



Core Principles for Islamic Finance: Integrating with the Global Regulatory Framework

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ISLAMIC FINANCIAL SERVICES BOARD

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THE NATIONAL BANK
OF KAZAKHSTAN

12th IFSB Summit 2015

Core Principles for Islamic Finance: Integrating with the Global Regulatory Framework

Kazakhstan, 20–21 May 2015

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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 12th Summit focused broadly on three key issues that face the Islamic finance and global community.

First, how to strengthen the national regulatory and supervisory framework, in a way that is consistent across borders, to enhance the stability and resilience of Islamic finance.

Second, how to facilitate the integration of Islamic finance into the global surveillance framework that monitors the stability of the global financial system.

Third, how to strengthen international linkages in Islamic finance so that a new “Silk Road” emerges, consisting of a network of cross-border financing, investment and cooperation, connecting all the regions and jurisdictions of the world that are today pursuing their interest in Islamic finance.

The 12th Summit took place against a background of uncertainty regarding the prospects for global economic growth over the medium term. There was also concern over the possibility of a recurrence of cross-border volatility in financial markets. While these developments clouded medium-term prospects, the Summit provided an opportunity to focus on core issues for Islamic finance that transcend them.

Chief amongst these issues is the rapid and sustained growth of Islamic finance, and its increasing integration into the international financial system, which presents both opportunities and challenges.

The most critical challenge is ensuring financial stability, against the pressures generated by both high growth and increasing cross-border integration. Cross-border consistency in the principles that guide its regulation will strengthen the prospects for the orderly growth of Islamic finance.

In this respect, the issuance by the IFSB of its *Core Principles for Islamic Finance Regulation* (CPIFR or IFSB-17) represents a landmark towards achieving common international regulatory standards.

The CPIFR, which can be used by both advanced and emerging market jurisdictions, will permit national authorities to identify the gaps in their existing regulatory framework, and the measures needed to fill these gaps in a way that is internationally consistent.

The CPIFR are benchmarked against the new global regulatory architecture, which will facilitate the integration of Islamic finance into the global surveillance framework.

The issuance of the CPIFR has taken place against the background of a deeper interest in Islamic finance by international bodies. This is reflected in the issuance by the IMF of a Staff Discussion Note, titled, ‘*Islamic Finance: Opportunities, Challenges, and Policy Options*’ in April 2015. The subsequent announcement, later in the year, by the IMF’s Managing Director, that the institution would seek to strengthen its policy advice on Islamic finance, in particular in relation to stability and resilience issues underscores the evolving role of Islamic finance in the global financial architecture.

The Summit also discussed issues related to Islamic finance as an alternative form of financing that can both link economies while serving fundamental goals of national economic development and of social inclusion. The increasing interest in the use of *Sukūk* to fund investment in both social and physical infrastructure featured at the Summit, which noted the inclusion of Islamic finance as a potential tool for infrastructure financing on the official agenda of the Group of 20 (G20) Summit in Turkey.

PREAMBLE

Other issues discussed were the IFSB Guidance Note 6 complementing the global liquidity standards, and the Prudential and Structural Islamic Financial Indicators (PSIFIs), both issued in April 2015. The PSIFIs are the first set of internationally comparable measure of the soundness of Islamic banking systems, and represent an important tool for evaluating the consistency in the adoption of both global and the IFSB standards.

With regional and international hubs for Islamic finance being planned across advanced jurisdictions and emerging markets alike, the Summit provided a forum to facilitate greater dialogue amongst key players on this important set of issues.

To sum up: Islamic finance is today a US\$2.3 trillion industry, one in which rapid growth has resulted in the emergence of ten economies in Africa, Asia and the Middle East, in which the sector is now of systemic importance. There is also widening interest on the sector in non-traditional jurisdictions. Real and financial sector linkages are being developed across economies, facilitating common approaches through shared interest and a sharing of views. A new global regulatory architecture now looms large, with a common focus, shared by Islamic finance jurisdictions, on monitoring the soundness of financial systems, and achieving consistency in this undertaking.

It is this cornucopia of developments, focusing on regulation and supervision, and the contribution of Islamic finance to the growth and stability of the global economy, that are reflected in this year's 12th IFSB Summit proceedings.

OPENING AND KEYNOTE SESSION

“The global Islamic finance industry should expand beyond its traditional boundaries to maintain double-digit growth rates, and in this regard, Kazakhstan has become an important partner as a gateway to Central Asia and the CIS,” declared The Right Honourable Karim Massimov, the Prime Minister of Kazakhstan, in his keynote address opening the 12th Annual IFSB Summit.

This partnership is manifested in the Government of Kazakhstan’s approval of the *Roadmap of Development of Islamic Finance 2020*, an initiative first mooted in 2009 following the adoption of the *Islamic Finance Act 2009* which facilitated the authorisation of Islamic banks and the issuance of *Sukūk* – the first country in the Commonwealth of Independent States (CIS) region to do so. The roadmap initially envisaged developing Almaty into a regional Islamic financial centre, capitalising on the Islamic Development Bank (IDB) opening its regional office for the CIS there in 1997 and the subsequent development of the Islamic finance sector in the country. Its other key objective was to promote bilateral trade with and attract foreign direct investment from the Organisation of Islamic Cooperation (OIC) member countries.

Islamic finance, as Prime Minister Massimov highlighted, is the most dynamic segment of global finance. As such, Kazakhstan is keen to leverage this dynamism for the benefit of the country and the CIS region. Since 2009, the government has embarked on a series of reforms to facilitate the introduction of Islamic financial services and institutions, and to position the country as the gateway for Islamic finance to the CIS region.

These reforms include the establishment of a legal and regulatory framework and the development of infrastructure for the Islamic finance industry, as well as efforts to enhance the level of awareness among the population.

Roadmap of Development of Islamic Finance 2020

To further support this initiative, the Kazakhstan government in 2012 enhanced and extended the scope and timeline of the *Roadmap of Development of Islamic Finance to 2020*.

The roadmap includes:

- i. further improvements in legislation and regulation of Islamic finance;
- ii. promotion of research and educational activities in Islamic finance, including accreditation;
- iii. the development of Islamic financial infrastructures, including money market, capital market, *Takāful*, microfinance, small-to-medium enterprise (SME) financing, accounting standards, consumer education and protection;
- iv. introduction of measures for international cooperation with multilaterals and industry bodies;
- v. foreign direct investment (FDI) incentives to attract Islamic investment;
- vi. development of a platform for regional *Sukūk* origination; and
- vii. development of Islamic finance product innovations specifically suited to local and regional economic requirements.

In a further development, President Nursultan Nazarbayev announced his plan to create the Astana International Financial Centre (AIFC), an ambitious project to cement Kazakhstan’s position as a leading centre for finance, with the official launch scheduled for 1 January 2018.

Prime Minister Massimov confirmed that the draft law to effect this plan would be presented to parliament for approval later in 2015. It would also result in the relocation of the National Bank of Kazakhstan (the central bank) and the Kazakhstan Stock Exchange (KASE) from the former capital, Almaty, to the new capital, Astana. As such, “Islamic banking would also play an important role in making Astana not only an international financial centre, but also a regional leader in Islamic finance”.

The establishment of AIFC also ties in with President Nazarbayev’s Vision 2050 for the country. Equally importantly, it fits in with the revival of the ancient *Silk Road* linking China with the West, with Kazakhstan serving as a pivotal regional logistics centre on this road. More specifically, it is envisaged that Astana could ideally serve as the historic hub of the *New Silk Road for Islamic Finance*.

There is no doubt that Kazakhstan is a relatively more developed Islamic finance market in the CIS region. But as H.E. Kairat Kelimbetov, Governor of the National Bank of Kazakhstan, maintained in his welcome address to the IFSB Summit, Islamic finance is also one of the fastest growing areas in global finance – a fact that Kazakhstan could not ignore.

Kazakhstan and Islamic Finance

In this context, Kazakhstan’s accession to membership of the IFSB in 2011 constitutes an important platform for the country to refine and enhance its Islamic finance architecture and proposition.

“Participation in the IFSB allows Kazakhstan to receive effective support for the enhancement of standards for Islamic financial institutions in Kazakhstan and, therefore, to strengthen our country’s position as a regional leader in this field,” explained Governor Kelimbetov.

At the same time, a robust Islamic financial sector with its impressive growth rates may serve the economy of Kazakhstan as one of the main instruments for development. In this respect, Islamic finance offers “a complete alternative to the traditional financial system in Kazakhstan, which allows for the provision of services in the field of Islamic banking, *Takāful*, Islamic leasing and funds, as well as issuance of *Sukūk*”.

Kazakhstan, like other IFSB members, emphasises that the integration of Islamic finance with the global regulatory framework is only made possible by the joint efforts of all national regulatory authorities. “The main issue to understand is that a more integrated Islamic financial sector will lead to a healthier and more effective global financial system performance. We expect Kazakhstan to become one of the leading countries in the Islamic financial services industry. The opening of Islamic banks in the CIS territory and the issuance of *Sukūk* have been viewed favourably by the Islamic finance community,” concluded Governor Kelimbetov.

The IFSB itself has pledged to continue to offer its support to the National Bank of Kazakhstan in its implementation of the roadmap, particularly in those areas falling under its mandate for the promotion of strong regulatory regimes for the Islamic financial sector. This is done *inter alia* through the three key aspects of the IFSB’s mandate, namely to issue high-quality standards and guiding principles for the regulation and supervision of Islamic finance; capacity building in member jurisdictions, in particular in the area of assisting them to adopt the IFSB standards; and serving as a platform for international cooperation on issues of stability and resilience in Islamic finance.

Global Proliferation of Islamic Finance and an Increased Role for Sukūk in Social and Physical Infrastructure

This 12th IFSB Summit takes place against a background of continued uncertainty in the global economy and prospects for GDP growth over the medium term. There is also concern over the possibility of a recurrence of cross-border volatility in financial markets. Despite the above, the estimated US\$2.3 trillion Islamic finance industry continues to register double-digit growth on an overall basis, ranging from 20% to 40% in some key markets. This has resulted in a rising interest in Islamic finance – in both traditional jurisdictions in the Middle East & North Africa (MENA) region, South-East and South Asia, as well as in new jurisdictions including in non-Muslim markets in Europe, Africa and Asia. This reflects the widening recognition that Islamic finance is a viable and alternative form of financing that can serve fundamental goals of national economic development and of social inclusion, while also serving to strengthen the stability and resilience of financial systems.

One Islamic finance instrument in particular, *Sukūk*, has caught the attention of global bodies, including the G20, the International Monetary Fund (IMF) and the World Bank, especially in its use to fund investment in both social and physical infrastructure. However, the erratic recovery of the global economy, together with depressed oil prices and subdued demand in China and India because of a slowdown in GDP growth, could impact global *Sukūk* issuance largely because of knock-on effects and reluctance by issuers to enter the market as a result of these uncertain conditions. Furthermore, Standard & Poor's (S&P) projects that "the total *Sukūk* issuance is likely to drop significantly on the back of lower issuance from Central Banks that have switched to other shorter liquidity management instruments".

Nevertheless, the dominant theme was still of rapid growth and expanding potential, which has led to the increased interest by and engagement of the major international bodies and multilaterals with the global Islamic financial system. The IFSB, indeed, has already shared a Briefing Note with the G20 Working Group on Infrastructure Financing on how Islamic finance can be integrated into PPP approaches for infrastructure finance. The study commissioned by the G20 from the IMF on the efficacy of *Sukūk* as an infrastructure funding mechanism is to be presented at the next G20 Summit in Turkey.

The World Bank, in particular, has assisted its stakeholders to structure *Sukūk* for the financing of health programmes for immunisation and vaccination of children. The US\$500 million debut *Sukūk* issued by the International Finance Facility for Immunisation Co. (IFFIm) managed by the World Bank in November 2014 is a case in point, with talk of a follow-up issuance and another by the International Finance Corporation later this year.¹ The above innovations suggest that a multilateral development bank (MDB) can play a strong role in supporting Islamic finance for developmental purposes, even if it does not issue *Sukūk* on its own balance sheet.

In addition, the IFSB and the Asian Development Bank (ADB) have jointly published a report titled *Islamic Finance in Asia*, which provides guidance to policymakers on the issues, opportunities and challenges they will face as they mainstream Islamic finance into their national development goals.

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A further US\$200 million *Sukūk* issuance by IFFIm took place in September 2015.

Potential Impact of Core Principles for Islamic Finance Regulation

The 2015 Summit theme highlights three challenges and opportunities for the global Islamic finance industry: (i) how to strengthen the national regulatory and supervisory framework, in a way that is consistent across borders, to enhance the stability and resilience of Islamic finance; (ii) how to facilitate the integration of Islamic finance into the global surveillance framework that monitors the stability of the global financial system; and (iii) how to strengthen international linkages in Islamic finance so that a new “*Silk Road*” emerges, consisting of a network of cross-border financing, investment and cooperation, connecting all the regions and jurisdictions of the world that are today pursuing their interest in Islamic finance.

In this context, the IFSB’s *Core Principles for Islamic Finance Regulation* (banking segment) represents a very important milestone towards achieving common international regulatory standards for Islamic finance. The Core Principles are also benchmarked against the Revised Basel Core Principles (BCPs). The IFSB cooperated closely with the international standard-setting community, including the Basel Committee, the IMF and the World Bank, and other multilaterals such as the IDB and the ADB, in preparing the standard. The development of the IFSB’s *Core Principles for Islamic Finance Regulation* (CPIFR) was in response to the existence of gaps in the regulatory and supervisory framework in many countries. The CPIFR assist supervisory authorities that are regulating and supervising Islamic finance to identify applicable principles and benchmarks, to fill the gaps in the existing policies and regulations in their jurisdictions.

The CPIFR addresses this difficulty by prescribing the essential elements that must be present in the supervisory regime in order to promote a financially sound sector and provide an adequate level of customer protection. As such, both advanced and emerging market jurisdictions can use these principles as a benchmark for assessing the quality of their regulatory and supervisory systems, and for identifying future work to achieve a baseline level of sound regulations and practices for Islamic finance.

If widely adopted, the CPIFR will provide the basis for a globally consistent regulatory framework for Islamic finance. However, the key question remains how the adoption of the CPIFR can be facilitated in a practical manner, given that it is something new in Islamic finance and needs to be tested. Implementation could be facilitated by member jurisdictions through self-assessments of their regulatory and supervisory systems; through peer reviews conducted, for instance, within regional settings or by regional organisations; through the IMF and World Bank’s Financial Sector Assessment Program (FSAP); and as reviews conducted by, or with the assistance of other, third parties.

In this respect, the IFSB Council has endorsed the launching of a pilot project phase in which interested member jurisdictions will be supported by the IFSB in their take up and implementation of the Core Principles and the associated assessment methodology.

Islamic Financial Services Industry (IFSI) Stability Report 2015: Key Insights

The opening session of the IFSB Summit culminated in the launch of the flagship *Islamic Financial Services Industry (IFSI) Stability Report 2015*, which is published by the IFSB.

The Secretary-General of the IFSB, Mr Jaseem Ahmed, summarised the key findings of the Report:

- i. Despite the global economic slowdown, growth has been robust across Islamic financial sectors, with the banking sector growth rate at about 17% per annum during the post-crisis period, 2007–14.

- ii. The growth rate of *Sukūk* issuances was even higher during this period, at about 19% per annum. However, these growth rates have been moderating since last year.
- iii. As a result of high and sustained growth, there are now ten jurisdictions in which the Islamic financial sector is of systemic importance, which the IFSB, together with the IMF, defines as a jurisdiction where 15% or more of financial sector assets are Islamic.
- iv. Islamic banks continue to be well-capitalised, with higher levels of high-quality capital than mandated by regulatory requirements.
- v. While profitability, capitalisation, asset quality and other indicators show encouraging trends, the relative scarcity of *Shari'ah*-compliant high-quality liquid assets points to a long-term requirement – which is for additional and flexible liquidity management tools – the absence of which poses potential risks to the stability and resilience of Islamic banks.

The *Stability Report 2015* underscores the immediate and long-term challenge for the Islamic finance industry, which is to develop *Shari'ah*-compliant financial markets and instruments, and financial safety nets, that will aid the risk and liquidity management capabilities of financial institutions, while contributing to the ability of the authorities to maintain control over monetary aggregates and risks to financial stability at the economy-wide level.

This agenda, the IFSB concludes, is a demanding one that will be aided by policy roadmaps for Islamic finance, such as those being prepared and implemented by a number of IFSB member jurisdictions including, of course, the Government of Kazakhstan. Indeed, Kazakhstan exemplifies, in a special way, a wider phenomenon that can be observed in Central Asia and beyond – a gathering of interest, resolve, and weight of effort to strengthen the basis for integrating Islamic finance into the national and international economy.

Global Overview of the IFSI: Trends and Policy Developments

The growth of all sections of Islamic finance has continued unabated over the last decade or so, albeit it has moderated in the past three years. The industry has experienced double-digit growth in assets of 17% per annum between 2007 and 2014, and total assets under management (AUM) is estimated at US\$2 trillion at end-2014.

The Gulf Cooperation Council (GCC) countries account for the largest portion of these assets, as the sector is poised to gain mainstream relevance in most of its jurisdictions. The region accounts for almost two-fifths of global Islamic finance assets, thus reflecting the importance of Islamic finance for many of its members.

The IMF has recently put together an External Advisory Group for Islamic finance comprising standard-setters for the industry and leading external experts whose task is to assess and identify policy issues, and to enhance coordination with different stakeholders and those interested in Islamic finance. The IFSB participates in this Group and has contributed its comments on various draft working papers and notes on Islamic finance prepared by the IMF staff. The IFSB has also organised a training seminar on Islamic finance for the staff of the IMF at the latter's headquarters. The ADB and the Arab Monetary Fund have also been supportive through various technical assistance initiatives to develop Islamic finance in their targeted member countries.

At the standard-setting level, a number of financial regulatory initiatives have been undertaken by the Basel Committee for Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO). These initiatives include compliance with Basel III capital adequacy and liquidity leverage ratios and arrangements.

The IFSB, too, has taken a number of initiatives to complement the above and has issued 23 standards and guidance notes to date, with the latest ones being the landmark standard on Core Principles (IFSB-17), and the Guidance Note on Quantitative Aspects of Liquidity Management (GN-6). The IFSB's standards are benchmarked against those of our international comparators, with whom it works closely – namely, the BCBS, the IAIS and the IOSCO.

In terms of capacity building, the IFSB is updating its current *Strategic Performance Plan* for the period 2016–18, which would allow it to increase its support to member jurisdictions. Similarly, the IFSB takes advantage of its wide membership to strengthen cooperation among supervisory agencies, the private sector and other stakeholders towards the common goal of enhancing the resilience and stability of Islamic finance. The sharing of perspectives from different jurisdictions, and the establishment of closer cross-border relationships and understandings, are indeed stepping stones the IFSB utilises towards joint action on common goals.

At the same time, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has revised some existing accounting standards and introduced a few new ones on financial reporting. The International Islamic Financial Market (IIFM), too, has published several standards for documentation relating to various money market instruments. On the supply side, the International Islamic Liquidity Management Corporation (IILM) has issued around US\$8.6 billion of short-term *Sukūk* to facilitate cross-border liquidity management for Islamic financial institutions (IFIs). The IDB, too, has extended its *Sukūk* issuance programme from US\$10 billion to US\$25 billion, thus deepening the short-term *Sukūk* market and increasing the options for investments.

But as the industry is poised to sustain its growth trajectory, it is important to ensure that adequate liquidity is generated in line with the industry's needs.

Proaction and Progress in the UAE

All these developments have facilitated further development and implementation of the Islamic financial services industry. At the national level, policymakers and regulatory authorities are at various stages of implementation of these initiatives. Legal and regulatory reforms are being designed to strike a balance between supporting the growth of Islamic finance and sustaining financial stability.

Taking the example of the United Arab Emirates (UAE), which is a pioneer of the Islamic finance industry and where the first Islamic commercial bank, Dubai Islamic Bank, was established in 1975, the country is striving to grow into a major regional Islamic finance hub. The IFSI in the UAE grew at a faster pace after 2000 when a number of Islamic banks and Islamic windows of conventional banks were established. Today, there are 44 market players straddling a cross-section of institutions offering Islamic financial services (IIFS). Islamic banking assets in the UAE in 2014 had a compound annual growth rate (CAGR) of 10.8%, compared with 8.4% for conventional banking assets. At the end of 2014, Islamic banking assets in the UAE totalled US\$110 billion, which is a 17.5% market share of total banking assets. Islamic finance also accounted for 19.2% of total bank lending in the country.

The prospects for further growth for the Islamic finance industry are promising. The Governor of the Central Bank of the UAE (CBUAE), H.E. Mubarak Rashed Khamis Al Mansoori summarised the key aspects of growth, and addressed squarely the issues and challenges of future development. He observed that, in 2014, CBUAE introduced a number of initiatives to strengthen the development of the industry.

These initiatives include:

- i. establishing a Higher *Shari'ah* Authority at the central bank, the details of which are being deliberated by a Working Group comprising officials from the regulatory authority and the UAE Banks Federation;
- ii. expanding the eligible liquidity management instrument universe of the central bank to *Sukuk* and other such securities in addition to the current Islamic certificates of deposit (CDs);
- iii. updating regulation on an ongoing basis to include the specificities of *Shari'ah*-compliant contracts;
- iv. strengthening the capacity of the central bank's Islamic finance supervision;
- v. enhancing training of central bank staff through workshops to ensure that appropriate supervision and regulation of the Islamic finance industry is effected; and
- vi. a commitment to cooperate with a number of countries to foster cross-border collaboration, to contribute to the development of the global Islamic finance system, and to enhance economic and financial linkages between these countries.

Policy Progress, Deficiencies and Value Proposition

There was a time a decade or so ago that the Islamic finance industry was in danger of becoming ghettoised, but thanks to the commendable efforts by industry organisations, and the development of a global Islamic finance architecture, albeit a work in progress, the industry has been nurtured on the right track and is now an essential component of the mainstream global financial system. There is optimism over the phenomenal double-digit growth of the industry, but in reality AUM were a mere 1.25% of global banking assets. Even if the industry reaches the projected total of US\$6.5 trillion by 2020, it would still constitute a mere 2% of global banking assets.

The question remains: If the potential, resilience and unique value proposition of Islamic finance is that it can be the harbinger of financial stability in the global system, why is it not spreading as it is sometimes expected, especially after the Global Financial Crisis of 2008–9 when collateralised debt obligations (CDOs) and other exotic instruments purveyed by the conventional banking industry which were not backed by real assets, had no social utility and no link to the real economy, brought the global financial system and economy to near collapse? That void should have been filled by the Islamic finance industry.

The wider unique characteristics of Islamic finance are implicit: low level of leveraging; avoidance of unproductive and unethical activity, including speculation and gambling; preference for risk-sharing and equity-based instruments; clearly defined risks; transparency and disclosure with an added filter of *Shari'ah* compliance and a higher fiduciary responsibility. So, what needs to be done for Islamic finance to realise its potential? The conventional financial sector, it is often suggested, has failed to serve the needs of the underprivileged, the unbanked and the poorer sections of society.

The direction of Islamic financing, however, is dominated by real estate transactions, business working capital and public financing for governments to meet their fiscal deficits. Similarly, the majority of funds generated by the IIFS in the form of profit-sharing investment accounts and deposits are not being channelled to finance SMEs, microfinance and micro-*Takaful*. Islamic microfinance is an attractive proposition which is still adequately underutilised but which could be channelled through the unique instruments of *Zakat*, *Qard al-Hasan* and *Awqaf*. The industry is in dire need of a much more coordinated approach, especially in delivering towards the development and other goals of OIC countries that are faced with huge economic challenges in GDP growth, income disparities, poverty alleviation and infrastructure needs.

There is today a better understanding that the absence of *Shar'ah*-compliant financial products is a major impediment to the objective of financial inclusion in many countries. Indeed, Islamic finance, through its very faith-based ethos and connectivity to the real economy, offers innovative mechanisms in the form of risk-sharing and participation financing that can help SMEs in the critical initial start-up phase. Taken together, these issues suggest that there is great value in the MDBs and other international agencies mainstreaming Islamic finance into their development and operational agendas.

Here, social *Sukūk* can also play an important role. Illiquid assets all over the OIC countries can be monetised through *Sukūk* issuance to finance urban regeneration, transport, energy and housing projects. At the same time, Islamic finance will not take off unless the industry and governments invest in human resource development. The new generation of professionals must inculcate a knowledge of modern finance plus that of *Fiqh al Muamalat* (Islamic law relating to financial transactions). INCEIF and many other universities globally are adopting this multilayered approach to offer Islamic finance courses and research programmes. However, the consensus is that the education effort needs to be dramatically boosted without impairing the quality of education, but at the same time serving the needs of the nascent industry.

Islamic finance offers the promise of support to growth and stability. It can make a difference in financial inclusion, access for SMEs to financing, and in infrastructure investment. Large segments of the Muslim population globally remain underserved by conventional finance. In the OIC countries, only 24% of adults have a bank account and only 7% have access to formal financing. The principles of risk-sharing and a strong link to credit mean that Islamic finance is well-suited to SME financing. These same values also suggest that Islamic finance would be ideal to support funding infrastructure.

Islamic finance helps to promote financial stability through its risk-sharing and asset-based nature and can promote better risk management because the full backing of bank loans and lower leverage helps macroeconomic stability. A large proportion of deposits in Islamic finance are on a profit- or loss-sharing basis. This has the explicit bail-in capacity, offering better loss absorbency in case of financial distress. As such, Islamic finance has considerable promise because it promotes financial stability, has the potential to foster inclusive growth, and its risk-sharing properties make *Sukūk* suitable for infrastructure finance and development.

However, in order to realise the value proposition of Islamic finance, says the IMF, the unique risks and characteristics of Islamic finance products have to be recognised and regulated. In this way, the global industry will flourish.

Key Policy Issues in Islamic Finance Related to Financial Stability

The IMF's Mr Ananthakrishnan Prasad, Mission Chief, Middle East and Central Asia Department, stressed the need to tailor regulations to the specificities of Islamic finance, in line with the standards issued by the standard-setting organisations in Islamic finance. Similarly, a consistent implementation of these standards remains a challenge. These implementation issues can stifle the orderly development of the Islamic finance industry. Supervision of *Shar'ah* compliance is another challenge. Most jurisdictions do not have adequate, if any, oversight for the *Shar'ah* approval process. For on-site supervision, 80% of jurisdictions do not have any dedicated manuals dealing with Islamic banks; while for off-site supervision, the figure is 85%.

The treatment of profit-sharing investment accounts (PSIAs) is also a challenge. Most countries still treat PSIAs as deposit risk fully transferred to shareholders. This undermines the loss absorbency of PSIAs. Only six countries allow some pass-through, varying from 50% to 70%. As a result of this, Islamic banks are

holding higher liquidity and reserve buffers. The IMF also observes that several regulatory authorities in the OIC countries do not have the capacity, and in some cases the willingness, to put in place sound *Sharī'ah* compliance frameworks for Islamic banking. The short supply of qualifying *Sukūk* is also a major impediment due to the lack of high-quality issuances, which can impact on profitability because many Islamic banks have to hold surplus cash. Safety nets in Islamic finance are also underdeveloped – namely, lack of deposit insurance schemes and a lender of last resort (LOLR). Very few countries have a dedicated *Sharī'ah*-compliant deposit insurance scheme, while some have a single scheme applicable to both Islamic and conventional banking. The same scenario applies to LOLR.

Despite its proliferation, *Sukūk* markets continue to face specific framework challenges. Many markets still lack an enabling environment for *Sukūk* origination, complete with legal and regulatory gaps and lack of uniformity of structures and clarity of *Sharī'ah* governance. There is also limited standardisation of structures, documentation and *Sharī'ah* rulings; under-development of risk assessment tools; and a lack of market depth as characterised by the lack of sovereign issuances.

In terms of financial stability, there is a lack of true sale securitisation; uncertainty over investor rights, especially over whether *Sukūk* certificate holders have greater priority over general creditors in case of default; recourse to law and court procedure; and risk mitigation issues relating to market, operational, concentration and liquidity risks. The Islamic finance industry is also faced with entrenched monetary policy and liquidity management challenges. Liquidity management can impact on the profitability of Islamic banks, especially those that hold excess liquidity. It is an understatement that in most jurisdictions there is a weak or non-existent universe of central bank *Sharī'ah*-compliant short-term liquidity management tools through which banks can park their reserves and capital requirements. This has a knock-on effect on monetary policy and liquidity management of these countries. However, developments are taking place in various jurisdictions in terms of Islamic repos, Islamic discount windows, Islamic deposit facilities, and central bank *Sukūk* and Islamic notes.

Jurisdictions, according to the IMF, should level the playing field between conventional and Islamic banking. The current tax system favours debt over equity. Islamic finance, because of its multiple layers, may attract higher transaction taxes such as double stamp duty for *Ijārah*-based real estate transactions. Here tax arbitrage can be limited if international standards are adopted and laws amended, and if regional and cross-border cooperation on tax is boosted.

Insights from the Sukūk Market: Pricing and Issuer Dynamics

The *Sukūk* market has grown with increased internationalisation. Developments in non-Muslim jurisdictions are also encouraging, with the United Kingdom, Hong Kong, Luxembourg and South Africa all issuing debut *Sukūk*. In the UK, the government has also introduced *Sharī'ah*-compliant student loans and a framework for SME financing. However, demand continues to outstrip supply, which is why most *Sukūk* are well over-subscribed. With issuers, especially in the GCC, adopting a “buy-and-hold” strategy, this has locked liquidity in the market and stunted secondary trading, save in Malaysia.

However, S&P stresses that the dampener on the *Sukūk* market could be the depressed oil price and its impact on government-sponsored projects and liquidity in core markets; the impending Fed interest rate increase and its impacts on global liquidity; and the fact that lower liquidity in banking systems may result in lower *Sukūk* issuance by central banks. The Islamic finance market itself stresses that the industry seems to be weathering the above effects.

Market players stress that some governments are in fact reverting to issuing bonds and *Sukūk* to raise funds to cover budget deficits which, contrary to the above, could stimulate the *Sukūk* market. In countries such as Kuwait, the parliament is currently deliberating over a draft *Sukūk* law that would pave the way for sovereign issuances. Morocco, Tunisia, South Korea and Uganda have all recently introduced *Sukūk* legislation. Moreover, S&P observes that the share of cross-border *Sukūk* is again increasing, so there will be more cross-border capital flows.

Many investors in *Sukūk* are attracted to Islamic finance because of its ethical values and the fact that the transactions are linked to assets in the real economy and not backed by speculative and fictitious derivatives. However, on average, most *Sukūk* are still a bit more expensive than conventional bonds, albeit this is not necessarily the experience in Malaysia, the GCC and for the UK *Sukūk*. *Sukūk* pricing remains erratic, with credit quality an important determinant, and may be affected by:

- i. the impact of Fed tapering, because liquidity may drop and become more expensive;
- ii. the very close correlation of creditworthiness and the expected profit rate of short-term *Sukūk*;
- iii. the fact that the higher is the risk, the more expensive is the *Sukūk* pricing; and
- iv. the fact that the higher is the rating, the lower is the expected rate of return.

Islamic Finance in CIS and European Countries: Challenges and Progress

While still concentrated largely in traditional markets in the MENA region and Malaysia, the Islamic finance industry is now appearing in the United States, United Kingdom, European Union, and South and West African markets. Within a few years, another area of concentration may be Kazakhstan and Russia, where there will be opportunities in almost every sector, especially *Sukūk*.

In terms of Islamic finance regulation, Kazakhstan is clearly ahead of other countries in the region. Broadly, the CIS countries can draw lessons from other established markets to improve their own regulatory frameworks and the development of the Islamic finance sector in their jurisdictions. This will depend on the policy support the industry gets from the governments in the region. Kazakhstan has revealed policy objectives to develop Islamic finance in the country and to act as a gateway for the CIS. Policy support is also emerging in Russia, where a working group in the Duma (Russian parliament) is working on a draft law to facilitate the introduction of Islamic finance and *Sukūk*.

In the CIS in general there is a serious lack of qualified human capital in Islamic finance. Human resources development and training is driven by regulators in some countries and by market players in others. This is the single most important requisite for the future growth of Islamic finance in the CIS. Even in Kazakhstan, where there are a lot of experienced bankers, knowledge of Islamic finance needs to be strengthened.

CIS countries are also looking at Islamic finance as a way to access investment from capital-rich countries in the GCC and South-East Asia in all major sectors and as a mechanism to transfer knowledge. *Sukūk* is an ideal instrument for attracting investment from abroad and could serve as a significant conduit for the wider development of Islamic finance in the CIS.

To summarise, the Islamic finance industry is a “work in progress” with a lot more to do. The industry is gaining more prominence, and there is huge potential for growth in all countries. It is important that the various markets

have a common understanding and consistency of approach in how they view Islamic financial products. This is implicit in the IMF's recently published *Staff Discussion Note on Islamic Finance*. These developments reflect the emergence of sizeable national Islamic finance sectors in the Middle East, Asia and Africa, as well as recognition of the policy and regulatory challenges this poses to national and international authorities.

NEW REGULATORY DEVELOPMENTS AND THE IMPACT ON THE ISLAMIC FINANCIAL SERVICES INDUSTRY

The Global Financial Crisis exposed major shortcomings in the global financial system, especially weaknesses in the global regulatory architecture and the failure of regulatory authorities to rein in excessive private-sector risk-taking, which in turn incurred substantial costs to the system. Some other glaring shortcomings were the lack of high-quality capital, especially to cover various risks of financial institutions during periods of economic and financial downturns; the wholly unexpected drying up of liquidity, which resulted in a near breakdown in financial markets, with several major financial institutions finding it difficult to cover their obligations, thus forcing regulatory authorities to take emergency liquidity and other measures; the lack of macroprudential policies and a supervisory framework; and serious inadequacies in microprudential supervision, risk management and corporate governance.

New Global Regulatory Reforms – G20 Agenda and Basel III

The crisis has nevertheless led to an overhaul of the global financial regulatory system led by the G20 Agenda, which mandated the Financial Stability Board (FSB), standard-setting bodies and the IMF with the task of restoring global financial stability. The Agenda covers all the sectors of the financial services industry, and focuses equally on enhancing the supervisory and enforcement elements of regulation and on strengthening rules and standards.

The core goals of these developments include strong microprudential regulation that is globally coordinated; effective supervision; a robust cross-border resolution framework; and a larger regulatory perimeter that includes, for instance, addressing shadow banking issues, and strengthening accounting standards, data gaps and credit ratings. Overall, the G20/FSB Regulatory Reform Agenda encompasses:

- i. strengthening prudential regulatory standards for capital, liquidity and risk management under Basel III;
- ii. developing a macroprudential regulatory framework;
- iii. managing systemically important financial institutions (SIFIs);
- iv. crisis management and resolution mechanisms; and
- v. reforms regarding over-the-counter (OTC) derivatives markets and shadow banking.

The key components of the macroprudential policy framework are: identification of market failures; a system-wide review of the risks to the stability of the financial system; defining specific roles of all key stakeholders in maintaining financial system stability; and analysis of business cycles to manage risks arising from the pro-cyclical tendencies of the financial system.

The Basel III framework, which is a cornerstone of resilience through its new capital and liquidity frameworks, is in the process of being implemented, although regulatory authorities in many of the emerging countries are still grappling with the implementation of Basel II.

The liquidity framework has refined the concept of high-quality liquid assets (HQLA) and introduced two standards: the Liquidity Coverage Ratio (LCR), to maintain sufficient high-quality liquid assets to meet expected cash outflows over a 30-day stress scenario; and the Net Stable Funding Ratio (NSFR), to have stable funding in place to address funding needs over a stressed one-year period, among others, to bolster this framework. The LCR came into effect in 2014, but is to be phased in by 2019.

The Basel III reforms also aim to increase the quantity and quality of capital, reinforced by the introduction of explicit capital buffer standards and tighter eligibility standards; and to improve risk management through a new leverage ratio, enhanced risk coverage and new capital standards for counterparty credit risk.

Impact on Islamic Finance

The impact of the Basel III requirements on IIFS continues to evolve. Generally, Islamic banks were more resilient during the financial crisis because of their stronger capitalisation, real asset financing, prohibition on speculative transactions, restrictions on debt trading, higher liquidity reserves, and profit- and loss-based funding sources. However, they were not immune to the overall macroeconomic conditions prevailing in local and regional markets which necessitate a higher focus on improved risk management, capital and liquidity frameworks.

In terms of the increased capital quantity and quality measures, IIFS in general are already well capitalised with high-quality capital. However, in raising additional Tier 1 and Tier 2 capital, IIFS in some jurisdictions may face an issue of meeting *Shari'ah* and operational requirements for instruments that can meet the loss absorbency characteristics required for consideration as capital. In terms of the capital conservation and pro-cyclical adjustment buffers, there would be increased pressure on the capital of IIFS to maintain these buffers. IIFS can also be as vulnerable to pro-cyclicality as their conventional counterparts. In terms of the LCR and NFSR, IIFS tend to hold high levels of liquidity; however, in the absence of high-quality liquid assets and their active secondary markets, IIFS may need to hold high levels of cash and reserves, ensure a better maturity match with their liabilities, and raise more capital in the absence of *Shari'ah*-compliant deposit insurance due to higher run-off factors on PSIAs and deposits, and may need to invest in international *Sukuk* / HQLAs.

The IFSB's Response to Global Regulatory Developments

H.E. Dr Abdulrahman Al Hamidy, Director General and Chairman of the Board, Arab Monetary Fund, highlighted the new developments in the regulatory landscape which seek to promote financial stability, with a special focus on the implementation of new IFSB standards on liquidity and capital adequacy that complement the global regulatory reforms in these areas.

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

Since 2012, the IFSB has introduced seven standards that align Islamic finance with global reforms. These include standards on liquidity risk management, stress testing, risk management for *Takāful* undertakings, revised capital adequacy, revised supervisory review process, *Core Principles for Islamic Finance Regulation* (banking segment)(CPIFR), and a guidance note on quantitative measures for liquidity risk. At the same time, three new standards are being prepared on *ReTakāful* undertakings, stress testing for the banking sector, and disclosure requirements for Islamic capital markets.

Importantly, the *Core Principles for Islamic Finance Regulation* explicate the essential elements that must be present in the supervisory regime in order to promote a financially sound sector and provide an adequate level of customer protection for the users of financial services in various sectors most of which might not be fully familiar with the features of the products. Thus, it provides a progression to the next level of financial

sector supervision, whereby the CPIFR provides a high-level framework that not only covers the prudential regulation aspects related to risk management, corporate governance and transparency of institutions but also broader and more fundamental issues such as the responsibilities, powers and legal protection of the supervisory authority itself. Thus, instead of a piecemeal approach to financial regulation that focuses on individual regulatory standards, a core principles framework provides guidance on the necessary elements required in a supervisory regime in order to establish a financial sector that is sound and able to withstand system-wide shocks emanating from within and outside the jurisdiction. Similarly, the principal objectives of consumer protection, linkage with the real sector and enhancing financial inclusion are also accounted for in a core principles framework. Issuance of the CPIFR also provides impetus in making Islamic finance part of the global surveillance framework.

The importance of the IFSB's *Prudential and Structural Islamic Financial Indicators (PSIFIs)* on the financial soundness and growth of the Islamic banking systems cannot be over-emphasised. Reliable data and timely statistics have been the bane of the Islamic finance industry, albeit this situation is constantly improving in key markets as industry practice and regulatory requirements of disclosure and transparency improve. This is due partly to the ongoing introduction of new international disclosure and reporting standards.

The launching of PSIFIs, developed with technical assistance from the ADB and IDB, represents an important milestone in the ongoing transformation of Islamic finance into a globally significant undertaking. The indicators are the first set of internationally comparable measures of the soundness of Islamic banking systems and are based on the IMF's Financial Soundness Indicators (FSIs) on the strength or vulnerabilities of financial systems. They are customised to the specific characteristics of Islamic banking and finance.

The indicators are also part of an international effort involving the IFSB and other organisations to construct a comprehensive picture of activity in the Islamic financial services industry. Due to the rapid growth and significance of Islamic finance in many jurisdictions, such information is increasingly needed to understand the structure, soundness and growth of the Islamic finance component within the entire financial system.

In practical terms, this is good news for economists, market analysts, researchers and academics, in that the PSIFIs will allow more considered comparative analysis of the Islamic banking sector within national economies and comparisons between the conventional and Islamic banking systems.

Crucially, the PSIFIs highlight information on the size, growth and structural features of Islamic banking systems, as well as their macroprudential condition, by looking at measures of their capital, earnings, liquidity, and exposures to various types of risks; however, they also cover indicators of capital adequacy and liquidity based on newly issued IFSB standards to complement international regulatory reforms under the Basel III regime.

The IFSB's Programme for Facilitating the Implementation of Standards (FIS)

The IFSB has in place an extensive programme for facilitating the implementation of its standards (FIS), with representatives of the regulatory and supervisory authorities (RSAs) and market players trained through a set of interactive engagements consisting of presentations, case studies, group discussions and hands-on exercises. The IFSB also conducts three annual "train-the-trainers" workshops especially for the staff of RSAs supervising the Islamic banking, *Takāful* and Islamic capital market sectors.

These workshops are used as a main tool to support the RSAs in implementing the various principles included in CPIFR, as well as the IFSB's other standards. Recently, the IFSB has completed the preparation of e-learning modules for its various standards, funded by the ADB Technical Assistance. In this respect, CPIFR is being prioritised for the preparation of an e-learning module, which will provide another outreach mechanism and capacity-building tool to reach out to a wider audience of IFSB members who are not able to participate in the FIS workshops. CPIFR is not a typical standard on a particular area of supervision; rather, it provides an overarching framework for the assessment of necessary elements that should be present in a supervisory system in order to be sound and resilient in the face of internal and external events. Thus, its implementation is much more challenging than a standard or a guiding principle.

Even in the conventional banking sector, various FSAP reports attest to the fact that RSAs find it challenging to incorporate all the “essential criteria” included in the BCPs, which results in their being assessed as either “materially non-compliant” or “non-compliant”. As such, the implementation of CPIFR in member jurisdictions will require a much closer, longer-term engagement with the RSAs, which goes beyond the FIS workshops or e-learning modules. The IFSB has been engaged in providing technical assistance to a select number of member RSAs in the past, which will need to be beefed up to support the the implementation of the CPIFR or IFSB-17. The Secretariat has already outlined its priorities for standards implementation in the draft *Strategic Performance Plan 2016–2018*.

A recent comparative study on the implementation of the IFSB standards has also showed that an alternative approach could be worth consideration, which will involve “de-grouping” of an IFSB standard such that implementation is prioritised for a particular principle, or group of principles, rather than for the whole standard. This approach could be useful for those jurisdictions that are relatively new to Islamic finance or face capacity constraints. Another consideration in the implementation of IFSB-17 is whether a jurisdiction gives due consideration to the presence of “pre-conditions” or “necessary elements” in its supervisory framework.

Case Study – Pakistan: Policy Developments and Key Initiatives in Islamic Finance

H.E. Mr Saeed Ahmed, Deputy Governor, State Bank of Pakistan (SBP), explained how the Islamic finance industry in Pakistan has been steadily growing over the past few years. The market share of total assets has almost doubled in the last five years, from 7.2% in 2010 to 11.8% in 2014, and deposits similarly have increased from 6.7% to 10.4%, respectively.

The commitment of the Pakistan government to developing the Islamic finance market in the country is underlined by the establishment of a High Level Steering Committee on Islamic Finance in December 2013. The committee is comprised of top *Shari'ah* scholars, senior government officials, industry experts and business leaders.

The SBP has also adopted a Roadmap for Islamic Banking and Finance, which comprises several components, including: development of a policy and legal framework; tax neutrality, capacity building and awareness in key institutions; development of Islamic financial markets; and development of short-term liquidity management tools for Islamic banks authorised by the SBP. In addition, the Roadmap aims to boost research and development in Islamic finance, and to promote coordination among stakeholders and the equity-based model of financing.

The SBP's approach to regulating IIFS is risk-based macroprudential supervision, comprising adherence to the prudential regulations; stress testing based on single-factor sensitivity and regression-based analysis; off-site surveillance and on-site supervision; and observance of financial soundness indicators (FSIs). It has

a timetable for the implementation of Basel III capital requirements and has successfully adopted four IFSB standards on risk management, corporate governance, *Sharī'ah* governance and disclosure. Similarly, it has adapted six AAOIFI standards.

The SBP has issued its *Strategic Plan for the Islamic Banking Industry (2014–18)*, the key initiatives of which include amendments in the tax and legal framework to create a level playing field for IFIs; promoting a *Sharī'ah* governance framework for the industry, which inculcates *Sharī'ah* board oversight through internal and external *Sharī'ah* audits; rationalising minimum capital requirements; expanding the Islamic Financial Accounting Standards (IFAS); developing Islamic capital markets through the issuance of guidelines for the *Sukūk*, *Takāful* and *Muḍārabah* sector; and conducting Knowledge, Attitude and Practices (KAP) surveys. In terms of liquidity management, the SBP conducts open market operations based on *Bai Muajjal* of GOP (Government of Pakistan) *Sukūk* and is working on a *Sharī'ah*-compliant alternative for LOLR.

The SBP is also promoting private-sector development through incentives for the use of Islamic financing facilities, including Islamic export refinance, long-term financing, and a credit guarantee scheme for small and rural enterprises.

Case Study – African Continent and Kenya: Potential, Policy Developments and Key Initiatives in Islamic Finance

Mr Badru Jaffar Swaleh, Head of *Sharī'ah* Department, First Community Bank, Kenya, stressed that the global regulatory reforms are focusing on strengthening markets and financial institutions so that they are more sound and stable. Reforms are directed at addressing risk management weaknesses that led to the recent financial crisis, in particular in managing counterparty and liquidity risks, and systemic risk arising from interconnections between financial institutions. Private-sector balance sheets are also under scrutiny in view of heightened concerns about excessive leveraging and maturity transformation.

These reforms impact on financial systems and institutions in both the developed economies and those in the emerging and developing economies (EMDEs), including in Sub-Saharan Africa (SSA). The financial sector in some SSA countries has been growing rapidly in the past two decades. New products have been introduced, and financial institutions (mainly private) are playing an increasing role in financial intermediation, including cross-border financial flows.

In particular, four SSA countries have considerable potential for becoming a regional hub of Islamic finance – namely, Kenya, Mauritius, Nigeria and South Africa. However, Islamic finance in SSA remains small, although it has good potential given the demography of the region, the growing middle class and the potential for financial deepening by private enterprise – local and foreign direct investment (FDI). There are some 45 IIFS – comprising commercial banks, investment banks, *Takāful* operators and fund managers – in SSA out of the estimated 600-plus IIFS in the world.

In 2014, South Africa issued its debut sovereign offering – a US\$500 million *Sukūk Al Ijārah* with a tenor of five years and nine months that was well oversubscribed, especially by GCC investors. Gambia has already issued a short-term, local-currency *Sukūk*, and Senegal raised more than US\$200 million in its first local-currency *Sukūk*. In Kenya, the Capital Markets Authority is currently structuring a regulatory and policy framework under its Capital Markets Master Plan, which includes, *inter alia*, an Islamic Capital Market to facilitate the issuance of *Sukūk*. The Central Bank of Kenya (CBK) is also in the process of developing a *Sharī'ah Governance Manual* for the Islamic banking industry, which may lead to the establishment of a National *Sharī'ah* Supervisory Council.

Kenya currently has two full-fledged Islamic banks and five Islamic windows. Two international Islamic banks are also poised to enter the market following licensing approvals from the CBK. Similarly, in Nigeria, two applications from foreign investors for non-interest (Islamic) banking licences have been lodged with the Central Bank of Nigeria. This would complement the one full-fledged non-interest bank and the handful of windows operating there.

Islamic banking, although still in its infancy in Kenya and in Africa in general, has a lot of opportunity for growth. The reasons are manifold:

- i. The two Islamic banks in Kenya mobilised assets of US\$244 million and deposits of US\$302 million – about 1% of the total banking sector – in a relatively short space of time.
- ii. The World Bank recently named Kenya as the third-largest financial sector in Africa, while the IMF forecasts a GDP growth rate of 7.5% for Kenya in the year 2016.
- iii. All the main regulatory authorities in Kenya have officially pledged their commitment to developing an Islamic finance industry in the country and to help its growth in a bid to see Nairobi become the Islamic finance hub for East Africa.

However, the challenges remain. For example, in Kenya, market players want to see the *Islamic Finance Act 2008* amended to address the issues of double taxation, especially related to real estate transactions; LOLR; and *Shari'ah* governance, especially the role and functions of *Shari'ah* Supervisory Councils of individual IIFS. Similarly, the central bank's higher minimum capital requirements, as well as new rules to boost capital buffers, pose a challenge to market players. Liquidity management remains a major hurdle for Islamic banks in Kenya, and the CBK is aware of this challenge for Islamic banks and its associated risks. The liquidity ratio for banks stands at 20%. Additionally, there are the LCR and NSFR, introduced under Basel III. Islamic banks could face pressure on their profitability due to increased competition for retail deposits. Similarly, preferential treatment for more stable sources of funding and the rationalisation of wholesale financing products, including committed credit and back-up liquidity lines, could push more customers to the securities markets.

The global financial reform agenda has made some important strides; however, achieving an appropriate balance between preserving the safety and soundness of the financial system and allowing financial institutions and markets to perform their intended functions remains an ongoing challenge for market players and their supervisors. General regulatory and supervisory challenges going forward include strengthening of the Islamic financial regulatory infrastructure through the development of early warning tools, consolidated supervision of financial groups, strengthening of IIFS's capital and reduction of pro-cyclicality, and the development of financial safety nets.

Apart from the above considerations, specific regulatory and supervisory challenges for Islamic finance on the other hand include: the development of legal and regulatory frameworks consistent with *Shari'ah* principles; the need for IIFS to engage more in profit- and loss-sharing and real sector transactions; the need for standardised disclosures and clarity of the supervisory role; greater market education to create awareness of the industry and its products; and the serious lack of qualified Islamic finance human resources.

ROLE OF THE CORE PRINCIPLES FOR ISLAMIC FINANCE IN ENHANCING REGULATORY CONSISTENCY AND RESILIENCE OF THE INDUSTRY

The rationale behind introducing the core principles for various sectors was to enhance the resilience of the financial system; to guide regulators and supervisors in developing regulatory regimes and practices; and to serve as a benchmark for assessing the consistency of implementation across different countries. So far, various international standard-setting bodies have issued core principles for a number of sectors, which include: banking, insurance, securities market, financial conglomerates, financial market infrastructures, deposit insurance, and anti-money laundering and financing for terrorism.

It is important to note that the core principles have not been the starting point of the work of any global standard-setting body. The BCBS was established in 1974 and focused in the early years on issuing standards on various aspects of the regulation and supervision of internationally active banks. For example, its framework for consolidated supervision and its first capital accord (Basel I) were issued in 1979 and 1988, respectively. However, its first set of *Core Principles for Effective Banking Supervision* (BCPs) was issued in 1997, with its assessment methodology published two years later. Similarly, the IAIS, established in 1994, issued its standard on solvency for the insurance sector in 2000, though its core principles (ICPs) were issued in 2003 for the first time. Thus the use of an incremental approach has been natural to the work of standard-setting bodies.

Rather than having of a piecemeal approach to financial regulation that focuses on individual regulatory standards, a core principles framework provides guidance on the necessary elements required in a supervisory regime in order to establish a financial sector that is sound and able to withstand system-wide shocks emanating from within and outside the jurisdiction. Similarly, the principal objectives of consumer protection, linkage with the real sector and enhancing financial inclusion are also accounted for in a core principles framework.

Salient Features, Structure and Objectives of the CPIFR

The preparation of *Core Principles for Islamic Finance Regulation* (IFSB-17) for the banking segment is seen by the industry as a major step forward in providing a tool for assessing a supervisory regime in a jurisdiction – which is greatly reinforced with the participation of multilaterals such as the IMF, World Bank, BCBS, IDB and ADB, as well as RSAs for the banking, insurance and capital market sectors in the Working Group (WG) that prepared this standard.

IFSB-17, also known as CPIFR, is a comprehensive document and incorporates much of the Basel Core Principles. The aim was to change only what needed to be changed and to keep the principles assessable, and within the competence of the relevant RSAs. IFSB-17 was approved for adoption by the Council of the IFSB in its meeting in April 2015. The CPIFR document is structured in four sections: an introduction; an overview of the preconditions for effective supervision of IIFS; outline of the use of the assessment methodology in assessing compliance with the CPIFR, and practical considerations in conducting an assessment; and the CPIFR in full, with their associated assessment criteria.

The key objectives of IFSB-17 are:

- i. To provide a set of core principles for the regulation and supervision of the IFSI, taking into consideration the specificities of the IIFS in the banking segment and complementing the existing international standards, especially the Basel Core Principles.

- ii. To provide a minimum international standard for sound regulatory and supervisory practices for the effective supervision of the IIFS.
- iii. To protect consumers and other stakeholders by ensuring that the claim to *Shari'ah* compliance made explicitly or implicitly by any IIFS is soundly based.
- iv. To safeguard the systemic stability by preserving the linkages between the financial sector and the real economic sector which underlie Islamic finance.
- v. To ensure that IIFS act in accordance with their fiduciary responsibilities in all their operations, especially in regard to investment account holders (i.e. investors in PSiAs).

This approach adopted by the WG to prepare IFSB-17 was to facilitate the assessors that would be involved in the review of both Islamic and conventional financial sectors in a dual banking system. It would also enhance comparability and consistency in the assessments and help the assessors to adopt a uniform approach when dealing with the elements that are common to both the Islamic and conventional banking systems. The WG assessed the relevance of the BCPs and their associated methodology for application to Islamic finance, and retained them in their entirety where this seemed appropriate, while providing additional guidance where this was relevant.

Each of the BCPs has been examined individually, and where needed, appropriate wording was introduced to reflect the unique features of Islamic finance. The result: a total of four additional core principles were introduced, while one existing core principle was replaced in its entirety. Thus, against the 29 core principles issued by BCBS, IFSB-17 includes 33 core principles. However, the most significant and far-reaching changes have been made to the detailed criteria that are proposed to facilitate the assessment of these core principles.

The new or replaced core principles cover certain topics of particular relevance to Islamic finance, which provide guidance and set out supervisory expectations on the treatment of investment account holders, the *Shari'ah* governance framework, equity investment risk and regulation of Islamic window operations. Another core principle, which has been replaced in full, is one that in Basel focuses on interest rate risk, which is not applicable to Islamic finance. This now deals with rate of return risk in the banking book. Another 19 principles have undergone a revision in the text of the core principle itself and/or in the assessment methodology. Some others have been retained unamended.

Focus on Robust Assessment Methodology

The assessment of countries' regulatory frameworks governing Islamic financial activities in a consistent manner will be beneficial not only for enhancing global financial stability, but also for promoting best practices. Any core principles document and its associated assessment methodology can be utilised in a number of ways that primarily involve either a self-assessment by the respective RSA or an assessment by third parties. The CPIFR and its assessment methodology is a good tool for understanding and comparing different countries' regulatory frameworks governing Islamic banking activities. Therefore, it will be useful for countries' self-assessments; for the Financial Sector Assessment Programme (FSAP) conducted by multilaterals such as the IMF and the World Bank (WB); and for peer reviews conducted within regional groupings of banking supervisors. In the latter case, the third-party assessor may include other RSAs – often termed “peer reviewers”. Similarly, the IMF/WB review involves the degree of adherence of international standards as a basis for the Reports on the Observance of Standards and Codes (ROSCs) under the FSAP. In recent years, all these modalities have become more interconnected. For example, an FSAP is typically preceded by a self-assessment by the respective RSA, which facilitates the task of the IMF/WB mission and helps them understand not only the basic

elements of supervisory powers, roles and responsibilities, but also the overall legal and regulatory framework before they start their assessment. Similarly, the new framework outlined by the Financial Stability Board, which is agreed by the G20 nations, stipulates a peer review two–three years subsequent to each FSAP conducted for a jurisdiction. These peer reviews are conducted by a team consisting of selected representatives from other G20 RSAs.

However, in recent years, after the issuance of the Revised Basel Core Principles with a stringent assessment criteria, it has been observed that self-assessment and FSAP reviews provide relatively diverse results on various core principles, with the former being much more positive. Therefore, it is now widely acknowledged that for more reliable results, a self-assessment should be combined with some type of third-party review.

For the Islamic financial services industry, a number of recent FSAP reports for jurisdictions with an Islamic financial services industry have acknowledged that a separate assessment for the respective Islamic finance sector could not be conducted as the available assessment methodology does not distinguish between conventional and Islamic markets and separate assessment standards for Islamic finance have not yet been developed. IFSB-17 aims to help bridge this gap. For the assessment modalities of the new core principles, it is expected that all the available mechanisms would be utilised, though that would depend largely on the jurisdiction-specific requirements and marked conditions.

The FSAP is not a frequent phenomenon for most of the non-G20 jurisdictions, and many of the IFSB member jurisdictions have either never participated in an FSAP or have undergone such a review only once in the last five years or so. Therefore, it is envisaged that all the options for assessment will be explored by the IFSB member countries and could include, among other things, the establishment of regional groups and peer review teams.

This assessment would be beneficial for the jurisdictions that are new to Islamic finance, as well as for those that have some experience in supervising this industry. Similar to conventional core principles, IFSB-17 has been envisaged to be applicable to all jurisdictions regardless of the level of development or sophistication of the markets and the type of products or services being offered and supervised. It aims to help jurisdictions with a nascent Islamic finance sector to promote consistency in terms of implementing prudential standards through identifying the gaps and issues in supervisory practices, legal framework and regulations.

Preconditions for Effective Supervision

An important consideration in the implementation of IFSB-17 is whether a jurisdiction gives due consideration to the presence of “preconditions” or “necessary elements” in its supervisory framework. These infrastructure components are largely institutional in nature, and are increasingly viewed as an essential component of both Islamic financial market development and overall financial system stability.

As these elements might not be within the sole mandate and scope of work of the supervisory authority, they cannot therefore be evaluated as part of an assessment of the RSA itself. This is why IFSB-17, following the BCP, treats them not as part of the core principles themselves, but as preconditions which an external assessor would comment on but not formally rate as part of the assessment.

These preconditions relate to macroeconomic policies; the framework for financial stability policy formulation; public infrastructure; the framework for crisis management, recovery and resolution; systemic protection or public safety net; and effective market discipline. While they are as applicable to the financial system in which

IIFS are operating, as to a conventional one, there is a need for their proper interpretation and application in order to provide a basis for effective supervision of the IIFS. In particular, several preconditions need to be approached in ways that recognise the specificities of Islamic finance if they are to provide a level playing field to the IIFS and their conventional counterparts such as public safety nets and recovery and resolution frameworks. There are particular issues in relation to recovery and resolution in Islamic finance, including, for example, the correct contractual treatment of IAHs, *Sukūk* issued as capital instruments and the rights of their holders, and priorities among creditors of a failed IIFS.

Similarly, while any decision on the appropriate level of systemic protection is a policy question to be addressed by the relevant authorities, including the government, particularly where it may result in a commitment of public funds, supervisory authorities will have an important role to play because of their in-depth knowledge of the financial institutions involved and their interconnections that may amplify systemic risk.

The State of Islamic Finance in Turkey, Qatar and GCC

Dr Ali Al Amari, Senior Director, Qatar Financial Centre Regulatory Authority, explicated the need of the industry to have a minimum international standard on the key principles of sound regulatory and supervisory practices to promote effective supervision of the IIFS. He elaborated on the current work of the RSAs to identify necessary changes, as well as measures undertaken in the local regulations in compliance with the CPIFR. This was complemented by updates on the current Islamic finance infrastructure, its future plans, and outlooks in Turkey and the Gulf countries, with a special focus on Qatar.

The GCC states are the largest Islamic finance markets in terms of assets under management. According to various estimates, the total Islamic banking assets in the region exceed US\$400 billion.

According to various estimates, the total Islamic banking assets at Q2 2014 in Bahrain amounted to US\$24.6 billion; in Qatar US\$66 billion; in the UAE US\$99 billion; and in Saudi Arabia US\$275 billion. The total number of IIFS, including commercial banks, investment banks and *Takāful* operators, in Bahrain is 35, in Qatar 16, in the UAE 39, and in Saudi Arabia 64. In Qatar, specifically, total Islamic banking assets in 2014 amounted to QR260 billion – up from QR219 billion in 2014. This amount compared to the total banking assets in Qatar of QR1,012 billion in 2014 and QR916 billion in 2013.

Some of the jurisdictions have undergone FSAP and reviews by the standard-setting bodies such as the BCBS for their regulatory consistency assessment programme. Similarly, the IMF has covered Islamic finance in the Article IV assessment issued for various GCC jurisdictions.

In other jurisdictions, such as Turkey, the BCPs have been applied to “Participation Banks” without any distinction. In Turkey the development of Islamic finance (“participation banking”) is an important goal for the government. The number of participation banks has increased to seven with the entry of three new banks in the last year or so. The participation banks command a 5% market share of total banking assets, although the target is to increase this to 15% by the end of the decade. One of the components of the Istanbul International Finance Center project is the development of participation banking and an interest-free financial system. In an action plan to achieve this objective, the Banking Regulation and Supervision Agency (BRSA) is responsible for “reviewing the international standards related to interest-free finance and implementing them in Turkey along with any new regulations that may be necessary”. As such, it is the BRSA that is currently working on identification of necessary changes in local regulations to comply with the CPIFR.

The Way Ahead

All these objectives are interlinked and mutually reinforcing, which promotes the establishment of a robust and resilient Islamic financial services industry that is well integrated with the surveillance framework for the global financial system.

With the fast growth of the Islamic finance industry in many parts of the world, and the associated increase in number of institutions and sophistication in the variety of products and services offered, many jurisdictions find it challenging to fully appreciate the underlying risks in the products and operations offered by these institutions and their impact on the stability and resilience of the overall financial system. More importantly, many supervisory authorities that are regulating and supervising the IIFS sectors face challenges in identifying applicable principles and benchmarks for assessing the gaps in the existing policies and regulations in their jurisdictions, which can suitably accommodate the unique features of the institutional structure of the IIFS.

Similar to the core principles for other sectors, a set of core principles for Islamic finance explicates the essential elements that must be present in the supervisory regime in order to promote a financially sound sector and provide an adequate level of customer protection for the users of financial services in various sectors most of which might not be fully familiar with the features of the products. The IFSB's plan to introduce core principles for other sectors such as Islamic capital markets and *Takāful* would further reinforce the realisation of the aforementioned objectives and help to integrate these sectors with the global financial system.

ENABLING FRAMEWORK FOR THE ASSESSMENT OF REGULATORY AND SUPERVISORY REGIMES

The need to have an enabling framework that meets the preconditions of sound regulation and supervision in order to facilitate the development of a surveillance infrastructure is paramount for any financial system for Islamic finance. Given the Global Financial Crisis of 2008, which brought the global financial system to near-collapse, and the nascent history of contemporary Islamic finance, the above exercise becomes implicit and indeed is highly pertinent.

Financial transactions under Islamic finance are conducted via contracts of exchange, which are *Al-Bay'*, and not through interest-based debt contracts. For this exchange to take place there is a need for markets, and for rules which govern the behaviour of the market players and the participants: these are rules of law, modified property rights, a high degree of trust, efficient contract enforcement and good governance. Unless these are in place, the markets do not behave in a responsible and normal way; therefore, the market outcomes are socially and economically inefficient.

Moreover, all financial assets under Islamic finance are contingent claims because there is no determined rate of return, no redeemability, and it is risk-sharing. Therefore, the conduct of both the counterparties and (particularly) the one who is acting on behalf of the investment account holders (in the Islamic banking sector) or *Takāful* participants (in the *Takāful* sector) is critical for the success of the transaction objectives.

One can have a very elegant regulatory and supervisory framework in the central banks or supervisory authorities, but unless the enabling environment – which encompasses the government policymakers of that particular jurisdiction, the financial institutions themselves, the market players and all other complementary regulators – are on the same wavelength, the supervisory and regulatory framework will be meaningless and ineffective.

Key Building Blocks and Agenda for an Enabling Environment for Islamic Finance

H.E. Dr Ishrat Husain, Former Governor of State Bank of Pakistan, currently the Dean and Director of Institute of Business Administration, Pakistan, indicated that an effective agenda for enabling environmental and key preconditions should have the following components:

- i. **Ensuring consistency and continuity of policy commitment at the highest level of government decision-making.** With the change in governments, the lack of continuity creates uncertainty about the evolution and growth of Islamic finance.
- ii. **A clear and present legal environment that lays down the laws under which Islamic finance has to be administered.** Recourse to law, a developed court procedure, a system of dispute resolution and arbitration, qualified in both the incumbent legal system – whether English Law or Code Napoleon – and, of course, *Fiqh Al Muamalat* (Islamic Law relating to Financial Transactions), are similarly imperative.
- iii. **A dispute resolution mechanism that is expeditious, inexpensive and accessible to the layman.** Court litigation is both expensive and protracted. It could take a long time to get disputes resolved. Meanwhile, uncertainty about the exchange and the contract remains high.
- iv. **Overcoming a serious dearth of both long-term and short-term government paper for liquidity management.** If the Ministry of Finance, which is the borrowing authority, or the public-sector corporations do not have a regular programme for issuing these papers, which can be used for liquidity management,

Islamic banks will always remain at a disadvantage. They will have too much cash, and therefore their remuneration to investment account holders will also be comparatively lower than that of conventional finance, which has many ways in which to maximise returns.

- v. **Ensuring depositor protection.** In many jurisdictions there are deposit insurance schemes, but very few have *Shari'ah*-compliant ones. This is particularly relevant for small depositors. If, for any reason, they lose their savings because of a bank failure, this will have a spillover effect on the entire Islamic banking system.
- vi. **Overcoming the lack of effective insolvency provisions or laws.** This lack creates a problem, especially for the genuine enterprise that loses money for reasons beyond its control and therefore is blacklisted by the entire banking system. In the United States, six out of ten new enterprises fail in the first year of their existence. However, they have very strong bankruptcy laws and these entrepreneurs are not denied credit for their subsequent ventures. This creativity in enterprise leads to innovation. This is not the case in Muslim jurisdictions.
- vii. **Ensuring the presence of a *Shari'ah*-compliant lender of last resort and a Bank Resolution Framework,** whereby some banks with temporary liquidity shortages or other aberrations can be bailed out and, as such, remain solvent despite the fact that they have some transient problems in managing their affairs.
- viii. **Achieving harmonisation between various markets relating to LOLR and Bank Resolution Frameworks.** Given the increasing incidence of cross-border transactions and investment, the importance of this cannot be overstated. It is pertinent to all types of financial systems and jurisdictions.
- ix. **Creating a tax-efficient regime.** *The Economist* recently commented on the distortions created, particularly in the United States and some European countries, when interest is given exemption and is deductible from taxation. This puts equity and equity sharing instruments at a disadvantage, because the after-tax return is much higher for those who are leveraging than for those who are using their equity. Therefore, this discrimination against equity and in favour of debt, as far as the tax regimes are concerned, should be removed. In an important development, the Turkish Parliament passed a law in 2015, providing similar treatment of issuances of equity by the corporates as applies to their debt issuances.
- x. **Removing the perpetual problem of the standardisation of contracts under Islamic finance** because of the non-uniformity of *Shari'ah* interpretations. Unless there is a resolution of discrepancies in the interpretations of the *Shari'ah* boards, there will always be high transaction costs for Islamic finance instruments, which will put them at a disadvantage.
- xi. **Ensuring regulatory authorities are adequately resourced to carry out their prudential and supervisory responsibilities and mandates.** This pertains not only to financial resources, but also to the requisite policy, legal, court, governance and accountability frameworks.
- xii. **Implementing global prudential, governance, accounting and *Shari'ah* standards issued by standard-setting bodies in Islamic finance.** The processes in drafting these standards are well established, highly professional and consultative. Their implementation will support harmonisation and orderly development of the industry.

An Integrated Approach to the Development of Islamic Finance: A Case Study of Malaysia

Bank Negara Malaysia (BNM) has been an early adopter of internationally accepted prudential standards and guiding principles to inculcate best practice in Islamic finance in Malaysia. The country has already adopted the comprehensive range of prudential and supervisory standards issued by the IFSB. Malaysia has developed

its Islamic finance system in a pragmatic and comprehensive way based on a well-connected Islamic finance ecosystem to ensure sustainable industry growth. This approach pre-empts the possibility of regulatory and market gaps developing, and pre-supposes the presence of an active *Takāful* sector, an Islamic capital market (especially a *Sukūk* market) and an Islamic asset management industry for the system to function efficiently. In terms of safety nets, Malaysia established the Malaysian Deposit Insurance Corporation, which covers both the conventional and Islamic banking sectors. Malaysia also requires professional services – in particular, legal and accounting firms – to facilitate the efficiency of Islamic finance transactions on which they advise and structure.

The Malaysian model is characterised by the presence of well-established legal, *Sharī'ah* governance and regulatory frameworks. As such, legal certainty for the conduct of Islamic finance business is entrenched in the system. BNM in 2009 fully recognised the dual banking system, the conventional one operating alongside an Islamic finance system. In the process of developing and regulating the two systems, there was a need to create parity and neutrality in order to foster the orderly functioning of the Malaysian financial system. Managing the risk of instability is paramount to BNM's mandate.

The industry is driven by a dedicated *Islamic Financial Services Act 2013*, which details the provisions with regard to the entry point, going concerns on regulation, as well as supervision and resolution. To ensure parity for the Islamic finance industry with existing legislation, BNM established the Law Harmonisation Committee, which, wherever applicable, makes recommendations to amend other legislation to facilitate Islamic finance, including dispute resolution. Similarly, the *Sharī'ah* Governance Framework in Malaysia comprises the National *Sharī'ah* Advisory Council at BNM, which is the apex *Sharī'ah* authority for the industry, but also requires each IIFS to establish its own *Sharī'ah* board to help them oversee the day-to-day running of their operations. BNM has also updated its *Sharī'ah* Governance Framework to enhance the *Sharī'ah* function while ensuring independence and professionalism of each aspect of the *Sharī'ah* governance process for both Islamic banks and *Takāful* operators.

BNM is also currently working on an important aspect of the *Sharī'ah* standard, by developing the full documentation to spell out the expectation of the *Sharī'ah* contracts that the banking institution will be employing in developing their product; and supports the full suite of *Sharī'ah* operational standards to help the institution to operate efficiently and innovate products. It has also adopted most of the IFSB standards to govern Islamic banking operations.

BNM has also introduced a *Sharī'ah*-compliant LOLR facility; has an active Islamic liquidity management system for IIFS; an active Islamic money market and a well-developed primary and secondary market for *Sukūk*; a commodity trading house to facilitate commodity *Murābahah* transactions; and a talent development programme to serve the development of the Islamic finance sector and to enhance knowledge and education.

BNM also established INCEIF, a dedicated training institution to develop Islamic finance professionals; ISRA (International *Sharī'ah* Research Academy for Islamic Finance) to conduct applied research on *Sharī'ah* methods to facilitate the introduction of product innovation; and market education programmes to promote awareness of Islamic finance among ordinary citizens.

BNM has issued specific policies to address the unique features of Islamic finance that are consistent with the recommendations of the IFSB standards. These include Capital Adequacy Standards; Supervisory Review Process; Transparency and Market Discipline Standards and Guidelines; Capital Adequacy Frameworks for Islamic Banks; Pillar 2 (ICAAP); Pillar 3 (Capital Disclosure Requirements) (the latter two providing a basis for identifying and measuring the risk status of *Sharī'ah* contracts for the purposes of capital adequacy

computation, and to measure risk at different stages of the contract); and BNM guidelines, which include those on *Sharī'ah* and Operational Standards, Financial Disclosure, Investment Account Framework, and the Rate of Return Framework.

It is important, however, that jurisdictions offering Islamic finance should continually assess their local financial regulatory environment, particularly relating to the legal framework and institutional capacity, so as to improve the effectiveness of regulation in driving the development of Islamic finance in their particular market. Supervisors need a strong understanding of *Sharī'ah* in order to ensure *Sharī'ah* compliance. In this context, the IFSB standards are very important tools in assessing the robustness of the regulatory framework.

Redefining the Implementation of Investment Accounts and their Intermediation Role

The Islamic deposit (based on *Qard* or *Wadī'ah* contracts) is a principal-guaranteed product, while the investment account is not. If one evaluates the investment account based on the capital adequacy standards issued by the IFSB, then one can ascertain whether or not there can be effective transferring of the risk to the investor. The IIFS does not require any more capital to support that kind of business, except to cover operational risk against any negligence, fraud, misconduct or breach of the contracted terms. However, in many jurisdictions the law does not explicitly allow an institution to offer these kinds of products by assimilating it with a deposit regulations framework.

The offering of investment accounts would benefit from some enabling regulatory and supervisory frameworks. As an example, under Malaysia's *Islamic Financial Services Act (IFSA) 2013*, the differences between Islamic deposits and investment accounts have been clearly stipulated, detailing what sorts of contracts can be used to create the Islamic deposit and to support the investment account offering. This is important, because it differentiates between a deposit and an investment account, enabling a customer to make an informed choice. The assets of the investment account also have to be ring-fenced to make liabilities attributable to investors upon bank liquidation.

At the regulatory level, BNM's new guidelines to IIFS in their offering of investment accounts sets out regulatory expectations of product structure, fund management, oversight arrangement, risk management, business conduct, and disclosure and prudential requirements related to investment accounts. It also devised a rate of return framework that provides the basis of the determination and distribution of investment profits for an investment account placement. In the context of capital adequacy frameworks, it stipulates assessment criteria on effective risk transfer of investment accounts that qualify the bank not to provide any capital buffer for assets funded by the investment account and also allows it to be exempted from any single customer limit.

Qualifying investment accounts, which result in significant mitigation of liquidity risk, are also exempted from the statutory liquidity requirements applicable to investment account offerings. In terms of the resolution, the BNM framework provides greater clarity on the treatment of investment accounts in the event of bank liquidation. For investment accounts not covered by the deposit insurance scheme, investment account holders have full recourse to the investment account assets, which are ring-fenced from other assets.

Malaysia has also recently established an investment account platform to facilitate the efficient operationalisation of the investment account and to bridge the investors with the prospective venture or entrepreneur. This platform would be managed by IIFS authorised in Malaysia. When the IIFS offers an investment account, it would need to perform its fiduciary duties, which include due diligence, suitability assessment, underwriting and performance monitoring. In this way, the platform will serve to bring together the investor where the bank

will mobilise the investment so the venture can realise the business opportunity on the investment account platform whereby the investor can know exactly what kind of venture he wants to put his money into with the Islamic bank. Here there would be greater transparency in the disclosure of the investment account framework, and it will be catering at the very end of the financial sector development, one having to depend on banking products, the other having to depend on high-end capital market products, *Sukūk* and equities.

Role of Macroprudential Policy and Challenges in Its Implementation

A key feature of the post-crisis regulatory architecture is the priority accorded to the objective of financial stability with an integrated framework that further stresses the importance of macroprudential approaches to risk management. On the macroprudential regulation side, the questions are: How to prevent systemic risk – the risk of widespread disruptions to financial services; in terms of the time dimension – pro-cyclicality – making sure that we do not get into a boom–bust cycle; and the cross-sectional dimension: how to avoid concentration of and interconnectedness of risks. The response in terms of regulatory governance has been to have an integrated regulatory framework, with both macro- and micro-supervision through one agency. The other response has been through inter-agency financial stability committees, with a close collaboration between the banking, capital markets, insurance and other sectors.

THE NEW SILK ROAD: THE IMPORTANCE OF REGULATORY COOPERATION FOR CROSS-BORDER INTEGRATION

Mr Khaled Mohammed Al Aboodi, Chief Executive Officer and General Manager, Islamic Corporation for the Development of the Private Sector (ICD); Daud Vicary Abdullah, President and Chief Executive Officer, International Centre for Education in Islamic Finance (INCEIF), Malaysia; and Jean-Marc Goy, Counsel for International Affairs, Commission de Surveillance du Secteur Financier, Luxembourg, deliberated on the challenges and opportunities offered by the new Silk Road and the emerging Islamic finance jurisdictions.

Thought leaders in the global Islamic finance industry have over the last few years championed the creation of a New Silk Road for the industry linking China and East Asia to Central Asia, South Asia, South-East Asia, the Middle East, Europe, Africa and beyond. This is in tandem with the New Silk Road for trade and investment, and the Iron Silk Road railway network connecting the same regions. These initiatives are essentially a revival of the historical Old Silk Road linking China, the Middle East and Europe. Almaty in Kazakhstan is an important crossroad along this Silk Road, along with other Central Asian cities such as Bukhara, Tashkent and Samarkand.

Parallels between the Old Silk Road and Modern Islamic Finance

What are the parallels between the Old Silk Road and the new one, and how can the Islamic finance industry draw from the experience of the Old Silk Road?

The establishment of the Old Silk Road was primarily guided by the development of new products and the search for new markets. These same aspirations have also guided the continuing expansion and growth of modern Islamic finance. In addition, the Old Silk Road was arguably a culmination of unprecedented collective efforts by all the different markets. Much in the same way, the ongoing evolution of modern Islamic finance has been led by the global interaction of markets across different regions of the world.

Lessons from the Old Silk Road

There are invaluable lessons that can be learned from the experience of the Old Silk Road, especially in terms of economic relationships, societal developments and political will. The Old Silk Road was a network of trade routes that existed not solely for the purpose of trading in silk, but also for trade in a range of commodities and products. A key contributing factor in the success of the trading network was the steady supply of safe and high-quality products. And silk was a great example. Given that silk was a relatively new product at that time, the silk producers had gone to great lengths to ensure that their products were of a high quality.

Another important lesson from the Old Silk Road is the importance of the protection of the network of trading routes. As such, there were large investments by communities along the land route, as well as the maritime trading routes, to provide a safe passage for the flow of trade. These investments included the building of forts and defensive walls along the trading routes. In addition to physical infrastructures, communities also established efficient administration and security to ensure the overall protection of the routes.

Indeed, these collective efforts in protecting the routes were the equivalent of “building an enabling environment” for growth of trade.

Furthermore, another important lesson that could be learned from the Old Silk Road is that of the indispensable necessity of global collaboration. Due to this strong integration and cooperation, the Old Silk Road successfully encouraged communities to collaborate to mutually leverage and benefit from the opportunities that arose.

The global Islamic financial industry can benefit from the above experiences of the Old Silk Road to support the growth, expansion and aspirations of the modern Islamic finance Silk Road, and in so doing realise its huge potential.

The emergence of Islamic financial products and services has created linkages between financial service providers across continents to trade on the New Silk Road. Today, Islamic finance will advance as it is in a better position to further facilitate economic and financial interlinkages, to offer mutually reinforcing benefits to those who participate in it. The further internationalisation of Islamic finance will thus influence the patterns of the global economy – in particular, it will facilitate the financial and economic integration between countries along the Silk Road from Asia to the Middle East and Africa and the more advanced economies of the West.

At the beginning of this decade, the world has already witnessed the shifting of trade activities to the emerging economies, which now account for about 63%, or about US\$37 trillion, of world trade, which is an increase of about 70% from a decade ago.

Indeed, the Islamic finance industry has huge potential, which could open up new prospects for the New Silk Road. Islamic finance, for example, is now a widely recognised industry in the world and offers a wide range of *Shari'ah*-compliant capital markets and insurance products, in addition to full-fledged banking services. Strong growth rates have been recorded across all sectors of the Islamic finance industry in the last few years.

Going forward, there are a number of value propositions that Islamic finance can provide for social economic and financial linkages along the New Silk Road. Islamic finance is backed by real underlying assets, and there exist a huge number of investment opportunities – particularly in the MENA region and in Asia. There is indeed a huge demand for asset-based infrastructure and project finance in both regions, which are particularly suited for Islamic finance. *Sukuk* is a unique Islamic financial instrument that is well suited for infrastructure finance because of its risk-sharing element and could also help fill the financing gap.

Islamic finance, due to its risk-sharing and equity-oriented nature, is also suited to the investment requirements of the New Silk Road regions. Inherent in Islamic finance is a clear delineation of roles and responsibilities of lenders and borrowers, risks and profit-sharing contracts. It also promotes greater transparency and corporate governance, which are important in cross-border transactions. Islamic financial products offer investors portfolio diversification and new investment opportunities. These products also encourage risk management and co-financing through explicit disclosure and transparency of the roles and responsibilities as defined in the contract. Islamic finance for the investee allows access to new sources of funds and liquidity, new risk management options and new mechanisms of price discovery.

Potential of Funding to the Private Sector through Islamic Finance: Role of the ICD in Promoting Cross-Border Investments and Integration

The Islamic Corporation for the Development of the Private Sector (ICD), the private-sector funding arm of the Islamic Development Bank Group, is a major multilateral conduit for promoting and financing the private sector in its member countries. ICD's mandate is specifically to provide *Shari'ah*-compliant finance for private-sector projects in member countries that generate local employment, competition and entrepreneurship, thus contributing to the development of the real economy.

Armed with a paid-in capital increase to US\$2 billion and an authorised capital increase to US\$4 billion, and a mandate from ICD's board to raise additional funding from the financial markets to fund its ever-increasing commitments, the Corporation is looking with renewed confidence to 2016 despite a difficult year for markets in 2015 characterised by depressed oil prices, a sluggish recovery in the global economy, continued instability in the MENA region and the looming interest rate rise indicated by the US Federal Reserve.

The AA-rated ICD is in resource mobilisation mode. It has mandated HSBC to arrange an Islamic MTN (Medium Term Notes, or *Sukūk*) Programme (most likely of up to US\$5 billion) and recently raised US\$400 million of bridge financing through the Syndicated *Murābahah* market with two tranches – a US\$100 million and US\$300 million tranche – precisely to meet its liquidity requirements. The MTN programme will help ICD to mobilise funding at a cheaper rate and lower the cost of financing, which would enable it to provide more funding to its clients. The Corporation plans to issue a US\$500 million *Sukūk* in the near future following board and *Sharī'ah* approval of its final structure.

A sizeable chunk of these resources will be directed towards financing the private sector in Central Asia, Asia and Africa. Turmoil in the MENA region has affected business, with the project pipeline more depressed. The ICD extends lines of finance, invests in equity of Islamic banks, establishes joint venture leasing companies, and has established a number of SME funds aimed at financing small enterprises that need expansion capital. In the last two years, the ICD has also emerged as an adviser for *Sukūk* origination and helped Senegal, for instance, in issuing its debut *Sukūk* in 2014. It has mandates from at least four other countries to help them issue inaugural benchmark sovereign *Sukūk*.

In 2014, the cumulative approvals of the Corporation increased to over US\$3 billion from inception. These projects added value to member countries' economic and social development in a number of ways. Equity investments accounted for the bulk of approvals last year, representing about half of the total approvals.

Last year, ICD was also successful in diversifying its portfolio in terms of both sectoral distribution and regional composition. In financial services, agriculture, telecommunications and industry – to name a few of the dominant sectors, among many – ICD offered key equity investments, extended lines of finance, and other modes of Islamic finance to support a wide range of private-sector companies.

Importance of Public Awareness of and Education on Islamic Finance

INCEIF's CEO, Mr Daud Vicary Abdullah, stressed that in order to progress further, Islamic finance needs to work on three areas: education, perception and liquidity. In particular, cross-border liquidity is a fundamental need of any industry or business for its global development.

Since the Global Financial Crisis there appears to be a growing realisation that an alternative model is required to move away from debt-based to equity-based financing and from risk-transfer to risk-sharing finance. World leaders and captains of industry are debating whether the global financial system is fit for purpose, and concluding that it is probably not. They are showing a lot of interest in the idea of getting back to the "real economy" instead of relying too much on the financial economy, and are placing more emphasis on risk-sharing and the escalating debt.

The timing for getting value propositions across in terms of Islamic finance and initiatives that we are seeing in graduate central Asia is absolutely vital. Education is also critical. It is not just about producing a PhD graduate who does research, and it is not just about producing Masters graduates; it is about every tier of education.

There are still many misperceptions about what Islamic finance is, and how the industry is represented by its stakeholders. Even after more than 20 years, a frequently asked question is whether non-Muslims can participate. There is still quite a bit to do to change perceptions.

Perceptions can be changed around concepts of risk-sharing, the greater good, and financial inclusion. The Islamic finance industry now has an infrastructure that is represented by globally acknowledged organisations such as the IFSB. The Islamic finance industry can be confident that it has a credible argument and proposition. The challenge now is to ensure that more people understand that proposition, not as a faith-based one but as a business and value proposition.

Country Experience of Luxembourg in Promoting Islamic Finance

Mr Jean-Marc Goy, Counsel for International Affairs, Commission de Surveillance du Secteur Financier, Luxembourg, shared the country experiences of Luxembourg with regard to the development of Islamic finance. Luxembourg is an international financial centre and, as such, a place for Islamic finance service providers, institutions and products. The connection between Luxembourg and Islamic finance goes back to 1978 when the first Islamic finance institution, Islamic Banking Holdings Company Ltd (Luxembourg SA), was established in the Duchy. It was followed in 1983 by the establishment of a *Shari'ah*-compliant insurance company. In 2002, Luxembourg was the first stock exchange in Europe to list *Sukūk* (issued in this case by Shell (Malaysia) Bhd). Many *Sukūk* have since been listed on the Luxembourg Stock Exchange.

The Banque centrale du Luxembourg, the central bank, is also the first central bank in Europe to become a member of the IFSB. Luxembourg was a founding member of the International Islamic Liquidity Management Corporation. Today, Luxembourg is the third-largest centre for *Shari'ah*-compliant investment funds. To further cement its commitment to its Islamic finance proposition, Luxembourg in 2014 issued its debut sovereign *Sukūk*, which was the first sovereign *Sukūk* denominated in euros. The Luxembourg government is also currently considering issuing a follow-up sovereign *Sukūk*.

In Luxembourg, the legal and regulatory framework is adapted to facilitate the introduction of Islamic financial products. The current rules can be applied together with the *Shari'ah* requirements. The Luxembourg Supervisory Authority also looks at new products on a case-by-case basis, to see whether the current rules apply or whether they have to be further adapted to make the products *Shari'ah*-compliant.

Luxembourg is a very small country, unlike Kazakhstan. However, Luxembourg has a very big domestic market because it is one of the six founding nations of the European Union, which has 28 member states and a market of roughly 400 million inhabitants. That is what Luxembourg considers its domestic market.

Luxembourg's financial institutions are also active beyond the borders of Europe, whether it is in Islamic or conventional finance. As such, the Duchy always tries to open up and to think internationally and on a cross-border basis. This is something to be recommended to other countries or financial centres, whether along the New Silk Road or elsewhere. International cross-border operations are what the world needs. International cross-border financial cooperation is a key objective of the Luxembourg regulatory authorities, especially between central banks and service providers.

The Duchy makes the most of its geographical location and its relationships with neighbouring countries and beyond. This is a practice the key countries along the New Silk Road should emulate.

Promoting Sukūk Issuance by Corporate Entities to Fund their Projects as well as Sovereigns for Public Infrastructure and Budget Financing

Kazakhstan is investing a great deal in infrastructure, and is also encouraging neighbouring countries to do so, not just in hard infrastructure but also in soft infrastructure, such as customs procedures and bureaucracy in general, which need to be standardised across this New Silk Road.

There is a general consensus that *Sukūk* is an ideal way of funding hard infrastructure, whether through sovereign *Sukūk* or quasi-sovereign *Sukūk*. Kazakhstan recently announced its intention to issue a debut sovereign *Sukūk* and is researching the most appropriate structures.

Sukūk is very important for sovereigns. The ICD, for instance, advised the Government of Senegal to issue a debut sovereign *Sukūk* – a CFA200 million issuance – in 2014. This issuance was over-subscribed by Islamic banks in West Africa in which ICD has an equity stake. Sovereign Senegal was already issuing bonds, and the question was would *Sukūk* add any value? Senegal is a member of the West African Economic and Monetary Union (WAEMU) states, which have a common central bank, BCEAO. ICD engaged with the Senegal government for three years and with WAEMU about *Sukūk* origination in the Union. Similarly, under a memorandum of understanding, ICD helped the BCEAO to develop a legal framework to facilitate some Islamic financial products, including *Murābahah* (cost-plus financing), *Ijārah* and *Sukūk*.

The main issue was regulation because the legal system in the West African francophone countries is based on Code Napoleon (French Law). Senegal showed good leadership, which enabled it to issue the first sovereign *Sukūk* in Africa, ahead of South Africa. Similarly, ICD has also signed two mandates with Niger and Côte d'Ivoire – both members of WAEMU – to advise them to issue debut sovereign *Sukūk*. Côte d'Ivoire issued debut *Sukūk* in November 2015 for CFA150 million.

ICD has also signed a mandate with Niger to issue its debut sovereign *Sukūk*, but for various reasons this initiative has been stalled. However, the Corporation is talking to several corporations in Nigeria, advising them to enter the *Sukūk* market with debut corporate issuances. In this market segment alone, the ICD is in negotiations with other African counterparts, which would keep it busy for the next five years. In Niger, the discussion is centred on how to link *Sukūk* to finance infrastructure. The challenge is to familiarise the regulatory authorities about the structures and how to make *Sukūk* appealing to investors. The role of the ICD is to ensure that the *Sukūk* product is a win-win for both sides.

According to ICD, this is something that can be replicated in Central Asia along the New Silk Road. While ICD started with structuring sovereign *Sukūk*, its ultimate goal is to promote corporate *Sukūk* issuance. Unfortunately, the private sector is still largely dependent on the conventional banking sector in terms of funding. As such, the learning curve on *Sukūk* and Islamic finance is quite steep. However, the starting point is always the presence of the legal and regulatory frameworks to facilitate *Sukūk* origination.

ICD is also advising Jordan, whose Minister of Finance has confirmed that the Ministry is in the process of finalising the country's debut sovereign *Sukūk* issuance. According to Islamic banking sources in Jordan, the proceeds would be used to finance development projects earmarked by the government, including those of the Jordan Water Authority and the National Electric Power Company. The *Sukūk* would also be an instrument to absorb excess liquidity (estimated to be JD1.4 billion) held by Jordan's Islamic banks. The Jordanian Ministry of Finance signed an agreement with ICD in early May, whereby the Corporation would provide Transaction Technical Support for the country's proposed debut domestic *Sukūk* offering. According to ICD, by creating a domestic Islamic capital market, an IDB member country would be able to provide an alternative to its

treasury bills for Islamic financial institutions to invest in. Although it is not practically common for global *Sukūk* arrangers, ICD took responsibility to fill this gap in the market, which naturally falls within the developmental principles of the IDB Group. In recent years, Jordan has introduced new *Sukūk* law and guidelines, which has been in preparation since 2010 and was finally adopted by both the Lower House of Representatives and the Upper House in Amman in 2012. Similarly, the Jordanian government intends to outline a domestic sovereign *Sukūk* issuance programme in the 2016 National Budget. The proceeds would be used to finance purchasing headquarters for the Kingdom's diplomatic missions, build schools and other government offices, particularly rented buildings with a steady rental income stream.

One checklist for *Sukūk* is embodied in the acronym STARS – *Sharī'ah* framework; tax issues; accounting treatment; regulatory standards. Similarly, in order to develop the *Sukūk* markets, there is a need for market education to increase awareness of the instrument. The jurisdictions should also understand the starting point for issuing *Sukūk*, taking into consideration their legal structure as well as market and infrastructure development. It might not be feasible to wait until a country has the perfect framework. The major issue in Senegal, for example, was identifying government assets, putting these assets in a separate legal entity, and also for the *Sukūk* to be eligible for repo transactions. The issue of requisite policy is also reflected in the example of Kazakhstan, where with the political will and support, the legal and regulatory framework was developed through amendments in the law. Today the country has a friendly legal and regulatory environment for developing Islamic finance. The serious dearth of qualified human resources for developing an Islamic capital market in many countries remains a challenge. Similarly, finding the suitable underlying asset pools for *Sukūk* issuance has been a hindrance in some markets. Finally, the issue of cross-border risks and how to mitigate them through collaboration between regulatory authorities and stakeholders is a consideration for the issuers in international currencies or those targeting to list their *Sukūk* in international or regional markets.

CONCLUSIONS AND RECOMMENDATIONS

The 12th Annual IFSB Summit provided a vigorous and robust platform for discourse in all sessions, comprising a wide range of topics and views pertinent especially to the main Summit theme of “Core Principles for Islamic Finance: Integrating with the Global Regulatory Framework”.

Not surprisingly, a number of conclusions and recommendations emerged from the various sessions – all aimed at helping to take the Islamic finance industry to the next level in its contemporary evolution.

The growing importance of Islamic finance around the world, its integration into the global financial system and the lessons learned from the financial crisis made it clear that regulation in this field should be strengthened, with necessary attention to the building blocks.

There was a strong consensus that the promulgation of the CPIFR is an important step for enhancing the resilience of Islamic financial institutions and systems around the world; and for promoting best practices globally in the field of Islamic finance regulation. A major contention was that the IFSB, with the support of its members, should strive to do more to ensure the widespread adoption of CPIFR and its other standards by its member countries and the consistent implementation across jurisdictions where Islamic finance is part of the overall financial system. Similarly, the implementation of the IFSB standards should be a demonstrable action of support for the IFSB and its work in setting prudential and supervisory standards. A strong recommendation was that the major markets where Islamic financial products are offered should perform self-assessments or invite third-party assessors to carry out the review of their Islamic financial systems. In this way, the Islamic finance industry would give certainty and further comfort to stakeholders and customers in that jurisdiction, and as such begin to help close the gap in shortfalls in market awareness, education and protection.

The issuance of the CPIFR is also a progression to the next level of financial sector supervision, whereby core principles provide a high-level framework that not only covers the prudential regulation aspects related to risk management, corporate governance and transparency of institutions but also the broader and somewhat more fundamental issues such as responsibilities, powers, and legal protection of the supervisory authority itself.

The focus on enhancing market discipline through greater transparency to investors and other stakeholders supports the objective of a resilient financial sector. RSAs would also greatly benefit from the core principles framework by applying a globally consistent framework for the supervision of the financial sector that has been suitably modified to address the specific nature of operations of the IIFS. It will also support the implementation of other IFSB standards that are associated with various core principles and provide best practices and guidance on a number of areas of financial sector supervision. As such, the next steps would be to introduce IFSB core principles for the Islamic capital markets (including *Sukūk*) and *Takāful* segments.

The impact of the Basel III requirements on IIFS continues to evolve. In terms of the increased quantity and quality measures, IIFS in general are already well capitalised with high-quality capital. However, in raising additional Tier 1 and Tier 2 capital, IIFS may face an issue of meeting *Shari'ah* requirements for instruments that can be considered as capital. Some Islamic banks maintain that it becomes complex to calculate capital adequacy due to the variation in the treatment of PSIAs across jurisdictions.

Post-financial crisis there has been a major shift within the conventional space in dealing with regulation and coming up with a new framework – in particular, adopting the idea of macroprudential regulation, encompassing issues such as systemic risk and how to prevent it, the Basel III provisions on solvency and liquidity measurements.

Private-sector funding is a major challenge for the Islamic finance industry, given that the private sector usually forms the backbone of an economy. The Islamic Corporation for the Development of the Private Sector, the private-sector funding arm of the Islamic Development Bank Group, is a major multilateral conduit for promoting and financing the private sector in its member countries.

Other conclusions drawn were:

- i. Despite the continuing global economic volatility and the low oil price environment, Islamic finance continues to thrive with double-digit growth with new markets in Africa, Asia and Europe opening up in addition to the traditional markets in the MENA region and South East Asia.
- ii. *Sukūk* issuance has caught the imagination of the world, with the G20 and multilateral bodies exploring the efficacy of *Sukūk* as a suitable instrument to finance especially infrastructure in Muslim member countries.
- iii. The *Sukūk* market may face pressure in 2015 in terms of primary issuances due to difficult market conditions. The sector is still faced with serious impediments, including the lack of secondary trading and short-term *Sukūk* for liquidity management purposes.
- iv. Major multilaterals including the IMF and the World Bank are showing increasing interest in Islamic finance, largely because in several countries the industry is of systemic importance.
- v. Islamic banks continue to be well-capitalised with higher levels of high-quality capital than mandated by regulatory requirements. But as the industry is poised to sustain its growth trajectory, it is important to ensure that adequate liquidity is generated in line with the industry's needs in their move to new regulatory architecture demand.
- vi. The industry is in need of a more coordinated approach, especially in delivering towards the development and other goals of OIC countries, which are faced with huge economic challenges in addressing income disparities, poverty alleviation and infrastructure needs.
- vii. Some sentiments pointed to the fact that the value proposition of Islamic finance is not being fully realised. In order to realise the value proposition of Islamic finance, says the IMF, the unique risks and characteristics of Islamic finance products have to be recognised and regulated. In this way the global industry will flourish. Instead of mimicking conventional finance products, there should be more products to serve financial inclusion by financing SMEs, through microfinance programmes and leveraging the unique institutions of *Zakat* and *Waqf*.
- viii. There is a clear need to tailor regulations to the specificities of Islamic finance. Similarly, there is a critical need for safety nets in Islamic finance, including deposit insurance schemes, resolution frameworks and LOLR.
- ix. Islamic finance education, market awareness and employment placements for the next generation of Islamic bankers remains a pressing challenge.

In new markets such as Central Asia, the major hurdles stunting the development of Islamic finance include: lack of tax neutrality treatment for Islamic finance products; shortage of qualified human resources; and issuances of benchmark sovereign *Sukūk*, etc. CIS countries are looking at Islamic finance as a way to access investment from capital-rich countries in the GCC and South-East Asia in all major sectors and as a mechanism to transfer knowledge. *Sukūk* is an ideal instrument for attracting investment from abroad. This could serve as an ideal conduit for the wider development of Islamic finance in the CIS.

In Turkey the development of Islamic finance (participation banking) is an important goal for the government. One of the components of the Istanbul International Finance Center project is the development of participation

banking and an interest-free financial system. There is an action plan to achieve this objective. In this action plan, the BRSA is responsible for reviewing the international standards related to interest-free finance and implementing them in Turkey along with any new regulations that may be necessary.

In Pakistan, the State Bank of Pakistan has formulated a *Strategic Plan for the Islamic Banking Industry (2014–18)* whose key initiatives include amendments in the tax and legal framework to create a level playing field for the IIFS; promoting a *Sharī'ah* Governance Framework for the industry, which inculcates the oversight of individual *Sharī'ah* boards over internal and external *Sharī'ah* audits; rationalising minimum capital requirements; expanding the Islamic Financial Accounting Standards (IFAS); developing Islamic capital markets through the issuance of guidelines for *Sukūk*, *Takāful* and *Muḍārabah*; and conducting KAP surveys.

Kenya, South Africa, Nigeria and Mauritius are among the many countries in rising Africa that have considerable potential to become a regional hub of Islamic finance. However, Islamic finance in SSA remains small, although it has good potential given the demography of the region, the growing middle class, and the potential for financial deepening. However, it would require changes to the legal and regulatory frameworks as well as taxation regimes, availability of financial safety nets, and strengthening of *Sharī'ah* governance frameworks.

Malaysia has developed its Islamic finance system in a pragmatic and comprehensive way based on a well-connected Islamic finance ecosystem to ensure sustainable industry growth. This approach seeks to pre-empt the possibility of regulatory and market gaps developing, and pre-supposes the presence of an active *Takāful* sector, Islamic capital market (especially a *Sukūk* market), and an Islamic asset management industry for the system to function efficiently. In Malaysia, the Islamic banking industry has achieved a market share of 26% of the total banking sector; *Sukūk* constitute more than half of bonds outstanding (both government and private *Sukūk*); the *Takāful* sector has a 13% market share of the total insurance sector; and the Islamic fund industry has an 18% market share.

The Duchy of Luxembourg, too, is trying to add value to its Islamic finance proposition. To further cement its commitment to this proposition, Luxembourg in 2014 issued its debut sovereign *Sukūk*, which was the first sovereign *Sukūk* denominated in euros. The Luxembourg government is also currently considering issuing a follow-up sovereign *Sukūk*.

There are parallels between the historical Old Silk Road linking China to the Middle East and the West and the new one. The contention is that the Islamic finance industry can draw from the experience of the Old Silk Road in terms of development of new high-quality products, the search for new markets, and building an enabling environment through solidarity and collaboration.

The Islamic finance industry is a “work in progress” with a lot more to do. The industry is gaining more prominence, and there is huge potential for growth in many countries. It is important that the various markets have a common understanding and consistency of approach in how they view Islamic financial products and their regulation and supervision.



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