11th IFSB Summit

New Markets and Frontiers for Islamic Finance: Innovation and the Regulatory Perimeter

21 - 22 May 2014, Mauritius

PROCEEDINGS

Organised by: ISLAMIC FINANCIAL SERVICES BOARD

Hosted by: BANK OF MAURITIUS

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Mauritius, 19–22 May 2014

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ISBN: 978-967-5687-40-2

Contact information:
Islamic Financial Services Board
Level 5, Sasana Kijang, Bank Negara Malaysia
No. 2, Jalan Dato' Onn
50480 Kuala Lumpur, Malaysia
Tel: +6 03 9195 1400
Fax: +6 03 9195 1405
Email: ifsb_sec@ifsb.org

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 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**.

THE IFSB ANNUAL SUMMITS

The Annual IFSB Global Summit is the most important event organised by the Islamic Financial Services Board (IFSB). Held in the month of May, the Summit addresses issues of relevance to the work of the IFSB. Attendees to the Summit range from Governors, Directors, Board Members, Chairmen and heads of financial institutions from across the globe. The Summit traditionally addresses key issues pertinent to the global financial regulatory landscape from the perspective of the Islamic financial services industry, and its development moving forward.

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PREAMBLE

The theme of the 11th Islamic Financial Services Board (IFSB) Summit 2014, "New Markets and Frontiers for Islamic Finance: Innovation and the Regulatory Perimeter", could not be more pertinent, for this was the first IFSB Summit to be held on the African continent, which is widely regarded as the new frontier for Islamic finance.

The geographical expansion of Islamic finance into new markets has underscored the opportunities as well as challenges faced in new jurisdictions that seek to take advantage of this alternative source of development financing to drive inclusive growth. The face of finance and banking worldwide has changed remarkably in recent times.

Public policy makers, regulators, standard-setters, bankers and rating agencies are all under a new spotlight. Regulators and governments are more alert than ever before to such issues as management of risk in banking, the need to exercise effective regulatory oversight, and the importance of having in place robust stress-testing and resolution mechanisms, as well as lender-of-last-resort (LOLR) facilities, to avert systemic collapse and the actions of imprudent financial institutions.

It is in this evolving brave new world that Islamic finance is breaking new ground and extending its footprint with products and services that can trace their origins to the seventh century, but which are still fresh and innovative in this modern setting.

Most appropriately, it was pertinent that this Summit addressed not only the hopes for a continuing expanding horizon for Islamic finance, in pioneering such services into new continents and sectors, but also the pressing issues of the day.

These issues include the outlook for the global Islamic financial services industry (IFSI) and the latest public policy developments; the state of the legal and regulatory environment of Islamic finance; the rise of *Sukūk*, and especially its market development and regulation; the role of Islamic finance in promoting financial inclusion, sustaining innovation, and expanding the regulatory perimeter through striking the right balance; and the opportunities and challenges ahead, especially in new and emerging Islamic finance jurisdictions.

In emerging markets in Africa and Asia, the approaching deadline for attaining the Millennium Development Goals in 2015, and the difficult prospects for financing economic development post-2015, have spurred the search for additional sources of financing and raised interest in Islamic finance among both policy makers and multilateral development banks.

Indeed, opportunities for Islamic finance in the African countries stem from the need to fund long-term growth strategies and infrastructure spending, as well as to spur private-sector investment. According to the World Bank's *Project Finance and Infrastructure Report* (March 2014), a sum of US$93 billion a year, or 15% of Africa's GDP, is required to meet the infrastructure investment needs of Sub-Saharan Africa (SSA) alone.

Similarly, the middle class is also growing rapidly and today constitutes 34% of the African population. At the same time, *Sharī`ah*-compliant financing to small- and medium-sized enterprises (SMEs) – which form the backbone of African economies – as well as Islamic microfinance can help to create jobs, support economic growth and eradicate poverty through greater financial inclusion.

But accessing the deepening global pools of *Sharī`ah*-compliant funds and savings will require progressive enhancements to the legal, regulatory, disclosure and *Sharī`ah* governance frameworks.

Among developed economies, too, there is greater recognition of the relevance and the potential development and growth impact of Islamic finance, and of its ability to mobilise savings and wealth creation.

At the same time, regular issuances of new and innovative *Sukūk* (denominated in both international and domestic currencies, and covering both the short-term and medium- to long-term horizons) have emerged as effective new and alternative ways of raising funds, managing liquidity, enhancing Tier I and Tier II capital, and boosting intra-Islamic trade and investment.

For a standard-setting body such as the IFSB, the challenge is to integrate its mission – which is to promote a sound and resilient Islamic finance industry – into policy objectives and goals for sustainable economic growth and development at the national, regional and global levels.

The global regulatory community has recognised that innovation is critical to achieving lower costs for financial transactions, and hence to widening financial and social inclusion, which aids financial stability. This recognition underscores the importance of casting the regulatory perimeter in a way that is proportionate to the risks, so that it does not stifle innovation.

Islamic finance has very specific needs and risk structures, however, which are best addressed through well-designed risk management systems and programmes for building awareness and capability, as well as through measures that ensure a level playing field – which is critical to the viability of Islamic finance. It is important for regulators and policy makers to recognise and plan for this early on.

Against this backdrop, the 11th Summit provided an ideal opportunity to take stock of the progress of global financial and regulatory developments from the perspective of Islamic finance, and of the challenges that lie ahead in driving inclusive growth, while examining different policy and regulatory approaches to managing the attendant risks.

In this context, the Islamic finance industry has a compelling story to tell and this is reflected in this year's summit proceedings.

OPENING AND KEYNOTE SESSION

"These are exciting times for Islamic finance. My vision is to see Mauritius emerge as an international financial centre of repute. I am confident that Mauritius stands poised to sustain and further develop a buoyant Islamic financial services industry. Our country is a new market, a new frontier for Islamic finance," concluded H.E. Dr The Honourable Navinchandra Ramgoolam, GCSK, FRCP, Prime Minister of Mauritius, in his Keynote Address to delegates at the opening session of the 11th Annual IFSB Summit.

Based on this forward-looking declaration of intent and the spectacular sustained growth which the Islamic finance industry has been experiencing over the past decade in particular, several key points emerged in this opening session.

Impact of the Rapid Growth and Resilience of Islamic Finance

The rapid growth and resilience of Islamic finance during the financial crisis is a feature of this recent experience that is attracting global attention. The growth rate since 2009 is about 17% per annum. This growth is largely led by the Islamic banking sector, which now represents about 80% of total Islamic finance assets.

These sustained growth rates are transforming the industry while also raising new opportunities and challenges. In the traditional jurisdictions, strong growth has led to the emergence of systemically important Islamic financial institutions, primarily banks. The growth rate is also driving greater awareness of Islamic finance, which in turn is contributing towards geographical expansion in new markets in Asia, Africa and Europe.

In terms of increasing interest, there is greater recognition of Islamic finance in developed economies such as the United Kingdom, Hong Kong, Luxembourg and others, but there is also in emerging markets in Asia and Africa the recognition that the approaching deadline for attaining the Millennium Development Goals and the difficult prospects for financing economic development post-2015 require the search for additional sources of financing.

It is in this context that Islamic finance is emerging as an alternative form of financing that can contribute to national and global goals of sustainable economic and social development.

New Markets

New markets potentially have much to offer. For instance, Mauritius is a thriving internationally oriented offshore financial market that is increasingly serving the needs of global investors. Its aim in introducing the necessary enabling environment to facilitate Islamic finance is not to compete with the established Islamic financial centres, but to position itself as the bridge to Africa and the gateway for trade and investment. Mauritius has been a member of the IFSB since 2007 and is a founder member of the International Islamic Liquidity Management Corporation.

Many new jurisdictions are increasingly keen to build institutions and businesses that are not only economically successful but also sensitive to the cultural, ethical and other ethnic needs of different groups. As such, they are just as keen to embrace financial inclusion, which is a key perspective that is required to build a successful Islamic finance industry. Moreover, these markets could provide a gateway to new ideas, new services and new partnerships as Islamic finance seeks to extend its frontiers.

The Growth of Islamic Finance and Regulatory Challenges

The global financial crisis (GFC) has shown that the risk-sharing that is at the heart of Islamic financing offers a principle that could mitigate and dampen the distorted incentives and excessive risk-taking behaviour that underpinned the GFC. But, as Islamic finance grows, the danger that the growth will come from “conventionalising” Islamic finance could open the way to the same risks as are inherent in conventional finance. Thus, instead of Islamicising conventional banking, it would be prudent to learn the lessons of the GFC and develop a unique ethics-based model of financial intermediation.

As such, regulators need to look carefully at fast-growing markets. As Islamic finance grows, so too will the number of regulatory issues that must be addressed.

The Growth of Islamic Finance and Africa Rising

Africa is on the march. Revival and economic growth in Africa is now recognised as a beacon of hope for its one billion inhabitants.

The continent is reporting pockets of GDP growth that are the envy of the developed economies. Islamic finance, similarly, is a phenomenon that is experiencing spirited growth. In many respects, the two have mutual synergies, which offer exciting opportunities but also challenges.

The IFSB’s membership in Africa is expanding. Of its 184 members (as at April 2014), 34 are from Africa and they come from 12 nations and regional groups and include 13 regulators as well as 21 market players. Thus, there is a strong, diverse and growing African voice in the IFSB.

As such, a sound and resilient IFSI could play an important role in Africa’s economic revival and development. Opportunities for Islamic finance in Africa stem from a number of factors. These include the need to fund growth strategies and infrastructure spending, as well as to spur private-sector investment; reaching out to under-served groups is a key aspect of this. But economic and social turnaround is not without challenges and would need to be conducted in a way that sustains economic growth.

At the same time, it would be foolhardy to underestimate the magnitude of the task that lies ahead in Africa, especially as the continent approaches the deadline for the achievement of the Millennium Development Goals. Africa is a region with huge potential, but also with stark governance, economic and social disparities. For example, Kenya leads the world in mobile phone payments and services; and yet 80% of the African population in general is unbanked.

While Islamic banking assets have grown at an impressive pace in recent years and are estimated at US$2 trillion this year, only about 1% of this amount has been channelled to the African continent.

New opportunities are arising in Africa. Massive investments are required in public infrastructure, and in the production of energy, health, agribusiness and education to enable the continent to take advantage of the evolving economic conditions. Africa needs finance to drive its development. The World Bank estimates that nearly US$93 billion is required annually to finance infrastructure in Africa. With only two-thirds of this amount funded currently, there is a wonderful opportunity for Islamic finance to bridge that gap of US$35 billion. As such, *Sukūk* is a particularly attractive source of financing, and the market is seeing the greater integration of Islamic finance in the public expenditure framework of member countries through the issuance of sovereign *Sukūk*, which provide the basis for the development of capital markets and of corporate participation through corporate *Sukūk*. Yet, further progress depends on reforms being carried out to the legal and regulatory frameworks, the sequencing of these reforms with efforts to strengthen capabilities, and ensuring that awareness of Islamic finance keeps pace with the goals that are set for it.

These stark figures underscore the challenges and opportunities that lie ahead for the Islamic finance sector at large and for the IFSB in particular in its role as the prudential and supervisory standard-setting body for the global industry.

Ethical and Socially Responsible Investment

There is a growing interest in ethical and socially responsible investment (SRI) in the conventional banking world today. It is notable that the roots of SRI in the conventional world have a religious influence. The Quakers, Methodists and others have been pioneers in defining ethical products in the stock markets – for example, excluding investment that touches on alcohol, tobacco, gambling and armaments.

Islamic banking and finance – with its inherent ethical principles of risk-sharing, transparency and disclosure, asset-backed financing, a proscription on usury and wanton speculation, and serving the real economy – contributes towards this global movement for SRI. Indeed, increasingly, people want to see how non-conventional alternative modes of banking and finance such as Islamic finance can become a greater dynamic force in promoting economic growth and social development.

Relatedly, the World Bank, the Islamic Development Bank (IDB) and other agencies are promoting the concepts of “green” *Sukūk*, for investments in environmental sustainability, and social *Sukūk*, to cover a wide range of investments in the social sector.

The Transforming Role of the IFSB

It remains a priority for international regulatory and supervisory standards and best practices for Islamic finance to be implemented to foster effective and efficient cross-border financial flows.

In this respect, the IFSB has contributed significantly through the publishing of some 22 standards and other related guidance for the IFSI, including banking, *Takāful* and Islamic capital markets, in the key areas of capital adequacy, risk management, disclosure, and corporate and *Sharī`ah* governance.

However, the clarion call in Mauritius is for the proper adoption of these standards, which would allow jurisdictions to integrate their domestic financial system into the global Islamic financial system.

The encouraging sign is that more and more jurisdictions are now adopting IFSB standards, with one or two calls even urging mandatory adoption as opposed to voluntary adoption. The IFSB itself favours an approach to adoption and implementation that inculcates increasing market knowledge about these standards and extending technical assistance to member countries to develop their regulatory and supervisory frameworks, which would facilitate the adoption of the standards.

The tremendous growth in the IFSI has also led to a number of distinct additional challenges.

For the global regulatory and standard-setting community, the critical issue is to achieve lower costs for financial transactions and hence to widen financial and social inclusion, which aids financial stability. It underscores the importance of shaping the regulatory perimeter in a way that is proportionate to the risks, so that it allows scope for and does not stifle innovation.

This is something to which the IFSB remains committed. Its work programme is designed to integrate financial inclusion objectives into the regulation and supervision of Islamic finance. An additional workstream is the preparation of a set of core principles for Islamic finance regulation and an assessment methodology for compliance that would integrate Islamic finance into the global surveillance mechanism conducted by the International Monetary Fund (IMF) and the World Bank in their Financial Sector Assessment Program (FSAP). Work has already started on this and the hope is to introduce the first set of core principles in the first half of 2015.

Similarly, the next step forward would be to develop core principles for *Takāful* and capital markets, and later on also to address financial safety nets in a similar way.

Strengthening the awareness and capacity building for implementation of existing IFSB standards is another area of focus of the IFSB. A survey of its members conducted by the IFSB in 2013 informed the board that members face numerous impediments in their legal and regulatory frameworks, as well as limited staff capabilities. Members have asked the IFSB for longer-term technical assistance in this respect. This is a challenge that requires an adequate and strong response from the IFSB to sustain its value and usefulness to its members and to the wider global community. It is as important a priority for the IFSB as developing core principles. It is something that will need planning, additional resources, coordination with partner institutions, and hence time to fully operationalise.

The IFSB takes very seriously the challenges faced by new jurisdictions in Europe, Africa and Asia in trying to integrate Islamic finance into their legal and regulatory frameworks. This is something that is the core mandate of the board, whose responsibility is to help countries that are trying to address the specific risk structures which are best addressed through well-designed risk management systems and programmes for awareness and capacity building, as well as measures that ensure a level playing field with conventional finance. However, it is important that regulators and policy makers work together to recognise and plan for this early on.

GLOBAL OVERVIEW OF THE ISLAMIC FINANCIAL SERVICES INDUSTRY: OUTLOOK AND POLICY DEVELOPMENTS

The Islamic financial services industry is one of the outstanding success stories in modern banking and finance. It is not surprising that a United Nations Development Programme economist described contemporary Islamic finance as one of the few original concepts to emerge from the South.

Indeed, next year (2015), the industry celebrates its 40th year of existence in its contemporary phase. The consensus in the session was that the industry's impressive growth trajectory during this period, which has seen total assets increase from US$150 billion in 1990 to an estimated US$1.8 trillion at the end of 2013, with the potential to rise to US$3 trillion by the end of this decade, represents one of the most remarkable growth dynamics in the global financial system, especially in such a short space of time.

The figures for FY2013, according to the IFSB's *Islamic Financial Services Industry (IFSI) Stability Report 2014*, which was launched at the 11th Summit, indicate year-on-year growth of 18.6%, with double-digit growth across all sectors of the industry. The growth of Islamic finance assets under management (AUM) achieved a compound annual growth rate of 17.07% during 2009–2013.

The banking sector accounted for 79.8% of AUM, followed by *Sukūk* with 15%, funds with 4%, and *Takāful* (Islamic insurance) with 1.1%.

In terms of geographic concentration, Saudi Arabia is by far the single largest Islamic banking market, accounting for 18% of global Islamic banking assets, followed by Malaysia (13%), United Arab Emirates (UAE) (7%), Kuwait (6%) and Qatar (4%).

In 2013, both the funds and *Takāful* sectors recorded strong growth at 10.2% and 15.5%, respectively, although this was from a much lower base than banking sector assets. Islamic investment funds had a mere US$73.7 billion in total under management in 2013, with Saudi Arabia being the largest Islamic funds AUM domicile, accounting for 41% of global Islamic funds assets, followed by Malaysia with 22%.

Similarly, gross *Takāful* contributions reached a mere US$19.87 billion in 2013, highlighting the gross under-representation of *Takāful* in the Islamic finance sectoral mix.

Global *Sukūk* issuances have been most remarkable during the post-crisis period, serving a variety of purposes. Nevertheless, global *Sukūk* issuances totalled US$119.71 billion in 2013, a decrease of 8.77% on the record US$131.2 billion of issuances in 2012. The value of *Sukūk* issuances in the last three years has exceeded US$300 billion. In the first nine months of 2014, *Sukūk* issuances have reached US$89 billion, with new sovereign issuers including the UK, Hong Kong, Senegal and South Africa. The *Sukūk* growth trajectory is widely expected to continue for the foreseeable future.

This rapid growth and the successful development of Islamic finance, according to the Islamic Corporation for the Development of the Private Sector (ICD), the private-sector funding arm of the Islamic Development Bank Group, has truly signified its dynamism and resilience as a form of financial intermediation especially as witnessed during and after the 2008 GFC.

On aggregate, the global Islamic finance industry is expected to remain on this growth trajectory and is projected to surpass the US$2 trillion mark by the end of 2014.

The growth drivers, according to session participants, include:

i) a growing interest in and awareness of Islamic finance supported by supply-side dynamics by private financial institutions;
ii) governments' aggressive spending on infrastructure; and
iii) an increasingly active role played by government, regulatory agencies and multilateral bodies.

Impact of High Growth Rates

The high growth rate of the industry has led to the emergence of Islamic finance sectors that have attained systemic importance in a number of key economies in Asia and the wider Gulf and Middle East.

At a benchmark of 20% of total financial sector assets, according to the IFSB's *IFSI Stability Report 2014*, there are seven national economies in which Islamic finance could be described in this way. At a 15% threshold the number of jurisdictions with systemically important sectors, or sectors that are too big to ignore, rises to 11.

Growth of the sector is also triggering stronger public policy responses in which the authorities in an increasing number of jurisdictions are developing medium to longer-term plans to support stability and resilience objectives by providing a framework for orderly growth.

The observed correlation between growth of markets and greater public policy scrutiny indicates that the ostensible absence of a strong public policy stance is not an insuperable obstacle; rather, it is a stance that is itself subject to change as the result of greater awareness and market development.

At the international level, according to the IMF, recent developments in Islamic finance, especially its rapid proliferation and the impressive growth in the *Sukūk* market, call for more attention from global institutions involved in financial sector development and stability. Key challenges are macroprudential policies aimed at stability, and access to finance to spur inclusive growth.

In this respect, the IMF in this session confirmed that the fund is engaged to support its membership and will increase its attention to this sector from the perspectives of its global surveillance function. The IFSB is facilitating this task, and helping to promote the integration of the institutions offering Islamic financial services (IIFS) into the global economy through the development of a set of core principles for Islamic finance regulation. The above announcement, and those made in London in 2013, and by the Prime Minister and Central Bank Governor of Mauritius in the opening session of this Summit, each with its distinct but complementary vision, reflect progress towards the coordination of policy and regulatory objectives that is needed to provide a firm foundation for the IFSI to grow and flourish.

Emerging Opportunities and Challenges in New Markets

While advanced Islamic banking markets in the Gulf Cooperation Council (GCC) countries and Asian regions will evolve and grow through the innovation of new products and services and regulatory advancement by the financial regulators, there is strong evidence of emerging opportunities in new markets.

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While Islamic finance has attracted much attention through the spate of new sovereign *Sukūk* issuers in non-traditional markets, the progress continues beyond the *Sukūk* market. For instance, Kuveyt Turk Participation Bank has applied for a full-fledged banking licence in Germany, which would be the first in the European Union outside the UK, traditionally the European capital of Islamic finance since the early 1980s.

Hong Kong, too, has made significant progress in developing the tax, legal and regulatory underpinnings for its goal of launching the city as a global *Sukūk* issuance sector.

Africa, as mentioned earlier, is a major new frontier for Islamic finance, with a number of commentators contemplating the establishment of an Islamic finance "Silk Road" stretching from China through Asia, the Middle East, Europe and into Africa.

We are effectively witnessing the internationalisation of Islamic finance. But to build on the above momentum, according to the ICD, a timely and comprehensive integration of the IFSI is urgently required.

Clarity on Sharī`ah Matters and Governance

There also needs to be greater understanding and clarity on *Sharī`ah* matters, because this will contribute towards convergence and harmonisation of the interpretations across jurisdictions. In this regard, the consensus is to encourage collaborative and constructive engagement among scholars, regulators, practitioners and all stakeholders within and across the regions.

As an example, in order to address the growing global demand for transparent and accurate industry information across global Islamic finance markets, last year the ICD and Thomson Reuters successfully collaborated to develop the first-ever Islamic Finance Development Indicator – a single, composite numerical measure representing the overall health and growth of the Islamic finance industry worldwide.

Human Capital Development

The rapid growth of the Islamic finance industry has led to a mismatch between the number of IIFS and the dearth of qualified and experienced personnel. The urgent need is to step up training and development of skilled human capital based on education best practice and accreditation.

The ICD's Islamic Finance Talent Development Programme (IFTDP), set up in collaboration with the International Centre for Education in Islamic Finance (INCEIF) in Malaysia, has the key objective of building a pool of highly talented young Islamic finance executives. To date, 37 professionals have joined the programme and the first cohort of 11 professionals successfully graduated earlier this year.

GLOBAL OVERVIEW OF THE ISLAMIC FINANCIAL SERVICES INDUSTRY: OUTLOOK AND POLICY DEVELOPMENTS

The Role of Multilaterals in Policy and Regulatory Matters

Multilateral development banks (MDBs) and financial sector agencies with a focus on Islamic finance have a significant role to play in supporting the industry as it goes through this transformation stage.

This support includes:

i) assisting in the growth of cross-border financial institutions through the provision of long-term lines of financing;

i) providing technical assistance in helping governments and supervisory authorities to construct effective legal and regulatory frameworks for Islamic finance policies; and

ii) providing capacity building to regulatory institutions with a view to implementing the changes required for proper financial integration.

The IDB Group stands out for its significant contribution to the growth of the IFSI, which is part of its core mandate and that of its affiliates, including the ICD, the Islamic Corporation for Insurance of Investments and Export Credit (ICIEC) and the Islamic Trade Finance Corporation (ITFC). The ICD, specifically through its line of financing and equity investments, has contributed to the establishment, expansion and modernisation of private-sector IIFS and has significantly promoted access to Islamic finance. For example, the ICD, through its holding company Tamweel Africa Holding, has invested in four Islamic banks in West Africa for improving SMEs' access to Islamic finance. It also offers advisory services to governments, and public and private companies, on economic, financial, institutional and legal aspects issues. Similarly, it has established a spate of *Ijārah* (leasing companies) in the GCC, North Africa, Central Asia and Malaysia, and more recently has launched SME funds in West Africa and in the GCC and Asia. In Saudi Arabia, it has also launched an Islamic mortgage company and a housing development joint venture.

The ICD has also taken several initiatives to assist the governments of several African countries to help in the issuance of *Sukūk*. For example, the ICD was one of two mandated lead arrangers, with Citigroup, of the debut CFA100 million *Sukūk* issued by Senegal in August 2013. It also has further mandates from two West African governments to advise them on their debut *Sukūk* issuances.

According to the IMF, the rapid growth of the Islamic finance industry underscores the importance of understanding the emerging challenges faced by national and international policy makers.

The key challenges the IMF sees are to financial stability, access to finance, and supporting macro-policies to spur the industry's growth. The Fund is engaged in the issue of Islamic finance and is trying to provide and service the needs of its member countries, be it policy advice, technical assistance or training.

The IMF has also observed that the rapid growth of the Islamic finance industry and the emergence of sizeable sectors in a number of economies requires corresponding action to strengthen the staff and policy capabilities within the institution. For the Fund, there are compelling reasons to be engaged in the provision of policy advice, technical assistance and training in the face of stepped-up demand by its membership, especially in the Middle East and North Africa (MENA) region.

Going forward, the IMF sees three core challenges – namely, financial stability aspects in order to build a stable and sound industry; financial deepening and its support of more inclusive growth; and macroeconomic policies, which need to support a level playing field between conventional and Islamic finance and its support of growth.

While IIFS are generally well capitalised, they are less profitable, which is clearly observable after the GFC. According to the IMF, while there are differences in risk profile between Islamic and conventional banks, overall there is no clear-cut evidence that there is a difference in resilience between conventional and Islamic financial institutions.

However, the IMF agrees that while the Islamic finance sector withstood the global crisis very well, it is suffering from the second-round effects in the real economy – notably in the real estate sector, due to its substantial exposure.

To monitor the stability of the IIFS sector, the IFSB's recent standards and the work by national regulators is creating a broad stress-testing framework. Subsequent to its 2012 *Standard on Stress Testing* (IFSB-13), the IFSB is to launch in 2014 a *Technical Note on Stress Testing*, which will provide a methodology to assess the Islamic financial system.

Overall, Islamic banks are liquid, but liquidity management suffers from shortages in highly liquid assets, and the lack of money markets and LOLR facilities. But, the increased issuance of *Sukūk*, notably sovereign *Sukūk* with different maturities, would help in deepening the capital market and provide more liquid assets for Islamic banks. Similarly, according to an IFSB survey conducted in 2013, only 6 out of 24 jurisdictions surveyed have LOLR facilities.

Sukūk issuance can add to market depth; and while issuances are holding up in the MENA region, the volumes, frequencies, benchmark issuances and maturities are still insufficient to help IIFS better manage their liquidity. New asset-based issuances would help in this respect. They are also insufficient to break the buy-and-hold behaviour that is detrimental to secondary trading in the market. The dearth of monetary policy instruments, especially at a time when IIFS are proliferating, is a concern. Tax policy and public finance management matter if there is not a level playing field between conventional banks and IFIs.

Sharī`ah*-compliant deposit insurance schemes are still missing in most Muslim countries, which leads to less confidence in the industry. Similarly, bank resolution frameworks also need to be developed, and consumer protection is of the essence. It needs to cover *Sharī`ah compliance depositor and investor protection, which will lead to more confidence in the industry.

Other challenges include lack of financial literacy, lack of transparency and disclosure, and a dearth of contract structures.

In terms of the Muslim countries, the IMF has observed that in general the Muslim populations are statistically under-covered and under-served in terms of access to formal savings and credit. This is especially so in the MENA region and in Africa, which areas have the lowest level of financial inclusion. Another constraint is the woeful access to Islamic finance by SMEs. Only 8% of SMEs had access to such finance in the Middle East and Africa.

The IMF has also observed that Muslims prefer *Sharī`ah*-compliant financial services to conventional ones, even if they are more expensive. In a survey of three Muslim-majority countries, almost half of the population preferred *Sharī`ah*-compliant financial products to conventional products.

The IMF noted that Islamic finance has the potential to contribute to financial inclusion and stability. By bringing the financially under-served population into the economic mainstream through financial inclusion policies, the industry can truly contribute towards more sustainable and equitable economic growth, which is at the heart of Islamic finance.

The Global Economic and Regulatory Landscape and Islamic Finance

As an integral part of the larger global financial system, the IFSI is also affected by global developments in bank regulation. The good news, says the IMF, is that growth in the world economy is picking up and its strengthening should also lead to continued demand for Islamic finance instruments and products.

The economic recovery is now also being supported by growth in the advanced economies, and becoming more broad-based. As a result, there is a changing environment for emerging markets and not necessarily for the worse.

Stronger growth in advanced economies means higher demand and stronger exports from emerging countries, and that is good news for them. As such, normalisation of advanced economies and tightening monetary policy means tighter financial conditions in emerging markets.

The view from the Fund is that, overall, the export effects will outweigh the tighter financial conditions over time, as long as this transition is a smooth one. More risk-averse investors, low inflation or deflation in the Euro area, and disrupted capital flows out of emerging markets could make it more difficult for periphery countries to recover.

The policy priorities are to continue fiscal consolidation, recapitalisation of banks in many countries, and dealing with household and corporate excessive debt levels. Another priority would be to increase growth through acceleration of structural reforms and greater public investment.

G-20 committed to lifting GDP over the next few years through accelerated structural reforms, and public investment in infrastructure will be a key factor.

The implication for the financing side is that many member countries are expected to tap into surplus savings of other countries, including possibly through more *Sukūk* issuances.

Growth is strengthening in the MENA region, especially in the oil-exporting countries, where there is strong non-hydrocarbon growth and a recovery in the hydrocarbon sector as well. The positive move is coming from the oil importers' side, many of whom have been going through political transition. The Fund sees a pick-up in exports and investments. While this is good news, it is not enough to address unemployment issues in many MENA countries.

However, the funding costs for emerging countries have been affected since US tapering talks in May 2013. MENA yields for bonds and *Sukūk* have declined in a region where there is high liquidity in the markets. The general sentiment on emerging markets is improving compared to the negativity of last year. This bodes well for the future.

Sukūk carry lower yields, which are quite pronounced. This is a reflection of the supply of funds. The IMF expects current account surpluses of US$300 billion a year to continue. This is twice the level of annual *Sukūk* issuances. The Fund expects these surpluses to continue to support demand for Islamic finance instruments – in particular, *Sukūk*.

In terms of the regulatory environment, the impact of Basel III capital adequacy and liquidity standards is crucial. An Ernst & Young report stresses that the impact of Basel III on IIFS operating in GCC region will result in a 3% loss in their capital-to-asset ratio due to the stringent conditions attached to Tier I and Tier II requirements and enhanced focused on risk measurement.

The minimum capital is bound to increase, which means a few domestic Islamic banks will need to hold more capital because of increased requirements for domestic systemically important banks. But the need for increased capital is not significantly different from that of conventional banks.

Under the Basel III liquidity coverage ratio (LCR) and corresponding high-quality liquid assets (HQLA) requirements, the lack of a liquidity infrastructure, and the higher deposit run-off factor due to the lack of *Sharī`ah*-compliant deposit insurance schemes, pose special challenges for Islamic finance.

In terms of the new capital buffers such as the conservation and countercyclical buffer, the impact is virtually similar for Islamic and conventional banks. The challenge for emerging markets, however, would be to find the right set of indicators that can correctly predict the excessive credit growth in the economy.

Similarly, in terms of the leverage ratio, Islamic banks are likely to be less affected by this requirement compared to conventional banks, due to the surfeit of cash arising from the dearth of *Sharī`ah*-compliant instruments. Also, the *Sharī`ah* requirement of prohibiting a debt–equity ratio above 33.3% will ensure that Islamic banks are not adversely affected.

The IFSB has recently issued its *Revised Capital Adequacy Standard for IIFS* (IFSB-15), which covers such areas as components of capital, the capital conservation buffer, countercyclical buffer, leverage ratio, etc. This standard broadly covers most of the developments made in Basel III related to capital adequacy and macroprudential policy. The IFSB is also working on a draft guidance note on quantitative measures for liquidity risk management in IIFS, which will complement recent regulatory developments at the global level related to liquidity risk, including the LCR and net stable funding ratio (NSFR).

THE LEGAL AND REGULATORY ENVIRONMENT OF ISLAMIC FINANCE

It goes without saying that the primary factors critical to the success of the Islamic finance industry, which is based on ethical faith-based principles, are the trust and confidence of customers; the safety and soundness of IIFS; and human capital, especially in terms of expertise and capacity.

As such, the consensus by the panelists at this session was that an effective legal and regulatory environment contributes immensely to the success of the above factors. This is not unique to Islamic finance; it is crucial to the wider global financial services sector, of which Islamic finance is a niche segment, albeit a rapidly growing one.

In the context of the session theme, a recent IMF Islamic banking survey of 39 countries pointed to the limited progress in the all-important enabling environment. In only 17 jurisdictions was legislation governing the practice of Islamic banking passed by a representative assembly. Only three jurisdictions had a separate regulatory framework, and ten jurisdictions had a separate unit within a supervisory agency for IIFS. Similarly, only three jurisdictions had a separate *Sharī`ah*-compliant deposit insurance regulatory framework.

The Ever-changing Global Regulatory Landscape

The GFC has led to an overhaul of the global financial regulatory system. The crisis exposed the weaknesses in regulatory architecture and the failure to reign in excessive private-sector risk-taking, which in turn incurred substantial costs to the system. The G-20 agenda mandated the Financial Stability Board (FSB) and IMF to perform the vital task of sustaining global financial stability through a new regulatory architecture that strengthens resilience. This mandate focused as much on enhancing the loss absorbency of capital, and controlling excessive risk-taking behaviour, in addition to supervisory and enforcement elements of regulation, as it did on strengthening rules and standards.

The core goals of the IMF financial sector assistance focuses on: strong microprudential regulation that is globally coordinated; effective supervision; a robust cross-border resolution framework; a macroprudential framework; and a larger regulatory perimeter that includes, for instance, addressing shadow banking issues, and strengthening accounting standards, data gaps and credit ratings.

The G-20/FSB regulatory reform agenda encompasses efforts to:

- i) enhance the resilience of financial institutions;
- ii) end too-big-to-fail institutions;
- iii) transform shadow banking into transparent and resilient market-based financing; and
- iv) make the derivatives market safer (OTC – over-the-counter – reforms).

These efforts are complemented by reforms in a range of other areas, such as credit rating agencies and, more recently, insurers.

The consensus is that the progress of the regulatory reform agenda is mixed – some initiatives are nearing implementation, while others remain a work in progress. In terms of supervisory intensity, the world seems to be moving from the issuance of standards towards their effective, consistent implementation across borders.
The Basel III framework, which is a cornerstone of resilience through its new capital and liquidity frameworks, is well in place with a defined timeline for implementation. The liquidity framework has refined the concept of high-quality liquid assets (HQLA) and introduced two standards, the LCR and NSFR, among others, to bolster

this framework. The LCR comes into effect in 2014 but is to be phased in by 2019. A robust dialogue between the IFSB and the Basel Committee on Banking Supervision (BCBS) has seen the recognition, for the first time, of Islamic finance in the published revised core principles, LCR framework and other documents of the BCBS. Thus, for the first time, Islamic finance has featured in a Basel standard in that a certain type of *Sukūk* can qualify to be included as an HQLA.

At the supervisors' level, Turkey's Banking Regulatory and Supervision Agency (BRSA) drew attention to the insufficient progress within the industry in properly addressing the short-term liquidity needs of IIFS. It proposed that central bank money market transactions should be developed to meet the possibility of creating a *Sharī`ah*-compliant repurchase (repo) market that can be used by Islamic banks. In Turkey, there is an imperative to establish a domestic trading platform for commodity *Murābahah* transactions. The Treasury's *Sukūk* issuance could be further developed and diversified; and, equally important, retail and corporate customers should be further informed about *Sukūk* products and their efficacy. Globally, a robust secondary market for *Sukūk* trading should be developed that should be led by credible market makers.

These sentiments are echoed equally in non-Muslim jurisdictions such as Kenya. Here, the lack of *Sharī`ah*-compliant liquidity instruments, which places Islamic banks at a huge disadvantage vis-à-vis conventional banks, severely constrains the access of the former to interbank funds. This has forced the banks to resort to *Tawarruq* placements with a very limited number of banks in the market. The absence of a *Sharī`ah*-compliant discount window at the Central Bank of Kenya is also a huge challenge. The broader challenge, common to many African jurisdictions, is insufficient awareness of the specific needs of Islamic finance; Islamic financial institutions, which cannot enter into interest-based activities, are too often treated identically to conventional financial institutions.

The Impact of Basel III on Islamic Finance

Market sentiments are mixed about the impact of Basel III on IIFS. The Dubai Financial Services Authority (DFSA), for example, while appreciating the prompt work on the part of the IFSB in issuing the revised capital adequacy standard for IIFS (IFSB-15), believes that Islamic banks are not likely to find it overly challenging to comply with the enhanced capital requirements coming out of Basel III, though they might find meeting the enhanced liquidity requirements relatively more challenging.

In regard to the latter, the IFSB is in the process of undertaking a thorough review of the proposed parameters of the new liquidity standards so that these specificities of Islamic finance are fully taken into account in the calculation of these ratios.

Legal and Regulatory Challenges in Islamic Finance

Apart from developments in the global legal and regulatory environment – in particular, Basel III – which also affect IIFS, there are certain specific and unique challenges facing the Islamic finance industry, as was highlighted by speakers in this session. These challenges include *Sharī`ah* compliance and governance; and form versus substance in Islamic financial transactions.

a) Sharī`ah Compliance and Governance

This is a core requirement of the Islamic finance legal and regulatory landscape. As such, the consensus was that compliance has to be considered as a primary issue facing the industry.

One of the challenges faced by the industry globally in this respect is the divergence in views or interpretations of various *Sharī`ah*-compliant products or services across borders. This assumes critical importance as the industry is growing to address a global marketplace, often attempting to meet the needs of clients across borders. A divergence in views, it is agreed, could not only limit the growth of IFIs but also infuse an element of uncertainty in their transactions. Uncertainty in transactions and consequential risk exposures are anathema to financial markets.

Needless to say, the role of *Sharī`ah* supervisory boards is critical to effective *Sharī`ah* governance and related risk management in the IIFS. The constitution and performance of *Sharī`ah* supervisory boards has in the past attracted intensive debate between the approach of firms having their own *Sharī`ah* boards and that of having a national *Sharī`ah* board which endorses market-wide practices and products.

The DFSA supports a "hybrid approach" which might provide the necessary flexibility, allowing for innovation, balanced with consistency and certainty. This approach sees the establishment of an apex *Sharī`ah* body at the national regulatory level – at the central bank and other supervisory authorities such as the Securities Commission and/or insurance regulator – but at the same time allowing individual IIFS to have their own *Sharī`ah* boards. *Sharī`ah* bodies at the supervisory level could act as the final arbiter of *Sharī`ah* matters and rulings relating to *Fiqh Al Mu`āmalat* (Islamic laws relating to financial transactions).

This is the model that Malaysia has pioneered and which is enshrined in the country's *Central Bank Act, Securities Commission Act* and the new *Islamic Financial Services Act 2014*. The model is being used, with variations, by several other countries, including Pakistan, Indonesia, Brunei, Kuwait and, lately, Oman. Turkey, on the other hand, has no *Sharī`ah* board at the regulatory level. Each participation (Islamic) bank has its own *Sharī`ah* board.

Clearly, there is a significant degree of learning from cross-country experience that is currently under way, and this is likely to lead to greater definition in policies emerging down the road.

b) Form Versus Substance in Islamic Financial Transactions

This relative emphasis on form assumes greater importance in view of the conviction of some observers that the underlying philosophy of *Sharī`ah* principles would have contributed greatly towards addressing many of the undesirable ideas and practices that caused the GFC. The speakers contended that substantive compliance with *Sharī`ah* principles would take the industry on a path of greater safety, soundness and resilience towards shocks from future crises. While it is important to achieve growth, it should be viable and sustainable, and complying with *Sharī`ah* principles in substance would place the Islamic finance industry on that path. Another downside of the current level of focus on form is that some of the *Sharī`ah*-compliant products offered by the industry are generally seen and treated by regulators and other stakeholders as having a similar risk and return profile to that of conventional financial products.

Standardising operating practices and transactions would mitigate operational risk and uncertainty faced by the industry in respect of legal and *Sharī`ah* compliance issues in relation to the underlying transactions in the business.

The recommendation is for harmonising contracts and operating procedures for various business segments or products offered by the IIFS. Research initiatives in this respect should be supported, but at the same time an active dialogue is essential between regulators, policy makers, *Sharī`ah* scholars, and market participants in order to work towards greater standardisation and harmonisation without jeopardising the innovation and creativity needed for the industry to grow.

Capacity Building at Regulators and Supervisory Institutions

The need for capacity building in terms of professional expertise available with both the regulators and regulated entities is another pre-requisite for sustainable growth of Islamic finance.

In this respect, the IFSB, with its initiatives towards capacity building for effective implementation of IFSB standards, should be commended, encouraged and adequately resourced to carry out this vital work. Among others, the IFSB's initiative to establish a web-based e-learning platform will go a long way towards supporting capacity building among the regulatory community.

Capacity building is an issue that goes beyond the banking sector and Islamic finance. In fact, it is high on the agenda of the Growth and Emerging Markets Committee within IOSCO (International Organization of Securities Commissions), which focuses on the capital market sector. Funding is a major issue, and IOSCO is exploring the possibility of funding this work through an IOSCO foundation. There is also a proposal for private or industry donations to be used in supporting capacity building, one which some find troubling because of potential conflict of interest issues.

Others in this session were of the view that there is no conflict in allowing industry funds to be used for this purpose provided requisite constraints plus checks and balances are put in place. The DFSA, for instance, sees little difference between such a practice and the relatively common occurrence of regulators being funded wholly or (as in the DFSA's case) in part by industry fees and levies.

The consensus is that it is essential that the stakeholders in the Islamic finance domain contribute towards strengthening the expertise and capabilities available in the sector to address the expected needs of customers and the growth of the sector.

In a non-Muslim jurisdiction such as Kenya, a major challenge is the lack of knowledge and expertise on the part of the supervisory authorities in regulating *Sharī`ah* compliance risk, which is a major risk faced by Islamic banks there.

Some Member Country Experiences

The Dubai International Financial Centre (DIFC), which employs 15,000 people, sees itself as a jurisdiction of choice for global firms and, for many local financial services groups, as their regional management hub serving MENA and Africa.

At the end of May 2014, there were 440 regulated entities operating in the DIFC, of which 334 are involved in providing financial services. As at the end of 2013, the total asset base of the regulated entities amounted to US$58.6 billion, the majority of which was contributed by banks. In terms of other significant business segments, DIFC firms also reported managing assets to the value of US$13.3 billion. Insurance firms in the DIFC reported aggregate gross written premiums of US$1 billion in 2013. A total of US$16.35 billion of *Sukūk* are also listed on the Nasdaq Dubai Exchange.

The DIFC has also attracted a wide range of service providers of global stature, from law firms and audit firms, to market information providers and training agencies. These developments, together with the base of qualified and experienced financial services professionals, have contributed to making DIFC a self-sustaining ecosystem for sustainable growth of financial services and providing a marketplace for the wider MENA and African markets.

In Turkey, potentially a major future market for Islamic finance, according to the BRSA, the market share of participation (Islamic) banks is steadily increasing. At the end of 2013, the four participation banks accounted for 6.3% of total banking deposits, employing 17,135 personnel in 973 branches throughout the country. The aim is to increase market share to 15% by the end of the decade. There is also a possibility of two new state-owned participation banks getting authorisation.

Participation banks are different in many respects from Islamic banks elsewhere in that they mainly support the real economy in financing SMEs, trade, housing, industry and manufacturing. However, the industry faces certain challenges in Turkey, some of which include:

i) lack of qualified human capital, education and training, and certification of Islamic finance courses;
ii) overwhelming concentration on *Murābahah*-based transactions and a dearth of profit-sharing products;
iii) current liquidity regulations compel the IIFS to maintain high amounts of cash, due to the absence of a sufficient number and volume of *Sharī`ah*-compliant liquidity products;
iv) lack of tax incentives for *Sharī`ah*-compliant products; and
v) limited funding sources, with *Murābahah* syndication the mainstay. (More recently, however, *Sukūk* are emerging as a very important instrument for raising long-term funding or competitive yields.)

In contrast, in a non-Muslim jurisdiction such as Kenya, which has two dedicated IIFS, the challenges are more fundamental. Banks such as First Community Bank (FCB), the largest Islamic bank in terms of balance sheet, are licensed under the Banking Act, which was amended in 2006 to give the Minister of Finance powers to exempt Islamic banks from certain clauses of the Act. Islamic banks prefer the introduction of dedicated legislation that institutionalises the provision that all Islamic financial transactions shall be treated not as trading or business transactions but as financing transactions, so that the profits derived from such transactions are taxed as income rather than as profits from sale or trading transactions.

The Central Bank of Kenya (CBK) has directed that the Islamic banks will be regulated in the same way that conventional banks are; hence the same taxation regime is to be applied to Islamic banks.

For the FCB, the additional challenges are clear and present:

i) uncertainty as to how Islamic financing instruments and documentation will be treated in local courts of law;
ii) a severe shortage of skills in the labour market in regard to Islamic finance in all spheres that the bank has to interact with, such as with lawyers, accountants, bankers, regulators, etc.; and
iii) uncertainty in regard to the tax treatment of Islamic financing transactions.

Conclusion

The general consensus of this session is that regulatory reform is making progress, but the job is far from finished and is an ongoing process. Better rules and regulations are not sufficient in themselves, but should be supported by an integrated programme of capacity and awareness building. It is incumbent on public policy makers, regulators, banks and other financial players to change their behaviour. As such, enhancement of supervision and regulation needs to be given due attention. There is also an important need to identify and address unintended consequences of regulation from the perspective of cost and the profile of emerging market economies.

While progress is being achieved in respect of shadow banking, "too-big-to-fail" institutions and OTC derivative market reforms, the consensus is that it will take some time before we see the final picture. In these areas, it is Standard & Poor's (S&P's) view that the impact on the Islamic financial services industry will be relatively less, given the nature, scale and complexity of its activities in respect of these segments.

However, a recent Islamic banking survey carried out by the IMF was quite revealing in another way. In only 17 jurisdictions was legislation governing the practice of Islamic banking passed by a representative assembly. Only three jurisdictions had a separate regulatory framework and ten jurisdictions a separate unit within a supervisory agency for IFIs. Similarly, only three jurisdictions had a separate *Sharī`ah*-compliant deposit insurance regulatory framework.

SUKŪK, MARKET DEVELOPMENT AND REGULATION

The Islamic financial services industry with its emphasis on serving the real economy through productive financing and investments has an important role to play in supporting long-term economic growth and development. Indeed, in trade, investments in certain areas, infrastructure and wealth management, the Islamic finance industry has made impressive inroads.

In addition, the capacity to mobilise funds has also increased substantially, with over US$500 billion raised through *Sukūk* issuances in the five years following the financial crisis (2009–2013), in contrast with just US$92 billion raised in the five years before the crisis (2002–2006).

The Growth Dynamics of Sukūk

The growth dynamics of the *Sukūk* market are tempered by the lack of authoritative primary data and statistics. For instance, a report on the global Islamic finance market produced by the Malaysia International Islamic Financial Centre (MIFC) in 2013 put global *Sukūk* issuances at US$119.71 billion, a decrease of 8.77% from the record US$131.2 billion of issuances in 2012. On the other hand, data from Bloomberg for the same period put the figures at US$166.3 billion in 2012 and US$124.5 billion in 2013.

Sukūk issuances for the first eight months of 2014 totalled US$89 billion, and the year-end figure is expected to surpass the 2013 total.

The *Sukūk* market remains a collection of regional and local markets, with Malaysia still the strongest market despite a 25% decline in 2013. Malaysia last year accounted for 62% of all *Sukūk* issuances, followed by Saudi Arabia with 18%.

The market is still dominated by sovereign and quasi-sovereign issuers, albeit the private-sector involvement is fast increasing. Domestic currency issuance dominates, especially in Malaysian Ringgit and Saudi Riyal. A major trend over the past three years has been the increasing number of issuances by foreign issuers largely from Saudi Arabia, Kuwait, Bahrain, Turkey and the UAE in the Malaysian Ringgit market.

Conversely, issuances in important new currencies point to the widening reach of the *Sukūk* market. For instance, Khazanah Nasional, the Malaysian sovereign wealth fund, has issued two *Sukūk* in the Singapore dollar market and one in the Renminbi market. Malaysia's telecoms giant, Axiata, has also issued a Renminbi *Sukūk*. There is already talk of the development of a Renminbi *Sukūk* market, following the issuance of the US$1 billion benchmark debut issue by the Special Administrative Region of Hong Kong in September 2014.

International issuances represented only 16% of total *Sukūk* in 2013. Data from S&P show that in 2012 international *Sukūk* issuances accounted for US$19.6 billion out of a total issuance of US$139.7 billion. Similarly, in 2013, the figure was more or less the same, at US$19.7 billion out of a total *Sukūk* issuance of US$119.7 billion.

The investor profile continues to be dominated by accounts from the Middle East and Malaysia. However, investors from the UK, Europe and Offshore US are on the rise. S&P also notes that the premium for international *Sukūk* issuance has not deterred issuers to date, especially the large issuers. *Sukūk* are generally considered costlier compared with conventional bonds. The reasons are that the structured nature of *Sukūk* and the low liquidity make *Sukūk* more expensive.

However, the latest data from the GCC and Malaysia suggest that yields on *Sukūk* and conventional bonds are highly correlated. Indeed, Gulf corporates and project finance companies have recently raised *Sukūk* at a cost below that required for comparable conventional bonds. In Malaysia, too, pricing for some *Sukūk* issuances is now more competitive than conventional equivalent issuances.

Progress through Innovation

Growth and prosperity constantly put pressure on firms and businesses to create new products and to expand into new markets and territories. However, prosperity also leads to the emergence of new classes of investors with more than simple financial needs: individual and institutional investors, mutual funds and pension managers, *waqf* establishments and sovereign wealth funds, etc.

This pressure to introduce new products and services and to satisfy the diverse needs of increasingly sophisticated investors engenders competition among businesses on two fronts: production and fund mobilisation. Hence, from the perspective of the economy, mobilising funds through innovative signalling (spawning new, tailor-made financial products) is just as important as technological creativity.

With its growing prominence, according to the IDB, Islamic finance now requires innovation along the entire spectrum of the financial services delivery system. There is a need to strengthen existing institutions and to create specialist organs – for example, settlement exchange for *Sukūk*, adjudication and arbitration centres, compliance rating agencies, and so on.

The objective is to improve efficiency and therefore lower the cost of finance; to streamline processes; and to develop universally acceptable credit benchmarks (perhaps even an alternative to Libor). The vision is to develop and standardise products and services, adhere to common compliance rules and enhance liquidity.
The industry has already recognised the need for innovative financial instruments, and new *Sukūk* structures are continually being developed and introduced to the market. These include hybrid *Sukūk* based on *Wakālah* combined with *Murābahah* or *Mushārakah* structures, exchangeable *Sukūk*, contingent capital *Sukūk*, and so on. However, some newly introduced *Sukūk* are complex, and perhaps even opaque, with the intention of replicating the risk/return profile of conventional bond instruments.

In addition to the risk of non-compliance with *Sharī`ah* principles, it is possible that embedded within these structures is a weak credit quality. (Less than 4% of existing *Sukūk* are currently rated, and only about 19% of the total outstanding amount is rated investment grade.)

This trend of weakening credit quality, according to the IDB, is unlikely to taper since creative financial instruments have typically been used to side-step financing constraints for low-quality issuers to gain access to the markets (e.g. through the uses of collateralised debt obligations, mortgage-backed securities, etc.).

Growth Drivers of Sukūk

The growth drivers for the *Sukūk* market are manifold. But they are subject to several caveats and conditions. The consensus in this session is that many of the main markets for Islamic finance have a large and growing population, favourable demographics with a huge youth percentage, generally positive economic indicators, and a rising penchant for ethical investments especially among the young, who, in markets such as Saudi Arabia, the UAE, Kuwait, Oman, Qatar, Turkey and Malaysia, are key demand drivers for Islamic financial services and products.

Economic conditions are key and remain favourable, although some risks persist. According to S&P the real GDP growth estimates for 2013 for the four main Islamic finance markets – Malaysia, Indonesia, Saudi Arabia and the UAE – are 4.8%, 5.85%, 4% and 3.65%, respectively. The forecast for 2014 is even more encouraging – 5.2% for Malaysia, 5.6% for Indonesia, 4.6% for Saudi Arabia and 3.76% for the UAE.

Economic prospects in these markets are to a large extent dependent on prevailing world oil prices, which are projected to remain close to US$100/barrel.

There are signs that *Sukūk* as an asset class will also continue to develop as businesses seek to tap into the large pool of investable funds within Muslim countries and communities and more conventional investors seek exposure to emerging economies. This is particularly so in Malaysia, Saudi Arabia and now markets such as Turkey, judging by repeat issuers such as Khazanah, Dana Infra, Tenaga, PLUS Berhad and Petronas in Malaysia, and GACA, Sabic, SEC, DAAR and several of the banks in Saudi Arabia; and new entrants to the market especially in the kingdom and in Turkey, including all four participation banks.

The *Sukūk* issuances pertain largely to infrastructure, for which there is a high demand for spending across the GCC, Africa and Asia.

Efforts by the IFSB to introduce key standards on capital adequacy, liquidity management and *Sukūk*, and by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) to harmonise financial reporting, are helping to inject a much-needed maturity into the market. But this is a perpetual work in progress given the dynamic nature of financial services, in which innovation drives regulation.

The IFSB, for instance, has reiterated the critical importance of government issuances of *Sharī`ah*-compliant securities, of which *Sukūk* is a prime example, in a sufficient volume and range of maturities to help address the constraints and lead to the development of liquid markets and instruments for liquidity management and other purposes.

A comprehensive and integrated approach to the development of *Sharī`ah*-compliant money and securities markets, according to the IFSB, will be important for those jurisdictions that wish to encourage the development of a strong and vibrant Islamic banking sector.

With respect to the application of the liquidity coverage ratio introduced as a part of the Basel III regulatory reforms package, while the availability of *Sharī`ah*-compliant HQLA in many jurisdictions is improving, in others the development of *Sharī`ah*-compliant markets and instruments is expected to take more time. In the latter case, the alternative liquidity arrangements (ALA) suggested in the LCR framework provide a way of meeting these requirements until such time as HQLA are available in sufficient supply, with deep and active secondary markets. One such alternative is the use of central bank "committed facilities", which can be provided at a fee. Another alternative provides the option to use *Sukūk* denominated in a foreign currency.

Finally, although there are significant hurdles ahead before we can say that a robust liquidity management framework is in place for Islamic finance, there are also encouraging developments.

Indeed, a number of countries have launched their sovereign *Sukūk* programmes with this end in mind. Some of the recent additions to this group of countries are developing the capacity to fully integrate Islamic finance into their government public expenditure programme. This would set the stage for a progressive mitigation of the current constraints on the liquidity framework.

The IDB is not only an active but also a crucial participant in the *Sukūk* market and is very committed to the continued development of the market. The IDB closed its latest issuance in September 2014 – a five-year US$1.5 billion *Sukūk Al-Wakālah*. The issuance is the second international *Sukūk* issued by the multilateral development bank in 2014 under its US$10 billion Trust Certificate Issuance Programme, which was launched in December 2013.

In addition, the IDB has issued two *Sukūk* through private placement in 2014 – a US$1 billion *Sukūk* with a tenor of five years in July, and a US$100 million *Sukūk* in April. As such, in total the IDB has raised US$4.1 billion from the markets in 2014 alone under the new US$10 billion Trust Certificate Issuance Programme, which means that the programme is almost half depleted in a mere nine months.

The IDB is under pressure to increase its programme to much higher levels to enable it to issue *Sukūk* much more frequently and in larger volumes, so as to build a strong issuance history with which a wider base of investors can become familiar. This would also drive down the cost of finance, and therefore issuance, which is still comparatively higher than peer multilaterals, including the African Development Bank (AfDB).

Sovereigns and multilaterals indeed are playing a lead role in issuance to fund growth and diversify fiscal funding in a host of countries, and at the same time adding to the market depth.

Greater cross-border cooperation by regulators has led to the establishment of a level playing field in both traditional and non-traditional markets. Regulators continue to strengthen frameworks, lower barriers to entry, and deepen liquidity in the *Sukūk* markets.

Refinancing activities will increase as a big stock of both Islamic and conventional financing transactions approach their maturity. S&P, for instance, projects that *Sukūk* refinancing alone needs US$50 billion in 2014. *Sukūk* listing on international stock exchanges such as the London Stock Exchange, the Irish Stock Exchange, the Luxembourg Stock Exchange and Nasdaq Dubai are now becoming regular. However, very little secondary trading, if at all, takes place on these exchanges, which are basically primary listings.

An interesting new feature of *Sukūk* is its eligibility for repo arrangements. The inaugural CFA100 million sovereign *Sukūk* issuance by Senegal in August 2014 is a case in point. The Central Bank of West African States (BCEAO) confirmed that "the *Sukūk* Parts (Securities or Certificates) can be validly sold and repurchased through sale and repurchase agreements".

The IFSB has stressed earlier the importance of government issuances of *Sharī`ah*-compliant papers. The data, however, suggest that the task ahead is daunting. According to the IFSB's *Working Paper on Sharī`ah-compliant Lender of Last Resort*, issued in April 2014, only 23% of regulatory and supervisory authorities (RSAs) have *Sukūk* as repo arrangements in place compared with their conventional counterparts with 84% of repo and reverse repo arrangements. Similarly, only 29% of regulatory and supervisory authorities (RSAs) had Islamic central bank or government issuances in place compared with 72% for conventional equivalents. Discount windows and deposit facilities follow the same trend – 10% and 25% of RSAs for Islamic products, and 88% and 79% for conventional counterparts. This highlights the need for further research on the development of *Sharī`ah*-compliant structures to provide similar facilities to the IIFS.

The Rise of Social & SRI Sukūk

There have been important recent developments in the *Sukūk* market, especially in relation to social and socially responsible investment variants. This is more than 12 years after the first and only social *Sukūk* issued to date – a SG$35 million *Sukūk Al-Mushārakah* issued by the Islamic Religious Council of Singapore in 2002 to develop a *Waqf* property.

In September, the Securities Commission Malaysia launched the world's first SRI *Sukūk* framework, which is aimed at facilitating the financing of sustainable and responsible investment initiatives. The proposal for an SRI *Sukūk* framework was first announced in the 2014 national budget speech of Finance Minister Mohd Najib Abdul Razak, who is also the Prime Minister.

The introduction of the SRI *Sukūk* framework is part of the Commission's developmental agenda to facilitate the creation of an ecosystem conducive for SRI investors and issuers and is also in line with the rising global trend of introducing "green" and social impact bonds to facilitate and promote sustainable and responsible investing.

To date, "green" *Sukūk* have been very limited apart from a small offering by a French entity working together with a company that produces solar panels.

The World Bank is also exploring the use of Islamic financing instruments for climate change mitigation as well as for meeting fundamental public goods objectives in the field of health. Thus "green" and "social" *Sukūk* are on its agenda. In addition, as the Treasury Manager of the International Finance Facility for Immunisation Company (IFFIm), the World Bank is arranging for a "social" *Sukūk* to fund IFFIm.*

World Bank officials see several similarities between SRI and Islamic finance. Both have deep historical precedents but have only developed as major areas of finance since the 1980s. Both focus on individuals using their money in a manner that conforms to their beliefs. Both have grown at a very rapid rate since 2000, and both forms of finance have been largely bottom-up demand-driven. (Financial institutions have devoted more resources to these areas in response to bottom-up demand from customers.)

Like Islamic finance, SRI has seen impressive growth over the last few decades. The original "proto-SRI" activity was boycotts against industries considered sinful on mainly religious grounds, including slave trading and alcohol production.

In the 1960s and 1970s, SRI grew beyond the religious context to include investment boycotts for political reasons, especially companies involved in the Vietnam War and those dealing with Apartheid South Africa. Since the 1990s, SRI has grown beyond a single-issue focus to a recognised investment strategy.

Today, the SRI sector has estimated AUM of US$3 trillion.

* The three-year *Sukūk* was duly issued on 27 November 2014 in the amount of US$500 million.

Some observations in this session were that Islamic finance and conventional SRI are not just similar; each has something to offer the other, and a “bridge product” could be developed that appeals to both markets. For example, SRI lacks fixed-income instruments. The sector has a discomfort with general obligation bonds, compounded by the difficulty of segregating bond proceeds for a specific purpose. In this respect, *Sukūk* provide an ideal solution for conventional SRI in that it is a fixed-income product with a specific asset focus, with *Sukūk* certificates representing rights to receive payments flowing from specified assets or ventures. As such, there is a high level of certainty as to how the proceeds will be used.

Sharī`ah board approval should not be an impediment, which is, in fact, a kind of built-in “SRI due diligence”. A perceived problem for Islamic finance is an excessive focus on “negative screening”. *Sukūk* structures have focused primarily on avoiding interest, as opposed to focusing on the purpose of funds, which can lead to a sense of form over substance. In return, conventional SRI can offer a solution to Islamic finance through “impact investing” by not just avoiding investing in certain industries, but by actively promoting social change through their investment activities.

Although conventional SRI and Islamic finance have both grown substantially, both areas suffer from limited liquidity in the fixed income space. As such, a product that appeals to both markets would have access to the combined liquidity. The opportunity beckons for a “socially responsible” *Sukūk* that bridges conventional SRI and Islamic finance without compromising the principles of either one.

Sukūk and Infrastructure

Sukūk and infrastructure have a natural fit. Yet, there is a mismatch between total *Sukūk* issuance and the volume and number of *Sukūk* specifically aimed at infrastructure financing. According to the MIFC, global *Sukūk* issuances totalled US$119.71 billion in 2013, a decrease of 8.77% on the record US$131.2 billion of issuances in 2012. However, S&P data suggest that in 2012 only US$17.6 billion, through 95 *Sukūk* issuances, was related to infrastructure.

These issuances have included *Sukūk* for airport infrastructure such as those issued by GACA in Saudi Arabia and MAHB in Malaysia; *Sukūk* for road infrastructure, such as those issued by PLUS Berhad and Prasarana in Malaysia; and several related to the oil and gas industry.

The infrastructure asks and spends in both developed and emerging economies, including the IDB member countries, will run into trillions of dollars over the next decade or so.

Infrastructure is a good base for *Sukūk* issuance, and nowhere is it larger than in its traditional strongholds of Asia and the GCC, which have large Capex requirements going forward.

In the post-financial crisis era, it is not only SMEs that are experiencing a credit squeeze; banks are also reluctant to provide long-term financing. With the high capital charges under Basel III, this problem of long-term lending by banks will be exacerbated. Indeed, Basel III’s capital rules are likely to limit bank financing for long-term projects.

Sukūk, by its very nature, lends itself to longer-term financing. At the same time, issuers can access new investor bases and diversify funding sources. On the downside, however, the uncertain/volatile returns of many infrastructure projects dissuade long-term buy-and-hold investors. As such, it becomes a market education process, in which governments – the gatekeepers and instigators of infrastructure projects – need to play the lead role.

Key Challenges and Future Success Drivers

The reality, according to S&P, is that although the *Sukūk* market is fast evolving, it still has some way to go to become a mainstream asset class. An encouraging sign is that *Sukūk* issuance in 2014 is set to exceed US$100 billion for the third consecutive year.

The challenges are implicit:

i) Most *Sukūk* issuances remain domestic ones, and many (especially in Saudi Arabia) are through private placements. Issuers have largely sought to tap into known and local liquidity pools, which are privately placed with pre-selected institutional investors.

ii) The low levels of standardisation of documentation and transparency are still a hindrance in making it a mainstream asset class.

iii) Standardisation could boost international *Sukūk* issuances and push down *Sukūk* pricing.The S&P view is that the premium for *Sukūk* issuance over conventional bonds rates would decline if *Sukūk* documentation were more highly standardised and default resolution mechanisms were clearer.

iv) Standardisation would enable investors to trust that their investments complied with *Sharī`ah* law. It could further lower issuance costs, because issuers could use standard documentation on which there was already a readily available, accepted religious opinion. It could also increase the predictability of the post-default process, benefiting both investors and issuers and reducing yield to levels comparable with conventional bonds.

v) Liquidity has so far built up only slowly, partly because it is building in fragmented domestic liquidity pools.

vi) The lack of quality market makers has hampered the development of an international secondary trading market for *Sukūk*. Malaysia remains the only exception.

vii) Not surprisingly, to date, *Sukūk* have been mainly issued as OTC instruments.

viii) Investors require transparent pricing because they need to be able to accurately determine the value of their investments. Pricing formation has often proved difficult, even for listed *Sukūk*, as most of them do not trade frequently.

ix) Government benchmarks are important to facilitate pricing formation for private issuance. Key markets such as Saudi Arabia and Kuwait have yet to issue sovereign benchmark *Sukūk*, albeit they do not issue conventional bonds either.

x) Comparable issues are also scarce in some markets. As such, there is not enough diversity of *Sukūk* structures in most markets, which tend to be dominated by *Sukūk Al-Ijārah* and/or *Murābahah* or *Tawarruq Sukūk*.

xi) The IFSB itself contends that despite the truly remarkable growth of the *Sukūk* market, the shortage or unavailability of *Sharī`ah* -compliant securities/*Sukūk* in many jurisdictions compels IIFS to maintain a higher level of cash and non-earning liquid assets than conventional institutions. This puts them at a competitive disadvantage to their conventional counterparts.

xii) In those jurisdictions where *Sharī`ah* -compliant securities/*Sukūk* are available, the lack of an active trading or repo market remains an ongoing problem.

xiii) More generally, in the majority of jurisdictions there is a lack of a *Sharī`ah* -compliant lender-of-last-resort (SLOLR) scheme to protect IIFS’ soundness and stability in situations of serious liquidity stress.

The future drivers are equally implicit:

i) The strong economic prospects (GDP growth, young demographics) and demand for infrastructure investment augurs well for the market over the next few years.

ii) Many *Sukūk* issuance jurisdictions, both in traditional and non-traditional markets, now have supportive regulatory infrastructure and tax-neutrality measures in place.

iii) *Sukūk* issuance by sovereigns and quasi-sovereigns, and multilaterals, is likely to be a mainstay for the foreseeable future.

iv) The asset management industry is seeking to broaden Islamic asset classes. A number of *Sukūk* funds are emerging. However, the success of this depends on a greater and more diverse volume of paper becoming available. As the figures suggest, this is improving, but the critical mass and frequency of issuances are crucial.

v) The launch in 2013 of the *Sukūk* Insurance Policy by the Islamic Corporation for the ICIEC, the export credit agency of the IDB Group, as a credit enhancement tool for sovereign issuers (mostly unrated or investment grade rated) should stimulate issuances from non-traditional sovereign issuers. ICIEC's cover extends only to US$125 million and is initially confined to *Sukūk Al-Ijārah* only. The Corporation hopes to extend this facility later to corporates and also plans to increase the cover ceiling. A logical further development would be the establishment of a *Sukūk* Guarantee Fund, which has been mooted by ICIEC, its parent the IDB and some key industry players to offer third-party guarantees for *Sukūk* issuances.

It may take a few years for the *Sukūk* market to be fully integrated. Several new issuers – both sovereign and corporate – may tap the international *Sukūk* market to broaden their investor base, which will give greater depth to the market. The consensus is that increasing standardisation would lead to faster growth of a truly global marketplace for *Sukūk*.

THE ROLE OF ISLAMIC FINANCE IN ECONOMIC DEVELOPMENT: PROMOTING FINANCIAL INCLUSION, SUSTAINING INNOVATION, EXPANDING THE REGULATORY PERIMETER – STRIKING A BALANCE

While stressing the increasing impact of the Islamic finance industry on society, economic development, poverty alleviation and financial inclusion, this highly engaging and relevant session suggested that Islamic finance is not a panacea for the problems of Muslim countries, nor of the world at large.

At best it has a mere four decades of experience in its contemporary phase. But it has made spectacular inroads in this short space of time to catch the imagination and attention of a spectrum of stakeholders, including international agencies such as the IMF, the World Bank, and standard setters including the BCBS. Islamic finance is increasingly viewed as a viable alternative system of financial intermediation, based not only on certain market principles but equally importantly on a set of ethical values that has a role to play in contributing to economic growth, financial stability, development impact, wealth creation, poverty alleviation and financial inclusion.

The challenge is how to further integrate Islamic finance with the global financial system, without compromising on its core principles, while serving the real economy and society.

Finance and the Poor

The Islamic economy comprises three important components: the public, private and social welfare sectors. A key segment is financial services whose ethos is not only to fund economic activity, mobilise savings and create wealth, but also to promote social justice and to provide a safety net to the less fortunate in society through social and financial inclusion measures.

The consensus in this session is that providing financial services to the poor is an important tool in alleviating poverty. More than half of IDB member countries can be described as least developed countries (LDCs) under UN criteria. So, the challenge ahead for the Muslim world is enormous, and the task for the Islamic finance sector is even more daunting.

Why? As the data suggest, this is due to a wide range of governance, market and regulatory shortcomings. The poor do not have access to financial services because they are considered unprofitable or they voluntarily exclude themselves for cultural, religious and other reasons, typically succumbing to what one presenter called "the static view of poverty".

The statistics relating to access to and involvement in banking for the Muslim regions are indeed grim. Based on IMF/World Bank data, in South Asia (SA), Sub-Saharan Africa (SSA) and MENA, the proportion of adults with an account at a formal financial institution is a mere 33%, 24% and 18%, respectively, against the global average of 50%. As such, a large chunk of the Muslim world remains under-banked and under-served, irrespective of whether the financial system is conventional or Islamic.

In the West African Monetary Union (WAMU), which has eight member countries, only 5.71% have accounts at formal banks, although this figure increases to 21.01% when other financial institutions are included, such as microfinance institutions. Indeed, there are 729 microfinance institutions in the WAMU countries, albeit that an overwhelming percentage of the assets are concentrated in 68 such institutions.

At the same time, the sources of finance for most households from the above three regions are revealing. A large chunk comes from friends and family; followed by store credit, banks, credit union or microfinance; and lastly from informal lenders, including loan sharks. Similarly, the reasons for the loans are primarily for emergencies or health, home construction or purchase, school fees, and funeral or wedding expenses.

Financial Regulation and the Poor

Regulators and legislators have an important role to play here. The contention is that if laws and regulations are too rigid, then this could stifle innovation in the financial sector and thus discourage the introduction of new products, services and initiatives, including financial inclusion, which could result in a scramble for regulatory arbitrage.

Public policy objectives of regulators of the financial sector include ensuring the safety and soundness of financial institutions (microprudential regulation); mitigating systemic risk (macroprudential regulation); protecting customers/investors; enhancing the fairness and efficiency of markets; and various social objectives, including the promotion of financial inclusion.

The traditional rules-based regulation (ex-ante setting of detailed rules, ex-post implementation by market players) is not suitable for regulating a dynamic and complex financial system. Therefore, a principles-based approach is desirable, providing general principles ex-ante by the supervisors and implementation of specifics by regulatees ex-post.

One speaker suggested that the new governance regulatory framework, which includes meta-regulation and risk-based regulation, can better deal with innovations, but that regulatory perimeters for innovations should be contextual and should depend on the activities, risks, scale of operations and clients served.

He urged the urgent scaling up of the knowledge and skills of the regulators through continuous education and training programs to understand and manage complex and dynamic financial activities; as well as far greater cooperation between regulators, regulated entities and other non-state entities. As such, the goal of regulation would be to support positive innovations and limit negative innovations.

Financial Innovation and the Poor

Innovation can occur at the organisational, process and product levels. The motivations of financial innovation are to reap higher returns or rent by addressing agency and information asymmetry problems; responding to taxes and regulation; mitigating the negative impacts of risk and globalisation; completing inherently incomplete markets and product suites; minimising transaction, research and marketing costs; and taking advantage of technological shocks.

The impact of innovation, however, can be both positive and negative. The positive impact could be the promotion of growth, inclusiveness, the improvement of efficiency, and the rebalancing and allocation of risks, especially across sectors and borders. The negative impact, on the other hand, can be reputational risk and loss of market integrity; consumer disservice through overcharging and misspelling; and the increased numbers of insolvencies of institutions and systemic risks.

The speaker suggested a regulatory framework for innovation, which includes a cost–benefit analysis (CBA) of the implications and impact of risks in different activities; its systemic relevance; and the types of customers and clients served. The benefits of using a CBA to regulate innovation include the provision of a clear rational decision-making strategy; the reduction of risks of unintended effects; greater protection to consumers; and the promotion of transparency and disclosure.

One excellent example relates to financial inclusion, technology and regulation, and how they can be synergised to achieve mutual goals. Financial inclusion provides services to the poor, including storage of money for safe-keeping, money transfer, payment of debt, credit, investment, and so on. But the cost of delivery of services to the poor is high. The suggestion is to use mobile technology to reduce the costs of providing micro-services. Already in countries such as Kenya, which has the largest incidence of mobile phone banking in the world, various new non-financial institutions are involved in the delivery of such services, particularly mobile network operators.

Because of consumer protection, financial stability and anti money laundering (AML) considerations, the speaker suggested regulatory perimeters for mobile money based on staggered regulation including prudential regulation and a low regulatory burden on new ventures, and consumer protection. An outstanding and successful example is M-Pesa (M for “mobile”; pesa is Swahili for “money”), which is a mobile phone–based money transfer and microfinancing service, launched in 2007 by Vodafone for Safaricom and Vodacom, the largest mobile network operators in Kenya and Tanzania. It has since expanded to Afghanistan, South Africa and India, and in 2014 to Eastern Europe. M-Pesa allows users with a national ID card or passport to deposit, withdraw and transfer money easily with a mobile device.

Inclusive finance challenges in this respect are effectively a trade-off between outreach and sustainability, based on two broad approaches – the poverty approach and the commercial approach. The former focuses on outreach and/or is dependent on subsidised financing, very often on a non-profit basis. In this context, the poor are seen as high risk; as such, the scale of financial services is very small if not non-existent. The latter promotes sustainability and self-sufficiency with services, *inter alia*, provided by for-profit organisations.
For inclusive Islamic finance, the specific challenges include the wider application of Islamic modes of financing at the micro-level through microfinance and micro-*Takāful*, *ArRahn*, *Qarḍ Al-Hasan*, *Waqf*, *Zakat* and *Sadaqah*. However, as was reiterated in the session, the main impediments are the lack of knowledge, resources and linkages between providers and the available resources. Market education and training can enhance both *Sharī`ah* compliance and the efficiency of the processes.

Financial Inclusion and the Poor

Financial inclusion is typically defined as the proportion of individuals and firms that use financial services, and has become a subject of considerable interest among policy makers, researchers and other stakeholders, including the G-20.

The level of financial inclusion varies widely around the world. Globally, about 50% of adults have a bank account, while the rest remain unbanked. Not all the 2.5 billion unbanked need financial services, but barriers such as cost, creditworthiness, travel distance and documentation requirements are critical.

The poor, women, youth, and rural residents tend to face greater barriers to access. Among firms, the newer and smaller ones are confronted by more binding constraints; for example, in developing economies, 35% of SMEs report that access to finance is a major obstacle to their operations.

According to the Indonesian Financial Services Authority, it is imperative to have a national strategy of financial inclusion encompassing financial intermediation through the right mix of products tailored to the needs of targeted customers and expanding outreach; social intermediation to provide technical assistance and training that not only focuses on financial services but also on improving people's skills and capabilities; synergies between bank and non-bank financial institutions, especially microfinance institutions; and the adoption of information and communication technology such as mobile banking.

The challenges include: enhancing the role of financial institutions from their traditional role of financial intermediation to include also social intermediation; combining financial and social services, and assisting the practice of repayment ethics and social cohesion; and overcoming the lack of capital, technology and expertise. Financial inclusion goes hand-in-hand with financial literacy policies.

Islamic Finance and Financial Inclusion

A central tenet of Islam is to develop a prosperous, just and egalitarian economic and social structure in which all members of society can actively contribute to its economic and social development.

Concepts such as financial inclusion, SME financing, charitable institutions such as *Waqf*, *Zakat*, *ArRahn*, *Sadaqah* and *Wasiyat*, and even philanthropy, are all considered to be part of the wider "Islamic moral economy". As the Islamic finance industry endeavours to inculcate financial inclusion, the irony remains that in many countries, including the UK, Singapore and South Africa, the phenomenon is derived from the need of Muslims, as minorities, to have financial products and services consistent with both their faith principles and the laws of the land.

In many Muslim countries there has been further segmentation, not in terms of whether or not the population is Muslim, but rather on the basis of whether certain sections that comprise a minority within Muslim societies want to have access to *Sharī`ah*-compliant banking, finance, and insurance products and services.

Over the last two decades the IFSI has started to engage in terms of financial inclusion, partly by design and partly by accident. This has primarily been through the cooperative movement, microfinance and pawnshops (*ArRahn*), and through the provision of micro-insurance (*Takāful*).

Some countries are more advanced than others. Malaysia, Indonesia, Turkey, Pakistan and Bangladesh have thriving microfinance sectors, backed by enabling legislation and the appropriate regulatory oversight. Indonesia and Pakistan even have a special microfinance bank authorisation category, perhaps among the only few in the world.

Research done by the World Bank confirms not only a low level of access to formal banking by the poor, but also their preference for Islamic finance micro-facilities, save in Tunisia. Very often, financial inclusion policies are also linked to the country's SME development programme. But the clarion call is for a more organised multilateral approach encompassing governments, regulators, standard setters, financial institutions and, of course, community-based stakeholders. One suggestion was for the IFSB itself to establish a financial inclusion forum to give member countries technical support on regulatory issues pertaining to IIFS and their products and services in this respect.

THE ROLE OF ISLAMIC FINANCE IN ECONOMIC DEVELOPMENT: PROMOTING FINANCIAL INCLUSION, SUSTAINING INNOVATION, EXPANDING THE REGULATORY PERIMETER – STRIKING A BALANCE

11th IFSB Summit

Islamic Finance and SMEs

In many developing countries, small- and medium-sized enterprises are often considered to be the backbone of their economies. However, the same is true of many developed economies, such as Germany. In some developed countries the contribution of SMEs to GDP is as high as 60%, compared to less than 20% in regions such as the West African Monetary Union.

It is important to recognise that the SME sector, like the Islamic finance one, is highly disparate, ranging from well developed to adequate to meagre to non-existent. This applies equally to government support, legal and regulatory oversight, the number of specialised institutions, the availability of funds and expertise, and – notably in the case of Saudi Arabia – even government-subsidised guarantees through *Kafalah*.

Both conventional banks and Islamic banks offer very low levels of funding to SMEs, which are considered a high risk for manifold reasons. SME funding, comprising mainly short-term facilities, thus far has totalled a mere US$60 million, which is about 30% of their loan portfolio. Unfortunately, SMEs in the WAMU countries have a high rate of non-performing loans (NPLs).

Barriers to the development of the SME sector include asymmetry of information, a small number of specialised industries and insufficient long-term resources for credit unions. This, in the WAMU region, for instance, has resulted in a high rate of SME failure. The WAMU governments have introduced a community charter of SMEs, which includes an official definition of an SME and key actions to support the sustainability of SMEs, including tax incentives and promoting the financing of SMEs through credit unions and SME funds.

A recent development is the launching of several SME funds by the ICD, the private-sector funding arm of the IDB Group, in various regions including the GCC, Central Asia, South-East Asia and the latest one in the process of being launched in West Africa.

Indeed, WAMU expects greater engagement from the ICD in equity participation in new Islamic banks; in the establishment of leasing companies; in the provision of lines of credit for Islamic banks; in the provision of more lines of guarantees; in greater technical assistance to IIFS for the financing of SMEs; and in structuring investment funds aimed at SME development.

The upside for SME involvement in the economy includes sub-contracting opportunities related to projects with an emphasis on women and youth employment generation. However, according to WAMU, because of the high NPL risk, governance and regulatory issues have to be appropriate. WAMU has suggested a regulatory framework encompassing a risk-weighting for prudential supervision (enlarging the range of accepted guarantees), tax incentives and waivers for leasing companies and SME funds, and the creation of a specific alternative listing platform for SMEs at the regional stock exchange (BRVM).

Concomitant with the rise of the SME sector is the emergence of credit reference bureaus with up-to-date data on the credit history of SMEs to pre-empt fraud and mitigate NPLs, and of databases providing financial data and information on non-financial institutions. However, there is also a need for entrenched guarantee schemes and a collateral registry.

SMEs and micro-enterprises are an important component of financial inclusion, where Islamic finance can play a vital role in helping to develop an ethics-based institutional framework for the sector.

Financial Education and the Poor

Institutions such as INCEIF see human capital development in the financial sector as the key. The bigger the talent pools, the better for the industry. But here the challenges are the provision of quality education, accreditation and professional standards, and interoperability. Education is a powerful empowerment tool, and Islamic finance education is for all. Capacity building is required at all levels, from policy makers to regulators, legislators, market players, academics, *Sharī`ah* scholars and consumers.

Islamic finance education, according to INCEIF, is a three-tier process involving leaders and regulators; the workforce (corporate and financial industry players); and the masses (the consumers). The strategy should be to demystify Islamic finance and in the process change the mindset of the masses.

In terms of understanding the key components, it is important to strike a balance between financial inclusion and risk-sharing. The demonstration effect of Islamic finance education is in quality independent research, compilation of case studies, market education and the creation of awareness.

NEW AND EMERGING ISLAMIC FINANCE JURISDICTIONS: OPPORTUNITIES AND CHALLENGES AHEAD

New markets and jurisdictions bring exciting potential opportunities but also real challenges, especially in the adoption of the requisite enabling legal and regulatory framework. New and emerging Islamic finance jurisdictions, as Bank Negara Malaysia (BNM) contends, can learn from the experiences of other more established Islamic finance centres.

At a stroke, the new jurisdictions have the opportunity to jump-start 30 years of modern Islamic finance practices. They could move quickly, avoid expensive pitfalls and adopt best practices. The basic premise here is that Islamic finance is for all. Its appeal extends to a larger global community, regardless of their faith and ethnic origins. In fact, the more jurisdictions that adopt Islamic finance, the better for the future of the industry. BNM goes even further by stressing that Islamic finance is not only for Muslims, and cannot be successful if it is supported by Muslims only. Indeed, many now recognise that the inherent characteristics of Islamic finance are consistent with universal values.

Many of its tenets contribute to economic and financial stability – for example, restrictions on overleveraging; linkage of transactional activities to the real economy; and a requirement for strong governance and transparency. In Malaysia, Islamic finance has gained acceptance among all, irrespective of their race or religion. Non-Muslims make up more than 50% of the customer base of Islamic banks. Similarly, the *Sukūk* market that totalled US$160 billion as at December 2013 is characterised by the involvement of a diverse set of players of all creeds. The players include multinational corporations and institutions such as the World Bank, Toyota, Nomura Holding Japan, AEON Credit and Shell, to name a few.

Non-Muslims use Islamic finance because it makes business sense, being as competitive as, and providing a welcome alternative to, conventional banking.

Based on Malaysia's 31 years' experience of Islamic finance, BNM has several observations for new jurisdictional entrants to the market.

These include:

i) New and emerging jurisdictions need not go through the trial-and-error period of the more established centres and can avoid making costly mistakes. Global best practices and standards can be adopted and adapted to suit local circumstances. There is no necessity to reinvent the wheel. Established Islamic finance jurisdictions are more than happy to share their experiences. There are already proven practices and documentation that bridge the gap between theology and practice. Accountants, lawyers, tax experts, regulators and bankers have put their minds to creating standardised agreements and instruments that are widely accepted across jurisdictions through bilateral and multilateral agreements. These agreements and instruments have stood the test of the market and of time. It is wise to adapt and customise them to the local environment.

ii) *Sharī`ah* governance is a pillar of Islamic finance. Many concepts and contractual characteristics are already resolved and widely accepted. These common factors are many and the differences are very few. Unfortunately, there is still a very small minority who are dissenting over these minor differences, thus creating doubt and uncertainty especially among those who are not familiar with the industry. This is not good for the confidence and general acceptance of the public. In Islamic history, diversity and differences of opinion through *Ijtihad* were indeed celebrated. In this respect, mutual recognition and diversity of opinions on *Sharī`ah* matters would go a long way in resolving different interpretations and understandings.

iii) The aim for new jurisdictions should be to start small but with confidence and to achieve success with a series of well-targeted groups. This does not require a focus on high-end Islamic financial products such as *Sukūk* and fund management. Embark on initiatives that could assist the low- and middle-income groups, including SMEs. Start with basic banking facilities: saving accounts, current accounts and term deposits. Provide financing facilities that are simple and easy to understand, such as microfinancing and micro*Takāful*.

iv) The government, through its public and financial policy, has an important role to play. Its commitment is key, but commitment must be commensurate with substantive action. For new entrants to the Islamic financial industry, sovereign *Sukūk* issuance by government would be a bold and strategic move. Naturally, the private sector will follow suit, as there is already a readily available pricing benchmark.

v) Similarly, central banks and monetary authorities can play a catalytic role in promoting a new market. Central banks have the capacity to issue *Sharī`ah*-compliant money market instruments to enable investment in short-term papers. It could assist in the liquidity management of Islamic banks. It also gives an opportunity for the public at large to invest in short-term *Sharī`ah*-compliant papers. At the same time, conventional investors have an opportunity to invest in a new asset class.

New Emerging Jurisdictions

New markets come and go. The test of time is the orderly introduction of Islamic finance; of equal importance is its sustainability. It is a question not only of what new jurisdictions can offer Islamic finance, but also of what Islamic finance can offer their economies and societies.

New jurisdictional regions which are now the recognised frontiers for Islamic finance are Sub-Saharan Africa (SSA) led by South Africa, Nigeria, Senegal and Kenya; Central Asia, led by Kazakhstan, Azerbaijan and Tatarstan; North Africa led by Tunisia and Morocco; and Western Europe led by the UK and including France, Luxembourg, Ireland and Germany.

a) Africa Rising

Africa traditionally has suffered from negative stereotypes and perceptions about its governance, stability, lack of infrastructure and corruption. But with its huge natural resources, especially oil, gas, minerals and agriculture, it remains a magnet for foreign companies and investors despite the above perceptions. With a market of one billion people and the fact that some of the more important economies are growing at estimated GDP rates of between 4.5% and 6% per annum, the currency of certain countries in SSA has increased.

According to Nairobi-based First Community Bank, Kenya and other East African nations are among a number of African countries that are consistently posting better returns on investments than most of the “safe havens”, which deteriorated fundamentally in 2008 and 2009.

Many countries in Africa are now evolving as economic hubs for trade and investment. These countries, then, are new and emerging jurisdictions that present manifold opportunities to investors who are willing to look beyond their history.

The East African region in general, and the East African Community (EAC) in particular, have a total population of 306 million people, of which Muslims constitute over 60 million. The EAC economy is growing at an average 6% per annum, and the total GDP of the five EAC nations is US$100 billion. Kenya has the highest GDP per capita: US$1,600, compared with the average of US$727.

These economic fundamentals and the financial and capital market reform agenda that is currently being implemented, according to First Community Bank, positions the country as the ideal hub of Islamic finance in East Africa.

This is further backed by the country’s relative political stability, its better infrastructure and abundant natural resources, the regulatory support of all four financial regulatory bodies to make Kenya the hub of Islamic finance, and the steady growth of the existing IFIs and the entry of even the conventional banks into the market through Islamic banking “windows”.

The main challenges facing the two Islamic banks and the one *Takāful* insurer in Kenya include: differences in accepted standards of *Sharī`ah* compliance; insufficient capital, a lack of experienced human capital and inadequate investment in IT infrastructure; and, above all, notions about “high-risk” investments in Africa, including corruption and insecurity.

However, out of adversity come opportunities. Insufficient capital restricts the business of an IIFS but at the same time offers opportunities for strategic partnerships with well-established and capital-rich counterparts from the Middle East and South-East Asia. Such partnerships will create better and stronger IIFS in these emerging and new jurisdictions, and at the same time serve, support and develop communities at the bottom of the pyramid who are, besides Asia, also found in Africa.

The human capital challenge should not be underestimated. The three IIFS in Kenya, for instance, employ over 700 people. Of these, less than 3% have degree-level qualifications in Islamic finance. A bank such as First Community Bank devotes a large portion of its resources to training and retaining staff. The answer lies in training more personnel even as a social and Islamic service to the growth of Islamic finance in the country and the region, which is what First Community Bank’s Islamic Finance Training Centre has recently embarked upon.

Innovations in IT and constant upgrades, “always-on” customer demands, growth of non-traditional financial instruments such as mobile telephone transfers (Kenya pioneered this innovative money transfer process), and non-financial service organisations such as PayPal mean high and continuous investment in a bank’s service-oriented architecture and fully integrated IT infrastructure, and its seamless cross-channel portals, connectivity and regular maintenance to ensure front-office, middle-office and back-office IT efficiency to achieve and render customer-centric experience and satisfaction.

Most of Africa, East Africa and Kenya, in particular, are ready for the next phase of growth – strategic partnerships that address the considerable scope and give the investing partners:

i) ready access to an expectant niche market – a multitude of discerning Muslims who have in the past few years begun to demand *Sharī`ah*-compliant foods and finance;
ii) a foothold in existing institutions in these jurisdictions, which are significantly competitive;
iii) host partners would have access to liquid capital to address capital adequacy ratios and strategic growth plans; and
iv) strengths and expertise that have been developed over longer periods, tried-and-tested systems, methods, products, *Sharī`ah* governance issues, expert personnel and broader markets.

Following the recent successful sovereign *Sukūk* issuances by Senegal and South Africa, more such *Sukūk* issuances are expected to come to the market. Here two multilaterals are playing an important role. The ICD, for instance, played a crucial role in advising the government of Senegal and the BCEAO, together with Citigroup, on its debut *Sukūk* and paving the way for such issuances by other member countries of the WAMU. ICD has confirmed that it has further mandates from two WAMU countries to advise them on *Sukūk* issuances.

At the same time the International Islamic Liquidity Management Corporation, whose mandate is to issue short-term *Sharī`ah*-compliant papers to help banks manage their short-term liquidity arrangements, has also signed a memorandum of understanding with the African Development Bank (AfDB) with a view to cooperating in issuing short-term *Sukūk* to assist IIFS in member countries in Africa in their liquidity management.

BNM, in fact, would like the AfDB to go a step further by joining up with other multilaterals and sovereigns to launch a mega *Sukūk* fund to finance infrastructure and development projects in the continent. These initiatives could further kick-start the Islamic finance movement in SSA.

b) Central Asian Promise

Of the Central Asian countries, Kazakhstan is the most developed Islamic finance market, albeit the base is still low compared to the more established market in the Middle East and Asia. The other markets with promise include Azerbaijan, Uzbekistan, Turkmenistan and the Russian region of Tatarstan.

The number of IIFS is limited, comprising very few banks, the major exception being Al Hilal Bank in Almaty, Kazakhstan, which is a wholly-owned subsidiary of the Abu Dhabi-based Al Hilal Bank, and a spate of investment and *Ijārah* companies primarily set up by the IDB and ICD. Kazakhstan also has one *Takāful* company, called Mutual Halal Insurance. The ICD has also established an Islamic leasing company and is in the process of converting a conventional Kazakh bank into an Islamic bank, following the acquisition of a 35% equity stake in the bank.

These countries are resource rich – Kazakhstan and Azerbaijan are oil producers; Turkmenistan has large gas deposits; and Uzbekistan is one of the world's largest cotton producers. While their economic fundamentals are encouraging, they are dogged with potential governance and stability issues. Kazakhstan, for instance, had an estimated real GDP growth of 6% in 2013.

Financial sector development, too, is characterised by growing deposits and loans to the economy, and by a concerted effort to build the necessary financial architecture. In addition, Kazakhstan has the stated policy of becoming the regional hub for Islamic finance.

Not surprisingly, the National Bank of Kazakhstan is actively working towards achieving this goal. It is in the process of establishing a comprehensive legal and regulatory framework for Islamic finance, and is promoting public awareness of the industry in the country. Already in place is an Islamic banking law (2009) and a *Sukūk* law introduced in 2011.

The government has also launched a Business Roadmap (2010–2020), which includes a component on the development of Islamic finance, whose implementation will contribute to the creation of conditions for the stable development of IFSI, especially *Sukūk* issuances, thus creating a critical mass of issuers, investors and market participants. Indeed, the Development Bank of Kazakhstan issued the country's first and only *Sukūk* to date two years ago, interestingly in the Malaysian ringgit market.

The National Bank of Kazakhstan is also an Associate Member of the IFSB and receives invaluable support and technical assistance in implementing the global prudential standards for IIFS operating in Kazakhstan.

The country also has a professional association, The Association of Islamic Finance Development, whose mandate is to facilitate the systematic and comprehensive development of the Islamic finance market in Kazakhstan through active cooperation with government agencies and international organisations.

With the aim of improving the image of Kazakhstan as a country developing Islamic finance, Kazakhstan hosts various international forums and conferences on Islamic finance.

The National Bank of Kazakhstan maintains that major barriers to the development of the Islamic finance market in the country and the region include:

i) Low public awareness of Islamic financing both by businesses and retail customers. Currently, there is moderate demand from businesses and the public for a limited amount of products offered by Islamic banks. Existing expectations may be significantly distorted due to the lack of knowledge among potential clients of Islamic financial products.
ii) Difficulty in adapting Islamic finance to meet the current provisions of the legal framework. Refinement of and amendments to the existing law will take some time, albeit there is an urgent need to reform the tax regime to facilitate a level playing field with equivalent conventional products, including tax neutrality, double stamp duty, etc.
iii) A serious dearth of qualified *Sharī`ah* advisories. According to the National Bank of Kazakhstan, currently there are no home-grown *Sharī`ah* scholars; hence, there is a risk that IIFS are being established that will include insufficiently qualified scholars on their boards. This, in turn, could compromise the *Sharī`ah* governance function and create uncertainty as to the compliance of products, services and contracts with *Sharī`ah* requirements.

Multilateral Measures

The apex and natural multilateral institution to help new and emerging jurisdictions in Islamic finance is the Jeddah-based IDB Group. Its core mandate includes the promotion of Islamic finance globally, including in new and emerging jurisdictions. IDB affiliates such as the ICD, ICIEC, ITFC and Islamic Research and Training Institute (IRTI) also play an important role. Supporting new and emerging jurisdictions for Islamic finance is also done through collaboration between governments, central banks and regulatory authorities, and between the IDB Group and the above affiliates and industry bodies with other multilaterals such as the BCBS, Bank for International Settlements, the IMF, World Bank, International Finance Corporation (IFC) and the regional MDBs such as the Asian Development Bank (ADB) and AfDB.

Islamic finance is now a priority for the World Bank in its programmes and deliberations with member countries that are common also to the IDB. In 2013 it established a Global Islamic Finance Development Center in Istanbul. The IMF is cooperating with the IFSB in developing core principles for the assessment of Islamic banks that would also facilitate its Financial Sector Assessment Program (FSAP) initiative. The IFC is playing a growing role in taking equity positions in private-sector IIFS, including banks and mortgage companies, and has even issued two *Sukūk* to fund these activities. The ADB, on the other hand, has jointly established an Islamic Infrastructure Fund with the IDB and is providing technical assistance to the IFSB and some developing member countries on Islamic finance.

The IDB – as one speaker from the Group, speaking in a personal capacity, stresses – has several vehicles of intervention in supporting and promoting new and emerging Islamic finance jurisdictions. These include:

- i) supporting and creating Islamic finance infrastructure institutions;
- ii) developing and disseminating Islamic finance instruments and products;
- iii) investing in private IIFS;
- iv) providing technical assistance and capacity-building support; and
- v) providing research and human resource development in Islamic finance.

The IDB Group speaker suggested five ways in which the IDB could enhance the above vehicles and thus contribute to the development of emerging and new jurisdictions for Islamic finance.

He urged the IDB to continue to support the development of the Islamic finance regulatory framework through institutions such as the IFSB and AAOIFI. A major bottleneck in this respect is resources for technical assistance in the face of exploding demand for such assistance from both member countries and new and emerging jurisdictions. The IDB, he insists, should increase the funding of technical assistance in promoting the Islamic finance regulatory architecture per se, but particularly in new and emerging jurisdictions for Islamic finance. Finance is the major impediment, he contends; much less of an issue is the availability of know-how and expertise.

The IFSB at the same time should develop ways of tapping private-sector resources to complement the IDB and other public donors. The IFSB has established a committee to work towards this objective, but the committee needs to be encouraged to look beyond the public sector and government-linked entities and to try to find ways and means to tap private-sector resources.

Technical support, he observes, could also come from the IDB's own Reverse Linkages Strategy – where there is a twinning of countries: a country which has successfully developed the necessary Islamic finance regulatory and legal infrastructure is matched with countries in need of the technical assistance to implement these. The IDB has successfully implemented this strategy in other areas.

Malaysia and Bahrain are the advanced jurisdictions and could be twinned with, for instance, Oman and Kazakhstan, respectively. The IDB could play a role in bringing such partnerships together and in helping to finance this reverse linkage initiative.

The role of multilateral institutions is to strengthen and enhance the role of international Islamic finance infrastructure institutions. The IDB should not only continue to support these, but should also help to enhance collaboration and coordination between them. There is indeed much more room for this collaboration and coordination.

The IDB also has a crucial role to play in strengthening the Islamic finance market through investment in the equity of various IIFS in new and emerging jurisdictions. Over the last four decades, the IDB has already invested equity in 32 IIFS in 20 jurisdictions. The ICD, similarly, has established a holding company, Tamweel Africa, which is based in Dakar, Senegal, whose mandate is to take equity positions in IIFS in SSA countries. The IDB and ICIEC also invested in *Takāful* Re based in the UAE, which is the first *ReTakāful* company to be established.

The IDB could also further deepen the Islamic finance market, including in new and emerging jurisdictions, through extending more lines of credit, as well as through the *Sukūk* market and Islamic microfinance. The IDB has done much work to develop this project, which is a major instrument to increase access by the poor to Islamic finance resources in these countries. The IDB is also reforming the *Awqaf* and *Zakat* sectors, thus increasing the contribution of Islamic finance to the third sector.

The ITFC, too, is innovating trade finance structures and Islamic export finance, including the two-step *Murābahah* which enables the syndication of *Murābahah* transactions.

The ICIEC has pioneered the provision of *Sharī`ah*-compliant export credit and investment insurance and reinsurance to facilitate greater intra-Islamic trade investment, and also trade and investment between member countries and non-member countries. Its *Sukūk* insurance policy is expected to boost sovereign *Sukūk* issuances.

The final and most important area is development of human resources and talent for Islamic finance, in which area the IDB could play an even bigger role. This is of critical importance for the development of Islamic finance in new and emerging jurisdictions. Progress could be made by supporting and expanding the work of IRTI and the Islamic Finance Talent Development Programme of the ICD in conjunction with INCEIF.

The IDB should also initiate an executive training programme for Islamic finance executives on a continuous education basis, and further expand its scholarship programme to support postgraduate studies in Islamic finance. The IDB has such programmes with both Oxford and Cambridge universities, albeit these scholarships are confined to science and technology subjects.

Finally, the IDB Group speaker recommended that the IDB needs to consolidate and amalgamate the offering of technical assistance under one window. At present, this function comes under various entities and is not well coordinated, which in turn creates confusion, bottlenecks and time wasting from those that seek this assistance.

In conclusion, the key takeaway from this session as espoused by the Host Governor, H.E. Rundhersing Bheenick of the Bank of Mauritius, in his capacity as Chairman, is that Islamic finance is for all and is here to stay, and that Mauritius, as a new and emerging jurisdiction, does not equate it with any particular religion.The Bank of Mauritius does not mind calling this form of financing "Islamic finance". After all, what is in a name? The important thing is to increase consumer education so as to break down the current resistance.

New and emerging jurisdictions such as Mauritius offer themselves as agents to the Islamic finance industry to be a bridge between this growing pool of funds looking for a *Sharī`ah*-compliant home and the crying needs of Africa in terms of infrastructure finance. Mauritius, he maintained, has the legal and institutional infrastructure to support the establishment of businesses targeting cross-border investments and operations. Above all, it has the rule of law. Mauritius has what it takes to help promote Islamic finance to make it acceptable and closer to mainstream banking in the continent of Africa.

CONCLUSIONS AND RECOMMENDATIONS

The six sessions of the 11th IFSB Annual Summit covered a wide range of topics, which initiated robust discussions and resulted in several observations, comments and recommendations.

The world economy is on the mend. The recovery, especially in the developed economies, will have a positive impact on the emerging countries, which in turn could open up new opportunities for Islamic finance.

The consensus is that the progress of the G-20/FSB Global Financial Reform Agenda is mixed – some initiatives are nearing implementation, while others remain a work in progress. In terms of supervisory intensity, the world seems to be moving from emphasis on standards issuance towards their effective implementation.

The Basel III framework, which is a cornerstone of resilience through its new capital and liquidity frameworks, is well in place with a defined timeline for implementation. The liquidity framework has refined the concept of HQLA and introduced two standards, the LCR and NSFR, among others, to bolster this framework. The good news is that for the first time Islamic finance has featured in a Basel standard, and that new initiatives are being undertaken in various jurisdictions to increase the supply of HQLA for the IIFS.

That Islamic finance is here to stay is now well recognised. Indeed, its growth trajectory, now with estimated assets under management reaching US$2 trillion, represents one of the most remarkable growth dynamics in the global financial system, especially in such a short space of time.

The rapid growth of the Islamic finance industry, according to the IMF, calls for more attention to the industry from all the institutions, including the Fund, involved in promoting financial stability. The IMF agrees that while Islamic finance withstood the global crisis very well, it is susceptible to the second-round effects in the real economy, notably in the real estate sector, due to its substantial exposure.

The IFSB and national regulators have done substantial work to promote the stability of IFSI. However, stress-testing models and the full methodology to assess the Islamic financial system are still to be fully tested. The IFSB will soon launch a new *Technical Note on Stress Testing* that will provide further guidance on this subject. Overall, Islamic banks are liquid, but liquidity management suffers from shortages in HQLA, and from the lack of active *Sharī`ah*-compliant money markets and LOLR facilities. The increased issuance of *Sukūk*, notably sovereign *Sukūk* with different maturities, would help to deepen the capital market and provide more liquid assets for Islamic banks.

The FSB and the IFSB have a shared goal in promoting the stability and resilience of the global financial system. However, for the IFSB, there is the broader objective of promoting and growing the Islamic finance sector through the consistency of treatment across jurisdictions that is provided by its standards.

Market sentiments are mixed about the impact of Basel III on IIFS. Some believe that Islamic banks are not likely to find it overly challenging to comply with the enhanced capital requirements coming out of Basel III, though they might find meeting the enhanced liquidity requirements relatively more difficult. In regards to the latter, the IFSB is in the process of undertaking a thorough review of the proposed parameters of the new liquidity standards so that these specificities of Islamic finance are fully taken into account in the calculation of the ratios.

The high growth rate of the industry has also led to the emergence of Islamic finance sectors that have attained systemic importance in a number of key economies in Asia and the wider Gulf and Middle East. Growth of the sector is also triggering stronger public policy responses, with the authorities in an increasing number of jurisdictions developing medium- to longer-term plans to support stability and resilience objectives by providing a framework for orderly growth of the industry.

But to build on the above momentum, a timely and comprehensive integration of the IFSI is urgently required, which makes it a priority for national regulators to implement international regulatory and supervisory standards and best practices for Islamic finance in order to foster consistency in the regulatory regimes across regions and facilitate effective and efficient cross-border financial flows. In this respect, the IFSB has contributed significantly through the issuance of some 22 standards for the industry – in all key areas of capital adequacy, risk management, disclosure and transparency, as well as *Sharī`ah* governance.

The IFSB is indeed preparing a set of core principles for the regulation of Islamic finance in the banking sector and an assessment methodology for compliance that would facilitate not only self-assessment and peer reviews by the supervisory authorities, but which is also expected to bring Islamic finance into the global surveillance mechanism conducted by the IMF and the World Bank in their FSAP.

Despite this, an IFSB survey itself reveals that many members face numerous impediments in their legal and regulatory frameworks, as well as limited staff capabilities.

As such, the recommendation is that the IFSB and its partners redouble their efforts in this respect. Members have asked the IFSB for longer-term technical assistance. This is a challenge that requires an adequate and strong response from the IFSB if it is to sustain its value and usefulness to its members and to the wider global community. In fact, it is as important a priority for the IFSB as developing core principles and other standards. It is something that will need planning, additional resources, coordination with partner institutions, and hence time, to fully operationalise.

The clarion call in Mauritius was also for the proper adoption of IFSB standards, which would allow jurisdictions to integrate their domestic financial system into the global Islamic financial system.

For the global regulatory and standard-setting community, the critical issue is to achieve lower costs for financial transactions and hence to widen financial and social inclusion, which aids financial stability. It underscores the importance of shaping the regulatory perimeter in a way that is proportionate to the risks so that it allows scope for and does not stifle innovation.

As the IFSI continues its journey to become a vibrant, dynamic and competitive global intermediation mechanism, it is imperative that the industry does not lose sight of the ethics and values that are at its roots. It is only by bringing the financially under-served population into the economic mainstream through financial inclusion policies that the industry can truly contribute towards more sustainable and equitable economic growth, which is at the heart of Islamic finance.

The picture painted by the data is depressing. Muslims are the most excluded sector in terms of access to formal bank accounts and formal credit. Similarly, the SME sector is under-funded, but Islamic finance can play a liberating role.

Market players would like to see governments, regulators, standard setters, financial institutions and, of course, community-based stakeholders take a more organised, multilateral approach to pushing for financial inclusion. One suggestion was for the IFSB itself to establish a Financial Inclusion Forum to give member countries technical support on regulatory issues pertaining to IIFS and their products and services in this respect.

There was also consensus that regulatory reform is making progress, but that the job is far from finished and is an ongoing process. Better rules and regulations alone would not suffice. It is incumbent on public policy makers, regulators, banks and other financial players to change their behaviour. As such, risk-based supervision is the key, which fully takes into account the specific nature of Islamic finance and distinguishing features in the products offered by IIFS. There is also an important need to identify and address the unintended consequences of regulation.

The impressive growth of Islamic finance has also attracted the attention of new and emerging jurisdictions in Asia, the Middle East and Sub-Saharan Africa, which is considered to be the new frontier of Islamic finance. The notion that “Africa is rising” is well justified. The revival and economic growth in Africa is now recognised as a beacon of hope for its one billion inhabitants.

Several countries see themselves as bridges or gateways for Islamic finance to a wider continental or regional market – Mauritius, South Africa, Kenya, Hong Kong, the UK and Luxembourg, to name a few.

The crucial message from Bank Negara Malaysia to these new jurisdictions is not to re-invent the wheel, but to learn from the experiences of other more established Islamic finance centres such as Malaysia, Bahrain and the UAE. They could move quickly, avoid expensive pitfalls and adopt best practices. All they have to do is ask for assistance.

Africa, Asia and other parts of the developing world have a tremendous and growing need for infrastructure. As such, *Sukūk* is a particularly attractive source of financing and the market is seeing the greater integration of Islamic finance in the public expenditure framework of member countries through the issuance of sovereign *Sukūk*, which provide the basis for the development of capital markets and for corporate participation through corporate *Sukūk*. If the growth trajectory of global *Sukūk* issuance continues as it has done over the last two years, it could become the iconic Islamic fund-raising instrument, now attracting not only traditional issuers, but also, and perhaps more importantly, non-traditional ones from the developed and emerging economies in the UK, Hong Kong and South Africa.

However, the latest data from the GCC and Malaysia suggest that yields on *Sukūk* and conventional bonds are highly correlated. Indeed, Gulf corporates and project finance companies have recently raised *Sukūk* at a cost below that required for comparable conventional bonds. In markets such as Malaysia and the UAE, pricing for some *Sukūk* issuances is now quite competitive compared with conventional equivalent issuances.

Innovations in the *Sukūk* market include the introduction of SRI and “green” *Sukūk*, “social” *Sukūk* issued against *Waqf* assets, and even *Sukūk* being issued to fund immunisation programmes, one of which the World Bank is currently arranging. The market is also observing a series of innovative *Sukūk* issuances that are intended to comply with the requirements of the Basel III capital framework.

In a bid to increase harmonisation in the disclosure of *Sukūk* and other Islamic capital market products, the IFSB plans to commence a new project, *Disclosure of Islamic Capital Market Products*, in the coming months.

The IFSB's publications contend that, despite the truly remarkable growth of the *Sukūk* market, the shortage or unavailability of *Sharī`ah*-compliant securities/*Sukūk* in many jurisdictions compels IIFS to maintain a higher level of cash and non-earning liquid assets than is required of conventional institutions. This puts them at a competitive disadvantage compared to their conventional counterparts.

Other major shortcomings of the IFSI that were identified include the lack of *Sharī`ah*-compliant deposit insurance schemes, which tended to undermine confidence in the industry; poor public awareness and market education about the principles and products of Islamic finance; the low financial literacy in these markets; and the lack of standardisation of structures, contracts and *Sharī`ah* interpretations.

Human capital development, market education and the capacity building of regulators on Islamic finance are urgent priorities for the industry going forward. If established markets are struggling to cope with these, what hope do new and emerging markets and the Islamic finance industry have of gaining a proper foothold?

There is an urgent need both for the knowledge and skills of regulators to be scaled up through continuous education and training programmes so that they can better understand and manage complex and dynamic financial activities; and for far greater cooperation between regulators, regulated entities and other stakeholders of the Islamic finance sector.

ISLAMIC FINANCIAL SERVICES BOARD

Level 5, Sasana Kijang, Bank Negara Malaysia
No. 2, Jalan Dato' Onn
50480 Kuala Lumpur, Malaysia

www.ifsb.org

ISBN 9789675687402