



The Future of the Islamic Financial Services Industry: **Resilience, Stability and Inclusive Growth**

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**10th IFSB Summit 2013: The Future of the Islamic Financial Services Industry:
Resilience, Stability and Inclusive Growth**

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PROCEEDINGS

**ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)**

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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 lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes the issuance of exposure drafts and 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**.

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Preamble

In its 10th Anniversary Summit, the IFSB reflects the first decade of its existence, from 2002 – 2013, a decade characterised by the rapid and continuing growth of the Islamic financial services industry (IFSI) in terms of quantity, sophistication and geographic outreach on the one hand, and the near-collapse of the conventional global financial system with subsequent efforts to revive, revise and reform it on the other. The IFSB was an active participant of the industry, interacting with both existing and new regulatory and supervisory authorities and market players of the IFSI, as well as interacting with the international standard-setters – banking, capital markets and insurance – of the global financial system. Through its strategic planning exercise, the IFSB outlined the implications of the international regulatory reforms (in particular Basel III) for the IFSI, which resulted in an internal strategic plan for the issuance of new guiding principles on liquidity risk management and stress testing as well as the revision of previous standards on capital adequacy and supervisory review process.

The global financial crisis, which started in the banking sector, rapidly spread over all financial sectors and across many jurisdictions. The interconnectedness of the global financial system had reached an unprecedented level, and the regulatory response to the crisis has had to be both cross-sectoral and cross-border. An increase of cross-sectoral links has also been observed in Islamic finance, urging regulators to adopt more encompassing regulatory approaches. The relative resilience of Islamic finance during the global crisis, as well as its ethical underpinnings, caught significant interest and attention not only in the Muslim world, but also in the West. We saw new jurisdictions opening up to Islamic finance and consequently widening the geographic outreach of the IFSI. In addition, institutions offering Islamic financial services (IIFS) started to explore new frontiers in non-Muslim countries to cater to the sizeable Muslim minorities (particularly in Europe) who are still underserved by IIFS, as well as to meet the rapidly growing demand for ethical finance and socially responsible investing.

Given the ethical underpinning of Islamic finance, there is now greater appreciation of Islamic finance as a socially responsible system that can serve the poorer segments of society and can thus, support inclusive growth, leading to social and economic development. Pioneering models and innovative approaches to further develop Islamic finance in this regard are also promoted by international multilateral institutions such as the Islamic Development Bank (IDB), the World Bank and the International Monetary Fund (IMF).

The development of Islamic finance into new and emerging jurisdictions has brought to the fore a host of regulatory challenges. In this regard, the adoption and implementation of the IFSB standards and guiding principles would assist regulatory and supervisory authorities to develop the necessary internationally compatible framework and best practices for the supervision of the industry in their respective markets.

Lessons drawn from the development of the industry in the last 10 years can guide the way forward – highlighting signposts and providing insights – for the future development of the IFSB as well as the institutional infrastructure of the IFSI as a whole.

1. Financial Regulatory Reforms: Global Overview

When the IFSB commenced its operations in March 2003, a main concern during these early days was adequate consideration and coverage of the specificities of Islamic finance in the existing global regulatory regimes. Examples of “pre-crisis” standards issued by the IFSB are those on risk management, corporate governance, disclosure, supervisory review process and capital adequacy, which encompassed the three pillars of the Basel II regime. In addition to issuing governance standards for *Takāful* and Islamic collective investments schemes (ICIS), the IFSB later issued cross-sectoral guidance on areas such as conduct of business and *Sharī'ah* governance. Lessons learnt from the global financial crisis added new regulatory and supervisory dimensions such as liquidity risk management, stress testing and enhanced disclosures. In addition, international regulatory reforms necessitated an updating of the capital adequacy standards covering Islamic financing products, *Sukūk*, securitisation and real estate. The IFSB work programme on the issuance of new and the revision of previous standards provided a platform for discussions and evaluations of the implications of global reform packages – in particular Basel III – for the IFSI.

In order for these new standards to be in parallel with the global regulatory reforms, the IFSB intensified its collaboration with the global standard-setting bodies for all major sectors of the conventional financial system – banking, capital markets and insurance. As the single standard-setter for prudential regulation for the IFSI, the IFSB standards cover the full range of Islamic financial services that complement the work of various standard-setters on a number of supervision issues, including macroeconomic stability. The increased collaboration between the IFSB and other global standard-setters has provided the necessary platform for the better placement and integration of IFSI into the global financial system, where its value proposition is increasingly gaining appreciation by the major stakeholders.

1.1. Implementation of the IFSB standards and Collaboration with Global Standard-Setters

During the first decade of its existence, the IFSB achieved a convergence of previously very divergent (or non-existing) national regulations for the IIFS on the one hand, and an effective interaction with global standard-setters on the other hand.

Adoption and Implementation of IFSB Standards

The IFSB has so far developed 15 standards and guiding principles as well as 6 guidance and technical notes (hereinafter to be collectively referred as standards and guidelines or SAGs). These SAGs have been adopted or have significantly impacted the framework for regulation and supervision of IIFS in a large number of IFSB member and non-member jurisdictions. Akin to the approach adopted by other standard-setting bodies in the conventional sector, the IFSB SAGs are voluntarily adopted by the member jurisdictions. Similarly, owing to the differences in the stages of development of Islamic finance in the respective jurisdictions – which is also a component of the strength and evolution of the overall financial system – each member of the IFSB determines its own timeline for the implementation of the IFSB SAGs. It must be said, however, that the IFSB is at a considerable distance from achieving the voluntary and consensus-driven approach in which the members of the Basel Committee have jointly committed to a common time frame for the adoption of global regulatory reforms.

Currently, implementation of the IFSB SAGs is at different stages in different jurisdictions. Based on a survey conducted by the IFSB in 2011¹, over half of the jurisdictions have implemented or plan to implement the SAGs over the next three to five years. In some countries, however, the time frame is shorter in view of the progress that has been made in the industry. The SAGs that feature most frequently in terms of completion, or advanced stage of progress in implementation, are typically the ones issued earliest. IFSB-1 through IFSB-6 feature prominently in these categories, and are the ones most frequently cited as planned for implementation. For those jurisdictions that do not have concrete timelines for implementation, a number of pragmatic reasons have been cited by the respective regulators. These reasons range from countries considering their Islamic finance sector is still too small for particular regulation, to others saying that they refer to the IFSB recommendations without a formal implementation of standards (which would require a long legislative process). This can be an expeditious and effective *modus operandi* in these jurisdictions. However, with notable improvements in the legal systems across the globe to accommodate Islamic finance as a part of the financial sector legislation and the rapidly increasing market share of the IFSI in domestic markets, many regulators are finding compelling reasons to make headway on the implementation of the IFSB SAGs.

Interaction with global standard-setters

The IFSB has enhanced its collaboration with the international institutions and standard-setters, especially after the financial crisis of 2007-2008. Being the only supranational institution dealing with prudential regulation, supervision and stability issues of the IFSI, its interactions with institutions such as the IMF and the Bank for International Settlements (BIS) – both of which are members of the IFSB – have resulted in various joint or reciprocated initiatives that were mentioned in various sessions of the Summit.

The IMF is not a standard-setter in the strict meaning of the term, but it is the prime supranational body for analysing and discussing macroeconomic stability issues in a cross-sectoral and comprehensive global perspective. It is also the institution mandated by the global community to conduct surveillance of the global economy. (All of its members participate in the consultation exercise known as the Article IV discussions.) Its aim is “to make financial sectors in member countries resilient and well-regulated”. Islamic finance has reached market shares of 15-20% and more in a number of Muslim countries with “dual” financial systems (where conventional and Islamic finance coexist). The Islamic finance segment in these countries has reached a quantitative dimension that cannot be ignored in stability analyses. Malaysia was the first country which opted for an explicit inclusion of its IFSI in the IMF’s Financial Sector Assessment Programme (FSAP) for various market segments. The purpose of the FSAP, which is a voluntary exercise, is to identify strengths and vulnerabilities of a country’s financial system and to recommend appropriate policy responses. The IFSB pursues similar objectives in relation to systemic stability as the IMF. Both institutions have sought cooperation and interaction with each other on policy and on stability issues. This was affirmed by Christine Lagarde, Managing Director of the IMF, in her video message to the Summit participants. As the FSAP requires a national development plan with a systematic placing of Islamic finance and its existing, and anticipated, cross-sectoral and cross-border linkages of the country’s financial landscape, the inclusion of Islamic finance in the FSAP will assist the national authorities to clarify their own strategic vision with regard to Islamic finance through peer review and self-assessment. It would also facilitate the roll-out of the IFSB SAGs in the respective jurisdictions.

BIS in its mission to “serve central banks in their pursuit of monetary and financial stability and to foster international cooperation in those areas”, is spearheading the work on the new

¹ A second IFSB Survey on the Implementation of IFSB SAGs is in the advanced stage of completion at the time of writing these proceedings. The findings of this Survey will be submitted to the IFSB Council in its meeting scheduled in Doha, Qatar on 10 December 2013.

global stability architecture, especially for the banking and insurance industries. Jaime Caruana, General Manager of the BIS, sent a video message for the Opening Session of the Summit in which the close cooperation of the BIS and the IFSB was reaffirmed. The IFSB, as a member of Basel Consultative Group established by the Basel Committee on Banking Supervision (BCBS), has engaged in various communications with these organisations to present the impact of the new regulatory developments on the IFSI. The interactions of the BCBS and its G-20 members have also resulted in a number of publications by the Committee alluding to the need to recognise the importance of taking into consideration the impact of global regulatory reforms on Islamic finance.

The IFSB, BCBS and IMF are now cooperating on a consistent and systematic basis, including through their participation of the latter two organisations in an IFSB working group on “Core Principles for Islamic Finance Regulation” launched in 2013.

The International Association of Insurance Supervisors (IAIS) and International Organization of Securities Commission (IOSCO) are the specialised global standard setters for insurance and capital markets. The IFSB has also established fruitful working relationships with the IAIS and IOSCO. The IFSB established a joint working group with the IAIS, which published a Paper on “Issues in Regulation and Supervision of *Takāful*” in August 2006. This Paper identified the key themes on which the standards on *Takāful* sector can be prepared by the IFSB. These areas included: a) Corporate Governance; b) Financial and Prudential Regulation; c) Transparency, Reporting and Market Conduct; and d) Supervisory Review Process. In view of that, the IFSB has issued several SAGs for the *Takāful* industry in the past decade, namely: Guiding Principles on Governance for *Takāful* Undertakings (IFSB-8), Standard on Solvency Requirements for *Takāful* Undertakings (IFSB-11), Guidance Note on the Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on *Takāful* and *Re-Takāful* Undertakings (GN-5) and Exposure Draft on Risk Management for *Takāful* Undertakings (ED-14) which is expected to be approved as a standard in December 2013. The IFSB plans to start a new joint project with the IAIS on micro *Takāful* sector in 2014. The IFSB has also worked on a number of joint projects with the IOSCO, the latest of which has been the publication on “Disclosure Requirements for Islamic Capital Market Products” in 2013.

1.2. Implications of International Regulatory Reforms for Islamic Finance

It is widely recognised that IIFS were less affected by the global financial crisis than most “global players” of conventional finance. This robustness, however, does not mean that the Islamic finance industry was totally shielded from and unaffected by the crisis. What became apparent was that causes, triggers and transmission mechanisms of crises in Islamic finance differ from those in conventional finance. For example, Islamic banks did not participate in speculative markets for financial derivatives, but many were overexposed to risks in the real estate market and asset price bubbles. They also suffered from maturity mismatches and learned that assets were less liquid under stress conditions than initially anticipated. It became apparent that IIFS were exposed to a serious liquidity risks due to underdeveloped interbank markets and the lack of *Shari’ah*-compliant lender of last resort facilities in most jurisdictions.

Basel III Implications: Liquidity Risk Management of IIFS

A major impediment to the development of a sizeable cross-border Islamic interbank market is the lack of high quality liquid assets (HQLA). The availability of *Shari’ah*-compliant instruments to suit the varying liquidity needs of IIFS is a precondition to cope with some of the implications of the Basel III reform package for IIFS, especially Islamic banks. Such instruments, which should be virtually free of, or have minimal credit or counterparty risk, should ideally be issued by a sovereign or a widely recognised international institution. For

this purpose, the IFSB spearheaded the establishment of the International Islamic Liquidity Management Corporation (IILM) by central banks, monetary agencies and multilateral organisations in 2010.

A major development of Basel III reforms package has been the introduction of two new liquidity ratios – the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The former is designed to ensure that a bank holds sufficient liquid assets to cover 30 days of stressed outflows of funds. The latter aims to limit the funding of long-term illiquid assets with unstable short-term funds, in particular those with wholesale money, for a time horizon of up to one year. The issue for Islamic banks is not the limitation of leverage (as it is for many conventional banks) since the leverage of Islamic financial institutions is generally low compared to conventional counterparts. However, problems can arise from the limited availability of HQLA which are required for meeting the LCR. This limitation can compel many regulators to use various alternative liquidity arrangements (ALA) that are envisaged in the Basel III publication.

Central banks of several countries – Brunei, Indonesia and Malaysia in Asia, Bahrain, Sudan and the UAE in the Arab world – have taken concrete measures to provide tools for liquidity management and to support the emergence of an Islamic interbank money market. However, these are mainly domestic solutions whose efficiency can be limited by the relatively small size of the domestic Islamic finance industry. The issuance of high quality short-term *Sukūk* by the IILM could extend the scope and volume of cross-border liquidity management tools for the IIFS.

Another major hurdle in meeting the LCR and NSFR requirements is the classification of unrestricted profit-sharing investment accounts (PSIA). They are the major source of funding for many IIFS, but owing to the lack of a *Shari'ah*-compliant equivalent to conventional deposit insurance in most jurisdictions, such accounts will be classified in the “unstable” category which refers to the probability of it being withdrawn in stressed market conditions. Notwithstanding formidable conceptual hurdles, these proposals would not only help to meet liquidity requirements and thus strengthen the robustness and stability of the Islamic financial system, it would also be a major contribution to consumer protection. Its effectiveness could be enhanced by having *Shari'ah*-compliant lender of last resort facilities, which are also underdeveloped or non-existent in many jurisdictions. The IFSB is currently undertaking research on alternative concepts for *Shari'ah*-compliant lender of last resort facilities and deposit insurance schemes.

Basel III Implications: Regulatory Capital of IIFS

Basel III has tightened the capital requirements insofar as “banks” are required to hold more capital of higher quality (common equity tier 1 capital). In addition, Basel III has introduced a capital conservation buffer, a discretionary counter-cyclical buffer, and a minimum leverage ratio (tier 1 capital divided by average total consolidated on-and off-balance sheet assets). The capital requirements are even tighter for the global systemically-important banks and the domestic systemically-important banks. Although there is no Islamic bank on the list of global systemically-important banks, some large Islamic banks are expected to reach the level of being systemically important in a few jurisdictions.

The increased focus on “risk absorbent capital” by Basel III has demonstrated greater appreciation of Islamic finance principles by the conventional world, where most of the IIFS currently hold an overwhelming percentage of their capital in the form of equity. The actual capitalisation of Islamic banks, in particular those in the GCC, is strong and beyond the Basel minimum levels. This comfortable situation could deteriorate in the future, and the question of other forms of regulatory capital besides equity – additional tier 1 and tier 2 – has to be addressed. However, working on suitable *Shari'ah*-compliant capital instruments that can be eligible for the aforementioned components of capital need thorough deliberations by the *Shari'ah* scholars, standard-setters, regulators and market players on the instruments that

are subordinated, hybrid or have features of contingent capital. A few perpetual *Sukūk* have been issued by two IIFS in the United Arab Emirates that meet most of the features of being included in the additional tier 1 capital. The IFSB Revised Capital Adequacy Standard (IFSB-15) provides necessary guidance on the structure and criteria for *Sukūk* that could be considered part of these capital components.

2. Market Development and Cross-sectoral Regulation of Islamic Finance

The financial crisis clearly demonstrated the interconnectedness of all sectors of the conventional financial services industry – banking, capital markets and insurance – with each other. This interconnectedness is also becoming apparent in the Islamic financial services industry. Islamic finance was dominated by the banking sector until the early 2000s. More recently, the Islamic capital market sector (particularly *Sukūk*) has gathered pace, its growth preparing the ground for a more rapid expansion of the *Takāful* sector in the near future. The level of financial sector sophistication differs in the member jurisdictions of the IFSB, but the general channels and specificities of Islamic finance, and the interconnectedness between the financial sectors are retained.

2.1 Market Developments in Islamic Banking, Islamic Capital Market and *Takāful*

The IFSI has continuously grown in all its sectors, i.e. Islamic banking, *Sharī'ah*-compliant equity and debt capital markets, *Takāful* and *Re-Takāful* and Islamic non-bank financial institutions (NBFIs).

- Islamic banking is the largest sector of IFSI, and its market shares continue to grow in most countries.
- The growth of the Islamic capital market was mainly driven by the *Sukūk* market with most of the *Sukūk* structured as *Sharī'ah*-compliant debt certificates. *Sukūk* have become a new asset class which also attracts conventional markets players. Islamic fund management industry has also gained pace in many jurisdictions and a number of new mutual funds offer a variety of risk metrics to attract investors of various risk appetites.
- *Takāful* is still the smallest segment of the IFSI, and its growth potential – in particular in the family *Takāful* business – has not yet been fully realised. It still struggles with the shortage of suitable *Sharī'ah*-compliant medium- to long-term securities with predictable returns.

A detailed presentation of the market developments can be found in the Islamic Financial Services Industry Stability Report 2013 published by the IFSB in May 2013.

On a global scale, Islamic finance is no longer in its infancy. It has not only proven its commercial viability but also its resilience in times of financial turmoil. Islamic finance is increasingly considered as an alternative to conventional finance, not only by market participants, but also by policy-makers and regulatory authorities.

Islamic finance has become more sophisticated over the last decade. More sophisticated products are needed to better meet the demands of the market. However, this sophistication gives rise to new legal and *Sharī'ah* compliance issues, and may pose new regulatory challenges.

2.2 Approaches to Cross-sectoral Regulation of Islamic Finance

Financial institutions – conventional as well as Islamic – offer a broad range of intertwined products and services. They also use products of other sectors as inputs for their own outputs. For example, the savings component of family *Takāful* is based on capital market products (e.g. *Sharī'ah*-compliant stocks), banks may take recourse to short-term *Sukūk* for their liquidity management, and a *Takāful* cover could be used as collateral for bank financing.

Coherence and Cooperation

The organisational structures of banking, capital market and insurance/*Takāful* regulation differ between jurisdictions. Some have established a comprehensive financial services authority (FSA) as the single regulator and supervisor for all sectors of their financial services industry, while others have separate regulatory and supervisory institutions for the different sectors. The regulation and supervision can be based on a single law that covers both conventional and Islamic financial services, or on separate laws for the conventional and Islamic segments.

Cross-sectoral regulation of Islamic finance does not require a unified FSA, but it needs a common understanding of all regulatory authorities to adopt a cross-sectoral perspective of financial regulation taking into consideration the cross-sectoral linkages.

A cross-sectoral approach would mean, for example, that similar standards of disclosure are applied for comparable products, irrespective of the sector of the service provider: The customer should get essentially the same information on an investment product irrespective of whether he or she buys it from a bank, from an investment fund or as a component of a family *Takāful* package from a *Takāful* operator.

Country Experiences

The global financial crisis of 2007-2008 made clear the dangers of widely unregulated intertwined cross-sectoral and cross-border transactions. Turkey, an IFSB member country, had suffered from a severe financial and economic crisis in 2000-2001. To prevent future crises, the Turkish government implemented a consistent and coherent reform package to rehabilitate and restructure the banking sector to increase its efficiency and competitiveness, to strengthen surveillance and supervision, and to achieve fiscal and monetary stability. These reforms had served to strengthen the resilience of Turkey's financial sector during the recent global crisis. Nevertheless, Turkey has improved its regulatory framework further. It established an interdepartmental Economic Coordination Board and a cross-sectoral Financial Stability Committee, comprising the Central Bank, the Capital Markets Board, the Banking Regulatory and Supervisory Agency and the Savings Deposit Insurance Fund. Most recently, Turkey enacted several new codes, including a new capital markets law. In a nutshell, Turkey has demonstrated the importance and effectiveness of credible fiscal policy and structural financial sector reforms. These initiatives were supported by a comprehensive reform programme for the improvement of regulatory oversight and the strengthening of insolvency frameworks, as well as effective cooperation and coordination among ministries, the central bank and regulatory and supervisory authorities. This created not only a systemic stability framework but also a conducive environment for product diversification and better quality of financial services.

In Indonesia, the central bank (Bank Indonesia, BI) plays an active role in the development of the IFSI and emphasises the links with the productive sector of the real economy. BI is not only concerned with the interconnectedness of the banking sector with the capital markets and *Takāful*, but also with cross-sectoral product innovations and the financing of projects with particular relevance for economic development. BI promotes innovations that bring forth genuine financial products based the uniqueness of *Sharī'ah* principles instead of mere

replications of conventional products. BI has facilitated discussions between Islamic banks, Majelis Ulama Islam (National Ulema Council) and the Financial Accounting Standards Board to promote product development, innovation and cross-sectoral harmonisation of Islamic financial products and services. BI has also embarked on public awareness programmes for Islamic finance products. It pays special attention to links between Islamic finance and industries which are prioritised by the government. It has set a certain minimum percentage of total financing for the financing of the productive sector and for SMEs, and it has limited consumer financing by increasing the minimum amount of down payments from customers. By channelling funds into the productive sector and by financing SMEs, Islamic banks promote economic development and contribute to inclusive growth.

For risk and liquidity management purposes, BI has developed interbank *Muḍārabah* certificates as money market instruments, and has introduced a commodity trading scheme. It reviews *Sharī'ah*-compliant hedging instruments to mitigate currency risks, and it actively supports the development of cross-border liquidity instruments as a member of the IILM. *Sukūk* play an important role in this field, and BI has established cross-sectoral cooperation with the Capital Market Supervisory Agency (BAPEPAM) to develop *Sharī'ah*-compliant products such as *Mushārah Sukūk*, *Istisnā' Sukūk* and exchange-traded funded (ETF) products. BI has also facilitated various forms of cooperation between Islamic banks and non-bank financial institutions, for example *Takāful* operators, mutual funds and financing companies. These cross-sectoral activities within the IFSI are based on cross-sector policies which BI develops jointly with the BAPEPAM as the authority for non-bank financial institutions (NBFIs). This active cooperation among supervisory authorities will be strengthened by the establishment of the Financial Services Authority (OJK) as the single supervisor of all financial institutions in Indonesia, including Islamic banks, starting 2014.

Cross-Border Issues

The cross-sectoral approach should be extended to a cross-border approach. Domestic markets are often too small for cost reducing and efficiency enhancing economies of scale and scope and for effective competition. However, the opening of domestic markets for financial institutions from other countries could create opportunities for regulatory arbitrage if home and host country authorities follow different uncoordinated regulatory approaches.

To reap the benefits of cross-border transactions without unwanted regulatory arbitrage, it is important that the regulators agree on common requirements and cooperate across jurisdictions. Global harmonisation of regulations from a cross-sectoral perspective (or at least harmonisation among the IFSB member countries) is also of increasing importance for an effective home and host country supervision of internationally active financial groups.

The IFSB has been supporting and promoting the cross-sectoral and cross-border harmonisation of regulations through its SAGs. The Revised Capital Adequacy Standard (IFSB-15), issued in 2013, includes guidance on the capital adequacy aspects of both banking and capital market products, including *Sukūk*.

Similarly, an ongoing project on the preparation of Core Principles for Islamic Finance Regulation will cover various cross-sectoral aspects of banking core principles. The participation of the international standard-setting bodies such as BCBS, international organisations and multilateral development banks – including the IMF, the World Bank, the Islamic Development Bank and Asian Development Bank – provides impetus to the integration of Islamic finance and the global financial system as well as greater appreciation of the value proposition of Islamic finance at the global level. With this increased interaction, the global standard-setters will be familiarised with and sensitised for the peculiarities of Islamic finance.

3. New Markets, New Frontiers – Prospects and Challenges

One of the most striking characteristics of Islamic finance in recent years has been its geographical spread. The geographical expansion of Islamic finance has taken place predominantly in the Muslim world, as well as in countries with significant, if minority, Muslim populations. In addition, there is the possibility of expansion into non-Muslim markets through new business models for new types of customers, such as ethical investors. The penetration of Islamic finance in these new markets opens a significant growth potential not only in the Muslim world but also in Western countries – provided the products and services of the IIFS meet the expectations of the new customers and are competitively priced. The legal and regulatory environments can be a decisive success factor in this regard.

3.1 New Markets: Geographical Expansion

Oman and Kazakhstan are two examples of new markets in the Muslim world. As “newcomers”, both countries benefitted from the experiences of earlier jurisdictions. The authorities in both countries recognised the importance of the legal and regulatory framework for the development of a robust, resilient and sound IFSI and took positive steps to enhance its internal capacity and build the necessary awareness on the distinguishing elements and characteristics of Islamic finance.

Oman took the “fast track”. The decision to allow Islamic banking was taken in mid-2011, following which the existing banking law was amended and a detailed regulatory framework that drew from experiences of other jurisdictions was installed after deliberations with experts and market players. The first full-fledged Islamic bank and four Islamic windows (of conventional banks) started business in early 2013. The authorities were fully aware of the views towards Islamic windows in some jurisdictions. The decision to approve Islamic windows in Oman was made to create, in a short time, a sufficiently large number of market players and create competitiveness in Islamic finance. They also wanted to give the opportunity for existing banks to explore the potentials of the new market for which a huge demand and a market share of about 20% after five years was anticipated. Windows can also serve to prevent massive shifts of deposits from existing to newly established banks, which may threaten the stability of the banking system.

The regulatory regime was supplemented by liquidity management tools, dispute resolution schemes and capacity building initiatives. The Omani authorities have issued fit-and-proper criteria for *Shari'ah* board members. However, the disharmony or divergence of the legal opinions of individual *Shari'ah* boards of the banks is seen as a challenge. Should this continue to be an issue, the harmonisation of *Shari'ah* interpretations by a Central *Shari'ah* Board, the establishment of which is envisaged in a medium term perspective, may become desirable.

Kazakhstan is another example of a very supportive government that wants to promote Islamic finance. As in the case of Oman, the authorities of Kazakhstan are well aware of the paramount importance of a conducive legal and regulatory environment, and they looked toward adopting best practice examples from other jurisdictions. However, the existing legal framework, market perception and public awareness in Kazakhstan are fundamentally different from Oman. The National Bank of Kazakhstan received support from the IFSB and the IDB in the development of Islamic finance in the jurisdiction. In 2009, Kazakhstan adopted a law to support Islamic finance, and in 2012 the President endorsed an Islamic finance roadmap for the country until 2020. However, the central bank was confronted with considerable challenges. Lack of public awareness and knowledge among potential clients

are hindrances on the market side, and a less flexible contract law (that requires the detailed description of concrete Islamic finance products) and an unsupportive tax regime are obstacles in the legal system. They also face a shortage of qualified personnel, and there are reportedly a small number *Sharī'ah* scholars in Kazakhstan who understand the intricacies of modern banking and finance. In spite of this unfavourable environment, the first IIFS in Kazakhstan (including a bank, a *Takāful* operator and an investment fund) has been established by capital from the Gulf region. There is strong political will from the government to position Kazakhstan as the regional hub for Islamic finance among the CIS countries of Central Asia within 10 years. The president has accorded the development of a *Sukūk* market in Kazakhstan and the funding of SMEs high priority.

3.2 New Frontiers: Non-Muslim Customers and Ethical Investments

Proponents of Islamic finance have always emphasised that Islamic finance is not limited for Muslims. This implies a virtually “unlimited” market potential, which can only be tapped against the strong competition of the more established conventional market players. For the IIFS to attract customers, they must offer them a competitive edge over conventional financial service providers. This “something” could be the ethical dimension of Islamic finance.

The experience of the near-collapse of an over-leveraged and speculation-driven global financial system has underscored the extent to which finance had become detached from the real economy. Islamic finance offers a system that is more tightly linked to the real economy, and its observance of the Islamic principles prevents pure speculation and excessive leverage. This system has been recognised in the West, with increasing numbers of people viewing Islamic finance as an alternative financial model based on ethical principles, which they share irrespective of the religious underpinning. The concept of Islamic finance is also well received by regulators in Europe from a number of perspectives including that of providing a wider range of financial products to consumers. Regulators and policy-makers have also noted the principles of equity finance, real asset backing, asset-linked securities, and risk-sharing – all features of Islamic finance that could enhance financial stability. In particular, many regulators are forming the view that an alternative asset class, with a somewhat different set of associated risks, could help widen and diversify risk exposures and hence contribute to systemic stability. However, Western regulators are also aware that the practice falls short of the ideal when IIFS make extensive use of products which replicates conventional debt-based instruments. They have also taken note of differences in *Sharī'ah* interpretations and limitations of the range of instruments for risk and liquidity management. Furthermore, reserve requirements, monetary policy tools, lender of last resort facilities and deposit insurance schemes have been identified as problem areas. These issues are not new. Regulators in Muslim countries with dual banking systems have been confronted with these issues and have found the solutions. A number of new market developments and the introduction of innovative solutions to the issues in these predominantly Muslim markets and at the international level can provide guidance to the Western regulators in their efforts to create a level playing field for the IIFS.

A level playing field is a precondition for a successful market entry of financial institutions that satisfy the growing demand for more ethical financial products and services. However, IIFS must be mindful of the high expectations of ethically-oriented customers. Ethical finance and responsible investing in Europe and North America have growth rates which are as impressive as those of Islamic finance. This has started with stock selection procedures which are very similar to the identification of *Sharī'ah*-compliant stocks, namely “negative screens”: Investors listed stocks (and bonds) of prohibited or disliked businesses (such as alcohol, weapons, etc.) and excluded them from their investment universe. There is a wide overlap of businesses shunned by Western ethical investors and IIFS, possibly making

Sharī'ah-compliant funds appealing to Western ethical investors who are satisfied with negative screens.

However, ethical finance in the West has developed a more sophisticated selection criteria, incorporating elements of “positive screens”. In this case, companies are screened for their performance related to corporate social responsibility or for the environmental or social impact of their businesses. Institutional investors, who are the main drivers of responsible investing, are supported by a diversified infrastructure, including specialised data and indexproviders, screening consultants, legal advisers, marketing firms, asset managers, industry associations and lobby groups.

Islamic finance has to take note of, and learn from, the level of sophistication that responsible investing has reached in the West. While IIFS have established practices to avoid the employment of funds in socially harmful activities, they still lack a sufficiently broad range of “impact investment products”. However, Islamic finance may fill a gap by adding innovation to the responsible investing sector. Most impact investing is based on the stock markets while fixed income instruments have so far not been widely introduced. Islamic finance has developed *Sukūk* as a new asset class that can flexibly combine features of equity and debt financing, and it can have a “socially responsible investing” direction in the use of funds. This idea was put forward by the World Bank in the context of finance for inclusive growth and will be further outlined below.

4. Inclusive Growth and Innovation in Islamic Finance

After the financial crisis, policy-makers and regulators have frequently stressed the importance of inclusive and equitable growth for achieving financial stability and economic development. Islamic finance will contribute to this next phase of development through inclusive growth with the explicit aim of reducing poverty. The theoretical considerations and global insights by the World Bank are confirmed by the success of the IDB interventions. The World Bank has outlined a new financial instrument that has the potential to link development projects with ethical investors in a form that is attractive to both IIFS and ethical investors in the West – the “socially responsible *Sukūk*”.

4.1 Finance and Development

Poverty is a global problem, and the World Bank is committed to eliminate extreme poverty and boost shared prosperity at the global level. Well-functioning financial systems contribute to economic development and poverty reduction because they allocate scarce resources to the most productive ventures. More specifically, financial systems providing critical financing to business enterprises boost economic growth, prosperity and job creation. At the same time, providing long-term financing for infrastructure is an essential precondition for sustainable growth and development.

Islamic finance can contribute to financial sector development in several respects. IIFS may be more resilient and may react differently to unforeseen shocks, which helps to diffuse risk in the financial system. IIFS are alternatives to conventional financial institutions which implies more competition and diversification of financing sources, resulting in increases in the depth, breadth and efficiency of the financial system. IIFS will enhance the access to financial services, in particular to those households and businesses that want to avoid *Riba* in their financial transactions.

Well-developed and well-functioning financial systems are of immediate importance for the poor. Sound financial institutions and markets enable households to save, invest and take advantage of income-generating opportunities. Reliable access to savings, credit, insurance, pensions and remittances assist households in smoothing consumption, managing risk and dealing with adverse shocks. The principles of Islamic finance – such as partnership and equity-style financing, profit- and loss-sharing, and tangibility – are particularly suitable to support inclusive growth and poverty reduction:

Microfinance institutions provide financial products and services that are tailored to the needs and capacities of the poor. However, many poor Muslims stay away from microfinance because nearly all microfinance products of banks and NBFIs are *Riba*-based. One third of the world's poor are Muslims, and nearly three quarters of them do not use formal financial services. In many cases, financial institutions are simply out of reach for them (especially in rural areas), but this may soon be solved by modern communication technologies or new forms of branchless banking. However, as long as the financial services for the poor are provided by conventional institutions, they would not appeal to 20-40% of the poor Muslims. Studies conducted by the Islamic Research and Training Institute (IRTI), the World Bank and others indicate that there is a huge demand for Islamic microfinance, which surpasses by far the actual supply. Islamic microfinance represents less than 1% of the global microfinance programmes. It is noteworthy that 96% of the institutions providing Islamic microfinance are specialised microfinance and rural banks, NGOs, NBFIs and cooperatives, but they contribute only 38% of the financing, while 60% of the volume is provided commercial banks, in which only 2% offer Islamic microfinance. The dominance of commercial banks in the

microfinance sector is an issue for both banking regulators and specialised supervisory authorities for the microfinance sector.

Islamic microfinance is still in its formative stage. The study of best practice examples has led the IDB/IIFT to take a differentiated approach. People in extreme poverty require social assistance, especially if they are unable to independently earn a living due to disability or old age. Islam provides several institutions of social support for the most vulnerable people, which supplement microfinance – people in extreme poverty (“hardcore poor”) will receive support from *Zakat* funds and charitable donations (*Sadaqāt*). They may also benefit from *Awqāf*. Microfinance addresses the “moderately poor” and services include payment services, savings products and micro-*Takāful*. Microfinance also supports the “active poor”, who can submit project ideas to receive financing, training and other non-financial support. Capacity building measures are often crucial for the success of the micro-project financing. For this purpose, Islamic microfinance institutions could cooperate with various well-established conventional microfinance organisations or international development agencies.

Poverty alleviation policies should not be confined to the poor but should also provide funding for small and medium-sized enterprises, which create jobs for the active poor and may utilise the products of new micro-entrepreneurs as inputs for their businesses.

4.2 Pioneering Models and Innovative Approaches

At present, *Murābahah* and *Qarḍ al-Hasan* dominate Islamic microfinance. Other contracts such as *Salam*, *Istisnāʾ*, *Ijārah* or partnership modes of financing (*Muḍārabah*, *Mushārah*) are insignificant, but their benefits should be explored more systematically.

The IDB has launched several pilot projects, and the World Bank has made assessments of exceptional practices. Some of the innovative approaches introduced are as follows:

- The IDB has established a US\$250 million Youth Employment Financing Facility (YEF) to improve the livelihoods of the unemployed potentially active youth through micro- and small-enterprise technical assistance and financing schemes in the Arab region. A special target group of the YEF are unemployed higher education graduates.
- The IDB has set up a US\$50 million *Muḍārabah* facility to finance Islamic microfinance institutions. The institutions can utilise funds from this facility and distribute financing based on a variety of *Sharīʿah*-compliant contracts to address financial inclusion issues.
- The World Bank draws the attention to the unique Akhuwat model in Pakistan. It provides free *Qarḍ al-Hasan* loans which are financed by donations and distributed to the active poor through mosques and churches. The operating costs are extremely low and the recovery rate extremely high. This model puts strong religious motives – to support people in need and to reciprocate received support – into practice.
- A more elaborate model that combines *Ijārah* financing for fixed assets with a *Murābahah* facility for complementing working capital for small businesses and farmers was practiced in Afghanistan.

The most seminal approach is the structuring of a “socially responsible *Sukūk*”. It has been observed that interest in socially responsible investments has grown rapidly over the last decade. It has already been mentioned that ethical financing in the West can generate a huge market potential for IIFS, provided they can offer responsible investors with the right products. Ethical finance and Islamic finance have a wide overlap in excluding sectors which are considered not beneficial or harmful to the society from their investment universe. However, conventional ethical finance has gone beyond negative screening and has moved towards impact investing: Ethical investors are no longer content with “doing no harm”. Instead they want assurance that their money is invested in projects or sectors with a

positive impact on, for example, community development, biodiversity, or climate change. Islamic finance is technically still lagging behind in this field. IIFS have not yet developed appropriate products and investment vehicles for this purpose, although the aspirations of responsible investing resonate very well with Islamic principles.

There is also a deficiency in the conventional “socially responsible investments” (SRI) sector – most impact investment vehicles are equity-based. Instruments with fixed returns are very short in supply (if available at all), but they would facilitate a better balancing and optimisation of SRI portfolios. This gap could be filled by a “socially responsible *Sukūk*”. The World Bank or an IIFS could become the originator and structure a *Sukūk* such that the proceeds from the issuance are invested (e.g. on an *Ijārah* basis) in one or several projects with a social impact – for example, in low income housing projects, in ecological projects or in projects related to health and education infrastructure. The *Sukūk* holders will then receive a predetermined cash flow. *Sukūk* issuances of low or unrated institutions could be supported by guarantees from sovereigns, private foundations, supra-national institutions etc.

The beauty of a socially responsible *Sukūk* is its potential to link conventional SRI with Islamic finance. On the conventional side, it allows impact investing and is a sought-after fixed income instrument. On the Islamic side, it is a *Sharīʿah*-compliant instrument, which allows impact investing. The concept of a socially responsible *Sukūk* shall get much attention in the global (conventional and Islamic) financial community if the World Bank takes the lead for a first issuance.

5. Lessons Drawn and Signposts for the Future

The contributions of the 10th Summit gave an overview and assessment of global financial regulatory reforms and their implications for the IFSI. It also looked into the regulatory implications of the interconnectedness of the different sectors of the IFSI, analysed the prospects and challenges of new markets and explored the possibilities for innovations and policy measures that facilitate inclusive growth.

Eminent personalities involved in the work of the IFSB from its beginning have been asked to share their views on the first 10 years of the IFSB, and to translate the lessons they drawn into signposts for the future. The results are a number of landmark recommendations, some of which go beyond the mandate of the IFSB, and would enrich the institutional infrastructure of the IFSI.

5.1 Research Foundation

The main focus of regulators has been primarily on the regulation and supervision of individual financial institutions, with an added dimension on systemic risk. It has become apparent in the aftermath of the financial crisis that the clarification of causalities and interdependencies require increased focus on macro-prudential surveillance, which necessitates better utilisation and research on tools such as stress testing. Knowledge gaps in these areas are similar, if not more in Islamic finance compared to conventional finance. There are many issues – from stability analyses and marketing research to product development and impact assessments – which require in-depth research. To support research, it would be useful to set up a repository for Islamic finance data, collected not only from published reports of market players but also from data provided by central banks and regulatory and supervisory authorities in a structured and regular manner. The IFSB should be able to establish the most comprehensive and reliable database on Islamic finance.

Research has been one of the objectives of the IFSB. Within the available resource envelope, the IFSB has started to cooperate with other institutions with research capacities such as the Bahrain Institute of Banking and Finance (BIBF), the International Centre for Education in Islamic Finance (INCEIF), the International Shariah Research Academy for Islamic Finance (ISRA) and the Statistical, Economic and Social Research and Training Centre for Islamic Countries (SESRIC-OIC). A significant upgrading of the research capabilities for the IFSI was proposed by Professor Datuk Rifaat Ahmed Abdel Karim, the inaugural Secretary-General of the IFSB, who suggested the establishment of an independent International Islamic Financial Research Foundation. The IFSB could be the right body to lobby for such an institution, and its members – market players and central banks – should be able to jointly mobilise the resources needed for this landmark project.

5.2 Global *Sharī'ah* Committee

There is an ongoing debate on “*Sharī'ah* fragmentation”, not only between different jurisdictions but also within the same jurisdiction. *Sharī'ah* scholars differ on the *Sharī'ah* compliance of particular products and services. This may create problems even within one jurisdiction, but is particularly an obstacle for cross-border transactions between market players in the Gulf and in Southeast Asia. A harmonisation of *Sharī'ah* interpretations in one form or another was called for by several prominent speakers – including Professor Datuk Rifaat Ahmed Abdel Karim, H.E. Dr Ishrat Hussain, former Governor of State Bank of

Pakistan and H.E. Ahmad Mohamed Ali Al-Madani, the President of the IDB. The minimum solution would be a systematic collection of all relevant *Fatāwa* (with their rationale) and the establishment of a “*Fatwa* clearing house”. As an outstanding signpost project, the President of the IDB suggested the creation a globally-accepted *Sharīʿah* committee, whose task would be to facilitate the standardisation of *Sharīʿah* interpretations.

5.3 International Court for Islamic Financial Products

There are broad areas which have gained prominence during the last crisis, including conflict resolution, dispute settlement and insolvency regimes. The IFSB has looked into these issues, among others in a joint programme, leading to a publication, with the World Bank in 2010. The relevance of these issues was highlighted by prominent speakers such as H.E. Sultan Bin Nasser Al Suwaidi, Governor of the Central Bank of the United Arab Emirates. Professor Datuk Rifaat Ahmed Abdel Karim drew the attention of the audience when he mentioned that legal uncertainties and risks originated from the fact that conventional courts had limited or no *Sharīʿah* expertise to decide cases of dispute over Islamic finance contracts and products. As a solution, he proposed the establishment of an International Court for Islamic Financial Products.

5.4 Upgraded Islamic Financial Stability Forum

The regulatory landscape and economic coordinates have changed. The centre of economic gravity is shifting from the West to the East, and the interconnectedness of the emerging markets has increased considerably. Islamic finance is set to follow this pattern. Greater interdependence supports the efficient allocation of resources in the real economy, it also increases the risk of contagion in cases of financial crisis. The threats of cross-border spillovers require regulators and policy-makers give more attention to international governance and work towards greater international coordination of policies. For Islamic finance, the Islamic Financial Stability Forum (IFSF) was launched by the IFSB in 2010 as a platform of information exchange and policy discussion among regulatory and supervisory authorities of the IFSI.

It was proposed by H.E. Dr.Zeti Akhtar Aziz and Professor Datuk Rifaat Ahmed Abdel Karim to “upgrade” the mandate of the IFSF to an institution for policy-making. Once a common understanding of systemic issues (e.g. stability threats) is reached, the next step would be the formulation of a common policy response. Gathered experts and high-ranking decisions makers suggested that the IFSF could become a decision-making body in this manner. The model for the future status of the IFSF could be in parallel with the Financial Stability Board.

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