









Islamic Financial Services Industry Development: Ten-Year Framework and Strategies

A MID-TERM REVIEW











Islamic Research & Training Institute (IRTI)

Establishment

The Islamic Research and Training Institute (IRTI) was established by the Board of Executive Directors (BED) of the Islamic Development Bank (IDB) in conformity with paragraph (a) of the Resolution No. BG/14-99 of the Board of Governors adopted at its Third Annual Meeting held on 10th Rabi-ul-Thani, 1399H corresponding to 14th March, 1979. The Institute became operational in 1403H corresponding to 1983. The Statute of the IRTI was modified in accordance with the resolutions of the IDB BED No.247 held on 27/08/1428H.

Purpose

The Institute undertakes research for enabling the economic, financial and banking activities in Muslim countries to conform to Sharī ah, and to extend training facilities for personnel engaged in development activities in the Bank's member countries.

Functions

The functions of the institute are to:

- A. Develop dynamic and innovative Islamic Financial Services Industry (IFSI).
- B. Develop and coordinate basic and applied research for the application of Sharī'ah in economics, banking and finance.
- C. Conduct policy dialogue with member countries.
- D. Provide advisory services in Islamic economics, banking and finance.
- E. Disseminate IFSI related knowledge through conference, seminars, workshops, apprenticeships, and policy & research papers.
- F. Provide learning and training opportunities for personnel engaged in socio-economic development activities in member countries.
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Establishment

The Islamic Financial Services Board (IFSB), which is based in Kuala Lumpur, was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. It serves as an international standard-setting body of regulatory and supervisory agencies that have vested interest in ensuring the soundness and stability of the Islamic financial services industry, which is defined broadly to include banking, capital market and insurance. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with Sharī ah principles, and recommend them for adoption. To this end, the work of the IFSB complements that of the Basel Committee on Banking Supervision, International Organisation of Securities Commissions and the International Association of Insurance Supervisors.

As at April 2014, the 184 members of the IFSB comprise 59 regulatory and supervisory authorities, eight international inter-governmental organisations, 111 financial institutions and professional firms as well as six self-regulatory organisations (industry associations and stock exchanges) operating in 45 jurisdictions.

Malaysia, the host country of the IFSB, has enacted a law known as the Islamic Financial Services Board Act 2002, which gives the IFSB the immunities and privileges that are usually granted to international organisations and diplomatic missions.

Adoption of Standards

As at April 2014, the IFSB has issued twenty-two Standards, Guiding Principles, Guidance and Technical Notes for the Islamic financial services industry. The Standards and Guidelines prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines which involve, among others, the issuance of exposure draft and, where necessary, the holding of a public hearing.

Awareness Promotion

The IFSB is actively involved in the promotion of awareness of issues that are relevant or have an impact on the regulation and supervision of the Islamic financial services industry. This mainly takes the form of international conferences, seminars, workshops, trainings, meetings and dialogues staged in many countries.

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Bismillāh al-Rraḥmān al-Rraḥīm

Allāhumma şalli wa-sallim 'ala Sayyidinā Muḥammad wa-'ala ālihi wa- saḥbih

FOREWORD

We are pleased to present this review of progress made in the Islamic financial services industry (IFSI). The current review marks an interim assessment of the industry since the publication of the Ten-Year Framework for the development of the IFSI, issued by the Islamic Financial Services Board (IFSB) and the Islamic Research and Training Institute (IRTI) in 2007.

As the report discusses, much has been achieved in the industry over the past years. Growth, resilience and geographic expansion have been hallmarks of the industry despite challenging global macroeconomic conditions. Modern Islamic finance is, by many accounts, stronger and better developed than at any time in its 40-year history.

The industry's considerable achievements have not been without controversy, as voices have been raised regarding the authenticity of some of the innovations introduced. This conflict between innovation and authenticity is a healthy one, as is the participation in Islamic finance of conventional industry players with expertise in financial engineering. The balance between what seems to some as an excessive reliance on ideas and structures from conventional finance will over time shift as knowledge, skills, the market and, above all, consumer feedback shape the future. Islamic finance jurisdictions and institutions are now moving towards new range of products and services with the emergence of expertise, knowledge and skills in Islamic finance in the many centers of its global practice.

While the development of Islamic financial markets has flourished in line with the market generally, in many cases this has been characterised by wider rather than deeper markets. Deep and vibrant capital markets appear to be evident only where the legal and financial infrastructure and governance mechanisms are strong.

This raises the issue of the necessary balance to be struck between public and private sectors in the further advancement of Islamic finance. The private sector role remains critical to Islamic finance, but it can be enhanced – and, indeed, amplified – through a stronger public policy posture that focuses on the key areas where public support or public–private partnerships are important. The industry needs not just a level playing field, but also a strong guiding hand.

Raising public awareness remains a critical issue for the global industry, and there is a role here for both public and private sectors, and for a sharing of views and information between them. Better risk management, both at the macroeconomic level and within individual financial institutions, remains vital to the growth and resilience of the global industry. Here, too, a strong public policy posture is needed to strengthen the incentives to improve risk management capabilities within the private sector.

We invite you to examine the findings of the enclosed report and its applicability to your institution, country and sector. We remain deeply committed to furthering the development of the IFSI, and are hopeful that this report may be of service to this end.

Professor Dato Dr. Mohd Azmi Omar Director General Islamic Research and Training Institute Jaseem Ahmed Secretary-General Islamic Financial Services Board



ACKNOWLEDGEMENTS

In its 10th meeting on 26 March 2007, the Council of the IFSB approved a draft document entitled "Islamic Financial Services Industry Development (IFSI): Ten-Year Framework and Strategies", which was jointly prepared by the Islamic Development Bank/Islamic Research and Training Institute (IDB/IRTI) and the IFSB. In its 19th meeting held on 17 November 2011, the Council approved the proposal to review the Ten-Year Framework, following a recommendation on the need for a mid-term review in the 6th IDB Global Forum on Islamic Finance in June 2011. Subsequently, the IFSB and IRTI took the initiative to review the 2007 Ten-Year Framework.

At the direction of the IFSB's Council, the Mid-Term Review was prepared under the supervision of the IFSB Technical Committee through a sub-committee established in June 2012 that outlined the roadmap for the review of the Ten-Year Framework. The sub-committee comprised Mr. Bakarudin Ishak, Bank Negara Malaysia; Mr. Zainal Izlan Zainal Abidin, Securities Commission of Malaysia; Mr. Haseeb Ullah Siddiqui, IDB; and Mr. Lotfi S. Zairi, The Islamic Corporation for Insurance of Investments and Export Credits. The sub-committee was supported by a joint team from the IFSB Secretariat and IDB/IRTI. The roadmap, which included proposals on the approaches and methodologies, the work programme, and the establishment of a High Level Review Committee, was followed by an extensive process of consultation and drafting that benefited from the involvement of a broad set of contributors.

The drafting of the Mid-Term Review of the Ten-Year Framework was undertaken by a team of writers, led by Mr. Aamir A. Rehman of Fajr Capital Advisors, UAE. The team consisted, in the first phase, of Professor Habib Ahmed, Sharjah Chair in Islamic Law and Finance, Durham University, UK; Professor Obiyathulla Ismath Bacha, Dean of Graduate Studies, International Centre for Education in Islamic Finance (INCEIF), Malaysia; and Mr. Iqbal Asaria, CBE, Associate, Afkar Consulting, London, UK.

The Mid-Term Review Report also benefited immensely from the comments and feedback received from the IFSB Council and Technical Committee, the High Level Review Committee for the Mid-Term Review project, as well as participants in the Mid-Term Review forums convened in Doha (April 2013) and Kuala Lumpur (May 2013), hosted by Qatar Central Bank and Bank Negara Malaysia, respectively. Special thanks goes to H.E. Sanusi Lamido Aminu Sanusi, the then Governor, Central Bank of Nigeria, for chairing the High Review Committee meeting on 17 September 2013 in Istanbul, Turkey, which was hosted by the Banking Regulation and Supervision Agency of Turkey, and which provided key guidance on the finalisation of the document.

Following this, the IFSB and IRTI/IDB appointed Fajr Capital Advisors to finalise the Report. In this exercise, Mr. Aamir A. Rehman was supported by Mr. Abdur-Rahman Syed and Mr. Syabil 'Arifin Jamil from Fajr Capital Advisors.

In addition to thanking each of the above individuals and institutions, we would also like to express our thanks to the various multilateral organisations in the IFSI for their feedback and support, the regulatory and supervisory authorities as well as institutions offering Islamic financial services (IIFS) in various jurisdictions who participated in the Mid-Term Review Survey, as well as Taylor Nelson Sofres Malaysia Sdn Bhd who contributed to the preparation of the report by assisting in the survey analysis.

The project was led jointly by IFSB and IRTI. The IFSB team consisted of Mr. Abdelilah Belatik (Assistant Secretary-General, IFSB at the time), Mr. Zahid ur Rehman Khokher (Assistant Secretary-General, IFSB) and Ms. Noor Ashikin Ismail (Member of the Secretariat, Technical and Research, IFSB) as Joint Project Coordinator from IFSB. The IRTI team consisted of Dr. Salman Syed Ali (Senior Economist, IRTI), Dr. Abdul Ghaffar Ismail (Manager, Islamic Economics and Finance Research Department, IRTI) and Dr. Hylmun Izhar (Economist, IRTI) as Joint Project Coordinator from IRTI.

The IFSB-IRTI Joint Secretariat would also like to thank Mr. Jaseem Ahmed, Secretary-General of the IFSB, and Professor Dato Mohd Azmi Omar, Director General of IRTI, for their contribution, guidance and supervision throughout the Mid-Term Review process.

The Secretariat is grateful to all these individuals for their guidance, written and oral contributions, and active engagement throughout the Mid-Term Review process. Indeed, the Mid-Term Review of the Ten-Year Framework would not have been successful without the firm commitment and cooperation by all parties. We collectively offer this vital project to our members as a strategic roadmap in developing the IFSI.

The IFSB-IRTI Joint Secretariat Mid-Term Review

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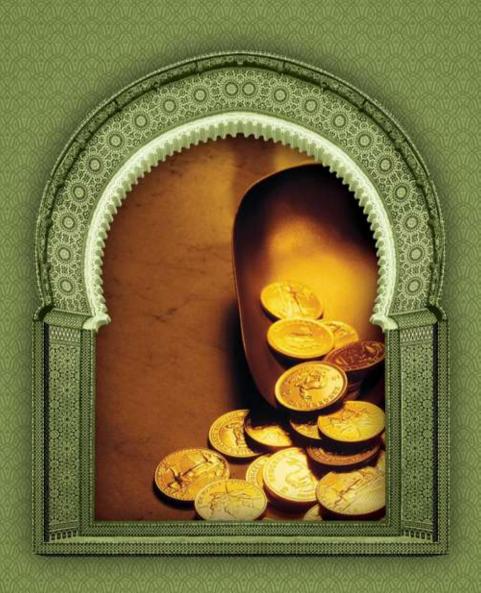
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1 EXECUTIVE SUMMARY

1 EXECUTIVE SUMMARY

The contemporary Islamic financial services industry (IFSI) is evolving. It now has 40 years of experience, and this experience builds on a long legacy of principles and financial practices throughout Muslim societies. The industry is rooted in a set of principles, including the establishment of economic justice, the equitable distribution of wealth, and the channeling of savings towards productive and beneficial real economic activity.

1.1 The Ten-Year Framework

In March 2007, the Islamic Development Bank (IDB) and Islamic Financial Services Board (IFSB) published a pivotal document on the state and future of the IFSI. The report, entitled "Islamic Financial Services Industry Development: Ten-Year Framework and Strategies" ("Ten-Year Framework"), sought to lay out a roadmap for the development of this rapidly evolving and strategically vital industry.

The Ten-Year Framework provided an overview of the industry, highlighting key opportunities and challenges. The document also offered 13 core recommendations for the development of the industry.

1.2 Goals of the Mid-Term Review

In 2013, the IDB and IFSB initiated a mid-term review of the Ten-Year Framework ("Mid-Term Review") as more than half of the period has passed. The Mid-Term Review seeks to assess the impact of macroeconomic events, to monitor progress in implementing the recommendations, and to propose additions or modifications to the recommendations to guide the industry. The current document reports the findings of this Review, with the following goals in mind:

- to assess the impact on the respective Islamic finance segments arising from developments in the global financial system post-crisis;
- to examine the progress and current status of the priorities and initiatives suggested in the Ten-Year Framework and Strategies;
- · to identify the gaps involved in implementing the priorities and initiatives; and
- · to assess the need for a re-orientation of such priorities and initiatives.

The Mid-Term Review thus seeks both to assess progress made by the industry in implementing the 2007 recommendations, and to amend the recommended Ten-Year Framework in the light of developments since its publication.

1.3 Key Findings

The Mid-Term Review has generated the following key findings:

The industry has shown growth and resilience

The IFSI continues to thrive. The industry has shown positive signs of development, with growing market share, an expanding number of institutions, and numerous industry-level initiatives under way. This expansion is a reflection of customer confidence in the industry, whose concept is proven in many markets.

Islamic finance is an integral part of the financial systems of IDB member countries and IFSB members ("member countries"), and has deservedly been a key area of focus for central banks, regulators and governments as part of their overall financial services strategies. Fostering the IFSI is consistent with policy objectives to expand consumer choice, to foster financial inclusion, and to attract foreign investment.

The industry's resilience has been evident in its ongoing expansion and profitability despite a series of financial crises or external forces affecting the financial systems of member countries, regions and the world at large.

Macroeconomic events or external factors have brought both challenges and opportunities

The global financial services industry has changed substantially since 2007. The level and pace of change have been higher than expected, with changes of a fundamental nature taking place in a short span of time. These shifts create both opportunities and challenges for the IFSI. Embracing and adapting to these shifts can position the industry for long-term growth; failing to do so would be a lost opportunity for the industry and for the economies it serves.

The IFSI has not been immune from crises or external factors facing the global financial system. These crises have had both direct and indirect impacts on the industry as they have affected the economies of member countries, the approach to financial regulation, the strength of partners and counterparties, and the value of assets and investments.

Nevertheless, there have been opportunities created by macroeconomic and sector-level change. Member countries have acted as important centres of growth as the global economy has stumbled. Political developments in recent years have also made several member countries more open to Islamic financial services and the benefits it offers. Technological innovations such as branchless financial services are now available and can allow the industry to broaden its future reach.

These developments underscore the changing policy and financial environment globally in which alternative sources of funding for economic development are being prioritised as traditional sources from developed countries come under strain. At the same time, there is greater recognition in Western jurisdictions that Islamic financial services can contribute to the stability of their broader financial systems. Most of all, perhaps, is the recognition by the global community that the IFSI industry has durable commitments from an expanding range of stakeholders.

The development of the industry has varied by sector

Islamic banking remains the most developed sector of the industry. Its governance, supervision and regulation have likewise remained most developed, as banking authorities recognise and include Islamic banking in their overall regimes. The Islamic banking sector is reported to have grown at an annual rate of 16% in the period 2008–2012, reaching USD1.7 trillion by the year 2013.¹ Estimates of the asset size and growth rate vary significantly (another report, for example, estimates banking assets to be USD950 billion,² while the IDB's database has estimated USD1.3 trillion³); however, the consistent findings are that the sector is rapidly increasing, with assets near or above USD1 trillion. Moreover, nearly three-quarters of the industry's assets are in the banking sector: it is estimated that 73% of total Islamic finance assets worldwide are banking assets.⁴

Islamic capital markets – and especially *Sukūk* markets – have also developed significantly. Total annual issuance volume has gone from USD46.4 billion in 2007 to USD139 billion in 2012. Starting from a low base, this is nonetheless a near-threefold increase, with a five-year CAGR of 24.5% in issuance. Although the market values of certain *Sharī`ah*-compliant instruments have shown mixed performance due to overall capital market challenges and *Sharī`ah*-related challenges remain, the breadth and sophistication of such instruments has improved.

Islamic non-banking financial institutions (NBFIs) continue to grow and play an important role in meeting the objectives of the industry. Islamic investment banks, asset managers, principal investors, Islamic microfinance and specialised financial institutions have remained active. Although the Islamic financial sector appeared to have performed better than its conventional counterparts in the immediate aftermath of the global financial crisis, it was eventually affected due to economic interlinkages, and investment banks were affected disproportionately.

¹ Ernst & Young, World Islamic Banking Competitiveness Report, 2013–14.

² ICD and Thomson Reuters, Islamic Finance Development Report 2013.

³ Islamic Banks Information System (IBIS) IRTI-IDB database, using data from 69 major Islamic banks.

⁴ ICD and Thomson Reuters, Islamic Finance Development Report 2013.

Charitable institutions such as $Awq\bar{a}f$ and $Zak\bar{a}h$ funds, as well as socially oriented institutions such as pilgrimage funds, continue to play an important role in the section and for society overall.

In the meantime, Islamic microfinance has transitioned from a concept with isolated case studies to a fledgling sector across multiple markets. A 2013 study by the World Bank-backed Consultative Group to Assist the Poor (CGAP) accounted for 255 Islamic microfinance institutions serving 1.28 million clients across 19 countries. Even so, this customer base represents less than 1% of microfinance clients worldwide.⁵

A similar shift can be observed in the *Takāful* and *ReTakāful* sector. Market estimates vary, but a consistent finding is that the sector has grown significantly in the review period.⁶ According to a 2013 study, global gross *Takāful* contributions stood at approximately USD11 billion at yearend 2012, more than two-and-a-half times the total in 2007.⁷ A vital component of the industry and a sector with much potential, *Takāful* still needs to address fundamental questions about its business models before it can make further headway.

1.4 Updated Framework Recommendations

The 13 framework recommendations proposed in the Ten-Year Framework and Strategies Report remain pertinent. To more accurately reflect the current status of the IFSI, modest changes have been made to some of the original recommendations, three recommendations have been added, and the updated set has been grouped according to three themes:⁸

- Enablement: fostering conditions for the industry to thrive;
- Performance: enhancing the effectiveness of institutions active in the industry; and
- Reach: expanding the set of potential beneficiaries of the industry.

The 16 recommendations from the Mid-Term Review (retaining the numbering of the 2007 Framework except where the recommendations are new) are reproduced below. The new recommendations (numbers 14–16) are marked with an asterisk (*):

⁵ Mayada El-Zoghbi and Michael Tarazi (2013), "Trends in Sharia-Compliant Financial Inclusion", CGAP Focus Note No. 84, March.

⁶ Ernst & Young Global Takaful Insights 2013. We note that various sources define Takaful differently, and thus calculate the market size with varying parameters.

⁷ Ibid

⁸ The original framework categorised recommendations as institutional and infrastructural; the new categorisation focuses on the outcomes desired from the framework

	Enablement	
1	Facilitate and encourage the operation of free, fair and transparent markets in the Islamic financial services sector	
5	Develop the required pool of specialised, competent and high-calibre human capital	
6	Promote the development of standardised products through research and innovation	
8	Develop an appropriate legal, regulatory and supervisory framework, as well as an IT infrastructure that would effectively cater for the special characteristics of the IFSI and ensure tax neutrality	
9	Develop comprehensive and sophisticated interbank, capital and hedging ⁹ market infrastructures for the IFSI	
12	Foster collaboration among countries that offer Islamic financial services	
14*	Develop an understanding of the linkages and dependencies between different components of Islamic financial services to enable more informed strategic planning to be undertaken	
	Performance	
2	Enhance the capitalisation and efficiency of institutions offering Islamic financial services (IIFS) to ensure that they are adequately capitalised, well-performing and resilient, and on par with international standards and best practices	
4	Enhance Sharī'ah compliance, effectiveness of corporate governance and transparency	
7	Enhance the implementation of the international prudential, accounting and auditing standards applicable to the IFSI	
11	Strengthen and enhance collaboration among the international Islamic financial infrastructure institutions	
15*	Foster and embrace innovative business models, including new technologies and delivery channels, in offering Islamic financial services	
	Reach	
3	Enhance access by the large majority of the population to financial services and enhance access to funding for SMEs and entrepreneurs	
10	Promote public awareness of the range of Islamic financial services	
13	Conduct initiatives and enhance financial linkages to integrate domestic IFSI with regional and international financial markets	
16*	Strengthen contributions to the global dialogue on financial services, offering principles and perspectives to enhance the global financial system	

 $^{^{9}}$ Although the term derivatives was used in the 2007 document, it has been recommended that the phrase hedging be used as a more appropriate description.

Progress on 2007 recommendations has been mixed

Progress made on the original recommendations has been mixed. Several member countries have seen rapid improvement in legal and regulatory frameworks as well as associated market infrastructure. In other member countries, these improvements have not yet been made. Many countries have adopted international standards specific to Islamic financial services; many have not yet fully done so.

In certain countries, the pool of specialised talent with Islamic finance expertise is growing rapidly. Public awareness – while remaining a challenge – has enabled the Islamic finance industry to continue expanding its market share.

At this mid-term juncture, most of the recommendations require greater focus from member countries in order to reach the aspirations envisioned within the ten-year period. The work remains largely unfinished.

Key Performance Indicators have been proposed to monitor progress

While the 2007 document provided recommendations, the metrics for tracking progress were generally not articulated. Such metrics are crucial for assessing progress.

The Mid-Term Review thus proposes a set of Key Performance Indicators (KPIs) to be used to measure progress in each recommendation. It is suggested that member countries adopt these KPIs as important measures, and track them on a regular basis. Member countries are urged to set national targets for these KPIs, and record progress made towards meeting those targets. Doing so can help ensure concrete implementation and advancement of the recommendations.

A stronger implementation plan has been proposed

To complement the recommendations, the Mid-Term Review proposes a stronger implementation plan. This plan includes concrete initiatives – to be undertaken by a range of stakeholders – to bring the recommendations to life. Among these stakeholders, central banks and governments are especially important in driving implementation.

1.5 Diversity of Approaches

Member countries are a diverse group of nations. They span a range of regions, cultures and stages of economic development. They adopt a range of Islamic law, common law and civil law jurisdictions. The report's sponsors and the Review Committee appreciate that expectations must vary from country to country.

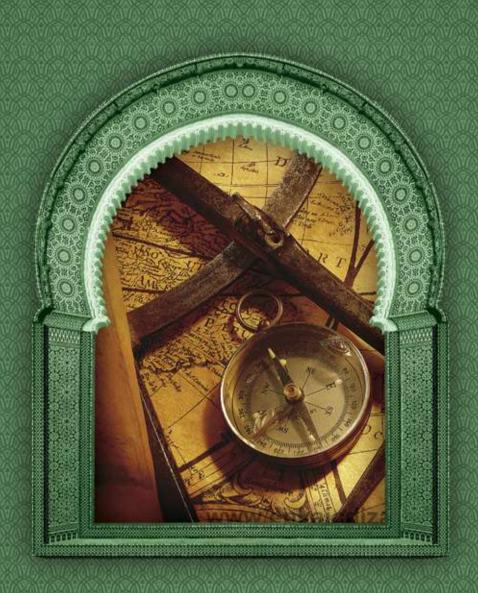
In conducting the Mid-Term Review, it was observed that diverse views were particularly salient in regards to whether:

- countries should have specific laws for Islamic financial services or rather fit Islamic structures into a single set of financial services laws;
- countries should adopt national-level Sharī'ah boards or retain Sharī'ah governance solely at the institutional level;
- central banks should allow conventional institutions to offer Islamic financial services;
- the adoption of international standards specific to Islamic finance is essential; and
- product standardisation should be a policy objective.

While diversity of use in these areas is appreciated, a key underlying theme is that a supportive public policy stance is essential for enabling the industry to reach its full potential. Member countries have been successful under various models; each choice brings benefits and drawbacks. Nevertheless, a strong and supportive public policy stance can help contribute to greater confidence that energises the private sector.

The report therefore does not seek to prescribe specific approaches to the choices above. It does, however, urge member countries to deliberate carefully on these matters and form well-considered strategies. We hold that Islamic financial services offer benefits to the people and economies of member countries, and advocate thoughtful strategies on how these benefits can best be availed.





2 METHODOLOGY



2 METHODOLOGY

The Mid-Term Review has been undertaken through a methodology combining expert input, independent review and a detailed survey.

Key elements of the methodology included:

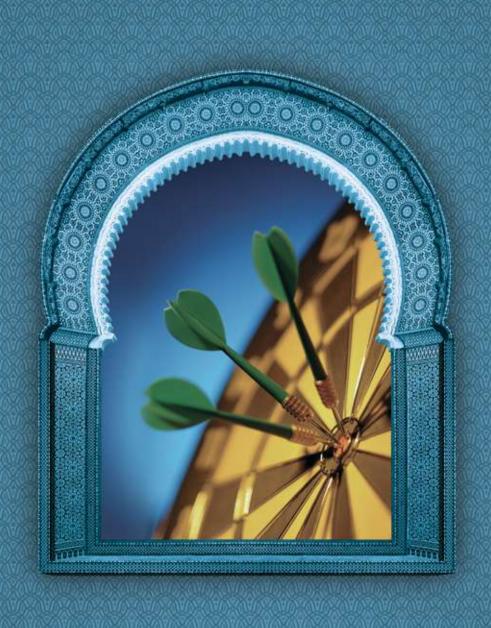
- Expert input, including drafting by a group of specialised consultants;
- A detailed survey on the state of the industry, collecting data from supervisory bodies and private sector participants;
- Robust review by both the Technical Committee of the IFSB and a set of independent reviewers (Review Committee) comprising regulatory and supervisory authorities, international intergovernmental organisations, professional firms, *Sharī`ah* scholars, academicians, as well as prominent individuals of the IFSI;
- A series of interactive presentations and roundtable feedback, solicited at forums in Doha and Kuala Lumpur, as well as at a Review Committee meeting in Istanbul between April and September 2013; and
- Final review by senior review bodies of the IFSB and IDB Group, including a committee of Central Bank Governors from member countries.

The Review therefore combines the considered views of industry experts with a set of survey input from both public and private sector stakeholders. In adopting this methodology, the IDB and IFSB have sought a blend of qualitative and quantitative input provided by a diverse set of contributors.

The Review comprises several analytical sections, the interrelationships among which can be illustrated with the following conceptual diagram:

Figure 1: Conceptual Flow of the Mid-Term Review





3 OVERALL ASSESSMENTS

3 OVERALL ASSESSMENTS

3.1 Commentary on Overall Progress

Tracking the overall progress of the industry is a challenging task. The degree of progress made varies substantially from sector to sector within the industry (for example, in Islamic banking as compared to *Takāful* and *ReTakāful*). Additionally, the advancement of the industry varies a great deal from country to country. Commentary on overall progress, therefore, can only be general in nature.

Despite these inherent challenges, there is merit in taking an overall snapshot of progress made in the IFSI since 2007. Such a snapshot allows for a macro understanding of the areas of greatest achievement, and those in which there is a need for greater focus and attention.

In assessing overall progress, the following broad observations can be made:

Progress has been achieved towards each recommendation

The 13 recommendations from 2007 cover a wide range of suggestions for governments, regulatory and supervisory bodies, and private institutions. Collectively, they called for a comprehensive set of efforts to enable the growth of the industry.

At the mid-term of the period, concrete progress can be seen in each of the areas cited. There is no recommendation on which progress has failed to take place. The degree of progress, however, varies substantially from recommendation to recommendation and is discussed in detail later in this Review.

No recommendation has been completely "achieved"

It is similarly noted that no recommendation has been completely "achieved" at this stage of the Review. Efforts continue to be required in each of the 13 areas in order to enable a thriving IFSI.

The original 13 recommendations thus remain relevant, and are affirmed in the current Review. Additional recommendations are also added later in this document.

The industry's progress is inherently linked to the overall financial services environment

The IFSI operates within the overall global economy and financial sector, and particularly within the financial sectors of IDB and IFSB member countries. Progress made in the overall

financial sectors of member countries tends to benefit Islamic financial services, and progress in Islamic financial services often depends on sector-wide policies and actions.

Transparency, corporate governance, access to international markets, and compliance with international standards are examples of areas where the linkage is strong. Islamic financial services benefit when countries' overall financial sectors make progress in these areas.

Areas requiring more "localised" action have seen the most substantial progress

Certain Framework recommendations (such as enhancing capital efficiency) rely on action at the level of a single country or within a set of domestic institutions. Others (such as fostering collaboration among countries that offer Islamic financial services) require coordinated action by a set of multiple stakeholders in the industry.

Areas in which more "localised" action is needed have shown substantial progress. This is particularly true in countries where there exists a national-level commitment to fostering the IFSI

To achieve more progress in the areas requiring action by multiple stakeholders, active collaboration and coordination are needed. The Review seeks to highlight these areas and encourage collaboration.

Progress in Islamic banking has generally been stronger than progress in other sectors of financial services

Islamic banking remains the most developed sector of the IFSI, showing greater scale and maturity than NBFIs, *Takāful* and *ReTakāful*. Since 2007, the Islamic banking sector has continued to advance and has been a focus of government, supervisory bodies and market participants.

The current Review brings attention to the needs of the Islamic financial services sector overall, which extends well beyond Islamic banks. Islamic microfinance institutions, finance companies, asset managers, *Takāful* and *ReTakāful* institutions, endowments, and other types of financial institutions are all essential for the industry as a whole. The Review reveals a need for a more holistic view by stakeholders in enabling the overall industry.

Summary Table of Progress

The table below provides a summary view of progress made and challenges remaining for each of the 13 recommendations:

No.	Recommendation	Areas of Progress	Challenges Remaining
1	Facilitate and encourage the operation of free, fair and transparent markets in the Islamic financial services sector	 Financial sectors of member countries generally operate on a free-market basis IIFS are held to the same standards of transparency as their conventional counterparts 	 Member countries vary greatly in their standings in transparency indices Regulatory enablement required for fair competition by IIFS often not present
2	Enhance the capitalisation and efficiency of IIFS to ensure that they are adequately capitalised, well-performing and resilient, and on par with international standards and best practices	IIFS (especially banks) generally have strong capital adequacy and have shown resilience IIFS are held to the same capital requirements as their conventional counterparts	 There are few large-scale, highly capitalised institutions IIFS often under-perform their conventional counterparts in terms of capital efficiency (return on assets (ROA), return on equity (ROE), etc.) Some IIFS (particularly investment companies) have shown vulnerability in the crisis Capital adequacy ratio (CAR) of many Islamic banks is showing a decreasing trend over the years¹⁰ Offering innovative Sharī ah-compliant capital instruments/Şukūk that meet the requirements of loss absorbency as per Basel III/ IFSB-15 remains a challenge
3	Enhance access by the large majority of the population to financial services	 Over 200 microfinance institutions offer Islamic products and services¹¹ 36% of Islamic banks surveyed reported offering microfinance facilities¹² 	 Only 1% of global microfinance clients use Islamic financial services¹³ IIFS have generally not been at the forefront of new business models (mobile banking, peer-to-peer, micro-savings, etc.) that can have a large impact on expanding access

¹⁰ Observation based on a survey report conducted by IFSB Secretariat in Q2–Q3 of 2011 on Revised Capital Adequacy Standard (IFSB-15), which was deliberated on in the 3rd Meeting of the Working Group held in the Central Bank of the UAE on 5 October 2011.

11 CGAP Focus Note No. 84, March 2013.

¹² IFSB-IRTI Mid-Term Review Survey, 2013.

¹³ CGAP Focus Note No. 84, March 2013.

No.	Recommendation	Areas of Progress	Challenges Remaining
4	Enhance Sharī ah compliance, effectiveness of corporate governance and transparency	 27% of regulators reported having implemented standards for Islamic financial products and services¹⁴ Regulations on corporate governance in general and <i>Sharī ah</i> governance in particular have been issued by supervisory and regulatory authorities in various jurisdictions National <i>Sharī ah</i> boards have been introduced in several jurisdictions to enhance governance and transparency 	- Greater differentiation between Islamic and conventional products can help the industry demonstrate its values more clearly - Disclosures on the features and risk profile of Islamic finance products are often low - Few regulatory and supervisory authorities have issued transparency and disclosure requirements/ regulations as a part of financial statements of Islamic financial institutions
5	Develop the required pool of specialised, competent and high-calibre human capital, and ensure utilisation of state-of-the-art technology	Breakthrough educational initiatives have been launched in various Islamic finance jurisdictions Online training and certification programmes have taken root and are expanding access to specialised training	 72% of respondent Islamic banks cited a lack of skilled human capital as a very significant or significant challenge¹⁵ Expertise in <i>Takāful</i>, asset management and other sectors likewise remains a challenge
6	Promote the development of standardised products through research and innovation	Important progress has been made in standardising certain structures (e.g. interbank and money market, hedging instruments) Prominent research centres have been established in member countries and beyond	 Only 41% of respondent Islamic banks reported having good or advanced capacity in research and development of the substantial in Takāful, microfinance and other NBFIs
7	Enhance the implementation of the international prudential, accounting and auditing standards applicable to the IFSI	A large majority of Islamic finance jurisdictions fully or "partially" follow IASB and Basel Committee standards IFRS adoption is increasing in Islamic finance jurisdictions	- Islamic finance specific standards (IFSB and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have been adopted less widely, although many jurisdictions are in the process of implementation, especially with the growth in the market share of Islamic financial services in respective sectors - There is a need for adequate technical assistance/ implementation guidance for regulatory and supervisory authorities - There is a need for capacity building of the staff of the regulators involved in the supervision and surveillance of IIFS

If IFSB—IRTI Mid-Term Review Survey, 2013.
 Ibid.
 Ibid.

No.	Recommendation	Areas of Progress	Challenges Remaining
8	Develop an appropriate legal, regulatory and supervisory framework as well as an IT infrastructure that would effectively cater for the special characteristics of the IFSI and ensure tax neutrality	 Specific regulations for Islamic financial services are increasingly prevalent 65% of respondent jurisdictions reported having banking regulations for Islamic banking¹⁷ 	 Tax neutrality, safety net (e.g. <i>Sharī ah</i>-compliant deposit insurance) provisions, and other aspects are less prevalent Slow progress made on the legal framework development that can help Islamic finance sector
9	Develop comprehensive and sophisticated interbank, capital and derivatives ¹⁸ market infrastructures for the IFSI	- Prominent initiatives (e.g. International Islamic Liquidity Management Corporation (IILM) and International Islamic Financial Market (IIFM)) have been undertaken to enhance liquidity management and capital markets	 Domestic interbank markets are lacking or inactive in many Islamic finance jurisdictions Key asset classes (e.g. sovereign \$\int \lu\tilde{u}
10	Promote public awareness of the range of Islamic financial services	- Expansion of market share suggests increased awareness of Islamic financial services	- 73% of respondent Islamic banks cited a lack of awareness of Islamic banking products and services as a very significant or significant challenge! - Awareness of <i>Takāful</i> and other NBFI services often lags awareness of Islamic banking
11	Strengthen and enhance collaboration among the international Islamic financial infrastructure institutions	- Collaborative efforts (e.g. the Ten-Year Framework) are under way and growing	Greater collaboration could help spur progress in areas requiring the involvement of multiple stakeholders and countries
12	Foster collaboration among countries that offer Islamic financial services	Multilateral forums have allowed for the exchange of expertise and ideas Bilateral collaboration has also taken place between certain countries	Greater collaboration could spur cross-border expansion or investment Fewer than half of regulator respondents reported having foreign Islamic banks in their jurisdiction
13	Conduct initiatives and enhance financial linkages to integrate domestic IFSIs with regional and international financial markets	- Large, sophisticated IIFS generally enjoy access to regional and international markets	- Smaller institutions (and especially NBFIs) often lack access to markets beyond their borders

¹⁷ Ibid.

¹⁸ Although the term derivatives was used in the 2007 document, it has been recommended that the term hedging be used as a more appropriate description.

19 IFSB–IRTI Mid-Term Review Survey, 2013.

3.3 Detailed Progress by Recommendation

The following section provides more detailed commentary on the progress achieved in each recommendation since the publication of the 2007 Framework.

Recommendation 1: Facilitate and encourage the operation of free, fair and transparent markets in the Islamic financial services sector

The financial sectors of IDB and IFSB member countries operate, for the most part, on a free-market basis. While numerous member countries have Islamic banks with government shareholding, these banks generally compete in an open market with a wide range of competitors. Clients are free to choose their banks, and banks must compete for business on a commercial basis

Over the past years, member countries have continued a trajectory towards greater transparency. Disclosure requirements for the financial sector are typically robust. Islamic banks are held to the same requirements as their conventional counterparts. In some jurisdictions, Islamic banks are in fact subject to additional disclosure requirements on matters such as their profit and loss distribution computations.

It is also noteworthy that markets in which Islamic banking was either disallowed or discouraged have now adopted more open approaches. Reforms and regime changes have fostered a climate of greater economic freedom, which in turn enables people to adopt Islamic finance.

In member countries, disclosure requirements and other transparency-related policies tend to be more developed in the banking sector than in other sectors of the financial services industry. Malaysia and Bahrain have made significant strides in encouraging the development of transparent markets in the *Takāful and ReTakāful* sector. Other jurisdictions are increasingly using these models to develop their own versions.²⁰

Recent studies for the $Tak\bar{a}ful$ and $ReTak\bar{a}ful$ sector show that the level of transparency in these operations is below that observed in the conventional insurance and re-insurance sector. This is a cause for concern, as transparency and absence of Gharar are key features of $Tak\bar{a}ful$ and $ReTak\bar{a}ful$.

On the matter of overall fairness and freedom of the marketplace, governance indicators provided by the World Bank serve as a useful reference.²² The table in Figure 2 tracks changes in the standings of various countries along the following criteria: (1) strength of legal rights, (2) business extent of disclosure, (3) business regulatory environment, (4) transparency, accountability and corruption in the public sector, and (5) ease of doing business.

²⁰ Alpen Capital, GCC Insurance Industry, August 21, 2011.

²¹ Ibid.

²² World Bank Indicators, 2007-2012.

Figure 2: World Bank Indicators for Organization of Islamic Cooperation (OIC) Member Countries (Progress from 2007 to 2012)

	Strength of rights ind 2012 Score change from		public sector rating 2011 Score and 2012 Score		Business extr disclosure in 2012 Score change from	index environment rating e and 2011 Score and		Ease of doing business index 2012 Score and change from 2011		
AVERAGE	4.84	•	2.63	⇔	5.90	•	3.11	•	119.96	\Leftrightarrow
Afghanistan	6	•	2	\Leftrightarrow	1	\Leftrightarrow	2.5	⇔	168	•
Albania	9	\Leftrightarrow			8				85	-
Algeria	3	\Leftrightarrow			6	\Leftrightarrow			152	•
Azerbaijan	6	\Leftrightarrow			7				67	-
Bahrain	4	\Leftrightarrow			8	\Leftrightarrow			42	-
Bangladesh	7	\Leftrightarrow	2.5	-	6	\Leftrightarrow	3.5	\Leftrightarrow	129	-
Benin	6		3.5	\Leftrightarrow	6	\Leftrightarrow	3.5	\Leftrightarrow	175	
Brunei	7	\Leftrightarrow			4	\Leftrightarrow			79	1
Burkina Faso	6	•	3.5	•	6	\Leftrightarrow	3.5	•	153	-
Chad	6		2	\Leftrightarrow	6	\Leftrightarrow	2	-	184	
Cameroon	6	•	2.5	\Leftrightarrow	6	\Leftrightarrow	3	\Leftrightarrow	161	-
Comoros	6		2.5	‡	6	⇔	2.5	\Leftrightarrow	158	\Leftrightarrow
Djibouti	1	\Leftrightarrow	2.5	\Leftrightarrow	5	\Leftrightarrow	3.5	\Leftrightarrow	171	\Leftrightarrow
Egypt	3	\Leftrightarrow			8				109	•
Guinea	6	•	2	-	6	\Leftrightarrow	2.5	•	178	•
Guinea-Bissau	6	•	2.5		6	\Leftrightarrow	2.5	⇔	179	•
Gabon	6	•			6	\Leftrightarrow			170	-
Guyana	4	\Leftrightarrow	2.5	-	5	\Leftrightarrow	3	\Leftrightarrow	114	\Leftrightarrow
indonesia	3	\Leftrightarrow			10				128	•
Iran	4	\Leftrightarrow			7				145	•
Iraq	3	\Leftrightarrow			4	\Leftrightarrow			165	
Jordon	2	⇔			5	⇔			106	,
Kazakhstan	4	•	-		9	\			49	•
Kuwait	4	⇔			7	\Leftrightarrow			82	•
Kyrgyz Republic	10	•	2.5	\Leftrightarrow	8	<u>~</u>	3.5	\Leftrightarrow	70	ě
Lebanon	3	⇔		47	9	⇔		- 17	115	ě
Malaysia	10	⇔			10	⇔			12	•
Maldives	4	\Leftrightarrow	3	•	0	\Leftrightarrow	4	\Leftrightarrow	95	
Mali	6	•	3.5	⇔	6	⇔	3.5	⇔	151	,
Mauritania	3	⇔	2.5	•	5	\Leftrightarrow	3	—	167	ě
Morocco	3	⇔		_	7	47		•	97	,
Mozambique	3	⇔	3	\Leftrightarrow	5	\Leftrightarrow	3	\Leftrightarrow	146	ě
Niger	6	•	3	⇔	6	⇔	3	⇔	176	ě
Nigeria	9	⇔	3	\Leftrightarrow	5	⇔	3.5	•	131	⇔
Oman	4	⇔		\v	8	⇔	3.5	-	47	⇔
Pakistan	6	⇔	2.5	\Leftrightarrow	6	⇔	3		107	•
Oatar	4	⇔		47	5	⇔		Ť	40	⇔
Saudi Arabia	5	A			9	47			22	•
Senegal	6	_	3.5	•	6	\Leftrightarrow	4	\Leftrightarrow	166	•
Sierra Leone	7	A	3	•	6	٧,	3	•	140	•
Sudan	4	⇔	1.5	į.	0	\Leftrightarrow	2.5	Ţ.	143	
Surniname	5	⇔		Ť	1	⇔		Ť	164	ě
Svria	1	⇔			7	⇔			144	ě
Tajikistan	2	—	2.5		8	47	3.5	\Leftrightarrow	141	•
Togo	6	•	2.5	•	6	\Leftrightarrow	2.5	•	156	•
Tunisia	3	⇔			5	٧٧		Ť	50	•
Turkev	4	⇔			9				71	ě
Uganda	7	⇔	2.5	-	2	\Leftrightarrow	4	\Leftrightarrow	120	•
UAE	4	⇔	2.3	_	4	⇔		\	26	•
Uzbekistan	2	⇔	2	•	4	⇔	3	⇔	154	⇔
Yemen	2	\	2.5	•	6	⇔	3	•	118	•
Temen		√ √	2.3	_	U	√ √	,	_	110	_

Source: World Bank (Worldbank.org)

Notes: For the first four indicators, a higher score is better. For the final indicator, a lower score is better. No data available for libya, somalia or Turkmenistan.



As indicated in Figure 2, overall progress has been mixed. On average, OIC member countries have shown improvement in two areas: the strength of legal rights and the business extent of disclosure. On average, transparency, accountability and corruption in the public sector, as well as ease of doing business, are unchanged. The indicators suggest that, on average, the business regulatory environment has deteriorated in member countries.

While these indicators pertain to the economies overall and not to the financial sector alone, they nonetheless provide a useful perspective on the business environment in member countries. They are also especially relevant in the area of capital markets, as capital markets rely on transparency and the overall quality of business regulation to foster investor confidence.

Recommendation 2: Enhance the capitalisation and efficiency of IIFS to ensure that they are adequately capitalised, well performing and resilient, and on par with international standards and best practices

Despite the success and growth of the Islamic banking sector, there are relatively few large-scale, strongly capitalised institutions. Most Islamic banks operate in a single country, with only a handful of banks achieving substantial scale across multiple countries or regions. Despite being well-capitalised for their domestic markets, these banks are often not sufficiently capitalised to pursue expansion into other countries.

In our survey²³ of Islamic banks, respondents indicated a high level of capital adequacy. Of the 117 respondents to the survey, 49 reported capital adequacy of 15% or higher (of which 26 reported capital adequacy of 20% or above).

Many Islamic banks, though adequately capitalised, under-perform their conventional counterparts in terms of capital efficiency.²⁴ Islamic banks' ROE often lags due to challenges associated with (1) having more limited Treasury and liquidity management options, and (2) operating at a smaller scale and thus being more impacted by fixed costs such as staff, operating infrastructure and technology systems.

Overall, the Islamic banking sector has shown resilience through the ongoing crises. Some high-profile bankruptcies, "bail-outs" and forced mergers have, however, taken place and have affected confidence.

Islamic banks remain subject to the same capital and prudential requirements as their conventional counterparts, which is an important safeguard for the industry. Three IDB member countries are members of the Group of 20 (G20), and are thus obliged to adopt Basel III and other regulations for all their financial institutions. Islamic banks also have prudential

²³ The term "our survey" used throughout this document shall refer to the Mid-Term Review Survey undertaken by IFSB and IRTI, unless otherwise stated.

²⁴ Ernst & Young, World Islamic Banking Competitiveness Report, 2013–2014.

requirements (articulated by the IFSB) that are specific to the nature of their business and are compatible with the Basel requirements. The wider adoption of IFSB standards would help in achieving greater comparability of IIFS across jurisdictions as well as ensuring that the risk-sharing structures of Islamic banks are not subjected to more onerous capital requirements than their conventional counterparts. A positive development in recent years is the increase in tempo by which jurisdictions are adopting IFSB standards, but much more can be achieved. The adoption of IFSB standards will reduce the chances of regulatory arbitrage, ensure that capital adequacy regulations suit the risk exposure of *Sharī`ah*-compliant contracts, provide adjustments required in the capital adequacy ratio (CAR) for profit-sharing investment accounts, and offer eligibility criteria and the contractual structure for issuing capital instruments that meet the criteria of going concern and gone concern capital.

The most stable way for large-scale Islamic banks to emerge will be through organic growth, retained earnings, and selective acquisitions and mergers. The cross-border expansion of the Al Baraka Banking Group, Al Rajhi Banking and Investment Corporation, Kuwait Finance House and others are examples. As certain Islamic banks consistently perform well, their capital will naturally expand as a consequence of commercial success. Market forces can separate strong banks from weak ones as the industry continues to evolve. Recent mergers in the Gulf Cooperation Council (GCC) region, particularity in the United Arab Emirates and Bahrain, illustrate this point.

In the Islamic NBFI sector, capitalisation appears strong although profitability is often a challenge. Figure 3 presents the status of a sample of 58 Islamic NBFIs during the post-crisis period. The NBFIs have equity of USD248.5 million and hold assets worth USD638.6 million on average. These figures indicate that the NBFIs are well capitalised, with the equity to assets ratio for all NBFIs in the sample being 38.9%. The NBFIs in the GCC region appear to have larger equity and assets than those in non-GCC countries. The results also show that, on average, the NBFIs are operating at a loss in the financial reporting year. Specifically, among the 58 NBFIs in the sample, 27 (or around 47%) had incurred losses. Even with relatively high levels of capitalisation, many Islamic NBFIs were incurring losses. Most of the post-global financial crisis cases of insolvencies and bankruptcies in the IFSI involved NBFIs.²⁵

²⁵ M.R. Raghu, Murtaza Pattherwala and Animesh Tulsyan (2013), Dealing with Bankruptcy in the GCC: A Key Missing Block in the Reform Agenda, Kuwait Financial Centre Markaz Research, January. Kuwait reports that, for example, Global Investment House restructured its USD1.7 billion debt in December 2009 and Aayan Leasing & Investment Company finalised a KD205 million (USD743.6 million) five-year, debt restructuring deal with nine creditors in May 2011. Similarly, The Investment Dar (TID) announced a restructuring plan in March 2010 covering KD1.4 billion (USD5 billion) in debt. Other insolvencies include Noor Financial Investment Company, which rescheduled its debt of KD11 million in October 2011. A few Islamic NBFIs also filed for bankruptcies after the crisis. Arcapita Bank (formerly known as First Islamic Investment Bank), a Bahraini Islamic-investment firm with over USD7 billion in investments, filed for bankruptcy protection under Chapter 11 in U.S. Bankruptcy Court in Manhattan following an inability to repay a USD1.1 billion maturing facility in March 2012. Similarly, UM Financial, an Islamic NBFI in Canada, filed for bankruptcy in December 2011.

Figure 3: NBFIs (Islamic Investment Companies and Others), 2008–2011

(USD million)

Region		Total Assets	Total Equity	Total Liabilities	Net Profit/Loss
A 11 (59)	Total	37,039.13	14,416.15	22,622.98	-250.79
All (58)	Average	638.61	248.55	390.05	-4.40
CCC (51)	Total	36,804.91	14,232.13	22,572.78	- 251.91
GCC (51)	Average	721.66	279.06	442.60	- 4.94
Others (non-	Total	234.22	184.02	50.20	1.12
GCC) (7)	Average	33.46	26.29	7.17	0.19

Source: Islamic Finance Information Services

Muḍārabah companies are specialised Islamic NBFIs in Pakistan. The Securities and Exchange Commission Pakistan (SECP) regulates these institutions along with leasing companies and investment banks. Figure 4 shows that Muḍārabah companies are smaller than other NBFIs in terms of assets. However, they are better capitalised and have superior performance compared to other NBFIs, on average. This is apparent as the Muḍārabah companies have a higher capital/asset ratio (46.7% compared to 14.4% for leasing companies and 15.2% for investment banks) and better ROA (4.3% compared to 0.4% for leasing companies and 1.7% for investment companies).

Figure 4: Muḍārabah Companies and Other NBFIs in Pakistan, 2011

USD million

Total (USD million)		Profit/Loss	Total Assets	Equity
Mardanhah Camaniaa (20)	Total	11.46	264.94	124.29
Muḍārabah Companies (26)	Average	0.44	10.19	4.78
Landing Communica (10)	Total	1.51	341.47	49.07
Leasing Companies (10)	Average	0.15	34.15	4.91
I t. D (2)	Total	1.24	73.21	11.09
Investment Banks (3)	Average	0.41	24.40	3.70
All (39)	Total	14.21	679.63	184.45
	Average	0.36	17.43	4.73

Source: Securities & Exchange Commission of Pakistan (SECP)

The social aspect of Islamic finance can best be implemented by establishing Islamic microfinance institutions that provide financial services to the poorer sections of the population. However, as providing financial services to the poor is often costly, microfinance institutions

face a trade-off between outreach and sustainability.²⁶ The trade-off between outreach and sustainability is closely related to the organisational formats used to deliver the financial services. Depending on the missions of organisations, two broad approaches can be identified. The first is the poverty approach in which the financial institutions operate as non-profits with goals of providing finance to the poor and core-poor. Under this approach, financial services are provided by non-governmental organisations (NGOs), government agencies, cooperatives and development finance institutions. As operating costs in serving the poor can be high, the long-term sustainability of the operations of these organisations without subsidies becomes an issue. The second approach focuses on self-sufficiency and operates like other for-profit institutions. The operations of financial institutions are sustained by providing larger loans to the less poor at higher interest rates or rates of return. One way this is done is by the linking approach whereby banks provide services to the poor through intermediaries or special programmes. While a commercial approach to providing financial services can help the growth of micro and small enterprises, it may fail as a tool for eliminating core poverty.

In the 2012 survey published by the Sanabel network, it was found that in a sample of 36 Islamic microfinance institutions, 49% were registered as NGOs, 24% as NBFIs, 6% as microfinance banks, and 3% each as government organisations and cooperatives.²⁷ The remaining 15% of the microfinance institutions were linked to commercial banks. A recent CGAP survey of 255 Islamic microfinance institutions globally serving 1.28 million clients in 19 countries reveals that 97% of the institutions providing Islamic microfinance are NBFIs and the remaining 3% are commercial banks.²⁸ However, the latter provide the bulk of financing covering 60% of the clients. These figures indicate that the commercial banks do well with the breadth of outreach in terms of number of clients served. However, the non-profit NBFIs are expected to perform better when it comes to the depth of outreach in terms of reaching the poor.

Being a small percentage of the total microfinance industry, information on the performance of global Islamic microfinance institutions is limited. Data on microfinance institutions in general show that the rate of return of those in the Middle East and North Africa (MENA) region is higher than their counterparts in other regions such as East Asia and the Pacific, Eastern Europe and Central Asia, Latin America and Caribbean South Asia and Africa.²⁹

While various research papers present contradictory evidence on the issue, a comprehensive study by Hermes, Lensink and Meesters (2011), Microfinance: Its Impact, Outreach, and Sustainability, using data from 435 microfinance institutions covering 11 years, clearly identifies the trade-off between outreach and sustainability.

²⁷ Sanabel (2012), Islamic Micro and Small Medium Enterprise (MSME) Finance Survey, www.sanabelnetwork.org/ UserFiles/file/Publications/Transparency%20Publications/Islamic%20Micro%20and%20Small%20Medium%20Enterprise%20(MSME)%20Finance%20Survey/Islamic%20MSME%20Survey%20-English.pdf.

²⁸ Mayada El-Zoghbi and Michael Tarazi (2013), Trends in Sharia-Compliant Financial Inclusion, CGAP Focus Note No. 84, March.

²⁹ MIX and Sanabel Analysis of Key Trends, 2011 Middle East and North Africa Regional Snapshot, March 2012, www. themix.org/sites/default/files/2011%20MENA%20Regional%20Snapshot 0.pdf.

For *Takāful* and *ReTakāful*, regulators are becoming aware of the emerging issues as the industry grows. In particular, issues such as surplus sharing and the obligation of *Takāful* operators to provide *Qard* in the event of deficits are being tackled. Regulators are also becoming aware of the need for credible rating of the providers of *Takāful* and *ReTakāful*. Without a clear line on these issues, rating of the providers of these services will suffer.

Discussion has also started on the implications of the Solvency II proposals for the global insurance industry and the institution of risk-based capital requirements. At the international level, a major development has been the IAIS pronouncement to work on a global capital standard for insurance companies by end 2016.³⁰ The IFSB *Takāful* standards are anticipating this challenge. For the *Takāful* sector, the IFSB has already issued its solvency standard called IFSB-11. From 2014, the IFSB will start its research on "capital resources for *Takāful* sector" which will be then transformed into a Guidance Note.

Although the Framework recommendation is focused on capitalisation at the institutional level (and not at the overall sector level), it is nonetheless noted that the capitalisation of IIFS, funds, $Suk\bar{u}k$ and other capital market instruments remains only a small part of the overall financial system. While the pool of $Shar\bar{\iota}$ ah-compliant capital is growing strongly, its absolute size remains limited in the context of the overall financial system.

Recommendation 3: Enhance access by the large majority of the population to financial services

It is estimated that only about 20% of the world's Muslim population has any access to financial services at present.³¹ The Framework recommendation to increase access to financial services thus remains a critical one for Islamic finance jurisdictions.

Microfinance institutions play an important role in providing financial access to poorer segments of population that commercial banks fail to service. A CGAP survey of 255 Islamic microfinance institutions globally in 19 countries indicates that less than 1% of the microfinance clients use Islamic microfinance.³² This implies that there is a vast scope for expanding Islamic microfinance services to the poor in IDB member countries.

Islamic banks likewise have an important role to play in financial inclusion. In many member countries (and also in Muslim-minority countries), sizeable segments of the population avoid

^{30 &}quot;IAIS Commits to Develop by 2016 a Global Insurance Capital Standard", IAIS Press Release, 9 October 2013, www. iaisweb.org/view/element_href.cfm?src=1/20052.pdf, accessed 6 January 2014.

³¹ Cull, Demirgue-Kunt and Morduch (2013), Banking the World: Empirical Foundations of Financial Inclusion, Massachusetts Institute of Technology.

³² Mayada El-Zoghbi and Michael Tarazi (2013), "Trends in Sharia-Compliant Financial Inclusion", CGAP Focus Note No. 84, March.

the banking sector due to a lack of *Sharī`ah*-compliant services. The introduction of viable Islamic banks is itself an important factor in promoting financial inclusion. As addressed in a separate recommendation, raising awareness of Islamic financial services is often a challenge.

Apart from *Sharī`ah* concerns, large segments of member country populations remain unbanked due to a lack of financial assets or their being located far from bank branches. Certain observers have questioned why Islamic banks have not been able to reach under-served segments despite these segments' apparent inclination towards Islamic finance. While there may be multiple reasons, one key factor may be the lack of cost-efficient service models to make serving such customers profitable. However, the introduction of "branchless", internet and mobile banking would make it easier to reach rural customers, and other technologies would help to lower the cost of serving retail customers.

Islamic microfinance and microsavings institutions are an important trend in enabling financial inclusion. Traditional banks do, however, also have a key role in promoting access to financial services. The challenge is to devote adequate focus and resources to identifying and implementing profitable ways to serve currently unbanked customers – both individuals and small enterprises requiring access to funding. Of the respondent banks in our survey, only 36% reported offering microfinance facilities.

NBFIs have the potential to serve clients not covered by banks. Different types of NBFIs can offer services to diverse segments of the population. For example, investment banks, asset management companies and private equity firms serve institutional investors and affluent clients, while leasing companies are expected to serve primarily the business sector. Similarly, an expanded microfinance sector can provide services to sections of the population that are usually not served by banks.

Although data on the overall size of the IFSI in some countries exist, information on the breakdown of the types of financial institutions providing these services is not available. However, it is expected that the NBFI sector in most IDB member countries is small and Islamic NBFIs would be a small percentage among these institutions.³³

Some encouraging approaches have been tried in Indonesia, Malaysia and Sri Lanka. In these countries, there have been attempts to couple microfinance provision with micro-*Takāful* provision. If used with appropriate innovative technology, this has the potential to create a virtuous circle of rapid financial inclusion.

³³ Rocha et al. (2011: 75), The Status of Bank Lending to SMEs in the Middle East and North Africa Region: The Results of a Joint Survey of the Union of Arab Bank and the World Bank, World Bank Policy Research Working Paper 5607. The World Bank, Washington DC, indicates that while the banking sector in the MENA region is larger than other regions, the non-bank financial sector is underdeveloped.

A number of capital market developments have made it possible for broader sections of the population to participate. This has mainly been due to the provision of divisibility, which makes it possible for small investors to participate in the biggest investment assets. Mutual funds are a good example; Real Estate Investment Trusts (REITs) are another. Exchange Traded Funds (ETFs) also offer divisibility in a portfolio of listed stocks. Finally, Malaysia's recently introduced Exchange Traded Şukūk and Bonds (ETSB) provide divisibility by enabling the small/retail investor to purchase units in a Şukūk portfolio for as little as RM1,000. Where Şukūk facevalues are typically RM5 million, the ETSB provides bite-size pieces to the smallest investor.

It is noted that financial inclusion is sometimes seen as a social objective (and not a commercial one) and thus not actively pursued by private institutions. While there indeed are often challenges to profitably serving under-served customers, new technologies and innovative business models have the potential to substantially reduce such costs. Additionally, it is noted that the Framework seeks to shape the industry as a whole, and a thriving industry can include for-profit, not-for-profit and socially oriented institutions serving a wide range of mandates.

Recommendation 4: Enhance Sharī`ah compliance, effectiveness of corporate governance and transparency

Important progress has been made in the establishment of national *Sharī`ah* boards and *Sharī`ah* standards in key member countries. The rationale for such measures includes a drive to ensure customers that all banks which claim to be Islamic are in fact conforming to a common set of *Sharī`ah* requirements. Some 27% of regulators responding to our survey reported having implemented *Sharī`ah* standards for Islamic financial products and services.

The introduction of national boards helps address the ongoing issue of having a shortage of *Sharī`ah* scholars available to supervise a growing number of banks, and may also allow the scholars more time for product development. Under the typical model of a national *Sharī`ah* board, each bank still needs to have *Sharī`ah* supervision, but can rely on national standards (or a national set of principles) for many of its key questions. *Sharī`ah* scholars can thus devote more time to the boards on which they serve. In the case of Morocco, it has been proposed that individual banks will not have *Sharī`ah* boards and therefore fully rely on the national *Sharī`ah* board.

In many key member countries, regulators have chosen a more de-centralised model of *Sharī`ah* supervision. Without a national *Sharī`ah* board, there is no national uniformity, but each bank has greater flexibility in adopting the standards acceptable to its own *Sharī`ah* board. The decentralised model has benefits in fostering a diversity of views, and keeps the central bank out of the role of needing to opine on *Sharī`ah* matters. There are thus benefits and drawbacks of both the centralised and de-centralised models.³⁴

³⁴ There is a growing body of research on the benefits and drawbacks of various Sharī ah governance models. The work of Murat Onal of Funds@Work, for example ("The Small World of Islamic Finance – Sharī ah Scholars and Governance – A Network Analytic Perspective"), identifies a set of relevant issues.

Corporate governance and transparency standards of Islamic banks are generally in line with the local market standards of the countries in which they operate. It can be argued that the presence of a *Sharī'ah* supervisory board could enhance overall governance standards by ensuring another step of independent review and oversight.

Only 35% of regulators responding to the survey undertaken by the IFSB and IRTI reported having *Sharī`ah* governance standards in place. Even in countries that adopt a de-centralised model, central banks may wish to consider *Sharī`ah* governance frameworks that do not specify *Sharī`ah* rulings but do set requirements on how *Sharī`ah* compliance is governed within institutions. An example of such a regime is the Dubai Financial Services Authority.

In certain segments of the population, there are perceptions that Islamic banks have made "compromises" in *Sharī`ah* authenticity. Although the sector continues to grow, there remain sceptical segments who question whether Islamic banks are genuinely different from their conventional counterparts. For example, certain *Tawarruq*-based structures that are mainstays of many Islamic banks – such as commodity *Murābaḥah* – have been viewed as questionable and affect the perception of the industry's authenticity.

In the survey of 117 banks undertaken by the IFSB and IRTI, respondents overwhelmingly cited *Murābaḥah*-based contracts as "most favourable ... based on customers' demand". Fifty-six per cent (56%) reported *Murābaḥah* as the most favourable, followed by *Ijārah* at 14%. Only 3% reported *Muḍārabah* as most favoured, and only 3% reported *Muṣhārakah* as most favoured. These findings indicate that Islamic banks continue to view *Murābaḥah*-based financing as the most commercially viable contract available.

If Islamic banks choose to place greater emphasis on product differentiation, such differentiation can help address the concerns of certain segments regarding *Sharī'ah* authenticity and rigour. This will require a level of commitment by these banks to demonstrate differentiation from conventional financial services.

In countries where there are no specific regulatory guidelines on *Sharī`ah* governance, *Sharī`ah* compliance is carried out at the institutional level; however, this can raise problems. A few cases exemplify problems of *Sharī`ah* compliance in these environments. A specific example involves an Islamic NBFI that was not able to fulfil its financial commitments to another institution. The Islamic company claimed in an English court that the *Wakālah* agreement used between the parties was not *Sharī`ah* compliant and, as such, was void as it violated its Articles of Association. This was despite the fact that the agreement had been approved by the *Sharī`ah* supervisory board.

The lack of regulatory requirements for information disclosure and transparency in some jurisdictions for NBFIs not only weakens consumer protection, but also makes these institutions more prone to crisis. The governance, transparency and *Sharī'ah* compliance

can be enhanced in financial institutions if international standards and guidelines are used as the basis for implementing national regulatory requirements. However, many countries have yet to implement the IFSB standards on corporate governance (IFSB-3) and disclosure and transparency (IFSB-4).³⁵ IFSB reports that ten jurisdictions have either "Completed" or are "In Progress" in implementing IFSB-3, while 11 jurisdictions are at the "Planning [to implement]" stage. In the same report, for IFSB-4, nine jurisdictions indicated they have "Completed" or are "In Progress", while 13 jurisdictions are in the "Planning [to implement]" stage.³⁶ Similarly, only six jurisdictions have adopted the AAOIFI *Sharī`ah* standards globally.³⁷

For the *Takāful* and *ReTakāful* sector, a number of key *Sharī`ah* challenges have as yet to be addressed. These range from the definition of *Takāful* to the *Sharī`ah* status of many of the *Takāful* and *ReTakāful* provision models that have emerged. For example, a "cooperative model", which may diverge from the traditional *Takāful* model, has been proposed in at least one jurisdiction.

Sharī'ah compliance remains a difficult issue in capital markets, particularly in relation to cross-border transactions or multinational marketing of products. On the other hand, we observe that market-led convergence on Sharī'ah issues is taking place in relation to cross-border issuances; moreover, Sharī'ah-compliant structures are being designed to meet the requirements of international investors. This issue of the standardisation of requirements for compliance remains an albatross. The recently conducted Mid-Term Review Survey among Islamic Capital Markets (ICM) industry players found the lack of Sharī'ah governance to be a key issue. In most jurisdictions, the lack of a national Sharī'ah board for ICM entities was cited as an inadequacy. Sharī'ah governance appears to be internally driven and thus institution/entity specific. Although 57% of respondents had external reviewers, the lack of a national body implies varying standards.

Recommendation 5: Develop the required pool of specialised, competent and high-calibre human capital and ensure utilisation of state-of-the art technology

The industry has made great strides in recent years in pursuing its human capital development agenda. While there certainly remains a gap between the "required" pool and the supply of available talent, the supply has grown substantially due to the efforts of a wide variety of institutions. The suggestion has also been made that specialist educational institutions develop professional codes of ethics for Islamic finance professionals.

³⁵ IFSB (2006), Guiding Principles on Corporate Governance, Kuala Lumpur: Islamic Financial Services Board; and IFSB (2007), Disclosures to Promote Transparency and Market Discipline, Kuala Lumpur: Islamic Financial Services Board

³⁶ IFSB (2013), IFSB Standards Implementation Survey (2013), Kuala Lumpur: Islamic Financial Services Board.

³⁷ These countries are Bahrain, Pakistan, Qatar, Sudan and Syria ("AAIOFI – Governance and Auditing Standards", presentation at 4th Annual IIBI–ISRA Thematic Workshop, London, September 2012).

In the Mid-Term Review Survey of Islamic banks, 72% of respondents cited a "lack of skilled human capital" as a very significant or significant challenge in developing the Islamic banking business in their jurisdictions. This finding indicates that – despite the progress made in developing human capital – a shortage of skilled staff remains a major challenge.

Universities across IDB and IFSB member countries, as well as in Europe and North America, have increased their attention to Islamic finance education. Specialised programmes (or at least specific courses) in Islamic finance and economics are available in many member countries, making exposure to the field far more accessible than before. These programmes cover areas including principles of Islamic economics, the basics of financial services, the *Fiqh* of transactions, the structures used for Islamic finance, as well as industry-specific accounting, prudential and risk management requirements.

In Malaysia, the establishment of the International Centre for Education in Islamic Finance (INCEIF) as a specialised higher education body is a prime example of a commitment to developing professionals. In addition to its academic programmes in Kuala Lumpur, INCEIF enters into partnerships with institutions in other countries to collaborate in the delivery of Islamic finance education. Bahrain Institute of Banking and Finance (BIBF) is another prime example of Islamic finance education, and numerous universities in the West have programmes in the field

Online certification and training programmes have made Islamic finance training available very broadly, reducing the need for physical travel to the locations in which courses are offered. Internet-based delivery channels have made the addressable audience of these courses much wider than ever before. Online training firms have trained thousands of individuals – often working with banks that make the training available to their employees.

While these advances have been admirable, there remain challenges in identifying appropriate talent for Islamic banks, especially in senior management roles. For this gap to be bridged, it is necessary both (1) to continue to broaden and deepen the reach of Islamic finance training and education; and (2) to ensure that professionals emerging from these programmes have adequate practical and commercial experience to be successful. Today, many banks continue to prefer hiring bankers with conventional experience, as specialists with Islamic finance backgrounds often do not have comparable levels of practical and professional experience. In the spirit of the recommendation, it is hoped that the pool expands and is strengthened such that institutions will prefer hiring such specialists.

There is still a key lacuna in the development of suitably qualified *Sharī`ah* scholars to service the industry. This has led to an unsustainable workload for the small number of adequately qualified scholars and has had a detrimental effect on the development of the industry. Institutions such as International *Sharī`ah* Research Academy (ISRA) are engaged in this area and progress is being made. There remains excess demand for adequately trained scholars, and institutions are needed to produce such scholars.

For the *Takāful* and Re*Takāful* sector, the dearth of adequately qualified personnel and especially *Sharī`ah* scholars is even more pronounced. This shortage is hampering the development of innovative products to address the unique needs of the market. The development of *ReTakāful* solutions to meet the unique challenges of the industry falls foul of this constraint.

The Mid-Term Review Survey of ICM regulators found short-term training, conferences and seminars to be the main platform for capacity building. Only 21% of participants provided scholarships for the study of Islamic finance. Surprisingly, despite the lack of formal training, the survey found that only 14% of participants felt that they had inadequate capacity in *Sharī`ah*. For the key operational areas such as Treasury, Liquidity and Risk Management, 21% felt inadequately equipped. It is understandable that short-term training would be a preferred tool for capacity building, as such training requires lower investment of time and other resources. While short-term training may be sufficient to meet daily operational needs, greater emphasis on formal and in-depth education/training is needed to bring the industry to its next level of development.

Recommendation 6: Promote the development of standardised products through research and innovation

One of the underlying causes of the global financial crisis was the use of complex products with opaque risk features both at the retail and institutional levels. There are some suggestions to regulate the complex products that involve information asymmetries and have systemic implications.³⁸ A number of Islamic products are complex, as these involve multiple classical contracts that are often not well understood. As Islamic financial products have a bare *Sharī`ah*-compliant and reputational risk, in addition to the standard regulatory risks, standardisation is particularly important.

Several industry bodies have made substantial progress in promoting the standardisation of certain products and services. Standard-setting bodies such as AAOIFI have played an important role, as have the IIFM and other bodies. These standard-setting bodies provide accounting and *Sharī`ah* standards, as well as producing standardised contractual framework.

Investment in research and development has, however, remained quite limited compared to the requirements of the growing industry. Research departments of industry bodies and academic centres in universities have helped advance the research agenda. Some financial institutions – such as Meezan Bank and Kuwait Finance House – have full-fledged research and product development units which generate new ideas and structures for the use of the industry. Greater investment in these areas, however, can help foster research and innovation beyond what is currently undertaken. Only 41% of respondents to our survey reported having "good" or "advanced" capacity in research and development. This was the weakest figure among the ten areas of capacity examined.

³⁸ Ana Carvajal, Randall Dodd, Michael Moore, Erlend Nier, Ian Tower and Luisa Zanforlin (2009), "The Perimeter of Financial Regulation", IMF Staff Position Note, 29 March.

In the *Takāful* and *ReTakāful* sector, a number of "plain vanilla" standard product structures have emerged over the last five years. However, there is still a preference for excessive customisation utilising non-standard features. The rationale of commercial confidentiality is often used to explain a lack of standardisation.

For the provision of *Takāful* and *ReTakāful*, there is currently no effective, specialised forum for the development of standardised products. There have been attempts such as the Global *Takāful* Group (GTG), but these have had minimal impact on product development in the industry. The option for utilising conventional re-insurance also presents opportunities for a widely diverging and often confusing product offering.

Recommendation 7: Enhance the implementation of the international prudential, accounting and auditing standards applicable to the IFSI

Compliance with prudential, accounting and auditing standards is generally well enforced by national regulators in IDB and IFSB member countries. These national standards, in turn, increasingly comply with international standards and norms.

Although only six jurisdictions have required AAOIFI standards, an increasing number of institutions are also adopting voluntary standards from the IFSB, AAOIFI and IIFM. Increasing adoption remains an important goal, towards which progress is being made. In our survey of regulators, 15% reported full compliance with IFSB standards, while 42% reported that they "partially follow" these standards. In a separate IFSB survey of banking regulations, 80% of responding jurisdictions have either completed or are in the planning stage for all the IFSB standards.³⁹

Figure 5 summarises respondents' reporting of their compliance with various international standards.

Figure 5: Survey Results on Compliance with Various International Standards

Standard	"Fully follow"	"Partially follow"	Sum of "fully" and "partially" follow
International Accounting Standards Board	58%	19%	77%
Basel Committee for Banking Supervision	46%	39%	78%
Organization for Economic Co-operation and Development	27%	35%	62%
Accounting and Auditing Organization for Islamic Financial Institutions	19%	31%	50%
Islamic Financial Services Board	15%	42%	57%

³⁹ IFSB (2013), IFSB Standards Implementation Survey (2013), Kuala Lumpur: Islamic Financial Services Board.

As shown in Figure 5, member regulators have made greater progress in adopting overall international standards (International Accounting Standards Board (IASB) and Basel) than they have in adopting standards that are specific to the IFSI (AAOIFI and the IFSB).

Implementation of the industry-specific standards should be considered in light of the following factors. The first consideration is the overall market share of Islamic finance in a particular jurisdiction. For example, unless the market share of Islamic finance grows to a noticeable level – say, 5% – regulators may not see Islamic finance standards as a high priority. Second, partial implementation is a meaningful achievement because many of the standards are principle-based and, therefore, are applied with suitable modifications in every jurisdiction.

Compliance with the international prudential, accounting and auditing standards requires the establishment of appropriate information and accounting infrastructures for all financial institutions at the national level. The commentary above on the adoption of standards applies mainly to banks. Since the NBFIs do not collect deposits but provide a direct link between suppliers and users of finance, their financing contracts are simpler; therefore, it is relatively easy to apply Islamic financing rules to particular accounting rules. Regulators should require different NBFIs to prepare their annual reports using particular accounting standards. For IIFS including NBFIs, AAOIFI accounting and auditing standards would be appropriate for their published financial statements, reflecting the Islamic nature of the contracts. However, these standards have been implemented in six jurisdictions only.⁴¹

There has been a move towards the formal adoption of IFRS in many jurisdictions. Many of these are in conflict with the standards and guidelines issued by the AAOIFI. Since the AAOIFI standards have not been adopted widely, this creates a preference for adherence to IFRS by providers of Islamic financial services at the expense of adherence to AAOIFI standards. The original Ten-Year Framework document suggested "Broadening the representation in the governance structure of AAOIFI to include a greater role for national accounting and audit standards, and initiating a programme to upgrade current standards and develop new ones". This offers the prospect of reconciling conflicting guidance and increasing the adoption of AAOIFI standards.

⁴⁰ The IFSB Survey on Implementation of Standards (2013) demonstrates a strong positive correlation between the market share of Islamic finance in a particular sector (Islamic banking, *Takāful* or Islamic capital market) and the implementation of its standards in respective jurisdictions.

⁴¹ These countries are Bahrain, Jordan, Lebanon, Qatar, Sudan and Syria. www.aaoifi.com/en/about-aaoifi/about-aaoifi.html.

There have been some new initiatives to resolve this issue in a systematic manner. The IASB has established a working group on Islamic finance, and this could be a very promising development.

For the *Takāful* and *ReTakāful* sector, the separation of shareholder and contributor interests poses unique challenges. This aspect is also leading to conflicting treatments under AAOIFI and IFRS. The IFSB has issued a number of standards for the *Takāful and ReTakāful* sector – mainly dealing with corporate governance, solvency and risk management issues – which address the matter of shareholders' and contributors' interest

The adoption of international standards plays a vital role in enabling capital markets to tap cross-border sources of capital. In the absence of compliance with an international accounting standards body such as AAOIFI or IFRS, financial statements of companies would not be comparable. The credibility of the reported numbers would be questionable if each institution uses its own method. The result would be higher perceived risk and therefore a higher required risk premium. For firms from non-compliant jurisdictions, this translates into higher costs of capital. Thus, non-compliance is not cost-free. For companies aspiring to an international presence, this higher cost can be a significant hurdle. The adoption of international standards such as AAOIFI and IFSB is therefore particularly important for the development of international capital markets.

Among regulators responding to the Mid-Term Review Survey, 57% reported that contradictions with existing rules and regulations were a key challenge to implementing international standards; 65% were unsure or unaware of available international standards; while 72% cited lack of knowledge and supporting infrastructure to implement international standards in ICM.

Recommendation 8: Develop an appropriate legal, regulatory and supervisory framework as well as an IT infrastructure that would effectively cater for the special characteristics of the IFSI and ensure tax neutrality

The 2007 Framework identified ten areas for legal and supervisory enablement recommended to "ensure equal opportunity" for Islamic banks. To date, progress has been mixed in these areas, as noted in Figure 6.

Figure 6: Progress Made in Ten Areas for Legal and Supervisory Enablement

Recommended enablement	Progress to date
Liquidity support, such as lender of last resort (LOLR) facilities	Central banks have generally positioned themselves as lenders of last resort, even in times of crisis, for all banks (both conventional and Islamic) under their supervision. Whether the financing to Islamic banks would be undertaken on a <i>Sharī ah</i> -compliant basis is often less clear.
Neutrality regarding capital requirements to be accorded to assets of Islamic banks as compared to those of conventional banks	As noted earlier, Islamic banks are generally subject to the same capital requirements as their conventional counterparts. The unique attributes of the assets of Islamic banks call for appropriate risk-weighting. The IFSB standards have covered this aspect and have been recently updated and enhanced by IFSB-15 (Revised Capital Adequacy Standard).
3. Sharī`ah-compliant return on bank reserves held at central banks	Greater focus is required by central banks to provide Sharī ah-compliant returns on statutory reserves; only a minority of member countries do so today.
Appropriate treatment of investment accounts for mandatory reserves and capital requirements	The IFSB has produced standards on the treatment of investment accounts.
5. Investment opportunities in sovereign issues	Most member countries have not yet issued sovereign \$\sukuk\$ or other \$Shar\tilde{t} ah\$-compliant instruments. Two large economies that have done so in recent years are Turkey and Indonesia.
Proper understanding of Islamic banking services and their equal treatment vis-à-vis conventional product	As noted earlier, most central banks treat Islamic products on par with their conventional counterparts.
7. A clearer understanding of the <i>Sharī`ah</i> governance structures and efforts to facilitate them further	Some member countries have specific requirements for <i>Sharī`ah</i> governance; most do not.
Extension of safety net systems such as Sharī`ah- compliant deposit insurance	Only 31% of regulators in our survey reported having <i>Sharī ah</i> -compliant deposit insurance in their jurisdictions. Throughout recent crises, deposits and investment accounts of Islamic banks have enjoyed the safety nets available to all licensed banks. *It is noted that "investment accounts" based on
	Muḍārabah or Mushārakah may not qualify for deposit insurance in certain jurisdictions.
9. Ensuring that the legal system is supportive	Among regulators responding to our survey, 65% reported having banking regulations for Islamic banking. Such regulation, however, does not always ensure that commercial laws and the overall legal system support Islamic banking. Forty-two per cent (42%) reported having "guidance for <i>Sharī ah</i> -compliant contracts".
Ensuring tax neutrality for Islamic financial contracts	Among regulators responding to our survey, 46% reported tax neutrality for Islamic banking contracts. Additional focus is thus required in the tax neutrality of Islamic banking contracts.
	The matter of <i>Zakāh</i> treatment also calls for consideration.

Regulators and supervisors have developed increasingly deliberate strategies for Islamic banks. In our survey undertaken by IFSB and IRTI, 39% of regulators reported having strategic plans in place for the development of the Islamic banking sector; an additional 15% reported that they are "developing" such plans. Greater support and collaboration (1) between these regulators and international industry bodies, and (2) among these regulators can result in the development of more sound and better-informed plans.

These may be reflected in differentiated treatment within the body of regulations, though most members still subject them to exactly the same regime as conventional banks. Some members regulate Islamic banks through distinct Islamic banking laws (a dual-regime model); others operate a single-regime model through which Islamic banks are subject to only the same laws as their conventional counterparts.

In our survey, 58% of regulators reported having legislation in place "for the establishment and operation of Islamic banks and/or Islamic windows". Some 65% reported having banking regulations "specific for Islamic banking operations".

Over the past years, regulators and supervisors in several key countries have expressed greater openness to Islamic banking. Islamic banking is accommodated in more member countries today than it was in 2007. Tax neutrality remains a challenge, particularly in countries that are newly allowing Islamic banking.

IT solutions are increasingly available through both specialist vendors and generalist providers of technology solutions to banks.

While regulators and supervisors worldwide are generally more aware and accommodating of Islamic banking than before, there remain countries with large populations in which Islamic banking is either entirely absent or very nascent. India and China are examples of such countries.

As the NBFI sector is comprised of various types of institutions with different organisational formats and sizes, one model cannot be used to regulate them. The laws should provide for tiered regulation whereby different institutions would be regulated with different intensities depending on their sizes, functions, products and operations. Different approaches can be taken to regulate NBFIs.⁴² One would be the institutional approach whereby specific regulations would apply to institutions depending on their legal format. Under this approach, as NBFIs are registered as non-banks they may be regulated by a separate regulatory body, even though some of these may

There are four regulatory approaches: institutional, functional, integrated and twin peaks. While under the institutional approach a firm's legal status determines the regulatory body that supervises the entity, in the functional approach the nature of a firm's business determines the regulator. In the integrated approach, all regulation and supervision is carried out by a single regulator; and under the twin peak approach the safety and soundness regulation is carried out by one regulator and the conduct of business supervision by another body. For a discussion on the four approaches, see Group of Thirty (2008), The Structure of Financial Supervision: Approaches and Challenges in a Global Market Place, Washington DC: Group of Thirty.

be deposit taking. Another is the functional approach, in which the regulator regulates activities irrespective of the institutional format. According to this approach, all financial institutions that are deposit taking would be subject to prudential regulation, while non-deposit-taking NBFIs may not come under the prudential purview of the regulators. The regulatory environment will vary depending on the regulatory approach that applies in different jurisdictions. There is also a need for coordination between supervisory authorities of various sectors within a jurisdiction (e.g. banking, capital markets, etc.). A shared willingness to support the IFSI is needed.

The recent global financial crisis, however, has shown that there is a need for non-prudential regulation of NBFIs, particularly with respect to disclosure, corporate governance and risk management regimes. A relatively lax regulatory regime for NBFIs can lead not only to insolvencies, but also to regulatory arbitrage whereby banks open up NBFI subsidiaries to benefit from lenient regulatory standards. In this regard, regulatory guidelines based on the International Organization of Securities Commission (IOSCO) Core Principles and the Core Principles for the Financial Market Infrastructure can be applicable for some NBFIs such as brokerage and asset management firms.

A good example of a sound regulatory regime for a limited class of NBFIs is Pakistan. The SECP oversees the operations of NBFIs under its Specialised Companies Division, which performs functions of both regulation and supervision. The regulatory role is implemented by the Policy, Regulation and Development Department, which carries out the registration, authorisation and enforcement of regulatory provisions. The NBFIs covered by this department include non-bank financial companies dealing with investment, leasing, housing financial services and *Muḍārabah* companies. Note that while the *Muḍārabah* companies are specialised Islamic financial institutions, other NBFIs are not necessarily *Sharī`ah* compliant. To ensure *Sharī`ah* compliance in the former, the SECP has a three-member Religious Board to oversee the *Sharī`ah*-related issues in these companies. For other institutions, it has constituted a separate, larger *Shari`ah* Board. The supervisory role of SECP is performed by the Supervision Department, which carries out both on-site inspection and off-site surveillance.

Microfinance can also be provided by different types of institutions with a variety of organisational formats and sizes; hence, one model cannot be used to regulate them. The Basel Committee on Banking Supervision (BCBS) has issued a document where it has explicated the applicability of Basel Core Principles for microfinance institutions. These principles can also be used for Islamic microfinance institutions. ⁴³ However, the principles need to be tailored and interpreted according to the needs of different types of microfinance institutions and

⁴³ BCBS (2010), Microfinance Activities and Core Principles for Effective Banking Supervision, Basel Committee on Banking Supervision, August, https://www.bis.org/publ/bcbs175.pdf.

the activities in which they are involved. Given the variety of institutional types involved in providing microfinance, the regulatory framework would depend on the institution type and activities carried out. Figure 7 shows, as an example, the regulatory regimes for different types of microfinance institutions in Indonesia.

Figure 7: Organisational Diversity and Regulatory Regimes for Microfinance Institutions in Indonesia

Microfinance Institution Type	Ownership	Organisational Format	Authorised Activities	Regulated by
Com. Banks	Private/State	Limited Liab. Company (LLC)	Full service bank	Indonesia Financial Services Authority/ Otoritas Jasa Keuangan (OJK)*
Bank Rakyat Indonesia (BRI) Unit Desa	Indonesia (BRI) BRI (state-owned)		Full service bank	OJK*
Bank Perkreditan Rakyat Syariah (BPRS)	Rakyat Syariah Private parties/		Savings and time deposits, loans	OJK*
Baitul Maal wa Tamwil (BMT)	Initiated by NGOs	Cooperatives	Savings deposits and micro-loans (members only)	Ministry of Coops

^{*} Prior to 31 December 2013 under the supervision of Bank Indonesia (BI).

In the area of *Takāful* and *ReTakāful*, key developments led by the industry have taken place. Progress has also been made in creating appropriate supervisory frameworks, and in designing legislation and products to ensure tax neutrality. However, conventional insurance companies make heavy use of debt-based instruments for investment, and asset–liability matching relies on these. Such instruments, or even close analogues for them, are much scarcer in Islamic markets, leading *Takāful* product design to be skewed in the direction of overcoming this handicap, sometimes at the expense of underlying objectives. The lack of access to all asset classes, especially a "fixed income" class, has posed difficult additional challenges to the *Takāful* and *ReTakāful* sector in developing an appropriate range of products.

Recommendation 9: Develop comprehensive and sophisticated interbank, capital and derivatives⁴⁴ market infrastructures for the IFSI

Many Islamic banks continue to operate unsophisticated treasuries (relying almost entirely on basic placements), due to a number of factors. One is the scarcity of liquidity management

⁴⁴ Although the term "derivatives" was used in the 2007 document, it has been recommended that the term "hedging" be used as a more appropriate description.

solutions and short-term assets available for investment. A second factor is that Islamic banks have often struggled to attract top-calibre treasury professionals experienced in sophisticated products. This is due, at least in part, to the fact that Islamic bank treasuries are often smaller than their conventional counterparts and thus the scale of the opportunity does not always compare favourably. The fact remains that Islamic liquidity management and interbank markets – important as they are to the IFSI – are a very small part of the overall liquidity management industry.

The formation of IILM – an international body enabling stronger interbank liquidity management – is a milestone development for the industry. Though still nascent, this institution enjoys strong international support and has the potential to have a substantial impact in enabling Islamic banks to deploy excess liquidity more efficiently. IILM launched its first short-term cross-border $Suk\bar{u}k$ in August 2013.

While IILM and other initiatives endeavour to create products, liquidity management contracts and platforms, enhanced liquidity management of institutions will require increased skill and execution capabilities within the treasury areas of Islamic banks.

Domestic interbank markets for Islamic banks exist in certain countries, but many member countries (even those with Islamic banks) lack such domestic markets. The development of domestic Islamic interbank markets is thus an important component of central banks' agendas for developing the Islamic finance in their countries. Additionally, the issuance of sovereign $Suk\bar{u}k$ (of various tenures) plays a vitally important role in broadening the range of liquidity management instruments available to Islamic banks.

It can also be noted that current liquidity management solutions have traditionally relied on commodity *Murābaḥah* and *Wakālah* structures, which are deemed by certain observers as less authentic than other structures. The development of *Muḍārabah*- and *Mushārakah*-based liquidity solutions has begun, with interbank *Muḍārabah* being cited as an important tool used by IIFS in a recent IFSB survey. Another recent innovation has been the introduction of "collateralised commodity *Murābaḥah* transactions". Central banks of UAE and Malaysia have already issued regulations on this product.

Like banks, NBFIs could benefit from robust interbank and capital markets to manage both short-term liquidity and long-term investment needs. However, in most jurisdictions, the Islamic money market is in a rudimentary stage. Non-deposit-taking Islamic NBFIs have the potential to raise funds from the capital market by issuing $Suk\bar{u}k$ to finance their operations.

In order to fund their activities, microfinance institutions are increasingly seeking to move away from donor-dependent organisations and to tap the capital markets instead.⁴⁵ Whereas some Islamic NBFIs such as investment banks and companies have raised funds using $\S uk\bar{u}k$, the microfinance institutions and other smaller financial institutions have yet to tap these markets.

Hedging contracts are important for IIFS in managing risk and investment exposure. The launch of the *Taḥawwut* (Islamic hedging) framework by IIFM, modelled on the International Swaps and Derivatives Association (ISDA) master agreement, is an important development in this area. This framework provides standardisation, whereas previous hedging structures were institution-specific and required bilateral negotiation. If this *Taḥawwut* framework results in the growth in offering of relevant risk mitigation products, this will benefit the *Takāful* and *ReTakāful* sector, as well as other institutional investors. Hedging solutions are increasingly needed for appropriate access to all asset classes and the matching of assets and liabilities. It is also noted that a major challenge for Islamic hedging contracts will be the Basel recommendation on clearing such transactions through Central Counter Parties (CCPs) and exchanges.

Recommendation 10: Promote public awareness of the range of Islamic financial services

Certain key member countries – particularly the GCC and Malaysia – enjoy high levels of public awareness of Islamic financial services. These are the markets where Islamic finance is most mature.

In a large number of countries, however, public awareness of the industry remains more limited. A relative lack of awareness of the industry remains a barrier to growth in many high-potential markets such as Turkey, Indonesia and Pakistan.

Survey data is not available on the level of awareness of Islamic banking. Market share of the industry may, however, provide some perspective on customer awareness (and comfort with) Islamic banking. In our survey, only ten member countries reported that Islamic banking assets comprised 10% or more of their overall banking assets. These countries included Sudan (which reported 100% Islamic banking), Saudi Arabia, Brunei, Kuwait, Malaysia, Qatar, Bahrain, Bangladesh, the UAE and Jordan. Although Iran was not a respondent in the survey, its banking sector is deemed to be 100% Sharī ah compliant.

In our survey of Islamic banks, a striking 73% of respondents named "lack of awareness of Islamic banking products and services" as a very significant or significant challenge in

⁴⁵ Mayada El-Zoghbi and Michael Tarazi (2013), "Trends in Sharia-Compliant Financial Inclusion", CGAP Focus Note No. 84, March.

⁴⁶ Subsequent to the Mid-Term Review Survey, Pakistan reached 10% market share.

developing the Islamic banking business in their jurisdictions. This was the highest figure attributed to any challenge.

Greater efforts to raise awareness of Islamic finance – potentially as part of an overall initiative to enhance financial literacy in such countries – can have a positive impact on both the industry and the economy overall.

Given the use of sale- and equity-based modes, Islamic financial products are inherently complex by their nature. Moreover, a lack of information disclosure and awareness of the Islamic products has led to a general perception that they are similar to their conventional counterparts. Given the newness and the complexity of Islamic financial products, there is a need to raise awareness of these products among the public. In particular, various features of the debt- and equity-based Islamic financial products need to be publicised so that the clients understand the risk–return profiles of these products. Consumer protection laws can require financial institutions to disclose all relevant information of the products they sell. For example, regulations in Indonesia require financial institutions to be transparent about the features of the products.⁴⁷

The relatively better performance of the Islamic financial sector during the global financial crisis provides an opportunity to expand the scope and scale of operations by targeting customers from all backgrounds. In this regard, the features of financial products offered by various IIFS including NBFIs and microfinance institutions need to be publicised and offered to both Muslim and non-Muslim clients.

There remains a common perception in the market that Islamic financial products are at best alternative formulations of conventional products in the market, without having any inherent values in themselves. In the provision of *Takāful* and *ReTakāful*, this perception is more embedded. With a poor record of commercial viability and a great deal of leakage to the conventional re-insurance industry, the proposed virtues of risk-sharing in *Takāful* and *ReTakāful* provision are difficult to demonstrate.

These features of the present provision of products make promotion of public awareness difficult. However, a number of dedicated forums have emerged to spearhead thought leadership in the *Takāful* and *ReTakāful* industry. This, together with publication of annual surveys of the industry by major international industry players, has done much to create awareness of the

⁴⁷ Bank Indonesia Regulation Number 7/6/Pbi/2005 Concerning Transparency in Bank Product Information and Use of Customer Personal Data.

opportunities and challenges faced by the industry. Dedicated journals and industry directories covering *Takāful* and *ReTakāful* have also been launched. The global insurance industry is now reasonably well informed of the key features of *Takāful* and *ReTakāful* services provision.⁴⁸ Relatively little, however, has been done to facilitate the promotion of awareness of these products to the public.

Increased awareness of socially responsible investing (SRI) and ethical finance overall provides an important opportunity for the IFSI. The ethics underlying Islamic finance are highly consistent with the broader SRI movement, and these commonalities illustrate the general relevance of Islamic finance. As appreciation of SRI and ethical finance grows worldwide, the IFSI can enhance awareness of its values by highlighting their relevance to these fields. At the same time, the sophistication of the investment filters used by the global SRI industry provides a useful example for the IFSI to study and apply. The concept of "SRI Şukūk" has been introduced by the government of Malaysia, and the use of Şukūk of development finance has been discussed by the World Bank Group.

Recommendation 11: *Strengthen and enhance collaboration among the international Islamic financial infrastructure institutions*

There is a positive trend towards deeper collaboration among industry bodies such as the IDB Group, the IFSB, AAOIFI, IIFM and others. The Ten-Year Framework exercise is itself an example of collaboration between the IDB Group (through IRTI) and the IFSB partnering on a key initiative.

As the number of infrastructure institutions has grown, there has been a trend of staff bringing expertise from one institution to another. This helps to foster communication and the transfer of best practices, and enhanced collaboration is expected in the years ahead.

As regulatory regimes in member countries are diverse and often under-developed, there is a need to come up with a regulatory framework and principles for Islamic NBFIs and microfinance institutions. Furthermore, it would be helpful if the infrastructure institutions could collaborate to introduce best practices and replication of successful products in various NBFIs.

It is noted that while project-based collaboration between infrastructure organisations has grown, the number of informal linkages exceeds the number of formal collaborations. Increased formalisation of these ties may spur greater cooperation and demonstrate collegiality among the organisations serving the industry.

⁴⁸ Takaful Primer – Full proceedings of the annual International Takaful Summits (www.takafulprimer.com).

Recommendation 12: Foster collaboration among countries that offer Islamic financial services

Multilateral development finance institutions such as the IDB, and infrastructure institutions such as the IFSB, AAOIFI, the IIFM and the IILM, have been key catalysts in spreading knowledge and expertise in Islamic finance. These institutions have been especially valuable for banking supervisors and regulators to exchange best practices between countries. The long-standing involvement in Islamic finance by the World Bank and the continued participation of the Asian Development Bank (ADB) are promising indicators for the future.

In a noteworthy development, the D-8 countries (Bangladesh, Egypt, Indonesia, Iran, Malaysia, Nigeria, Pakistan and Turkey) have begun initiatives to foster collaboration. Islamic financial services (including banking, microfinance and capital markets) are an area of focus for this collaboration. All eight members of this group are OIC member countries.

Bilateral/multilateral exchanges and collaboration between countries are forming, and can be particularly helpful for deeper and more detailed technical collaboration. As regional bodies (such as Association of Southeast Asian Nations (ASEAN), Asia-Pacific Economic Cooperation (APEC), and the GCC) become more influential and regional economies become more integrated, regional forums on Islamic banking supervision will likely play an increasingly important role.

In our survey, fewer than half of the regulators reported having foreign Islamic banks operating in their jurisdiction. This is an interesting data point, reflecting both (1) the scarcity of Islamic banks that are active in multiple countries, and (2) the potential for greater collaboration and licensing of Islamic banks to expand operations to new countries.

Observers such as the International Monetary Fund (IMF) have noted a need for policies that both (1) incentivise foreign banks and (2) support domestic banks in providing funding to cross-border clients. These measures, while domestic in nature, can have an impact in the collaboration across markets offering Islamic financial services.

Beyond the banking sector, there is a need for greater focus on collaboration and on the exchange of ideas and best practices. As a significant step in the progress of strengthening cooperation among the OIC stock exchanges, the formation of the "Organization of Islamic Cooperation Member States' Stock Exchanges Forum" is an important milestone. It aims to provide a dedicated platform and communication channel for representatives to discuss cooperation and to initiate the groundwork to harmonise rules and regulations governing market operations.

As Islamic microfinance institutions are still small and emerging in most IDB member countries, they face certain unique risks and challenges. Collaboration and sharing of experience could help publicise and exchange knowledge and good practices among Islamic microfinance institutions. This is done to some extent by Sanabel, a network of microfinance institutions for the Arab world. Similarly, more focused collaboration in the *Takāful* and *ReTakāful* sector is recommended.

Recommendation 13: Conduct initiatives and enhance financial linkages to integrate domestic IFSIs with regional and international financial markets⁴⁹

The development of an international $Suk\bar{u}k$ market is an important step in providing domestic institutions access to funding beyond their borders. It is noted that many subscribers to $Suk\bar{u}k$ have been conventional investors or conventional asset managers – opening up a pool of capital that would otherwise have been difficult to bring to the industry.

The largest and most sophisticated Islamic banks generally enjoy strong ties with regional and international markets. These ties are often intermediated by the Islamic business units of conventional international banks, which can draw on their existing relationships and infrastructure to act as "market makers".

Smaller Islamic banks often lack such linkages, or access them with less efficiency. Stronger market links would help small Islamic banks enhance their performance and their overall competitiveness.

With the increased pace of globalisation, the financial linkages of the domestic financial sector and international financial markets are expected to increase. Among the NBFIs, Islamic investment banks are expected to play an important role in international financial markets. However, for this to happen, the Islamic NBFIs need to be larger and be able to sustain their operations and manage the risks in an increasingly interconnected world.

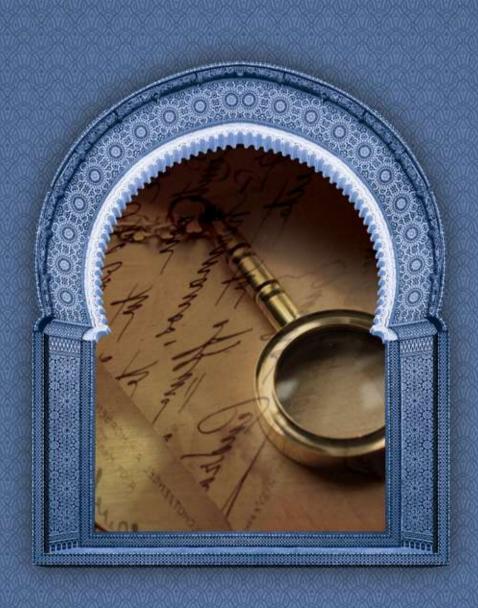
At the national level, there is a need to enhance linkages between different sectors to create synergies for the development of the Islamic financial sector as a whole. For example, NBFIs such as leasing firms and microfinance institutions can raise funds from the capital markets to finance their activities.

In the *Takāful* and *ReTakāful* sector, the lack of a standard definition of what constitutes *Takāful* is presenting challenges for adequate interaction and collaboration. However, the *Takāful* and

⁴⁹ Excerpted from the Ten-Year Framework and Strategies (2007).

ReTakāful sector is gaining traction in international industry forums. Regulators such as the United Kingdom's Prudential Regulatory Authority (PRA) and Financial Conduct Authority (FCA) have also enabled the interaction by licensing a full *Takāful* operation in the UK under existing legislation. This has set a notable precedent for other regulators to follow.

Additionally, it is noted that experimentation has taken place with the Islamic Interbank Benchmark Rate (IIBR), which is meant to be an alternative to conventional pricing benchmarks. If this benchmark gains prevalence, it may encourage more IIFS to participate in overseas interbank markets.



4 SECTOR-LEVEL ASSESSMENTS

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4.1 Islamic Banking

Impact of Macro and Environmental Shifts

The global banking sector has changed substantially since 2007. The level and pace of change have been higher than expected, with significant changes of a fundamental nature having taken place in a short period.

These fundamental macro and environmental shifts create both opportunities and challenges for the Islamic banking sector. Embracing and adapting to these shifts can position the sector strongly for long-term growth; failing to do so would be a lost opportunity for the sector and for the economies it serves.

• Shift in the engines of growth for the global economy

Over the past years, emerging markets have been increasingly identified as key engines of growth for the global economy. Sluggish growth in the world's largest economies contrasted with rapid growth in key emerging markets has led to what economists have called a "two-" or "three-speed" global economy. While mature economies remain vitally important to the global economy, sources of global growth are now more diversified.

These contrasting growth prospects have accelerated the eastward shift in the world's economic "centre of gravity". Economies of the Middle East and Asia – including key Muslim member countries – are seen as increasingly central. The G20 – a summit that plays a key role in international economic policy – now includes three IDB and IFSB member countries (Turkey, Saudi Arabia and Indonesia).

Key member countries – particularly in the GCC region – continue to generate strong budget surpluses and national savings year after year. The combination of sustained energy prices, growing populations and ongoing economic reforms has allowed certain member countries to flourish despite the overall global economic challenges.

The shift creates numerous opportunities for Islamic banks, including (1) managing the savings and wealth being created, (2) supporting ongoing economic growth by providing financing, and (3) exercising increased influence in global forums and decision-making bodies. These global forums include both forums that have traditionally been dominated by Western economies (such as the G20, IMF and World Bank) and new forums that provide greater focus on emerging economies in Asia, the Middle East and Africa.

The shift likewise raises new challenges for the sector. For Islamic banks to play a sizeable role in financial intermediation, they must offer competitive propositions that customers will prefer. As for cross-border financial intermediation — which is a large opportunity in light of global trends — Islamic banks need to demonstrate an ability to offer world-class services in cross-border contexts customarily led by conventional banks.

Third, Islamic banks need to deepen their ties to certain global engines of growth (such as China, India, Russia and Brazil) with which financial relationships have historically been quite limited. Islamic banks continue to concentrate their interbank relationships with European Union-(EU) and United States- (US) based institutions, although the main engines of economic growth are elsewhere. By 2012, for example, China boasted four of the world's top ten capitalised banks, yet the exposure of IIFS to Chinese banks is minimal. As trade links grow with these emerging markets, there is a strong opportunity for financial intermediation. The fact that China, India, Russia and other centres of growth have substantial Muslim populations may further indicate the feasibility of Islamic banking ties with these countries.

• Ongoing financial crises

Since 2008, the world has witnessed waves of successive financial crises. Ranging from institutional crises (e.g. the failure of Lehman Brothers) to systemic crises (e.g. the virtual collapse of European debt markets) to sovereign debt and currency crises (e.g. fundamental challenges to the Eurozone), the very pillars of the global financial system have been rocked. These crises create both opportunities and challenges for the Islamic banking sector.

The continued "state of crisis" has called into question the merits of the conventional financial system. Observers as diverse as the IDB Group, a Vatican newspaper and the Anglican Church have publicly noted that Islamic finance principles could play a role in avoiding such crises and fostering a more stable financial system. Leading Western economists have increasingly argued for and engaged with the Islamic finance community – for example, Willem Buiter advocated Islamic finance principles in his writings; 50 and Jeffrey Sachs has presented at IDB events and partially taken Islamic finance for the expansion of his Millennium Villages programme. These are only two examples from among numerous prominent economists who have expressed positive views on Islamic finance.

Questioning of the conventional system has given the industry an unprecedented opportunity to articulate a distinctive, principle-based approach to financial intermediation. The Islamic

Willem Buiter (2009), "Islamic finance principles to restore policy effectiveness", Financial Times blog, 22 July, http://blogs.ft.com/maverecon/2009/07/islamic-finance-principles-to-restore-policy-effectiveness/#axzz2sGrh6ulh, accessed 6 January 2014.

banking sector, has, however, struggled to articulate an alternative vision. The products adopted by Islamic banks are generally viewed as replicas of their conventional counterparts. While Islamic economists have offered conceptual frameworks and theoretical arguments on the differentiation of the Islamic system, banks have struggled to demonstrate these substantive differences in practice.

The financial crises and the associated impact on asset values have clearly had an impact on the performance of Islamic banks. Banks with heavy exposure to real estate, for example, have suffered as asset values fell and clients defaulted. There have also been some high-profile bankruptcies (particularly among investment companies licensed as investment banks), indicating that Islamic banks – like their conventional counterparts – can be vulnerable to economic shocks and market collapses.

· Fundamental reviews of financial regulation

The ongoing crises have prompted regulators around the world to fundamentally review their approaches to financial regulation. The past few years have witnessed deep changes in the realms of capital adequacy, liquidity requirements, large exposure (concentration) rules, transparency with customers, deeper KYC ("know your client") screening requirements, and the segregation of retail deposit-taking and risk-taking investment banking activity. "Shadow banking" has also been an increased focus of regulators seeking to protect depositors, shareholders and the public at large. Increasing emphasis on bringing more forms of credit "on to the balance sheet" has implications for the reporting and capital requirements of Islamic financial services.

In this regulatory dialogue, Islamic banks have a noteworthy perspective to offer. Certain concepts of Islamic finance – such as limiting debt to the value of assets being financed, ensuring that all parties to a contract have clear offer and acceptance, and (in most schools of thought) avoiding the sale of debt (other than at par) – have direct relevance to the regulatory discussions at hand

At the same time, Islamic banks are subject to the same overall regulations that shape the sector. Increased capital adequacy requirements, for example, raise challenges for Islamic and conventional banks alike. This is due to the fact that Islamic banks undertake the same systemic role as their conventional counterparts, and thus require similar supervision. It is thus important that Islamic banks (1) embrace and adapt to the new regulatory approaches arising in the sector, and (2) play an active role in influencing regulation for the good of the financial system overall. This is especially crucial for areas in which changes to regulation may have more adverse

consequences for IIFS as compared to their conventional counterparts. Islamic banks will face greater challenges in meeting the requirements of new liquidity standards such as the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), due to the unavailability or short supply of high-quality liquid assets (HQLA) and deposit insurance that are *Sharī`ah* compliant.

· Government reform in key markets

In key IDB and IFSB member states, important reforms have been witnessed in recent years. These changes have, in general, sought more participatory governments, greater power given to the people, and more political and economic freedoms. This trend has (in certain jurisdictions) included greater openness to Islamic finance as a response to customer demand. Countries in North Africa, Central Asia and Africa are among those in which such reforms have taken place. In certain countries, openness to Islamic finance has resulted in regulatory and statutory changes that support the development of the industry.

Oman has opened to Islamic finance, with Central Bank regulations now in place for Islamic finance and several banks active in the sector. This reform makes Islamic finance now available in all six countries of the GCC. Elsewhere in the GCC, Qatar has amended its regulations to require that Islamic financial services be provided by fully Islamic banks or subsidiaries, no longer permitting a "window" model.

Several key markets in the Arab world have undergone changes in government, including Egypt, Libya, Tunisia and Yemen. In each instance, the core demand was for greater responsiveness to the demands of the general public in setting policy decisions. This trend may likely lead to greater appreciation of consumer preference for Islamic finance in jurisdictions where it has been under-developed. The region's regimes remain, however, in flux and the ultimate impact on the openness to Islamic financial services cannot be judged.

These changes, nonetheless, represent a very substantial opportunity for Islamic finance to enhance financial participation and inclusion. The momentum this brings to the Islamic banking sector is sizeable, as the countries with new regimes represent roughly one-third of the total Arab population.

Newly opened markets will, however, need technical assistance in designing their regulations and policies. At the same time, both public and private sector actors will need to study the examples of their predecessors in other countries so as to apply best practices and avoid common mistakes.

· Internet and mobile technology platforms

Internet and mobile technology platforms have evolved tremendously since 2007. Internet and mobile banking can greatly enhance customer convenience. Importantly, they can also provide a revolutionary level of access to financial services by customers who previously could not reach bank branches or be profitably served by banks.

Embraced effectively, internet and mobile platforms can help Islamic banks grow their customer bases and serve their clients better. Promoting financial inclusion, as noted in the original Framework document of 2007, is a key objective of the industry. Internet and mobile technologies have the potential to play an important role in serving this goal.

While many Islamic banks have adopted internet and mobile banking, Islamic banks are generally not seen as being at the forefront of these technologies. Many Islamic banks have begun developing alternative customer service channels. In our survey of banks offering Islamic financial services, 65% reported offering internet banking and 58% mobile banking. Embracing these channels more fully can help Islamic banks better achieve both their commercial objectives and the industry's goal to enable more comprehensive financial participation. Alternative customer services channels require capital investment, but this investment is often well justified based on cost savings and increased customer loyalty.

Interestingly, 50% of respondents reported using the social media tool Facebook and 29% reported using Twitter. These platforms – which have become important only in recent years – can potentially play a role in raising awareness of Islamic financial services and helping these banks market their services more effectively. It is also noteworthy that only 62% of respondents considered their marketing capabilities to be "good" or "advanced" – making marketing the second-weakest area (second only to research and development).

• Deep distrust of the banking sector

A final, key trend to observe is that the banking sector today faces deep distrust. Ongoing financial crises have fuelled a perception of irresponsible bankers causing public harm while accruing private benefit. While the main driver of this has been public sector bailouts of institutions, a series of conduct scandals involving misconduct including instances of widespread mis-selling and market manipulation have added to the perception that the whole sector has lost its way ethically.

In a 2013 public survey published in the UK by YouGov and the University of Cambridge, 73% of respondents described banking's reputation as "bad". It had by far the worst reputation of the 26 industries tested, with only 4% of respondents feeling that banks "observe high ethical and moral standards".

This distrust gives the Islamic banking sector the opportunity to distinguish itself as a more values-based alternative to the conventional financial system. The current level of differentiation between Islamic and conventional banks may, however, not be sufficient to demonstrate added benefits of Islamic banking. It is likewise important that Islamic banks differentiate not only in terms of financial structures and products, but also in business ethics and commercial values. Such differentiation could both align more fully with customers' expectations of Islamic banks and also position them to capture greater acceptance and market share.

The matter of differentiation between Islamic and conventional banking is a delicate one, and insufficient differentiation may be hindering the industry's growth in certain key markets. Whereas many customers are open to Islamic finance if its products replicate the effects of conventional products, there are others who expect greater differentiation.

While, in theory, Islamic bankers would be more trustworthy (due to their institutions' added focus on ethics and values), it is not clear that Islamic banks are seen as different enough to warrant a higher level of trust. As Islamic banks increase their focus on authenticity and differentiated products, they can hope to win a large share of public trust and goodwill, which is currently lacking for the banking sector as a whole. This poses an interesting question as to whether the ethical counselling of Islamic banks provided by *Sharī'ah* supervisory boards should include overall commercial ethics in addition to products and structures.

Our survey of Islamic banks revealed interesting examples of how the offerings of Islamic banks may often be more favourable to customers than the offerings of their conventional counterparts. Around 75% of respondents reported overdraft facilities to be "not applicable" to their offerings, and 63% reported credit card and other unsecured revolving financing to be "not applicable". These two types of product – overdrafts and revolving credit – are often viewed as most detrimental to customer wellbeing, incurring substantial (and often unexpected) charges. The fact that most respondents do not have these products may suggest that the industry's product mix is more favourable to customers.

Progress Made in the Sector

Since the 2007 formulation of the Framework recommendations, the Islamic banking sector has progressed substantially. The sector continues to enjoy strong levels of growth, and is broadly viewed as a "proven" concept in the key markets it serves. Whereas some in the 1980s and 1990s had questioned whether Islamic banking was merely a fad, in the 2010s it is firmly viewed as a viable and growing industry.

The above observations are discussed in detail in Section 3 of the Mid-Term Review of the Framework.

The following broad observations can be made by way of summarising progress made in the sector:

· Islamic banking continues to grow strongly

The Islamic banking sector is reported by Ernst & Young to have grown at an annual rate of 16% in the period 2008–2012, reaching assets of USD1.7 trillion by the year 2013.⁵¹ Estimates of the asset size and growth rate vary significantly (another report, for example, estimates banking assets to be USD950 billion⁵²), but the consistent findings are that the sector is rapidly increasing in size, with assets near or above USD1 trillion.

The sustained growth of the sector throughout the financial crisis is seen as a sign of resilience and of ongoing relevance to customers worldwide.

· Islamic banking remains the core of the Islamic financial services industry

It is estimated that 73% of total Islamic finance assets worldwide are banking assets.⁵³ Nearly three-quarters of the industry's assets, therefore, are in the banking sector.

While banking dominates the asset base of the industry, banks comprise a much smaller proportion of institutions offering Islamic financial services. It is estimated that over a thousand institutions offer Islamic financial services, of which fewer than 363 are banks⁵⁴ The overall industry enjoys a rich diversity of institutions, with banks playing a central role.

The ongoing development of the industry is highly dependent on the success of Islamic banking. While NBFIs and other institutions are crucial for the holistic development of the industry, banking is the most dominant form of Islamic finance in the market today, and is expected to remain so throughout the remaining period of the Ten-Year Framework.

• Islamic banking is expanding its market share

In the Survey undertaken by the IFSB and IRTI, ten member countries reported that Islamic banking assets comprised 10% or more of their overall banking assets. These countries included Sudan (which reported 100% Islamic banking), Saudi Arabia, Brunei, Kuwait, Malaysia, Qatar,

⁵¹ Ernst & Young, World Islamic Banking Competitiveness Report, 2013–14.

 $^{^{\}rm 52}~$ ICD and Thomson Reuters, Islamic Finance Development Report 2013.

⁵³ Ibid.

⁵⁴ Ibid.

Bahrain, Bangladesh, the UAE and Jordan. Although Iran was not a respondent in the survey, its banking sector is deemed to be 100% Islamic.

This development reflects a milestone for the industry, and it is further noteworthy that the countries in which market share of more than 10% has been achieved include countries in the GCC, Association of Southeast Asian Nations (ASEAN), South Asia, Africa and the Levant.

• Competition is becoming more intense

As the sector has evolved, competition among Islamic banks (particularly in domestic markets) has increased. New Islamic banks have been formed in numerous markets, including those where Islamic banking is new (such as Nigeria) and others where the sector is well established (such as the UAE). It is also noteworthy that, in certain countries, the new banks being formed tend to be Islamic rather than conventional. In Saudi Arabia, for example, three recently launched retail banks are Islamic.

Of the estimated 363 institutions offering Islamic banking, 69% are fully Islamic ("standalone") banks, while the remaining 31% are conventional banks offering Islamic services through "windows". The presence of such windows (where allowed by regulators) adds to the competitive intensity in the marketplace.

Competition is an important element of free markets, and the Framework recommendations call for "free, fair and transparent markets". Competition has enhanced the range of choices available to customers, and has forced institutions to enhance their products and services to win market share. Particularly when a market has more than one Islamic bank, customers are free to choose the institution that best satisfies their needs.

• Institution-level performance remains a key challenge

As discussed in Section 3 of the Mid-Term Review, Islamic banks often face challenges in achieving high performance as institutions. Profitability, capital efficiency and scale are some of the challenges faced by many Islamic banks.

Depending on the samples used, some publications reported that Islamic banks performed better than their conventional counterparts. However, in an analysis comparing a set of "top 20" Islamic banks with a set of comparable conventional institutions, E&Y found the Islamic banks, on average, lag conventional banks in their ROE (12.6% vs. 15.0%). Average growth, however, of the Islamic banks exceeded that of their conventional counterparts (15.8% vs. 13.8%). In a study on Islamic banks in the MENA region (covering data until 2009) it was found that

⁵⁵ Ibid.

⁵⁶ Ernst & Young, World Islamic Banking Competitiveness Report, 2013–14.

Islamic banks achieved a similar return on assets (ROA) to their conventional counterparts. ROE, however, was lower in the case of Islamic banking compared to the conventional banking sector, "reflecting higher capitalisation and lower leverage of Islamic banks".⁵⁷

Islamic banks reported a number of institution-level challenges through the Survey undertaken by the IFSB and IRTI, including a scarcity of specialised talent and limited research and development capabilities.

· Regulatory enablement remains a challenge

Within the IFSI, regulations for Islamic banking are the most developed. In the Survey undertaken by the IFSB and IRTI, 65% of respondent regulators reported having banking regulations "specific for Islamic banking operations".

As discussed in Section 3 of the Mid-Term Review, progress on the ten areas for legal and supervisory enablement identified in the 2007 Framework has been mixed. For example, only 31% of regulators responding to the Survey undertaken by the IFSB and IRTI reported having *Sharī`ah*-compliant deposit insurance in their jurisdictions.

• Reach has expanded, but remains incomplete

A key goal of the 2007 Framework was to expand the reach of Islamic finance to those who lacked access to it. Over the past years, the reach of Islamic banking has grown as (1) new markets have opened to Islamic finance, and (2) the industry itself has matured and expanded its customer base.

In a 2013 report, it was estimated that 38 million customers are served by Islamic banks.⁵⁸ While the growth in this figure is impressive, a customer base of 38 million represents less than 2.5% (or one in 40) of the global Muslim population.

In recent years, new markets in the Middle East, Central Asia, Africa and Europe have opened to Islamic finance and expanded the potential customer pool substantially. Additional expansion has been enabled by the introduction of microfinance services by Islamic banks. Of the banks responding to the Survey undertaken by the IFSB and IRTI, 36% reported having microfinance facilities.

⁵⁷ Salman Syed Ali (2012), "Islamic Banking in the Middle-East and North-Africa (MENA) Region", Islamic Economic Studies, Vol. 20, No. 1, pp. 1–44, at 42.

⁵⁸ Ernst & Young, World Islamic Banking Competitiveness Report, 2013–14.

As the Islamic banking sector remains the most developed sector of the IFSI, Section 3 provides significant detail on the progress made in Islamic banking over the past years.

In summary, the central achievements of the Islamic banking sector in recent years have been its growth, increased market share, and expansion to new markets. Significant achievements have also been made in the areas of regulation and institutional development, to which greater attention is required to be paid if the pace of growth is to be sustained.

Opportunities and Challenges Ahead

Trends in the macro environment and within the industry itself create both opportunities and challenges for the sector. Whereas a number of these have been highlighted in a prior section (Impact of Macro and Environmental Shifts), the current section summarises key implications for the sector in the years ahead.

Opportunities

• Tapping the "demographic dividend"

Member countries generally enjoy young populations and rapidly growing workforces. As more young people enter the workforce, member countries have the opportunity to expand their economies and achieve sustained, broad-based growth. These demographics also raise the challenge of creating jobs and economic opportunity for young people entering the workforce. The promotion of small–medium-sized enterprises (SMEs) and entrepreneurship is often seen as a key mechanism for creating the required jobs.

Islamic banks are well positioned to tap into this "demographic dividend" in the years ahead. Growth in the workforce can spur economic growth through increased economic output, government expenditure and consumption. Government investments in infrastructure projects are a prime example of the type of growth initiatives required as populations expand. Such GDP growth creates the opportunity and need for financial services.

By positioning themselves strongly and competitively in the marketplace, Islamic banks can be institutions of choice – particularly for younger customers who have been familiar with Islamic banking from a young age. This requires developing products and services that are truly useful, address real needs and are competitive with conventional counterparts, such that Islamic banks can truly be the bank of choice. Such products and services would help Islamic banking differentiate further from its conventional counterparts.

· Serving newly opened markets

As discussed earlier, several key countries in the Arab world, Central Asia, Africa and Europe have recently opened up to Islamic finance. These countries in which major reforms have taken place comprise a significant portion of the IDB member state constituency.

Serving these newly opened markets offers an exceptional opportunity for the sector to expand its presence and its impact. This is especially the case in member countries where latent demand for Islamic banking has been present but not yet served. Opportunities exist for both domestic propositions in these markets and cross-border involvement by overseas IIFS.

· Connecting emerging markets, the new centres of growth

In the current macroeconomic context, emerging markets remain the key centres of growth for the global economy. Several key growth centres – including Turkey, Indonesia, the GCC and ASEAN regions – are largely member states but have limited trade between one another.

Islamic banks enjoy a natural opportunity to position themselves as bridges connecting these new centres of growth. Doing so can position the sector for ongoing strength and increased relevance in the changing global economy.

· Contributing to the global dialogue

The ongoing financial crises have, as discussed earlier, prompted a high level of re-questioning of the conventional financial system. This creates an unprecedented opportunity for the Islamic banking sector to contribute to a global dialogue on the very nature of the banking system.

This opportunity has been further bolstered by (1) the increased clout of member countries (three of which are members of the influential G20), and (2) the active attention the industry has already received in international commentaries on the financial system. This is reflected in the recognition accorded to Islamic finance in key documents, namely FSB 2012, BCBS 2012 Core Principles, and BCBS 2013 Liquidity Framework. The Consultative Group of the BCBS has been an important platform through which the IFSB has conducted a dialogue with the global standard-setting community on the specific requirements and specificities of Islamic finance.

Some observers believe the IFSI has not played an active enough role in the dialogue – further underscoring the present opportunity. Industry bodies such as the IDB and IFSB can consider a targeted strategy for working with the three G20 members – Turkey, Saudi Arabia and Indonesia – to help bring Islamic finance more strongly to this forum. Other multilateral

bodies such as the World Trade Organization (WTO) are also important forums in which an Islamic perspective can be communicated.

Contributing to the global dialogue will not only help the Islamic banking sector itself, but can also enable it to have a genuine impact on the broader financial system by transferring valuable principles and good practices.

Challenges

Enabling job creation

The young demographics of member countries create both the promise of a "demographic dividend" and the profound challenge of creating job opportunities for young people. Member states around the globe are increasingly focusing on SME promotion, economic diversification and entrepreneurship initiatives in order to meet the job creation imperative.

Islamic banks can contribute to the challenge of enabling job creation by increasing their level of SME funding, support for entrepreneurs, and overall involvement in enhancing financial literacy among young people. If the sector can prove relevant to this overarching challenge, Islamic banking can be an important enabler of economic growth and overall stability in member states

In our survey of 117 banks, 30% reported working capital to be their most favoured SME financing service. By contrast, short-term and long-term commercial financing were reported as most favoured by 19% and 11% of respondents, respectively. This suggests that Islamic banks are able to offer much-needed working capital financing to SMEs – an economically vital service in member countries.

Our survey findings suggest that banks have already begun addressing the SME challenge. Fifty-four percent (44%) of respondents reported having a "specific initiative for SME financing" in response to central bank directives. These initiatives range from discounted rates, to establishing SME desks for women business owners, to streamlined approval processes, to broadened product offerings.

• De-politicising the enablement of Islamic finance

Islamic banking can play a vital role in fostering financial inclusion and participation. In many member countries, large segments of the population have either avoided the banking sector entirely or under-utilised it due to $Shar\bar{\tau}$ ah concerns. Enabling Islamic finance is crucial for bringing these segments into the banking system, providing fair access to credit and strengthening the formal economy.

Often, however, the enablement of Islamic finance has been seen as a political matter. Governments have conflated the enablement of Islamic finance with support for broader "Islamic" movements or parties. Officials have thus been reluctant to support Islamic finance for fear that it will equate to supporting religious parties or movements. Efforts to enable Islamic finance, especially in North Africa, have historically been resisted not on economic grounds but because supporting Islamic finance could embolden Islamic political movements. This has also featured in Asia, especially South Asia.

It is critical that the Islamic finance community develop an approach that addresses this misconception. Governments and supervisors in member countries should be urged to appreciate Islamic finance as a measure of sound economic policy and not an agenda of specific parties. Islamic finance brings financial inclusion, an emphasis on real economic activity, and other core principles which are valuable on their economic merits. Failure to recognise the question as an economic one makes it a politically sensitive matter, to the detriment of customers and of the economy as a whole.

The core principles of Islamic finance, such as the removal of exploitation, focus on genuine economic activity, socially responsible investment, and concerns for social equity and poverty alleviation, are ethical in nature. Islamic finance, therefore, must not be seen as a partisan issue.

• Engaging with global banks

Global banks – such as HSBC, Standard Chartered and Citibank – have played an important role in the growth of the Islamic banking sector. The direct and visible involvement of these institutions – especially in the 1990s and early 2000s – helped demonstrate the viability of the sector and encouraged member countries to appreciate the relevance of Islamic banking. Global banks continue to be active not only in retail and corporate businesses, but also in creating vitally important wholesale and institutional solutions (e.g. treasury products) for the industry.

In recent years, enthusiasm for Islamic banking within global banks has been less visible. HSBC, for example, has announced the exit of retail Islamic banking services from all markets except Saudi Arabia and Malaysia. Retail operations are being wound down in the Middle East (except Saudi Arabia), Bangladesh, the UK, the US and beyond. This is largely a post-global financial crisis effect, and is linked to concerns about profitability in a more cost-sensitive environment. Reasons for this may also include an increased strategic focus on the core markets of these global banks rather than on growth businesses such as Islamic finance, as well as concerns about compliance and perception in certain markets.

On the one hand, any retrenchment by global banks creates opportunities for regional and local institutions to fill the void and take more leadership in the sector. On the other hand, keeping global banks engaged in Islamic banking is important in underscoring the universal relevance of the sector and its fundamental commercial appeal.

• Building institutional capacity

In addition to the specialist talent needed for Islamic banking (mentioned elsewhere in the Report), it is noteworthy that Islamic banks will need to build their overall institutional capacity to reflect the changing requirements of banking. Increasingly complex regulatory, compliance and risk management requirements, for example, call for deeper capacity and expertise in Islamic banks.

4.2 Islamic Non-Bank Financial Institutions (NBFIs)

Islamic NBFIs diversify the financial services sector, make it more resilient, and help it achieve greater financial inclusion. Because they often require less formation capital and operate under fewer constraints than Islamic banks, they also allow for greater experimentation to develop new Islamic financial products that are both competitive and *Sharī'ah* authentic.

A broad variety of NBFIs operate in the Islamic financial services sector. Figure 8 maps the broad NBFI space in terms of customer segments and service offerings.

Figure 8: Mapping of NBFI Sector

Institutional		Asset		
Corporate	Investment banks and funds managers, venture capital, private equity, etc.)		Corporate foundations	
Affluent	Financing companies	Brokerage, fund	Hajji funds	Awqāf, trusts and Zakāh
Mass Market	Financing companies, Credit unions and cooperatives	managers and <i>Muḍārabah</i> companies ⁵⁹		Awqāf, Zakāh Qarḍ al-Hasan funds ⁶⁰
Under-banked	Microfinance Pawn shops	Microsavings		
	Financing	Investment	Pilgrimage	Philanthropy

⁵⁹ A distinct legal form found in Pakistan.

⁶⁰ Prevalent in Iran.

NBFIs have the potential to serve clients not covered by banks. Different types of NBFIs can offer services to diverse segments of the population. For example, investment banks, asset management companies and private equity firms serve institutional investors and relatively well-off clients, while leasing companies are expected to serve primarily the business sector. Similarly, an expanded microfinance sector can provide services to sections of the population that are usually not served by banks.

Impact of Macro and Environmental Shifts

Islamic finance continues to win new markets in both Muslim-majority and Muslim-minority jurisdictions. In a wider (and growing) set of markets, Islamic finance is viewed as an additional source of foreign investment from GCC-based investors with high levels of liquidity. In 2013 alone, $Suk\bar{u}k$ laws were at various stages of passing in Egypt, Tunisia and Morocco, and plans for sovereign $Suk\bar{u}k$ were announced by markets as diverse as Nigeria, Hong Kong, Luxembourg and the UK. These are promising signs for the growth of Islamic NBFIs, and for $Suk\bar{u}k$ issuance in particular.

The recent global financial crisis has exposed key weaknesses in the global financial system. The inadequate regulation and supervision of financial institutions and products was among the key causes leading to the crisis. In response, new legal and regulatory measures have been undertaken at national and global levels (e.g. Basel III, the Dodd-Frank Act, etc.) whose ramifications are still being worked out by market participants. More generally, the near meltdown of the global financial system demonstrated the fragility of highly leveraged debt-dominated systems at the individual, institutional and government levels.

In this environment, NBFIs are likely to face increased scrutiny. Investment banks played a key role in precipitating and exacerbating the crisis, raising fundamental questions about conflicts of interest, exotic structured products, executive compensation and entitlement to government bailouts. Although the Islamic financial sector appeared to have performed better than its conventional counterparts in the immediate aftermath of the global financial crisis, it was eventually affected due to economic interlinkages, and NBFIs were affected disproportionately.

Progress Made in the Sector

• The Islamic NBFI sector is still small and evolving

Less data exists on NBFIs than for banks in the IFSI, especially on the breakdown between different types of financial institutions. Data from different sources nevertheless suggests that the sector is still small and evolving.

For one, the NBFI sector in most OIC member countries is generally small, and Islamic NBFIs are a small percentage among these institutions. ⁶¹ The Survey undertaken by the IFSB and IRTI confirms this point for the ten jurisdictions responding (including from MENA, three from Asia and Africa, and three from Muslim-minority countries). In 2012, just five of the ten countries had Islamic NBFIs. Of the total of 51 NBFIs in these five countries, 14 were financing companies, 10 were investment companies, 26 were *Muḍārabah* companies (a distinct legal form in Pakistan) and one was a pawn-broking business.

A sample of 58 Islamic NBFIs from a different source⁶² affords some key insights about the status of Islamic NBFIs in the post-crisis period. As of the end of 2011, this set of NBFIs on average held equity of USD248.5 million and assets worth USD638.6 million. These figures indicate that NBFIs are generally well capitalised, with a total equity to assets ratio of 38.9% for the sample. In particular, NBFIs in the GCC appear to have more equity and assets than in other regions.

These results also show that even with relatively high levels of capitalisation, many Islamic NBFIs were incurring losses (nearly half of the NBFIs in the sample). In fact, the NBFIs in the data set were as a whole operating at a small net loss in the financial reporting year.

• NBFIs were more affected by the global financial crisis

An assessment of institutional resilience during the financial crisis suggests that NBFIs were harder hit by the global financial crisis. In fact, several of the post-global financial crisis cases of insolvencies and bankruptcies in the IFSI involved NBFIs.⁶³

In cases involving GCC-based companies reported between 2008 and 2011:

- Three GCC-based investment companies announced restructuring of debt;
- At least three GCC-based leasing and finance companies required bail-outs or restructuring; and
- One investment bank filed for bankruptcy protection. 64

These cases are not surprising given the scale of the global financial crisis. Even if Islamic banks and investors were generally insulated from the original crisis, the subsequent real estate crisis in the GCC hit conventional and IIFS alike. Those with high exposure to the real estate sector were hit hardest. Additional causes of their vulnerability included a funding model that

⁶¹ Rocha et al. (2011: 75) indicates that while the banking sector in the MENA region is larger than other regions, the non-bank financial sector is underdeveloped.

⁶² Euromoney's Islamic Finance Information Service database.

⁶³ Information derived from M.R. Raghu, Murtaza Pattherwala and Animesh Tulsyan (2013), "Dealing with Bankruptcy in the GCC: A Key Missing Block in the Reform Agenda", Kuwait Financial Centre Markaz Research, January.

⁶⁴ Ibid.

relied on short-term *Murābaḥah* funding for long-term obligations. Seen as less "systemic" than banks, NBFIs were also less likely to receive government bail-outs in times of crisis.

In addition to adverse market conditions, the crisis also revealed a failure of governance, both among NBFIs themselves (and in their risk management practices, in particular), and more generally by regulators and supervisors. In fact, the Islamic financial services sector is underregulated in many jurisdictions. In a recent survey of IFSI leaders, 3% of respondents thought that the Islamic financial sector is over-regulated, 31% that it is appropriately regulated, and 66% that it is under-regulated. Since NBFIs generally face less regulation than banks, this point is particularly applicable to Islamic NBFIs.

· Islamic investment banking has been very successful

Investment banks play a special role in the financial sector, deploying savings to the real economy by financing companies and projects. Broadly speaking, investment banking activities include arranging corporate finance, underwriting and distributing securities (such as shares or $Suk\bar{u}k$), and advising institutional clients in both the public and private sectors.

Investment banks also connect domestic financial sectors to international financial markets by supporting cross-border finance and the development of capital markets. Notwithstanding setbacks from the global financial crisis, Islamic investment banking has grown and matured in the period of review.

Islamic investment banking services are generally provided by the following types of institutions:

- Specialised, standalone Islamic investment banks, which are found in both OIC member countries and in certain non-member countries:
- Investment banking units or subsidiaries of Islamic banking groups; and
- Conventional investment banks (either based in the OIC region or global).

Specialised, standalone Islamic investment banks meet an important strategic need for the industry to serve the most sophisticated institutional clients. The existence and ongoing success of many specialist Islamic banks reflect the relevance of their services and their increasing ability to compete for client mandates.

For strategic reasons – the desire to develop native manufacturing capabilities or to back a local or regional champion, for example – industry observers have often advocated for greater

⁶⁵ As reported by Daud Vicary Abdullah, Addressing Liquidity Management Challenges to Enhance the Financial Stability of the Islamic Financial Services Industry. Second Islamic Financial Stability Forum, Jeddah, Kingdom of Saudi Arabia, 14 December 2010.

scale through consolidation. One example of consolidation in the industry comes from Bahrain, with the December 2013 launch of Ibdar Bank following a three-way merger of Bahrain-based firms Capivest, Elaf Bank and Capital Management House in 2012. As for a new investment "megabank", efforts have been launched by industry leaders to raise capital for such an institution.

Investment banking units (or subsidiaries) are often key elements of the strategies of Islamic banking groups. Such units allow the groups to broaden their client base, diversify their business and generate fee-based income. Their affiliation with full-service banking groups often gives these units better access to clients, capital and talent. Investment banking units of Islamic banking groups have increasingly gained prominence as underwriters, arrangers and advisers on major transactions.

The sector's ability to attract conventional investment banks (from both Muslim-majority and Muslim-minority markets) is a sign of its mainstream relevance. While the entry of international retail banks has often been limited to a few banks, numerous global conventional investment banks are highly active in the Islamic investment banking. Providing Islamic investment banking service both leverages the expertise and competitive advantages of these global investment banks and requires far less capital or institutional commitment than Islamic retail banking does. In fact, global financial groups with both institutional and retail capabilities have often led with an institutional offering.⁶⁶

In entering the Islamic investment banking market, conventional investment banks pose strong competition to specialised Islamic investment banks. In contrast to retail banking (where dedicated Islamic banks often win more customers than Islamic windows of conventional banks), institutional clients may often be willing to engage with conventional institutions as long as they can certify the *Sharī`ah* compliance of specific transactions. In such cases, conventional investment banks can often draw on an established track record, specialist expertise for more complex transactions, and the ability to distribute transactions to a broad and deep network of investors.

Asset managers have significant opportunities

The asset management sector is highly reflective of the core purpose of Islamic financial intermediation. Asset managers facilitate the flow of savings to economic activity through investments. The Islamic asset management industry has continued to expand as more investors seek *Sharī`ah*-compliant outlets for their savings.

⁶⁶ Citi Islamic Investment Bank was incorporated as early as 1996, but Citigroup never proceeded with a retail franchise despite having a significant presence in Muslim-majority markets. (A planned roll-out for autumn 2001 was aborted.) HSBC Amanah was incubated in HSBC Investment Bank when it was first established in 1998 (then as Global Islamic Finance), and continues to maintain an active investment banking function even after scaling back its retail operations to Saudi Arabia and Malaysia in 2013.

Dedicated managers face competitive challenges in building the industry. There is a need to build sufficient track record and credibility to give comfort to institutional investors. In turn, building such a track record requires access to some capital from early investors.

As with investment banking, *Sharī`ah*-compliant asset management includes the active participation of conventional institutions. Many conventional asset managers, including several of the world's largest asset managers, have launched Islamic funds to attract Islamic investors. Dedicated Islamic asset managers can develop products that are specifically tailored for the needs of Islamic investors and may be preferred by certain institutional investors who seek to promote Islamic institutions.

Certain macro trends nevertheless favour the development of more dedicated Islamic asset managers, including:

- Ongoing capital formation and large pools of savings (including sovereign wealth funds, pensions and endowments) in OIC-member countries;
- Increased interest in investment flows among developing markets (including intra-OIC markets), a theme for which local asset managers are well positioned;
- Strategic interest from institutional investors in OIC member countries to strengthen local investment capabilities; and
- Increased appreciation of socially responsible and ethical investments, a category in which Islamic asset managers are well positioned to compete.

Venture capital and early-stage investing, a specialised form of asset management, has particular relevance to the recommendations of the Ten-Year Framework. The Framework calls for greater access to financial services in member countries, and the Mid-Term Review has strengthened the relevant recommendation to include SME and entrepreneurial finance. Fostering Islamic venture capital industries in member countries can play an important role in giving business owners access to capital under terms that comply with their beliefs.

Islamic private equity similarly promotes real economy investment and can also foster capital flows between member countries. In recent years, both sovereign and private investors in member countries have established and invested in Islamic private equity firms with regional and intra-OIC investment mandates.

· Financing companies play a key role

Financing companies (e.g. home financing, agricultural finance, auto financing or the financing of home appliances) play an important role in developing markets and broadening access to financing to a larger pool of customers. Especially as countries transition from lower income

to middle income levels of prosperity, finance companies are an important mechanism for the middle class to enhance their quality of life. Islamic home financing companies, in particular, have played a particularly important role in enabling ownership as awareness of Islamic finance has grown across markets.

In the development of the IFSI, financing companies can and have served a variety of functions, depending on the market and development stage:

- As a first form of Islamic finance in new markets (e.g. Muslim-minority communities
 establishing home financing companies in the US and Canada as a more feasible alternative
 to full-fledged banking);
- As a platform for growth for mature players in existing markets (e.g. banks establishing subsidiaries for providing Islamic financing);
- As a disruptive strategy by new entrants in existing markets (e.g. new institutions entering the Islamic financial services sector with less capital and more flexibility); and
- As a means for policy-makers and supervisors to broaden access to Sharī `ah-compliant credit.

Like their conventional counterparts, Islamic financing companies enjoy certain advantages but also face particular challenges. Since they have greater flexibility in their operating models, they can reach more customers. They also generally enjoy higher profit rates. Conversely, taking on higher-risk customers also means that they face higher credit risk. Access to funds is also a challenge, especially in less developed markets. Where capital is available, financing companies expect to have a higher cost of funds.

• Microfinance institutions have broadened access

Islamic microfinance institutions have a particularly interesting and valuable position in the Islamic NBFI landscape because of their outreach to the poorer (and thereby "un-bankable") sections of the population.

In the last five years, Islamic microfinance has transitioned from a concept with isolated case studies to a fledgling sector across multiple markets. Though still in its infancy, the sector is having an impact. A 2013 study by the World Bank-backed CGAP identified 255 Islamic microfinance institutions serving 1.28 million clients across 19 countries. Even so, this customer base represents less than 1% of microfinance clients worldwide.⁶⁷ Being a small percentage of the total microfinance industry, information on the aggregate performance of Islamic microfinance institutions is limited. Available data generally shows that the rate of

⁶⁷ Mayada El-Zoghbi and Michael Tarazi (2013), "Trends in Sharia-Compliant Financial Inclusion", CGAP Focus Note No. 84, March.

return of those in the MENA region is higher than that of their counterparts in other regions (East Asia and the Pacific, Eastern Europe and Central Asia, Latin America and Caribbean, South Asia and Africa).⁶⁸

Since providing financial services to the poor traditionally carries higher administrative costs, Islamic microfinance institutions often face a trade-off between outreach and sustainability.⁶⁹ This trade-off explains much of the diversity in legal form and delivery approaches among Islamic microfinance institutions. Mission-driven institutions have prioritised the social goals of microfinance and have tended to organise themselves as non-profits, government agencies, cooperatives or development finance institutions. Their challenge has been to sustain operations in the long term without continued donations or subsidies.

The second approach focuses on self-sufficiency and operates like other for-profit institutions. The operations of financial institutions are sustained by providing larger loans to the less poor at higher interest rates (in the case of conventional institutions) or profit rates/mark-ups (in the case of IIFS). One way this is done is by the linking approach, whereby banks provide services to the poor through intermediaries or special programmes. While a commercial approach to providing financial services can help the growth of micro and small enterprises, it may be less effective as a tool of eliminating core poverty.

Non-government organisation

Non-banking financial institution

Commercial bank

Microfinance bank

Government organisation

Cooperative

Figure 9: Islamic MFIs in the Arab World, by Corporate Structure

Source: CGAP and Sanabel: "Islamic Micro and Small Medium Enterprise Finance Survey", 2012

⁶⁸ MIX and Sanabel Analysis of Key Trends, 2011 Middle East and North Africa Regional Snapshot, March 2012. www. themix.org/sites/default/files/201120%MENA%20Regional%20Snapshot 0.pdf.

⁶⁹ While various research papers present contradictory evidence on the issue, a comprehensive study by Hermes, Lensink and Meesters (2011), using data from 435 microfinance institutions covering 11 years, clearly identifies the trade-off between outreach and sustainability.

In a 2011–2012 survey, CGAP and Sanabel found that in a sample of 36 Islamic microfinance institutions in the Arab world, half were registered as NGOs, a fourth as NBFIs, and 15% as commercial banks (with the remaining 12% registered as microfinance banks, government organisations or cooperatives). According to the 2013 CGAP study cited earlier, commercial banks account for only 3% of microfinance institutions and yet provide some 60% of total financing to clients. These figures indicate that the commercial banks do well with the breadth of outreach in terms of number of clients served. However, the non-profit NBFIs are expected to perform better when it comes to the depth of outreach in terms of reaching the poor.

The dominant mode of Islamic microfinance has been *Murābaḥah* by a wide margin (672,000 customers and a USD413 million portfolio, according to the 2013 CGAP survey), followed by *Qarḍ al-Hasan* (191,000 clients and a USD156 million portfolio). The two structures represent two different strategies to structure debt financing without interest: by substituting interest with a service charge, or by substituting a loan transaction with a sale.

More fundamental alternatives are available but have been largely unexplored – that is, to substitute debt financing altogether with an equity-based or charity-based instrument. These are certainly promising directions worthy of continued investment and experimentation. At the same time, it can also be said that – insofar as it alleviates economic hardship among disadvantaged communities – microfinance represents the best use of debt-based instruments such as *Murābaḥah* and *Tawarruq*.

Opportunities and Challenges Ahead

If supported appropriately, NBFIs can play a pivotal role in extending the reach and richness of Islamic financial services.

Islamic NBFIs have greater opportunities to innovate

Islamic NBFIs face many of the same constraints that Islamic banks do. They must satisfy client segments with different attitudes towards *Sharī`ah* compliance: sympathetic clients who readily adopt the Islamic financial products on offer, discriminating clients who are willing to adopt Islamic financial products but only if their economic features are also competitive, and sceptical clients who would like to follow the *Sharī`ah* but are not convinced that the products currently available are substantively any different from their conventional counterparts. Being pulled in two directions – towards market competitiveness and *Sharī`ah* authenticity – therefore continues to be a challenge for Islamic NBFIs, as it does for the Islamic financial services industry generally.

⁷⁰ Sanabel, "Islamic Micro and Small Medium Enterprise (MSME) Finance Survey", 2012.

Islamic NBFIs have a distinctive advantage, however: their business models grant a high degree of flexibility. It may thus be possible for NBFIs to serve a wider set of markets than Islamic banks alone, including countries with no specific legal and regulatory framework for Islamic financial services.

Their institutional flexibility opens up key areas of opportunity for NBFIs:

- Innovation: NBFIs are also freer to experiment and to come up with new products that are both competitive and authentic. Different types of NBFIs can pursue product innovation in multiple directions, continually pushing the industry forward. Venture capital firms and private-equity firms, for example, are particularly well positioned to use and promote equity-based products. There are fewer Shart`ah constraints on their nature of business, and they operate in a space where market participants are accustomed to assessing different types of risk.
- Medium- to long-term growth: NBFIs can contribute positively to growth as they
 provide medium- to longer-term investments and financing. For example, leasing
 companies and venture capital firms usually provide longer-term financing to businesses
 and entrepreneurs in the form of leases and equity, respectively.
- Financial inclusion and outreach: By providing additional and alternative financial
 services, NBFIs improve general system-wide access to finance. In particular, they fill the
 gaps in financing in cases where banks fail. As most banks do not serve poor clients due
 to higher costs and risks, financial services can be provided to this segment by specialised
 poverty-focused microfinance institutions.
- **Stability:** A diversified financial sector that includes banks and non-bank financial intermediation provides a basis for a sound and stable financial system. ⁷¹ NBFIs can act as a buffer against negative shocks in an economy that affect the banking sector adversely. Notwithstanding, the resilience of NBFIs to other shocks will depend on the degree and quality of regulatory oversight of NBFIs themselves.

To manage NBFIs such as venture capital firms or leasing companies requires specific skills in managing the different risk profiles of their operations. For Islamic NBFIs, additional expertise in developing and managing Islamic financial products would also be necessary. One of the key constraints on the development of the NBFI sector would be the scarcity of professionals who have the right skills set to operate and manage Islamic NBFIs.

Another major challenge for NBFIs is to mobilise medium- and long-term financing to support their growth. One way to do this may be raise funds by tapping into the capital markets.

Marie-Renee Bakker and Alexander Gross (2004), Development of Non-bank Financial Institutions and Capital Markets in European Union Accession Countries, World Bank Working Paper No. 28, The World Bank, Washington DC.

· Greater oversight is needed

The recent global financial crisis has shown that there is a need for greater oversight of NBFIs, particularly with respect to disclosure, corporate governance and risk management regimes. Less stringent regulatory regimes for NBFIs can lead not only to insolvencies, but also to regulatory arbitrage whereby institutions of one category undertake less responsible behaviour than counterparts in other categories. In this regard, regulatory guidelines based on the IOSCO Core Principles can be applicable for some NBFIs such as brokerage and asset management firms. Similarly, best practices identified by bodies such as CGAP can be applied for microfinance institutions.

The regulatory and legal challenge for most countries is to come up with an accommodating regulatory regime that promotes the growth of the NBFI sector. As the NBFIs constitute various types of institutions with different organisational formats and sizes, one model cannot be used to regulate them. Instead, different intensities of regulation can be applied to different types of institutions or activities. Some institutions (e.g. leasing and mortgage companies) may not require prudential regulatory purview, but can nevertheless be subject to a robust non-prudential regulatory regime to protect clients and avoid instability. Specific accounting and auditing principles for the IIFS need to be recognised and implemented by the relevant public bodies and authorities. In some cases, new legislation may be appropriate to support unique specialised financial institutions – for example, special *Mudārabah* companies enabled in Pakistan by the *Mudārabah* Companies and *Mudārabah* Flotation and Control Ordinance 1980.

Serious consideration should also be given to the regulation of complex products that involve information asymmetries and have systemic implications. The use of complex products with opaque risk features was, of course, one of the underlying causes of the global financial crisis. In the case of Islamic NBFIs, there are additional risks to consider: the complexity entailed in *Sharī`ah* structuring because of multiple classical contracts that are not well understood by all market participants, the need for (and varieties of) *Sharī`ah* compliance, and the reputational risks that any losses or failures inflict on a young industry. The Islamic financial system can become susceptible to instability if the perception of stakeholders about the Islamic products becomes negative, causing a serious loss of trust and credibility.

• Microfinance institutions warrant further support

While microfinance institutions have higher expectations of them given their social mandate, they are ironically freer to innovate for several reasons. For one, they have less competition from financial institutions when serving an unbanked clientele. They also have less shareholder or investor pressure to deliver financially competitive returns. Finally, they can also more

⁷² Ana Carvajal, Randall Dodd, Michael Moore, Erlend Nier, Ian Tower and Luisa Zanforlin (2009), "The Perimeter of Financial Regulation", IMF Staff Position Note, 29 March.

credibly justify using debt-based instruments such as *Murābaḥah* and *Tawarruq* on *Sharī`ah* grounds for relieving economic hardship.

The Islamic microfinance sector has so far been supported by a narrow base of financial support. That funding can be broadened in two key ways. The first is a move away from donor-dependent organisations to those tapping the capital markets. Whereas some Islamic NBFIs such as investment banks and companies have raised funds using $Suk\bar{u}k$, microfinance and other smaller financial institutions have yet to tap these markets.

A second strategy would be to integrate the traditional charitable institutions of waqf and Zakāh into the operations of Islamic microfinance institutions. Funds from these sources constitute funds that can be used to uplift the poorer sections of the population. The challenge to use these charitable sources in the financial sector is to come up with workable models that can be used in poverty-focused development finance. These institutions can be used for asset building and production purposes to complement funds of Takāful and microfinance. These complementary funds can be given as either grants or interest-free loans (Qard al-Hasan) according to the needs of the beneficiary. As these complementary funds will reduce the need to divert money for consumption and/or purchase of assets, it is expected that the funds taken for productive activities will be invested accordingly. As a result, the overall return on invested funds is expected to be higher and the probability of default is expected to be relatively lower.

Given the multifaceted nature of poverty and the risks facing the poor, there has been discussion of a paradigm shift from microfinance to "inclusive finance", which entails providing a variety of financial services to the poor, including capacity building, savings, credit and insurance facilities. These financial services enable the poor to acquire capital to engage in productive ventures, manage risks, increase their income and savings, and move out of poverty. The Islamic microfinance sector needs to expand its operations beyond financing and provide other services on competitive and affordable terms. To be able to do this, however, would require regulatory backing. For example, in many countries, microfinance institutions cannot offer savings products due to regulatory restrictions.

To resolve the high costs and sustainability problems of microfinance institutions, technology can be used to provide services at reduced costs. Whereas mobile banking has been used in many developing countries and also by some conventional microfinance institutions in a few IDB member countries, Islamic microfinance institutions still have to introduce these in their operations. Another contemporary use of technology is cloud financing, whereby an internet-based platform is used to connect investors and entrepreneurs.

⁷³ Mayada El-Zoghbi and Michael Tarazi (2013), "Trends in Sharia-Compliant Financial Inclusion", CGAP Focus Note No. 84, March.

⁷⁴ UN (United Nations) (2006), Building Inclusive Financial Sectors for Development, New York: United Nations.

⁷⁵ Micoal Pistelli (2010), Mix Microfinance World: 2010 Arab Microfinance Analysis and Benchmarking Report, Microfinance Information Exchange.

Collaboration and sharing of experience could help publicise and exchange knowledge and good practices among Islamic microfinance institutions. This is already done to some extent by organisations such as CGAP and Sanabel, a network of microfinance institutions for the Arab world.

The Islamic microfinance sector would also benefit from government support and regulatory oversight. Given their social orientation, microfinance institutions can be expected to take a variety of legal forms: for-profit corporations, non-profit corporations and cooperatives. Following Basel Committee recommendations, regulation and supervision should be appropriately designed for the type and size of microfinance institution transactions. ⁷⁶ To ensure that the unbanked are served responsibly, regulators will also need to ensure that financial inclusion is accompanied at every step with consumer protection, transparency and financial literacy. If not, they will be exchanging one problem (financial exclusion) with another (exploitation) as microfinance becomes more commercially viable.

4.3 Takāful (Islamic Insurance) and ReTakāful (Re-Insurance) Services

As a *Sharī'ah*-compliant risk intermediation industry, *Takāful* and *ReTakāful* offer critical services to individuals, families, businesses and the economy. The benefits of *Takāful* and *micro-Takāful* coverage for individual welfare and financial inclusion are clear. *Takāful* coverage is necessary to protect Islamic banks and asset management institutions from key risks that increase operational costs and impair competitiveness. In addition, *Takāful* coverage may sometimes serve as a source of investible funds. The integration of *Takāful* and *ReTakāful* into the provision of Islamic financial services is also critical to the successful growth and stability of the industry.

Impact of Macro and Environmental Shifts

The increase in the size of the IFSI also mirrors the general economic growth in Muslim countries. Relatively higher GDP levels and continuing urbanisation of Muslim societies open up more need for insurance solutions. As insurance penetration rates mirror GDP levels, there are significant opportunities for *Takāful* growth.

The evolution of new technologies provides a unique opportunity to create financial inclusion. Thus, while only 20% of the target population is "banked", probably over 60% has access to mobile telephony.⁷⁷ Emerging technologies can be harnessed to bypass the constraints on

⁷⁶ BCBS (2010), Microfinance Activities and Core Principles for Effective Banking Supervision, Consultative document, Basel Committee on Banking Supervision, February, p. 1.

⁷⁷ Robert Cull, Asli Demirgue-Kunt and Jonathan Morduch (2013), Banking the World: Empirical Foundations of Financial Inclusion, Massachusetts Institute of Technology.

providing insurance to the "unbanked". This has particular relevance for Muslim-majority markets, where insurance penetration is particularly low.

Finally, the mainstreaming of the IFSI has also meant that it is now subject to global regulatory and industry standards and disciplines. Thus, bodies such as AAOIFI and IFSB are increasingly required to synchronise their activities with international accounting and regulatory bodies, and have taken welcome steps in this direction.

Progress Made in the Sector

• The Takāful sector has grown significantly

Market estimates vary, but a consistent finding is that the *Takāful* sector has grown significantly in the period since the Ten-Year Framework was issued. Recording to a 2013 Ernst & Young study, global gross *Takāful* contributions stood at approximately USD11 billion at year-end 2012, more than two-and-a-half times the total in 2007.

Whereas there were about 80 *Takāful* and *ReTakāful* companies operating in various jurisdictions in 2007, that number had grown to 174 by year-end 2011. (A number of those companies are subsidiaries or windows of conventional insurance companies.)

Overall, the market is highly concentrated, especially when compared with other sectors of the IFSI. By one account, the top three countries represent 75% of global *Takāful* assets, while the top ten represent 99%.⁸⁰

The product mix has also evolved. Whereas general $Tak\bar{a}ful$ remains slightly more popular in the GCC, life and medical $Tak\bar{a}ful$ have shown stronger growth, particularly in Malaysia. In addition to some independent $ReTak\bar{a}ful$ operators, major re-insurers have also stepped in to offer $ReTak\bar{a}ful$ as well.⁸¹

· Return on equity has lagged

While growth has been strong, financial performance has been more mixed in the period of review. In particular, *Takāful* and *ReTakāful* operators have found that their ROE is significantly lower than in conventional insurance. Some of this can be accounted for by the youth of the industry and time taken to attain critical mass. Critical mass, in turn, is difficult to achieve in the absence of robust and imaginative distribution channels.

⁷⁸ EY Global Takaful Insights 2013. We note that various sources define Takaful differently, and thus calculate the market size with varying parameters.

⁷⁹ EY Global Takaful Insights 2013.

⁸⁰ ICD Thomson Reuters, Islamic Finance Development Report 2013.

⁸¹ EY Global Takaful Insights 2013.

However, competition has also led to tightly priced market entry strategies which are proving difficult to re-price. In some instances, this is leading to a build-up of "sticky" *Qard al-Hasan* with no clear strategy for its timely repayment. As a result, many *Takāful* operations have effectively become risk transfer operations. This is in danger of undermining the very essence of *Takāful*. There is also a parallel inability to distribute any surplus, leading to self-defined reputation risk for the industry.

As a result, many *Takāful* operators are re-evaluating the commercial viability of their commitments to the industry. This problem is especially acute in the GCC region, as pointed out by a Standard & Poor's report in July 2013.⁸²

• The success of Takāful and ReTakāful is linked to Islamic capital markets

The vital link between efficient Islamic capital markets and viability of *Takāful* and *ReTakāful* provision has become increasingly evident. Investment returns are an important contributor to the success of the insurance and *Takāful* industries. The industry needs access to appropriate products for asset–liability matching.

In the case of family *Takāful* provision, especially of investment-linked products, the availability of investment in *Sharī`ah*-compliant asset classes becomes very important to deliver a likefor-like return to that given by the conventional product providers. A significant shortage in the availability of the right combination of a near liquid "fixed-income" class for Islamic asset managers has led to lower returns or similar returns with a higher risk profile adopted in investment management.

Conversely, *Takāful* operators have been able to operate in environments where active Islamic capital markets exist. The ability of *Takāful* providers to compete for business has also been less impaired in these settings.⁸³

• Regulators are taking a more active role

As the industry grows, regulators are more fully recognising the nuances of *Takāful* and *ReTakāful* provision. Malaysia and Bahrain have made very encouraging advances in this regard, having taken significant strides in encouraging the development of transparent markets in the *Takāful* and *ReTakāful* sector. Other jurisdictions are increasingly using these models to develop their own versions. §4 Key gaps include standard guidelines on issues such as surplus sharing, the obligation for the provision of *Qard al-Hasan* to cover deficits in the claims fund,

⁸² Standard & Poor's, "Competition and Overcapacity Are Harming the UAE Takaful Sector", 3 July 2013.

⁸³ Ernst & Young, World Takaful Report of 2009, 2010, 2011, 2012.

⁸⁴ Alpen Capital, "GCC Insurance Industry", 21 August 2011.

and the rights of participants in *Takāful* companies. Lack of a standard regulatory take on these issues leads to ambivalence about the ratings assigned to the operations.⁸⁵

Outside Muslim-majority markets, *Takāful* growth is being enabled by regulators such as the UK's Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA), which replaced the Financial Services Authority (FSA). These regulators' licensing of a full *Takāful* operation in the UK under existing legislation has created an important precedent for other regulators to follow.

• Industry awareness of Takāful and ReTakāful is rising

The general awareness of Islamic financial services has increased manifold in the last five years. At the same time, the industry has not successfully positioned the unique features of *Sharī`ah* structured products. This is particularly true of *Takāful* and *ReTakāful*, possibly because the prohibitions on *maysir* and *Gharar* are less well understood than the prohibition on riba. Moreover, the commercial viability of *Takāful* is still being tested, with a great deal of leakage to the conventional re-insurance industry – making the proposed virtues of risk-sharing in *Takāful* and *ReTakāful* more difficult to demonstrate.

Despite these constraints, a number of dedicated forums have emerged to spearhead thought leadership in the *Takāful* and *ReTakāful* sector. Together with the publication of annual surveys and reports by major international industry players, these forums have done much to create awareness of the opportunities and challenges faced by the industry. Dedicated journals and industry directories on *Takāful* and *ReTakāful* have also been launched. Even if the consumer requires greater education, the global insurance industry is now reasonably well informed of the key features of *Takāful* and *ReTakāful* services provision.⁸⁶

Opportunities and Challenges Ahead

· Linkage with other forms of Islamic financial services

As the global IFSI continues to grow, *Takāful* and *ReTakāful* should also benefit since *Sharī`ah*-compliant products and structures require *Sharī`ah*-compliant insurance. There has, however, not yet been any systematic effort to tie in the provision of *Takāful* and *ReTakāful* with the provision of Islamic financial services and products. There is a clear synergy between the two, and exploiting this has the potential to create significant new areas of business. Thus *Ijārah* pools, *Murābaḥah* financings, *Mushārakah* financing, *Istisnā* funding and real estate investments could be required to have *Takāful* protection (protection based on contractual

 $^{^{85}}$ Standard & Poor's, "Competition and Overcapacity Are Harming the UAE \textit{Takāful}\ Sector", 3 July 2013.

⁸⁶ Takāful Primer - Full proceedings of the annual International Takāful Summits (www.takafulprimer.com).

agreement or types of projects such as building, shipping (export or import)) rather than be insured conventionally. For this to work successfully, issues of human capacity and expertise need to be addressed effectively.

• The rise of family Takāful

There are two types of family *Takāful*:

- **Protection** *Takāful*. This is mainly health-related business such as death and disability *Takāful*. It shares some characteristics with general *Takāful*, but is typically longer term. This makes its economics different for example, investment returns are more important in the economics of the *Takāful* operators.
- **Protection plus savings** *Takāful*. These are also longer term and the features of the products are usually focused on the investment returns. In this case, the investment returns are more important in the economics of the participants.

The narrative around *Takāful* generally centres on general *Takāful*, with family *Takāful* treated as a specialty product. If the general conception of *Takāful* can be widened to include family *Takāful*, the industry stands to break significant ground for several reasons:

- In the past several years, family and medical *Takāful* have recently shown more positive growth momentum than general *Takāful*, especially in ASEAN markets;
- Family and medical *Takāful* offer long-term growth prospects;
- Family *Takāful* also creates opportunities to provide other bolt-on products such as investment-linked life, healthcare and pension products; and
- There is a rising trend in the GCC to mandate health insurance, from which family and medical *Takāful* can benefit.

Key challenges have to be addressed to unlock this strategic opportunity:

• Popular misconceptions remain about the Sharī'ah permissibility of life insurance. Rebranding life insurance as family Takāful has helped to some degree, but Sharī'ah scholars can play a greater role in promoting market acceptance (as investment and social security tools). Since many family Takāful services are investment linked, they require vibrant Islamic capital markets to provide the required asset–liability matching possibilities. To date, equity and property classes have served this purpose well enough, but the growing Şukūk market is still too small to provide sufficient support. This is hampering the development of an efficient secondary market for these securities.⁸⁷ As

⁸⁷ Ernst & Young, World Takaful Report of 2009, 2010, 2011, 2012.

a full range of asset classes becomes more available, *Takāful* and *ReTakāful* providers should be able to capitalise on the increasing demand for family *Takāful* products.

· ReTakāful requires greater scope and capacity

The scope and capacity of *ReTakāful* still poses challenges to the sector. *ReTakāful* capacity in "family" lines is adequate, but lacks the resources and advisory reach of conventional providers. In large general lines, capacity is still an issue and operators are ill-equipped to service this growing business.

With this state of affairs, many *Takāful* operators are still allowed by their *Sharī`ah* supervisory boards to avail themselves of conventional re-insurance facilities. As a result, many *ReTakāful* operators are also forced to provide modalities which differ little from those provided by their re-insurance counterparts. This further complicates the viability and distinctiveness of *ReTakāful* provision.

It appears that the simple risk-sharing model for *Takāful* provision is not proving adequate for *ReTakāful*. This may also need discussion among *Sharī`ah* scholars and other experts to arrive at acceptable models for *ReTakāful* provision for treaty and facultative provision.

• Investment in micro-Takāful can unlock new markets

Relatively little progress has been made in enhancing financial inclusion over the last five years. Only about 20% of the Muslim population is banked or has access to financial services. Thus the vast majority of the Muslim population is effectively not presently serviced by Islamic financial service providers, including *Takāful* and *ReTakāful* service providers. 88 This effectively limits their growth potential in newer but large potential markets such as Indonesia, India, Nigeria, Pakistan and Bangladesh. The kind of *Takāful* provision needed in these markets is also different from the traditional urban markets. Agricultural and livestock protection and *micro-Takāful* products are much more relevant in these markets.

Some encouraging approaches have been tried in Malaysia, Indonesia and Sri Lanka. In these countries there have been attempts to couple microfinance provision with *micro-Takāful* provision. If used with appropriate innovative technology, this has the potential to create a virtuous circle of rapid financial inclusion.

Micro-Takāful is not by itself a commercial proposition, but serves financial inclusion, improves the efficacy of microfinance and expands the total market for Islamic financial services. *Takāful* and *ReTakāful* providers can play a leading role in this initiative if appropriately supported by the resources of the state and the utilisation of *Zakāh* funds.

⁸⁸ Robert Cull, Asli Demirguc-Kunt and Jonathan Morduch (2013), Banking the World: Empirical Foundations of Financial Inclusion, Massachusetts Institute of Technology.

The use of $Zak\bar{a}h$ funds for $micro-Tak\bar{a}ful$ has already been accepted in Malaysia and Indonesia. In contexts where the use of $Zak\bar{a}h$ is allowed, it can significantly enhance the impact of microfinance.

• Greater conceptual clarity is required

The broader challenge for *Sharī'ah* advisers, standard-setting bodies, regulators and market actors is to review the structure of *Takāful* and *ReTakāful* in light of operators' accumulated experience of what has worked in the marketplace. Early comparisons to mutual insurance or cooperatives have not always been borne out in practice: as the various *Takāful* models have evolved, it has become clear that the provision of *Takāful* and *Retakāful* is in effect a hybrid between a for-profit shareholder involvement in the form of the *Takāful* operator and a risk-sharing pool based on '*Tabarru*' contributions by participants.

The *Takāful* operator today is compensated by an ad hoc combination of *Wakālah* fees, *Muḍārabah* share of investment profits, and share of any underwriting surplus under various formulations. The sharing of underwriting surpluses presents challenges, and these have been dealt with by different jurisdictions in a variety of ways. Most jurisdictions have recognised some form of surplus sharing, albeit by way of "performance fees" for the *Takāful* operator. Standard-setting bodies have taken different approaches to this issue. AAOIFI has made two recent pronouncements, first disallowing any form of surplus sharing with the *Takāful* operator and then restricting any surplus sharing to the employees of the *Takāful* operator and not its shareholders. The IFSB has been more flexible on this point, and the three *Takāful* standards it has issued do not disallow surplus sharing.

In the meantime, some regulators have been retreating from the whole idea of risk-sharing. While Saudi Arabia and Iran pursue their own approaches to *Sharī`ah*-compliant insurance, whether risk-sharing is critical to *Takāful* remains an open question.

Until the core features of *Takāful* are identified, it will remain difficult to promote *Takāful* as a value-driven ethical product. To date, it can be argued that too much emphasis has been put on the potential for surplus sharing. This feature (which is not essential to the risk-sharing provision of insurance) has been much more difficult to deliver and has raised expectations which often are not met.

This lack of clarity on the nature of $Tak\bar{a}ful$ itself is having an impact on the branding of the industry and the successful promotion of its unique features. It is also leading to considerable introspection by shareholders of $Tak\bar{a}ful$ operators as to their future role in the industry. Global players who had enthusiastically entered the industry are also seen to be reviewing their commitments.

• Standard-setting and harmonisation are needed

The divergence in how AAOIFI and IFSB treat the issue of surplus sharing points to the need for greater discussion and harmonisation among the sector's key standard-setting bodies. A number of other issues also require successful resolution.

- Recent studies for the *Takāful* and *ReTakāful* sector show that the level of transparency in these operations is below that observed in the conventional insurance and re-insurance sector. This is a cause of concern, as transparency and the absence of *Gharar* are meant to be a key feature of *Takāful* and *ReTakāful*.89
- Discussion has also started on the implications of the Solvency II proposals for the global
 insurance industry and the institution of risk-based capital requirements. The IFSB has
 issued standards for *Takāful* which address these challenge. This discussion is still much
 less advanced than those on the parallel Basel III framework negotiations for banks and
 financial institutions.
- For the Takāful and ReTakāful sector, the separation of shareholder and contributor
 interests poses unique challenges which have, as yet, not been adequately addressed. This
 aspect is also leading to conflicting treatments under AAOIFI and IFRS.
- There has been a move towards formal adoption of IFRS in many jurisdictions. Some of
 these standards are in conflict with the standards and guidelines issued by the AAOIFI.
 Since the AAOIFI standards have not been adopted widely, this creates a preference for
 adherence to IFRS by providers of Islamic financial services at the expense of adherence
 to AAOIFI standards

4.4 Islamic Capital Markets

Impact of Macro and Environment Shifts

Global capital markets have undergone significant turmoil. As the major economies suffer the consequences of debt-induced crises, there is much soul-searching with regards to economic thought and long-held assumptions are being questioned. It has become clear to more and more observers that debt-reliant systems are inherently unstable, and that instability can have huge social, economic and political costs. Economic policy-making is at an inflection point.

⁸⁹ Alpen Capital, "GCC Insurance Industry", 21 August 2011.

Global economic power is shifting eastwards. To many emerging economies of Asia, the new economic centre of gravity is China. Looking ahead, the global economic geography is likely to be multipolar. As the world realigns to a multipolar economic geography, opportunities for new regional financial centres are likely to develop. Developing greater cross-border trade and financial linkages will be critical. At issue is the extent and scope of the role that Islamic finance can play in underpinning these developments.

Within the Muslim world, important macroeconomic trends are under way. Populations are growing, economies are diversifying, the adoption of technology is increasing, and financial markets are taking root. Several jurisdictions in the Muslim world have sought to establish themselves as international financial centres. Amidst these changes, political and social stability remain a challenge in many Muslim countries.

Progress Made in the Sector

Progress against individual framework recommendations has been addressed in Chapter 3 across the different sectors for the sake of consistency. Eight key observations are nonetheless worth highlighting about Islamic capital markets.

· Islamic equity markets are deepening

The flexibility in Islamic law for equity investments has enabled Islamic equity capital markets to develop. The nature of the underlying business and its capital structure need to be screened to ensure compliance, but the basic equity structure fits Islamic finance strongly. As a result, Islamic equity markets in Muslim-majority markets benefit strongly from the depth of overall equity capital markets in these countries. By the same token, they also suffer from some of the same limitations.

The basic methodology for Islamic equity investing has been in place since the Dow Jones Islamic Market Index first demarcated the investible universe of *Sharī`ah*-acceptable equities in 1999.

Figure 10: Islamic Equity Markets; Key Indices

Index Provider	Partner	Index Series	Equity Indices	First Launched
Dow Jones		Dow Jones Islamic Index Series	60	1999
FTSE	Yasaar	FTSE Sharī`ah Indices	8	2000
Standard & Poor's	Ratings Intelligence Partners	S&P Sharī`ah Indices	33	2006
MSCI	Dar Al Istithmar	MSCI Global Islamic Indices	31	2007
Thomson Reuters	IdealRatings	Thomson Reuters IdealRatings Indices and SAMI Halal Food Indices	TBD	2011
	Crescent Wealth	Thomson Reuters Crescent Wealth Islamic Australia Index	1	2012

Source: Corporate websites

Certain regulators have begun adopting their own screening methodology for the Islamic equity market. The Securities Commission Malaysia has been publishing the *Sharī`ah*-compliant list of listed securities on its stock exchange (Bursa Malaysia) based on its own screening methodologies

While business activity and financial screens filter out a number of sectors and companies, the remaining investible universe is still quite significant. Taking the example of two of the most prominent Islamic indices, equities covered by Islamic indices represent roughly half of their conventional counterparts:

Figure 11: Equities Covered by Two Islamic Indices

Coverage of conventional benchmarks (by flora-adjusted market cap)

Sector	S&P 500 shariah	Dow Jones Islamic Market World
Consumer discretionary	43.5%	30.7%
Consumer staples	58.7%	29.0%
Energy	83.5%	71.4%
Financials	2.0%	2.4%
Health care	79.6%	80.6%
Industrials	64.0%	43.1%
Information technology	86.0%	81.8%
Materials	65.3%	61.7%
Telcommunication Services	0.0%	23.0%
Utilities	0.0%	8.3%
Total	54.7%	41.5%

Note: Tables are for Illustrative purpose only Data as of 30 June 2013

Source: S&P Dow Jones Iindies, as cited in Michel Orzana, "How Indexing Impacts Shariah- Compliant Investing" S&P Dow Jones Iindies, McGraw Hill Financial, 2013

The same data also show how Islamic equities tend to skew away from financial services and towards energy, healthcare and information technology. This sectoral distribution has generally served the Islamic equity investment well. Not only did it provide for superior returns during the sustained growth among technology companies stocks in the 1990s, but it also insulated Islamic investors to some degree in the period under review (2007–2013), as financial crises hit financial services stocks the hardest.

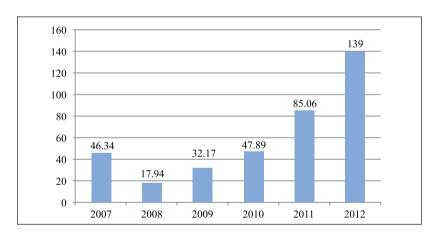
Over the long term, however, the performance of Islamic equity indices has been highly correlated with their conventional counterparts and presents similar risk—return characteristics taken as a whole. While this does not seem to support the assertion of some Islamic investing advocates that Islamic investors will necessarily or generally get superior returns, it does demonstrate that Islamic equity markets are sufficiently deep for investors to participate in without disadvantage.

• Şukūk markets are growing

<u>Ṣukūk</u> are not only the most prominent Islamic capital market instrument, but also one of the great success stories of the IFSI. Non-existent in 2000, there is close to USD250 billion outstanding as at end-2012. Figure 12 shows the trend in global *Sukūk* issuance since 2007.

Figure 12: Global Şukūk Issuance, 2007- 2012

USD million



Source: Thomson Reuters Zawya

Focusing on the period since 2007, total annual issuance volume has gone from USD46.4 billion in 2007 to USD139 billion in 2012. Starting from a low base, this is nonetheless a near-threefold increase, with a five-year CAGR of 24.5% in issuance.

Total year-end outstanding value of $\S uk\bar{u}k$, an indication of market depth, is even more impressive. CAGR over the 2007–2012 period has been 34.4%.

The short history of $Suk\bar{u}k$ and its widespread success is an indication of what is possible within Islamic capital markets with proper execution. The $Suk\bar{u}k$ market is strategically important not only for the IFSI, but for the economic development of OIC member countries. It can be a significant source of public infrastructure and development financing from domestic savers and foreign investors alike.

Sovereign $Suk\bar{u}k$ have been a catalyst for the $Suk\bar{u}k$ market. In the first nine months of 2013, around 70% of $Suk\bar{u}k$ issued were from government institutions, following a steady trend in the period of review. In recent years, countries that have issued sovereign $Suk\bar{u}k$ for the first time include Indonesia (2011) and Turkey (2012), taking the total list of countries issuing $Suk\bar{u}k$ to 22 by year-end 2012. Sovereign $Suk\bar{u}k$ are vital for deepening the market, setting pricing benchmarks and encouraging private issuances. They can continue to play a leadership role in developing the $Suk\bar{u}k$ market by issuing $Suk\bar{u}k$ of varying tenures, various structures, and denominated in both local and foreign currencies.

The development of the Ṣukūk market has not been without setbacks or controversy, however. Some of the Sharī`ah scholars who led the charge with early Ṣukūk issuance became critics of subsequenk Ṣukūk structures by 2007. By then, the asset-backed Ṣukūk based on Islamic debt contracts (Ijārah and Murābaḥah) that had first won Ṣukūk international acceptance in 2002 were being eclipsed by asset-based Ṣukūk and blended-assets Ṣukūk based on equity-based contracts (especially Mushārakah and Muḍārabah) in order to give greater flexibility to issuers short on physical assets. A 2008 AAOIFI pronouncement against some of the features of these contracts has led to mixed results. After falling out of favour for two to three years, Mushārakah and Muḍārabah contracts have re-emerged amidst a broader distribution of contracts, including newer structures such as the Wakālah-based Sukūk.

80.000 70,000 *Ijārah* 60,000 Murābaḥah 50,000 Mudārabah 40,000 Mushārakah 30,000 Istisnā` 20,000 Wakālah 10.000 0 2007 2008 2009 2010 2011 2012 Aug-13

Figure 13: Global Sukūk Issuance by Sharī'ah Contract, 2007 – August 2013 (in USD million)

Source: Thomson Reuters Zaywa, "Şukūk Perceptions and Forecast Study 2014"

⁹⁰ Thomson Reuters Zawya, April 2013.

We can expect this picture to keep evolving as issuers, *Sharī`ah* scholars and practitioners continue to experiment in response to each other's concerns.

A critical issue is the extent to which the surge in $Suk\bar{u}k$ issuance in recent years reflects a structural long-term shift towards this mode of financing, and the extent to which it is a response to bank-deleveraging which typically results in a contraction of indirect bank financing. Mitigating this issue is the increasing number of countries that are developing medium-term reform plans that seek to integrate Islamic finance, and $Suk\bar{u}k$ issuance, into their public expenditure frameworks. The full implementation of these reforms is likely to lead to greater development of the corporate Islamic securities sector as benchmarks are established.

Money Market

The period in review has also seen developments in the money market, which plays a critical role in liquidity management. To remove the liquidity management bottleneck for Islamic banks, Bank Negara Malaysia, Malaysia's central bank, established the Islamic Interbank Money Market (IIMM) in 1994. Since then, the IIMM has grown substantially. Figure 14 shows the total annual traded volume by instrument for IIMM from 2007 to 2011. Over that period, total traded volume has increased by 100% for a CAGR of 19%.

Figure 14: Malaysia's Islamic Money Market, 2007–2011

	2007	2008	2009	2010	2011
WADĪ'AH	1047	1904	2132	2140	2365
MURĀBAḤAH	41	80	54	59	57
	1088	1984	2186	2199	2422
INTERBANK	301	242	198	212	305
OTHERS	254	255	121	108	236
TOTAL	1643	2481	2505	2519	2962

Total Annual Traded Volume (RM billion)

Source: Islamic Interbank Money Market, Central Bank of Malaysia (iimm.bnm.gov.my)

In addition to the IIMM, Malaysia has also established a new entity, the *Bursa Suq Al Sila*, in 2009. This is an electronic trading platform designed to facilitate *Murābaḥah*-based transactions by way of trading crude palm oil. Bursa Suq Al Sila is part of the main stock exchange, Bursa Malaysia. Trading volume on *Bursa Suq Al Sila* has grown impressively. From 2010 (its first full year) to 2012, CAGR of volume traded has averaged 74%.

In 2000, Bank Indonesia (BI), the Indonesian central bank, introduced the Sharia Interbank Money Market (PUAS) and initiated the Bank Indonesia Wadiah Certificate (SWBI) for the first time, both for liquidity management of Islamic banks and to provide an avenue for investment. The Bank Indonesia Wadiah Certificate was amended in 2008 by Sharia Bank Indonesia Certificate (SBIS) by *Ju'alah* contract. The SWBI/SBIS were used for bilateral transactions with BI. Moreover In 2008, BI introduced Indonesia's sovereign *Şukūk* (SBSN) and SBIS REPO for Islamic banks. In addition, the Jakarta Futures Exchange (JFX) operates a trading platform similar to *Bursa Suq Al Sila*. The underlying commodities are cocoa and coffee.

The UAE, Bahrain, Brunei and Sudan all have liquidity management facilities for IIFS. However, these are bilateral transactions with their respective central banks. While bilateral transactions can help overcome liquidity issues, price discovery is not possible in the absence of multiple players and market trading. IIFS operating under such systems cannot establish their costs of funds. In such cases, the interest rates of the conventional markets are used to indicate what profit rates should be for IIFS transactions.

Internationally, the main development in liquidity management has been the establishment of IILM. This Kuala Lumpur-based entity was established in 2011 with the objective of offering liquidity management services to IIFS across borders. Owned by 11 central banks and the IDB and its subsidiary ICD, the IILM issued its first *Sukūk* in 2013.

While *Sharī`ah* concerns remain, Islamic hedging instruments have also made noteworthy progress in the period of review, especially in Malaysia and the GCC. Among the new products that have been introduced are Islamic Profit Rate Swaps (IPRS), intended for IIFS to manage mark-up rate risks arising from duration gaps. For currency risk management, a number of *wa'ad-based* hedging products have been developed for *Sharī`ah*-sensitive importers and exporters to manage their risks. Similarly, Islamic FX swaps and cross-currency swaps have become more common. The popularity of these products has been held, in part, due to the IIFM's ISDA/IIFM *Taḥawwut* Master Agreement that has simplified documentation for cross-currency swaps. IIFM's efforts at the standardisation of the profit rate swap, Islamic cross-currency swap and FX forward, interbank Commodity *Murābaḥah*, investment *Wakālah*, and profit rate swap, have also helped. Finally, several *Sharī`ah*-structured products with embedded options or other hedging features are being offered by IIFS in a number of markets. Several *Sukūk* structures, too, have included hedging features.

Being mostly over-the-counter (OTC) products, there is little information on traded volumes of the Islamic hedging instruments. The proliferation of these products is clear evidence of the

popularity, which is required by the IIFS for effective management of profit rates and currency risks. And yet virtually none of these existed in 2007.

• Islamic funds are abundant, but face strategic challenges

Islamic mutual funds have experienced a strong recovery since 2007. By the third quarter of 2013, Thomson Reuters and Lipper's estimate for total assets under management (AUM) was USD56 billion, twice the USD28 billion at year-end 2007. The total number of funds was 1,065, compared with 576. The implied average fund size is USD53 million – an increase of 8% from the 2007 figure of USD49 million. The year 2013 may, in fact, have been pivotal, with the highest number of new funds in three years (94) and the lowest number of closures in four years (22).

Figure 15: Global Islamic Funds, 2007 - Q3 2013 by number (left axis) and AUM USD billion (right axis)



Source: Thomson Reuters: Global Islamic Asset Management Report 2014

• Despite the opportunities, Islamic funds face strategic challenges

Funds are still highly concentrated within three hubs – Saudi Arabia, Malaysia and Luxembourg account for more than 70% of Islamic funds globally – with a lack of active regulation in other relevant markets. They also remain concentrated in traditional asset classes, with some movement in *Sukūk* funds and money market funds.

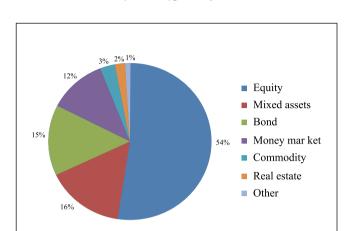


Figure 16: Global Islamic Funds by Asset Type, as of 2013

Source: Lipper, as cited in "Global Islamic Asset Management Report 2014" Thomson Reuters, 2013

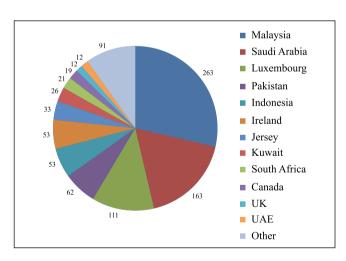


Figure 17: Global Islamic Funds by Domicilie, as of 2013

Note: "Other" comprises Bahrain, Cayman Islands, Guernsey, Singpore. USA, Australia, India, Egypt, Qatar, Tunisia, Isle of Man, Mauritius, Morocco, France, Japan, Oman, Russia, Switzerland and Turkey

Source: Thomson Reuters: "Global Islamic Asset Management Report 2014"

More significantly, scale remains the greatest challenge for the Islamic fund industry. Whereas the conventional industry is dominated by the institutional sector – with some 70% institutional funds – 80% of Islamic funds are designed for retail investors. Without the contribution of insurance, pensions, banks and other institutions, the fund flow to the Islamic fund industry remains limited, affecting the profitability of fund managers. Smaller players are affected disproportionately, forcing liquidation. Greater support from Islamic banks, growing the *Takāful* sector and unlocking the potential of Islamic pensions are all avenues to increase institutional participation and thereby industry scale.

• A few jurisdictions have specific regulators for Islamic capital markets

A broad number of regulators in OIC jurisdictions are engaged with Islamic capital market activity to some degree, and a few jurisdictions even have independent bodies or market platforms allocated to Islamic capital market activity or supervision. Outside jurisdictions that aim for complete *Sharī'ah* compliance (e.g. Iran and Sudan), regulators broadly prefer to integrate Islamic capital market activity within the conventional regulations and platforms available.

Figure 18: ICM Regulators in the Mid-Term Review Survey

No	Jurisdiction	Institution
1	Brunei	Autoriti Monetari Brunei Darussalam
2	Turkey	Capital Markets Board of Turkey
3	Bahrain	Central Bank of Bahrain
4	Ireland	Central Bank of Ireland
5	Luwambaura	Commission de Survellance de Secteur Financier
3	Luxembourg	Banque centrale du Luxembourg
6	UAE	Emirates Securities and Commodities Authority
7	UAE	Dubai Financial Services Authority
8	S. Korea	The Financial Supervisory Service
9	Kazakhstan	National Bank of the Republic of Kazakhstan
10	Thailand	Securities and Exchange Commission
11	Malaysia	Securities Commission Malaysia
12	Oman	Capital Market Authority
13	pakistan	Securities and Exchange Commission of Pakistan

Note: Due to limited data provided by Banque Centrale du Luxembourg, its responses have been reported under Commission de Surveillance du Secteur Financier

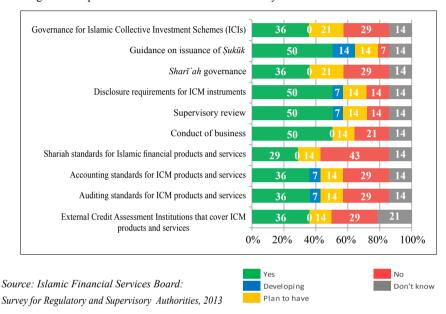
Source: Islamic Financial Services Board: Survey for Regulatory and Supervisory Authorities, 2013

When compared to Islamic banking regulation and supervision, regulators are generally also less likely to have dedicated frameworks or resources for Islamic capital markets. Among 14

IFSB member regulators engaged in Islamic capital market activity surveyed for this Mid-Term Review, just half had any independent guidelines or standards in place for Islamic capital markets. Less than half had a *Sharī`ah* governance framework, *Sharī`ah* standards for Islamic Capital Market products, or independent accounting or auditing standards.

Figure 19: Prudential Infrastructures for ICM

ICM regulator responses in the Mid-Term Review survey



A few recent developments are worth noting here. The *Sharī`ah* governance framework for Islamic capital market in Malaysia has been embedded in the section 316 of Capital Markets and Services Act 2007 (CMSA) which is administered by the Securities Commission Malaysia. In addition, its *Sharī`ah* governance framework includes the requirements for registration of *Sharī`ah* advisers as well as the outlining of the processes and procedures for *Sharī`ah* compliance in Islamic Capital Market products. The Securities and Exchange Commission of Pakistan established a *Sharī`ah* board in 2013. Finally, we can expect ongoing collaboration between IOSCO and the IFSB in the production of corporate governance standards on transparency and disclosure that meet both *Sharī`ah* guidelines and prevailing international standards. The collaboration with IOSCO resulted in the publication of a book in 2013.⁹¹

Remaining challenges include the need for $Suk\bar{u}k$ trading platforms, especially in the face of recent regulatory developments favouring centralised clearinghouses over bilateral transactions, and

⁹¹ Disclosure Requirements for Islamic Capital Market Products, September 2013, www.ifsb.org/sec03.php.

the need for regulators to take measures (such as issuing guidelines and ensuring favourable tax treatment) to encourage $Suk\bar{u}k$ issuances by corporate and government-linked companies (GLCs).

As new international capital and prudential regimes take effect, higher liquidity requirements will require IIFS to direct more funds to short-term, liquid assets. In many markets, the current supply of $Suk\bar{u}k$ is too scarce to meet the needs of these institutions. These challenges highlight both the need for high-quality $Suk\bar{u}k$ and the substantial opportunity for the sector to continue its growth.

• Overall, OIC capital markets remain small

The limitations of Islamic capital markets are not only a result of inattention by regulators. They are in fact a reflection of the overall limitations of capital markets in Muslim-majority markets. OIC capital markets remain small across the board: equity markets, debt markets, foreign exchange markets and derivatives. Institutional reforms are needed to strengthen the rule of law, transparency, investor protection and property rights. Likewise, constraints on doing business need to be reduced.

For all the attention on key Muslim markets, Muslim country stock exchanges are still very small relative to more mature markets. The entire MENA region, for example, represented only 2.2% of world equity market wealth in 2007 and an estimated 2.0% by 2012 (Standard & Poors).

Small markets are less liquid, and illiquidity comes with increased volatility. The higher volatility is a reflection both of shallowness and a lack of integration with global markets. Such markets are also susceptible to manipulation and syndicated ramping. The net cost of all this is higher required risk premiums and, consequently, higher implied cost of funds to listed firms. The higher cost of capital reduces the competitiveness of firms.

Something similar can be said of foreign exchange markets, for several reasons. First, most exports of the Muslim world are commodities, most of which have an international price in US dollars. Second, most Muslim nations, especially those of MENA, have currencies pegged or quasi-pegged to the US dollar. While this eliminates currency risk between export earnings and domestic revenue, it may not be advantageous to the export of non-commodity items nor for building a non-commodity export base. For these reasons, FOREX markets have remained infantile. The Bank for International Settlements (BIS) does a triennial survey of foreign exchange trading. The latest survey, done in 2010, features just one currency from Muslimmajority markets: the Turkish lira.

⁹² Nasser Saidi, Nasser Saidi and Associates (2013), "Asia: Coming Financial Transformation", presentation at Asian Finance Forum, Seoul, 27 May.

Figure 20: Top 20 Currencies by Traded Volume

Rank	Currency	Rank	Currency
1	US dollar	11	Korean won
2	Euro	12	Singapore dollar
3	Japanese Yen	13	Norwegian krone
4	Pound sterling	14	Maxican peso
5	Australian doller	15	Indian rupee
6	Swiss franc	16	Russian ruble
7	Canadian dollar	17	Polish zloty
8	Hong Kong dollar	18	Turkey lira
9	swedish krona	19	South African rand
10	New Zeland	20	Brazilian real

Source: BIS Triennial Survey, 2010

This survey is perhaps the best indication of foreign exchange activity in the Muslim world. More than an indication of the under-development of a component of capital markets, it portrays the lack of production/manufacturing denominated in member-country currencies. Oil and gas – key exports for many member countries – are US dollar-based markets.

· ICM have not fully reached the mass market

A number of capital market developments have made it possible for broader sections of the population to participate. This has mainly been due to the provision of divisibility, which makes it possible for small investors to participate in the biggest investment assets. Mutual funds are a good example; REITs are another. ETFs also offer divisibility in a portfolio of listed stocks. Finally, Malaysia's recently introduced ETSB provide divisibility by enabling the small/retail investor to purchase units in a *Şukūk* portfolio for as little as RM1,000. Where *Şukūk* facevalues are typically RM5 million, the ETSB provides bite-size pieces to the smallest investor.

Expanding the reach of Islamic capital markets would bring a number of economic benefits, including:

- Enabling small investors to build wealth;
- Making the investor base broader and more stable;
- · Enabling small companies to access capital market; and
- Potentially limiting the volatility associated with sudden inflow and outflows from speculative investors.

Opportunities and Challenges Ahead

The macroeconomic environment today and industry developments to date present several key opportunities.

- 1 For a world questioning neoclassical economics and seeking new ideas and alternatives, Islamic finance rooted in ethics represents a refreshing new alternative. Articulated and communicated appropriately, it can gain traction. Market conditions also present an opportunity to introduce and propagate risk-sharing instruments, especially in environment where interests are low and liquidity is high.
- 2 As the economic geography of the world becomes multipolar, it presents opportunities for the consolidation of existing Islamic finance centres or the establishment of new ones. Leadership is needed to initiate the establishment of such centres and to ensure that they complement rather than compete with/erode each other. Since economies of scale are key to success in financial services, some concentration is to be expected and is in fact desirable.

That there is opportunity for the creation and viable operation of financial centres is evident from the fact that ten of the world's top 20 sovereign wealth funds (SWFs) are from Muslim countries. 93 Clearly, petrodollars are being recycled through Western financial centres. Muslim deficit nations may be "borrowing" from surplus-generating Muslim countries via Western banks. This financial intermediation is not only highly profitable but provides economic power for the banks over borrowing nations.

A corresponding challenge is how to channel competition among aspiring financial centres. Muslim-majority markets are likely to have the capacity for multiple successful financial centres as long as each can identify its own niche and value proposition. As domestic markets and institutional capabilities are under development, countries may wish to follow a strategy of building up capabilities of domestic firms and domestic regulatory abilities as they gradually open up to greater cross-border financing. Further, new technologies allow for collaboration between large and small financial centres, reducing the old winner takes all hub-and-spoke model.

3 While the dynamics of the oil industry have been important to the development of Islamic finance, clearly, new avenues for growth and capital accumulation are necessary. Islamic finance and Islamic capital markets can be a growth generator, at least for the better-placed nations. Going by the experience of Switzerland, Luxembourg, Singapore and the like, financial services can be high value added and provide for high-income jobs.

⁹³ Ibid.

4 The potential for equity capital markets is significant. A study by the McKinsey Global Institute of asset allocation by households in different regions of the world found MENA households to have 65% of investments in the form of cash and deposits. ⁹⁴ Of the total USD2.7 trillion estimated aggregate amount, nearly two-thirds was held as cash and short-term deposits. A mere 18% was invested in equities.

Another indication of the huge available potential for capital market development is the number of companies from OIC member countries that have chosen to raise equity capital by way of depository receipts (DRs), both ADRs (American depository receipts) and GDRs (global depository receipts). Over the four-year period 2007–2011, the number of firms has nearly doubled (from 77 to 147). Companies may choose to seek external funds by way of DRs for several reasons. These may, in certain instances, include a lack of trust, limited confidence in the rule of law, and limited institutional development. In any case, the phenomenon of DRs indicates the presence of world-class OIC-based companies that are not fully engaging the local markets.

5 Greater institutional participation remains both a challenge and an opportunity. Retail customers and investors have traditionally been the engine of the Islamic financial services industry, with less *Sharī'ah* affinity demonstrated by corporates, institutions or governments. In the markets where Islamic finance has seen the greatest growth and regulatory enablement, governments are in a position to build significant scale by allocating even a portion of sovereign wealth funds and public pension funds to be invested in a *Sharī'ah*-compliant manner.

4.5 Infrastructure and Industry Bodies

Institutional development in the IFSI has taken place at different levels. The industry has achieved its current level of development not only through the efforts of financial institutions and their customers, but also through a broad array of private, public and multilateral bodies that provide the "infrastructure" of the industry.

For an overview of the industry's supporting infrastructure, the relevant institutions and activities can be mapped in terms of the function they play (standard setting, market platform, information and research, training and professional services) and sector in which they operate (private, public or multilateral) (see Figure 21).

⁹⁴ Ibid.

⁹⁵ See "Islamic Capital Market Products: Developments and Challenges", IRTI Occasional Paper No. 9 (2005), pp. 56-60.

Figure 21: Mapping of Industry Infrastructure

	Private Sector	Public Sector	Multilateral
Standard setting		Central banks Capital markets authorities Takāful regulators National Sharī ah boards (where present) Other supervisors	Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Islamic Financial Services Board (IFSB) Organization for Islamic Cooperation (OIC) Fiqh Council
Market catalysts	Private liquidity management platforms Rating agencies Arbitration bodies	Interbank markets Sharī `ah-compliant deposit insurance providers Liquidity management platforms by stock exchanges and central banks	International Islamic Liquidity Management Corporation (IILM) International Islamic Financial Market (IIFM) International Islamic Court for Resolution and Arbitration (IICRA) International Islamic Rating Agency (IIRA)
Information and research	Private universities Research institutes Data providers	Public universities Public research bodies Statistics agencies Sharī ah academies and research institutions	Islamic Research and Training Institute (IRTI)
Training	Private universities Training and accreditation institutes	Public universities Public training and accreditation programmes	Islamic Research and Training Institute (IRTI)
Professional services	Sharī`ah advisers Law firms Audit and assurance firms Consulting firms		

The Mid-Term Review, like the original Framework document, focuses primarily on the multilateral bodies that provide the industry's global infrastructure. The roles of public sector and private sector bodies in members' countries are, nonetheless, recognised as fundamentally crucial in enabling the industry to thrive.

Progress Made in the Sector

• Multilateral bodies have expanded

The key progress to highlight in view of the original recommendations is the establishment of new standard-setting bodies and the need to harmonise their efforts for optimal effect. Several financial standard setters have been founded in the past two decades: AAOFI (Islamic accounting, auditing and *Sharī`ah* standards), IFSB (prudential regulatory standards) and IIFM (Islamic financial market). Coordination among them has also been evident, particularly with the role of the IDB Group as a founding supporter or shareholder of all these bodies. Of course, much more progress can be made in enhancing the synergies and reducing the potential for duplication of effort.

Of special note since the creation of the Ten-Year Framework document is the breakthrough progress to facilitate effective cross-border Islamic liquidity management. The IILM, whose establishment was spearheaded by the IFSB, was founded on 25 October 2010 as an Islamic international institution established by central banks, monetary authorities and multilateral organisations to create and issue short-term *Sharī`ah*-compliant financial instruments. By creating more liquid *Sharī`ah*-compliant financial markets for IIFS, the IILM aims to enhance cross-border investment flows, international linkages and financial stability. Indeed, this initiative reflects substantive progress in achieving the recommendation of the Ten-Year document that states "develop a comprehensive and efficient infrastructure for the Islamic financial services industry for interbank liquidity management as well as for Islamic capital markets".

In April 2013, in a key move aimed at creating a robust global cross-border market for Islamic financial instruments and strengthening the liquidity management of IIFS, the IILM launched its inaugural *Şukūk* Programme pursuant to the granting of an A-1 public rating by Standard & Poor's Rating Services. The IILM short-term *Şukūk* Programme served as a significant milestone, as it was the first (1) *Sharī ah*-compliant US dollar-denominated short-term highly rated financial instrument in the market to be issued at maturities of up to one year; (2) money market instrument backed by sovereign assets in the form of *Şukūk;* and (3) multi-jurisdictional primary-dealer network to facilitate distribution to investors worldwide. Furthermore, on 26 August 2013, the IILM successfully conducted an auction of its inaugural US dollar-denominated short-term *Şukūk* of USD490 million. The *Şukūk*, which was fully subscribed, has tenure of three months and was priced at LIBOR + 30bps.

With respect to a recommendation which states, "develop the required pool of specialised, competent, high-calibre, human capital and ensure utilisation of state-of-the-art technology", a growing body of collaborative works between international Islamic infrastructure institutions has been very promising. IDB, IRTI and the IFSB have been involved in policy discussions and development forums such as the IFSB Council, Technical Committee and working groups on a variety of new prudential standards and guiding principles.

The active involvement of the IFSB in promoting the awareness of issues that are relevant to, or have an impact on, the regulation and supervision of the IFSI has resulted in greater awareness of pertinent topical issues related to the development of the IFSI and increased promotion and dissemination of information on the standards and guiding principles that the IFSB has developed or is developing. These programmes necessitate the provision of a platform for the IFSB, its members and the industry at large, from which to engage with various regulators and supervisory authorities, and other industry stakeholders, to discuss topical issues of common interest. The IFSB's Islamic Financial Stability Forum serves as such a platform, and its members have discussed a broadening of its scope to make it more similar to the Financial Stability Board in conventional finance.

In the area of the Islamic capital market, IIFM has been instrumental in creating a niche area in the standardisation of products, documentation, related processes, and guidelines and recommendations. Some of its achievements to date are the creation of (i) the *Taḥawwut* Master Agreement, (ii) *Mubādalat al-Arbāḥ* (Islamic profit rate swap), (iii) the Islamic Interbank Unrestricted Master Investment *Wakālah* Agreement, and (iv) the Master Agreement for Treasury Placement.

Collaboration has been enhanced

Since October 2009, a number of workshops have been jointly organised with the IRTI/IDB under the IFSB–IRTI/IDB Capacity Building Initiative. The initiative reflects the IRTI/IDB commitment to assisting with capacity building in Islamic finance. Furthermore, between 2007 and 2013, the IFSB conducted 148 FIS workshops in 26 member countries. A total of 1,965 participants, representing regulatory and supervisory authorities and market players, have benefited from these workshops. The IFSB's membership has increased from 137 members as at December 2007 to 185 members at December 2013. The membership comprises 58 regulatory and supervisory authorities, eight international inter-governmental organisations, 112 financial institutions and professional firms, and seven self-regulating organisations (industry associations and stock exchanges) operating in 45 jurisdictions.

An establishment of the International Islamic Centre for Reconciliation and Arbitration (IICRA) was also the result of collaboration between IDB, General Council for Islamic Banks and Financial Institutions (CIBAFI) and the UAE, where it is headquartered. IICRA is an international, independent, non-profitable organisation and one of the major infrastructure institutions of the ISFI. Its main objective is to settle all financial or commercial disputes that arise between financial or commercial institutions that choose to apply the provisions

⁹⁶ IFSB, The IFSB Bulletin, January 2014, vol. 1, issue 2, www.ifsb.org/docs/The%20IFSB%20Bulletin_2nd%20Issue_ January%202014.pdf, accessed 30 January 2014.

⁹⁷ IFSB, "List of Members: By Category", www.ifsb.org/membership.php, accessed 30 January 2014.

of *Sharī* `ah principles in resolving their disputes, between the financial institutions and their clients, or between them and others, either through reconciliation or arbitration.

IIFM, in collaboration with IRTI and IFSB, has also contributed significantly to the capacity building by regularly organising industry consultative meetings, seminars, briefing sessions and workshops on specific issues or initiatives as part of its industry awareness programme.

The Ten-Year Framework and the current Mid-Term Review are themselves examples of collaboration between infrastructure institutions. These initiatives reflect the shared commitment of the IFSB and the IDB Group to support the development of the industry.

• Public sector bodies drive national strategies

Within member countries, public sector bodies are pivotal to forming and executing Islamic finance strategies.

Supervision functions are undertaken by central banks, capital market authorities and *Takāful* regulators. Public sector bodies also act as key market platforms, facilitating Islamic deposit insurance and accepting *Sharī`ah*-compliant statutory deposits. Public universities generate substantial research and information on the IFSI, particularly in countries that have established dedicated programmes for the field. Additionally, some governments have funded training and certification bodies within their countries – providing an important element of infrastructure for the industry.

As will be discussed in a separate section of this report (the Implementation Plan), public sector bodies have a central role in fostering infrastructure.

· Private infrastructure is also crucial

It is noted that infrastructure services provided by private institutions are also crucial for the industry. Such private sector institutions include both not-for-profit organisations (such as private universities generating research and information) and for-profit companies (such as professional services firms offering *Sharī`ah*, legal, rating or consulting services).

Private infrastructure institutions have become increasingly active in the industry as it has matured and expanded. The presence of these institutions is a positive sign of the industry's relevance and recognition of its potential. The fact that entrepreneurs and founders are able to establish such entities also reflects the (overall) free-market nature of the industry.

Opportunities and Challenges

The long-term growth of the IFSI globally will ultimately depend on the production of new knowledge and skills that can support the industry. In this regard, it is necessary to produce a skilled and knowledgeable workforce that can manage various institutions of the IFSI. To achieve this, modalities need to be worked out in human capacity-building initiatives at the national level

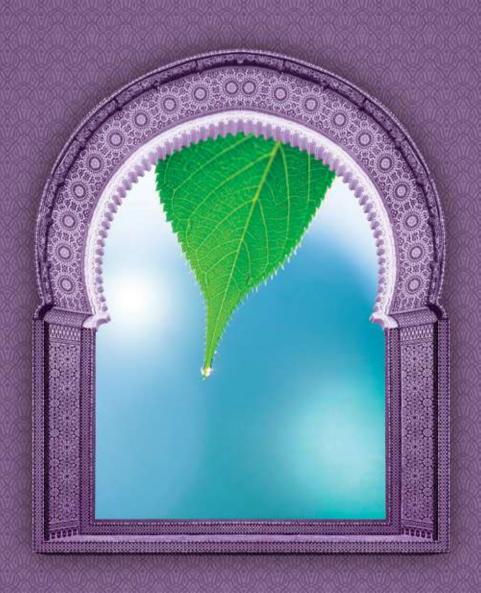
There is also a dearth of reliable and detailed data on Islamic finance-related products and institutions. Private data companies and advisory firms have been increasingly active in generating data for the industry. IDB research and certain IFSB programmes (e.g. the Prudential and Structural Islamic Financial Indicators (PSIFIs)) seek to address this issue. If Islamic finance is to prosper, the need to produce innovative ideas that can be put into practical application cannot be over-emphasised. There is also a need to bridge the gap between the research/academic institutions on the one hand and the industry on the other hand. Given the novelty and complexity of Islamic financial products, programmes have to be initiated to enhance financial literacy and awareness of these products.

The key coordination challenge is to harmonise the activities of institutions with overlapping mandates and activities. This will enable the IFSI to engage more effectively with other national and international supervisory and regulatory authorities. For example, the use of international standards of IFSB would help harmonise regulations that will be particularly useful when undertaking the cross-border linking of markets. The involvement of the IDB Group and key industry players would be needed for successful implementation of this requirement.

Delivering the strategy will also require a more cost-efficient approach in view of the limited financial resources available to several of the key industry bodies. This will require tight controls on expenditures and an expanded effort to raise revenues through fee-based activities. In designing fee-based activities, it is suggested that partnerships be entered into with a number of strategically chosen educational, research and capacity-building organisations. In the case of IFSB, it will draw upon its existing relationships, principally with the IDB and other multilateral development banks, while also seeking partnerships with other strategically identified institutions.

Additional challenges faced by other infrastructure bodies that can be highlighted are as follows:

- Broader implementation of the standards issued by multilateral bodies (such as the IFSB and AAOIFI) among member countries;
- More active participation of and strong support from regulators, IIFS and other market participants (e.g. provision of reliable financial data);
- Standard-setting bodies need to be vigilant in terms of developments by conventional standard setters in relevant areas (e.g. accounting, auditing, banking, capital market, financial market infrastructure, etc.) and be proactive in issuing standards and guidelines on the adaptation of these changes for the IFSI;
- The fact that IIFS are still focusing on conventional ways to settle their financial disputes; and
- In the case of IICRA, it has the challenge of persuading IIFS to include arbitration clauses in its contracts and transactions.



5 RECOMMENDATIONS AND METRICS

5 RECOMMENDATIONS AND METRICS

5.1 Updated Framework Recommendations

The 13 Framework Recommendations proposed in the Ten-Year Framework and Strategies Report have stood the test of time. To more accurately reflect the current status of the IFSI, modest changes have been made to some of the original recommendations, three recommendations have been added, and the updated set has been grouped in three themes:⁹⁸

- Enablement: fostering conditions for the industry to thrive;
- Performance: enhancing the effectiveness of institutions active in the industry; and
- Reach: expanding the set of potential beneficiaries of the industry.

The 16 recommendations from the Mid-Term Review (retaining the numbering of the 2007 Framework except where the recommendations are new) are set out below. The new recommendations (numbers 14–16) are marked with an asterisk (*):

Enable	ment
1	Facilitate and encourage the operation of free, fair and transparent markets in the Islamic financial services sector
5	Develop the required pool of competent, skilled and high-calibre human capital and ensure utilisation of state-of-the-art technology
6	Promote the development of standardised products through research and innovation
8	Develop an appropriate legal, regulatory and supervisory framework, as well as an IT infrastructure that would effectively cater for the special characteristics of the IFSI and ensure tax neutrality
9	Develop comprehensive and sophisticated interbank, capital and hedging ⁹⁹ infrastructures for the IFSI
12	Foster collaboration among countries that offer Islamic financial services
14*	Develop an understanding of the linkages and dependencies between different components of Islamic financial services to enable more informed strategic planning to be undertaken
Perfor	mance
2	Enhance the capitalisation and efficiency of IIFS to ensure that they are adequately capitalised, well-performing and resilient, and on par with international standards and best practices

⁹⁸ The original framework categorised recommendations as institutional and infrastructural; the new categorisation focuses on the outcomes desired from the framework.

⁹⁹ Although the term derivatives was used in the 2007 document, it has been recommended that the term hedging be used as a more appropriate description.

4	Enhance Sharī ah compliance, effectiveness of corporate governance and transparency
7	Enhance the implementation of the international prudential, accounting and auditing standards applicable to the IFSI
11	Strengthen and enhance collaboration among the international Islamic financial infrastructure institutions
15*	Foster and embrace innovative business models, including new technologies and delivery channels, in offering Islamic financial services
Reach	
3	Enhance access by the large majority of the population to financial services, and enhance access to funding for SMEs and entrepreneurs
10	Promote public awareness of the range of Islamic financial services
13	Conduct initiatives and enhance financial linkages to integrate domestic IFSIs with regional and international financial markets
16*	Strengthen contributions to the global dialogue on financial services, offering principles and perspectives to enhance the global financial system

5.2 Key Performance Indicators for Measuring Progress

Setting Key Performance Indicators (KPIs) poses a challenge; as such, metrics were not part of the original Ten-Year Framework. With the growth of the industry, however, it is felt that well-designed KPIs can help address weaknesses and monitor progress in a more focused way. A view of the proposed KPIs is given below:

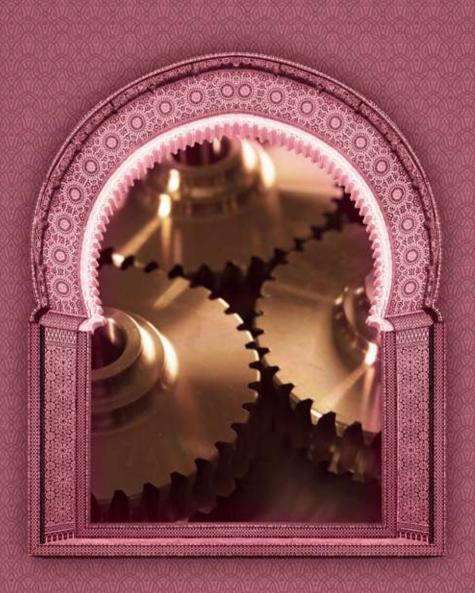
No.	Recommendation	Key Performance Indicators
1	Facilitate and encourage the operation of free, fair and transparent markets in the Islamic financial services sector	Progress made by member countries on World Bank governance metrics Percentage of member countries operating free market financial systems Level of transparency of Islamic banks compared with conventional counterparts
2	Enhance the capitalisation and efficiency of IIFS to ensure that they are adequately capitalised, well-performing and resilient, and on par with international standards and best practices	 2.1 Average capital adequacy of Islamic banks 2.2 Average ROE of Islamic banks 2.3 Average ROE of <i>Takāful</i> companies 2.4 Market capitalisation of member country capital markets

No.	Recommendation		Key Performance Indicators
3	Enhance access by the large majority of the population to financial services, and enhance access to funding	3.1	Percentage of population with access to financial service Number of Islamic microfinance institutions in member
3		3.2	countries
	for SMEs and entrepreneurs	3.3	Percentage of Islamic banks offering SME and entrepreneurial finance
		3.4	Number of member countries with SME and entrepreneurial finance programs (public sector or NGOs) that are <i>Sharī'ah</i> compliant
4	Enhance Sharī`ah compliance, effectiveness of	4.1	Number of member countries with national <i>Sharī`ah</i> standards or national <i>Sharī`ah</i> boards
	corporate governance and transparency	4.2	Number of countries adopting international <i>Shart`ah</i> standards in their supervision framework
		4.3	Corporate governance standards and disclosure standards of Islamic financial institutions
5	Develop the required pool of competent, skilled and high-calibre human capital	5.1	Percentage of countries with Islamic finance education available (within general educational institutions or specialised Islamic finance institutes)
	and ensure utilisation of state-of-the-art technology		Access to specialised Islamic finance training through internet-based platforms
		1.3	Number of professionals receiving industry-specific qualifications
6	Enhance the development of standardised products	6.1	Number and usage of standardised products with published structures and contracts
	through research and innovation	6.2	Volume of published research on product innovation and standardisation
		6.3	Number and usage of innovative products
7	Enhance the implementation of the international prudential, accounting and auditing standards		Percentage of members requiring compliance with applicable, Islamic finance industry-specific prudential, accounting and auditing standards as generated by industry standard-setting bodies
	applicable to the IFSI	7.2	Collaboration with international standard-setting bodies such as Basel Committee, IAIS, IOSCO and IASB

No.	Recommendation	Key Performance Indicators
8	Develop an appropriate legal, regulatory and supervisory framework, as well as an IT infrastructure that would effectively cater for the special characteristics of the IFSI and ensure tax neutrality	8.1 Percentage of member countries with tax neutrality, legal enablement and other basic enablers of Islamic banking as enumerated in ten recommendations from the 2007 Framework and reviewed in this document 8.2 Level of new and social media adoption by IIFS
9	Develop comprehensive and sophisticated interbank, capital and hedging infrastructures for the IFSI	9.1 Percentage of member countries with domestic Islamic interbank markets 9.2 Number of member countries with developed regulatory and market infrastructure for Islamic capital markets
10	Promote public awareness of the range of Islamic financial services	 10.1 Percentage of member countries with market share of Islamic finance of 10% or greater 10.2 Percentage of Islamic banking, <i>Takāful</i>, Islamic capital markets and Islamic microfinance activities as a proportion of the total for the respective sector in member countries 10.3 Number of member countries with awareness-raising programmes on Islamic finance (as standalone programmes or part of broader financial literacy)
11	Strengthen and enhance collaboration among the international Islamic financial infrastructure institutions	 11.1 Number of collaborative projects between infrastructure institutions 11.2 Impact assessment analysis of collaborative projects between infrastructure institutions
12	Foster collaboration among countries that offer Islamic financial services	12.1 Number of collaborative projects (multilateral and bilateral) between countries that offer Islamic financial services (e.g. technical assistance on regulation, public awareness campaigns, etc.)
13	Conduct initiatives and enhance financial linkages to integrate domestic IFSIs with regional and international financial markets	 13.1 Number of initiatives under way in member countries to link domestic IFSIs with regional and international financial markets (e.g. the facilitation of introductions between IFSIs and overseas capital market participants) 13.2 Issuances of cross-border Islamic financial instruments 13.3 Observer or delegate status for Islamic finance services infrastructure bodies on international regulatory bodies

No.	Recommendation	Key Performance Indicators
14	Develop an understanding of the linkages and dependencies between different components of Islamic financial services to enable more informed strategic planning to be undertaken	 14.1 Regular tracking of the industry-level KPIs 14.2 Re-visiting the framework strategies at the end of the Ten-Year period 14.3 Inclusion of Islamic finance statistics in the national and regional statistics of member countries 14.4 Participation in the Islamic Financial Sector Assessment Programme (iFSAP), an initiative that provides supplementary templates on Islamic finance for the World Bank–IMF Financial Sector Assessment Program 14.5 Participation in self-assessment, peer review and/or IMF-WB FSAP on the basis of Core Principles for Islamic Finance Regulation
15	Foster and embrace innovative business models, including new technologies and delivery channels, in delivering Islamic financial services	 15.1 Percentage of IIFS utilising internet, mobile banking and other forms of alternative channels 15.2 Introduction of innovative business models such as peer-to-peer financing, crowdfunding, digital payments, etc.
16	Strengthen contributions to the global dialogue on financial services, offering principles and perspectives to enhance the global financial system	 16.1 Participation by Islamic infrastructure institutions and regulators in reviews of the overall financial system at international forums (e.g. the G20, Basel Committee, IMF/ World Bank, etc.) 16.2 Explicit reference and consideration of Islamic finance principles in communiqués and proceedings of key international forums (e.g. the G20, Basel Committee, IMF/World Bank, etc.) 16.3 Number of dialogues held between OIC central banks, stock exchanges and regulatory authorities on various issues of Islamic finance 16.4 Number of papers prepared or events organised providing Islamic perspective on the current and long-term strategic issues pertaining to the global financial system





6 IMPLEMENTATION PLAN

6 IMPLEMENTATION PLAN

Implementing the Framework Recommendations is a complex endeavour. Achieving the results requires the efforts of a broad range of stakeholders.

The current chapter first outlines the envisioned roles of various stakeholders in implementing the Framework Recommendations. It then identifies a set of initiatives suggested to address immediate needs and opportunities for the advancement of the industry.

6.1 Stakeholder Map

The table below identifies the roles of various stakeholders in achieving the Framework Recommendations. The stakeholders considered include central banks and supervisors, governments, financial institutions, other private institutions and multilateral bodies.

Stakeholders

	Central Banks and Supervisors	Governments	Financial Institutions	Other Private Institutions	Multilateral Bodies
Pillar 1: Enablement					
Recommendation 1: Facilitate and encourage the operation of free, fair and transparent markets in the Islamic financial services sector	Set and enforce fair, free and transparent financial services regulation Contribute to creation of credit and business information sharing platforms	Set and enforce fair, free and transparent regulation of the overall economy Improve rule of law and protection of property rights Facilitate the creation of credit and business information sharing institutions	Comply with regulations and operate with strong business ethics Enhance disclosures (including disclosures on products and services) to enhance transparency	Comply with regulations and operate with strong business ethics	Identify and promote best practices in ensuring free, fair and transparent markets

	Central Banks and Supervisors	Governments	Financial Institutions	Other Private Institutions	Multilateral Bodies
Recommendation 5: Develop the required pool of competent, skilled and high-calibre human capital and ensure utilisation of state-of-the-art technology	Support and establish capacity-building programmes in the jurisdiction Include consideration of specialised Islamic finance expertise in "fit and proper" assessments of institutions and individuals	Encourage Islamic finance training as part of the overall education agenda	Encourage and reward specialist training in Islamic finance	Offer Islamic finance training through universities, institutes and religious education institutions	Contribute expertise to training and development programmes and encourage the sharing of best practices
Recommendation 6: Enhance the development of standardised products and innovation to promote scale and breadth	Promote standardisation through national Sharī ah boards (where present) or collaboration between scholars Sponsor research in Islamic finance and economics	Sponsor research in Islamic finance and economics	Engage in collaboration across financial institutions Undertake research and development efforts	Undertake research and development efforts in private universities and institutes	Develop and disseminate standards and standardised product structures for the use of the industry Undertake research and development efforts
Recommendation 8: Develop an appropriate legal, regulatory and supervisory framework as well as an IT infrastructure that would effectively cater for the special characteristics of the IFSI and ensure tax neutrality	Develop and enforce enabling supervisory framework	Ensure tax neutrality, legislation and other public sector support required by the industry	Engage with supervisors and governments to articulate the special characteristics and needs of the industry	Provide required specialist support (legal, accounting, compliance, IT, etc.) to apply the framework in practice	Identify and promote best practices in legal, regulatory and supervisory framework Advocate for required changes

	Central Banks and Supervisors	Governments	Financial Institutions	Other Private Institutions	Multilateral Bodies
Recommendation 9: Develop comprehensive and sophisticated interbank, capital and derivatives market infrastructures for the IFSI	Develop interbank markets and supervisory frameworks for capital markets Accept Sharī 'ah-compliant statutory reserves and central bank deposits	Develop exchanges and other market platforms (either standalone or as part of broader platforms) for Islamic capital market securities Foster Islamic capital markets by issuing Sukūk and other Sharī ah- compliant securities Include Islamic finance in public—private partnerships, privatisations, and the financing of government- linked companies	Participate in interbank markets Foster capital markets as underwriters, arrangers and market-makers	Participate in Islamic capital markets as investors and issuers	Promote international and cross-border platforms for liquidity management and the exchange of securities Identify and promote best practices in capital market infrastructure Include Islamic finance in public-private partnerships, and in cofinancing of projects with other multilateral development banks
Recommendation 12: Foster collaboration among countries that offer Islamic financial services	Engage in collaborative efforts with counterparts in other jurisdictions	Include Islamic finance on the broader agenda of international collaboration	Undertake expansion beyond home markets, deepening cross-border ties and spreading expertise	Spread expertise and best practices through specialist support (legal, accounting, compliance, IT, etc.) across borders	Act as forums for the exchange of expertise and best practices Introduce parties with a mutual interest in collaboration

	Central Banks and Supervisors	Governments	Financial Institutions	Other Private Institutions	Multilateral Bodies
Recommendation 14: Develop an understanding of the linkages and dependencies between different components of Islamic financial services to enable more informed strategic planning to be undertaken	Develop national holistic developments and developments and the Islamic finar	ment of the ue consideration tts multilateral fforts to initiate analysis of nd stability in	Undertake robust strategic planning, exploring opportunities in multiple sectors of the industry	Support the implementation of the national plans	Ensure a holistic outlook in the development of standards, guidelines and research about the industry Initiate support for iFSAP, peer reviews and and self-assessment against Core Principles for Islamic Finance Regulation Where feasible, pilot test the templates in collaboration with other multilateral financial institutions Initiate reports that can shed light on linkages, developments and stability of the Islamic financial sector

	Central Banks and Supervisors	Governments	Financial Institutions	Other Private Institutions	Multilateral Bodies		
Pillar 2: Performanc	Pillar 2: Performance						
Recommendation 2: Enhance the capitalisation and efficiency of IIFS to ensure that they are adequately capitalised, well- performing and resilient, and on par with international standards and best practices	Set and enforce appropriate capital adequacy and prudential requirements for financial institutions	Set and enforce appropriate financial services laws and provide support to the sector when needed	Comply with capital adequacy and prudential requirements Identify and adopt best practices beyond statutory requirements Enhance capital efficiency and financial performance through strong business results	As clients and investors, demand strong performance and high standards from financial institutions	Provide industry-wide standards for capital adequacy and prudential requirements Increase awareness about the standards Provide, where feasible, technical assistance and input to supervisors		
Recommendation 4: Enhance Sharī`ah compliance, effectiveness of corporate governance and transparency	Set and enforce appropriate standards for corporate governance and transparency Establish a Sharī`ah governance framework Increase awareness about the standards among IFSIs and the general public	Set and enforce appropriate laws for corporate governance and transparency Through financial literacy programmes, enhance customer savvy and comprehension of disclosures	Comply with standards for corporate governance and transparency Comply with Sharī ah governance framework Embrace spirit of good governance and spirit of Sharī ah guidance	As clients and investors, demand full compliance with corporate governance, transparency and Sharī ah standards Recognise and reward superior governance and Sharī ah standards	Provide international standards for corporate governance, transparency and Sharī ah compliance Increase awareness of the standards among the regulators and governments Provide, where feasible, technical assistance and input to supervisors		

	Central Banks and Supervisors	Governments	Financial Institutions	Other Private Institutions	Multilateral Bodies
Recommendation 7: Enhance the implementation of the international prudential, accounting and auditing standards applicable to the IFSI	Adopt and enforce where relevant both general standards (e.g. Basel Committee) and industry-specific standards (e.g. IFSB and AAOIFI)	Facilitate the adoption of IFSB and AAOIFI standards	Comply with relevant standards Adopt industry- specific standards on a voluntary basis (where not mandatory)	As clients and investors, demand full compliance with relevant standards	Provide international standards Increase awareness of the standards Provide, where feasible, technical assistance and input to supervisors
Recommendation 11: Strengthen and enhance collaboration among the international Islamic financial infrastructure institutions	As members of infrastructure institutions, encourage collaboration	Provide support and encouragement to infrastructure organisations	Provide, where appropriate, financial and technical support		Enhance collaboration through joint initiatives and ongoing, sustained efforts
Recommendation 15: Foster and embrace innovative business models, including new technologies and delivery channels, in delivering Islamic financial services	Accommodate innovation and new business models (e.g. mobile banking) in financial regulation and supervision	Support innovative business models as part of financial inclusion strategy	Launch innovative business models and embrace new delivery channels	As clients and investors, encourage innovative business models	Identify and promote best practices in innovative business models

	Central Banks and Supervisors	Governments	Financial Institutions	Other Private Institutions	Multilateral Bodies
Pillar 3: Reach					
Recommendation 3: Enhance access by the large majority of the population to financial services and enhance access to funding for SMEs and entrepreneurs	Set and enforce appropriate regulations for financial inclusion in under-served areas	Provide support and incentives for financial inclusion, SME financing and entrepreneurial finance	Enhance attention to SME and entrepreneurial financing as part of business strategy	As investors and business owners, consider Islamic finance as a source of funding	Identify and promote best practices in SME and entrepreneurial finance
Recommendation 10: Promote public awareness of the range of Islamic financial services	Include Islamic finance in overall initiatives pertaining to financial literacy and awareness-building		Promote wider range of services and products to broaden awareness of the industry's offerings	As clients and investors, raise the profile of Islamic financial services	Foster international awareness of Islamic finance through research and events Identify and promote best practices in awareness building
Recommendation 13: Conduct initiatives and enhance financial linkages to integrate domestic IFSIs with regional and international financial markets	Ensure that regulations enable domestic institutions to broaden international ties	Support initiatives to deepen international linkages through engagement with counterparts	Include participation in international financial markets as part of overall strategy	Actively participate, where appropriate, in international financial markets as part of overall strategy	Support linkages to integrate domestic institutions with international markets and provide technical assistance
Recommendation 16: Strengthen contributions to the global dialogue on financial services, offering principles and perspectives to enhance the global financial system	Consider Islamic finance principles as valuable input in shaping overall financial regulation	Include Islamic finance principles in multilateral discussions at key forums (e.g. the G20) on the global financial system	Through performance and positive impact, act as practical examples of Islamic finance principles	In the media and other forums, consider the merits of Islamic finance principles	As representatives of the IFSI, consistently highlight its relevance to discussions of the global financial system

6.2 Key Initiatives

Over the course of the Mid-Term Review process, over 70 initiatives were suggested to support the implementation of the recommendations. These initiatives included ideas from sector specialists, input from expert reviewers, and guidance from various review committees.

These ideas have been synthesised and prioritised into a list of 20 key initiatives based on their potential impact and the feasibility of implementation. They are listed below along the three pillars of the framework – Enablement, Performance and Reach – and each is then discussed in detail.

	Integrate Islamic finance in national development plans		
	Introduce national Islamic financial services master plans		
	Enhance regulatory implementation and enforcement		
	Harmonise, where possible, regulation and regulatory frameworks across borders		
	Adopt and strengthen national Sharī'ah governance frameworks		
Enablement	Where mandates overlap, align the positions of industry bodies		
	Link Islamic financial markets across borders		
	Form a "Technical Assistance and Linkage Network"		
	Form regional working groups		
	Foster information-providing institutions that support the provision of Islamic finance		
	Incorporate Islamic finance data in statistical and official reporting		
	Institute centralised R&D for Islamic financial products in addition to the decentralised R&D		
Performance	Establish diversified financial institutions		
	Demonstrate the industry's distinctive value proposition		
	Fund public infrastructure projects to build Islamic capital markets		
Reach	Revitalise <i>Zakāh</i> and <i>Awqāf</i> for greater financial inclusion and make them an integrated part of Islamic financial system		
	Ensure that regulations allow for the use of new technology to provide affordable services		
	Engage with newly opened markets		
	Foster the financing of a wider set of economic sectors		
	Brand Islamic financial services for wider markets		

Integrate Islamic finance in national development plans

As countries form and revise their national development plans, Islamic finance should be considered as an important contributor. Policies to promote job creation through SME finance, for example, can have Islamic finance components in order to expand their reach and impact. Similarly, the use of Islamic finance to fund national projects (e.g. infrastructure, privatisations or foreign direct investment (FDI)) is an important opportunity for countries to consider in their development plan.

Including Islamic finance in overall national development plans is a step that both strengthens these development plans and enables the Islamic finance industry to broaden its impact. It is thus suggested that national planners include Islamic finance in charting their overall development.

Introduce national Islamic financial services master plans

Given the nascent nature of the Islamic financial sector in many countries, introduction of national Master Plans can provide a strategic framework for the development of the industry in different countries. The Master Plan should identify the areas that need to be strengthened for a healthy and balanced growth of the Islamic financial sector. The Plan would also include national specific KPIs for different segments of the industry that need to be monitored over time.

Where appropriate, these Master Plans should include provisions for a supportive legislative framework. As most IDB member countries have either common law or civil law regimes, a legal and regulatory infrastructure supportive of the IFSI is necessary for the development of a sustainable and dynamic industry. Laws that can support the different segments of Islamic finance such as banking, *Takāful* and NBFIs need to be enacted. The laws would not only detail the requirements for formation, activities that could be undertaken and regulatory aspects of IIFS, but also clarify the conceptual issues related to transactions related to Islamic finance.

A prudent regulatory framework in line with the post-crisis era is essential for the healthy development of the IFSI. In this regard, the revised IFSB standards on capital adequacy and liquidity risk management can be useful guides to prepare national regulatory frameworks and associated infrastructure for the Islamic financial sector in different countries.

In the wake of recent crises, NBFIs warrant particular attention. A tiered and balanced regulatory structure that is not burdensome on the institutions, hampering their growth on the one hand, and is not too lax, leading to mismanagement and instability on the other hand, is needed for the sound and stable growth of Islamic NBFIs. Whereas regulatory standards and guidelines

for Islamic banks exist, there may be a need to develop international regulatory standards and guidelines (prudential and non-prudential) for Islamic NBFIs that can be used by different countries.

Additionally, these Master Plans should also include a framework for the governance and risk management of IIFS in order to enhance stability, improve disclosure and enhance industry growth in the long run. These measures should include the adoption or elaboration of international best practices and reporting standards, including IFSB and AAOIFI guidelines. Incentives (such as tax rebates on costs incurred for compliance) can be used to encourage adoption in the initial stages.

We note that the concept of national Master Plans was a key element of the original Framework document published in 2007. Since the publication of the Framework, several countries have formulated such plans, to the benefit of their Islamic finance industries and their financial systems overall.

Enhance regulatory implementation and enforcement

Enabling the industry requires not only a regulatory framework, but also careful and methodical implementation. Similarly, enforcement is also crucial to ensure that regulations have their intended effects.

In certain cases, institutional reform may be needed to enhance the implementation and enforcement of regulations. The allocation of human and financial resources to implementation and enforcement (rather than to policy formulation alone) is also important for this initiative.

Harmonise, where possible, regulation and regulatory frameworks across borders

It is acknowledged that regulations and regulatory frameworks will necessarily vary across jurisdictions. Such variations reflect the unique circumstances and priorities of each government and supervisor.

Harmonisation, however, is an important objective. The harmonising of regulations allows for greater cross-border market activity and encourages more collaboration between market actors. Mutual recognition of approvals (e.g. recognising a fund approved in one jurisdiction as marketable in another) is one example of the type of harmonisation that can help the industry flourish.

Adopt and strengthen national Sharī`ah governance frameworks

Adopting national *Sharī`ah* governance frameworks mitigates both *Sharī`ah* and reputation risks. *Sharī`ah* governance guidelines offered by industry bodies are an appropriate point of departure for this exercise, to be elaborated on by each jurisdiction based on local needs and dynamics.

As part of this exercise, regulators may consider documenting all *fatāwa* related to Islamic financial services adopted in a particular jurisdiction along with the rationale for approval. Such documentation will promote transparency, instill confidence among clients, and promote growth in the long run. Similarly, introducing standard templates or guides for contracts at the national level that are broadly accepted will simplify the structuring and *Sharī`ah* approval process.

Sharī`ah governance frameworks may include the use of national *Sharī`ah* boards, as several member countries have introduced. Such frameworks, however, can still be applied in jurisdictions that choose not to have national *Sharī`ah* boards. The presence of a solid governance framework brings substantial benefits with or without a national *Sharī`ah* board.

Where mandates overlap, align the positions of industry bodies

There is a need to harmonise the activities of different Islamic infrastructure institutions. Such harmonisation can create synergies on the one hand and avoid replications on the other hand. Harmonisation activities of international infrastructure institutions would also lead to more consistent approaches and greater appropriate regulatory framework for oversight of the industry. It will enable the IFSI to engage more effectively with other national and international supervisory and regulatory authorities. For example, the use of international regulatory standards of IFSB would help harmonise prudential regulations, and use of AAOIFI accounting and *Sharī`ah* standards would help to bring uniformity in accounting and contract documentation practices. These will be particularly useful when undertaking the cross-border linking of markets.

The involvement of the IDB Group and key industry players would be needed for successful implementation of this requirement. The IDB is currently undertaking an initiative to enhance the alignment of industry bodies, and this initiative is expected to bring benefit to the industry as a whole.

Link Islamic financial markets across borders

Many transactions in Islamic securities are still bilateral and do not flow through market platforms. Without market trading, price discovery is not possible. In the absence of a price

discovery mechanism, Islamic financial markets often lack efficiency, or rely on conventional benchmarks for pricing.

By linking Islamic financial markets more fully, participants can benefit from greater depth and efficiency. Funds from one country will move across borders to industries or sectors that provide the highest return. Returns or the cost of funds could, ideally, become more linked to real sector returns. Market trading also enables standardisation, which in turn reduces transaction costs and improves liquidity.

Some of the required infrastructure can be supplied by computerised linkage between financial market centres, the OIC Stock Exchanges Forum or via the IILM platform. Other aspects of infrastructure – such as accounting, tax, legal structuring and governance matters – may be more complex and require additional effort. The efforts required to make cross-border linkages workable will be justified for larger transactions and in instances where access to a broader pool of participants is desirable.

Form a "Technical Assistance and Linkage Network"

The IDB Group and IFSB can, where feasible, provide technical assistance to member countries to develop, regulate and supervise their Islamic finance sectors. This is an important service in supporting the implementation of the recommendations.

In additional to these multilateral bodies, a "Technical Assistance and Linkages Network" can be formed of stakeholders willing to provide assistance to member countries. The Network could include government bodies, central banks and private institutions willing to provide technical assistance to other member countries. As and when technical assistance is requested, the Network can be activated to support the member country.

A broader Technical Assistance and Linkages Network can deepen the capacity for technical assistance available for member countries. It also provides member institutions an opportunity to pro-actively offer to share their experiences and expertise. It is proposed that the Network communicate its availability on at least an annual basis, keeping member countries aware of its presence and interest in being of service.

Form regional working groups

As regional bodies (such as the GCC and ASEAN) take on greater importance, their role in setting financial and supervision policy will likely grow. Regional working groups can be formed in the sphere of Islamic financial services to cater to the needs of the growth of the

industry. Within regional groups, there can often be wide variance in the approach to and maturity of the IFSI. Member countries with more experience can share their perspectives with members of the same regional bodies, and are likely to have a high degree of relevance and affinity to one another. One goal of these working groups would be to publicise and exchange knowledge and good practices for different segments of the Islamic financial sector.

Regional working groups can meet adjacent to regional summits (e.g. adjacent to meetings of the central bank governors of OIC or GCC member states). Doing so can make coordination easier and enhance the relevance of these forums to overall regional priorities.

As a first step, the secretariats of existing industry bodies can reach out to secretariats of regional bodies to explore the level of interest and the feasibility of implementation.

Foster information-providing institutions that support the provision of Islamic finance

Several countries have implemented or are in the process of launching national credit bureaus. Such bodies play an important role in enabling financial institutions (both Islamic and conventional) to make better-informed financing decisions. They also introduce greater dynamism to the financial services sector, as the presence of bureaus makes it easier for institutions to take on new clients or for clients to switch between institutions.

As many IIFS are relatively new entrants in the marketplace, the introduction of credit bureaus and other information sources such as business rating bureaus and entrepreneurial capacity evaluation is particularly important in helping them access a broader pool of potential customers and support equity-based and project financing.

Incorporate Islamic finance data in statistical and official reporting

A lack of comprehensive and reliable data remains a key challenge for the industry. Private researchers and advisory firms have been increasingly active in producing research on the industry, but the underlying data can often have issues in its reliability and accuracy.

It is suggested that official statistical reviews and reports include data on Islamic finance. Where information is collected on the financial sector, additional detail should be included on the Islamic finance industry, in particular.

The IFSB has initiated a project to facilitate the monitoring and analysis of the soundness and stability of the IFSI through a set of prudential, structural and financial stability indicators.¹⁰⁰

¹⁰⁰ Islamic Financial Services Board (2011), "Revised Compilation Guide on Prudential and Structural Islamic Financial Indicators", March, www.ifsb.org/docs/201120%23-12-PSIFI%20Compilation%20Guide%20(Final%20Clean).pdf, accessed 30 January 2014.

It has already issued a detailed Compilation Guide in 2007, later revised in 2011, to provide guidance to national compilers and supervisory bodies on the collection, compilation and reporting of the data to the IFSB.

In the review process of the Mid-Term Review, the Statistical, Economic and Social Research and Training Centre for Islamic Countries (SESRIC) noted its interest in ensuring that Islamic finance data be captured in statistical reporting. As a body of the OIC, SESRIC can play a vital role in enabling such inclusion and thereby strengthening the fact and scientific base on which decisions regarding the IFSI are made. However, there is a need to consolidate and synergise such initiatives in the IFSI to minimise duplication of effort and create a common reference point for the major growth and stability indicators in the industry. IRTI also collects annualised data on Islamic banks, which can be expanded to include other financial institutions.

Institute centralised R&D for Islamic financial products in addition to decentralised R&D

To foster more innovative and more authentic Islamic financial products, one or more product development programme(s) can be formed. Such programmes would have the mandate to apply research undertaken in financial services internationally, as well as at specific Islamic finance research centres and academic institutions, and to use the knowledge to develop new products. These programme(s) should apply existing research to develop new, commercially viable, products and services.

Products and instruments that require particular attention are Ṣukūk, Takāful, personal finance and liquidity management, the currently employed structures for which face the greatest lack of conceptual clarity and Sharī`ah agreement.

These programme(s) would provide a "public good" to the industry and also lay the groundwork for a new generation of more differentiated Islamic financial products, addressing the apprehension that Islamic finance closely resembles conventional debt-based products and will inevitably lead to the same problems of leverage as conventional finance. Among the possible funding sources for such a centre could be contributions from IIFS, either from their profits or from mandatory "purification" funds through which income from impermissible sources must be applied to charitable purposes.

Establish diversified financial institutions

While Islamic banks will continue to play an important role in the future growth of the IFSI, there is a need to support the development of other segments of the sector for a balanced growth of a stable and inclusive industry. This would require establishing a variety of NBFIs, *Takāful*

companies and intermediaries linked to capital markets. A diverse financial sector would include various equity-based NBFIs such as venture capital and private equity funds, microfinance institutions, and unique institutions such as *Mudārabah* companies.

Diversification can be achieved through both (1) the broadening of products and services provided by existing financial institutions, and (2) the establishment of new, specialist institutions in various non-bank service lines. Both of these approaches are valuable, and may be applied in different contexts based on the strategic preferences of market participants.

The existence of a diversified set of financial institutions in an economy will not only be able to provide financial services to different market segments, but can also make the financial sector stable and resilient to shocks. Initiatives by the regulatory authorities and their respective governments to encourage the creation of investment companies that channel savings to genuine economic activity (e.g. venture capital, private equity and other investment firms) are examples of how a diversified industry can better serve the overall economy.

Demonstrate the industry's distinctive value proposition

Islamic finance has a distinctive value proposition to offer member countries and the world at large. This value proposition includes not only *Sharī`ah*-specific provisions, but also broadly universal principles supporting financial inclusion, linking financing more closely with the real economy, and fostering a more stable financial system.

The challenge, however, lies in demonstrating this distinctive value proposition in practice as well as in principle. Many of the Framework's recommendations relate to aspects of this proposition, and acting on them can help further substantiate the merits of the sector.

Fund public infrastructure projects to build Islamic capital markets

This proposal is aimed at solving two problems while also contributing to Islamic capital market development. The two problems are: (1) the growing need for better infrastructure in emerging markets as well as in the Muslim world; and (2) the growing need for Islamic securities to enable the development of Islamic capital markets. The basic idea is to have $Suk\bar{u}k$ whose returns are linked to infrastructure project returns. Any infrastructure project that generates revenue – for example, power generation plants, ports, tolled highway, rail systems, mass-rapid transit systems, etc. – would be suitable.

Financing such projects with long-dated $Suk\bar{u}k$ (either profit-and-loss sharing or debt-based) addresses the problems above while also reducing the strain on the government's development budget. Reducing the size of the $Suk\bar{u}k$ denomination would allow the small investor and

ordinary households to invest in them and participate in the development. Given the long tenure of the $Suk\bar{u}k$, they can be listed and traded on exchanges and be bought and sold through financial institutions at the latest market prices. Eventually a number of such $Suk\bar{u}k$ from different countries and different underlying projects could be securitised and packaged to one or more international exchanges. Thus, households from one country could be funding projects in other countries as well.

Revitalise Zakāh and Awqāf for greater financial inclusion and make them an integrated part of the Islamic financial system

Zakāh and Awqāf are key components of the Islamic economic system and play vital roles in Muslim economies. Awqāf often hold large volumes of (typically illiquid) assets, and Zakāh funds have a central role in channelling funds to the needy and mobilising savings for social good.

There is a need to develop operational models that integrate $Zak\bar{a}h$ and $Awq\bar{a}f$ into the formal Islamic financial system to provide inclusive financing, particularly to the poor. For non-profit organisations focusing on poverty, charitable funds from these sources can provide support to sustain their activities. For commercial for-profit organisations, $Awq\bar{a}f$ can provide sources to funds that can be used to expand their outreach to the poor.

Zakāh and Awqāf can (where allowed by Sharī ah scholars) be used for asset building and production purposes to complement funds of Islamic microfinance institutions and micro-Takāful companies. Funds from these sources can also be used to provide grants or interest-free loans (Qarḍ al-Ḥasan) based on the needs of the beneficiary. As these complementary funds will reduce the need to divert money for consumption and/or purchase of assets, it is expected that the funds taken for productive activities will be invested accordingly.

As the practice of liquid $Awq\bar{a}f$ (holding financial assets rather than real estate or other types of assets) expands, $Awq\bar{a}f$ also are important participants in Islamic investments and Islamic capital markets. Given the potential size of their asset base, $Awq\bar{a}f$ can have a substantial impact on these sectors.

Ensure that regulations allow for the use of new technologies to provide affordable services

Promoting innovation and new technologies will offer opportunities for the provision of affordable financial services to a larger section of the population at reduced costs. Modern technologies such as innovative payment and mobile systems can be effectively used to deliver various financial products such as microfinance services and *Takāful*. In particular, mobile

banking technologies that are being used to provide conventional microfinance services can also be introduced for Islamic finance. Similarly, internet-based cloud financing may be a good platform to connect investors with entrepreneurs.

To improve the use of these technologies, regulatory enablement is crucial. Commercial will and a drive for innovation are also necessary from the private sector.

Engage with newly opened markets

Engaging with markets that have newly opened up to Islamic finance is both critically important and highly urgent. If managed well, these markets represent a large-scale opportunity. If, however, the introduction and growth of Islamic finance is not managed well, these markets may have a negative experience and the overall credibility of the sector could suffer.

It is thus an immediate priority for industry bodies, governments, regulators and private institutions to engage with newly opened markets. Doing so is both timely and consistent with the missions and mandates of many such organisations.

Foster the financing of a wider set of economic sectors

While capital markets are closely linked to other sectors such as manufacturing, trading and even agriculture, the Islamic banking sector has been heavily involved in commodity-based trading in deploying its deposits. Financing has, of course, been provided to a wide set of commercial clients, but often Islamic banks are heavily focused on the financing of retail consumption.

IIFS could meaningfully contribute to economic growth by diversifying financing to other productive sectors such as agriculture and manufacturing and newer sectors such as renewable and alternative energy. Diversification of financing into other sectors will also reduce macroeconomic vulnerability to shocks.

Engaging different segments of the Islamic financial sector can play a key role in supporting this initiative. Non-deposit-taking NBFIs and microfinance institutions can raise funds for financing a broader set of sectors, offering risk-bearing investments to clients. Whereas real estate has often been a focus of Islamic NBFIs, the opportunity exists to significantly broaden the range of sectors financed.

Brand Islamic financial products for wider markets

In order to enhance its global relevance, the IFSI should market its products to humanity at large. Branding Islamic financial services as values-driven is critical to differentiate them from conventional products and requires a sustained effort over a long period of time. Careful consideration is required as to how best to highlight the universal appeal of Islamic financial services, while reflecting the fact that the underlying principles are rooted in the religion of Islam.

Successful penetration into new markets would require developing efficient products that can compete with the conventional products on the one hand, while highlighting the unique features of Islamic finance that can attract clients seeking ethical dealings on the other. Successful implementation of this strategy could reap significant rewards for the industry in the long run, and ensure that Islamic finance benefits not only Muslims but also values-oriented clients from all traditions



7 COMMITMENT FROM THE SPONSORS

7 COMMITMENT FROM THE SPONSORS

The opportunities and challenges facing the IFSI require mutual collaboration by a wide range of stakeholders. As the originators and sponsors of the Ten-Year Framework, the IFSB and IRTI acknowledge a special responsibility to foster this collaboration.

We are actively supporting the implementation of the amended recommendations of the Mid-Term Review in multiple ways:

Outreach	Circulation by IFSB, IDB Group and distribution partners
	Downloading copies on to a dedicated website as well as IFSB, IRTI and IDB websites
	Discussions at IFSB, IRTI and partner events
	Webinars on selected themes
Follow-up	Monitoring Key Performance Indicators
	Ten-Year Review in 2018
Support	Information queries
	IFSB and IRTI resources
	Requests for technical assistance

Outreach

In the course of preparing this report, we have engaged key stakeholders of the IFSB, IRTI and the wider IDB Group, as well as a number of industry experts. In addition to making it directly available to IFSB and IDB stakeholders, we have identified a number of distribution partners to ensure the widest readership. We are also planning discussions of the report findings at IFSB, IRTI and partner events in order to encourage implementation in member countries. Selected themes will also be discussed on webinars hosted by the sponsors.

Follow-up

The Mid-Term Review, like the original Ten-Year Framework in 2007, is meant to be a living document. We have deliberately added Key Performance Indicators for the enumerated recommendations to enable relevant institutions and member countries to track their individual progress. We also intend to monitor the industry-wide progress on these recommendations, culminating in a final review in 2018 – that is, upon the completion of the period envisioned by the Ten-Year Framework.

Support

Readers who would like further information about the Ten-Year Framework or the Mid-Term Review are encouraged to contact us. The IFSB is pleased to share its global prudential standards and guiding principles, including the latest published reports as well as exposure drafts. More information can be found on the IFSB website at www.ifsb.org. IRTI also has a wide range of resources for reference, including research publications, industry data and training resources. More information can be found at the IRTI website at www.irti.org.

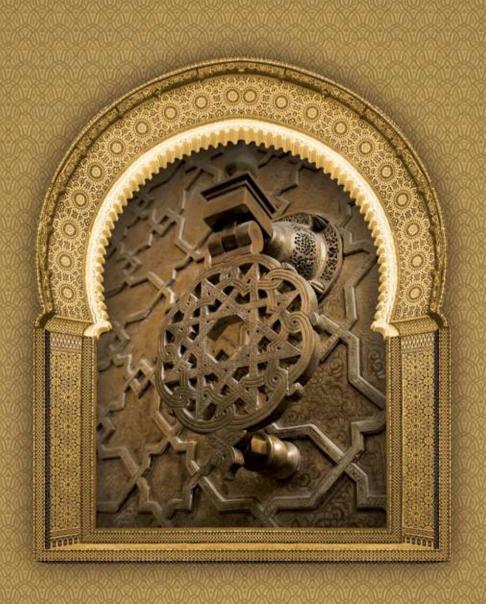
In addition to general support, IFSB and IRTI can, where feasible, offer expertise or technical assistance to interested institutions and member countries for the customised application of the Mid-Term Review recommendations and implementation plan at their institution or in their market. For details, please contact us at the email addresses below.

Islamic Financial Services Board

Web: www.ifsb.org Email: ifsb sec@ifsb.org

Islamic Research and Training Institute

Web: www.irti.org Email: irti@isdb.org



APPENDIX

APPENDIX 1: ADDITIONAL RESOURCES

Reports and indicators

The Mid-Term Review offers a comprehensive framework for the continued development of the Islamic financial services industry. Readers will nonetheless benefit from other publications that may offer complementary metrics, more details by sector or country, or annual reporting. We have therefore selected some of the most pertinent industry-level analytical reports and industry development indicators for further reading. Other kinds of resources – books, academic papers, directories and information services – have not been included here, but also play important roles.

Report or Indicator	Publisher	Industry Wide	Sector Level	Country Level	Metrics
Islamic Financial Services Industry Development: Ten-Year Framework and Strategies	IDB, IRTI and IFSB	•			
Islamic Finance and Global Financial Stability	IDB, IRTI and IFSB	•			
Islamic Financial Services Industry Stability Report	IFSB (2013, 2014)	•	•		
Islamic Finance Development Report, with Islamic Finance Development Indicator	ICD and Thomson Reuters			•	•
Financial Sector Assessment Programme for Islamic Financial Industry (iFSAP)	IRTI, World Bank and IMF	•		•	•
Global Islamic Finance Report, with Islamic Finance Country Index	Edbiz Consulting	•		•	•
World Islamic Banking Competitiveness Report	McKinsey & Co (2008–2010), EY (2011–2013)		•		
Global Islamic Asset Management Report	Thomson Reuters and Lipper		•		
Islamic Funds and Investments Report	E&Y		•		
Şukūk Perceptions and Forecast	Thomson Reuters Zawya		•		
Global Takāful Insights	E&Y		•		
Islamic Social Finance Report	IRTI		•		

From the Sponsors

The original Ten-Year Framework was published in 2007 by the Islamic Development Bank (IDB), Islamic Research and Training Institute (IRTI) and Islamic Financial Services Board (IFSB). It is the most comprehensive policy-oriented study of the Islamic financial services industry available, and the progenitor to this Mid-Term Review.

IDB, IRTI and IFSB also produced "Islamic Finance and Global Financial Stability" in 2009, which grew out of the Forum on the Global Financial Crisis and its Impact on the Islamic Financial Industry, convened by the IDB, and the ensuing Task Force on Islamic Finance and Global Financial Stability, an international group of international scholars, practitioners and experts in Islamic finance. The report covers the conceptual role of Islamic finance in enhancing financial stability, assesses the Islamic financial industry in the wake of the global financial crisis, and proposes recommendations to strengthen the financial architecture of the industry.

Development indicators

The Islamic Corporation for the Development of the Private Sector (ICD), in conjunction with Thomson Reuters, issued its inaugural Islamic Finance Development Report 2013, featuring an Islamic Finance Development Indicator to measure the country-level progress of the Islamic financial services industry. The Indicator is a composite weighted index assessing a total universe of 82 countries (including all OIC member countries as well as non-OIC countries with Islamic financial institutions) across five priority areas: quantitative development, knowledge, governance, corporate social responsibility and awareness. ¹⁰¹ The ICD is a member of the IDB Group, and thus a sister organisation of IRTI (an issuer of the Framework and of the Mid-Term Review).

The Global Islamic Finance Report, published by Edbiz Consulting, has produced annual reports on the development of the Islamic financial services industry since 2010. In 2011, it initiated the Islamic Finance Country Index (IFCI) to assess industry development by country. As of 2013, the Index ranks 43 countries in the Islamic financial services industry on eight variables with different weightings: Muslim population (7.2%), number of institutions involved in the Islamic finance industry (20.3%), number of full-fledged Islamic banks (21.8%), the size of Islamic financial assets (13.9%), total outstanding $Suk\bar{u}k$ (6.6%), regulatory and legal infrastructure (4.9%), a central $Shar\bar{t}$ ah supervisory regime (19.7%), and education and culture (5.7%). 102

The iFSAP (Financial Sector Programme for Islamic Financial Industry) initiative provides supplementary templates for the World Bank-IMF Financial Sector Assessment Program

¹⁰¹ Mapping Islamic Finance Development: Islamic Finance Development Report 2013, ICD and Thomson Reuters.

¹⁰² Global Islamic Finance Report 2013, Edbiz Consulting.

(FSAP) to assess the overall development and stability and compliance with the prudential regulations. This work emerged from the IDB-World Bank Working Group on Islamic Finance, beginning with a gap analysis of FSAP for the purposes of Islamic financial development in 2009. iFSAP's 2012 study compiles relevant conventional and Islamic regulatory standards and presents a set of templates to enable FSAP to assess the Islamic financial services industry.

These development indicators are complementary tools to the Ten-Year Framework, and help to quantify certain areas of development highlighted in the Framework.

Sector-level reports

Arguably the most widely distributed report on the Islamic banking sector is the World Islamic Banking Competitiveness Report, introduced yearly at the Bahrain-based World Islamic Banking Conference organised by MEGA. The report was published by McKinsey & Company for the years 2008–2010, and has since been produced annually by Ernst & Young.

Islamic funds have been another focus of industry reports. EY's Islamic Funds and Investments Report complements its Islamic banking report, and was most recently published in 2011. The Global Islamic Asset Management Report is another key resource, the inaugural issue of which was published by Thomson Reuters in partnership with Lipper for 2014.

Thomson Reuters also publishes an annual report on the $Suk\bar{u}k$ sector, the most recent issue of which was " $Suk\bar{u}k$ Perceptions and Forecast Study 2014".

EY also publishes a report on the *Takāful* sector entitled Global *Takāful* Insights, the inaugural issue of which was published in 2013.

Meanwhile, IRTI has undertaken an annual Islamic Social Finance Report focusing on the $Zak\bar{a}h$, Awq $\bar{a}f$, and Islamic not-for-profit microfinance sectors. This analysis provides a needed complement to the various reports on the Islamic financial industry's commercial sectors. The inaugural 2013 report covers South and South-East Asia, with future reports expected to cover other regions.

Technical Assistance

The sponsors of this report, IRTI and IFSB, are available for technical assistance in relevant areas to assist the implementation of the Ten-Year Framework's recommendations (see "Commitment from the Sponsors" on pages 129–131 for details). Other key resources for technical assistance include the World Bank and the Asian Development Bank.

The World Bank provides technical assistance to member countries in developing both their overall financial systems and their Islamic finance industry. OIC member countries are encouraged to refer to the relevant country assistance programme as well as the work of the World Bank's global centre of excellence for Islamic finance (established in Istanbul in 2013) for further information. As noted in the previous section, IRTI is also working with the World Bank to develop the Financial Sector Assessment Programme for Islamic Financial System (iFSAP).

The IDB and Asian Development Bank (ADB) have 13 member countries in common, and ADB's Developing Member Countries represent about 80% of the global Muslim population. In addition to Islamic co-financing agreements with the IDB, the ADB is committed to providing on-the-ground support to local Islamic financial regulators and institutions through its country assistance programmes.

APPENDIX 2: GLOSSARY OF ARABIC TERMS

Awqāf (singular waqf)	Religious endowment – that is, a voluntary and irrevocable dedication of oness wealth or a portion of it, in cash or kind (such as a house or a garden), and its disbursement for <i>Sharī`ah</i> -compliant purposes.
Fatāwa (singular fatwa)	A juristic opinion or pronouncement of facts given collectively by the <i>Sharī`ah</i> board, or individually by a mufti, or a faqīh on any matter pertinent to <i>Sharī`ah</i> issues, based on the appropriate methodology.
Fiqh	Knowledge of the legal rulings pertaining to conduct, which has been acquired from specific evidence in the <i>Sharī`ah</i> .
Gharar	Deceptive uncertainty, where details concerning the sale contract are unknown or uncertain.
Ijārah	An <i>Ijārah</i> 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 instalments of lease rental.
Istisnā`	An <i>Istisnā</i> 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.
Maysir	Gambling.
Mubādalat al-Arbāḥ	Islamic Profit Rate Swap.
Muḍārabah	Mudārabah 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 Mudārib (or labour provider). Profits generated by that enterprise or activity are shared in accordance with the terms of the Mudārabah agreement, while financial losses are to borne solely by the capital provider unless the losses are due to the Mudārib's misconduct, negligence or breach of contracted terms.
Murābaḥah	A <i>Murābaḥah</i> 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).
Mushārakah	A Mushārakah 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 moveable 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 Mushārakah agreement, while losses are shared in proportion to each partner's share of capital.

Qard/Qard al-Hasan	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 agreed period.		
ReTakāful	Islamic re-insurance.		
Sharī`ah	Sum total of the Islamic system as revealed to Prophet Muhammad s.a.w. and as recorded in the Qur'an as well as deducible from the Prophet's divinely guided lifestyle called the Sunnah.		
Şukūk (sing. Şakk)	$Suk\bar{u}k$ (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.		
Tabarru'	Grant of property by a person with complete legal capacity without a compensation. In the context of <i>Takāful</i> operations, <i>Tabarru'</i> is the amo of contribution to be relinquished by the <i>Takāful</i> participant as a donat for fulfilling the obligation of mutual help and to be used to pay clais submitted by eligible claimants.		
Taḥawwut	Islamic hedging		
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.		
Tawarruq	Purchasing an asset, then selling it to a third party to obtain cash.		
Wa'd	A promise to perform certain action(s) in the future.		
Wadī'ah	An amount deposited whereby the principal is guaranteed.		
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.		
Zakāh	Annual alms-giving by Muslims based on accumulated wealth. It is obligatory for all who are able to do so.		

APPENDIX 3: LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ADRs	American Depository Receipts
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
AUM	Asset under management
BCBS	Basel Committee on Banking Supervision
BI	Bank Indonesia
BMT	Baitul Maal wa Tamwil
BPRS	Bank Perkreditan Rakyat Syariah
BRI	Bank Rakyat Indonesia
CAGR	Compound annual growth rate
CGAP	Consultative Group to Assist the Poor
CIBAFI	General Council for Islamic Banks and Financial Institutions
DRs	Depository Receipts
ETFs	Exchange Traded Funds
ETSB	Exchange Traded Şukūk and Bonds
EU	European Union
FCA	Financial Conduct Authority
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FX	Foreign exchange
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GDR	Global Depository Receipts
GTG	Global Takāful Group
IASB	International Accounting Standards Board
ICD	Islamic Corporation for the Development of the Private Sector
ICM	Islamic capital markets

IDB	Islamic Development Bank
IFCI	Islamic Finance Country Index
IFIs	Islamic financial institutions
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
iFSAP	Financial Sector Assessment Program for Islamic Financial System
IIBR	Islamic Interbank Benchmark Rate
IICRA	International Islamic Centre for Reconciliation and Arbitration
IIFM	International Islamic Financial Market
IIFS	Institutions offering Islamic financial services
IILM	International Islamic Liquidity Management Corporation
IIMM	Islamic Interbank Money Market
IIRA	Islamic International Rating Agency
IMF	International Monetary Fund
INCEIF	International Centre for Education in Islamic Finance
IOSCO	International Organization of Securities Commission
IPRS	Islamic Profit Rate Swaps
IRTI	Islamic Research and Training Institute
ISDA	International Swaps and Derivatives Association
ISRA	International Sharī`ah Research Academy for Islamic Finance
IT	Information technology
JFX	Jakarta Futures Exchange
KPIs	Key Performance Indicators
KYC	Know your client
LCR	Liquidity Cover Ratio
LIBOR	London Interbank Offered Rate
LLC	Limited liability company
LOLR	Lender of last resort
MENA	Middle East and North Africa

NBFIs	Non-bank financial institutions
NGOs	Non-governmental organisations
NSFR	Net Stable Funding Ratio
OIC	Organisation of Islamic Cooperation
ОЈК	Otoritas Jasa Keuangan (Financial Services Authority)
OPEC	Organization of the Petroleum Exporting Countries
OTC	Over-the-counter
PRA	Prudential Regulatory Authority
REITs	Real estate investment trusts
RM	Ringgit Malaysia (Malaysian currency)
ROA	Return on assets
ROE	Return on equity
R&D	Research and development
SBIS	Sharia Bank Indonesia Certificate
SECP	Securities and Exchange Commission of Pakistan
SME	Small and medium enterprise
SWBI	Bank Indonesia Wadiah Certificate
SWFs	Sovereign Wealth Funds
TID	The Investment Dar
UAE	United Arab Emirates
UK	United Kingdom
US	United States
USD	US dollar



Islamic Development Bank (IDB)

Establishment

The Islamic Development Bank is an international financial institution established in pursuance of the Declaration of Intent issued by the Conference of Finance Ministers of Muslim Countries held in Jeddah in Dhul Qa'dah 1393H (December, 1973). The inaugural Meeting of the Board of Governors took place in Rajab 1395H (July 1975) and the Bank was formally opened on 15 Shawwal 1395H (20 October, 1975).

Vision

By the year 1440H Hijrah, IDB shall have become a world-class development bank, inspired by Islamic principles that have helped significantly transform the landscape of comprehensive human development in the Muslim world and help restore its dignity.

Mission

The mission of IDB is to promote comprehensive human development, with a focus on the priority areas of alleviating poverty, improving health, promoting education, improving governance and prospering the people.

Membership

The present membership of the Bank consists of 56 countries. The basic condition for membership is that the prospective member country should be a member of the Organization of Islamic Cooperation (OIC), pay its contribution to the capital of the Bank and be willing to accept such terms and conditions as may be decided upon by the IDB Board of Governors.

Capital

As of the month of Rajab 1431H, the Authorized Capital of the Bank was ID 30 Billion, and the Issued Capital was ID 18 Billion, of which ID 17.474 Billion was subscribed with ID 4.031 Billion Paid-Up.

Group

At present the IDB Group is made up of Islamic Research and Training Institute (IRTI), International Islamic Trade Finance Corporation (ITFC), The Islamic Corporation for Insurance of Investments and Export Credit (ICIEC) and The Islamic Corporation for the Development of the Private Sector (ICD).

Headquarters and Regional Offices

The Bank's headquarters is in Jeddah in the Kingdom of Saudi Arabia. Four regional offices were opened in Rabat, Morocco (1994), Kuala Lumpur, Malaysia (1994), Almaty, Kazakhstan (1997) and Dakar, Senegal (2008).

Financial Year

The Bank's financial year is the lunar Hijra year.

Accounting Unit

The accounting unit of the IDB is the Islamic Dinar (ID), which is equivalent to one SDR - Special Drawing Right of the International Monetary Fund.

Languages

The official language of the Bank is Arabic, but English and French are also used as working languages.

Islamic Financial
Services Industry
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A MID-TERM REVIEW

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