well as regulations to reduce intermediation cost.46 The CTI ratio of the participation banks also improved due to the positive duration gap on policy rates cut given that the pass-through from cuts on funding expenses occurred faster than on margin on financing provided, due to the longer maturity of the latter.

The Central Bank of the Republic of Turkey (CBRT) subsequently commenced gradual tightening of the monetary policy from 3Q20. The hikes in policy rates are expected to cause a decline in the profit margin on financing activities. The anticipated slow growth in demand for financing due to the rate hike would make the participation banks susceptible to declining profitability. This may be compounded by the likely faster pass-through of the policy rate on deposit given the reliance on short-term deposits in Turkey’s participation banks. Nonetheless, the outlook for the profitability of the Turkish participation banks remains favourable on account of front-loaded provisioning to mitigate any incidence of deteriorating asset quality, as well as the positive effect of new regulations on reducing the cost of financial intermediation.

Chart 2.1.1.2 Islamic Banking Average ROA for Stand-alone Islamic Banks by Country (3Q19 –3Q20)

Source: PSIFIs and IFSB Secretariat Workings

46 For instance, on 27 November 2020, the commission rate applied to reserve requirements maintained against the USD-denominated deposits and participation funds was decreased from 1.25% to 0%.
2.0 ASSESSMENT OF THE SOUNDNESS AND RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

Chart 2.1.1.3 Islamic Banking Average ROE for Stand-alone Islamic Banks by Country (3Q19 –3Q20)

Source: PSIFIs and IFSB Secretariat Workings

Chart 2.1.1.4 Islamic Banking Net Profit Margin by Country (3Q19 –3Q20)

Source: PSIFIs and IFSB Secretariat Workings

Chart 2.1.1.5 Islamic Banking Cost-to-Income Ratio by Country (3Q19 –3Q20)

Source: PSIFIs and IFSB Secretariat Workings
2.1.2 Liquidity

The liquidity position of the Islamic banking sector in many jurisdictions tightened in 1Q20 due to the dual shock of COVID-19 and falling oil prices and production. The various liquidity support measures adopted across jurisdictions, including the use of liquidity buffers, policy rate cuts, suspension of cash reserve requirements, liquidity injections, etc., have yielded positive outcomes in most cases by providing relief from liquidity pressures at least in the interim. While most jurisdictions, especially those with a healthy pre-pandemic liquidity buffer, were either unaffected, or registered a positive rebound in their liquidity position in either 2Q20 or 3Q20, a few others registered a continuous decline in their liquidity conditions, albeit at a slower rate.

The tightened liquidity observed in some jurisdictions is due to, among many factors, mismatches from delayed cash inflows as households and small to medium enterprises (SMEs) take advantage of the moratoria offered by RSAs as measures to ease the burden of the COVID-19 pandemic amid macroeconomic pressures, runaway inflation rates and negative economic outlooks. Moreover, the Islamic banking sector in most jurisdictions lacks Sharī’ah-compliant avenues for liquidity management and is prone to liquidity risk arising from the maturity transformation of converting short-term funding, especially through UPSIA, to long-term investments. Nonetheless, as shown in Charts 2.1.2.1 and 2.1.2.2, both the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) as measures of both short-term and medium to long-term liquidity resilience are above the 100% threshold for all but one jurisdiction⁴⁹ that reported both ratios in their IFSB PSIFIs.

For the country-by-country analysis, four indicators were used to assess the aggregate liquidity performance of the Islamic banks across jurisdictions. These include: LCR, NSFR, Financing to Deposit Ratio (FDR), and Liquid Asset to Short-term Liabilities Ratio (LASLR) for the entire Islamic banking sector (see Charts 2.1.2.1 to 2.1.2.4).

Based on the liquid assets ratio (LAR), the Bahrain Islamic banking sector registered declining liquidity from 1Q20 to end 3Q20 at 15.4%. This performance is not peculiar to the Islamic banking industry in the country, as the LAR for both the retail and wholesale conventional banks also declined by an average of –2.3% as at end-2Q20. Nonetheless, the liquidity position of the Islamic banks in Bahrain is expected to remain strong on the back of the continued likelihood of stable funding from deposits from the public sector.⁵⁰ Moreover, the launch of the one-week Sharī’ah-compliant contracts – the Islamic ṣukūk Liquidity Instrument (ISLI) – by the CBB in 2020 provides further options for liquidity management. ISLI allows holders of the CBB-issued dinar-denominated ḫiṭarah to raise liquidity against the instrument for a week. To ensure a level playing field between the Islamic banks and the conventional banks, an intraday credit facility is also made available to the former against tradable Islamic securities holdings such as ḥiṭarah ṣukūk.

While the Omani Islamic banking sector’s liquidity remained above the threshold, it fluctuated during the period. In addition to having the highest FDR among all the jurisdictions included in this report, the LCR declined while the NSFR only rebounded to the minimum threshold in 3Q20. Though the FDR dropped to 108.7% in 3Q20 it remains high and portends the likelihood of not having enough liquidity to cover unforeseen funding needs. A rebound in the liquid assets to short-term liabilities ratio (LASLR) registered in 2Q20 was sustained to reach 30.2% in 3Q20 and may be an indication of a widening structural funding gap in the short term. The latter notion is supported by the adequate, but declining, LCR recorded throughout the period under review, which reached 181.6% in 3Q20. The NSFR, as a portion of capital and liabilities expected to be available over a one-year period, breached the 100% threshold in 1Q20 up to 2Q20 before a rebound saw it end 3Q20 at 113.8%.

The outcome of the liquidity stress test by the CBO reveals that all Omani banks have the capability to face the assumed liquidity shock and to survive a deposit

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⁴⁹ The Islamic banking sector in Bangladesh registered a decline in LCR in 1Q20, rebounded in 2Q30, but fell below the threshold again in 3Q20. In terms of the NSFR, only the Islamic banking sector in Oman registered a below-threshold ratio prior to 3Q20 but rebounded above the minimum threshold in the quarter.

⁵⁰ Although Bahrain was able to tap international markets for funds in early 2020, the country also has one of the highest financing needs, reaching 37% of GDP per year in 2020. This could have implications for the stable funding provided by the public sector to Islamic banks.
The FDR of the UAE’s Islamic banking sector remained high, averaging 93.1% over the period under review. Specifically, the FDR ended on a higher note of 94.3% in 3Q20 on account of financing having grown faster than deposits, especially from 2Q20. In terms of LASLR, the sector recorded a back-to-back quarterly decline up to 2Q20 before rebounding in 3Q20 to end the quarter at 19.74%. Despite the high FDR, it is expected that the liquidity position of the UAE’s Islamic banking sector will strengthen on the back of the Zero Cost Funding (ZCF) facility provided by the CBUC to the banks to encourage financing of MSMEs under the TESS programme. The TESS measures, which have been extended to June 2022, also allow banks to reduce NSFR by 10% to 90%, increase the advances to stable resources ratio (ASRR) by 10% to 110%, and to treat the ZCF facility as a stable funding source with a 50% factor regardless of its maturity.

The short-term liquidity position of Brunei’s Islamic banking sector remained strong despite a widening structural funding gap at the outbreak of the pandemic. However, the sector recorded a rebound in 3Q20 with an improvement in LASLR to reach 95.7%. The liquid assets ratio of 46.0% as at end-3Q20 is also within range of the 49.8% registered for the entire banking sector in Brunei during the same period. The sector can meet the demand for short-term withdrawal of funds without facing liquidity problems when the existing short-term funding expires. The liquidity position of the sector is expected to improve further following the introduction of the I-Bills programme in October 2020 with the aim of strengthening effective and efficient liquidity management of banks in Brunei by offering a broad range of money market instruments. The I-Bills, which are also eligible as collateral under the BDCB Shar‘īh-compliant funding facilities, have a 14-day tenor and are issued weekly to licensed banks only at a zero-coupon based on the sukūk wakalah bi‘l ujrah structure. The sector is also expected to withstand losses based on a healthy regulatory capital buffer and with the Tier-1 capital averaging 99.3% of the total regulatory capital, reflecting the highest degree of capital certainty.

Overall, the liquidity position of Saudi Arabia’s Islamic banking is expected to remain strong on the back of stable non-profit deposits, a retail focus that reduces funding concentration, and a massive liquidity injection into the banking system by SAMA. Saudi banks enjoy a significant support from SAMA given the country’s large external reserves. However, the banking liquidity situation may deteriorate if the drop in oil prices experienced in 1Q20 reoccurs, and if there is a resurgence in global COVID-19 cases, which may significantly reduce global energy demand. Moreover, the fact that the funding of the country’s banking sector is related to the government may also impact funding if the sovereign reserves continue to experience some form of stress and depletion.

Despite SAMA’s support, the Saudi Arabia Islamic banking sector registered a declining but adequate liquidity position during the period under review. The FDR, although still higher than the 90% threshold, remained flat initially but increased slightly from 2Q20 and ended 3Q20 at 93.30%. The short-term funding structural gap reflected in the LASLR indicates that the sector initially recorded a decline but rebounded from 2Q20 before declining again to end 3Q20 at 27.36%. The sector registered a declining streak in both the LCR and NFSR from 4Q19 to 3Q20, ending the period at 145.69% and 122.05%, respectively. Although both ratios were below their pre-pandemic levels, they were also well over the 100% threshold, indicating the resilience of the Saudi Islamic banks to withstand both short-term and long-term liquidity stress.

FDR has been set at 90% in Saudi Arabia since 2016. However, in order to encourage banks to offer more investment products, a new calculation method that assigns different weights to deposits based on their maturity was introduced (effective 1 April 2018).

SAMA injected SAR 50 billion (USD 13.3 billion) into the banking sector to keep it functional in providing credit to the private sector, especially the SMEs. Another SAR 50 billion was injected into the banking sector via deposit placements in June 2020 to boost liquidity and financing to the private sector.

The changes regarding the NSFR and ASRR came into effect on 1 August 2020 and will end on 31 December 2021. Relief arising from both measures can only be utilised within the UAE financial system and economy.

51 FDR has been set at 90% in Saudi Arabia since 2016. However, in order to encourage banks to offer more investment products, a new calculation method that assigns different weights to deposits based on their maturity was introduced (effective 1 April 2018).
52 SAMA injected SAR 50 billion (USD 13.3 billion) into the banking sector to keep it functional in providing credit to the private sector, especially the SMEs. Another SAR 50 billion was injected into the banking sector via deposit placements in June 2020 to boost liquidity and financing to the private sector.
53 The changes regarding the NSFR and ASRR came into effect on 1 August 2020 and will end on 31 December 2021. Relief arising from both measures can only be utilised within the UAE financial system and economy.
In response to the eased monetary stance of Bank Indonesia (BI), the FDR of the Indonesian Islamic banking sector remained around its historical average, while the LASLR improved during the period under review. Over the period 4Q19–3Q20, slight fluctuations were observed between quarters; on average, an FDR of 85.6% was registered. The FDR of 82.8% as at end-3Q20 was lower than its pre-pandemic level. On the other hand, the LASLR, which recorded a decline in 1Q20, rebounded in 2Q20 and was sustained in 3Q20 to reach 23.1%. This performance could be linked to the accommodative liquidity conditions in the country and quantitative easing via the injection of liquidity into the banking sector, which, as at December 2020, was worth IDR 694.9 trillion. This allowed the Islamic banking sector to accommodate any liquidity pressure. Liquidity was also bolstered by the growth of both remunerative and non-remunerative funding, and by a decline in growth in financing to the private sector. Moreover, in addition to relaxing the requirements for both the LCR and NSFR, Indonesian banks were allowed to use their liquidity buffer.

The liquidity position of the Indonesian Islamic banking sector is expected to strengthen for a number of reasons, including the retail focus of the deposit-dominated funding structure. In addition, the foreign currency net position is expected to strengthen on the back of BI’s stabilisation measures to ensure foreign capital inflows to provide foreign currency liquidity through reduced foreign currency reserve requirements by 400 basis points to attenuate foreign currency liquidity pressure. Moreover, there are various accommodative liquidity policy measures in place in the country, such as the reduction of the threshold for both LCR and NSFR to 85%. This will allow banks to accommodate immediate liquidity pressure.

The liquidity position of the Malaysian Islamic banking sector remained strong aided by huge surpluses, stable funding sources, improved financing repayments, and regulatory flexibilities and support. The FDR of the Islamic banking sector, which declined in 1Q20 at the outbreak of the pandemic, increased afterwards to end 3Q20 at 98.0%. In terms of the LASLR, the sector recorded a fluctuating performance during the period. Following a decline in 1Q20, a rebound of was recorded in 2Q20 followed by another decline in 3Q20, to reach 125.6%.

Based on the BNM’s Annual Report 2020, the sector also registered an LCR of 137.2%, indicating its short-term resilience to liquidity shock. The BNM reduced the LCR threshold below 100% and the NSFR to 80% until 30 September 2021, allowing banks to draw down on liquidity buffers. Other measures included lowering of the statutory reserve requirements (SRR) ratio by 100 basis points to 2%, as well as permission for principal dealers to use both Malaysia Government Securities (MGS) and Malaysia Government Investment Issues (MGII) of up to RM 1 billion for the purpose of meeting SRR requirements until 31 December 2020.

Unlike in many other jurisdictions, there were no specific COVID-19-induced liquidity cushioning policy measures in Afghanistan. This may have been due to the excess liquidity in the sector prior to the pandemic. The FDR of the full-fledged Islamic bank in Afghanistan is the lowest among the jurisdictions covered in this report. Specifically, the FDR declined to 26.4% in 3Q20, while the LASLR also declined during the same period, reaching 170.7%, indicating further deterioration in the structural funding gap. Nonetheless, both ratios are well above their 15% and 20% thresholds, respectively, in the jurisdiction. In comparison, while the Islamic banking sector’s LAR was lower than the average of the entire banking industry, at 60.2%, the former’s LASLR was much higher than the latter’s 67.0% as at 3Q20.

The liquidity outlook for Afghanistan’s Islamic banking presents a mixed position. It remains promising given that there are no immediate pressures, and DAB has been able to ensure that there is no erosion of public confidence in the banking system. DAB has also enhanced its early warning system for identifying any signs of liquidity stress. However, the pre-existing liquidity challenges in the Islamic banking sector in Afghanistan may persist due to the maturity mismatch between PSIAs and non-remunerative deposits – often on a short-term basis – as the main source of funding on the one hand, and the relatively long-term nature of financing on the other. The lack of money market

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54 BI allowed a 300-basis points reduction in Rupiah reserves, as well as a 50 basis-point reduction in Rupiah reserves for banks that advanced financing to SMEs, priority non-SMEs or export-import activities.  
56 No Shari'ah-compliant financing data were reported for 4Q19–2Q20.
2.0 ASSESSMENT OF THE SOUNDNESS AND RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

The liquidity performance of the Islamic banking sector in Bangladesh reflected that of the entire banking industry, whose FDR also declined and ended 3Q20 at 74.0%. Overall, the FDR of the Islamic banking sector in Bangladesh was below the BB FDR threshold of 92% set for the sector. The LASLR and the FDR declined to end 3Q20 at 75.3% and 91.6%, respectively, due mainly to remunerative and non-remunerative funding sources having increased faster than the growth in Sharīʻah-compliant financing. Specifically, deposits grew faster due to the increased remittances inflow during the period, of which the Islamic banking sector handled 27.2% as at 3Q20. Sharīʻah-compliant financing, on the other hand, grew relatively more slowly, reflecting the slowdown in economic activity and the precautionary measures taken by businesses and households to adjust their expenditure and draw down on existing facilities.

The Islamic banking sector in Iraq recorded one of the highest liquidity indicators in 3Q20 among all the countries covered in this report. Specifically, the FDR of 98.3%, although high seems not to pose any immediate threat to the sector in the event of any unforeseen fund requirements. This notion is hinged on the fact that the LASLR of 290.3%, the LCR of 245.1%, and 165.8% as at 3Q20 were not only higher than the regulatory thresholds, but also the highest among the countries covered in this report. No specific liquidity policy measure due to COVID-19 was put in place by the CBI, other than a directed lending initiative under the “one trillion ID” scheme for which it offered 5 million Iraqi Dinars. While the regulatory capital indicators were very satisfactory and compared favourably with the more advanced Islamic banking sector in other countries, a cautious optimism is required given that the level of Islamic banking development in Iraq is still relatively low. The fact that Iraq is also an oil-dependent economy and does not currently have Sharīʻah-compliant liquidity instruments in its Islamic financial market that could be leveraged on in the event of a liquidity shock highlights the country’s vulnerability.

The BB implemented various liquidity support policy measures to ensure fund availability by and uninterrupted business operations of the country’s banks. For example, during the period under review, the cash reserve ratio was reduced by a cumulative 350 basis points to 2.0% on a bi-weekly average basis, and to 1.5% on a daily basis. The repo rate was reduced by a cumulative 125 basis points to 4.45%, while the reverse repo rate was reduced by 75 basis points to 4.00% during the period. The bank rate was also cut by 100 basis points to 4.00%, while the investment deposit rate (IDR) was extended by 2 percentage points to 92%. Although these policies could have positively impacted the liquidity of the Islamic banking sector in Bangladesh, its short-term liquidity position deteriorated over the period 3Q19–3Q20 based on an assessment of the indicators used in this report.

The Bangladesh Islamic banking sector also recorded deteriorating short-term and long-term liquidity positions. This is based on the fluctuating LCR and NSFR figures recorded during the period under review. In terms of the latter, the biggest change was recorded in 2Q20, but the indicator declined to end 3Q20 at 83.1%, which was also below the 100% threshold. This performance compared unfavourably with that of the entire banking sector, whose LCR was 213.5% during the same period. This performance figure indicated that, in a stressed situation, the Islamic banking sector in Bangladesh fell short of a sufficient buffer of high-quality assets to meet its cash outflow obligations for the next 30 days.

The NSFR, on the other hand, remained fairly stable over the period under review and above the regulatory threshold of 100% to end 3Q20 at 114.3%. This performance compared favourably with that of the entire Bangladesh banking sector, which recorded an NSFR of 110.6% during the same period. This result was surprising as, with the exception of Oman, every other country whose NSFR was reported recorded a decline. Although no significant improvement was recorded, the Islamic banks in Bangladesh would seem to rely more on stable funding for their operations.

Both the FDR and LASLR of the Islamic banking sector in Jordan recorded a rebound in 2Q20

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following the temporary impact of the COVID-19 lockdown in 1Q20. Although the LAR of 36.1% recorded by the sector was lower than the 47.0% recorded for the entire Jordanian banking system, it was higher than the average for the MENA non-oil-exporting countries at 30.0% as at end-3Q20. An improvement in FDR was recorded to end 3Q20 at 81.9%. The LASLR also recorded a positive rebound in 2Q20 and was sustained in 3Q20 to reach 61.6%.

The fact that a rebound was recorded in the liquidity indicators suggests that the CBJ's liquidity measures taken to stimulate economic recovery due to the impact of COVID-19 were effective. The CBJ provided JOD 2.5 billion in liquidity support to enhance access to finance by individuals and SMEs at a minimal charge of 2% and payable over 10 years. This measure was expected to strengthen the liquidity position of Jordanian banks. The CBJ also slashed the cash reserve ratio by 200 basis points to 5.0% and redeemed its certificates of deposits with banks, thus releasing JOD 550 million and JOD 500 million in liquidity in the process.

The Lebanese Islamic banking sector registered a streak of declining FDR during the period under review, due mainly to shrinking demand for financing. The cut in financing rate in domestic and foreign currency by 405 and 251 basis points, respectively, had little or no impact on the declining demand for financing during the period under review. Specifically, the FDR declined throughout the period to end 3Q20 at 25.2%.

The declining FDR does not necessarily imply growing deposits. In fact, the contrary is true in the case of the Lebanese Islamic banking sector despite a restriction placed on deposits withdrawal by the BDL.59 The excessive reliance on deposit funding as a source of funds exposed the Islamic banking sector in Lebanon to a challenging liquidity management situation. Moreover, the deteriorating liquidity situation was compounded by the Euro-bond cross-default by Lebanon, which resulted in the total cessation of payment obligations by the Lebanese government to the bondholders. The high exposure of the Lebanese banks to such government securities triggered a sense of panic, resulting in a high rate of withdrawals as a manifestation of lack of confidence in the entire Lebanese banking sector. Deposits contracted by USD 15.6 billion, or 9.8%, to end 1H20 at USD 143.3 billion (4Q19: USD 158.9 billion). This trend was also observed in the PSIA as the main source of deposit, which declined by –41.5% y-o-y as at end-3Q20. Deposit withdrawals could persist for as long as the lack of confidence in the system persists.

The BDL issued several circulars relating to monetary and exchange rate policies during the period under review.56 Notwithstanding, the fact that the Islamic banking sector – like the entire Lebanese banking sector – has a huge foreign currency exposure in a monetary system that is fragmented and with myriad exchange rates makes the liquidity outlook challenging. Maturity mismatch in liquidity arising from the short-term nature of foreign currency deposits by customers and the placement of such foreign currency deposits in long-term investments increases the vulnerability of the sector to sudden deposit outflows. Perhaps the BDL may offer limited liquidity support in the current stressed situation.60

The Islamic banks in Pakistan recorded declining FDR throughout the period under review to end 3Q20 at 55.7%. Nonetheless, this performance was better than that of the overall banking industry in Pakistan, which registered an FDR of 45.0% as at end-3Q20. Conversely, the liquidity position of the Pakistani Islamic banks based on LASLR recorded improvements over the period under review. After an initial decline in 1Q20, a rebound was recorded to end 3Q20 at 53.2%. The Islamic banks in Pakistan also recorded a fluctuating but adequate LCR and NSFR to end 3Q20 at 216.1% and 158.1%, respectively. Nonetheless, both the LCR and NSFR remained well above the threshold of 100%.

The funding and liquidity position of the Pakistani Islamic banks is expected to remain strong, especially due to growth in retail deposit and investment accounts. Compared to the overall banking industry, which experienced a 17.3% growth rate in deposits

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58 This situation has since worsened as Lebanese rushed to withdraw their deposits following the civil unrest in the country that began in October 2020.
During the period under review, the Islamic banks recorded an increase of 26.0% y-o-y as at end-3Q20. Deposits are also expected to surge as remittances increase and economic recovery builds momentum.\(^6\)

**The FDR of the Palestinian Islamic banking sector remained stable before recording an increase to end 3Q20 at 78.2%**. The LASLR, however, fluctuated over the period under review. Specifically, the LASLR rebounded in 2Q20 before declining again to end the period under review at 33.8%. Although the NSFR declined throughout the period to reach 126.0%, the strength of the short-term liquidity position of the Islamic banking sector in Palestine deteriorated to 151.2% in 3Q20. Nonetheless, both the LCR and NSFR as at end-3Q20 were above the 100% threshold.

Due to the limited intervention capability of the PMA in the absence of a national currency and comprehensive monetary policy tools, the strength of the liquidity position of the Islamic banking sector was tested by the economic implications of the COVID-19 pandemic. Moreover, the irregular remittance of clearance revenues by the Israeli government to the Palestinian government, and the decision of the latter not to receive incomplete clearance funds from the former due to political disagreements on a number of issues, led to a severe liquidity strain on the economy. Notwithstanding, the adequacy of the liquidity during the period under review could be linked to the intervention of the PMA, which provided additional liquidity of USD 1.5 billion to banks in mid-March 2020 to last over a four-month period to mid-July 2020.

**The liquidity of the Islamic banking sector in Libya indicated a structural funding gap from 2Q20.** This is hinged on the declining LASLR, which rose in the previous quarters, before declining sharply to end 3Q20 at 104.8%. The LAR also fluctuated throughout the period under review, ending at 99.1% in 3Q20. Although both ratios were higher than their pre-pandemic levels, neither has rebounded since the decline in 3Q20. Early data provided by the Central Bank of Libya (CBL) indicated that both the LAR and LASLR of the Islamic banking sector in the country declined further, to 99.1% and 103.7%, respectively, in 4Q20.

No specific monetary policy nor liquidity intervention was introduced by the Central Bank of Sudan (CBS) due to the outbreak of the COVID-19 pandemic. The Islamic banks in Sudan registered a decline in FDR to end 3Q20 at 56.0%. The LASLR on the other hand, though rebounded in 2Q20 declined again in 3Q20 to end the period at 101.5% indicating further deterioration in structural funding gap.

Despite recording a rebound and remaining higher than the regulatory threshold during the period, the NIB sector in Nigeria registered a y-o-y decline in liquidity. The sector recorded a rebound in FDR in 2Q20 to reach 26.1% and remained flat afterwards in 3Q20. In terms of the LASLR, the NIB sector in Nigeria recorded a decline up to 3Q20 to end the review period at 49.5%. This trend is similar to that experienced in the domestic market, in which case the liquidity ratio for the entire Nigeria banking industry declined to 61.8% as at end-3Q20. This could be linked to, among other things, compliance with cash reserve ratio obligations, as well as to an increase in Sharī‘ah-compliant financing due to economic reopening. The NIB sector’s liquidity management capacity was also impeded by the lack of Sharī‘ah-compliant instruments, which puts it at a disadvantage compared to the country’s conventional banks.

Nonetheless, the outlook for the liquidity position of the NIBs is expected to improve. This is hinged on the fact that the sector is growing quite quickly, and its liquidity ratio is well above the regulatory threshold of 10%.\(^6\) The sector has also benefited from the one-year moratorium on all repayments on CBN intervention facilities. According to the CBN, Nigerian banks’ access to a standing deposit facility has increased in 3Q20 to square up liquidity positions, especially given that applicable rates have been reduced by 300 basis points to 4.5%. The CBN also injected NGN 3.6 trillion into the banking system as part of its accommodative policy stance to ensure the sector is liquid and able to support economic recovery. Furthermore, the NIBs are mainly funded by retail deposits, whose growth is also expected to attenuate the liquidity pressure that may arise due to the increasing demand for Sharī‘ah-compliant financing. The NIB sector, being nascent, has limited exposure to foreign currency liquidity shock.


In Nigeria, the minimum liquidity ratio threshold for commercial banks is 30%, while it is 20% for merchant banks and 10% for NIBs.
and, as such, may not be affected by oil-price volatility or any consequential global conditions that could impede raising foreign currency funding in the near term.

The Turkish participation banking sector remained resilient to liquidity shocks. The sector recorded a rebound in both FDR and LASLR in 2Q20, and in LCR in 3Q20. The FDR remained flat afterwards and ended 3Q20 at 67.5%. The sector ended 3Q20 with a LASLR of 72.4%. The LCR also registered a rebound to end 3Q20 at 230.6%. The rebound recorded in liquidity was due to the capability of the participation banks to manage both Turkish Lira liquidity and foreign exchange liquidity. The policy rate was also cut from 12% to 8.25%, during the first half of 2020, while the action of the CBRT to purchase sovereign bonds also boosted liquidity in the banking system. These measures kept financing channels operational, incentivised both businesses' and households' demand for financing, and bolstered the participation banks’ liquidity capacity to meet such financing demands, which soared in 2Q20. The participation banking sector also recorded growth in funding sources. Specifically, PSIA grew by 9.1%, other remunerative funding such as murābahah grew by 19.0%, and non-remunerative funding such as wadī`ah accounts grew by 21.4%.

The CBRT commenced a gradual tightening of monetary policy from August 2020 to moderate the fast recovery seen in the economy on the back of strong credit growth and consideration of the inflationary and external balance effects. Later in 3Q20, the one-week repo rate was also raised, while the operational framework for liquidity management was also subsequently revised so that all funding should be provided at the policy rate. Notwithstanding, the outlook for the liquidity position of the Turkish participation banks seems resilient due to a healthy liquidity buffer and consistent growth in both remunerative and non-remunerative funding sources.

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Chart 2.1.2.1 Liquidity Coverage Ratio for Stand-alone Islamic Banks by Country (3Q19–3Q20)

Source: PSIFIs

63 The LCR of 230.60% registered by the participation banks as at end-3Q20 compares favourably with the 144% and 249% recorded for the total and foreign exchange LCR, respectively, of the entire Turkish banking sector as at October 2020.
2.0 ASSESSMENT OF THE SOUNDBNESS AND RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

**Chart 2.1.2.2 Net Stable Funding Ratio for Stand-alone Islamic Banks by Country (3Q19–3Q20)**

Source: PSIFIs

**Chart 2.1.2.3 Financing-to-Deposit Ratio by Country (3Q19–3Q20)**

Source: PSIFIs

**Chart 2.1.2.4 Liquid Assets to Short-Term Liabilities Ratio by Country (3Q19–3Q20)**

Source: PSIFIs
2.0 ASSESSMENT OF THE SOUNDNESS AND RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

The Saudi Banking Sector since the Outbreak of COVID-19

The year 2020 was an eventful one for the Saudi banking sector, with strong headwinds stemming from recessionary forces affecting both the oil and non-oil sectors of the economy because of the COVID-19-induced downturn and the health-related precautionary measures taken. Strong capital and liquidity buffers at the start of the year helped the banking system to weather the crisis.

In addition, together with the Saudi government, SAMA adopted a strong, swift and proactive approach to reducing the impact of the pandemic-induced downturn on the Saudi financial system. An extensive package of fiscal, monetary, financial and supervisory measures was implemented to maintain the stability of the financial system, to preserve its lending capacity to the economy and to SMEs in particular, to maintain adequate liquidity in the banking sector, to provide financial support for businesses and households, and to promote e-banking services.

The most important policy measures taken for the banking sector included the following:

- SAMA introduced a programme to defer payment of dues to banks and finance companies from SMEs. As of mid-January 2021, the Deferred Payments Program has deferred more than SAR 124 billion in total.
- Guarantees or financing cost reductions for SMEs have allowed them to maintain employment levels in the face of COVID-19.
- A dedicated SAR 50 billion liquidity support line now exists from SAMA to the banking sector.
- All customers are exempted from fees incurred for transactions through electronic channels, for incurring below-minimum low-balance thresholds, for refinancing operations or for termination of existing agreements.
- Supervisory and accounting guidance to banks addresses some of the challenges stemming from the impact of the pandemic on the banking sector.

Islamic banking and finance have used, and will continue to use, new growth mediums in this dynamic and changing environment. The continued development of human capital for the industry, versed in both Shari’ah elements and new technological understandings, will also be a key enabler for its successful future state.
2.1.3 Funding structure

The proportion of foreign currency funding vis-à-vis the total funding of the global Islamic banks remained relatively unchanged between 4Q19 and 1Q20. The proportion of foreign currency financing, on the other hand, was higher than foreign currency funding in the early part of the period under focus. Specifically, despite declining from 12.3% in 4Q19 to 12.0% in 1Q20, the proportion of foreign currency financing is higher than the marginal increase from 10.6% to 10.9% of foreign currency funding during the same quarters. Subsequently, in 2Q20, there was a convergence as both the former and latter declined. Foreign currency financing subsequently declined at a faster rate and later was less than foreign currency funding in 3Q20 (see Chart 2.1.3.1).

The various jurisdictions that provided data on this particular indicator were evenly split between those that recorded an increase in foreign currency funding and those that recorded a contraction and reduced reliance on foreign currency funds. Lebanon and Afghanistan’s Islamic banking sectors continue to lead with the highest foreign currency funding levels, at 86.6% and 60.9%, respectively.

In Afghanistan, while the forex positions of the Islamic banking windows in the country were within the ±40% limits for overall foreign exchange position and the ±20% limits on individual currency position set by DAB, the foreign exchange position of the full-fledged Islamic bank lay well outside the limits. It is important that the bank’s foreign position is brought to within the regulatory limits, especially given the volatility of the Afghanistan Afghani (AFN).

The foreign currency funding (financing) to total funding (financing) ratio for the Bangladesh Islamic banking sector remained the lowest among the countries covered in the sample. Between 4Q19 and 3Q20, the average proportion of foreign exchange funding to total funding remained high at 86.7%, while the average of the share of foreign currency financing in total financing remained higher at 92.8%. This translated to a 7.8% y-o-y growth in net foreign exchange open position as at end-3Q20.
inflow of wage earners’ remittances, especially from the Gulf. The latter declined on account of low import payments due to the slowdown in economic activity during the period.

The Islamic banks in Pakistan recorded an improvement in foreign currency funding, accounting for 5.5% of total funding. This could be attributed to the surge in inflow of foreign workers' remittances in the quarter. Foreign currency financing declined, accounting for 1.7% of total financing, due to the impact of the lockdown imposed in the country.

The Islamic banking sector in Oman registered a slightly higher proportion of foreign currency financing compared to foreign currency funding as at 3Q20. This is not expected to generate any foreign exchange risk given that the local currency is pegged to the USD. In contrast, a higher foreign currency funding compared to foreign currency financing was registered in both Brunei and the UAE compared to other oil-producing economies. In other jurisdictions with flexible exchange rates, such as Indonesia, Malaysia, Pakistan and Turkey, excessive volatility was mitigated via foreign exchange interventions.

In Indonesia for instance, the foreign currency net position is expected to strengthen on the back of BI's stabilisation measures to ensure foreign capital inflows to provide foreign currency liquidity through reduced foreign currency reserve requirements by 400 basis points to attenuate foreign currency liquidity pressure. In Malaysia, the foreign exchange net open position is expected to be sustained given the reforms going on in Malaysia's foreign exchange market. For instance, the exemption granted to exporters from converting foreign exchange proceeds below RM200,000 per transaction, and permission to extend hedging of foreign financing obligations from the previous maximum period of 12 months to the duration of the underlying tenure.

2.1.4 Financing Exposure

The pattern of the Islamic banks’ and Islamic banking windows’ financing activities remained largely similar to that witnessed since 2018. Except for a slight switch in proportion, the financing exposure remained concentrated in the household, and wholesale and retail trade sectors, followed by the manufacturing sector. Compared to 3Q19, the financing to household sector increased by 1 percentage point (pp) to 27%, while financing to the wholesale and retail trade sector decreased by –1pp to 26%, of the total financing from the Islamic banks and windows in the jurisdictions for which data were available as at 3Q20 (see Chart 2.1.4.1). This sector was followed by the manufacturing sector, which decreased by –1pp at 17%; by construction, which increased by 2pp to 8%; and by the real estate and agriculture sectors, which remained unchanged at 6%.

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BI allowed a 300-basis points reduction in Rupiah reserves, as well as a 50 basis-point reduction in Rupiah reserves for banks that advanced financing to SMEs, priority non-SMEs or export–import activities.
and 4%, respectively. The proportion of financing to other sectors also remained unchanged at 12%. Chart 2.1.4.2 shows the sectoral composition of financing exposure by country.

As at 3Q20, real estate financing received the highest (28.6%) financing from the Islamic banks in Bahrain. This result was on account of the relaxation in the financing-to-value ratio for new residential houses during the period as part of measures by the CBB to support lending activities by the banks. Compared to 3Q19, financing to the real estate sector increased by 5.54% y-o-y. Financing to the household sector accounted for 16.8% and recorded a modest 1.76% y-o-y increase. The wholesale and retail trade and manufacturing sectors received 11% of total financing in the Bahraini Islamic banking sector.

In Oman, 41.8% of the financing exposure of the Islamic banks is to the household and personal financing sector as at end-3Q20. This proportion is similar to the approximately 40% recorded for the same sector by the entire Omani banking system. Although the CBO set prudent limits on financing to households based on the borrower's repayment capacity, the real effect of the economic contraction on such borrowers will become discernible once forbearances are unwound. The construction sector accounted for the second-highest portion of Sharī‘ah-compliant financing among Omani Islamic banks, at 16.3%, while the manufacturing sector accounted for 10.46%. A slower-than-expected economic recovery may result in declining capital spending on construction, thus heightening the vulnerability of the Omani Islamic banks to the sector. However, the fact that the manufacturing sector is key to the country's economic diversification agenda not only presents a positive development in terms of due monitoring from the regulatory authorities, but also explains its relative share of financing.

In Saudi Arabia, the household and personal financing sector accounted for 46.3% of the Sharī‘ah-compliant financing as at end-3Q20. The household sector financing of both the full-fledged Islamic banks and the Islamic windows increased due to the rapidly expanding demand for mortgage financing as per the government's "Vision 2030" project. The real estate sector accounted for 8.0% of total financing as economic activity picked up. While the manufacturing sector accounted for 8.9% of total financing, both the wholesale and trade financing sector and the construction sector accounted for 8.1% each.

The financing exposure of the Islamic banking sector in Brunei as at 3Q20 is mainly to the household (30.9%) and real estate (23.8%) sectors. The pick-up in the real estate sector could be linked to the increase in housing purchases and structural home improvements observed since 2019, and to the economic reopening in 2Q20, given that Brunei has

Source: PSIFIs and IFSB Secretariat Workings
recorded only a few imported cases of COVID-19 since then. Other sectors to which the Islamic banking sector in Brunei has a notable exposure include construction (11.6%), manufacturing (7.4%), and wholesale and trade financing (3.0%).

Financing provided to the real estate sector dominated the Indonesian Islamic banking sector as at 3Q20. Specifically, 27.8% of the total Sharī‘ah-compliant financing was advanced to the real estate sector. The distribution could be explained by BI’s campaign that urged the country’s banks to continue to lower their financing rates in order to help stimulate economic activity. Moreover, financing-to-value on housing financing was increased to 100% on both residential and business properties. The sector also benefited from the eased restrictions on the operation of malls in 2Q20, which buoyed real estate rentals and financing repayments for that property segment. The household sector also received a share of 19.4% as at 3Q20, which is expected to further increase due to the automatic financing repayment moratorium, and auto and mortgage financing. For instance, sales and service tax incentives were granted for auto purchases from 15 June 2020 until 30 June 2021. Although the complementary effects of the repayment assistance facility on the debt-serving capacity of borrowers cannot be discountenanced, the fact that households’ financial asset growth is higher than that of debt also indicated that their repayment capacity had been influenced by other means. Due to the relaxation of the movement control order in 2Q20, improvements have been recorded in the manufacturing and wholesale and retail trade sectors, which jointly account for 22% of the financing exposure of Islamic banks in Malaysia, while the exposure to the construction and real estate sectors as at end-3Q20 stood at 10.4% and 10.0%, respectively.

In Bangladesh, the manufacturing sector accounted for the largest share of Sharī‘ah-compliant financing among the full-fledged Islamic banks, at 39.3%, and for 45.4% among the Islamic banking windows, as at 3Q20. The wholesale and retail trade sector accounted for 36.4% of total Sharī‘ah-compliant financing among the full-fledged Islamic banks, and for 19.3% among the Islamic windows in the country, as at end-3Q20.

The real estate sector in Jordan accounted for a 24.7% share of the financing exposure of the Islamic banking in the country as at 3Q20. The sector has been faced with a declining trading volume and real estate price index since 2017. The sector was also affected by the pandemic, resulting in a decline in terms of the number of residential and commercial apartments sold, respectively, and a dip in the price index. The household and personal financing sector accounted for a share of 19.2%, while wholesale and retail trade financing accounted for 10.8%. The other sectors with at least a 10% financing exposure were electricity (16.2%) and construction (10.8%).

In terms of financing exposure, the largest share of the Sharī‘ah-compliant financing of the Islamic banks in Pakistan was to the manufacturing sector. Specifically, this sector accounted for 62.5% of total financing, although the share declined as at 3Q20. The wholesale and retail trade sector also recorded an increment to end 3Q20 with a share of financing of 8.2%. These sectors were very central to the economic recovery measures of the State Bank of Pakistan (SBP). In fact, as part of its policy responses to COVID-19, an Islamic Temporary Economic Refinance Facility (ITERF) scheme was launched in March 2020 to provide concessional Sharī‘ah-compliant financing to stimulate investment in manufacturing activities with the exception of the power sector.
2.1.5 Asset Quality

In 1Q20, the global Islamic banking industry’s asset quality ended a streak of improvement recorded since 4Q18 but rebounded subsequently. Measured by the average non-performing financing (NPF) ratio, the asset quality of Islamic banks and windows specifically registered a slight increase to 5.0% in 1Q20. However, apparently due to the various forbearance measures put in place across jurisdictions, the average NPF remained flat in 2Q20 and reduced further to 4.9% as at end-3Q20, down from 5.0% a year earlier (see Chart 2.1.5.1). This decline in average global Islamic banking NPF should be viewed with caution as implying a contraction in the cost of risk. As highlighted in later sections for each country, declining or stable NPF may also portend hidden vulnerability to asset quality issues which may only start to manifest as forbearance measures are suspended.

In terms of the sectoral distribution of the global Islamic banking NPF, three sectors with the highest impairment ratios, and which accounted for 53.7% as at end-3Q20, were: manufacturing (19.7%; 3Q19: 18%), wholesale and retail trade (18.8%; 3Q19: 23%), and household (15.2%; 3Q19: 16%). Other sectors were construction (14.9%; 3Q19: 12%), real estate (12.1%; 3Q19: 10%), and agriculture (3.0%; 3Q19: 2%). Other non-specified sectors accounted for the remaining 16.2% (3Q19: 19%). The sectoral composition of both financing and NPF varied greatly between countries and regions, and the weighted average may not reflect a balanced view of global economic sector exposures for Islamic banking across different jurisdictions. Such specific exposures are shown on country-by-country basis in Chart 2.1.5.2.

In Bahrain, both the non-performing financing ratio and provisioning decreased up to 2Q20 before increasing again in 3Q20 especially due to the real estate activities in the wholesale Islamic banking sector. Of note, COVID-19 aggravated the drop in the prices of real estate in addition to other factors, such as excess of supply over demand. Bahrain’s real estate and household sectors jointly accounted for 26%, while the wholesale and retail trade and manufacturing sectors accounted for 29% of the total NPF of the Bahraini Islamic banks. The possibility of asset quality deterioration remains a risk that may start to manifest as the financing deferral schemes are ended and the cost of risk starts to increase. The stress testing conducted by the CBB to assess the likely effect of the deferral scheme in Bahrain reveals that the impairment in deferred financing will start to accumulate a month after the forbearance measure is withdrawn. In this regard, the CBB requires that once the deferral period is over, banks should assess the peculiar financial circumstances of both their retail and corporate customers and proactively offer them the best possible credit recovery strategies.

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**Chart 2.1.5.1 Global Islamic Banking Average Gross Non-Performing Financing to Total Financing (4Q13–3Q20)**

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*Source: PSIFIs and IFSB Secretariat Workings*

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65 Average non-performing financing to total financing calculation is based on data from 24 jurisdictions contributing to the IFSB’s PSIFIs database (excluding Afghanistan, Egypt, Libya and Iraq, due to data limitations), with Palestine data included from 4Q16 and UK data from 4Q17. The computation for 4Q19 to 3Q20 also excludes Iran, Kuwait, Kazakhstan, Qatar, Sudan and the UK, for the same data reason.

67 The computation of the NPF is based on Islamic banking operations and relates to assets that are booked within Bahrain. As such, the NPF of overseas subsidiaries and branches of Bahrain Islamic banks is not considered.
The asset quality of the Omani Islamic banking sector continued its gradual deteriorating streak since 1Q18. The NPF increased q-o-q up to 3Q20 to reach 1.94%, although from a relatively low base compared to other GCC countries such as Bahrain and the UAE. However, the provision for NPF has also seen a significant increase during the period, albeit at a declining rate for both the full-fledged and Islamic banking windows. Four sectors accounted for almost 60% of the total NPF: construction accounted for 19.1%, manufacturing for 14.9%, household for 13.7%, and wholesale and retail trade for 10.8%. These sectors are all closely linked to economic downturns like that occasioned by COVID-19 and falling oil prices. The high level of household indebtedness prior to the pandemic may deteriorate further due to economic challenges and contraction in employment. This may be aggravated by the fact that Islamic banks are not able to charge late payment fees due to policy measures to ease the effect of the pandemic. The NPF in the construction sector could also have been aggravated by reduced expenditure on infrastructure projects due to the challenging economic conditions.

Considering the relatively low NPF despite the implementation of IFRS 9, the Omani Islamic banking sector’s asset quality is expected to remain strong. Moreover, as in other countries in the Middle East and the GCC region, most non-contact-intensive sectors such as manufacturing, and wholesale and retail trade, which accounted for up to a quarter of total Islamic banking NPF in Oman, have rebounded to their pre-pandemic levels. However, exposure to household and personal financing requires that adequate attention be placed on the likely vulnerability it presents. The deferment of financing and the suspension of changes in risk classification for deferred financing permitted by the CBO have largely been responsible for keeping the NPF at a low but increasing level. It is perhaps too early to determine the extent to which provision will be adequate for the high NPF and ECL that may crystallise due to likely declining property prices and high household debts once forbearance measures are suspended.

Although from a low base, the asset quality of Saudi Arabia’s Islamic banking sector deteriorated up to 2Q20 before registering a rebound in 3Q20. The rebound, recorded to end 3Q20 at 1.8%, was on the back of relatively lower risk due to Islamic banks’ retail focus and increased provisioning. The forbearance measures have also been very effective at keeping the NPF within a manageable range, although still worse off compared to 3Q19. Based on sectoral distribution, the construction sector and the wholesale and retail trade sector accounted for 21.7% and 20.2% of the Saudi Islamic banks’ NPF, respectively. Other sectors, in order of proportion of NPF, are the manufacturing sector at 19.9% and the household sector at 16.3%. These sectors are highly linked to the COVID-19-induced prevailing economic conditions, and in the event of a prolonged economic contraction amid declining sovereign reserves of the kingdom, asset quality may deteriorate further.

The true extent of asset quality deterioration will only manifest as the forbearances are lifted. However, in the interim, the various fiscal and monetary policy relief measures by SAMA have been very effective in keeping asset quality at manageable levels. This favourable outlook is expected to continue due to the extended forbearance period and the positive effects of policy measures on economic recovery amid gradual improvement in global oil prices and production.

The NPF of the UAE’s Islamic banking sector deteriorated throughout the period under review, albeit at a declining rate, to reach an NPF of 6.6% in 3Q20. The was due to the pandemic’s significant disruption of real economic activities and oil price shocks, as well as to Islamic banking’s exposure to the household and real estate sectors, which jointly accounted for more than 50% of total financing. While the households have had to bear the consequences of contraction in employment and dwindling income, the real estate sector was weakened by oversupply and a fall in demand due to the challenging economic conditions, lockdown and the increasing shift to virtual workspaces. Nonetheless, the asset quality outlook will also improve due to front-loaded provisions for NPF which increased on average by 3.7% over the period and by 15.2% y-o-y. Moreover, the impact of the economic recovery activities, including the waiver of lockdowns, the resumption of economic activity, and other prudential measures put in place in the country.

under the TESS programme have started yielding a positive effect. This was reflected in the 3Q20 asset quality performance of the sector.

**Brunei’s Islamic banking sector’s NPF fluctuated during the period under review.** Specifically, the NPF declined up to 1Q20, then marginally increased in 2Q20, before ending the period under review at 4.0% in 3Q20. This performance, however, compares favourably with that of the entire banking sector in Brunei, which recorded a net NPF of 4.7% in 3Q20. Although the largest share of financing is to the household sector, the NPF is lower at 14.4%. The highest NPF is from both the real estate and manufacturing sectors, at 25.8% and 23.1%, respectively. Based on the provision for NPF, which increased in 2Q20 after declining for most of the period, the asset quality outlook seems favourable. The downstream sector has also witnessed gradual improvements. Both factors are important to the country’s manufacturing sector given the high NPF from the sector. However, it is very likely that the monetary policy measures put in place by the BD have kept the NPF fairly stable at around its historical 4.0%.

The asset quality of the Indonesian Islamic banking sector remained stable due to the regulators’ relaxation policy on bank financing restructuring and repayment deferral. The increased loan provisioning puts the Islamic banking sector in a better position to weather the storm in the event of asset deterioration once the regulatory forbearances are suspended. Moreover, the partially relaxed financing classification that allows banks in the country not to immediately reclassify restructured financing to substandard has seen the NPF ratios continue to decline during the period. Specifically, the NPF increased up to 2Q20 before declining in 3Q20 to end the period at 3.2%, which is than its pre-pandemic level. Based on sectoral composition, 21.4% of the NPF of Indonesia’s Islamic banking is to the real estate sector. Other sectors with relatively high NPFs are manufacturing (16.4%), wholesale and retail trade (16.3%), and construction (15.7%). These sectors have been directly affected by the COVID-19-induced economic contraction. The asset quality outlook, very much like that of the entire banking system in Indonesia, depends on how fast the economic situation and (by extension) credit conditions improve. The soundness of the current asset quality position of the Islamic banking sector, which as at 3Q20 remained within desirable policy levels, will also be tested by the extent of non-provisioned losses in the sector when policy relaxation is ended in March 2022. While credit restructuring has proven effective in attenuating the effects of the COVID-19-induced disruptions, existing vulnerabilities would require that the regulators provide further guidance relating to provisioning as well as measures to build the financing momentum. For instance, the likely increase in impaired financing as repayment deferrals and relief measures are eventually ended may induce Indonesia’s Islamic banks to tighten their financing given their risk aversion sentiments. This may have further implications for their profitability and capital adequacy.

The asset quality of the Islamic banking sector in Malaysia remains healthy. Perhaps due to the initial impact of the pandemic, the NPF increased in 1Q20 but declined in subsequent quarters to end 3Q20 at 1.3%. Provisions by Islamic banks increased in 3Q20 due to, among other factors, the 40% overlay by banks in excess of the provisions based on the ECL model. This was necessary against future credit losses to ensure continued resilience against a potential rise in impairments given the increasing uncertainty surrounding the recovery phase of the pandemic. The BNM also granted a six-month blanket financing payment moratorium in 1Q20 until end-3Q20. Furthermore, the Shari‘ah Advisory Council (SAC) of BNM ruled that, based on the principle of ihsan (beneficence), accrued profits on both restructured and rescheduled financing extended to customers affected by the COVID-19 pandemic should not be capitalised by the country’s Islamic banks. The targeted repayment assistance measures extended to both households and SMEs to manage cash flow issues have been very effective in ensuring that the impairments from the household sector to which the full-fledged banks have 62.0% exposure and the Islamic windows 26.2% exposure have only increased marginally post the automatic blanket moratorium.

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69 BNM has subsequently urged banks to continue with a targeted rescheduling and restructuring of financing for viable and deserving customers who are still struggling to service their existing financing.

70 [https://www.bnm.gov.my/documents/20124/1085561/SAC+Statement+30th+SAC+Special+meeting+%28revised%29+ENG+16102020.pdf](https://www.bnm.gov.my/documents/20124/1085561/SAC+Statement+30th+SAC+Special+meeting+%28revised%29+ENG+16102020.pdf)
NPFs will likely increase, especially from sectors that are highly exposed to the pandemic and whose real repayment capability might have been masked by the repayment moratorium granted by BNM. Credit risk is still an issue as the proportion of Stage 2 household financing for the entire banking industry increased by 1.7 percentage points to 7.3% between 1H20 and 2H20.\(^{71}\) The Islamic banks, like their conventional counterparts, will, however, be faced with a challenge of incorporating forward-looking information into the measurement of ECL given factors such as uncertainty, relief measures and general economic recovery.

Notwithstanding the expected challenging situation, the roll-out of vaccines and improvement in the global business environment may quicken business recovery and repayment capabilities. Moreover, the fact that the banks have front-loaded their provisioning in 2020 will attenuate the effect of any significant increase in NPFs. The result of the BNM stress test also revealed that Malaysia's banks remain resilient against credit risks that might emanate from the household sector in the event of a prolonged crisis and a worsening rate of unemployment.\(^{72}\)

The average NPF ratio for Bangladeshi Islamic banking declined throughout the review period to end 3Q20 at 4.4%. This performance was similar to that obtained for the country's entire banking industry, which also recorded a reduction in overall NPL. The largest share of the NPFs was accounted for by the manufacturing sector, representing 39.2% as at end-3Q20. This was followed by the wholesale and retail trade sector, which accounted for 37.4%. The improvement in asset quality can be linked to the effectiveness of the policy measures by the BB, especially those relating to the moratorium facility provided to borrowers on financing, and increased provisioning against classified financing.\(^{73}\) Specifically, the BB put existing financing classification on hold and allowed banks to reschedule or restructure financing facilities, as well as providing a one-time exit and write-off of classified financing until the end of 2020. Moreover, the BB directed the banks to provide concessional agricultural financing, while it provided 5% profit as a subsidy. Notwithstanding, there is a possibility of hidden vulnerability as poor assets are expected to start manifesting once the moratorium facility is lifted.

The BB had already noted a shortfall of BDT 45 million in required provisioning – a provision maintenance ratio of 93% in the banking sector. The result of the stress test conducted by the BB as at end-2Q20 also revealed that if NPLs/NPFs of Bangladesh banks increase by 3%, 9% and 15%, the CAR of a corresponding 5, 30 and 36 banks will be below the minimum threshold. Moreover, if up to 10 of the top borrowers of any of the banks default or are downgraded, 100% provisioning would be required, while the CAR of up to 38 banks will fall below the minimum threshold.

After a temporary deterioration in 1Q20, the asset quality of the Islamic banking sector in Jordan rebounded in 2Q20. Perhaps due to the pandemic-induced challenging economic condition, the NPF of the sector increased to 2.9% in 1Q20. A rebound in NPF was recorded in 2Q20 and was sustained in 3Q20 to end the quarter at 2.6%. The NPF of the Jordanian Islamic banking sector remained highly concentrated in the wholesale and retail trade sector which accounted for a 52.7% share of total NPF. While this may not be of much concern given that financing exposure to the sector was lower at 10.8%, its dependence on further economic reopening and recovery deserves consideration. This is more so that the extent of impairment is masked, given that the CBJ has allowed deferment of repayment of outstanding financing and has provided JOD 500 million in a soft financing programme to support the SMEs that constitute the retail sector.

The real estate and household sectors, which are highly susceptible to the impact of a prolonged pandemic, accounted for 16.0% and 12.9%, respectively, of the NPF. The former has recorded a declining streak over the quarters in both the number of units sold and the price index. The latter increased on account of the lenient financing terms and extensive duration as urged by the CBJ. Although provision for NPF increased in both 1Q20 and 2Q20, it declined as at end-3Q20 on account of dwindling profitability. The asset quality outlook for the sector will become clearer as the repayment deferral, rescheduling and

\(^{71}\) https://www.bnm.gov.my/documents/201234/1095561/SAC+Statement+30th+SAC+Special+meeting+%29+revised%29+ENG+16102020.pdf


\(^{73}\) Classified financing is that which, although not necessarily past due, has unpaid profit or rental as well as an outstanding principal, thus putting it at risk of default because an Islamic bank is not sure if it can recoup its financing.
restructuring without any down payments or commissions charged, as permitted by the CBJ, are suspended.

The asset quality of the Islamic banking sector in Lebanon deteriorated during the period under review. The NPFs were extremely high in relation to those of the Islamic banking sectors of other countries covered in this report. The highest quarterly increase was recorded in 1Q20, during which NPF rose to 27.4%. This period marked not only the beginning of the lockdown due to COVID-19, but also when the Lebanese government defaulted on the Eurobond. The subsequent quarters also witnessed further deterioration in NPF, which reached 31.1% as at end-3Q20. The subsequent socio-economic impact of the pandemic, fuelled by the pre-existing challenging economic climate and high inflation due to the depreciation of the Lebanese Lira, contributed to a streak of q-o-q asset quality deterioration being recorded.

The severity of the extent of asset quality deterioration was perhaps masked by the policy response put in place by the BDL, which prohibited banks in the country from downgrading any financing delinquency by borrowers affected by the COVID-19 pandemic until 31 December 2020. Moreover, with a forecast economic contraction of –25% and a high depreciation of the local currency due to soaring inflation, there is a likelihood that impaired financing will also rise, given that most financing is denominated in USD. In August 2020, the BDL issued circulars mandating financial institutions operating in the country to apply a statutory ECL of 1.9% on foreign currency placement with it and 45% on foreign currency with the government.

The Islamic banking sector in Pakistan recorded improved asset quality in 2Q20. The NPF deteriorated to end 3Q20 at 3.7%. The asset quality generally seems better than the average for the entire commercial banks, which recorded NPLs to total financing of 9.9% and provisions for net financing of 84.7% as at end-3Q20. The sectoral NPF also reflected sectoral financing, as the manufacturing sector accounted for the largest share of the NPF at 44.1%. Other sectors with a lesser but notable share of the NPF are the household sector (10.3%), construction (4.1%), wholesale and retail trade (6.2%), and agriculture (2.0%). These sectors have all been affected in one way or another by the lockdown and economic slowdown caused by the pandemic.

Provisions remained stable on a q-o-q basis to end 3Q20 at 88.6%. The asset quality performance recorded during the period could have been worse if the policy measures put in place by the SBP were discounted. The SBP granted permission as well as regulatory relaxation to the banks to consider the deferral, rescheduling or restructuring of financing upon request by borrowers. For the deferral, payment of the principal financing amount was allowed to be delayed for up to 12 months until September 2020, while restructuring was until March 2021. For both measures, their effect on borrowers’ credit history, and an increase in the number of days past due (DPD) after which the financing is considered as non-performing, were disregarded. The debt-relief schemes have been very effective, as more than 1.8 million applications have been received, with a 97% approval rate worth PKR 903,469 billion.

Palestinian Islamic banks registered fluctuating asset quality performance during the period under review. The NPF of the sector deteriorated to 3.2% in 1Q20 before improving to end 3Q20 at 2.7%. At the outbreak of the pandemic, the PMA intervened to suspend procedures on default classification for four months, and to reduce the number of cheque books granted to customers, especially to individuals. In 2Q20, the PMA also instructed banks to mitigate the economic effects of COVID-19 by allowing borrowers the possibility to postpone the payment of their obligations with multiple options (e.g. overdraft, restructuring, rescheduling, a temporary tawarruq ceiling for Islamic banks). These measures, at least in the interim, may have masked the extent of asset quality deterioration. In this regard, the NPF of the sector needs attention given that provisions for NPF have been on a steady rise from 46.7% in 3Q19 to 59.3% as at the end of 2019. Specifically, the household sector recorded a 36.0% share of total NPF, while the wholesale and retail trade sector accounted for 10.1% of NPF as at end-3Q20.
The NIB sector in Nigeria recorded asset quality deterioration in 2Q20 but rebounded in 3Q20. Specifically, after sustaining improvement in asset quality for the previous five quarters from 2Q19, the NPF of the NIB sector deteriorated in 2Q20 to end the quarter at 8.9%. This NPF was also higher than the NPL of 6.4% for the entire domestic banking sector during the same period and the 5.0% threshold set by the CBN. The delayed impact of the pandemic and of falling oil prices in 1Q20 on the asset quality of the NIB was hinged on the sufficient provisioning of 118% made in the quarter, compared to the provisioning of 76% in 2Q20. However, the sector recorded improved performance in asset quality in 3Q20, with a decline in NPF to end the quarter at 7.4%. This could be linked to the sustained recoveries, write-offs and disposals of pledged collaterals generally recorded in the domestic banking sector in the country. Moreover, the CBN's regulatory forbearances allowed banks to temporarily restructure or reschedule financing to businesses and households that are most affected by the COVID-19 pandemic.

The participation banks in Turkey registered improved asset quality performance throughout the period under review. The improved performance in NPFs of the Turkish participation banks could be explained by the BRSA’s decision to extend the period of Stage 2 and NPL classification, the debt restructuring and instalment deferral practices, the strong increase in credit volume and the rapid recovery in economic activity. In this framework, while the NPL balance remained nearly flat during the pandemic, the volume of performing loans increased significantly as a result of the steps taken, which saw the NPF ratio of the participation banks decrease to 3.3% in September 2020.

While the asset quality of the Turkish participation banks may deteriorate in the period ahead due to the approaching maturities of postponed payments, the impact is expected to be moderated by increased provisioning. Moreover, the CBRT’s gradual tightening of monetary policy and the reduction in the maturity of consumer loans since 3Q20 are expected to reduce financing growth and, by extension, the NPFs.

Chart 2.1.5.2 Islamic Banking Average Gross Non-Performing Financing to Total Financing by Country (3Q19–3Q20)

Source: PSIFI

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In March 2020, the BRSA increased the payment deferral period for NPFs from 90 days to 180 days until 31 December 2020. The period for the delayed payment of Stage 2 loans was also increased, from 30 days to 90 days.
Box 3 COVID-19 Policy Measures and the Islamic Banking Sector in Bahrain
Contributed by the
Central Bank of Bahrain

In light of the recent global outbreak of COVID-19 and the preventative measures taken by the Government of the Kingdom of Bahrain to contain the virus, the CBB announced a number of measures to help offset the negative impact of the pandemic. The regulatory measures were taken to contain any financial repercussions for customers of the banking sector and to provide more liquidity and flexibility to enable banks to continue providing financing to their customers. The measures, which were continuously reviewed/reassessed in consultation with the banking sector, applied to both conventional and Islamic banks.

The goals of the measures were as follows:

1. To continue to support demand for credit growth and confidence and prevent a tightening of financial conditions.
2. To ensure liquidity support to the market and ensure that resources in the financial and banking system are available.
3. To work with financial institutions to ensure they provide continued access to funding for market participants (individuals, households, SMEs and local businesses) that are more likely to face temporary difficulties.
4. To ensure that monetary policies remain supportive.

The CBB measures were complementary to the BD 4.3 billion economic stimulus package (equivalent to 29.6% of nominal 2019 GDP) that was announced by the Government of Bahrain on 17 March 2020, which was aimed at providing economic assistance to individuals and businesses the majority of whom are not included in the state budget, and that includes contributions from the private sector.

CBB’s Regulatory Measures as Part of Precautionary Efforts to Contain COVID-19

<table>
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<tr>
<th>Date</th>
<th>Measures</th>
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| 16 March 20| CBB’s key policy interest rate on the one-week deposit facility was cut from 1.75% to 1.00%.
The overnight deposit rate was cut from 1.50% to 0.75%, the one-month deposit rate from 2.20% to 1.45%, and the CBB lending rate from 2.45% to 1.70%. |
| 18 March 20| CBB urged providers of point-of-sale (POS) devices to communicate with merchants to sterilise such devices regularly, and to require customers to directly enter and remove their cards from the devices. |
|            | CBB urged all licensees to follow and implement sterilisation instructions issued by the Ministry of Health and to submit a report on this. |
|            | The volume limit of contactless (NFC) transactions on POS devices was increased to BD 50-without the need to use a PIN code. |
### 2.0 ASSESSMENT OF THE SOUNDNESS AND RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

<table>
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<tr>
<th>Date</th>
<th>Action Description</th>
</tr>
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<tbody>
<tr>
<td>23 March 2020</td>
<td>CBB instructed money changers to disinfect all incoming currency notes and wholesale imported notes, and to equip employees with personal protective equipment.</td>
</tr>
<tr>
<td>29 December 2020</td>
<td>CBB directed licensees to offer their customers a six-month instalments deferment option, starting from 1 January 2021, on a similar basis to those mentioned above. Credit card exposures were excluded from the deferment option.</td>
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A cap of 0.8% was set on merchant fees imposed by local banks and finance companies on debit card transactions to reduce merchant and company costs.

CBB required retail banks, financing companies and microfinance institutions to postpone instalments for any Bahraini borrower or credit card holder and local businesses affected by the economic repercussions of the coronavirus without fees, interest on interest, or an increase in the profit/interest rate for a period of six months. On 20 September, these provisions were extended for a further four months.

CBB provided retail banks concessionary repo arrangements with up to six months at 0% on a case-by-case basis.

CBB reduced the cash reserve ratio for retail banks from 5% to 3%.

CBB requested to relax the loan-to-value (LTV) ratio for certain new residential mortgages.

Although the current deferral of instalment payments will end by 30 June 2021, other regulatory relaxations, including reduction in LTV ratios on residential mortgages, liquidity ratios and risk weights for SMEs, are likely to be phased out over a period of time after reassessment. Policy adjustments will be made based on the underlying conditions and changing assessments of real economy funding needs and the path of recovery.

Islamic banks continue to have comfortable capital positions and there is adequate liquidity in the market with easy access to finance. Credit growth is also expected to increase slowly, but steadily, in 2021. Overall, despite the pressure on profitability and asset quality, the financial stability risks are expected to remain stable based on the sound health of the Islamic banks and financial institutions and the expected recovery of the economy during 2021. Consequently, the banking sector will be able to overcome any ensuing challenges.

The CBB will continue to monitor the asset quality of Islamic banks, as it is recognised that a slowdown in the economy due to COVID-19 may affect the asset quality of banks, slow down business activity, and increase impairment in deferred loans that can accumulate after deferral programs have ended.

The CBB’s commitment to develop Islamic finance remains strong, and it will continue to work with the industry to ensure further progress to maintain Bahrain’s status as a leader in Islamic finance and its regulation.
On a policy level, the CBB continues to seek innovative strategies and policies for Islamic finance. With regards to regulations, in recent years the CBB has introduced a number of measures, including a new solvency framework for the takāful industry, new Shari’ah governance rules to complement the standards of the Accounting and Auditing Organization for Islamic Financial Institutions, (AAOIFI) and rules designed to enhance the independence of risk managers, compliance officers, internal auditors, internal Shari’ah reviewers, internal and external Shari’ah auditors, and anti-money laundering officers.

As part of the CBB’s vision to expand the scope of banking in Bahrain by promoting the adoption of the latest digital trends, several regulations were issued, including mandating the adoption of open banking for all Islamic retail banks.

The measures taken by the CBB since the start of the pandemic have largely been effective in achieving their desired objectives of ensuring that Islamic banks have adequate liquidity to support their ability to provide financing without any significant adverse impact on asset quality and capital while facilitating easier access to finance for borrowers, especially the SME and other sectors of the economy. No material changes to the asset quality, capitalisation and liquidity of the banking sector were observed.

### 2.1.6 Capital Adequacy

The Islamic banking industry entered the COVID-19-induced crises with stable capital adequacy ratios (CARs) that were also well above the IFSB’s and its respective jurisdictions’ regulatory thresholds. The average total and average Tier-1 CARs\(^ {78}\) of the global Islamic banking industry as at end-3Q20 were 18.3% (3Q19: 18.2%) and 16.1% (3Q19: 16.0%), respectively (see Chart 2.1.6.1). The various policy measures put in place across jurisdictions have helped to ensure that the regulatory capital ratios do not decline below the regulatory minimum on account of the outbreak of the COVID-19 pandemic. While, in the interim, a reduction in credit risk weights for financing to SMEs – for instance, as part of measures to ease the effect of the pandemic – would allow Islamic banks to provide more financing without much infringement of their CAR, the implications may be severe where there is no credible restoration plan, especially if the pandemic is prolonged and causes NPFs to build up and the value of collateralised assets deteriorates.\(^ {79}\)

The Bahraini Islamic banking industry maintained sufficient loss absorption buffers. Specifically, both the CAR and Tier-1 to risk-weighted assets (RWA) ratio fluctuated during the period by initially declining up to 2Q20 before rebounding in 3Q20 to end the period at 18.4% and 16.5%, respectively. This performance was lower compared to, for instance, the Bahraini conventional banks’ CAR of 21.1%. Despite both ratios still being below their pre-pandemic levels as at 3Q20, they were well above the thresholds set by both Basel and the IFSB, as well as the regulatory minimum of 12.5% and 10.5%, respectively, set by the CBB. This could be linked to the benefits from the regulatory changes to prudential standards, especially in recent times, which have helped to improve financial stability in the country. Moreover, the Bahraini Islamic banking sector’s CAR seems not to have been affected by the regulatory capital treatment adopted in the country on the requirements for the modification loss and provisioning for aggregate expected credit loss (ECL) amount relating to exposures classified as Stage 1 and Stage 2.

The regulatory capital ratios of the Omani Islamic banking sector remained healthy. Specifically, the sector recorded a decline in both CAR and Tier-1 capital to RWA up to 2Q20, before registering a rebound in 3Q20 with a CAR of 19.5% and Tier-1 capital to RWA of 13.3%. Although less than the pre-pandemic level, the sector’s CAR is higher than the threshold of 13.5%, which was reduced to 12.3% in March 2020 to counter the economic effect of the COVID-19 pandemic in the country.

\(^ {78}\) These ratios are calculated using the definitions prevailing for regulatory purposes in each jurisdiction. To the extent that these definitions change – for example, as a result of implementing new prudential regimes – this may lead to a change in the ratios and affect the y-o-y comparisons.

The outlook for the regulatory capital of the sector seems favourable based on the healthy pre-COVID-19 capital buffer due to both international and domestic regulatory reforms. Omani banks have, over the years, built the capital buffers needed to absorb shocks. In fact, Tier-1 capital constitutes over 94% of the Omani Islamic banking sector's regulatory capital throughout and prior to the four quarters under review. This indicates that the banks have high-quality capital. The outcome of the CBO's stress test under various severity scenarios based on December 2019 data indicates that all Omani banks would be able to absorb a sizeable increase in NPFs without breaching the thresholds for regulatory capital. Moreover, banks in Oman are generally less exposed to turbulence in the equity markets, as was noted at the outbreak of the pandemic in March 2020.

The Saudi Islamic banking sector maintained a healthy capital buffer. Prior to the outbreak of the COVID-19 pandemic, the sector maintained an average CAR of above 20% and average Tier-1 capital to RWA of above 18%. The impact of the dual shock of a dip in global oil prices and the economic lockdown due to COVID-19 was reflected in the decline recorded in both CAR and Tier-1 capital to RWA ratios in 1Q20. The sector recorded a rebound in its regulatory capital indicators from 2Q20 to reach a CAR of 19.7%, and a Tier-1 capital to RWA ratio of 18.0%, in 3Q20. The key drivers of the increasing capitalisation in the Saudi Islamic banking sector are the corresponding increases in both regulatory capital and RWAs. Specifically, the latter grew faster at 13.1% y-o-y compared to the 10.7% y-o-y and 11.1% y-o-y increase in regulatory capital and Tier-1 capital, respectively, as at end-3Q20. The regulatory capital of the Saudi Islamic banking sector is expected to remain strong on account of a healthy capital buffer, adequate provisioning for NPFs, economic recovery amid an improving operating environment, and a gradual but stable increase in global oil prices.

During the period, the CAR was well above the threshold of 10% set by the CBUC. Specifically, following a decline recorded up to 1Q20, a rebound was recorded in 2Q20 and sustained in 3Q20 with a CAR and Tier-1 capital to RWA ratio of 18.3% and 17.1%, respectively. The capitalisation performance of the UAE's Islamic banking improved across the two capital adequacy indicators on the back of declining RWAs. Moreover, banks in the country have been allowed to use capital buffers worth AED 50 billion, as well as a 15–25% reduction in provisioning for financing advanced to SMEs.

Brunei's Islamic banking sector registered declining regulatory capital indicators, albeit from a high and adequate base. Following an improvement in CAR and the Tier-1 to RWA ratio in 1Q20, the sector registered a back-to-back decline in the following quarters to end 3Q20 at 20.0% and 19.8% respectively.

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60 Average CARs calculation excludes Iran and is based on data from 16 jurisdictions contributing to the IFSB’s PSIIFs database (excluding Afghanistan, Egypt, Kuwait, Lebanon, Libya, Qatar, Sudan and the UK, due to data limitations).
Notwithstanding the decline, the regulatory capital of the Islamic banking sector is well above the regulatory minimum and compares well to that of the entire Bruneian banking sector, which registered a CAR of 21.1% in 3Q20.

Indonesia’s Islamic banking sector continued to maintain adequate but fluctuating regulatory capital ratios in the period under review. Despite the sector having entered the COVID-19 period on a strong and improving note, both the CAR and Tier-1 to RWA ratios have fluctuated to end 3Q20 at 20.4% and 18.8%, respectively. Though this performance has indicated the capacity of Islamic banking in Indonesia to withstand balance sheet shocks and unexpected losses, especially from COVID-19, it is less than the average performance of the entire Indonesia banking system, which recorded a higher CAR of 23.7% as at end-3Q20.

The fluctuation recorded in the regulatory capital ratios also reflected fluctuation and slow growth in the RWA, notwithstanding BI’s support and the relaxation of liquidity conditions and deposit growth. This perhaps reflected the Islamic banking sector’s risk-averse disposition and weak growth in financing advances, especially up to 2Q20. BI has maintained and adjusted macroprudential regulations to ensure that intermediation function is sustained in key sectors such as the property and automotive markets without infringing on prudential principles and risk management. The regulatory capital of Indonesia’s Islamic banking is also expected to strengthen in the periods ahead through the anticipated merger of three of the four largest banks in the country, as well as through the national economic recovery building momentum and strengthening as a result of BI’s policy responses.

The Islamic banking sector in Malaysia entered the pandemic on a strong footing and recorded a declining but adequate regulatory capital performance in the review period. Apparently due to the impact of the pandemic, both the CAR and Tier-1 to RWA started to decline from 1Q20 throughout the period under review, reflecting the trend in the domestic banking sector since the COVID-19 outbreak in which monthly CAR of 17.1% and Tier-1 to RWA of 14.5% were recorded in April 2020, being the lowest since November 2019.

Although the CAR and Tier-1 to RWA of the entire Malaysian banking industry rebounded and increased to 18.3% and 15.1%, respectively, as at end-2Q20, that of the Islamic banking sector recorded a further decline in both ratios in 3Q20 to end the period at 17.7% and 14.0%, respectively. Notwithstanding, both ratios remained well above the BNM’s regulatory capital thresholds of 8.0% and 6.0%, respectively.

Moreover, with an excess capital buffer of RM 123.7 billion as at end-3Q20, the banking sector is in a strong position to continue to cope with the challenges arising from the pandemic, absorbing potential shocks and providing any needed intermediation support to the real economy. In fact, the macro stress test conducted by BNM indicated that the banking system is very resilient, even after factoring in the relatively more challenging scenario experienced in 1H20. Specifically, the stress test reveals that if overall impairments rise by just above 4% of total advances by end-2021, the aggregate capital ratio would decline by 2 percentage points, which is very much covered by capital buffers.

The Islamic banking sector in Afghanistan remained well capitalised. Specifically, the CAR for the Islamic banking industry during the period under review remained higher than the Basel and IFSB regulatory minimum of 8% and the 12% threshold set by the DAB. The CAR and Tier-1 to RWA ratio, however, after improving consistently over the past three quarters, declined to end 3Q20 at 14.4% and 14.1%, respectively. The decline is explained by the increasing losses, and the lower rate of increase in regulatory capital, compared to the RWAs of the full-fledged Afghan Islamic bank. This was contrary to the performance of the entire Afghan banking sector, which recorded q-o-q increases in net equity position due to a gain in revaluation of assets available for sale (AFS) and remarkable profitability throughout 2020.

Based on the size of the Afghan Islamic banking industry, it is expected that the regulatory capital ratios will remain above the regulatory minimum and may start to strengthen as economic recovery from the
effects of the pandemic improves. However, given that one of the key drivers of profitability in the country’s banking sector is gains on currency revaluation, there may be significant implications for capital adequacy due to the volatility of the AFN against the USD.84 DAB has also developed a post-COVID-19 improvement plan with the aim of helping to rebuild capital in the event that it is significantly depleted on account of the pandemic. The plan included suspension of dividend payments, rescheduling of credit facilities, and reclassifying and reweighting of loans collateralised by international aid agencies. Banks, however, are encouraged by the DAB to take precautionary measures in line with the improvement plan to cope with any financial downturn that may result from the pandemic.

The regulatory capital ratios of the Bangladesh Islamic banking sector remained the lowest among the MESA countries and were adequate despite fluctuating during the period under review. The CAR and Tier-1 to RWA improved to end 3Q20 at 12.1% and 7.5%, respectively. These ratios were not only higher than the minimum threshold of 10.0% (or BDT 4.0 billion, whichever is higher) and 6.0% for CAR and the Tier-1 to RWA ratio, respectively, as set by the BB, but also compared favourably with the entire banking industry’s performance of 11.6% and 7.7% for both ratios, respectively, during the period under review.

Given that Bangladesh’s Islamic banks are not known for issuing sukūk for regulatory capital purposes, the increase in its total CAR could be attributed to general credit risk adjustment benefits from increased provisions and reduced NPFs. The effectiveness of the various policy measures put in place by the BB to strengthen the loss absorbency and operational expansion of the Islamic banks in the country was also reflected in the banks’ regulatory performance. The BB permitted banks to recognise 50% of the required provisions made against rescheduled financing due to COVID-19 as general provisions, and as eligible capital from 19 March 2020. Moreover, in March 2020, banks in Bangladesh were instructed not to distribute cash dividends before 30 September 2020 so as to build their capital base.85

The Jordanian Islamic banking sector’s capital adequacy remained one of the highest globally, despite recording fluctuating performance during the period under review. The sector registered a CAR of 23.2% and a Tier 1-1 to RWA ratio of 22.9% in 2Q20, which represented a turning point from the back-to-back decline registered in the two previous quarters. Both ratios declined again, to 22.1% and 21.9%, respectively, in 3Q20. The regulatory capital outlook for the sector is favourable. This is because the regulatory ratios were not only higher than the 12% minimum CAR threshold in the country, but also reflected a high loss absorption capacity in the event of shock as the Tier-1 capital remained, on average, at 99.0% of regulatory capital. The performance of the Islamic banking sector also compared favourably with that of the entire Jordanian banking sector, which recorded a CAR of 17.3%. The instruction by the CBJ that banks in the country should suspend payment of dividends in order to (among other considerations) bolster their capital base, enhance their capacity to mitigate against the impact of COVID-19, and provide the needed intermediation services to quicken economic recovery, bodes well for the sector.

The Islamic banking industry in Pakistan sustained a streak of improved performance in its CAR and Tier-1 to RWA ratio recorded since 2Q18. Specifically, during the period under review, the sector recorded a q-o-q improvement in CAR and Tier-1 to RWA ratio in 3Q20 to end the period at 19.5% and 15.6%, respectively. All capital adequacy indicators were well above the regulatory minimum of 10% for CAR, 7.5% for Tier 1 to RWAs, and 6.0% for CET1 to RWA set by the SBP. Moreover, the performance also compared favourably with those obtained in the entire banking sector of the country during which capital to total assets, and capital minus net non-performing advances to total assets, were 7.5% and 7.0%, respectively, for the period.

The improved regulatory capital performance of the Pakistani Islamic banks, especially during the challenging period of COVID-19, could be linked to the effectiveness of the various policy measures put in place by the SBP. Policy measures such as suspension of dividend declaration for the first two quarters of 2020, and a reduction of the capital conservation buffer by

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84 For example, while a decline of –70.99% q-o-q on gains on revaluation was recorded in 2Q20, an improvement of 56.26% q-o-q was recorded in 3Q20. In fact, the result of the stress test conducted by the DAB reveals that a 20% appreciation in the AFN over the USD will result in an increase in regulatory capital of AFN 27 billion.

85 This measure was later relaxed to allow for payment of dividends to individual investors.
100 basis points to 1.5%, have had a positive impact on the shock absorbance capacity of the Pakistani banks.

Notably, while the regulatory capital, especially Tier-1 capital, increased due to improved profitability and general reserves, Tier-2 capital increased on the back of unrealised gains on AFS and a rise in foreign exchange translation reserve due to depreciation in the Pakistani Rupee. Moreover, in response to the challenging operating environment during the period, regulatory capital also improved due to a contraction and shift to investment in less-risky assets such as federal government securities and ṣukūk and rated corporate exposure.

The regulatory capital of the Islamic banking sector in Palestine remained stable during the period under review. This is despite the fact that a slight decline was recorded in both the CAR and Tier-1 capital to RWA ratio to end 3Q20 at 15.3% and 14.4%, respectively. The slight decline over the period was due basically to the increase in the RWAs as Palestinian Islamic banks complied with the policy measures of the PMA to increase financing to the real economy, especially the SMEs under the “Estidama” (sustainability) scheme.

The outlook of the Islamic banking sector suggests a reasonable resilience on account of the consistently higher proportion of Tier-1 equity capital at an average of 94% of the total regulatory capital, the declining NPF in 3Q20 as economic activities resumed, and the provisioning for NPF, which increased during the same period. The latest stress tests conducted by the PMA also indicate that the banking sector in the jurisdiction is well capitalised above the 8% threshold and, as such, is in a better position to absorb shock, albeit at varying levels of scenario severity that may arise from the peculiar security, political and socio-economic challenges that may take place in the Palestinian economy.

The CAR for the NIB sector in Nigeria, although adequate and among the highest in this report, has been on the decline since 2Q20. The declining trend in CAR continued in 3Q20 to end the quarter at 21.9%. Nonetheless, the CAR for the NIB sector is well above the 10% threshold set by the CBN and the 15.4% registered by the entire banking system as at end-3Q20. The decline in CAR, especially after the COVID-19 outbreak, was due to the increased RWAs following the implementation of the policy measure by the CBN to stimulate the economy by providing financing to the real sector. Although there was a corresponding increase in total qualifying capital, this had a higher moderating impact on the conventional banks in Nigeria. The limited impact on the CAR of the NIB sector in Nigeria could be explained by its relatively small size of only about 0.7% of the total banking assets in the country.

The outlook suggests the NIB sector is resilient against losses on the back of a healthy regulatory capital buffer. The gradual increase in global oil prices, economic reopening and a rapidly developing Islamic banking market also support this expectation. However, much depends on the speed and magnitude of economic recovery from the COVID-19 shock, vaccine roll-out, stable oil prices and production output, improved internal security, and the economic diversification drive of the country to reduce its dependence on the volatile downstream sector.

The participation banking sector in Turkey recorded improvements in regulatory capital indicators up to 2Q20. However, in 3Q20, the CAR and Tier-1 capital to RWA ratio of 18.7% and 15.0%, respectively, recorded by the participation banks represented a decline. Notwithstanding, the regulatory CARs were above both the regulatory threshold of 8.0% and the targeted threshold of 12.0% set by the BRSA.

Generally, the increase in CAR in the domestic banking sector could be linked to the increase in profitability, and to the effect of the increase in equity position due to the announcement by the BRSA in March 2020 that value losses in the portfolio of securities at fair value through other comprehensive income should not be included in the computation of CAR until after 31 December 2020. In April 2020, the BRSA also permitted banks to use a risk weight of 0% on foreign exchange obtained from the central government of Turkey when calculating their risk exposure. The purpose of this measure was to minimise the implications of exchange rate volatility on the CAR of Turkish banks.

The PMA launched the scheme with the aim of providing a soft financing facility to SMEs impacted by the crisis at a low rate of 3% and an extended repayment period of 36 months.
2.0 ASSESSMENT OF THE SOUNDNESS AND RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

Chart 2.1.6.2 Islamic Banking Average Total Capital Adequacy Ratio by Country (3Q19 - 3Q20)

Source: PSIFI and IFSB Secretariat Workings

Chart 2.1.6.3 Islamic Banking Average Tier-1 Capital Adequacy Ratio by Country (3Q19 –3Q20)

Source: PSIFI and IFSB Secretariat Workings
BOX 4. Islamic Banking in the UAE Amid COVID-19
Contributed by the
Central Bank of the UAE

Overview of the Islamic Banking Sector in the UAE

The UAE has a well-established Islamic financial sector, comprising full-fledged Islamic banks, Islamic windows and Islamic finance companies with total assets of AED 782 billion. There are currently eight full-fledged local Islamic banks and two full-fledged foreign Islamic banks licensed to operate in the UAE. In addition, 17 conventional banks have established Islamic windows with an asset size of approximately AED 166.2 billion in 2020, increasing their diversity and market outreach. Furthermore, there are 11 Islamic finance companies in the UAE. Islamic finance companies accounted for 55% (AED 17.6 billion) of total assets of the finance companies sector in 2020. Full-fledged Islamic banks’ assets in the UAE grew by 5.0% during 2020, accounting for about 19% of total banking system assets; while the assets of Islamic windows decreased by 2.4%, accounting for approximately 5% of total banking system assets. The strong growth of the full-fledged Islamic banks in the UAE is reflected by a compounded annual growth rate of 5.6% over the last five years.

COVID-19 and Implications for the UAE Islamic Banking Sector

The UAE Islamic banking sector entered into the COVID-19 crisis from a resilient position with adequate capital and liquidity buffers. The challenging environment affected banks’ credit risk exposures and put pressure on profitability. Nonetheless, as at the end of 2020, the CAR of the full-fledged Islamic banks stood at 19.9%, funding and liquidity buffers were maintained above pre-COVID-19 levels and the financing capacity was sustained. During the course of the pandemic in 2020, financing growth of UAE Islamic banks continued at 7.0% y-o-y; deposits grew by 2.1%, while banks also tapped into capital market funding with a growth rate amounting to 6.8%. The challenging operating environment resulted in higher impairment provisions during 2020, which grew by around 11.7% y-o-y. While the sector remained profitable, aggregate profitability was impacted, reflected by a contraction in ROA (0.9%) vis-à-vis 2019 (1.2%).

The sector was supported by the CBUAE’s TESS programme, which helped to mitigate liquidity pressures and strengthen market confidence. UAE Islamic banks played a substantial role in providing relief to customers negatively affected by the COVID-19 pandemic. Under the TESS programme during 2020, Islamic banks granted payment deferral relief to more than 177,000 customers, 90% of which were individual retail customers. The payment deferrals were supported by a ZCF made available by the CBUAE to both conventional and Islamic banks, against eligible collateral in the form of certificates of deposit. The CBUAE makes available Shari’ah-compliant certificates of deposit based on commodity murabahah, and Islamic banks were advised to make use of this facility to support their drawings on the ZCF.

In addition, banks both conventional and Islamic have been granted temporary relief from certain other regulatory requirements. All banks participating fully in the ZCF are permitted to draw on up to 60% of their capital conservation buffers, and domestic systemically important banks (D-SIBs) are allowed to use up to 100% of their D-SIB buffers. Such banks are also allowed to fall below the LCR requirement of 100% provided that the ratio remains at or above 70%, and a similar adjustment has been made to the alternative eligible liquid assets ratio. All banks are allowed to fall below the NSFR of 100% provided that the ratio remains at or above 90% and a concession has also been made in the ASRR.

Other provisions include prescribing the treatment for provisioning purposes of customers participating in the TESS programme and ensuring that their credit scores are not adversely affected by so doing. More details on

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Figures in this article exclude the Financial Free Zones: Abu Dhabi Global Market and Dubai International Financial Centre
the TESS programme, which currently runs until 31 December 2021, can be obtained from the CBUAE website (https://www.centralbank.ae)

Standardisation and Harmonisation of Sharīʿah Requirements for Islamic Financial Institutions and the Regulatory Landscape

The CBUAE continues to develop its regulatory framework for Islamic financial institutions. With the adoption of the IFSB’s banking prudential standards, the CBUAE has strengthened the overall regulatory framework for the Islamic banking sector. Enhancing corporate governance, including Sharīʿah governance, has been a key focus of the CBUAE. In 2020, the CBUAE issued a landmark standard for institutions housing an Islamic window. The standard addresses issues related to the governance of the Islamic window within the licensed financial institutions, Sharīʿah-compliant management of assets and liabilities, IT systems, and reporting of the Islamic window’s activities.

With a view to supporting the UAE’s vision of becoming the centre for Islamic finance, the CBUAE took major steps in addressing the regulatory needs of the Islamic banking sector. One of the main achievements of the UAE in this regard is the establishment of the Higher Sharīʿah Authority (HSA).

The HSA was established, and its members appointed, as per resolutions enacted by the UAE Cabinet. Decretal Federal Law No. (14) of 2018, regarding the CBUAE and the organisation of financial institutions and activities, reaffirmed the establishment of the HSA and provided further details related to its mandate. The HSA aims to harmonise and standardise the practices of Islamic financial institutions, aligning them with internationally recognised Sharīʿah standards and widely recognised practices through collaboration with the relevant stakeholders. The HSA’s goal is to support the creation of a robust infrastructure that enables further development of the country’s Islamic finance sector and advances the UAE’s vision of becoming an internationally recognised hub for Islamic finance.

The Decretal Federal Law No. (14) of 2018 mandated the HSA to determine the rules, standards and general principles applicable to Sharīʿah-compliant businesses and licensed financial activities, and to undertake supervision and oversight of the Internal Sharīʿah Supervision Committees of licensed Islamic financial institutions. In addition, the HSA is mandated to approve Islamic monetary and financial tools developed by the CBUAE to manage monetary policy operations in the UAE, and to provide its opinion regarding the specific regulatory rules and instructions relating to the operations and activities of licensed Islamic financial institutions.

Guided by its work plan for 2018–22, the HSA in the course of three years adopted Sharīʿah standards issued by the AAOIFI, serving as the minimum requirement for Sharīʿah compliance for Islamic financial institutions. In addition, the HSA introduced a number of Sharīʿah governance measures to strengthen the assurance of Sharīʿah compliance in Islamic financial institutions.
2.0 ASSESSMENT OF THE SOUNDNESS AND RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

2.1.7 Leverage

The leverage ratio is a measure that acts as a supplement to risk-based capital requirements in order to help restrict the build-up of leverage and prevent damage to the financial system, and economy, resulting from any occurring deleveraging process. As per the BCBS and IFSB standards, the leverage ratio is applicable at the level of 3%. The regulatory leverage ratio was reported by eight PSIFIs-contributing jurisdictions, all of which have exceeded the 3% requirement (see Chart 2.1.7.1).

Generally speaking, Islamic banks are less prone to engaging in highly leveraged products, because Sharī`ah requires in principle that all financing be linked to transactions in the real economy – that is, production and trade transactions and activities. Similarly, there are restrictions on debt trading and engaging in products involving undue and excessive speculation (gharar). At the same time, risk-sharing means of raising funds are encouraged. The combination of these measures seriously limits the leverage effects in Islamic finance, although it does not completely eradicate this phenomenon.

Only to a limited extent do Islamic banks use return-paying deposits to leverage their capital. Although they may use unremunerated current accounts for this purpose, with few exceptions such current accounts do not constitute the bulk of an Islamic bank’s funding. Unrestricted PSIAs have historically been one of the major sources of funds for IIFS. Similarly, Islamic banks do not become involved in transactions involving gharar or other leveraged transactions such as collateralised debt obligations or resecuritisations. Nonetheless, there are a few practices and transactions that may involve IIFS in leveraged transactions. Some Islamic banks offer commodity Murabaha transaction (CMT) for liquidity financing to their customers as well as for raising deposits. Reverse CMT-based deposits are a form of leverage, which, together with CMT-based term financing, has the potential to create unlimited debt in the system. Based on the factors highlighted above, the IFSB considers it prudent that regulatory and supervisory authorities that are yet to implement the leverage ratio requirements in their jurisdictions are highly encouraged to do so.

![Chart 2.1.7.1 Islamic Banking Leverage Ratio by Country (4Q19–3Q20)](chart)

Source: PSIFIs and IFSB Secretariat Workings

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Leverage ratio = Tier-1 capital / total exposure
BOX 5. Implications and Effectiveness of Policy Response to the Recovery Phase of COVID-19 for the Islamic Banking Sector in Pakistan
Contributed by the State Bank of Pakistan

Introduction

The banking sector of Pakistan withstood the crisis created by the COVID-19 pandemic in a well-planned manner. This was made possible due to the existence of a robust regulatory and supervisory environment and the capital buffers built over the years. In particular, a broad range of policy actions taken by the authorities (Government of Pakistan, State Bank of Pakistan [SBP], and the Securities Exchange Commission of Pakistan) have helped the financial sector withstand the COVID-19 shock. As a result, the financial services remained uninterrupted even during the stressful phase of the outbreak.

SBP's Policy Response to the COVID-19 Situation

The SBP adopted a proactive approach in assessing the evolving COVID-19-related situation around the globe and within the country, which allowed it to identify the issues in a timely manner and draw policy prescriptions necessary for ensuring continuous provision of financial services and for limiting the impact of the pandemic. In this regard, the SBP took a number of steps to safeguard businesses and households, primarily designed to prevent the liquidity shock transforming into a solvency problem, without compromising on financial stability.

To gather first-hand information from the banking industry, to assess the implications of the COVID-19 pandemic for financial institutions and to firm up its policy response, the SBP conducted two flash surveys in the months of February and April 2020. Since then, the SBP has taken a host of policy measures to mitigate the risks associated with the pandemic. Some of the main measures taken are as follows:

1. Cognisant of emerging risks to macroeconomic stability and extraordinary circumstances, the Monetary Policy Committee (MPC) convened five meetings between 17 March and 25 June 2020 and reduced the policy rate by a cumulative 625 basis points to 7%. This is the sharpest reduction during a short span of time, and also one of the largest reductions in the policy rate, among the emerging economies. This aggressive monetary easing helped lower the borrowing cost to private and public businesses and households.

2. The SBP introduced a broad range of macroprudential measures to facilitate the financial sector in supporting the real sector of the economy and enhancing the loss absorption capacity of banks, including:
   - To support the banking sector to supply additional loans to businesses and households, the capital conservation buffer (CCB) was reduced from 2.5% to 1.5%. This relaxation made available an additional approximately Rs 800 billion for lending/investments.
   - To ease out borrowers’ repayment capacity, banks/DFIs were advised to defer repayment of principal loan amounts for one year, including the repayment of ṣukūk and term finance certificates.
   - The debt burden requirement was relaxed for consumer loans from 50% to 60%. This measure enabled approximately 2.3 million individuals to borrow more from banks.
   - The margin requirement on exposure against shares of listed companies was relaxed from 30% to 20%, and margin calls from 30% to 10%, to counter volatility in the Pakistan Stock Exchange.
   - A bar was placed on declarations of dividends for two quarters.
   - Banks/development financial institutions (DFIs) were allowed to recognise impairment loss, if any, resulting from the valuation of listed equity securities held as “available for sale” (AFS) in a phased manner equally on a quarterly basis during the calendar year ending December 2020.
   - Banks/DFIs were allowed to take exposure against the shares issued by their group companies to ease out those companies' liquidity requirements.
   - The criterion for classification of “trade bills” was relaxed by six months until September 2020.
   - The regulatory retail portfolio limit of Rs 125 million was increased to Rs 180 million for CAR calculations to support the growth of credit to the retail sector and SMEs.

3. The SBP introduced three refinancing schemes to prevent rising unemployment, to encourage investment activities, and to support the hospitals and health sector in providing services to fight the COVID-19 pandemic.
2.0 ASSESSMENT OF THE SOUNDNESS AND RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

a. Refinance Scheme for Wages to Prevent Layoffs (Rozgar Scheme)

<table>
<thead>
<tr>
<th>Cumulative Position as of</th>
<th>Requests for Financing</th>
<th>Approved Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. of Businesses</td>
<td>Amount PKR in million</td>
</tr>
<tr>
<td>13-Nov-2021</td>
<td>3,494</td>
<td>276,230</td>
</tr>
</tbody>
</table>

b. Refinance Facility for Combating COVID-19 (RFCC)

<table>
<thead>
<tr>
<th>Cumulative Position as of</th>
<th>Requests for Financing</th>
<th>Approved Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. of Hospitals</td>
<td>Amount PKR in million</td>
</tr>
<tr>
<td>25-Mar-2021</td>
<td>48</td>
<td>16,668</td>
</tr>
</tbody>
</table>

c. Temporary Economic Refinance Facility (TERF) (to Boost New Investments)

<table>
<thead>
<tr>
<th>Cumulative Position as of</th>
<th>Requests for Financing</th>
<th>Approved Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No. of Projects</td>
<td>Amount PKR in million</td>
</tr>
<tr>
<td>25-Mar-2021</td>
<td>652</td>
<td>639,618</td>
</tr>
</tbody>
</table>

4. The SBP took various measures to support exporters and importers, including:
   • Extension of time for settlement of foreign currency loans
   • Reduction of markup rate under the long-term financing facility (LTFF)
   • Relaxation of conditions for accessing credit under LTFF
   • Increasing time period for realisation of export proceeds
   • Enhancing advance payments limit for industrial imports.

5. To ensure the availability and continuity of financial services, the SBP issued a set of guidelines to banks, DFIs and microfinance banks (MFBs) to raise awareness regarding the pandemic, encourage customers to utilise alternate delivery channels (ADCs), and to make arrangements for the provision of uninterrupted financial services through ADCs in coordination with market participants.

6. To promote digital payments, the SBP issued instructions to waive charges on online fund transfer services to limit the physical contact of customers at branches. As a result, the volume of internet banking and mobile banking increased by 52.9% and 112.8%, respectively, during 9MCY20 (on a y-o-y basis).

7. The SBP also ensured a sufficient supply of fresh or disinfected cash to prevent the spread of the disease.

8. To enable customers to open and use the Branchless Banking (BB) platform, the deadline for biometric verification of legacy BB Level-1 accounts was extended to 30 September 2020.

9. The SBP encouraged authorised financial institutions (AFIs) to introduce biometric verification through smartphone applications and to use digital channels for BB agents’ onboarding with the objective of increasing the number of financial services access points.

10. In aggregate, the SBP has provided liquidity support of Rs 1.98 trillion (4.74% of GDP) to households and businesses since the outbreak of COVID-19.

The unconventional regulatory response to the financial sector in the context of the COVID-19 economic environment has yielded the desired results. There have been seamless liquidity management adjustments by individual players to answer withdrawal requests by their customers who were severely impacted by the economic lockdown. The availability of finance to the real sector at subsidised rates helped the economy to remain afloat, albeit at a slowed pace. The relief in terms of a moratorium on principal payments also helped entrepreneurs to remain operational. Measures taken for SMEs helped economic sentiment to remain alive, although temporary slowdowns in economic activity affected businesses due to lockdown restrictions and social distancing measures during H1CY20. However, as the virus restrictions eased, economic recovery began to strengthen in the second half of Cy20.
2.0 ASSESSMENT OF THE SOUNDNESS AND RESILIENCE OF THE
ISLAMIC FINANCIAL SYSTEM

Impact of SBP’s COVID-19 Relief Measures

<table>
<thead>
<tr>
<th>SBP Measures</th>
<th>Amount in PKR billion</th>
<th>Percent of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest rate benefit**</td>
<td>470</td>
<td>1.13%</td>
</tr>
<tr>
<td>Loan deferment</td>
<td>657.2</td>
<td>1.57%</td>
</tr>
<tr>
<td>Loan rescheduling</td>
<td>229.4</td>
<td>0.5%</td>
</tr>
<tr>
<td>Rozgar scheme</td>
<td>238.2</td>
<td>0.57%</td>
</tr>
<tr>
<td>New investment TERF/BMR</td>
<td>374.3</td>
<td>0.90%</td>
</tr>
<tr>
<td>Support for hospitals</td>
<td>10.1</td>
<td>0.02%</td>
</tr>
<tr>
<td><strong>Total Impact</strong></td>
<td><strong>1,979</strong></td>
<td><strong>4.74%</strong></td>
</tr>
</tbody>
</table>

*Progress as of 8 February 2021

SBP’s Regulatory Initiatives for Islamic Banking during the COVID-19 Pandemic

The SBP has played a pivotal role in the promotion and development of Islamic banking in the country. Being cognisant of the importance of the evolving Islamic banking industry, the SBP always endeavours to provide a level playing field to the Islamic banking industry. The COVID-19 outbreak has resulted in a range of implications for all types of financial institutions, and Islamic banking is no exception, being part of the banking system. The SBP embraced this challenge and rapidly rolled out a series of measures to protect the economy from the adverse economic impact of the COVID-19 pandemic, and all these measures (elaborated in the previous section) were also available to the Islamic banking industry and its customers. Some highlights for addressing the specificities of the Islamic banking industry may be observed from the following.

The SBP rolled out different refinancing schemes, as highlighted in the above section, to mitigate fallout from the COVID-19 outbreak. While introducing these different refinancing schemes, the SBP ensured the availability of Islamic versions of these schemes in order to enable Islamic banking institutions (IBIs) and their customers to recover from uncertainties over the worsening effects of the COVID-19 outbreak. In this context, the SBP issued Islamic versions of refinance schemes, such as an Islamic temporary refinancing facility, an Islamic refinancing facility for combating COVID-19, and an Islamic refinance scheme for payment of wages and salaries to the workers and employees of business concerns.

Further, with a view to facilitating the customers of IBIs and ensuring the smooth implementation of relaxation provided in respective prudential regulations related to deferment of principal or rescheduling/restructuring of financing facilities, the SBP issued guidelines for rescheduling/restructuring of financing facilities according to Sharī‘ah principles in April 2020. The issuance of these guidelines helped IBIs and their customers to deal with their specific Sharī‘ah-compliant modes of financing and offered possible solutions to address deferment or rescheduling and restructuring of financing facilities.66

Performance of the Islamic Banking Sector during the COVID-19 Pandemic

The overall assets and deposits of the Islamic banking industry have shown tremendous growth of 30% and 27.8%, respectively, during CY2020. The assets of the Islamic banking industry increased to Rs 4,269 billion, whereas deposits reached Rs 3,389 billion, by end-December 2020. As a result of this growth, the share of the Islamic banking industry’s assets in the overall banking industry’s assets increased to 17.0% by end-December 2020, compared to 14.9% by end-December 2019. Similarly, the share of the Islamic banking industry’s deposits in the overall banking industry’s deposits reached 18.3% by end-December 2020, compared to 16.6% by end-December 2019 (see figure below). The growth witnessed in assets and deposits of

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The Islamic banking industry is encouraging, particularly given that the industry was also faced with the challenges posed by the COVID-19 pandemic during 2020.

Financing (net) of the Islamic banking industry grew by 16% during CY2020. The asset quality of IBIs reflects an improvement compared to December 2019. The gross non-performing financing ratio (GNPFR) fell to 3.2% by end-December 2020 from 4.3% by end-December 2019. The provisioning coverage ratio also rose to 82.4% by end-December 2020 (from 54.0% in December 2019), which helped to improve the net NPF to net financing ratio to 0.6% by end-December 2020 (from 2.01% in December 2019).

The profit after-tax of IBIs remained at Rs 59.5 billion by end-December 2020, which was higher than the Rs 45.5 billion registered during the same period the previous year. The improved profitability was due mainly to higher core income (i.e. net profit income). With improved profitability, the resilience of IBIs – measured by the capital adequacy ratio (CAR) – increased to 16.6% by end-December 2020 (from 15.4% at December 2019). The prevailing CAR level is well above the minimum local and global requirements of 11.5% and 10.5%, respectively.

The Future Outlook

- The banking sector, including the IBIs, has withstood the pandemic-related uncertainties owing to capital buffers built over the years. This is in line with the stress test results reported in the Financial Stability Review (FSR) 2019, which showed that the banking sector, in general, would remain resilient to the various shocks, including COVID-19, during the medium term.
- However, the pandemic remains a major concern, despite the commencement of vaccination at home and abroad. This is because complete immunisation will take a considerable time given the population size and vaccine supply bottlenecks. Also, the emergence of COVID-19 variants may challenge the medical progress achieved so far.
- The aggressive liquidity support provided by the SBP in times of COVID-19 has helped to mitigate the risks to the financial system and the economy. However, any untimely winding up of its policy intervention could generate financial stability concerns such as elevated levels of credit risk.
- According to the latest Systemic Risk Survey (SRS), conducted in August 2020, the respondents perceive the critical risks for the financial system in the next six months to be mostly exogenous and global in nature.
- While COVID-19 has allowed banks to convert this stress situation into opportunities by enhancing digital payment services, it also raises cyber-security concerns.
2.2 Islamic Capital Market Resilience and Stability

The COVID-19 crisis signifies the greatest test of the resilience of the Islamic finance industry since the 2008 Global Financial Crisis, when Islamic finance segments showed relative stability. In general, the global financial system is faced with the dual challenge of sustaining the flow of financing to the real economy while preserving financial resilience. While the core of the financial system is more resilient entering this crisis, the initial shock of the COVID-19 pandemic placed the global financial system under considerable strain and liquidity stress, creating tighter financial conditions in the Islamic capital markets. The market strain was felt most strongly by emerging markets, including most core Islamic finance jurisdictions, which experienced the sharpest portfolio flow reversal to date, presenting serious challenges to more vulnerable countries. Although global financial conditions have eased and financial markets recovered over the year as a result of policy actions taken by most jurisdictions, the risks to global financial stability remain elevated. Continuing uncertainty about the duration of the pandemic, and the potential for deterioration of credit quality of issuers and for increased market volatility, elevate the potential vulnerability of the Islamic capital markets.

The COVID-19 pandemic and its impact on macro-economic prospects and on sovereign and corporate balance sheets continues to present downside risks for financial stability, including that of Islamic capital markets. While near-term financial stability risks have so far been contained, vulnerabilities that were exacerbated by the pandemic could materialise in the medium term. Weakened corporate fundamentals have the potential to translate into increasing default rates. This is particularly true for riskier firms that are more highly leveraged amid low funding costs in recent years and which currently face a downgrade risk.

The economic impact of the pandemic has been uneven across countries. Those countries that were more affected by the ramifications of the pandemic and have less fiscal policy room to deal with them are projected to recover more slowly than those that were less affected. While near-term concerns have been alleviated, significant uncertainty remains. Over the medium term, countries’ swiftness in containing the virus and in opening up their economies, the economic conditions in various jurisdictions and their pace of economic recovery, as well as whether any existing vulnerabilities have been worsened by the pandemic and jurisdictions’ ability to effectively mitigate such risks, will determine the resilience and stability of Islamic capital markets in the various jurisdictions.

2.2.1 Ṣukūk

The ṣukūk markets proved to be fairly resilient during the year, supported by accommodative policy actions. Despite a sell-off in March 2020, fixed-income returns for emerging markets and high-yield ṣukūk recovered, and in some cases even surpassed their pre-pandemic levels. A resurgence in issuances was also observed, with some jurisdictions even increasing annual issuances from their pre-pandemic level.

Notably, although the volume of ṣukūk issuances dropped in 2020, ṣukūk issuances denominated in foreign currencies increased by 7% [2019: local currency 77%; foreign currency 23%] due to favourable liquidity and global market conditions created by the policy actions taken by central banks (see Chart 2.2.1.1). The increase in foreign currency international issuances was supported by issuances from multilaterals including the IsDB and the IILM, issuances by Islamic banks including Tier-1 instruments, as well as USD issuances from Turkey, Indonesia, Bahrain and the UAE.

![Chart 2.2.1.1 Ṣukūk Issuances by Market (2020)](source: IFSB Estimates based on data from Bloomberg, Eikon-Refinitiv and Regulatory Authorities)

Malaysia and Saudi Arabia contributed to the strong local currency domestic issuances (see Chart 2.2.1.2). Malaysia continued to be a strong domestic issuer in 2020, although slightly more muted than in 2019, which
contributed significantly to the local currency/domestic issuances in 2020. Saudi Arabia also relied on its domestic sovereign sukūk programme in 2020 as part of its public debt strategy, with issuances by the National Debt Management Center (NDMC) of the Ministry of Finance (MoF) under the Saudi Arabian government’s Saudi riyal (SAR) denominated sukūk issuance programme.

Additionaly, despite an increase in the underlying credit risk, credit conditions remained favourable in 2020. While regulatory forbearance and liquidity support measures in many countries have been effective in avoiding or postponing the materialisation of credit risk, there is an increased possibility of corporate insolvencies and a need for restructuring or default of sukūk issuers with lower credit quality or that are more dependent on supportive market conditions. Due to the COVID-19-related disruption and low oil prices, an increasing proportion of corporate issuers have either been downgraded or face a negative rating outlook; consequently, the proportion of sukūk from issuers with negative outlooks has increased sharply. The majority of downgrades were in the high-yield segment, while investment-grade ratings have been comparatively resilient.

While there is a notable proportion of sukūk outstanding that are investment grade, the share of sukūk having lower than investment-grade ratings is also increasing. Those issuers who are more vulnerable
may find it more difficult to weather a pull-back of policy support measures, renewed economic shocks or financial market turbulence. This could, in turn, cause risk premia to rise and financial conditions to tighten. If the pandemic continues for much longer, the increasing debt burden of corporates can potentially turn into solvency issues. Different sectors may be affected to different extents, with the sectors that were affected by travel restrictions and lockdown measures facing the most pressure, as well as some pressure on the real estate sector in some regions.

A number of ṣukūk restructurings took place in 2020, while one international ṣukūk publicly defaulted. The restructurings in 2020 included: PT Garuda Indonesia, which extended the maturity of its ṣukūk by three years; Malaysian Airlines, which deferred by six months its USD 362.5 million ṣukūk and in early 2021 announced a restructuring; and NMC Health plc, which defaulted. Going forward, it is expected that there could be more requests for extensions or restructurings among ṣukūk issuers in 2021, along with possible defaults if downside risks materialise. However, notwithstanding the potential challenges facing ṣukūk issuers in 2021, the baseline expectations of default rates remain well below the levels seen during the Global Financial Crisis.

Short-term ṣukūk issuances contracted slightly but remained a significant portion of issuances in 2020. Liquidity support provided by central banks to counter liquidity constraints created by the pandemic lessened the need for ṣukūk issuances for liquidity management purposes in some jurisdictions, which contributed to a slightly lower volume of short-term issuances in 2020. However, short-term instruments for liquidity management were still significantly higher compared to pre-2019 levels. This was supported by continued issuance by the IILM, as well as from several jurisdictions including Bahrain, Brunei, Bangladesh, Kuwait, Turkey, Malaysia, Indonesia and Gambia.

The issuance of ṣukūk with maturities longer than 10 years also saw a contraction in 2020 relative to 2019. Around 42% of issuances in 2020 had maturities longer than five years. As discussed in the Sr2020, ṣukūk with longer maturities may create pockets of vulnerability in countries with higher debt levels. Given the economic impact of the pandemic and the resulting increase in both sovereign and corporate debt burdens, countries with high refinancing needs could potentially face rollover risks if conditions deteriorate. While approximately USD 65.9 billion of outstanding ṣukūk will mature in 2021, around 50% will mature in the next five years and 70% in the next 10 years, increasing the refinancing needs over the medium term. Slower economic recovery or further weakening of macroeconomic conditions could result in the emergence of fiscal vulnerabilities in some countries, which could, in turn, create challenges for financial stability.

Chart 2.2.1.3 Maturity Trend of All New Issuances (2008–20)

Source: IFSB Estimates based on data from Bloomberg, Eikon-Refinitiv and Regulatory Authorities
There has been considerable progress in increasing use of different types of Shari’ah-compliant contract types, which had historically been largely dominated by murabahah contracts. In 2020, the four most prominently utilised contract types — murabahah, ijarah, wakalah and hybrid — were almost similarly distributed. However, the use of profit-sharing contracts remains relatively low, with the market continuing to favour contract types with stable return profiles.

The geographical distribution of ṣukūk investors for international issuances in 2020 indicates that there is no longer a regional bias in ṣukūk investors, with all issuances receiving interest from international investors. As observed by the geographical distribution of investors in international ṣukūk issued from the GCC, apart from issuances by the IsDB, all other issuances had more than 50% of their investors from regions other than the MENA region. In particular, a high investor uptake from the UK/Europe and the US/Others also indicates capital flows from these regions into core Islamic finance markets and instruments due to the low interest rate environment and search for yield.

Chart 2.2.1.4 Ṣukūk Issuance by Structure (2020)

Source: IFSB Estimates based on data from Bloomberg, Eikon-Refinitiv and Regulatory Authorities

Chart 2.2.1.5 Geographical Distribution of Selected Ṣukūk Papers Issued in 2020

Source: IFSB Estimates based on data from Bloomberg and Eikon-Refinitiv
Investor breakdowns for new ṣukūk issuances in 2020 indicate a high demand from fund managers for ṣukūk, which mirrors the increase in fixed-income Islamic funds. There was also a high demand from Islamic banks for investment-grade ṣukūk. Consistent with previous trends, central banks tended to have a strong preference for the AAA-rated ṣukūk issued by the multilateral IsDB, while also taking up other corporate investment-grade ṣukūk.

**Chart 2.2.1.6 Investors’ Breakdown of Selected Ṣukūk Papers Issued in 2020**

The yield buckets for outstanding ṣukūk have shifted higher, with almost 80% yielding 3–10% (see Chart 2.2.1.7). Globally, the low-yield environment continues to encourage investors to search for yield, which contributed to the flow of funds back into emerging market ṣukūk, despite the ongoing economic recession. While inflow of funds into the emerging ṣukūk market is expected to push yields down, this has not been apparent, for a number of possible reasons. One may be that while there has been fund inflows into the ṣukūk market, it has not been large enough to result in a noticeable drop in yields because trading in the ṣukūk market is more limited, as investors tend to hold until maturity. A second reason for the shift towards higher yields in the ṣukūk market may be the rating downgrades for some ṣukūk issuers as a result of the recession. There was a predominant move towards negative rating actions by rating agencies in 2020, as the COVID-19 pandemic and lockdown put a strain on some issuers’ finances, particularly those in sectors that were most affected by lockdowns.

**Chart 2.2.1.7 Outstanding Volume of Ṣukūk by Yield Bucket (%) (2009–20)**

Source: IFSB Estimates based on data from Bloomberg and Eikon-Refinitiv
2.2.2  Islamic Funds

Investment funds weathered the market turmoil in early 2020 without any significant disruptions, and with only limited use of measures such as redemption restrictions and swing pricing, owing partly to the regulatory reforms and unprecedented actions taken by central banks to limit the impact of the pandemic. The value of assets under management of Islamic funds continued to increase in 2020 (see Section 1.3), indicating the overall resilience of this segment. Islamic funds tend to be more resilient due to the requirement to comply with Sharī‘ah principles that exclude riskier types of funds such as hedge funds or stable net asset value money market funds. This may have contributed, in part, towards limiting the impact of market volatility and other effects of the pandemic on Islamic funds. Another factor was the increased global liquidity as a result of policy measures and the resulting flow of funds into emerging market funds, particularly into more liquid money market funds. However, despite the more accommodative environment created by these policy measures, investor preferences for liquidity and flight-to-safety during times of uncertainty resulted in some outflows from investment funds that invest in less-liquid, fixed-income assets.

Islamic funds were primarily concentrated in money market, equity and fixed-income asset classes in 2020. The shift towards greater diversification across the different asset classes has continued in most of the core Islamic finance countries (see Chart 2.2.2.1). However, the pandemic and the uncertain environment have increased the preference of risk-averse retail investors for the relative safety of money-market-focused funds.

The size of Islamic funds has notably improved, particularly funds that have assets under management greater than USD 95 million (see Chart 2.2.2.2). This points to considerable progress in building the scale of Islamic funds. While the size of funds has increased, Islamic funds remain small relative to conventional funds and therefore create less concern related to their potential systemic risks if the global financial environment becomes more challenging.

Overall, in terms of financial stability risks in the near term, materialisation of any downside risks could result in an increase in risk aversion along with a surge in demand for safe assets, resulting in outflows from open-ended funds. While central bank support has relieved liquidity pressures in most markets, given that overall market uncertainty persists, the expected materialisation of economic downside risks through credit downgrades, defaults and declining market values has the potential to increase redemption pressure on the funds sector. Therefore, it is critical to ensure that funds’ underlying assets are liquid, fund managers are able to assess their value, and liquidity risk management practices are effective.

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Which limit redemptions for a certain time.

Where redemption prices are adjusted to account for transaction costs.

Noting the limitation in data availability, as the databases used may not capture all funds.
2.0 ASSESSMENT OF THE SOUNDNESS AND RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

Chart 2.2.2.2 Number of Islamic Funds by Asset Size (USD million) (2020)

<table>
<thead>
<tr>
<th>Year</th>
<th>&lt;USD5mln</th>
<th>USD5mln-USD25mln</th>
<th>USD25mln-USD95mln</th>
<th>&gt;USD95mln</th>
</tr>
</thead>
<tbody>
<tr>
<td>2020</td>
<td>32.2%</td>
<td>26.5%</td>
<td>23.0%</td>
<td>18.2%</td>
</tr>
<tr>
<td>2019</td>
<td>32.4%</td>
<td>30.5%</td>
<td>22.1%</td>
<td>13.9%</td>
</tr>
<tr>
<td>2018</td>
<td>33.3%</td>
<td>30.2%</td>
<td>23.4%</td>
<td>13.0%</td>
</tr>
<tr>
<td>2017</td>
<td>38.3%</td>
<td>30.9%</td>
<td>20.4%</td>
<td>10.4%</td>
</tr>
<tr>
<td>2016</td>
<td>43.0%</td>
<td>30.0%</td>
<td>19.0%</td>
<td>8.0%</td>
</tr>
</tbody>
</table>

Source: IFSB Estimates based on data from Bloomberg and Eikon-Refinitiv

2.2.3 Islamic Equity Markets

The global equity markets demonstrated a rapid recovery from the losses suffered due to market volatility and the steep crash in March 2020. Recovery in equity markets was aided by lower real interest rates coupled with the improved sentiment stemming from the global monetary and fiscal policy responses and a better-than-expected macroeconomic outlook.

Departing from the previous trend, emerging markets indices outperformed developed markets indices in 2020. In recent years, the returns of emerging markets have generally lagged those of developed markets. The strong growth in emerging markets reflects, in part, attractive valuations, positive prospects for economic recovery and currency tailwinds. In terms of regional performance, Greater China’s indices recovered quickly and outperformed other regional indices in 2020. The Asia-Pacific and GCC indices were relatively more muted, the latter being partly reflective of the poor performance of the energy sector in 2020. Equity markets in China and the United States outperformed other markets, largely driven by technology stocks.

While the performance of the equity market in 2020 and early 2021 has been broadly in line with forward-looking indicators, the risk of an abrupt equity market correction remains elevated, albeit diminishing. According to the IMF, stretched valuations in risk asset markets persist, despite the repricing in equity markets in September 2020, resulting in a disconnect between the rising market valuations and the evolution of the economy, which may also reflect, in part, investor expectations of continued policy support. This disconnect has been evidenced by the notable divergence between elevated economic uncertainty and compressed equity market volatility, although this gap has narrowed during the September sell-off. It has nevertheless created some concern that overvaluations may be at historically high levels in some countries and a market correction might follow, although this concern has diminished.
Returns of Equity Indices across Countries and Regions

**Chart 2.2.3.1**

- Dow Jones Global Index
- Dow Jones Islamic Market World Index

**Chart 2.2.3.2**

- Dow Jones Islamic Market World Emerging Markets Index
- Dow Jones Islamic Market Developed Markets Index

**Chart 2.2.3.3**

- Dow Jones Islamic Market GCC Index (USD)
- Dow Jones Global Index
- Dow Jones Islamic Market Asia/Pacific Index

**Chart 2.2.3.4**

- DJIM Developed
- DJIM Emerging

**Chart 2.2.3.5**

- DJIM Greater China
- DJIM Asia Pacific
- DJIM Europe
- DJIM GCC

Source: Bloomberg and Eikon-Refinitiv
2.2.4 Islamic Capital Market Stability Outlook, 2021

The market outlook seems to be currently positive, with the core Islamic finance countries – GCC countries, Malaysia, Indonesia and Turkey – expected to recover from the sharp recession experienced in 2020, albeit that recovery is expected to be generally slower than in developed countries. Oil prices are also expected to stabilise in 2021, which is likely to contribute to improved financing conditions in core Islamic finance markets and enable the global sukūk market to perform better in 2021.

However, downside risks for the core Islamic finance countries persist, including how quickly the COVID-19 pandemic can be controlled, the risk of a slower economic recovery than expected and further deterioration of economic conditions. Although geopolitical risks and trade uncertainty have declined, other factors, including economic policy direction, remain uncertain. The timing and depth of the pandemic could vary substantially across countries, with some economies expected to recover more quickly, while some emerging markets may experience more prolonged crises. Emerging market economies are also facing a risk of elevated financial and external sector vulnerabilities, as governments have increased their debt levels amid the pandemic and have limited fiscal space to support the slow recovery.

The outlook remains highly uncertain as vulnerabilities rise amid a prolonged pandemic, which may present potential headwinds to recovery. While global financial conditions are currently stable with receding fears of a financial crisis and improved global risk sentiment, a high degree of uncertainty remains regarding when lockdowns can end and economies can reopen completely. Although policy measures remain in place and have been effective so far, a growing number of more highly leveraged corporates with weakening fundamentals may result in the emergence of vulnerabilities within the capital markets, including downgrades, sukūk defaults and restructurings.

The Islamic funds sector is expected to remain stable and resilient, given the reduced exposure to high-risk assets. However, Islamic funds are nonetheless vulnerable to global economic and financial stressors, and therefore liquidity risk management remains particularly important for this sector.

The Islamic equity markets are currently at an all-time high, with Islamic indices outperforming conventional ones at a greater differential than ever before. However, the performance and volatility of Islamic equity markets are also largely in tandem with the conventional markets. Some concern remains of overstretched valuations in global equity markets, along with fear of a possible market correction. Globally, valuations of equity markets appear stretched, notwithstanding the repricing in equity markets in September 2020. This may, in part, reflect investors' expectations that policy support will continue and financing conditions will remain favourable, despite the recession. However, the risk of an abrupt equity market correction remains a concern, albeit a diminishing one. The reduced fear of a market correction reflects both a decrease in investor risk aversion as well as a fall in perceived probabilities attached to downside risk scenarios.

The role of regulators remains important in the recovery phase, and a combination of monetary, fiscal and financial policy action by countries would be required to enable a steady and sustainable recovery. Close, continuous monitoring and coordination will be essential to safeguard market confidence, and to contain financial stability risks in financial markets of vulnerable countries. Continued efforts to develop the Islamic capital markets remain important, with a need for deeper and more liquid markets to ensure financial stability and resilience to shocks that emanate from volatile capital flows to which emerging markets are more susceptible. As such, it would be essential to take steps to deepen the Islamic capital markets to ensure they are sounder and more resilient during periods of crisis.
2.0 ASSESSMENT OF THE SOUNDNESS AND RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

BOX 6. The Impact of the Pandemic on Liquidity and the Role of the IILM

Contributed by the International Islamic Liquidity Management Corporation

In 2020, the unprecedented event of a global pandemic affected not only the financial services industry, but also the lives and livelihoods of many participants. From conventional banks to institutions offering Islamic financial services (IIFS), all market participants suffered from the unexpected market sell-off, which was almost like that experienced during the 2008 Global Financial Crisis (GFC). However, Islamic banks entered the March 2020 crash better capitalised than during the GFC. The main difference between the two episodes of financial crisis was not only the immediate intervention from central banks to mitigate the liquidity stress, but also the unknown impact of the global economic shutdown in countering the spread of the pandemic. Pricing, risk metrics and credit exposures have been stressed, with a major impact on short-term funding, especially the USD-denominated markets – the industry benchmark.

Financial distress often targets vulnerable countries and institutions. This time, the rule stands, with emerging markets bearing the heaviest risk burden. The IIFS, mainly present in emerging countries, faced the same situation, with reforms resulting from the GFC and the nature of asset-backed business mitigating the damage. The development of Islamic market infrastructures, as well as industry standards and tighter regulations as a result of the post-crisis reforms (capital ratio, risk exposure, collateral treatment, etc.), enabled institutions to absorb the COVID-19 market shocks.

The establishment of the IILM as a cross-border liquidity tool provider is an example of this development, helping institutions to cope with liquidity issues within both the Islamic and conventional finance worlds. The access to high-quality assets contributed to stabilising the industry, including banks and non-bank financial institutions. As a complementary tool, the IILM ṣukūk blends perfectly with fiscal and monetary policy established by central banks to maintain the flow of liquidity within the economies and serve all financial institutions.

Even though the IFSI has developed, this crisis is a reminder of the long road to achieving long-term stability. International bodies and central banks can impact the macro landscape but are limited in action. The IILM aims to offer readily available tools such as high-quality assets dedicated to helping institutions to manage their liquidity while complying with regulations. The 2020 COVID-19 crisis was a real test drive, showing the importance of such institutions and their implementation.

At the heart of the pandemic back in March 2020, the IILM was able to address the demand for high-quality liquid papers, which reached its highest level since the GFC, by successfully issuing various tenors and thus helping Islamic banks to mitigate the effect of adverse market conditions while complying with their local regulations. This was accentuated in regions where the IILM issuances benefit from regulatory ṣukūk treatment. The total volume of the IILM monthly issuances remained unchanged, while some tenors were adjusted to fit the investors’ need for liquid papers. As regulatory requirements became paramount in this context of uncertainty, the need for papers classified as Level 1 high-quality liquid assets (HQLA) followed suit. The banks mainly use very short tenors to fulfil this requirement; therefore, the IILM chose to increase the supply of the one-month tenor through the year, which was in high demand. Indeed, asset–liability management desks and financial institutions overall were looking to park cash in the short-term bucket through safe-haven instruments.

On the other side of the IILM business model is the funding platform. The industry evolution since the GFC in 2008 highlighted the need for a diversified and secure financing platform. When properly regulated, a diverse financial system has the capacity to distribute...
risk more efficiently, grow economic resilience and allocate funds more effectively towards their most productive uses: serving the economy and global welfare. The unique platform developed by the IILM acts as a real partner to governments and central banks in their objective of providing stability and support to economies.

In 2020, the IILM outstandingly extended its funding base from USD 1.96 billion in January to USD 3.51 billion in September, as a result of its primary dealership structure, which enabled it to increase its total programme size to USD 4 billion. The IILM's business model is a two-way street and acts on both ends of the value chain and liquidity stream, providing liquidity tools for Islamic financial institutions and a funding platform for sovereign entities' investments. Funding needs have surged tremendously after the shock of the start of the pandemic, from all levels, and especially from sovereigns, which needed to take measures in anticipation of the adverse impacts on the budget and on the state's foreign reserves. Therefore, as per its mandate, the IILM has moved to support financing of sovereign entities in ways that fit the programme's requirements. The extent of the needs justified a programme increase up to USD 4 billion to cater for the borrowing entities' needs.

The IILM has worked closely with regulators and international bodies to contribute to the set-up of an international market infrastructure standard. The IFSI is growing, and its sustainability is linked to its framework and regulation, which are the basis for liquidity. So, while the credit spread and credit default spread (CDS) level of most entities spiked during spring 2020, most equity spread widened beyond normal, signalling a real decline in liquidity. In other words, the financial system caught a bug. Liquidity dried up and price discovery was impaired. Given the exceptional circumstances and the high volatility, some of these developments were expected. But the sharp increase in the yields of the safest global government bonds despite a flight to quality (US Bills) suggested a divergence in the markets. Despite this adverse situation, the IILM grew its offer to address an increasing demand from investors and institutions for a Shari’ah-compliant liquidity solution to serve its regulatory duty while strengthening its portfolio and balance sheet.

Across the global markets, the banking sector has experienced a prolonged slump of profits due partly to the unprecedented monetary stimulus that drove rates to all-time low levels. In addition, the GCC-based banks have suffered from the fall in oil prices driving down project market activity. Islamic banks could be more vulnerable to the current operating environment than their conventional peers, as they tend to have greater exposure to the real estate sector due to the asset-backing principle inherent in Islamic finance. Real estate being the preferred form of collateral, and with its value having declined for most of the GCC markets over the past three years, the banking sector will have challenges to overcome. Those weaknesses are pointing to stress signals in the liquidity system and funding activity. This stress is strongly mitigated by the structural aspect of the GCC banking sector, which benefits from an abundant liquidity. The unprecedented support provided by central banks regionally and globally will continue to alleviate pressures from the economic spillovers.

Policymakers, alongside central banks, will have an important role in safeguarding and preserving the stability of global financial markets and maintaining the health of the industry and system. Creditworthiness of borrowers has been challenged in more ways than one. The 2020 crisis is not simply about credit risk and solvency; it is mainly about liquidity – which drives the fluidity of exchanges that fuel the economies. This is where the IILM and other major international institutions play a vital role, on top of the central banks' policies, in ensuring that Islamic banks have high-quality liquidity instruments available in which to park their cash while waiting for better opportunities to redeploy it over the long term.

The IILM, via its genuine business model, serves the IIFS and global investors with liquidity tools that contribute to sustainable recovery, both during and following the pandemic. The Islamic banking industry is as much impacted as the conventional industry, and the IILM is ready to support countries to restore market confidence while containing liquidity risks. On a long-term basis, the objective remains to strengthen the IFSI through its recovery post-COVID-19.
2.3 Takāful: Assessment of Resilience

This section of the report focuses on the performance and risks, as well as the resilience, of the takāful sector. This sector inevitably operates within both local and wider macroeconomic environments, both of which have been heavily impacted by COVID-19 and the policy measures, in some cases quite dramatic, which governments have taken in response to it.

As regards the global insurance industry, the IAIS’s analysis indicates that by mid-2020 the solvency ratios of insurers had declined slightly, but overall, the industry’s capitalisation had remained resilient. The immediate impact on the industry was largely from financial market volatility and associated losses on investments, and one response by the industry was to reduce capital distributions – for example, dividends. Profitability was more strongly impacted, especially for life and composite insurers. There was, however, limited impact on liquidity, partly as a result of the measures taken by governments to inject liquidity into their economies. Insurers have also responded by rebalancing their asset portfolios, reducing their equity exposures and increasing their cash holdings; this can be seen across life, non-life and composite businesses.

As suggested in Chapter 1, the impact of the pandemic on premiums and claims has varied hugely by type of insurance. On the non-life side, apart from travel insurance, the most affected classes have tended to be commercial lines (e.g. business interruption and event cancellation), while some other classes have benefited from restricted travel patterns, and there has been surprisingly little impact on health insurance. Life insurers have, of course, experienced increased mortality as a result of COVID-19 mortality, but the impact appears to have been relatively modest.

Some major international reinsurers are already reporting some significant impacts on profits, particularly where they have provided cover in areas such as event cancellation. It thus seems almost inevitable that reinsurance/retakāful prices will rise, in some insurance classes at least, and that this will affect the economics of both conventional insurance and takāful. However, more recent analysis by a major broker of a limited group of major reinsurers has indicated that, while that group did incur substantial losses as a result of COVID-19 (including its impact on investments), its members nevertheless remained profitable and had more capital available to them at the end of 2020 than at its beginning. This suggests, at minimum, that the risk to the takāful sector of a shock transmitted through the reinsurance industry has not increased, and that the impact of any rate tightening is likely to be limited.

For takāful companies, as for conventional insurers, COVID-19 impacts are likely to vary greatly from firm to firm, depending on the business and investment mix, and also on the impact of COVID-19 in the countries in which they operate, as mitigated by government policies. Since takāful undertakings in mixed economies tend to be stronger in personal lines than commercial lines, it is likely that the impacts on them of increased claims in certain classes will be generally less than on the conventional industry. Overall, it appears likely that macroeconomic factors will dominate over industry-specific ones, and the biggest impact is likely to result from the setback to growth that the pandemic has caused in the large majority of economies. This generally optimistic view of the impact of COVID-19 on the resilience of the industry is, as discussed in Chapter 1, borne out by the 2020 data available for some countries.

The pandemic will also affect the way both conventional insurers and takāful operators do business. Both businesses and their customers have learnt to operate digitally to a much greater extent, and with a reduced reliance on person-to-person contact and physical offices. Although there will be some return to former patterns of working as the pandemic recedes, it will not be complete, and it is clear that the trend to digitalisation in the industry will accelerate. It may well be that businesses which have relied on a local presence and personal contact will find that some customers, at least, have become more willing to search in a wider online market for their cover.

Direct insurance in general, and takāful even more, are primarily national markets. Some large commercial risks may be placed cross-border, but most risks are placed with undertakings in the jurisdiction where the insurance is located. The pandemic has highlighted the importance of having a robust and well-capitalised industry to absorb shocks and maintain the resilience of the economies in which they operate.
risk is located and, even where insurers operate in multiple jurisdictions, they tend to do so through subsidiaries rather than branches. It is the retakāful/reinsurance market that connects national markets at a global level. It is thus more helpful to look at resilience indicators on a jurisdictional basis than on a global one, and this report does so for the major jurisdictions for which data are available.

As mentioned in earlier footnotes, the available data for takāful are problematic for many jurisdictions. Although the picture is improving, for only relatively few jurisdictions are consistent data series available over several years, and quarterly data series are rarer still. For this reason, the discussion here focuses on annual figures and attempts very little analysis of multi-year trends.

There is no common insurance capital standard in operation and local standards vary significantly. There can therefore be no meaningful analysis against regulatory capital ratios, but it is certainly possible to analyse against key business metrics.

One metric used in this chapter is the retention ratio, which is the ratio of net to gross contributions. Some commentary on the significance of this is appropriate. In essence, the retention ratio measures the extent to which risk is retained within the takāful undertaking, rather than ceded to retakāful/reinsurance undertakings. It is meaningful only for general takāful; for family takāful, the savings element of contributions obscures the picture. A very high retention ratio may signal that the takāful undertaking is not making sufficient use of retakāful to give protection against extreme outcomes; a very low one may signal that the undertaking is simply passing risk straight through to the retakāful/reinsurance market (“fronting”), making its competitive position vulnerable to changes in that market. But the optimum will depend on the financial strength of the undertaking and also on the nature of the business; high-frequency, low-severity business such as motor coverage can generally sustain higher retention ratios than low-frequency, high-severity classes such as space coverage (which largely covers the risks of satellite launches).

2.3.1 Bahrain

The takāful sector in Bahrain is dominated by general business, particularly medical and motor. The risk retention ratio for general business in 2019 was 65.5%, down slightly from 67.1% in 2018. One factor here is that takāful undertakings wrote more aviation risk in 2019, but all of this was ceded. Underwriting performance slipped into loss from a small profit in 2018, but with the help of increased investment earnings both the takāful funds and the shareholders’ funds saw surpluses. ROA was 2.2% and ROE was 7.5%, both up from 2018. While data do not exist to assess fully the effect of COVID-19, two listed takāful operators have published figures, both showing increased profits.

2.3.2 Saudi Arabia

As noted in the SR2020, 2018 was a bad year for many operators in the Saudi market, with overall net profits totalling only USD 48.8 million and some companies making losses. In 2019, profits had recovered to USD 228.8 million, mainly reflecting improved underwriting results. ROA was 1.34% (2018: 0.32%) and ROE 5.27% (2018: 1.22%). This improved performance led to increases in both policyholders’ and shareholders’ assets, and to modestly greater cash resources. In particular, shareholders’ equity increased by over 9% in the year.

Retention ratios varied greatly by lines of business, as already illustrated in Figure 1.4.2.1. The very low ratios in certain classes such as energy and aviation suggest a business model in which it is in fact the reinsurance/retakāful which provides the key cover, and probably underlies the structuring of the contract, with a direct insurer simply fronting the business. On the other hand, the high ratios for motor and health insurance suggest that in these areas there is very little dependence on reinsurance/retakāful, and operators feel confident in carrying even most of the tail risk associated with extreme outcomes. Saudi regulations require all licensed insurers to retain at least 30% of their risks, and the overall retention ratio (excluding life/savings business) was 83.6%, so it is unlikely that there are many companies dependent predominantly on fronting, or that the industry as a whole is at risk from

Footnotes:

94. The IAIS Insurance Capital Standard for internationally active insurance groups is currently in an observation phase.

95. Note that some data published by individual jurisdictions focus instead on the extent to which risk is retained within the local industry; that is, they exclude cessions to local retakāful/reinsurance operations from their calculations. This is less helpful in discussing resilience at the level of individual takāful operations, but data on this basis have had to be used in some instances. This is another reason why cross-jurisdictional comparison can be difficult.
changes in reinsurance/retakāful pricing internationally.

The overall loss ratio for general business remained essentially stable at 81.9% (2018: 82.3%), as improvements in the loss ratio for health insurance were largely offset by an increase in the loss ratio for motor insurance. The expense ratio also remained stable at 18.0%. This means that the combined ratio for takāful fell slightly over the year and sat just below 100%.

In the case of Saudi Arabia, 2020 data are also available. The evidence on contribution growth has been quoted in Chapter 1, as has the reduction in net claims. This led to a further reduction in the loss ratio, from the 81.9% quoted above to 76.7%. ROA increased to 2.05% and ROE to 7.52%, and the sector's overall solvency ratio, as compared with the jurisdiction's requirement, also increased.

Overall, the data suggest an industry that is in a stable and resilient state and has so far weathered the COVID-19 pandemic well. The sector is dominated by a relatively few large companies – eight companies account for around three-quarters of premiums – and, as already noted, the authorities are actively seeking consolidation, especially with an eye to reducing the number of smaller companies. This suggests that threats to stability are small and the exit of smaller companies could be managed without a material impact on the sector as a whole.

2.3.3 United Arab Emirates

In the UAE, the insurance industry as a whole saw a 29% increase in profits in 2019. However, much of this was attributable to improved performance by foreign branches and, to some extent, conventional local companies. For the takāful industry, profits increased by an apparently healthy 16.5%, but from a low base. As a result, ROA was only 0.9% and ROE was 3.4%.

Retention ratios fell in 2019 in all classes of insurance. However, takāful operators actually saw increases in their retention ratios, and have higher ratios than their conventional counterparts. In health insurance, which dominates the market, the ratio was 60.4%, up from 52.0% in 2018. The 2019 figure for conventional companies was 55.0%. For other types of conventional business, the takāful retention ratio was 49.8%, essentially unchanged from the previous year, against 33.8% for conventional companies, although this partly reflects a lesser presence for takāful companies in the large commercial lines business, where retention ratios are generally lower and some business is essentially fronted.

Net loss ratios for takāful operators were 74.1% for health and 48.7% for other general business. These figures represent an increase from 2018 in health, but a decrease in other business, the 2018 figures being 67.5% and 55.0%, respectively. In both cases, the ratios are lower than for the conventional counterparts. However, takāful operators have markedly higher expense ratios than their conventional counterparts, driven, it appears, by paying higher levels of commission. As a result, combined ratios were 98.7% for health (slightly higher than for conventional counterparts) and 73.7% for other general business (markedly higher than for conventional, but still very good).

The UAE publishes exhaustive benchmarking data. From this, some slightly more worrying features emerge. Takāful companies have, on average, only slightly more own funds than the minimum capital requirement and at some points in 2019 dipped below it. This is likely to mean that some companies were in a markedly worse position. They also show worse positions for receivables outstanding than for conventional firms. This information hints that, while the overall position of the takāful sector is satisfactory, there may be some operators that are struggling and for which remedial actions may be necessary.

2.3.4 Brunei Darussalam

In Brunei, while life insurance accounts for 37.8% of the total insurance sector, it accounts for only 21.1% of takāful. The corollary of this is that takāful is much stronger in general insurance, where it has a majority share of the market. There are two groups active in takāful, each operating one general and one family takāful undertaking; this makes it possible and appropriate to look at the published accounts individually.
In general takāful, one undertaking achieved an ROA of 1.5% and an ROE of 6.2%; the other achieved an ROA of 0.5% and an ROE of 2.9%. Both had retention ratios of the order of 80%, suggesting a focus largely on personal lines and on relatively low-volatility business. Loss ratios were 38.3% and 47.4%, and expense ratios 35.7% and 27.0%, respectively. Although both companies have seen sharp rises in their expense ratios, these are against a relatively comfortable background.

The same cannot be said for family takāful. In this area, one undertaking achieved an ROA of 1.5% and an ROE of 7.4%. However, the other moved sharply from profit to loss, with an ROA of –0.3% and an ROE of –1.2%. Net claims paid at that undertaking were sharply up, in a way that does not seem to correlate simply with growth in the business, but a more important factor was a drop in investment income. However, both undertakings began with solid financial positions and, given their ownership structures, neither appears to be under any immediate threat.

2.3.5 Malaysia

In Malaysia, the takāful sector is dominated by family business, primarily savings products. As already noted, contributions grew substantially and held up well through 2020. Participants’ risk funds grew through both years, as did investment funds. These showed a dip in the first half of 2020 but had more than recovered by the end of the year, implying that the economic measures taken by the authorities in response to COVID-19 had succeeded in avoiding any major impact on investment values, and hence on returns to contributors. ROA in 2019 was 1.9% and ROE was 14.1%. In short, there is nothing in the data available to suggest anything other than a stable industry.

For general takāful, the large increase in contributions in 2019 has already been noted. Growth continued, though a little more modestly, in 2020, despite COVID-19, led by motor, which in Malaysia is the dominant class for general business. ROA was 6.0% and ROE was 19.4%, representing very healthy returns to shareholders. Net claims incurred rose by 26.6% in 2019, due mainly to a big increase in motor claims, but were essentially unchanged in 2020. The claims ratio, which has been on a generally upward trend, reached a new high of 58.2% in 2019, but fell to 55.7% in 2020. Overall profitability also seems to have been maintained, from the data so far available. Again, the industry appears to be robust.

2.3.6 Jordan

The Jordanian market is dominated by general insurance, with life insurance accounting for just under 14% of total premiums. A broadly similar pattern applies in takāful, where only two undertakings now offer takāful (a third having been closed in 2014). Both are composites. For one, the ROA in 2019 was 4.5% and the ROE 9.1%; for the other, the figures were 4.0% and 7.5%, respectively. In this case, the overall profitability disguises very different outcomes for non-life and life business. While life business was profitable for both undertakings, the former company made substantial losses on its non-life business, especially in motor and medical (which were unprofitable for both). Its overall profit nevertheless represents a turnaround from 2018, where it made an overall loss. Loss ratios in these two classes were 108.4% (motor) and 81.9% (medical) for the first undertaking and 88.1% (motor) and 89.4% (medical) for the other. Data for the market as a whole show a number of conventional insurers also making losses in these classes.

For Jordan, some 1H20 data are available. For the industry as a whole, and in national currency, they show a 5.2% reduction in non-life premiums compared with the same period in 2019, offset by a 21.5% reduction in claims paid. There was a small rise in life premiums. The non-life premium reductions were largely in motor, but also to a significant extent in medical. These reductions presumably reflect an economy that has been quite hard hit by the pandemic, with the loss of travel and hospitality receipts and also a reduction in remittances. However, takāful showed an overall small increase in market share and materially improved technical results from those of the corresponding period in 2019.

2.3.7 Pakistan

Takāful data for Pakistan need to be treated with some

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96 Unfortunately, the data on retention ratios take account only of retakaful/reinsurance ceded outside Malaysia, so they do not serve the same purpose as elsewhere in assessing takaful operators’ business. They are therefore not quoted here.

97 In this case, the relevant figures are before tax.

98 These calculations are based on claims paid (rather than incurred), and gross rather than net premiums, because of data availability.
caution, not only because of certain data gaps but also because the sector is dominated by Islamic windows, which account for some 70% of gross premiums. Company-level measures such as ROA and ROE are essentially meaningless for these and, although they can be produced for the full-fledged companies, such measures give no useful picture of the sector as a whole.

On the non-life side, it can be said that the sector as a whole had a retention ratio of 66.2% and a loss ratio of 62.1%. The latter is materially worse than for conventional business (49.8%) and some companies showed loss ratios in excess of 100%.

A look at company statements readily available confirms the rapid growth of some takāful windows, in some instances with a degree of financial strain, evidenced by deficits in the policyholders' funds. None of these appears particularly large, however, and the issues for Pakistan seem to be mainly around the structure of the industry – in particular, whether the full-fledged companies can continue to compete with windows, which are often run by much larger conventional companies.

2.3.8 Turkey

Box 7 gives some detail on the structure and growth of participation insurance in Turkey and the discussion here is therefore brief. The sector is dominated by general business, with life (family) business accounting for less than 8% of contributions. Although in 2019 there were four full-fledged participation companies and eight windows,\textsuperscript{99} in terms of size the full-fledged undertakings are dominant, accounting for almost 92% of contributions. Of these undertakings, two are owned by Islamic banks (in one instance, by a joint venture of two banks) and the other two have a large majority shareholding by a society of agricultural cooperatives.

In discussing the stability of the sector, it is thus appropriate to focus on the full-fledged companies – in particular, on those undertaking general business. The risk retention ratio for these companies was 62.6%. (The figure for windows was 58.5%.) Data are not available by class of business, although the overall market is dominated by motor insurance, which accounts for around half of all general business, so these figures appear reasonable.

\textsuperscript{99} In 2020, the figures were six full-fledged companies and six windows
The insurance and pension sector in Turkey is regulated and supervised by the Insurance and Private Pension Regulation and Supervision Agency of Turkey (SEDDK). It was established by the law coming into force in June 2020. The institution has a public legal personality and administrative and financial autonomy. The headquarters of the institution are in Istanbul.

1. Measures Taken by SEDDK in Response to COVID-19

SEDDK, as a regulatory and supervisory authority, has responded mainly by taking measures to provide operational relief to insurers about fulfilling their legal obligations so that they can continue providing insurance services despite changed conditions. In this context, SEDDK issued some regulations to support insurers and customers and some of them are mentioned below.

- Giving additional time to present financial statements.
- Allowing distance sales for agents and brokers.
- Allowing insurance experts to perform remote investigations.
- Extension of the review periods of dispute files, as well as allowing the electronic filing of appeals in the Insurance Arbitration Commission.
- The postponement of the General Assembly of stakeholders in the sector.
- Giving additional time for the presentation of actuarial reports.
- Removing invoice submissions in health insurance compensation payments and ensuring policies were not cancelled.
- Allowing time extensions due to anticipating possible delays in premium payments within the scope of the measures taken by the Ministry of Health.
- Removing additional premiums considering possible delays in traffic insurance policies.
- Removing Static Internet Protocol (IP) control for a while to ensure that insurance companies, agents, intermediaries, experts, etc.,

2. Participation Insurance and Some Developments in the Sector

Participation insurance is one of the new development areas of the insurance sector in Turkey. The total premium production amount of participation insurance is approximately TL 4.3 billion as of the end of 2020, and its share in the entire insurance sector is 5.2%. When we evaluate the last five years, an average growth rate of over 50% has been achieved on an annual basis. Currently, the number of companies serving in the participation insurance field is 12, six of which operate as full-fledged participation companies. Islamic pension funds comprise 18% of the total fund size, amounting to TL 170 billion. Thirteen of the 15 pension companies have Islamic pension funds.

The first regulation in the participation insurance sector in Turkey was the Regulation on Working Principles and Procedures in Participation Insurance, dated 2017. After three years of experience, the new regulation, Regulation on Insurance and Private Pension Activities within the Framework of Participation Principles, was issued at the end of 2020.

This new regulation is highly important in the development of the sector and for the consistency of Shari’ah principles and their implementation. The project was completed over a period of two years with contributions from all the relevant public- and private-sector stakeholders in the light of experiences of Turkey and other countries. Surveys, committees and working groups, and one-to-one meetings with companies were held. The experience and work of international organisations in this field, such as the IFSB and AAOIFI, were also taken into consideration. This regulation will contribute to the development of the Islamic finance ecosystem in Turkey.

It had been observed that implementation of the takāful model, which is based on tabarru-based contracts and

BOX 7. Participation Insurance in Turkey and Response to COVID-19
Contributed by the Insurance and Private Pension Regulation and Supervision Agency of Turkey (SEDDK)
the segregation of funds, was not in line with its principles. This negatively affected the development of the sector and brought about many operational difficulties and legal incompatibilities. The model has been removed from the main axis of the new regulation and its implementation is left to preference. The Turkey model now constitutes the basic framework of the regulation. It is easy to apply, imposes less of an operational burden, is easily understandable and explainable, and (most importantly) it is consistent with the principles of tabarru-based contracts.

In the previous regulation, the members of the advisory committee and the working procedures and principles were not sufficiently defined. There was no organisational structure to implement the decisions of the advisory committee and observe compliance. With the new regulation, mechanisms such as the participation compliance unit and a participation internal audit report were introduced and a Sharī‘ah governance framework mechanism was established.

A legal basis for Islamic pension funds and private pension companies had not been established previously. The new regulation now defines the legal framework of these activities. In addition, its scope includes institutions such as the Agricultural Insurance Pool, the Turkish Natural Catastrophe Insurances Pool and the Guarantee Account, where large amounts are managed. The Islamic window possibility, which negatively affects both the development of the sector in the long term and the relevant Islamic values, will be terminated by the end of 2021. From then, only companies that are full-fledged will be able to operate in this field. In order to increase the number of well-equipped human resources needed in this field, a training-examination and certification mechanism has been established for all related company personnel and intermediaries.

3. What Does “the Turkey Model” Mean?

Turkey’s new participation insurance model is known as “the Turkey Model”. The model is different from the common takāful model, which is derived from tabarru-based contracts and the segregation of funds. “Islamic insurance” means insurance activities that are Sharī‘ah-compliant. According to Turkey's approach, takāful is just the name of an insurance model under the Islamic insurance perspective. It does not refer to the only Islamic insurance model permissible in practice. Therefore, the Turkey model is also the name of an insurance model under the Islamic insurance perspective.

The Turkey model facilitates effective surveillance and supervision activities by focusing on the principles of transparency, accurate information and accountability. In this case, insurance contracts do not have to be based on tabarru principles, and companies do not have to segregate their funds. There is no structure of takāful operator and risk fund. The structure is the same as in conventional insurance companies.

The main criteria of the Turkey Model are:
1. No insurance coverage for prohibited activities.
2. Sharī‘ah-compliant investment.
3. Establishment of a Sharī‘ah committee within the company.

Provided that these three criteria are met, it is no longer necessary to change the legal, organisational, financial or technical structure and practices used in the implementation of traditional insurance. For instance, companies can use their current insurance contracts and their own funds to provide Islamic insurance services. They can use the same financial statement as for conventional insurance, provided that the time value of money and the substance and the form principles are in line with Sharī‘ah. As a result, the Turkey model is easily applicable, understandable and explainable; and it has less operational burden and a self-audit mechanism.

4. Conclusion

SEDDK is now an independent public entity as a regulatory and supervisory authority on the insurance sector in Turkey. While ensuring the longevity of the insurance companies and maintaining insurance customer protection and satisfaction remain its top priorities, the SEDDK has also contributed to mitigating the impact of the COVID-19 pandemic, and the development of the Turkish financial markets in cooperation with both domestic and international stakeholders via various policy measures.
THE ROLE OF ISLAMIC SOCIAL FINANCE IN A POST-COVID-19 FINANCIAL SYSTEM STABILITY
3.0 THE ROLE OF ISLAMIC SOCIAL FINANCE IN A POST-COVID-19 FINANCIAL SYSTEM STABILITY

3.1 Introduction

Financial system stability may be defined as the capability of the financial system “to allocate funds efficiently and absorb shocks as they arise, thus preventing disruption of real sector activities and the financial system”.\(^{103}\) Since the financial system operates within the economic system and interacts with social and ecological/environmental systems, financial instability can arise from internal/endogenous or external/exogenous sources. An example of the former is the Global Financial Crisis, which originated endogenously within the financial sector.\(^{101}\) Exogenous sources of financial instability have origins in external shocks that affect economies, social systems and the environment adversely, which in turn impact the financial sector negatively.

Starting as a health crisis, COVID-19 turned into social/human crises that have caused severe downturns in the world’s economies. While the sound and robust regulatory framework introduced after the GFC has reduced the likelihood of creating instability within banks, the impacts of COVID-19 on the economy and communities can transmit to the financial sector. This is confirmed by the Depository Trust & Clearing Corporation (DTCC) Systemic Risk Barometer Survey, which identified the pandemic to be the top risk that can threaten financial stability in 2021.\(^{102}\) Since economic and social vulnerabilities are potential external sources that can affect the financial industry, ensuring stability of the financial system will require steps to be taken to mitigate the adverse impact of the COVID-19 pandemic on economic and social systems.

This chapter discusses the ways in which Islamic social finance (ISF) can enhance economic and social resilience and help to promote financial systems stability. This is done by, first, discussing the impact of the pandemic on the economy and then identifying the factors that can affect financial systems stability arising from external negative shocks such as COVID-19. The roles that ISF can play in mitigating the effects of these factors, and thereby enhancing resilience in economies and helping to promote financial stability, are then discussed.

3.2 COVID-19: Economic and Social Impact

Starting as a health crisis, COVID-19 morphed into economic and social crises in which societies faced a difficult choice between saving lives and protecting livelihoods. The immediate reaction, to protect lives, saw lockdowns imposed in many countries that slowed business operations, caused closures and layoffs, increased unemployment and decreased aggregate demand, which further affected businesses negatively. The overall global output shrunk by 4.4\% in 2020,\(^{103}\) and economic losses from COVID-19 are expected to be between USD 10 trillion and USD 82 trillion in the next five years.\(^{104}\) The International Labour Organization (ILO) estimates the losses to labour income due to unemployment to be in the range of from USD 860 billion to USD 3,440 billion, which would result in lower consumption and negatively affect the continuity of businesses and the resilience of economies.\(^{105}\)

While COVID-19 has significantly slowed economies overall, the impact on different sectors of the economy has been varied. The services sectors such as hospitality, education, transportation, etc. were hit harder than the manufacturing sector, and smaller businesses were affected more than larger firms.\(^{106}\)


\(^{103}\) International Monetary Fund (2020), World Economic Outlook: A Long and Difficult Ascent, October. Washington, DC: IMF.

\(^{104}\) Andrew Mitchell (2020), “COVID-19 is a Stark Reminder that Our Assault on the Natural World Has Consequences”. https://www.weforum.org/agenda/2020/05/humanity-assault-on-the-natural-world-has-paved-the-way-for-covid-19/


Similarly, the economic impact on different segments of the population has been disproportionate, which has created further inequalities. Not only were the health systems inadequate to deal with the pandemic, but poorer households faced steep declines in income levels. The disproportionate impact on low-income groups is likely to increase the inequalities and make them more vulnerable, which can potentially cause socio-economic instability.

At a broader level, COVID-19 is expected to create a poverty tsunami that could push half a billion people into poverty. It has unleashed a human development crisis that has decreased the Human Development Index to mid-1980 levels for many countries and is threatening to reverse years of progress of the Sustainable Development Goals (SDGs).

### 3.3 Financial Sector Stability and Resilience: Origins and Factors

As indicated, financial instability can arise from endogenous and exogenous sources. While the endogenous factors arise from internal operations of financial institutions, the exogenous factors are external shocks that can affect the financial sector adversely. Since the financial system is interconnected with the economic, social and ecological systems, there are several channels through which negative shocks in these systems can induce instability in the former. The endogenous and exogenous factors related to COVID-19 that can cause financial systems instability are discussed below.

#### 3.3.1 Endogenous Factors

Internal factors determining the stability of financial systems can be discussed at the micro level as resilience of financial institutions and at the macro level as stability of the financial system. At the micro level, the soundness of the balance sheet in terms of the quality of assets, the liquidity, percentage of short-term liability, complexity of products, lack of transparency and higher leverage will determine the overall stability of financial institutions.

At the macro level, a larger financial industry relative to the real economy increases the likelihood of a crisis. However, a diversified financial system with banks and different types of non-bank financial institutions (NBFIs) will be relatively more stable, since the impacts of negative shocks on various sectors are expected to be different. For example, empirical studies find that cooperative banks fare better than commercial banks during a crisis.

While a diversified financial system tends to be more stable, the interconnectedness of different sectors determines how a crisis propagates. Given that risks can transmit across financial institutions, there is a need to take a holistic and system-side perspective in dealing with the stability-related issues that include non-bank financial institutions. Although the banking industry has been able to withstand the negative shocks due to its high levels of capital and liquidity introduced after the GFC, the impact on NBFIs was varied, with some sectors showing weaknesses and vulnerabilities during the pandemic period. For example, a survey of 300 microfinance institutions (MFIs) worldwide shows that they were affected by COVID-19 in the first half of 2020 and face risks of lower profitability and solvency. However, the insurance industry was not significantly affected, as very few firms had business interruption insurance against pandemic risks.

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107 Daniel Mahler and Christopher Lukner (2022). “This is the Effect COVID-19 Will Have on Global Poverty, according to the World Bank”.


3.3.2 Exogenous Factors

Health Crisis

The COVID-19 pandemic highlighted the direct human costs that can adversely affect economies and financial sectors. The World Health Organization (WHO) reports that globally there were 113.989 million confirmed cases of COVID-19 and 2.531 million deaths as of 2 March 2021.\textsuperscript{115} Being unhealthy at the micro level directly affects income levels of households negatively, while at the macro level, poorer health of the population can have an adverse impact on human capital, economies and the financial sector. The pandemic demonstrated the lack of robust health systems in many emerging and developing economies and the unequal access to health services within countries. Building resilient populations would need investments in health and social security systems to better sustain the negative shocks of pandemics and recover quickly.

Business Slowdown

The COVID-19-induced lockdown slowed economic activity and resulted in a decline in revenues of businesses. The resulting liquidity problems for firms made it difficult for them to cover their costs of operations and service their debt obligations. For example, a survey carried out in early April 2020 of 1,000 micro-enterprise owners in Pakistan showed a decrease in sales and income of 90% and an immediate concern about securing food. As a result, 70% of the microfinance borrowers indicated their inability to repay their loans.\textsuperscript{116} The micro and small enterprises (MSEs) have been hit hard by COVID-19 and there are indications that around 40% of these businesses may not reopen after the pandemic is over.\textsuperscript{117} The decline in business and incomes of MSEs and resulting business closures are likely to increase credit losses and affect the stability of the financial sector.

Job Losses

A large number of individuals lost their jobs due to the pandemic, or saw their incomes decline, and consequently faced difficulty in meeting their expenses for basic things. The ILO estimates that 255 million jobs were lost globally, resulting in a decline in income of USD 3.7 trillion due to the pandemic in 2020.\textsuperscript{118} A survey of 2,675 low-income people in Bangladesh carried out in April 2020 reports that 93% of the respondents experienced a decline in income of an average of 75% over a month.\textsuperscript{119} The survey also shows that 14% of all respondents did not have food in their homes, with the figure rising to 18% for those living in urban areas. Higher unemployment among the poorer households is likely to affect the microfinance sector adversely, since those who lost jobs will have difficulty repaying their loans.

Inequalities

Since the brunt of the effects of negative shocks is borne by the poor and vulnerable, the resulting disruption widens income and wealth inequalities. While an increase in inequality increases the demand for debt by the poorer households whose incomes have stagnated, the higher incomes of richer households enable them to supply larger amounts of savings. Empirical studies confirm the positive link between inequality and debt growth. The higher debt levels of poorer household financed by the higher savings of wealthy households can lead to the creation of debt bubbles, which increases the likelihood of financial instability.\textsuperscript{120} Empirical studies confirm that an increase in inequality can lead to financial instability and crisis.\textsuperscript{121}

Debt Levels

A key factor that can exacerbate instability due to external negative shocks is high levels and expansion of public and private debt, which can be a cause of

\textsuperscript{115} World Health Organization (2021). “WHO Coronavirus Disease (COVID-19) Dashboard”. https://covid19.who.int/?gclid=Cj0KCQiAvbiBBhD-ARIsAGM48bzuUQx8aTq4QsXFLLBqimoLClpDYJRx6wHEQZwMo4YUs4jA8Q0B8aAvstEALw_wcB
safeguarding lives and livelihoods by adopting policies that address the socio-economic, humanitarian and human rights aspects of the crisis, with a focus on the vulnerable. Third is instituting a transformative recovery process that “Builds Back Better”, to create resilient and just societies and economies in the future. The latter would also consider using policies that can improve environmental sustainability.

Given the above perspective, appropriate risk management strategies and policies can be broadly discussed as short-term responses to mitigate the adverse impact of COVID-19 and as longer-term strategic plans to enhance resilience against negative shocks in the future. The long-term strategies for managing uncertain risks of negative shocks such as COVID-19 can be viewed as precaution-based strategies that avoid large uncertain risks and as resilience-focused strategies used to improve risk absorption capacities and reduce vulnerabilities. While the former is a risk avoidance strategy that reduces exposure to risks, the latter increases the ability to cope with the consequences in the event of occurrence of future risk events.

Policy responses depend on whether the origins of financial stability are endogenous or exogenous. A key approach for dealing with endogenous factors to promote financial stability in financial institutions is to have a robust regulatory framework that can enhance the resilience of financial institutions. The enhanced capital and liquidity requirements for the banking sector that were put in place after the GFC have made it more resilient and enabled banks to sustain the short-term impact of COVID-19. Regulatory interventions to enhance financial stability include measures related to liquidity and funding that maintain adequate liquidity and funding conditions for financial intermediaries, safeguarding and ensuring the smooth functioning of payment systems that includes facilitating digital payments, and providing regulatory guidance and

3.4 COVID-19 and Financial Sector Resilience and Stability: Policy Framework

The policy and strategic framework for mitigating the impact of COVID-19 on financial sector stability can be viewed at different levels. For example, the United Nations (UN) identifies three pillars of policy responses to COVID-19. First, in the short term, is saving lives by delivering a large-scale, coordinated and comprehensive health response. Second is safeguarding and ensuring the smooth functioning of payment systems, and providing regulatory guidance and

human rights aspects of the crisis, with a focus on the vulnerable. Third is instituting a transformative recovery process that “Builds Back Better”, to create resilient and just societies and economies in the future. The latter would also consider using policies that can improve environmental sustainability.

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3.4 COVID-19 and Financial Sector Resilience and Stability: Policy Framework

The policy and strategic framework for mitigating the impact of COVID-19 on financial sector stability can be viewed at different levels. For example, the United Nations (UN) identifies three pillars of policy responses to COVID-19. First, in the short term, is saving lives by delivering a large-scale, coordinated and comprehensive health response. Second is safeguarding and ensuring the smooth functioning of payment systems, and providing regulatory guidance and

human rights aspects of the crisis, with a focus on the vulnerable. Third is instituting a transformative recovery process that “Builds Back Better”, to create resilient and just societies and economies in the future. The latter would also consider using policies that can improve environmental sustainability.

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introducing policies to ensure proper functioning of financial markets and NBFIs such as asset managers, insurance companies and pension funds.\textsuperscript{128}

Numerous diverse policy responses can be taken to deal with the adverse economic and societal impacts of COVID-19 and affect financial stability. For example, the ILO identifies policy responses under four pillars: stimulating the economy and jobs; supporting enterprises, employment and incomes; protecting workers in the workplace; and using social dialogue between government, workers and employers to find solutions.\textsuperscript{129} The University of Oxford provides a more detailed list of policy responses to COVID-19 under the themes of containment and closure (eight policies), economic response (four policies), health systems (seven policies) and other responses.\textsuperscript{130}

### 3.5 Islamic Social Finance: Context, Institutions and Instruments

The third or non-profit sector plays an important role in an economy. Many essential needs of people from the vulnerable segments of society cannot be satisfied by the private sector, which is driven by a profit motive, due to market failures, on the one hand; or by the public sector, due to governmental failures arising from the lack of resources and operational capabilities, on the other hand. The non-profit sector, which is driven by altruism, benevolence and compassion, can fill the gap by providing various essential services that are necessary to build healthy communities and bring about economic and social stability.

The role of the Islamic social finance sector in the overall financial system can be viewed in terms of market failure in the financial sector that financially excludes a large percentage of the population. This is particularly true for developing countries, where a significant percentage of the population do not have access to basic financial services. For example, while 60.7% of the world population above 15 years had an account with a financial institution in 2014, the corresponding average for Middle Eastern countries was 5.6%.\textsuperscript{131} Given its social objectives, the ISF sector can complement the role played by the commercial financial sector by providing essential financial services to the financially excluded sections of the population.

Encouraged by religious values, the non-profit sector has historically played a prominent role in Islamic societies. The contemporary ISF sector constitutes the traditional charitable institutions of zakāh and \textit{waqf}, institutions based on mutual cooperation, and microfinance institutions. While zakāh forms one of the pillars of the religion, making it mandatory for all Muslims above a threshold level of wealth to pay it annually, Islamic teachings also encourage Muslims to make voluntary charitable donations (\textit{sadaqah}) for social causes. One form of voluntary donation is \textit{waqf} (plural: \textit{awqaf}) through which endowments providing benefits to beneficiaries over time are established. Another form of charity that is encouraged is interest-free loans (\textit{qard hassan}) provided to people in need.

The ISF sector will also include capital market instruments such as \textit{ṣukūk}, unit trusts, and \textit{waqf} shares or certificates. \textit{Waqf} shares or certificates of small denomination enable individuals to contribute to the corpus of the waqf. Similarly, online platforms provide opportunities for retail donors to contribute to \textit{waqf} funds that can be used for different projects and causes. The \textit{waqf} sector can play an important role in serving social needs and can provide inclusive financial and other social services such as education and health.

Beyond zakāh and \textit{awqaf}, the ISF sector will include other non-profit charitable organisations or non-governmental organisations (NGOs) that provide different social goods and services that can include financial services. Furthermore, Islamic financial institutions can also contribute to social impact by having either specific microfinance or \textit{mikrotakāful} programmes. Another option for Islamic financial institutions is to collaborate with the charitable sectors and provide blended finance that serves a social

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130 Thomas Hale, Noam Angrist, Thomas Boby, Emily Cameron-Blake, Laura Hallas, Beatriz Kira, Saptarshi Majumdar, Anna Petherick, Toby Phillips, Helen Taitlow and Samuel Webster (2020). Variation in Government Responses to COVID-19, BSG-WP-2020/032. 

131 Global Findex Global Financial Inclusion Database.
3.6 Islamic Social Finance: Financial Stability and Resilience

This section discusses the role of the ISF sector in promoting financial stability in economies by mitigating the impacts of negative shocks in general and COVID-19 in particular. At the global level, the IsDB has issued USD 1.5 billion worth of sustainability sukūk to deal with the impact of COVID-19 on its member countries. The proceeds will be used for social projects that provide access to essential services such as health and education and SME financing. A few countries have recognised that the ISF sector can play an important role in tackling some of the problems arising from COVID-19. For example, the national-level response to COVID-19 in Malaysia included Islamic social finance (see Box 8), with the country issuing ṣukūk Prihatin to raise funds for recovery from the pandemic. Similarly, the Government of Indonesia has issued Cash Waqf Linked ṣukūk, the proceeds from which will be used in social sectors such as education and health (see Box 10). The ISF sector responded to the pandemic by introducing programmes to mitigate the adverse impact of COVID-19 on communities (see Box 10 for Indonesia and Box 11 for the UK). The ISF institutions and instruments that can be used to deal with each of the factors that affect financial instability due to COVID-19 identified in the previous section are discussed below.

### Table 3.5.1 Islamic Social Finance: Institutions and Instruments

<table>
<thead>
<tr>
<th>Instruments Institutions</th>
<th>Zakāh (Sadaqah)</th>
<th>Grants</th>
<th>Interest-Free Loans (Gard hassan)</th>
<th>Financing (with Returns)</th>
<th>Takāful</th>
<th>Capital Market Products</th>
<th>Goods and Services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Zakāh institutions</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Waqf institutions</td>
<td></td>
<td>X</td>
<td>X</td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Charitable organisations</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Financial institutions</td>
<td></td>
<td>X</td>
<td>X</td>
<td></td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>


**BOX 8.**

**COVID-19 and Islamic Social Finance in Malaysia**

Malaysia is one of the few countries that explicitly identified Islamic social finance as a policy tool for dealing with COVID-19. In response to the pandemic, the Government of Malaysia launched a national-level comprehensive programme, the Prihatin Rakyat Economic Stimulus Package 2020, on 27 March 2020 with the objectives of protecting rakyat (people), supporting businesses and strengthening the economy. The stimulus package consisted of a total of RM 250 billion, of which an amount of RM 100 billion was allocated to the supporting businesses. The government issued sukūk Prihatin in September 2020 to raise RM 500 million that will be used to support the National Economy Recovery Plan. With a two-year tenor and paying 2% return, the tax-exempt sukūk is open to both retail and institutional investors with an option of waiving a part or whole of the principal amount at maturity. The issuance recorded commendable acceptance as it was oversubscribed to the tune of RM 666 million.

The Supporting Businesses component of the Prihatin Package includes a Social Financial Programme that would channel donations to entrepreneurs “in the form of initial capital for micro-entrepreneurs using zakāh funds and matched with microfinancing at affordable rates”. Bank Negara Malaysia introduced a social finance programme on a pilot basis in collaboration with participating Islamic banks, State Islamic Religious Councils and implementation partners. The iTEKAD programme (which translates to "my determination") combines social finance instruments (e.g. zakāh, waqf and sadaqah) to provide initial capital and microfinancing to eligible micro-entrepreneurs. Selected entrepreneurs would not only receive funds to start businesses, but also receive structure training and mentoring on entrepreneurship and financial management. The first phase of the programme was implemented by Bank Islam Malaysia Berhad (BIMB), Federal Territory Islamic Religious Council (MAIWP) and SME Corporation Malaysia in May 2020. The implementation of iTEKAD will be further expanded in 2021 with the participation of more Islamic financial institutions, states and implementation partners, which can support the effective delivery of the programme.

BIMB launched the RM 5 million iTEKAD Microfinancing Programme with an additional RM 300,000 provisions from the Zakāh fund to provide between RM 5,000 and RM 50,000 to micro-enterprises for a period of one to five years to finance working capital and/or capital expenditure. With a profit rate charge of 4%, no collateral or guarantee is required to obtain the financing.

In 2020, the Securities Commission (SC) of Malaysia also launched a Waqf-Featured Fund Framework to facilitate the offering of unit trusts and wholesale funds with a waqf feature. The framework provides a platform for fund managers to launch products that integrate commercial with social objectives. In this regard, Amanah Saham Nasional Berhad (ASNB) of Permodalan Nasional Berhad (PNB) is planning to introduce waqf services to all ASNB unit trust holders. This service will allow unit holders to endow some of their units into an ASNB waqf fund which will make them eligible for income tax deduction. Returns from the waqf fund will be channelled to the different waqf projects of national interest. It is also noteworthy that in 2017, the SC launched a Sustainable and Responsible Investment sukūk Framework, which identifies waqf properties or assets as one of the eligible projects under its implementation.

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136 The total allocation for the iTEKAD programme by BIMB is actually RM 5.3 million, which includes: (i) an RM 5 million allocation for the microfinancing programme; and (ii) an RM 300,000 provision of zakat funds. [https://www.malaymail.com/news/money/2020/05/14/bank-islam-allocates-rm5.3m-for-itekad-micro-financing-programme/1866196](https://www.malaymail.com/news/money/2020/05/14/bank-islam-allocates-rm5.3m-for-itekad-micro-financing-programme/1866196)
3.6.1 Endogenous Factors

As indicated, the stability-related endogenous factors can be discussed at the micro and macro levels. At the micro level, ISFIs can be divided into regulated and non-regulated entities. While the former are financial institutions providing regulated financial services and include NBFI’s, examples of the latter would be zakāh and waqf-giving grants. The regulations relating to deposit-taking banks and other NBFI’s providing financial services would be different and would vary across different jurisdictions. For example, in Indonesia, while Shari’ah Rural Banks (BPRS) are regulated by Otoritas Jasa Keuangan (OJK), the cooperative-based microfinance institutions, Baitul Mal wa Tamwil (BMT), have oversight from the Ministry of Cooperatives and SMEs.

For ISFIs providing regulated services, stability would require having adequate capital and liquidity to withstand the impact of negative shocks such as COVID-19. As indicated, in the aftermath of the pandemic there are concerns about the stability of the segments of the NBFI sector that are not regulated as stringently as banks. In countries in which the sector is relatively large and not well-regulated, the likelihood of financial instability increases. There is a need to strengthen the overall regulatory regimes for NBFI’s that include the ISFIs to enhance their resilience to shocks.

Non-regulated ISFIs constitute grant-making non-profit institutions and public entities. The business models of the non-regulated ISFIs such as zakāh and waqf tend to make them resilient to negative shocks such as COVID-19 for a couple of reasons. First, zakāh payments are calculated as a percentage of wealth, and the returns on waqf are dependent on the corpus or capital that generates the return. The revenues of these ISFIs will remain relatively stable during downturns, as they are dependent on the value of capital/wealth, which is relatively stable and not expected to decrease drastically during the pandemic. Second, the impact of COVID-19 is uneven across households, with the higher-income groups being less affected than those in lower income groups. It is likely that the charitable donations would increase during a crisis such as COVID-19, due to the religious motivation of helping people in need. These features of ISFIs enable them to increase the support provided to vulnerable households and help dampen the negative impact of COVID-19 on households. This can be seen in the case of Akhuwat in Pakistan (Box 9) and the National Zakāh Foundation (NZF) in the UK (Box 10), whose charitable activities increased during the pandemic period. It is interesting to note that while NZF increased its distribution in the UK during the pandemic, the other charities in the UK suffered huge declines in their donation collections.

At the macro level, ISFIs add to the diversity of the financial sector, which promotes financial stability. Furthermore, since the non-profit and for-profit sectors are not closely connected in terms of financial linkages, the systemic risks arising from the non-profit ISFIs are negligible.

Nur Indah Riwajanti (2013). Islamic Microfinance in Indonesia: A Comparative Analysis between Islamic Financial Cooperative (BMT) and Shari’ah Rural Bank (BPRS) on Experiences, Challenges, Prospect and Role in Developing Microenterprises, Durham theses, Durham University, UK. Available at Durham E-Theses Online: http://etheses.dur.ac.uk/9386/
Akhuwat is a unique Islamic social finance institution launched in 2001 in Pakistan with the vision to create a “poverty-free society built on the principles of compassion and equity”. Akhuwat operates on a model of “creating a bond of solidarity between the affluent and the marginalised” and provides interest-free loans to the poor to help them start businesses and become self-reliant. The model leverages on social capital built on religious teachings of justice, compassion and brotherhood, and operates through centres in religious places of worship such as mosques and churches. Applicants must have two guarantors to get interest-free loans (qard hassan) and upon getting the loans are encouraged to become givers themselves by making very modest donations (often 2 cents a day). The donation and grants-based model has expanded rapidly over the years and challenges the traditional microfinance models. Table B9.1 shows that the organisation expanded its operations during COVID-19 by increasing the number of branches by 24 (to a total of 835) and providing an amount of PKR 17.55 billion to an additional 0.48 million families during January–October 2020. The figures showing a very high recovery rate of 99.85% during the pandemic indicate the resilience of Akhuwat’s operations. Akhuwat is also engaged in low-cost housing, education services, health services and clothes bank projects.

### Table B9.1 Akhuwat Operations during COVID-19

<table>
<thead>
<tr>
<th></th>
<th>Dec-19</th>
<th>Oct-20</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Branches</td>
<td>811</td>
<td>835</td>
<td>24</td>
</tr>
<tr>
<td>Total Benefiting Families (mln)</td>
<td>3.87</td>
<td>4.34</td>
<td>0.48</td>
</tr>
<tr>
<td>Amount Disbursed (PKR bln)</td>
<td>103.05</td>
<td>120.60</td>
<td>17.55</td>
</tr>
<tr>
<td>Percentage Recovery</td>
<td>99.93%</td>
<td>99.85%</td>
<td></td>
</tr>
</tbody>
</table>

### 3.6.2 Exogenous Factors

#### Health Crisis

While the government plays a key role in providing health services in most countries, in many developing and emerging economies these services seemed inadequate during the pandemic. The financial sector can mitigate the health-related issues by providing more financing to develop the health infrastructure such as hospitals, on the one hand, and health and life insurance/takāful to all segments of the population, on the other hand. While there has been an increase in health insurance in some GCC countries during recent times, the overall insurance and takāful penetration in many Organization of the Islamic Cooperation (OIC) member countries is very small. For example, while the global average of insurance penetration is 6.1% of GDP, the GCC average was 1.7% in 2018. In the case of Saudi Arabia, the insurance/takāful penetration was 1.19% of GDP of which 0.68% was health insurance, 0.48% was general insurance, and 0.04% was protection and saving. The IFS sector can play an important role in providing essential protection against health problems arising from COVID-19 to vulnerable sections of the population. Traditionally, waqf played an important role in providing health services in Muslim societies and can continue to provide those services to the poorest households in future. The long-term health-related issues can be dealt with by investing in the health infrastructure that can cater to the needs of the poor. Furthermore, zakāh and waqf can be used to cover the health-related costs of poorer households (see Box 10). The ISFIs can also provide micro health and life takāful to cover the health-related costs of these households.

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141 The information on Akhuwat is taken from its webpage.
142 [https://akhuwat.org.pk/about/](https://akhuwat.org.pk/about/)
To finance recovery from COVID-19, the Indonesian government issued retail Cash Waqf Linked ᵃṣ.getSeconds(30, 210, 200) (CWLS) SWR001. By purchasing CWLS, the donors (waqif) donate funds, either temporarily or permanently, which are then used in public projects such as public markets, hospitals, schools, etc. The returns on these investments will be distributed to social programs such as education, health and financing MSMEs. Priced at IDR 1 million (USD 68) per unit, the wakala-based ᵃṣ.getSeconds(30, 210, 200) SWR001 had a two-year tenure paying an annual return of 5.5%. A total of IDR 14.91 billion (USD 1.07 million) was raised during October–November 2020 from 1,041 donors (waqifs). While in the case of temporary waqf the donated amounts are returned to the donors at maturity, in permanent waqf the principal amount is reused for other public projects.

Though Rumah Zakāh (RZ) is a zakāh organisation, it also operates Rumah Waqaf which manages the Gelombang (Wave) Waqf programme. The waqf assets managed by Rumah Waqaf include cash and various other real assets. During the COVID-19 pandemic, cash waqf was used to build water wells for the poor, mosques, madrasah (Islamic schools), an aromatic coconut garden, mini markets, food barns, a clove factory and vegetable gardens, and for sheep fattening and renting houses. It also provided Qurans and ventilators for COVID-19 patients and used cash to help micro-entrepreneurs with interest-free loans. More than 500,000 beneficiaries received waqf across 28 cities in 18 provinces of Indonesia.

After the first case of COVID-19 was reported in Indonesia on 2 March 2021, the national zakāh organisation, BAZNAS, initiated a Crisis Center for COVID-19 with all zakāh institutions in the country to coordinate ideas and projects needed to mitigate the impact of the virus on vulnerable communities. Along with its existing programmes, BAZNAS has started a Special Emergency Program which had two further components: a Health Emergency Program and a Social-Economy Emergency Program. The Health Program included projects on education related to healthy living behaviour, use of sprayed disinfectant, distribution of masks and hand-sanitisers, the provision of personal protective equipment, the provision of ambulance and health services by BAZNAS hospitals, etc. The specific projects under the Social-Economy Program included distribution of family logistic packets and cash for work for vulnerable groups, SMEs, and beneficiaries with disabilities. The distribution of zakāh funds under different programs and the number of beneficiaries during March–September 2021 are shown in Table B10.1.

We thank Dian Masyita, Dean, Faculty of Economics and Business, Indonesian International Islamic University (IIIU) for information on Rumah Waqaf; and Ali Chamani Al Anshory, Senior Researcher, Center of Strategic Studies, National Board of Zakat (BAZNAS) for providing the information on BAZNAS.

**Business Slowdown**

Business slowdown implies a decline in incomes of businesses and the creation of liquidity shortages, which makes repayments to financial institutions difficult. Resolving the issues would require short-term policies of responding to the needs and restoring businesses on the one hand and developing long-term strategies to enhance their capacities and resilience on the other hand. Islamic microfinance institutions and waqf can provide liquidity support in the form of qard hassan and financing to the MSEs (see Boxes 9 and 10). Long-term resilience can be enhanced by providing financing that can be invested to build productive capacity and takāful services that can protect them against negative shocks.

**Job Losses**

Job losses due to COVID-19 affected low-income households the most, since they work in sectors that were hardest hit and because they have little or no savings. While in some countries the government has provided relief in the form of direct transfers such as social security, unemployment benefits, etc., in many emerging and developing economies this is not the case. Zakāh and sadaqah can be used to provide cash transfers to the poor, the needy and those in debt to meet their immediate needs (see Boxes 10 and 11). Waqf and endowments are also able to provide relief and support to those who have lost their jobs due to pandemic-induced lockdowns (see Box 12). MFIs can provide qard hassan to people to cover their living expenses in cases of need, and zakāh and waqf can improve the long-term resilience of the household sector by investing in capacity building of individuals through training and improving their skills. Furthermore, given that significant financial exclusion exists in most OIC member countries, Islamic MFIs can provide essential financial services to segments of the population not served by the Islamic banking sector. For example, MFIs can provide households with Sharī‘ah-compliant opportunities to save/invest which can be used as buffers in the case of future negative shocks.

**Inequalities**

Addressing inequalities is a core part of a socio-economic response to dealing with the downturn of economies and a humanitarian crisis in the aftermath of COVID-19. The institutions of zakāh and waqf play an important role in minimising income and wealth inequalities that are made worse during COVID-19. While zakāh transfers a percentage of wealth to beneficiaries annually, waqf represents social capital whose returns are used for some social benefit. Furthermore, charitable organisations can also provide qard hassan instead of interest-based financing that is exploitative.

In the long term, there is a need to make investments that can enhance the resilience of livelihoods of the poor to reduce their vulnerability. A population’s resilience to pandemics increases when inequalities in the availability of health services to different segments of society are reduced. As indicated, zakāh and waqf can can be used to build the capacity of individuals through education and training. A key part of capacity building is enhancing the financial education and literacy of the poor. Since poor literacy is a key factor contributing to income and wealth inequalities, waqf and ISFIs can contribute to enhancing Islamic financial literacy among the poor. Furthermore, the provision of takāful services protecting the livelihoods of individuals against pandemics can mitigate the negative impacts that increase inequalities.

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BOX 11. National Zakāh Foundation (NZF) UK: Resilience in Providing Relief during COVID-19

The UK economy was hard hit by COVID-19, with GDP decreasing by 9.9% during 2020. Several million people were furloughed, and the number of people claiming unemployment benefits increased since the outbreak of the pandemic. Higher unemployment, lower incomes and high levels of uncertainty affected the country’s charities sector, which was estimated to lose GBP 4 billion in donations and with 70% of charities indicating the possibility of being insolvent by year-end. However, Islamic charities saw their incomes increase, with Muslims giving more to support others during this time of distress.

National Zakāh Foundation (NZF) in the UK is one of the few organisations that collects zakāh in the country and spends it on beneficiaries locally. The pandemic affected many Muslim households, and NZF responded to the increase in demand for support through its Hardship Relief Fund. In the immediate aftermath of the pandemic, the number of applications increased from 405 in February 2020 to 2,777 in April 2020, while the corresponding zakāh distribution increased from GBP 100,000 to GBP 304,000 during the period. Given the increase in applications due to COVID-19, NZF partnered with Islamic Relief UK through which the latter provided GBP 350,000 to NZF’s Hardship Relief Fund to benefit an additional 1,600 people. Table B11.1 shows the changes in the overall number of applications and amount disbursed during 2019 and 2020 by NZF.

Table B11.1 NZF Number of Applications Received and Zakāh Distributed (2019–20)

<table>
<thead>
<tr>
<th></th>
<th>2019</th>
<th>2020</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of applications received</td>
<td>7,348</td>
<td>19,244</td>
</tr>
<tr>
<td>Amount of zakāh distributed</td>
<td>GBP 2.9 m</td>
<td>GBP 3.7 m</td>
</tr>
</tbody>
</table>

We thank Rizwan Yusoof, Director of Services, NZF UK, for providing the information on NZF UK.

https://www.ons.gov.uk › articles › december2020
Debt Levels

Higher levels of debt are directly linked to insolvencies and bankruptcies, which can affect financial stability. In response to COVID-19, countries with high debt levels have had to carefully balance short-term fiscal support for recovery with long-term debt sustainability. While the debt helps the firms to cope with liquidity problems arising as a result of low revenues from slow sales, it can increase their long-term costs and likelihood of insolvency if the economic recovery is slow. Increasing debt at the household level can also be problematic as there is a positive relation with poverty, inequalities and indebtedness. In this regard, zakāh, waqf and sadaqah can play an important role in providing debt relief to the poor.

One way to reduce long-term vulnerability is to use equity-based financing, which will not only enhance stability but also promote growth. Since Islamic banks have constraints on using equity-based modes of financing, one option would be for the ISF sector to provide patient equity capital that can lower leverage and bring about stability and growth in the economy in general and in the MSE sector in particular. While this is not being done currently, waqf and specialised equity-based ISFIs can take initiatives to provide partnership-based financing that shares the risks during downturns and makes the overall financial sector more stable.

Ecological Imbalances

Climate change and environmental degradation pose long-term threats to economies and financial systems. There are concerns about even more serious pandemics occurring if these environmental issues are not dealt with. Given that COVID-19 has been linked to the environmental crisis, moving forward there is a need to embed sustainable finance in operations while resetting the new post-pandemic normal. This can be done by developing sustainable economic and financial systems that integrate environmental and social risks and opportunities into business models. An Islamic financial sector that includes ISFIs needs to contribute to this effort by embedding environmental and social risks in their operations. For example, investments of cash waqf should not only be Sharīʻah-compliant, but also fulfil certain environmental, social and governance (ESG) criteria. Studies show that socially responsible investments have performed better during shocks such as COVID-19 in terms of both higher returns and lower volatility. Since the poorer sections of the population are not served by commercial takāful, waqf and ISFIs can also develop new social safety and takāful structures that can help to mitigate the negative impact of environmental risks and pandemics on the poor and the vulnerable. An example of this is endowment funds in Saudi Arabia created by the government and corporations to help mitigate the impact of COVID-19 (see Box 12).

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3.0 THE ROLE OF ISLAMIC SOCIAL FINANCE IN A POST-COVID-19 FINANCIAL SYSTEM STABILITY

BOX 12. COVID-19 and Endowment Funds in Saudi Arabia

While the Health Endowment Fund (HEF) was established in Saudi Arabia in 2008, many companies and financial institutions contributed around SAR 370 million to this fund after the outbreak of COVID-19, as shown in Table B12.1. The HEF, which has since received over SAR 1 billion in contribution, uses its resources to provide health-related services to combat the effects of the pandemic.

The Saudi Ministry of Human Resources and Social Development launched a SAR 500 million Community Fund to which the Ministry donated SAR 50 million and the General Authority of Awqaf contributed SAR 100 million; SAR 50 million came from other endowments and companies. The charitable funds were used to provide subsidies and grants to people who were affected by loss of income or work due to lockdowns and curfews.

Table B12.1 Donations to HEF

<table>
<thead>
<tr>
<th>Donor</th>
<th>Amount (SAR mln)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aramco</td>
<td>200.00</td>
</tr>
<tr>
<td>Bupa Arab Company</td>
<td>20.00</td>
</tr>
<tr>
<td>Sheikh Suleiman Al Rajhi</td>
<td>9.00</td>
</tr>
<tr>
<td>Charitable Foundation</td>
<td></td>
</tr>
<tr>
<td>Southern Region Cement Company</td>
<td>2.50</td>
</tr>
<tr>
<td>Mediterranea Insurance Company</td>
<td>3.00</td>
</tr>
<tr>
<td>National Commercial Bank</td>
<td>33.00</td>
</tr>
<tr>
<td>Al-Rajhi Bank</td>
<td>25.00</td>
</tr>
<tr>
<td>Saudi Arabian British Bank</td>
<td>17.00</td>
</tr>
<tr>
<td>SAMBA Bank</td>
<td>16.50</td>
</tr>
<tr>
<td>Arab National Bank</td>
<td>12.00</td>
</tr>
<tr>
<td>Banque Saudi Fransi</td>
<td>12.00</td>
</tr>
<tr>
<td>Saudi Investment Bank</td>
<td>6.50</td>
</tr>
<tr>
<td>Al-Jazira Bank</td>
<td>5.60</td>
</tr>
<tr>
<td>Al Bilad Bank</td>
<td>5.60</td>
</tr>
<tr>
<td>Gulf International Bank</td>
<td>2.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>369.70</strong></td>
</tr>
</tbody>
</table>

Table 3.6.2.1 summarises the Islamic social finance institutions and instruments that can be used to mitigate various exogenous factors that can cause instability of financial systems in the short and long term.

**Table 3.6.2.1 Mitigating Exogenous Factors: Islamic Social Finance Institutions and Instruments**

<table>
<thead>
<tr>
<th>Health Crisis</th>
<th>Short-Term Coping</th>
<th>Long-Term Resilience</th>
</tr>
</thead>
<tbody>
<tr>
<td>Institutions</td>
<td>Zakāh, Waqf, Charitable organisations</td>
<td>Waqf, ISFIs</td>
</tr>
<tr>
<td>Instruments</td>
<td>Zakāh, Grants (sadaqah)</td>
<td>Invest in hospitals/medical services, micro<em>takāful</em> (health &amp; life)</td>
</tr>
</tbody>
</table>

**Business Slowdown**

| Institutions    | Waqf, MFIs                                                                       | Waqf, ISFIs                                                                        |
| Instruments     | Qard hassan, Financing                                                           | Financing to enhance capacity, *takāful*, invest in building capacity              |

**Job Losses**

| Institutions    | Zakāh, Waqf, Charitable organisations, ISFIs                                      | Waqf, ISFIs                                                                        |
| Instruments     | Zakāh, Grants (sadaqah), Qard hassan savings                                       | Invest in building capacity, increase                                              |

**Inequalities**

| Institutions    | Zakāh, Waqf, Charitable organisations, ISFIs                                      | Waqf, ISFIs                                                                        |
| Instruments     | Zakāh, Grants (sadaqah), Qard hassan savings                                       | Invest in building capacity, *takāful*                                             |

**Debt Levels**

| Institutions    | Zakāh, Waqf, Charitable organisations                                             | Waqf, ISFIs                                                                        |
| Instruments     | Zakāh, Grants (sadaqah), Qard hassan                                             | Invest in building capacity, use partnership contracts, *takāful*                 |

**Ecological Imbalances**

| Institutions    | Zakāh, Waqf                                                                       | Waqf, ISFIs                                                                        |
| Instruments     | Grants                                                                           | Sustainable investments, *takāful*                                               |
3.7 Challenges and Way Forward

Although the ISF sector has potential to mitigate the adverse impact of negative external shocks such as COVID-19 which can cause financial instability, in many countries the ISF institutions and instruments are not being used optimally, for various reasons. Some of the key factors that inhibit the use of the ISF sector and the ways in which its role can be enhanced are discussed below.

Legal and Regulatory Framework

In many countries the ISF sector is constrained by inadequate enabling legal and regulatory frameworks. For example, whereas zakāh laws in Algeria and Libya have instituted well-performing zakāh funds, in Tunisia no such fund exists due to the lack of supporting law. Furthermore, waqf properties in many countries have either been lost or remain underdeveloped due to a lack of political will and outdated laws. Since a supporting legal and regulatory environment is necessary for effective operations of contemporary non-profit organisations and NBFIs, there is a need to have supporting laws that can promote the ISF sector. Examples of new waqf laws that can help promote the waqf sector include those enacted in Sudan and Morocco. Another way in which the collection of zakāh can be increased is to modify the tax system to allow deduction of zakāh from tax payments.

Institutional Development

Key factors that have a low impact on the ISF sector are inefficient institutional structures and poor governance/management. In many countries, most of the zakāh is distributed by individuals and not through institutional channels, which reduces the overall impact. Similarly, waqf properties are underdeveloped, yielding low returns. Their governance and management are also poor, which negatively impacts their operational efficiency. Increasing the effectiveness of the ISF sector would require improving the quality of human resources and employing professionals to manage the institutions. Zakāh organisations in Indonesia and the UK are good examples of contemporary, well-managed ISF organisations run by professionals (see Boxes 10 and 11). There is also a need to increase transparency and disclosure of ISF operations, since the flow of donations is directly linked to trust in and the credibility of institutions. A successful donation-based microfinance institution providing qard hasan that is growing at a fast pace is Akhuwat in Pakistan (see Box 9).

Innovative Approaches and Instruments

The efficiency and effectiveness of ISF can be enhanced by instituting innovative approaches and instruments to develop, generate and distribute funds. In some countries, such as Saudi Arabia and Singapore, ṣukūk has been used to raise funds to develop waqf assets, which has significantly increased their income-earning capabilities. One option for enhancing its operational efficiencies and expanding the ISF sector would be to use technology at different levels. Examples from Malaysia highlight the use of waqf shares or certificates, and of online crowd-funding platforms to raise funds to develop existing waqf properties and create new ones.

Community Awareness and Financial Literacy

On the supply side, increasing the awareness of zakāh and waqf will help to expand the ISF sector. While people are generally aware of zakāh and waqf, there is a lack of knowledge in terms of their contemporary relevance and applications. For example, public awareness of zakāh obligations is very low in the Sub-Saharan region. To increase contributions to the ISF sector, there is a need to educate people about how to calculate zakāh and about the new types of wealth, such as stocks, ṣukūk, etc. on which zakāh is due. Similarly, contributions to creating new social waqf are low partly due to a misconception that waqf is created only for religious purposes, such as mosques. Civil societies and ISF institutions can raise awareness among the masses of the religious motivations of charitable giving to increase contributions and enlarge the ISF sector further.

157 Ibid.
Collaboration and Partnership

Given the enormous need and the complexity of the problems, there is a need for partnership among institutions from different sectors to create social impact and enhance welfare. The integration of ISF with other sectors would require effective collaboration between Islamic financial institutions, religious/waqf authorities, and non-traditional partners such as social enterprises, charitable organisations and other capacity-building providers.¹⁶¹ Such collaboration would create synergies and enable each stakeholder to contribute their knowledge and expertise towards enhancing the financial and social resilience of the target groups. It is important to have high-quality implementation partners to ensure the efficacy, sustainability and impactful delivery of the ISF programmes.

3.8 Conclusion

COVID-19 represents an external shock that did not directly affect the banking sector; however, the economic and social impacts of the pandemic can potentially affect the stability of financial systems. Other than discussing the endogenous micro- and macro-determinants that can affect the financial sector, this chapter identified the external economic, social and environmental factors arising due to COVID-19 that can impact on financial stability. Specifically, the exogenous factors that can affect the financial sector include health crises, business slowdowns, job losses, increased inequality, debt levels and ecological imbalances. After identifying the institutions and instruments of the ISF sector, the chapter examined the role they can play in mitigating the impact on the stability of financial systems of these external factors.

A large and robust ISF sector can promote stability directly by diversifying the financial system and indirectly by promoting financial and social inclusion through providing inclusive financial services to the poorer sections of the population. A larger ISF sector would complement the commercial financial sector and create an overall financial ecosystem that is more inclusive and stable. The two key pillars of the ISF sector, zakāh and waqf, can provide stable sources of funds that can be used to tackle the adverse impact of negative shocks such as COVID-19. Since zakāh is calculated as a percentage of wealth and waqf represents social capital that is relatively stable during negative shocks, they can continue to provide support to the vulnerable sections of society during a pandemic. Prior to COVID-19, achieving their SDGs and dealing with the climate crisis were key concerns for most countries. COVID-19 not only impeded the gains that were made in achieving these goals, but also highlights the need to make significant changes moving forward. In this regard, the ISF sector needs to transform to become more effective and resilient in order to help promote the development of sustainable and stable economic, social, environmental and financial systems.

¹⁶¹ This has been highlighted in Bank Negara Malaysia’s Annual Report 2020. 
GLOBAL DEVELOPMENTS:
IFSB INITIATIVES AND ACTIVITIES
4.0 GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

4.1 Global Developments and Impacts on the IFSI

In 2020 and the early months of 2021, global standard setters for the banking, securities and insurance sectors, such as the BCBS, IOSCO, IAIS and the FSB, issued a number of documents that are relevant to the IFSI and to the standard-setting work of the IFSB. These include standards, final reports, consultation reports and survey reports. The IFSB, being the complementary global standard setter for the Islamic banking, Islamic capital markets and takāful sectors, monitors closely the work streams of global standard setters, and this section of the report provides an update on those documents that are particularly relevant to the IFSB’s future standards work.

As with the IFSB, the work of other standard setters has been heavily impacted by the COVID-19 pandemic. Some standard setters have done significant short-term work in response to it – for example, providing members with access to information on measures taken in other jurisdictions. There have also been some postponements of the implementation dates for agreed reforms in order to allow institutions to focus more fully on their responses to the pandemic. On the other hand, the pandemic has exposed some issues of longer-term relevance. In some cases, standard setters have already responded to these – for example, in the BCBS’s consultation on new Principles for Operational Resilience. In others, the issues have been earmarked for future standards work; for example, IOSCO has identified as a new priority theme for 2021 “Remote working, misconduct risks, fraud and scams, and operational resilience, in the context of the COVID-19 pandemic”. It is likely that further issues will be identified as standard setters continue their analyses of the effects of the pandemic.

Partly because of COVID-19, operational risk has been a particularly strong theme across standard setters this year. In addition to the BCBS’s Principles for Operational Resilience, it also published for consultation a very substantially revised set of Principles for the Sound Management of Operational Risk, while the FSB both consulted on and finalised a set of Effective Practices for Cyber Incident Response and Recovery. IOSCO consulted on revisions to its Principles for Outsourcing, with operational resilience a key driver of the proposed changes. These will be an important set of documents, but there are no obvious Islamic specificities.162 Their influence on the work of the IFSB will therefore be felt primarily in future standards on broader topics such as risk management or the supervisory review process.

Another continuing theme has been the impacts of financial technologies, particularly crypto-assets and so-called stablecoins, but also including topics such as the use of artificial intelligence and machine learning by asset managers and other capital markets intermediaries, and the use of big data analytics in insurance. This work has, however, been largely exploratory and, for the present, has not resulted in definitive standards.

Other publications with relevance for IFSB’s work are discussed below. This discussion does not, however, summarise all aspects of each publication, for which readers are referred to the websites of the relevant standard setters.

4.1.1 Financial Stability Board


Of the various analyses of the impact of the pandemic, the two named above, submitted by the FSB to the G20 in November 2020, are among the most important in terms of their implications for future standards work. In particular, the Holistic Review notes that the regulatory reforms and market-driven adjustments in the aftermath of the 2008 financial crisis have resulted in credit risk being increasingly intermediated and held outside the banking sector. As a result, market liquidity has become more central to financial resilience, while traditional market-making activities may have become

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162 Although Shari’ah non-compliance risk is technically an aspect of operational risk, it is normally managed separately and is the subject of separate standards, which of course are relevant only for Islamic finance.
more restricted. The COVID-19 shock caused a repricing of risk and a heightened demand for safe assets, but also created imbalances in the supply and demand for liquidity. Both non-government money market funds and some open-ended funds experienced redemptions and sometimes liquidity strains.

Fortunately, central counterparties remained resilient, and unprecedented interventions by governments and regulators allowed markets to continue to function. However, the FSB has identified a forward work programme focusing particularly on fund liquidity and non-bank financial institutions. Much of this work will be analytical, but it is likely that some changes in standards will emerge. While Islamic capital markets have some characteristics that in this context are helpful (e.g. extremely limited use of derivatives), in other areas (e.g. the ṣukūk market) a shortage of liquidity is a recognised issue. The IFSB will therefore evaluate the standards that emerge from the FSB’s work programme and assess any standards work of its own that should be undertaken to address Islamic specificities. It is also possible that some of the analysis will be available in time to influence the IFSB’s current work to produce a Guidance Note on policies to develop the ṣukūk market.

The FSB is continuing its work on assessing lessons learnt from COVID-19 – in particular, the implications for financial stability, and will be producing further reports during 2021.

**Key Attributes Assessment Methodology for the Insurance Sector**

As part of its continuing programme on resolution and recovery, the FSB in August published the above paper, effectively providing an insurance-sector-specific interpretation of its Key Attributes of Effective Resolution Regimes for Financial Institutions. These attributes are in principle applicable to systemically significant insurers, but may well influence national resolution regimes more generally. Another piece of work in the same broad area has been the IAIS’s Application Paper on Resolution Powers and Planning, published for consultation in November 2020. The paper aims to provide guidance to supervisors and/or resolution authorities on resolution planning and the practical application of resolution powers in the insurance sector. While some of this guidance is specific to internationally active insurance groups, other parts have wider application.

The IFSB has so far published one research paper on resolution, recovery and insolvency regimes for Islamic financial institutions (WP-07, published in 2017). This paper focused mainly, but not exclusively, on banking. Should the IFSB decide in the future to develop a standard covering resolution and recovery for takāful undertakings, the Key Attributes Methodology will be a very important input.

**4.1.2 Basel Committee on Banking Supervision**

*Basel Committee Work Programme and Strategic Priorities for 2021/22*Z

In April 2021 the BCBS published its programme and priorities for 2021–2. The programme confirmed that a clear end had been reached in terms of the Basel III policy development agenda and that, in that area, the focus would be on implementation and evaluation. It has, however, signalled that it will complete existing work on the prudential treatment of crypto-currency exposures, on which a consultation document was published in June 2021, and on disclosure requirements related to market risk and sovereign exposures; the disclosure requirements, in particular, may have some impact on future IFSB standards.

**4.1.3 International Organization of Securities Commissions**

*Development of Emerging Capital Markets: Opportunities, Challenges and Solutions*

In October 2020, IOSCO published the above report from its Growth and Emerging Markets Committee. It is not a standard, but a contribution to the work of the G20 International Financial Architecture Working Group, whose 2020 programme included the development of domestic capital markets to support growth and enhance resilience, particularly in emerging market jurisdictions. However, it is particularly relevant to the work of the IFSB, not only because many of the leading
jurisdictions in Islamic finance rank as emerging markets, but also because the IFSB has recently begun work on a Guidance Note on the development of the ṣukūk market. Although the IOSCO report focuses primarily on equity markets, many of the ideas contained in it will fall to be considered as part of that work.

4.1.4 International Association of Insurance Supervisors

2021–2 Roadmap

In February 2021 the IAIS published its 2021–2 Roadmap, effectively its work programme for those two years. The Roadmap includes only a limited amount of new standards work, in a period when the current version of the Insurance Capital Standard is in its five-year monitoring period. However, like other standard setters, the IAIS will be assessing lessons learnt from the COVID-19 pandemic and the policy responses to it. This is likely to influence current projects in areas such as operational resilience.

Although the IAIS plans a limited amount of new standards work, the Roadmap does include several Application Papers and Issues Papers. Some of these will be in areas where there are clearly Islamic finance specificities. One will be the Application Paper on the Supervision of Control Functions, the definition of which for a takāful undertaking would naturally include some functions associated with Shari‘ah governance. Another will be the Issues Paper on Insurer Culture, which will raise questions as to how far the culture of takāful is different from that of conventional insurance, and perhaps what incentives are created by its contractual structure. These and other papers may therefore have implications for the future work of the IFSB and will need to be evaluated once they become available at least in draft. In particular, the Application Paper on the Supervision of Control Functions may well be relevant to the standard on takāful supervision currently under development.

4.1.5 Trustees of the IFRS Foundation

Consultation Paper on Sustainability Reporting

One development that is likely to have an effect on the future standards architecture was the publication by the Trustees of the IFRS Foundation of a consultation paper on sustainability reporting. This paper, which received significant support from a number of organisations and governments, proposed the creation of a new Sustainability Standards Board under the auspices of the Foundation. This board would develop standards for sustainability reporting by businesses generally, not specifically in financial services. It was suggested that its initial work might be on disclosures related to climate change, but it might then extend its standards to other aspects of sustainability.

A post-consultation statement by the trustees in February 2021 indicated “growing and urgent demand to improve the global consistency and comparability in sustainability reporting” and strong demand for the IFRS Foundation to play a part in this. With strong encouragement from other bodies and governments, the IFRS Foundation is moving ahead with the aim of establishing an International Sustainability Standards Board before the end of October 2021.

The IFRS Foundation’s initiative was partly a response not only to the perceived need but also to a diverse set of initiatives from various bodies, public and private, to establish standards related to climate change or to environmental issues more generally. A need for greater coordination had been recognised for some time. The Task Force on Climate-Related Financial Disclosures (TFCD) established by the FSB has been particularly influential in the area of financial disclosures, and the FSB has now undertaken to work with other organisations to develop a coordinated forward-looking programme to address climate-related financial risk.

While there are no obvious Islamic specificities to climate or sustainability disclosures, these topics are particularly important to the IFSI because of the principles that underlie Islamic finance. The IFSB has therefore incorporated disclosures based on the work of the TFCD in two of its standards. In the longer term, any new standards from a Sustainability Standards Board may impact future IFSB disclosure standards. It is hard at this stage to gauge the potential impact of the programme being developed by the FSB.

\[\text{IFSB-22 and IFSB-25.}\]
4.2 IFSB Standards, Research and PSIFIs Activities

4.2.1 Update on Standards under Development

The IFSB currently has nine standards, technical notes and guidance notes under development.

Those within its Islamic banking workstream are discussed below.

Resolution and Recovery Plan (RRP) for IIFS

The IFSB’s Technical Note on RRP for IIFS aims to help the relevant RSAs and related authorities to establish an effective recovery and resolution framework and appropriate tools for effective implementation of recovery and resolution for IIFS in a manner fully compliant with Shari‘ah principles. This will include setting out the required measures to carry out effective recovery and resolution planning for IIFS, as part of their proactive measures to prepare for any potential stressed situation; supporting and enabling effective resolvability assessments essential for bespoke resolution regimes for the IIFS; and providing the Shari‘ah governance in relation to resolution and recovery planning for IIFS.

Technical Note on Shari‘ah-compliant Liquidity Management Tools

This technical note on Shari‘ah-compliant liquidity management tools aims to provide harmonised and standardised liquidity management instruments that will meet Shari‘ah rules and principles and which RSAs can transpose into national regulations for the purpose of managing liquidity issues of their IIFS. The TN is also intended to provide technical guidance on the modus operandi of the specific Shari‘ah-compliant liquidity management tools, highlight risks associated with these instruments, and assess their implications in relation to liquidity risk management and regulatory capital requirements for IIFS.

Guiding Principles on Corporate Governance for IIFS

This standard aims to revise and extend the existing standard, IFSB-3. IFSB-3 was issued in December 2006, since which time there have been substantial developments in other corporate governance standards, most notably the issue in 2015 of updated versions of the G20/OECD Principles of Corporate Governance and the BCBS Corporate Governance Principles for Banks. The new standard aims to reflect these developments, and developments in the Islamic banking sector since IFSB-3 was issued, and to provide a modern and comprehensive framework for corporate governance for Islamic banks.

Those within its Islamic capital markets workstream are:

Core Principles for Islamic Finance Regulation (CPIFR): Financial Market Infrastructures (FMIs)

The main objective of the CPIFR (FMIs) is to provide a set of core principles for financial market infrastructures and their regulation and supervision, taking into consideration the specificities of Islamic finance, while complementing the existing international standards, principally the CPSS-IOSCO Principles for Financial Market Infrastructures (April 2012) and its associated disclosure framework and assessment methodology (December 2012). It intends to provide a comprehensive standard for effective regulation, supervision and oversight of capital markets (FMIs) addressing the specificities of Islamic finance; to equip RSAs with minimum international benchmarks to ensure safe, transparent and robust FMIs; and to assist the RSAs in assessing the quality of their regulatory framework for their respective FMIs and identifying areas for improvement.

Guidance Note on Deepening the Islamic Capital Markets

The Islamic capital market is currently the most rapidly growing segment in the Islamic financial services industry. However, at this stage of development, there is an increasing focus by many jurisdictions on the need to develop deeper and more liquid Islamic capital markets. Islamic finance-specific issues to be addressed in this guidance note include: (i) promoting liquidity in ṣukūk markets; (ii) the need to have a tax regime that does not penalise ṣukūk by taxing asset transfers in and out; (iii) establishing a yield curve through sovereign issues of different tenors; (iv) the
need for a regulatory regime to understand specific ṣukūk requirements; (v) the appropriate currencies of issue; (vi) the development of institutional investors; (vii) increasing retail investor participation; (viii) product development and innovation; and (ix) the need for market makers, rating agencies, Shari‘ah scholars, etc. Other possible issues for discussion include green and SRI ṣukūk, as well as the role of technology and digitalisation.

Those within its takāful workstream are:

Core Principles for Islamic Finance Regulation: Takāful

The CPIFR takāful standard aims to provide an international benchmark to promote a sound regulatory and supervisory system for the takāful sector. A fair, safe and stable takāful sector will benefit and protect the interests of participants, beneficiaries and claimants, as well as contribute to the stability of the Islamic financial system. A hierarchical structure of principles, standards and guidance material, consistent with that of the IAIS Core Principles, is being proposed, within a structure that supplements those Principles and, like other IFSB Core Principles, covers the full range of regulatory issues.

Revised Standard on Solvency Requirements for Takāful (Islamic Insurance)

The revised solvency standard for takāful undertakings, replacing the existing IFSB-11, is intended to foster confidence among the general public – in particular, takāful participants – in the financial stability of the takāful sector. It aims to increase the likelihood that a takāful undertaking would be able to meet all its contractual obligations and commitments; to act as an early warning system for regulatory intervention and immediate corrective action; and to provide a buffer so that even if the takāful participants are to suffer a loss in the event of failure of a takāful undertaking, the impact can be limited or reduced, especially the systemic effects. The standard will take account of developments in conventional standards since IFSB-11 was issued in 2010, especially the IAIS Insurance Capital Standard and the finalisation of the European Solvency II regime.

Conduct of Business and Its Prudential Supervision in Takāful

This new standard recognises the link between conduct of business and prudential risks, and the significant difference between conduct-of-business issues in takāful and those in conventional insurance. It therefore aims to provide comprehensive supervisory guidance to the RSAs within the conduct-of-business environment and to articulate the link between prudential and conduct-of-business risks to strengthen the prudential supervisory framework and practices.

The standard within its cross-sectoral workstream is:

Revised Guiding Principles on the Sharī‘ah Governance Framework for IIFS

The IFSB and the AAOIFI have partnered to jointly provide a revised set of guiding principles on the key components of a sound and effective Sharī‘ah governance system for institutions offering Islamic financial services. The joint standard intends to synergise efforts by both the IFSB and AAOIFI to provide consistent and harmonised Sharī‘ah governance guidelines for IFSI stakeholders. In the case of the IFSB, it will replace IFSB-10, issued in December 2009.

4.2.2 Synopsis of IFSB Research Projects

The IFSB has issued four working papers since the publication of the Stability Report 2020. IFSB working papers are research-based publications intended to lay the groundwork for future standards development and implementation. The papers can be downloaded from the IFSB website.

WP-15: Risk-based Supervision in Islamic Banking

WP-15 investigates risk-based supervisory (RBS) practices among the IFSB’s RSA members for the Islamic banking industry in their respective jurisdictions. The paper finds that RBS frameworks are equally as relevant, applicable and important for Islamic banks (IBs) as they are for conventional banks (CBs). However, applying RBS in Islamic banking, including for IBs that are domestic systemically
important banks, would require taking cognisance of some additional unique risks that are not applicable to CBs. These risks include Sharī‘ah non-compliance risk, rate-of-return risk, equity investment risk and displaced commercial risk. These risks should be included in the final risk rating and assessment of IBs for supervisory purposes. To this end, it is suggested that IBs should develop key performance indicators (KPIs) with a framework of tolerance levels for all risk categories. In addition, and preferably via the use of technology, there should be a transparent and credible mechanism for accessing KPI information, which should be readily available to and applied by the RSAs while conducting RBS for risk assessment of Islamic banks.

**WP-16: Regulatory and Supervisory Issues in Takāful Windows**

WP-16 discusses the basic elements in the regulation and supervision of takāful windows; identifies specific issues and challenges, particularly with regards to the applicable principles and benchmarks; and addresses Sharī‘ah requirements in the takāful operations. It is intended to highlight the challenges encountered by supervisors who are introducing a takāful window for the first time and are unfamiliar with some of the procedures and the expertise required in order to supervise this new type of activity. The paper discusses the regulatory toolkit available for the supervision of takāful windows, including market entry requirements and key elements of the supervisory review process to assess the window’s compliance and the accountability of organs of governance. In addition, it assists supervisory authorities to develop an integrated system for assessing the governance framework, capital adequacy, risk management framework and retakāful programme. In addition, it highlights issues concerning the supervision of cross-border activities of takāful and retakāful branches or subsidiaries of foreign (re)insurance entities.


WP-18 assesses the preliminary effects and implications of the COVID-19 pandemic for the stability of the Islamic banking industry in eight IFSB member jurisdictions. Data used for the analysis were extracted from the IFSB Prudential and Structural Islamic Finance Indicators (PSIFIs) from 1Q18 to 3Q20 and were compared across the core prudential indicators in the PSIFIs to observe quarter-on-quarter changes and to assess the statistical significance of preliminary effects of the pandemic. The capital adequacy Z-score for each quarter is computed as a proxy for Islamic banking sector stability. Findings indicate that, while the Islamic banking sector across jurisdictions in the sample was stable and still recorded prudential indicators well above the minimum regulatory and historical average thresholds, some changes could be observed for particular indicators and countries following the COVID-19 outbreak. The implications of the findings are also discussed, while recognising that the data used are still very preliminary and that government stimulus measures remain in place in many countries which in the longer term will need to be withdrawn, with further impacts on the Islamic banking industry.

**WP-19: Digital Transformation in Islamic Banking**

WP-19 investigates the activities relating to the digital transformation process of IBs based on data from a survey questionnaire returned by 80 IBs across 21 IFSB member jurisdictions. The paper investigates the IBs’ rationales for digitalisation, as well as their current status and the technologies they have adopted. The paper also investigates the regulatory approaches, challenges, prudential risks and financial stability implications of digitalisation of Islamic banking. The paper found that IBs’ digitalisation process, while still in progress, has gained momentum since the outbreak of the COVID-19 pandemic. Among other reasons cited in the paper, strengthening competitiveness, enhancing operational efficiency and improving customer satisfaction are the main rationales for IBs’ digitalisation drive. The technologies adopted include mobile and digital wallets, biometric authentication and application programming interfaces. Notwithstanding, IBs’ digitalisation drive has been impeded by legacy infrastructure, and by the lack of both the requisite human resources and an open banking infrastructure and architecture. The paper examines the implications of the benefits and the risks of digitalisation for the stability of the Islamic banking industry and makes recommendations on the way forward.
4.0 GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

4.2.3 Final Review of the IsDB–IFSB Ten-Year Framework and Strategies Paper

The IFSI Ten-Year Framework and Strategies Report, covering the period 2008–18, was first issued in 2007, followed by a Mid-Term Review issued in May 2014. The Mid-Term Review discussed the proposed measures to address the gaps or challenges in meeting the objectives of the Ten-Year Framework, as well as the roles of the public and private sectors and other stakeholders in carrying out the key recommendations, taking into account the state of development of the IFSI in the respective jurisdictions.

The Mid-Term Review also proposed 16 recommendations comprising 13 from the 2007 document and three new additions, which are further grouped into three themes, namely: “enablement”, “performance” and “reach”. Additionally, the Mid-Term Review publication identified a total of 20 key initiatives to support the implementation of recommendations. These initiatives are grouped along the three pillars of the framework: “enablement”, “performance” and “reach”. Importantly, the Mid-Term Review envisioned that the review of the industry-wide progress of the recommendations and key performance metrics would culminate in a final review, which essentially marks the completion of the period envisioned by the Ten-Year Framework; hence, the need to embark on this last phase of the Ten-Year Framework to complete the entire project.

The final review will examine the progress and current status of the priorities and initiatives recommended in the Mid-Term Review across the Islamic banking, Islamic capital markets, takāful, and Islamic non-banking financial institutions segments, respectively. It will assess the effects on the respective Islamic finance segments of developments in the global financial system and propose key recommendations and implementation initiatives for the future direction of the IFSI as a global financial ecosystem.

The project, which is expected to culminate in a final report that will be jointly published by both the IsDB and IFSB, is presently being carried out by a working group comprising staff of both organisations and external consultants. A review committee from the IFSB Technical Committee has also been appointed to provide a technical review at various stages of the project.

4.2.4 PSIFIs Database: A Repository of Global Islamic Finance Data

The prudential and structural Islamic financial indicators database, as a global platform of Islamic finance statistics which reflects Sharī`ah-compliant accounting practices and regulatory standards in its compilation, has now reached a sustainable stage in terms of regular reporting of Islamic banking data from 24 jurisdictions. Data have been regularly disseminated on a quarterly basis since 2015 and underlie the analysis of the position of the Islamic banking industry in this report. The PSIFIs project currently compiles Islamic banking data from Afghanistan, Bahrain, Bangladesh, Brunei, Egypt, Indonesia, Iran, Iraq, Jordan, Kazakhstan, Kuwait, Lebanon, Libya, Malaysia, Nigeria, Oman, Pakistan, Palestine, Qatar, Saudi Arabia, Sudan, Turkey, the United Arab Emirates and the United Kingdom. Overall, the PSIFIs member countries collectively hold more than 95% of global Islamic banking assets.

In 2020, the IFSB published for the first time Detailed Financial Statement (DFS) information for Islamic banking, initially covering seven jurisdictions. The DFS information, as the name suggests, covers the aggregated income statements, balance sheets and memorandum items for the Islamic banking sector. The DFS provides analysts with information that enables them to experiment with different variations of the indicators and to examine other linkages of the accounts with the general economy. The full structural information can also facilitate comparison to microdata from individual enterprise financial reports and from various commercial databases that present bank-by-bank reporting. The DFS parallels the IMF’s collection of similar accounts covering full national banking systems (conventional and Islamic combined).

In 2020 the IFSB also began to collect PSIFIs data for the takāful and ICM sectors and published the first takāful data, initially covering four jurisdictions. Similar to the CAMELS analytic framework used for organising prudential indicators for Islamic banking, takāful
indicators use a “CARMELS” framework that has an additional measure for retakāful: Capital Adequacy, Asset Quality, Reinsurance, Management, Earnings, Liquidity, and Sensitivity to Market Risk. Reinsurance, which results in transfer of risk to a reinsurance/retakāful undertaking, is added because it is directly related to the soundness of the operation.

The PSIFIs for the ICM cover three main areas: ṣukūk, Shari‘ah-compliant equities and Islamic funds. Data collection for this sector was impacted by the COVID-19 pandemic and the additional loads which this imposed on capital markets regulators. The Secretariat has therefore not yet been able to disseminate data for this sector. Given that this is the initial phase of data collection, it is currently in the process of a thorough review of submitted data and follow-up with the participating jurisdictions.

4.3 Facilitating the Implementation of IFSB Standards (FIS) Initiatives

Since its establishment, the IFSB has conducted several types of activity that support the implementation of standards in member countries. These activities include: FIS workshops, Technical Assistance (TA), Policy Advice (PA), an E-learning Platform, an Outreach Program, the translation of IFSB standards into additional languages, and the provision on the IFSB website of Frequently Asked Questions (FAQs) for standards, guidance notes and technical notes. Some of these activities are meant to educate and raise awareness on IFSB standards. Others provide direct support to member RSAs, since technical support is extended during the drafting of policies and regulations, to ensure consistency with the IFSB’s standards.

The Secretariat also conducts an annual implementation survey to assess the progress made in implementing the IFSB’s published standards and understand the major challenges and constraints faced in this regard. The feedback received from members also helps in identifying strategies that can assist in accelerating and strengthening the process of implementing the IFSB’s standards.

In additional to the above activities, the IFSB Secretariat introduced new initiatives in its Strategic Performance Plan 2018–2020 that aim to further enhance the implementation support provided to member RSAs. The newly introduced initiatives include the publishing of an Implementation Guidelines (IG) Report, development of the Impact and Consistency Assessment Program, building a database of experts in IFSB standards through conducting the Train the Trainers Program and publishing Frequently Asked Questions (FAQs) on IFSB standards, guidance and technical notes. The following summary provides further information on these new initiatives.

4.3.1 Impact and Consistency Assessment Program (ICAP)

The IFSB Secretariat has been working on the development of an assessment program that aims to assess the consistency and impact of IFSB standards in member countries. The ICAP assessment is meant to provide a validated representation of the implementation status of particular member RSAs and to allow the identification of any regulatory gaps that might have a serious impact on the financial sector in member jurisdictions. It will also allow the IFSB to extend any support required to remedy gaps and to ensure effective implementation of standards.

The initiative aims: to promote the full and consistent adoption of IFSB standards by identifying provisions in the standards that are not reflected in domestic regulations and practice; to assess the current and potential impact of any deficiencies for the objectives of the regulator; to help member jurisdictions by providing technical assistance to undertake the reforms needed to improve the alignment of national regulations with IFSB standards; to assess the impact of implementing IFSB standards on member countries; and to ensure that Islamic financial institutions and markets in member jurisdictions are effectively regulated and supervised on an equitable basis with conventional financial institutions.

The introduction of ICAP as one of the main activities under implementation will have several benefits for both the IFSB and member RSAs. While it will help the IFSB to achieve a vital part of its core mandate, it will allow member RSAs participating in the ICAP program
to have a better understanding of the implementation of IFSB standards and the effects of these standards in the local market. They will be able to identify any gaps in implementation, as well as the impact of implementing IFSB standards on the relevant parts of their Islamic finance industry. However, the program will focus initially on assessing implementation, while developing the tools to assess impact, which will be challenging, particularly in the case of the standards that do not have quantitative outcomes.

Two ICAP approaches will be available, initially, for the Islamic banking sector.

In a full assessment, the group of standards to be assessed will be agreed with the assessed jurisdiction. A task force will be set up, coordinated by the IFSB Secretariat, and an Assessment Team and a Review Team will be identified. The assessment templates for the standards chosen will be customised, particularly with a view to avoiding overlaps where the same topic is discussed in more than one standard. The jurisdiction will make an initial self-assessment, which will form the basis of the Assessment Team’s work. That work will include considering how the impact can be assessed in the case of the standards in question. The Assessment Team’s draft report will be discussed with the jurisdiction before being reviewed by the Review Team and finalised. Issues identified in the report will be followed up with the jurisdiction subsequently.

Because the basic assessment templates for a core group of standards will be published, they can also be used by jurisdictions wishing to undertake self-assessments. The documentation gives guidance on how this can be done in an appropriately rigorous way.

4.3.2 Train the Trainer Programme

With over 187 members from 57 jurisdictions, including 79 RSAs, and the rapid growth of Islamic finance, meeting members’ demands and expectations in terms of building capacity and providing technical assistance becomes a challenge for the IFSB. To meet such demands and provide adequate support to members, the Secretariat is launching its Train the Trainer programme in order to expand the implementation support to member RSAs. This has become a top priority for the IFSB.

The programme is intended to engage master trainers, who are highly skilled and have a throughout understanding of IFSB standards, in coaching new trainers who are less experienced with IFSB standards. The program will be structured to create subject-matter experts in IFSB standards who can both train colleagues within their own RSA and act as resident consultants on standards implementation.

Although initially trainers will come from member RSAs, it is hoped that it will be possible later to include independent external experts. The IFSB Secretariat hopes to establish a roster of highly skilled subject-matter experts, including both staff of member RSA institutions and independent external experts who can be involved in IFSB Implementation Support missions in member jurisdictions. In this role, subject-matter experts will undertake short-term assignments and will provide their expertise to assist member RSAs to implement IFSB standards.

The programme will help to drive implementation of IFSB standards, increase efficiency, and provide customised consultation and solutions to IFSB member RSAs. The benefits envisaged are:

To the IFSB RSA members:

• Developing an in-house talent pool to support in-house capacity building and implementation of the IFSB standards
• Efficient and economic response to Islamic finance capacity building and policy needs
• Customised solutions to address talent gaps
• Fast track to achieve high IFSB standards implementation rates and to address implementation challenges.

To the subject-matter experts:

• Learning from different countries’ experiences in developing Islamic finance and implementing IFSB standards
• Having an in-depth exposure to policymaking in Islamic finance in different jurisdictions
4.3.3 Implementation Guidelines (IG)

The implementation of IFSB standards may be a challenge in some jurisdictions that have limited experience of implementing standards for Islamic finance. To achieve effective implementation, member jurisdictions should have in place the proper infrastructure to support the Islamic finance sector and, ideally, a skilled and experienced policy team.

The implementation guidelines project aims to:

- Create an opportunity for member jurisdictions who want to improve their implementation rates by leveraging on the experience of other member jurisdictions
- Document and share basic implementation steps by RSAs that have successfully implemented IFSB standards
- Highlight the main challenges faced by member RSAs in implementing IFSB standards and how they were overcome.

The IFSB Secretariat kicked off the IG project in 2020 and engaged with some member RSAs in different jurisdictions who have achieved high implementation rates to document their experience. The first publication from the IG project is planned to be in 2021 and will focus on the key areas that led to the development of Islamic finance in these countries and the necessary steps taken by the RSAs to achieve their high implementation rates.

4.3.4 Highlights of the IFSB Standards Implementation Survey 2020

The IFSB Standards Implementation Survey is an annual survey exercise, undertaken by the IFSB, covering IFSB RSA members. Specifically, the survey helps in assessing the progress made by member RSAs in implementing the IFSB’s published standards, and in understanding the major challenges and constraints the RSAs face in the process. Information from past surveys has informed the implementation initiatives discussed above. As in previous years, the survey relies on self-reporting; no verification of the responses is undertaken, nor is any assessment made of the completeness of implementation.

A total of 29 RSAs participated in the 2020 survey, which was conducted between 26 January and 15 March 2021. Taking into account that some RSAs regulate more than one sector of Islamic finance, this gave 21 responses for banking, 13 for capital markets and 7 for takāful. The number of responses was higher than for 2019 (20 RSAs), but still markedly down on the figures for 2017 and 2018 (42 and 41, respectively). This is likely due to the continuing effects of COVID-19 on RSAs’ operations. Of the 29 respondents in 2020, 15 were in common with the 2019 survey. This pattern, of an approximately 50% overlap between one year and another, was also seen in the 2020 survey. Given the relatively small numbers involved, the changes in the sample need to be borne in mind when assessing the significance of changes from year to year. In addition, this year, as in previous years, it is likely that there will be some selection effect, with those RSAs most committed to implementation being the most likely to respond.

The overall level of reported implementation of IFSB standards was the same as in 2019, at 55%. However, there were slight increases in the proportions reporting that implementation was either in progress or in the planning stage.

![Chart 4.3.4.1 Overall Implementation of IFSB Standards in 2020](image)
Looking at those respondents that also responded to the 2020 survey shows a small increase in implementation.

The status charts for the three subsectors are given below. In each case, they include the cross-sectoral standards (on Shari’ah governance and conduct of business) as applied in that sector. For Islamic banking only, it is also meaningful to look at the standards areas in which implementation has been most complete. (Looking at the data in this way takes account of the fact that in some areas standards have developed over time, with later standards substantially superseding earlier ones.)
As in past years, the survey looked at the obstacles to implementation that respondents saw. Some of these, like the time taken to implement standards, which came top of the list, are essentially related to the jurisdiction’s own processes. However, the responses in the area of human resources and capacity building continue to suggest that this is an area where international institutions may be able to give support through capacity-building initiatives. Some of these may be difficult, however. In particular, the development of Shari’ah scholars takes a long time and some of the newer Islamic finance jurisdictions may have very limited traditions of Shari’ah scholarship in financial services.
This chart helps to illuminate the one that follows, which sets out respondents’ views of the potential significance of the implementation tools which the IFSB might deploy to assist its members. In comparison with last year, most of the possible tools show slightly increased scores. Although this could be the result of the change in the sample, it may be that the increased pressures of the COVID-19 pandemic on many RSAs have left them feeling more in need of support.

**Chart 4.3.4.9 Significance of Implementation Tools**
LIST OF BOXES, TABLES, CHARTS AND FIGURES

BOXES

1. Moody's Outlook of the Islamic Financial Services Industry in 2021
2. Islamic Banking Sector's Development in Saudi Arabia Amid the COVID-19 Pandemic
3. COVID-19 Policy Measures and the Islamic Banking Sector in Bahrain
4. Islamic Banking in the UAE Amid COVID-19
5. Implications and Effectiveness of Policy Response to the Recovery Phase of COVID-19 for the Islamic Banking Sector in Pakistan
6. The Impact of the Pandemic on Liquidity and the Role of the IILM
7. Participation Insurance in Turkey and Response to COVID-19
8. COVID-19 and Islamic Social Finance in Malaysia
9. Akhuwat: A Compassion-Based Resilient Islamic Social Finance Model
10. COVID-19 and Islamic Social Finance in Indonesia
11. National Zakāh Foundation (NZF) UK: Resilience in Providing Relief during COVID-19
12. COVID-19 and Endowment Funds in Saudi Arabia

TABLES

1.1.1 Breakdown of Global IFSI by Sector and Region (USD billion, 2020)
2.2.1.1 Demand Comparison for Selected Ṣukūk Issued in 2020
3.5.1 Islamic Social Finance: Institutions and Instruments
3.6.2.1 Mitigating Exogenous Factors: Islamic Social Finance Institutions and Instruments

CHARTS

1.1.1 Islamic Banking Share in Total Banking Assets by Jurisdiction (3Q20)
1.1.2 Islamic Banking Assets in Jurisdictions with an Islamic Banking Sector of Systemic Importance (3Q20)
1.1.3 Ṣukūk Outstanding in Jurisdictions with an Islamic Banking Sector of Systemic Importance (4Q20)
1.1.4 Jurisdiction Share of Global Islamic Banking Assets (%) (3Q20)
1.2.1 Islamic Banking Assets (USD) and Market Share (%) (3Q20)
1.2.2 Regional Islamic Banking Assets (USD billion) (2018–3Q20)
1.2.1.1 Global Islamic Banking Assets, Financing, and Deposit CAGR (3Q18–3Q20)
1.2.1.2 Islamic Banking Assets Annual Growth Rates for Various Countries (3Q19–3Q20)
1.2.1.3 Islamic Banking Aggregate Financing Annual Growth Rates for Various Countries (3Q19–3Q20)
1.2.1.4 Islamic Banking Aggregate Deposit Annual Growth Rates for Various Countries (3Q19–3Q20)
1.3.1.1 Global Ṣukūk Issuances and Ṣukūk Outstanding Trends (2004–20)
1.3.1.2 Ṣukūk Issuances by Issuer Type (2020)
<table>
<thead>
<tr>
<th>LIST OF BOXES, TABLES, CHARTS AND FIGURES CONT'D</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.3.1.3(a) Sovereign Ṣukūk Issuances by Jurisdiction of the Originator (2020)</td>
</tr>
<tr>
<td>1.3.1.3(b) Corporate Ṣukūk Issuances by Jurisdiction of the Originator (2020)</td>
</tr>
<tr>
<td>1.3.1.4 Total Ṣukūk Issuances by Domicile (2020)</td>
</tr>
<tr>
<td>1.3.1.5 Global Ṣukūk Issuances by Sector (2020)</td>
</tr>
<tr>
<td>1.3.1.6 Green Ṣukūk Issuances (2017–20)</td>
</tr>
<tr>
<td>1.3.2.1 Growth in Assets under Management and Number of Islamic Funds (2008–20)</td>
</tr>
<tr>
<td>1.3.2.2 Islamic Fund Assets by Domicile (2020)</td>
</tr>
<tr>
<td>1.3.3.1 Ten-Year Historical Performance (2011 – February 2021)</td>
</tr>
<tr>
<td>1.3.3.2 Performance of Islamic Indices vs. Global (2020)</td>
</tr>
<tr>
<td>1.3.3.3 Sector Allocation and Sector Performance (2020)</td>
</tr>
<tr>
<td>1.3.3.4 S&amp;P 1200 Sector Performance (2020)</td>
</tr>
<tr>
<td>1.4.2.1 Takāful Contributions by Jurisdictions (USD million) (2019)</td>
</tr>
<tr>
<td>1.4.2.2 Takāful Gross Contributions/Total Sector Gross Contributions (%) (2019)</td>
</tr>
<tr>
<td>2.1.1.1 Global Islamic Banking Weighted Average ROA and ROE (1Q17–3Q20)</td>
</tr>
<tr>
<td>2.1.1.2 Islamic Banking Average ROA for Stand-alone Islamic Banks by Country (3Q19 – 3Q20)</td>
</tr>
<tr>
<td>2.1.1.3 Islamic Banking Average ROE for Stand-alone Islamic Banks by Country (3Q19 – 3Q20)</td>
</tr>
<tr>
<td>2.1.1.4 Islamic Banking Net Profit Margin by Country (3Q19 – 3Q20)</td>
</tr>
<tr>
<td>2.1.1.5 Islamic Banking Cost-to-Income Ratio by Country (3Q19 – 3Q20)</td>
</tr>
<tr>
<td>2.1.2.1 Liquidity Coverage Ratio for Stand-alone Islamic Banks by Country (3Q19–3Q20)</td>
</tr>
<tr>
<td>2.1.2.2 Net Stable Funding Ratio for Stand-alone Islamic Banks by Country (3Q19–3Q20)</td>
</tr>
<tr>
<td>2.1.2.3 Financing-to-Deposit Ratio by Country (3Q19–3Q20)</td>
</tr>
<tr>
<td>2.1.2.4 Liquid Assets to Short-Term Liabilities Ratio by Country (3Q19–3Q20)</td>
</tr>
<tr>
<td>2.1.3.1 Global Islamic Banking Average Foreign Currency Funding and Financing to Total Funding and Financing (1Q18–3Q20)</td>
</tr>
<tr>
<td>2.1.4.1 Weighted Average Percentage of Financing and Non-Performing Financing to Selected Economic Sectors as at 3Q20</td>
</tr>
<tr>
<td>2.1.4.2 Islamic Banking Sectoral Composition of Financing by Country (3Q20)</td>
</tr>
<tr>
<td>2.1.5.1 Global Islamic Banking Average Gross Non-Performing Financing to Total Financing (4Q13–3Q20)</td>
</tr>
<tr>
<td>2.1.5.2 Islamic Banking Average Gross Non-Performing Financing to Total Financing by Country (3Q19–3Q20)</td>
</tr>
<tr>
<td>2.1.6.1 Global Islamic Banking Average Capital Adequacy Ratios (1Q18–3Q20)</td>
</tr>
<tr>
<td>2.1.6.2 Islamic Banking Average Total Capital Adequacy Ratio by Country (3Q19-3Q20)</td>
</tr>
<tr>
<td>2.1.6.3 Islamic Banking Average Tier-1 Capital Adequacy Ratio by Country (3Q19-3Q20)</td>
</tr>
<tr>
<td>2.1.7.1 Islamic Banking Leverage Ratio by Country (4Q19–3Q20)</td>
</tr>
<tr>
<td>2.2.1.1 Ṣukūk Issuances by Market (2020)</td>
</tr>
<tr>
<td>2.2.1.2 Ṣukūk Issuance by Currency (2020)</td>
</tr>
<tr>
<td>2.2.1.3 Maturity Trend of All New Issuances (2008–20)</td>
</tr>
<tr>
<td>2.2.1.4 Ṣukūk Issuance by Structure (2020)</td>
</tr>
<tr>
<td>2.2.1.5 Geographical Distribution of Selected Ṣukūk Papers Issued in 2020</td>
</tr>
<tr>
<td>2.2.1.6 Investors’ Breakdown of Selected Ṣukūk Papers Issued in 2020</td>
</tr>
<tr>
<td>2.2.1.7 Outstanding Volume of Ṣukūk by Yield Bucket (%) (2009–20)</td>
</tr>
<tr>
<td>2.2.2.1 Islamic Fund Assets by Asset Class (2020)</td>
</tr>
<tr>
<td>2.2.2.2 Number of Islamic Funds by Asset Size (USD million) (2020)</td>
</tr>
<tr>
<td>2.2.3.1-5 Returns of Equity Indices across Countries and Regions</td>
</tr>
<tr>
<td>4.3.4.1 Overall Implementation of IFSB Standards</td>
</tr>
</tbody>
</table>
### LIST OF BOXES, TABLES, CHARTS AND FIGURES CONT’D

| 4.3.4.2 | All IFSB Standards: Consistent Members 2020 |
| 4.3.4.3 | All IFSB Standards: Consistent Members 2021 |
| 4.3.4.4 | Overall Implementation of Islamic Banking Standards |
| 4.3.4.5 | Number of Implemented Islamic Banking Standards by Key Areas by RSAs |
| 4.3.4.6 | Overall Implementation of IFSB ICM Standards |
| 4.3.4.7 | Overall Implementation of Takāful Standards |
| 4.3.4.8 | Top Three Challenges Related to Human Resources and Capacity Building |
| 4.3.4.9 | Significance of Implementation Tools |

### FIGURES

| 1.4.2.1 | Distribution of Retention Ratio across Classes in Saudi Arabia |
| 2.1.1   | Key Indicators for the Assessment of Islamic Banking Resilience |
## IFSB Membership Benefits

<table>
<thead>
<tr>
<th>No.</th>
<th>Membership Benefits</th>
<th>Full</th>
<th>Associate</th>
<th>Observer</th>
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<tr>
<td>1</td>
<td>Be part of a prestigious international organisation with the broadest representation in the IFSI, from 57 countries</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>2</td>
<td>Attend the IFSB General Assembly</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>3</td>
<td>Vote at the IFSB General Assembly</td>
<td>✓</td>
<td></td>
<td></td>
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<tr>
<td>4</td>
<td>Attend the IFSB Council Meeting</td>
<td>✓*</td>
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<tr>
<td>5</td>
<td>Be a member of the Executive Committee</td>
<td>✓</td>
<td></td>
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<td>6</td>
<td>Be a member of the Technical Committee</td>
<td>✓</td>
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<td>7</td>
<td>Submit nomination for the IFSB Secretary-General</td>
<td>✓</td>
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<tr>
<td>8</td>
<td>Participate (by invitation) in Working Groups, Task Force and Closed-door discussions for the development of the IFSB prudential standards</td>
<td>✓</td>
<td>✓</td>
<td>✓**</td>
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<tr>
<td>9</td>
<td>Ability to comment on IFSB exposure drafts</td>
<td>✓</td>
<td>✓</td>
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<tr>
<td>10</td>
<td>Request for Policy Advice</td>
<td>✓</td>
<td>✓</td>
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<td>11</td>
<td>Receive Technical Assistance</td>
<td>✓</td>
<td>✓</td>
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<td>12</td>
<td>Participate in the IFSB workshops (national &amp; regional) and public hearings on exposure drafts at no charge</td>
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<td>13</td>
<td>Participate in the IFSB e-Workshops via webinar</td>
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<td>Participate in the IFSB Capacity Building Program</td>
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<td>15</td>
<td>Participate in IFSB Train of Trainer (ToT) Programme</td>
<td>✓</td>
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</tr>
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<td>16</td>
<td>Support for IFSI Country Analysis and Self-Assessment</td>
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<td>17</td>
<td>Complimentary access to IFSB Standards E-Learning</td>
<td>✓</td>
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<td>18</td>
<td>Participate in the IFSB events on a complimentary/priority basis and/or at special members’ rates</td>
<td>✓</td>
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<td>19</td>
<td>Collaborate for events, research and publications</td>
<td>✓</td>
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<tr>
<td>20</td>
<td>Receive complimentary copies of IFSB publications</td>
<td>✓</td>
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<td>✓</td>
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<td>21</td>
<td>Access to materials of IFSB events and meetings and other web-based services at the Members’ Zone of the IFSB website</td>
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<td>✓</td>
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<td>22</td>
<td>Speaking and networking with other members from 57 countries</td>
<td>✓</td>
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<td>23</td>
<td>Host of IFSB Summit (bi-annual landmark event)</td>
<td>✓</td>
<td>✓**</td>
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<td>24</td>
<td>Hosting IFSB Working Group and Task Force Meetings</td>
<td>✓</td>
<td>✓</td>
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<tr>
<td>25</td>
<td>Participate in IFSB’s Prudential and Structural Islamic Financial Indicators (PSIFIs) Programme</td>
<td>✓</td>
<td>✓</td>
<td>✓**</td>
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</tbody>
</table>

* Full Members who are not Council members may attend by invitation.
** For regulatory and supervisory authorities and international inter-governmental organisations only
*** For regulatory and supervisory authorities only

For more information about the IFSB member contact, membership@ifsb.org or please visit www.ifsb.org
# IFSB Membership List

## Full Members

<table>
<thead>
<tr>
<th>Number</th>
<th>Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Islamic Development Bank</td>
</tr>
<tr>
<td>2</td>
<td>Central Bank of Bahrain</td>
</tr>
<tr>
<td>3</td>
<td>Bangladesh Bank</td>
</tr>
<tr>
<td>4</td>
<td>Autoriti Monetari Brunei Darussalam</td>
</tr>
<tr>
<td>5</td>
<td>Banque Centrale De Djibouti</td>
</tr>
<tr>
<td>6</td>
<td>Central Bank of Egypt</td>
</tr>
<tr>
<td>7</td>
<td>Bank Indonesia</td>
</tr>
<tr>
<td>8</td>
<td>Otoritas Jasa Keuangan, Indonesia</td>
</tr>
<tr>
<td>9</td>
<td>Central Bank of the Islamic Republic of Iran</td>
</tr>
<tr>
<td>10</td>
<td>Securities and Exchange Organization, Islamic Republic of Iran</td>
</tr>
<tr>
<td>11</td>
<td>Central Bank of Iraq</td>
</tr>
<tr>
<td>12</td>
<td>Central Bank of Jordan</td>
</tr>
<tr>
<td>13</td>
<td>Agency of the Republic of Kazakhstan for Regulation and Development of the Financial Market</td>
</tr>
<tr>
<td>14</td>
<td>Astana Financial Services Authority, Kazakhstan</td>
</tr>
<tr>
<td>15</td>
<td>Central Bank of Kuwait</td>
</tr>
<tr>
<td>16</td>
<td>Central Bank of Libya</td>
</tr>
<tr>
<td>17</td>
<td>Bank Negara Malaysia</td>
</tr>
<tr>
<td>18</td>
<td>Securities Commission Malaysia</td>
</tr>
<tr>
<td>19</td>
<td>Central Bank of Mauritania</td>
</tr>
<tr>
<td>20</td>
<td>Bank of Mauritius</td>
</tr>
<tr>
<td>21</td>
<td>Bank Al-Maghrb, Morocco</td>
</tr>
<tr>
<td>22</td>
<td>Central Bank of Nigeria</td>
</tr>
<tr>
<td>23</td>
<td>National Insurance Commission, Nigeria</td>
</tr>
<tr>
<td>24</td>
<td>Nigeria Deposit Insurance Corporation (NDIC)</td>
</tr>
<tr>
<td>25</td>
<td>Central Bank of Oman</td>
</tr>
<tr>
<td>26</td>
<td>State Bank of Pakistan</td>
</tr>
<tr>
<td>27</td>
<td>Qatar Central Bank</td>
</tr>
<tr>
<td>28</td>
<td>Saudi Arabian Monetary Authority</td>
</tr>
<tr>
<td>29</td>
<td>Capital Market Authority, Saudi Arabia</td>
</tr>
<tr>
<td>30</td>
<td>Monetary Authority of Singapore</td>
</tr>
<tr>
<td>31</td>
<td>Central Bank of Sudan</td>
</tr>
<tr>
<td>32</td>
<td>Banking Regulation and Supervision Agency, The Republic of Turkey</td>
</tr>
<tr>
<td>33</td>
<td>Central Bank of the Republic of Turkey</td>
</tr>
<tr>
<td>34</td>
<td>Insurance and Private Pension Regulation and Supervision Agency of Turkey (IPRSA), Turkey</td>
</tr>
<tr>
<td>35</td>
<td>Central Bank of the United Arab Emirates</td>
</tr>
<tr>
<td>36</td>
<td>Dubai Financial Services Authority, U.A.E.</td>
</tr>
</tbody>
</table>

## Associate Members

<table>
<thead>
<tr>
<th>Number</th>
<th>Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>37</td>
<td>Asian Development Bank</td>
</tr>
<tr>
<td>38</td>
<td>Bank for International Settlements</td>
</tr>
<tr>
<td>39</td>
<td>The International Monetary Fund</td>
</tr>
<tr>
<td>40</td>
<td>The World Bank</td>
</tr>
<tr>
<td>41</td>
<td>The People's Bank of China</td>
</tr>
<tr>
<td>42</td>
<td>Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), Germany</td>
</tr>
<tr>
<td>43</td>
<td>Hong Kong Monetary Authority</td>
</tr>
<tr>
<td>44</td>
<td>Indonesia Deposit Insurance Corporation</td>
</tr>
<tr>
<td>45</td>
<td>Capital Markets Authority, Kenya</td>
</tr>
<tr>
<td>46</td>
<td>Central Bank of Kenya</td>
</tr>
<tr>
<td>47</td>
<td>The Bank of Korea</td>
</tr>
<tr>
<td>48</td>
<td>Capital Markets Authority, Kuwait</td>
</tr>
<tr>
<td>49</td>
<td>Banque du Liban, Lebanon</td>
</tr>
<tr>
<td>50</td>
<td>Banque centrale du Luxembourg</td>
</tr>
<tr>
<td>51</td>
<td>Labuan Financial Services Authority, Malaysia</td>
</tr>
<tr>
<td>52</td>
<td>Malaysia Deposit Insurance Corporation</td>
</tr>
<tr>
<td>53</td>
<td>Banco de Mocambique, Mozambique</td>
</tr>
<tr>
<td>54</td>
<td>Securities and Exchange Commission, Nigeria</td>
</tr>
<tr>
<td>55</td>
<td>Capital Market Authority, Oman</td>
</tr>
<tr>
<td>56</td>
<td>Palestine Monetary Authority</td>
</tr>
<tr>
<td>57</td>
<td>Bangko Sentral ng Pilipinas, Philippines</td>
</tr>
<tr>
<td>58</td>
<td>Qatar Financial Centre Regulatory Authority, U.A.E.</td>
</tr>
<tr>
<td>59</td>
<td>Qatar Financial Centre Authority</td>
</tr>
<tr>
<td>60</td>
<td>Qatar Financial Markets Authority</td>
</tr>
<tr>
<td>61</td>
<td>The Insurance Supervisory Authority, Sudan</td>
</tr>
<tr>
<td>62</td>
<td>Khartoum Stock Exchange, Sudan</td>
</tr>
<tr>
<td>63</td>
<td>Bank of Tanzania</td>
</tr>
<tr>
<td>64</td>
<td>Ministry of Treasury and Finance, The Republic of Turkey</td>
</tr>
<tr>
<td>65</td>
<td>Central Bank of Tunisia</td>
</tr>
<tr>
<td>67</td>
<td>Emirates Securities and Commodities Authority, U.A.E.</td>
</tr>
<tr>
<td>68</td>
<td>Bank of Uganda</td>
</tr>
<tr>
<td>69</td>
<td>Bank of England</td>
</tr>
<tr>
<td>70</td>
<td>Banque Centrale Des Etats de L'afrique de L'ouest (BCEAO), West African Monetary Union</td>
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<tr>
<td>71</td>
<td>Conseil Régional de l'Epargne Publique et des Marchés Financiers (CREPMF), West African Monetary Union</td>
</tr>
<tr>
<td>72</td>
<td>Bank of Zambia</td>
</tr>
</tbody>
</table>

## Observer Members

<table>
<thead>
<tr>
<th>Number</th>
<th>Institution</th>
</tr>
</thead>
<tbody>
<tr>
<td>73</td>
<td>Banque Ouest Africaine de Développement (BOAD)</td>
</tr>
<tr>
<td>74</td>
<td>Islamic Corporation for the Development of the Private Sector (ICD)</td>
</tr>
<tr>
<td>75</td>
<td>Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC)</td>
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<td>76</td>
<td>Da Afghanistan Bank, Afghanistan</td>
</tr>
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<td>77</td>
<td>Al Salam Bank, Bahrain</td>
</tr>
<tr>
<td>78</td>
<td>Bahrain Islamic Bank, Bahrain</td>
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<tr>
<td>79</td>
<td>First Energy Bank B.S.C., Bahrain</td>
</tr>
<tr>
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<td>Islamic International Rating Agency (IIRA), Bahrain</td>
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<td>Kuwait Finance House, Bahrain</td>
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</tr>
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</tr>
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<td>86</td>
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</tr>
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<td>87</td>
<td>Faisal Islamic Bank of Egypt</td>
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<tr>
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</tr>
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<td>89</td>
<td>Prudential Corporation Asia, Hong Kong</td>
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<td>Country</td>
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<td>The Hong Kong Association of Banks</td>
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<td>PT Bank Syariah Mandiri, Indonesia</td>
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<td>93</td>
<td>Bank Keshavarzi, Islamic Republic of Iran</td>
</tr>
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<td>94</td>
<td>Sarmad Insurance, Iran</td>
</tr>
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<td>Bank of Japan</td>
</tr>
<tr>
<td>96</td>
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<td>97</td>
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</tr>
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<td>105</td>
<td>Boubyan Bank K.S.C., Kuwait</td>
</tr>
<tr>
<td>106</td>
<td>Kuwait Finance House K.S.C., Kuwait</td>
</tr>
<tr>
<td>107</td>
<td>Kuwait International Bank K.S.C., Kuwait</td>
</tr>
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<td>KFH Capital Investment Company K.S.C.C., Kuwait</td>
</tr>
<tr>
<td>109</td>
<td>National Bank of the Kyrgyz Republic</td>
</tr>
<tr>
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<td>Al Baraka Bank Lebanon, Lebanon</td>
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<tr>
<td>111</td>
<td>Bursa Malaysia Berhad</td>
</tr>
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<td>112</td>
<td>Affin Islamic Bank Berhad, Malaysia</td>
</tr>
<tr>
<td>113</td>
<td>Al Rajhi Banking and Investment Corporation (Malaysia) Bhd., Malaysia</td>
</tr>
<tr>
<td>114</td>
<td>AmBank Islamic Berhad, Malaysia</td>
</tr>
<tr>
<td>115</td>
<td>Bank Islam Malaysia Berhad, Malaysia</td>
</tr>
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<td>116</td>
<td>Bank Kerjasama Rakyat Malaysia Berhad, Malaysia</td>
</tr>
<tr>
<td>117</td>
<td>Bank Muamalat Malaysia Berhad, Malaysia</td>
</tr>
<tr>
<td>118</td>
<td>MUFG Bank (Malaysia) Berhad, Malaysia</td>
</tr>
<tr>
<td>119</td>
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<tr>
<td>120</td>
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<tr>
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<td>Etiqa Family Takaful Berhad, Malaysia</td>
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<tr>
<td>122</td>
<td>Export-Import Bank of Malaysia Berhad, Malaysia</td>
</tr>
<tr>
<td>123</td>
<td>Finance Accreditation Agency Berhad, Malaysia</td>
</tr>
<tr>
<td>124</td>
<td>Hong Leong Islamic Bank, Malaysia</td>
</tr>
<tr>
<td>125</td>
<td>International Centre for Education in Islamic Finance (INCEIF), Malaysia</td>
</tr>
<tr>
<td>126</td>
<td>Kuwait Finance House (Malaysia) Berhad, Malaysia</td>
</tr>
<tr>
<td>127</td>
<td>Maybank Islamic Berhad, Malaysia</td>
</tr>
<tr>
<td>128</td>
<td>MBSB Bank Berhad, Malaysia</td>
</tr>
<tr>
<td>129</td>
<td>Nomura Asset Management Malaysia Sdn. Bhd., Malaysia</td>
</tr>
<tr>
<td>130</td>
<td>OCBC Al-Amin Bank Berhad, Malaysia</td>
</tr>
<tr>
<td>131</td>
<td>Prudential BSN Takaful Berhad, Malaysia</td>
</tr>
<tr>
<td>132</td>
<td>RHB Islamic Bank Berhad, Malaysia</td>
</tr>
<tr>
<td>133</td>
<td>RUSDI Investment Bank, Malaysia</td>
</tr>
<tr>
<td>134</td>
<td>Maldives Monetary Authority</td>
</tr>
<tr>
<td>135</td>
<td>Financial Services Commission, Mauritius</td>
</tr>
<tr>
<td>136</td>
<td>The Moroccan Capital Market Authority</td>
</tr>
<tr>
<td>137</td>
<td>Lotus Capital Ltd., Nigeria</td>
</tr>
<tr>
<td>138</td>
<td>Jaiz Bank Plc, Nigeria</td>
</tr>
<tr>
<td>139</td>
<td>Marble Capital Limited, Nigeria</td>
</tr>
<tr>
<td>140</td>
<td>Bank Nizwa S.A.O.G., Oman</td>
</tr>
<tr>
<td>141</td>
<td>Securities and Exchange Commission of Pakistan</td>
</tr>
<tr>
<td>142</td>
<td>Habib Bank Limited, Pakistan</td>
</tr>
<tr>
<td>143</td>
<td>Barwa Bank, Qatar</td>
</tr>
<tr>
<td>144</td>
<td>Masraf Al Rayan, Qatar</td>
</tr>
<tr>
<td>145</td>
<td>Qatar International Islamic Bank, Qatar</td>
</tr>
<tr>
<td>146</td>
<td>Qatar Islamic Bank, Qatar</td>
</tr>
<tr>
<td>147</td>
<td>Qatar National Bank, Qatar</td>
</tr>
<tr>
<td>148</td>
<td>Al Rajhi Banking and Investment Corporation, Saudi Arabia</td>
</tr>
<tr>
<td>149</td>
<td>Bank AlJazira, Saudi Arabia</td>
</tr>
<tr>
<td>150</td>
<td>National Commercial Bank, Saudi Arabia</td>
</tr>
<tr>
<td>151</td>
<td>Saudi British Bank, Saudi Arabia</td>
</tr>
<tr>
<td>152</td>
<td>Ministry of Economy, Finance and Planning, Senegal</td>
</tr>
<tr>
<td>153</td>
<td>Tamweel Africa Holding, Senegal</td>
</tr>
<tr>
<td>154</td>
<td>Fitch Ratings Singapore Pte Ltd, Singapore</td>
</tr>
<tr>
<td>155</td>
<td>HLC Foundation Limited, Singapore</td>
</tr>
<tr>
<td>156</td>
<td>Standard &amp; Poor’s Singapore Pte Ltd., Singapore</td>
</tr>
<tr>
<td>157</td>
<td>Dahabshiil Bank International, Somalia</td>
</tr>
<tr>
<td>158</td>
<td>Oasis Crescent Capital (PTY) Ltd., South Africa</td>
</tr>
<tr>
<td>159</td>
<td>Amana Bank, Sri Lanka</td>
</tr>
<tr>
<td>160</td>
<td>Al Jazeera Sudanese Jordanian Bank, Sudan</td>
</tr>
<tr>
<td>161</td>
<td>Al Salam Bank, Sudan 162Bank of Khartoum, Sudan</td>
</tr>
<tr>
<td>162</td>
<td>Byblos Bank Africa Ltd., Sudan</td>
</tr>
<tr>
<td>163</td>
<td>Byblos Islamic Bank, Sudan</td>
</tr>
<tr>
<td>164</td>
<td>Faisal Islamic Bank, Sudan</td>
</tr>
<tr>
<td>165</td>
<td>Islamic Insurance Company, Sudan</td>
</tr>
<tr>
<td>166</td>
<td>Shiekan Insurance and Reinsurance Co. Ltd., Sudan</td>
</tr>
<tr>
<td>167</td>
<td>Sudan Financial Services Company, Sudan</td>
</tr>
<tr>
<td>168</td>
<td>Tadamon Islamic Bank, Sudan</td>
</tr>
<tr>
<td>169</td>
<td>National Bank of Tajikistan</td>
</tr>
<tr>
<td>170</td>
<td>Central Bank of the Turkish Republic of Northern Cyprus</td>
</tr>
<tr>
<td>171</td>
<td>Albaraka Turk Participation Bank, The Republic of Turkey</td>
</tr>
<tr>
<td>172</td>
<td>Capital Markets Board of Turkey</td>
</tr>
<tr>
<td>173</td>
<td>Kuwait Turkish Participation Bank, The Republic of Turkey</td>
</tr>
<tr>
<td>174</td>
<td>Ziraat Katilim Bankasi, The Republic of Turkey</td>
</tr>
<tr>
<td>175</td>
<td>Insurance Authority, U.A.E.176Abu Dhabi Islamic Bank, U.A.E.</td>
</tr>
<tr>
<td>176</td>
<td>Al Hilal Bank, U.A.E.</td>
</tr>
<tr>
<td>177</td>
<td>Capital Shield Insurance Brokers L.L.C, U.A.E</td>
</tr>
<tr>
<td>178</td>
<td>Dubai Islamic Bank, U.A.E.180Dubai Islamic Economy Development Centre, U.A.E</td>
</tr>
<tr>
<td>179</td>
<td>Emirates Islamic Bank PJSC, U.A.E.</td>
</tr>
<tr>
<td>180</td>
<td>Mashreq Al Islami, U.A.E.</td>
</tr>
<tr>
<td>181</td>
<td>Moody’s Investors Service Middle East Limited, U.A.E.</td>
</tr>
<tr>
<td>182</td>
<td>SALAMA - Islamic Arab Insurance Co., U.A.E.</td>
</tr>
<tr>
<td>183</td>
<td>Sharjah Islamic Bank, U.A.E.</td>
</tr>
<tr>
<td>184</td>
<td>Tiybr Payments, U.A.E.</td>
</tr>
<tr>
<td>185</td>
<td>United Nations Development Programme – UNDP</td>
</tr>
</tbody>
</table>