



IFSB Summit 2017

22–24 October 2017 | Abu Dhabi

**Reinvigorating the Momentum of Islamic Finance:
Solidifying Resilience and Sustaining Growth**

PROCEEDINGS

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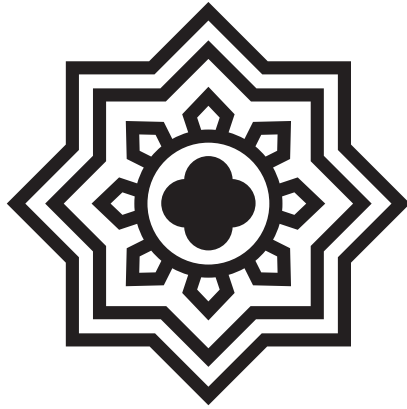


ISLAMIC FINANCIAL SERVICES BOARD

Hosted by



مصرف الإمارات العربية المتحدة المركزي
CENTRAL BANK OF THE U.A.E.



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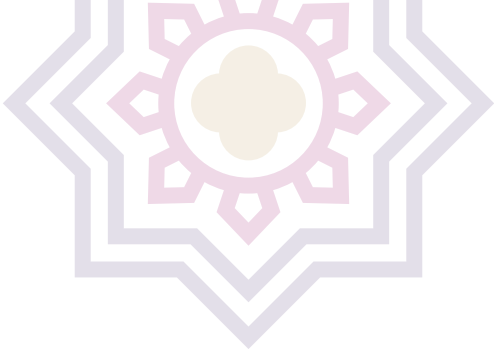


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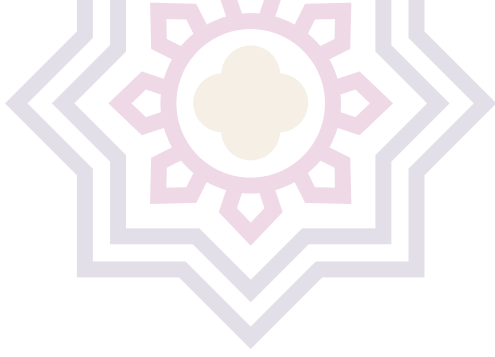
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ISLAMIC FINANCIAL SERVICES BOARD

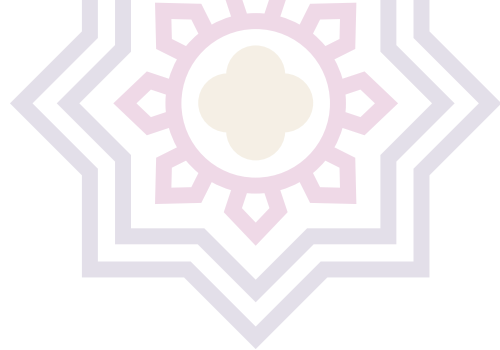
ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

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 market and insurance sectors. The standards prepared by the IFSB follow a stringent due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes holding several Working Group meetings, issuing exposure drafts and organising public hearings/webinars and reviews by the IFSB's Sharī'ah Board and Technical Committee. 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 SUMMIT

The IFSB Summit serves to raise the profile of the IFSB in the international financial arena, as well as to increase global awareness and understanding of the Islamic financial services industry. Since the inaugural Summit in 2004, it has become the IFSB's most important and largest awareness programme. Attendees at the Summit include: governors, directors, board members and chairmen of financial institutions; and chief executive officers, managing directors, senior managers, senior executives, academics and partners from various financial industry segments: banking, insurance/takāful, capital markets, legal and auditing firms, financial service providers and educational institutions. The Summit's theme typically addresses key issues pertinent to the global financial regulatory landscape from the perspective of the Islamic financial services industry, and to its development moving forward.

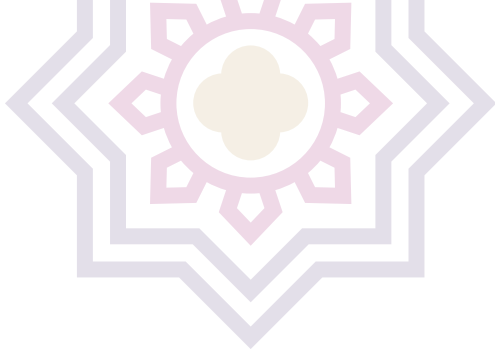


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Preamble

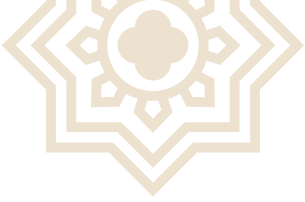
After a modest beginning about 40 years ago, Islamic finance has experienced rapid expansion in a growing number of jurisdictions since the beginning of the 21st century. Islamic banks have achieved market shares of between 15% and 50% in 10 countries (and 100% in two countries where the financial systems were fully Islamised). Islamic banking is on its way to mainstream status in several of those countries. On the other hand, market penetration is significantly below the 15% threshold, and often rather marginal, in about 40 other jurisdictions where Islamic finance is practised. Furthermore, the overall growth rate of Islamic finance – which was close to 20% in past periods – has fallen to high single-digit rates. The performance in some strategically important areas is even worse; for example, the trend for the issuance of corporate *ṣukūk* has been negative over the past few years. It seems that Islamic finance has lost some of its momentum. It is time, therefore, to discuss strategies for reinvigorating the industry so that it remains resilient and able to sustain its growth.

Several factors have contributed to the present situation. Paradoxically, one cause of the slowdown in expansion of Islamic finance is its past success. It is estimated that in many Muslim countries about 15–20% of the population will only accept Sharī'ah-compliant financial products. The penetration rates of Islamic banks have often reached a level that approximates this segment, meaning that the core market is widely covered. For further growth, Islamic financial institutions have to attract, from conventional banks, customers whose requirements differ somewhat from those of the core group. They compare banks and their products in terms of customer experience, product features and price. A growing number of bank customers expect a full range of digital facilities, which reportedly not all Islamic banks can as yet offer. Furthermore, if Islamic and conventional banking products serve the

same purpose, customers of conventional banks do not consider the Sharī'ah compliance of a product a feature that would justify a higher price or lower return. A growing number of conventional bank customers are interested in ethical products, and here Islamic banks could gain an edge provided that Sharī'ah compliance does not mean only a different legal form but also a more ethical substance. Islamic financial institutions might study products traded on a specialised exchange for green or sustainable and responsible investment (SRI) securities in the West to get a better understanding of what is in demand.

The competition with conventional financial institutions for customers has intensified at a time when the external environment for Islamic financial institutions is becoming more difficult. About 80% of Islamic finance is concentrated geographically in the GCC, Iran and Malaysia – that is, in countries where oil exports play a very important role. Persistently low oil prices have curtailed the spending power of governments, dried up excess liquidity, and effected huge budget deficits. Contrary to some expectations, this has boosted conventional debt financing much more than the issuance of sovereign *ṣukūk*. It has become apparent that the structuring of *ṣukūk* takes significantly more time and resources than the issuing of a bond. In countries where the private sector depends on public-sector spending, the government should seek external funds for financing its deficit. While the bond market is global and highly liquid, the same cannot be said for the *ṣukūk* market.

It has been observed of the private sector that corporates – at least in the GCC – prefer financing by banks over capital market instruments because the issuance of a bond or *ṣukūk* requires an uncomfortably high level of disclosure of business details to the public. Should, nonetheless, a corporate consider tapping the capital market as a



PREAMBLE

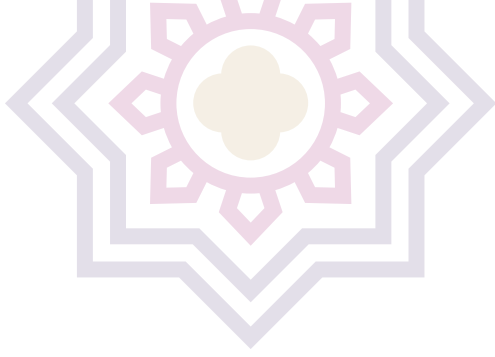
first-time issuer, it will notice that a bond is a rather standardised instrument that does not require much customisation, whereas a *ṣukūk* must be customised due to the necessary involvement of a real asset. This makes the issuance of *ṣukūk* more complex, time-consuming and expensive.

For corporates that are less bothered by disclosure requirements, FinTechs offer new Sharī'ah-compliant financing alternatives through peer-to-peer lending or equity crowdfunding. Regulators generally welcome these new competitors to traditional banks and often offer regulatory sandboxes for time-limited real-life experiments with new business models. Some regulators expect that successful concepts and technologies will also benefit conventional and Islamic banks and their customers. As in conventional banking, FinTechs may disrupt a limited number of business lines of Islamic banks such as payment and remittance services or investment advice, but they will probably not disrupt the core business of banks, financing – at least not as long as the secretive mindset is widespread in the business community. It may be a problem that Islamic banks are not at the forefront of FinTech developments, so that their customers will probably benefit from efficiency gains, cost reductions or enhancements of consumer

experiences through technological advancements later than the customers of competing conventional banks, if they benefit at all.

In addition to the tougher competitive environment, Islamic banks suffer from unresolved long-term structural weaknesses such as insufficient liquidity management tools, and they feel additional pressure from tightened prudential regulations, especially on liquidity. It should give them some relief that regulators and policymakers increasingly recognise the need for lender-of-last-resort facilities, Sharī'ah-compliant deposit insurance schemes, conflict resolution mechanisms, and regular programmes for the issuance of *ṣukūk* that Islamic banks can use as high-quality liquid assets.

The 2017 IFSB Summit has extensively discussed not only the factors that contribute to the observed loss of momentum, but also strategies and measures for a solution, which are summarised in the Conclusions chapter. From there, one can conclude that while regulators do not yet see an imminent threat to the resilience of the Islamic finance industry in general, and Islamic banks in particular, they are concerned about how to resume and sustain growth and enable the industry to deliver on its value proposition.



Opening and Keynote Session

In his opening speech, H.E. Mubarak Rashed Al Mansoori, Governor of the Central Bank of the United Arab Emirates (UAE), noted that his country has had the pleasure of hosting the IFSB Summit for the second time. Islamic finance has progressed exceptionally well in this country since the first full-fledged Islamic bank was established in Dubai in 1975. Building on this remarkable success, Dubai has announced an ambitious strategy to become the world's capital of the Islamic economy. To this end, the Dubai Islamic Economy Development Centre was established in 2013, working with stakeholders to devise and implement programmes and initiatives to turn the vision into a reality.

Islamic Banking and the Islamic Economy in Dubai

By the end of 2017, eight well-capitalised and liquid Islamic banks accounted for approximately 20% of total assets and 24% of total deposits in the banking sector of the UAE. Financing is concentrated in the private sector, particularly in real estate, trade, and small and medium-sized enterprises (SMEs). In addition, infrastructure projects could be beneficiaries of a further growth of Islamic finance. The Central Bank of the UAE supports Islamic banks in managing their liquidity by issuing Islamic certificates of deposit and by availing themselves of the collateralised *murābaḥah* facility, which is a marginal lending facility similar to a discount window.

Islamic banking has become systemically important in the UAE. The asset-based nature of Islamic finance helps to curb excessive leverage, investments in highly leveraged assets and short selling, suggesting that the Islamic model is likely to foster financial stability and render the global financial system less prone to financial distress. This has also been recognised by the International Monetary Fund (IMF)

and the World Bank, which have taken steps to collaborate, innovate and develop the prospects of Islamic finance in a sound and sustainable way.

In spite of its overall success, the growth of Islamic finance has slowed in recent years, and the industry is facing challenges that it needs to address. There is no time for complacency if Islamic finance is to attain its goal of sustainable and inclusive growth.

H.E. Abdullah bin Ahmed Al Saleh, Under-Secretary of the Ministry of Economy for Foreign Trade and Industry of the UAE, highlighted the significant opportunities in the Islamic economic landscape that are available not only in the member countries of the Organisation of Islamic Cooperation (OIC) but globally for all participants in the world economy.

An Islamic economy is obliged to develop outstanding models of good governance. This should not be done in isolation. Instead, it is hoped that participants in the Islamic financial services industry (IFSI) can learn from the experiences of other countries and share knowledge in this regard. Events such as the IFSB summits can serve as a useful platform for sharing knowledge, competencies and best-practice examples in the IFSI.

The progress of Islamic finance in the UAE over the past couple of years is remarkable, and it is expected that the Islamic economy will be an enabler of the coming post-oil phase of the Gulf economies. It will be a major actor in the future economy of the UAE. Various issues have to be addressed in order to advance Islamic economics and finance further. The harmonisation of legal frameworks and the standardisation of dispute resolution mechanisms are high on the agenda. It is encouraging to see the growth of new businesses in the *ḥalāl* industry, but such enterprises need support in order to gain traction. Finally, recently emerging digital platforms



and FinTech companies represent innovative business models and technologies with cost-saving, efficiency-enhancing and service-improving potentials, as well as the potential to disrupt the industry, and thus deserve more attention from a regulatory perspective.

Reinvigorating Momentum, Solidifying Resilience and Sustaining Growth

The Acting Secretary-General of the IFSB, Mr. Zahid ur Rehman Khokher, summarised the impressive growth performance of Islamic finance over the past decade: Islamic banking has grown threefold, *ṣukūk* sixfold and *takāful* fivefold since 2007. But he also emphasised that there is no room for complacency. Islamic banking has reached systemic importance, with a market share of at least 15% in only 12 countries. In the other 35 OIC countries, its share is on average much smaller. The *takāful* sector and *ṣukūk* market have gained significance in only about a dozen countries. Similarly, the corporate *ṣukūk* market remains underdeveloped, and the secondary market is active in only a very few jurisdictions. At the institutional level, Islamic finance has yet to produce a global brand in Islamic banking.

It is time to reinvigorate the momentum of Islamic finance, to solidify its resilience and to sustain its further growth. The IFSB has not only taken various initiatives to support the industry technically, but has also highlighted its ethical underpinnings and efforts to create a just and inclusive financial system, as follows:

- The legal and regulatory environment has to keep pace with the growth and diversification of the sector. For this, the IFSB has developed standards and guidelines compatible with those of other global standard setters, and those pertaining to areas not directly covered by other standard setters.
 - The IFSB supports strategies to enhance access to Islamic financial services for all segments of the population, and especially SMEs, with the help of modern information and communication technologies.
 - Industry players and regulators can contribute to the emergence of Islamic finance as a more secure and less risky model of finance with a deeper qualitative appeal to its customers.
 - The IFSB encourages governments and central banks to intensify their efforts to provide the industry with much-needed, high-quality, Sharī'ah-compliant liquidity instruments, and to link sovereign *ṣukūk* issuance programmes with the national development agenda and monetary policy objectives.
- The IFSB commemorated the 15th anniversary of its establishment on 3 November 2017. As at December 2017, its membership has grown from 9 to 185 members from 57 jurisdictions, covering 75 regulatory and supervisory authorities, eight international inter-governmental organisations (including the Islamic Development Bank [IDB] as a full member and the Asian Development Bank [ADB], Bank for International Settlements [BIS], IMF and World Bank as associate members), and 102 private-sector members such as banks, *takāful* operators, industry associations, professional firms and rating agencies. In the fulfilment of its mandate, the IFSB has been engaged primarily in the issuance of standards and guidances for the industry, in capacity building and in international cooperation.
- a. *Standards and guidances:* The IFSB has issued 27 standards, guiding principles and technical notes to regulate, supervise and promote the stability of all three sectors of the Islamic finance industry. The alignment of Islamic banking regulations with Basel III reforms required the issuance of new standards and revision of earlier ones. In this context, the IFSB issued the Core Principles for Islamic Finance Regulation (CPIFR) (Banking Segment)



in 2015. In a press release, the Executive Board of the IMF announced its willingness to consider the CPIFR as the international standard for the supervision and regulation of Islamic banks and surveillance of Islamic banking systems. The IFSB has begun to draft CPIFR for the Islamic capital market to complement the Core Principles issued by the International Organization of Securities Commissions (IOSCO) for the conventional capital market. To prepare and supplement the standards and guidances, the IFSB has initiated research on topics such as financial safety nets (including Sharī'ah-compliant lender-of-last-resort and Sharī'ah-compliant deposit insurance schemes), consumer protection, Sharī'ah non-compliance risks, and *microtakāful*. The latest work in progress is on resolution, recovery and insolvency in institutions offering Islamic financial services (IIFS), and on *takāful* capital requirements. An empirical study with the IMF and the Arab Monetary Fund will be undertaken on issues of anti-money laundering and combating the financing of terrorism (AML/CFT) relevant for Islamic finance. The IFSB's annual flagship Islamic Financial Services Industry Stability Report has become the most widely referenced industry report in Islamic finance. Since 2003, it has analysed global regulatory developments and the implications for Islamic finance, provided an assessment of the resilience of the various segments of the Islamic finance industry, and highlighted emerging issues in Islamic finance.

- b. *Capacity building*: The IFSB encourages its members and stakeholders to implement the Core Principles as well as other standards and guidelines that will help regulators and supervisors to identify gaps in their supervision regimes. The IFSB offers its member jurisdictions technical assistance to adopt its standards by means of workshops, policy advice, e-learning modules and outreach programmes.
- c. *International cooperation*: The IFSB regularly organises events in various regions globally (such

as this Summit) to strengthen international cooperation among supervisory agencies, the private sector and other stakeholders. On an institutional level, the IFSB teams with international partners for projects such as the joint publication of a book on *takāful* with the World Bank, or on financial safety nets with the International Shariah Research Academy for Islamic Finance (ISRA), supported by the ADB. Another international cooperation project is the Prudential and Structural Islamic Financial Indicators (PSIFIs) database, comparable to the IMF's Financial Soundness Indicators (FSIs). Currently, 21 countries and three international organisations (ADB, IDB and IMF) are part of its Task Force. These countries collect, review and disseminate quarterly data on the Islamic banking industry which are published on the IFSB's website. With 15 quarters of data (as of December 2017) for about 35 indicators and coverage of over 90% of global Islamic banking, the PSIFIs are the most reliable and consistent database of macro-level statistics for the Islamic banking industry. Already, work has started on an expansion to cover *takāful* and the Islamic capital market.

Evolution of Islamic Banking: Historic Forks and the Trail Ahead

In his keynote address, Mr. Iqbal Khan, Chief Executive Officer of Fajr Capital, provided a historical perspective on Islamic finance by quoting a leading publication which in 1984 made a rather dire prediction for the growth of the industry when it said, "the Quran in one hand, the calculator in another: will the Prophet's profit rise or fall." As the Islamic finance industry grew, support came from another source linking the Islamic finance movement as a continuation of the corporate social responsibility (CSR) tradition of other religions. Dr. Paul Mills, in his seminal work entitled "Interest in the Monotheistic Scriptures and its Impact on Modern Financial Systems", regarded Islamic finance as a continuation of the Abrahamic faiths' prohibition on interest and the continuation of



the CSR traditions of all faiths. After paying tribute to the founders of the Islamic finance industry, Mr. Khan stated that the true essence of Islamic finance is about serving communities, not markets.

If one were to look at the Islamic finance industry from a mountaineering perspective, the industry could be seen to be somewhere around halfway up the mountain. Looking down from that perspective, it is evident that, in the 1970s, the industry had two decision points at the “foot of the mountain”: (a) start the journey and build the framework as growth of the industry dictated; or (b) wait for the ideal framework before launching the industry. The founders wisely decided to start the journey. Had they not done so, we would still be waiting for the Islamic finance industry to be launched under an ideal framework. However, there was another fork on the road up the mountain, which was the choice between a banking model and the asset management model. The founders chose the well-travelled path of the banking model and therefore created the Sharī’ah-compliant banking system.

From a historical perspective, the 1970s were a time of huge enthusiasm for Islamic finance as a consumer-to-business (C2B) model. The industry was driven by the strong and deep commitment of retail investors, with a strong focus on *muḍārabah* and *mushārah* contracts. However, the industry was not ready, and in the 1980s, after considerable difficulties, it shifted to the *murābahah*, *istiṣnā’* and *ijārah* contracts as modes of financing. In the same period, syndications of cross-border risks in Islamic countries became a solution for the growth and development of many OIC economies. During this period, Islamic finance became the provider of cross-border lines in a range of countries, called the “IDB Member countries”. This premise was based on the fact that when you are close to risk, you can understand it better and therefore also price it better. This premise became the competitive relevance of the Islamic finance industry. In the 1990s the industry saw the opening up of equity as an asset class, which led to further growth. At the turn of the century, in the year 2000 and beyond, *shukūk* became a leading mode of financing. By 2010,

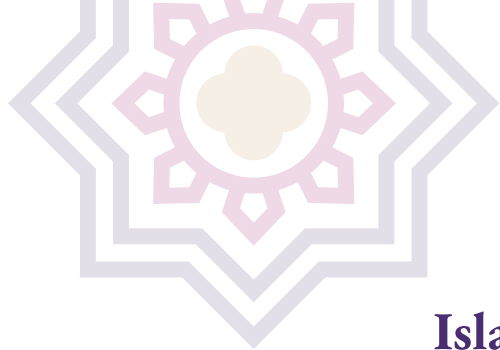
the focus of the industry was also on connecting the financial sector to the real economy. The overall size of the industry in this period increased notably, from around USD 200 billion at the beginning of the millennium to an estimated USD 2.8 trillion today. Islamic banking holds a 75% market share, while *shukūk* accounts for 16%, followed by Islamic funds at 4%, and *takāful* and Islamic microfinance each with a 1% share. To date, we have created Islamic finance in the shade of the conventional banking system, with the industry offering an alternate form of banking and successfully managing to democratise financing.

However, if we look up the mountain, we see the broadening and deepening of the Islamic finance industry and the opening up to Islamic finance of institutional investors, such as sovereign wealth funds, pension funds and endowment funds, which are increasingly playing an important role in the growth and future development of this industry. In addition, the committed retail investors who started the industry are going back to their corporate constituencies and demanding that their funds be managed in a Sharī’ah-compliant manner. In this period, we have also seen the growth of asset management in the real economy and further alignment with ethical and CSR investors. However, for the Islamic finance industry to create a demonstration effect would require greater transparency and authenticity. For Islamic financial institutions to grow further, they will need to create fortress balance sheets and build a dashboard of leading indicators.

At the macroeconomic level, aligning with the reform of the financial architecture as proposed by both the Volcker’s and Vickers reports requires the industry to move towards narrow banking, based on a *muḍārabah*-linked financial intermediation with safekeeping and narrow banks taking care of basic banking services and controlling the payment system. Looking up the mountain, we also see the opportunity for the evolution of the business model to shift to cooperative finance, mutuality and participation finance in terms of both financing and investment.



The fact that around 70% of the world's 2.8 billion Muslims are still underbanked, and a larger proportion of that population are underinsured from all forms of *takāful* policies, highlights the importance of democratisation of wealth, microfinance and philanthropy. Educational institutions such as the International Centre for Education in Islamic Finance (INCEIF) will play a vital role, under the guidance of industry-building institutions, in driving this shift and creating a role-model financial institution that can create a demonstration effect.



SESSION 1

Islamic Finance: From Niche to Mainstream

The first panel session was chaired by H.E. Dr. Abdulrahman Al Hamidy, Director General and Chairman of the Board, Arab Monetary Fund. The panelists were Mr. Irfan Siddiqui, President and Chief Executive Officer, Meezan Bank Limited, Pakistan; Dr. Mohamed Damak, Senior Director, Global Head of Islamic Finance, S&P Global Ratings, UAE; and Sheikh Osaid Mohammed Adeeb Kailani, Global Head of Shari'a, Abu Dhabi Islamic Bank, UAE.

Islamic banking started about 40 years ago in a market niche, where it remained for roughly two decades with a relatively small number of Islamic banks with moderate asset volumes. However, since the turn of the century, the number and size of Islamic banks has grown rapidly so that Islamic banking has come out of the niche and moved towards the mainstream in a number of jurisdictions. It is of systemic significance in more than 12 countries where the market share of Islamic banks has reached a threshold of 15%. The recent progress of Dubai has already been mentioned, while the case of Meezan Bank in Pakistan is another example of the rapid movement from niche to mainstream. However, not all sectors of Islamic finance have developed in this manner. *Takāful* is still a niche product in most Islamic countries, as is the market for sovereign *shukūk* (with the notable exception of Malaysia). A lack of standardisation has been identified as the major obstacle inhibiting more rapid development of *shukūk* markets at the national and global levels.

Islamic Banking on the Way to the Mainstream in Pakistan

The successful growth of Meezan Bank can be taken as an indication that Islamic banking has the potential to become mainstream and to overtake conventional banking in Pakistan. Meezan Bank was the first Islamic bank in the country when it started operations

in 2002. It is now its largest Islamic bank, and the seventh largest bank overall. Its growth was fuelled by a huge demand for Sharī'ah-compliant banking services. The market penetration is about to reach 15%. A further increase to 30–40% over the next five years is possible, but may be impeded by physical limitations such as the time and resources needed to establish new branches and train human resources, as well as by the non-availability of sovereign *shukūk* for the investment of surplus funds.

Although Meezan Bank is sometimes criticised for offering products that are reminiscent of their conventional counterparts, its customers are satisfied with them because of the assurances given by prominent scholars serving on the bank's Sharī'ah board as to the products' Sharī'ah compliance. Proponents of more profit and loss sharing in Islamic banking ignore the fact that the average customer is neither able nor willing to take on more risk when they may not fully understand the products. There is certainly a need for more consumer education; however, for the time being, depositors want some return and capital protection. Such a combination cannot be provided contractually, for Sharī'ah reasons, but a cautious investment policy could minimise risks and provide factual capital protection.

Financing on the basis of trade contracts is an adequate strategy, but investments in higher-yielding sovereign *shukūk* would be even better. However, although Islamic banks have urged the government to launch a programme of regular *shukūk* issuances, such a thing does not yet exist. As the products of Islamic banks look similar to those of conventional banks, Islamic banks have to offer comparable prices, and in the interest of consumer protection and systemic stability Islamic banks should be regulated as stringently as conventional banks. Regulation shall, among other aims, enhance transparency for



consumers. Combined with consumer education initiatives, it may be possible that, in the future, informed consumers will opt for “true” profit-and-loss sharing investment accounts as they have been introduced in Malaysia. This may help to create a more distinct profile of Islamic banking when it progresses further on its way to the mainstream in Pakistan.

From Islamic Banking to Islamic Economy in Dubai

Building on the success of Islamic banking in the UAE, the government has decided to make Dubai the capital of the Islamic economy. Islamic finance on its way from niche to mainstream is not progressing at the same speed in all three sectors. Islamic banking has been advancing considerably faster than the Islamic capital market and *takāful*. In the *ṣukūk* market, structures have shifted from those that require more tangible assets towards others that require less, and innovation is ongoing.

The infrastructure of the *takāful* sector is incomplete or barely existent in many countries. Its growth would benefit from a more supportive legal and regulatory environment, not only for *takāful* itself but also for Islamic pension funds, *waqf* and Shari‘ah-compliant trusts. Furthermore, more specific Shari‘ah standards for these areas should be developed.

Shari‘ah standards – and adherence to them – could also reduce what has been called a “*fatwā* risk”. It may exist in cases where:

- the Shari‘ah board of an Islamic financial institution includes members with less capable Shari‘ah scholars;
- a *fatwā* was given by minority members of the Shari‘ah board; or
- the product structure that was approved by the Shari‘ah board is different from the structure that is actually implemented by the management.

To achieve mainstream status, Islamic financial institutions should adopt ambitious consumer protection policies. They must ensure that Islamic products differ from conventional ones not only in form, but also in substance. In particular, Islamic products should advance the benefit (*maṣlaḥah*) of consumers. The employees of Islamic financial institutions should be qualified to explain to a consumer how the specificities of a product meet their particular requirements.

Customers should be given sufficient explanations about the structure of a product and ample time to understand all their rights and obligations before signing a contract. Should the need arise after the product sale, channels should be available for the customer to give feedback to the Islamic financial institution and to approach its Shari‘ah department, especially in cases where flaws have been detected in the product structure. Customers, regulators, management and Shari‘ah bodies of the Islamic financial institution should cooperate to reduce mistakes and improve corporate governance in the interests of a sound and flourishing IFSI.

Mainstreaming *Ṣukūk* by Standardisation

Globalisation of the Islamic finance industry would benefit substantially from globalisation of the Islamic capital market. The *ṣukūk* markets experienced remarkable growth in the years following the financial crisis, but growth has slowed in recent years. To bring it closer to the mainstream, more standardisation is required in the *ṣukūk* market. Its high complexity and the lack of standardisation are the main obstacles to mainstreaming the Islamic capital market. In some countries (e.g. the UK and Turkey), it took years from the initial announcement to the actual issuance of the first sovereign *ṣukūk*; others (e.g. Kenya and some West African countries) backed off once they realised the complexity of a *ṣukūk* issuance. They had to understand that *ṣukūk* are not “Islamic bonds”. They are very different in substance from conventional



bonds and include risks of underlying assets that do not exist in bonds. Therefore, rating agencies had to develop specific *ṣukūk* rating methodologies that differ from bond ratings.

Time to market can be shortened for recurrent issuances when the maiden *ṣukūk* can be taken as a template for following *ṣukūk*. Similar results could be achieved for first-time issuances by the standardisation of legal documentation and of Shari'ah interpretations that could lead to a type of model contract. Standard setters such as the IFSB and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have prepared the ground, but national regulators have to implement their standards.

On its way to the mainstream, Islamic banking is facing new challenges from potentially disruptive FinTechs. The probability of a disruption is high for the money transfer and payments business, but less so for the financing business of Islamic banks in the GCC and MENA regions. There are some FinTechs active in SME financing through peer-to-peer lending or crowdfunding platforms, but they will not disrupt the financing business of banks. First, businesses in the GCC and MENA regions prefer financing through banks, which require less public disclosure than financing platforms. Second, banks concentrate the financing on large incorporates and often neglect SMEs.



SESSION 2

The FinTech Innovative Progression: Boon or Bane for Traditional Financial Institutions?

The session was chaired by Ms. Vineeta Tan, Editor, Islamic Finance News, Malaysia. Presentations were made by H.E. Chuchi G. Fonacier, Deputy Governor, Supervision and Examination Sector, Bangko Sentral ng Pilipinas (BSP); Mr. Luke Ombara, Director, Regulatory Policy and Strategy, Capital Markets Authority, Kenya; and Mr. Craig Moore, Founder and Chief Executive Officer of Beehive Group, UAE.

In 2017, *Islamic Finance News* (IFN) tried to map every Islamic FinTech entity globally. Over 100 FinTechs have been identified in various markets, with the UAE one of the top five jurisdictions in the world in terms of FinTech companies for Islamic finance. However, the pioneer of FinTech in the developing world is Kenya.

Kenya's M-Pesa project used text messages sent via simple mobile phones for the transfer of money and other basic financial services. It was a great success in terms of financial inclusion of people with no bank access. As more people became bankable, traditional financial institutions also benefited from the project. The government has recently initiated the sale of retail bonds in small denominations through mobile channels. In principle, a similar project for retail *ṣukūk* is conceivable. In the Philippines, FinTech start-ups usually cooperate with traditional financial institutions – conventional as well as Islamic – in the development of applications that can reduce costs, enhance efficiency and improve the customer experience in banking. In the UAE, a crowdlending platform has been established that could have a disruptive potential for traditional banks. However, the platform focuses on the financing of SMEs, which are not a prime target group for traditional banks. The amounts provided through the platform are relatively small, while the traditional banks prefer larger tickets, which are more cost-effective. So far, crowdfunding is a kind of complement to bank financing in the UAE.

Kenya: From Mobile Banking to FinTech

Kenya is the pioneer of an inclusive banking model based on information and communication technology (ICT). The FinTech success story happened at a time when mobile phones were not yet smart but had only short message service (SMS) capabilities.

M-Pesa, M-Akiba and Regulation

The government started the M-Pesa project in 2007 with the aim of boosting financial inclusion. M-Pesa facilitated the transfer of small amounts of money through SMS, the withdrawal and deposit of money through bank agents, and the taking out of small loans. By June 2017, M-Pesa had 130,000 bank agents in Kenya and 287,000 worldwide, the number of active customers had grown to 21 million, and Kenya had the highest level of financial inclusion of any country: 86%. Ten years after M-Pesa, the government launched M-Akiba to facilitate the purchase of Treasury bonds by retail investors in small amounts via mobile phone. While traditional banks were offering interest rates of 3–5%, M-Akiba paid 10%. Such a huge difference means that retail banks will come under pressure when the government raises USD 50 million through retail bonds.

The financial sector is regulated by different authorities. The following are of particular relevance for FinTech:

- Central Bank of Kenya, in charge of the issuance of payment service provider licences, the authorisation of banks' mobile service solutions, the registration of mobile money transfer platforms, the registration of deposit-taking microfinance institutions, and AML and know your customer (KYC) regulations;



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- Capital Markets Authority (CMA), in charge of public offer exemption regimes and AML/KYC; and
- Communications Authority, in charge of the registration of platforms offering crowdfunding services by information over communication systems through short code services.

The Kenyan government and regulators support the application of advanced ICT in the finance sector. The CMA is preparing the ground for a regulatory sandbox for FinTech start-ups.

ICT and FinTech for Islamic Finance

ICT and FinTech can make Islamic finance more accessible to the masses. The geographic outreach of Islamic financial institutions could be extended throughout Kenya. The already high inclusion rate could be increased even further when Islamic financial services come within reach of Muslims who excluded themselves voluntarily from the *ribā*-based conventional financial system. The concept of the M-Akiba bond could be replicated for Shari'ah-compliant retail *sukūk*; underutilised Islamic capital could be harnessed for social development through crowdfunding and pooled funds; and FinTech can bring innovations to Islamic social finance and SME financing.

However, a number of challenges have to be addressed. Discussions on the Shari'ah compliance of major elements of FinTech, such as blockchain technology, cryptocurrencies and smart contracts, as well as on appropriate Shari'ah governance structures, are ongoing. An enabling environment for Islamic FinTechs requires a holistic approach that includes:

- proportionate licensing requirements;
- access to Islamic finance and Shari'ah expertise for product development;
- a sandbox for “disruptive” FinTechs;
- partnering financial institutions for “enabling” FinTechs; and

- a path for the graduation of successful FinTechs from the sandbox to incubators and accelerators.

Finally, the FinTech oversight must include a robust AML and KYC regime, measures to reduce cyber risk, provisions to enhance data privacy, and safeguards for systemic stability. To achieve all this, Kenya brings together the industry, policymakers and regulators in its collaborative approach to regulation.

Partnership-type FinTech in the Philippines

FinTech companies in the Philippines are active in mobile wallet applications, remittance platforms, digital payment systems, peer-to-peer transfer schemes, loan origination systems, credit scoring and digital KYC. A social media platform provides an additional channel for the secure and convenient delivery of financial services. A first microfinance investment platform shall soon become operational, as well as a digital cash system.

Innovation-friendly Regulation

Bangko Sentral ng Pilipinas (BSP) supports FinTech by an innovation-friendly regulatory approach based on three principles.

- Risk-based, proportionate and fair regulation is calibrated according to identified risks in defined activities and not based on the type of entity that delivers them. This principle promotes a level playing field and ensures that beneficial innovations are not hampered by excessive compliance requirements.
- Multi-stakeholder collaboration is necessary to ensure the consistency of policies and to prevent regulatory arbitrage in an area with a multiplicity of players and multidimensional relationships between FinTechs and financial sector players. The continuing engagement with industry players also fosters a shared understanding of risks, financial inclusion goals and market conduct expectations.



- Consumer protection shall ensure that innovations work to the benefit of consumers, especially the most vulnerable ones and those availing themselves of financial services for the first time. Transparency, product suitability, security and confidentiality must be paramount considerations in the design and development of digital solutions.

Sandbox, National Retail Payment System and RegTech

BSP has created a regulatory sandbox to enable FinTechs that conduct businesses, such as crowdfunding and peer-to-peer lending, for which specific regulations do not yet exist to operate in a live environment during an experimental phase.

BSP is not only developing a regulatory environment, but has also participated itself in a FinTech project launched in 2015, the National Retail Payment System (NRPS). The NRPS aims to establish a safe, efficient, reliable and affordable retail payment system for all kinds of payments and fund transfers between accounts, as well as for international remittances using any digital device. BSP is also engaged in the development of RegTech solutions for data transmissions to the central bank and for automated complaint handling through a digital portal.

FinTechs are less disruptive but more of a partnership type in the Philippines where they develop solutions (e.g. for loan origination) that can also be used by banks so that, in the last instance, consumers will benefit from more convenience, wider choices and lower prices. The digital transformation of the Philippine banking system will benefit conventional as well as Islamic financial institutions and their customers.

Shari'ah-compliant Crowdfunding for SMEs in the UAE

The peer-to-peer (P2P) lending platform Beehive was launched in 2014 and offers both conventional and Islamic financing. It became the first platform globally

to be independently certified as Shari'ah-compliant in 2015. The majority of funding requests coming to the platform are for Shari'ah-compliant financing.

Focus on SMEs

SMEs are among the greatest drivers of GDP growth and employment. They account for about 60% of GDP in the UAE and for 90% of employment. However, financing of SMEs makes up only 3–4% of the banks' balance sheets. This indicates a disconnect between SMEs and bank financing. In many countries, including the UAE, SMEs struggle to get financing at a reasonable price, or even at all. Beehive tries to give SMEs access to finance at a reasonable cost and – probably more important – with reasonable speed. For SMEs, the costs of finance are important, but time to finance is often an even more critical factor.

Like a bank, Beehive analyses financial data and assesses the credit and business risk of a loan application by an SME through a proprietary quantitative credit-scoring model. Projects with a positive outcome based on this procedure will be put on the P2P platform, where they become open to investors who are willing to lend to the business. The SME sets a target amount to be raised and provides potential investors with information on its business plan. Investors can then decide whether and how much they are willing to lend to the SME. They can allocate relatively small amounts (with a minimum of USD 25) to an individual project and diversify their risk by spreading their total investable funds over many different projects. Once a sufficient number of investors have subscribed so that the target amount is reached, the collected funds will be transferred to the SME. The SME will repay the capital plus interest for a conventional loan or profit shares for a Shari'ah-compliant financing according to an agreed schedule.

P2P SME Financing as a New Asset Class

Beehive has opened up a new asset class for Islamic investors that is uncorrelated to the usual Shari'ah-compliant equities, *sukūk* or real estate. It channels Islamic liquidity into the SME sector, which is the engine of growth of the real economy, and thus creates a



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win-win situation. The new asset class offers attractive returns of high single or low double-digit rates.

Now in its third year, Beehive's financing has reached approximately USD 30 million per year, and the rate of defaults and non-performing loans stands at approximately 1.2% – a good result compared to the banking industry. Beehive targets the top 20% of SMEs in any market and aims to become the “lender of first resort” for this target group. Therefore, Beehive is quite selective, but applications from strong SMEs that do not make it onto its platform still have a fair chance of getting bank financing. The difference is that they will have to pay a higher rate. The average cost at Beehive is around 12.5%, compared to more than 17–18% for an unsecured bank loan, meaning a cost saving of 25–30%. Once all the required information is received by Beehive from the SME, the decision on whether to admit the SME to the platform is typically taken within 48–72 hours.

Competition, Complementarity and Regulation

Beehive is a new competitor to banks, but only in a very limited segment. This segment is not of particular interest to larger banks because of the relatively small average size of the SME loans. Furthermore, the Beehive's opening up of a new Sharī'ah-compliant asset class also benefits Islamic banks. In some Western countries, banks and other institutional

investors have started to invest through platforms in SMEs that have gone through a project assessment by the platform operator. This makes the P2P and crowdfunding platforms far less disruptive in the SME realm than may initially appear to be the case, and can even create opportunities for cooperation.

On the other hand, a number of well-established platform operators have found it attractive to expand their lending business beyond the platform and to add current accounts, debit cards, remittances and more to their range of services. For this they need a banking licence. As a result, lending platforms may have disrupted some individual banks, but they have not disrupted banking.

The challenge of FinTechs for the regulators is that the regulatory systems were originally built around financial intermediaries – in particular, banks – that needed strong risk management capacities, capital buffers, liquidity management facilities, etc. Now the regulators have to deal with platforms that neither have nor need any of these controls. This requires a shift of the risk perspective: from prudential risks to consumer/investor risks as well as greater focus on conduct of business or reputational risks of the platforms. It falls within the regulators' mandate to ensure that the users' risks of platform services are well understood and mitigated.

Implementing New Regulatory Reforms: Achieving a Balance between the Soundness and Competitiveness of Institutions offering Islamic Financial Services (IIFS)

The session was chaired by H.E. Dr. Zamir Iqbal, Vice President Finance and Chief Financial Officer, Islamic Development Bank. The panelists were H.E. Jameel Ahmad, Deputy Governor, State Bank of Pakistan; Mr. Jaseem Ahmed, Former Secretary-General of the IFSB; Mr. James O'Brien, Head of Regulatory Development, Banking Supervision, Central Bank of the UAE; and Mr. Ghiath Shabsigh, Assistant Director, Monetary and Capital Markets Department, International Monetary Fund.

Regulatory systems are not static. They evolve continuously in reaction to changes in the financial markets. Regulators and international standard setters do react to lessons learned from financial crises, but they are also forward-looking and adapt regulations to new technologies and business models.

Regulatory Reforms in Pakistan

The State Bank of Pakistan (SBP) follows a unified regulatory approach, with a similar set of standards and regulatory requirements for both conventional and Islamic banks. An exception is made in the case of a few specific regulations for Islamic financial institutions only, such as instructions for profit and loss distribution.

The SBP has revisited the regulatory requirements for Islamic financial institutions, revised some of the prudential regulations, and issued additional guidelines for risk management, profit and loss distribution, and pool management for Islamic banks. Pakistan is one of the few countries to have issued a detailed Shari'ah governance framework. The SBP has also examined its own supervisory approach and strengthened on-site inspections with a focus on Shari'ah compliance as well as off-site supervision. The SBP has developed a monitoring framework with financial soundness indicators for conventional and

Islamic banks, including capital adequacy ratios, non-performing financing ratios, liquidity ratios, profitability ratios, and so forth. Finally, the SBP has developed a stress-testing framework for the central bank as well as for conventional and Islamic financial institutions.

The implementation of the IFSB standards in Pakistan is progressing, but further actions have to be taken. The *Guiding Principles on Stress Testing (IFSB-13)* and *Guiding Principles on Shari'ah Governance Systems (IFSB-10)* have been broadly adopted. The *Standard on Disclosure to Promote Transparency and Market Discipline (IFSB-4)* has also been broadly implemented. The *Revised Capital Adequacy Standard (IFSB-15)* and the *Guiding Principles on Conduct of Business (IFSB-9)* are under review.

The soundness and competitiveness of Islamic financial institutions are not always in full harmony. Increasing competition may tend to increase risk-taking incentives and, consequently, the probability of bank failure. Therefore, effective financial regulations and safety nets shall ensure an appropriate balance between competitiveness and stability. Effective Shari'ah governance is key in this regard. Ensuring Shari'ah compliance should minimise the negative externalities of innovation and create stronger links between financial intermediaries and the real economy. Other key areas include ensuring that: (i) regulations are flexible and able to cater for changes in infrastructure and the legal environment, as well as for innovation, complemented by regular monitoring; (ii) there is effective coordination between the regulators of the financial sector; and (iii) transparency and disclosure requirements are enhanced.

Issues to be considered going forward include the issuance and consistent implementation of further standards, the development of an efficient liquidity framework, and enhancement of transparency.



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- Further standards that should be issued include: a framework for systemically important Islamic financial institutions; an Islamic financial institutions resolution framework to address specific features of Islamic banking that differ from those of conventional banks; and guidance on cross-border and consolidated supervision and financial safety nets.
- More attention needs to be given to the consistent implementation of IFSB standards across jurisdictions. Differences may be due to specific legal and regulatory requirements in a particular jurisdiction, but also may arise from differences in understanding and interpretation of parts of the standards. For balance to be achieved between soundness and competitiveness, a consistent implementation of standards across jurisdictions is important.
- An efficient liquidity framework is essential for a sound and competitive Islamic financial system.
- Better disclosure and improved transparency should be achieved by enhanced information systems at both the institutional and the systemic level.

Regulatory Evolution in the UAE

The evolution of Islamic finance in the UAE began with the establishment of Dubai Islamic Bank in 1975. Since then, Islamic finance has gone from niche to mainstream. By the end of 2017, eight Islamic banks and 23 Islamic windows of conventional banks were active in the UAE. Islamic bank deposits represent almost 24% of total deposits of UAE banks, and Islamic bank assets are around 21% of total UAE bank assets.

Six Pillars of the UAE Regulatory Framework

Following a recent extensive stock-taking exercise, regulation in the UAE (as laid down in the Central Bank Law) has been based on six pillars:

- a. Risk management in institutions starts with risk appetite statements and requires a comprehensive risk governance infrastructure.
- b. Basel III compliant liquidity requirements and capital regulations have been implemented.
- c. The Central Bank of the UAE (CBUAE) assesses the internal control system of banks – in particular, their compliance and internal audit functions.
- d. The CBUAE has established a resolution and recovery system and a deposit protection scheme, supplemented by efforts to minimise moral hazard induced by safety nets.
- e. The CBUAE deals with new developments in the market, such as FinTech. For example, in a regulation on digital payments the CBUAE brought together telcos, FinTechs and banks to support financial inclusion and financial sector development. More recently, a regulation on crowdfunding and support for SME financing has been drafted and shall soon be issued.
- f. The overarching and most important pillar of the UAE regulatory framework is corporate governance. The CBUAE has placed great emphasis on how corporate governance structures – that is, institutional structures, processes and the organisational culture – have been designed and implemented. This will include, for example, governance regulations to ensure that the remuneration of top executives is aligned with the long-term sustainability of the institution. Another challenge is the integration of Sharī'ah governance into the overall governance structure and operational processes (including internal audit and compliance). The regulator aims at a cohesive governance system that is based on the organisation's culture.



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The UAE does not have a separate legal document with regulations for Islamic banks. Instead, specificities of Islamic financial institutions are covered by separate articles in each regulation or standard. Given the size of the sector, a specific set of Islamic finance regulations may be considered in the future.

Support for Islamic Finance

The CBUAE supports the liquidity management of Islamic banks in several ways.

- The CBUAE has made Sharī'ah-compliant certificates of deposit (ICD) available to Islamic banks since 2010. Besides being liquidity management tools, ICDs are also used as monetary policy instruments by the CBUAE. The tenors of ICDs range from one week to five years. They are primarily issued in AED, but (depending on demand) also in USD and (for longer tenors) in EUR.
- In 2014, the CBUAE introduced an Interim Marginal Lending Facility (IMLF) for banks. The facility allows banks to borrow from CBUAE on an overnight basis through a tri-party collateral management agreement signed with either Clearstream or Euroclear. In 2015, a Sharī'ah-compliant IMLF was introduced which extends the eligible collateral that can be used to include Sharī'ah-compliant securities.
- When introducing the Basel III liquidity regulations in the UAE, the CBUAE took a proportionate approach (now also discussed within the Basel committee): the Basel III liquidity requirements were only applied to internationally active banks in the UAE. Less sophisticated and locally focused smaller banks are exempted from the complex requirements. Instead, they have to observe the Eligible Liquid Assets Ratio, which is a simple percentage of total liabilities to be held in liquid form.

The latest significant regulatory development for the Islamic banking sector is the establishment of the Higher Sharī'ah Authority (HSA), which was approved by the UAE government in 2016, and launched in February 2018. The HSA will deal with matters brought to it by the CBUAE as well as by Islamic financial institutions. The CBUAE will consult the HSA in matters relating to:

- prudential regulations for the Islamic finance sector;
- Sharī'ah-compliant products or instruments for central banking and monetary management functions; and
- Sharī'ah matters arising from the Sharī'ah audit of the Islamic financial services of the financial institutions under the regulation and supervision of CBUAE.

Any Islamic financial institution can refer to the HSA for Sharī'ah assistance and opinion. The HSA may pass rulings (*fatāwā*), resolutions and recommendations. Financial institutions can also refer to the HSA in case of any dispute between its Sharī'ah board and management.

The CBUAE expects that the HSA will contribute to the much-needed standardisation, transparency and consistency of the Islamic finance industry, and facilitate the more rapid development of new products and services. This shall have a very positive impact on the overall development of Islamic finance in the UAE.



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From Intrusive to Dialogic Regulation

It has always been a major challenge for regulators to balance growth with soundness. There are valid arguments for both viewpoints. The industry will argue for less regulation and greater freedom to conduct business, whereas regulators are concerned with risks and therefore tend to be more heavy-handed. In the post-crisis period, the regulatory approach has become very intrusive, yet it is debatable whether regulation in itself can prevent the next crisis. What is really needed is a change of behaviour – that is, of governance and culture. However, regulators who focus on this solution have to recognise the difficulty of changing governance and culture.

Financial institutions and regulators should enter into a dialogue in order to find a balance between competitiveness and soundness – that is, between growth and regulatory oversight. Regulators should make efforts to better understand business models and their inherent risks and try to contain them by issuing proportionate regulations. Transparency and consistency of business models and regulations are necessary to achieve credibility and create trust in financial institutions and the regulatory system. Good corporate governance is paramount for long-term success and sustainability. If trust is lacking, regulators often revert to a conservative fall-back position with less or no regulatory innovation. The principle of proportionality is embedded in the regulatory development agenda of the CBUAE with a focus on the risks posed to the soundness of the financial system and to consumers. Finding an equilibrium between growth and soundness is challenging, but by demonstrating good corporate governance and keeping the dialogue going between the industry and the regulator, the regulator can restore confidence in the industry, which will help in finding a reasonable balance between growth and regulatory oversight.

A recent example of a dialogic regulation is the FinTech space. Explanations of business models by FinTech start-ups and the establishment of regulatory sandboxes support a better mutual understanding and appropriate regulation that protects systemic stability

and consumers without imposing undue restrictions on the development of innovative products and business concepts.

From Crisis to Crisis: Lessons for Regulators

September 2017 marks not only the 10th anniversary of the global financial crisis, but also the 20th anniversary of the Asian financial crisis. Lessons should be learned from both crises.

Time magazine condensed a widely held sentiment of the late 1990s onto a title page that depicted three men as “the Committee to Save the World” after the Asian crisis. The three men (Alan Greenspan, Robert Rubin and Larry Summers) represented two American institutions: the Federal Reserve System and the US Treasury. Multilateral institutions and Asian leaders were strikingly absent. Ten years later after the global financial crisis, such a composition would no longer be expected. Strong emerging markets and international organisations were indispensable in containing and overcoming the crisis. The committee to save the world today would look very different. All its members would be women, and it would comprise leaders of the Federal Reserve System (Janet Yellen and Lael Brainard), the IMF (Christine Lagarde), and Malaysia (Dr. Zeti Akhtar Aziz, former central bank governor) as a crisis-tested emerging market.

Aggravation of Crises by Powerless Regulators

Regulators should learn a fundamental lesson from a dramatic event at the beginning of the global financial crisis. A medium-sized but rapidly expanding bank, Northern Rock, ran into difficulties in meeting the liquidity demands of its depositors when its capital market funding faltered in the course of the unfolding financial crisis. A run by depositors was in the making, which the Bank of England tried to prevent by announcing a rescue package for the bank. However, instead of preventing the run, the announcement instigated it by revealing the weakness of the existing deposit protection system, which covered only £2,000. It was completely rational, therefore, for depositors to try to get their money out as soon as possible. The Bank of England realised that the



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UK's bankruptcy law did not provide for the resolution of banks; it was applicable only to corporates. This implied that the Bank of England could either close down or nationalise the bank; it had no means to keep parts of it going, recapitalise it and bail-in creditors. These instruments simply did not exist. Hence, the lender-of-last-resort (LOLR) function turned out to be futile. It became apparent that a medium-sized bank could become a systemic risk in the most sophisticated financial system in the world, which the most sophisticated central bank had serious difficulty in containing. In essence, the regulator had long been lulled into a false sense of security and complacency before the crisis hit. If it can happen in such an advanced jurisdiction, it can happen anywhere.

This dramatic episode and the following cascading events provided a number of lessons:

- Crisis buffers are vital to stability: there needs to be adequate core capital to absorb losses and sufficient stocks of high-quality liquid assets to meet liquidity shortfalls.
- There is a need for effective LOLR facilities and deposit insurance schemes, as well as a proactive supervision and effective resolution regime.
- All these components have to be integrated into a consistent stability framework. The stability framework for Islamic finance must be as comprehensive and robust as it is for conventional finance, with additional elements to cater for the specificities of a Sharī'ah-compliant system.

The Second Generation of IFSB Standards

The lessons of the crisis have been well understood by the IFSB. Its activities since the financial crisis can be characterised as a “second generation” work programme. The prime objective was to align the regulatory framework for Islamic banks with Basel III standards. The second generation of IFSB standards, launched since 2012, covers the measurement and management of liquidity risks, stress testing, risk management of *takāful* undertakings, capital

adequacy (revised), the supervisory review process (revised), core principles for Islamic banking, regulation of *microtakāful*, guiding principles on *retakāful* undertakings, stress testing for Islamic financial institutions, and disclosure requirements for Islamic capital market products. The two most important of these second-generation standards are IFSB-15 on capital adequacy and GN-6 on liquidity risk measurement.

With respect to capital adequacy, it should be noted that Islamic banks have robust capital buffers. Their high-quality, loss-absorbent capital (primarily tier 1 common equity) exceeds the regulatory requirements by approximately 14% and is much higher than that found on average in conventional banking. IFSB-15 gives national regulators flexibility to address the issue of risk-absorbent capital instruments. It suggests perpetual and unsecured *mushārakah shukūk* as additional tier 1 capital for loss absorption in “going concern” situations. *Muḍārabah* and *wakālah shukūk* could account for tier 2 capital – that is, as “gone” capital – provided their term is at least five years and they are convertible into shares of common equity at the point of non-viability or insolvency. The trigger point and conversion ratio must be clearly specified.

Macroprudential measures of the capital adequacy framework should observe specificities of Islamic banks:

- Countercyclical buffers may be less relevant for Islamic banks that finance real investments and are less exposed to the cyclicity of financial markets. However, sectors such as real estate have their own business cycles to which Islamic banks with a high sectoral concentration could be exposed.
- Islamic banks are, on average, much lower leveraged than conventional banks. There is thus less need for regulatory limitations on the leverage ratio.
- There are only a few domestic systemically important Islamic banks (D-SIBs), so regulations



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relating specifically to these may become more relevant only in the future.

- The capital conservation buffer is important in both conventional and Islamic banking. Regulators should look at the business models of individual banks to contain whatever threats they might pose to systemic stability.

Islamic banks do have highly liquid assets, but mainly in the form of cash. Holding cash as the consequence of an absence of Shari'ah-compliant investment opportunities implies the loss of potential income and a competitive disadvantage for Islamic banks in terms of risk management and profitability. The post-crisis Basel standards for high-quality liquid assets (HQLA) create challenges for Islamic finance because of underdeveloped markets and a lack of tradable securities.

It has to be admitted that the transposition of the detailed Basel III rules into equivalents for Islamic finance adds to the complexity of the system, but it cannot be taken for granted that this will effectively prevent – and not just postpone – the next crisis. Maybe the better approach is to try to reduce complexity and focus on a few simple issues, such as the quality and amount of capital and the leverage ratio. If the limits for leverage are set high enough, this may be a simple but sufficient and more effective regulation than observance of the many Basel III ratios, which, through their complexity, still facilitate a too generous leverage.

The IMF in Support of Islamic Finance

The IMF has been involved in Islamic banking at the staff level since the mid-1980s. Since the late 1990s, it has been providing advisory services and technical assistance to member countries on various topics such as central banking operations, financial regulation and *shukūk* issuances. Over the decades, Islamic banking has grown rapidly in size and complexity. It has established a presence in G20

member countries (Saudi Arabia, Turkey, Indonesia) and large emerging markets, but it is also practised in low-income countries where it has contributed to financial inclusion and deepening. This has given rise to an increasing number of regulatory issues and challenges for supervisory authorities and central banks. In 2017, the Executive Board of the IMF held its first formal discussion on Islamic banking and the future role the Fund should play in this area. The Board adopted an IMF staff paper on ensuring financial stability in countries with Islamic banking that covers key features of the Islamic banking model and risk implications, the legal and governance frameworks, regulation, supervision, AML/CFT, resolution regimes and financial safety nets.

Progress and Deficiencies in Building the Islamic Banking Ecosystem

IMF staff assessed the progress made by subsystems of the Islamic ecosystem with regard to financial stability.

- a. *Prudential regulations*: Robust key standards – for example, for capital adequacy and the supervisory process – have been developed. Good progress is acknowledged. The *Core Principles for Islamic Finance Regulation (Banking Segment)* (CPIFR) (IFSB-17) have been issued and may become important assessment tools for the IMF in the future. A key challenge in prudential regulation is the wider adoption and implementation of standards – in particular, those on liquidity management.
- b. *Legal foundations*: The legal environment for Islamic banking is rather complex and depends on specifics of the various jurisdictions. Catering for Shari'ah issues related to Islamic finance adds to the complexity of the legal systems. Nevertheless, legal certainty and clarity are critical to mitigate potential risks, prevent regulatory arbitrage and ensure stability. There is a broad awareness of these issues, and many countries have already amended their laws to accommodate Islamic finance. However, this has not been done by all



jurisdictions, including some with systemically important Islamic banks. Thus, the progress in this area is mixed.

- c. *Governance framework*: Progress has been made in developing governance standards by institutions such as the IFSB and AAOIFI. However, IMF staff are still concerned about the process for issuing *fatawā*, the governance of Sharī'ah compliance procedures, and covenants related to investment account holders. As the "equity of investment account holders" is the first stability buffer after capital, the treatment of investment account holders particularly with regard to the distribution of profits and losses must be clear and transparent. These issues are not yet settled.
- d. *Safety net*: IMF staff consider that progress regarding safety nets (deposit insurance, LOLR) is insufficient. There is significant heterogeneity across jurisdictions; it is almost as if no two jurisdictions are alike. There is a need for a consensus on the coverage of deposit insurance, the priority of claims, the role of deposit insurance in resolution, and the compatibility with Sharī'ah principles. Many jurisdictions apply one deposit insurance to all types of banks, conventional as well as Islamic. This may be acceptable from a stability perspective, but not from the perspective of Sharī'ah principles in banking. Only a limited number of countries have LOLR facilities for Islamic banks, and there are significant variations and complexities among the instruments. This somehow defeats the purpose of a lender of last resort, whose instruments should be simple and deployed quickly in a critical situation. Another gap in the safety net architecture is the lack of HQLA for Islamic banks – that is, particularly domestic-currency government *ṣukūk*.
- e. *Resolution regime*: Clarity is needed on resolution powers and tools, the role of Sharī'ah boards in resolution, and the hierarchy of creditors. The IFSB released a working paper on this topic, "Recovery, Resolution and Insolvency Issues for Institutions

Offering Islamic Financial Services" (WP-07), in December 2017.

- f. *Liquidity management*: An inadequate liquidity management framework can undermine the growth potential of Islamic banking and potentially threaten the stability of the Islamic banking sector. Progress in this key area is insufficient. Only very few countries have put in place adequate and robust liquidity management frameworks for Islamic banks.

In conventional finance, the absence of sufficient quantities of safe and high-quality liquid assets – that is, government Treasury bills – led the private sector to design complex triple-A rated mortgage-based securities, collateralised debt obligations, asset-backed commercial paper, etc., which all collapsed in the crises when it was suddenly realised that they were not liquid at all. To prevent a similar crisis in Islamic finance, the industry needs support by central banks and governments through the regular issuance of simply structured liquid sovereign *ṣukūk*.

"Hybridity" in Islamic Banking

The lack of HQLA in the form of deep and liquid government *ṣukūk* in domestic currency has already led to the design of hybrid financial products for liquidity management purposes. In an environment where the enabling infrastructure for genuine Islamic banking is not fully developed, hybrid financial products that meld features of conventional banking products with Islamic banking elements produce outcomes that are effectively like conventional finance. Even hybrid financial institutions have emerged – namely, Islamic banks operating solely on the basis of *murābaḥah* on the asset side and reverse *murābaḥah* on the liability side (which creates a balance sheet structure that closely resembles that of conventional banks). Admittedly, hybrid products do have benefits for banks: they allow Islamic banks the use of the conventional finance infrastructure for liquidity management, as well as the development of new financial instruments for funding and lending. Some of these hybrid instruments were also helping



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Islamic banks to rapidly expand their balance sheets. However, there is also a downside of hybrid products – namely, new complex risks. There is a significant increase in Islamic banks' exposure to liquidity, market and interest rate risks that would not exist without hybrid products. These risks are difficult to assess, and it is not clear how they should be managed by banks and on the supervisory level. For example, it is doubtful whether the applicable prudential regime should be Basel III or IFSB. Furthermore, uncertainties prevail about the relevant legal and accounting framework, governance structure, consumer protection and reputational risk.

The Future Role of the IMF

The Executive Board of the IMF took note in February 2017 of the growth of Islamic banking and the opportunities it offered for enhanced financial intermediation and inclusion and for the funding of economic development. It also took note of the

complexities, unique risks and regulatory challenges of Islamic banking. The Board called for the staff's continued support of the work of the relevant international standard setters to help address gaps in the regulatory framework for Islamic banking. The staff had proposed to formally recognise the *CPIFR (Banking Segment)* (IFSB-17) as the international standard for the supervision and regulation of Islamic banks, which would put the IFSB standard on the same level as the standards of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions or International Financial Reporting Standards. The Executive Board looks forward to receiving a formal proposal for endorsement in 2018. If endorsed, the IMF could then (i.e. after 1 January 2019) use the CPIFR in jurisdictions where Islamic banking is deemed systematically important in the context of surveillance programmes, in the financial programme design with these countries, and in capacity development activities.



SESSION 4

Islamic Capital Markets: Towards Greater Harmonisation in Cross-border Activities

Chairman of the session and first presenter was Mr. Ashraf Mohammed, Assistant General Counsel and Practice Leader – Islamic Finance, Asian Development Bank. The other members of the panel were Dr. Obaid Al Zaabi, Acting Chief Executive Officer, Securities and Commodities Authority, UAE; Mr. Robert Scharfe, Chief Executive Officer, Luxembourg Stock Exchange; and Mr. Lilian Le Falher, Executive Manager, Head of Treasury, Financial Institutions and Capital Markets, Kuwait Finance House, Bahrain.

The Islamic capital market comprises the market for Sharī'ah-compliant listed equities, the *ṣukūk* market and the Islamic funds market. The *ṣukūk* market has attracted most of the public attention. It seems that this market has somewhat lost its momentum. The growth of the volume of *ṣukūk* globally is due to sovereign issuances, including issuances by government-related entities (GREs), or multilateral development banks (MDBs) and international organisations (IOs). However, expectations of soaring sovereign *ṣukūk* issuances in response to the huge budget deficits of the oil-exporting countries have been disappointed, and the medium-term growth trend of corporate *ṣukūk* is negative. Many observers expect that greater harmonisation and standardisation could facilitate more cross-border activities and, by this broadening of the market, encourage more issuances.

A Snapshot of the *Ṣukūk* Market

The IFSB's *Islamic Financial Services Industry Stability Report* (IFSISR) of 2017 shows for the last decade an increase in the global volume of *ṣukūk* outstanding from USD 51 billion in 2006 to about USD 320 billion in 2016. According to the International Islamic Financial Market (IIFM), Asia dominates the *ṣukūk* market with 74% of the global issuances, followed by the GCC with around 22%. The shares

of Africa and Europe and others are much smaller: 2.5% and 2.3%, respectively. The market leader in sovereign *ṣukūk* issuances (including issuances of GREs, MDBs and IOs) in 2016 was Malaysia with 51%, followed by Indonesia (15%) and the UAE (8%). In 2016, there were three new entrants into the *ṣukūk* market from Africa – Senegal, Côte d'Ivoire and Togo – and more may follow soon. The United Kingdom announced that it would re-enter the *ṣukūk* market in 2019 for a renewal of its first issuance in 2014. Corporate *ṣukūk* are more important for development, but they have seen an actual decline of nearly 26% from slightly less than USD 21 billion in 2015 to slightly more than USD 15 billion in 2016 (IFSISR, 2017). The market for corporate *ṣukūk* issuances was tapped by issuers across nine jurisdictions, with Malaysia leading (50%), followed by the UAE (18%) and Saudi Arabia (12%). The downward trend began in 2013 with the US Federal Reserve scaling back its quantitative easing programme, leading to concerns of globally rising interest rates. Other factors that impede corporates from issuing *ṣukūk* are concerns about their cost-effectiveness compared to conventional bonds, the complexity of *ṣukūk* structures, issues in terms of governance, and deficits with respect to the harmonisation of standards. Furthermore, various countries faced socio-political and macroeconomic challenges in 2015–16.

It is important to see these absolute numbers in relation to the dimension of the conventional markets. For example, the total assets of the Islamic banking industry are around USD 1.4 trillion compared to around USD 130 trillion of global banking assets. With a share of little more than 1% of the global assets, Islamic banking remains small on the global scale. To illustrate this in a slightly different manner: if all existing Islamic banks were to merge into one, this Islamic “mega-bank” would be the size of Société Générale or Barclays. Globally, more than 20 banks



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account for assets of roughly USD 1 trillion (and in some cases much more). This huge difference in the dimensions of conventional and Islamic banking should not be forgotten when double-digit growth rates are highlighted by the commentators. Because of the small base, the above-average growth rates of the past have not changed the global proportions significantly. For the *ṣukūk* market, the situation is even worse. The volume of the global capital market crossed the USD 100 trillion mark for outstanding bonds in 2017, which is not very far from the USD 130 trillion of banking assets. In contrast to this, the size of the Islamic capital market is only around USD 300–350 billion of outstanding *ṣukūk* – one quarter or less of the global Islamic banking assets. In the GCC, this relation is even more biased towards banking: total GCC banking assets (conventional and Islamic) are approximately USD 2.4 trillion, while the GCC capital market (conventional and Islamic) accounts for USD 300 billion.

The Regulatory Framework for Securities in the UAE

The Securities and Commodities Authority (SCA) of the UAE is responsible for the legal, regulatory and supervisory framework of the country's capital market, while competencies for operational regulations (market and listing rules) have been delegated to the Abu Dhabi Securities Exchange (ADX) and the Dubai Financial Market (DFM) as the two self-regulating entities under the SCA.

- The SCA issues legislative Acts for the regulation and supervision of Islamic capital market products and service providers such as Shari'ah-compliant investment funds, special purpose vehicles (SPVs), Shari'ah-compliant hedge contracts, and rating agencies for Islamic products. The SCA also updates *ṣukūk* regulations and plays a role in capital adequacy regulations through assigning risk weights to Islamic products. It is in charge of a sandbox initiative to stimulate innovation in Islamic financial markets. The SCA has to introduce a

Shari'ah governance system, and approve and qualify Shari'ah supervisory board members. The organisation of training programmes and an awareness programme on Islamic financial markets falls into the ambit of the SCA, along with cooperation with international standard setters, including IOSCO, AAOIFI and IFSB. Finally, the SCA has to explore possibilities of passporting Islamic products and services from abroad into the UAE financial markets.

- The roles of the financial securities markets (ADX and DFM) are: (i) to issue rules that regulate the listing and trading of securities and hedge contracts in accordance with Shari'ah; (ii) to set the rules for the screening of Shari'ah-compliant securities; (iii) to update clearing, settlement and trading regulations for Islamic products; and (iv) to develop investment indices for Islamic securities. In addition to the regulatory tasks, ADX and DFM are engaged in the development of technology, the marketing of financial products, and the creation of momentum and liquidity in the securities markets.

The SCA is facing a number of challenges in implementing its road map towards reliable and robust Islamic securities markets. They include:

- the high costs and complexity of Islamic capital market products (due to multiple contracts, the involvement of Shari'ah committees, the need to establish SPVs, etc.);
- the need for special methods for trading and clearing of Islamic securities which differ from those for conventional securities;
- different Shari'ah views, which can hamper the tradability of securities;
- the simulation of traditional financial instruments in the structuring of Islamic products when innovative, credible and competitive products are needed to attract investors and increase the market depth;



- the scarcity of qualified staff with knowledge and expertise in both technical and Sharī'ah aspects; and
- the lack of a specialised legal framework for Sharī'ah-compliant products.

The most critical challenge seems to be the lack of generally applied Sharī'ah standards. The problem is not so much the existence of standards – AAOIFI has issued around 60 Sharī'ah standards – but the fact that they are not applied by all Sharī'ah committees and Sharī'ah scholars. This is a dilemma that probably impedes the flourishing of not only the Islamic securities market, but the Islamic finance industry as a whole. Since AAOIFI and other international standard setters do not have the authority to force the industry to adopt the standards, they could either be implemented voluntarily by the Sharī'ah boards of Islamic financial institutions or be enforced by the national regulators. It would contribute to a more globalised Islamic finance industry if several national regulators adopted standards in a coordinated action. However, not all jurisdictions approve the standards issued by international standard setters such as AAOIFI, because they do not cover all aspects of Islamic finance that regulators consider relevant (e.g. continuous disclosure, conduct of business, stakeholder relations, etc.). Hence, a globally concerted implementation of AAOIFI standards is not yet on the agenda.

The Luxembourg Exchange for Green Bonds

The Luxembourg Stock Exchange (LuxSE) is an international exchange with more than 36,000 listings of more than 2,500 issuers from more than 100 countries in any currency that is freely tradable on the market. Since LuxSE is focused on fixed-income instruments (72% of its overall business), it has a huge turnover. More than 10,000 new securities with a volume of EUR 1.2 trillion were listed in 2016. Luxembourg's involvement with Islamic finance

dates back to 1978, when the country was the first European jurisdiction to host an Islamic finance institution. LuxSE listed its first *ṣukūk* in 2002. The central bank of Luxembourg became a member of the IFSB in 2009 and joined the International Islamic Liquidity Management Corporation (IILM) in 2010. The financial regulator (Commission de Surveillance du Secteur Financier, CSSF) set up a guidance for *ṣukūk* and Islamic investment funds, and the Luxembourg government issued the first Euro-denominated sovereign *ṣukūk* in 2014.

Structural Similarities between Islamic and ESG Securities

Recently, LuxSE started to focus on a market segment that has a lot of affinities with Islamic finance, namely ESG finance. The acronym stands for “environmental, social and governance”, but other terms such as “sustainability” or “responsible investment” have very similar meanings. After the Paris UN Climate Conference in 2015, the market for responsible investments – in particular, green finance – took off.

Islamic and ESG securities such as *ṣukūk* and ESG bonds, which are both traded at LuxSE, have a number of elements in common, including:

- the ethical elements in their investment policies;
- the application of exclusion lists;
- specific certification procedures; and
- annual reviews of performance beyond mere economic indicators.

These are common elements, but they are not identical. Structures are similar, but definitions and the substance of financed businesses differ between Islamic and ESG finance.

Islamic and ESG finance also share a number of challenges. Both struggle to reach a critical mass, to harmonise cross-country compliance rules, to



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lower structuring costs and increase commercial performance, and to enhance visibility and liquidity. These challenges are particularly serious in an economic environment where capital is extremely cheap and easily available. Issuers of *shukūk* or ESG bonds not only need to go through complicated and costly structuring procedures, but their securities continue to be complex to handle even after the issuance.

The Specialised “Full Service Exchange”

LuxSE took several initiatives to address some of these challenges for the ESG or green bond market, and the Luxembourg experience may help in addressing similar challenges in the *shukūk* space. In September 2016, LuxSE launched the world’s first “green exchange” with the prime objective of providing an international platform with visibility for issuers of and investors in green bonds. The green exchange does the same as a conventional exchange but with an exclusive focus on green and sustainable investment products. Compared to conventional bonds, green bonds require additional information, external certification and more reporting – all of which create extra costs.

A listing on the green exchange gives a green bond wider and more prominent visibility and saves the issuers some of the costs of a PR campaign. It also eliminates for investors the hassle of searching the web for green bond issuers, or of contacting them for printed information. LuxSE’s green exchange makes information on each listed green bond freely and conveniently accessible to individual and institutional investors worldwide through its own website. Just one year after its launch, the green exchange covers 50% of all green bonds issued worldwide. There is a positive feedback loop: the greater the number of investors who like the platform, the more issuers will list on it, and the sooner the system will grow – to the advantage of all its users.

In May 2017, the platform was extended to social bonds, and within a couple of months it has attracted the largest concentration of social bonds. The latest addition is a so-called sustainable window. Sustainable securities often blend features of green and social bonds for the financing of sustainable projects. The green exchange has added indices, notably Chinese green bond indices, to the platform, with the aim of having all financial instruments that can be classified as green, social or sustainable on the platform. This would also include green *shukūk*. The two existing green *shukūk* have not joined the Luxembourg green exchange (maybe because it was not known at the time of listing), but future green *shukūk* are welcome. Banks are working on green exchange-traded funds (ETFs), and the green exchange has launched, again with China, the first green equity index, which is displayed on the platform.

The ultimate aim of the platform is to present investors with the full range of available instruments for responsible investment, and Islamic securities may have the potential to be included, provided the similarities between ESG and Islamic finance are not only structural or formal but also in substance. A convergence could emerge, for example, in bonds and *shukūk* that are financing projects related to the Sustainable Development Goals (SDGs) of the UN, particularly the infrastructure-related SDGs 6 (clean water and sanitation), 7 (affordable and clean energy), 9 (industry, innovation and infrastructure) and 11 (sustainable cities and communities). The instruments presently on the green exchange platform cover 12 of the 17 SDGs, and the SDGs will probably become a key guidance for responsible investing in the future. Already, one asset management company – SEDCO Capital – has structured a new set of products following a “prudential ethical approach” that combines the best of Shari’ah compliance with ethical investment. Obviously, there are means of cooperation and of creating bridges between the two markets, and both sides can learn from each other.



Potential for *Shukūk* in Infrastructure and SRI

Although the relative weight of the *shukūk* market in the global Islamic financial system is disproportionately low, the absolute figures are still noteworthy. It is sometimes argued that the identification of high-quality projects could invigorate the issuance of attractive securities and bring forth a matching demand by investors at the same time. The ADB sees the financing of infrastructure as a huge potential for the *shukūk* market.

Infrastructure Needs of Asia

Asia alone will need USD 26 trillion for the period 2016–30 to meet its infrastructure requirements in sectors such as power, transport, telecommunications, and water and sanitation. The investment needs for the whole Asian region have been calculated as USD 1,340 billion per year from 2016 to 2020, while current investments are estimated to be USD 881 billion annually. The average investment gap for the coming years has been calculated as around USD 500 billion per year. If public financing could cover roughly half of the gap, then around USD 250 billion would have to be raised by private financing – which requires a massive increase from the actual USD 63 billion of private investments. Islamic finance structures – in particular, *shukūk* – could contribute substantially to filling the gap. In addition, China has shown interest in Islamic finance, as its New Silk Road project includes huge infrastructure projects in those OIC member countries for which innovative conventional and Sharī'ah-compliant financial engineering is expected.

A recent study by the World Bank and the Islamic Development Bank (IDB), “Mobilising Islamic Finance for Infrastructure Public–Private Partnerships”, has highlighted a number of reasons why there is a natural fit between Islamic finance, infrastructure projects and public–private partnerships (PPPs): (i) infrastructure projects meet the requirement for *shukūk* to be asset-backed or asset-based; (ii) *shukūk* facilitate risk sharing between the investors, the project company, the government and the operators; (iii) the ethical basis

of Islamic finance requires high environmental, social and governance standards for infrastructure projects; (iv) a growing liquidity pool in Islamic finance could be used primarily for infrastructure financing; and (v) Islamic modes of financing could be utilised alongside conventional finance in large infrastructure projects.

SRI *Shukūk* in Health Care and Green Energy

Besides infrastructure financing, *shukūk* could also be used for socio-economic development projects. The IDB used proceeds from a *shukūk* to finance health care. Another example is the USD 500 million *shukūk* issued by the International Financial Facility for Immunisation to fund the vaccination development and immunisation programmes of the Global Alliance for Vaccination and Immunisation.

Another area with promising growth potential is green *shukūk*. In July 2017, the world's first green *shukūk* facility was issued under Malaysia's SRI *Shukūk* framework, a USD 60 million funding for a solar power project in Sabah. In October 2017, a USD 236 million *shukūk* was issued to fund three large-scale solar projects in Kedah, Malaysia. The potential of the green *shukūk* market is yet to be unlocked.

The huge potentials in *shukūk*, ethical finance and green finance should be activated. A number of measures can be taken to attract more market players, particularly corporate issuers, to broaden and deepen the *shukūk* markets: tax shelters on interest payments should be eliminated to level the playing field for debt and equity financing; and tax deductibility should be extended to expenses incurred on the issuance of *shukūk*. Regulations should be developed that allow the transfer of ownership without any additional costs for the issuer of *shukūk*.

Malaysia has been a pioneer in incentivising and promoting the issuance of *shukūk* over and above conventional instruments. Islamic capital market regulations should be harmonised internationally to create a global legislative and regulatory framework conducive for the issuance of *shukūk*. Sharī'ah



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governance should be improved through universal standards. The secondary market liquidity should be promoted by a global listing platform that creates greater transparency. Finally, default resolution frameworks and investor protection provisions need to be strengthened.

The Need for *Ṣukūk* as High-quality Liquid Assets

Ṣukūk can be suitable instruments for the financing of long-term infrastructure projects. However, there is also a need for *ṣukūk* for a different purpose: new regulations require banks to hold a certain quantity of high-quality liquid assets (HQLA) for liquidity management purposes. The financing book of Islamic banks (equivalent to the loan book of a conventional bank) is typically not very liquid, but *ṣukūk* and other capital market instruments are liquid. As a result, HQLA are mostly capital market instruments. Therefore, it is very important for Islamic banks to have further issuances of HQLA that they can put on their balance sheets. The cooperation of all stakeholders is required for more issuers to emerge. To make *ṣukūk* liquid, the issued volume has to be sizeable. To ensure high-quality *ṣukūk*, sovereign issuers or very strong corporate issuers are needed. Because of the general lack of corporate issuers in many Muslim countries, Islamic banks depend on sovereigns to issue the needed HQLA.

Reluctance of Corporates to Issue *Ṣukūk*

A fundamental problem of capital markets in many Muslim countries – maybe to a lesser degree in Asia than in the GCC – is the lack of corporate issuers from the private sector. The near-absence of corporates has contributed notably to the disproportionately small size of the capital market in Islamic finance.

The main reason why entrepreneurs and corporates are not ready to go to the capital market to raise funds is that they are not willing to share information about their business with unknown potential investors as well as the general public. They would rather seek

financing from banks with which they have long-standing relations. Banks treat information about the business of their corporate clients confidentially. The close relationship with banks is not a specific issue of Islamic finance but a general attitude of corporates – at least in the GCC region.

Entrepreneurs and managers do not like to share business information with other parties, including banks. When they realise that the regulations of the capital market authority require the disclosure of “nearly everything” to the general public when issuing a *ṣukūk* or bond, they back off. This also applies to new forms of financing through peer-to-peer lending or crowdfunding, where business information has to be made public on the matchmaking platform. If bank financing is available, it is the preferred method of financing for corporates, and it will probably take a long time to change this attitude.

There is another reason why most corporates are reluctant to issue *ṣukūk*. Very often they do not want to raise money for the acquisition of a specific asset, as is assumed by most types of *ṣukūk*. Instead, they are seeking funds to finance their business in general. *Ṣukūk* could be structured for that purpose, but they would either be equity-like instruments that corporates do not like, or they require assets that corporates may not have. It is obviously not an easy task to incentivise corporates with no particular sensitivity for Sharī‘ah compliance to issue *ṣukūk* instead of conventional bonds – especially at times when money is cheap and easily available.

Standardisation: Potentials and Limitations

The most frequently quoted obstacle for a more vibrant global *ṣukūk* market is the lack of harmonisation or standardisation of legal documents and Sharī‘ah interpretations. There is a wide agreement that both the buy side and the sell side of the capital market would benefit from more harmonisation and standardisation.



Cross-border Transactions and First-time Issuers

Standardisation supports cross-border transactions. The success of the IILM can be taken as an example, but it also shows how onerous and time-consuming it can be to achieve a consensus, which is a precondition for standardisation. Another institution that brings together stakeholders with different perspectives to work on an international standardisation and harmonisation of documentations for Islamic finance products is the IIFM. Furthermore, recent cases have shown that Sharī'ah non-compliance risks can have significant material consequences. They could be avoided by a global implementation of legal and Sharī'ah standards such as those issued by AAOIFI. It should be noted that standardisation does not require a full harmonisation of all details. Experiences from other markets and countries (such as the green bond market and China) indicate that it is possible to cater for national specificities without obstructing the desired cross-border flow of capital.

Standardisation is not only relevant in a cross-border perspective, but could also help to increase *ṣukūk* issuances locally. An approved standard documentation would reduce the workload of all stakeholders and the issuers' structuring costs. Standardisation makes it easier for issuers to tap the market for the first time and subsequently to continue with *ṣukūk* issuances on a regular basis. It would also speed up the issuing process and help to increase the number of issuances on the sell side and the turnaround on the buy side.

Ill-prepared Sovereigns

Standardisation does not solve the problem of unpreparedness. Sovereigns have learned that a first-time *ṣukūk* cannot be issued on short notice in many jurisdictions. In the GCC and other oil-exporting countries, governments did not feel the need to tap the capital market as long as oil prices stood at USD 120–130. Their legal and regulatory systems were (and sometimes still are) not prepared for *ṣukūk* issuances. Once a decision to issue a *ṣukūk* is taken, time-consuming coordination problems between different government bodies may emerge. For

example, the central bank may be the leading body for the issuance, but the asset transfer may be the responsibility of the Ministry of Finance, and further government bodies may also need to be involved. Finally, a lack of basic knowledge can delay or inhibit a *ṣukūk* issuance: reportedly, a government had announced the issuance of a *ṣukūk* with the wrong understanding that it is an Islamic bond – that is, a simple debt security like a conventional bond – not realising that appropriate assets have to be identified, transferred and repurchased. The legal and Sharī'ah complexity and the time needed for structuring have grossly been underestimated. On the other hand, the time factor should not be overemphasised and generalised too much. This is a particular problem of first-time issuers. Experiences from the GCC and elsewhere show that the “time to market” becomes much shorter for sovereigns and corporates that have already issued their first *ṣukūk*.

Sharī'ah Indifference

Standardisation of Sharī'ah interpretations will not help to overcome another obstacle: Sharī'ah indifference. It seems that in most countries where Islamic finance is practised, the majority of corporates and investors are not particularly sensitive to Sharī'ah compliance. Issuers of capital market instruments compare *ṣukūk* with bonds and decide primarily on the basis of structuring costs, the time until funds become available, and the price of *ṣukūk* or bond financing. For investors, it is primarily a comparison of *ṣukūk* and bond yields. Competition has brought *ṣukūk* yields more or less in line with bond yields, so that there is no clear pricing advantage for *ṣukūk* or bonds. However, there are disadvantages for *ṣukūk* with regard to the complexity of the structure, the costs of structuring and the time needed before funds become available. As long as some form of transfer of ownership is maintained as a distinctive feature of *ṣukūk* compared to bonds, legal documents for *ṣukūk* will be more comprehensive, and more parties will be involved in their drafting (e.g. Sharī'ah experts, lawyers, tax authorities, asset owners). The results are higher costs and more time-consuming processes.



SESSION 4
ISLAMIC CAPITAL MARKETS:
TOWARDS GREATER HARMONISATION IN CROSS-BORDER ACTIVITIES

Suitability for Conventional Market Players

It is often argued that *ṣukūk* are fundamentally different from bonds. In theory, there is no doubt about this. In practice, however, more and more *ṣukūk* are structured – especially through the use of purchase undertakings – in such a way that they mimic fixed-income products and fixed-income risks. Leaving aside Sharī'ah compliance concerns, practitioners in the treasury departments of Islamic banks find *ṣukūk* with fixed-income structures helpful, because conventional banks are also buying these Islamic securities and they are often the main suppliers in the secondary market. Accurate numbers are not available, but it seems, for example, that conventional banks in Bahrain are at least as active as Islamic banks in buying *ṣukūk* issued by the central bank, and they enhance the liquidity of the secondary *ṣukūk* market. Therefore, *ṣukūk* issuers who want to place large-size issuances with both Islamic and conventional buyers tend to structure *ṣukūk* as fixed-income products, irrespective of Sharī'ah concerns.

Marketability of Asset-backed Ṣukūk

The successful infrastructure *ṣukūk* were primarily sovereign or quasi-sovereign issuances for projects in public ownership. The presence of the public sector means a de facto credit enhancement. It is doubtful whether a corporate financing of infrastructure through *ṣukūk* could be as cost-effective as the sovereign financing if the de facto credit enhancement were

absent, at least as long as the infrastructure *ṣukūk* are asset-based. The commercial risk of the issuer and the availability of credit enhancements are major determinants of the pricing, which impacts the cost-effectiveness of asset-based *ṣukūk*. If infrastructure *ṣukūk* were to be asset-backed, the pricing would be determined by the income streams of the project itself, so that third-party guarantees and other credit enhancements should no longer be of relevance.

Whether the investors are prepared to buy asset-backed *ṣukūk* depends, among other things, on their readiness (i) to bear the real risks of the underlying assets, and (ii) to accept that these *ṣukūk* will no longer be fixed-income instruments. It is important to remember that investors in the *ṣukūk* market are primarily Islamic financial institutions. Islamic banks that are regulated according to similar prudential standards as conventional banks are hardly in a position to accept, to any significant degree, the physical and commercial risks of real assets. Islamic banks are not ready for larger quantities of asset-backed *ṣukūk* that would end up in the investment books of the banks, while their actual need is for *ṣukūk* that can be entered as HQLA in their banking books. They need *ṣukūk* structured as fixed-income instruments. There is obviously a dilemma in the industry, and this may, to some degree, explain why probably 95% of all *ṣukūk* issued today are asset-based.



SESSION 5

The Way Forward for Islamic Finance: Strengthening Value Proposition, Sustaining Resilience

The concluding session was chaired by H.E. Mubarak Rashed Khamis Al Mansoori, Governor, Central Bank of the United Arab Emirates. Panellists were Dr. Fahad Ibrahim Alshathri, Deputy Governor for Research and International Affairs, Saudi Arabian Monetary Authority; Mr. Khalid Hamad Abdul-Rahman Hamad, Executive Director – Banking Supervision, Central Bank of Bahrain; Mr. Marzunisham Omar, Assistant Governor, Bank Negara Malaysia; and Mr. Mustafa Serdar Bosca, Principal, The Boston Consulting Group, UAE.

The competitive environment for Islamic banks is rapidly changing. Islamic banks have successfully penetrated core customer groups, persistently low oil prices have reduced the liquidity in the markets, prudential regulations have become more complex, and regulators are pushing towards more standardisation in Sharī'ah matters. The Islamic finance industry will undergo a consolidation in some key markets. It has to catch up on new financial technologies, create more public awareness of its benefits, and deliver on its value proposition.

Attracting Customers from Conventional Finance

Islamic finance has become a global industry. Its products are offered in more than 50 countries, and this has been achieved in less than 50 years. For a long time, the industry grew at double-digit rates. However, over the last couple of years this growth has slowed and the penetration of Islamic banking has stagnated at 1.2% of global banking assets. This slowdown can be attributed to three key challenges:

a. The segment of those customers who will only work with Islamic banks is already fully penetrated.

b. Islamic banks' value proposition is lagging behind that of their conventional peers.

c. Various structural challenges have not yet been fully addressed.

Consultancies have found that in many countries about 15–20% of Muslims will only use Sharī'ah-compliant financial products. Looking at the penetration rates around the world, it seems that Islamic banking has reached a level that approximates this segment. Further growth requires the attraction of customers who are also willing to deal with conventional banks. For this segment, Islamic banks have to understand better what these customers want.

For retail customers, three things are important: excellent customer service, very good digital channels, and a strong financial position of the bank. Islamic banks have to address these needs if they want to attract retail customers for whom Sharī'ah compliance is not a key criterion for choosing a bank. SMEs and corporates as bank customers also want a superior digital experience. They do not want to have to spend time in branches or to visit the bank; they want to do their banking through digital channels anytime and anywhere.

Market research has shown that customers appreciate the financing and savings products of Islamic banks. But the research has also shown deficits in the value proposition in two areas: Islamic banks are lagging behind conventional peers in service quality and in digital offerings. The financial position of Islamic banks is usually better than that of their conventional peers in terms of profitability and stability of returns. However, there are some structural challenges that need to be addressed: the absence of a large and liquid Islamic interbank money market, a deep and liquid *ṣukūk* market, and a widely accepted pricing benchmark for



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Islamic instruments. These are particular aspects of the underdeveloped liquidity management framework in Islamic banking. To overcome these challenges and to meet the expectations of customers, Islamic banks have to catch up with conventional banks in regard to customer service quality and digitisation, and they must unlock innovation to solve the liquidity management issues.

Adapting to New Environments

In order to map the way forward, it is important to know the actual position: trade protectionism is on the rise, the economies of emerging markets and developing countries are showing strong growth, and the recovery of the oil market is slow. In addition, the number of social and political conflicts, especially in the MENA region, is increasing.

New Realities

These developments have implications for Islamic finance in three areas:

- a. The slow recovery of oil prices has enhanced macro-uncertainties for Islamic finance, as the Islamic finance industry is highly concentrated in oil-exporting countries. The depressed oil prices and the slow recovery of oil markets will limit its growth potential.
- b. The growth of Islamic banking assets has slowed, and Sharī'ah-compliant equity indices have performed more weakly than conventional equity indices.
- c. In theory, the budget deficits can be seen as new growth opportunities for Islamic finance, and many observers have anticipated a boost for the *ṣukūk* market. However, a comparison of the total financing requirements of GCC countries with the volume of *ṣukūk* issuances over the last few years reveals that Islamic finance is far too small to meet the financial needs of those governments, which have to take recourse to the conventional markets.

Furthermore, the absorption of global liquidity by sovereign bond issuances may even have a crowding-out effect on *ṣukūk* markets. Hence, the large budget deficits of oil-exporting countries can exhaust the limits of the Islamic finance industry.

Structural Challenges

The Islamic finance industry has not only to deal with an unfavourable macroeconomic environment, but also to address structural challenges on its way forward.

- The Islamic finance industry must become more innovative to better manage liquidity and satisfy customer demands. It requires a more sophisticated set of products to boost financial inclusion and to meet efficiently the financial needs of individuals, corporates and sovereigns.
- Islamic finance has to associate itself more with economic and financial development needs. As Islamic banking is concentrated in the OIC countries where around 50% of adults do not have a bank account and where the income of more than 700 million people is less than USD 60 per month, financial inclusion and economic development should rank high on the agenda of Islamic bankers.
- Trust on the part of users of Sharī'ah-compliant products and services is key for the success and growth of the Islamic finance industry. The World Bank's *Financial Development Report 2014* indicated that 12% of adults in the MENA region were willing to exclude themselves voluntarily from the banking system for religious reasons. These people could be integrated into the financial system if the Islamic finance industry can win their trust and give credibility to the Sharī'ah compliance of its products. Trust and credibility are also essential for retaining existing customers and attracting from conventional banks new ones who value the Sharī'ah compliance of financial services.



- The Islamic finance industry is geographically highly concentrated in the GCC countries, Malaysia and Iran. These countries account for roughly 80% of the global Sharī'ah-compliant assets. This concentration renders the industry highly dependent on energy market developments. A geographic diversification and expansion in regions with different economic profiles could make Islamic finance more resilient and mitigate the impact of business cycles in the energy sector on the Islamic finance industry.

New Priorities for Regulation

It seems to be a general consensus that the Islamic finance industry has reached a size and level of maturity that creates a need to reflect on how its strong foundations can take the industry to the next level. Central banks as regulators have to achieve a balance between the contribution of Islamic finance to financial development and the stability of the financial system. Consequently, they should address issues in three areas.

- a. Regulators shall enhance investor protection and improve the awareness of specificities of Islamic finance among investors and consumers. This is important in creating trust and credibility as a precondition for the growth of the industry.
- b. The infrastructure of the *ṣukūk* markets should be improved to increase the speed of *ṣukūk* issuances and reduce the heavy costs of structuring. This will benefit both the private sector and the sovereigns that have to finance budget deficits by debt instruments. The improvements should also support the issuance of retail *ṣukūk* to enhance the savings culture.
- c. Progress in the areas of technical, legal and Sharī'ah standardisation would help to keep the balance between financial development and financial stability.

Progress in all these areas cannot be brought about by regulators alone. Market players, consumers,

international standard setters and other stakeholders have to work together to achieve the objectives. For example, Islamic banks should ensure practices of fair risk sharing and be vigilant to Sharī'ah compliance and the "Islamicity" of certain debt-like instruments such as *tawarruq*. This is important for enhancing credibility and trust among market participants. International standard setters such as the IFSB and AAOIFI will continue to play an important role. The Saudi Arabian Monetary Authority recently joined AAOIFI, which could do more to reach out to regulators and help them understand their Sharī'ah standards. International standards can help to increase the speed of financial innovation. They are also important for resolution, recovery and insolvency procedures across jurisdictions, especially when jurisdictions are involved that do not have national Sharī'ah boards.

Consolidation and Progress in Islamic Finance

The deep and unprecedented drop in oil prices has significantly affected the economies of oil-producing countries. The emergence of alternative energy sources at affordable prices suggests that the current oil price level may continue for some time. Since the GCC governments rely heavily on oil as their key source of revenue, their spending capacity is severely curtailed. This poses significant challenges to the economic development of the GCC and to the Islamic finance industry. In addition, developments on the regulatory front create further challenges for Islamic banks: Basel III, IFRS 9 and the like are putting pressure on banks concerning provisioning, capital adequacy and liquidity. The relatively small size of most Islamic banks is not an advantage, as evidenced by the number of Islamic banks – in particular, Islamic investment banks – that have had to close down or merge when struggling with tougher regulatory requirements and inefficient business models. Against this backdrop, the Islamic banking industry needs to address a number of key issues if it is to secure a more prosperous future.



SESSION 5

THE WAY FORWARD FOR ISLAMIC FINANCE: STRENGTHENING VALUE PROPOSITION, SUSTAINING RESILIENCE

Reviewing Banks' Tool Boxes

Islamic treasury and money markets need to diversify to overcome the one-sided concentration on controversial commodity *murābahah* for liquidity management and use alternative instruments such as unrestricted *wakālah*. Central banks have not developed enough monetary policy tools to facilitate efficient liquidity management, and there are not enough issuances of high-quality liquid *shukūk* by Islamic banks, sovereigns and quasi-sovereigns.

Murābahah and *ijārah* remain the dominant product structures for Islamic financing in most countries. *Mushārahah* structures are rare due both to the absence of effective risk management tools and to the unsupportive mindsets of boards and executives. It is a great concern that in certain jurisdictions commodity *murābahah* is increasingly replacing genuine product structures such as *murābahah*, *ijārah* and *salām*. Yet, the industry needs a gradual and calculated approach for transitioning to a *mushārahah*-based business model with innovative approaches for risk management in Islamic banks.

Rating

Islamic banks that have become domestically important publicly listed institutions have to be rated. This may require a change of mindsets, and of the way in which business is conducted. It means opening themselves up to public scrutiny and accountability, and this should become an integral part of a long-term strategy for institutional development. At present, only a few Islamic banks in the GCC are rated – relatively less than their conventional counterparts. Bahrain encourages Islamic banks to be rated, and three of the six Islamic retail banks have indeed been rated.

Public Awareness and Communication

There is a lack of public awareness about Islamic banking. It is somewhat odd that in most Muslim countries the share of the Muslim population is between 50% and 95%, while the share of Islamic banking is only a small fraction of this. It is important to understand the reasons for this discrepancy. One is that the Islamic banking industry as a whole has not

done enough to reach out to its potential customers in a simple, effective and credible way. Adherence to its core principles makes Islamic finance more fair, egalitarian and sustainable in the long run, but the industry has been unable to communicate these principles and values to the public.

There is no globally, or at least regionally, recognised spokesperson for the industry. There is also no unified digital and social media strategy. Moreover, the industry has been unsuccessful in communicating the consumer benefits of its products. Whether the customer's motivation is faith, convenience, service quality or product features, an Islamic bank must be able to address all the needs of its customers. Given the high percentage of Muslims in the population of Bahrain and the very low penetration of the domestic market, the regulator should contribute, in a joint effort with the industry, to raising the profile and public awareness of Islamic finance in all its segments – banking, *takāful* and *shukūk*.

Human Resources: Qualifications and Ethics

The industry has deficits in developing its human resources. It lacks internationally accepted professional qualifications equivalent to CPA, CFA, CA, ACA, etc. AAOIFI's recently revamped Certified Islamic Professional Accountant (CIPA) qualification is a good example of what the industry needs. There are very few institutions globally that are providing world-class education and training in Islamic finance. Because Islamic finance is a faith-based industry, customers and other stakeholders and the general public have high expectations regarding the integrity, professionalism and performance of the management and staff of Islamic financial institutions.

Banks need skilled and experienced professionals to manage risks. Islamic banks have not been able to attract top talents in risk management. There is a particular shortage of people who understand both the risks in conventional banking as well as the unique aspects of Islamic credit, market, operational and liquidity risks. There is also a need to invest more in research and development in order to address



issues and challenges that Islamic banks are facing. Potential topics include, for example, the use of interest rates as benchmarks in Islamic finance, and the relationship between banks and unrestricted investment account holders. Topics like these should be researched in terms of all the relevant dimensions: technical, commercial, socio-economic, legal and Shari'ah compliance.

High ethical standards have to be observed on all levels of Islamic financial institutions. The global financial crisis has shown how the breakdown of ethics results in disastrous consequences for institutions, individuals and the entire system. Because of high claims and expectations, unethical behaviour of an individual Islamic bank could have dire consequences for the whole industry. Ethical self-regulation by the industry would be best; however, if that does not materialise, then regulatory authorities have to act.

Regulatory Coordination and Standard Setting

Cooperation among regulators in Islamic finance could be improved. Up until now, each jurisdiction has been working on its own to develop Islamic finance. Only few formal attempts have been made to learn from each other or to share experiences in a systematic way. Such cooperation can help to achieve standardisation in the industry.

The level of standardisation in the industry is suboptimal. Standard setters such as the IFSB, AAOIFI and IIFM have come up with Shari'ah, accounting, governance, risk management and money market standards. They should go through an overhaul in terms of their scope, mandates and organisational set-up in order to deliver even more value to the industry. On the other hand, many jurisdictions do not apply those standards that already exist. If differences become obstacles for the stability and sustainable growth of the global Islamic finance industry, they should be put aside, and all stakeholders should work together to reach proper standardisation. Adoption of the IFSB, AAOIFI and IIFM standards should be seriously considered. Regulatory and Shari'ah compliance have to be

enhanced within the Islamic finance industry to facilitate healthy and sustainable growth.

Towards Value-based Intermediation in Malaysia

The necessary condition for Islamic finance to deliver on its value proposition is resilience and strength of the industry. A weak Islamic financial system will not be able to deliver and would threaten the sustainability of economic growth.

Regulatory Environment and Systemic Relevance

Regulatory authorities must ensure that Islamic finance can develop in a comprehensive manner while maintaining financial stability through the development of legal, regulatory, supervisory framework and supportive market infrastructure.

- The development of a deep and liquid Islamic interbank market started in Malaysia in the early 2000s, and today the regular issuance of *ṣukūk* by either the government or the central bank ensures that the country's Islamic banking institutions have the necessary short-term liquidity for their operations.
- Malaysia's Islamic banking assets account for 28% of its total banking assets. The share of Islamic banks in deposits and financing is even higher, namely one-third. A quarter (25%) of the financing for SMEs is provided by Islamic banks.
- It should also be mentioned that Malaysia has the largest *ṣukūk* market and a vibrant Shari'ah-compliant asset management industry.

After decades of double-digit growth, the pace of growth of Islamic finance has moderated to single-digit rates in the last few years. Islamic finance has reached a critical mass, and a significant market penetration in Malaysia signified by the double-digit growth rates of the earlier periods may no longer be possible. In a country like Malaysia, where only 60%



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of the population is Muslim and only a small subset of that is consciously looking for Sharī'ah-compliant products and services, the sustainability of Islamic finance depends on its appeal to the larger population. This gives rise to the question of how Islamic finance could move forward and continue to grow.

Collaborative Efforts to Deliver the Value Proposition of Islamic Finance

After consultations with market players and other key stakeholders, the central bank issued a strategy paper on value-based intermediation. The aim of this initiative is to strengthen the role and impact of Islamic finance by going beyond Sharī'ah compliance towards value-based intermediation, meaning the delivery of the intended outcomes of Sharī'ah through practices, conduct and offerings that generate a positive and sustainable impact on the economy, community and environment, without compromising the financial returns to shareholders. The concept of value-based intermediation re-aligns the focus of Islamic finance towards creating a greater socio-economic impact.

In order to deliver the value proposition of Islamic finance, four ingredients are required: innovation, talent, technology and internationalisation.

- a. *Innovation*: The economic landscape and the demography of Malaysia are evolving along with the financial needs of businesses and individuals. Islamic financial institutions have to improve their products and services continuously in order to meet new demands such as the financing of SMEs or retirement planning and asset management for individuals.
- b. *Technology*: By adopting technological innovations, Islamic financial institutions will be able to deliver superior-quality products and services and compete on an equal footing with conventional financial institutions.
- c. *Talent*: Malaysia is endeavouring to ensure that quality talent are entering the industry, as well as to elevate the professionalism of those who are

already in the workforce. For example, in relation to the talent supply side, the International Centre for Education in Islamic Finance (INCEIF) will launch its action-based learning within its Master of Science course as a flagship programme where graduates will be exposed to practical industry experiences prior to joining the workforce. At the same time, Islamic financial institutions must be willing to pay adequate remuneration to attract quality talent, not only in areas unique to Islamic finance but also in more general areas such as data science.

- d. *Internationalisation*: The world offers many opportunities for Islamic finance. Besides the infrastructure needs of many Muslim countries, there are opportunities in countries where financial inclusion is relatively low, or in financing international trade. Islamic countries should collectively use Islamic finance capacities to support more intra-regional trade within the OIC. This would make a positive impact on the economic development of the Muslim world. Infrastructure, inclusion and OIC trade are just three examples of significant opportunities for Islamic finance to grow by supporting real economic activities that benefit the whole Muslim community.

Standardisation may support internationalisation, but it should not be overlooked that there is already a lot of convergence within the Islamic finance community not just with regard to Sharī'ah matters, but also in prudential regulations. Moving forward on the international level, it may be easier if the focus is on areas with similarities rather than creating disputes about differences. Sharī'ah does allow for differences of opinion. The real issues are not the differences, but the uncertainties they may create. Malaysia has installed a Sharī'ah Advisory Council as the highest body to decide on all Sharī'ah matters related to Islamic finance. Its most significant contribution is in providing certainty in Sharī'ah requirements on Islamic financial transactions.



Key Stakeholders

The experience of Malaysia indicates that continued growth would require collaboration of all stakeholders who are involved in the Islamic finance journey. The three key stakeholders are the government, regulators and Islamic financial institutions themselves.

The government has provided strong support to the Islamic finance industry. Not only has it ensured tax neutrality between Islamic and conventional finance, but it has also provided tax incentives from which the Islamic finance industry has benefited significantly.

The role of the regulators goes beyond just ensuring that financial institutions fulfil prudential requirements and maintain the stability of the financial system. Malaysian regulators also play a very active role in creating the necessary infrastructure for a robust growth of the Islamic finance industry. The regulator's developmental role is crucial for bringing the Malaysian Islamic finance industry to the next level. It endeavours to ensure that the industry ultimately delivers on its promise of creating value and making an impact on the real economy and the community.

Going Forward in the UAE

Islamic banking in the UAE has a market share of over 20%. Its financing volume is around USD 95 billion, and the asset size is approximately USD 140 billion.

This is a significant size, but the industry has probably not yet exploited its full potential. The eight Islamic banks and the windows in the UAE are driven by competition to innovate and extend the range of products and services they offer.

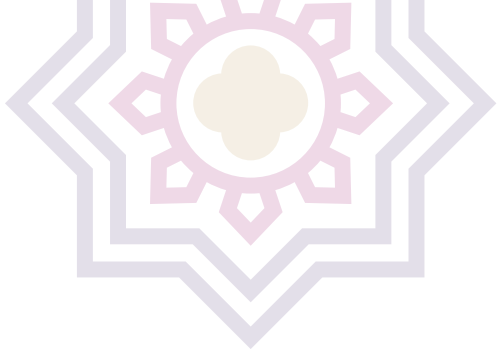
In May 2017, the UAE government decided to establish the Higher Sharī'ah Authority (HSA) for Banking and Finance to strengthen the consistency of the Islamic finance industry across the UAE. This means that the UAE will have common Sharī'ah standards for products. The common platform,

however, shall not hinder the Islamic banks from innovating and competing not only with conventional banks but also among themselves. More clarity in Sharī'ah compliance issues, more innovative products and better communication could enhance the level of awareness and contribute to the further growth of the industry in the UAE.

The creation of the HSA may also help to emphasise the similarities among Sharī'ah interpretations in different jurisdictions. Based on this, efforts should be made to implement international standards so that the Islamic finance industry can really take off as a cross-border industry.

One area where much work remains to be done to establish a cross-border market is the issuance of *ṣukūk*. It sometimes appears as if each *ṣukūk* issuance is bespoke and unique. This creates complexity, which is not conducive to the development of a deep and flourishing international *ṣukūk* market. An area where Islamic finance institutions are seemingly lagging behind their conventional competitors is the adoption of FinTech solutions. However, the FinTech opportunities have now been recognised, and there is no reason why Islamic finance should not catch up. One example of an innovative Sharī'ah-compliant peer-to-peer financing platform has been presented during this summit. Its size is very small, but maybe an Islamic bank could use the technology and scale it up.

The UAE government and regulators support initiatives by the Islamic finance industry to become more innovative and cross-border oriented.



Conclusions

The presentations and discussions held during the 2017 Summit have yielded a large number of ideas for reinvigorating the momentum of Islamic finance. They cover a wide range of themes, from deficiencies in existing regulatory regimes to the formation of a common vision for a value-based intermediation through Islamic finance.

Standardisation and Harmonisation

Standardisation and harmonisation were a recurring theme in many contributions, and the prime concern was the *ṣukūk* market. Calls were made for a standardisation of legal documentation and for Sharī'ah interpretations to shorten the initial time to market and recurrent issuances, and to reduce the costs and complexities associated with the issuance of *ṣukūk*. This is seen as a precondition for more corporate *ṣukūk* issuances in national markets, which could be supported by appropriate tax measures. It is also seen as an important step in overcoming market fragmentation, which is due to different Sharī'ah views on the tradability of securities, and in creating a truly global *ṣukūk* market.

However, standardisation and harmonisation may not be a panacea. It may be possible to create model contracts and templates, but since *ṣukūk* involve ownership of real assets that meet Sharī'ah requirements, even asset-based *ṣukūk* will be more elaborate and more costly than a standard bond.

It has been pointed out that standard setters such as the IFSB and AAOIFI have already issued a large number of standards. It has been noted that these standards may not cover all the areas that are relevant for regulators, and the standard setters are encouraged to continue with their work. However, the main problem may not lie in the lack of standards, but

in their implementation. This is primarily a task of the standard setters themselves, as well as a collective responsibility of the industry, especially regulators and supervisors. That the level of implementation is felt to be insufficient could be due to several reasons: (i) the process of implementation has commenced in many jurisdictions only when Islamic finance has reached a critical mass; (ii) the process of implementation can be time-consuming, as it requires amendments and revisions of existing legal systems and regulatory regimes; (iii) the implementation capacity of regulatory and supervisory authorities and institutions offering Islamic financial services may be severely constrained; and (iv) national standards may be considered sufficient.

An alternative to standardisation and harmonisation of details has been touched upon in passing when the passporting of foreign securities was mentioned. Passporting is based on the recognition of a common goal of regulation and the principle of home country supervision. It needs an acceptance that the same goal – for example, Sharī'ah compliance – could be achieved by different methods and procedures. It has been pointed out that, over time, a lot of convergence has been achieved on the fundamentals of Sharī'ah compliance in finance, and that, going forward, one should focus more on commonalities than on differences. It may be worthwhile to take a closer look at the principle of mutual recognition as an alternative to harmonisation of details. The breakthrough in the creation of the European single market came after the strategy of harmonisation of details was replaced by the principle of mutual recognition.

Sharī'ah Governance Systems

An increasing number of countries have recently introduced a central Sharī'ah board (which is the term used by AAOIFI in its recent Governance Standard No. 8), including jurisdictions where Islamic finance



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has been practised for decades, such as the UAE, as well as newcomers to Islamic finance, such as Oman. This will certainly contribute to more clarity and legal certainty in Sharī'ah matters in these countries. However, it is not enough to achieve an international harmonisation and standardisation. It cannot be ruled out that national central Sharī'ah boards have specific interpretations that are not in line with the views of others. Their installation should not replace efforts for a coordinated implementation of standards developed by international standard setters such as the IFSB and AAOIFI because their standards are based on a consensus of groups of leading Sharī'ah scholars who represent the different geographies and schools of Islamic jurisprudence.

Effective Communication Strategy

It was recognised that an important element of consumer protection is consumer education and market transparency. The regulators recognised that individual banks are very active in this regard, but that the industry as such is still lacking a comprehensive communications strategy. They called for an awareness campaign in which the regulators themselves also should play an active role. Better-informed customers may challenge practices of their banks, and therefore complaint handling and dispute resolution schemes should be implemented. Central Sharī'ah boards could play an important role in this regard.

FinTech

The overall attitude of regulators towards FinTechs has been supportive. Regulators have provided regulatory sandboxes, applied proportionate regulation, and are even actively involved in the development of FinTech solutions. It was recommended that regulators enter into dialogues with market players to better understand the business models of newcomers from the FinTech scene and to be better prepared for enacting proportionate prudential regulations.

Other Regulatory Deficiencies and New Issues

A number of further specific regulatory deficiencies and new issues have been identified, including the following:

- The framework for liquidity management has to be improved. Central banks and governments should provide, on a regular basis, sufficient instruments such as domestic-currency denominated sovereign *ṣukūk* that banks can use as high-quality liquid assets.
- In jurisdictions where Islamic finance is still small and its level of complexity is low, the full application of Basel III regulations would create an unreasonable regulatory burden. Therefore, regulators should follow the principle of proportionality.
- In some jurisdictions, individual Islamic banks are approaching the size of domestic systemic importance. This requires the design of a regulatory framework for systemically important Islamic financial institutions.
- Most countries where Islamic finance is practised have introduced crucial elements of financial safety nets – in particular, deposit insurance schemes. However, these schemes differ significantly in coverage and in Sharī'ah compliance among the various jurisdictions. It was suggested to harmonise these elements to support cross-border transactions.
- It has been found that standards of international standard setters have been implemented in several jurisdictions, but that their regulatory practices still differ due to divergent understandings of parts of the standards in the different jurisdictions. This underlines the importance of measures to achieve a common understanding of international standards and consistency in their implementation.



- The regulators duly noted that the *CPIFR (Banking Segment)* (IFSB-17) may be recognised by the IMF as international standards to be applied in the context of its surveillance programmes and financial sector assessments.

Value Proposition

The old debate about form over substance is continuing with a few new accents. A new term has been introduced for financial products that meld features of conventional banking products with Islamic elements: “hybrid” products. Islamic banks justify what critics call the “mimicking” of conventional products by reference to the demands of customers who prefer capital-protected savings products with predetermined returns. International organisations and some regulators would like to see more engagement of Islamic finance in financial inclusion projects, in the private financing of infrastructure, and in various kinds of socially responsible investments, from ecology and energy to health care and community development. In short, regulators would like to see more clearly the social–economic impact of Islamic finance. A promising strategy for moving the industry to the next level of value-based intermediation is the regular consultation and collaboration of market players, regulators, Sharī’ah scholars and other key stakeholders.

IFSB Summit 2017 Presentations

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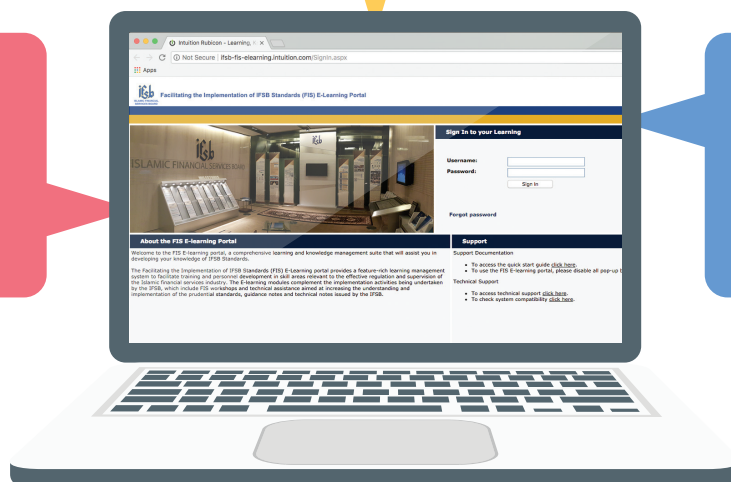
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