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IFSB 4th PUBLIC LECTURE ON
FINANCIAL POLICY AND STABILITY

➤ 2011 ➤ Amman, Jordan

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Constraints on Growth in Islamic Finance

Lecture by **Baljeet Kaur Grewal** | *Managing Director & Vice Chairman
KFH Research Limited*



ISLAMIC FINANCIAL SERVICES BOARD



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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**.

Constraints on Growth in Islamic Finance

Baljeet Kaur Grewal

Islamic finance industry overview

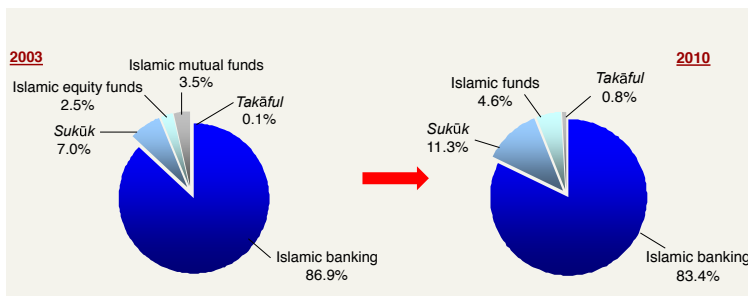
The onset of Islamic finance as an alternative to the conventional financial system has gained traction in the last decade, owing to rapid financial liberalisation, enhanced market intermediation and a growing awareness of *Sharī'ah* banking. The Islamic financial industry is today no longer a peripheral industry, but an important component of the global financial architecture.

Total Islamic assets worldwide have increased from approximately US\$150 billion in the 1990s to in excess of US\$1 trillion in 2010, underpinned by the industry's strong financial infrastructure and institutional framework, robust participation from both Islamic and non-Islamic institutions, and a supporting regulatory charter.

The success and development of the Islamic finance industry is witnessed in various segments of the industry – namely, *Sukūk* Islamic banking, *Takāful* and fund management. As at end-2010, the *Sukūk* market was estimated to be worth approximately US\$143 billion. The Islamic banking sector worldwide is valued at approximately US\$850 billion in terms of assets, while the total global *Takāful* contributions have risen to USD9.1 billion. In the Islamic funds industry, assets under management grew by 15% globally to reach US\$52.3 billion in 2009. As at end-2010, Islamic banking assets represented 83.4% of overall Islamic assets,

followed by *Sukūk* funds (11.3%) and Islamic funds (4.6%).

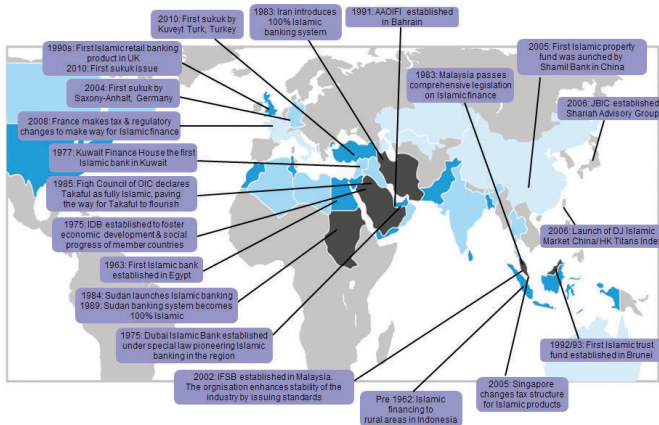
Figure 1: Breakdown of Islamic Assets



Sources: Central banks, IFSB, Zawya, KFHR

Extensive interest in Islamic finance from different parts of the world is also driving the international dimension of Islamic finance. The IFSB expects the value of global Islamic finance assets to reach US\$1.6 trillion by 2012.

Figure 2: A Global Industry



Sources: Central banks, IFSB, KFHR

Islamic finance has demonstrated its competitiveness and resilience during the global financial crisis. The industry is now entering a fundamentally different environment in this post-crisis era. Efforts are being focused on the further development of Islamic financial markets, the financial infrastructure, and research and development to support innovation, and on enhancing the legal, regulatory and supervisory framework. These areas are crucial in strengthening the resilience of Islamic finance, which would in turn enhance its potential to contribute to global financial stability and a greater shared economic prosperity.

Today, Islamic finance is in transition to the next stage of development: greater international integration. Hence, collective efforts undertaken by both the regulators and

Islamic finance institutions to mobilise a higher level of global cooperation will help to further propel the prospects of Islamic finance moving forward.

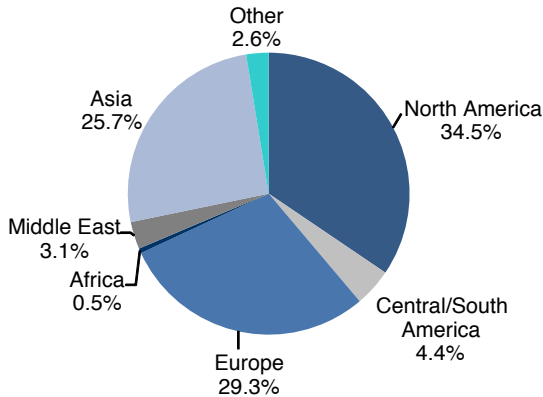
As Islamic finance has become a crucial component of the global financial system, several countries are now in the race to become Islamic financial hubs, including established financial centres such as London, Hong Kong and Singapore. Encouraged by the growth of Islamic finance centres across the globe, new markets such as Luxembourg, South Korea and Australia also aspire to become Islamic financial centres.

The global financial system

Global wealth currently held by 4.4 billion people has increased 72% since 2000 to reach US\$195 trillion driven by robust growth in emerging markets, many of which are comprised of large, diverse Muslim populations. Global wealth is estimated to grow 61% to US\$315 trillion by 2015.

A decade ago, emerging markets accounted for 37% of the global economy; today, they account for 46%. According to the International Monetary Fund, emerging markets' share could rise to 51% by 2014 given the continued investment. The emerging markets already attract almost 50% of foreign direct investment (FDI) global inflows and account for 25% of FDI outflows. Also fuelling this robust growth are rallying commodity prices, which are a key factor in the growing wealth of emerging markets.

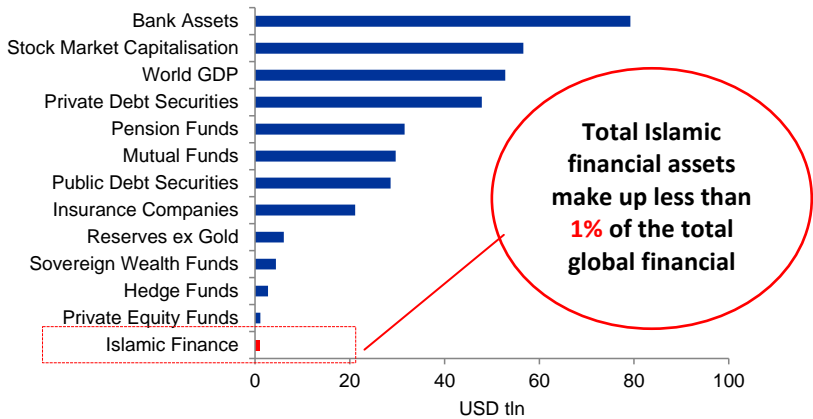
Figure 3: Percentage of World Net Worth (2010)



Sources: IMF, KFHR

On the other hand, US banking assets are valued at approximately US\$13.3 trillion at the end of 2010, while global banking assets are forecast to reach US\$85 trillion by the end of 2011. To put this into context, the value of global Islamic assets across all asset classes remains minuscule in comparison to that of their conventional counterparts.

Figure 4: Global Assets (2010)

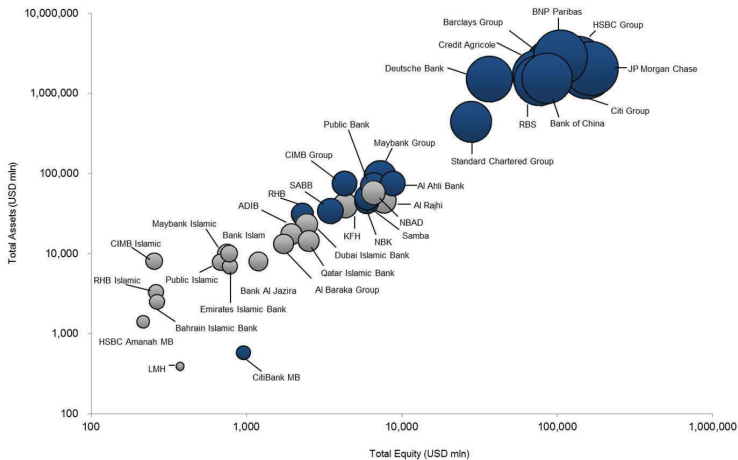


Sources: Various sources, KFHR estimates

Facing the challenge

Currently, market capitalisation of Islamic banks pales in comparison to that of their conventional counterparts. The top ten Islamic banks' market capitalisation was only 4.1% of the top ten conventional banks' market capitalisation at end-2010.

Figure 5: Market Capitalisation (Islamic Banks vs. Conventional Banks)



Sources: Individual institutions, KFHR

Note: figures taken are latest available which range between 2009 and 2010

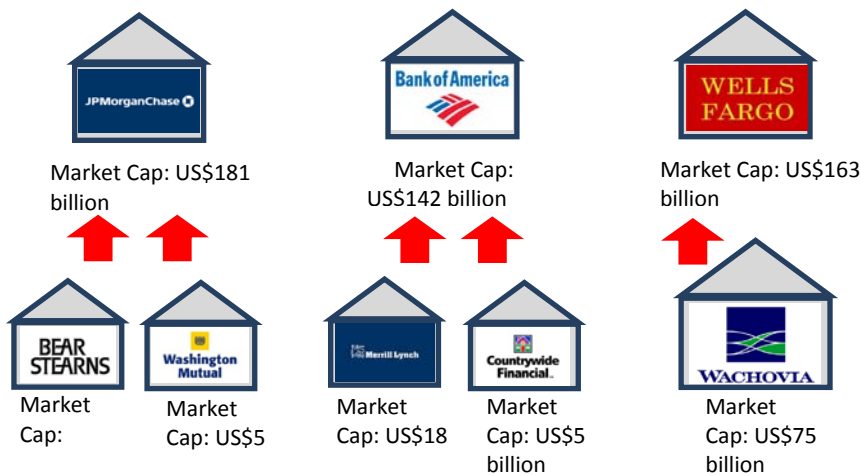
Concurrently, Islamic banks were much less affected by the global financial crisis, being still able to earn a profit while conventional banks made record losses, exacerbating the crisis. In 2008, the net profit of Islamic banks totalled US\$4.74 billion, compared to a loss of US\$4.2 billion incurred by the conventional banks. As a result, total assets of the top ten Islamic banks as a percentage of the top ten conventional banks increased from 0.8% in 2008 to 1.0% in 2010.

In the post-crisis arena, Islamic banks are facing an uphill challenge as the conventional banks recapitalise

and consolidate to become bigger than ever. With large bailouts by governments around the world and bigger balance sheets to take advantage of devalued stocks, conventional banks have been able to return to profit in no time. In 2010 alone, the average top ten conventional banks’ (by pre-crisis market capitalisation) net profit increased by 139% year-on-year. Meanwhile, the same statistic for the Islamic banks was a 55% decline in net profit during the same period, due to the delayed effects of the financial crisis and a weaker asset quality.

The largest US banks have grown larger since the financial crisis, and the number of “too-big-to-fail” banks will increase by 40% over the next 15 years, according to data compiled by Bloomberg. The following US financial institutions were swallowed up after the financial crisis, making the big banks even bigger:

**Figure 6: Institutional Consolidation
Post-Financial Crisis**



Sources: Bloomberg, KFHR

The five largest institutions now make up 58% of the total US banking assets. Islamic financial institutions will continue to be diminutive compared to the large conventional financial institutions and their value proposition will remain diluted.

Reaching critical mass

The need for Islamic finance to reach critical mass cannot be understated. It has been identified as the number one target by industry experts for Islamic finance to become truly competitive with the conventional system. Ways to achieve this target could include reaching out to untapped markets and audiences, or consolidating existing platforms to build an entity that can influence multiple areas of the market with expertise and capital.

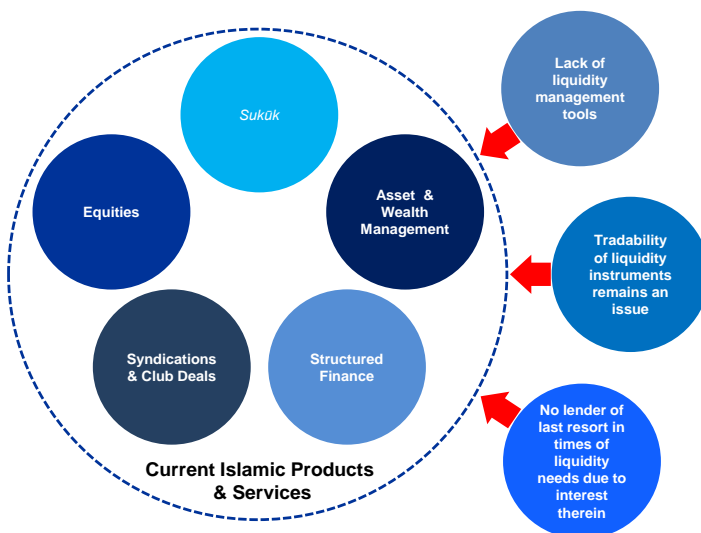
There is a need for a large-scale Islamic financial institution, with substantial leverage in the form of vast capital, to generate change. The current fragmentation in the domestic markets has led to margin erosion and difficulty in scaling up business operations. However, a large Islamic financial institution would be able to differentiate itself by scaling up through its presence in key financial markets which, in turn, would give access to vital funding sources, generate the product profile crucial to penetrating new markets, and influence global markets/investor awareness.

The huge infrastructure requirements in the GCC and Asia-Pacific regions bode well for the large financial institution as an opportunity to provide capital to meet the growing demand for structured products and project

financing. Furthermore, the underserved small and medium-size enterprise (SME) market presents huge potential for willing partners. With abundant expertise, a large institution may well be able to develop alternative forms of financing, such as private equity and venture capital, to penetrate this largely untapped market.

Another often-mentioned challenge in the Islamic finance industry is the issue of liquidity. It is no secret that Islamic financial markets currently lack the liquidity, breadth and depth of conventional financial markets. Islamic financial institutions' (IFI) product range has developed rapidly over the last ten years to meet the demand from both retail and corporate entities. However, IFIs still face the challenge of a lack of instruments to manage liquidity. As a result, products are short-ended given the current constraints. Therefore, it is critical for Islamic financial institutions to innovate and revolutionise *Sharī'ah*-compliant products to enhance and manage liquidity. Large Islamic financial institutions can enhance market liquidity, and hence product pricing, by integrating their global and regional market operations.

Figure 7: Product Development and Liquidity Conundrum



Source: KFHR

Many banks may still have limited capabilities and expertise to consistently originate and structure large Islamic deals, which can often comprise pioneering arrangements and features. The need for highly skilled staff therefore increases with the development of innovative Islamic financial products and services. To meet this human capital requirement, large financial institutions can act as knowledge centres to attract foreign talent from the existing international financial hubs, as well as retain local talent.

Further areas of focus in capacity building and talent development include:

- the need for practitioners and stakeholders to be highly qualified and equipped with the requisite technical knowledge and skills;
- the need for specialised training and educational institutions;
- the development and adoption of industry best practices, as well as the harmonisation of *Shari'ah* practices while reviewing standards to facilitate policy development and implementation;
- the collaboration and exchange of knowledge across jurisdictions; and
- supplementary research into and development of key specialised areas.

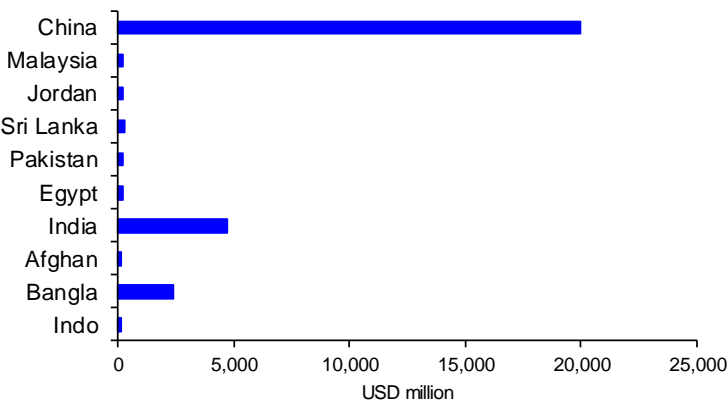
The second area for reaching critical mass is Islamic microfinance. In 1963, an Islamic version of the microfinance model was developed in Egypt. Currently, there are more than 200 Islamic microfinance institutions around the world.

The supply of Islamic microfinance is currently concentrated in a few countries, mainly Indonesia, Bangladesh and Afghanistan, which account for around 80% of global outreach. Despite the strong growth of Islamic finance over the years, Islamic microfinance is still in its nascent stage and currently forms part of an informal economy.

A 2007 global survey on Islamic microfinance undertaken by the Consultative Group to Assist the Poor

shows that Islamic microfinance has an estimated global outreach of only 380,000 customers and accounts for only around 0.005% of total microfinance outreach. Although 2010 estimates now put this figure at 0.05%, the potential still remains mainly untouched.

Figure 8: Selected Countries' Microfinance: Gross Loan Portfolio (2010E)



Sources: Mixmarket, KFHR

The SME market is a largely untapped space with huge potential, especially in emerging markets where economic growth is robust. Islamic microfinance is designed to work together in this space, which could catapult Islamic finance to the market penetration it needs for the masses.

The slow growth in Islamic microfinance is due mainly to the fact that such facilities were usually provided by specialised institutions such as non-government

organisations, and not by Islamic banks, despite the many elements of microfinance which can be considered consistent with the broader objectives of Islamic banking. For the industry to reach its full potential, Islamic microfinance should be integrated into a country's mainstream banking and financial system. This will help to:

- create greater awareness of products;
- encourage product innovation;
- improve access to microfinance;
- widen and strengthen the distribution channels; and
- standardise regulation and improve transparency.

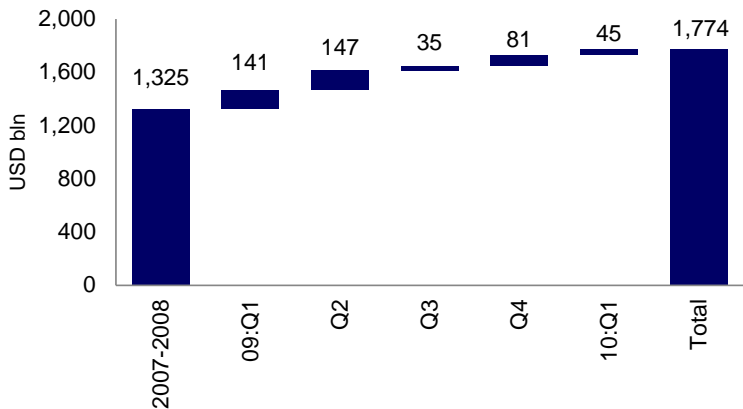
The regulatory challenge

A big part of the recent financial crisis can be blamed on regulatory failures. As a result of the financial crisis, the global financial sector lost almost US\$1.8 trillion, which sent many economies into a recession. Financial markets had been subject to gross liberalisation over the last ten years, which allowed financial institutions to dish out credit to uncreditworthy customers and create the highly complex financial derivatives to bet against, without having to answer for the consequences thereof.

The lack of regulation during the global recession has led many economists to reconsider their views on the market-based model of economic theory and its viability in today's societies in conventional banking. Many governments around the world have introduced financial and economic reforms as a form of government intervention to produce a well-regulated financial

environment with the aim of preventing a similar financial crisis in the future.

Figure 9: Worldwide Write-Offs and Credit Losses



Sources: *The World Islamic Banking Competitiveness Report 2010–2011*, KFHR

Bold measures are being developed in various international forums with fundamental changes to the current approaches to financial regulatory and supervisory oversight. The new regulatory framework is aimed at being one that is premised on a greater emphasis on ethics, fairness and accountability, and which promotes global economic, social and environmental sustainability. It should be anchored on a sensible balance of supporting growth while maintaining financial stability, and be founded on greater international coordination of regulatory approaches and supervisory oversight with a crisis management framework that will reduce systemic risk and the severity of any such future financial crises.

Islamic finance, which is fast becoming a unique and integral part of the global financial system, will inevitably be impacted by the changing global landscape of financial regulation, especially given the internationalisation and continued growth of Islamic finance. The global call for improved regulation and increased oversight will thus intensify the efforts that have already been undertaken to strengthen the financial regulation of Islamic finance.

To support the orderly development of Islamic finance, it is vital to accelerate the development of the critical building blocks of the Islamic financial system in order to respond to the changing economic and financial landscape. This is important to ensure a more integrated Islamic financial services industry globally that is able to withstand shocks and adverse market developments through putting in place building blocks that will strengthen the resilience of the Islamic financial system and by the application of mutually acceptable rules and standards.

With this in mind, the building blocks of a robust and sound regulatory framework are at the core of Islamic finance. Starting at the top, any Islamic organisation must ensure proper corporate governance processes which are relevant and particular to Islamic principles. Combined with proper oversight at both the board and senior management levels, this will ensure that a large financial institution will not be the cause of a systemic failure of the kind witnessed in the global financial crisis.

At a risk management level, it is central that institutions must incorporate risk sharing between the organisation and its clients and customer base. The risk-sharing principle is at the heart of Islamic economics and has led experts such as Abbas Mirakhor to conclude that sharing risk is central to insulating an economy from shocks similar to those of the financial crisis. The growing dependency on debt-based instruments was a major contributor to the viscosity of the global financial crisis. Therefore, the introduction of liquid, equity-based risk-sharing instruments will shield institutions from the effects of future shocks and help to build a more sustainable financial system.

Equally important is a prudent capital adequacy framework. In 2005, the IFSB introduced its second standard, which covers the capital adequacy of institutions offering Islamic financial services. The standard is important to reference, as it is the first in the world to recognise the inherent risks of *Shar'ah* contracts and deals with them by assigning risk weights thereto, thereby creating a level playing field among the Islamic institutions in adopting and developing risk identification and measurement practices that meet internationally acceptable prudential standards. A unified adoption of this standard will ensure that institutions offering Islamic financial products and services assign sufficient capital to cover the risk of the institution's Islamic operations. The IFSB standard is currently the only international guideline to integrate the Islamic contracting principles.

Case study: Malaysia

It is largely viewed that Malaysia was resilient against the global financial crisis due to the country's strong fundamentals and inherently sound financial regulatory framework. Furthermore, the domestic banks were not directly exposed to the US sub-prime crisis, thanks to the government's earlier rules that limited the outflow of foreign investments.

Figure 10: Performance of the Equity Markets in 2008 and 2009

Index	2008 Returns	2009 YTD Returns
Malaysia	-39.30%	-2.10%
South Korea	-40.70%	-6.20%
Taiwan	-46.00%	1.40%
Thailand	-47.60%	-6.80%
Hong Kong	-48.30%	-17.10%
China	-48.90%	-12.10%
Singapore	-49.20%	-14.10%
Indonesia	-50.60%	-5.10%
India	-52.90%	-13.70%

Sources: Bloomberg, KFHR

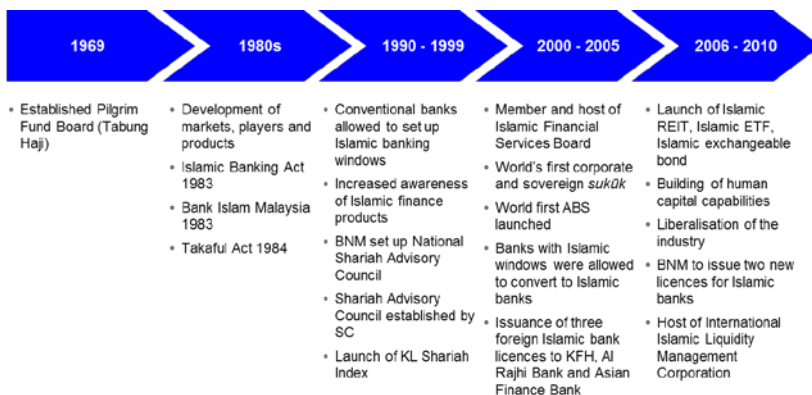
Note: Year-to-date as at 6 March 2009

Similarly, Islamic banking in the country was well shielded from the effects of the crisis due to the Islamic financial institutions' strict adherence to Islamic principles, which prevents high levels of leveraging and speculative activities. The majority of Islamic banks' capital remained strong despite an economic slowdown in the country.

Malaysia is one of the pioneering countries in successfully developing its Islamic finance industry. The

government and regulators are highly committed to developing a complete Islamic financial system that includes banking, *Takāful* and the capital market. Since the start of Islamic finance in the country in 1969 with the establishment of the Pilgrim Fund, Islamic finance has grown tremendously to become a truly integral part of the financial system, operating side-by-side with the conventional system. This systematic development has required a huge effort on the part of the regulatory bodies in order to produce a favourable environment for this rapid growth to take shape.

Figure 11: Milestones of Malaysia's Islamic Finance Industry



Sources: GIFF Report 2010, KFHR

As Malaysia moves forward with its economic transformation programme, the demands placed on the financial sector to be an enabler, catalyst and driver of growth will increase. The financial sector as a whole is expected to grow in size, from 4.6 times GDP now to 5–6

times GDP by 2020. The significance of financial markets, relative to funds raised through financial intermediaries such as banks, will continue to rise. In meeting the needs of the new high-value-added economy, the financial sector needs to be developed further and become innovative in its approach in order to facilitate higher levels of domestic and international trade and investment. One such innovative approach is the development of a comprehensive and vibrant Islamic financial industry.

To match this rapid growth, the regulatory authorities have introduced a comprehensive regulatory and supervisory framework for Malaysia's dual financial system. Stronger standards have been set for corporate governance, transparency, disclosure, accountability, market discipline, risk management and customer protection. These various measures put in place by the authorities have enabled Malaysia to be ranked the tenth most competitive nation in the *World Economic Report* by IMD, Switzerland. Some of the domestic regulations introduced include:

- Corporate Governance Guidelines;
- Rate of Return Framework;
- Guidelines on Financial Disclosure;
- *Sharī'ah* Committee Guidelines;
- Islamic Money Market Guidelines;
- Capital Adequacy Standards;
- *Mushārakah* and *Mudārabah*;
- PSIA Risk Absorbent Framework;
- Property Development and Investment Activities; and
- Firewalls for Islamic Window Operations.

To instil financial stability, market discipline and public confidence, the above regulations are married with the following international best practices and guidelines:

- Capital Adequacy Standard (2005);
- Guiding Principles on Risk Management (2005);
- Guiding Principles on Corporate Governance (2006);
- Transparency and Market Discipline (2007);
- Supervisory Review Process (2007);
- Capital Adequacy for *Sukūk*, Securitisation & Real Estate Investment (2009); and
- Guiding Principles on Governance for Islamic Collective Investment Schemes (2009).

A strong *Sharī'ah* framework helps to increase consumer confidence and provides greater flexibility for Islamic financial institutions to be innovative within the boundaries of the *Sharī'ah*. To this effect, Bank Negara Malaysia (BNM) introduced its *Sharī'ah* Governance Framework (SGF).

The SGF outlines the expectations of BNM on Islamic financial institutions' *Sharī'ah* governance structures, processes and arrangements to ensure that all their operations and business activities are in accordance with the *Sharī'ah*. Given the rapid developments in Islamic finance over recent years, the SGF aims to strengthen the *Sharī'ah* governance process, decision-making, accountability and independence of *Sharī'ah* advisories. In this regard, the new SGF will provide comprehensive guidance on the roles and responsibilities of the *Sharī'ah* committee, the board and the management of

Islamic financial institutions to ensure that their operations are in compliance with the *Shari'ah*.

This extraordinary step by the Malaysian central bank is the first attempt in the world at providing a comprehensive framework to regulate all facets of operations of the Islamic financial institutions in accordance with the *Shari'ah*.

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Another initiative by the country's regulatory authorities was to set up an international Islamic financial centre that would help to promote a better understanding of international Islamic finance, as well as take initiatives to make Malaysia a better-regulated and more attractive destination for Islamic finance.

The Malaysia International Islamic Financial Centre (MIFC) initiative launched in 2006 helped to strengthen the country's position as an international hub of Islamic finance. The MIFC initiative comprises a community network of financial and market regulatory bodies, government ministries and agencies, financial institutions, human capital development institutions and professional services companies that are participating in the field of Islamic finance.

Under the MIFC initiative, financial institutions are welcomed to use Malaysia as a platform for their Islamic finance activities, leveraging on the comprehensive system and conducive environment for Islamic finance business available in Malaysia. Various incentives are accessible to financial institutions participating in MIFC, including new licences for conducting foreign currency businesses, attractive tax incentives and facilitative immigration policies.

Overall, these initiatives and regulations have the following effects on the Malaysian Islamic financial system:

- maintain the confidence of the public with IFIs as the custodians of public funds;
- promote a competitive financial system which provides efficient and reliable services;
- ensure the health of each IFI for the development of a sound and stable financial system;
- prevent the risk of a contagion and systemic failure of the financial system;
- promote good market practices and high standards of corporate governance;
- ensure IFIs are managed competently by strong and capable management teams; and
- protect customers' and stakeholders' interests.

Conclusion

It is critical to build the robust components of the financial infrastructure and to strengthen key institutions to ensure the stability and dynamism of the Islamic financial system. In this regard, the IFSB highlights the eight building blocks required for strengthening the Islamic financial infrastructure. Together, they incorporate strong governance, which is crucial to the Islamic finance industry moving ahead. Nevertheless, the leverage of Islamic finance and its sustainability can only be further enhanced by a large, sizeable Islamic financial institution that is able to compete in the global arena against the current large conventional banks.

For Islamic finance to reach the next wave of growth, it must extend to reach the critical mass. Opportunities to get there include the following:

- **A large-scale institution**, which will have all the capabilities to penetrate the various segmented markets with expertise and knowledge while providing *Shari'ah*-compliant financial solutions.
- **Microfinance**, which has the potential to create opportunities for the untapped SME market of the emerging economies and to capture interest in Islamic microfinance needs.
- **Sound regulation** to ensure that Islamic finance has a decent chance of growth and development while expanding to the critical mass.

Some of the remaining challenges to be overcome include the development of human capital, enhancement

of product development, identifying the right opportunities, and the delivery of appropriate returns for the risks involved.

The emerging markets are witnessing robust economic growth, with the SME market remaining an unexploited sector in these territories. This large potential, which is also supported by the growing Muslim population, could propel Islamic finance to the next level.



Baljeet Kaur Grewal is Managing Director & Vice Chairman of Kuwait Finance House Research Ltd. Kuwait Finance House is also the only Islamic bank worldwide with a notable Investment Banking Research presence, instrumental in promoting Islamic banking and facilitating portfolio fund movement globally.

Prior to this, Baljeet was attached to Maybank Group Malaysia, ABN AMRO Bank and Deutsche Bank, London, with her experience ranging from credit structuring, origination and syndication to capital market research. She has broad experience in investment banking, having participated in notable fund-raising transactions in Asia and the Middle East.

To date, she has undertaken research in Islamic finance with a principal focus on debt capital markets and sukuk. She has written and published numerous articles on developing economies and debt markets, world economic growth, and the GCC and South-East Asian economies, and has addressed numerous international conferences and forums.

Baljeet holds a first-class honours degree in International Economics from the University of Hertfordshire, UK and has undertaken extensive research with the London School of Economics and international bodies. She is currently pursuing her Executive MBA at Cambridge University, UK. She is also the recipient of the prestigious Sheikh Rashid al-Maktoum Award for Regional Contribution to Islamic Finance in Asia 2006.

Under Baljeet's leadership, KFH Research has recently won the following awards:

- *Best Research in Islamic Finance, Master of Islamic Funds Awards, Islamic Fund World 2007*
- *New Provider for Islamic Finance Research, KLIFF 2008 Islamic Finance Awards*
- *Best Islamic Research Company, Islamic Finance News Awards Poll 2008*
- *Contribution to Research in Islamic Finance 2008, International Islamic Forum Dubai*
- *Best Islamic Finance Research House, The Asset Triple A awards 2009 Islamic Finance*
- *Best Islamic Finance Research House, The Asset Triple A awards 2010*

