



Islamic Finance for Asia: Development, Prospects, and Inclusive Growth



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- 3.1: Issues with a Conventional Approach to Financial Inclusion

AAOIFI	–	Accounting and Auditing Organization for Islamic Financial Institutions
ACIA	–	ASEAN Comprehensive Investment Agreement
ADB	–	Asian Development Bank
AIC	–	Arab Investment Court
ALA	–	alternative liquidity approaches
ALC	–	asset lease company
ASEAN	–	Association of Southeast Asian Nations
AuM	–	asset under management
BCBS	–	Basel Committee on Banking Supervision
BIBF	–	Bahrain Institute of Banking and Finance
BNM	–	Bank Negara Malaysia
BSAS	–	Bursa Suq Al Sila
BSP	–	Bangko Sentral ng Pilipinas
CAGR	–	compound annual growth rate
CAR	–	capital adequacy ratio
CBMA	–	Central Bank of Malaysia Act 2009
CDO	–	collateralized debt obligation
CDS	–	credit default swap
CMB	–	Capital Markets Board of Turkey
ETF	–	exchange traded fund
FDI	–	foreign direct investment
GDP	–	gross domestic product
HQLA	–	high quality liquid asset
IAH	–	investment account holder
IAIS	–	International Association of Insurance Supervisors
IBBL	–	Islami Bank Bangladesh Limited
ICSID	–	International Centre for Settlement of Investment Disputes
IDB	–	Islamic Development Bank
IFI	–	Islamic financial institution
IFSB	–	Islamic Financial Services Board
IFSI	–	Islamic financial services industry
IIFM	–	International Islamic Financial Market
IIFS	–	institutions offering Islamic financial services
IILM	–	International Islamic Liquidity Management Corporation
IIRA	–	International Islamic Rating Agency
IMF	–	International Monetary Fund
INCEIF	–	International Centre for Education in Islamic Finance
IOSCO	–	International Organization of Securities Commissions
IRTI	–	Islamic Research and Training Institute
KFHR	–	Kuwait Finance House Research Limited
LCR	–	liquidity coverage ratio
MDB	–	multilateral development banks

MoU	–	memorandums of understanding
MSMEs	–	micro, small, and medium-sized enterprises
NBK	–	National Bank of Kazakhstan
NKEA	–	national key economic area (Malaysia)
NSFR	–	net stable funding ratio
OIC	–	Organisation of Islamic Cooperation
PER	–	profit equalization reserve
PRC	–	People's Republic of China
PSE	–	Philippine Stock Exchange
PSIA	–	profit sharing investment account
REIT	–	real estate and investment trust
RIB	–	revenue-indexed bond
RSAs	–	regulatory and supervisory authorities
S&P	–	Standard & Poor's
SBP	–	State Bank of Pakistan
SIFI	–	systemically important financial institution
SKRA	–	strategic key result area

The financial crisis of 2007–2008 that led to the global crisis, brought a sharp contraction in the growth rates of global gross domestic product and, of aggregate global financial assets. The Islamic financial services industry, however, grew at an estimated compound annual growth rate of 20% per annum during 2007–2013, partly due to its limited exposure to risky financial instruments, growth from a low base as well as inherent strengths, to reach estimated total assets of USD1.8 trillion as at year-end 2013. The Islamic banking sector, which represents approximately 80% of total Islamic financial assets, was a major driver of this growth.¹

In Asia, the strong growth of Islamic finance is led by Bangladesh, Brunei Darussalam, Indonesia, Malaysia, and Pakistan. Azerbaijan, Hong Kong, China, Kazakhstan, Singapore and Thailand also have a growing niche of Islamic finance. The strong growth of Islamic finance in Asia has been exemplified by the emergence of large Islamic banks and the issuance of *Sukūk*, a capital raising instrument that provides undivided ownership over underlying assets, as an attractive *SharTah*-compliant asset in the region. At the end of 2013, Islamic banking and *Sukūk* in Asia represented 49% and 45%, respectively, of the global Islamic finance assets.² This growth can be witnessed not just in the size of total assets and the number of Islamic finance institutions and products, but also in the development of underlying financial infrastructure supporting the industry, such as legal and regulatory frameworks and human capital development.

Broadly speaking, the growth of Islamic finance has underscored its potential as an alternative financing source for infrastructure and economic development in Asia, a source of investment financing in both advanced and emerging economies, and as a means for diversifying funding and broadening risk exposures at both institutional and macroeconomic levels. An additional dimension of Islamic finance is that it provides financial services for all segments of the population, thus improving financial inclusion, including for those who are currently unbanked or not inclined to use other financial products.

Further development of Islamic finance needs to address challenges related to capacity building needs of supervisory authorities and market players, as well as the development of legal and regulatory frameworks that can cater to the specificities of the Islamic finance industry.

The Asian Development Bank (ADB) and the Islamic Financial Services Board (IFSB) organised a conference on *Islamic Finance for Asia: Development, Prospects and Inclusive Growth and a Roundtable Session for Regulators* on 4–5 November 2013 at the ADB Headquarters in Manila, Philippines. This joint-publication of the two organisations, which is authored by selected presenters of the conference and roundtable, is produced against the backdrop of the growing importance of Islamic finance in ADB's member countries.³ The authors have presented their views on various aspects of Islamic finance, namely the growth and development of Islamic finance in Asia, legal and regulatory issues, financial inclusion, the role of *Sukūk*, implementation of the global prudential standards, initiatives undertaken by governments and the public sector, and the way forward for Islamic finance in Asia. The conference has increased the awareness on Islamic finance among ADB's developing member countries, as a potential source for cofinancing projects.

¹ IFSB Islamic Financial Services Industry Stability Report 2014

² MIFC, Sustained Growth in Emerging Asia Offers Regional Expansion for Islamic Finance, March 2014

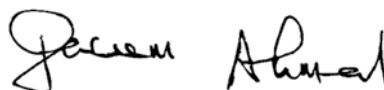
³ Malaysia, for example, targets to increase the share of its Islamic banking sector from 29% in 2010 to as much as 40% by 2020, while Pakistan recently launched a strategic plan aimed at increasing the market share of its Islamic banking sector from the current 10% to 15% by 2018.

The ADB and the IFSB would like to thank the contributors to this publication for their efforts. The publication has benefitted from the review of a team at the IFSB Secretariat, headed by Assistant Secretary-General Zahid ur Rehman Khokher⁴; a team at the ADB headed by Assistant General Counsel and Islamic finance practice leader Ashraf Mohammad and Sani Ismail, Team Leader for the ADB-IFSB technical assistance and Kuwait Finance House Research.

The *Islamic Finance for Asia: Development, Prospects and Inclusive Growth* is a useful resource for better understanding the Islamic financial services industry in Asia, and a valuable reference for jurisdictions in other regions that aim to understand, introduce and develop Islamic finance.



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March 2015

⁴ Other IFSB team members included Members of the Secretariat, Mustafa Tasdemir, Saad Bakkali, Siham Ismail, Rosmawatie Abdul Halim and Ida Shafinaz Ab Malek.

Chapter 1: Islamic Finance for Asia: Innovation, Inclusion and Growth

Baljeet Kaur Grewal

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Baljeet Kaur Grewal is the Managing Director & Vice Chairman of KFHR Research Limited (KFHR), the Investment Research subsidiary of Kuwait Finance House. In her capacity, Baljeet heads the Global Economic & Investment Research and Advisory teams at KFHR, the first Islamic bank worldwide to have a notable research presence in Islamic finance. KFHR has won 14 awards of global excellence.

Prior to this, Baljeet was the Head of Investment Banking Research at Maybank Group, Malaysia. Prior to that, she was attached to ABN AMRO Bank and Deutsche Bank, London, with experiences ranging from Credit Structuring, Loan Syndication and Economic & Capital Market Research. She has broad experience in investment banking, having participated in notable Islamic fund raising transactions in Asia & the Middle East as well as in strategic planning and execution of investment banking organisational change. To date, she has undertaken research in Islamic finance with a principle focus on debt capital markets and Sukuks in emerging markets.

Baljeet has a 1st Class Honours degree in International Economics from the University of Hertfordshire and an MBA from University of Cambridge, UK. She is also the recipient of the prestigious Sheikh Rashid al-Makhtoum Award for Regional Contribution to Islamic Finance in Asia 2006, as well as accolades honouring women in Islamic finance. She is also a regular speaker on Islamic Finance at University of Cambridge, UK.

Chapter 2: Islamic Finance: Stability, Resilience and Regulatory Issues

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Simon Archer is a Visiting Professor at the ICMA Centre, Henley Business School, University of Reading, UK, with particular responsibility for Islamic Finance, and Adjunct Professor at INCEIF, Kuala Lumpur.

Previously, he was Professor of Financial Management at the University of Surrey, after being Midland Bank Professor of Financial Sector Accounting at the University of Wales, Bangor. After studies in Philosophy, Politics and Economics at Oxford University, he qualified as a Chartered Accountant with Arthur Andersen in London and then moved to Price Waterhouse in Paris, where he became Partner in charge of Management Consultancy Services.

Since beginning an academic career, Professor Archer undertaken numerous consultancy assignments, including acting as consultant to the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB). He has been a Visiting Professor at a number of universities and business schools, including IIUM in Malaysia, Bordeaux, Metz, Paris-Dauphine, HEC and EAP-ESCP in France, Copenhagen Business School in Denmark, and Frankfurt and Koblenz in Germany.

Professor Archer is also the author and co-editor of a considerable number of works and academic papers on international accounting and on issue in Islamic finance.

In 2010, Professor Archer received an award from the Central Bank of Bahrain and Kuwait Finance House, Bahrain for his “outstanding contribution to the Islamic Financial Services Industry”.

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Madzlan Mohamad Hussain is a partner and head of the Islamic Financial Services Practice of Zaid Ibrahim & Co.

He has previously served the Islamic Financial Services Board (IFSB), an international standard-setting organisation for prudential regulations of the global Islamic financial services industry, where he contributed to the development of prudential framework in respect of corporate governance for all segments of Islamic financial services and led the IFSB's initiatives in highlighting legal issues in the global Islamic finance industry.

In his practice, besides advising Islamic financial institutions in the development and documentation of products and execution of Islamic finance transactions, he has the experience of advising on various corporate exercises including mergers and acquisitions, corporate and debt restructuring and the establishment of new financial institutions. He has been enlisted as an expert consultant by the Islamic Development Bank (IDB), the World Bank (WB) and the International Monetary Fund (IMF) in their technical assistance grants to several countries which were keen to introduce Islamic banking laws.

Madzlan holds a Bachelor of Laws degree from the International Islamic University Malaysia and a Master of Science in Islamic Economics, Banking and Finance from Loughborough University, United Kingdom. He was a former Chevening Visiting Fellow at the Oxford Centre for Islamic Studies, United Kingdom and has done an attachment with the Legal Department at the Federal Reserve Bank of New York.

Chapter 3: Islamic Banking: Financial Inclusion as a Core Concept

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Prior to his current assignment, he had more than twenty years of experience with the World Bank Treasury dealing with risk management, structured finance and assets management. His research interest includes Islamic Finance, Financial Engineering, and Risk Management.

He has written extensively on Islamic finance and has published articles in reputed academic journals. He has co-authored several books on Islamic finance on diverse topics including risk analysis of Islamic banks, financial stability of Islamic finance, risk-sharing in Islamic finance, and Islamic finance and economic development. He holds a Ph.D. in international finance from the George Washington University. He has also served as Professional faculty at Carey Business School of The Johns Hopkins University.

Chapter 4: Islamic Capital Market: The Role of Sukuk for Development

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Born in 1974, Murat Haholu graduated from University of Ankara, Law School, with LL.B degree in 1996. He then started his career at the Capital Markets Board of Turkey in 1997. He worked for 4 years as an assistant expert at the CMB. In 2001, he was appointed as an expert. He got his MBA degree at the Atilim University in Ankara in 2004. Then in 2007, he went to the American University Washington College of Law. He holds an LL.M degree on Business and Financial Regulation. In the CMB, he worked in many projects such as securitization, public disclosure. He also worked in the project regarding the implementation of the European Union Acquis into Turkish Capital Markets Law. Among the other projects he worked in are asset backed securities and asset covered bonds. He is currently working in the project on Sukuk Issuances at the CMB in the Department of Corporate Finance. Currently, he has been working as the head of surveillance, a division of that department.

Chapter 5: Implementation of the IFSB Standards

Zahid ur Rehman Khokher

Assistant Secretary - General
Islamic Financial Services Board

Zahid has been working with the Islamic Financial Services Board (IFSB) since January 2008 and has more than 15 years of regulatory and standard setting experience in the financial sector. He supervises the standard-setting and research programme of the IFSB and provides immediate leadership and guidance required by the relevant staff. He is also responsible for overseeing key initiatives, among others, Integrated Result Based Management Framework and strategic performance planning for the Secretariat. His role also involves cooperation and development of the Islamic financial services industry by fostering relationships with IFSB members, multilateral development banks and other international organisations.

He is also member of the Basel Consultative Group and IAIS-IFSB Joint Working Group on Microtakaful.

He has also worked as Joint Director in the Islamic Banking Department of State Bank of Pakistan, where he was involved in assignments related to the introduction and enhancement of Islamic prudential and regulatory framework in the country. His experience in the central bank also includes on-site inspection, foreign exchange supervision, and treasury.

Zahid is a Chartered Islamic Finance Professional (CIFP) from INCEIF, Malaysia (2009). He holds Masters in Business Administration (2005), Computer Science (1998) as well as Statistics (1995). He also holds PGD in Islamic banking and insurance from IIBI, London, UK (2001).

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Chapter 6: Legal and Regulatory Issues for Islamic Finance Post-crisis**Saleem Ullah***

Director, Finance Department
State Bank of Pakistan

Saleem Ullah is a career Central Banker with over 18 year's Central banking experience at various important positions including Head Microfinance Division (MFD), Head Strategic Management, Director Agricultural Credit, Director Development Finance and Director Islamic Banking.

As Head MFD from 2001 to 2005, he pioneered the development of regulatory and supervisory framework for Microfinance Banks in Pakistan, which is considered as one of the most progressive in the world. Since assuming the responsibilities as Director Islamic banking about 3 years back, he has taken several key initiatives to improve the policy and regulatory environment to facilitate growth and development of the Islamic finance industry on sound footings. The initiatives include development of detailed instruction on profit and loss distribution and pool management policies of Islamic bank, development of Islamic microfinance model, development of liquidity management solutions for Islamic banking Institutions.

By qualification, he is a business graduate of Bahaudin Zakariya University, Multan, Pakistan and an associate member of Institute of Cost and Management Accountant of Pakistan. He has also done Masters in Public Policy from Kennedy School of Government, Harvard University as a mid career student. His career spans over 18 years of central banking experience primarily in the areas of banking supervision and development finance.

Note: The views presented in the article are the author's own and not those of State Bank of Pakistan.

Chapter 7: Taking the Initiative for Islamic Finance: Role of Governments and Private Sector

Badlisyah Abdul Ghani

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Badlisyah Abdul Ghani is the Executive Director and Chief Executive Officer of CIMB Islamic, Head of the Group Islamic Banking and the Country Head of Middle East and Brunei, CIMB Group.

As the Executive Director and Chief Executive Officer, he manages and oversees the overall Islamic banking and finance franchise of CIMB Group known as CIMB Islamic.

He sits on various boards of companies and is currently the Alternate Director to Chairman of CIMB Principal Islamic Asset Management Berhad; Alternate Director of CIMB-Principal Asset Management Berhad and CIMB Wealth Advisors Berhad; Member of the Investment Committee of CIMB Principal Asset Management Bhd; Director of CAPASIA Islamic Infrastructure Fund (General Partner) Ltd; Director of CIMB Middle East BSC (C) Baharin and Director of Islamic Banking and Finance Institute Malaysia.

Badlisyah has 16 years of domestic, regional and global banking experience in various roles. He has been recognised by top international publications as the “Top 20 Pioneer in Islamic Finance”, “Islamic Banker of the Year” and awarded the “Outstanding Contribution to the Development of Islamic Finance” award for his role in the global Islamic financial market. He sits on the Islamic Capital Market Consultative Panel of Bursa Malaysia and both the Exchange Committee and the Licensing Committee of the Labuan International Financial Exchange.

Badlisyah is 39 years old and holds a Bachelor of Laws degree from the University of Leeds, United Kingdom and an alumni of the ICLIF Program.

Chapter 8: The Way Forward: A Roadmap for Asia

Dr. Ishrat Husain

Dean and Director

Institute of Business Administration, Pakistan

Former Governor, State Bank of Pakistan

Dr. Ishrat Husain joined the elite Civil Service of Pakistan in 1964 and served in the field in Sindh and then East Pakistan (now Bangladesh) and also held mid-level policy making positions in the Finance, Planning and Development Departments before moving to Washington in 1979 to join the World Bank. He became the Bank's Resident Representative to Nigeria in 1983.

Ishrat Husain was appointed the Governor of Pakistan's Central Bank in December 1999. He was conferred the prestigious award of "Hilal-e-Imtiaz" by the President of Pakistan in 2003. The Banker Magazine of London declared him as the Central Bank Governor of the year for Asia in 2005. He received the Asian Banker Lifetime achievement award in 2006.

He was appointed the Chairman, National Commission for Government Reforms in May, 2006 with the status of Federal Minister and held that position for two years reporting directly to the President and Prime Minister of Pakistan.

In March 2008, he took over the charge of the office of the Dean and Director, IBA, Karachi – the oldest graduate business school in Asia. During 2005-06 he was appointed by the Board of IMF as a member of a three person panel to evaluate the IEO and was also a member of the Mahathir Commission 2020 vision for the Islamic Development Bank (IDB). He also advised the IDB for creating its poverty reduction fund. He is currently a member of Middle East Advisory Group of the IMF and the Regional Advisory Group of the UNDP. He is currently the Chairman World Economic Forum Global Advisory Council on Pakistan. Since 2011 he is serving as an independent Director on the Board of Benazir Income Support Programme (BISP) the largest Social safety net and conditional cash transfer program targeted at the poor households of Pakistan.

Dr. Husain has maintained an active scholarly interest in development issues. He has authored 12 books and monographs and contributed more than two dozen articles in refereed journals and 15 chapters in books. His book "Pakistan: The Economy of the Elitist State" published by Oxford University Press in 1999 is widely read in Pakistan and outside. He is regularly invited as a speaker to international conferences and seminars and has attended more than 100 such events all over the world since his retirement as the Governor. He is the Distinguished National Professor of Economics and Public Policy and serves on the Boards of several research institutes, philanthropic and cultural organizations.

Ishrat Husain obtained Master's degree in Development Economics from Williams College and Doctorate in Economics from Boston University in 1978. He is a graduate of Executive Development program jointly sponsored by Harvard, Stanford and INSEAD.



CHAPTER 1

Islamic Finance for Asia: Innovation, Inclusion, and Growth

Baljeet Kaur Grewal

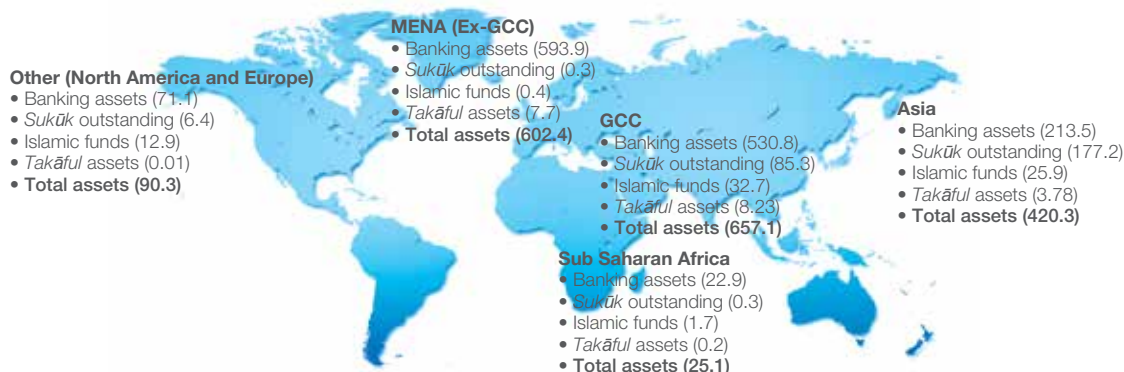
Overview of Islamic Finance in Global Markets

The inception of the global Islamic finance industry can be traced back to the 1960s and 1970s when the first modern *Shari'ah*-compliant financial institutions were set up in a few Middle Eastern countries and Malaysia along with the multilateral establishment of the Islamic Development Bank. Since then, the global Islamic financial services industry has grown substantially over the last few decades (see Box 1.1 for salient features of Islamic finance), entering its fifth decade of existence in the modern era. The industry's assets have grown from \$150 billion in the mid-1990s to approximately \$1.9 trillion as at the first half of 2014. The sector has sustained (see Figure 1.1 for regional statistics) double-digit growth rates annually, achieving a compound annual growth rate (CAGR) of 16.94% during 2009–2013. The global Islamic financial assets are well on course to surpass the milestone \$2 trillion mark in 2014, fueled by geographical and sectoral expansions. In addition, active roles played by various government and regulatory agencies in promoting the development of Islamic financial markets in their respective countries are serving to widen the outreach of the Islamic financial services industry. This process has been supported by the efforts of global multilateral entities including the likes of the Islamic Financial

Services Board (IFSB), the Islamic Development Bank (IDB), and other international agencies such as the World Bank, the International Monetary Fund (IMF), and the Asian Development Bank (ADB).

The industry's geographical presence has grown beyond its traditional markets in the Middle East and Southeast Asia and includes new players from diverse regions such as Europe, Central Asia, and Africa. There are now more than 600 Islamic financial institutions operating across more than 70 economies including non-Organisation of Islamic Cooperation (OIC) members such as the United Kingdom, Luxembourg, Mauritius, and Singapore. In terms of product offerings, the industry is now able to provide a wide range of products to meet the varying needs of both retail and corporate customers. Moreover, the industry's offerings now include *Shari'ah*-compliant capital markets (equities and *Sukūk* or Islamic bonds), assets and funds management, as well as *Takāful* (Islamic insurance) services. There are a number of conventional banks that have introduced parallel Islamic banking operations.

Figure 1.1: Global Islamic Finance Assets by Region (H1 2014E)



E = estimate, GCC = Gulf Cooperation Council, H = half.
Note: Figures in brackets are in \$ billion.

Source: KFH Research.

Box 1.1: Islamic Finance: The Salient Features

Islamic finance transactions must be free from the use of “*Riba*” (interest). *Sharī‘ah*, or Islamic law, prohibits any increase in returns from commercial transactions without the reward seekers sharing the risks or stake in the economic activity. As a result, returns on investments must be based on real economic activities and/or underlying assets, performance on which the contractual relationship between parties is structured. Transactions may also be based on sale-contracts where profits are legitimately earned from the sale of underlying assets at a price which covers the asset’s original cost plus profit.

In general, Islamic financial mechanisms aim to promote profit and loss structures to ensure contracting parties share the risks of venture among them. Apart from *Riba*, other elements prohibited in financial transactions are excessive uncertainties in contractual performance (*Gharar*), and gambling and/or chance-based outcomes in transactions (*Maysir*). In addition, transactions involving activities deemed impermissible in Islam such as alcohol brewery, gambling, and casino operations are prohibited. Moreover, the financial contracts must be free from any sort of coercion, corruption, and deception and the contracting parties must express their free mutual consent in accepting a deal.

Figure B1.1.1: Salient Features of the Islamic Financial System

Salient Features	• Interest-based lending and the financing of unethical goods and services are prohibited.
	• Returns on investments must be based on real economic activities and/or underlying assets, performance.
	• Islamic finance discourages hoarding and prohibits transactions with extreme uncertainties, and gambling and related activities.
	• Equity participation, temporary equities, credit sales, leasing, and other suitably designed modes replace interest-based finance, thus promoting the practice of risk sharing.
	• Financial engineering to design new products and instruments must comply with the <i>Sharī‘ah</i> requirements.
	• Private property and free markets are basic to the economic system; any transaction leading to injustice and exploitation is prohibited.
	• Islamic finance upholds contractual obligations and the disclosure of information, which in turn reduces the risk of asymmetric information and moral hazard.

Source: KFH Research.

While the industry has grown across various financial segments, the Islamic banking sector continues to dominate the global portfolio of Islamic financial assets accounting for an estimated 79.8% share as at the first half of 2014. Assets with Islamic banks and Islamic banking windows have grown at a CAGR of 17.4% between 2008 and 2013. The *Sukūk* sector, however, is the top performing sector of the global Islamic finance industry, evidenced by the larger and more frequent issuances in the market by both existing and new debutant issuers. The

annual *Sukūk* issuances in the primary market have surpassed the \$100 billion in the last 2 years and are poised to once again achieve this feat in 2014 (first half of 2014: \$66.2 billion). In terms of global *Sukūk* outstanding, the volume reached \$286.4 billion in the first half of 2014, up 16.8% from \$245.3 billion in the first half of 2013. *Takāful* remains a nascent industry, constituting only an estimated 1.0% share of the global Islamic financial assets as of the first half of 2014. On the other hand, the Islamic funds sector has grown comparatively faster with assets

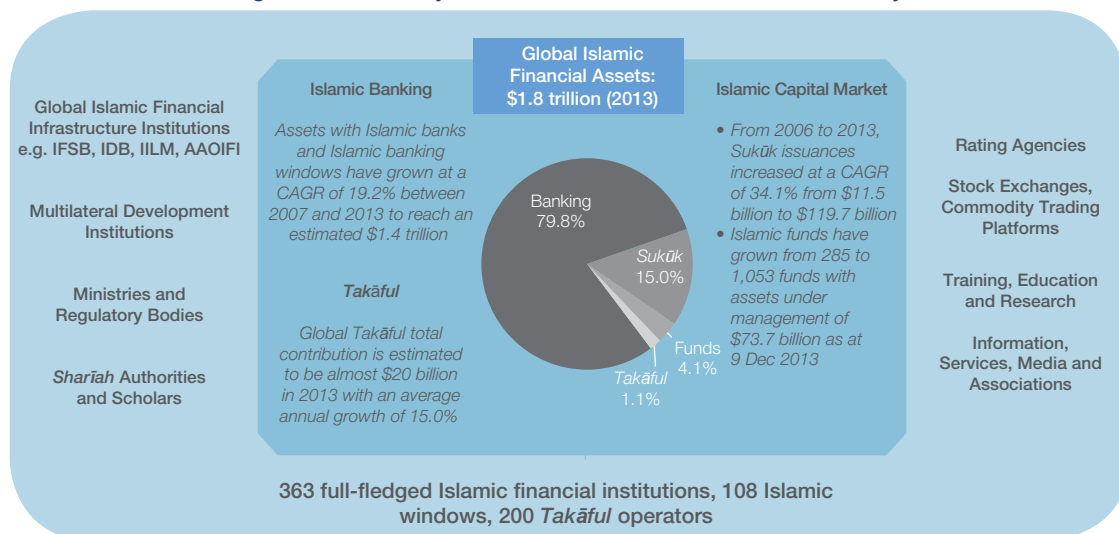
under management worth \$75.1 billion as of the first half of 2014. The sector has steadily grown fourfold from about 285 Islamic funds in 2004, to nearly 1,069 Islamic funds in the first half of 2014. These developments are among several notable key trends that reflect the increasing interest and awareness of Islamic finance globally.

Alongside the growing internationalization of the Islamic finance industry, its growth is being supported by improvements in the overall Islamic finance architecture. Among key global bodies supporting Islamic finance growth (see Figure 1.2) and development include the IDB, IFSB, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), International Islamic Financial Market (IIFM), and the International Islamic Liquidity Management (IILM) Corporation. These organizations have been instrumental in taking

initiatives and measures aimed at fostering greater use of Islamic financial instruments and mechanisms to promote inclusive growth and Islamic financial awareness, and providing a consistent basis for prudential standards and *Shari'ah* governance.

Efforts in strengthening market linkages and facilitating internationalization of Islamic finance were also among the key focus of the industry's stakeholders. Forging cross-border linkages is central to these aims as more efficient mobilization and allocation of funds across regions would bring mutually reinforcing gains to the countries involved as well spur growth of the Islamic finance industry at large. The growth of the industry has also led to the establishment of many higher academic and training institutions around the world that now offer academic programs in Islamic finance to develop the pool of talent needed to drive the industry.

Figure 1.2: The Ecosystem of the Islamic Financial Services Industry



Source: KFH Research.

Throughout the evolution of the industry, national regulatory bodies have been instrumental in supporting the growth and development of the industry by ensuring clarity on regulations, gradual harmonization in industry standards,

sound corporate governance principles, and accommodative legislative infrastructure. These are critical for the sustainable and sound expansion of the Islamic finance industry while further boosting stakeholder confidence in this alternative financial

system. On the legislative and regulatory side, diverse efforts are underway in Asia, the Middle East, Europe, and, lately, sub-Saharan Africa. Most notably, Malaysia introduced the Islamic Financial Services Act 2013, which came into effect on 30 June 2014, and this is arguably considered the world's first omnibus legislation on Islamic finance. Hong Kong, China's Legislative Council passed the Loans (Amendments) Bill 2014 in March 2014 which enables the government to raise money through alternative bonds such as *Sukūk*. In the following subsections of this chapter, notable regulatory developments currently taking place in Asia across the various Islamic finance sectors will be highlighted. Furthermore, subsequent chapters in this publication also present a case study analysis on regulatory and legal developments in key Islamic finance countries such as Malaysia while highlighting the present challenges and possible solutions on the way forward.

Meanwhile, over the years, the focus of regulatory bodies and multilateral agencies has also been directed toward analyzing the stability and resilience of the Islamic financial system. In general, the Islamic finance sector was found to have better weathered the global financial crisis of 2008–2009. Consequently, it has become of great stakeholder interest to study the key *Sharī'ah* principles which possibly contribute toward the relatively enhanced stability and resilience of the Islamic finance sector. The same is extensively discussed in many subsequent chapters of this publication, including current pitfalls in Islamic financial practice which could lead to instability risks. Furthermore, measures to mitigate these risks are also provided by the various authors across the chapters.

The IFSB also supports financial stability in the Islamic financial system by issuing global prudential standards and guiding principles for the industry, broadly defined to include the banking, capital markets, and insurance sectors. To date, the IFSB has published 16 standards, 5 guidance notes, and 1 technical note on various aspects relevant for the financial viability and stability of the Islamic financial institutions. The IFSB also regularly holds seminars, workshops, and forums on various topics relevant to prevailing market conditions and these serve as critical platforms for the IFSB to engage with the industry stakeholders in order to disseminate new information as well as obtain feedback on newly emerging market challenges and needs. Particularly for financial stability, since 2010, the IFSB has hosted the Islamic Financial Stability Forum where leading industry experts present on topics representing pressing industry challenges of the time. The IFSB also publishes an annual Financial Stability Report and most recently has released the Islamic Financial Services Industry Stability Report 2014 at its 11th Annual Summit, held in Mauritius.

The private sector has spearheaded the sector's growth through innovative product developments. Product innovation has enabled the sector's offerings to include a diverse range of financial products suited to meet the evolving market needs. In recent times, the Islamic finance industry's scope is being widened to penetrate into newer growth areas which, for example, range from funding green, ethical, and environment-friendly development projects to ones as diverse as enabling of international risk management using *Sharī'ah*-compliant hedging instruments. Islamic finance players are increasingly turning toward financial engineering and innovations to develop *Sharī'ah*-compliant products that can cater to modern market needs.

Finally, the role of Islamic finance as a potential catalyst for enhancing financial inclusion has also received growing attention over the years. As per surveys conducted by various international institutions including the World Bank and Pew Research Center, there exists a segment of society that wishes to voluntarily exclude themselves from the formal financial system on account of religious

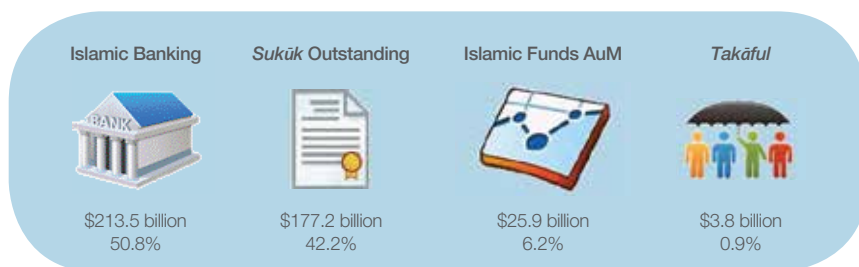
reasons. Islamic finance provides a *Sharīah*-compliant and ethical alternative to meet the needs of such segments. In addition, the variety of risk-sharing contracts in Islamic finance further provide an ideal medium to all other borrowers as they do not have to bear all risks associated with engaging financial services. Implicitly, this would lower the cost of financing and doing business.

Islamic Finance in Asia: Progress and Opportunities

Asia is a pivotal part of both the global economy and the Islamic financial system. The region is home to the largest portion of the Muslim population in the world, while also being a key driving force of global economic growth. At present, the Islamic financial landscape in Asia is dominated by Islamic banking and *Sukūk* sectors (see Figure 1.3 and 1.4). Overall,

the Islamic finance sector as a whole accounts for a combined value of over \$420 billion or an estimated 23.4% of global Islamic financial assets. Islamic asset management remains a nascent but budding industry in Asia which has seen steady growth post-financial crisis. The *Takāful* industry accounts for less than 1.0% of regional Islamic financial assets.

Figure 1.3: Islamic Finance Landscape in Asia (end-2013)



AuM = asset under management.

Source: KFH Research

The strong growth momentum of Islamic finance is driven by many factors. Central to this is the core values of Islamic finance itself. Islamic financial institutions (IFIs) endeavor to provide economically viable financing alternatives in the global financial system, framed within the boundaries set by *Sharīah* principles. These institutions run parallel to the conventional financial institutions and more or less perform all those functions that a modern financial institution is expected to provide. The difference lies in their philosophies and operations. The fundamental

philosophy behind the conventional banking system is the use of the “interest rate,” which provides an opportunity for lenders with surplus funds to earn fixed rates of returns by loaning their funds out to borrowers who must repay the borrowed amount and an additional price (interest rates) at a future date. *Sharīah* prohibits returns from commercial transactions without the reward seekers sharing the risks or stake in the economic activity. As a result, returns on investments must be based on underlying economic activities and/or assets on which the

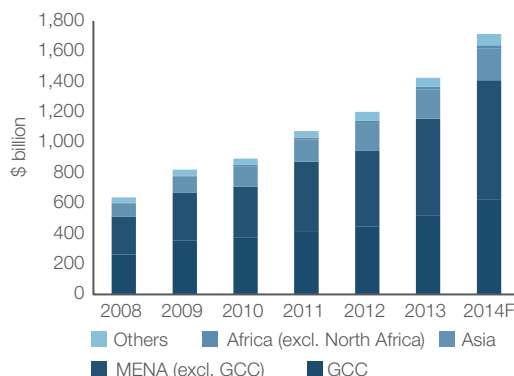
contractual relationship between transacting parties is structured. Thus, a fully compliant Islamic economy would eliminate the two fundamental reasons for the widespread bankruptcies during crisis periods—legally binding liabilities of corporations to service their debts outstanding according to the predetermined rates and excessive leveraging beyond their economic value.

From a broader perspective, the asset-based nature and risk-sharing aspects of Islamic finance can be utilized for greater integration with the real economy and improve the overall economic balance between real and finance sectors. Asian markets also have the largest concentration of Muslims in the world, which facilitates a ready market for the introduction and distribution of *Shari'ah*-compliant products and services.

Islamic Banking: Surging Stakeholder Interest

Islamic banking in Asia has witnessed an increasing number of new entrants either by way of new institutional setups or by existing conventional banks leveraging on their conventional setups. Realizing its sizable market potential for Muslim and non-Muslim banking customers alike, many stakeholders (including both public and private entities) are intensifying efforts to make fast progress to advance in the Islamic finance industry. Among the developed Islamic banking jurisdictions in Asia are Malaysia, Bangladesh, Pakistan, and Brunei Darussalam. Malaysia is one of the global leaders for Islamic financial services and held an estimated 10.0% share of the global Islamic banking assets as at the end of 2013. Comparatively, Indonesia, Pakistan, and Brunei Darussalam have smaller shares, but their growth and regulatory developments in recent years have enabled them to expand their volume of *Shari'ah*-compliant banking assets. As at the end of 2013, Malaysia contributed 70.5% of the regional Islamic banking assets (\$135.5 billion), followed by Indonesia (9.5%, \$20.2 billion) and Pakistan (5.3%, \$10.2 billion), while other countries contributed to the remaining 14.7% (see Figure 1.5).

Figure 1.4: Global Islamic Banking Assets—Growth Trend by Region (2008–2014F)



F = forecast, GCC = Gulf Cooperation Council, MENA = Middle East and North Africa.

Source: Central banks, CEIC, annual reports, KFH Research

Other growing jurisdictions for Islamic banking services include Indonesia and Sri Lanka. In other parts of Asia, several jurisdictions with large Muslim populations, such as India, the People's Republic of China (PRC), and most of the Commonwealth of Independent States, remain largely untapped, which highlights new market opportunities for Islamic financial institutions to penetrate. The East Asian powerhouses (e.g., Japan, Republic of Korea, and Hong Kong, China) have also shown interest in developing Islamic banking markets locally as well as to create windows of opportunity for issuers to tap the *Sukuk* market via their shores.

In 2014 to date, a number of Islamic banking-related developments have taken place across Asia that indicates strong growth prospects for this segment. Notably in India, the world's second most populated country, the Reserve Bank of India, the country's central bank, has begun a review of regulations on Islamic banking in India. In this regard, the central bank is reported to have established an internal committee consisting of senior central bank officials amid calls for a re-evaluation of Islamic banking regulations in the country.

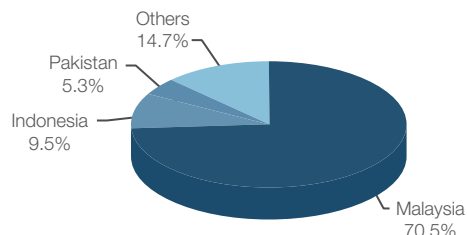
Similarly in the Philippines, the country's central bank, Bangko Sentral ng Pilipinas (BSP), has sought the help of Malaysia in developing the Islamic banking industry. The BSP has been holding talks with Bank Negara Malaysia (BNM) regarding the creation of a framework for Islamic banking in the Philippines. In September 2013, the BSP submitted a request to the government to have its charter amended allowing the bank to issue *Sharī'ah*-compliant instruments to Islamic banks, in particular interbank lending products.

Among existing markets, the Malaysian Islamic banking practice is shifting toward a contract-based regulatory framework by providing legal recognition to the contractual requirements in accordance with *Sharī'ah*. The shift is in line with the new Islamic Financial Services Act 2013. In this regard, the *Sharī'ah* Advisory Council of BNM is enhancing the existing *Sharī'ah* parameters on various Islamic finance contracts in order to introduce new *Sharī'ah* standards that set out mandatory and optional requirements applicable in Islamic financial transactions along with guidelines on operational parameters to enable uniformity of *Sharī'ah* rulings across institutions.

In Pakistan, the central bank, State Bank of Pakistan (SBP), launched a 5-year strategic plan for Islamic finance in February 2014 which targets an increase in the sector's share of banking system assets from around 10.0% as of December 2013 to 15.0% by 2018. More recently, this target has been revised to achieve a 20.0% share by December 2018. The *Sharī'ah* Governance Framework issued by the SBP has also come into effect starting 1st October 2014. The framework by SBP aims to further strengthen the overall *Sharī'ah* compliance environment in Islamic banking institutions (IBIs) in Pakistan while institutionalizing the *Sharī'ah* compliance function in IBIs. The regulator is also finalizing details on an Islamic liquidity framework, consisting of an Islamic interbank money market and a *Muḍārabah*-based placement facility run by the central bank.

Other notable developments include the International Bank of Azerbaijan, the country's biggest bank, currently working with national authorities on drafting an Islamic banking law in Azerbaijan. Meanwhile in Tajikistan, the law on Islamic banking activity, approved in draft form by the country's lower chamber of parliament in May 2014, came into force on 5 August 2014 with the aim of granting licenses to financial institutions operating on *Sharī'ah* principles and regulating their activities.

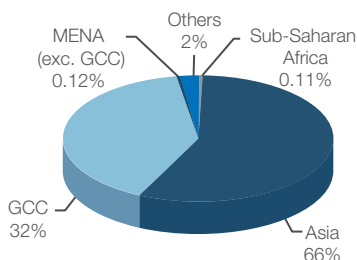
Figure 1.5: Islamic Banking Assets in Asia by Domicile (2013)



Source: Central banks, CEIC, annual reports, KFH Research.

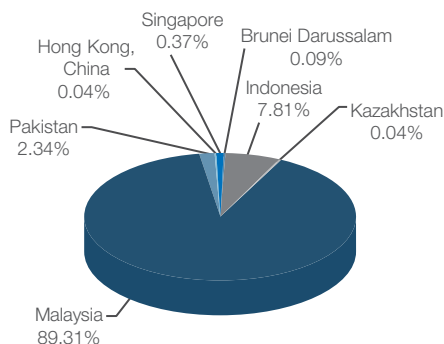
***Sukūk* Market: Rapidly Expanding Frontiers**

The *Sukūk* markets in Asia have been sparked by a series of developments and commitments from potential players in the last 5 years. A number of new jurisdictions have been home to *Sukūk* issuance during 2013 as sovereigns and particularly corporates eye the opportunity to secure lower funding costs and diversify funding sources. Malaysia has maintained its dominance in *Sukūk* issuances over the years globally, with countries from the Gulf region catching up. Malaysian new *Sukūk* issuances accounted for 68.8% (see Figure 1.6) of the global primary *Sukūk* market share as at the end of 2013 followed by Indonesia (4.68%), Pakistan (0.37%), and Brunei Darussalam (0.33%). Among other economies that have issued *Sukūk* (see figure 1.7) in Asia are Singapore, Kazakhstan, and Hong Kong, China that are looking to diversify their funding options following liquidity constraints in international markets. Malaysia, being a leader in global *Sukūk* issuances, has also made progress in cross-border issuances as part of the efforts to facilitate greater mobilization of funds across regions.

Figure 1.6: *Sukūk* Outstanding by Region (2013)

GCC = Gulf Cooperation Council, MENA = Middle East and North Africa.

Source: IFIS, Bloomberg, Zawya, KFH Research.

Figure 1.7: *Sukūk* Outstanding in Asia (2013)

Source: IFIS, Bloomberg, Zawya, KFH Research.

During the first half of 2014, a number of regulatory developments took place across several Asian *Sukūk* markets. Notably in Malaysia, the Malaysian Prime Minister in 2013 introduced the Socially Responsible Investment Sukūk Initiative in the Malaysian Annual Budget 2014, which seeks to encourage sustainable and responsible investments. In this regard, the Securities Commission Malaysia is currently in the process of finalizing a framework for socially responsible *Sukūk* and the framework is expected to be launched in the third quarter of 2014. Following this framework, Malaysia is expected to take a lead in spearheading issuances of socially responsible Islamic bonds which will further drive growth in the global *Sukūk* industry.

In Pakistan, SBP is currently in the process of finalizing details on a *Sharīah*-compliant liquidity framework ahead of the country's proposed US dollar sovereign *Sukūk* issuance later this year. The current shortage of sovereign *Sharīah*-compliant debt instruments has been highlighted as one of the industry's most pressing problems by industry participants, along with a lack of public awareness regarding the sector and the quality of regulatory support. Pakistani regulators are taking necessary steps to address these challenges and any remedies for liquidity management are likely to include *Sukūk* instruments which will spur new *Sukūk* issuances in the country.

Meanwhile, the *Sukūk* market is expected to kick off in the Kyrgyz Republic as well in the near future. On behalf of the Kyrgyz Republic, the State Service for Regulation and Supervision of Financial Markets has signed an agreement with legal firm Simmons & Simmons through which the latter will advise the government on its Islamic finance endeavors which include growing the domestic *Sukūk* and *Takāful* markets. The consultancy services will be funded by the IDB through a technical assistance grant.

Islamic Funds: Growing Potential

Asia has been an important part of the growing global wealth in recent years, as strong fundamental economic growth has produced a larger number of high net worth individuals and created the need for more wealth management products. Islamic funds registered in Asia are primarily dominated by Malaysia with a total of 266 funds registered as of the end of 2013, followed by Indonesia (70), Pakistan (55), and Thailand (4) (see Figure 1.8).

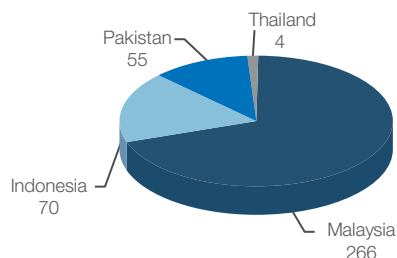
Malaysia is the second largest market by assets under management behind Saudi Arabia, with approximately \$16.4 billion in assets or 22.0% of the industry total. Malaysia's Islamic finance industry benefits from a well regulated environment, with

a transparent legislative system and supporting infrastructure. This makes it a particular prime destination for wealth management, and in particular Islamic wealth management, given the domestic population demographics as well as its regional positioning both geographically and as a hub for Islamic finance.

In the first half of 2014, there were a number of favorable Islamic-funds-related developments in Malaysia which are likely to spur further momentum in the Islamic funds market. For instance, effective from June 2014, foreign firms have been allowed to assume complete ownership over unit trust management companies in Malaysia. This permits foreign managers to market funds to retail investors; prior to the removal of barriers, the distribution of foreign-owned funds (of wholesale kind only) was limited to Malaysian residents whose net worth exceeded RM3 million (\$935,000).

Meanwhile, Malaysia's state pension fund, the Employees Provident Fund, is studying the possibility of establishing the world's first stand-alone state-backed Islamic pension fund, looking at the viability of such a fund from accounting, legal, and *Shari'ah* compliance standpoints. Presently, the fund invests a third of its portfolio in *Shari'ah*-compliant securities; however, there is a strong demand from depositors for wholly *Shari'ah*-compliant investments.

Figure 1.8: Islamic Funds Registered in Selected Asian Jurisdictions (number, 2013)



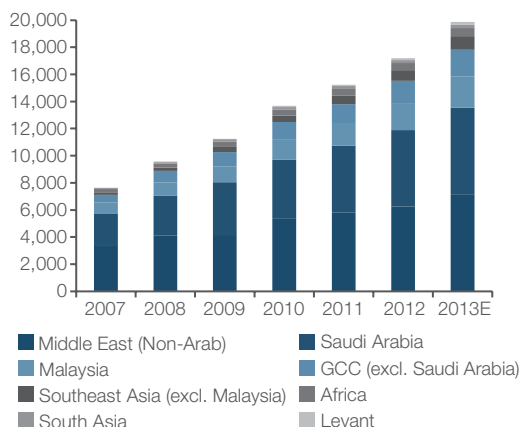
Source: Bloomberg, KFH Research.

In another development, in March 2014, Malaysia listed its second tradable *Shari'ah*-compliant exchange traded fund (ETF), managed by i-Vcap Management. This development is indicative of the increasing investor appetite for the new investment tool (which offers a low-cost, passive approach to investing in a *Shari'ah*-compliant equity portfolio) in Malaysia and larger Asia as a whole. Bursa Malaysia currently has five listed ETFs, including i-Vcap's MyETF-DJIM25 which was the first Islamic ETF in Asia.

Takāful: Potential Development Prospects

Another developing sector is the *Takāful* sector. The development and growth of Islamic finance in Asia (see Figure 1.9 for regional breakdown) presents strong opportunities for *Takāful* operators to expand their geographical outreach in the region given that many of the Asian economies are emerging markets with relatively large populations, strong economic growth performances, and generally low insurance penetration rates. At present, the *Takāful* industry in Asia is firmly established in Malaysia, which contributes the major share. However, other countries from South and Southeast Asia such as Bangladesh, Pakistan, Indonesia, and Brunei Darussalam are also further developing their *Takāful* markets, capitalizing on their established regulatory frameworks that help support the growth and expansion of the domestic *Takāful* industry. In comparison, newer jurisdictions such as Afghanistan and Kazakhstan have also witnessed the introduction of *Takāful* products. Additionally, there is a strong potential to offer *Takāful* services in other Asian economies considering Islamic finance such as Azerbaijan, the PRC, Japan, the Kyrgyz Republic, the Philippines, and Hong Kong, China.

Figure 1.9: *Takāful* Gross Contributions by Region (2013E)



E = estimate, GCC = Gulf Cooperation Council.

Source: World Islamic Insurance Directory, EY, KfH Research.

Among recent *Takāful*-related developments in Kazakhstan, legislative changes to the country's Islamic finance law regarding *Ijārah* (or Islamic leasing) and *Takāful* were put forward last year by a special committee of the National Bank of Kazakhstan (NBK), which is responsible for Islamic finance development, to the government. The legislation is currently awaiting approval by parliament, with the expectation that it will be ratified and adopted at some point this year.

In the more established market of Malaysia, the *Takāful* industry is expected to witness notable changes in the following years as Section 16 (1) of the Islamic Financial Services Act 2013 critically enforces separation of

licenses between the general and family *Takāful* segments and provides a time period of 5 years for existing composite operators to bifurcate between the two segments. This measure aims to achieve a stronger business focus in either family or general *Takāful* for *Takāful* operators and also bring Malaysian insurance laws to be in parallel with international insurance laws. A framework for the provision of basic family *Takāful* and life insurance products through direct channels has been set as one of the critical targets in 2014 for Malaysia's financial services, a National Key Economic Area (NKEA), as part of the government's Economic Transformation Programme.

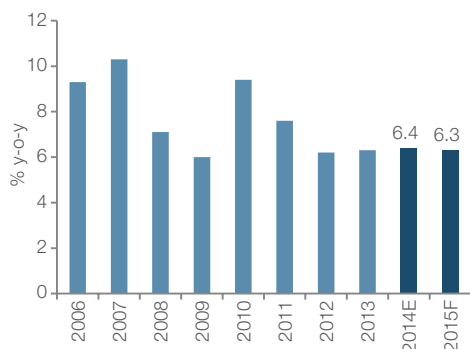
Finally in Pakistan, based on an original regulatory amendment introduced in 2012, the regulator had allowed the introduction of *Takāful* windows by conventional insurance companies as a measure that was likely to spur the *Takāful* market share in the country. However, a group of five existing *Takāful* operators in Pakistan had earlier challenged this ruling in court citing such a measure would distort the Islamic insurance industry in Pakistan. Recently in April 2014, the group reached a groundbreaking agreement out-of-court with the plaintiffs agreeing to withdraw their petition challenging the *Takāful* Rules 2012 while leaving the provision about window operations fully intact. As such, the biggest players of conventional insurance in Pakistan have announced the launch of their Islamic window operations this year which is expected to result in tremendous expansion of the Islamic insurance segment in Pakistan, a country with a low insurance-to-gross domestic product (GDP) penetration rate of 0.7%.

Asia's Economic and Demographic Profiles

As the most dynamic region in the world, Asia has an important role to play in shaping the agenda for balanced and sustainable growth. Economic growth in Asia continues to outpace the rest of the world, with the region rapidly increasing its importance in the global economy, and real GDP growth will average

6.4% annually in Asia in 2014–2015. Currently, three of the world's four largest economies by purchasing power parity (PPP) are Asian; the PRC, India, and Japan (see Figure 1.10) already account for a quarter of the world economy, with that share increasing to 30.0% by the end of the decade.

Figure 1.10: GDP Growth Trend and Projections for Asia (2006–2015F)



E = estimate, F = forecast, GDP = gross domestic product, y-o-y = year on year.

Note: The Asia aggregate includes the People's Republic of China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei, China; Thailand; and Viet Nam.

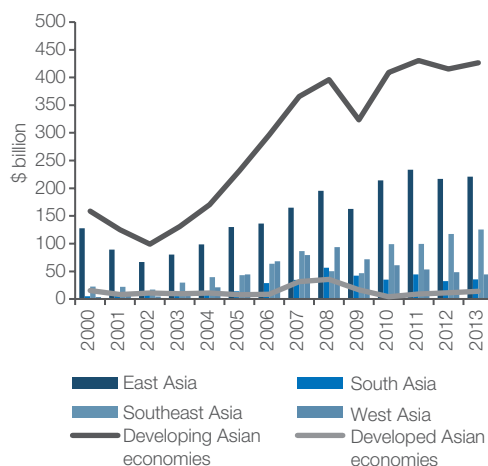
Source: Bloomberg, KFH Research.

A by-product of Asia's larger economic significance in the world economy is deeper regional integration. Intra-regional trade increased by 280.0% over the 10-year period through 2012, with shipments within Asia currently accounting for a fifth of world trade. Australia and Hong Kong, China, for instance, are reaping the benefits of the sustained activity; increased mining capacity in Australia allows significantly larger commodity exports to meet the demand in the PRC and the rest of Asia, while Hong Kong, China continues to function as a major regional trade and services hub. Furthermore, the Association of Southeast Asian Nations (ASEAN) Economic Community, to be operational in 2015, will further deepen trade ties within Asia.

Asia continues to be the world's top recipient region of foreign direct investment (FDI), accounting for nearly 30.0% of global FDI inflows, according to United Nations Conference on Trade and Development (UNCTAD). Total inflows to developing Asia (excluding West Asia) amounted to \$382 billion in 2013, 4.0% higher than in 2012 (see Figure 1.11). FDI inflows to East Asia rose by 3.0% to \$221 billion in 2013. With inflows at \$124

billion, the PRC again ranked second in the world and narrowed the gap with the United States, the country with the largest global inflows. Meanwhile, inflows to ASEAN countries rose by 7.0% in 2013, to \$125 billion, while FDI inflows to South Asia rose by 10.0% to \$36 billion. For some low-income countries in developing Asia, weak infrastructure has long been a major challenge in attracting FDI and promoting industrial development. Moving forward, rising intra-regional FDI in infrastructure industries, driven by regional integration efforts and enhanced connectivity between subregions through the establishment of inter-subregional corridors, is likely to accelerate infrastructural buildup and promote economic development. The ten ASEAN member states and their six free trade agreement partners have launched negotiations for the Regional Comprehensive Economic Partnership. In 2013, combined FDI inflows to the 16 negotiating members amounted to \$343 billion, accounting for 24.0% of global FDI flows.

Figure 1.11: FDI Inflows to Asia (2000–2013)



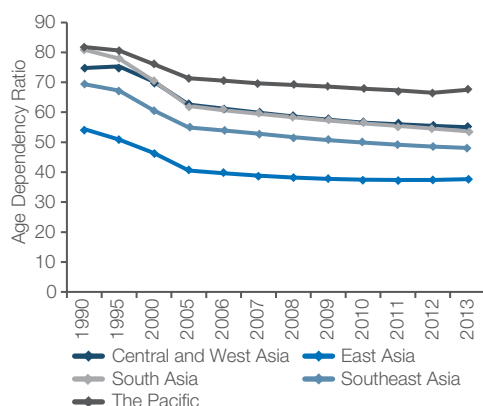
FDI = foreign direct investment.

Source: UNCTAD, KFH Research.

Asia is the world's largest and most populous continent with a population of 4.3 billion people, making up 60.0% of the world's current human population. With roughly 1.4 billion and 1.2 billion

people respectively, the PRC and India currently account for 36.3% of the world's population and are expected to account for roughly the same share in the next 30 years. Nevertheless, the overall numbers hide the fundamental changes that will have occurred by then. The bulk of population growth in Asia over the next three and a half decades will be in South Asia, a result not of high birthrates but of the large number of people of childbearing age, itself the product of past higher levels of fertility.

Figure 1.12: Age Dependency Ratio in Asia (1990–2013)



Source: ADB, KFH Research.

The falls in birthrate across Asia mean that there is currently a concentration of working-age population in most Asian countries. Economists call this feature of population transition (see Figure 1.12) in Asia the demographic dividend, because it provides the opportunity for more productive investment of capital and for a stronger focus on developing the human capital of the next generation of workers, both essential features of economic development. Economies such as Japan and the Asian tiger economies of the Republic of Korea and Taipei, China benefited from the demographic dividend during their earlier periods of high economic growth. Capturing the demographic dividend is now a major objective in the progress of development in Malaysia, Thailand, Indonesia, and the PRC. The economies of South Asia and elsewhere also need to ensure that they capitalize on this source of growth potential.

The above trends and statistics show various prospects for Islamic finance to grow in this region. Being the most populous region in the world, Asia's favorable demographic structure, comprising a significant young population and a rising middle-income segment, constitutes a huge and growing consumer market, which can heighten the demand for a wider spectrum of Islamic financial products and services, thus increasing opportunities in retail and investment banking, *Takāful*, and fund and wealth management businesses in the region.

Asia's Developmental Needs Moving Forward: Role of Islamic Finance

Islamic finance has firmly established itself as an alternative funding source in several emerging markets. Against the backdrop of global macroeconomic challenges and financial pressures in major markets, the fast expanding pool of global *Shari'ah*-compliant liquidity has become an attractive source for various sovereigns, government-related entities, and corporates to tap into in order to meet their financing needs. Specific to Asia, the trends and statistics highlighted earlier show various prospects for Islamic finance to grow in the region.

Asia's growth and developmental needs moving forward require substantial amounts of investments in the region's infrastructure sector in order to

upgrade the existing facilities while developing new ones to correspond to the growing population. Furthermore, the fiscal and revenue expenditures of various governments are expected to increase in support of the various development projects as well as to stimulate national economies in the light of growth challenges in the world economy. Surging Asian exports, which are key determinants of economic growth in most export-oriented Asian economies, also require necessary funding support in the form of trade financing products. On the retail side, being the most populous region in the world, Asia's favorable demographic structure, comprising a significant young population and a rising middle-income segment, constitutes a huge and growing consumer market.

Islamic finance has promising potentials to meet the various funding needs highlighted. The industry's offerings include economically viable products that are combined with the benefit of being ethically compliant. To date, Islamic finance has provided financing solutions across several sectors including (i) infrastructure financing, (ii) government fiscal and revenue expenditure financing, (iii) corporate and retail financing, (iv) ethical investment solutions to corporate and retail investors, (v) trade financing for international trade, and also (vi) Islamic insurance services.

Sukūk instruments have been specifically instrumental in being used as a medium to channel the *Shari'ah*-compliant funds to the various deficit entities in Asia and elsewhere. In 2014, debut sovereign issuances took place in the United Kingdom, Senegal, the Emirate of Sharjah, Luxembourg, and Hong Kong, China. Going forward, Islamic finance has the potential to partly support the various growth and development plans of Asian economies by providing the necessary financing.

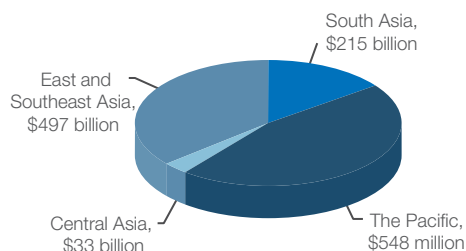
Infrastructure Needs: Islamic Capital Market Opportunities

The infrastructure sector has seen a large portion of the raised *Sukūk* funds directed to development projects, largely driven by infrastructure projects from both the Gulf Cooperation Council (GCC) and Southeast Asian regions. Between 2001 and 2013, a total of \$84.3 billion worth of infrastructure *Sukūk* was issued by nearly 10 different countries. The market for infrastructure *Sukūk* has generally (see Figure 1.14) been dominated by issuances from Malaysia.

It is reported that in the 10-year period from 2010 to 2020, the 32 developing member countries of the Asian Development Bank (ADB) are expected to be in need of \$8.22 trillion as infrastructure investments. With this estimation, the amount needed for investment annually will reach up to \$747 billion over 2010–2020. About 68.0% of the total

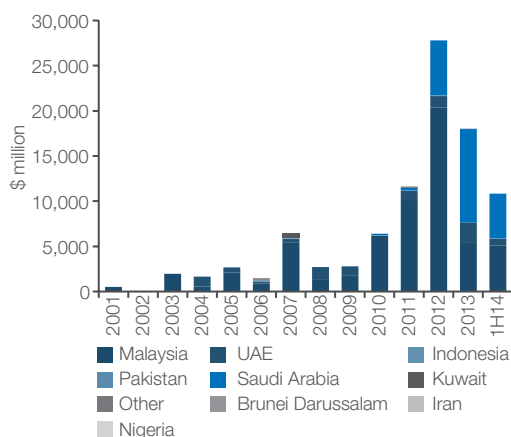
investment is needed for new capacity investments in infrastructure, while the remaining 32.0% is allocated for replacement of existing assets. East and Southeast Asia will need the most funds by the end of 2020, as both regions require about 66.55% of total Asian infrastructure investment needs. Strengthening bond markets, promoting public–private partnerships, and improving the financial environment (see Figure 1.13) to spur foreign investment flows are among the key focus of Asian government and financial authorities to support the large infrastructure financing requirements.

Figure 1.13: Annual Infrastructure Investments Needs in Asia by Subregion



Source: ADB.

Figure 1.14: Infrastructure Sukūk Issuances by Country (2001–H1 2014)



H = half, UAE = United Arab Emirates.

Source: IFIS, Zawya, Bloomberg, KFH Research.

Using infrastructure *Sukūk*, Asian economies can partly support the huge infrastructure investment needs in the region. *Sukūk* have played a significant role in funding the infrastructure sector (see Figure 1.15 – Figure 1.18 for *Sukūk* case studies) over the past decade, with proceeds raised from issuances being utilized for both low- and high-profile projects. The very nature of *Sukūk*, combined with their flexibility, allow them to be structured in various ways. This has attracted corporate and sovereign entities to choose *Sukūk* as a viable alternative financing instrument. Infrastructure *Sukūk* can be structured using various types of *Shar'ah* contractual principles. Among the foremost principles utilized are *Ijārah*, *Murābahah*,

and *Mushārahah*. Collectively, these three structures accounted for more than 79.0% of all issuances during the second half of 2010 until the first half of 2013. The central merit of *Mushārahah Sukūk* is that it promotes principles of risk sharing where investors and issuers agree to share profits and absorb losses based on actual outcomes of the underlying business activity.

Overall, from 2001 to 2013, Malaysian-domiciled infrastructure *Sukūk* accounted for 67.5% of all infrastructure *Sukūk* issuances, followed by Saudi Arabia with 20.0% and the United Arab Emirates with 10.8%. Other notable countries that have issued infrastructure *Sukūk* include Qatar, Indonesia, Pakistan, and Kuwait.

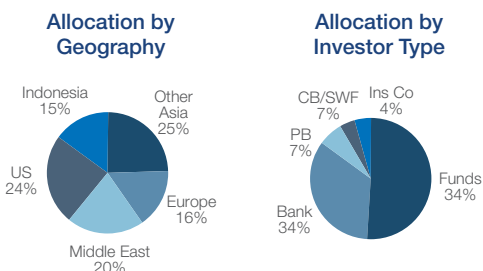
Selected Case Studies of Sukūk Issuances in Asia

Figure 1.15: Republic of Indonesia – \$1.5 Billion Global Sukūk due 2019

Key Offer Terms

Issuer	Perusahaan Penerbit SBSN Indonesia III
Obligor	The Republic of Indonesia
Documentation	\$5 billion Trust Certificates Issuance Program
Tenor	5.5 years
Size	\$1.5 billion
Coupon	6.125%
Yield	6.125%
Maturity	15 March 2019
Listing	Singapore Stock Exchange (SGX-ST)

Distribution Statistics



Transaction Highlights

- ✓ **Largest single tranche** international *Sukūk* offering from an Asian (non-Middle East) sovereign issuer
- ✓ The transaction **marks Indonesia's largest international Sukūk offering**, its fourth international *Sukūk* transaction since 2009 and the second issued under its existing Trust Certificates Issuance Program
- ✓ The transaction was **well-received by investors**, accumulating a \$5.7 billion orderbook across 300 accounts globally
- **Highly receptive transaction, resulting in a well-diversified investor base**
 - **Markets were very receptive of the transaction**, driven by the scarcity value of high-quality emerging market sovereign issuers
 - **High-quality orderbook with a number of global real money account participation** in a meaningful manner, including a strong 24.0% participation from US accounts

CB/SWF = Central Banks / Sovereign Wealth Funds, PB = Private Banks, Ins Co = Insurance Companies.

Source: Presentation by Usman Ahmed at the IFSB-ADB Conference Nov 2013.

Figure 1.16: Sime Darby – Inaugural \$800 Million 5-/10-yr *Sukūk* Offering

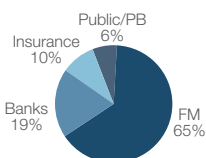
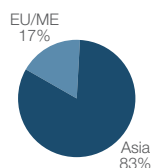
Key Offer Terms

Obligor	Sime Darby Berhad	
Issuer	Sime Darby Global Berhad	
Tenor	5-year due 2018	10-year due 2023
Issuer Size	\$400 million	\$400 million
Coupon	2.053%	3.290%
Settlement	T + % (29 January 2013)	

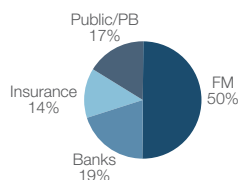
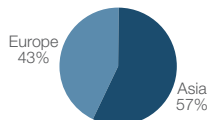
Distribution Statistics

Allocation by
GeographyAllocation by
Investor Type

5 Year Tranche



10 Year Tranche



EU/ME = European Union / Middle East; PB = Private Banks; FM = Fund Managers.

Source: Presentation by Usman Ahmed at the IFSB-ADB Conference Nov 2013.

Transaction Highlights

- ✓ **1st Malaysian and 1st *Sukūk* issuer** globally to issue in the G3 international debt markets in 2013
- ✓ **Lower-ever coupon by any corporate globally** in the US dollar *Sukūk* market and the lowest-ever US dollar coupon by a Malaysian borrower in both the 5-year and 10-year tenors
- ✓ Rare international G3 *Sukūk* offering in Asia from one of the leading conglomerates in Malaysia **which achieved a rating a notch above the sovereign**
- ✓ **Priced 40bps over a theoretical new 10-year Malaysia sovereign bond**
- **Optimal pricing outcome amid robust demand from a high-quality diverse investor base**
 - **Final pricing was at the tight end** of revised guidance with an orderbook of about \$4.2 billion (5-year) and \$4.5 billion (10-year) achieving and overwhelming oversubscription of about 10.9 times

Figure 1.17: Malaysia Airport Holdings – \$500 Million *Sukūk* Offering

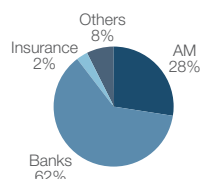
Key Offer Terms

Issuer	Malaysia Airports Holdings Berhad (MAHB)	
Issuer Ratings	AAA/A3 (RAM / Moody's)	
Issue Ratings	AAA (RAM)	
Islamic Principle	Mushārahkah	
Tenor	3-year due 2016	5-year due 2018
Issue Size	RM250 million	RM250 million
Par Coupon (s.a)	3.85%	4.15%
Settlement	6 September 2013	

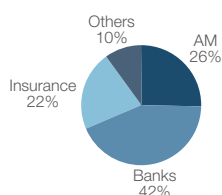
Distribution Statistics

Allocation by Investor Type

3-Year Tranche



5-Year Tranche

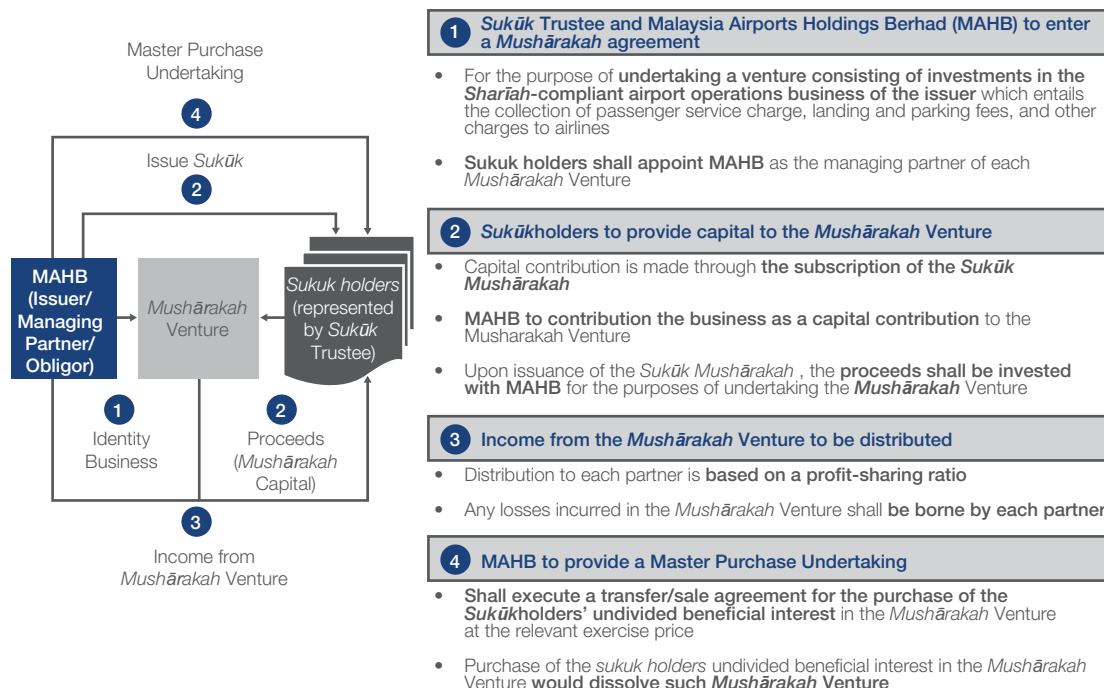


AM = Asset Managers.

Source: Presentation by Usman Ahmed at the IFSB-ADB Conference Nov 2013.

Transaction Highlights

- ✓ **1st dual tranche offering** by MAHB and **1st Mushārahkah Sukūk** by MAHB with all previous *Sukūk* in Al Ijara format
- ✓ **Rapid-fire intraday execution** enabled by *Mushārahkah* format a week after Information Memorandum was released to investors
- ✓ Despite challenging market conditions, the **final pricing for both tranches was 5 basis points inside of the wide end** of the initial price guidance
- ✓ **3 times and 4 times orderbook oversubscription** for 3-year and 5-year respectively
- **MAHB completed its inaugural issuance** of RM500 million Senior *Sukūk* via a dual tranche offering pursuant to the new Senior *Sukūk* Programme
- **Optimal pricing outcome amid robust demand from a high-quality diverse investor base**
 - **Tapping of the capital markets was very timely** and allowed the company to seize a good market window to achieve low-cost funding

Figure 1.18: Malaysia Airports Holdings – *Mushārah* Structure

Source: Presentation by Usman Ahmed at the IFSB-ADB Conference Nov 2013.

Financial Inclusion in Asia: Role of Islamic Finance

Asia's rapid growth in recent decades has lifted hundreds of millions out of extreme poverty, but the region remains home to two-thirds of the world's poor, with more than 800 million Asians still living on less than \$1.25 a day and 1.7 billion surviving on less than \$2 a day (ADB 2012). One reason for this could be the low rates of financial inclusion among the needy segments of the society. According to the World Bank, financial inclusion is an important driver of economic growth and poverty alleviation as access to finance can boost job creation, raise income, reduce vulnerability, and increase investments in human capital. However, several countries in Asia with large Muslim populations including Pakistan, Afghanistan, Indonesia, and others have low financial inclusion rates (see Figure 1.19 and Figure 1.20).

Figure 1.19: South and Central Asia – Account at a formal financial institution (% age 15+)

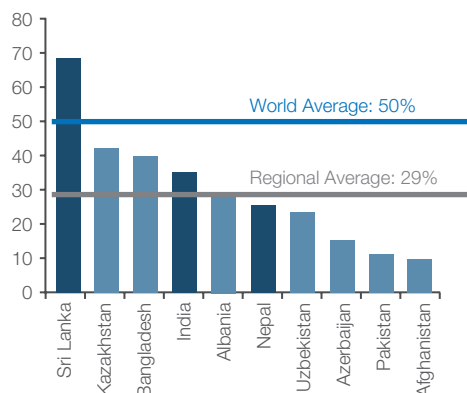
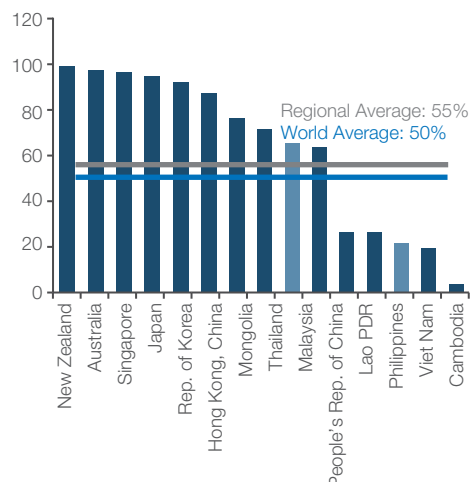


Figure 1.20: East Asia and Pacific – Account at a formal financial institution (% age 15+)



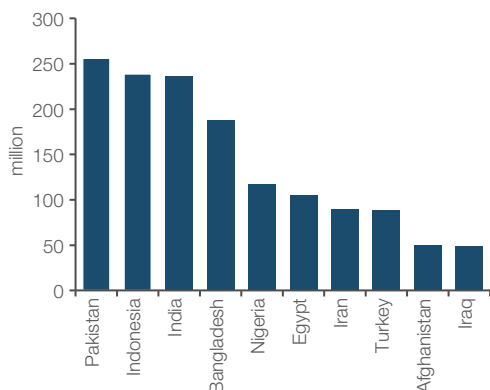
Lao PDR = Lao People's Democratic Republic.

Source: World Bank, KFH Research.

In Asia, inclusive growth, defined as economic growth with equality of opportunity, is one of the three strategic objectives of ADB. Income disparities and unequal access to economic opportunities and social services remain key issues in Asia despite the region's robust economic growth. To achieve the vision of an Asia and Pacific free of poverty, as laid out in ADB's guiding Strategy 2020, ADB supports pro-poor growth in its developing member countries that is inclusive and environmentally sustainable, and draws on the region's increasing levels of cooperation and integration. ADB supports partner governments, commercial and rural banks, cooperatives, and semiformal institutions, including nongovernment organizations, to ensure permanent access to institutional financial services for the region's poor people and their micro- and small businesses. Financial inclusion includes microfinance, SME finance, and other provisions of financial services to poor individuals, among others savings facilities, insurance, remittances, and access to financial markets.

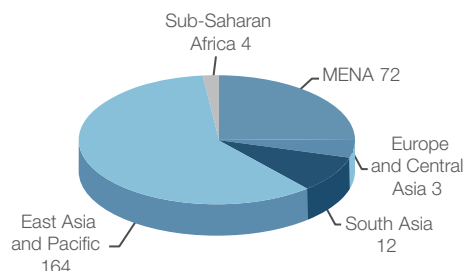
Islamic microfinance has the potential to expand financial inclusion at unprecedented levels throughout the Muslim world. Among the world's top 10 countries with the largest Muslim populations are five in Asia. By 2020, it is estimated that more than 60.0% of the global Muslim population will be residents in Asia. Currently, an estimated 1.28 million clients use *Shari'ah*-compliant microfinance services, a fourfold increase since 2006, according to the survey released in April 2013 undertaken by the Consultative Group to Assist the Poor. It is reported there are now 255 Islamic microfinance institutions around the world, with a total outstanding loan portfolio amounting to \$628 million. Approximately 70.0% of the providers (see Figure 1.22) of Islamic microfinance services are from East Asia, the Pacific, and South Asia. According to the survey, an estimated 1.28 million clients in 19 countries use *Shari'ah*-compliant microfinance services and approximately 82.0% of these clients reside in only three countries—Bangladesh (445,000 clients), Sudan (426,000 clients), and Indonesia (181,000 clients).

Figure 1.21: Largest Muslim Population by Country (2030)



Source: Pew Research Center.

Figure 1.22: Number of *Shari'ah*-Compliant Microfinance Institutions



MENA = Middle East and North Africa.

Source: El-Zoghbi and Tarazi (2013), KFH Research.

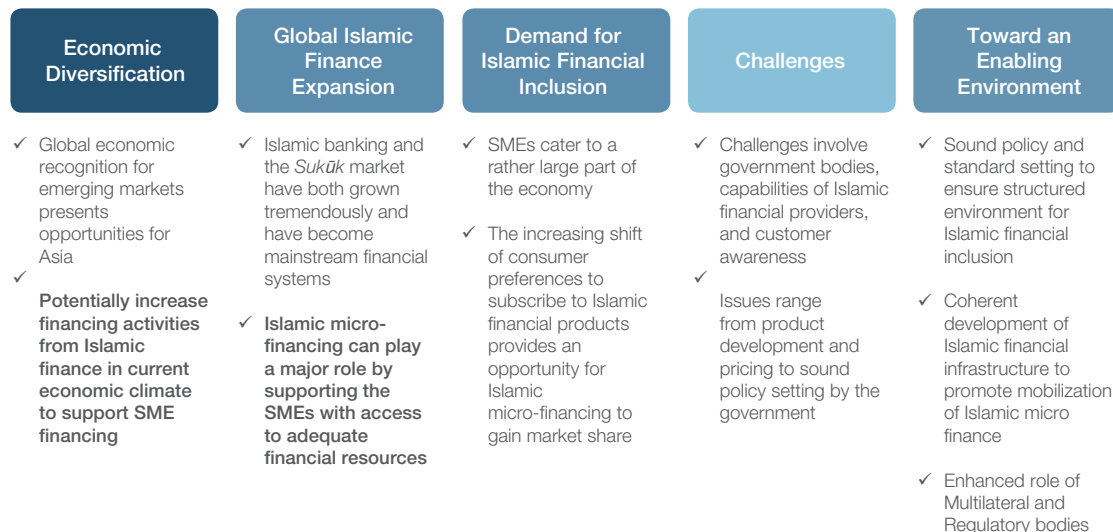
The opportunities for Islamic microfinance are promising, underpinned by strong economic growth in emerging markets, government ambition to reduce poverty levels and enrich the standard of living, the growing preference for *Shari'ah*-compliant products, and a large burgeoning Muslim population. Islamic finance presents opportunities for greater financial inclusion in Asia, particularly in Bangladesh, Afghanistan (see Figure 1.21), Indonesia, and Pakistan. The survey by the Consultative Group to Assist the Poor has shown that in Afghanistan, Pakistan, and Indonesia, for example, adults prefer to seek financing from family and friends and informal credit unions rather than loans from financial institutions that charge interest. In order for the industry to reach its full potentials in eliminating poverty, governments and regulators across the developing world should consider integrating Islamic microfinance into countries' mainstream banking and financial systems. This will help create greater awareness of products, encourage product innovation, improve access to microfinance, widen and strengthen the distribution channels, as well as result in real economic growth across all levels of the socioeconomic fabric.

Conclusion

Asia is a pivotal part of both the global economy and the Islamic financial system. Looking forward, Islamic finance has a promising opportunity to partly fill the role of providing the necessary financial intermediation required by Asia. The Islamic financial system offers alternative financing mechanisms to emerging markets to support their economic development drive in diverse areas such as infrastructure needs, enhancing trade relationships with OIC member countries, supporting capital expenditure needs of governments, and helping to improve the financial inclusion ratios of various jurisdictions. Islamic finance development in this region is expected to further support the economic growth of the region. However, more effort needs to

be undertaken to facilitate an enabling Islamic finance industry within new jurisdictions and to advance developed Islamic financial markets to the next level. Regulation and legislation enhancement, expansion of the *Shari'ah* talent pool, and greater product innovation (see Figure 1.23) to cater for the awareness and diverse demographic needs of the Asian population are among key areas for improvement. In particular, the industry is expected to explore product and process innovation to offer partnership financing that are best suited to cater for specific needs of lower-income populations and at the same time to clearly define market segments and develop robust risk assessment models to better penetrate unbanked segments.

Figure 1.23: Drivers Sustaining Islamic Finance in Asia



SMEs = small and medium-sized enterprises.

Source: KFH Research.



CHAPTER 2

Islamic Finance Stability, Resilience, and Regulatory Issues

Professor Simon Archer
Madzlan Mohamad Hussain

This chapter focuses on the role of legal and regulatory infrastructure in promoting financial stability and resilience in Islamic finance. It starts from the discussion on latest regulatory developments at the global level and their implications on the regulation of Islamic financial services industry, specifically on Islamic banks. It is followed by a discussion on corporate governance and responsibilities of governing organs in

Islamic financial institutions. The chapter also provides insights on the roles and responsibilities of the courts – including its officials such as judges and lawyers – which will have direct influence and contribution in determining whether Islamic financial institutions will retain their stability and resilience, as they cannot afford to be hampered by prolonged and unresolved disputes affecting their reputation and credibility.

The Role of Regulation in Promoting Financial Stability and Resilience

One of the principal aims of regulation of the finance sector is to promote financial stability and the resilience of financial institutions (microprudential regulation) and of the financial system as a whole (macroprudential regulation). It has to be said that, as was shown by the financial crisis of 2007–2008 and the subsequent global recession, its effectiveness in achieving this aim has been quite limited. A major factor in this ineffectiveness was the failure of institutions (in most cases banks) that were considered “too big to fail” because of the systemic consequences that their failure would entail, and which were therefore “bailed out” at the public expense by the central banks or other public agencies. In a number of cases (e.g., Spain), this led to previously healthy public finances becoming precarious.

As a consequence, the Basel Committee on Banking Supervision (BCBS) made a number of significant additions and revisions to its Basel II framework, by issuing the various components of Basel III. The main changes relate to liquidity risk, which was largely overlooked by Basel II, and loss absorbency of capital, with the objective of reducing the need for “bailouts” at public expense by introducing a greater element of loss-absorbent capital instruments some of which would act to “bail in” the holders of such instruments. One should also mention the qualitative aspects of corporate governance and risk management, a subject addressed by the BCBS in its October 2010 document *Principles for Enhanced Corporate Governance*. This was a revision of its earlier 2006 guidance on this topic, subsequent to which, as is noted in paragraph 6 of the 2010 document, there were “a number of

corporate governance failures and lapses, many of which came to light during the financial crisis that began in mid-2007.” Another, quantitative, aspect of risk management was addressed by the BCBS in *Principles for Sound Stress Testing Practices and Supervision* (May 2009).

In this part, the capital and liquidity provisions of Basel III are first reviewed, followed by an examination of the main implications of these for Islamic finance.

Capital Provisions of Basel III

In June 2011, the BCBS published a revised version of its Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (December 2010). This key document set out the BCBS’s proposals for both a revised capital regime and a new liquidity risk management framework.

The three tiers of capital in Basel II are replaced by two tiers, distinguished by their loss absorbency characteristics. Tier 1 consists of common equity (Common Equity Tier 1 – CET1) and additional tier 1 (AT1) instruments. The latter are required to be of permanent duration and to be subordinated to all other forms of capital other than common equity, but are not expected to absorb losses while the institution is a “going concern.” Tier 2 (T2) consists of instruments that become loss absorbing at the point of the institution’s non-viability; in other words, the holders of such instruments are “bailed in” by absorbing losses when the institution is a “gone concern” so as to remove or reduce the need for “bailouts” at public expense.

Designing AT1 and T2 capital instruments, which offer just the required degrees of loss absorbency in “going concern” and “gone concern” scenarios, has proved challenging in the case of conventional banks.

In addition, the minimum capital requirements in Basel III are higher than in Basel II and include two buffers. The “capital conservation buffer” is a mechanism that allows the industry supervisor to require an institution whose capital has fallen below the required minimum level to suspend profit distributions until its capital has been restored to the required minimum level. The “countercyclical buffer” is a macroprudential tool that allows the supervisor to require institutions to hold additional capital in periods of economic boom to mitigate the systemic risk of excess credit buildup during such periods. Another macroprudential measure in Basel III, intended to mitigate the “too big to fail” problem, made provision for supervisors to require systemically important financial institutions (SIFIs) to hold additional capital.

Liquidity Provisions of Basel III

In September 2008, the BCBS published its Principles for Sound Liquidity Risk Management and Supervision. This was followed by Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (December 2010, revised June 2011), and then by Basel III: The Liquidity Coverage Ratio and Liquidity Monitoring Tools (January 2013) and Basel III: The Net Stable Funding Ratio – Consultative document (January 2014). The latter two documents develop the sections of the 2010/11 document that deal with liquidity risk, by setting out quantitative metrics for monitoring exposures to liquidity risk over 30-day (liquidity coverage ratio or LCR) and 12-month (net stable funding ratio or NSFR) time horizons. As the BCBS pointed out in its 2013 document (paragraph 2), “during the early

‘liquidity phase’ of the financial crisis that began in 2007, many banks – despite adequate capital levels – still experienced difficulties because they did not manage their liquidity in a prudent manner.”

Both the LCR and the NSFR are challenging for banks, and their implementation is being phased in gradually from 2015 onward in the case of the LCR, and delayed until 2018 in the case of the NSFR. The LCR requires banks to hold a stock of high quality liquid assets (HQLA) sufficient to cover expected cash outflows over a 30-day period in conditions of liquidity stress. The main difficulty is the tight definition of HQLA, which may be in short supply in emerging market economies as well as for Islamic banks. The NSFR requires banks to match the maturities of (i) the funds tied up in its assets and off-balance sheet exposures (required stable funding) given their liquidity characteristics and residual maturities; and (ii) the portion of funds available from capital, liabilities, and other sources expected to be reliable (available stable funding) over a 1-year time horizon. Application of this metric has the effect of constraining banks’ traditional ability to earn a spread from maturity transformation, and for this reason has encountered opposition from the industry.

Main Implications of Basel III for Islamic Banks

Aforementioned developments have implications for Islamic banks in a number of areas of capital and liquidity regulation, as discussed in the following:

Components of Eligible Capital and Minimum Capital Requirements

Due to *Sharīah* compliance reasons, Islamic banks are prohibited from issuing capital instruments such as preferred shares or subordinated debt securities. This presents them with particular challenges if they wish to issue instruments that qualify as AT1 capital or as T2 capital.

AT1 Capital

To meet the AT1 criteria, capital instruments must be perpetual in terms of maturity and subordinated to the claims of depositors and general creditors of the bank. An Islamic bank may issue “general obligation” *Mushārah Sukūk*, the holders of which share *pari passu* with common shareholders both in the bank’s profits and losses and in its obligations to creditors (that is the significance of “general obligation”). Such *Sukūk* are thus in substance a form of nonvoting common shares. Their lack of governance rights may be compensated by a greater share of profits (but not of losses) *pro rata* to their share of equity capital; however, this would make them particularly dilutive from the common shareholders’ point of view.

It is unclear how Islamic banks could issue AT1 instruments that would rank before the common shares. One possibility, subject to *Sharīah* approval, might be a form of conditionally convertible equity (*Mushārah* or *Mudārah*) *Sukūk*. These would have claims over assets financed by the *Sukūk* (and over the *Sukūk* holders’ share of income therefrom) ranking before those of shareholders, provided the trigger for conversion into common equity (the capital ratio falling to a specified level such as 5.125%)¹ had not been reached.

T2 Capital

The challenge in Islamic finance is to design *Sharīah*-compliant instruments (*Sukūk*) such that the holders are “bailed in” if the issuer reaches the point of nonviability and would fail if not rescued in some way. “Bailing in” is intended to remove or reduce the need for a “bailout” at public expense.

One possibility would be convertible asset-based *Ijārah Sukūk* with the conversion trigger being the point of non-viability, at which point the assets would be exchanged for common shares according to a prespecified exchange ratio. The *Sukūk* could not be asset backed, as in that case the *Ijārah* assets

would be held by a bankruptcy remote special purpose vehicle, and bankruptcy remoteness would make it impossible for the assets to be exchanged for common shares. Another possibility might be convertible *Mudārah Sukūk*, but these would not have the quasi-fixed income characteristics of *Ijārah Sukūk* and would therefore be less appealing.

In either case, there is a potential *Sharīah* issue of *Gharar* (uncertainty) with respect to the terms of conversion, as in the circumstances the value of the common shares would be uncertain and probably very low.

Minimum Capital Requirements

Apart from the issues concerning eligible AT1 and T2 instruments, the application of the new minimum capital requirements to Islamic banks does not appear to be problematic. In general, Islamic banks are more generously endowed with common equity than conventional banks. However, it is worth noting that the application of the countercyclical buffer may raise issues of the appropriate measure to use in economies largely based on hydrocarbons or other natural resources.

Liquidity Provisions

It is widely acknowledged that liquidity risk management raises particular problems for Islamic banks. With regard to funding liquidity, various facilities that are routinely available to conventional banks, such as interbank markets, collateralized borrowing via sale and repurchase agreements (*repo*) and central bank lender of last resort facilities are not *Sharīah*-compliant, and *Sharīah*-compliant alternatives are unavailable in many cases. As regards market liquidity, there is a severe shortage of *Sharīah*-compliant income-producing HQLA. In emerging market economies, there may indeed be a shortage of any kind of HQLA denominated in the local currency.

¹ See Basel III Definition of Capital – Frequently Asked Questions (December 2011), paragraph 16.

Liquidity Coverage Ratio

The BCBS has to some extent taken account of the shortage of HQLA in Basel III: The Liquidity Coverage Ratio and Liquidity Monitoring Tools (January 2013), by permitting so-called alternative liquidity arrangements (ALAs) in “jurisdictions with insufficient HQLA” (paragraphs 55–68). Paragraph 68 refers specifically to “*Shari’ah*-compliant banks” and states that “national supervisors in jurisdictions in which *Shari’ah* compliant banks operate have the discretion to define *Shari’ah* compliant financial products (such as *Sukuk*) as alternative HQLA applicable to such banks only, subject to such conditions or haircuts that the supervisors may require.” It is not clear how much of a concession this is, since presumably such *Sukuk* or other financial products would have to meet the criteria for HQLA at least in terms of credit quality and liquidity.

It would seem that such discretion would be most likely to be used in conjunction with Option 3 of the ALA, which permits the additional use of Level 2 assets subject to greater “haircuts.” Option 3 is normally restricted to Level 2A assets, for which the credit quality criterion is a minimum of AA–, and the liquidity criterion is being traded in large, deep, and active repo or cash markets with a proven record as a reliable source of liquidity in the markets even during stressed market conditions; that is, a maximum decline of price or increase in “haircut” over a 30-day period of significant liquidity stress not exceeding 10.0%. Possibly the discretion would allow a version of Option 3 to be extended to Level 2B assets, for which the liquidity criterion in particular may be less constraining but the “haircut” may be as high as 50.0%.

Net Stable Funding Ratio

It remains to be ascertained whether the NSFR poses any particular problems for Islamic banks that it does not already pose for conventional banks. The increasing use by Islamic banks of term deposits based on Commodity *Murābahah* Transactions in place of profit sharing investment accounts may, however, reduce their available stable funding by subjecting them to refinancing risk, especially when the Commodity *Murābahah* Transactions-based deposits have short maturities.

Role of the Islamic Financial Services Board

In carrying out its mission, the Islamic Financial Services Board (IFSB) addresses key issues relevant to the financial stability and resilience of the Islamic financial services industry by issuing standards and other guidance. With respect to the Islamic banking sector, the IFSB revised its standard on Capital Adequacy in response to Basel III, issuing IFSB-15 in January 2014, following new standards on Liquidity Risk Management (IFSB-12) and on Stress Testing (IFSB-13) issued in March 2012. IFSB-12 is being supplemented by a guidance note on the quantitative measures of liquidity risk management (LCR and NSFR) which is in the course of preparation. The guidance note focuses mainly on the LCR and related issues, since the LCR is due to be implemented gradually from January 2015, whereas the NSFR is not due to be implemented until January 2018 and some details have yet to be finalized following the publication of a consultative document in January 2014. A substantially revised standard on the supervisory review process for Islamic banks is currently at the exposure draft stage (ED-16).

For the *Takaful* sector, the IFSB has issued standards on governance (IFSB-8, December 2009), solvency (IFSB-11, December 2010), and risk management (IFSB-14, December 2013).

The Roles of Boardrooms and Courtrooms in Islamic Finance

As Islamic finance is an industry which is still in its infancy and is undergoing rapid growth around the world, the effectiveness of regulatory and legal infrastructure for Islamic finance will always be tested in both the boardrooms and the courtrooms. In boardrooms, organs of governance such as the board of directors, senior management, and the *Sharī'ah* supervisory boards will have pertinent roles to ensure that the Islamic financial institutions uphold sound business decisions, preserve integrity, and appropriately comply with laws and regulations including *Sharī'ah*. The prevalent commercial and contractual nature of relationships between the Islamic financial institutions and their stakeholders means that disputes may arise from time to time—which certainly need to be resolved, and the courtrooms shall then play a role. Legal officials such as judges and lawyers will have direct influence and contribution in determining whether Islamic financial institutions will retain their stability and resilience, since businesswise they cannot afford to be hampered by prolonged and unresolved disputes as this may affect their reputation and credibility.

In this respect, the importance of continuous strengthening of the infrastructure cannot be overemphasized as the roles of boardrooms and courtrooms are linked, not least because failures in the boardroom tend to end up before the courts.

Failures in the boardroom (i.e., failures of any of the organs of governance such as the board of directors, senior management, and the *Sharī'ah* supervisory boards to serve their specific duties and responsibilities) may bring about the following consequences:

- Breaches of the law or of regulations
- Breaches of *Sharī'ah* rules and principles and resultant reputational damage and loss of income. Although *Sharī'ah* compliance is ultimately the responsibility of the board of directors, the influential role played by the senior management and *Sharī'ah* supervisory board cannot be underestimated and hence obviously in this respect the organs of governance share collective accountability.

- Financial losses due to inadequate risk management and poor investment or financing decisions
- Losses elsewhere in the industry through systemic risk

Failures in the courtroom (i.e., failures of any of the officials such as the judges and lawyers to, among others, duly uphold the law and interpret its applications correctly) may result in

- injustice to parties in dispute;
- unfair infliction of financial loss to the disputing parties or even to the public;
- lack of compliance with *Sharī'ah* rules and principles, and incorrect interpretation of *Sharī'ah*-compliant contracts;
- reputational damage to Islamic financial institutions and the industry; and
- systemic pressure on the rest of the market.

While some judges or lawyers may not feel comfortable with public expectations on their roles vis-à-vis Islamic finance disputes, the court cannot abdicate this duty, especially in cases where parties in the dispute may have nowhere else to turn for dispute resolution. Although greater use could be made of arbitration and mediation if competent authorities were available, the court remains an important legal infrastructure without which the industry may not be able to operate in vacuum.

The Challenge: Creating an Orderly and Effective Interface

It is reasonable to anticipate that there will be complex interactions between the boardroom and courtroom, including possible mismatches between civil law and *Sharī'ah*, as well as lengthy discussions between the various organs of governance and legal officials. As such, a major challenge is to bring about an orderly and effective interface between the requirements of *Sharī'ah* rules and principles in financial and commercial matters, including the legal

and regulatory framework. There are also legitimate expectations among the public to see the court serve the law and deliver justice to Islamic finance disputes in a cost-efficient and timely manner—a standard at least comparative to disputes involving conventional finance transactions.

Although ideally legal officials must be well versed in the technical aspects of Islamic finance, they are currently in the process of evolving their knowledge and developing their learning curves. In this regard, attention needs to be paid to the impact that a single decision by the legal authority can have on the Islamic finance industry as a whole.

An effective legal and regulatory framework for Islamic finance would provide the following:

- an enabling environment that accommodates and facilitates the development of what is arguably still a young industry;
- a clear and efficient system that preserves the enforceability of Islamic finance contracts in a context of “legal pluralism,” that is the coexistence of civil law (whether based on the common law or on statutes) and the *Sharʿah*; and
- a credible and reliable forum for the settlement of legal disputes arising from Islamic finance transactions.

An enabled environment should include legislation that oversees the licensing process and supervisory aspects of Islamic financial institutions. In addition, it must include a tax regime that does not place Islamic finance in a disadvantaged position, while also incorporating supportive infrastructure, such as financial reporting standards that take into account specificities of Islamic finance, and establishment of facilities for developing human resources for the Islamic finance industry. The process can substantially benefit through active initiatives by multilaterals such as the IFSB and the Islamic Development Bank (IDB) since this can expedite sharing of experience among regulatory and supervisory authorities as well as foster adoption of international prudential standards and best practices.

In terms of dispute resolution, a number of other institutional arrangements can play an important role. Authorities may adopt strategies that best suit their legal systems and requirements. These include, among others, the establishment of special courts within the judicial system with judges that are fully conversant with *Sharʿah* issues in finance and commerce. Such courts should have access to, and be guided by, authoritative *Fatāwa* (*Sharʿah* resolutions) where these are available within the jurisdiction. It is also important that high-quality law reports be published so as to record precedents and assist the jurisprudential processes of *qiyāas* (analogy) and *ijma* (consensus), which are conducive to the harmonization of thinking among *Sharʿah* jurists. At the same time, it should be possible to lighten the burden on the courts and avoid the costs and delays of litigation by making more systematic use of arbitration and mediation using *Sharʿah* and Islamic finance experts as arbitrators and mediators.

For cross-border disputes, it would be most valuable to have an internationally recognized adjudicating body, such as an International Islamic Arbitration Tribunal or possibly an International Islamic Finance Court, to achieve resolution of such disputes. This would require individual countries to give recognition to such an international body and to agree to implement its decisions.

Feasibility of an International Mechanism for Dispute Resolution

The feasibility and prospects for such a mechanism are indeed promising. As it is and for illustration, an initiative along a similar structure has been started through investment treaties. The following are a few examples:

- The Organisation of Islamic Cooperation (OIC) is a union of 57 Muslim member states through the Agreement for Promotion, Protection and Guarantee of Investments among the OIC Member States (OIC Agreement), which, to date, has been signed by 33 member states and

ratified by 27. It sets out the minimum standards applicable to incoming capital and investment between member states. In 2012, in the case of Hesham al-Warraq v. Indonesia, an arbitration tribunal which proceeded based on United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules decided that the OIC Agreement did allow investors to take host states to arbitration. As under the OIC Agreement, decisions of tribunals are final and binding, each contracting party is under an obligation to implement an award in its territory as if it were a final and enforceable decision of its national courts, irrespective of whether that contracting party is party to the dispute. The agreement contains a so-called “fork in the road” provision, meaning that an investor is precluded from bringing simultaneous proceedings before an arbitral tribunal and national courts.

- Another working model can be exemplified by the Unified Agreement for the Investment of Arab Capital in the Arab States (Arab Investment Agreement), which is an investment treaty concluded between the members of the League of Arab States. Under the Arab Investment Agreement, a specific body—namely the Arab Investment Court (AIC)—is established for the purpose of hearing disputes brought under it. The AIC is seated at the permanent headquarters of the League of Arab States in Cairo and is composed of at least five serving judges each with a different Arab nationality (which must not be the same nationality as either of the parties to the dispute). In 2013, in a case arbitrated before the AIC, Mohamed Al-Kharafi & Sons Co., a Kuwaiti company, successfully won an arbitration award against the Government of Libya.
- Besides this, the Association of Southeast Asian Nations (ASEAN), which is a regional grouping for cooperation mainly in areas concerning economic development, has also taken up a similar initiative through the ASEAN Comprehensive Investment Agreement

(ACIA), which entered into force on 29 March 2012. The ACIA contains, among others, legal protections such as the right of investors to submit investment disputes to the International Centre for Settlement of Investment Disputes (ICSID) for arbitration. However, this treaty includes a number of limitations, in particular by requiring, where applicable, specific approval by the competent state authority and by limiting the possibility of “treaty shopping” (by anticipating the possibility of member states to deny the benefits of the treaty to certain types of investments). Investors intending to invoke the protection of this treaty accordingly need to take particular care to ensure that their investments fall within the scope of protection under this treaty.

It is therefore important for stakeholders of the Islamic finance industry, whether in the boardroom or courtroom, to increase their understanding and awareness of the international dispute resolution mechanisms available to them and collaborate with the respective authorities to see how Islamic finance can be part of such treaties and invariably benefit from the same.

In addition to dispute resolution mechanisms, the legal and regulatory infrastructure should provide (in conjunction with the IFSB and other international standards) authoritative guidance for Islamic financial institutions.

Selected Important Developments in Malaysia, a Premier Islamic Financial Center

As a well-recognized Islamic financial center, Malaysia has shown its ability to understand the complexities of issues arising in the boardrooms as well as courtrooms when it comes to ensuring stability and resilience of the Islamic finance industry. Hence, the Malaysian model in regulating and promoting effectiveness of the boardrooms and courtrooms is worth considering by regulatory and supervisory authorities.

Besides adopting international best practices for boardroom (i.e., governance) functions as is the case in most jurisdictions, the Malaysian central bank has taken a further initiative by issuing three sets of guidelines which are highly relevant to the above:

- (i) Guidelines on the Introduction of New Products, according to which any new products offered by Islamic financial institutions require BNM approval;
- (ii) *Sharī'ah* Governance Framework, which requires that the board of directors and senior management share a responsibility for supporting the *Sharī'ah* Committee in the oversight of *Sharī'ah* compliance issues; and
- (iii) *Sharī'ah* Standards, which set out the basic requirements that must be adhered to in the documentation and operation of some products so as to minimize the risks of errors and failures in *Sharī'ah* compliance.

These guidelines have been instrumental in helping to ensure that the boardrooms of Islamic financial institutions are always cautious and prudent in their decision making.

In addition, the Malaysian legal infrastructure has been reinforced by the Central Bank of Malaysia Act (CBMA) 2009. Sections 56–57 of the CBMA provide that resolutions of the *Sharī'ah* Advisory Council of BNM on any matters that arise in an

Islamic finance dispute are binding on the courts and arbitrators. Although there have been contentions raised as to whether such provisions are in fact constitutional, considering they may deprive the court from the necessary independence, the courts in Malaysia have ruled that their powers to make findings on facts or to apply a law on the facts and make decisions remains intact and unfettered, as the *Sharī'ah* Advisory Council's role is limited to ascertaining the Islamic law on any financial matter and issuing a ruling upon reference made to it. BNM has also acted as *amicus curiae* in a number of cases, thus ensuring that the court has access to legal arguments from the prudential regulator's perspective. The effect of these measures has been to substantially reinforce the effectiveness of the dispute resolution process, whether by the court or by arbitration, and this has helped strengthen public confidence in the competence of the court and arbitrators to resolve complex Islamic finance disputes with access to assistance from the right *Sharī'ah* experts.

In sum, as a result of the above, Malaysia may be said to have an enabled environment that accommodates and facilitates the development of the Islamic finance industry. Malaysia instills a clear and efficient system that preserves the enforceability of Islamic finance contracts and provides a credible and reliable forum for the resolution of disputes arising from transactions in Islamic finance.

Concluding Remarks

Financial regulation is concerned with two main sets of issues: the protection of investors and customers for financial products (financial conduct), and the financial stability and resilience of finance sector institutions and of the sector as a whole (prudential—micro and macro). In the case of Islamic finance, issues arise of corporate governance, compliance, the legal system, and the responsibility of the board

of directors, and of capital and liquidity requirements as addressed by this chapter. The Islamic financial services industry would derive no benefit from being under-regulated, and the IFSB is working to facilitate the inclusion of the Islamic financial services industry in the global system of financial regulation with due regard to the specificities of the institutions that make it up.



CHAPTER 3

Islamic Finance: Financial Inclusion as a Core Concept

Dr. Zamir Iqbal

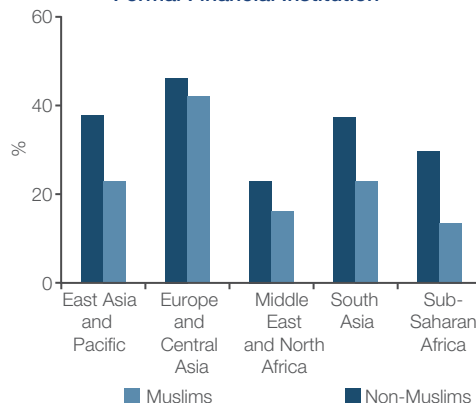
There is evidence suggesting that financial development and improved access to finance in a country, referred to as financial inclusion, is not only able to accelerate economic growth but can also reduce income inequality and poverty. Enhancing the access to and the quality of basic financial services (such as availability of credit, mobilization of savings, insurance, and risk management) facilitates sustainable growth and productivity, especially for micro, small, and medium-sized enterprises (MSMEs). Despite the essential role of financial inclusion in the progress of achieving efficiency and equality in a society, as of the latest count (Demirguc-Kunt and Klapper 2012), close to 2.5 billion people around the globe, or about 70.0% of the adult population, have no access to basic financial services.

Access to finance is an issue of particular significance to the so-termed nonbankable members of society. In the case of prospective entrepreneurs, they invariably lack adequate collateral to qualify for traditional bank financing. Therefore, alternative mechanisms have been developed for such client groups such as microfinance, small and medium-sized enterprise (SME) finance and micro-insurance. These techniques have been partially successful in enhancing financial inclusion but not without challenges.

Two of the leading indicators of access to finance are the holding of a formal bank account and the receiving of credit from a financial institution. Although inaccessibility of finance is a serious issue for all developing countries, it is especially severe in

Muslim-majority countries. In a sample of 41,922 individuals in 39 countries, where Muslims make up between 5.0% and 95.0% of the total population, self-reported Muslims were less likely (i) to have a formal account and (ii) to save at a formal financial institution (Figure 3.1). The low level of financial inclusion among Muslims is explained by either factors of voluntary exclusion (such as religious considerations) or those of involuntary exclusion (such as discrimination, lack of financial literacy, lack of collateral, etc.). Interestingly, among the cited barriers, religion is the least frequent: only about 7.0% of the total Muslim population in 148 countries around the world said religion was their main reason for not having a formal bank account (Demirguc-Kunt, Klapper, and Randall 2013).

Figure 3.1: Share of Adults with an Account at a Formal Financial Institution



Source: Demirguc-Kunt, Klapper, and Randall (2013).

Financial Inclusion and Its Importance

Understanding the linkage of financial inclusion with economic development is important. There is a voluminous literature in economics and finance on the contribution of finance to economic growth and development. The main reason why finance, financial inclusion, or access to finance matters is that financial development and intermediation

have been shown empirically to be a key driver of economic growth and development.¹ Development economists suggest that the lack of access to finance for the poor deters key decisions regarding human and physical capital accumulation. For example, in an imperfect financial market, poor people may find themselves in the “poverty trap,”

¹ Recent experimental evidence from three randomized impact evaluations suggests that while increasing access to credit does not produce the kind of dramatic transformations expected by earlier literature, it does appear to have some important, albeit more modest, outcome.

(Source: Baughet et al. 2011)

as they cannot save during harvest-time or borrow to survive starvation. Without a predictable future cash flow, the poor are also incapable of borrowing against future income to invest in education or health care for their children. Modern development theories analyzing the evolution of growth, relative income inequalities, and economic development offer two tracks of thinking. One track attributes imbalances in redistribution of wealth and income in the economy as an impediment to growth, while the other track identifies financial market imperfections as the key obstacle (Demirguc-Kunt, Beck, and Honohan 2007). Proponents of the redistribution of wealth theory claim that redistribution can foster growth and a focus on redistributive public policies, such as land

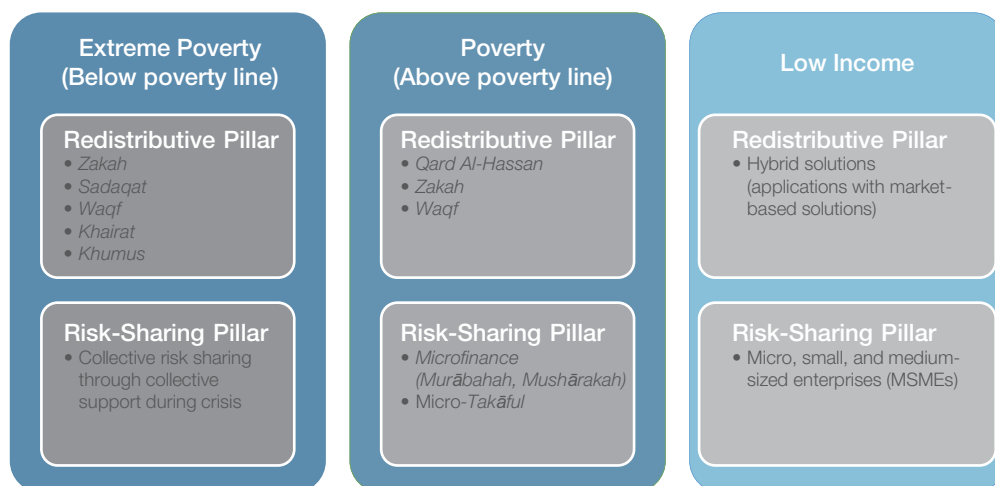
or education reform focusing on schooling, savings, or fertility changes, can lead to reduction in income inequality and poverty. The other school of thought attributes market failure and imperfect information leading to financial market frictions as the obstacle to growth (Stiglitz and Weiss 1981). Indeed, financial market frictions can be the critical mechanism for generating persistent income inequality or poverty traps. Financial market imperfections, such as information asymmetries and transactions costs, are likely to be especially binding on the talented poor and the micro- and small enterprises that lack collateral, credit histories, and connections, thus limiting their opportunities and leading to persistent inequality and slower growth.

Concept of Financial Inclusion in Islam

The core principles of Islam lay great emphasis on social justice, inclusion, and sharing of resources between the haves and the have-nots (see Figure 3.2). Islamic finance addresses the issue of financial inclusion from two directions: one through promoting risk-sharing contracts, which provide a viable alternative to conventional debt-based

financing, and the other through specific instruments of redistribution of wealth among society. Both risk-sharing financing instruments and redistributive instruments complement each other to offer a comprehensive approach (see Box 3.1) to enhance financial inclusion, eradicate poverty, and build a healthy and vibrant economy.

Figure 3.2: Targeted Approaches to Enhance Inclusion



Source: Author's

Box 3.1: Issues with a Conventional Approach to Financial Inclusion

The experience with microcredit or microfinance since its inception has been mixed, as there is a growing concern that initial expectations were overestimated. The following is a summary of the key challenges facing the microfinance industry in achieving a sustainable impact on poverty alleviation:

- (i) **High interest rates.** Conventional microfinance institutions are often criticized for charging very high interest rates on loans to the poor. These high rates are justified by these institutions as an outcome of high transaction costs and high risk premiums. However, this imposes undue stress on the recipient to engage in activities that produce returns higher than the cost of funding, which may not be possible in many cases.
- (ii) **Not every poor individual is a microentrepreneur.** Merely making the capital accessible to the poor is not the solution, without realizing that not every poor individual or recipient of microcredit has the skills set or the basic business sense to become an entrepreneur.
- (iii) **Diversion of funds.** There is the risk that the funds will be diverted to nonproductive activities such as personal consumption. In some cases, microcredit may lead the poor into a circular debt situation where borrowing from one microlender is used to pay off the borrowings from another lender.
- (iv) **Large-scale fund mobilization.** While some microfinance institutions have had a significant impact on poverty, others have been less successful; microfinance institutions generally cannot mobilize funds on a large scale and pool risks over very large areas in the way that more traditional, formal financial institutions can.
- (v) **Product design.** The financial services needs of poor households may require different product features with different payment and delivery structures as opposed to typical debt-based lending.
- (vi) **Absence of private sector participation.** As mentioned above, due to limited supply, coverage, products lineup, and funding by the informal, semiformal, and non commercial sectors, the effectiveness of microfinance institutions is often compromised.

Source: Author's compilation.

Economic development and growth, along with social justice, are the foundational elements of an Islamic economic system. All members of an Islamic society must be given the same opportunities to advance themselves; in other words, a level playing field, including access to the natural resources provided by Allah. For those without work and for those who cannot work (including people with disabilities), society must afford the minimum requirements for a dignified life by providing shelter, food, health care, and education. Islam emphasizes financial inclusion more explicitly, but two distinct features of Islamic finance—the notions of risk sharing and redistribution of wealth—differentiate its path of development significantly from the conventional financial model.

Islam ordains risk sharing through three main venues:

- (i) contracts of exchange and risk-sharing instruments in the finance sector;
- (ii) redistributive risk-sharing instruments which the economically more able segment of society utilize in order to share the risks facing the less able segment of the population; and
- (iii) the inheritance rules specified in the Koran through which the wealth of a person at the time of passing is distributed among present and future generations of inheritors.

The Islamic system advocates risk sharing in financial transactions, and a financial system based on risk sharing offers various advantages over the conventional system that is based on risk shifting. Use of risk-sharing instruments could encourage investors to invest in sectors such as MSMEs which are perceived as high-risk sectors. Given an enabling environment, investors with a matching risk appetite are likely to be attracted to providing capital for these sectors. This argument can be supported by the growing market for private equity in general, but with reduced information asymmetry, the MSME sector can also attract private equity funds.² With increased availability of funds for these sectors, one could expect an increase in financial inclusion in the system.

The second set of instruments meant for redistribution are used to redeem the rights of the less able in the income and wealth of the more able. Contrary to common belief, these are not instruments of charity, altruism, or beneficence, but these are instruments of redemption of rights and repayment of obligations.

In practical terms, the Koran makes clear that creating a balanced society that avoids extremes of wealth and poverty, a society in which all understand that wealth is a blessing provided by the creator for the sole purpose of providing support for the lives of all of humankind is desirable. The Islamic view holds that it is not possible to have many rich and wealthy people who continue to focus all their efforts on accumulating wealth without simultaneously creating a mass of economically deprived and destitute. The rich consume opulently, while the poor suffer from deprivation because their rights in the wealth of the rich and powerful is not redeemed. To remedy this, Islam prohibits wealth concentration, imposes limits on excessive consumption through rules prohibiting *israf* (overspending), *itlaf* (waste), and *itraf* (ostentatious and opulent spending). It then highly recommends that the net surplus, after moderate spending and consumption necessary to maintain a modest living standard (savings through reduced consumption), be shared with the members of society who, for a variety

of reasons, are unable to work; hence, the resources they could have used to produce income and wealth were utilized by the more able.

The Koran considers the privileged individuals able as trustee-agents in using these resources on behalf of the low-income segments. In this view, property is not a means of exclusion but inclusion in which the rights of those less able in the income and wealth of the more able are redeemed. The result would be a balanced economy without extremes of wealth and poverty. The operational mechanism for redeeming the right of the less able in the income and wealth of the more able are the network of mandatory and voluntary payments such as *Zakat* (2.5% on wealth), *Khums* (20.0% of income), and payments referred to as *Sadaqat*.

The most important economic attribute that operationalizes the objective of achieving social justice in Islam is that of the distribution–redistribution rule of the Islamic economic paradigm. Distribution takes place post-production and sale when all factors of production are given what is due to them commensurate with their contribution to production, exchange, and sale of goods and services. Redistribution refers to the post-distribution phase when the charge due to the less able are levied. Islam's redistributive instruments include set of mechanisms comprising either mandatory levies (*Zakat*, *Khums*, etc.), philanthropic contributions (*Sadaqat and Waqf*, or benevolent loans (*Qard Al-Hassan*). These means are essentially repatriation and redemption of the rights of others in one's income and wealth. Redeeming these rights is a manifestation of belief in the oneness of the creator and its corollary, the unity of the creation in general and of humankind in particular. It is the recognition and affirmation that God has created the resources for all of humankind who must have unhindered access to them. Even the abilities that make access to resources possible are due to the creator. This would mean that those who are less able or unable to use these resources are partners of the more able.

² Before the financial crisis, several microfinance programs were able to issue bonds and raise funds from the private sector as the microfinance sector was considered a profitable one.

As mentioned earlier, there are two pillars which constitute the framework for financial inclusion. The first pillar consists of the core principle of risk sharing, which is promoted through permitted contractual agreement for undertaking business transactions as well as through the concept of risk sharing with less fortunate members of the society through self-help and exhibition of solidarity during difficult and unexpected times of economic distress. The second pillar consists of Islam's instruments of distribution and redistribution as explained earlier. These two pillars can be combined in varying degrees to combat different segments of society who are denied access to finance. For example, the segment facing extreme poverty (i.e., those below the poverty line) will be most eligible for receiving financing and financial assistance through the redistributive pillar rather than engaging in any business transactions. However, during an economic crisis or a natural calamity, other fellow Muslims are advised to go beyond the minimum prescribed contribution and share these risks with voluntary contributions.

Case Studies

One of the instruments of redistribution is *Zakah*, which has a great potential as the main resource of social spending supporting poverty alleviation in an Islamic society. The argument is not only theoretically true, but can be supported by empirical evidence.³ Mohieldin et al. (2011) determine whether the *Zakah* collection in Organisation of Islamic Cooperation (OIC) countries is sufficient to cover the estimated shortfall of resources to alleviate poverty. Using this estimation, they find supporting evidence that 20 out of 39 OIC countries can actually alleviate poverty among those living with an income under \$1.25 per day using resources generated through *zakah* collection alone. In a recent study by the Islamic Development Bank (IRTI 2014), it is shown how *Zakah* resources can be utilized to cover a resource

shortfall in terms of percentage of gross domestic product (GDP) in several Muslim countries (Table 3.1). Even minimum resources available through *Zakah* could cover the resource shortfall for incomes below \$1.25 per day in two of the most populous Muslim countries (i.e., Pakistan and Indonesia).

For those in poverty but who are above the poverty line, the objective would be to use the redistributive instruments to provide livelihood sustainability, basic needs, and training to prepare them for active participation in economic activities, and the use risk-sharing instruments to develop microfinance and microinsurance (*microTakāful*) schemes. Research has shown that such a combination could be a catalyst for getting people out of poverty and into the mainstream economy. Finally, the third segment of low-income individuals will have less dependence on redistributive instruments and will be suitable candidates for risk-sharing instruments to develop MSMEs that could provide sustainable incomes. It has been suggested that in order to stimulate growth through the MSME sector, financial engineering can be used to develop hybrid solutions where some redistributive instruments are combined with risk-sharing instruments to find market-based financing solutions (Iqbal and Roy 2013).

The next section sheds light on how the issue of financial inclusion has been tackled in select Muslim countries by applying Islamic instruments of risk sharing and redistribution.

This does not mean that *Zakah* is a totally new mechanism of poverty reduction as it is already distributed to the poor in several Islamic countries. However, an argument can be made that proper collection, streamlining, accountability, prioritization, and allocation to productive activities can have a significant impact on enhancing access and opportunity for the poorer segments of society, which will ultimately lead to a reduction in poverty.

³ See Kahf (1989), Shirazi (2006), and Mohieldin et al. (2011).

Table 3.1: Resource Shortfall for Poverty Alleviation and Potential of *Zakah* in Closing the Gap (% of GDP)

Country	Resource shortfall per annum for incomes below		<i>zakah</i> (1)	<i>zakah</i> (2)	<i>zakah</i> (3)
	\$1.25 per day	\$2.00 per day	under 3 different estimation methods		
Malaysia	0.012	0.020	1.105	2.364	2.665
Pakistan	0.709	5.201	1.727	3.694	4.164
Indonesia	0.411	2.831	1.582	3.383	3.814
Bangladesh	5.596	23.100	1.560	3.336	3.761
Tajikistan	1.554	8.192	1.698	3.633	4.095

GDP = gross domestic product.

Source: IRTI (2014).

Waqf (endowment) is another Islamic instrument which has great potential for enhancing financial inclusion.⁴ For example, the estimated market valuation of registered *awqaf* assets in India is approximately \$20 billion, as estimated by the Report on Social, Economic and Educational Status of the Muslim Community of India (2006).⁵ If such assets

are managed properly and fully utilized, it could yield an annual return of 10% resulting in expected annual cash flows of \$2 billion which amounts to approximately 0.325% of the country's GDP, which could be sufficient to pull India's Muslim population of over 138 million people out of poverty (IRTI 2014).

Pakistan

There are several institutions in Pakistan offering microfinance, but only a few offer *Shari'ah*-compliant microfinance. Akhuwat is one of the leading institution's offering innovative *Shari'ah*-compliant microfinance services based on the underlying contract of *Qard-Al-Hassan*. The scheme has made a significant impact in alleviating poverty at the lowest cost possible since the financing is based on interest-free lending

to families and the institution has maintained a very low operating cost because of their operating model. The institution features operating out of mosques or churches and the majority of staff work as volunteers, thus keeping the costs at a minimum compared to other microfinance institutions. The performance of the institution is remarkable, and it enjoys one of the highest recovery rates among its peers (see Table 3.2).

Table 3.2: Akhuwat Microfinance Institution in Pakistan

Key Features	Cost Structure		Progress	Total
• Interest-free loans (<i>Qard-ul-Hassan</i>)	Interest	Zero	Total Loans	300,000
• Use of mosque / church			Amount Disbursed	RS. 4 billion (\$40 million)
• Family loans	Processing Fee	Zero	Active Loans	140,000
• Local philanthropy			Percentage Recovery	99.8%
• Volunteerism	Profit	Zero	Number of Cities	110
• Borrowers become donors			Number of Branches	157
• Simple operations leading to cost efficiency	Application Fee	Zero		

Source: Akhuwat

⁴ A *waqf* (plural *awqaf*) is the product of a voluntary endowment of assets to a trust, whose usufruct is earmarked for charitable purposes specified by the founder. The latter appoints a trustee over the *waqf* who is responsible for the implementation of stipulations inside the *waqf* deed. The trustee is compensated for the services rendered either from the earnings generated by the *waqf* or through a fixed remuneration package.

⁵ The report was prepared by a committee appointed by the Government of India under the chairmanship of Justice Rajinder Sachar (popularly known as the Sachar Committee).

Bangladesh

Approaches to financial inclusion in Bangladesh took different dimensions at different points in time. The post-liberation era observed expansions in rural branches of the nationalized banks and promotion of cooperative societies. This was followed by private banks in the 1980s, including Grameen Bank and microfinance institutions. At a later stage, the Islamic microfinance division of Islami Bank Bangladesh Limited (IBBL) was established in the 1990s, taking a “finance plus” approach and preference for women in microfinancing. These steps and the supportive measures of the central bank have taken Bangladesh to a leading position in South Asia with regard to financial inclusion parameters.

IBBL’s model of financial inclusion is based on a two-pronged approach: financial inclusion and social inclusion. The model targets the rural poor and urban poor through its flagship programs, the Rural Development Scheme and Urban Poor Development Scheme. Through a graduation process, the eligible beneficiaries can move on to start SMEs. Under social inclusion, the program takes care of health services, education, training, relief, and rehabilitation of the ultra-poor to enable them to become bankable. The bank has a separate corporate social responsibility program that complements the financial inclusion drive. Islamic finance in Bangladesh has experienced a faster growth than its conventional counterpart.

Banking, insurance, and nonbank financial institutions are among the prime actors in this segment of finance. Currently, there are eight full-fledged Islamic banks and two nonbank financial institutions with Islamic operations in Bangladesh. Islamic bonds are also operational. Islamic banks presently account for almost 25.0% of the domestic banking system. Between 2008 and March 2013, they grew at a pace of 26.0% per year, surpassing the growth of conventional private commercial banks at 22.0% per year.

Historically, people of South Asia, especially Bangladesh, are well known for their endowment activities. Haji Mohammad Mohsin Trust, Hamdard Laboratories (WAQF) Bangladesh, Anjuman Mufidul Islam (AMI), and others fall in this category. Recently banks have come forward to manage endowment funds. Currently, five Islamic and three private commercial banks with Islamic windows have cash *waqf* deposit schemes. A cash *waqf* is a way to allow depositors and other contributors to make cash contributions to an endowment which is maintained by the Islamic bank. In 2012, *waqf* funds of five Islamic banks stood at Tk460 million.

There are still unmet demands for microfinance as about 30.0% of the population live below the poverty line. Demand for Islamic microfinance services are on the rise with the participation of the Islamic banks in the financial inclusion campaign. At present, 15 Islamic microfinance institutions hold only 2.96% of total members covered and 4.37% of the amounts financed. This shows room for growth of Islamic microfinance. An average of Tk75.00 million per year was for social safety net spending under the Rural Development Scheme during the last 4 years. Growth in the number of members has been observed at 6.5%, 16.0%, and 21.0%, respectively, in 2010, 2011, and 2012.

Financial inclusion goes on increasing with the expansion of existing programs and creation of newer groups’ access to Islamic microfinance. IBBL through its Rural Development Scheme now has a presence in 15,507 villages with 733,520 group members, of which 94.0% are female. The bank launched a new microfinance program, the Urban Poor Development Scheme, in May 2012 to extend micro-investment facilities to slum dwellers in the urban areas. Social Islami Bank Limited has recently joined hands with a nongovernment organization, Muslim Aid Bangladesh, to partly finance their microfinance activity. Financial inclusion has further deepened by opening of 599,472 farmers accounts and 105,114 school students accounts at a minimum balance of Tk10. The Association of Muslim Welfare

Activities in Bangladesh, a federation of 320 Islamic microfinance institutions, has 101,943 investment clients who received Tk2.05 billion in 2010.

Islamic microfinance institutions working among the

poor on the principle of equity and justice proved their worth as more contributory toward poverty alleviation in Bangladesh. Hence, Islamic microfinance has become a popular model with substantial growth in comparison to peer microfinance operators.

Philippines

Bangko Sentral ng Pilipinas (BSP) recognizes that financial inclusion is a worthy policy objective that can be pursued alongside the promotion of stability and efficiency in the financial system. Working toward the achievement of both financial stability and financial inclusion requires at least the same amount of energy, imagination, and serious attention. BSP has taken several measures in establishing a supportive regulatory environment that can allow market-based solutions to address financial access issues. The general approach is to promote an enabling environment based on the proportionate application of sound and generally accepted regulatory and supervisory principles. This is the approach that was taken in mainstreaming microfinance in the banking sector. The success of microfinance efforts has emboldened BSP to move toward a more ambitious goal of increasing access to financial services for all.

BSP has undertaken specific measures that bear the potential of increasing access to finance in a significant way. The bank is focusing on facilitating conventional microfinance, but given the developments in *Shari'ah*-compliant microfinance and increasing demand by the local Muslim population, BSP is developing its capacity to better understand the dynamics of *Shari'ah*-compliant microfinance to enhance access to finance to those who are currently excluded from the system due to their preference for *Shari'ah*-compliant products.

On the conventional side, BSP has taken the following measures:

- (i) **Expanded range of products.** Circular 694 expanded the microfinance products to include microenterprise loans, microfinance plus (for growing enterprises), microdeposits, and microinsurance.

- (ii) **Expanded physical network.** Circular 694 enables banks to establish a presence in areas where it may not be immediately economically feasible to set up a full bank branch by allowing a “stripped down” or simple branch called a microbanking office (MBO). This addresses problems of cost and branch viability. MBOs are operationally attached to a nearby full branch. It also allows areas that are unserved and/or underserved to have access to a wide range of financial services that these MBOs can provide ranging from loans, savings, remittances, e-money conversion, bill payments, payout services, and limited foreign exchange purchases.

- (iii) **Expanded virtual reach.** Circulars 649 (9 March 2009) and 704 (22 December 2010) on electronic money, electronic money issuers, and electronic money network service providers provide the platform for an efficient retail payments platform, foster the establishment of a ubiquitous agent network, and provide scope for outsourcing automated systems, network infrastructure, and a network of agents in relation to the e-money business.

- (iv) **Lower barriers to customer acquisition.** Circular 706 provides scope for banks to have a risk-based and tiered system of classifying customers (i.e., low, average, high risk); establishes a framework for applying reduced, average, and enhanced due diligence, customer acceptance, retention, and identification process based on the level or risk of the customer; and allows the outsourcing to or relying on a third party for the face-to-face requirement of Know-Your-Customer (KYC), and gathering of information and documents.

- (v) **Informed and protected consumers.** Circulars 730, 754, and 755 updated rules implementing the Truth in Lending Act to Enhance Loan Transaction Transparency. These updated rules will help ensure the protection of consumers, promote healthy competition among credit providers, and enable the smooth and orderly functions of the entire financial system. This regulation is also very timely as calls for enhanced consumer protection are intensifying, specifically as affirmative financial inclusion policies lead to the availability of an ever widening range of financial products and services.

Taken together, BSP sees these recent issuances as groundbreaking measures that can unlock the potential of reaching the large populations of unbanked in the Philippines. In all of these undertakings, proportionate regulation is the necessary approach. Useful innovations need not be stifled but instead allowed to operate in an environment where the risks associated with such innovations are adequately understood and addressed and where there is a judicious and proportionate application of sound principles.

Concluding Remarks

Access to finance is hampered by information asymmetries and market imperfections which need to be removed before enhancing finance. When it comes to developing countries' finance sectors, which are not very well developed and the formal finance sector is underdeveloped, it is important that attention is paid to improve institutions critical for finance sector development. Improved access to finance in many developing countries is constrained by an underdeveloped institutional framework, inadequate regulations, and a lack of specialist supervisory capacity. Policy makers need to take steps to enhance key legal, information, and regulatory institutions in their country.

Regulators should make financial inclusion a priority. Despite the significance of financial inclusion, it is observed that it is still not a priority for financial regulators in most OIC countries. The OIC countries need to develop a regulatory and supervisory framework that supports wide financial inclusion based on sound risk management and with sufficient consumer protection. Financial inclusion should be considered a goal alongside prudential regulation and financial system stability. The Consultative Group to Assist the Poor and World Bank Financial Access survey (2010) of financial regulators worldwide found that regions that include financial access in their strategies and mandate their financial regulators to carry such agendas are also those that reform the most. Regulators with a financial inclusion strategy

are more likely to have a bigger financial inclusion mandate under their purview and more resources and staff dedicated to working on these matters.

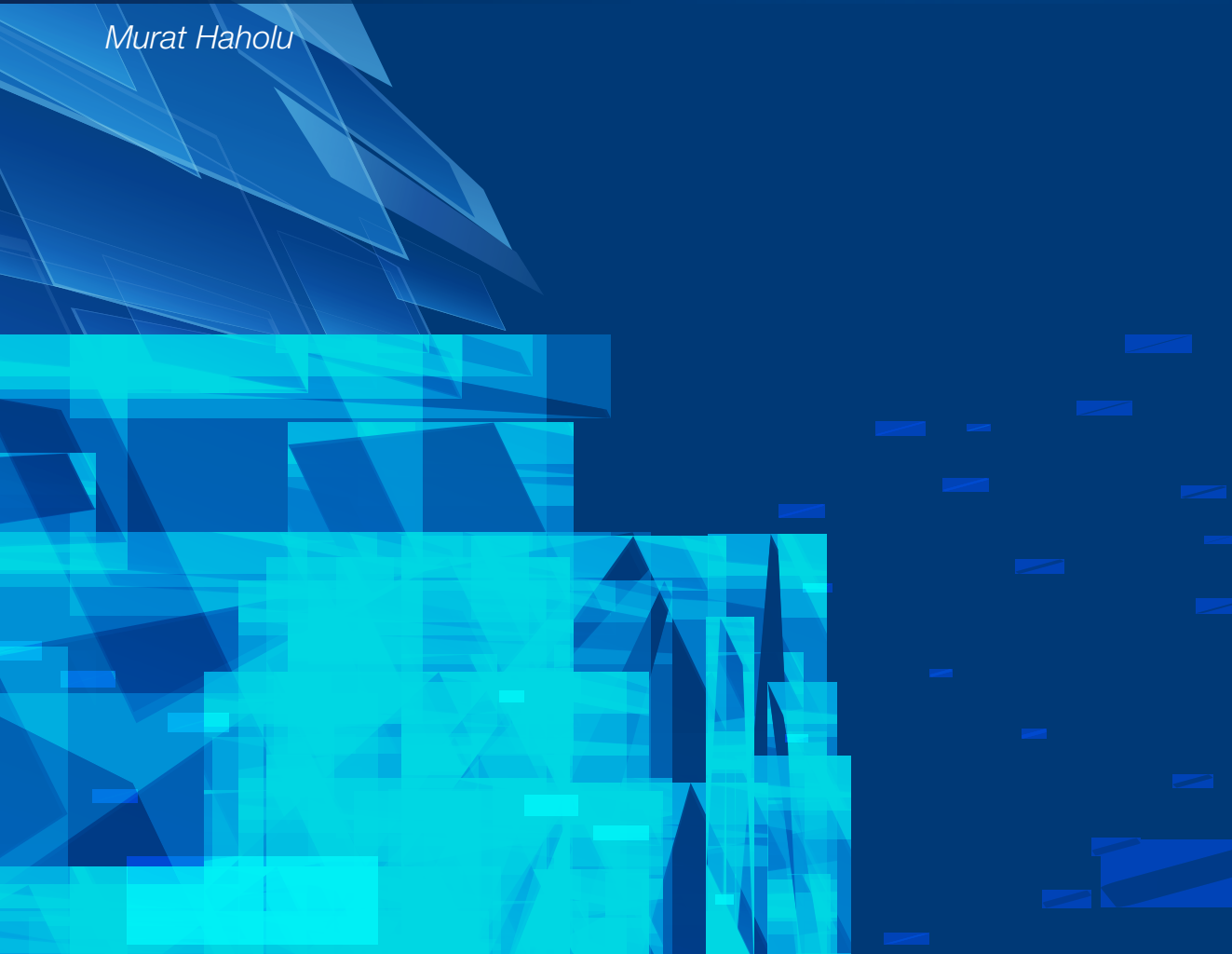
The growth of Islamic microfinance will depend to a large degree on whether financial institutions can develop sufficiently attractive financial products and services, which are competitive with conventional products in terms of pricing, transparency, processing time, and burden on the client. *Shari'ah*-compliant microfinance and SME financing is limited in its scope and scale because of lack of knowledge concerning *Shari'ah* products, of accounting and regulatory standards for *Shari'ah*-compliant microfinance, and of adequate monitoring and supervisory setups.

By integrating *Shari'ah*-compliant products and customer information into the formal finance sector, it will not only enhance access but also help integrate Islamic finance with conventional finance. For example, by bringing borrowers' information to credit bureaus, financial institutions of all types could extend access to new customers, while managing risks and costs more effectively. This will also help *Shari'ah*-compliant financial institutions to expand their funding source and enhance their risk-sharing mechanism, as an institution with its clients' credit information available to the public can establish its reputation much more easily than one with an informal credit history system.

CHAPTER 4

Islamic Capital Markets: Potentials and Prospects for Development

Murat Haholu

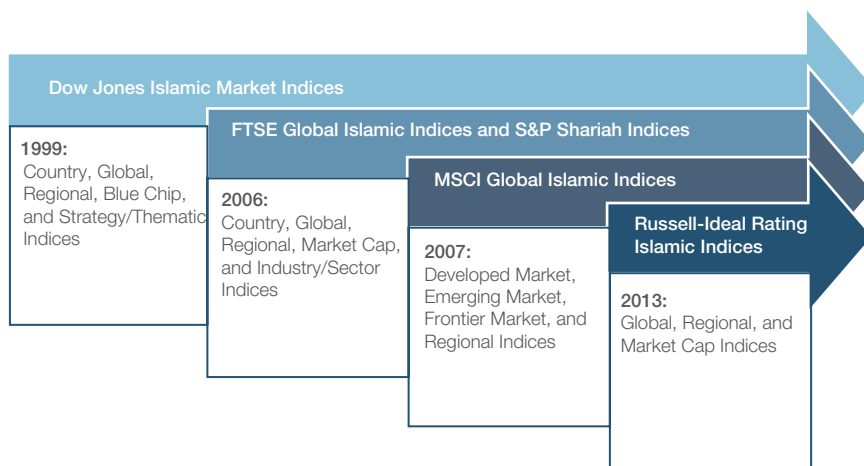


A Global Overview

The introduction of Islamic finance during the 1970s had predominantly been based on developing *Shari'ah*-compliant banking systems. However, post-1990s onward, there has been considerable interest across the key Islamic finance markets of the Gulf Cooperation Council (GCC) and Malaysia to develop appropriate *Shari'ah*-compliant capital market products and services. *Shari'ah*-compliant financial instruments notably serve various critical functions in an economy ranging from funding capital requirements, enabling growth in wealth and assets, while also providing short- to long-term liquidity for diverse purposes. The added advantage of the Islamic capital market instruments is the ethically compliant nature of product structuring which aims to achieve economically viable financial practices combined with principles of ethics and sustainability. Since the early 2000s, the global Islamic capital market has been growing in depth and size across jurisdictions, with numerous entities across sectors

raising capital in ways that comply with Islamic principles. As of today, the global Islamic capital market is a multisector segment that includes holistic financial instruments including *Sukuk* (Islamic bonds), Islamic equities, Islamic funds, and other Islamic structured products including real estate and investment trusts (REITs) and exchange-traded funds (ETFs). The Islamic equity sector has firmly established itself in key global bourses and jurisdictions and the world's major financial index providers, such as Dow Jones, Standard & Poor's, and FTSE, all have *Shari'ah*-compliant equity listings (see Figure 4.1) which have allowed the *Shari'ah*-compliant equity and funds market to blossom. As an example, the Dow Jones Islamic Market indices cover more than \$10 trillion market capitalization in over 40 countries. These developments have enhanced the attractiveness of Islamic financial markets as an asset class for investment.

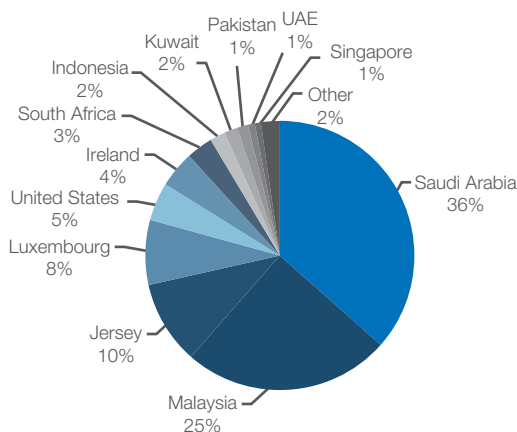
Figure 4.1: Major Islamic Indices for Equity Markets



Source: Dow Jones, S&P, FTSE, MSCI, Russell Investments, KFH Research.

The listing of *Shari'ah*-compliant equities and indices effectively allows development of Islamic mutual funds and structured products by the Islamic finance suppliers (Najeeb and Vejzagic 2013). There are now more than 1,049 mutual funds, managing an estimated \$72.5 billion in assets, that are compliant with Islamic principles. Saudi Arabia and Malaysia are the two leading Islamic capital market domiciles, holding more than 60.0% of total Islamic fund assets globally. In addition, the stock market capitalization of the two bourses in these countries, Bursa Malaysia (see Figure 4.2) and Saudi Tadawul, is the largest among the key Islamic finance hubs: as at the end of 2013, Bursa Malaysia's total market capitalization stands in excess of \$450 billion while that of the Saudi Tadawul similarly stands at approximately \$467.4 billion.

Figure 4.2: Global Islamic Assets under Management by Domicile (as of 17 June 2014)



UAE = United Arab Emirates.

Source: Bloomberg, Zawya, KFH Research.

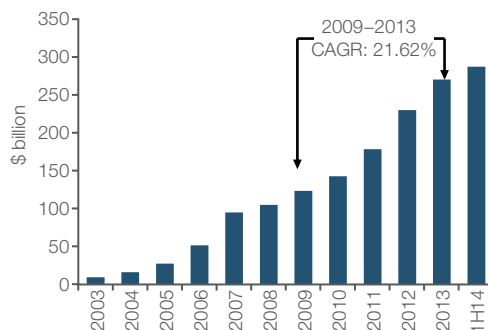
On the debt component of the Islamic capital markets, the global *Sukūk* market is a notable segment, having developed from only one issuance in the 1990s to over \$100 billion worth of issuances in the last 2 years (2012–2013). The tremendous popularity of *Sukūk* in recent years is evident with its robust growth in amounts outstanding at a compound annual growth rate of 21.6% during 2009–2013, making it the fastest expanding segment of the Islamic finance industry. The

issuance momentum (see Figure 4.3) in the sector has particularly surged during the post-financial-crisis years and the volume of issuances averaged over \$95 billion per year during 2010–2013. The greater momentum, particularly after the financial crisis, highlights the relevance and applicability of the Islamic finance sector to the global markets. In modern times, *Sukūk* have evolved from a basic corporate financing instrument to serve a variety of purposes in the global financial markets including as means of financing:

- (i) sovereign fiscal needs,
- (ii) countries' infrastructural spending requirements,
- (iii) corporate budgetary and debt refinancing needs,
- (iv) Islamic banks' capitalization instruments,
- (v) Islamic banks' liquidity management instruments, and
- (vi) instruments of investments for both individual and institutional investors (e.g., fund management companies, *Takāful* operators, etc.).

In particular, since the first global sovereign issuance by Malaysia in 2002, *Sukūk* are widely being pursued by various sovereigns globally. Sovereign *Sukūk* issuances constitute more than 60.0% of total *Sukūk* issuances in the last three and half years (2011 until the first half of 2014). A number of high-profile non-Muslim jurisdictions including the United Kingdom, Luxembourg, and Hong Kong, China have also now issued sovereign *Sukūk*.

Figure 4.3: Global *Sukūk* Outstanding (2003–H1 2014)

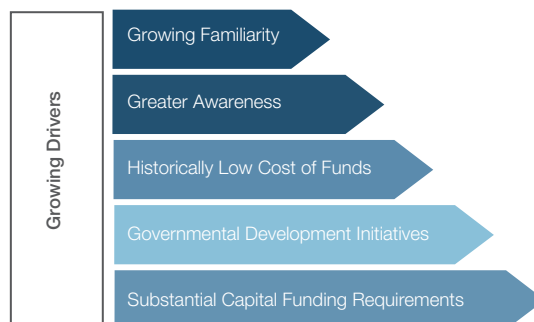


CAGR = compound annual growth rate, H = half.

Source: KFH Research.

Over the years, *Sukūk* have also evolved in terms of their structures and the markets now have instruments structured on a variety of underlying contracts (e.g., *Murābahah*, *Mushārakah*, *Ijārah*, etc.) with both fixed and flexible returns. The instruments also come with a variety of tenors and maturities. Of late, the evolution in *Sukūk* structures has been to develop perpetual *Sukūk* for banking institutions in order to comply with the capital adequacy requirements of the Basel III standards. To date, a total of 30 jurisdictions (Organisation of Islamic Cooperation [OIC] and non-OIC alike) have tapped the *Sukūk* market to raise funds in a *Sharīah*-compliant manner (excluding offshore jurisdictions).

Figure 4.4: Growth Drivers of the *Sukūk* Market



Source: KFH Research.

Going forward, *Sukūk* are likely to be the main source of growth in Islamic capital markets underpinned by a number of growth drivers (see Figure 4.4). Over the last 2–3 years, Azerbaijan, France, Gambia, Jordan, Kazakhstan, Luxembourg, Mauritius, Nigeria, Turkey, Yemen, and Hong Kong, China have entered the global *Sukūk* markets to tap into the fast-growing global pool of *Sharīah*-compliant liquidity funds.

Overall, the Islamic capital market is one of the most promising sectors of the global Islamic finance industry and is expected to play a greater role in Islamic finance. The growing pool of wealth in the major Islamic finance jurisdictions of the GCC and Southeast Asia, combined with the willingness of regulators to support the development of an Islamic capital market, promises to drive the sector to greater heights.

Malaysia's Experience

The Malaysian Islamic capital market is worth over RM1.5 trillion, accounting for 56.0% of the overall Malaysian capital market as at the beginning of 2014. Malaysia's Islamic capital market offerings include a holistic product ecosystem comprising *Sharīah*-compliant equity, debt, funds, and structured products. The marketplace is comprehensively backed by robust and clear legislation and guidelines by the regulator, Securities Commission Malaysia. In addition, a centralized body, the *Sharīah* Advisory Council of Securities Commission Malaysia maintains oversight of the compliance aspects of all Islamic products and offerings. The sector's growth and expansion are duly supported by domestic ancillary firms such as rating agencies, asset managers, training and education providers, as well as efficient trading platforms and/or exchanges.

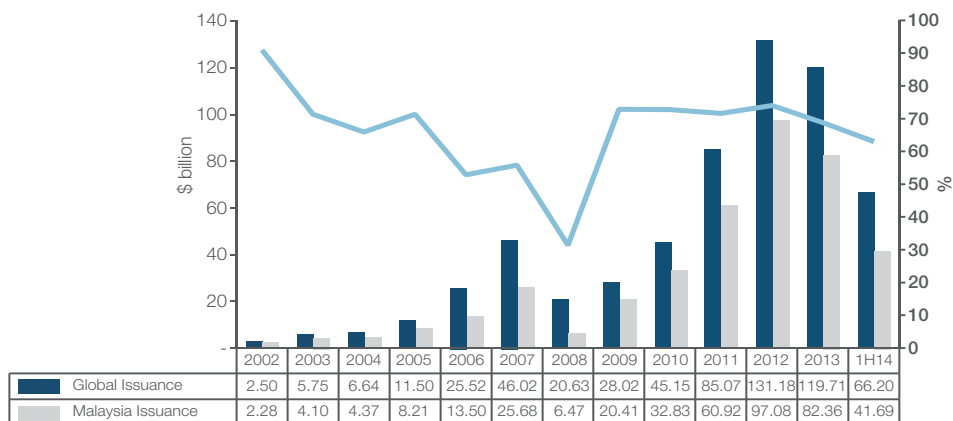
The Malaysian Islamic capital market has a long history of innovative evolution that has driven the growth and expansion of this sector. For example, Malaysia established two Islamic unit trust funds back in 1993, effectively paving the way for the development of the Islamic fund management industry. Malaysia is also noted for its creative leadership in launching the first Islamic REITs in the world and the introduction of Asia's first Islamic ETF spearheading efforts in developing Islamic capital market structured products.

As of the first half of 2014, approximately 73.5% of total securities listed in Bursa Malaysia are *Sharīah* compliant. These effectively translate into a market capitalization of more than RM1 billion (\$300 million). The Islamic benchmark indices, Emas (21.7%) and

Hijrah (24.2%), both have outperformed the main KLCI index (17.7%) on a year-on-year basis as at the end of the first half of 2014. In the Islamic funds sector, Malaysia domiciles 185 *Shari'ah*-compliant unit trust funds with a net asset value of RM45.3 billion as at the first half of 2014. Approximately 16.7% of total assets under management in the country are *Shari'ah* compliant; an increased proportion compared to the 14.8% in the first half of 2013. Furthermore, there are 64 *Shari'ah*-compliant wholesale funds in the country with a net asset value of RM17.8 billion. In addition, Malaysia domiciles two Islamic ETFs accounting for 31.5% of the total ETF market in the country and also three Islamic REITs accounting for 41.9% of the total REITs market. *Shari'ah*-compliant wealth management on structured products and private equity and/or venture capital is also thriving in the Malaysian financial markets.

On the debt component of Islamic capital markets, Malaysia is once again regarded to be the pioneer in issuing *Sukūk*. The Malaysian central bank issued Government Investment Issues way back in 1983 to help address the liquidity management issues in their first Islamic bank, Bank Islam (Cizaka 2011). Ten years later when the Islamic banking segment was opened for competition, the central bank introduced an Islamic money market on 3 January 1994, marking an important milestone in the liquidity management of Islamic banks (Najeeb and Vejzagic 2013). Since then, Malaysia has positioned itself as the global leader in *Sukūk* issuances and in provision of liquidity management services for Islamic financial institutions. In the first half of 2014, the Malaysian *Sukūk* market accounted for 63.0% of global new *Sukūk* issuances; it has sustained its leadership in the *Sukūk* market since 2001 (see Figure 4.5).

Figure 4.5: Malaysian *Sukūk* Primary Market Share vs. Global (2002–H1 2014)



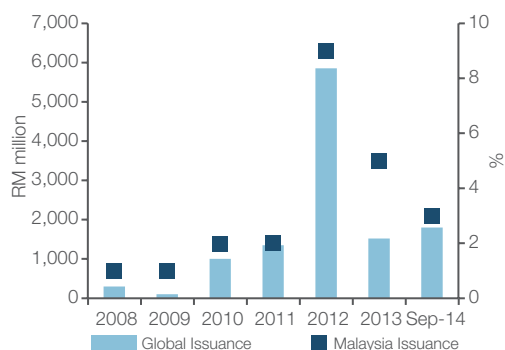
H = half.

Source: KFH Research.

The Malaysian *Sukūk* market is also internationally attractive and is a preferred domicile among foreign issuers. A total of 23 *Sukūk* tranches by 11 different issuers from 7 different jurisdictions have tapped the Malaysian *Sukūk* market between 2008 and September 2014, a number far higher than any other onshore *Sukūk* jurisdiction. Collectively, these 23 *Sukūk* tranches have raised almost RM12 billion in proceeds for the various issuers. Among the various regions, the Asian issuers (Singapore; Hong Kong, China; and Kazakhstan) have raised

the most volume, accounting for 53.0% of the total proceeds raised by foreign issuers in the between 2008 and September 2014. Comparatively, the GCC issuers (Saudi Arabia, United Arab Emirates, and Kuwait) have raised nearly 40.0% (see Figure 4.6) of the volume in the sample period, and this figure includes issuances by the multilateral Islamic Development Bank. In 2014, a Turkish participation bank also tapped the Malaysian *Sukūk* market raising RM800 million.

Figure 4.6: *Sukūk* Capital Raised by Foreign Issuers in Malaysia (2008–Sep 2014)



Source: KFH Research.

Moving forward, the Malaysian Islamic capital market has a strong growth potential in meeting the financial needs of the new and upcoming market sectors which include the likes of the global halal industry, the global green financing sector, the alternative Islamic segments (e.g., *Awqaf*), and meeting regulatory requirements (e.g., Basel III). Furthermore, in line with the Securities Commission's Capital Market Masterplan 2 which calls for widening the international base of the Malaysia Islamic capital market, there are four key focus areas as a way forward for the industry:

- (i) Responsible innovation accounting for various environmental, social, and economic concerns
- (ii) Mobilization of foreign funds
- (iii) Increase in foreign currency deals within Malaysia
- (iv) Attracting global players with the best talent in the marketplace

In a nutshell, Malaysian Islamic capital market propositions are widely being utilized by local and international stakeholders, leveraging on the country's sound and robust ecosystem for *Shari'ah*-compliant financing.

The Philippines' Experience and the Role of the Philippine Stock Exchange

The Government of the Philippines has announced that they will allocate P400 billion (about \$9 billion) for public infrastructure projects in 2014, which is up 35.0% from the allocation in 2013. Further, by 2016, the allocation is expected to rise to P820 billion (equivalent to \$19 billion). In the Philippines, gross domestic product (GDP) growth remains strong. The Philippines' GDP is among the highest in Asia, expanding quarter on quarter at an average of about 7.0% since first quarter of 2012.

Sukūk are among the *Shari'ah*-compliant fund-raising tools that could be explored in the country to fund various projects including infrastructure. *Sukūk* could be used to fund economic activities in which

the Philippines has strength (e.g., agriculture, textile, electronics, and automotives). As such, *Sukūk* could be one of the possible fund-raising options to support the economic growth of the Philippines.

One of the strategies that the Philippine Stock Exchange (PSE) could adapt is offering a variety of products to the markets, particularly businesses. The ethical investment climate plays a very important role in capital markets. In the PSE's road shows across the Philippines, especially in the south, there was already a demand for products compliant with *Shari'ah* standards. In the Philippines, the Muslim population accounts for 10.0% of the total population.

In terms of Islamic finance development thus far, the PSE has an Islamic index calculated by Standard & Poor's. It has also engaged a *Sharī'ah* advisory consultant, Ratings Intelligence, to provide guidance on different standards and practices. The PSE has conducted market education and awareness campaigns to educate the public on Islamic finance, including organizing an industry briefing and a roundtable on Islamic finance. The PSE requested the assistance of the National Commission of Muslim Filipinos, a government entity, to form a technical working group, composed of the insurance commission, the central bank, the tax authority, the securities commission, the Institute of Islamic Studies of the University of the Philippines, and the only Islamic bank in the Philippines, Al Amanah Islamic Bank. The objective of the technical working group is to pave the way for a *Sharī'ah*-compliant stock screening. The end result is to have an identifier for the stocks that are compliant with the standards of Islamic finance.

As for the challenges in the Philippines, the lack of local *Sharī'ah* experts and limited numbers of *Sharī'ah* advisors are key issues. The Philippine Islamic finance market is in need of training its own experts. In this regard, having a general, reputable

Sharī'ah advisor assist the PSE could be efficient from a timing perspective, to help the PSE achieve its short-term objectives. Government support is also an important factor as regulatory facilitation is necessary to remove arbitrage, tax inequalities, and other national coordination.

By 2015, the objective is to have an Association of Southeast Asian Nations (ASEAN) integrated finance community, to which the ASEAN finance ministers have committed. The private sector is very much aware not only that rationalization of regulations is needed but also that, from a business perspective, the competitiveness of the Philippine capital market would be very critical because the financial markets will be integrated.

Despite the lack of a legal and regulatory framework, the PSE has found a very pragmatic way to move forward with some conflicting targets by the end of the year. There will be a list of *Sharī'ah*-compliant equities, and by the second quarter of 2015, there will be a *Sharī'ah* index of such equities. The PSE is also pushing for a new law on Islamic finance, in particular the equalization of tax treatment for conventional and Islamic finance instruments.

Turkish Islamic Finance Experience

The Turkish participation (as Islamic finance is referred to in Turkey) sector is rapidly emerging as a frontrunner in the global Islamic banking industry. The Partnership Banks Law No. 5411, approved in November 2005, paved the way for the development of the country's participation banking industry (see Table 4.1 for Islamic banking sector statistics).

Table 4.1: Turkish Banking Sector Key Statistics (H1 2014)

Type	Number	Assets		Loans		Deposits	
		(TL billion)	(% share)	(TL billion)	(% share)	(TL billion)	(% share)
Depository	32	1,579.0	89.9	974.7	89.0	917.6	93.5
Development and Investment	13	76.8	4.4	58.7	5.4	-	-
Participation	4	100.2	5.7	61.7	5.6	63.9	6.5
Total	49	1,756.0		1,095.1		981.5	

– = These are specialized financial institutions that do not raise deposits from public.

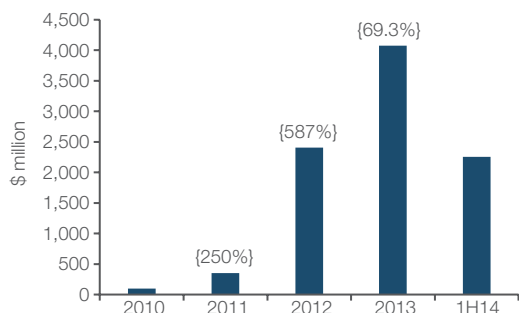
Source: Central Bank of Turkey, KFH Research.

There are also a growing number of sovereign *Sukūk* benchmarks that are encouraging corporations to issue securities, thereby deepening the country's capital market and liquidity flows. *Sukūk* (or participation/lease certificates as they are known in Turkey) have attracted considerable interest (see Figure 4.7) in the Turkish capital market since the issuance of the country's first sovereign *Sukūk* in September 2012. The Government of Turkey's inaugural \$1.5 billion sovereign *Sukūk* in 2012 sent investors a clear signal about the country's

commitment to the global *Sharī'ah*-compliant finance industry. As at the first half of 2014, the volume of Turkish *Sukūk* outstanding amounted to \$7.6 billion, representing a tremendous exponential jump since the country's first issuance in 2010 worth \$100 million (see Figure 4.8) by Kuveyt Türk.

As the holistic participation finance sector expands in the country on the back of firm regulatory support, participation banking is expected to also benefit in tandem with the overall sector's expansion in assets.

Figure 4.7:
Sukūk Issuances in Turkey (2010–H1 2014)

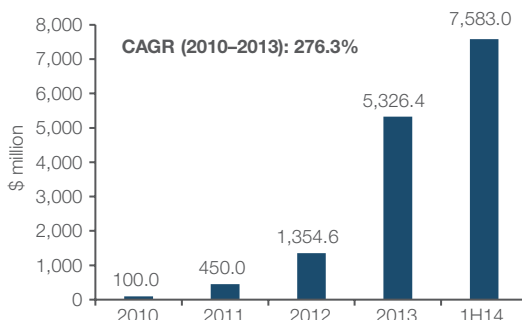


CAGR = compound annual growth rate, H = half.

Note: Figures in { } indicate year-on-year change in annual issuances.

Source: Bloomberg, IFIS, Zawya, KFH Research.

Figure 4.8:
Sukūk Outstanding in Turkey (2010–H1 2014)



In terms of the regulatory framework, Turkish Islamic financial services are regulated by three separate regulators. The participation banking sector is regulated by the Banking Regulation and Supervision Agency, the Sovereign *Sukūk* market falls under the purview of the Turkish Treasury while other capital market instruments and products (e.g., equities) are regulated by the Capital Markets Board of Turkey (CMB). This fragmented approach allows each regulator to focus on their own objectives and duties without being exposed to overall reputation and contamination risks of other sectors.

Turkish Islamic capital markets are still in their infancy. However, there have been some cross-border issuances amounting to \$1.2 billion. In addition,

the Turkish domestic *Sukūk* market has seen \$200 million issuances which were made by three issuers. Turkish Treasury has also issued sovereign revenue-indexed bonds (RIBs), with two issuances per year. Returns on sovereign RIBs are indexed to revenues of state-owned enterprises. Currently, RIBs do not hold too much attention and not all participation banks invest in sovereign RIBs as these securities are not suitable for their mandate. The treasury ended the RIB program in early 2012 and launched the first sovereign *Sukūk* in September 2012, followed by the second sovereign *Sukūk* in October 2013. The two issuances amounted to \$2.75 billion. In addition, the treasury has issued two domestic *Sukūk* amounting to \$1.7 billion.

The aim of the issuance is to promote the Islamic financial market in Turkey and create a benchmark curve for the upcoming private sector issuances. This also underlines the government support and policy on Islamic finance policy in Turkey. These are vital to encourage the development of a *Sukūk* market in the relevant country.

At this point in time, there is strong support from the government and the state institutions regarding the sovereign issue. The upcoming third Bosphorus bridge project and other highways may be financed by sovereign *Sukūk* issuances according to latest announcements by the government.

To this end, *Sukūk* issuers have enjoyed more favorable pricing in Turkey compared to conventional instrument issuers globally. Various factors have contributed to this phenomenon. For instance, robust regulatory frameworks contributed to the growing trend of *Sukūk* issuances. In comparison to their conventional counterparts, the inherent nature of the involvement of assets and project financing has been a positive feature of *Sukūk* and contribute to their favorable issuance terms. A strong demand for *Sukūk* has also been a main driver of competitive pricing.

Regulatory Framework for Turkish *Sukūk* Market

The development of the regulatory framework for Turkish lease certificates has notably evolved over the past few years starting 2010. The first *Sukūk* regulation was introduced in 2010 by the CMB regarding lease certificates (see Figure 4.9) and asset lease companies. This regulation was designed basically to enable interest-free financing and investment in capital markets and therefore regulate the most popular and basic *Sukūk* type of its time: the *Ijārah Sukūk*.

The regulation also introduced the establishment of an asset lease company (ALC) as an issuer to fulfill a special purpose vehicle's role for issuances. Since

there is no trust mechanism in Turkish law which is based on codified civil law, an ALC is designed as a joint stock corporation with minimum requirements.

In early 2011, major tax exemptions were granted for issuers and investors. The CMB has levelled the registration fee imposed on *Sukūk* issuances. In mid-2012, an amendment was made to the Public Finance and Debt Management Law in order to smooth the way for sovereign *Sukūk* issuances, which was immediately followed by the first Turkish sovereign *Sukūk* issuance by the Turkish Treasury worth \$1.5 billion.

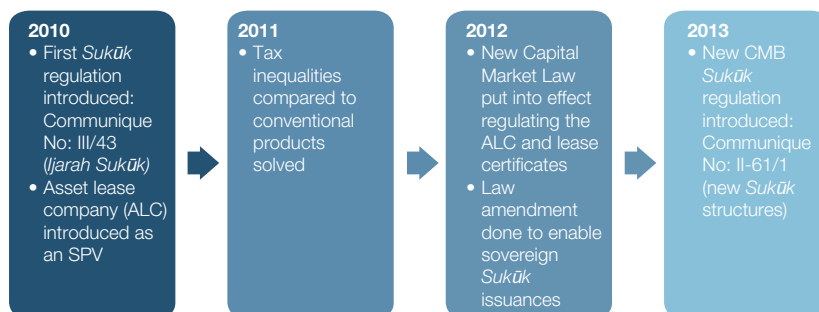
Following these improvements in the Turkish *Sukūk* market, a new Capital Market Law was published in late 2012 and put into effect on 30 December 2012. An ALC is counted as a "capital market institution," that is, it is regulated and supervised by CMB, giving extra protection and confidence to investors.

Following the new law, a new *Sukūk* regulation has been prepared, taking into account both new law provisions and demands expressed by the private sector. The new *Sukūk* regulation, Communiqué No. III-61/1, was enacted in June 2013.¹

There were some limitations in the first *Sukūk* regulation so that only *Ijārah Sukūk* was regulated. The old regulation was based on transfer of an asset and issuers eventually ran out of assets. Furthermore, eligible underlying assets were constrained to tangible goods, property, and intangible assets. Some early challenges in Turkey included lack of a trust mechanism, of tax neutrality, and of a legal framework. Today, these have all been overcome. The old *Sukūk* regulation was mainly designed to bring about an "interest-free bond" structure into Turkish capital markets. Hence, it was crucial to create a level playing field for *Ijārah Sukūk* with conventional products. In order to resolve the tax inequalities between *Ijārah Sukūk* and conventional bonds, a law granting specific tax exemptions granted for lease certificates was enacted in February 2011.

¹ For the text of the regulation, see www.cmb.gov.tr/apps/teblig/displayteblig.aspx?id=473&ct=f&action=displayfile

Figure 4.9: Development of the Regulatory Framework for Turkish Lease Certificates



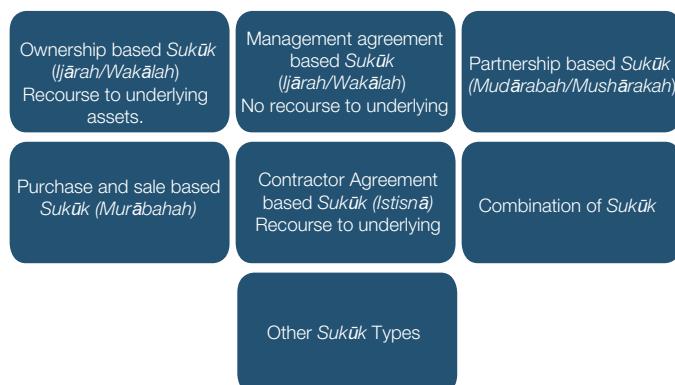
SPV = special purpose vehicle; CMB = Capital Markets Board of Turkey.

Source: Presentation (Capital Markets Board of Turkey).

The following are the main points regulated in the new Capital Market Law regarding *Sukūk* and ALCs:

- All kinds of assets and rights can take place in the portfolio of an ALC. In other words, an ALC can issue lease certificates based on all kinds of rights without any limitations.
- An ALC cannot deal with any other activity except the ones indicated in its articles of association and no real rights may be established in favor of third persons on the assets and rights it holds except those permitted in its articles of association.
- An ALC cannot lease or transfer these assets and rights against the interests of lease certificate holders. Until lease certificates have been redeemed, the assets and rights taking place in the portfolio of an ALC cannot be pledged other than for the purpose of collateral, cannot be put up as collateral, cannot be attached even for the purpose of collecting public receivables, cannot be included in the bankruptcy estate, and cannot be subject to any cautionary injunction even when the management or audit of the issuer is transferred to a public institution.
- In the event that the issuer cannot fulfill its obligations arising from *Sukūk* in due time, its management is transferred to a designated public institution, its permission of activity is cancelled, or it goes bankrupt, the income generated from the assets in its portfolio shall be used primarily in the payments to be made to *Sukūk* holders. The CMB is authorized to take all kinds of measures for the purpose of protecting the rights of *Sukūk* holders.
- The CMB has the authority to determine principles and procedures concerning the establishment of an ALC and its articles of association, activity principles, types and qualities of the assets and rights an ALC can take over and the keeping of the records related to them, and ALC management, liquidation, and termination principles.

Figure 4.10: Regulated Sukūk Structures



Source: Presentation (Capital Markets Board of Turkey).

The lease certificates designed and the *Sukūk* structures include but are not limited to the following:

- lease certificates based on ownership (*Ijārah* (see Figure 4.10) or *Wakālah Sukūk* – true sale)
- lease certificates based on management agreements (*Ijārah* or *Wakālah Sukūk*)
- lease certificates based on partnership (*Mushārahah* and *Mudārabah Sukūk*)
- lease certificates based on purchase and sale (*Murābahah Sukūk*)
- lease certificates based on contractor agreements (*Istisnā Sukūk*)
- combination of those mentioned above and any other structure accepted by the CMB.

The CMB issuance fee is also lowered for *Sukūk* issuances to offset inherent costs associated with underlying transactions which do not exist when compared with conventional debt instruments.

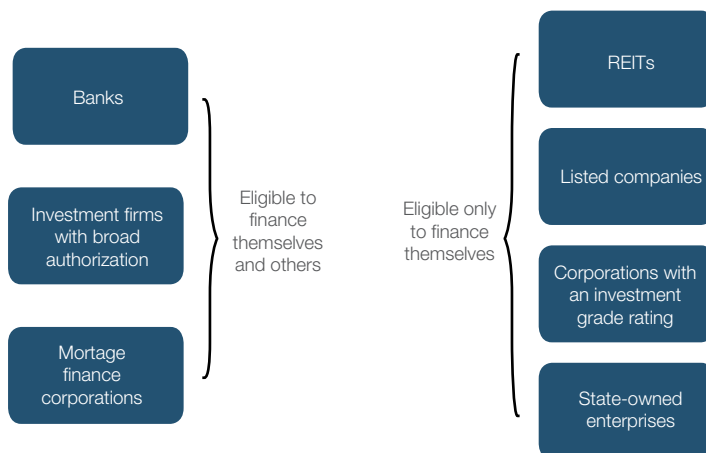
In the new regulation, the “one ALC one issue rule” has been annulled since the new law gives the CMB the authority to determine types and qualities of the assets and rights an ALC can take over and keeping of records related to them. Therefore, an

ALC may issue different *Sukūk* at a given time. The new regulation, therefore, specifies that all rights and responsibilities relating to these underlying assets and rights are to be monitored and reported separately for each issuance. This will effectively eliminate the commingling risk with regard to an ALC’s assets.

For lease certificates based on ownership or an independent contractor agreement (*Ijārah/Wakālah* – true sale or *Istisnā*), the issue amount has been restricted to 90.0% of the underlying asset’s fair value. Circumstances that necessitate the determination of the market value of assets and rights are stated clearly and must be as per International Valuation Standards by appraisal firms approved by the CMB. Meanwhile, in order to prevent conflict of interests between an ALC and the originator, an independent board member requirement has been introduced for voting on critical decisions.

For lease certificates based on management agreements and purchase and sale, originators can only be companies eligible to create an ALC by the regulation and determination and use of market value of assets and rights have been broadened.

Figure 4.11: Eligibility for Creating Asset Lease Companies



REIT = real estate and investment trust.

Source: Presentation (Capital Markets Board of Turkey).

The sponsors of an ALC have been broadened since an ALC is counted as a capital market institution in the new law. According to the regulation, an ALC can be founded by banks, investment firms of a certain capacity, or mortgage finance corporations. These are eligible to finance themselves and others, while the following are eligible only to finance themselves (see Figure 4.11):

- listed real-estate investment companies,
- first and second group corporations as defined in the CMB's corporate governance regulations,
- corporations with an investment grade rating note, and
- Treasury subsidiaries.

In some cases, a conflict of interest between investors and the originator may occur. In order to protect the investors and prevent such conflicts of interest, the new regulation has some provisions, including the following:

- There must be an independent board member in an ALC.
- One board member must have a Capital Market Activities Advanced Level License.
- Important decisions are tied to the independent board member's affirmative vote.

These decisions may be defined in articles of association or on a case-by-case basis under CMB oversight.

There are two types of securities that can be designed as Islamic financial instruments in Turkish capital markets. These are asset-backed securities and real estate certificates. According to the regulation of asset-backed securities, an "asset finance fund" must be created and the assets must be transferred from the originator to the fund's portfolio. On the other hand, asset-based securities are debt securities secured by the assets in the fund portfolio.

Fund assets may comprise the following:

- Receivables arising from consumer loans other than residential mortgage loans, commercial mortgage loans, vehicle loans, project finance loans, and business loans given by banks and finance companies
- Receivables arising from lease agreements made by the authorized institutions
- Receivables arising from sale of real estate properties belonging to the Housing Development Administration of Turkey

- (iv) Any cash equivalent short-term investments aimed at investing the proceeds of the assets in the fund portfolio
- (v) Assets in the reserve accounts
- (vi) Other assets approved by the CMB

The real estate certificate is a security issued by the issuers to finance real estate projects to be constructed or in the process of being constructed. Redemption of real estate certificates by the issuer can be done in two ways: The investor may be redeemed in exchange for a property from the real estate project or for fair value of the real estate certificate determined by a valuation report.

Overall, the participation finance sector is set to flourish in the near future, driven primarily by encouraging initiatives undertaken by the Turkish authorities and the rising demand for participation-structured financial products and services inside the country. Turkey's growing linkages with major Islamic finance hubs—such as Malaysia and those in the GCC—promise to present additional growth opportunities for participation financial institutions by helping them leverage on cross-border expertise.

Turkey is internationally recognized as being one of the top emerging markets and has a dynamic and growing economy which offers a wide range of promising investment opportunities. Especially in terms of capital markets, Turkey has a great potential. Thus, in compliance with national efforts to expand the securities market in Turkey, developing the Islamic side of the capital markets is also very crucial in terms of diversifying the range of products—and more importantly to reach more investors nationally and globally. The new *Sukūk* regulation has moved the Turkish private *Sukūk* market one step forward. The CMB continues to work with the industry to set high regulatory standards and create resilient *Sukūk* models.



CHAPTER 5

Implementation of Global Prudential Standards for the Islamic Financial Services Industry

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Mohd. Sani Mohd. Ismail*

Supervision of the Finance Sector and Unique Risks in the Islamic Finance Sector

Macro- and Microprudential Approach to Finance Sector Supervision

This chapter attempts to address important aspects of implementation of the global prudential standards for the Islamic financial services industry. The theme of the chapter corresponds to the ultimate objective of the implementation of prudential standards prepared by the Islamic Financial Services Board (IFSB) which is to enhance the soundness and stability of the Islamic financial services industry (IFSI) and the financial systems where institutions offering Islamic financial services (IIFS, also referred to as “Islamic banks”) operate either fully or side by side with their conventional counterparts. Overall, the chapter discusses various perspectives, including approaches to finance sector supervision, key risks in the Islamic finance sector, an overview of the IFSI, the development of supervisory and prudential standards, concerted implementation efforts to promote the adoption of standards, and the nature of support multilateral development banks can provide to facilitate this objective.

Without going into detail on the cause of the global financial crisis, two key observations can be derived. First, the stable inflation path as achieved over a quarter century prior to the crisis was insufficient to preserve financial stability. Stable inflation is important but not sufficient. Second, the macroeconomy and financial system are not necessarily self-correcting. This leads to a focus on strengthening the regulatory systems in order to achieve the objectives of financial and macroprudential stability. In particular, there is a consensus that the regulation and supervision of financial institutions need to go beyond a microprudential perspective and adopt a macroprudential orientation.¹

The term “macroprudential” is not new (Clement 2010). In fact, it was first used in the late 1970s in

unpublished documents of the Cooke Committee, which was the precursor to the Basel Committee on Bank Supervision (BCBS). After the global financial crisis, which later transformed into a broad-ranging economic crisis, the term has seen a revival among regulators and policy makers, and there is now wider agreement on its relevance. Macroprudential refers to an approach with explicit consideration of the threats to the stability of the financial system as a whole. In essence, the macroprudential approach looks at the financial system as a single portfolio. Indicators used in macroprudential analysis include data on capital adequacy, leverage, asset quality, liquidity, and sensitivity to systematic risks and degree of correlation or linkages in the financial system.

This approach differs from the microprudential approach in that the latter is primarily concerned with risk assessment of individual financial institutions. The Warwick Commission (2009, p. 12) summed the distinction best in its publication: “microprudential regulations examine the responses of an individual bank to exogenous risks. It does not incorporate endogenous risk, and it neglects the systemic implications of common behavior.” The distinction is important because both conceptually and in practice it is possible to have a situation where the risk management of individual institutions is deemed acceptable, but these risks may collectively create systemic instability. This is especially true in the case where risk may be multiplied through collateralized debt obligations, which may then lead to a concentration of risks at the systemic level, yet which may not be evident if regulators are to just assess risk at the individual institution level. In fact, microprudential regulations on their own may make a bad situation worse by creating a domino or spiral effect that leads to systemic instability. An example

¹ Source: Borio C. (2011); Central banking post crisis: What compass for uncharted waters? BIS Working Papers No. 353

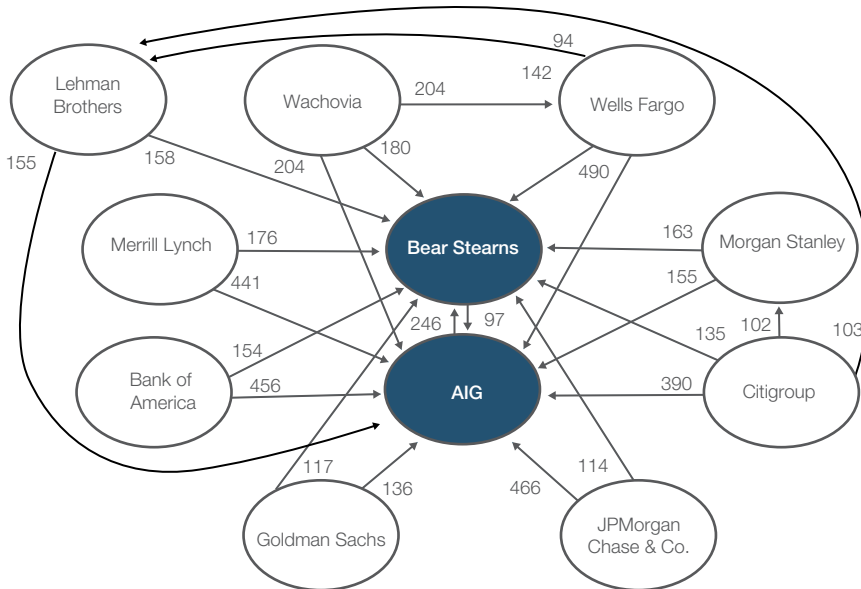
is when individual banks sell off toxic assets, which may be recommended using the regulatory matrix often prescribed by a microprudential approach (University of Warwick, 2009). However, there can be no sellers without buyers and when major banks are selling the same class of toxic assets, what is deemed prudent on an individual level may lead to systemic risk. It is therefore understandable then that the Bank of England (2009) described macroprudential policy as the missing piece of the jigsaw between macroeconomic policy and the regulation of individual financial institutions (microprudential regulations).

Since the global financial crisis, regulators of the financial system have developed several methodologies to assess finance sector linkages. The four most often cited are the network approach,

co-risk model, distress dependence matrix, and the default intensity model (IMF 2009).

The International Monetary Fund (IMF) describes the co-risk model as a methodology that “draws from market data, but focuses on assessing systemic linkages at an institutional level.” (IMF 2009, chapter 2, p. 2) Figure 5.1 shows how using the co-risk model would have identified the degree of linkages of the financial institutions. This would have then made it clear that failure of the companies in the center of the diagram would set off cascading consequences affecting all other institutions and ultimately the financial system. This gave rise to the phrase “too connected to fail” instead of the conventional “too big to fail.” The risk linkages may not have been captured using a traditional microprudential approach.

Figure 5.1: Co-Risk Model



Source: Bloomberg, LP.; Primark Datastream; and IMF staff estimates.

However, this is not to say that macroprudential regulations are the silver bullet for financial regulations and that the microprudential approach is irrelevant. On their own, they are necessary but not sufficient for effective financial regulations. The international consensus, including the Bank for International Settlements (BIS) and the IMF, has described them as complementary and not substitutes. In fact, the modern regulator needs various tools from regulatory to supervisory and enforcement to regulate the financial system in a prudent manner. In the IMF Executive Board's discussion on macroprudential policy, the board welcomed the analysis of interactions between macroprudential policy and other policies and highlighted that effective, macroprudential policy needs to be complemented by appropriate monetary, fiscal, and other finance sector policies which are to be supported by strong supervision and enforcement (IMF 2013).

The question then is: How does this consensus affect Islamic finance? Has Islamic finance developed to a stage that it can be considered to be systemically important if not on a global scale then at least for some countries? Although comparatively the IFSI only represents approximately 1.0% of global assets, the annual growth rate of approximately 20.0% since 2000 underlines its significance. In terms of global assets, Islamic finance grew from \$1.5 trillion at the end of 2012 to an estimated \$1.8 trillion by the end of 2013. This means that Islamic finance assets grew at an estimated compound annual growth rate of 17.04% during 2009–2013. IFSI assets are expected to surpass the \$2 trillion mark in 2014.² In summary, Islamic finance is now too large to ignore and, in a number of countries, is approaching systemic importance. Thus, the reasonable approach would be to develop the macroprudential framework to complement the existing microprudential tools in Islamic finance. It is apt that the majority of the standards issued by the IFSB since 2012 have focused on developing both the micro- and macroprudential framework including standards on liquidity risk management, stress testing,

revised capital adequacy, and revised supervisory review process. To fully appreciate the importance of implementing the IFSB prudential standards (covering both macro- and microprudential aspects), it is critical to understand the different types of risk in Islamic finance.

Risks in Islamic Finance Transactions

Islamic finance generally has been less affected by the global financial crisis compared to its conventional counterpart. This was largely because Islamic finance had limited exposure to structured products such as collateralized debt obligations (CDO) and credit default swaps (CDS) which undermined conventional finance. There are features of Islamic finance that make it potentially more stable and more resilient in facing unexpected economic circumstances. This is provided that Islamic finance stays true to its twin tenets of materiality or validity of transaction and mutuality of risk sharing. The former means that transactions in Islamic finance must be backed by genuine trade and business transactions and not just transactions on paper. There is a one-to-one mapping of financial transactions with the underlying asset (IFSB 2010). This principle would disqualify contracts and transactions such as CDOs as the underlying asset would just be multiple layers of securitized debt, such that the real asset is far removed from the investor. Further, a clear distinction between conventional bonds and *Sukūk* is that unlike conventional bonds, *Sukūk* represent more just than the credit risk of the issuer, but also an ownership stake in a project which was funded by the investors buying the *Sukūk*. This principle was emphasized by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in 2008 pronouncing that, "*Sukūk*, to be tradable, must be owned by *Sukūk* holders, with all rights and obligations of ownership, in real assets, whether tangible, usufructs or services, capable of being owned and sold legally..." (AAOIFI Statement on Sukuk, February 2008).

² All statistics are obtained from the IFSB's Islamic Financial Services Industry Stability Report 2014. Further details on growth and development of Islamic finance are provided in the section "Growth Dynamics of the Islamic Financial Services Industry."

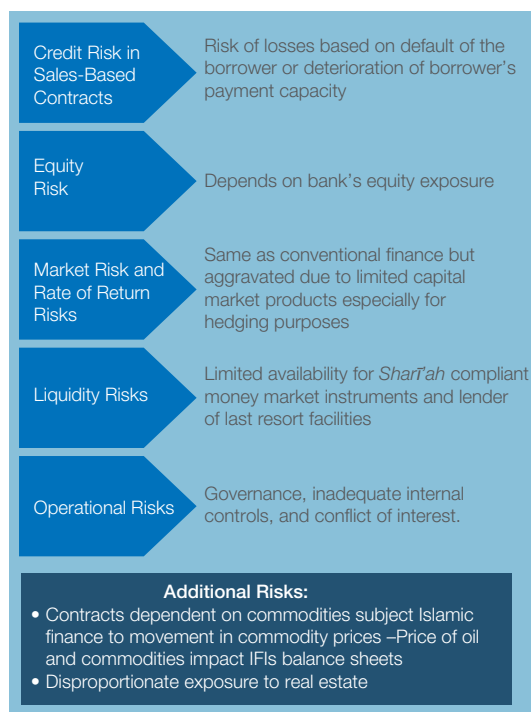
The second principle, mutuality of risk sharing, simply means that Islamic finance encourages risk sharing between the financial institution or entrepreneur and investors. Profit in dollars and cents are not to be declared upfront; distribution of profit is based on the real outcome of the entrepreneurship. The two most popular partnership contracts are *Mudārabah* and *Mushārahah*. If a *Mudārabah* transaction suffers a loss, then the capital providers lose their capital whereas the entrepreneurs lose their time and effort. The entrepreneurs are not liable for the loss of capital unless the loss is a result of negligence or fraud. In *Mushārahah* contracts, any loss is distributed according to the ratio of investment. This principle that ties the distribution of profit or loss to the actual outcome of the transaction, provided that they are accompanied by proper due diligence and disclosure, reduces the risk to all parties.

Empirically, there is some evidence that Islamic finance fared better than the conventional system during the financial crisis of 2008–2009. For example, while the assets under management (AuM) in the global mutual fund industry dropped by 27.0% in 2008 (\$19 trillion) from \$26.1 trillion in 2007, the AuM of the Islamic fund management industry actually grew during the same period from \$48.7 billion in 2007 to \$51.4 billion in 2008 (Ernst & Young 2010). However, Islamic finance is not immune to risks, including unique risks peculiar to the sector. There are after all several examples of *Sukūk* defaults, such as those involving East Cameron Partners in the United States, Investment Dar in Kuwait, and the Saad Group in Saudi Arabia. There was also the prominent case of near default of the Nahkeel *Sukūk* in Dubai totaling \$3.5 billion. Adverse market conditions, credit crunch, and asset bubble deflation coupled with unique risks such as sectoral concentration in real estate assets posed significant challenges to Islamic finance. The risks can be categorized as follows: (i) credit risk in sales-based contracts, (ii) equity risk, (iii) market risk, (iv)

liquidity risk, (v) rate of return risk, and (vi) operational risk including governance and inadequate internal controls. Unique risks to Islamic finance include disproportionate exposure to real estate assets, and an overreliance on commodities in structuring contracts may affect IFIs' balance sheet when there is significant movement in the price of commodities.

The next section does not seek to cover all the different types of risks in Islamic finance.³ See Figure 5.2, which summarizes the risk into six categories. There are of course other ways to categorize the risks, including (i) financial, (ii) operational, (iii) business, and (iv) event risks.

Figure 5.2: Types of Risks in Islamic Banking Transactions



IFI = Islamic finance institution.

Source: Based on Karim and Archer (2007).

³ Karim and Archer (2007) provides a detailed explanation of all categories of risk in Islamic finance.

Before delving further, a qualifier needs to be added. It was noted earlier that one of the risk mitigation features of Islamic finance is risk sharing through either *Mudārabah* or similar equity-based contracts for mobilization of funds. A *Mudārabah* contract, in particular when used as a substitute for a conventional deposit, has the potential to minimize the risk for financial institutions as they are not obligated to provide a fixed amount of return or dividend in conventional finance to depositors. This replaces interest-based financing with mutual risk sharing. Taken this way, fund providers (called investment account holders or IAH) are treated akin to investors and the “deposit” is commonly known in Islamic finance as a profit-sharing investment account (PSIA). Investors have the option of investing either in a restricted investment account which resembles a mutual fund or in an unrestricted investment account which resembles a conventional deposit where the financial institution is given discretion in their investment-making decision so long as they are *Sharīʿah*-compliant. *Mushārahah* contracts, on the other hand, where both parties provide capital for a particular entrepreneurship is a good model for venture capital where the angel investor or venture capitalist can provide the seed capital and the entrepreneur shares some of the financial risk by also contributing some capital. Since the exact amount of profit is not determined upfront and the loss is distributed based on capital contribution of each party, this should lead to sound due diligence.

However, upon closer inspection of the portfolio of Islamic banks, it is evident that the percentage of these risk-sharing contracts in their portfolio is limited compared to contracts based on sale for profit. Statistics show that Islamic banks prefer *Murābahah* contracts (sale for profit) which can be used for retail financing, with figures of up to 41.0% of their portfolio, compared to risk-sharing instruments such as *Mudārabah* and *Mushārahah*, which only stand at 11.0% and 12.0%, respectively (Karim and Archer 2007). There are of course legitimate reasons for this. Regardless, it does suggest that the mutuality of the risk-sharing principle is not popular at least in Islamic banks.

The focus of the next subsection is on *Mudārabah* risk and liquidity risks as these are peculiar and particularly relevant to Islamic finance and merits closer analysis. Understanding these risks will also demonstrate the importance of implementing the IFSB standards.

Risks in Managing Profit-Sharing Investment Accounts

As noted earlier, Islamic banks can structure *Mudārabah* contracts, in particular unrestricted investment accounts, as substitutes for a conventional deposit. Using this type of contract, the banks take on the role of *Muḍarib* (working partner) and the depositors are considered *Rabb-ul-Mal* (capital provider) and referred to as IAH. The returns they get should in theory depend on the profit of the investment made by the Islamic banks. However, in reality, Islamic banks face competitive pressure from their peer Islamic banks and, in a country with a dual banking system, from other conventional banks as well. In fact, for conventional banks which operate an Islamic window as part of their operations the competitive pressure is within the same entity. If Islamic banks provide a lower rate of return, then investors may decide to withdraw their investments and place them in another Islamic bank. With the exception of those who are investing out of religious conviction, others may even withdraw and deposit their capital in a conventional bank offering a higher dividend rate. This happens especially in jurisdictions that do not have a working *Sharīʿah*-compliant deposit insurance scheme, where the IAH under the *Mudārabah* contract is exposed to capital loss. Therefore, Islamic banks that adhere strictly to the principles of a *Mudārabah* contract could potentially face mass withdrawal, which in extreme cases can lead to a bank run. There may also be supervisory pressure from the regulator for the bank to set aside funds to smooth the profit payout to the IAH (Sundararajan 2010).

This has led to a practice common among Islamic banks known as smoothing the profit payout to IAHs. This practice, in certain ways, resembles the income smoothing in accounting terms, which means the use of accounting techniques to level out net income fluctuations from one period to the next.⁴ Some examples of income-smoothing techniques include deferring revenue during a good year or delaying the recognition of expenses in a difficult year because performance is expected to improve in the near future. IFSB Guidance Note 3 (Practice of Smoothing the Profits Payout to Investment Account Holders) (GN-3) covers this practice in detail. This part will only cover the four techniques practiced by Islamic banks in brief:

- (i) Reducing the profit of the bank as *Mudārib*
- (ii) Transferring from shareholders' current or retained profits to an IAH subject to shareholder approval
- (iii) Profit equalization reserve (PER), where a certain amount from the investment profits is set aside before allocation among the shareholders and the IAH and the calculation of the bank's *Mudārib* share of profits
- (iv) Investment risk reserve, where a reserve is maintained by setting aside amounts from the investment profits attributable to the IAH, after deducting the bank's *Mudārib* share of profits to cover losses of the capital invested by the IAH.⁵

An IFSB survey supported through ADB's technical assistance program demonstrated that the practice of smoothing is indeed prevalent among Islamic banks, in particular the first three techniques outlined (Sundararajan 2010). In the case of the first and second techniques, where risk of return is transferred from the IAHs to the bank, this may lead to displaced commercial risk.⁶ Even when banks use

the technique of PER, which mitigates this risk, there are still reasons for concern, especially for the IAHs.

Chief among them are disclosure, corporate governance, and what is known as intergenerational transfer.⁷ On disclosure, the same survey showed that some banks do not reveal the extent of profit smoothing in their annual reports and to their IAHs. Aside from the issue of transparency, this creates a two-fold problem for the IAH. First, unlike the shareholders, the IAHs do not have an avenue to provide express approval (or disapproval) when a portion of their profit is set aside in the PER. Hence in the absence of disclosure, the IAHs will be left completely unaware that a portion of their profit is being withheld in the PER for the future. Second, the nondisclosure of profit smoothing may also create an artificial impression that the investment is making returns in line with the expectations of the IAH when in truth the investment is underperforming. The issue of corporate governance is potentially even more serious. The establishment of a PER mechanism (especially if not disclosed) has the potential to negatively affect the IAH while benefiting the bank and their shareholders. In effect, the IAHs are sharing in the reduction of profit that would otherwise only be shouldered by the bank and its shareholders, had they smoothed the profit using the first and second techniques described, especially as IAHs do not have a vote on forgoing a portion of their profit and the establishment of the PER. Even if such terms are included in the *Mudārabah* contract signed upon opening of the account, these terms are likely to be general, vague, and not ones clearly explained to the IAHs. This then creates a conflict of interest for the bank in its role as *Mudārib* and may affect its fiduciary obligation to protect the investments of the IAH.

⁴ However, in Islamic banks, the objective and techniques adopted for smoothing profit payouts have some conceptual differences with the accounting term for income smoothing.

⁵ Some definitions are taken from IFSB Guidance Note 3.

⁶ Displaced commercial risk is covered in detail in the IFSB Standard for Institutions (Other Than Insurance Institutions) Offering Only Islamic Financial Services (IFSB-1), Guidance Note 3 and 4.

⁷ IFSB Guidance Note 3 covers other issues of concern, including liquidation, capital adequacy, and harmonization.

Finally, as in any pooling of funds over a time period, there is always an issue with intergenerational transfer. Put simply, this means that an IAH who forgoes a portion of the profit in a given year may not benefit from the smoothing of profit through PER if the IAH is a short-term investor and withdraws his or her investment before the use of the PER. Often, the IAHs are asked to agree, upon signing of their contract, to forfeit their claim to the PER if they withdraw their investment. While it is also possible that a new IAH may benefit from profit smoothing from the PER to which the IAH did not contribute, one IAH's gain does not justify the loss of another IAH.

IFSB Guidance Note 3 provides some guidance to supervisory authorities on supervision of profit smoothing. These include (i) the board of directors playing an oversight role and paying due attention to the bank's policies on displaced commercial risk and smoothing of profits with particular attention on the bank's fiduciary duty to the IAH; (ii) the setting up of a Governance Committee as recommended in IFSB-3 (Corporate Governance Standards), to safeguard the interest of the IAH, in particular where there is a conflict of interest; (iii) adequate and proper disclosure of the practice; and (iv) clear terms and conditions to be incorporated in the PSIA contract and in a language that can be comprehended by an average reasonable person.⁸ While there is no one-size-fits-all solution, the supervisory authority should pay due attention to these guidance and related recommendations in the IFSB standards. After all, investor protection is one of the key functions of a supervisory authority.

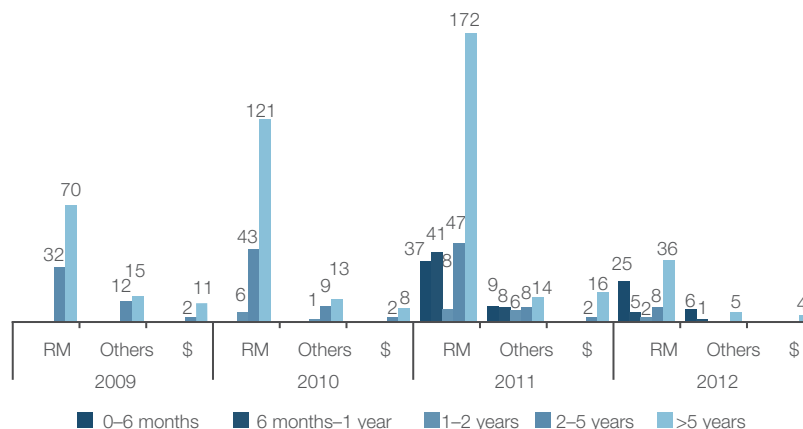
Liquidity Risk

The global financial crisis has highlighted liquidity risk as a major source of concern. Market turmoil emphasized the significant linkages between liquidity risk management, bank capital adequacy, money markets, monetary operations, and the importance of a systemic liquidity infrastructure. The global financial crisis was exacerbated by a combination of credit and liquidity shocks as toxic

assets were sold and financial institutions that had very thin liquidity ran for capital. When the interbank market locked up, the crisis became systemic. Without liquidity, banks may face a run, which will have an adverse effect in the real sector as banks provide financial intermediation for businesses and retail customers. Such is the importance of liquidity management that many international organizations such as the Financial Stability Board and the BCBS have issued guidelines and standards for liquidity risk management. One of the Group of Twenty's medium-term recommendations on prudential oversight states: "Supervisors and central banks should develop robust and internationally consistent approaches for liquidity supervision of and central bank liquidity operations for cross border banks" (Statement from G20 Summit, Washington, 15 November 2008).

Liquidity risk is equally relevant to institutions offering Islamic financial services (IIFS), especially due to the limited *Sharīah*-compliant money market instruments. Despite the growth in *Sharīah*-compliant financing, cross-border *Sharīah*-compliant liquidity management remains a challenge and short-term *Sukūk* issuances are in short supply given that the majority of *Sukūk* in the market are not suitable for efficient *Sharīah*-compliant liquidity management either due to tenor or currency mismatches, nontradability or lack of rating, or a combination thereof (see Figure 5.3 showing insufficient short-term *Sukūk* for liquidity management). Other instruments that are available for liquidity management carry large transaction costs due to complicated structures, and are not sufficiently flexible in a systemic crisis. The closest alternative available is central banks' short-term *Sukūk*, which are not regularly issued in international currencies. This problem is exacerbated by differences in *Sharīah* interpretation, which makes certain contracts unacceptable in certain jurisdictions. For instance, instruments based on *Bai Ul Inah* (sale and buyback agreement) and *Bai Ul Dayn* (debt trading) are not widely accepted across jurisdictions.

⁸ Detailed guidance can be found in Guidance Note 3

Figure 5.3: Insufficient Supply of Short-Term *Sukūk* for Liquidity Management

Note: Numbers indicate *Sukūk* issuances in different currencies by tenor.

Source: Bloomberg.

This places IIFS at risk during a credit crunch as they do not have sufficient short-term assets to obtain liquidity. The alternative of holding a higher percentage of cash reserves is unsatisfactory in the good times as it places Islamic finance institutions at a competitive disadvantage compared to their conventional counterparts and in turn will create pressure to match the dividends offered by conventional banks, as discussed earlier. The underdeveloped money market and lack of available instruments also mean that IIFS will have difficulty in complying with new international standards such as Basel III, which require banks to hold greater levels of high-quality liquid instruments issued by the public and private sectors, such as government securities as well as liquid corporate instruments. In addition, the limited money market instruments also hamper the central banks' liquidity management since liquidity vis-a-vis IIFS can only be managed through transactions involving *Sharīah*-compliant money market instruments.

In order to study the issues related to the Islamic money market and liquidity risk management, the IFSB issued its Technical Note in March 2008, which

made the following recommendations to resolve the aforementioned problems:

- Design Islamic money market and Islamic government financing instruments with desirable characteristics (i.e., relatively low risk, simply designed, regularly issued, widely held, and supported by a robust payment and settlement system).
- Incorporate Islamic government finance instruments as an integral part of the overall public debt and financing program, and foster the development of an Islamic government securities market.
- Actively use Islamic government finance instruments in market-based monetary operations of the central bank to manage liquidity in the Islamic money market.
- Develop efficient trading arrangements and the associated market microstructure for Islamic money and government finance instruments, and develop in parallel the foreign exchange markets.
- Provide supervisory guidance and incentives for effective liquidity risk and asset liability management by IIFS, and foster in parallel privately issued Islamic money market securities.

The IFSB also issued Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services (IFSB-12) in March 2012. IFSB-12 delineates a set of guiding principles for the robust management of liquidity risk by IIFS and their vigorous supervision and monitoring by supervisory authorities, taking into consideration the specificities of the IIFS, while complementing relevant international standards and best practices. Apart from specifying the prerequisites of liquidity infrastructure, this document outlines 23 guiding principles comprising 1 general principle, 14 guiding principles for the IIFS, and 8 guiding principles for supervisory authorities.

The guiding principles for the IIFS specify the structure of the liquidity risk management process and provide necessary guidance on the identification, measurement, monitoring, control, reporting, and mitigation of liquidity risk. Those for supervisory authorities outline important elements of the supervisory framework to monitor the liquidity positions and the liquidity risk management framework of IIFS that include, among others, initiatives for the development of a robust national liquidity infrastructure, supervisors' contingency planning for IIFS, and supervisors' role as provider of *Sharīah*-compliant liquidity support to IIFS.

An important development in liquidity risk management in Islamic finance is the establishment of the International Islamic Liquidity Management Corporation (IILM). The IILM was founded on 25 October 2010 to address this constraint with the mandate to facilitate cross-border liquidity management among IIFS by making available a variety of *Sharīah*-compliant instruments, on commercial terms, to suit the varying liquidity needs of these institutions. The establishment of the IILM was based on the recommendation of the High-Level Task Force on Liquidity Management

which was endorsed by the IFSB Council in April 2010. ADB has supported the establishment of the IILM through its participation in the task force and technical working groups. As of January 2014, the IILM Governing Board consists of the central banks and monetary agencies of Indonesia, Kuwait, Luxembourg, Malaysia, Mauritius, Nigeria, Qatar, Turkey, the United Arab Emirates, and the Islamic Development Bank Group.

Since its establishment the IILM has issued two 3-month A-1 rated *Sukūk*. The first issuance amounted to \$490 million in August 2013 and the second amounted to \$860 million in January 2014. As of June 2014, the first *Sukūk* (\$490 million) has been reissued in November 2013, February 2014, and May 2014, while the second *Sukūk* (\$860 million) has been reissued in April 2014. All issuances were fully subscribed by IILM-appointed participating dealers. The total amount of the IILM's outstanding *Sukūk* as of January 2014 is \$1.350 billion.⁹ Its fifth issuance was on 23 April 2014 worth \$860 million. The IILM's ability to reissue the *Sukūk* of August 2013 and subsequently issuing four more *Sukūk* in 2014 should allay any concern of the IILM having a one-off issuance. In its August 2014 issuance, the IILM lengthened maturities by auctioning \$400 million in 6-month *Sukūk*.

Another source of concern is whether the *Sukūk* will be actively traded in the secondary market. If the primary dealers buy and hold the *Sukūk*, then the instruments will not reach the hands of IIFS, which would not help IIFS liquidity management. While the IILM is planning an important pioneering role in support of liquidity management, there remains the need for complementary action at the national level by sovereigns to meet the demand of IIFS and to bring the market to a tipping point to begin secondary trading.

⁹ Information obtained from press releases on the IILM website.

In early 2014, there was also an announcement by the governments of the United Kingdom, Luxembourg, and Hong Kong, China of their interest to issue *Sukūk*. The United Kingdom issued its inaugural 5-year £200 million *Sukūk* in July 2014. Demand was very strong, with orders totaling around £2.3 billion. Similarly, in September 2014, Hong Kong, China issued its inaugural *Sukūk*, with an issuance size of \$1 billion and a tenor of 5 years, making it the world's first US dollar-denominated *Sukūk* originated by an AAA-rated government. The *Sukūk* saw strong demand from global investors, attracting orders exceeding \$4.7 billion. The *Sukūk* issuance comes after the legislative changes made in Hong Kong, China in July 2013 which provide a taxation framework for

Sukūk issuances comparable to that for issuances of conventional bonds. Likewise, Luxembourg issued its first 200 million euro (\$254 million) 5-year Islamic bond in October 2014, becoming the first AAA-rated government to issue euro-denominated *sukuk*.

While all these developments bode well for the industry, the resolution of structural problems faced by the IFSI will need concerted efforts by stakeholders in the multilateral development banks (MDBs). The deliberations in this section also highlight the importance of the IFSB's role in providing guidance on liquidity risk management, aiming to enhance the overall financial stability of the IFSI and make the case for why MDBs should support its work.

Preparation and Implementation of IFSB Prudential Standards

This section on the role of the IFSB and the implementation of the IFSB Standards begins with a brief discussion on the growth dynamics of the IFSI. This is followed by a discussion of the IFSB's mandate and objectives and an overview of its operational framework and progression of the standards from the first- to second-generation standards. The dynamics of standards preparation covering the due process of the IFSB standards preparation are covered later. This due process outlines how the IFSB ensures that various stakeholders of the IFSI are involved in various stages of the standards preparation. The progress of the IFSB standards implementation, covering the findings of IFSB standards implementation surveys conducted in 2011 and 2013 are also presented, demonstrating how the results are fed into the IFSB's results-based Strategic Performance Plan 2012–2015. Finally, the implementation challenges and strategies to enhance the implementation of the IFSB Standards are outlined and discussed, followed by a concluding section.

Growth Dynamics of the Islamic Financial Services Industry

In recent years, growth in the size and number of institutions, resilience, and geographic expansion have

been the key features of the development trajectory of the IFSI. According to the IFSB Islamic Financial Services Industry Financial Stability Report (2014), total Islamic finance assets grew to an estimated \$1.8 trillion by the end of 2013. Islamic banking remains the dominant sector within the IFSI with approximately 80.0% of total Islamic financial assets. The IFSI is estimated to chart a compound annual growth rate of 17.04% between 2009 and 2013.

For the Islamic banking industry, the pace of growth has been moderating recently, but the average growth rate of more than 17.0% after 2009 is still impressive. Islamic banking assets are concentrated in the Gulf Cooperation Council (GCC) countries and in Southeast Asia. However, some non-GCC Middle East and North African countries have experienced a rapid expansion in recent years or made a new entry (Jordan, Yemen, Tunisia, Libya, and Morocco) last year. On the other hand, the size of the *Takāful* industry is still too small to make a significant contribution to the stability of Islamic banking.¹⁰ Regardless of regional differences, the further growth of *Takāful* would benefit not only from awareness campaigns but also from the availability of more fixed-income investment instruments such as *Sukūk* of longer tenures.

¹⁰ According to the IFSB Islamic Financial Services Industry Financial Stability Report (2014), the *Takāful* industry can, in principle, contribute to the stability of the banking sector through a reduction of asset and credit risks; general *Takāful* compensates for a “deterioration” in financed assets, and family *Takāful* protects families with outstanding financing amounts (such as home financing) against default in case of an untimely death of the breadwinner.

Besides Islamic banking and the *Takāful* industry, the Islamic capital market with long- and short-term *Sukūk* is also crucial for the IFSI. The *Sukūk* market is one of the fastest growing segments of Islamic finance with an annual growth rate of more than 40.0% from 2005 to 2012. The *Sukūk* market does not exist in isolation as it is closely linked with the global conventional capital markets. It is noted that conventional corporations are active in the *Sukūk* market both as issuers and investors, and the pricing of *Sukūk* is largely dependent on demand and supply in the global market for debt securities. This demand and supply is largely influenced by monetary policy in the United States (e.g., tapering its quantitative easing policy), which has reduced the demand for both conventional bond and *Sukūk* issuances in these markets, and, as a consequence, *Sukūk* issuances—particularly corporate *Sukūk*—dropped significantly.

Overall, growth of the IFSI will continue to be supported by

- rapid geographical spread, beyond predominantly Muslim markets and jurisdictions;
- expansion of Islamic financial services beyond the banking sector (i.e., into *Takāful*, capital markets, and other sectors);
- emergence of *Sukūk* as one of the most attractive of *Sharī'ah*-compliant assets;
- development of global Islamic financial infrastructure to ensure the resilience and stability of the industry (e.g., IDB, IFSB, AAOIFI, and IIFM);
- encouraging demographics and growing awareness of Islamic finance products and services; and
- cross-border liquidity management tools.

About the IFSB and Its Objectives

The IFSB is an international standard-setting body for the regulatory and supervisory agencies that have a vested interest in ensuring prudential standards and in promoting the soundness and stability of the IFSI, that is broadly defined to include banking, the capital market, and insurance (*Takāful*).

Clauses 4 (a) and (b) of the IFSB Articles of Agreement state that the objectives of the IFSB, among others, are to promote the development of a prudent and transparent IFSI by introducing new or adapting existing international standards consistent with *Sharī'ah* principles, and recommending these for adoption. In other words, instead of reinventing the wheel, the IFSB actually builds on the wisdom of other international standard-setting bodies but adds value to the framework through a “cross-sectoral approach” of financial regulation and additionally strict compliance with *Sharī'ah* rules and principles. In this respect, the IFSB serves Islamic finance in a way that is comparable to its counterparts in conventional finance—the BCBS, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS).

In addition to its primary mandate of issuing prudential standards and guidelines for the IFSI and helping the member jurisdictions implement them, the IFSB Articles of Agreement also identify additional roles, which play a complementary role to the principal mandate. These roles, which are part of the objectives of the IFSB, include liaising and cooperating with relevant organizations currently setting standards for the stability and the soundness of the international monetary and financial systems and those of the member countries. Similarly, the IFSB is expected to encourage cooperation among member countries in developing the IFSI and to facilitate training and personnel skills development in areas relevant to the effective regulation of the industry and related markets. Moreover, the IFSB is also mandated to undertake research into, and publish studies and surveys on, the IFSI and establish a database for the industry.

In realizing this mandate, the IFSB membership comprises stakeholders from different segments of the financial industry covering regulatory and supervisory bodies of the banking industry, securities and/or insurance/(*Takāful* industries), and market players. As at April 2014, the 184 members

of the IFSB comprise 59 regulatory and supervisory authorities (RSAs), 8 international intergovernmental organizations, 111 financial institutions and professional firms, as well as 6 self-regulatory organizations (industry associations and stock exchanges) operating in 45 jurisdictions.

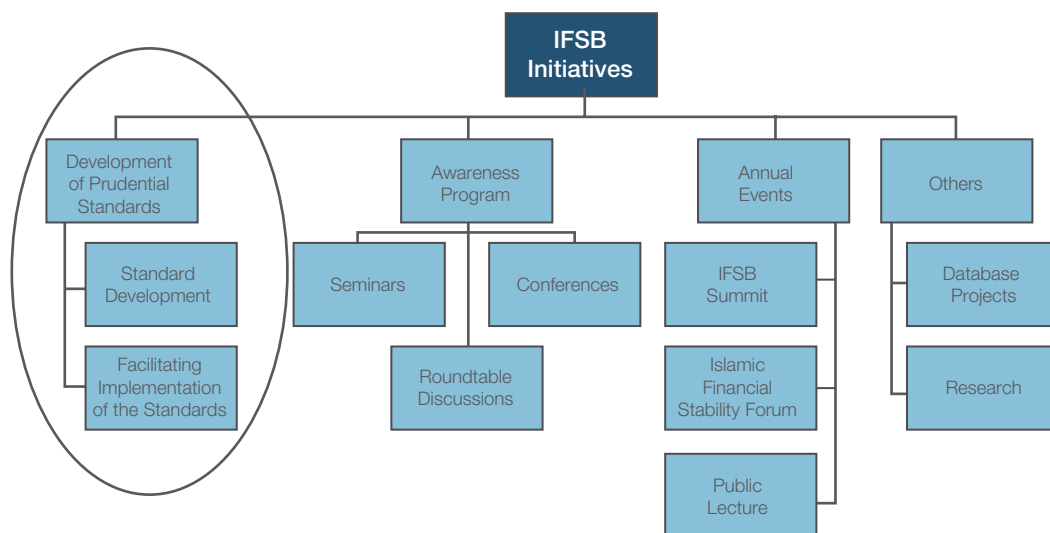
The eight international intergovernmental organizations are the World Bank, International Monetary Fund, Bank for International Settlements,

Asian Development Bank, Islamic Development Bank, Islamic Corporation for the Development of the Private Sector, Islamic Corporation for the Insurance of Investments and Export Credit, and International Islamic Liquidity Management Corporation (IILM). This representation of the different stakeholders from the various segments of the financial industry in its membership greatly assists the IFSB in adopting an integrated risk-based approach to the supervision of IIFS.

Operational Framework and Progression of IFSB Standards

In order to achieve its objectives, the IFSB's operational framework (see Figure 5.4) includes various components, such as development of prudential standards, facilitation of standards implementation, awareness programs, annual events, and other activities. In addition to developing prudential standards, the IFSB also conducts research and coordinates initiatives on industry related issues, as well as organizes roundtables, seminars, and conferences for regulators and industry stakeholders. The IFSB is actively involved in promoting awareness of issues that are relevant or have an impact on the regulation and supervision of the IFSI. This mainly takes the form of international conferences, seminars, workshops, trainings, meetings, and dialogues staged in various countries.

Figure 5.4: Operational Framework of the Islamic Financial Services Board



IFSB = Islamic Financial Services Board.

Source: IFSB.

On the development of prudential standards, in order to ensure the soundness and stability of the IFSI, as of March 2014, the IFSB has issued a range of prudential and supervisory standards, including 16 standards and guiding principles, 5 guidance notes, and 1 technical note to address the specific nature of IIFS operations for the banking, *Takāful*, and capital market sectors. The first series of standards issued by the IFSB, from IFSB-1 through IFSB-11, covered a wide range of prudential and regulatory issues for the three IFSI sectors. With the fast pace of growth of the IFSI and its interconnectedness through cross-border transactions, the IIFS have transformed themselves to handle all kinds of transactions, from simple to

more intricate and innovative. Corresponding to the fundamental changes in the global regulatory environment over the years, the IFSB has been in the process of issuing a number of revised standards and guiding principles including new “second-generation” standards to capture the sophistication of the IIFS operations and global reforms in the form of Basel III. The introduction of second-generation standards such as IFSB-12 (Liquidity Risk Management), IFSB-13 (Stress Testing), IFSB-15 (Revised Capital Adequacy Standard), and IFSB-16 (Revised Supervisory Review Process) has been well received by the IFSB members and industry (see Table 5.1 lists the standards issued by the IFSB).

Table 5.1: Progression of Islamic Financial Services Board Standards

First-Generation Standards	Second-Generation Standards (as at H1-2014)
• IFSB-1: Risk Management (December 2005) • IFSB-2: Capital Adequacy (December 2005) • IFSB-3: Corporate Governance (December 2006) • IFSB-4: Transparency and Market Discipline (December 2007) • IFSB-5: Supervisory Review Process (December 2007) • IFSB-6: Governance for Islamic Collective Investment Schemes (December 2008) • IFSB-7: Capital Adequacy Requirements for <i>Sukūk</i>, Securitisation, and Real Estate Investments (December 2008) • IFSB-8: Governance for Islamic Insurance (<i>Takāful</i>) Undertakings (December 2009) • IFSB-9: Conduct of Business (December 2009) • IFSB-10: Sharāh Governance Systems (December 2009) • IFSB-11: Solvency Requirements for <i>Takāful</i> (Islamic Insurance) Undertakings (December 2010) • TN-1: Islamic Money Market and Liquidity (March 2008) • GN-1: Capital Adequacy (Credit Ratings Assessments) (March 2008) • GN-2: Capital Adequacy (Commodity <i>Murābahah</i> Transactions) (December 2010)	• IFSB-12: Liquidity Risk Management (March 2012) • IFSB-13: Stress Testing (March 2012) • IFSB-14: Risk Management for <i>Takāful</i> Undertakings (December 2013) • IFSB-15: Revised Capital Adequacy Standard (December 2013) • IFSB-16: Revised Supervisory Review Process (March 2014) In Progress Standards • Core Principle for Islamic Finance Regulation (Banking) - Expected 2015 • Guidance Note on Quantitative Measures for Liquidity Risk - Expected 2015 • Guiding Principle for Re<i>Takāful</i> (Islamic insurance) Undertaking - Expected 2016

H = half, IFSB = Islamic Financial Services Board.

Note: The second generation of standards were mainly driven by the IFSB Study on Implications of Global Financial Reforms on the Islamic Financial Services Industry (2009–2010).

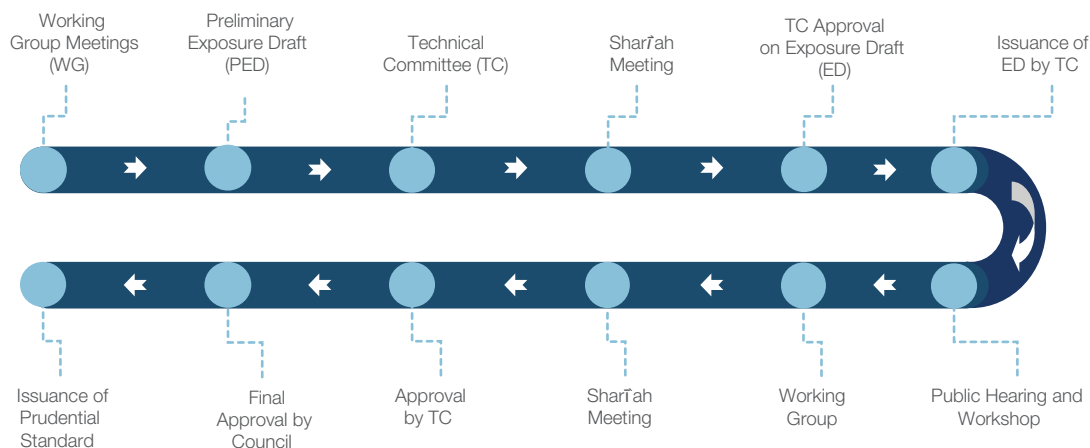
Source: IFSB.

Due Process of Preparing the IFSB Standards

As a standard-setting body, the IFSB is tasked, among others, to assess and identify the needs of the IFSI to determine the appropriate standards and guiding principles to be developed. The preparation of standards by the IFSB follows a lengthy due process involving various stakeholders of the IFSI to produce high-quality, best practice, implementable standards as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines and the Standard Operating Procedures, which were approved by the Council at its 2nd meeting in Bahrain on 30 April 2003 and 16th meeting in Khartoum on 6 April 2010, respectively.

This due process includes four stages: (i) preparation stage (i.e., undertaking various preparatory steps before the project commences); (ii) development stage (i.e., accomplishing various milestones toward developing the exposure draft); (iii) public consultation stage (i.e., disseminating the exposure draft to a wide audience and engaging various stakeholders of the IFSI in reviewing the draft); and (iv) finalization and adoption stage (i.e., revising the exposure draft based on the public consultation process and thereafter recommending the standard to the IFSB Council for adoption). A summary of the key milestones for the due process is illustrated in Figure 5.5.

Figure 5.5: Key Milestones for the Due Process



Source: IFSB.

Referring to Figure 5.5, the preparation of the standards/guidelines requires the establishment of working groups, which comprise representatives from RSAs from countries that are full members of the IFSB, national or international organizations involved in setting or promoting standards, regional or international professional or industry associations, as well as market players and professional services firms. The involvement of supervisory bodies and intra-governmental organizations in the preparation of standards ensures that there is wider participation and representation of different regions and regulatory regimes. It also helps in wider acceptability of IFSB standards at the supervisory level, which ensures wider implementation and adoption of these standards when issued.

Apart from the working group meetings, the due process also involves two Sharī'ah Board meetings (Sharī'ah Board of the Islamic Development Bank) to ensure that the standards comply with *Sharī'ah* rules and principles, before issuing the exposure draft and final standard. Before *Sharī'ah* Board meetings, the draft is translated into Arabic, which is then reviewed by the Arabic Editing Committee consisting of IFSB members. During the entire timeline of the project, the IFSB Technical Committee¹¹ is kept abreast of the developments in order to ensure that the project remains on track and that its underlying objectives are met on a timely basis. After five working group meetings, which involve conducting surveys and working on the preliminary exposure draft, the final exposure draft is approved by the Technical Committee for public consultation for about 3 months.

During the public consultation phase, the exposure draft is sent out to all IFSB members, along with other industry stakeholders, for written feedback. The IFSB also organizes workshops or public hearings as a part of the public consultation with the aim of creating public awareness and receiving broader participation of stakeholders (such as member and nonmember RSAs, MDBs, market players, academics, Sharī'ah scholars, and the public at large) that have a vested interest in Islamic finance. After revising the document based on the public consultation phase, the document is then revised and discussed by the working group and reviewed by the Sharī'ah Board. After their clearance, the document is submitted to the Technical Committee for their recommendation to the IFSB Council for adoption of the standard. The IFSB Council gives the final approval to adopt the standard.

This due process provides an overview of robust process of standards preparation by the IFSB which ensures wider participation of the industry stakeholders in various stages of the due process. The active involvement of the IFSI stakeholders also helps wider appreciation of the guiding principles

and other best practices suggested in the IFSB standards and thus support the early adoption by various jurisdictions.

Progress on the Implementation of IFSB Standards

This subsection relates to the implementation of IFSB prudential standards. As an international standard-setting organization, the impact or value of the IFSB's operations is critically linked to whether its standards are adopted and they actually shape the regulation and supervision of Islamic finance at the jurisdiction level in a way that promotes the resilience and stability of the IIFS and financial system in general. Therefore, the issuance of any standards and guidelines by the IFSB (either new or revised) does not mark the end of a journey for the development of a prudential framework in a specific area. Rather, it marks a platform for additional work to be undertaken to further strengthen the soundness and stability of the IFSI. The IFSB Secretariat therefore ensures that upon issuance of standards and guidelines, concerted efforts are undertaken to implement the standards across the jurisdictions. Hence, the need for assessing the status of the standards' implementation in the IFSB member jurisdictions is of greater attention in order to support implementation efforts and strategies.

It is important to note that similar to other international standard-setting organizations such as the BCBS, IFSB members implement its standards and guidelines on a voluntary basis as the IFSB does not have enforcement powers. The IFSB, nevertheless, is mandated to assist its members in adopting its standards and guidelines. Each IFSB member is entitled to determine its own timeline for implementation based on the market and industry dynamics in its territory and/or jurisdiction. The implementation in this sense is influenced by priorities of various supervisors within a jurisdiction taking into account finance sector development, human resources, and economic factors, among others.

¹¹ According to Article 29, the Technical Committee is the body responsible for advising the IFSB Council on technical issues within its terms of reference (as determined by the council).

Implementation Survey Results

The IFSB Secretariat conducted a Survey of Implementation in 2011 among the IFSB members in conjunction with the preparation of the IFSB Strategic Performance Plan 2012-2015. The survey was the first time that the IFSB collected factual, systematic information on the implementation progress. The following (see Table 5.2) are the key findings:

- (i) Of the responding jurisdictions, nine have already implemented one or more standards. Of those nine jurisdictions, five have implemented three or more standards.
- (ii) Nineteen jurisdictions are in the process of implementing, or have plans to implement one or more standards.
- (iii) The implementation plans in these countries are framed mostly in terms of a 3–5-year time frame, although in some countries the time frame is shorter in view of the progress that has been made.
- (iv) The standards that feature most frequently in terms of completion, or advanced stage of progress in implementation, are typically the ones issued earliest. IFSB-1 through IFSB-6 feature prominently in these categories, and are the ones most frequently cited as planned for implementation.

Table 5.2: Summary of Standards and Guidelines Implementation with Respect to Banking Supervisory Authorities (as at end of 2010)

	IFSB-1	IFSB-2	IFSB-3	IFSB-4	IFSB-5	IFSB-6	IFSB-7	IFSB-8	IFSB-9	IFSB-10	IFSB-11
1: Complete	3 (13%)	6 (24%)	6 (24%)	4 (16%)	4 (16%)	0 (0%)	2 (8%)	1 (5%)	1 (4%)	1 (4%)	0 (0%)
2: In progress	6 (25%)	4 (16%)	5 (20%)	8 (33%)	4 (16%)	3 (14%)	3 (13%)	3 (14%)	4 (17%)	6 (25%)	2 (9%)
3: Planning	9 (38%)	9 (36%)	9 (36%)	6 (24%)	10 (40%)	5 (23%)	10 (42%)	6 (29%)	11 (48%)	11 (46%)	7 (32%)
4: Do not plan to	6 (25%)	6 (24%)	5 (20%)	7 (28%)	7 (28%)	14 (64%)	9 (38%)	11 (52%)	7 (30%)	6 (25%)	13 (59%)
Base	24	25	25	25	25	22	24	21	23	24	22

IFSB = Islamic Financial Services Board.

Notes:

1. Values in table indicate number of jurisdictions.

2. Complete: implementation is complete

3. In progress: implementation is in progress

4. Planning: not yet in progress, but planning to implement

5. Do not plan to: not in progress and no plan to implement, e.g., because not relevant to supervisory authority

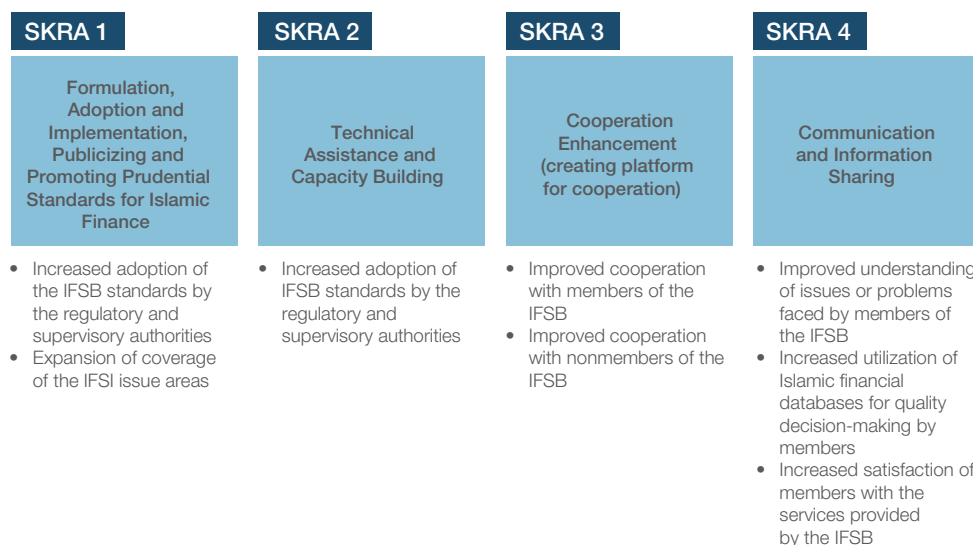
6. Base: total number of jurisdictions.

Source: IFSB Standards Implementation Survey (2011).

In its Strategic Performance Plan, the IFSB identified four strategic key result areas (SKRAs), which include SKRA 1: Formulation, Adoption and Implementation, Publicizing and Promoting Prudential Standards for Islamic Finance, and SKRA 2: Technical Assistance and Capacity Building (see Figure 5.6). These two

SKRAs require the IFSB Secretariat to conduct an annual survey on standards implementation among its member RSAs with the aim to follow up on the progress of the standards implementation and to assess the support required by the authorities in implementing the standards.

Figure 5.6: Islamic Financial Services Board Strategic Performance Plan (2012–2015)



IFSB = Islamic Financial Services Board, IFSI = Islamic financial services industry, SKRA = strategic key result area.

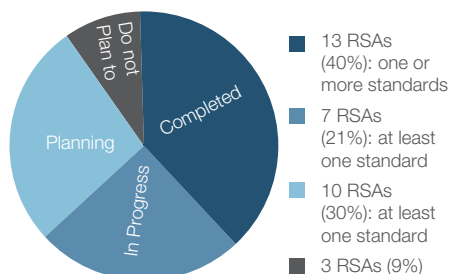
Source: IFSB Strategic Performance Plan (2012–2015).

Following this, the IFSB undertook its second IFSB Standards Implementation Survey in 2013 to assess the status of the IFSB standards, with a view to formulating policy recommendations for the implementation process over the medium to longer term, and examining implementation and technical assistance strategies how the IFSB can assist its members accelerate and strengthen the process of implementing the standards. A total of 33 RSAs responded to the survey.

The following are the key findings of the 2013 survey:

- **Implementation of standards has increased significantly in 2 years.** Overall, the survey found that 13 RSAs (40.0%) out of the total of 33 implemented one or more IFSB standards, in 7 RSAs (21.0%) implementation was already in progress, 10 RSAs (30.0%) planned to implement at least one standard, and 3 RSAs (9.0%) did not plan to implement any of the standards. The results indicate a considerable improvement from the 2011 survey results with regard to the rate of implementation (see Figure 5.7).

Figure 5.7: Standards Implementation in Regulatory and Supervisory Authorities with More Than 5.0% Market Share

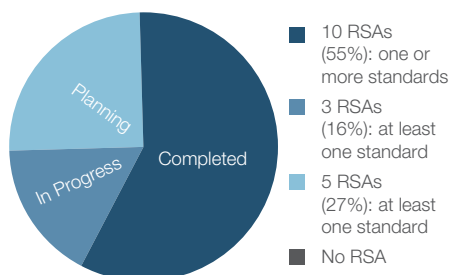


RSAs = regulatory and supervisory authorities.

Source: IFSB Standards Implementation Survey (2013).

Moreover, considering the implementation by 18 RSAs where the market share of Islamic finance assets in the respective sector is more than 5.0%, implementation is much stronger. In these jurisdictions, it was observed that 10 RSAs (55.0%) implemented one or more IFSB standards, in 3 RSAs (16.0%) implementation was in progress, 5 RSAs (27.0%) planned to implement at least one standard, and no RSA was in the “do not plan to [implement]” category (see Figure 5.8).

Figure 5.8: Standards Implementation by Regulatory and Supervisory Authorities – Overall Basis



IIFS = institutions offering Islamic financial services, RSAs = regulatory and supervisory authorities.

Source: IFSB Standards Implementation Survey (2013).

- More RSAs are planning to implement standards.** Another important finding is that all the IFSB standards in the banking sector were already implemented completely by one or more RSAs (see Table 5.3). Moreover, out of 9 RSAs who implemented at least one standard completely, all of them are full members of the IFSB, except one central bank, and most of them have a more than 5.0% market share of assets in the respective sector. The results also show that about 20 (80.0%) RSAs had an implementation status ranging from “completed” to “planning to implement” the IFSB standards. Only three RSAs, who are associate members of the IFSB, did not plan to implement any IFSB standards because of insignificant shares of assets in IIFS and also because of absence of regulatory and supervisory frameworks for this sector in their respective jurisdictions.

Table 5.3: Summary of Standards Implementation by the Respondent Regulatory and Supervisory Authorities (2013)

	IFSB- 1	IFSB- 2	IFSB- 3	IFSB- 4	IFSB- 5	IFSB- 6	IFSB- 7	IFSB- 8	IFSB- 9	IFSB- 10	IFSB- 11	IFSB- 12	IFSB- 13
1: Completed	6 (24%)	6 (24%)	4 (16%)	4 (16%)	3 (12%)	2 (33%)	3 (13%)	4 (67%)	6 (19%)	7 (21%)	1 (17%)	1 (4%)	3 (12%)
2: In progress	5 (20%)	4 (16%)	7 (28%)	5 (20%)	5 (20%)	3 (50%)	2 (9%)	1 (17%)	4 (13%)	9 (27%)	1 (17%)	4 (16%)	1 (4%)
3: Planning	11 (44%)	12 (48%)	11 (44%)	13 (52%)	13 (52%)	1 (17%)	13 (57%)	1 (17%)	14 (44%)	11 (33%)	3 (50%)	15 (60%)	17 (68%)
4: Do not plan to	3 (12%)	3 (12%)	3 (12%)	3 (12%)	4 (16%)	- (-)	5 (22%)	- (-)	8 (25%)	6 (18%)	1 (17%)	5 (20%)	4 (16%)
Base	25	25	25	25	25	6	23	6	32	33	6	25	25
Sector	B	B	B	B	B	C	B	T	C	C	T	B	B

IFSB = Islamic Financial Services Board.

Notes:

1. Complete: implementation is complete

2. In progress: implementation is in progress

3. Planning: not yet in progress, but planning to implement

4. Do not plan to: not in progress and no plan to implement, e.g., because not relevant to supervisory authority

Sectors: B: Banking, C: Islamic Capital Market, T: Takāful, C: Cross Sector (covering three sectors)

5. Base: total number of jurisdictions?

Source: IFSB Standards Implementation Survey (2013).

Based on the implementation status, the RSAs planning to implement the standards were asked to indicate the approximate time frame under three given options—within 1 year, 1–3 years, or 3–5 years—for complete implementation of each of the IFSB standards. The results show that a few of the RSAs will implement the standards within 1 year; however, most RSAs indicated that they were accelerating their time frames for standards adoption from the 1–5 years indicated in the 2011 survey to a 1–3 year duration.

Implementation Challenges

The 2013 survey also collected information on challenges faced by RSAs to implement the IFSB standards. The key challenges were categorized mainly into seven areas and the RSAs were asked to rank those challenges on a scale of 1–5 (1 being the most significant and 5 the least significant). The lower the mean value, the higher the importance level of any given challenge. Table 5.4 exhibits the ranking order of challenges based on the mean values and compares the results with the 2011 survey.

Table 5.4: Ranking of Challenges in the Standards Implementation

Challenges	2013 Survey			2011 Survey		
	Mean	Rank	Base	Mean	Rank	Base
Need to change regulatory and supervisory framework	2.40	1	29	2.70	1	25
Lack of personnel with relevant knowledge/ experience/ training	2.50	2	30	3.00	2	25
Cost of implementation	3.38	3	29	3.90	3	25
Institution size and complexity	3.45	4	29	4.10	4	25
Lack/poor quality of data to support implementation of the standards	3.60	5	30	4.10	4	25

Source: IFSB Standards Implementation Survey (2013).

The results show that in 2013, the rankings of the various challenges were mostly similar to those in the 2011 survey, though low mean scores point to an increasing intensity of these challenges. The “need to change the regulatory and supervisory framework,” and “lack of personnel with relevant knowledge/experience/training” are considered the two key challenges faced by RSAs, as depicted by the lower mean values compared to others. The results also suggest a higher need of RSAs on capacity building initiatives to assist in staff training.

Strategies to Enhance Implementation of the IFSB Standards

Facilitating the Implementation of IFSB Standards Workshops

Since November 2007, the IFSB Secretariat has been conducting a series of workshops called “Facilitating the Implementation of IFSB Standards (FIS) Workshops” to assist its members in the adoption and implementation of the standards in their respective jurisdictions. This is in line with the IFSB Council’s directive to focus on facilitating standards implementation among its member countries. The IFSB Secretariat has therefore accorded this activity highest priority and has allocated more resources to carry it out. To date, the IFSB has organized 145 workshops in 26 countries, which have in total trained more than 2,000 participants representing a wide range of stakeholders in the IFSI. The FIS workshops cover the IFSB published standards and these modules are continuously being developed and improved for the benefit of the IFSB members, and the industry at large. Since October 2009, some of the FIS workshops have been supported by technical assistance from the Islamic Development Bank and ADB under the capacity building initiative.

The following are some of the key FIS initiatives:

- **IFSB–FIS regional/country workshops.** These are designed to facilitate the implementation in respective countries and regions. So far, regional workshops have been conducted to target RSAs and market players in Africa, the Middle East, Southeast Asia, and Central Asia.
- **IFSB–FIS RSA workshops.** These are specifically tailored for the IFSB member RSAs. Three dedicated workshops for each sector—Islamic banking, *Takaful*, and Islamic capital markets—are held annually. The workshops facilitate discussion among the representatives on pertinent issues and sharing of their experiences on the implementation of IFSB standards within the regulatory community.
- **IFSB–FIS technical assistance workshops.** These are specifically tailored workshops in selected jurisdictions where member RSAs request the IFSB to cover specific standards either because they have plans of their implementation or they have implemented them and would like to train their staff on the technicalities of the subject matter.

Responding to members' feedback as shown in the 2011 survey undertaken for the purpose of developing the Strategic Performance Plan, the IFSB started introducing "country experience sessions" in the FIS workshops. These sessions encourage the sharing of experiences among IFSB member institutions, particularly regulatory and supervisory authorities, on the main issues, challenges, and successes in implementing the IFSB standards within their jurisdictions. Among the participating institutions sharing their experiences are the Central Bank of Bahrain, International Monetary Fund, Central Bank of Jordan, State Bank of Pakistan, Bank Negara Malaysia, Central Bank of Sudan, Banque Du Liban, and Sudan Financial Services Company.

The 2013 survey also asked respondents to identify whether or not they require FIS workshops to be conducted in their countries within the given 3-year period (2014–2016). Results indicate that all of the countries have requested for FIS workshops to be conducted in their jurisdictions to facilitate the implementation of the IFSB standards. Respondents also provided information on the prioritization of the standards and expected time frame for implementation. These results will provide a basis for planning the FIS workshops activities in the future.

E-learning

In addition to workshops, partner activities, and technical assistance initiatives as will be discussed, the IFSB plans to complement the workshops with e-learning programs to ensure a wider dissemination of the IFSB standards. The program is expected to foster (i) global awareness and understanding from regulators and supervisors as well as market players and industry experts on the IFSB standards, and (ii) the implementation of the IFSB standards by the industry to promote the resilience and stability of the IFSI at the global level. In 2011, the IFSB introduced the FIS E-Learning Programme (Development E-Learning Programme for IFSB-1). In 2013, the IFSB finalized its e-learning project for IFSB-6. The

IFSB plans to convert a majority of its standards into e-learning modules by 2015.

Partner Activities

The IFSB has also signed memorandums of understanding (MoUs) with various strategic partners, which are aimed, among others, at further penetration of its implementation efforts. The MoU partner activities include providing technical assistance to facilitate the implementation of the IFSB standards and to promote the development of the IFSI in member countries. MoU partner activities play an important role in facilitating the implementation of the IFSB standards in a variety of ways. The following are the roles of some of the partners:

Islamic Development Bank

The Islamic Development Bank (IDB) is a founding member of the IFSB and is represented on the IFSB Council. It has been member of the Task Force on Islamic Finance and Global Financial Stability 2010. Earlier in 2007, the IFSB and IDB/IRTI accomplished joint work on the Ten-Year Framework and Strategies for Islamic Financial Services Industry Development. This document has recently been revised by both the institutions in the form of a mid-term review. The IDB has also participated in most IFSB working groups, and has also provided technical assistance grants for various projects including (i) IFSB's Compilation Guide on Prudential and Structural Islamic Financial Indicators, (ii) Disclosures to Promote Transparency and Market Discipline, and (iii) Implementation of IFSB Standards.

Recently in 2013, the IFSB received new technical assistance from the IDB to support the FIS regional program on newly developed and existing *Takāful* standards, as well as to support the regional workshops in French-speaking countries. The IFSB successfully conducted workshops in three countries in 2013, some of which were supported by this technical assistance.

Asian Development Bank

The Asian Development Bank (ADB) is an associate member of the IFSB and, as of July 2014, it is the largest provider of technical assistance funds to the IFSB. The details of its technical assistance support and participation in IFSB activities are provided later. The ADB launched its first technical assistance support to the IFSB through joint funding with the IDB.

International Association of Insurance Supervisors

The International Association of Insurance Supervisors (IAIS) and the IFSB established a joint working group in 2005 to produce an issues paper on the applicability of the existing IAIS Core Principles on the *Takaful* sector and regulatory and supervisory standards to be developed by the IFSB on *Takaful*. This joint working group prepared the paper titled “Issues in Regulation and Supervision of *Takaful* (Islamic Insurance),” which was issued in August 2006, providing a background to *Takaful* as well as an analysis of the applications of IAIS Core Principles to the *Takaful* industry. Based on the themes identified in this paper, the IFSB has to date issued three standards and one guidance note for the *Takaful* sector. In 2014, both institutions started another joint initiative in the form of a research paper focusing on regulatory issues prevailing in the micro*Takaful* sector and its role in enhancing financial inclusion.

International Centre for Education in Islamic Finance

In 2013, the IFSB and the International Centre for Education in Islamic Finance (INCEIF) successfully developed the joint high-level training program “IFSB-INCEIF Executive Forum on Islamic Finance.” This forum aims to provide a platform for global leaders in Islamic finance to discuss selected emerging issues faced by the global IFSI. The forum places emphasis on issues related to supervisory and prudential regulation, both at the national and international levels. Since 2013, the IFSB and INCEIF

have organized three fora covering risk management, corporate and *Shari’ah* governance, *Takaful*, and the Islamic capital market sectors. The IFSB will continue to coorganize the executive forum with INCEIF and will look at opportunities of replicating the model in other countries.

Bahrain Institute of Banking and Finance

The IFSB and the Bahrain Institute of Banking and Finance organized a high-level training event in Manama, Bahrain in October 2014. Since an MoU signed 22 March 2012, the IFSB has partnered with the Bahrain Institute of Banking and Finance through its speakers program, where IFSB staff conduct training programs on the supervision of IIFS.

Technical Assistance

Technical assistance is another important area in which the IFSB is working closely with its MoU partners and other member organizations. The importance of this area has been reflected in the 2013 survey. In the survey, the member RSAs were asked to rank three types of technical assistance options for enhancing implementation of the IFSB standards. The options for technical assistance offered by the IFSB were (i) to organize more FIS workshops, (ii) to provide direct technical assistance to the RSA for implementation, and (iii) to prepare more technical notes/explanatory notes/tool kits for the facilitation process.

The results of the survey show that 18 out of 32 RSAs (56.0%) preferred to seek direct technical assistance from the IFSB as the most important option for implementing the IFSB standards. On the other hand, 10 RSAs (31.0%) ranked organizing FIS workshops as the most important option of technical assistance. Meanwhile, all the RSAs mentioned their interest in organizing FIS workshops in their countries during 2014–2015. Only five RSAs responded that preparing more materials is the most important option for facilitating the implementation process.

The IFSB and ADB signed an MoU in 2012, following which both ADB and the IFSB have been jointly implementing a regional technical assistance to common member countries. The technical assistance has various components, including one on facilitating the implementation of the IFSB standards in common member countries. Furthermore, a pilot project is being planned

to provide a higher level of support to selected developing member countries of ADB and IFSB in addressing capacity impediments. In addition, a comparative study that will outline the experience of jurisdictions that have successfully implemented selected IFSB standards is being conducted and will explore the challenges and difficulties of the experiences in this process.

Role of Multilateral Development Banks and ADB Technical Assistance

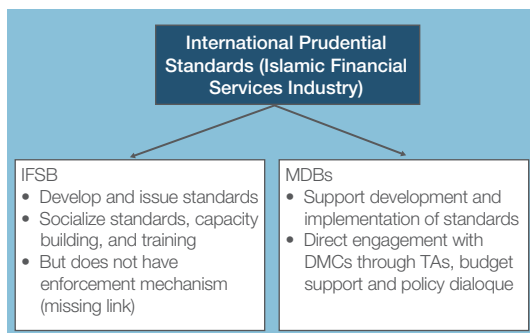
As mentioned earlier, as an international standard-setting body of regulatory and supervisory agencies for Islamic finance, the IFSB promotes the development of a prudent and transparent IFSI by introducing new or adapting existing international standards consistent with *Sharī'ah* principles, and recommends them for adoption. The final part of this statement provides an indication of the potential role of MDBs in partnering with the IFSB. Adoption of IFSB standards is voluntary in nature. The previous section has provided an overview of the IFSB's work program to support its members in the implementation of its standards through FIS workshops and other initiatives.¹² This is not dissimilar to the role of other standard-setting bodies such as the BCBS, IOSCO, and the IAIS. Having said that, IOSCO in 2013 put some teeth into the requirement of its members to be a full signatory to its Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information. IOSCO has provided a deadline and members who remain nonsignatories may face several actions, ranging from having their name published on the IOSCO website and noncooperation of other members, to suspension

of certain rights and privileges. Whether this new approach can be replicated by other setters is doubtful. It is, however, premature to contemplate such an approach in Islamic finance given its relative stage of development and the challenge in implementing prudential standards.

This then creates an opportunity for MDBs to play a role in implementation of IFSB standards. Beyond supporting the IFSB in developing such standards, by providing technical assistance and inputs, MDBs can leverage their relationships with supervisory authorities in Islamic finance to help them adopt these standards. This can be done in various ways through direct engagement at the regional and national level, and, in the case of sovereign operations, adoption of IFSB standards can be supported through technical assistance and budget support provided under a finance sector reform program agreed with the government. The prerequisites of taking this approach are explained next. Figure 5.9 summarizes the role of the IFSB and the potential role of MDBs in helping common members implement prudential standards.

¹² Between November 2007 and December 2011, the IFSB conducted 95 FIS workshops. Bangladesh, Brunei Darussalam, Indonesia, Malaysia, the Maldives, and Pakistan were some of the beneficiaries.

Figure 5.9: Role of the IFSB and Multilateral Development Banks in Supporting Common Members Jurisdictions



DMC = developing member country, IFSB = Islamic Financial Services Board, MDB = multilateral development bank, TA = technical assistance.

Source: IFSB.

There are two prerequisites for MDBs to advocate for adoption of the IFSB standards as part of a finance sector reform package: (i) need to evaluate importance of the IFSI in the developing member country, and (ii) evaluate importance of standards adoption within the overall finance sector reform agenda of developing member countries. The evaluation of the two prerequisites will determine the appetite and readiness of the supervisory authority to undertake the reform program, especially as adopting standards will likely include some legislative amendments or passing of new legislation.

A key asset for MDBs such as the ADB is its knowledge of the unique characteristics of the country, including its legal architecture and regulatory framework. It is likely that technical assistance will be required over the medium term to build a range of capabilities related to adopting and implementation of IFSB standards, and the broader financial infrastructure and enabling environment needed. Such technical assistance can have a work plan to implement a few standards in a given time period and, once this is completed, move on to the next phase of implementation.

ADB's Support through Technical Assistance

ADB, in recognition of the growing significance of Islamic finance among its developing member countries, joined the IFSB as an observer in 2003 and became an associate member in 2006. As of 2014, ADB has provided three regional technical assistance grants to the IFSB for the benefit of their common members. The first ADB technical assistance project, Development of International Prudential Standards for Islamic Financial Services, was approved in 2005.¹³ The goal of this technical assistance was the development of Islamic finance as a viable, sustainable, alternative finance mode that can catalyze economic development and reduce poverty. Several outputs were achieved under this technical assistance, including preparation of international prudential standards for market transparency and discipline as well as key principles for the development of an appropriate legal framework for asset securitization. In addition, it also supported the first phase of the Prudential and Structural Islamic Finance Indicators project, which included the preparation of the Compilation Guide on Prudential and Structural Islamic Finance Indicators (2008).

ADB support for the IFSB was sustained through the technical assistance, Development of Prudential and Supervision Standards for Islamic Financial Markets, approved in 2009.¹⁴ The impact sought by this technical assistance is greater harmonization and broader mutual recognition in Islamic finance markets and in Southeast Asia through the establishment of international prudential standards for Islamic financial institutions, an effective regulatory and supervisory framework, and a robust legal and liquidity infrastructure for the development of Islamic finance. The following key outputs were included under the technical assistance:

- (i) supporting implementation of standards through workshops on issues of capital adequacy and risk management of Islamic banks, *Sukūk*, and governance related to Islamic collective investment schemes;

¹³ \$400,000, with \$200,000 cofinanced with the IDB.

¹⁴ \$850,000, with \$425,000 cofinanced with the IFSB.

- (ii) assisting the IFSB in developing legal and liquidity infrastructure needed for Islamic finance's sound development and effective supervision;
- (iii) supporting the IFSB in working out strategies for Islamic capital market development in coordination with the IFSB's ongoing work on liquidity infrastructure;
- (iv) assisting the IFSB in preparing a diagnostic study in the area of interface between positive laws and *Sharī'ah* across all types of *Sharī'ah*-compliant asset securitization contracts; and
- (v) assisting the IFSB in implementing the next phase of the Prudential and Structural Islamic Finance Indicators project based on the compilation guide already developed under the previous technical assistance. The new phase included piloting the project in selected countries.

Under the technical assistance, a book titled *Strategies for the Development of Islamic Capital Markets* was also published in March 2011. The technical assistance was closed in September 2011. ADB took the opportunity to assess the performance of this technical assistance to guide the design and implementation of future assistance. Some of the key points from this assessment are that there needs to be a better link between activities in regional technical assistance on Islamic finance with national development programs, particularly in the finance sector, and that countries that have implemented the IFSB's prudential standards could play a role in helping other countries by sharing their experience through "reverse linkage."¹⁵

The most recent technical assistance, *Implementing Prudential Standards in Islamic Finance*, was approved in November 2012 and will be used to support activities until at least the end of 2015. The technical

assistance will focus on implementation of standards and systematic gathering of macroprudential data. Implementation of standards will take two different approaches. First, through workshops and capacity building activities provided by IFSB and, for the first time, development of an e-module platform so that all members can better understand the IFSB standards using interactive modules online. The e-module platform is not a substitute for the regular financial implementation standards workshops; rather, they will complement each other. The e-modules can provide a basic understanding of the standards which then enables FIS workshops to delve into a more technical discussion and with the potential of harnessing the "reverse linkage" model. A feature of this latest technical assistance is that while the activities will benefit all common members of ADB and the IFSB, the technical assistance is dedicated to supporting the central banks of Afghanistan, Bangladesh, Indonesia, and Pakistan.

Earlier in this chapter, the importance of the macroprudential framework in Islamic finance was discussed. One prerequisite of any macroprudential work is data gathering of financial institutions. This is a particular challenging area for Islamic finance as there is no systemic and comparable data collection. The technical assistance will attempt to address this challenge by reviewing the Prudential and Structural Islamic Finance Indicators project partially developed in the earlier technical assistance and look to make significant progress in this area.

In addition to supporting the IFSB and its members through regional technical assistance, ADB has also, where possible, played a role in developing Islamic finance in its finance sector programs. For example, the 2012 finance sector program in Indonesia had a component that encouraged the development of Islamic finance. There was also a direct reference to

¹⁵ Based on ADB (2012).

the IFSB standards. One of the policy actions identified and agreed with BAPEPAM-LK (Pengawas Pasar Modal dan Lembaga Keuangan; Indonesian Capital Market Supervisory Agency and Financial Institution) was the issuance of *Takāful* regulations based on the IFSB's Guiding Principles on Governance for *Takāful* undertakings.¹⁶ ADB can and should continue looking to adopt this approach in its finance sector programs in Southeast Asia and beyond.

Beyond providing technical assistance to the IFSB and common member countries, ADB has also supported the establishment of the IILM through participation by the ADB staff in the High Level Task Force chaired by Governor Zeti Akhtar Aziz of Bank Negara Malaysia. ADB staff also

participated in the working groups supporting the Task Force. In addition, ADB is involved in the promotion of the development of best international practices for Islamic finance by participating in IFSB working groups to develop international standards including the Core Principles for Islamic Finance Regulation Working Group. The working group was established to review the core principles available for conventional financial systems and prepare a principles document for the IFSI to facilitate a review of the sector from the perspective of cross-sectoral regulation and supervision. ADB is also a member of the IFSB Joint Working Group on Micro*Takāful* (Islamic Micro Insurance) sector and the IFSB Working Group on Guiding Principles for *ReTakāful* (Islamic Reinsurance) Undertakings.

Experience Sharing in the Implementation of IFSB Prudential Standards

This section covers a case study of the State Bank of Pakistan (SBP) in implementing IFSB standards.

Implementation of Banking Standards Issued by the IFSB

Having in place a comprehensive regulatory and supervisory framework is critical to ensure that the financial market operates on a sound footing. The existence of an elaborate regulatory environment not only helps promote market stability but also adds to the confidence and trust of the general public. Ever since the evolution of Islamic finance at the global level, the regulatory bodies have been engaged in developing a suitable regulatory framework responsive to the specific risks and operating nature of the IFSI. The role and contribution of the IFSB in developing prudential standards and facilitating the member countries in the implementation of the standards has been highly commendable. The consultative mechanism and rigorous process adopted by the IFSB for the development of the

standards is at par with reputed standard-setting bodies such as the BCBS, IOSCO, and the IAIS, which ensures buy-in and ownership of member institutions in the provisions and recommendations of the standards and guidelines. Furthermore, the IFSB's supportive role in the implementation of its standards through workshops, seminars, and conferences provides much-needed support and guidance to the industry for adoption of the standards.

The prudential standards issued by the IFSB help promote soundness and stability of Islamic financial markets, and contribute significantly toward standardizing and harmonizing the practices of this evolving *Sharīah*-compliant financial discipline. The standards ensure greater certainty about the regulatory environment and interpretations across jurisdictions, minimize opportunities for regulatory arbitrage, and play an instrumental role in internationalizing Islamic finance.

¹⁶ As of August 2012, all financial regulators in Indonesia including BAPEPAM-LK were merged into a single regulator known as OJK (Otoritas Jasa Keuangan; Indonesian Financial Services Authority of Indonesia).

SBP and the Securities and Exchange Commission Pakistan (SECP) are the two regulators for the finance sector in Pakistan with SBP overseeing banks (including microfinance and Islamic banks) and development finance institutions and SECP regulating nonbank financial institutions including insurance (*Takaful*) and capital markets. Accordingly, the adoption of IFSB standards related to Islamic capital markets and *Takaful* fall under the regulatory domain of SECP whereas SBP deals with the standards and guidelines applicable on Islamic banks.

SBP has adopted the incremental approach to adopting and implementing the IFSB standards. This approach is followed not only for the adoption of IFSB standards but also for the overall regulatory and supervisory framework for Islamic banks. As per this approach, the overall recommendations and guidelines of IFSB standards are reviewed to identify the gaps in the prevailing framework. Specific regulations are issued to fill the key gaps, keeping in view the need and specificities of the local environment.

SBP has so far adopted the IFSB Standard on Risk Management whereas the adoption of the IFSB Standards on Corporate Governance and *Sharīah* Governance are at an advanced stage of adoption. SBP is expected to issue a comprehensive *Sharīah* Governance Framework soon, which coupled with its existing corporate governance framework for the overall banking industry (including Islamic banks) would make its *Sharīah* and corporate governance framework fully in line with the recommendations of the IFSB corporate and *Sharīah* governance standards. The *Sharīah* governance framework developed through extensive consultation with all the key stakeholders explicitly defines the *Sharīah*-related roles and responsibilities of all key organs of Islamic banks including the board of directors, executive management, and the *Sharīah* board. The framework emphasizes that the role of *Sharīah* boards for *Sharīah* compliance is very important and critical; nonetheless, the primary and ultimate

responsibility for ensuring *Sharīah* conformity of Islamic banks' operations rests with the board of directors. The framework, effective from July 2014, is aimed at institutionalizing the *Sharīah* compliance function and improving the *Sharīah* compliance environment in Islamic banks and thus would be instrumental in enhancing public trust in *Sharīah* permissibility of Islamic banking products.

Furthermore, for adoption of another key recommendation of the IFSB Standards on Corporate Governance and Transparency and Market Discipline on safeguarding the interests of investment account holders, SBP has undertaken another initiative of issuing a detailed set of policy instructions to Islamic banking institutions on profit and loss distribution and pool management. The instructions, which standardize the local practices on the subject, also focus on enhancing disclosures to enable the investment account holders to make informed decisions about placing funds in or withdrawing funds from Islamic banks. The profit distribution framework requires the creation and management of pools based on the policy approved by the board of directors and *Sharīah* board as virtual enterprises with distinct and verifiable assets, liabilities, income, and expenditure. It also prescribes the expenses that can be charged to the pool and that borne by banks as *Mudarib*, the profit sharing ratio, and the range of weightages. The framework, effective since December 2012, has standardized the profit computation and distribution policies and practices of Islamic banks and has been well received by the industry and Islamic banks' clients.

In order to adopt the IFSB Standard on Capital Adequacy, SBP carried out an impact study to assess the impact on Islamic banks' capital adequacy ratio (CAR) under the IFSB standard formula and supervisory discretion approach. The study revealed that the consolidated CAR of full-fledged Islamic banks as per Basel II was 20.5%, whereas the same rose to 43.1% as per the IFSB standard formula. The same as per the IFSB supervisory discretion formula with 50.0%, 70.0%, and 80.0% Alpha (risk

absorbant factor for PSAs in Islamic banks) remained at 29.0%, 25.1%, and 23.5%, respectively. The CAR of the overall Islamic banking industry as per Basel II remained at 18.15%, compared to 35.83% as per the IFSB standard formula. The CAR of the entire industry as per the IFSB supervisory discretionary formula with 50.0%, 70.0%, and 80.0% Alpha remained at 24.61%, 21.55%, and 20.28%, respectively. Hence, the study concluded that the industry was adequately capitalized even with Alpha close to 1. Since after the issuance of the Revised Capital Adequacy Standard (IFSB-15) in December 2013, SBP has been working on implementing this important standard.

Issues and Challenges for the Implementation of IFSB Standards

Notwithstanding progress made by the IFSB to develop prudential standards for the IFSI; the implementation of such standards across jurisdictions remains a challenge. The following are the main issues impeding the implementation of the IFSB standards:

- (i) Problems with consistent understanding of the IFSB standards across the jurisdictions and limited capacity to review the existing regulatory framework and the guidelines provided in the IFSB standards, which could help identify the gaps and develop rules and regulations to fill the gaps.
- (ii) Not all jurisdictions demonstrate the desired level of ownership of Islamic finance and reflect the need for a separate regulatory framework.
- (iii) The current Islamic banking paradigm more or less has a similar risk profile to conventional banks, which, sometimes, reduces the urgency for issuing specific standards for this sector.
- (iv) No formal mechanism to assess compliance of legal, regulatory, supervisory, and *Shar'ah* compliance frameworks with the IFSB and other global standards is in place.
- (v) Implementation of the IFSB standards is not mandatory; rather, it depends on the discretion of the respective jurisdictions.

In light of the challenges mentioned earlier, the following recommendations are made to improve the implementation of the IFSB standards across the jurisdictions:

- (i) The efforts for enhancing the capacity levels and promoting better understanding of the IFSB standards may be intensified and more awareness and technical seminars both at the pre- and post-implementation stages may be conducted.
- (ii) The level of collaboration and cooperation among the jurisdictions may be strengthened through bilateral agreements and MOUs between the IFSB and its member countries for implementation of the standards.
- (iii) To demonstrate ownership of the standards, the adoption and implementation of the standards should be made mandatory for IFSB council members. The council member countries/central banks not providing plans to implement the standards in their respective jurisdictions may be replaced with countries willing to adopt the standards.
- (iv) A transparent and credible assessment process may be developed to assess the level of compliance with the IFSB standards.
- (v) Considering the growing significance of Islamic finance in the global, regional, and national financial landscape, efforts may be undertaken to cover Islamic finance under the umbrella of finance sector assistance programs.
- (vi) Greater and effective collaboration among IDB, IRTI, and the IFSB to address the issues with the current Islamic banking paradigm is necessary.

Conclusion and Going Forward

As the global industry enters its next phase of growth in an increasingly challenging economic and financial environment, this necessitates the need to have in place a comprehensive regulatory framework to ensure a resilient and stable industry moving forward, in particular given the escalating cross-sectoral nature and interconnectedness of the industry. However, along with the development of various supervisory and prudential standards—corresponding to the fundamental changes in the global regulatory environment arising from the Basel III capital and liquidity frameworks and related measures—a sustained level of implementation is crucial to keep the industry abreast with the changing and evolving global financial system. These standards, if effectively enforced and implemented by the relevant national regulatory authorities, would certainly contribute to enhancing financial soundness and stability in the IFSI.

This chapter started by emphasizing that the development of Islamic finance requires a comprehensive regulatory and supervisory approach comprising both macro- and microprudential frameworks. This becomes apparent when it is understood that although Islamic finance may not have the same exposure and risks of conventional finance, it has its own set of risks, including some which are unique to Islamic finance. The IFSB standards help the RSAs, industry players, and other stakeholders of the IFSI to understand these risks and adopt international best practices, consistent with *Shari'ah* principles, to supervise and operate the IIFS. Especially for the RSAs, it is of paramount importance that they have sufficient infrastructure, skills, and domestic guidelines to effectively supervise the operations of the IIFS. The prerequisites to supervise these institutions include a sound understanding of the risks involved in *Shari'ah*-compliant transactions and how such risks are to be monitored and supervised. Therefore, a consistent regulatory approach to supervise the IIFS across borders can help ensure that growth of these institutions is on a sound footing and thus contributes to the overall

stability of the financial system. In this respect, the IFSB facilitates the implementation of its standards and guiding principles by working together with its members and partners in a variety of ways.

The IFSB has also tracked the progress of the implementation through rigorous efforts at its secretariat. The results of the recent survey in 2013 indicated that there has been noteworthy progress in the implementation of the IFSB standards in the member countries. Not only have more jurisdictions adopted or are in the process of implementing IFSB standards, there has been an early take-up of the “second-generation” standards issued after the financial crisis. The results also highlight that the planning time frame for adoption of standards is shortening from 3–5 years in the 2011 survey to 1–3 years in the latest survey. The 2013 survey results also indicate a critical challenge for the IFSB to ramp up efforts for the implementation of prudential standards among member jurisdictions by undertaking various measures such as offering relatively longer term engagement through technical assistance.

Other international organizations, such as the BCBS and the Financial Stability Board, rely on peer pressure to obtain adherence to a set timetable for the adoption of standards. These tools include, among others, finance sector assistance programs, supervisory colleges, and peer reviews. The IFSB Standards Implementation Surveys have pinpointed key impediments facing the member jurisdictions, which suggest that peer pressure alone will not be sufficient to drive the progress on implementation. In fact, given the nature of the impediments, which are in the areas of the legal and regulatory frameworks as well as specialized skills and knowledge, a formal requirement to make the IFSB standards compulsory will also be ineffective. Based on these observations, there is need also for the provision of substantial technical assistance, combined with opportunities for the sharing of experiences between countries. Such technical assistance could enable

jurisdictions to address the skills, capabilities, and other weaknesses that act as binding constraints to policy, regulatory, and market development. In order to undertake these initiatives, the IFSB has been working on finding the resources and organizational modes and partnerships that help committed jurisdictions meet the challenges they face. In the past decade, a major source of support for the implementation of the IFSB standards has been the assistance from MDBs, primarily ADB and the IDB. There is a need, however, to continue to innovate. The development of the e-module platform to support the implementation of standards is consistent with this approach. Another area that shows great promise is the development of core principles of Islamic finance regulations that is being pursued by the IFSB. In analyzing financial stability of countries with an active Islamic finance sector, an assessment should also be made on the adoption and implementation of these standards by the Islamic financial institutions in these countries. Currently, the Financial Stability Board includes 12 standards as key standards of

sound financial systems.¹⁷ When the core principles for Islamic finance regulations are developed, these should be included as a benchmark for regulation and supervision of the Islamic finance sector.

The role of MDBs can also be enhanced and will require a more systemic approach. This will have to begin with the integration of Islamic finance in the finance sector operational plans, road maps, and country partnership strategies. This will provide the opportunity to strategize support for the development of Islamic finance and implementation of prudential standards from the outset, instead of on an ad hoc basis as and when the opportunity presents itself. Finally, with tighter resources, MDBs and the IFSB can also consider leveraging each other's experience and expertise through closer collaboration and joint activities, possibly even joint missions. The combination of the IFSB's Islamic finance expertise and MDBs' finance sector experts should produce synergies that will be very useful for their common members.

¹⁷ See Financial Stability Board. Key Standards for Sound Financial Systems. www.financialstabilityboard.org/cos/key_standards.htm (accessed 21 February 2014).



CHAPTER 6

Legal and Regulatory Issues for Islamic Finance: Post-Crisis Scenario

Saleem Ullah

The global financial crisis of 2007–2009 has had far-reaching implications not only for the financial systems but also for the real economies across the globe. The crisis is regarded as even more severe compared to the Great Depression of the 1930s in terms of its magnitude, geographical coverage, and impact on macroeconomic variables (i.e., aggregated demand and unemployment). The negative implications of the crisis are still being felt in various forms—for instance, the global economic slowdown, lingering European debt crisis, and low trust in the financial system’s ability to withstand economic and noneconomic shocks.

The institutions offering Islamic financial services (IIFS), however, generally performed better and remained resilient during the crisis due to inherent checks and balances prescribed by *Shari’ah* that did not allow IIFS to invest in toxic assets and derivatives.¹ The limited integration of IIFS with global financial markets also helped them to fare better in testing times. Policy makers, regulatory and supervisory agencies, and global standard-setting bodies, after undertaking extensive diagnosis of the crisis, have introduced a host of new regulations including enhanced capital requirements, stringent liquidity requirements, increased focus on macroprudential regulations, and more intensive supervision of derivatives to avoid a recurrence of any such crisis in future. As the IIFS are also

operating in a dynamic global business environment where intensive reforms of the global regulatory and supervisory framework are being undertaken, there is a vital need to continuously review and update the IIFS legal and regulatory framework to ensure that they remain sound and stable and have satisfactory risk measurement and management systems.

During the IFSB–ADB Conference on Islamic Finance for Asia, jointly organized by the Islamic Financial Services Board (IFSB) and the Asian Development Bank (ADB) and held in Manila in November 2013, a roundtable session for regulatory and supervisory bodies was also held to discuss legal and regulatory issues that the Asian Islamic finance industry needs to face in the post-financial-crisis environment. This chapter specifically first covers the roundtable discussions which, among others, include the background of the crisis and the resilience of IIFS during the crisis and reasons thereof. Second, the chapter discusses the key legal, regulatory, and supervisory reforms initiated by conventional regulatory and standard-setting bodies, the needs for such reforms, as well as the implications for the legal and regulatory framework for IIFS in the changed scenario. Third, the chapter also analyzes the issues related to current Islamic banking practices, the reforms needed in the Islamic finance paradigm, and challenges in the transition toward a more robust financial infrastructure.

Key Reasons for the Financial Crisis

The global financial crisis 2007–2009 was preceded by imprudent risk taking behavior by financial institutions leading to highly leveraged credit expansion. The underlying systemic vulnerabilities were neither recognized nor mitigated. The epicenter of the crisis was subprime residential mortgages, which fueled a housing price bubble in the United States.² How did this enormous credit expansion become possible? In fact, innovations in

financial products changed the banking model from “originate and hold” to “originate and disburse.” Traditionally, banks originate loans and hold them until maturity which provides the necessary incentive to banks to prudently appraise the loans and ensure their effective monitoring postdisbursement (Brunnermeier 2009). Risk shifting, contrary to risk sharing, became the underlying principle of the new banking model. Moreover, to give impetus to

¹ An IMF study by Imam and Kpodar (2010) shows that Islamic banking and finance (IBF) observed double-digit annual growth globally during the last decade and has progressed from a niche to a large industry in many countries.

² Brunnermeier (2009) and Mishkin (2011) provide insights on the crisis in temporal order.

originating the loans, lending standards and prudent banking practices were also compromised in pursuit of high rewards and bonuses. Through securitization, illiquid financial assets (such as residential mortgages, auto loans, credit card loans, etc.) were transformed into marketable debt securities. The most notorious structured credit products and asset-backed securities (ABSs) are collateralized debt obligations (CDOs) backed by mortgages, corporate bonds, and loans. These CDOs were then sold across the globe. The role of credit rating agencies which assigned very high ratings to the CDOs was also highly questionable as they failed to assess the quality of the underlying assets of the CDOs.

Islamic Banks' Resilience during the Crisis

While some conventional financial institutions, including financial giants such as Lehman Brothers, were collapsing, and Bear Stearns, American International Group (AIG), and many others were being bailed out by the United States Federal Reserve, the credit and overall assets of the Islamic banking system were expanding.³ Islamic banks not only have weathered the storm but also registered a respectable growth during the turmoil. Assets of the 500 largest Islamic banks grew around 30.0% from \$39.5 billion in 2008 to \$822 billion in 2009, the period during which the conventional financial institutions deleveraged their positions through sale of their assets (International Financial Services London 2010). The resilience of IIFS during the crisis could be attributed to (i) the asset-based nature of financing which ensures growth of the financial assets in tandem with the growth of real assets and thus checks for creation of artificial asset bubbles; (ii) *Sharī'ah* prohibition of investment in speculative avenues, sale of debt, and short selling which largely close the door for investments in derivatives considering their highly risky and speculative nature; (iii) lack of exposure investment in toxic assets such as CDOs, again primarily due to *Sharī'ah* restrictions; and (iv) the ethics-based nature of IIFS business.

Zaheer, Ongena, and van Wijnbergen (2013) also opined that the main reason for the resilience of IIFS during the crisis was the *Sharī'ah* prohibition on interest-based products and sale of debt so that IIFS could not invest in the instruments that were badly affected during the financial meltdown (i.e., derivatives and other similar products based on toxic assets like subprime mortgages). In another study covering 141 countries over the period 1995–2007, Beck, Demirgüç-Kunt, and Merrouche (2013) discovered that Islamic banks have a higher intermediation ratio and higher asset quality, and are better capitalized.

It was these inherent and built-in control mechanisms prescribed by *Sharī'ah* that ring-fenced the Islamic banks against the severe shocks created by the crisis and exposure to speculative and risky avenues. Apart from the *Sharī'ah* prohibitions and ethical nature of the business of Islamic banks, the broader enabling environment and business conditions (including legal and regulatory framework, risk management systems, human resources capacity, etc.) of Islamic banks were either the same or at a comparatively less developed stage than those of conventional banks.

Key Finance Sector Post-Crisis Reforms

After the financial crisis in the United States and the subsequent sovereign debt concerns in some European states, proposals have been put forward to strengthen the regulatory framework, including through significantly enhanced capital requirement and enhanced market discipline. The reforms introduced for this purpose

³ For details, see Hassan and Dridi (2010).

include the Basel III capital and liquidity frameworks. Basel III⁴ significantly enhanced capital requirements for banks and also prescribed stringent criteria for eligibility of an instrument to be part of regulatory capital. It also introduced capital conservation and countercyclical buffers to help control systemic risks arising from the interconnectedness of financial institutions and procyclicality. Furthermore, additional capital requirements for systemically important banks, both at the global and domestic level, were also introduced. The introduction of the leverage ratio is also aimed at strengthening the capital base and discouraging excessive leveraging. The other key reforms initiated include more stringent liquidity requirements through introduction of the liquidity coverage ratio and net stable funding ratio, complementing microprudential supervision with macroprudential supervision to identify system-wide risks and imbalances, and more extensive supervision of the derivatives markets. Furthermore, some jurisdictions have developed proposals for “problem banks resolution” to avoid system-wide implications of their failure.

The reforms and corrective measures introduced at the global level are largely in line with *Sharfah* principles. The revised capital adequacy standard Basel III significantly enhanced the size and quality of the banks’ capital to improve their ability to withstand exogenous as well as endogenous shocks. Islamic finance principles also encourage and allow equity based contracts and discourage debt based contracts. The savings deposits of Islamic banks are largely based on equity-natured *Mudārabah* which insulates Islamic banks from insolvency risk due to the pass-through nature of these deposits. In a number of jurisdictions, the savings deposits are categorized as quasi equity or redeemable capital. The IFSB capital adequacy standard also

recognizes the special nature of these deposits as its supervisory discretion criteria for the computation of the capital adequacy ratio (CAR) allows supervisory authorities to treat the savings deposits (profit sharing investment accounts, or PSiAs) as zero, partial, or full risk-absorbent. The zero risk-absorbent PSiAs behave just like conventional deposits, whereas fully risk-absorbent PSiAs are equity natured and thus require no capital to provide cushion to such depositors against credit and market risk. In practice, however, the savings deposits are not fully risk-absorbent as the IIFS in most of the jurisdictions use various profit-smoothing tools including *Hiba* (paid from IIFS capital and reserves) to pay market-comparable returns to their depositors. The profit distribution framework issued by the State Bank of Pakistan, however, does not allow IIFS to give *Hiba* to the savings depositors from its capital and reserves.

The European Parliament in April 2014 approved a financial framework called the Single Resolution Mechanism for restructuring of the banks facing severe solvency problems.⁵ The Single Resolution Mechanism will ensure that a failing bank in the banking union is handled promptly and efficiently, without shifting costs to the taxpayers and the real economy. It will also minimize the need for bailouts of failing banks through taxpayer money and help central banks and regulatory bodies in ensuring financial system stability. The bail-in of failing banks is one of the key components/tools of the mechanism, under which the failing bank will be “recapitalized” through allocation of the bank’s losses to the equity holders and then to creditors/depositors of the failing bank. Thus, in case of financial distress in the bank, the creditors/depositors would be treated as shareholders (burden sharing). Accordingly, a problem bank, for which a private investor could not

⁴ Basel III has been developed to strengthen the capital position both by increasing liquidity and decreasing leverage in the banks. Regulations about the structure of the banking system are proposed in the Volcker rule, Vickers initiatives, and Liikanen proposals. These initiatives broadly try to end implicit too-big-to-fail subsidies by reducing economies of scope (Gambacorta and Rixtel 2013) as the diversification by the large global banks has been intertwined with a high concentration of financial services in a few large and complex financial conglomerates (Boot 2011).

⁵ The banking union under a single supervisory mechanism would be operational in late 2014. For details, see http://europa.eu/rapid/press-release_IP-13-674_en.htm?locale=en

be attracted, will still continue to provide banking services without the necessity of a bailout by taxpayer funds. This sort of mechanism was actually practiced in the case of the Bank of Cyprus. The largest bank of Cyprus completed its recapitalization process through bail-in of depositors in July 2013. The bank transformed 60.0% of major depositors (over 100,000 euros) into its shareholders. Bailed-in depositors hold around 81.0% of the bank's share capital.

The ban on short selling soon after the financial crisis 2007–2009 in different countries including the United States, the United Kingdom, France, Germany, Switzerland, Ireland, and Canada is also a reflection of Islamic banking and finance principles, as in *Sharī'ah* (Islamic law) one cannot sell an object unless he or she owns it. Similarly, the issuance of a gross domestic product indexed bond⁶ by Greece during the crisis is also in congruence with Islamic banking and finance precepts as returns on any general government

securities should be related to the performance of the overall economy.

These examples from the conventional financial system amply demonstrate that the Islamic finance principles are not just theoretical and utopian concepts, but rather provide the basis for a practical, viable, and stable financial system. The size, severity, and magnitude of the financial crisis of 2007–2009 have probably forced the economists and policy makers to explore alternate solutions and systems to ensure financial system stability and to develop a just and equitable financial and economic system. It is therefore high time for Islamic economists, finance professionals, practitioners, and *Sharī'ah* scholars to develop practical solutions that meet the *Sharī'ah* objectives of equity, justice, and transparency and provide better value propositions to the masses. This would require significant changes in the current Islamic banking paradigm, which although it meets the minimum *Sharī'ah* requirements is not fully aligned with the objectives of *Sharī'ah*.

Current Islamic Banking Paradigm

Notwithstanding the aforementioned features of Islamic finance, which are the sources of stability in the Islamic financial system, the current Islamic finance paradigm is focused on offering *Sharī'ah*-compliant alternates (replicas) of conventional products with more or less similar risk profiles and economic outcomes. Furthermore, most of the Islamic finance transactions are debt based and priced on conventional benchmarks. The asset-based nature of Islamic banks transactions, though it ensures the productive use of the financial resources, increases the transaction cost due to additional processes introduced to comply with *Sharī'ah* requirements. This puts Islamic banks at a relative disadvantage vis-à-vis conventional banks, thus compelling them to give price discounts to compensate the clients for increased transaction costs (documentation as

well as monitoring) or to compromise on some of the processes to reduce the transaction costs, albeit at a risk of weakening *Sharī'ah* permissibility of the products/transactions.

There is now a growing trend of replacing asset-based financing with more flexible cash-based products (e.g., *salam-cum-wakalah*, *istisna-cum-wakalah*, etc.), which behave more or less like working capital in conventional banks. While these transactions and products do pass the *Sharī'ah* permissibility tests, they lack real-sector link and are meant for extending financing to the clients based on conventional benchmarks rather than undertaking real trade and/or business activity envisaged and encouraged by *Sharī'ah* principles. Similarly, one can see the growing urgency in some of the jurisdictions

⁶ The returns of these bonds are benchmarked on nominal gross domestic product growth rates to be achieved during different periods.

to introduce *Sharī'ah*-compliant derivatives to hedge different types of risks on Islamic banking institutions' balance sheets. Even on the liability side, Islamic banks in some key jurisdictions have started raising fixed return deposits using commodity *Murābahah*. These developments raise important issues for both the Public and Private sectors. One issue is in striking a balance between strengthening risk mitigation measures, whilst avoiding the use of instruments that are similar to those implicated in the global crisis. A second issue relates to the Islamic banking paradigm, if not reformed and aligned with *Maqasid Sharī'ah*, and whether it will lose its separate identity and converge to the conventional system. With exposure to almost similar risks and vulnerabilities as those of conventional banks, there would hardly be any need for a separate and distinct legal and regulatory framework for Islamic finance.

What Is the Solution?

Based on the various issues and challenges highlighted above in the current Islamic financial system, the following are some proposed solutions:

- Transition of Islamic banking toward a paradigm which is in line with *Maqasid Sharī'ah*
- Transition from “replicas” to “original” *Sharī'ah*-permissible products having a better value proposition for the clients, economy, and society
- Transformation from risk shifting toward a risk-sharing mechanism on both sides of the balance sheet
- Bringing “realism” to the products and transactions
- Financial intermediation plus model
- Universal banking model with commercial banking, investment banking, and real trade arms
- Segregation of payment system deposits and investment accounts
- Development of supportive and effective legal, regulatory, and risk management framework
- Development of supportive monetary policy regime including *Sharī'ah*-based money creation mechanism

The above proposed solutions would enable an appropriate portfolio different paradigm of the Islamic financial system, based on *Sharī'ah* principles of justice, transparency, and equity that would create value for all the stakeholders and ensure financial system stability due to its risk sharing as well as

ethics-based nature. One of the fundamental issues with the current Islamic banking paradigm is its focus on developing Islamic structure of conventional products with more or less similar risk and reward profiles. This approach has not only made Islamic banks inefficient vis-à-vis conventional banks due to greater transaction costs but has also been a source of negative perception for the Islamic finance industry.

The Islamic banks under the paradigm envisaged in this chapter will have three arms: (i) commercial banking arm to provide payment system related services, remittances, trade facilitation through letters of credit, etc.; (ii) investment banking arm to make risk and reward sharing (equity natured) investments in different *Sharī'ah*-permissible business avenues; and (iii) real trade/business arm to undertake different real business activities with a clear demarcation between banking and real business activities. Islamic banks will have two broad categories of deposits: (i) the *Qard*-based current deposits attracting a significantly large reserve requirement and investing the remaining portion in high-quality liquid assets to ensure smooth functioning of payment system, and (ii) investment deposits of varying maturities and risk profiles to be invested in an appropriate portfolio based on risk and reward sharing principles including funding the investment banking and real business arms of the bank.

This model, if developed and implemented professionally with sound risk management systems, will significantly improve the return profiles of Islamic banks both for the investment account holders (depositors) and shareholders and will enhance turnaround to the recognition and acceptability of Islamic finance as a distinct viable and competitive financial system that offers a better value proposition to its users and society as a whole. The critics of Islamic finance believe that the Islamic economic and financial system exists only in theory and is not practical. While it is true that the system in its entirety is not operative in any jurisdiction, however, the recent crisis has amply exposed the fault lines and vulnerabilities of the conventional financial system, and there has been increased awareness of the need for alternative approaches that could ensure financial system stability and promote ethical conduct. Further, as discussed in the earlier section that the reforms introduced by conventional regulators and

policy makers are largely compatible with the Islamic finance principles gives further credence to the utility and practicality of these principles for ensuring financial system stability.

However, in many jurisdictions the existing legal and regulatory framework which has been developed keeping in view the nature of business and risk profile of conventional banks, does not provide adequate recognition of the needs of the Islamic banking paradigm. The regulators and policy makers thus should make an objective assessment of the utility of the Islamic finance system (compatible with the *Shar'ah* objectives of a fair and just financial and economic system) for financial system stability and related socioeconomic objectives and, if satisfied, with its utility, initiate suitable changes in the framework to allow Islamic banks to adapt their business model in line with *Maqasid-Shar'ah*.

Conclusion

The latest financial turmoil in the United States and the sovereign debt crisis in European countries pose a key question to academics and policy makers: How can the financial system avoid these debacles? Some preventive and curative measures have been suggested in this regard. The European Commission suggested a bail-in, instead of a bailout, of the failing bank by transforming creditors of the failing bank into shareholders. This type of solution has already been applied to the Bank of Cyprus in the recent Cyprus crisis. The preventive measures consist of mainly the Basel III Accord, in which minimum capital requirements have been enhanced. A stringent liquidity requirement has been imposed on the banks requiring them to maintain conservative liquidity ratios (e.g., liquidity coverage ratio and net stable funding ratio). Moreover, micro- and macroprudential supervision has been proposed to regulate the finance sector.

In the aftermath of the current financial crisis, Islamic banking and finance has an opportunity to offer the world a financial system less prone to financial crises due to the inherent features of its business model. Islamic structures require the investors to share in the returns of the bank, whether positive or negative. Thus, the (investment) depositors of an Islamic bank are its time-limited shareholders, depending upon the maturity of the investment deposits. Since this provides an extra equity cushion for Islamic banks, the loss absorption capacity of an Islamic bank is higher than that of conventional bank. The fact is that conventional finance is proposing the features of Islamic finance only for the “failing” banks and not for the “successful” bank; that is, the proposed Single Resolution Mechanism only shares the downside of the bank's business with the creditors but not the upside.

The strength and comparative advantage of Islamic finance is in equity-natured transactions on both the assets and liabilities sides of Islamic banks' balance sheet. This would not only enhance their stability with minimum insolvency risk (due to the pass-through nature of profits and losses), but would also ensure equity-natured participation of a large number of depositors in different real sector projects. The equity-natured portfolio of financing and investments are also likely to significantly enhance the returns to the depositors and would improve acceptability and recognition of Islamic finance as a distinct, viable, and competitive system offering better value

proposition to its clientele and society as a whole. The existing legal and regulatory framework, however, does not provide the necessary space to Islamic banks to move toward this paradigm. Similarly, the existing risk management systems of banks are not tailored to manage the risks associated with this paradigm. The regulatory and supervisory bodies thus, in consultation with the practitioners and other stakeholders, should initiate studies to assess the feasibility of the proposed paradigm and make necessary amendments in the legal, regulatory, and risk management frameworks to allow a gradual movement toward the new paradigm.

CHAPTER 7

Taking the Initiative for Islamic Finance: Role of Governments and the Private Sector

Badlisyah Abdul Ghani

In order to have an effective discourse on the kind of initiatives for Islamic finance that governments and the private sector in any jurisdiction should be pursuing, it is important to understand the philosophy of Islamic finance. The emergence of Islamic finance is considered one of the important events of the millennium, an event that to a certain extent has contributed to the dynamics of the world's economic and political changes. The paradigm shift has the potential to forge greater international financial linkages between countries, particularly among the Islamic countries. Islamic finance can contribute toward a more optimum allocation of wealth across borders and help the world's Muslim population participate more actively in financial and economic activities.

As an exemplar of government's instrumental role in the development of Islamic finance, Malaysia took it upon itself to build and develop the Islamic banking and finance industry back in the 1960s, immediately after gaining independence in 1957. Despite the challenging political and economic environment at that time, the Government of Malaysia laboriously built up the industry from scratch through trial and error. It has been a progressive 50-year journey, and the regulatory, legislative, tax, and supervisory frameworks established in Malaysia for the Islamic finance industry can be seen being emulated by many countries all over the world.

The Origin and Modern Growth of Islamic Banking and Finance

Islamic finance aims to provide economically viable financial intermediation alternatives, framed within the boundaries set by Islamic principles. These activities involve the intermediation between the haves and have-nots across all customer segments in a manner consistent with *Sharī'ah*. It was a system developed under the reign of the Muawiyad and the Abbasid Caliphates from the year 661 to 850, and thereafter it was spearheaded by great Islamic empires such as those in Andalusia (Spain) until the year 1031, in Granada until 1492, in the Malacca

Sultanate until 1511, and in the Ottoman Empire (Turkey) until 1918. It is a system which has existed for the last 1,435 years but had lost its way due to changing political and legal systems across the Islamic world in the last millennia. It has been a slow lesson relearning what is available under the system over the last 50 years. Malaysia, as one of the global centers of Islamic finance, has been at the forefront of this modern day rediscovery and redevelopment of the industry.

The Exemplar of Government and Private Sector Partnership in Promoting Islamic Finance

In 1963, the Government of Malaysia via legislative enactment formed Tabung Haji or the Pilgrimage Fund, the first of its kind in the world. Tabung Haji enabled Muslims to save their money in a formal institution and enjoy good returns on their deposits in compliance with *Sharī'ah*. As a next milestone, in the early 1980s, Malaysia took steps to set up a commercial Islamic bank.

The initiative that led to the establishment of the initial formal, regulated framework for Islamic finance was done through a very strategic public-private partnership. A group of private individuals (as representatives of the banking industry) and public sector officials collaborated in the drafting of a white paper on Islamic banking and lobbied the government and parliament to enact a new law for

the same. The pioneering Islamic Banking Act was ratified in 1983 and saw the immediate establishment of the country's first licensed Islamic bank. This was followed by the enactment of the 1984 *Takāful* Act and establishment of the country's first licensed *Takāful* company in the same year.

Ten years after the incorporation of the first licensed Islamic bank and *Takāful* company, the government realized that Islamic banking and finance had more to offer to the country and could actually become one of the main components of the mainstream financial market alongside the conventional system. It was possible to use Islamic finance as the key for a more inclusive national development. As a result,

the Interest Free Banking Scheme (later known as Islamic Banking Scheme or Skim Perbankan Tanpa Faedah) was introduced which allowed all licensed conventional banks to offer Islamic banking products and services, provided separate funds are created for the latter to ensure there was no comingling of funds. The scheme led to the success in penetrating a wider customer base for the Islamic banking system in Malaysia: the Islamic banking share grew from a mere 1.0% over a period of 10 years since the establishment of the first Islamic bank to about 6.0% practically overnight. The Government of Malaysia has therefore realized that Islamic finance is equally demanded by non-Muslims due to its economic value propositions (see Figure 7.1).

Figure 7.1: Considerations of Muslim and Non-Muslim Customers in Adopting Islamic Finance

Shariah facilitates unlimited market for IFIs through innovative products and services as they are beneficial for both Muslims and non-Muslims customers.

Muslims:

Want products and services that provide them value and meet their personal and preferred *Shariah* application as found under the different school of laws-

- Hanbali
- Maliki
- Shafei
- Hanafi
- ...and many more

- Islamic financial market:
 - Banking
 - Money Market
 - Debt Capital Market
 - Equity Capital Market
 - Derivatives
 - Private Equity
 - *Takāful*
 - REITs
 - Asset Management
 - Wealth Management
 - Non FI Services
- Other Financial Products and Activities

Non-Muslims:

Want products and services that provide them value .

Do not care about *Shariah* compliance but care about ethical business and social responsibilities, which are embedded under *Shariah* principles.

IFI = Islamic financial institutions; REITs = real estate and investment trust; FI = financial institution.

Source: Author's own illustration.

Knowing that the integrity of the Islamic financial market and the stability of the overall financial market must be protected to provide certainty of business to the private sector players, the government amended the Banking and Financial Services Act 1989 to ensure an orderly undertaking of the regulated Islamic finance activities. All Islamic finance activities must be done by the conventional bank as a licensed Islamic window operating as “a bank within a bank” with its own capital allocation as well as separate balance sheet and profit and loss account. This created the right kind of industry discipline among the industry players. The Islamic window framework introduced by the government brought about proper risk management and asset liability management in the Islamic finance industry with an emphasis on an end-to-end *Shariah*-compliant system. This also went a long way to build consumer confidence in the broadening industry base from among the Muslim and non-Muslim customers.

The Islamic banking share of the market today is approximately 26.0% of overall banking assets and is growing faster than that of conventional finance. With Islamic banking proving to be an efficient and important component of the overall financial market in Malaysia, the government decided that the country must have a holistic, robust, and sustainable Islamic financial market encompassing all sectors including banking, insurance, money market, and capital market. As such, the government has introduced numerous initiatives for the development of the Islamic capital market. With foresight, the soft launch of this industry was back in 1984 when the government issued the first Islamic treasury papers which were initially intended to help liquidity management of Bank Islam Malaysia.

The continued issuance of benchmark sovereign *Sukūk* instruments by the government established a good benchmark yield curve that allowed the private sector to confidently undertake corporate *Sukūk* issuance in 1990s. In fact, the first ever corporate “bond” issuance in the country was a *Sukūk*. Shell MDS (Malaysia) issued the world’s first rated corporate *Sukūk* in 1990 to the amount of RM150 million. This was a sign of Malaysia’s significant Islamic finance potential and a source of considerable value proposition for Shell, one of the world’s largest corporates. Again, there has been a strong partnership between the government and the private sector in the development of the Islamic debt capital market in Malaysia.

Since the government established the Islamic Securities Guidelines in 2004 through a joint public–private sector consultative committee, various types of *Sukūk* issuances have been structured in the Malaysian capital market with tenures of less than 12 months to a 50-year *Sukūk* and lately perpetual *Sukūk*. Nearly two-thirds of total outstanding *Sukūk* today have been issued out of Malaysia, and the country dominates the primary *Sukūk* market with about half of all new *Sukūk* issues completed every year. Corporate *Sukūk* have outstripped conventional bonds with a more than 60.0% share

of total outstanding corporate issuances in Malaysia. The country is now home to the largest *Sukūk* market in Asia and the world.

Recognizing the demand for equity investment among Islamic investors, the Government of Malaysia introduced the world’s first regulated Islamic index in the early 1990s. This was followed by various regulatory guidelines to promote Islamic equity activities such as the Guidelines on *Sharīah*-Compliant Stocks, Guidelines on Islamic Initial Public Offerings, Guidelines on Islamic Real Estate Investment Trusts, and Guidelines on Islamic Warrants. With active participation by the private sector to manage their business consistent with the criteria set under the Islamic index as well as undertake all the different Islamic equity products facilitated under the various guidelines, Malaysia today hosts one of the largest Islamic stock exchanges where over 60.0% of companies listed are *Sharīah*-compliant.

With a strong Islamic banking sector and Islamic capital market (both equity and debt), there was increasing demand for Islamic asset management in the private and public sector investing communities. Existing licensed asset managers were allowed to offer Islamic fund management services in the late 1990s through the addition of new provisions under the existing regulation. The industry has seen phenomenal growth in the Malaysian market as players in the market undertook the activities to meet the vast demand. Malaysia has arguably one of the largest Islamic asset management industries in the world, challenged only by Saudi Arabia in terms of assets under management.

Islamic asset management has also gone beyond unit trusts to include alternative investments such as private equity funds, real estate investment trusts, exchange trade funds, and so on. Both the private and public sectors have played their roles in facilitating these efforts. In order to promote broader Islamic finance activities, the Government of Malaysia has introduced new licenses for foreign currency

asset management activities with seed funding given to qualified international fund managers. In order for Malaysian Islamic funds to be marketable in other parts of the world, the industry players ensured acceptance of these funds on foreign platforms such as the Undertaking for Collective Investment in Transferable Securities Directive that allows them to sell in the European Union.

A financial market without the ability to manage risk effectively and efficiently cannot be sustainable and stable. As such, the Malaysian regulator facilitated the introduction of a formal Islamic derivatives market in 2004. Once again, the government and the private sector worked together closely to develop the

Islamic derivatives instruments, as they were critical for the industry that had reached a significant size to be able to manage risk well. This has since allowed Malaysian Islamic banking players to be more effective in growing their Islamic finance business in the local as well as regional markets.

Today, Malaysia's Islamic financial market is to a very large degree complete, comprising the banking sector, the interbank money market, the debt and equity capital market, asset management, *Takāful*, other nonbanking financial activities, and the derivatives market as well, hence meeting diverse stakeholder needs (see Figure 7.2).

Figure 7.2: Development of Islamic Finance and Stakeholder Expectations

Development of Islamic finance is subject to basic stakeholders expectations and *Maqasid Al-Shariah* in each financial activities that is undertaken...



Note: Maqasid Al-Shariah means in whatever we do we must serve the interests of all human beings and to save them from harm. This influences how stakeholders' expectations are articulated and propagated.

Source: Author's own illustration.

The role that the government and the private sector in Malaysia have played in taking Islamic finance to its current state could be replicated, with certain adjustments, by any government and private sector in the world.

Islamic Finance: Global Context and Prospects

The industry has been growing at approximately 20.0% per year, driven partly by Islamic investors seeking more ethical forms of investment, rising Muslim wealth, international business interest in liquidity-abundant economies of the Gulf, and accompanying supporting initiatives of government and multilateral organizations. Together with strong economic growth across emerging Islamic countries, this provides a good impetus for the Islamic finance industry globally, as it will further drive both public and private sector interest in many jurisdictions.

Many economies with predominantly non-Muslim populations, including the United Kingdom, Japan, South Africa, France, and Hong Kong, China, are seeking to tap into the growing demand for Islamic financial products and services. In this light, many have announced initiatives for Islamic finance. For example, the United Kingdom has several locally incorporated Islamic banks and issued a debut *Sukūk* in mid-2014. London is eyeing the coveted position of an Islamic financial hub in the Western world. Singapore has similar aspirations in Asia. The Monetary Authority of Singapore has introduced regulatory changes to facilitate syndicated *Murābahah* transactions, *Sukūk*, and Islamic funds and is planning to do more to strengthen Islamic finance's footing in the country. Corporate interest in Islamic finance, reflected in several *Sukūk* issuances, have benefitted from such facilitation by the financial regulatory authority.

Following the first *Sukūk* issued out of the United States by a gas company, East Cameron Partners in Houston in 2006, corporates in the United States, United Kingdom, Japan, and the European Union have shown interest in utilizing the structure to raise funds to refinance existing corporate debt or to finance working capital and expansion activities, including acquisitions. A number of foreign companies—including Tesco, Aeon, and Nomura—have tapped the Islamic finance marketplace in Malaysia which boasts sophisticated regulations and a ready base of Islamic investors.

India's state of Kerala has allowed Islamic banking to be done through the nonbanking financial institutions. It is a commendable beginning, but it is not the same as having it done under the financial market regulatory framework to accord Islamic consumers similar protection as available under conventional finance. South Africa already has a history of Islamic finance spearheaded by the Bahrain-based Albaraka Banking Group; more recently, local banks such as ABSA, First National, Nedbank, and Standard Bank have entered the market in a much more committed drive, especially in retail banking and asset management. The Government of South Africa issued a much awaited *Sukūk* in September 2014.

The next phase of industrialization—which will see an annual infrastructure investment requirement for Asia of about \$750 billion up to 2020—cannot be financed solely out of equity or government revenue. There will be an increasing reliance on the debt markets for *Sukūk* and for financing syndications. Islamic finance is set to leverage its position because of its competitive pricing and now increasingly acceptable structures for a wider investor base. The extra tier of *Sharīah* compliance is no longer a barrier to entry for Islamic finance, as witnessed by the subscription of an increasing number of conventional banks in Europe, the United States, Asia, and South Africa to Islamic instruments such as *Sukūk* and *Murābahah* syndications. These banks are now increasingly comfortable with the risks associated with these instruments so long as a strong enabling environment is present to provide certainty of business. Such certainty can only be there if governments take a strong role for its facilitation.

An area of high potential for Islamic finance is in poverty reduction. With more than 650 million Muslims across the globe living in poverty (El-Zoghbi and Tarazi 2013), there is a compelling reason for governments and private sectors to push for further development of the industry to promote financial inclusion. Greater availability of *Sharīah*-compliant products and services of various

kinds (including microfinance and micro*Takāful*) will eventually lead to greater participation of the Muslim population in both domestic and global economic activities. Whatever the factors driving the Islamic finance industry globally, be it a profit seeking

or developmental agenda, the industry requires continuous improvement and innovation, supported by the government and the private sector, to meet the growing appetite for Islamic financial products and services.

Demand for Innovation and Rigor of *Sharī'ah* Governance to Meet Needs

The evolution of sophisticated Islamic financial products that have been structured based on multiple Islamic concepts has resulted in a new wave of innovation over the last 50 years since the rediscovery of Islamic finance. These products have become competitive and efficient both in terms of structure and pricing. Nonetheless, many seem to have looked upon innovation in Islamic finance over the recent years with suspicion.

Innovation in Islamic banking and finance must be looked at from a demand perspective and in a way that complies with *Sharī'ah* on a jurisdictional basis subject to local parameters in any one country, such as the law of the land, market conventions, culture, and customs. Herein lies the problem, however: What is right under *Sharī'ah* in any one country?

In Malaysia, both the government and the private sectors have approached *Sharī'ah* governance in a very pragmatic manner. Understanding this pragmatic role is critical for any initiative to take Islamic finance forward in any jurisdiction. Islamic banking and finance industry typically comprise many types of activity—banking, asset management, debt capital market, and so on.

The common market perception is that each *Sharī'ah* principle needs to be fitted into a specific activity. As an example, there is a predominant thought that the *Sharī'ah* principle of *Ijārah* is used

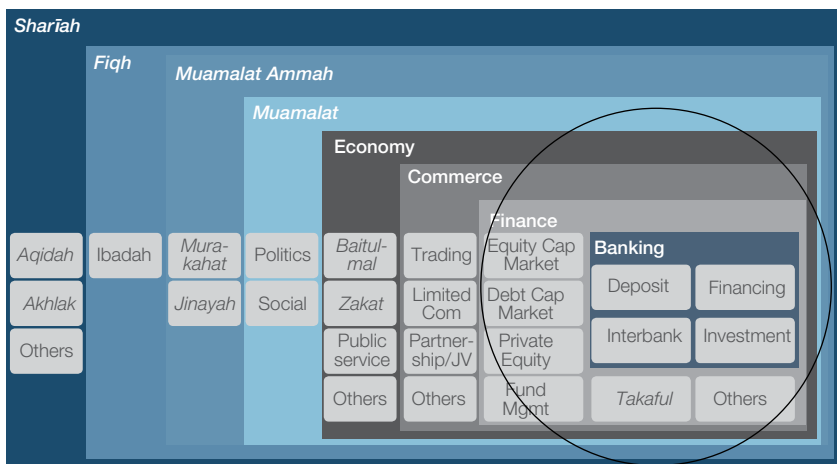
only for leasing activity. However, in the industry, a singular *Sharī'ah* principle can be used to facilitate various activities. As such, *Ijārah* can be used to for a financial lease, operational lease, home financing, corporate financing, small and medium-sized enterprise financing, car financing, project financing, credit cards, and *Sukūk*. The financial activity carried out is the real substance of the transaction and not necessarily the underlying *Sharī'ah* principle.

There is also a view that an Islamic financial activity can only be facilitated by a singular *Sharī'ah* principle. This, however, is inaccurate. Each financial activity could be structured using a combination of different *Sharī'ah* principles. For example, home financing can be facilitated using the *Bai Bithaman Ajil*, *Murābahah*, *Ijārah*, or *Mushārahah Mutanaqisah*. Moreover, in a single financial activity, various principles may be used, as in the example of a *Mushārahah Mutanaqisah* home financing facility in Malaysia which combines the principles *Bai* (sale), *Mushārahah* (joint ownership), and *Ijārah* (leasing).

These approaches are not only pragmatic but are also consistent with the *Sharī'ah* requirement for transparency and are in line with the need to manage systemic risk in the financial market. Both the government and the private sector must communicate the right information to the public, for without proper disclosure, the real impact on systemic risk cannot be appreciated and monitored (see Figure 7.3).

Figure 7.3: Position of Islamic Financial Activities within the Greater Islamic Economic System

IFI undertakes specific activities under *Sharīah* and the business and operating model it adopts reflects these and so does the innovation it undertakes under each.



IFI = Islamic finance institution, JV = joint venture.

Source: Author's own illustration.

Banking activities within the *Sharīah*-compliant system must be undertaken by a licensed bank, seeing that banking is a regulated activity in all countries. Similarly, Islamic insurance must be operated by a licensed *Takāful* company. Regulated Islamic debt or equity capital market transactions must be facilitated by licensed investment banks. It is hence evident that the *Sharīah*-compliant system is very similar to conventional finance, except that its activities must be done differently in accordance with the *Sharīah* requirements. However, how these contracts are applied may differ from one jurisdiction to another depending on local parameters adopted.

Differences of interpretation of *Sharīah* principles are allowed, and such flexibility is in fact one of the best features of *Sharīah*. Amongst Sunnis, there are four major schools of thought in Islamic jurisprudence. However, a jurisdiction may have followers from

other schools among the users of Islamic financial products and services, since each jurisdiction has to deal with international counterparts and customers. From a practitioner's perspective, private sector intermediaries must facilitate the differing demands among the customers, regardless of the possible differences in *Sharīah* preferences. The governments and regulators must provide an enabling environment to facilitate this.

Under the Islamic Banking Act 1983, which was recently replaced by the pioneering Islamic Financial Services Act 2013, Malaysia defines Islamic banking activities generically as those activities that are not in contradiction with *Sharīah*. This essentially allows for all recognized interpretations under any *Sharīah* school of thought, thus creating a market where demand and supply determine the most efficient and effective structures.

Furthermore, Islamic finance activities fall under the *Muamalat* section of *Sharī'ah*. Under *Muamalat* (human-to-human relationship), all matters are allowed unless proven impermissible specifically under the *Quran* and authentic *Hadith*. This differs from *Aqidah* (human-to-God relationship), which is applicable only to Muslims, where all matters are not allowed unless it is proven permissible specifically. Therefore, appreciating permissible differences in *Sharī'ah* is imperative when undertaking Islamic banking and finance activities.

In doing this, the industry needs to take guidance from experts in *Sharī'ah*. In Malaysia, there exists a regulated enterprise-wide *Sharī'ah* governance framework established under the Islamic Financial Services Act 2013. The financial regulator, through the *Sharī'ah* Advisory Council, ultimately governs all *Sharī'ah* matters in the Islamic banking and finance industry in the country. All licensed Islamic financial institutions are required to have a *Sharī'ah* committee, appointments to which are subject to regulatory approval. Prior to the legislation of the present *Sharī'ah* governance framework, the *Sharī'ah* committee of Malaysia's first licensed Islamic bank was used as the ultimate arbiter of

Sharī'ah in the whole market between 1983 and 1996, underscoring the importance of private sector involvement in managing industry integrity and propagating innovation. Centralization of *Sharī'ah* supervision also limited unproductive debate among Islamic financial institutions regarding the superiority of their products based on *Sharī'ah* criteria and instead has promoted greater transparency and disclosure.

In Malaysia, although the decisions of the *Sharī'ah* Advisory Council are binding on Islamic financial institutions, the financial regulator does not get involved in dictating what operational *Sharī'ah* preferences must be adopted by the market. The regulator simply provides an enabling process that allows the players to have their products cleared as financial products consistent with *Sharī'ah*. The regulator clears all such *Sharī'ah* applications as long as they are justifiable under the sources of *Sharī'ah* and, once cleared, plays the role of ensuring market confidence through monitoring and supervision it. Thus, the regulator supervises the management of *Sharī'ah* so as to ensure the stability of the market and systemic integrity and does not enforce *Sharī'ah* preferences upon market players.

Conclusion

The global Islamic finance industry is a business-driven industry that caters to the needs of multiple stakeholders, irrespective of religious beliefs held. Neither the government nor the private sector can take the initiative for Islamic finance forward without the other. Finance is a regulated activity, and Islamic finance, as one form of finance involved in financial intermediation across all known types of financial activities with consumers, thus must be regulated. If regulation is refused, then regulators would not be fulfilling the basic reasons for their existence, which is to provide an inclusive financial market and a stable financial system to support the government's objective of providing an optimal mechanism for wealth distribution among the populace and greater national development.

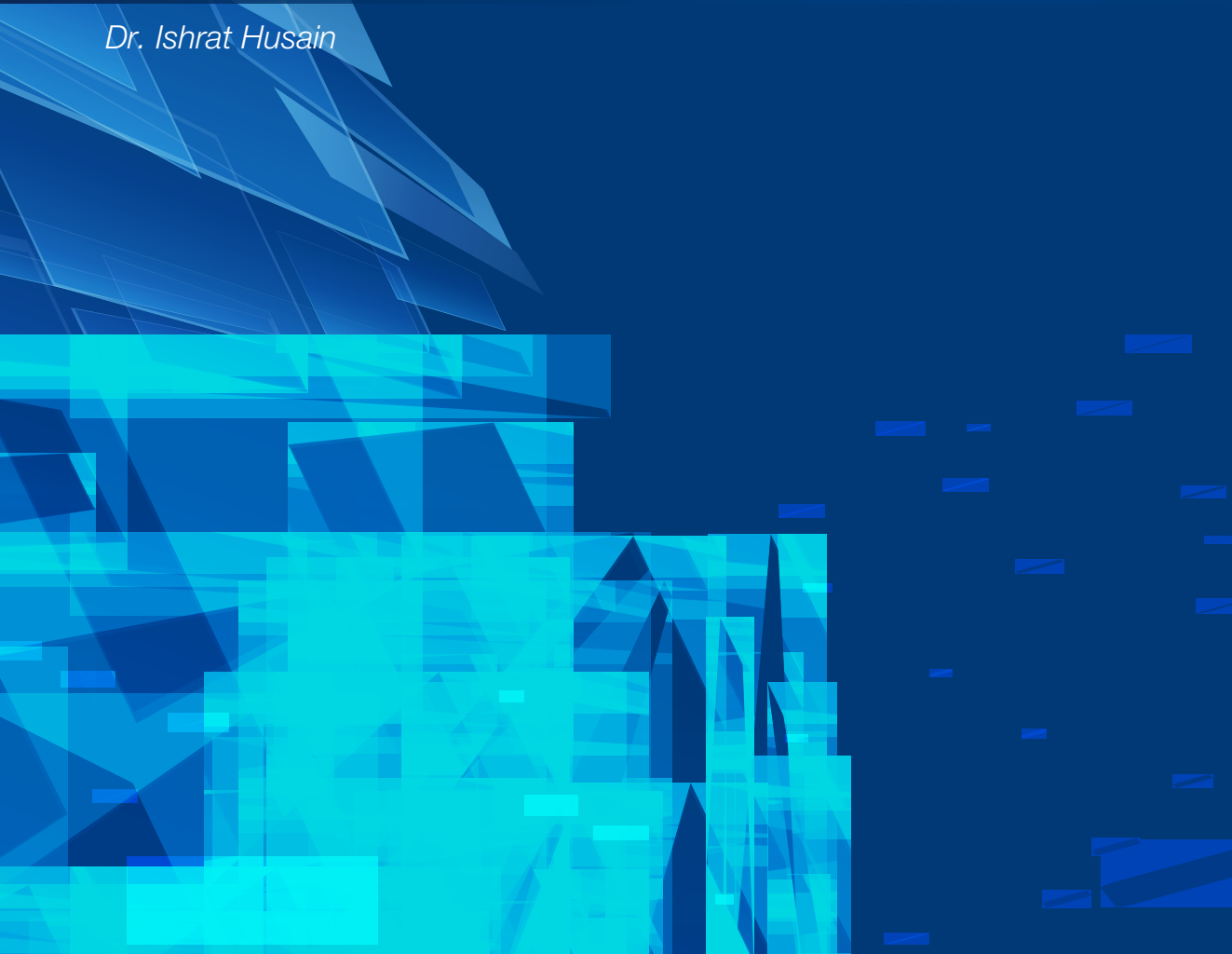
Both the government and private sector must play their part within a partnership to take Islamic finance to where it needs to be in the larger scheme of things. The government enables and facilitates, while the private sector executes. The cons of only one dominating the push for Islamic finance is clear: The industry would not grow and, if there is development, it would be weak without a real impact to the country. Hence, the public-private partnership must exist to take the initiative of Islamic finance to great heights in any particular jurisdiction. The pros of this proposition can be clearly seen from the success in the Malaysian financial market—the world's largest and most dynamic marketplace for Islamic finance.



CHAPTER 8

The Way Forward: Key Islamic Finance Challenges and Road Map for Asia

Dr. Ishrat Husain



The way forward for the global Islamic finance industry¹ has to be built upon an edifice where the distinctive and unique characteristics and the fundamentals of Islamic finance are closely set out, understood, and disseminated widely. In this regard, a

critical question posed forward is: What makes Islamic finance more stable and resilient against anticipated shocks vis-à-vis conventional banks? Would it be the *Shari'ah*-compliant financial instruments themselves or the practices and processes of Islamic finance?

Islamic Finance: The Resilience Factors

The Islamic financial system is built-in with principles of *Shari'ah* that naturally incorporate several factors promoting market discipline, stability, resilience, and overall ethical practices that instill prudence and soundness in transactions. An Islamic banking system promotes a unique underlying relationship between the depositors and shareholders; by use of partnership and risk-sharing contracts such as *Mudharabah*, deposits structured as special accounts have the propensity to absorb losses as opposed to passing them in entirety to shareholders alone. This enables the capital adequacy ratios of Islamic banks to be at comparatively higher levels than those of conventional banks as the loss-absorbing properties of special investment accounts reduce the burden on the equity capital.

Meanwhile, the *Shari'ah* prohibition on investments involving exposures to highly risky and uncertain contractual outcomes is an important source of financial stability. As such, Islamic financial institutions are shielded from investments in highly leveraged and toxic assets such as securitized derivatives and other exotic products in conventional finance. During the onset of the global financial crisis, several conventional investment banks were found to be highly leveraged on funds from the money markets and then placing these borrowed funds on risky investments for quick gains. Excessive risk taking is a natural consequence of the asymmetric relationship between appropriation of rewards and incurrence of risks among conventional finance players. In an event of market financial downside,

the shareholding risks are limited to their equities and there is an underlying sense of assurance that the government bailout using taxpayer money can save the day. However, if the risky investments pay off, it will result in magnified profits for the shareholders and management of these investment banks.

In Islamic finance, leveraging on borrowed funds from the money markets is not a norm as Islamic banks usually have ample liquidity at their disposal and it is the dearth of productive assets that keeps deposits underdeployed. As a result, Islamic finance follows a course of natural rather than unnatural growth, because it does not permit the existence of invented or contrived money. These factors contribute toward a relatively stronger confidence of depositors in Islamic banks and it is widely regarded that during the peak of the crises, several conventional finance depositors transmitted their funds to Islamic banks for safekeeping. The asset-based and/or asset-backed nature of financial transactions in Islamic finance helps establish a link with the real economic sector and limits risks growing out of proportion beyond the real economy.

Furthermore, Islamic banks did not participate in exotic structuring of securitized assets which deeply affected the major conventional banks. Exotic products such as collateralized debt obligations, which resulted from slicing and dicing various loan portfolios into structured financial assets, would not obtain *Shari'ah* compliance from the *Shari'ah* supervisory boards of Islamic banks.

¹ This chapter is based on the panel discussion that took place at the final session of the Conference. The panel was led by two chairpersons: Rajat M. Nag (Former Managing Director General of the Asian Development Bank) and Jaseem Ahmed (Secretary-General of the Islamic Financial Services Board). In addition, the panel consisted of three speakers: Richard Thomas (Chief Representative for Gatehouse Bank in Malaysia), Baljeet Kaur Grewal (Managing Director and Vice Chairman of Kuwait Finance House Research), and Madzlan Mohamad Hussain (Partner at Zaid Ibrahim and Co. in Malaysia)

Overall, it is a combination of *Sharīah*-compliant financial instruments as well as practices and processes in compliance with *Sharīah* that contributes toward the stability and resilience of Islamic finance.

Risks and Challenges Impacting the Industry

During the first phase of the global financial crisis of 2008–2009, Islamic banks were largely insulated from adversities as they did not carry any contrived products on their books. However, in the second phase, when the broader economy was impacted and disposable household incomes were reduced, real estate prices fell drastically. Real estate was the natural hedge for Islamic banking transactions and as real estate prices went tumbling down, Islamic banks were also adversely affected. However, Islamic banks did not require any taxpayer bailouts as was witnessed in the case of major conventional banks. In some cases, Islamic banks recapitalized themselves through the *Sukūk* market. Islamic financial institutions had relatively higher capital adequacy which provided a better cushion in case they incurred unanticipated losses.

One of the fundamental challenges of the Islamic financial system is the need for a holistic and robust ecosystem including regulations. As the system is still gradually building its resilience, and the regulatory system, standards, infrastructure, and institutions are beginning to evolve, it remains largely untested. The adoption of the regulations and standards by the central banks has been a slow process and confined to only a few countries, even among the large membership of the Islamic Financial Services Board (IFSB). Some IFSB members have stated that the binding constraint is the lack of adequately trained and experienced human capital, rather than anything else.

On the other hand, the Islamic finance industry faces a crucial challenge of balancing between maintaining profitability in a competitive environment and sustaining social responsibility. There is apprehension that any trade-off that strengthens social responsibility may be achieved at the cost of making profits for the shareholders and account

holders which still remains the prime *raison d'être* for the existence of these banks. In contrast, the dilution of social responsibility may deviate from its distinctive and unique feature. The line between following ethical values, which is the core proposition of Islamic finance, and earning adequate returns at the same time in a market that is volatile and that has high credit risks and other business risks is not at all easy and straightforward.

Another risk identified from past practices is that of poor quality in Islamic financial institutions' management. People entrusted with the task of managing these institutions have come mainly from a background of conventional finance and failed to appreciate the peculiar set of complexities involved in Islamic finance. This inadequacy of a trained and uniquely focused managerial pool and human talent across the industry remains an obstacle to its growth.

The other challenge is to have strong and supportive governance systems at the level of individual institutions. Islamic banks have to ensure they instill confidence and nurture trust among their stakeholders by adopting best governance practices that incorporate features enjoined under *Sharīah*. Any deviations, scams, scandals, or shortcuts will put the industry a step back. Accordingly, the incentive structures and compensation packages should be designed in a way that avoids the pitfalls of conventional financial institutions (i.e., excessive bonus payments based on inflated indicators). Bonuses should be payable when the actual results from the investments financed by the banks become available and not when the quarterly or annual profits at aggregate levels are announced.

A prominent risk from a business perspective is the comparatively higher transaction cost of Islamic finance because of the additional requirement of

Sharīah compliance. When every transaction is held up because it has to be reviewed and endorsed by the *Sharīah* board, an element of uncertainty is added. If the edicts and opinions of *Sharīah* boards were standardized and could be made available for ready reference, the structuring of transactions would not take up many resources, be it time or human. The manufacturing and marketing of preapproved *Sharīah*-compliant products on a large scale will mitigate this risk. Transaction costs can be reduced if the probability of predefault and postdefault events is minimized by careful screening and forceful monitoring under Islamic finance modes.

Meanwhile, the issue of liquidity availability for Islamic banks has been a long-standing concern affecting the industry. Unlike conventional banks, which have recourse to an active interbank money market, Islamic banks do not enjoy such a facility. The absence of liquidity management instruments puts Islamic banks at a serious disadvantage relative to their competitors in the market.

Moving Forward: A Road Map for Asia

In the next 10 years, Asia has an \$8 trillion investment gap that needs to be financed. This is an investment gap which may not be funded by conventional finance alone. On the contrary, the asset-backed nature of Islamic finance provides a better match for infrastructure projects. There are tremendous opportunities for Asia to expand the Islamic finance industry in order to support the fast growing economies of the region. Islamic finance is able to support many strategic areas such as financial inclusion, infrastructure investment needs, and insurance penetration as well as further attract funds to flow into the region. Asian markets are home to a large Muslim population, which facilitates a ready market for the introduction and distribution of *Sharīah*-compliant products and services, particularly for retail banking and *Takāful*. The progress that Asian countries have made represents more opportunities for the region to benefit from this rapidly growing *Sharīah*-compliant industry.

Finally, promotion of awareness about Islamic finance and financial literacy are critically important but have been neglected so far. There is no clearly defined responsibility as to who is going to carry out this function. In some countries, it has been a state-led approach for promoting Islamic finance; in others, it has been left to market forces through a demand-led approach to develop the system. Although there may be no uniform answer to this issue and each country will have to customize in relation to its own circumstances, governments or central banks have to take the lead by putting in place credible legislative, institutional, and regulatory structures. Market players, the media, educational institutions, and chambers of commerce and industry have to play an equally important role. Overall, the future road map for Islamic finance should be based on its unique selling proposition and on a proper governance framework in which the roles and responsibilities of the *Sharīah* board and the extent of its autonomy are clearly defined vis-à-vis other shareholders and management.

Asia is a pivotal part of both the global economy and the Islamic financial system, operating as a driving force of world economic growth. At present, the Islamic financial landscape in Asia is dominated by the Islamic banking and *Sukūk* sectors, which have driven Asia's robust growth trajectory in recent years, accounting for a combined value of over \$390 billion or 21.7% of global Islamic financial assets as at the end of 2013. Islamic asset management remains a nascent but budding industry in Asia which has seen steady growth following the financial crisis. The *Takāful* industry accounts for less than 1.0% of regional Islamic financial assets, despite a significant growth in the number of *Takāful* operators, highlighting considerable potential growth for the future.

The Islamic finance road map for Asia needs to start by making a realistic assessment and taking stock of the needs and requirements of the various markets.

It will then be feasible to match different Islamic financial solutions with the requirements of the market. Some of these solutions have already been tried in advanced Islamic economies and can be modified and adapted. In other cases, solutions have to be found by engaging the various stakeholders in these countries. The road map should be a constellation of developing policy, having an enabling environment, developing the laws, strengthening the regulatory framework, and making progress in capacity building.

Some countries in Asia have progressed well in terms of developing their Islamic finance industry because of the promotional support by the central banks. For example in Malaysia, Bank Negara Malaysia played

a pioneering role in guiding and steering the process of development of Islamic finance. The progress is impressive and Islamic finance represents more than 25.0% of the country's banking assets and nearly 57.0% of its capital market. Individual countries need to assess the structures and maturities of their financial markets when designing and delivering appropriate Islamic finance regulations. If successful ecosystems from other countries are introduced in a market without testing or investigation, the adaptation may not always be successful.

To end, Islamic finance has the potential to be an alternative to the existing financial system, but it still faces many challenges and risks that have to be managed and mitigated first.

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GLOSSARY

1.	Bay Ul Dayn	The sale of payable right either back to the debtor or to another third party. The payable right (debt) can be either money or commodity.
2.	Bay Ul Inah	A contract involving the sale and buy-back transaction of assets by a seller. A seller sells an asset to a buyer on a cash basis and later buys it back on a deferred payment basis where the price is higher than the cash price. It can also be applied when a seller sells an asset to a buyer on a deferred basis and later buys it back on a cash basis, at a price which is lower than the deferred price.
3.	Commodity Murābahah	A Murābahah-based purchase and sale transaction of Sharī'ah-compliant commodities, whereby the buyer purchases the commodities on a deferred payment basis and subsequently sells them to a third party on a cash payment basis.
4.	Diminishing Mushārakah	Diminishing Mushārakah or Mushārakah Mutanaqisah is a form of partnership in which one of the partners (customer) promises to buy the equity share of the other partner (financier) gradually until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, followed by the financier leasing his equity share to the customer throughout the tenure of the lease, the customer will gradually buy the other financier's share at market value or the price agreed upon at the time of entering into the contract. The "buying and selling" contract is independent from the partnership contract and should not be stipulated in the partnership contract since the buying partner is only allowed to give only a promise to buy. It is also not permitted for one contract to be entered into as a condition for concluding the other.
5.	Fatāwa (sing. fatwa)	A juristic opinion or pronouncement of facts given by the Sharī'ah board, a mufti, or a faqīh on any matter pertinent to Sharī'ah issues, based on the appropriate methodology.
6.	Fiqh	Knowledge of the legal rulings pertaining to conduct, which has been acquired from specific evidence in the Sharī'ah.
7.	Hamish al jiddiyyah	An amount of security deposit held as collateral by the institution offering Islamic financial services (IIFS) upon giving a binding promise. The purpose of Hamish al jiddiyyah is to determine the financial capacity of the customer and his seriousness in fulfilling the binding promise. The IIFS will take the amount of actual damage from the Hamish al jiddiyyah in case the customer breaches his undertaking.
8.	Hibāh	A unilateral transfer of ownership of a property or its benefit to another without any counter-value from the recipient.
9.	Ijārah	An Ijārah contract refers to an agreement made by an institution offering Islamic financial services to lease to a customer an asset specified by the customer for an agreed period against specified installments of lease rental. An Ijārah contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the Ijārah contract.
10	Ijma:	Consensus, usually on a given issue as represented by the agreement of the jurists.

11.	Istisnā`	An Istisnā` contract refers to an agreement to sell to a customer a non-existent asset, which is to be manufactured or built according to the buyer's specifications and is to be delivered on a specified future date at a predetermined selling price.
12.	Islamic window	An Islamic window is part of a conventional financial institution (which may be a branch or a dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are <i>Sharī'ah</i> -compliant.
13.	Mu'amalat	Economic transaction related to exchange of goods and services including financial transactions.
14.	Muḍārabah	A Muḍārabah is a contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity, which is to be managed, by the entrepreneur as the Muḍārib (or labor provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the Muḍārabah agreement while losses are to borne solely by the capital provider unless the losses are due to the Muḍārib's misconduct, negligence, or breach of contracted terms.
15.	Murābahah	A Murābahah contract refers to a sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in their possession at cost plus an agreed profit margin (selling price).
16.	Murābahah for the Purchase (Murābahah lil Amir bi Shira') (MPO)	An MPO contract refers to a sale contract whereby the institution offering Islamic financial services (IIFS) sells to a customer at cost plus an agreed profit margin (selling price), a specified kind of asset that has been purchased and acquired by the IIFS based on a promise to purchase from the customer, which can be binding or non-binding.
17.	Mushāarakah	A Mushāarakah is a contract between the institution offering Islamic financial services and a customer to contribute capital to an enterprise, whether existing or new, or to own a real estate or movable asset, either on a temporary or permanent basis. Profits generated by that enterprise or real estate/asset are shared in accordance with the terms of Mushāarakah agreement while losses are shared in proportion to each partner's share of capital.
18.	Qard	A non interest bearing loan intended to allow the borrower to use the loaned funds for a period with the understanding that the same amount of the loaned funds would be repaid at the end of the period.
19.	Qiyas	The process of analogical reasoning as applied to the deduction of juridical principles from the <i>Qur'an</i> and the <i>Sunnah</i> .
20.	Salam	A Salam contract refers to an agreement to purchase, at a pre-determined price, a specified kind of commodity not available with the seller, which is to be delivered on a specified future date in a specified quantity and quality. The institution offering Islamic financial services, as the buyer, makes full payment of the purchase price upon execution of a <i>Salām</i> contract. The commodity may or may not be traded over the counter or on an exchange.
21.	Sharī'ah	Divine Islamic law that encompasses all aspects of human life as revealed in the <i>Qur'an</i> and the <i>Sunnah</i> .

22.	Sharī'ah supervisory board	A specific body set up or engaged by the institution offering Islamic financial services to supervise its Sharī'ah compliance and governance system.
23.	Sukūk (sing. Sakk)	Sukūk (certificates), each of which represents the holder's proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such an asset.
24.	Tabarru'	Grant of property by a person with complete legal capacity without any compensation. In the context of Takāful operations, Tabarru' is the amount of contribution to be relinquished by the Takāful participant as a donation for fulfilling the obligation of mutual help and to be used to pay claims submitted by eligible claimants.
25.	Takāful	Takāful is derived from an Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly against a specified loss. In a Takāful arrangement, the participants contribute a sum of money as tabarru' (donation) into a common fund, which will be used for mutual assistance of the members against specified loss or damage.
26.	Urbūn	Urbūn is earnest money held as collateral (taken from a purchaser or lessee) to guarantee contract performance after a contract is established.
27.	Wa'd	A promise to perform certain action(s) in the future.
28.	Wad'ah	An amount deposited whereby the depositor is guaranteed his or her fund in full.
29.	Wakālah	An agency contract where the customer (principal) appoints the institution offering Islamic financial services as an agent (wakīl) to carry out business on their behalf.
30.	Waqf	An endowment of charitable trust in the meaning of holding certain property and preserving it for the confined benefit for a certain charitable objective and prohibiting any use or disposition of it outside that specific objective.
31.	Zakah	An obligatory contribution or tax which is prescribed by Islam on all Muslim persons having wealth above an exemption limit at a rate fixed by the <i>Sharī'ah</i> .

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