



**ISLAMIC FINANCIAL
SERVICES BOARD**

**ISLAMIC FINANCIAL
SERVICES INDUSTRY
STABILITY REPORT
2013**



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TABLE OF CONTENTS

Glossary	i
List of Abbreviations	iv
Foreword	1
Executive Summary	3
1.0 Development of the Islamic Financial Services Industry	7
1.1 Overview of the Islamic Financial Services Industry	7
1.2 Trends in the Development of Islamic Banks	10
1.3 Trends in the Development of the Islamic Capital Market	17
1.3.1 Islamic Indices	17
1.3.2 Islamic Funds	21
1.3.3 <i>Sukūk</i>	24
1.4 Trends in the Development of <i>Takāful</i>	32
1.5 Assessment of the Resilience of the Islamic Financial System:	
Technical Analysis of Selected Indicators of Islamic Banks	37
1.5.1 Profitability Performance of Islamic Banks	38
1.5.2 Financing-to-Deposit Ratios in Islamic Banks	39
1.5.3 Non-performing Financing in Islamic Banks	41
1.5.4 Capitalisation of Islamic Banks	42
1.5.5 Rating Comparison as an Indicator of Stability and Resilience	44
2.0 Islamic Finance and the Changing Global Financial Architecture	45
2.1 Global Initiatives to Promote Financial Stability	45
2.1.1 Financial Stability Board	46
2.1.2 Financial Stability Board, International Monetary Fund and the World Bank	48
2.1.3 Financial Stability Board and Basel Committee on Banking Supervision: Systematically Important Financial Institutions	50
2.1.4 Basel Committee on Banking Supervision	53
2.1.5 International Organisation of Securities Commissions	60
2.1.6 International Association of Insurance Supervisors	62
2.1.7 European Central Bank	63
2.2 Evolving Financial Architecture of Islamic Finance	65
2.2.1 Islamic Financial Services Board	66
2.2.2 Accounting and Auditing Organisation for Islamic Financial Institutions	74

2.2.3	International Islamic Financial Market	74
2.3	Assessment of the Implementation of the Islamic Financial Services Board Standards	75
3.0	Issues in Regulation and Supervision of Islamic Finance: Liquidity Management – Regulations, Interbank Markets and Lender of Last Resort	79
3.1	Liquidity Management	79
3.1.1	Liquidity Infrastructure	80
3.1.2	Developments on Prudential Framework and Industry Initiatives for Institutions offering Islamic Financial Services	84
3.1.3	The Way Forward	103
3.2	Strengthening the Financial Safety Net: <i>Shari'ah</i> -Compliant Lender of Last Resort (SLOLR)	104
3.2.1	Development of SLOLR	104
3.2.2	Tools for Monetary Operations of the Central Bank	106
3.2.3	Current Status of the Development of the SLOLR Facility	108
3.2.4	Supervisory Assessment of the Development of SLOLR Facilities	112
3.2.5	Key Challenges and Issues in the Development of the SLOLR Facility	112
3.2.6	The Way Forward	114
4.0	Emerging Issues in Islamic Finance: From Microfinance to Financial Inclusion and Beyond	115
4.1	Consumer Protection in Islamic Banking	116
4.1.1	Consumer Education	116
4.1.2	Consumer Protection by Product Regulation	118
4.1.3	Deposit Insurance	122
4.2	Financial Inclusion	131
4.2.1	Microfinance and Banking Regulation and Supervision	131
4.2.2	Financial Inclusion as a Core Concept	135
4.2.3	Conventional and Islamic Microfinance	141
4.2.4	Regulatory Issues	146
4.2.5	Branchless Banking	148
4.3	Responsible Investment	150
4.3.1	Responsible Investment and Financial Inclusion	151
4.3.2	Responsible Investment Approaches and Islamic Finance	152
5.0	Concluding Remarks	157

Appendices	160
Appendix 1: Sample Methodology	160
Appendix 2: IFSB Standards and Guidelines	162
Appendix 3: <i>Mubādalāh al-Arba`ah</i> Profit Rate Swap (PRS) Product Standard	163
References	166

GLOSSARY

Bay`	Sale or contract of sale.
<i>Bay` al-`Inah</i>	A contract involving the sale and buy-back transaction of assets by a seller. A seller sells an asset to a buyer on a cash basis and later buys it back on a deferred payment basis where the price is higher than the cash price. It can also be applied when a seller sells an asset to a buyer on a deferred basis and later buys it back on a cash basis, at a price which is lower than the deferred price.
Commodity <i>Murābahah</i>	A <i>Murābahah</i> -based purchase and sale transaction of <i>Sharī`ah</i> -compliant commodities, whereby the buyer purchases the commodities on a deferred payment basis and subsequently sells them to a third party on a cash payment basis.
<i>Darūrah</i>	<i>Darūrah</i> is an exigency in the event that if the necessary act is not done, then it shall lead to the destruction of five fundamental needs, namely religion, life, intelligence, progeny and property. The principle of <i>Darūrah</i> is only applicable in exceptional circumstances where the avoidance of the specific necessary act shall ruin the said fundamentals.
<i>Fatawa</i> (singular <i>Fatwa</i>)	A juristic opinion or pronouncement of facts given by the <i>Sharī`ah</i> board, a <i>Mufti</i> , or a <i>Faqīh</i> on any matter pertinent to <i>Sharī`ah</i> issues, based on the appropriate methodology.
<i>Gharar</i>	Deceptive uncertainty where details concerning the sale contract are unknown or uncertain.
<i>I`adat Al Shirā`</i>	Repurchase
<i>Ijārah</i>	An <i>Ijārah</i> contract is 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. An <i>Ijārah</i> contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the <i>Ijārah</i> contract.
<i>Istisnā`</i>	An <i>Istisnā`</i> contract is 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 pre-determined selling price.
<i>Kafālah</i>	Guarantee
<i>Kafālah bi al-Ujr</i>	Charging fee for guarantee
<i>Maslahah</i>	Public interest
Maysir	Gambling
<i>Mu`addal Ribh Mutaghayyar</i>	Floating rate
<i>Mu`addal Ribh Thābit</i>	Fixed rate
<i>Mubādalāh</i>	Swap
<i>Mubādalāh al-Arba`ah</i>	Profit rate swaps

<i>Muḍārabah</i>	A <i>Muḍārabah</i> contract is an agreement between the capital provider and a skilled entrepreneur whereby the capital provider will contribute capital to an enterprise or activity, which is to be managed by the entrepreneur as the <i>Muḍārib</i> . Profits generated by that enterprise or activity are shared in accordance with the terms of the <i>Muḍārabah</i> agreement, whilst losses are to borne solely by the capital provider unless the losses are due to the <i>Muḍārib</i> 's misconduct, negligence or breach of contracted terms.
<i>Muḍārib</i>	Labour provider
<i>Murābahah</i>	A <i>Murābahah</i> contract is an agreement 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).
<i>Mushārah</i>	A <i>Mushārah</i> contract is an agreement 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 the <i>Mushārah</i> agreement, whilst losses are shared in proportion to each partner's share of capital.
Muslim	A believer in or adherent of Islam.
<i>Qarḍ</i> / <i>Qarḍ al-Hasan</i>	A non-interest bearing loan intended to allow the borrower to use the loaned funds for a period with the understanding that the same amount of the loaned funds would be repaid at the end of the period.
<i>Rahn</i>	A contract to pledge a specified asset as security against a debt whereby the creditor (<i>Murtahin</i>) is entitled to hold custody of the asset. In the event of default by the debtor (<i>Rāhin</i>), the creditor may sell the asset.
<i>ReTakāful</i>	Islamic re-insurance
<i>Riba</i>	Usury
<i>Sadaqah</i> (plural <i>Sadaqāt</i>)	Donation
<i>Salam</i>	A <i>Salam</i> contract is an agreement to purchase, at a pre-determined price, a specified kind of commodity not available with the seller, which is to be delivered on a specified future date in a specified quantity and quality. The institution offering Islamic financial services, as the buyer, makes full payment of the purchase price upon execution of a <i>Salam</i> contract. The commodity may or may not be traded over the counter or on an exchange.
<i>Sharī'ah</i>	Divine Islamic law that encompasses all aspects of human life as revealed in the <i>Qur'an</i> and the <i>Sunnah</i> .

<i>Sukūk</i> (singular <i>Sakk</i>)	<i>Sukūk</i> (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.
<i>Tabarru'</i>	Grant of property by a person with complete legal capacity without any compensation. In the context of <i>Takāful</i> operations, <i>Tabarru'</i> is the amount of contribution to be relinquished by the <i>Takāful</i> participant as a donation for fulfilling the obligation of mutual help and to be used to pay claims submitted by eligible claimants.
<i>Tahawwut</i>	Hedging
<i>Takāful</i>	<i>Takāful</i> 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 <i>Takāful</i> arrangement, the participants contribute a sum of money as <i>Tabarru'</i> (donation) into a common fund, which will be used for the mutual assistance of the members against specified loss or damage.
<i>Tawarruq</i>	Purchasing an asset with deferred price, either on the basis of <i>Musawamah</i> (sale contract without the disclosure of the asset cost price and profit margin to the buyer) or <i>Murābahah</i> , then selling it to a third party to obtain cash.
<i>Wa`d</i>	A promise to perform certain action(s) in the future.
<i>Wakālah</i>	An agency contract where the customer (principal) appoints the institution offering Islamic financial services as an agent (<i>Wakīl</i>) to carry out business on their behalf.
<i>Waqf</i> (plural <i>Awqāf</i>)	A property that produces income and that may have been deeded to benefit a community.
<i>Zakat</i>	Alms giving

LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
ADB	Asian Development Bank
ADR	Advance-deposit ratio
ALA	Alternative liquidity approaches
ALFI	Association of the Luxembourg Fund Industry
ASRR	Advances to Stable Resources Ratio
ATM	Automated teller machine
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
BDL	Banque du Liban
BIBF	Bahrain Institute of Banking and Finance
BMI	Broad Market Index
BNM	Bank Negara Malaysia
BU	Bottom-up
CAGR	Compound annual growth rate
CAR	Capital adequacy ratio
CBB	Central Bank of Bahrain
CBRT	Central Bank of the Republic of Turkey
CBUAE	Central Bank of the United Arab Emirates
CDs	Certificates of deposit
CEBS	Committee of European Banking Supervisors
CFEB	Consumer Financial Education Body
CGAP	Consultative Group to Assist the Poor
CIB	Credit Information Bureau
CMF	Collateralised <i>Murābahah</i> Facility
CMT	Commodity <i>Murābahah</i> transactions
CPs	Core principles
CSR	Corporate social responsibility
D-SIBs	Domestic systemically important banks
DJIM	Dow Jones Islamic Market Indices
DOF	Department of Finance
EBA	European Banking Authority
ECAIS	External credit assessment institutions
ECB	European Central Bank
ED	Exposure Draft
EIBOR	Emirates Interbank Offer Rate
ELA	Emergency Liquidity Assistance



EMDEs	Emerging market and developing economies
Eurosif	European Sustainable Investment Forum
ESG	Environmental, social and corporate governance
ESRB	European Systemic Risk Board
ETFs	Exchange traded funds
EU	European Union
FCY	Foreign currency
FDR	Financing-to-deposit ratio
FIS	Facilitating of Standards
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Programme
FSB	Financial Stability Board
FSL	Financial stability law
FX	Foreign exchange
GATE	Global Commodity Finance Ltd.
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GLP	Gross loan portfolio
GPRS	General Packet Radio Service
G-SIBs	Global systematically important banks
G-SIIs	Global systemically important insurers
G-SIFIs	Global systematically important financial institutions
HQLA	High-quality liquid assets
IADI	International Association of Deposit Insurers
IAHs	Investment account holders
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IBB	Islamic Bank of Britain
IBIs	Islamic banks and Islamic banking windows
ICs	Investment Companies
ICAAP	Internal capital adequacy assessment process
ICMM	Islamic Capital and Money Market
ICP	Insurance Core Principles, Standards, Guidance and Assessment Methodology
IDB	Islamic Development Bank
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IIBOR	Islamic Interbank Offered Rate

IIFM	International Islamic Financial Market
IIFS	Institutions offering Islamic financial services
IILM	International Islamic Liquidity Management Corporation
IIMM	Islamic Interbank Money Market
ILO	International Labour Organization
IMF	International Monetary Fund
INCEIF	International Centre for Education in Islamic Finance
IOSCO	International Organization of Securities Commissions
IRR	Investment risk reserve
IRTI	Islamic Research and Training Institute
ISDA	International Swaps and Derivatives Association, Inc.
ISLI	Islamic <i>Sukūk</i> Liquidity Instrument
LCR	Liquidity Coverage Ratio
LCY	Local currency
LIBOR	London Interbank Offer Rate
LOLR	Lender of last resort
MDIC	Malaysia Deposit Insurance Corporation
MENA	Middle East and North Africa
MFBs	Microfinance Banks
MFIs	Microfinance Institutions
NGOs	Non-governmental organisations
NPF	Non-performing financing
NPLs	Non-performing loans
NSFR	Net Stable Funding Ratio
ODTIs	Other deposit taking institutions
OECD	Organisation for Economic Co-operation and Development
OIC	Organization of Islamic Conferences
OMOs	Open market operations
OTC	Over-the-counter
PIF	Participants' Investment Fund
PMN	Pakistan Microfinance Network
POS	Point-of-sale
PRF	Participants' Risk Fund
PRI	Principles for Responsible Investment
PSE	Public sector entities
PSIA	Profit-sharing investment accounts
QIS	Quantitative Impact Study
RI	Responsible investment

ROA	Return on assets
ROE	Return on equity
RSAs	Regulatory and supervisory authorities
RSPs	Rural Support Programmes
SAG	Standards and Guiding Principles
SAMA	Saudi Arabian Monetary Agency
SBBA	Sale and Buy-Back Agreement
SBIS	<i>Sharī'ah</i> -based Bank Indonesia Certificate
SBP	State Bank of Pakistan
SEA	South-East Asia
SHF	Shareholders' Fund
SIFIs	Systemically important financial institutions
SKRAs	Strategic Key Result Areas
SLOLR	<i>Sharī'ah</i> -compliant lender of last resort
SLR	Statutory Liquidity Requirement
SMEs	Small- and medium-sized enterprises
S&P	Standard & Poor's
SPP	Strategic Performance Plan
SRI	Socially responsible investment
SSS	Scripless Securities Settlement
TD	Top-down
UAE	United Arab Emirates
UK	United Kingdom
UN	United Nations
UNEP FI	United Nations Environment Programme Finance Initiative
UNHRC	United Nations Human Rights Council
UNICEF	United Nations Children's Fund
UPSIA	Unrestricted profit-sharing investment accounts
US	United States

FOREWORD

The *Islamic Financial Services Industry (IFSI) Stability Report* ("the Report") is another initiative by the Islamic Financial Services Board (IFSB) to engage with its stakeholders and the global IFSI on topics that fall within the operational mandate of the IFSB. This is undertaken through discussion and analysis of a select set of topics that provide an overview of recent developments affecting IFSI. In the choice of topics, the central component comprises issues related to the regulation and supervision of institutions providing Islamic financial services (IIFS). On these topics the IFSB will share with its stakeholders its assessment of the results of its internal research and surveys with the aim of achieving a broader and common understanding of critical issues. At the same time, the Report also seeks to identify emerging issues in Islamic finance that have implications for regulation and supervision, as well as for the substantive progress of Islamic finance.

The structure of this first edition of the Report is closely aligned to the objectives stated above. Chapter 1 provides an update on the performance of the industry in 2012. This is followed by two core chapters that address issues on supervision and regulation. Chapter 2 examines the implications of the changing global financial infrastructure for IIFS. Chapter 3 provides greater detail on two topics that are under close examination by the IFSB: liquidity management and the development of lender of last resort facilities on a *Shari'ah*-compliant basis. Each of these two topics has important implications for the resilience and stability of financial institutions and is furthermore critical to systemic stability objectives. In particular, the global discussions on liquidity management reforms involving the introduction of a Liquidity Coverage Ratio and a Net Stable Funding Ratio have generated strong interest and perhaps even apprehension amongst IIFS. The critical issues are in relation to access to liquid markets and to liquid instruments. On these issues, with the goal of achieving a level playing field, the IFSB has initiated a dialogue with the Basel Committee on Banking Supervision (BCBS) to obtain recognition of the specificities of Islamic finance as well as for the state of development of financial markets in the majority of jurisdictions in which Islamic finance participates. Chapter 3, therefore, is hoped to be of special interest to readers, in conjunction with the previous chapters. Finally, Chapter 4 takes up emerging issues of which consumer protection and financial inclusion are the most prominent.

It will be apparent from the above that the Report has objectives that are distinct from those to be found in the International Monetary Fund's (IMF) *Global Financial Stability Report*. Yet it shares with the IMF report and with the Financial Stability Reports issued by many central banks a common objective: that of providing an overview of the sources of risk and vulnerability. This exercise is conducted from the perspective of the stability of Islamic finance, and is the thread that links Chapters 1, 2 and 3. An additional area of risk is identified in Chapter 4 – that to potentially vulnerable consumers many of whom were previously unbanked. The Report builds upon the earlier *Islamic Finance and Global Financial Stability Report* that was jointly published by the IFSB, the Islamic Development Bank (IDB), and the Islamic Research and Training Institute (IRTI) in 2010. The 2010 study was a landmark publication prepared by a High Level Task Force commissioned by the IFSB Council which provided a global overview of key building blocks towards achieving greater stability and resilience in IFSI. The present study has the narrower objective of providing a continuing basis for better understanding of selected issues falling under the IFSB mandate.

The value of the Report to readers can only be measured by the debate and response it generates. We hope, in particular, that the broad membership of the IFSB will find the Report a useful complement to their better understanding of issues. We hope also that the platform provided by the Report will lead to responses that will also strengthen the IFSB's understanding of the challenges that our members and the global IFSI face.

The Report was produced by a core team from the Technical and Research Division of the IFSB Secretariat, led by Mr Abdullah Haron, Assistant Secretary-General at the time, and comprising Ms Noor Ashikin Ismail, who was the Project Leader, supported by Mr Zahid ur Rehman Khokher and Mr Jamshaid Anwar Chattha. Mrs Kartina Ariffin reviewed the sections on *Takāful*. The IFSB team was further supported by Professor Volker Nienhaus, who acted as lead consultant and took responsibility for writing the first draft of Chapter 4. Mrs Baljeet Kaur Grewal, Managing Director of KFHR Research (KFHR), and her team at KFHR were responsible for writing Chapter 1. Mrs Siham Ismail, Head of the Communications and Awareness Programmes at the IFSB, provided assistance in the formatting and publication of the final document. Mr Peter Casey read the draft report in its entirety and provided useful comments throughout.

Finally, the source and reliability of data features as a recurrent debate in Islamic finance. Here it is important to recognise the limitations of the data used in the Report. The two principal sources of new data on the IFSI used are KFHR (Chapter 1) and the IFSB (Chapters 2 and 3). In each case, the data are drawn from surveys and hence are subject to the well-known limitations, as well as strengths, that apply to such exercises. In particular, a notable feature of this report is in its drawing upon three major surveys by the IFSB. These surveys span the issues of implementation of IFSB standards, the capital structure of banks, and lender of last resort facilities. Suffice it to say, however, that the Report does not establish a uniform, global database which will lead to a definitive statement of the "true value" of assets under global management.

Jaseem Ahmed
Secretary-General
Islamic Financial Services Board

May 2013

EXECUTIVE SUMMARY

Trends in the Islamic Financial Services Industry

The global IFSI has grown in size and geographic coverage, now encompassing new jurisdictions and more institutions. While Islamic banking remains the pillar of most Islamic assets, developments are seen across all asset classes and beyond traditional products and services.

The Islamic banking industry charted a compound annual growth rate (CAGR) of 38.5% between 2004 and 2011. Strong growth was witnessed pre-2008 before showing marked slowdowns in profitability and financing activity, particularly in the Gulf Cooperation Council (GCC) region. Despite slower growth post-global financial crisis, the fundamentals of Islamic banks remain sound. Improving asset quality and a pickup in economic growth are expected to benefit the Islamic banking sector over the coming years.

Meanwhile, the Islamic capital market, namely *Sukūk*, Islamic funds and indices, continued to outpace most other asset classes in the global financial system. *Sukūk* issuances, for example, have charted a CAGR of 44.0% between 2004 and 2011. Despite a short slump in 2008, growth in issuances has been exponential as investors searched for safety post-crisis. Similar to the trend in the conventional bond market, the *Sukūk* market has seen relatively stronger demand in light of the limited supply, which pushed *Sukūk* yields lower, similar to conventional benchmarks. Additionally, a moderately different composition of equities in global benchmark indices has allowed Islamic indices to outperform the conventional equivalents post-crisis.

Takāful remains a nascent industry, with some significant market share in Malaysia and Saudi Arabia and sporadic significance elsewhere. Many *Takāful* Operators are still subject to conventional insurance regulations. Challenges aside, the *Takāful* industry is set to continue its growth trajectory given growing awareness, the development of investment-linked products and the current low penetration rates in Muslim majority countries.

The resilience of Islamic finance was evaluated through the comparison of Islamic banks' performance from various jurisdictions in the GCC and Asia against a sample of global conventional banks. The comparison showed that Islamic banks were resilient through sturdy capitalisation ratios which were clearly higher compared to the conventional banks. However, despite superior capital levels, capitalisation ratios have declined in 2011 from 2007, while the conventional banks have actually augmented their capitalisation levels. On another front, profitability was also intact to an extent and relatively higher compared to some conventional banks. However, concerns about asset quality remained at elevated levels due to exposure to the property market and single-borrower concentration in financing and, to some extent, from inadequacy of the risk management framework. In general, Islamic finance is well placed to meet the increased "return-to-basics" investor demand where investors are now more averse to the unknown risks embedded in complex financial instruments.

Selected Issues in and Building Blocks for Regulation and Supervision of Islamic Finance

The tighter Basel III capital requirements will be of particular relevance for the (mostly well-capitalised) Islamic banks with respect to *Shari'ah*-compliant, high-quality regulatory capital components and risk exposures related to *Shari'ah*-compliant products. These issues are dealt with in a revised IFSB capital adequacy standard under preparation.

In spite of some improvements, the lack of *Shari'ah*-compliant liquid instruments meeting stringent Basel III requirements continues. The document *Guiding Principles on Liquidity Risk Management* (IFSB-12) of 2012 sets the agenda in this field and provides principles not only for institutions offering Islamic financial services, but also for regulatory and supervisory authorities (RSAs), and suggests metrics and monitoring tools for liquidity risk management. The IFSB has conducted a survey on the adoption of Basel III liquidity standards which confirmed the urgency of further work on *Shari'ah*-compliant high-quality liquid assets. The IFSB will develop a Guidance Note on the adaptation of Basel III liquidity standards for IIFS, taking particular note of the liquidity coverage ratio in its refined 2013 version.

Liquidity risk management is seen as one of the most important challenges for Islamic banking by the regulators in most jurisdictions. This report provides a survey of steps taken by RSAs to support liquidity at IIFS and the banking sector in general. In recent years, some jurisdictions have created a more conducive environment for the issuance and trading of *Sukūk* and promoted the emergence of well-managed and vibrant securities exchanges and secondary *Sukūk* markets. The work on more money market instruments such as a *Shari'ah*-compliant alternative to repos or regular issues of liquidity *Sukūk* is continuing.

The IFSB has developed guiding principles for stress testing – for both individual Islamic banks and supervisory authorities – which take into account specificities of Islamic banks such as market risks in *Shari'ah*-compliant instruments and risk mitigation techniques, the status of investment account holders, and the particular challenges of liquidity risk management. In its present state of development, Islamic finance has specific vulnerabilities which must be reflected in stress testing exercises.

The IFSB continues to work on building blocks for resilience and stability of the IFSI. It is preparing the ground for a comprehensive set of cross-sectoral prudential standards for banking, capital markets and insurance. The strengthening of financial safety nets comprises the establishment of a lender of last resort (LOLR) for Islamic banks and deposit insurance, both in *Shari'ah*-compliant structures. The IFSB has advocated for both and surveyed the practice of its member countries. Only a few countries have *Shari'ah*-compliant LOLR and deposit insurance facilities. The IFSB surveys show that the technical solutions and operational details vary widely in both areas, and a discussion of concepts and an evaluation of experiences will be organised by the IFSB. An effective crisis management and resolution framework including an effective insolvency regime is essential for the further promotion of resilience and stability. Macro-prudential surveillance requires access to relevant data. To supplement conventional data by indicators reflecting specificities of the Islamic finance industry, the IFSB issued a *Revised Compilation Guide on Prudential and Structural Islamic Financial Indicators* in March 2011.

Emerging Issues in Financial Stability: From Microfinance to Financial Inclusion and Responsible Investment

While Islamic finance has shown its resilience and an outstanding quantitative performance, many people ask for more qualitative achievements. Most Islamic countries are less developed or emerging markets, and Islamic finance has great potential with respect to the alleviation of poverty and the promotion of sustainable development. Accordingly, microfinance, financial inclusion and responsible investing were chosen as this year's topic for the special section on emerging issues, with a special emphasis on regulatory requirements.

The aim of financial inclusion is the provision of financial services to people who are presently excluded from the formal financial system. Exclusion can be involuntary because low and unstable income makes people "unbankable", or because banks are not within their reach. Voluntary self-exclusion can be due to religious reasons such as the rejection of *Riba*. Financial exclusion implies high individual transaction costs and limited capacities for income generation and income stabilisation.

Microfinance provides basic financial services to poor people. The aim is to enhance the income-generating capacity of poor households. Islamic microfinance institutions can apply the same *Sharī'ah*-compliant contracts as Islamic banks – for example, *Murābahah* – to provide clients with real assets instead of cash. The assets can serve as collateral, and the direct provision reduces monitoring costs compared to cash loans. Islamic microfinance institutions can mobilise religiously motivated charitable donations (such as *Sadaqāt*) and can be supported by *Zakat* and *Qarḍ al-Hasan*. Cash *Waqf* with a long Islamic tradition could provide suitable legal structures.

Many people are excluded from financial services because no bank branches are within their reach. The income from small transactions is not sufficient to cover the costs of a traditional bank branch. Various forms of branchless banking (particularly via mobile phones and banking agents) have reduced the costs per transaction so substantially that access to basic financial services can become ubiquitous everywhere. Specific Islamic regulatory issues could be the complexity of *Sharī'ah*-compliant contracts and the *Sharī'ah* compliance of the value added chain and distribution channel.

Successful Islamic microfinance will integrate new groups of vulnerable people into the financial system. It would be in the interest of consumer protection and systemic stability to ensure consumer education and appropriate regulations for microfinance. The Basel Committee on Banking Supervision (BCBS) has recommended the application of adapted versions of its core principles for effective banking supervision also to deposit-taking microfinance institutions. Legislators and regulators could support the industry by the creation of a conducive legal and regulatory environment.

Although of different origin, Islamic finance, microfinance, and socially responsible investment (SRI) share some common ground. The aim of SRI is a financial return with due regard to a set of non-financial restrictions (e.g. no investment in adult entertainment or weapons of mass destruction) and objectives (e.g. social or ecological impact). Given its ethical aims, Islamic finance could tap into the rapidly growing SRI segment. However, a comparison of Islamic finance and SRI practices shows that concepts and techniques of conventional SRI are distinct from the *Sharī'ah* screening methods of Islamic finance. In particular, many SRI funds select their investments according to non-financial

“responsibility” or “impact” criteria which are not considered for Islamic portfolio selections. The recent financial crisis has opened a window of opportunity for Islamic finance also in non-Muslim countries. Its greater utilisation may be aided if the industry devotes more resources to “impact finance”.

1.0 DEVELOPMENT OF THE ISLAMIC FINANCIAL SERVICES INDUSTRY

1.1 Overview of the Islamic Financial Services Industry

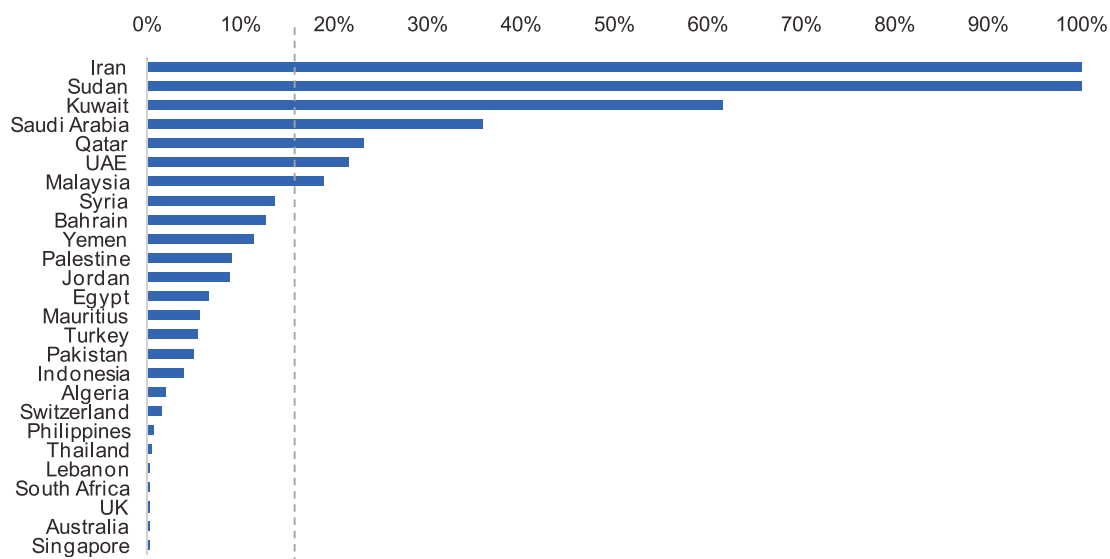
The IFSI has evolved in the aftermath of the financial crisis to provide alternative means of financial intermediation and a more diversified platform for allocating investible funds.

There have been significant developments in each asset class of Islamic finance since the *Islamic Finance and Global Financial Stability Report* of April 2010, including a growing number of industry players, particularly in new jurisdictions, the introduction of regulatory reforms, incentives and various government-sponsored initiatives to establish Islamic financial services in various markets, as well as an IFSI whose assets are estimated to have reached USD1.6 trillion as at end-2012, representing 20.4% growth y-o-y since end-2011.

By region, total Islamic financial assets are focused in the Middle East and Asia and remain heavily concentrated in Islamic banks. Aside from Iran and Sudan, which support a fully *Shari'ah*-compliant financial system, selected GCC states, Bangladesh and Malaysia are the main markets where Islamic finance has a systemic importance due to the increasing market share of IIFS operating within the respective jurisdictions. Models for measuring systemic importance of such institutions are at a very early stage of development. Nevertheless, one approach used by the BCBS in its Indicator-Based Measurement Approach is to measure assets under custody.¹ For the purpose of this report, a systemically important IFSI is defined as one in which the total assets of IIFS within a specified jurisdiction occupy a 15% or greater market share of the banking sector total assets. In Malaysia, for example, IIFS hold 20%² of total banking system assets as at end-2012, as illustrated in Chart 1.1.1. Breaking down the collective market share, the largest individual Islamic financial institution in the country contributes 4.7% to total banking assets. In the GCC, the same measure generates higher proportions with the largest Islamic financial institution in Saudi Arabia representing 15.4% of banking system assets as at end-2012, while in Kuwait the largest Islamic financial institution holds 31.1% of banking system assets.

¹ BCBS notes that a failure of a large custodian bank, holding assets on behalf of customers including other financial firms, could disrupt the operation of financial markets with potentially significant negative consequences for the global economy. Other firms may also have large counterparty exposures to custodian banks.

² Bank Negara Malaysia's Monthly Statistical Bulletin, February 2013. The percentage does not include development financial institutions.

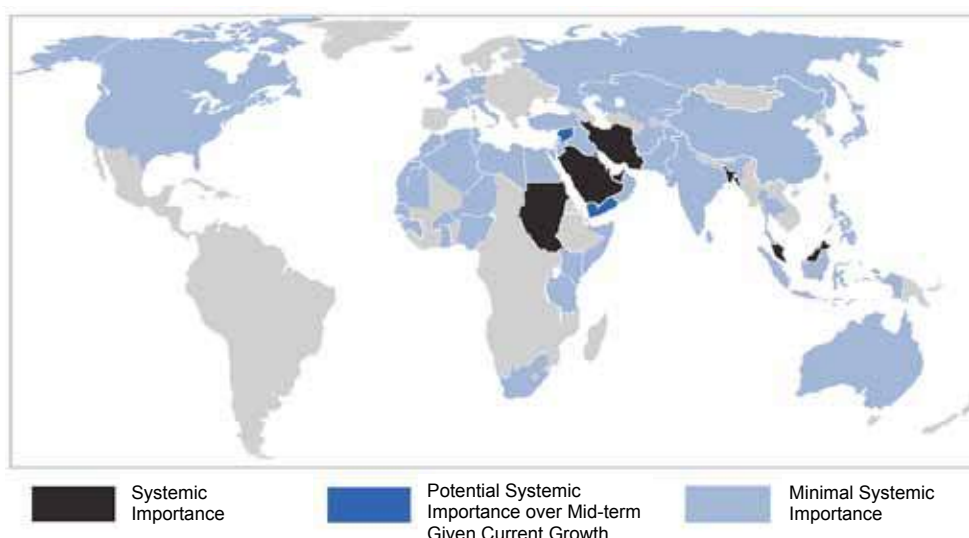
Chart 1.1.1: Islamic Banking Market Share by Jurisdiction (2012E)

Source: Central banks and regulatory authorities, individual institutions, Bloomberg, Zawya, corporate communications, The Banker, KFHR

Pakistan, Turkey and Indonesia, amongst others, however, harbour an emerging or niche Islamic finance market that has yet to capture a significant portion of the available clientele (such as Muslim households in the retail sector and corporations looking to fund operations through *Shari'ah*-compliant means, as well as regional investors due to the lack of capital market instruments) as compared to the aforementioned countries. Furthermore, institutions have not been able to capture sufficient market share to make them systemically important to the overall financial system in each respective jurisdiction. These markets are, however, rapidly expanding and therefore should be nurtured to ensure that they become instrumental in enhancing the qualitative aspect of the financial sector (such as improving financial inclusion) in the near future, while also recognising that their growth trajectory could make them potentially important in the more distant future.

Other jurisdictions such as Oman, Kazakhstan and Egypt are characterised by a nascent but peripheral Islamic finance industry given their recent mandate. Institutions within these areas are currently extraneous to the broader objective of ensuring financial stability of the Islamic finance industry. Although there may be some discussion on the stability or sustainability of such institutions themselves within the larger context of surviving current market conditions, it would be difficult to measure at what level they would impact stability in the global financial system.

Diagram 1.1.1: Islamic Finance Markets by Systemic Significance



Source: KFHR

The global IFSI, however, remains a small but growing sub-set of the global financial system. The industry's closest asset class in terms of similarity would be ethical finance, which is estimated at more than USD5 trillion³ in assets in Europe alone as at end-2009, five times that of Islamic finance during the same period.

Table 1.1.1: Breakdown of Islamic Financial Assets (USD billion, 2012E)

	Banking Assets	<i>Sukūk</i> Outstanding	Islamic Funds' Assets	<i>Takāful</i> Contributions
Asia	171.8	160.3	22.6	2.7
GCC	434.5	66.3	28.9	7.2
MENA (exc. GCC)	590.6	1.7	0.2	6.9
Sub-Saharan Africa	16.9	0.1	1.6	0.4
Others	59.8	1.0	10.8	0.0
Total	1,273.6	229.4	64.2	17.2

Source: Regulatory authorities, Bloomberg, Zawya, central banks, individual institutions, corporate communications, IFIS, The Banker, KFHR

Note: Where available, data are taken from primary sources (regulatory authorities, annual reports, etc.). Where primary data are unavailable, third-party data providers have been used. Where there were still information gaps, data were estimated based on historical growth trends and country-specific assumptions to derive final figures.

³ Eurosif (2010).

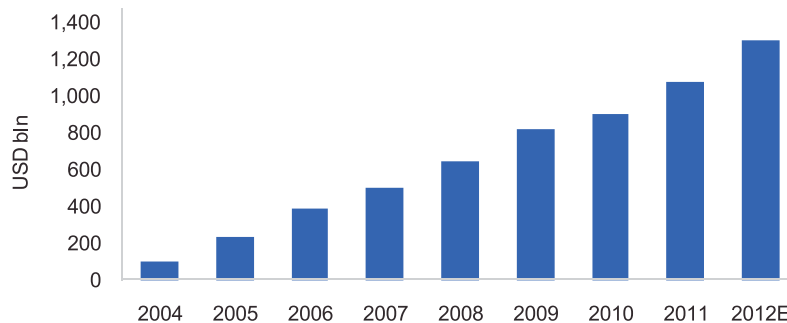
Given that the environment in which this growth has been achieved is constantly changing, and the renewed and prolonged macroeconomic uncertainties faced by the industry, the resilience of the IFSI needs to be examined further. In this regard, two distinct questions relating to the financial stability of the IFSI arise: (a) how sustainable over the coming years are the growth rates achieved thus far; and (b) how able is the industry to weather changes in the global economy and financial system, and to deal with emerging exogenous threats at the macroeconomic or global economy level?

The present context has also generated awareness in non-Islamic markets about the underlying principles of Islamic finance and ignited curiosity as to whether claims that they support financial stability hold water. As such, the role of Islamic finance in the global market has become an important topic for discussion in various gatherings and is given greater importance in terms of its potential contribution towards a healthy and diverse financial system.

1.2 Trends in the Development of Islamic Banks

Islamic banks are the main providers of *Shari'ah*-compliant services and are being entrusted with the majority of Islamic capital/financial assets, which likewise makes financial stability dependent on their success. Islamic banking has been the major driver of industry growth over the past decade, taking the largest share of financial assets. Assets with Islamic banks and Islamic banking windows have grown at a compound annual growth rate (CAGR) of 40.3% between 2004 and 2011 to reach USD1.1 trillion.

Chart 1.2.1: Islamic Banking Assets Growth Trend



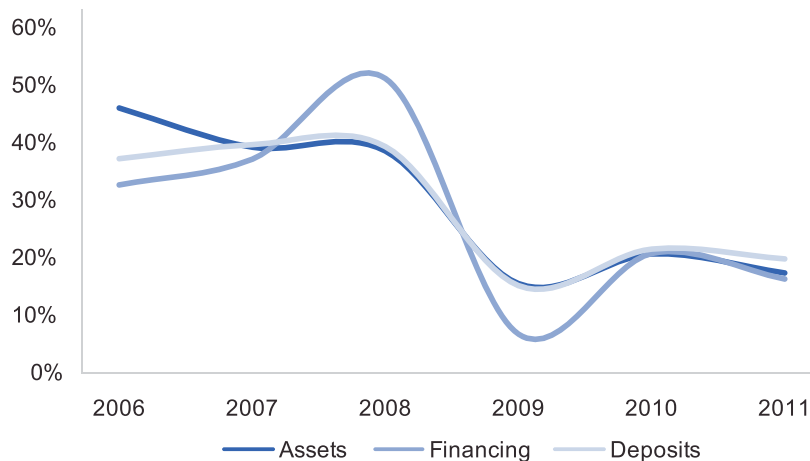
Source: Regulatory authorities, Bloomberg, Zawya, central banks, individual institutions, corporate communications, The Banker, KFHR

Islamic banking in the early 2000s was a niche market in most jurisdictions with only a few institutions offering basic depository and financing instruments. This was coupled with low awareness and demand for Islamic banking services, particularly in Asia Pacific and developed markets. Regulation was another area that was undeveloped in most jurisdictions until the mid-2000s, when various authorities began introducing and amending legislation to make it supportive of the Islamic banking industry's growth. Such amendments served to regulate, accommodate and incentivise *Shari'ah*-compliant transactions in a number of markets across the globe.

A sample of 50 Islamic banks across 11 countries shows that the Islamic banking industry has witnessed significant growth over recent years. The USD value of total assets with these Islamic banks reached USD411.4 billion as at end-2011, which represents 63.9% of the estimated total banking

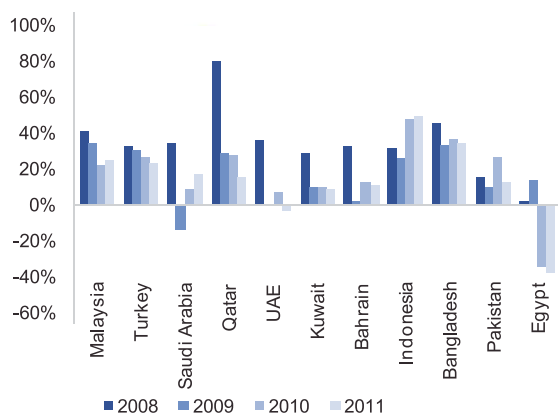
assets in 2011 if Iran is excluded. Total assets with these Islamic banks have grown at a CAGR of 16.6% between 2007 and 2011.

Chart 1.2.2: Islamic Banking Global Average Growth Trends



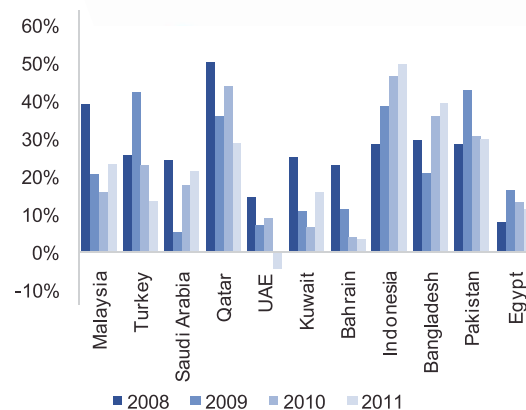
Source: Islamic banking sample, KFHR

Chart 1.2.3: Financing Growth Trend by Country

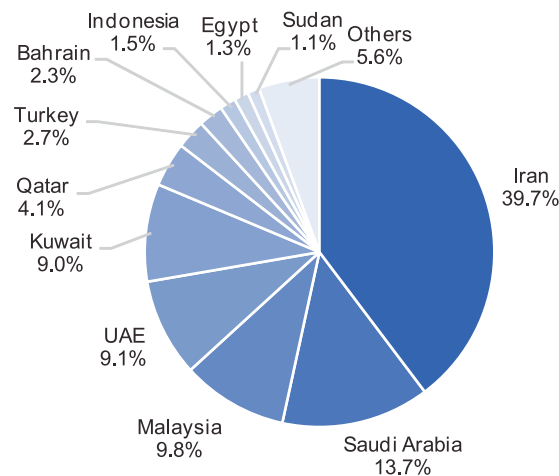


Source: Islamic banking sample, KFHR

Chart 1.2.4: Deposit Growth Trend by Country



During the global financial crisis period, despite the turmoil across financial markets, Islamic banks remained relatively resilient, still able to grow at a significant pace. The balance sheets of Islamic banks were relatively unscathed as compared to their conventional peers due to the fact that demand for financial products had been essentially domestic-driven, which was helped further by banks' high capitalisation and ample liquidity that provided a relatively higher degree of confidence to counterparties. An IMF working paper entitled "The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study" highlighted similar findings, including that factors related to Islamic banks' business model helped limit the adverse impact on profitability in 2008. Moreover, Islamic banks' credit and asset growth performed better than conventional banks in 2008 and 2009, contributing to financial and economic stability. The paper also found that external rating agencies' re-assessment of Islamic banks' risk was generally more favourable than that of conventional banks. Despite this, the paper highlighted that weaknesses in the risk management system of some Islamic banks led to greater declines in profitability in 2009 than experienced by conventional banks.

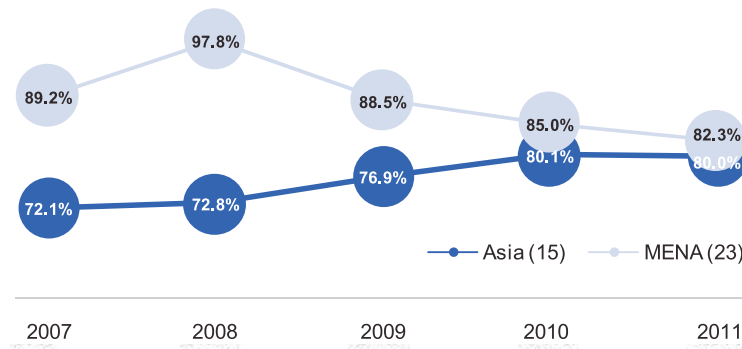
Chart 1.2.5: Domicile of Islamic Banking Assets (2011E)

Source: Regulatory authorities, Bloomberg, Zawya, central banks, individual institutions, corporate communications, The Banker, KFHR

Following the global financial crisis, Islamic banks in Asia have been able to increase their financing portfolios substantially and develop the retail Islamic banking sector to offer a more diverse range of products and services. Based on the sample of Islamic banks, the financing-to-deposit ratio (FDR) has since climbed steadily to 80% led by Malaysia and Bangladesh, despite sharp declines in Pakistan given slower financing growth. However, in the Middle East and North Africa (MENA), the FDR declined substantially in 2009 onwards as higher non-performing credits forced banks to be stricter in distributing financing. The declines were led by Islamic banks in Saudi Arabia, Kuwait and particularly Egypt in 2010 and 2011. The growth of *Shari'ah*-compliant investment opportunities has enabled Islamic banks to be more efficient in channelling funds to productive sectors. The small- and medium-sized enterprise (SME) market has been one such popular target of Islamic banks.⁴

⁴ For example, 69.4% of *Shari'ah* banks' financing activity in Indonesia as at end-2011. Bank Indonesia statistics.

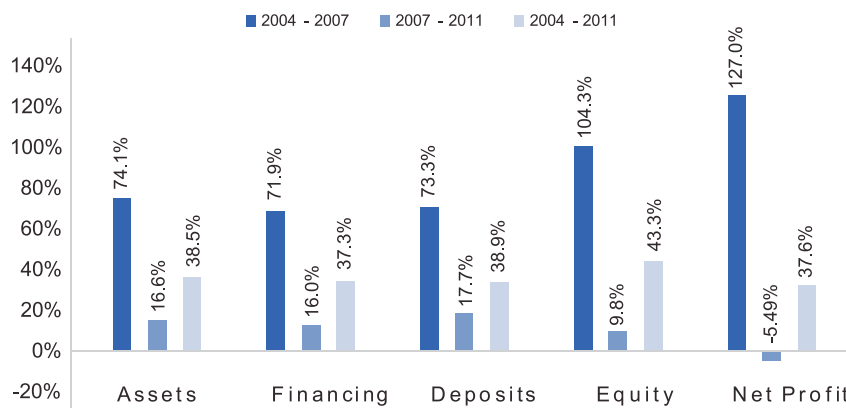
Chart 1.2.6: Financing-to-Deposit Ratio of Islamic Banks



Source: Islamic banking sample, KFHR

In comparison to growth witnessed prior to the financial crisis, there was a marked slowdown during 2008 and particularly in 2009 as the operating environment deteriorated substantially on the back of slower global economic activity and adverse investor sentiment.

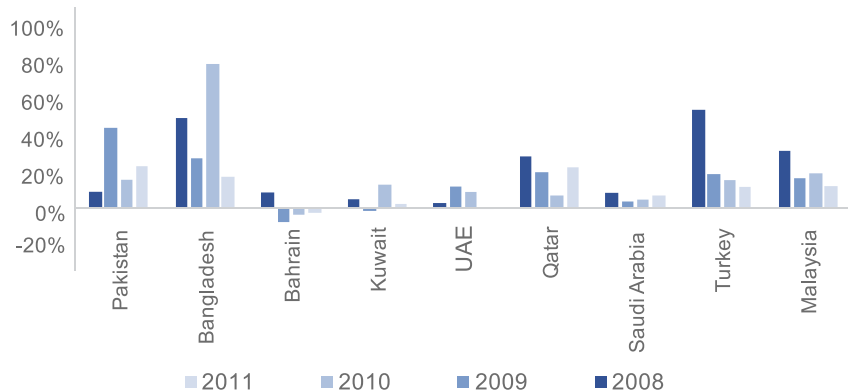
Chart 1.2.7: Compound Annual Growth of Key Islamic Banking Statistics



Source: Islamic banking sample, KFHR

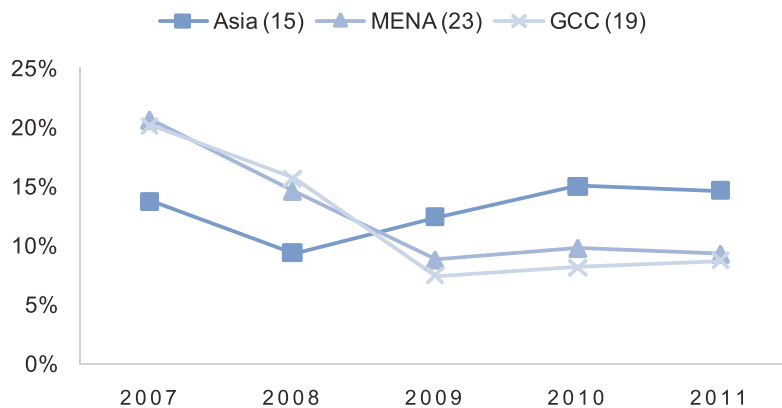
Islamic banks have been able to improve shareholders' value throughout the last decade through increasing equity positions and generating profitable returns, albeit at a slower pace after the global financial crisis. Total equity with Islamic banks has grown by 43.3% per annum on average between 2004 and 2011. Gains in equity since 2008 were led by institutions in Asia, while Qatar outperformed the GCC market average.

Chart 1.2.8: Total Equity Growth of Islamic Banks

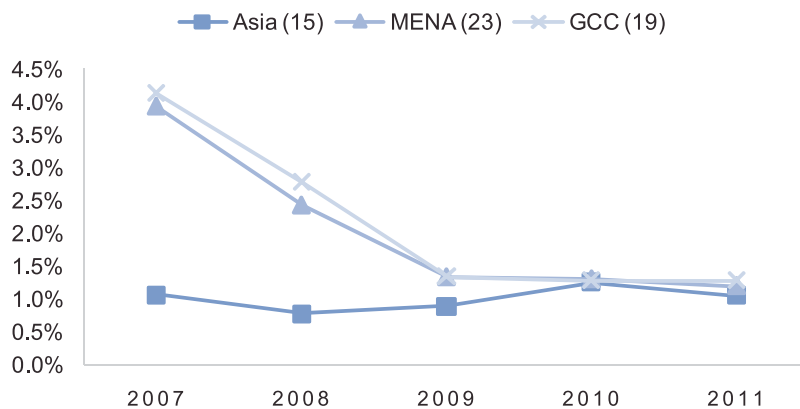


Source: Islamic banking sample, KFHR

In recent years, Islamic banks have been prolific in terms of introducing new products with increasing sophistication. There has been an increasing number of money market and interbank instruments developed to assist Islamic financial institutions in managing liquidity, while institutions in certain jurisdictions have focused on investment and wealth management products such as gold accounts and exchange traded funds (ETFs). Currently, there are new products being tailored towards helping institutions managing and hedging risks. In particular, central banks such as Bank Negara Malaysia (BNM) and the Central Bank of Bahrain have introduced money market and short-term *Sukūk* programmes for effective liquidity management. Such innovations and the continued development of *Sharī'ah*-compliant products and services, in both retail and wholesale markets, have ensured that Islamic banks remained mostly profitable over the past decade. GCC Islamic banks saw net profits decline in 2009 before improving thereafter. Growth within the region has been led by Islamic banks in Saudi Arabia and Qatar. Asian Islamic banks, however, managed to improve profitability overall since 2008, reinforcing some resilience shown post the global financial crisis.

Chart 1.2.9: Return on Equity

Source: Islamic banking sample, KFHR

Chart 1.2.10: Return on Assets

Source: Islamic banking sample, KFHR

Outlook and Challenges

Moving ahead, the Islamic banking industry is expected to witness further developments in emerging economies such as Turkey and Indonesia where Islamic intermediation, underpinned by the increasing demand for alternative banking products and services, continues to drive growth.

Encouraging developments in Africa, in the meantime, are expected to bring positive results given the region's growing demand for *Sharī'ah*-compliant and ethical products and services, the increasing number of middle-class populations, and measures undertaken by some of the governments to review and reform their respective banking laws to allow Islamic finance institutions to set up and thrive. Other jurisdictions in Central Asia such as Kazakhstan, Turkmenistan and Tajikistan, as well as Egypt in the Middle East, also have high potential given the demographics and support from government agencies.

Despite the positive developments expected, the lacklustre global economic environment and a shortage of education and product awareness in some jurisdictions, as well as legal and tax issues, are some of the challenges that the Islamic banking industry will face over the coming years.

One such legal and regulatory challenge is a consequence of the approach or regulatory framework adopted in various jurisdictions. In general, the approaches can be characterised either as integrated or as segregated:

- An integrated approach is where the regulatory authorities bring the IFSI under the ambit of the existing regulatory framework, as is the case in the United Kingdom (UK), Saudi Arabia, Luxembourg and Kuwait.
- A segregated regulatory approach creates two distinct regulatory frameworks and legislations for both the conventional and Islamic financial services industries, such as in Malaysia, Brunei and Pakistan. This is also known as a dual-banking or dual-financial system.

Each regulatory authority's decision on which approach to take in accommodating Islamic financial services is made with due consideration of the unique aspects of the respective operating environment and general legal system in which they regulate. At first glance, this diverse interpretation of how to regulate Islamic finance could create difficulties in implementing and applying international standards and established best practices. However, the application of broadly common principles within diverse legal traditions and institutional frameworks is not unique to Islamic finance.

In this context, it is increasingly important that there are mechanisms for ensuring a strong and sound regulatory platform that strengthens soundness and resilience whilst fostering market activities and growth in each particular jurisdiction. Furthermore, it is essential that regulators can uphold contract enforceability in a way that is intended in a *Shari'ah* governance framework, especially in conventional markets where there is no central *Shari'ah* authority. Therefore, a strong legal and regulatory approach would give market participants the confidence to engage in new and more advanced lines of business, such as infrastructure and project financing. Simultaneously, there could also be a continued effort to harmonise regulations in each jurisdiction towards international standards and best practices, such as those issued by the IFSB.⁵ Much like its conventional counterpart, Islamic finance exhibits increasing cross-border sharing of experiences as well as convergence in many, if not all, of its key dimensions.

Another key challenge faced by Islamic banks is that of risk management capacity. Stronger risk management capabilities are needed if Islamic banks are to take on large financing projects such as infrastructure projects. Therefore, there will be difficulty in shifting this capacity to Islamic financial institutions without increasing the human capabilities to be able to create an efficient risk assessment process for such projects. This would give institutions the ability to replicate some of the success of conventional banks that have been able to enter the GCC and emerging Asian countries and fund large infrastructure projects.

On the regulators' side, the creation of a *Shari'ah*-compliant lender of last resort (SLOLR) facility for the Islamic financial institutions in various jurisdictions is still in various stages of development. The

⁵ See Section 2.3, "Assessment of the Implementation of the IFSB Standards", for more information.

differences in terms of business model between Islamic and conventional banks mean that the effects of volatility in the financial markets, and more so the real economy, could force Islamic banks to seek financial support earlier than conventional banks. Moreover, institutions operating in conventional markets will be more exposed given their niche market presence and potential reluctance by the authorities to provide such a facility. At issue is that an appropriate safety net needs to be developed to ensure that in a time of difficulty, IIFS would be able to access provisions with regulatory authorities and ensure that the IFSI is not susceptible to systemic risks. This issue is discussed in detail in Section 3.2 of this report.

1.3 Trends in the Development of the Islamic Capital Market

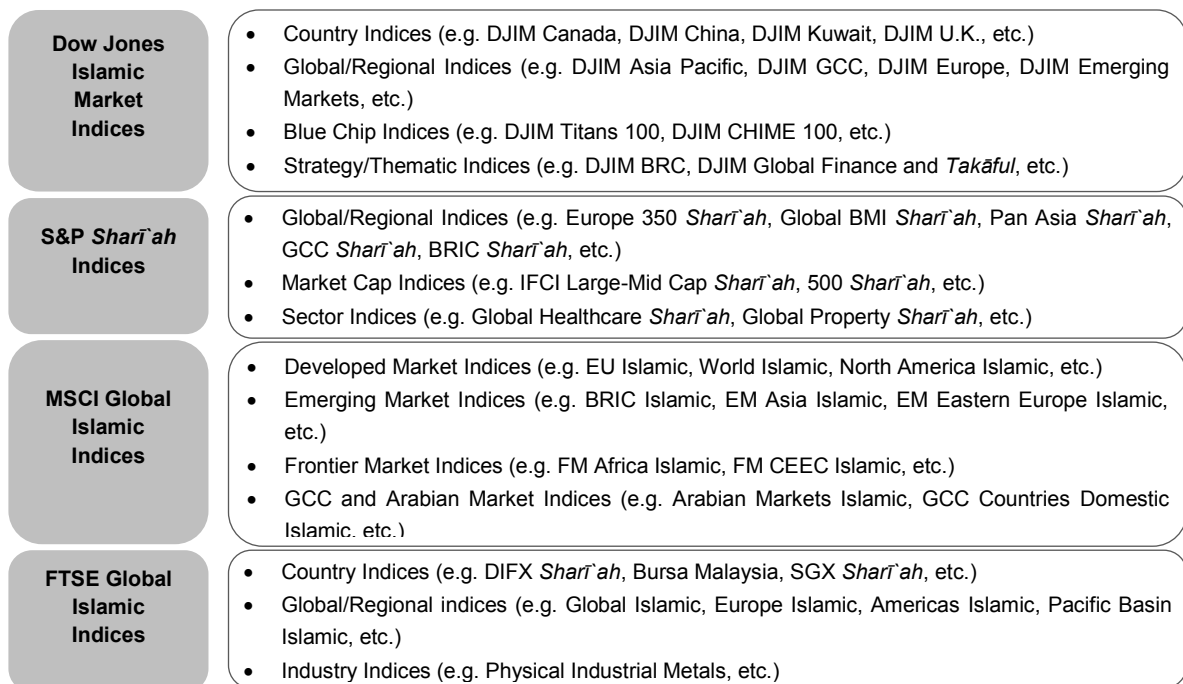
The Islamic capital market has developed significantly over the past decade in terms of both sophistication and size. The need to seek alternative funding sources has grown in tandem with the increasing number of corporates and public enterprises engaging in project and infrastructure finance undertaking activities in compliance with the *Sharī'ah* principles.

The development of both Islamic debt and equity has played an important role in the emergence of a vibrant Islamic capital market that facilitates cross-border capital flows and funding activities.

1.3.1 Islamic Indices

Since the launch of global Islamic indices in 1999, the range of available benchmark indices has blossomed, expanding across both regional and economic geographies. At present there are four major global Islamic indices providers that cover the Islamic equity market, as shown in Diagram 1.3.1.1.

Diagram 1.3.1.1: Islamic Indices Providers for Equity Markets



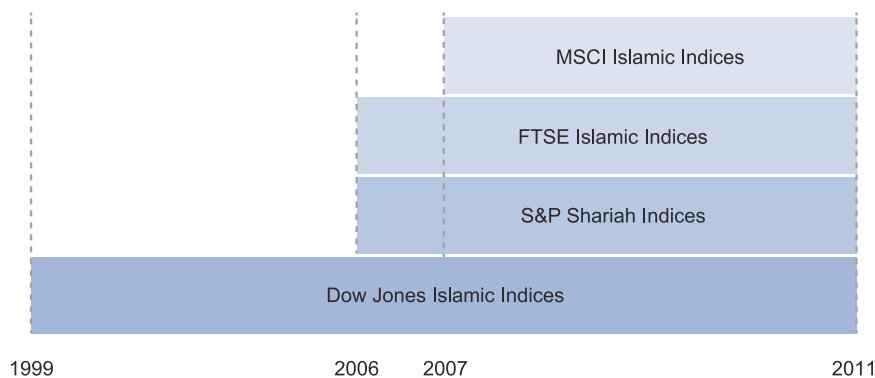
Source: Dow Jones, S&P, FSTE, MSCI, KFHR

The Dow Jones Islamic Market Indices (DJIM) family has expanded to provide a wide variety of benchmarks tracking *Shari'ah*-compliant securities – including indices for 69 countries, across both developed and emerging markets. The DJIM family also includes regional, industry sector and market-capitalisation indices, as well as specialised indices and custom measures.

Recognising the urgent need for Islamic equity indices, Standard & Poor's (S&P) initially applied *Shari'ah* screens to three headline indices – the S&P 500, the S&P Europe 350 and the S&P Japan 500 – in 2006. In 2007, S&P followed with the S&P GCC *Shari'ah* and the S&P Pan Asia *Shari'ah* Indices, to cater for the demand for *Shari'ah* product benchmarks for those regions. In 2008, S&P completed the review of the S&P Global Broad Market Index (BMI) Equity Indices, which consists of over 11,000 companies worldwide, for *Shari'ah* compliance, the result of which is the S&P Global BMI *Shari'ah* index comprising nearly 6,000 constituents, along with 10 sectors and 47 countries and regional sub-indices.

Similarly, FTSE also introduced its *Shari'ah* indices in 2006, starting with the FTSE Global *Shari'ah* Index Series, screened by Yasaar *Shari'ah* scholars. A further three Islamic indices were launched in August 2006. Meanwhile, MSCI began its Islamic indices series in 2007, which subsequently developed to cover over 50 developed and emerging countries and over 50 regions such as the GCC countries and Arabian markets.

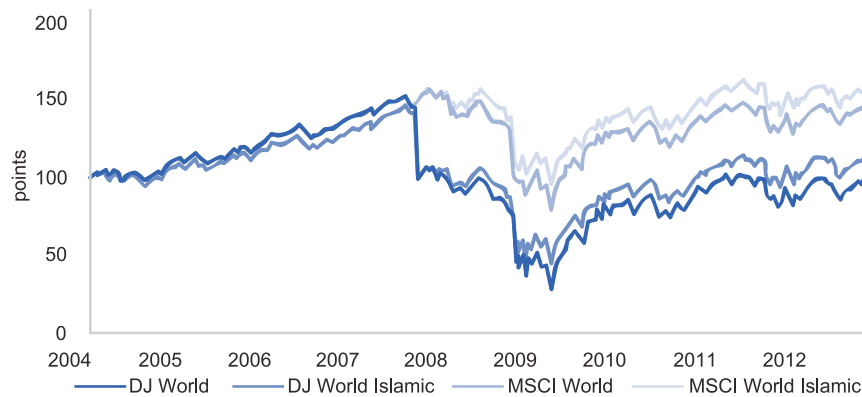
Diagram 1.3.1.2: Introduction of Global Islamic Indices: Timeline



Source: Dow Jones, S&P, FSTE, MSCI, KFHR

Such indices are used by the investment community throughout the world as tools for benchmarking the performance of *Shari'ah*-compliant stocks, bonds and mutual funds. As such, they have been instrumental in creating a *Shari'ah*-compliant investment universe for investors, especially in regards to global equity markets. In essence, the indices have opened trillions of dollars worth of investment opportunities with vast-ranging risk/return portfolio exposures. The indices have been particularly useful for fund and wealth management companies in tapping the wealth of the large Muslim market, as well as in capturing the interest of investors wanting to invest in ethical products.

Chart 1.3.1.1: Selected Global Conventional and Islamic Equity Markets Indices



Source: Bloomberg, KFHR

As shown in Chart 1.3.1.1, the global Islamic indices, the Dow Jones World Index and the MSCI World Index, improved by 14% (since 2004) and 7.8% (since August 2007), respectively. Looking closer at the specific differences between the conventional and Islamic counterparts, a number of factors help to explain why the Islamic indices have outperformed their peers.

For the Dow Jones indices, there are approximately three times the number of constituent companies included in the conventional global index as compared to the same Islamic index, which should generally allow conventional indices to remain less volatile as compared to the Islamic index given a broader dependency of companies that create a greater average performance. Similarly, in terms of total market capitalisation, the ratio increases to over seven times larger for the conventional index although, on average, constituents of the Dow Jones Islamic Market World Index have USD84.3 billion in market capitalisation as compared to USD58.1 billion in the Dow Jones World Index.

Chart 1.3.1.2:
Number of Constituents (as at end-1H12)

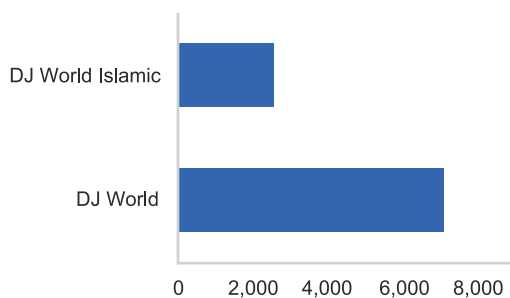
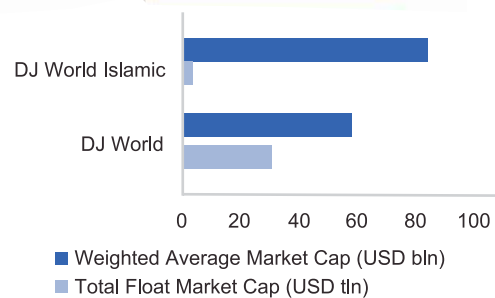


Chart 1.3.1.3:
Market Capitalisation (as at end-1H12)



Source: Dow Jones, KFHR

Constituents with more than USD10 billion in market capitalisation take a larger share in the Islamic index as compared to the conventional index in terms of both their number and total market capitalisation (as a percentage of the total). By industry, the Dow Jones World Index's main constituents represent the financial sector, whereas in the Dow Jones Islamic Market World Index, this is the second-lowest contributing industry by total market capitalisation.

Other differentiating factors between the two indices as a result of the *Shari'ah*-screening process include an increase in the constituents in the basic materials, health care and technology sectors within the Islamic index. The performance of the constituents in these sectors could well be one of the underlying reasons why performance for both indices as a whole has differed. The financial services sector was one of the worst affected areas during the financial crisis, while the consumer goods sector has remained sluggish post the global financial crisis on the back of weak economic growth.

Chart 1.3.1.4:
Size of Companies (as at end-1H12)

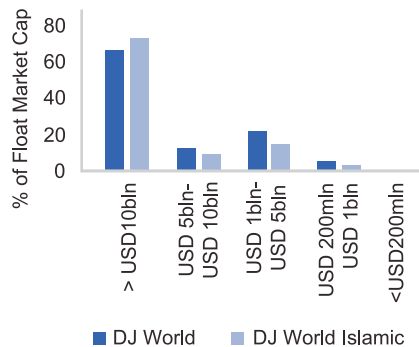
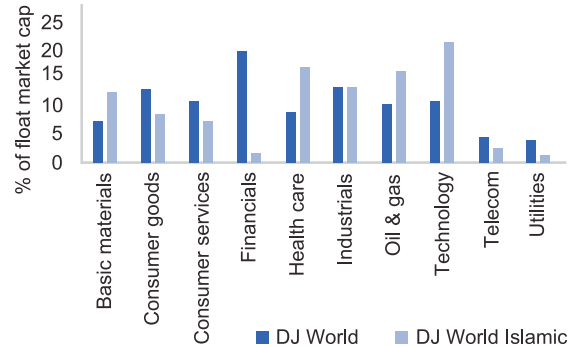


Chart 1.3.1.5:
Industry Composition (as at end-1H12)



Source: Dow Jones, KFHR

Similarly, the conventional benchmark has a greater exposure to the European sovereign debt crisis, with 23.5% share of total floated market capitalisation in the region as compared to 20.5% in the Islamic index.

Chart 1.3.1.6:
Market Composition (as at end-1H12)

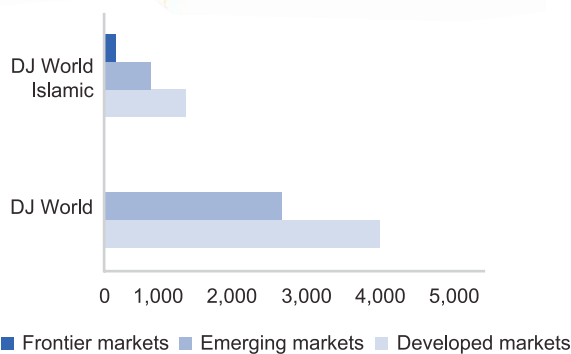
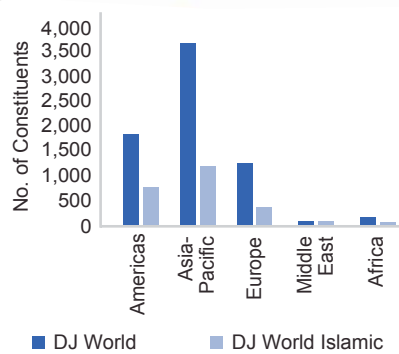


Chart 1.3.1.7:
Regional Composition (as at end-1H12)



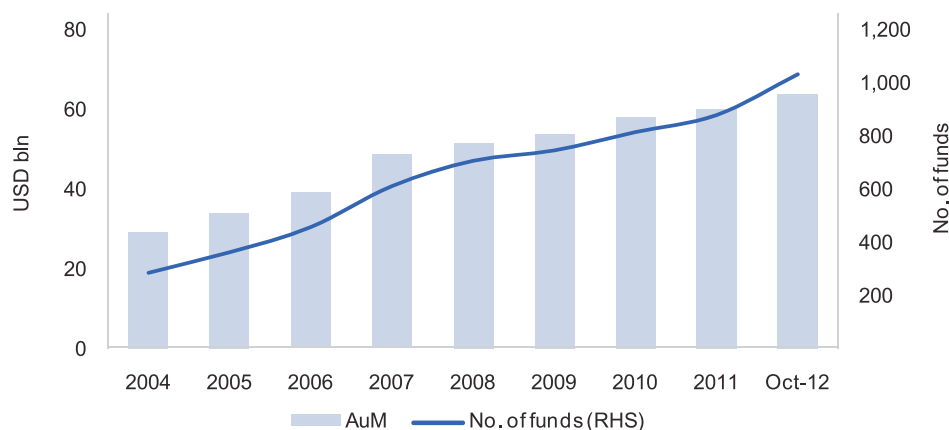
Source: Dow Jones, KFHR

1.3.2 Islamic Funds

Islamic asset and wealth management is a niche segment of the IFSI that has experienced stable growth since 2004. Islamic funds have grown from 285 in 2004 to 1,029 as at end-2012. Despite this, *Shari'ah*-compliant funds have been slow to develop sophistication and market depth. One of the main reasons remains that Islamic mutual funds are dependent on the availability of other *Shari'ah*-compliant solutions. Until the Islamic equity and fixed income markets have sufficient volume, Islamic wealth management solutions will still lack for opportunities.

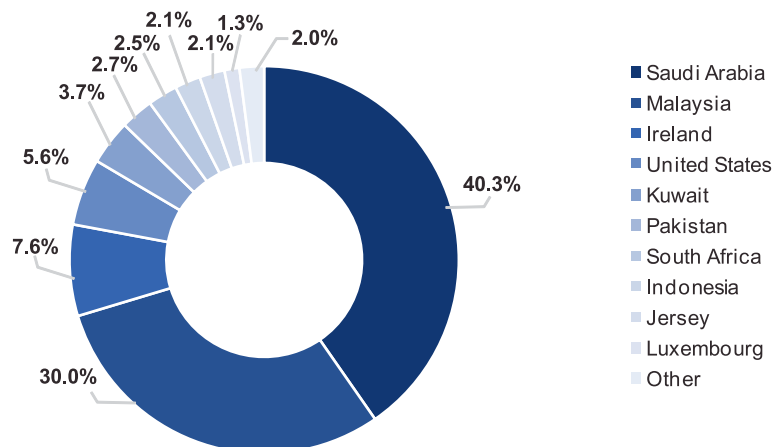
As the Islamic finance industry gains momentum, and awareness of *Shari'ah*-compliant solutions amongst various populations increases, Islamic funds have become increasingly retail driven. The rising wealth in Muslim nations, especially in the emerging economies and oil-rich countries, has helped drive investible assets to new heights. As at end-2011, assets under management of Islamic funds grew to USD60 billion from USD29.2 billion in 2004, representing a CAGR of 10.8%. This increased to USD64 billion as at end-October 2012.

Chart 1.3.2.1: Growth in Assets under Management (AuM) and Number of Islamic Funds



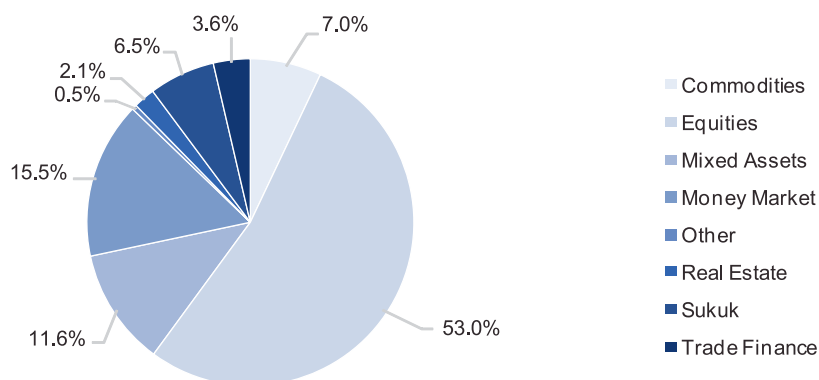
Source: IFIS, Bloomberg, KFHR

By domicile, Islamic funds' assets are concentrated in Saudi Arabia and Malaysia, followed by Ireland, the US and Kuwait, as at end-October 2012.

Chart 1.3.2.2: Islamic Funds' Assets by Domicile (October 2012)

Source: IFIS, Bloomberg, KFHR

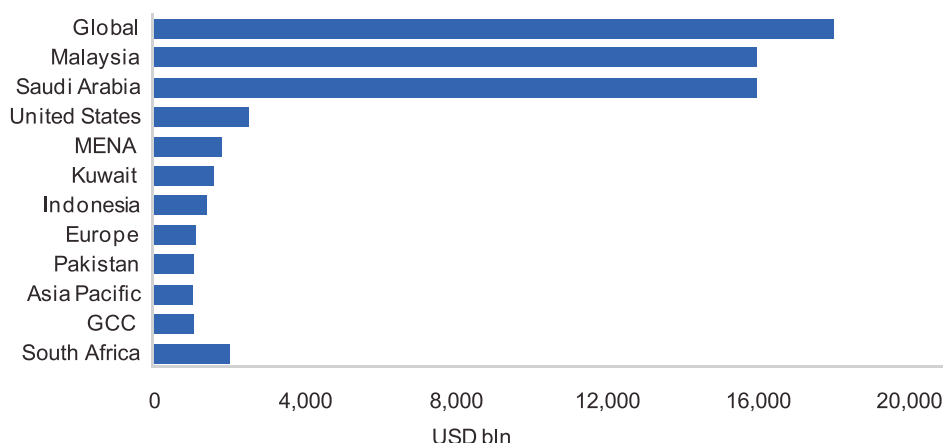
Despite the global economic downturn and the prolonged sovereign debt crisis in Europe, Islamic funds have managed to grow their assets on the back of strong market performance, as well as through a number of new funds raised. With the global equity indices underperforming, investors continue to search for alternative asset classes. In particular, commodity funds have been an attractive safe haven for a wide range of investors during the turbulent times. In terms of asset allocation, equities are the main asset class for *Shari'ah*-compliant funds worldwide, accounting for over half of all assets. Malaysia is the largest equity market for Islamic funds, with Saudi Arabia, the United States (US), Ireland and Kuwait being the other major markets. A growing portion has been allocated to money markets and *Sukuk* by investors with a lower risk appetite arising from concerns about the global economy.

Chart 1.3.2.3: Islamic Funds' Assets by Asset Class (October 2012)

Source: IFIS, Bloomberg, KFHR

The direction of investment of Islamic funds as at end-October 2012 was targeted towards Saudi Arabia and Malaysia individually, with 25.7% market share each, while funds managed under a global mandate accounted for 28.3%. The vast majority of funds raised in Saudi Arabia and Malaysia are channelled locally.

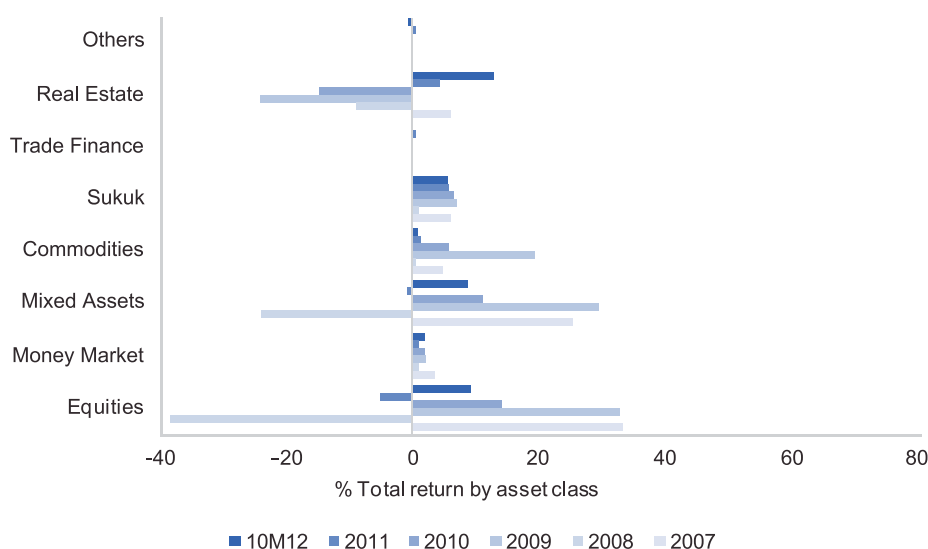
Chart 1.3.2.4: Islamic Funds' Assets by Geofocus (October 2012)



Source: IFIS, Bloomberg, KFHR

Commodity funds have been the best net performing asset class for Islamic investors between 2007 and 2011, growing by 41.81%, while a mixed asset allocation and equity funds returned 33.05% and 32.31%, respectively, over the same period. Islamic equity funds witnessed steep declines in 2008 before rebounding in 2009 and 2010. However, the asset class lost 5.01% in 2011 in line with the global equity market performance.

Chart 1.3.2.5: Total Return Performance of Islamic Funds by Asset Class



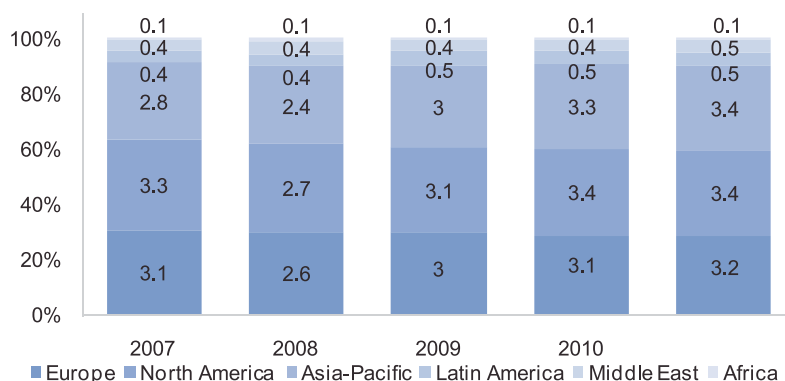
Source: IFIS, Bloomberg, KFHR

Outlook and Challenges

Overall, Islamic funds have evolved into wealth management vehicles, which cater to investors who want exposure to capital markets inside a *Shari'ah* framework. The Islamic asset management landscape post-crisis has seen investors that are more discerning in their investment choices. This is due to risk aversion and limited capital, resulting in the change to a more domestic-centric appetite. (Asian investors prefer Asian-themed funds, and Middle East investors prefer GCC funds.)

Moving forward, both the demand for and supply of Islamic funds is expected to grow given the mounting wealth and preference for *Sharī'ah* solutions. Future demand is expected to be generated from the growing attraction of Islamic funds for diversification in an uncertain economic environment, the growing preference for Islamic alternatives, as well as the improving track record of Islamic funds which opens investment opportunities to the larger fund managers, insurance funds and pension funds.

Chart 1.3.2.6: High Net-Worth Individual Distribution by Region (% Market Share & USD trillion)



Source: Capgemini, KFHR

On the supply side, the number of fund managers offering Islamic options will continue to expand, with potential for new jurisdictions becoming ever more likely. Meanwhile, fund managers are increasingly becoming familiar with Islamic structures and *Sharī'ah*-compliant investments which are set to improve performance.

1.3.3 Sukūk

Sukūk currently represents a dynamic part of the Islamic financial system that continues to grow at a remarkable pace. Growth has been driven by the need for securitisation among industry players to create market liquidity, as well as the need for fixed-term investments and credit facilities.

During the mid-2000s, government institutions and central banks began introducing short-term *Sukūk* programmes for managing market liquidity and financing government spending (largely project financing) which remain popular among domestic institutional investors given the short supply of liquidity instruments.

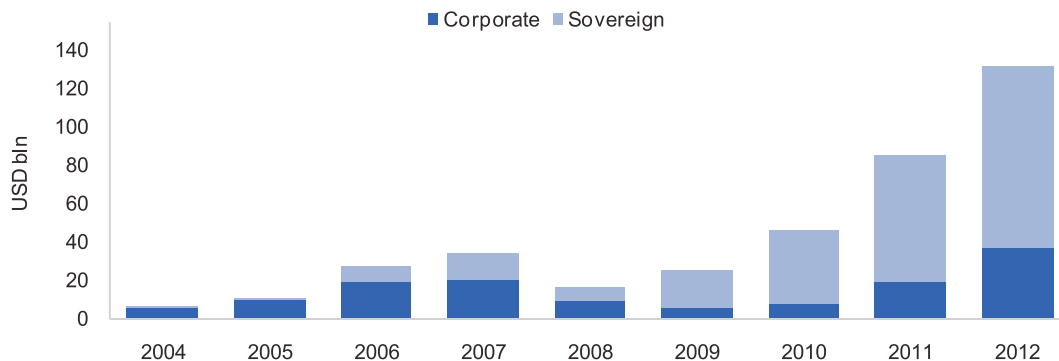
Following the global financial crisis, government entities began entering the market in numbers, while corporates remained reluctant to issue given conventional spreads were rising to record highs. Investors seeking a balance between yield and safety brought strong demand for government-guaranteed and highly rated papers, including those in the *Sukūk* market. In line with the conventional fixed-income markets, yields for *Sharī'ah*-compliant government papers declined on the flight to safety. The ensuing sovereign debt crisis in Europe and the slower global economic growth recovery has left investors with fewer investment options, leading to capital flows to emerging markets, commodities and alternative investments.

The strong performance of the *Sukūk* market in terms of spread resilience, efficient distribution, and their exposure to new markets and revenue streams has made them an attractive solution for Western institutional investors. Furthermore, large conventional players with global market reach have helped in terms of distribution to achieve broader investor consensus and added depth to the market by increasing participation.

With a much larger pool of outstanding sovereign *Sukūk* acting as key benchmarks in various jurisdictions, as well as the declining bond and *Sukūk* yields outside of Europe, the cost of borrowing on the corporate front has become more affordable in recent years. As such, corporate *Sukūk* issuances have surged beyond the pre-crisis levels, pushing total global issuances to record highs. Additionally, the still nascent stage of the *Sukūk* market in comparison to global bond markets means that room for growth remains substantial. As regulators become more serious about the viability of *Sukūk* instruments as well as the ongoing potential to raise funds at lower costs on the back of significantly low *Sukūk* yields, there will be the potential for new *Sukūk* issuers to tap the market. Regional dynamics are also an important factor for issuers wishing to access liquid markets such as the GCC and emerging Asia.

Since 2004, *Sukūk* issuances have increased at a CAGR of 45.2% until end-2012, from USD6.6 billion to USD131.2 billion. Despite a slump of 54.1% in 2008 due to the global financial crisis, the growth momentum rebounded from 2009 onwards, growing at a CAGR of 60.1% until end-2012.

Chart 1.3.3.1: *Sukūk* Issuance Trend



Source: Bloomberg, IFIS, Zawya, KFHR

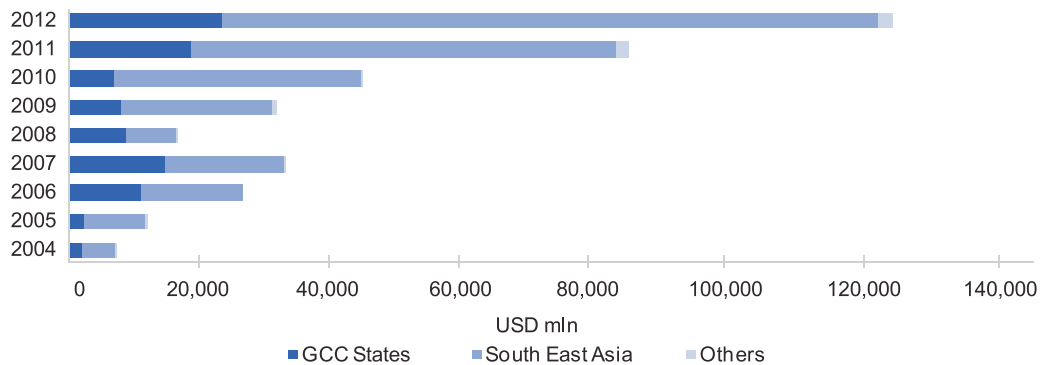
Diagram 1.3.3.1: Growth Drivers of the *Sukūk* Market

Source: KFHR

In 2012, the primary market was driven by sovereign issuers, particularly BNM, which issued a total of USD57.3 billion, or 43.7% of all issuances. By market share, Malaysia is the central *Sukūk* market for both number of deals and amount raised through *Sukūk* instruments. The country has a developed local and international currency platform that has enabled it to attract Malaysian corporates as well as foreign entities.

Elsewhere, the GCC states have seen regular issuances over the past six years which in 2012 took a market share of 18.0% of all primary market placements. The United Arab Emirates (UAE) and Saudi Arabia are the largest *Sukūk* domiciles in the region, both of which are traditionally driven by corporations and government-related entities raising funds in US dollars.

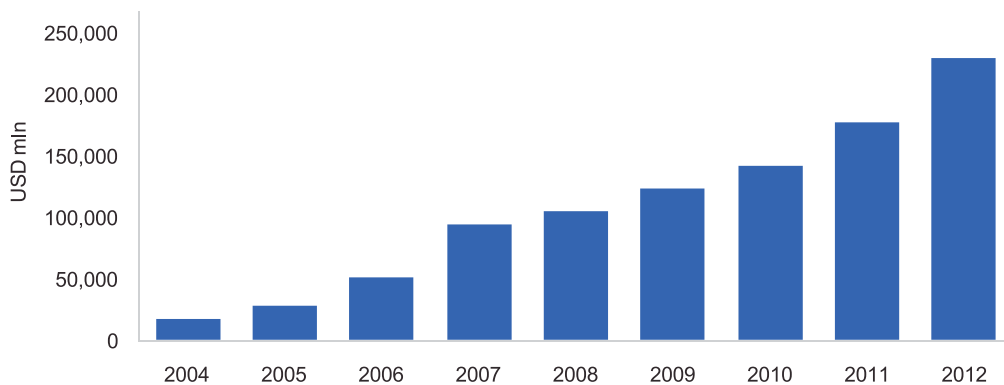
Chart 1.3.3.2: Sukūk Issuances by Region



Source: Bloomberg, IFIS, Zawya, KFHR

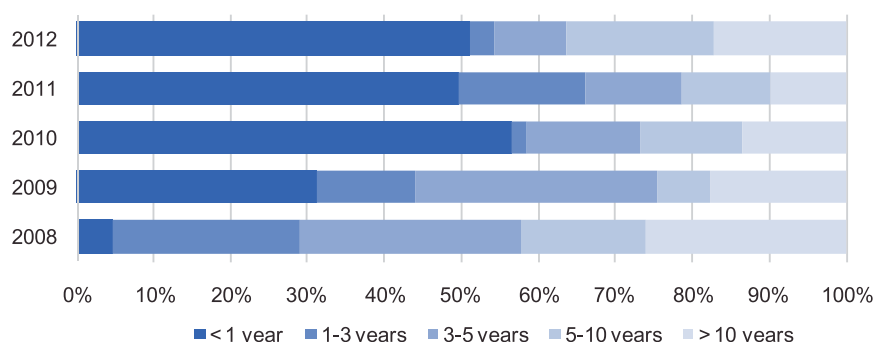
The assets available in the secondary market have grown substantially since 2004 at a CAGR of 39.3% to reach USD229.3 billion outstanding as at end-2012. Even with a slump in *Sukūk* issuances in 2008, the secondary market was able to grow given the long-term maturities of pre-crisis issuances.

Chart 1.3.3.3: Sukūk Outstanding Trend



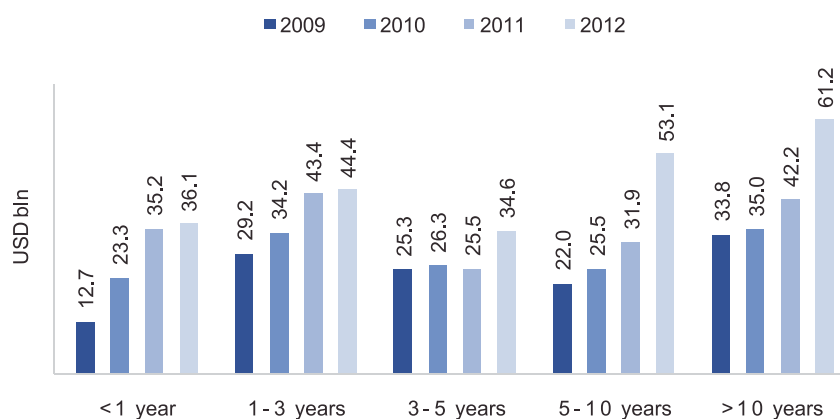
Source: Bloomberg, IFIS, Zawya, KFHR

After the global crisis, maturities shortened significantly as investors left long-term riskier investments for short-term, high-quality papers. Similarly, the growth in sovereign issuers put more short-term instruments into the secondary market, leading to slower secondary market growth post-crisis. However, in 2011 and 2012, the amount of *Sukūk* tenured at five years and above grew significantly, initiating the strong secondary market growth.

Chart 1.3.3.4: Sukūk Maturity Trend of New Issuances

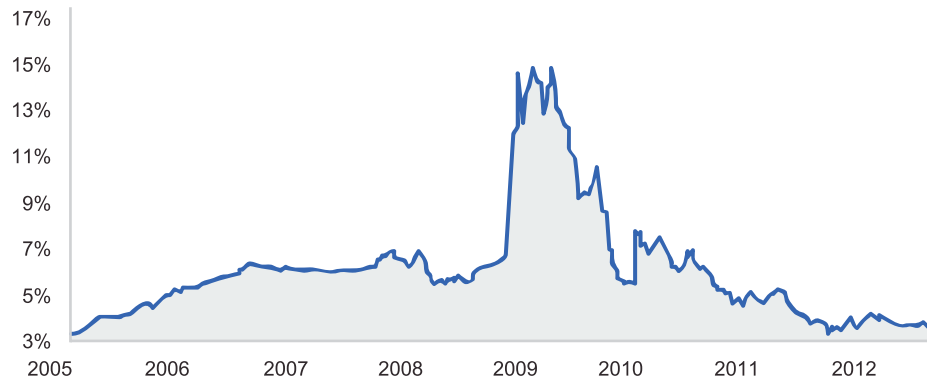
Source: Bloomberg, IFIS, Zawya, KFHR

In 2012, the amount to mature in five years and beyond grew substantially on the back of strong long-term primary market issuances growth during the year. Meanwhile the amount of short-term *Sukūk* liquidity in the capital market remained marginally higher than in the previous year. The main driver of this trend has been the corporate sector, which has taken advantage of the lower yields and cheaper funding costs.

Chart 1.3.3.5: Sukūk Maturity Trend of Outstanding Amount (as at end of period, USD billion)

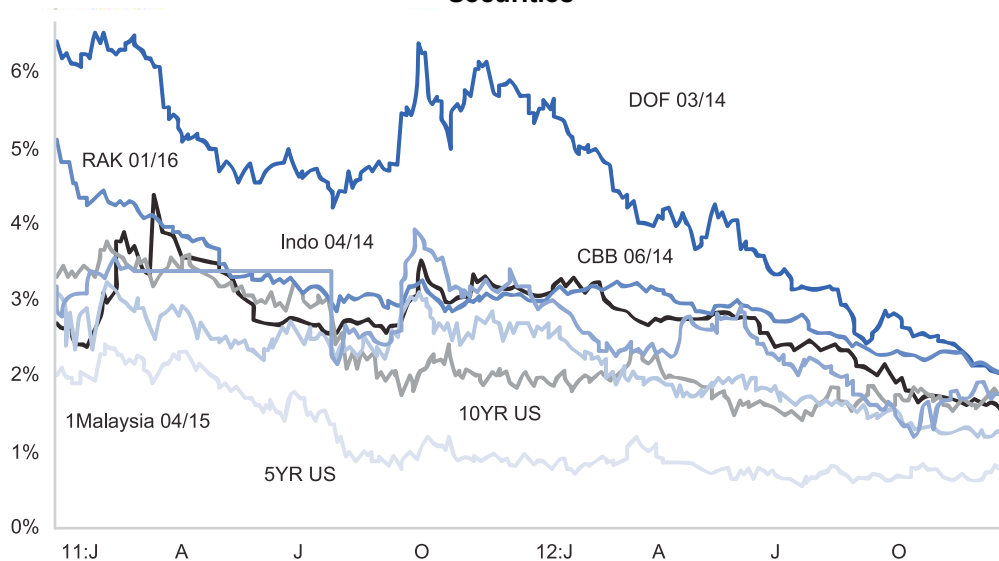
Source: Bloomberg, IFIS, Zawya, KFHR

In the context of the global financial crisis, *Sukūk* yields have been volatile, reacting to the situation in late-2008 as investors left the market with the demand for *Sukūk* papers hitting record lows. Shocks in the *Sukūk* market were caused by investors' uncertainty as to how such *Sharī'ah*-compliant instruments would perform when faced with a global financial market shake-out. Given the *Sukūk* market's corporate-driven nature pre-crisis, a downturn in the global economy had a much larger potential negative impact on the industry given disruption to the supply chains, production and operating profitability of its institutions. However, concerns were non-persistent once it became clear that the interlinkages between market issuers and the global financial situation were minor.

Chart 1.3.3.6: HSBC/Nasdaq SKBI Yield Index

Source: HSBC/Nasdaq, KFHR

Since the peak of the SKBI index in 2009, as highlighted in Chart 1.3.3.6, *Sukūk* yields have dropped remarkably, driven by increasing demand for *Sukūk* papers after a resilient performance over the crisis period, the desire to tap liquid markets such as the GCC and emerging Asia, as well as the continued subdued global economic performance, which pushed investors to search for lower-risk, fixed-income and alternative investments.

Chart 1.3.3.7: Selected Sovereign *Sukūk* Yields vs. Five- and Ten-Year US Government Securities⁶

Source: Bloomberg, KFHR

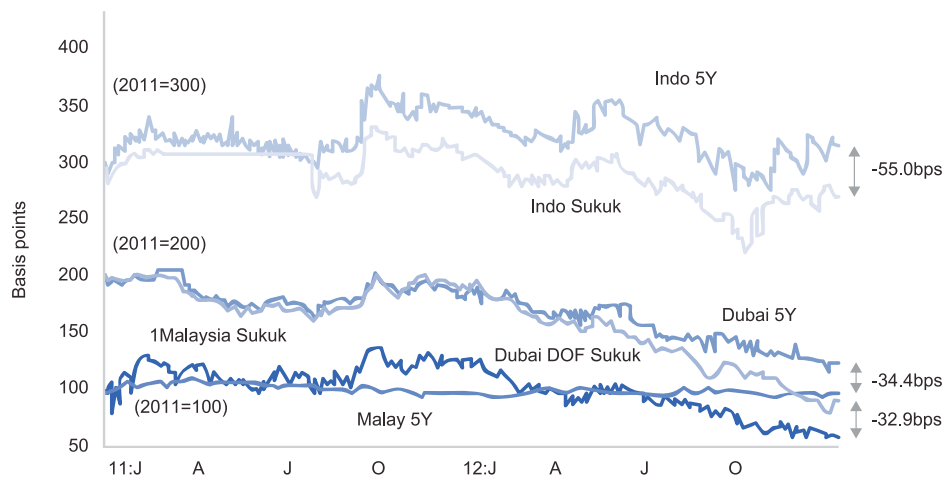
Sovereign yields have declined markedly post-global financial crisis in both the Islamic and conventional markets. Notably, most of the sovereign *Sukūk* yields shown in Chart 1.3.3.7 have outperformed the US ten-year Treasury Notes between end-2011 and end-2012. The 10-year US papers saw its yield compressed by 48.4% as compared to the Indonesian sovereign *Sukūk* maturing

⁶ RAK 01/16 = Ras Al Khaimah *Sukūk* issuance maturing in January 2016, Indo 04/14 = Indonesian sovereign issuance maturing in April 2014, 1Malaysia 04/15 = 1Malaysia Global *Sukūk* maturing in April 2015, CBB 06/14 = Central Bank of Bahrain issuance maturing in June 2014, DOF 03/14 = Dubai DOF *Sukūk* maturing in March 2014, 5YR US = US 5-year Treasury yield and 10YR US = US ten-year Treasury yield.

in 2014 which declined by 50.7% over the same period, Dubai Department of Finance's (DOF) *Sukūk* maturing in 2014 (-8.9%), 1Malaysia *Sukūk* maturing in 2015 (-58.6%) and the Central Bank of Bahrain (CBB) *Sukūk* maturing in 2014 (-43.4%).

In a direct comparison to their conventional counterparts, sovereign *Sukūk* also outperformed in the secondary market as surplus demand for *Sharī'ah*-compliant papers, as well as a shorter supply, raised prices and lowered yields over the period. For example, Chart 1.3.3.8 shows that the Indonesian sovereign *Sukūk* outperformed its conventional benchmark by 55 basis points between 2011 and 2012.

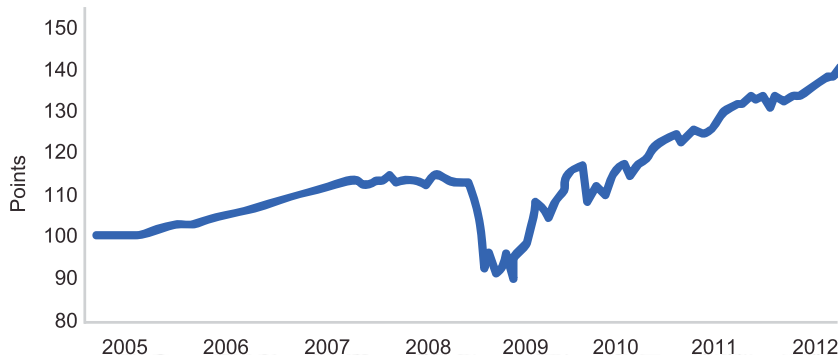
Chart 1.3.3.8: Sovereign Yield Comparison (*Sukūk* and Conventional Bonds)



Source: Bloomberg, KFHR

In terms of performance, the SKBI index returned 46.5% from end-2004 until end-2012, despite substantial losses in 2008. The index rebounded in 2009, returning 19.74% followed by positive growth between 2010 and 2012 (62.6%).

Chart 1.3.3.9: HSBC/Nasdaq SKBI Total Return Index



Source: HSBC/Nasdaq, KFHR

Given the unique characteristics of *Sukūk* structures, certain rating agencies have formulated a specific analytical methodology for rating *Sharī'ah*-compliant instruments with a goal to correctly assess the risks associated with such products and provide disclosure to investors. There are two

distinct methods of assessing the risk/return profile of *Sukūk* instruments according to their asset-based and asset-backed nature. For asset-based *Sukūk*, where assets are securitised and sold in the form of a trust, investors gain credit exposure to the underlying obligor and the return contractually agreed, as is the case in a conventional bond. Asset-backed *Sukūk*, however, include a true sale of the underlying asset, thereby generating returns and a risk association of the underlying asset, as is the case in conventional asset-backed securities transactions. Such initiatives help to improve market efficiencies and safeguard investors by ensuring *Sukūk* prices are related to their true risk/return profiles.

Outlook and Challenges

Significant demand for high-quality papers means that issuers continue to benefit from better credit terms. Moving forward, sovereigns are expected to continue the market lead as the likes of BNM, the Indonesian government and others upscale market issuances. The introduction of inaugural sovereign issuances by new jurisdictions is set to further strengthen the sovereign market in 2013. Meanwhile, countries such as Libya, Egypt and Tunisia are hard at work in creating a regulatory environment for future *Sukūk* issuances for the year and beyond.

Similarly, Islamic banks and financial institutions have come out in force recently, raising funds for supporting capital structures, refinancing and funding activities. Corporate issuances have grown significantly in 2012 and look set to continue throughout 2013.

Downside risks to *Sukūk* are principally in the form of knock-on effects to the global economy from excessive fiscal consolidation in the US, and a weakening of firewalls preventing contagion in Europe. While the latter appears to have been addressed by the European Central Bank's (ECB) unlimited support for sovereign bond issues, fiscal consolidation issues continue to face uncertainty in the US. A key risk is the emergence of an essentially globally integrated financial system in which fund managers following benchmarks respond to even small changes in returns and risk perceptions by exiting emerging markets.

In addition, in Europe, the lack of economic recovery supplements risks in the global bond market as well as the *Sukūk* market. Furthermore, austerity measures introduced in the European countries may dampen potential for significant economic recovery over the near term, which in turn may hamper the export potential of emerging markets. This may put a dent in growth prospects in markets such as Malaysia, Indonesia and the GCC, where *Sukūk* have predominantly been active. Lower global economic growth caused by the troubles in Europe may impede issuances in the *Sukūk* market, as was the case in 2008.

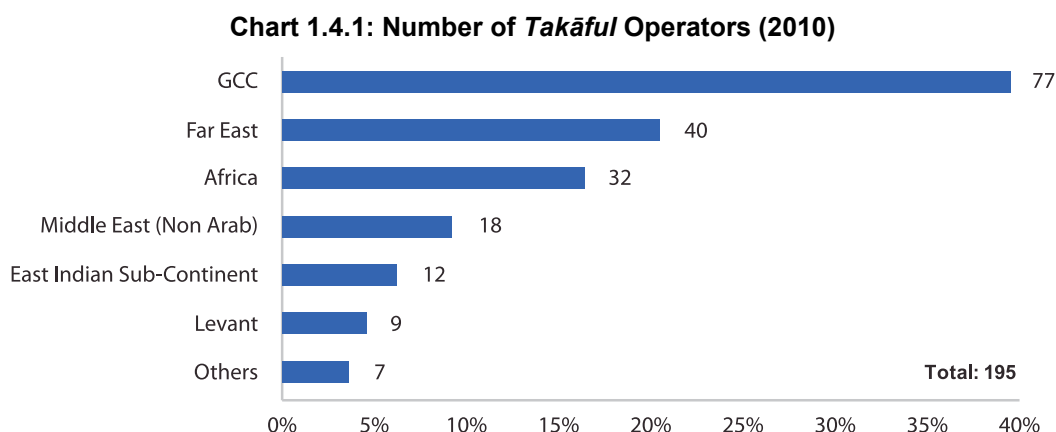
A further challenge is that Islamic products such as *Sukūk* have historically been more expensive solutions as compared to similar conventional products and services. A number of reasons have been proposed to explain this fact, such as the extra cost of ensuring *Sharī'ah* compliance, be it through applying screening criteria or seeking advice on compliance, the premium paid by first-time market entrants given the uncertainty and lack of past performance, or the overall complexity of transactions which draws in additional costs. In this respect, market players have the potential to innovate *Sharī'ah*-compliant products and services that can compete with their conventional peers, while regulators can

remove unnecessary impediments and costs that come with more complex *Sharī'ah*-compliant solutions.

However, on the market demand side, higher costs of issuing *Sukūk* have arisen due to the significant portion which are held to maturity by investing institutions, thus creating a lack of liquidity that deters certain investors (i.e. the pricing of liquidity risk). One solution to this could be the introduction of retail *Sukūk* issuances that allow for a wider investor base, such as was witnessed in the Indonesian and Malaysian markets. This will also help to address the issue of excess liquidity with Islamic financial institutions.

1.4 Trends in the Development of *Takāful*

Takāful remains the smallest segment of the IFSI despite notable developments in recent years. There were an estimated 113 *Takāful* Operators in 2006, two-thirds of which are located in the GCC, Far East and Africa regions. The number increased to 195 as at end-2010 with new operators appearing in the GCC, the Levant and other jurisdictions.



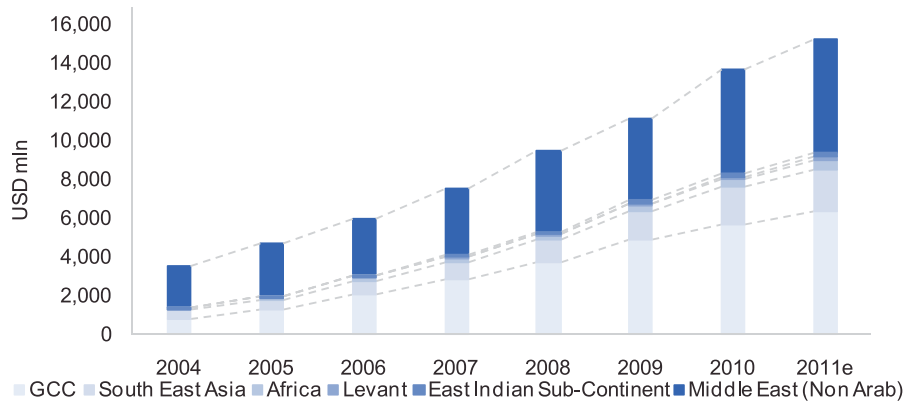
Source: *Takaful Re, KFHR*

Despite its relatively small market share as compared to its banking and capital market counterparts, the industry has witnessed growth since the first operator emerged in Sudan in 1979. In 2010, the global *Takāful* contributions reached USD8.3 billion. Although the actual to-date contribution is subject to uncertainty, the industry estimated the global total contribution to be at USD12 billion in 2012 with an average annual growth of 20%.⁷

Presently, the *Takāful* market is highly concentrated across countries such as Malaysia and the GCC states. However, there are a number of other jurisdictions, especially across Africa and Central Asia such as Nigeria, Gambia, Kazakhstan and Senegal, where there is growing interest in a *Sharī'ah*-compliant insurance model. In Asia, between 2008 and 2010 in South-East Asia and Bangladesh the industry showed a CAGR of 32.4% and 27.9%, respectively.

⁷ Ernst & Young *Takāful Report 2012*

Chart 1.4.2: *Takāful* Total Gross Contribution Trend



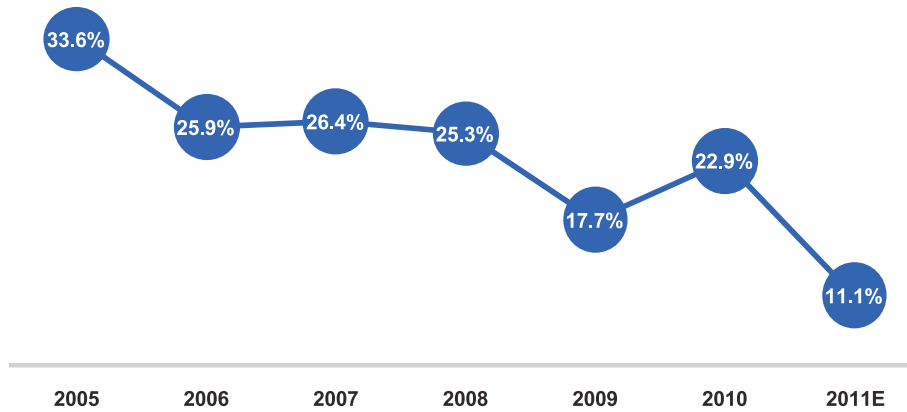
Source: *World Islamic Insurance Directory 2012*, central banks and regulatory authorities, individual institutions, KFHR

There are a number of drivers behind this growth, but the one that is increasingly important is the regulatory support through appropriate amendments in legislation to provide a level playing field with conventional insurance companies. Other factors fuelling the growth of *Takāful* worldwide are:

- (a) *Growing demand for Sharī'ah-compliant products.* Demand, rather than supply, is driving the development of *Takāful* products and services. Increasingly, existing Islamic banking customers are looking for an ever-broader range of Islamic financial instruments.
- (b) *Abundant liquidity.* The growth of the global *Takāful* industry is also related to the increasing liquidity of oil-producing nations. Sustained high oil prices over the years have contributed to the growing class of affluent individuals. This has encouraged this new class to give more thought to other aspects such as savings, investment and protection in the form of *Takāful* coverage.
- (c) *Growth of ReTakāful capacity.* International re-insurers have entered the *ReTakāful* business in several jurisdictions such as Malaysia, Bahrain and the Dubai International Financial Centre. At the moment there are approximately 30 *ReTakāful* Operators across the globe.
- (d) *A more efficient distribution channel of Takāful products.* The strategic cooperation between *Takāful* companies and other financial institutions such as the banks has helped to spread *Takāful* products at a faster rate. Banca*Takāful* products help *Takāful* companies to leverage the customer base of other financial institutions, thus increasing the *Takāful* penetration rate.
- (e) *Growth in other financing products such as housing financing,* which leads to an increase in housing *Takāful*.
- (f) *Introduction of micro-Takāful across the world to penetrate the poor sections of society.* Many *Takāful* Operators are starting to focus on developing simple and affordable products to provide coverage for the poor.

The impact of the global financial crisis on the *Takāful* sector appears to have been short-lived, with the industry's growth bouncing back to 22.9% in 2010 after decelerating to 17.7% in 2009, as shown in Chart 1.4.3. This is reflected by both the return on equity (ROE) as well as the return on investments.

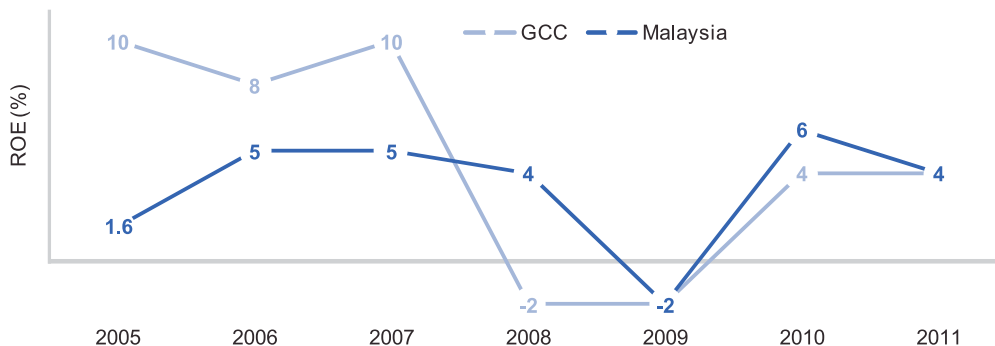
Chart 1.4.3: Global *Takāful* Contribution Growth



Source: World Islamic Insurance Directory 2012, central banks and regulatory authorities, individual institutions, KFHR

Chart 1.4.4 shows that the ROE ratio dropped to -2% for both GCC and Malaysian *Takāful* Operators in 2009, but returned to pre-crisis levels – 4% and 6%, respectively – in 2010.

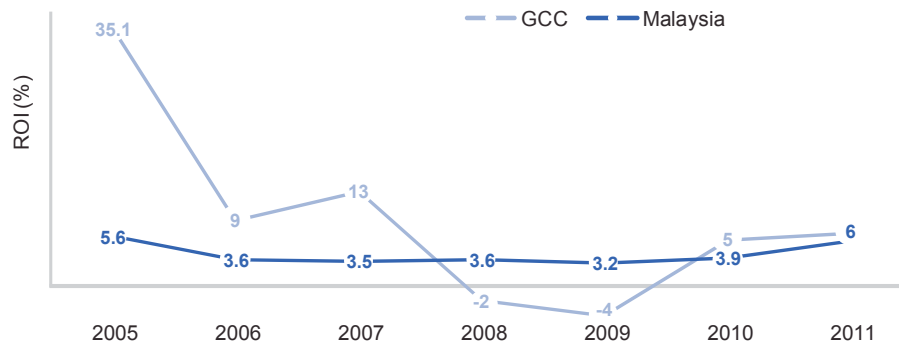
Chart 1.4.4: Average Return on Equity for a Sample of GCC and Malaysian *Takāful* Operators



Source: Ernst & Young, KFHR

Similarly, the return on investments for a sample of *Takāful* Operators showed strong resilience in Malaysia, whereas GCC *Takāful* Operators witnessed portfolio losses through 2008 and 2009 before returning to profitability in 2010.

Chart 1.4.5: Average Yield on Investments for a Sample of GCC and Malaysian *Takāful* Operators

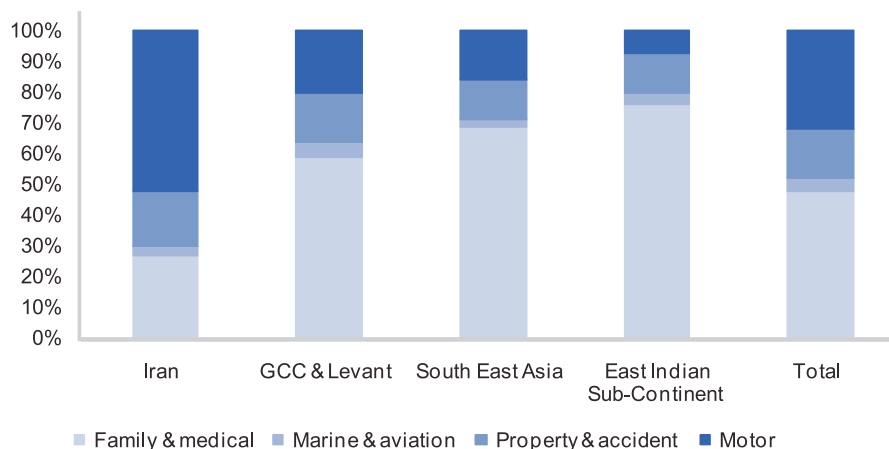


Source: Ernst & Young, KFHR

Independent studies and data providers have contributed to improved transparency by increasing the disclosure of *Takāful* contributions, supplemented by certain regulators who publish annual *Takāful* data. However, information relating to *Takāful* Operator assets and profitability remains scarce, and is mostly irregular wherever it is available. This is due mainly to the varying accounting policies in use around the world and minimal disclosure requirements. Nevertheless, selected data available for Malaysia and the GCC, two of the largest *Takāful* markets, indicate that *Takāful* Operators in these jurisdictions have performed relatively well in terms of profitability given the context of the financial crisis.

As shown in Chart 1.4.6, the contributions come mainly from the family and medical business segments, especially in the Asian region. The demand for General *Takāful* products, on the other hand, has also started to increase. These products, which more often than not require minimal modification of product features, cover risks which may go beyond the capacity of the individual *Takāful* Operators. With the increase in the number of *ReTakāful* Operators with sufficient capacity to accept risks from the *Takāful* Operators, the public is now acquiring wider access to the Islamic alternative to General Insurance.

Chart 1.4.6: Global Gross Contribution Income by Business (2010)



Source: Ernst & Young, KFHR

Outlook and Challenges

Growth of the industry comes with its own set of challenges as the market evolves. Whilst the demand side shows a significant expansion, the supply side faces continuing constraints. Issues regarding the solvency and risk management frameworks feature as key areas for attention by both market participants and regulators. In this context, the IFSB has joined the International Association of Insurance Supervisors (IAIS) in strengthening the supervisory framework to ensure that all the funds within the *Takāful* Operators' care are sufficient to absorb significant losses. This is reflected in IFSB-11: *Standard on Solvency Requirements for Takāful (Islamic Insurance) Undertakings* which was issued in December 2010, where a solvency framework is recommended to be adopted by *Takāful* Operators around the globe.

A specific issue for *Takāful* Operators is the governance framework in place to accommodate the different incentives and interests of its disparate stakeholders for its Shareholders Fund (SHF) as well as Participants' Risk Fund (PRF) / Participants' Investment Fund (PIF). A clear separation of responsibilities towards each fund requires careful consideration to avoid any conflict of interest. Strong governance mechanisms need to be in place, as a *Takāful* company has additional fiduciary responsibilities due to the unique relationship between the *Takāful* Operator and its participants. IFSB-8: *Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings*, issued in December 2009, provides a governance framework that serves as a reference for the design of governance structures in different jurisdictions.

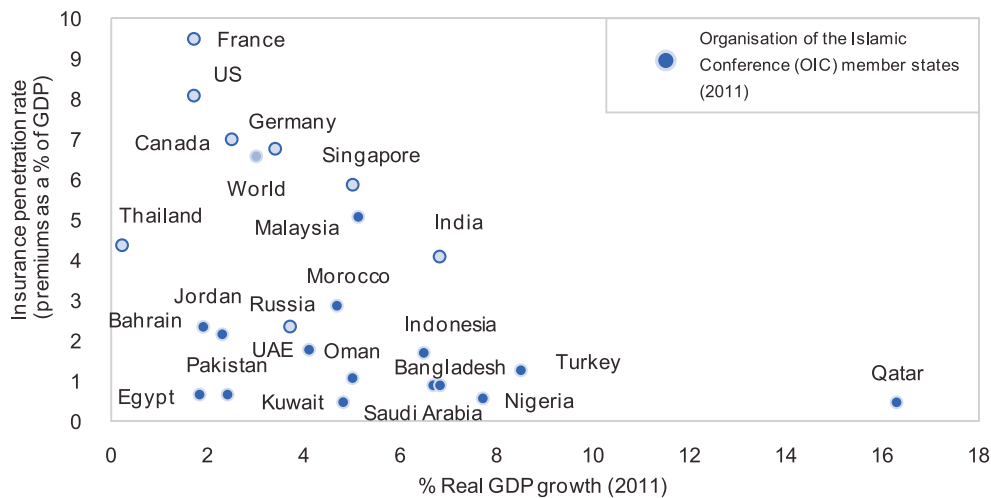
Another area of continuing debate is that of financial reporting of *Takāful* Operators, a debate that has intensified since the issuance of International Financial Reporting Standard 4 (IFRS-4) which controversially equates the *Takāful* undertaking model with the conventional insurance model. To some observers and participants there are no technical impediments to IFRS-4.⁸ However, stakeholders in the *Takāful* sector have raised concerns over issues relating to the definition of *Takāful* itself, the treatment of *Qard'*, as well as consolidation of both funds (SHF and PRF/PIF). This is an area which requires further careful deliberation by both *Takāful* Operators and supervisory authorities.

A further issue is that of the *Takāful* Operator ceding risk to conventional reinsurers. Under the concept of *Darūrah*, conventional reinsurance is permissible if there is limited recourse to *ReTakāful* Operators in the industry. With the increase in the numbers of *ReTakāful* Operators in recent years, however, there is a debate as to whether the *Darūrah* concept is still applicable. However, this may be premature, as the diversity of *Sharī'ah* approaches across jurisdictions continues to challenge those *Takāful* Operators who wish to conduct cross-border transactions. Some flexibility is still needed in invoking regulatory impediments relating to *Sharī'ah* interpretations of permissibility.

Despite the various challenges it faces, the *Takāful* industry is well placed to continue its remarkable growth given the growing awareness, development of investment-linked products and the low penetration rates in Muslim majority countries.

⁸ The Asian-Oceanic Standard Setters Group (AOSSG) Research Paper, "Financial Reporting Issues Relating to Islamic Finance", suggests that while they find no technical reason not to comply with IFRS, the *Sharī'ah* compliance side may require further scrutiny prior to agreeing to the standardisation of the financial reporting process for both institutions offering Islamic financial services and its conventional counterparts.

Chart 1.4.7: Insurance Penetration Rates and Real Gross Domestic Product (GDP) Growth of Selected Countries



Source: Swiss Re – Sigma No. 3 (2012), KFHR

1.5 Assessment of the Resilience of the Islamic Financial System: Technical Analysis of Selected Indicators of Islamic Banks

As at end-2011, based on the sample size of 50 Islamic banks from 11 countries, the Islamic banks generally posted healthy bottom lines albeit some on a declining trend. The decline was predominantly due to the provisions on investment and financing assets, given the effects of the global financial crisis. Also, the Islamic banking model, which is characterised by *Shari'ah*-compliant investment portfolios, lower leverage and adherence to *Shari'ah* principles that prohibit financing or investment in certain instruments, helped to contain the negative effects on Islamic banks' profitability.

On the whole, while capital adequacy and profitability have trended favourably despite weathering the financial crisis and the ensuing economic downturn, asset quality has deteriorated from the pre-crisis levels. Having said this, some jurisdictions in GCC are still contending with the effects of high provision on financing while managing the restructuring of financing portfolios on their balance sheets. Going forward, enhancing the overall external and internal aspects related to the financial stability of Islamic banks will require concerted efforts by both the banking community and the regulators in terms of the factors below (listed in no particular order):

- **Regulatory environment:** Further enhancement of the regulatory environment, which includes the regulatory framework and related legislation.
- **Infrastructure:** Development of ancillary areas – such as the *Shari'ah* Advisory Board, arbitral system and rating agency catering to Islamic finance.
- **Products and services:** Gauging the extent and evolution of the extensiveness of products and services offered, which is also a proxy for the level of demand from customers.
- **Ease of doing Islamic finance business:** Facilitating and providing initiatives by governments to accommodate the development of and to encourage Islamic finance business opportunities.
- **Statistics, marketing and education:** Driving initiatives and efforts to promote Islamic finance through marketing, education and reliability of collected data for study.

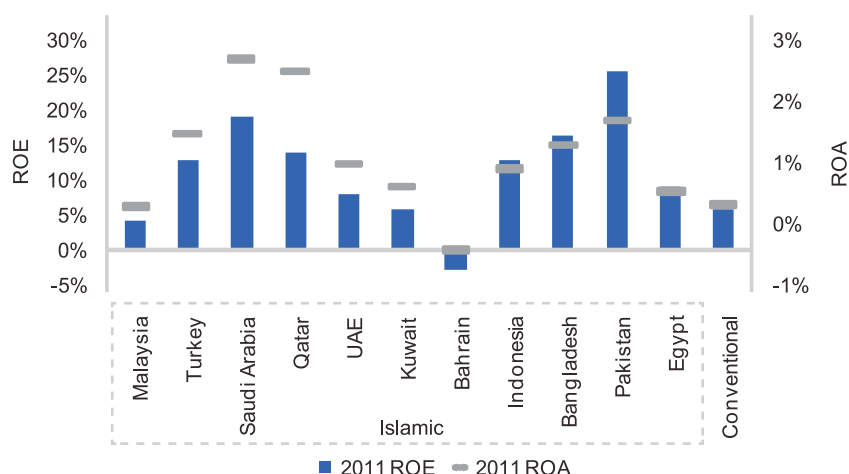
- *Risk management and audit:* Highlighting the importance and presence of a risk management framework for Islamic banks.

Based on the factors listed above, the Islamic banking industry should build sound defences in the form not just of regulatory support, but also in other areas which would put it on a more competitive footing against the conventional banking system and promote the financial stability of Islamic banking.

1.5.1 Profitability Performance of Islamic Banks

Pre-crisis, the profitability of Islamic banks was strong due to robust financing growth and investment activities. Profitability was subsequently impacted by both external and internal challenges, the results of the global financial crisis, and limitations in risk management capabilities. Islamic banks also suffered a decline in profitability due to high concentration risk in selected economic sectors (such as real estate in the GCC) as well as significant exposure to large single-customer accounts.

Chart 1.5.1.1: Profitability Performance of Islamic Banks (% , 2011)



Source: Islamic and conventional banking sample, KFHR

On a micro level, the larger Islamic banks were more profitable, as indicated by their ROE, than smaller Islamic banks,⁹ mainly due to the larger banks' broader diversification of financing and investing portfolios, the result of economies of scale, and stronger franchise value. Generally, Islamic banks contributed to financial and economic stability during the global financial crisis, given that their credit and asset growth was for the most part directed towards the consumer/retail sector, whereas corporates suffered the direct brunt of the global financial and economic crisis. Compared to the conventional banks on profitability, while the Islamic banks operate predominantly within their domestic markets, which were relatively less affected by the global crisis and hence were able to preserve profitability to an extent, global conventional banks were subject to deleveraging compounded by such factors as contracting economies in the crisis epicentre. Overall, the average ROE in 2011 recorded by the Islamic banks was 11.3% compared to the high of 17.9% in 2007.

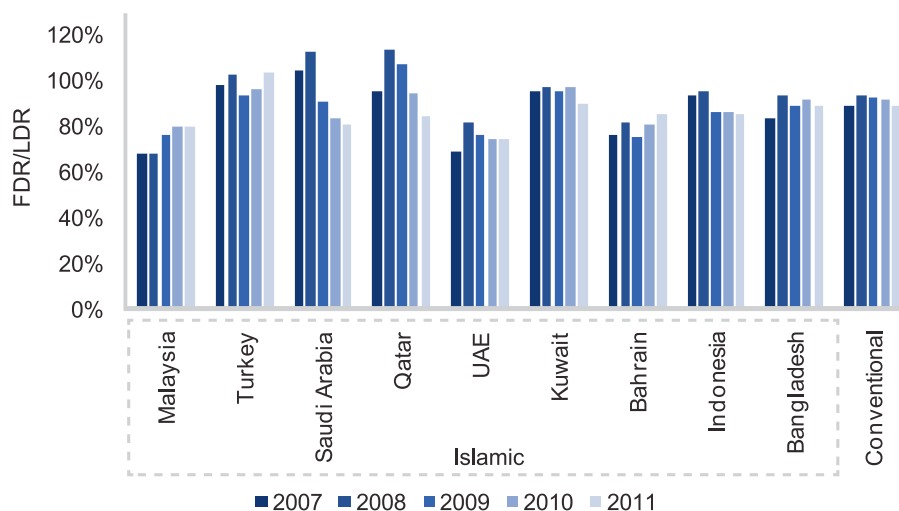
⁹ The smaller Islamic banks are referred to as such because of their size of total assets, business model and operations, and their relatively shorter operating history.

In view of their renewed growth following the global financial crisis, Islamic banks are expected to expand and grow their market shares. This growth, however, has to be supported by greater supervisory responsibility. Despite some countries displaying improved stability in profit generation, others might experience stagnation. This is due to the potential rise in the cost of funding, which could in turn suppress banks' margins. The moderation in trade finance from slower global economic activities, and declining trends in investment/merchant banking businesses and other operating income will have subsequent downside risks for fee and commission income.

1.5.2 Financing-to-Deposit Ratios in Islamic Banks

Referring to Chart 1.5.2.1, it can be observed that most of the sample countries' FDRs range between 80% and 100%, with the exception of two jurisdictions where it is more than 100%. This reflects high FDRs in the Islamic banks across jurisdictions compared to the conventional banks.¹⁰ Accordingly, the assessment of non-performing financing (NPF) is reflected in Chart 1.5.3.1. Islamic banks, especially in the GCC region, experienced high financing growth rates underpinned by robust economic and business activities. On the other hand, deposits growth was minimal, especially from the retail segment, as consumers resorted to spending during the economic boom.

Chart 1.5.2.1: Financing-to-Deposit Ratio of Islamic Banks



Source: Islamic and conventional banking sample, KFHR

Throughout the financial crisis, most Islamic banking jurisdictions suffered from substantial deceleration in financing growth, as economic and business activities slowed and large infrastructure projects were either delayed or cancelled. Subsequently, Islamic banks tightened their credit origination standards to limit their credit risk exposures, which caused financing growth to slow further. In contrast, total deposits of the Islamic banking sector increased quite significantly as consumers took precautionary measures to preserve wealth by increasing their savings. As shown in Chart 1.5.2.1, the average FDRs of Islamic banks eased to 83.1% in 2009 (2008: 89.8%) post global credit crisis. FDRs continued to moderate in 2011 to an average of 76% as concerns about the stability of the global

¹⁰ "Conventional banks" here refers to the top ten global conventional banks as listed in Appendix 1.

economy increased, which held financing activities in check.

The same decline in the loan-to-deposit ratio was apparent from the conventional banks. This is mainly due to the predicament in Europe, which led to the retreat of major European banks from some non-European markets, and especially the GCC. Further, conventional banks, as mentioned earlier, have somewhat managed their loan growth to control capital charges and sustain capital levels, in view of new regulatory requirements. However, going forward, financing activities in the GCC will stem from huge infrastructure projects instigated by the government to support economic growth, while Asia is concentrating on local consumption and export-related financing. In most jurisdictions, financing will be cautious, moderated by prevalent spill-over effects from developed economies.

The cost-to-income ratios of Islamic banks have generally increased, rising on average from 42.6% in 2007 to 51.3% in 2011. On the cost front, banking infrastructure spending weighed heavily, and included building/enlarging IT platforms, increasing distribution channels, enhancing and retaining the pool of skilled professionals, and reorganisation efforts to improve overall cost containment measures. These capital investments, while taking their toll on initial costs, should normalise in the long term once the capital investment gestation period ceases. It was also observed that a substantial portion of the rising costs comprised wages/salaries, which have inflated in line with the higher general price levels/inflation in some jurisdictions.

Chart 1.5.2.2: Cost-to-Income Ratio of Islamic Banks (2007 vs. 2011)



Source: Islamic banking sample, KFHR

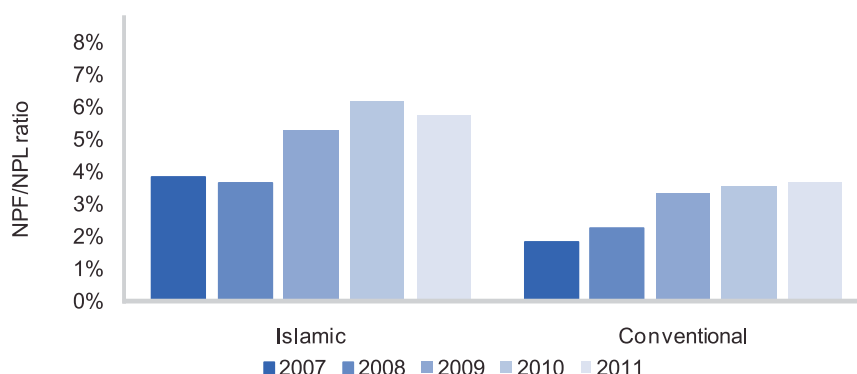
It was observed that the conventional banks, due to their geographical reach and size of operations, have recorded slightly higher cost-to-income, although this is expected given the size of their operations. Moving forward, Islamic banks have embarked on cost containment measures – that is, reducing administrative and general expenses – in an effort to bring down operating expenses and improve operational efficiency. Such measures are key to sustaining the bottom line of banks, given the increasingly competitive operating environment and volatile global economic conditions. While cost-to-income might not directly indicate overall financial stability, prudent cost management

supported by structured cost containment measures will contribute to sustained profit generation and increase overall profit accumulation, resulting in higher core capital build-up.

1.5.3 Non-Performing Financing in Islamic Banks

Chart 1.5.3.1 shows that the asset quality of Islamic banks was variable between 2007 and 2011, due to the challenging operating environment. On the other hand, Islamic banks' ability to manage and improve their asset quality is attributable to the robustness of their risk management and the types of NPF.

Chart 1.5.3.1: Non-Performing Financing/Loans to Total Financing/Loans



Source: Islamic and conventional banking sample, KFHR

In the GCC, active financing in real estate and investment companies was adversely impacted by the global financial crisis, which subsequently affected the asset quality of Islamic banks. NPF doubled between 2008 and 2009, and has since remained at high levels for certain countries within the GCC. As loan books stagnated in 2010 into 2011 for some markets in the GCC, the ratio of NPF to gross financing increased when problematic assets surfaced. While the asset quality of Islamic banks is on the path to recovery, some GCC countries are still contending with impairments accumulated during the 2008/2009 period.

Overall, Islamic banks in the GCC are expected to predominantly pursue financing in their domestic market to support economic expansion. Additionally, there is greater activity in GCC property markets, particularly in Dubai, Saudi Arabia and Abu Dhabi. While still below pre-financial crisis levels, this activity is expected to support the recovery of Islamic banks' balance sheets.

In Asia, meanwhile, asset quality has been manageable, although Islamic banks have had to grapple with delinquency issues emanating from corporate and retail financing defaults caused by the global economic downturn. However, in some jurisdictions, the banking sector's tight financing origination in response to the economic downturn has managed to address asset quality issues coupled with resilient financing growth pre- and post- the global financial crisis, contributing firmly to overall financial stability. Some Asian jurisdictions have also managed to chart a decline in NPF, though this could be due to the region's strong financing growth momentum and the unseasoned financing books (i.e. new

financing portfolios that are yet to experience asset quality deterioration).

While the GCC and Asian Islamic banks face different asset quality challenges, it is critical that Islamic banks enhance their risk management frameworks in order to manage delinquencies, particularly in the current volatile environment, and ensure financial stability within the market.

1.5.4 Capitalisation of Islamic Banks

After the global financial crisis, the BCBS introduced enhanced capital requirements as a part of Basel III, with reforms in a number of areas including, among others: (i) raising the quality of capital; (ii) requiring a higher regulatory capital base; (iii) enhancing the risk coverage of the capital framework; (iv) introducing a leverage ratio, which is supposed to serve as a backstop to the risk-based capital measures; (v) introducing a macro-prudential capital buffer to help contain systemic risks arising from procyclicality and from the interconnectedness of financial institutions; and (vi) recommending additional capital requirements for systemically important banks, both at the global and domestic level.

The IFSB issued its *Capital Adequacy Standard for IIFS* (IFSB-2) in December 2005. IFSB-2 addressed the specific structure and contents of the *Sharī'ah*-compliant products and services offered by the IIFS and provided detailed guidance on calculating capital adequacy requirements for IIFS offering these products and services. In subsequent years, the IFSB supplemented this standard with additional standards and publications in order to cover additional products and services offered by IIFS. These publications include: (i) GN-1: *Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on Sharī'ah-Compliant Financial Instruments*, March 2008; (ii) IFSB-7: *Capital Adequacy Requirements for Sukūk, Securitisations and Real Estate Investment*, January 2009; (iii) GN-2: *Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity Murābahah Transactions*, December 2010; (iv) GN-3: *Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders*, December 2010, and (v) GN-4: *Guidance Note in Connection with the IFSB Capital Adequacy Standard: The Determination of Alpha in the Capital Adequacy Ratio for IIFS*, March 2011.

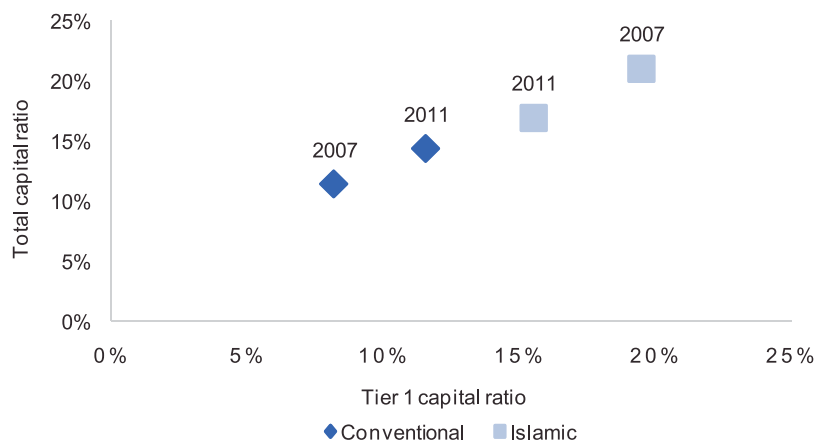
IFSB-2 and the other aforementioned publications were mainly based on Pillar 1 of Basel II, with the necessary modifications and adaptations to cater for the specificities and characteristics of the *Sharī'ah*-compliant products and services offered by the IIFS. Nevertheless, these publications did not provide detailed guidance on the various components of regulatory capital in IIFS and left it to the discretion of supervisory authorities to decide the criteria for various instruments to be included in the different capital tiers. Accordingly, to adopt at global level the developments discussed above, the IFSB issued its *Revised Capital Adequacy Standard* (ED-15) in November 2012 for public consultation. This standard is aimed at assisting the IIFS and their supervisory authorities in implementing a capital adequacy framework that will ensure effective coverage of their risk exposures and allocation of appropriate capital to cover these risks. In addition, the standard will provide guidance on the maintenance by IIFS of high-quality regulatory capital components that comply with *Sharī'ah* rules and principles. After incorporating the feedback during the public consultation process, the standard is expected to be issued at the end of 2013.

On capital positions, the capitalisation of Islamic banks is clearly divided into pre- and post-global financial crisis. Overall, Islamic banks' capitalisation is deemed to be sturdy. As Islamic banks operate on the tenets of *Shari'ah*, the quality of their capital has usually been better than that of conventional banks due to the former's reliance on common equity. The quantity of capital in many IIFS is also impacted by the higher capital adequacy ratio (CAR) requirements in many GCC countries. Being predominantly equity-based, the majority of Islamic banks' capital has been at an elevated level since there are minimal debts raised for capitalisation purposes. The average total CAR of a sample of Islamic banks as at end-2011 stood at 17%, while Tier 1 CAR was recorded at 15.5%. Although these levels were somewhat lower compared to the pre-financial crisis (2007) levels of 21% and 19.5%, respectively, it demonstrates that Islamic banks' capital is overwhelmingly denominated in common equity. This overcapitalisation in Islamic banks in the IFSB member countries is also reflected in Section 2.1.4, Table 2.1.4.2, "Comparison of Minimum vs. Actual Regulatory CAR".

Despite this, the financial crisis has taken its toll on capital positions, particularly in jurisdictions that were impacted by real estate/property development, leading to a substantial amount of financing impairment charges. However, even in these jurisdictions, CARs of Islamic banks strengthened post-2009 following government-supported recapitalisation and greater retentions of net income by these banks. The average regulatory Tier 1 and total capital ratios were maintained at levels above the regulatory requirements, which will eventually strengthen the ability of banks to absorb higher NPF moving forward. In addition, the Tier 1 ratios, as reflected in Table 2.1.4.3, "Comparison of Tier 1 Capital Requirements in Section 2.1.4", demonstrate the consistency.

Meanwhile, it is observed that there was a shift in capitalisation ratios for both the Islamic and conventional banks. Chart 1.5.4.1 shows that while the Islamic banks' capitalisation ratios remained higher than those of the conventional banks, they declined in 2011 from 2007 levels. On the other hand, conventional banks, due to the pressure to enhance capital buffers following the financial crisis, showed an increase in capitalisation ratios in 2011 compared to 2007.

Chart 1.5.4.1: Capitalisation of Islamic Banks (2007 vs. 2011)



Source: Islamic and conventional banking sample, KFHR

Overall, key capitalisation ratios have remained well above the regulatory levels. (Please also refer to Section 2.1.4 on the results of the ratios.) In addition, as noted above, Islamic banks were not adversely impacted by the first round of the global financial crisis to the extent experienced by their conventional counterparts. However, when the crisis turned into an economic crisis, Islamic banks were adversely affected, resulting in capital problems and, ultimately, the bankruptcy of some banks (e.g. Investment Dar and Arcapita Bank). While some Islamic banks still have high capital buffers and, hence, contribute to the financial stability of the banking sectors in which they operate, it is critical that Islamic banks continue to remain vigilant about their capital positions in order to remain well capitalised in a macroenvironment of continued uncertainty. Notwithstanding high capitalisation among the Islamic banks in many jurisdictions, their central banks are expected to require them to maintain appropriate additional capital buffers as recommended in the upcoming *Revised Capital Adequacy Standard* of the IFSB.

1.5.5 Rating Comparison as an Indicator of Stability and Resilience

Adding to the resilience discussion, Islamic banks' overall creditworthiness has been quite sound as indicated by their credit ratings. It is observed that conventional banks experienced more rating adjustments (mostly rating downgrades, with some negative outlooks) during 2008's global financial crisis compared to Islamic banks. Islamic banks' ratings are now on a par with those of conventional banks, and in some cases are rated higher (see Table 1.5.5.1).

Given the level of scrutiny that such institutions face as part of the rating process, the higher ratings reflect the sound fundamentals, credit strength, and prospects for growth in future business of Islamic banks relative to conventional banks. More importantly, the ratings highlight how Islamic banks have remained resilient throughout the challenging economic period.

2.0 ISLAMIC FINANCE AND THE CHANGING GLOBAL FINANCIAL ARCHITECTURE

Islamic finance is not an island, but an integral part of the global financial system. Except in those very few countries where conventional finance has been entirely replaced by Islamic finance, Islamic financial institutions share most of the legal and regulatory environment with their conventional counterparts. This does not mean that specificities of Islamic finance are irrelevant or can be ignored. Such specificities are essential for the identity and integrity of Islamic finance and need to be reflected in the legal and regulatory environment – be it through separate laws and regulations for Islamic financial institutions (segregated approach) or by amendments or interpretations of existing ones (integrated approach).

Global regulatory reforms are focusing on strengthening markets and financial institutions so that they are more sound and stable. Reforms are directed at addressing risk management weaknesses that led to the crisis, in particular in managing counterparty and liquidity risks, and systemic risk arising from interconnections between financial institutions. Private balance sheets are also under scrutiny in view of heightened concerns about excessive leveraging and maturity transformation.

Along with the new regulations, there is an increased recognition of the need for consistency in their cross-border adoption which has important implications for Islamic finance. A stronger role is envisaged for global standard-setting bodies, and greater coordination is expected of them with the IMF and related agencies.

2.1 Global Initiatives to Promote Financial Stability

Since the publication by the IFSB, IRTI and the IDB of the *Islamic Finance and Global Financial Stability Report* in 2010, the financial services industry has witnessed the introduction of further regulatory and supervisory reforms on the international level aimed at promoting global financial stability. A number of documents and initiatives in the area of financial stability have been published by international intergovernmental organisations such as the Financial Stability Board (FSB), the World Bank, and the IMF, as well as international standard-setting bodies such as the BCBS, the International Organisation of Securities Commissions (IOSCO), the IAIS and the International Accounting Standards Board (IASB).

The following sections highlight the most important initiatives undertaken by these organisations, as well as the potential impact on the IFSI.

2.1.1 Financial Stability Board

The FSB has published a number of regulatory reports on institutional and market infrastructure which include the derivatives market, resolution regimes for financial institutions, and deposit insurance systems. Summaries of these reports are provided in Table 2.1.1.1.

Table 2.1.1.1: Selected Regulatory Reforms Issued by the FSB since 2010

Title	Summary
OTC Derivatives Market Reforms (25 October 2010)	<ul style="list-style-type: none"> The crisis demonstrated the potential for contagion arising from the interconnectedness of over-the-counter (OTC) derivatives market participants and the limited transparency of counterparty relationships. The objective is to address weaknesses in OTC markets that had contributed to the build-up of systemic risk and to promote international consistency in implementation. The report includes 21 recommendations in relation to standardisation, central clearing, trading on exchanges or electronic trading platforms, reporting to trade repositories, and assessing progress and cooperating in OTC derivatives market reforms.
Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2011)	<ul style="list-style-type: none"> The report highlighted that any financial institution that could be systemically significant if it fails should be subject to a resolution regime. Having in place effective resolution regimes would allow authorities to resolve financial institutions in an orderly manner without taxpayer exposure to loss from solvency support, while maintaining continuity of their vital economic functions. Essential features that should be part of the resolution regimes of all jurisdictions include resolution authority and powers, legal framework conditions for cross-border cooperation, Crisis Management Groups, institution-specific cross-border cooperation agreements, resolvability assessments, and recovery and resolution planning.
Thematic Review on Deposit Insurance Systems (8 February 2012)	<ul style="list-style-type: none"> Events during the global financial crisis have illustrated the importance of having in place effective depositor compensation arrangements. The review was undertaken to take stock of FSB member jurisdictions' deposit insurance systems, and of any planned changes using the <i>Core Principles for Effective Deposit Insurance Systems</i> ("Core Principles")¹¹ as a benchmark. Recommendations include the adoption of an explicit deposit insurance system in order to maintain financial stability by protecting depositors and preventing bank runs, and full implementation of the Core Principles.

Source: IFSB

¹¹ Issued by the BCBS and the International Association of Deposit Insurers (IADI) in June 2009 to serve as a voluntary framework for effective deposit insurance practices.

Impact on the IFSI

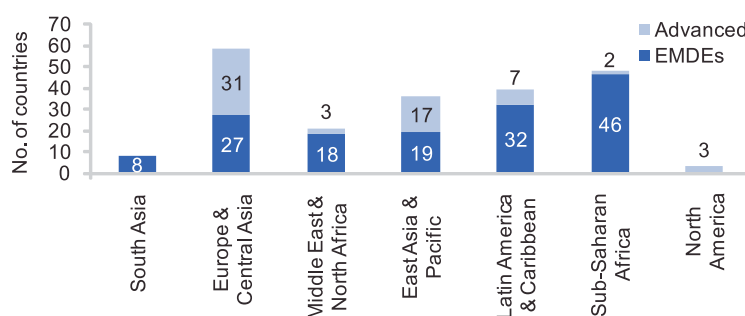
- (a) **OTC derivatives.** OTC derivatives benefit financial markets and the wider economy by improving the pricing of risk, adding to liquidity, and helping market participants manage their respective risks. Currently, IIFS have limited access to derivative products, given the requirement that the underlying assets in any transaction need to be tangible. However, there is a growing demand for hedging and *Shari'ah*-compliant products, such as profit rate swaps, to be utilised by IIFS for hedging purposes. Currently, there is a standard legal framework for OTC derivatives in the Islamic market, known as the ISDA/IIFM *Tahawwut* (Hedging) Master Agreement,¹² which is applicable across all jurisdictions where Islamic finance is practised. Nevertheless, given the potential contagion effect arising from the interconnectedness of OTC derivatives market participants, it is important for the IFSI to improve the transparency and regulatory oversight of OTC derivatives.
- (b) **Effective resolution regimes.** A number of IIFS in the GCC had experienced financial distress in terms of diminishing stocks and illiquid market arising from the global financial crisis, and were subsequently bailed out by the authorities. Although such assistance may not be at the expense of taxpayers' money, any IIFS that could be of systemic importance should be subject to a resolution regime which will allow authorities to resolve the institution in an orderly manner, taking into account the different national legal systems and market environments and sector-specific considerations. This would help to create a more credible and disciplined IFSI while at the same time providing incentives for market-based solutions, in particular given that the resolution of IIFS is an area that has received limited study to date.
- (c) **Deposit insurance systems.** For a number of reasons, such as the small size of Islamic deposits compared to total deposits in the overall financial system, many Islamic finance jurisdictions are still relying on the framework of conservative prudential regulations and proactive supervision. Such frameworks do not provide sufficient explicit protection to depositors and implicitly rely on government support in the event of bank failures, possibly at the expense of severe systemic disruption and exposing taxpayers to loss. In introducing a *Shari'ah*-compliant deposit insurance system for the IFSI, Islamic finance jurisdictions should also take into consideration factors that will help to enhance market discipline and to facilitate the adoption of an effective failure resolution regime for IIFS. (Please refer to Section 4.1.3 for a detailed discussion on deposit insurance.)

¹² Launched in March 2010 by the International Islamic Financial Market (IIFM) and the International Swaps and Derivatives Association, Inc. (ISDA).

2.1.2 Financial Stability Board, International Monetary Fund and the World Bank

As of October 2011, there were 150 emerging market and developing economies (EMDEs), as shown in Chart 2.1.2.1, with a diverse range of factors that have an impact on their respective financial systems, such as their economic size, development stage, and legal and institutional framework. Given their increasing role as engines of growth for the global economy, there is a need to safeguard the financial stability of these economies.

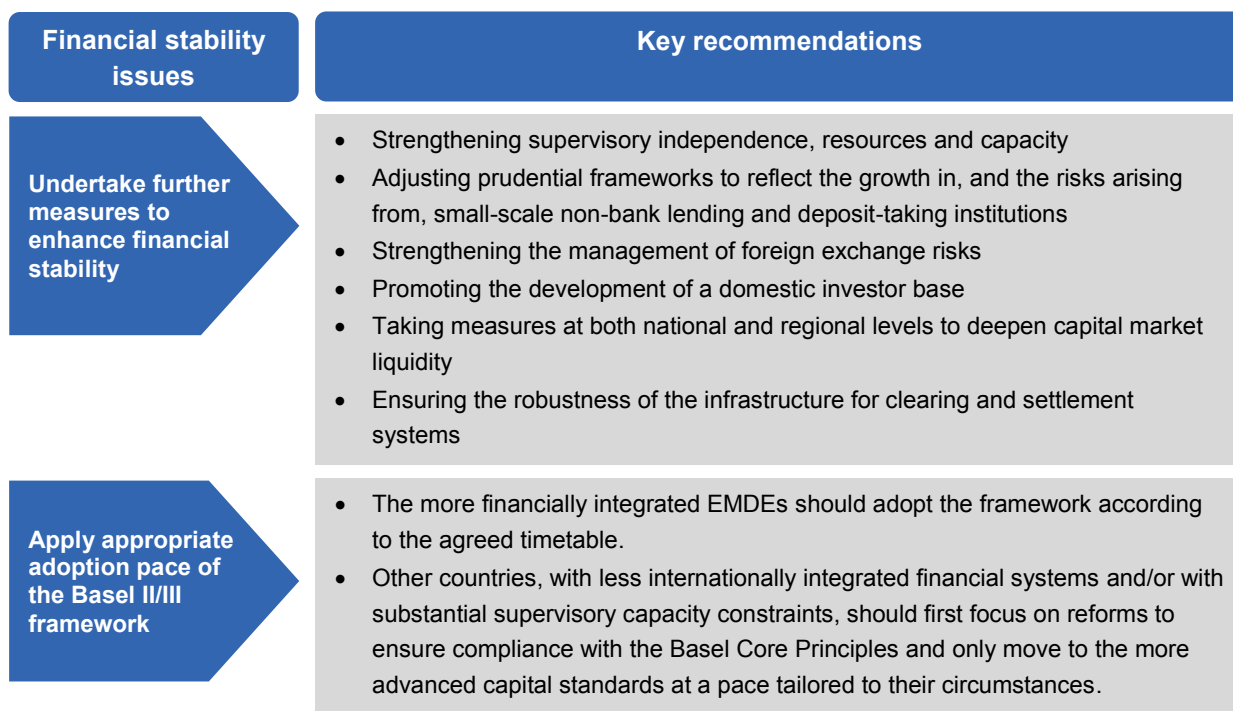
Chart 2.1.2.1: Advanced and Emerging Markets and Developing Economies (2011)



Source: The World Bank, FSB, IMF

In October 2011, the FSB, IMF and the World Bank published a report which focuses on five key financial stability issues in EMDEs, namely application of international financial standards, promotion of cross-border supervisory cooperation, expansion of the regulatory and supervisory perimeter, management of foreign exchange risks, and development of domestic capital markets. Diagram 2.1.2.1 summarises the key recommendations of the report.

Diagram 2.1.2.1: Financial Stability Issues and Summary of Key Recommendations for EMDEs



Develop supervisory capacity and strengthen supervisory authorities	<ul style="list-style-type: none"> To promote the development of supervisory capacity in EMDEs through targeted and well-coordinated technical assistance and other capacity-building activities. The BCBS, the IAIS and the IOSCO should take stock of the range of practices on resources and capacity – including on staffing and skill levels, training certification programmes, and financing options – and identify good practices to strengthen supervisory authorities in EMDEs.
Provide timely, accurate and comprehensive information	<ul style="list-style-type: none"> Home supervisors for large international banks should provide host supervisors with timely, accurate and comprehensive information on the parent bank via supervisory colleges and crisis management groups and/or via enhanced bilateral relationships.
Adopt multilateral arrangements	<ul style="list-style-type: none"> The IOSCO and IAIS should work with EMDEs to promote adoption of multilateral arrangements to facilitate cooperation and information exchange in the securities and insurance sectors.
Provide guidance and examine supervisory and prudential matters	<ul style="list-style-type: none"> The BCBS should provide guidance on: <ul style="list-style-type: none"> The application of new measures included in Basel III to EMDEs that do not intend to adopt the advanced approaches of Basel II The steps that EMDE supervisors can take to monitor and address the build-up of direct and indirect foreign exchange risks. The BCBS should also take stock of the range of practices on supervisory approaches, prudential regulations, and data reporting and disclosure requirements for small-scale non-bank lending and deposit-taking institutions.
Report of progress	<ul style="list-style-type: none"> The IMF and the World Bank should continue to assess the progress made by EMDEs in enhancing their financial stability frameworks.

Source: FSB, IMF and World Bank, *Financial Stability Issues in Emerging Market and Developing Economies*, October 2011

In essence, in designing new international financial standards and policies to address financial stability issues, international bodies need to take into account the following factors that characterise the financial industry in EMDEs:

- (a) **Wide diversity of financial systems.** To take into consideration the relative importance and cost-benefit trade-off of financial systems in EMDEs that differ widely across countries or for the same country over time.
- (b) **Underlying structural features.** To take into account the broader structural features of the economy in addressing the financial stability issue.
- (c) **Close link between financial stability and financial development.** To promote a well-sequenced financial development in EMDEs to support financial stability, and to ensure that the frameworks and financial sector policies keep up with market development to avoid creating new sources of financial instability.

Impact on the IFSI

Given that many Islamic finance jurisdictions are located in EMDEs, it is crucial for international organisations mandated for Islamic finance to take into account the distinct features and development of the IFSI in developing new standards and policies for the industry. In this regard, the IFSB recognises the different capacities and the different stages of market and institutional development amongst its members, and hence provides a platform for the affected jurisdictions to utilise its technical assistance in translating the IFSB Standards into practical rules, guidance notes and manuals for IIFS. The IFSB has been undertaking “Facilitating the Implementation of the IFSB Standards” (FIS) workshops for regulatory and supervisory authorities since November 2007, in addition to public workshops for IIFS.

2.1.3 Financial Stability Board and Basel Committee on Banking Supervision: Systematically Important Financial Institutions

Increasing the intensity and effectiveness of supervision is seen as key to reducing the moral hazard posed by systemically important financial institutions (SIFIs).¹³ A number of documents have been published by the FSB and BCBS, including, *inter alia*, the following:

- (a) *Intensity and Effectiveness of SIFI Supervision* (November 2010) report – proposing a number of recommendations for a more intense, effective and reliable supervision of financial institutions. The recommendations include supervisory mandates and powers, operational independence, resource allocation, improved techniques (including on stress tests), group-wide and consolidated supervision, continuous and comprehensive supervision, and supervisory colleges and home/host information sharing.
- (b) A consultative document on effective resolution of SIFIs (July 2011) which resulted in a comprehensive policy framework to address the systemic and moral hazard risks associated with SIFIs. This was followed by the issuance of a number of documents in relation to the subject, including *Key Attributes of Effective Resolution Regime for Financial Institutions* (November 2011), which sets out 12 essential features¹⁴ that should be part of the resolution regime of all jurisdictions.

In essence, the BCBS identified a five indicator-based measurement approach to classify and measure the systemic importance of banks and capture the potential impact of their distress or failure on the financial system. The five indicators are in terms of **bank size, interconnectedness, availability of substitutes for services the banks provide, global (cross-border) activity, and complexity**.

The FSB and BCBS have also identified an initial group of global SIFIs (G-SIFIs), namely 29 global systemically important banks (G-SIBs)¹⁵ that are expected to meet the resolution planning requirements by end-2012. The FSB and the standard-setting bodies are also extending the SIFI

¹³ According to the FSB, SIFIs are financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.

¹⁴ www.financialstabilityboard.org/publications/r_111104cc.pdf

¹⁵ The list will be updated annually, given that a financial institution can migrate in and out of the G-SIBs status over time, and between categories of relative systemic importance, depending on its performance.

framework to other systemically important financial institutions, namely domestic systemically important banks (D-SIBs), global systemically important insurers (G-SIIs), and systemically important non-bank non-insurance financial institutions.

On 11 October 2012, the FSB and the BCBS published a framework for identifying and dealing with D-SIBs.¹⁶ The objective of the framework is to reduce the probability of D-SIB failure associated with the local presence of a national or international bank in a given jurisdiction. The framework, which can be applied to both consolidated groups and to branches within a host jurisdiction, can be divided into two broad categories, namely: (i) the assessment methodology for D-SIBs; and (ii) higher loss absorbency requirements for D-SIBs. Details of these two categories are provided in Diagram 2.1.3.1. National authorities are expected to apply the requirements to banks identified as D-SIBs with effect from January 2016, in line with the phase-in arrangements for the G-SIFI framework.

Diagram 2.1.3.1: Framework for D-SIBs

1. The assessment methodology for D-SIBs

- Assessment methodologies should be public and clearly articulated with a focus on the impact D-SIB failure would have on both the domestic financial system and the domestic economy.
- In determining systemic importance:
 - Home authorities should consider banks from a (globally) consolidated perspective.
 - Host authorities should assess foreign subsidiaries in their jurisdictions on a consolidated basis which includes any downstream subsidiaries, some of which may be in other jurisdictions.
- Annual assessments of the systemic importance of domestic banks should be conducted by reference to bank-specific factors, namely:
 - Size;
 - Interconnectedness;
 - Substitutability/financial institution infrastructure; and
 - Complexity.

National authorities can also consider other factors that would inform the above list, such as the size of a bank relative to domestic GDP.

2. Higher loss absorbency requirements for D-SIBs

- From January 2016, any institution identified as a D-SIB will be subject to a higher loss absorbency requirement, which must be met fully by Common Equity Tier 1 through an extension of the Basel III capital conservation buffer.
- Banks that are both D-SIBs and G-SIFIs should be subject to the higher loss absorbency requirement, but double counting should be avoided. Specific higher loss absorbency requirements should be commensurate with the D-SIB's degree of systemic importance and could be affected by:
 - The resolution regimes (including recovery and resolution plans) in and between jurisdictions; and
 - Available resolution strategies and any specific resolution plan in place for the firm.

Source: FSB, BCBS

¹⁶ Just as additional requirements have been proposed by the BCBS in October 2012 for G-SIBs due to their cross-border negative externalities on the global financial system and economy, there are many banks that are not significant from an international perspective, but could have an important impact on their domestic financial system and economy compared to non-systemic institutions. Similarly, some of these banks may have cross-border externalities, even if the effects are not global in nature.

In November 2012, the FSB published a progress report on resolution of SIFIs which highlights the development of an assessment methodology for the key attributes to serve as guidance for jurisdictions and as a tool for the conduct of assessments in the context of peer reviews within the FSB framework for implementation monitoring or IMF and World Bank assessments of resolution regimes.¹⁷ The FSB plans to publish the draft of the methodology for public consultation in the second half of 2013.

Impact on the IFSI

Currently, none of the IIFS fall under the G-SIBs category due to their criteria and methodology. However, there is a possibility that D-SIBs application would be relevant in the context of IIFS in various jurisdictions. The scope and assessment of the implications need to be undertaken on a case-by-case basis by the respective RSAs, taking into consideration the relevance and applicability of the D-SIBs methodology.

It has been noted from the global financial crisis (2008) that Islamic banks were largely shielded from the first round of the crisis, given their specific characteristics. However, they were impacted by the second-round effects, in which adverse developments in the real sector had a negative impact on business activities and performance. In this respect, Islamic banks with cross-border activities could potentially pose systemic and potential contagion risks resulting in home-host supervisory challenges. Hence, in line with the FSB's policy measures for SIFI and G-SIBs, RSAs of the IFSI should also start to increase the intensity and effectiveness of supervision so as to reduce, if not prevent, the systemic and potential contagion risks posed by these Islamic banks.

The BCBS proposal on D-SIBs has, however, been less prescriptive than that proposed for G-SIFIs because of the scope of application. As such, it is based on the assessment conducted by the local supervisory authorities, which will evaluate the impact of failure on the local financial system and the domestic economy. Consequently, an appropriate degree of national discretion has been recommended in the proposed framework in order to accommodate structural characteristics of the domestic financial system. The RSAs should take into consideration the fact that Islamic banks could pose a more serious threat of a bank-run as compared to conventional banks in certain cases, given the risk of losses for investment account holders under *Muḍārabah* and where the deposits are also based on *Murābahah*-type contracts.

Given that many IIFS in various regions have become significant players in their domestic markets and may be considered as D-SIBs in their respective jurisdictions, a review of the D-SIBs framework is currently being undertaken by the IFSB and the relevant guidance will be reflected in the revised IFSB-2, which has undergone public consultation as an Exposure Draft (ED) on the *Revised Capital Adequacy Standard for IIFS* (ED-15).

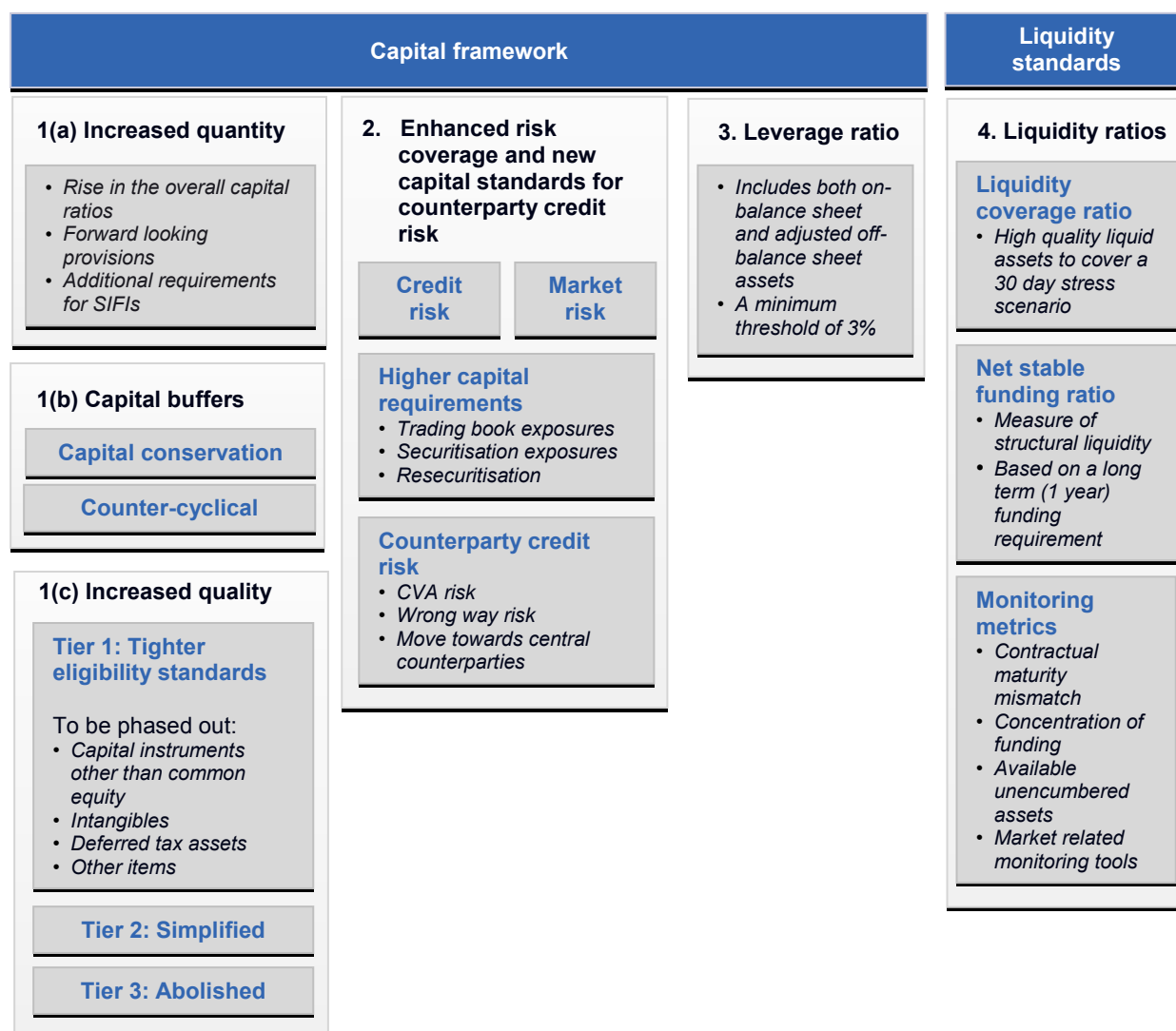
The RSAs can also utilise other relevant and applicable IFSB standards in dealing with D-SIBs (e.g. IFSB-3: *Guiding Principles on Corporate Governance* and IFSB-5: *Guidance on Key Elements in the Supervisory Review Process*).

¹⁷ www.financialstabilityboard.org/publications/r_121031aa.pdf.

2.1.4 Basel Committee on Banking Supervision

In 2012, the BCBS finalised a new Accord, Basel III, which comprised a capital and liquidity framework. Basel III aims to strengthen the global capital and liquidity rules by raising the quality and quantity of the regulatory capital base, enhancing risk coverage, supplementing the risk-based capital requirement with a leverage ratio, reducing pro-cyclicality by introducing counter-cyclical and capital conservation buffers, and addressing systemic risk and interconnectedness. The measures are expected to help enhance the banking sector's ability to absorb shocks arising from financial and economic stress and reduce the risk of spill-over from the financial sector to the real economy, hence supporting economic growth over the cycle. Diagram 2.1.4.1 illustrates an overview of the Basel III Framework.

Diagram 2.1.4.1: An Overview of Basel III Framework



Source: BCBS

(a) Capital Framework

As indicated in Diagram 2.1.4.1, the BCBS has substantially raised the quality, quantity, consistency and transparency of the capital base so that banks are better able to absorb losses both as a going concern and at the point of non-viability, with a much greater focus on common equity to absorb losses. The Basel III requirements will be implemented from the beginning of 2013 and will be progressively phased in by 2019, as shown in Table 2.1.4.1. In addition to the ratios, Basel III also introduced two forms of capital buffers: (i) a capital conservation buffer of 2.5% to provide comfort to the banks during periods of stress or crisis; and (ii) a counter-cyclical capital buffer which would allow regulatory authorities to require up to another 2.5% of capital during periods of high credit growth.

Table 2.1.4.1: Basel III: Increased Capital Requirements

	2011	2012	2013	2014	2015	2016	2017	2018	2019
	%								
Minimum Common Equity Capital Ratio	2.0	2.0	3.5	4.0	4.5	4.5	4.5	4.5	4.5
Capital Conservation Buffer	0.0	0.0	0.0	0.0	0.0	0.625	1.25	1.875	2.5
Minimum Common Equity plus Capital Conservation Buffer	2.0	2.0	3.5	4.0	4.5	5.125	5.75	6.375	7.0
Minimum Tier 1 Capital	4.0	4.0	4.5	5.5	6.0	6.0	6.0	6.0	6.0
Minimum Total Capital	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0
Minimum Total Capital plus Conservation Buffer	8.0	8.0	8.0	8.0	8.0	8.625	9.25	9.875	10.5

Source: BCBS

Furthermore, to address systemic risk and interconnectedness, Basel III has also introduced a new leverage ratio to supplement the risk-based measures of regulatory capital. The ratio will be used to reduce the build-up of excessive leverage in a financial institution as well as the financial system. Regulatory reporting for the new leverage ratio has commenced from January 2013, and the ratio will become effective from January 2018.

Impact on the IFSI

In general, IIFS have always been well-capitalised, as reflected in a survey undertaken by the IFSB in 2012. From the sample of 25 RSAs, it appears that the minimum capital adequacy ratio among the RSAs during 2008-2011 varied from 8% to 12% for both IIFS and conventional banks (Table 2.1.4.2). However, a majority of the RSAs require more than 8% CAR in their respective jurisdictions.

On the other hand, the actual CAR exceeded the minimum requirement in the majority of the jurisdictions in question. In 2011, the actual CAR for IIFS ranged from 10.72% to 28.01% vs. 11.46% to 20.79% for conventional banks, which suggested that IIFS are strongly capitalised within the banking system.

Table 2.1.4.2: Comparison of Minimum vs. Actual Regulatory CAR

RSA	2011						2010						2009						2008					
	IIFS			Conventional bank			IIFS			Conventional bank			IIFS			Conventional bank			IIFS			Conventional bank		
	Minimum CAR (%)	Actual (%)	Minimum CAR (%)	Minimum CAR (%)	Actual (%)	Actual (%)	Minimum CAR (%)	Actual (%)	Minimum CAR (%)	Minimum CAR (%)	Actual (%)	Actual (%)	Minimum CAR (%)	Actual (%)	Minimum CAR (%)	Minimum CAR (%)	Actual (%)	Actual (%)	Minimum CAR (%)	Actual (%)	Minimum CAR (%)	Actual (%)		
1	10.00	10.72	10.00	10.00	11.46	9.07	9.00	9.07	9.00	9.00	9.35	8.19	10.00	7.15	10.00	10.00	10.00	8.19	10.00	10.00	10.00			
2	10.00	17.95	10.00	10.00	15.95	16.75	10.00	10.00	10.00	10.00	15.48	14.91	10.00	19.03	10.00	10.00	10.00	14.91	10.00	20.28	10.00	13.00		
3	8.00	16.63	8.00	8.00	16.05	16.25	8.00	8.00	8.00	8.00	17.18	17.42	8.00	10.77	8.00	8.00	8.00	17.42	8.00	12.81	8.00	16.76		
4	12.00		12.00	12.00			12.00	12.00	12.00	12.00			10.00		10.00	10.00	10.00		10.00		10.00			
5	12.00	28.01	12.00	12.00	18.58	30.16	12.00	12.00	12.00	12.00	19.50	20.04	12.00	16.14	12.00	12.00	20.04	15.54	12.00	15.54	12.00	18.66		
6	10.00	24.50	10.00	10.00	19.80	26.60	10.00	10.00	10.00	10.00	21.50	12.70	10.00	25.10	10.00	10.00	12.70		10.00		10.00			
7	10.00	14.10	10.00	10.00	15.50	13.90	10.00	10.00	10.00	10.00	16.30	15.10	10.00	15.60	10.00	10.00	15.10	17.20	10.00	17.20	10.00	14.60		
8	12.00		12.00	12.00			12.00	12.00	12.00	12.00			12.00		12.00	12.00	12.00		12.00		12.00			
9	8.00	13.50	8.00	8.00	14.70	14.50	8.00	8.00	8.00	8.00	12.40	14.20	8.00	14.70	8.00	8.00	14.20	13.30	8.00	13.30	8.00	12.00		
10	8.00						8.00						8.00		8.00				8.00					
11	8.00		8.00	8.00	11.64		8.00	8.00	8.00	8.00	13.42	13.72	8.00		8.00	8.00	13.72		8.00		8.00	12.21		
12	10.00	20.15	10.00	10.00	20.79	17.05	10.00	10.00	10.00	10.00	15.77	15.94	10.00	16.34	10.00	10.00	15.94	20.76	10.00	20.76	10.00	14.02		
13	10.00		10.00	10.00	17.79		10.00	10.00	10.00	10.00	4.03	3.65	10.00		10.00	10.00	3.65		10.00		10.00	21.91		
14	12.00		12.00	12.00																				
15	12.00	26.91	12.00	12.00	20.64	26.64	12.00	12.00	12.00	12.00	21.01	19.68	12.00	26.01	12.00	12.00	19.68	18.99	12.00	18.99	12.00	19.25		
16	10.00		10.00	10.00			10.00	10.00	10.00	10.00			10.00		10.00	10.00			10.00		10.00			
17	8.00	14.04	8.00	8.00	16.55	15.07	8.00	8.00	8.00	8.00	18.97	20.62	8.00	15.27	8.00	8.00	20.62	15.21	8.00	15.21	8.00	17.99		
18	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00		
19			8.00	8.00	15.80				8.00	8.00	15.80	16.80				8.00	16.80				8.00	14.70		
20			10.00	10.00	11.70				10.00	10.00	12.30	11.80				10.00	11.80				10.00	11.20		
21			4.00	4.00	17.95				4.00	4.00	17.33	15.82				4.00	15.82				4.00	12.42		
22	12.00		12.00	12.00			12.00	12.00	12.00	12.00			12.00		12.00	12.00			12.00		12.00			
23	12.00	16.79	12.00	12.00	20.00	17.01	12.00	12.00	12.00	12.00	20.58	17.01	12.00	16.20	12.00	12.00	17.01	21.84	12.00	21.84	12.00	13.56		
24	8.00		8.00	8.00			8.00	8.00	8.00	8.00			8.00		8.00	8.00			8.00		8.00			
25	8.00		8.00	8.00			8.00	8.00	8.00	8.00			8.00		8.00	8.00			8.00		8.00			

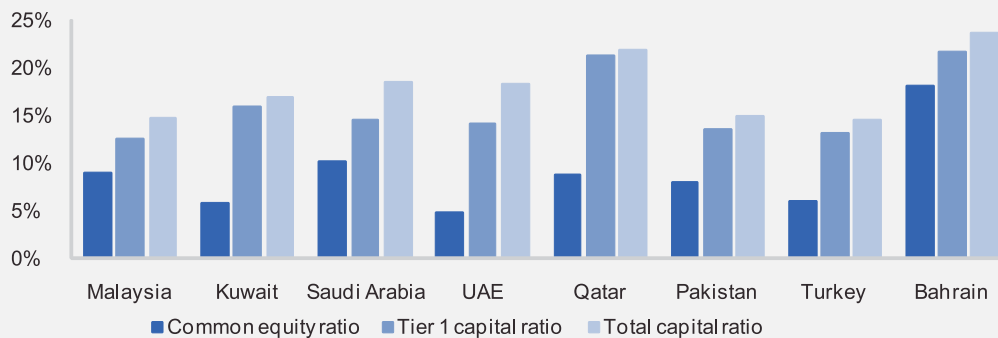
Source: IFSB Survey (2012)

Responses received from 21 RSAs show that the regulatory requirement for Tier 1 capital ranged from 4% to 10% for both IIFS and conventional banks during the same period (Table 2.1.4.3). In some cases, the regulatory requirements for Tier 1 capital are found to be higher, which indicates the robust capital base within the banking system.

Table 2.1.4.3: Comparison of Tier 1 Capital Requirements

RSA	2011		2010		2009		2008	
	IIFS (%)	Conventional banks (%)	IIFS (%)	Conventional banks (%)	IIFS (%)	Conventional banks (%)	IIFS (%)	Conventional banks (%)
1	5.00							
2	At least 50% of the total CAR	At least 50% of the total CAR	At least 50% of the total CAR	At least 50% of the total CAR	At least 50% of the total CAR	At least 50% of the total CAR	At least 50% of the total CAR	At least 50% of the total CAR
3		5.00		5.00		5.00		5.00
4	8.00	8.00	8.00	8.00	7.00	7.00	6.00	6.00
5	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
6	5.00	5.00	5.00	5.00	5.00	5.00	5.00	5.00
7	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
8	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
9	4.00		4.00		4.00		4.00	
10	20.00	19.92	16.92	14.38	16.34	14.55	20.69	13.64
11	6.00	6.00						
12	8.00	8.00	8.00	8.00	8.00	8.00	4.00	4.00
13	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
14	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
15	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00
16		12.40		12.20		12.90		11.00
17		9.60		9.70		9.20		9.50
18	6.00	6.00	6.00	6.00		6.00		6.00
19	16.95	18.28	17.50	18.68	16.76	14.90	22.40	11.87
20	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00
21	4.00	4.00	4.00	4.00	4.00	4.00	4.00	4.00

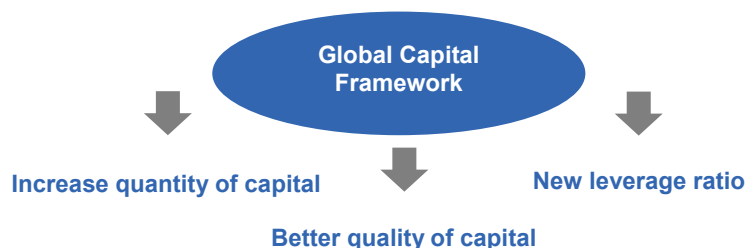
Source: IFSB Survey (2012)

**Chart 2.1.4.1: Capitalisation Ratios of Selected Islamic banks by Country against Basel III
(as at end-2011)**

Source: Banks' annual reports, KFHR

The increase in banks' capital quality, consistency and transparency will affect IIFS only at the margin (if at all) as the hybrid and Tier 3 capital do not play a significant role in the IIFS' capital structures. The principal impact of the enhancement to capital is to change the demographic of debt-based capital to one of equity. Nevertheless, areas that require attention include IIFS's response to the stringent criteria of Basel III. For example, in raising Tier 2 capital, IIFS will face an issue of meeting *Shar'ah* requirements for instruments that can be considered as capital, such as subordinated debt, hybrid capital, convertible contingent capital and *Sukūk*. The IFSB's ED-15 is expected to provide comprehensive guidance to RSAs and IIFS on the application of the capital adequacy framework.

IIFS share a number of similarities with conventional banks with respect to risk management, such as the treatment of market risk, profit rate risk and credit risk. However, since IIFS' debt to total assets should not exceed 33%, this suggests a lower risk profile for IIFS. Nevertheless, differences in the nature of contracts have subjected IIFS to unique and distinct risks such as *Shar'ah* non-compliance risk, fiduciary risk, rate of return risk and asset price risk. These unique risks of IIFS need to be taken into consideration when assessing the impact of the standard on IIFS (see Diagram 2.1.4.2).

Diagram 2.1.4.2: Basel III: Impact of the Global Capital Framework on IIFS**Current Scenario**

- Basel III approaches to enhance the quality of capital. The enhancement changes the demographic of debt-based capital to one of equity. IIFS already have a higher proportion of equity as capital.
- Basel III covers buffer capital ratios introduced via the Capital Conservation Buffer and Counter Cyclical Capital Buffer. The IIFS have introduced Investment Risk Reserve and Profit Equalisation Reserve.

Capital Impact

- Require IIFS to hold much more of the best form of capital while some of the existing capital will cease to count.
- Deductions from capital will increasingly be made from core Tier 1.
- Dividends and bonuses will be constrained to boost core Tier 1.
- IIFS will have to hold purer liquidity in a larger amount and match closely between their lending and deposit base.
- A large part of the IIFS' profits over the next decade will go into the new standing funds.

Leverage Ratio

- PSIA cannot be included in additional Tier 1 capital because they do not meet the criteria set out by Basel III.
- Assets financed by the PSIA's are excluded from the exposure measure because the PSIA's are not included in the Tier 1 capital.
- Generally, IIFS are not highly leveraged due to the strict prohibition of 33% debt-to-equity ratio.
- In summary, no noticeable impact on IIFS positions.

Source: IFSB ED-15

(b) Liquidity Management

Given that insufficient liquidity can be an independent source of risk even for banks that have remained solvent, Basel III has developed two minimum standards for funding liquidity to provide banks more breathing space in times of financial market stress – the Liquidity Coverage Ratio and Net Stable Funding Ratio. These ratios have been the subject of some controversy, leading to changes in the original proposals and to a gradual phasing in of the requirements.

Impact on the IFSI

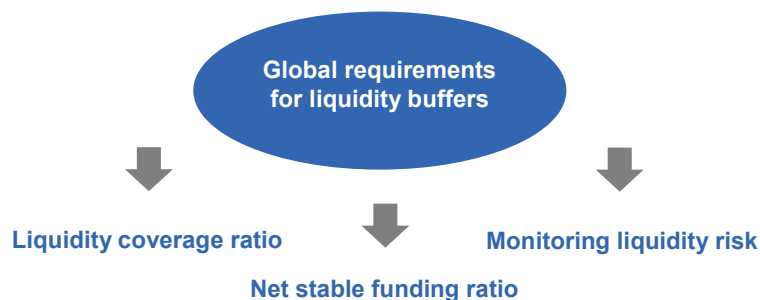
The introduction of the new leverage ratio is not expected to have a major impact on IIFS as they are usually not excessively leveraged due to the strict requirement that their debt-to-equity ratio should not exceed 33% for the business to be considered *Sharī'ah*-compliant. However, liquidity is an area where Islamic banks are likely to be impacted, principally due to the lack of liquid *Sharī'ah*-compliant instruments that can meet Basel III's stringent requirements, such as an active and sizeable market, the presence of committed market makers, low market concentration, and flight to quality. The IFSI also face a shortage of Level 1 assets in most jurisdictions, while *Sukūk* issued in jurisdictions which have a sovereign rating lower than AA- will be unable to meet the requirements for Level 2 assets.¹⁸ Diagram 2.1.4.3 summarises the impact of global requirements for liquidity buffers on IIFS. Section 3.1 of this report provides a detailed discussion on the subject of liquidity management in the IFSI.

The new liquidity rules will also indirectly support the change in the pricing of banking products and the rationalisation of product features, mainly due to banks moving towards rewarding products that generate liquidity benefits (e.g. long-term retail liabilities) against products that consume liquidity (e.g. long-dated corporate financing). Positively, Islamic banks would have to intensify and diversify their product offerings, supported by innovative product development to package more liquidity-friendly products that have longer-term features. Indirectly, this could also partially address the asset liability mismatch of Islamic banks. However, these could indirectly lead to concentration risk to a particular set of products, and place additional pressure on banks' margins and hence financing rates in a period of rising borrowing costs.

For the RSAs of the IFSI, the challenge is to intensify their efforts to review the structure and tenure of current Islamic funding sources to achieve a more stable funding base for Islamic banks. To assist the RSAs, the IFSB is developing a Guidance Note on quantitative measures for liquidity risk management in IIFS, which is expected to be issued in 2014.

¹⁸ Despite the challenges posed, various options are available for the application of the liquidity framework to IIFS. Basel III has suggested a few alternative treatments in jurisdictions where sufficient liquid assets are not available, such as the provision of contractual committed liquidity facilities, with a fee, by central banks, and the utilisation of additional Level 2 assets with a higher haircut when Level 1 assets are not available in sufficient volume.

Diagram 2.1.4.3: Basel III: Impact of Global Requirements for Liquidity Buffers on IIFS

**Current scenario**

- Liquidity has been a major issue in Islamic finance due to the nature of Islamic financial instruments and contracts which tend to be short to medium term given the lack of depth in the long-term liquidity market.
- Challenges also include: (a) lack of appropriate standardised liquidity instruments, (b) limited capability to transfer funds across borders, and (c) reliance on retail funding which locks the IIFS to domestic markets.

Liquidity requirement impact

- Highly rated *Sukūk* are considered to meet the stock liquidity requirements.
- The need to maintain a stock of assets that can be turned into cash requires the industry stakeholders to collaborate with one another.
- Treatment of PSIA and other sources of funds with respect to the run-off in the calculation of liquidity ratio.
- The role of rating agencies in determining *Sukūk* rating.

Source: IFSB Survey (2011)

With regard to the three aspects of Basel III above, one key question would be how are the IIFS coping with the timeliness of the implementation and subsequent integration of Basel III into their operations? Apart from this, what would be the cost impact on Islamic banks? Another area to consider is that executing most of the new Basel III requirements would require a considerable amount of timely generated data for risk management. As most IFIs are still assimilating themselves to the previous Basel requirements, it is perceived that full compliance with the new requirements would be a considerably challenging task and one that would involve substantial costs.

2.1.5 International Organisation of Securities Commissions

The global financial crisis highlighted a number of issues with securitisation, such as an over-reliance on ratings, lack of due diligence by investors, inadequate pricing of risk, and lack of motivation by originators and sponsors to undertake rigorous underwriting of credits that could actually form the underlying pool of assets. In July 2011, the Joint Forum, which consists of IOSCO, BCBS and IAIS, published a report on asset securitisation incentives, which, *inter alia*, encourages the following:

- (a) **Improved transparency by market participants** to ensure that investors, other market participants, and supervisors have access to relevant and reliable information.

- (b) **Greater document standardisation and less product complexity** to help reduce information asymmetries and stimulate liquidity in secondary markets.
- (c) Authorities to strive for **consistency across global markets and sectors**, taking into consideration local market circumstances, business models and legal systems.

In June 2012, as part of its work to strengthen the oversight and regulation of the shadow banking system, IOSCO released a consultation report on global developments in securitisation regulation which focuses on the role of cross-border issuance in deepening the markets and supporting growth in the real economy. The report, which aims to achieve greater harmonisation of the regulatory approach, delves into the areas of global regulatory and industry initiatives on risk retention, transparency and disclosure standardisation, and material differences in regulatory and industry approaches and their impact.

During the same month, the IOSCO also published a report on the development and regulation of institutional investors in emerging markets. Key recommendations for regulators include periodic review of the regulatory framework and coverage, combining deregulation with enhanced supervision and enforcement, and improving coordination with other regulatory bodies to monitor, mitigate and manage systemic risk.

Impact on the IFSI

Cross-border *Sukūk* issuances will have an impact on the IFSI in two areas, namely the development of innovative *Sharī'ah*-compliant products that are acceptable across Islamic finance jurisdictions, and robust and standardised regulatory frameworks with strong legal backing to protect customers/investors and ensure the sustainability of the industry. This gives rise to the question of how well regulated and prepared is the IFSI in terms of customer/investor protection and business conduct.

Distinct challenges to be addressed by the RSAs may include, *inter alia*, introducing initiatives to promote greater harmonisation of regulatory standards in relation to Islamic capital markets, and developing enhanced arrangements for cross-border resolution for *Sharī'ah*-compliant products. Collaboration among the jurisdictions and among the RSAs in strengthening customer/investor protection (consumer protection is explored in detail in Chapter 4) and business conduct will not only result in the resilience and stability of the industry but also help to facilitate greater cross-border financing moving forward.

In relation to this, the IFSB proposes to issue *Guiding Principles on Investor Protection in Islamic Capital Markets* as part of its Strategic Performance Plan 2012-2015. On 18 September 2012, the IFSB, in collaboration with IOSCO and Securities Commission Malaysia, conducted a Roundtable on Disclosure Requirements for Islamic Capital Market Products in Kuala Lumpur, Malaysia. The one-day Roundtable, which discussed issues arising from inadequate disclosure requirements and the importance of a strong disclosure regime in facilitating cross-border activity and the development of Islamic capital market products and services, would pave the way for collaboration between the IFSB and the IOSCO to address the imminent issues afflicting the Islamic capital market.

2.1.6 International Association of Insurance Supervisors

In June 2011, the IAIS established a Supervisory Forum to provide a platform for insurance supervisors to exchange information about their experiences of supervisory practices. This included discussions on trends and risks, and the sharing of ideas and experiences on supervisory methodologies. Of more significance is the IAIS's adoption of revisions to the IAIS Insurance Core Principles, Standards, Guidance and Assessment Methodology (ICP) in October 2011, which aim to further improve and strengthen the industry's supervision globally. The revised ICP are based on developments in insurance markets and supervision since their last revision in 2003. They include an entirely new principle guiding future work in the area of macro-prudential surveillance, and their assessment criteria are linked much more closely to observance of other IAIS standards.

In July 2012, as part of its three-year Development Phase, the IAIS released a draft of the Common Framework for the Supervision of Internationally Active Insurance Groups ("ComFrame"), which complements the revised ICP and provides the foundation required for supervisors to effectively collaborate in supervising complex cross-border insurance groups. Given the increasingly globally interconnected financial marketplace, ComFrame will not only contribute towards achieving global financial stability but also promote customer (individual policyholders) protection.

Impact on the IFSI

The current global market conditions necessitate the relevant RSAs to continue strengthening the IFSI. In this regard, the IFSB has already included a number of the IAIS's revised Core Principles in its existing Standards and Guiding Principles (SAGs), in particular in the areas of corporate governance, intermediaries, conduct of business and public disclosure. In November 2012, the IFSB issued ED-14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings* which aims to provide a minimum standard for the development of a risk management framework for *Takāful* Undertakings. The ED identifies certain key features which a *Takāful* Operator should consider when observing *Sharī'ah* rules and principles in its activities. The document calls for appropriate attention to be given to the risks arising from the segregation of funds between the Participants' Risk Fund, the Participants' Investment Fund and the Shareholders' Fund. The main objectives of the ED are to achieve the following:

- (a) To help understand the risks to which a *Takāful* Undertaking is exposed;
- (b) To provide minimum standards for the development of a risk management framework for ease of management of the *Takāful* Undertaking, and supervision by its governing bodies and supervisory authorities; and
- (c) To help create a safe and prudent environment for the growth, sustainability and development of the *Takāful* industry.

On the regulatory and supervisory aspect, however, there are a few areas that require attention and necessary actions. They include, *inter alia*:

- (a) Development of standards on group-wide supervision;
- (b) Supervision of a *Takāful* Undertaking under a conventional parent; and
- (c) Effective group supervision for *Takāful* and *ReTakāful* under various models so as to minimise conflicts between jurisdictions.

2.1.7 European Central Bank

In addition to regulatory reforms at the international level, the global financial industry has witnessed regulatory developments being undertaken at the regional level to further strengthen the stability of the financial system post-crisis. Although these regional developments may not have a direct impact on the IFSI, RSAs need to be mindful of these developments, and of the lessons that can be drawn from them, to help reinforce the stability of the IFSI as it continues to chart commendable growth moving forward.

An example will be the development taking place in the European Union (EU). The first Europe-wide stress tests conducted by national regulators in September 2009 with advice from the ECB were perceived as having shortcomings and were repeated in July 2010. This shows the practical difficulties and challenges in designing and calibrating meaningful stress tests for the financial industry, and underscores the need for careful planning and anticipation of market perceptions.

Following the crisis, the region's financial supervision has been undergoing significant reforms to address the need for stronger resilience, better infrastructure and greater harmonisation of rules. To allow the sharing of information and best practices, as well as fostering cooperation and identifying sources of systemic financial risks at an early stage, the ECB introduced a new supervisory framework which "provides a more consolidated and rational institutional design for linking the micro-prudential supervision of individual institutions with the supervision of linkages between institutions and within the broader system". The new supervisory framework consists of two pillars:

(a) **Macro-prudential supervision**

On 16 December 2010, the European Systemic Risk Board (ESRB) was established as an independent EU body to provide macro-prudential oversight of the financial system within the EU by identifying and assessing systemic risks, and issuing warnings and recommendations whenever necessary.

(b) **Micro-prudential supervision**

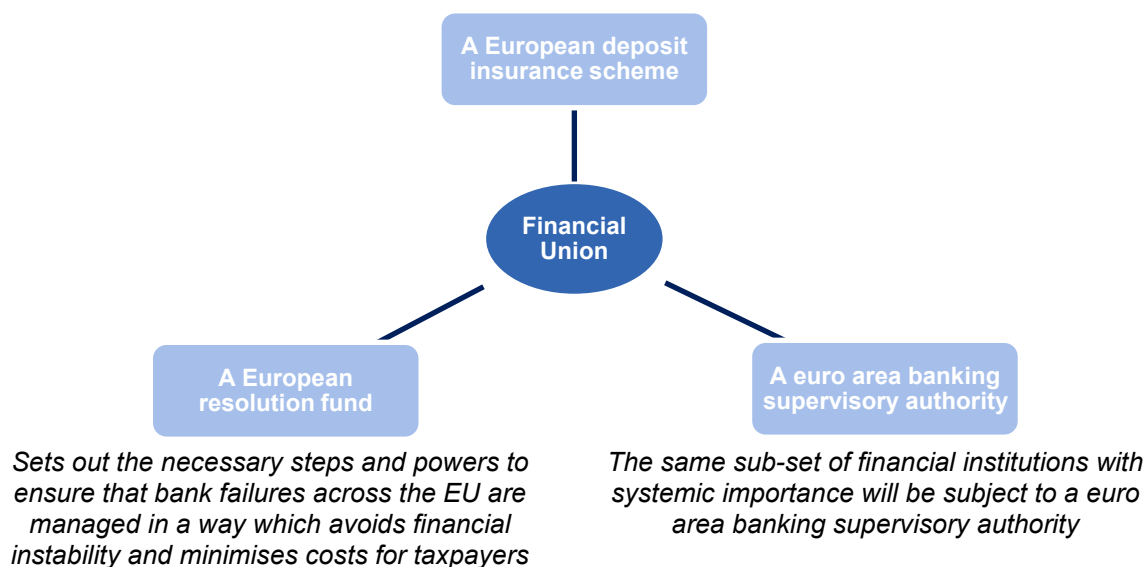
On 1 January 2011, the European supervisory framework was further strengthened with the establishment of three European Supervisory Authorities – European Banking Authority (EBA), European Securities and Markets Authority, and European Insurance and Occupational Pensions Authority – to oversee the banking sector, securities and markets, and insurance and occupational pensions, respectively.

The ECB also recognises that safeguarding financial stability in the EU requires an area-wide perspective where an effective macro-prudential framework is complemented by a similarly effective resolution mechanism. In this respect, the ECB supports the establishment of a financial union for the euro area to ensure that the region's banking and financial system is separated from the financial situation of the sovereigns, hence severing the link between fiscal imbalances, financial fragmentation and financial instability. As illustrated in Diagram 2.1.7.1, the financial union is based on three

elements, namely a European deposit insurance scheme, a European resolution fund,¹⁹ and a single euro area banking supervisory authority based around the ECB. However, this requires relevant procedures to be put in place at the EBA so as to prevent serious political disputes arising from the implied subsidy or transfer elements between not only EU member states but also non-euro area nations that sign up to such plans.

Diagram 2.1.7.1: A Financial Union for the Euro Area

The scheme to guarantee bank deposits (comparable to that of the Federal Deposit Insurance Corporation in the US) will apply to all EU banks so as to avoid unfair competition



Source: European Central Bank

Impact on the IFSI

In view of the slow growth in the EU, there is a likelihood of spill-over effects for emerging economies in terms of (a) lower growth prospects through reduced levels of foreign direct investment and financing for infrastructure, as well as (b) heightened cross-border financial volatility. The challenge for Islamic finance jurisdictions is to diversify funding sources and the investor base, as markets look for new investment opportunities to maximise returns on capital. Herein also lies an opportunity for Islamic finance through innovative financing mechanisms and solutions such as the financing of public expenditures on physical and social infrastructure.

Although the IFSI is not directly impacted by the sovereign debt crisis in the EU, IIFS and investors alike are expected to suffer from their exposure to *Shari'ah*-compliant stocks and real estate in the EU should the region's economic and financial environment continue to deteriorate. The GCC countries will be the least affected, given the strong government support and huge spending to protect and stimulate their economies. Other Islamic finance jurisdictions in South-East Asia (SEA) are also

¹⁹ On 6 June 2012, the European Commission adopted a legislative proposal for bank recovery and resolution. This fund applies to a subset of EU financial institutions that have systemic importance or significant cross-border operations. To minimise the cost for taxpayers, the fund will be only for institutions that are at the point of non-viability that need to be resolved and not for bail-outs of "going concerns".

unlikely to be affected given that they have little to do with the EU in terms of assets and trade exposures. Nevertheless, given that the SEA countries are far from decoupled from the global economy, the downside risks stemming from Europe remain. Although the outlook for the Islamic capital market segment in the EU remains promising, as witnessed by the encouraging developments²⁰ in the *Sukūk* market in the UK and France, the crisis is expected to somewhat stall the growth and development of the overall IFSI in the region as governments shift their focus towards repairing their financial systems and restoring the growth prospects of their economies.

Other issues highlighted by the EU that are of relevance to the IFSI include:

- (a) Designing rigorous, comprehensive and meaningful stress tests for IIFS;
- (b) Safeguarding financial stability;
- (c) Ensuring stronger resilience of the industry;
- (d) Having in place good governance, better infrastructure and greater harmonisation of rules; and
- (e) Introducing a resolution mechanism for the IFSI, such as a *Shari'ah*-compliant deposit insurance scheme.

2.2 Evolving Financial Architecture of Islamic Finance

To date, the IFSI has been spared the primary impact of the global financial crisis and continues to illustrate dynamic growth and development. However, the ongoing crisis in Europe and the US poses a tangible threat to the financial stability of both the US and emerging European countries, which could spill over to emerging markets, where a number of Islamic finance jurisdictions reside. Given that the IFSI has become an integral part of the global financial system, it cannot avoid being affected by the ongoing developments in the global financial system, as well as by the surge of reforms introduced by international regulatory bodies. It is therefore crucial for the IFSI to take actions to strengthen the Islamic financial system and architecture, tighten the regulatory and supervisory requirements, and introduce relevant measures to ensure the sustainability, stability and resilience of the industry moving forward.

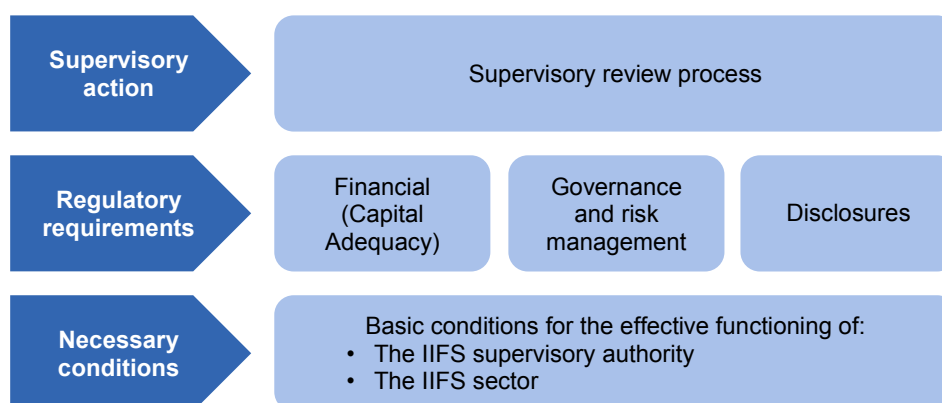
In response to the rapid regulatory reforms and development in the global financial industry, international standard-setting organisations for Islamic finance such as the IFSB, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and the International Islamic Financial Market have each undertaken various initiatives to review the existing and/or introduce new standards so as to further strengthen the industry and ensure its sustainability in the global environment that has, and will continue, to become more challenging. An overview of each organisation's recent developments is presented in the following sub-sections.

²⁰ Such developments include the announcement by Gatehouse Bank, the London-based *Shari'ah*-compliant investment bank, to issue the first real estate based *Sukūk* in the UK. France has also stated its interest in tapping the *Sukūk* market.

2.2.1 Islamic Financial Services Board

The IFSB is an international standard-setting organisation that promotes and enhances the soundness and stability of the IFSI by issuing global prudential standards and guiding principles (as shown in **Appendix 2**) for the industry, broadly defined to include banking, capital markets and insurance sectors. In advancing this mission, the IFSB promotes the development of a prudent and transparent IFSI through introducing new, or adapting existing, international standards consistent with *Sharī'ah* principles, and recommending them for adoption. Diagram 2.2.1.1 illustrates the broad areas of regulatory framework for the IFSB SAGs, and the SAGs issued by the IFSB to date.

Diagram 2.2.1.1: IFSB Standards and Guiding Principles – Regulatory Framework



Source: IFSB

In line with the global financial crisis and the BCBS developments, the IFSB has undertaken a number of initiatives to address the development taking place in the global financial industry. These include the issuance of the IFSB's *Guiding Principles on Liquidity Risk Management for IIFS*, the *Guiding Principles on Stress Testing for IIFS*, and ED-15: *Revised Capital Adequacy Standard*, as well as other initiatives such as establishing a working group on revising the supervisory review process standard.

The IFSB Guiding Principles on Liquidity Risk Management for IIFS

Given the growing market share of IIFS in many jurisdictions and their potential significance for systemic soundness and stability of the overall financial system, the need for a robust liquidity risk management framework for IIFS cannot be overemphasised. Hence, in March 2012, the IFSB issued IFSB-12: *Guiding Principles on Liquidity Risk Management for IIFS* to provide guidance to both the IIFS and the supervisory authorities on liquidity risk management. Detailed discussion on liquidity risk management for IIFS and IFSB-12 can be found in Section 3.1, "Liquidity Management".

The IFSB Guiding Principles on Stress Testing for IIFS

In particular, two seminal documents dealing with stress testing have been published in response to the global financial crisis. In May 2009, the BCBS published its *Principles for Sound Stress Testing Practices and Supervision*, and in August 2010 the Committee of European Banking Supervisors (CEBS) issued its *CEBS Guidelines on Stress Testing*. To complement these standards, in March 2012, the IFSB issued *Guiding Principles on Stress Testing* ("Guiding Principles"), which incorporate these developments while making appropriate adaptations to take account of the specificities of IIFS in terms of their risk exposures.

The Guiding Principles have stated that it is important for IIFS to recognise and take account of the implications for risk management arising from the differences between their operations and balance sheet structures and those of their conventional counterparts in their stress testing programmes. Given the specificities of IIFS, the question remains of how well IIFS will be able to absorb stresses and shocks that are more specific to the Islamic financial market. This implies an approach to stress testing (including various specific scenarios) that differs in some respects from that applicable to conventional institutions. In the first place, stress testing should be conducted in all aspects and scenarios with special attention to the position of the investment account holders (IAHs) and its implications for risk management. In addition, *Sharī'ah*-compliant risk mitigation techniques, *Sharī'ah*-compliant securitisation, real estate investment, and issues related to commodity *Murābahah* transactions need to be taken into account while designing and conducting stress testing exercises. The specific risk factors²¹ which will be critical to incorporate in stress testing scenarios and in IIFS-wide stress testing as a whole include credit risk, market risk, liquidity risk, rate of return risk, displaced commercial risks, investment risk for *Muḍārabah* and *Mushārah*, and operational risks which include qualitative risk factors such as *Sharī'ah* non-compliance risk. Significant failures in *Sharī'ah* compliance could severely damage the reputation of an IIFS as well as potentially having more immediate adverse legal and financial consequences (e.g. forfeiting of non-compliant income).

The objectives of the Guiding Principles are as follows:

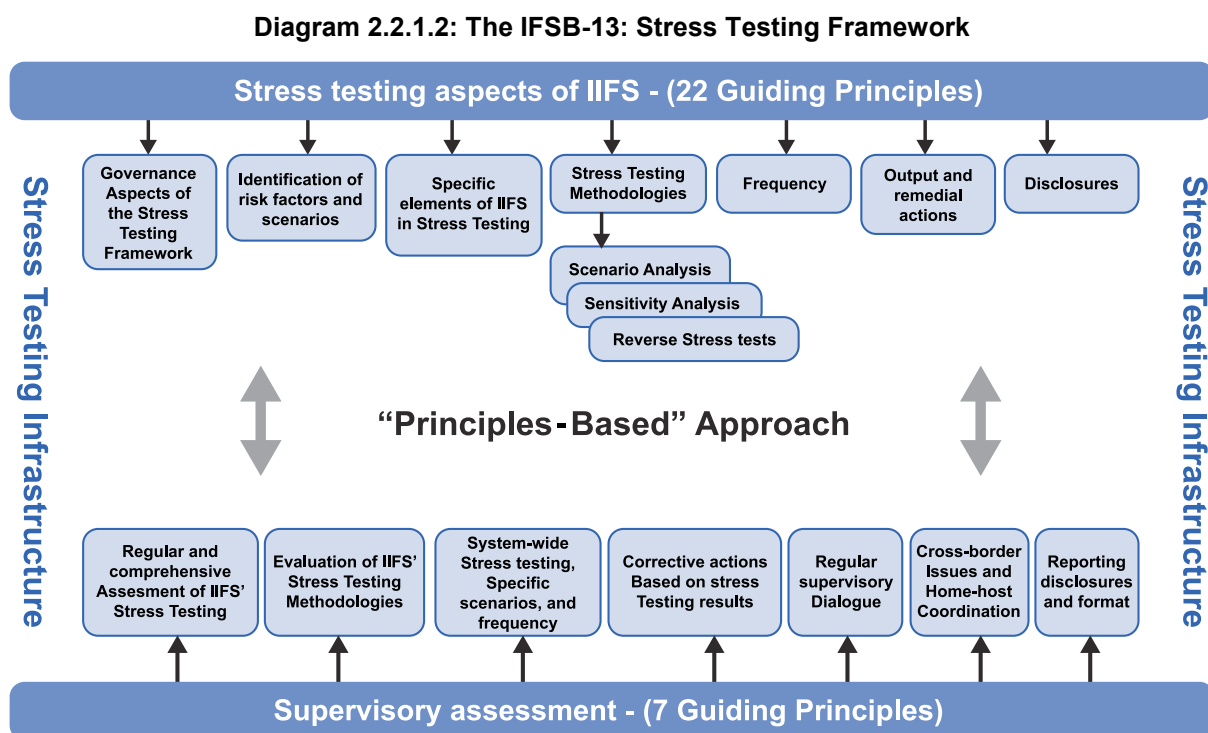
- (a) The stress testing framework for IIFS needs to take into consideration the specificities of IIFS, as well as the lessons learned from the financial crisis, while complementing the existing international standards on stress testing.
- (b) The framework should guide IIFS in assessing and capturing vulnerabilities under various stress testing scenarios, including extreme but plausible shocks, in order to achieve the following, *inter alia*:
 - identify how different portfolios respond to changes in key economic variables (e.g. benchmark rates,²² foreign exchange rates, credit quality, etc.);
 - assess the quality of assets to identify existing and potential loss exposures;
 - evaluate potential threats to the IIFS's ability to meet its financial obligations at any time arising from either funding or market liquidity exposures;
 - estimate the impact of stress events on baseline profit (as profits normally act as the first line of defence before dipping into capital); and
 - analyse the IIFS's ability to meet its capital requirements at all times throughout a reasonably severe economic recession.
- (c) For supervisory authorities, stress testing can be used:
 - as a surveillance tool for periodically testing the safety and soundness of the financial system (including IFSI);

²¹ The specific risk factors in the Guiding Principles are not intended to be exhaustive; IIFS are expected to identify the risk factors that are material to their institutions.

²² Benchmark rates include market-based reference interest rates such as LIBOR (London Interbank Offer Rate), EIBOR (Emirates Interbank Offer Rate), etc.

- from a financial stability perspective, to identify “weaknesses” in the financial system and structural (systemic) vulnerabilities arising from the specific risk profiles of IIFS individually and collectively; and
- as a supervisory tool for designing macro-prudential policies.

Diagram 2.2.1.2 summarises the IFSB’s *Guiding Principles on Stress Testing for IIFS*.



Source: IFSB-13

RSAs are expected to start implementation of these Guiding Principles in their respective jurisdictions from 2013. However, for stress testing to be effective in promoting risk management, and for an IIFS to develop a rigorous and robust stress testing framework, it needs to be complemented by the observance of international standards for stress testing and by the availability of a set of other infrastructure components that serve as the necessary conditions for an effective stress testing regime. Such components include the following:

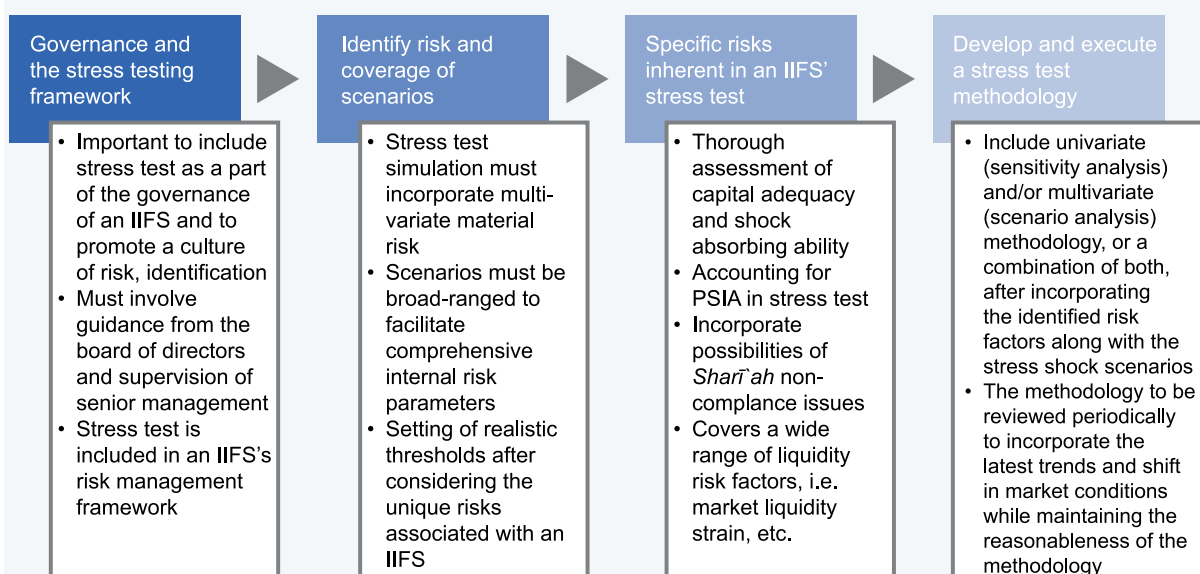
- Stress testing as a set of tools within a risk management framework;
- Data quality and management information system;
- Relevance of stress testing and sophistication of IIFS;
- Availability of models and modelling expertise; and
- Supervisory consideration and guidance on stress testing.

It is recognised that the costs of developing and implementing such a stress testing programme may seem high for some IIFS, particularly small- or medium-sized ones. However, the costs must be weighed against the potential loss mitigation, the value of the information and risk control gained, and the capital management that will result from an effective, well-designed stress testing programme.

Box Article: Operationalisation of IFSB-13 on Stress Testing: An Illustration of Stress Testing Exercise at an IIFS

As the macroenvironment uncertainties continue and are compounded by the spill-over effects into the Islamic finance space, IIFS face stronger pressures to ensure their stability and safeguard their assets while at the same time providing for adequate defensive measures. This is an opportune time to incorporate stress testing within an IIFS, as part of its defence mechanism. The adoption of a stress test framework fundamentally involves various phases. However, this fundamental framework can be customised according to the IIFS' needs and objectives.

Diagram 2.2.1.3: Developing the Stress Test Framework: An Illustration



Source: IFSB-13

The stress testing framework illustrated in Diagram 2.2.1.3 covers various dimensions of conducting stress testing for both IIFS and supervisory authorities. The framework also highlights the pre-conditions which have to be met before conducting the stress testing at the macro or micro level.

How to Conduct Stress Testing at an IIFS

Based on the above diagrams, the following questions show the sequence or the process involved as a guide for the IIFS to conduct a stress testing exercise, depending on the objective(s) of the stress test – whether for liquidity run or solvency purposes, etc.

- (a) **Who has the ultimate responsibility for conducting stress testing** – refers to who is ultimately responsible for conducting the exercise and for its outcome; e.g. Senior Management is responsible for operationalisation of the stress testing and the Board of Directors is responsible for the overall programme.

- (b) **What needs to be stressed** – refers to the identification of risk parameters that need to be stressed; e.g. credit risk, market risk, operational risk, displaced commercial risk.
- (c) **How often it needs to be stressed** – refers to the frequency of conducting the stress testing on the risk parameters identified in (b); e.g. weekly, monthly, quarterly, semi-annually or on an ad-hoc basis.
- (d) **What scenarios need to be considered** – refers to historical scenarios (i.e. backward-looking scenarios) or hypothetical scenarios (i.e. forward-looking scenarios).
- (e) **How it should be stressed** – refers to the methodology that would be employed by the IIFS during the stress testing exercise; e.g. sensitivity test analysis and/or scenario test analysis, with different levels of stress shock (mild, moderate and extreme). The methodology should also be supported by appropriate models (i.e. deterministic or stochastic, etc.), data and parameters (i.e. historical or hypothetical), and forecasting periods (i.e. long term or short term).

Once the IIFS has followed the above process, the next step would be to identify appropriate and meaningful mechanisms for translating the stress test results into **actions to support a range of decisions** appropriate to the purpose of the stress test; e.g. restructuring the portfolio/positions, reviewing liquidity adequacy and capital allocation, and risk limits.

After reviewing the stress test results and having considered certain possible remedial actions as stated above, an IIFS may subject itself to **further stress testing** with some adjustments. For instance, as a result of a first round of stress testing, if the results indicate a certain weakness or material deficiencies in stress testing, or if management is not satisfied with the stress testing outcomes related to certain products, portfolios or IIFS-wide, then management should require its IIFS to undertake further stress testing.

Supervisory Assessment of an IIFS Stress Testing

Once the IIFS has conducted a stress testing exercise, supervisory authorities should evaluate the extent to which the stress testing is embedded in the IIFS's risk management framework and has considered specific characteristics especially related to, *inter alia*, risk characteristics, and capital adequacy of the IIFS. They should also assess whether IIFS devote sufficient resources, and have adequate procedures in place, to undertake rigorous, forward-looking stress testing in order to identify circumstances or possible events that could result in significant adverse impacts on the IIFS and threaten its viability. Supervisory authorities should also consider whether senior management has been sufficiently involved in the stress testing programme and the Board of Directors sufficiently informed.

In addition to reviewing the IIFS' methodologies used in the stress testing exercise, supervisory authorities should also emphasise evaluation of the inputs of the stress tests that are carried out within stress testing methodologies – for instance, *inter alia*, they can evaluate the period of time during which the data sample is taken (normal vs. crisis), sample size, proxy data (before a big enough sample size is accumulated for a new product), simulation of data, and parameters used for simulation.

In their evaluations, supervisory authorities should also review whether the IIFS uses output from stress testing results (obtained through stress testing methodologies such as sensitivity and scenario analyses) appropriately, and shares results within the organisation (such as with risk managers and senior management) and properly acts upon the results (e.g. by taking remedial actions if sensitivity tests show large adverse outcomes or reveal model weaknesses).

The Gaps and Challenges of Stress Testing to an IIFS

The inclusion of additional parameters to the stress test for an IIFS not only puts it through a more rigorous stress test but also increases the demands to ensure that such a robust stress testing simulation is executed successfully. In this regard, IFSB under its guiding principles on stress testing highlighted the gaps and challenges with regards to stress testing simulations for IIFS which among others are:

- (a) IIFS are proactive in adopting stress testing but lack specific regulatory guidelines;
- (b) A relatively weak disclosure regime on stress testing practices in the IFSI;
- (c) Availability of robust stress test models and modelling expertise; and
- (d) Quality of data, which is critical in ensuring a successful stress test simulation and its results.

Source: IFSB-13

Exposure Draft 15 on Revised Capital Adequacy Standard

Islamic financial instruments are asset-based (*Murābahah*, *Salam* and *Istisnā`*, which are based on the sale or purchase of an asset; and *Ijārah*, which is based on selling the benefits of such an asset), profit-sharing (*Mushārah* and *Muḍārah*), agency (*Wakālah*), or *Sukūk* and investment portfolios and funds which may be based on the aforesaid assets. In the case of the asset-based instruments, the IIFS's gross return is the spread between the cost of the asset to the IIFS and the amount that can be recovered from selling or leasing it. Such instruments may therefore involve exposure to market (price) risk in respect of the asset, as well as credit risk in respect of the amount due from the counterparty.

In the case of the profit-sharing instruments, *Mushārah* and *Muḍārah*, the exposure is of the nature of an equity position not held for trading similar to an "equity position in the banking book"²³ as described in Basel II,²⁴ and is likewise dealt with under credit risk, except in the case of investments (normally short term) in assets for trading purposes, which are dealt with under market risk.

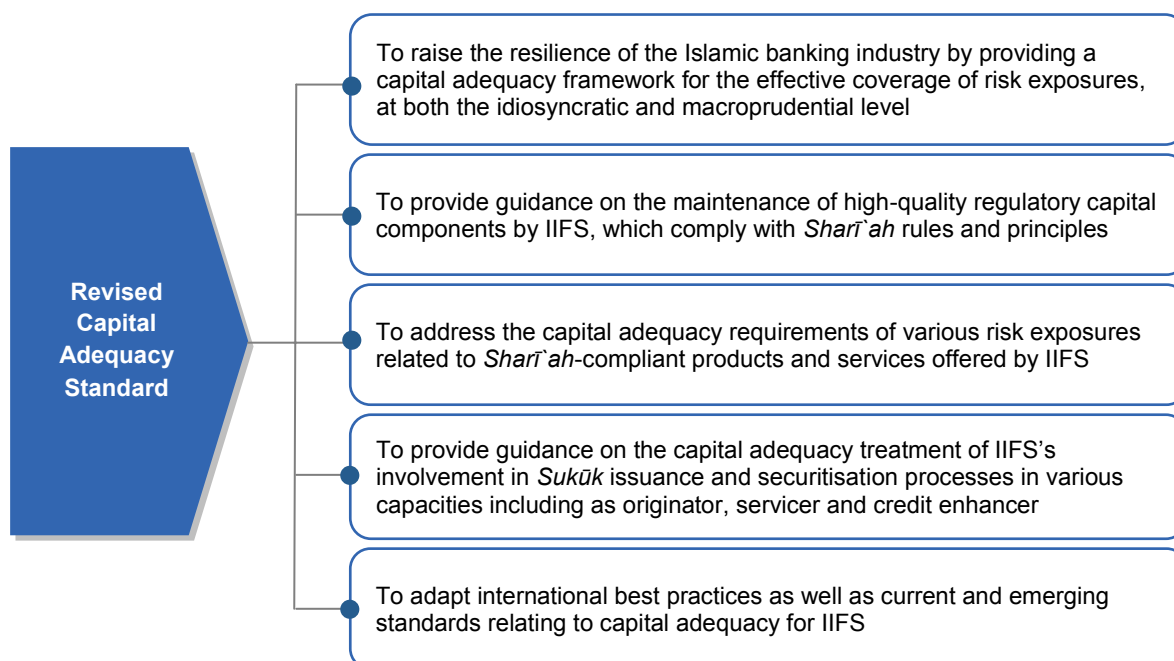
Given the above specificities of Islamic finance and in response to Basel III, the IFSB issued ED-15: *Revised Capital Adequacy Standard* in November 2012 to provide a more comprehensive guidance to RSAs and IIFS on the application of capital adequacy regulations and macro-prudential tools (detailed objectives are provided in Diagram 2.2.1.4). The revision includes providing guidance on components of capital that feature in Basel III and which require deliberation in relation to *Shari'ah*-compliant

²³ See paragraph 344 of Basel II, June 2006 version.

²⁴ Basel II – initially published in June 2004 by the Basel Committee on Banking Supervision – aimed to create a global standard governing the capital adequacy of internationally active banks. The BCBS issued a comprehensive version of the Basel II Framework on 4 July 2006. Basel II uses a "three-pillar" framework: (1) minimum capital requirements (addressing risk); (2) supervisory review process; and (3) transparency and market discipline. After the financial crisis that started in 2007, the BCBS issued a revised package of measures to enhance the three pillars of the Basel II framework and to strengthen the 1996 rules governing trading book capital. Some of the elements of Basel II have been further updated with the issuance of Basel III by the BCBS in December 2010.

treatments. The Standard provides detailed criteria for various components of capital as well as guidance on the application of new features introduced by the BCBS in its Basel III documents, with necessary adaptations for IIFS – namely, the capital conservation buffer, the counter-cyclical buffer and the leverage (or common equity to total exposures) ratio. Supervisory authorities are expected to start implementing the Standard in their respective jurisdictions with effect from 1 January 2014.

Diagram 2.2.1.4: The Main Objectives of the IFSB's Revised Capital Adequacy Standard



Source: IFSB

Other Initiatives

Other initiatives undertaken by the IFSB include the following:

- (a) **Supervisory review process.** The IFSB, through its revised supervisory review process working group, is currently revising IIFS-5 on the supervisory review process. The working group is tasked to provide guidance to the supervisory authorities on key elements in the supervisory review process of IIFS taking into consideration the specificities of the IIFS and the lessons learned from the global financial crisis, and, at the same time, to complement the existing international guidance on supervisory review process issued by BCBS. In the working group deliberations, one of the issues raised was concentration risk²⁵ and its implications under Pillar II to the RSAs in terms of proper capital allocation under an internal capital adequacy assessment process (ICAAP). The IFSB Survey (2012), as shown in Table 2.2.1.5, identified the main types of regulatory risk concentration limits/requirements, which range from single borrower to group and from credit concentration to capital market activities.

²⁵ A risk concentration is defined "as any single exposure or group of similar exposures (e.g. to the same borrower or counterparty, including protection providers, geographic area, industry or other risk factors) with the potential to produce (i) losses large enough (relative to an IIFS's earnings, capital, total assets or overall risk level) to threaten an IIFS's creditworthiness or ability to maintain its core operations or (ii) a material change in an IIFS's risk profile".

Table 2.2.1.5: Types of Regulatory Risk Concentration Limits/Requirements

Main Types of Limits
• Single borrower exposure limit
• Capital market exposure limit
• Exposures against single person and group
• Exposure against unsecured financing
• Credit concentration
• Limits for long or short currency positions balance limits
• Investments in securities
• Exposure to real estate financing and real estate investments
• Finance for total or partial acquisition of companies
• Connected party
• Country exposures limits
• Limit on exposure to shares, interest in shares and collective investment share
• Information technology setup limitation (Operational Risk)
• Prevention consideration (Operational Risk)
• Exposure to government and its agencies
• Restrictions on equity investments in non-financial institutions
• Limits for subsidiaries

Source: IFSB Survey (2012)

- (b) **Liquidity standards.** Following the issuance of the updated framework on the Liquidity Coverage Ratio by the Basel Committee, the IFSB plans to issue a new Guidance Note to adapt the Basel III liquidity standards for IIFS, taking into consideration the nature and specificities of their operations. This subject is further discussed in Section 3.1.2, “Developments on Prudential Framework and Industry Initiatives for IIFS”.
- (c) **Core principles for Islamic finance.** In line with the development of the BCBS’s revised core principles 2012, the IFSB Council, in its 21st meeting held on 12 December 2012 in Jeddah, approved the formation of a new Working Group for the IFSB *Core Principles for Effective Regulation and Supervision of Institutions in the IFSI*. It is envisaged that the outcome of the core principles for IIFS will be used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work to achieve a baseline level of sound supervisory practices on the necessary prudential framework for Islamic finance. The core principles of the conventional standard setters are also used by the IMF and the World Bank, in the context of the Financial Sector Assessment Programme (FSAP), to assess the effectiveness of countries’ banking supervisory systems and practices.

2.2.2 Accounting and Auditing Organization for Islamic Financial Institutions

AAOIFI is the Islamic international organisation that prepares accounting, auditing, governance, ethics and *Shari'ah* standards for Islamic financial institutions and the industry. In 2012, AAOIFI tightened the industry's standards by issuing seven new *Shari'ah* standards relating to governance and ethics – two major takeaways from the financial crisis – whilst at the same time giving priority to the protection of the interests of customers. The standards govern key areas of Islamic finance, namely financial rights and their management, liquidity management, bankruptcy, capital and investment protection, agency investment, calculation of profits transaction, and options of trust.

Amongst other standards AAOIFI has issued is a revised accounting standard on investment in real estate, issued in 2012, which sets out principles for the recognition, measurement, presentation and disclosure of investment in real estate that is acquired for the purpose of earning periodical income or held for future capital appreciation, or both. In addition, AAOIFI is currently reviewing its existing standards on investment accounts and *Takāful*, and developing a new governance standard for the *Shari'ah* Supervisory Board, all of which are expected to be finalised in 2013.

2.2.3 International Islamic Financial Market

IIFM²⁶ is the international Islamic financial market's organisation focused on the Islamic Capital and Money Market (ICMM) segment of the IFSI. Its primary focus lies in the standardisation of Islamic financial products, documentation and related processes at the global level. Some of the areas covered by the IIFM are as follows:

- (a) Addressing the product and documentation standardisation needs of the industry;
- (b) Providing a universal platform by bringing regulatory bodies, financial institutions, law firms, stock exchanges, industry associations, infrastructure service providers and other market participants on to a common platform through the creation of project-specific global working groups and committees;
- (c) Facilitating unification, *Shari'ah* harmonisation and legal reforms in Islamic financial markets; and
- (d) The functioning of the *Shari'ah* Advisory Panel, consisting of renowned scholars, to ensure wider *Shari'ah* acceptance.

Two important documents issued by IIFM are as follows:

- (a) Master Agreement for Treasury Placement (MATP) (2008); and
- (b) International Swaps and Derivatives Association (ISDA)/IIFM *Mubādah al-Arba'ah* (profit rate swap) product standard (2012), which is to be used for Islamic hedging purposes.

The ISDA/IIFM *Mubādah al-Arba'ah*, which is a consequent aspect of the ISDA/IIFM *Tahawwut* (Hedging) Master Agreement introduced in 2010, is an agreement to exchange profit rates between a *Mu'addal Ribh Thābit* (fixed rate) party and *Mu'addal Ribh Mutaghayyar* (floating rate) party, or vice

²⁶ IIFM was founded through the collective efforts of the IDB, Autoriti Monetari Brunei Darussalam, Bank Indonesia, Central Bank of Bahrain, Central Bank of Sudan and the Labuan Financial Services Authority (Malaysia) as a neutral and non-profit organisation. Besides the founding members, IIFM is supported by its permanent member, State Bank of Pakistan, as well as by a number of regional and international financial institutions and other market participants as its members.

versa. It is a binding unilateral promise and is binding one way only. It is being used or utilised in this transaction in order to ensure that the *Mubādalah* (swap) reaches its maturity. **Appendix 3** illustrates the ISDA/IIFM *Mubādalah al-Arbaah* two- and single-sale structures.

2.3 Assessment of the Implementation of the IFSB Standards

SAGs are of benefit only to the extent that they are implemented. Herein lies the challenge for the IFSB in raising its game in terms of the implementation of its SAGs. Drawing reference from the Basel process in the implementation of the capital framework, there are institutional lessons for both the IFSB and the IFSI as a whole:

- (a) Although Basel is voluntary, it is supported by a **political process at the highest level** of the global economic and financial policy architecture – that is, the G-20 process.
- (b) Basel's strength lies in its **capacity as a rule-making body**. The key steps involved in the implementation of Basel Standards are illustrated in Diagram 2.3.1, and are undertaken through comprehensive peer reviews conducted under the aegis of the Basel Committee's Standards Implementation Group. As a rule-making body, Basel has also been highly successful in reaching agreement on implementation through joint, voluntary measures.
- (c) Basel's strength also lies in the way in which it has served as **a platform for cooperation and sharing of experiences** between RSAs. This process has been greatly aided by, and indeed has led to, the development of a dense and close network of personal and institutional relationships amongst regulators and heads of supervision globally.

Diagram 2.3.1: Key Steps Involved in the Implementation of Basel Standards



Source: BCBS

Basel's achievements are formidable, and by this measure, the IFSB has some way to go to arrive at this kind of consensus and effectiveness. The benefits provided by the IFSB SAGs will not be realised unless the SAGs are implemented, on a consistent basis, across jurisdictions. Various factors are crucial to ensuring the consistent implementation of regulatory reforms. These include cross-border collaboration among regulatory and supervisory authorities, supplemented by vigorous implementation

efforts, as well as support at the highest level of the respective global and regional economic and financial policy architectures.

Like other standard-setting bodies such as the BCBS, the IFSB does not have enforcing powers to ensure that its SAGs are implemented. The IFSB is accountable to assist its members to adopt its SAGs, but it is not accountable for the implementation of the SAGs. Each member of the IFSB is entitled to determine its own timeline for implementation of the IFSB SAGs. However, the fact that the IFSB SAGs are voluntary is not in itself a limitation and it would be wrong to dismiss the voluntary process embedded within the IFSB.

Currently, implementation of the IFSB SAGs is at different stages in different jurisdictions.²⁷ Fully half of the jurisdictions have plans, framed over a three- to five-year period, to implement the SAGs in part or in full. In some countries, however, the time frame is shorter in view of the progress that has been made in the industry. Significant progress has been made in terms of baseline assessments, quantitative impact assessments, and evaluation of IIFS compliance with the IFSB Standards.

Table 2.3.1 summarises IFSB SAGs implementation with respect to banking supervisory authorities. The standards that feature most frequently in terms of completion, or advanced stage of progress in implementation, are typically the ones issued earliest. IFSB-1 through IFSB-6 feature prominently in these categories, and are the ones most frequently cited as planned for implementation. There are also a number of RSAs who do not plan to implement the SAGs, citing them as not relevant, given the non-existent or early stage of development of the IFSI in their respective jurisdictions.

Herein lies the challenge in respect of the implementation of the IFSB Standards. The RSAs of the IFSI are aware of and acknowledge the importance and relevance of the IFSB SAGs. However, there are numerous procedures involved before these SAGs can be approved and implemented - for example, the long process of obtaining the approval of Parliament. Hence, in regulating the Islamic finance segment, a number of countries – in particular, Singapore and the UK – resort to making references to the IFSB SAGs instead of implementing them. This route is deemed to be both expeditious and effective in these jurisdictions.

²⁷ A particular jurisdiction is said to have adopted the IFSB SAG when it is ready to make the necessary changes in its domestic laws, policies and regulations to meet the requirements stated in a standard. This change process has to take into account many factors, including the number of IIFS in the jurisdiction, the availability of resources, the level of maturity of the domestic market and the support from the domestic RSAs. These and other factors will determine the amount of time required by the RSAs before any SAG can be fully implemented within a jurisdiction.

Table 2.3.1: Summary of IFSB SAGs Implementation with Respect to Banking Supervisory Authorities* (2011)

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

* Based on 31 RSAs from 24 countries

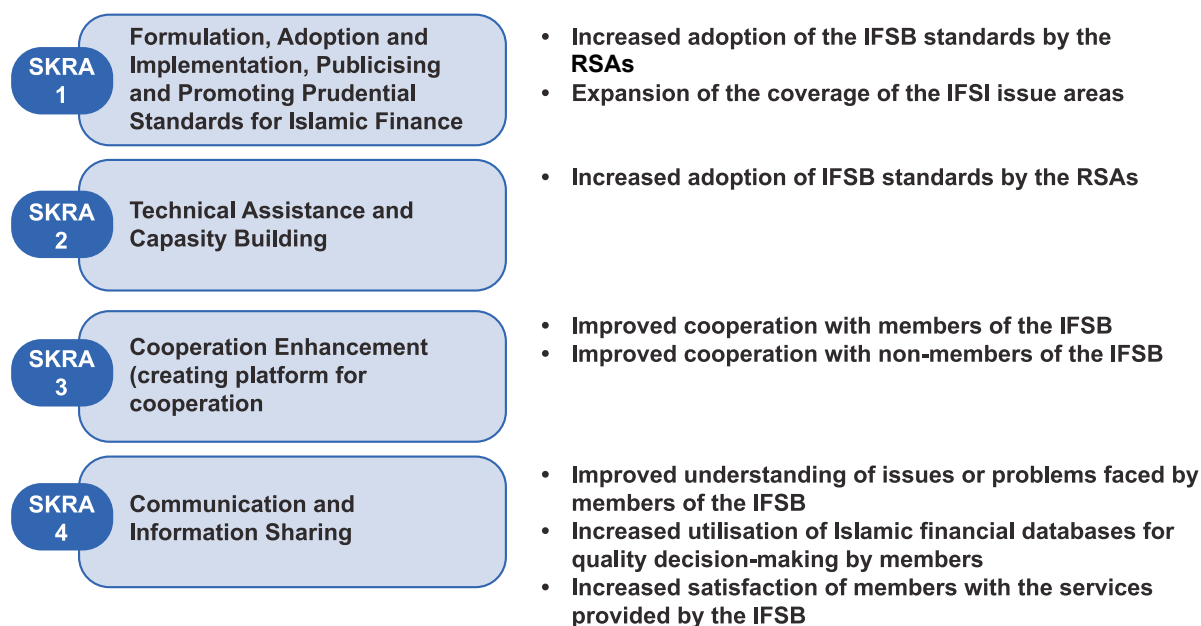
Source: IFSB Standards Implementation Survey (2011)

Having recognised the different capacities and the different stages of market and institutional development amongst the IFSB members, the IFSB has developed measures to aid the implementation process. This includes, *inter alia*, the following:

- (a) **The IFSB's standard development process** comprises a lengthy due process involving various stakeholders of the IFSI to produce high-quality best practice implementable standards.
- (b) **Provision of technical assistance** via the "Facilitating the Implementation of Standards" (FIS) workshops for RSAs as well as public workshops for the IIFS to enhance the awareness of the IFSB SAGs. Besides customising the FIS workshops to meet the requirements of its members, the IFSB also invites external speakers, in particular those from its member countries, to participate in the FIS workshops and share their experiences in implementing the SAGs.
- (c) **Introduction of e-Learning programmes** to assist member countries in terms of technical work and capacity building. In 2011, the IFSB introduced the FIS e-Learning Programme (Development e-Learning Programme for IFSB-1: *Guiding Principles of Risk Management for IIFS (other than Insurance Institutions)*). The IFSB is currently in the midst of finalising its e-Learning project for IFSB-6: *Guiding Principles on Governance for Islamic Collective Investment Schemes*.

In March 2012, the IFSB Council approved the Strategic Performance Plan (SPP) 2012-2015 for the IFSB which identifies four Strategic Key Result Areas (SKRAs) to provide greater coverage of the needs of its key stakeholders (Diagram 2.3.2). The SPP includes, *inter alia*, conducting annual assessment on the progress of the implementation of IFSB Standards. The results of the assessment are to be presented to the IFSB Council on a regular basis. This initiative is expected to encourage various RSAs to implement the IFSB Standards in their respective jurisdictions, taking into consideration their respective domestic legal and regulatory structures.

Diagram 2.3.2: The IFSB's Strategic Performance Plan 2012-2015



Source: IFSB Strategic Performance Plan 2012-2015

In addition to these measures, it is equally important for the jurisdictions to utilise to the utmost, as in Basel, the platform for cooperation that the IFSB provides to further strengthen cooperation amongst RSAs. The diversity of experiences and viewpoints, particularly on regulatory issues and concerns, the sharing of perspectives from RSAs of different jurisdictions and other Islamic finance standard setters, and the establishment of institutional relationships are the stepping stones to joint action on common goals of strengthening the resilience and stability of the IFSI.

Unlike Basel, this process within the IFSB is strengthened by the presence and participation of its members who represent the broad industry consisting of RSAs, industry associations, international inter-governmental organisations and market players. This, coupled with the appointment of senior staff members by their respective central banks to form the Technical Committee of the IFSB, helps to bring the vital elements of market and regulatory perspectives and priorities to its deliberations.

The IFSB also collaborates with multilateral organisations such as the IDB, the World Bank, the IMF and the Asian Development Bank (ADB). These institutions have not only recognised the importance of the role which Islamic finance can play in the global financial system, but have also offered their support for its promotion and for capacity building of supervisory authorities and industry players.

The IFSB is also strengthening its capabilities for capacity building through partnerships with educational institutions such as the International Centre for Education in Islamic Finance (INCEIF), and the Bahrain Institute of Banking and Finance (BIBF), which is expected to benefit the IFSI as a whole.

3.0 ISSUES IN REGULATION AND SUPERVISION OF ISLAMIC FINANCE: LIQUIDITY MANAGEMENT – REGULATIONS, INTERBANK MARKETS AND LENDER OF LAST RESORT

The previous chapters of this report provided an overview on the development of various sectors of the IFSI, including the banking, capital market and *Takāful* segments. More importantly, the analysis covered the trends, outlook and challenges with respect to various components of Islamic capital markets such as indices, *Sukūk* and fund management. These sections provided the setting for the report's coverage of various actions and initiatives taken by the global standard-setting institutions and multilateral supervisory authorities to promote soundness and stability in the financial sector. The report also provided insights into the evolving nature of the financial architecture of Islamic finance and the proactive response of international standard-setting organisations such as the IFSB to provide necessary guidance to the IIFS and their supervisory authorities to achieve the ultimate objective of a resilient and vibrant IFSI.

This chapter will focus on the developments and challenges related to two important issues impacting the stability of the IIFS and the financial system as a whole – that is, liquidity management and the financial safety net. The discussion in the previous chapters related to the developments in the Islamic banking sector and *Sukūk* market has implications for the introduction of liquidity risk management and financial safety net solutions; therefore, this chapter will make a reference to the earlier discussion where needed. The availability of a financial safety net in the form of SLOLR and deposit insurance (please refer to Section 4.1.3) serves mainly macro-prudential objectives of effective financial sector supervision. However, it also has some close associations with liquidity management of the IIFS at an institutional level.

3.1 Liquidity Management

Liquidity management has been typically one of the most challenging tasks faced by the IIFS, owing to *Sharī'ah* restrictions on engaging in interest-based transactions – both at the interbank and other levels – and limitations on transfer of debt, other than at its face value in a majority of jurisdictions. These fundamental issues, coupled with other factors – such as the scarcity of *Sharī'ah*-compliant instruments, lack of active secondary market activity, insufficient tools available to supervisory authorities for providing liquidity support to IIFS in normal and stressed market conditions, and absence of *Sharī'ah*-compliant open market operations for meeting the monetary policy objectives of the supervisor – make liquidity risk management a very challenging task for the IIFS. Though these market imperfections differ across various jurisdictions, nevertheless, most markets are facing one or more of the challenges mentioned above.

As a result, IIFS in most parts of the world are faced with the need to maintain a higher level of cash given the absence of *Sharī'ah*-compliant, high-quality liquid assets (HQLA) vis-à-vis their conventional counterparts. Given the need to remain sufficiently liquid to meet their day-to-day operational funding needs, these factors affect the performance and competitiveness of IIFS vis-à-vis conventional financial institutions. For other IIFS, the supply-side constraints on the availability of *Sharī'ah*-compliant instruments in various jurisdictions make it difficult to meet liabilities and financial obligations when having mainly illiquid assets. Lack of market makers and active secondary market trading in

these instruments makes liquidity management a more daunting task, as it becomes difficult for the IIFS to get funding liquidity when needed at a reasonable cost. Furthermore, the predominance of uncollateralised interbank transactions such as commodity *Murābahah* transactions (CMT), interbank *Muḍārabah* and interbank *Wakālah* results in increased counterparty risk apprehension in bilateral arrangements in stressed market conditions, thus reducing the level of available system-level liquidity even further. Due to such market conditions, the liquidity problems with one or more IIFS can augment the potential for systemic risk in crisis times.

Due to the critical importance of liquidity management for the IIFS, the *Islamic Finance and Global Financial Stability Report* issued by the IFSB-IDB-IRTI in April 2010 outlined, *inter alia*, the importance of a number of key building blocks where the industry needs to focus its attention. These include:

- (a) Enhancing the financial resilience and stability of the IFSI by the development of a robust national and international liquidity infrastructure, which encompasses the potential for monetary policy and money market operations;
- (b) Developing a set of comprehensive, cross-sectoral prudential standards and a supervisory framework covering Islamic banking, *Takāful* and the capital market, which take into account the specificities of IIFS; and
- (c) Strengthening the financial safety net mechanism – namely, LOLR facilities and emergency financing mechanisms – as well as deposit insurance, all of which need to be compatible with *Sharī'ah* principles.

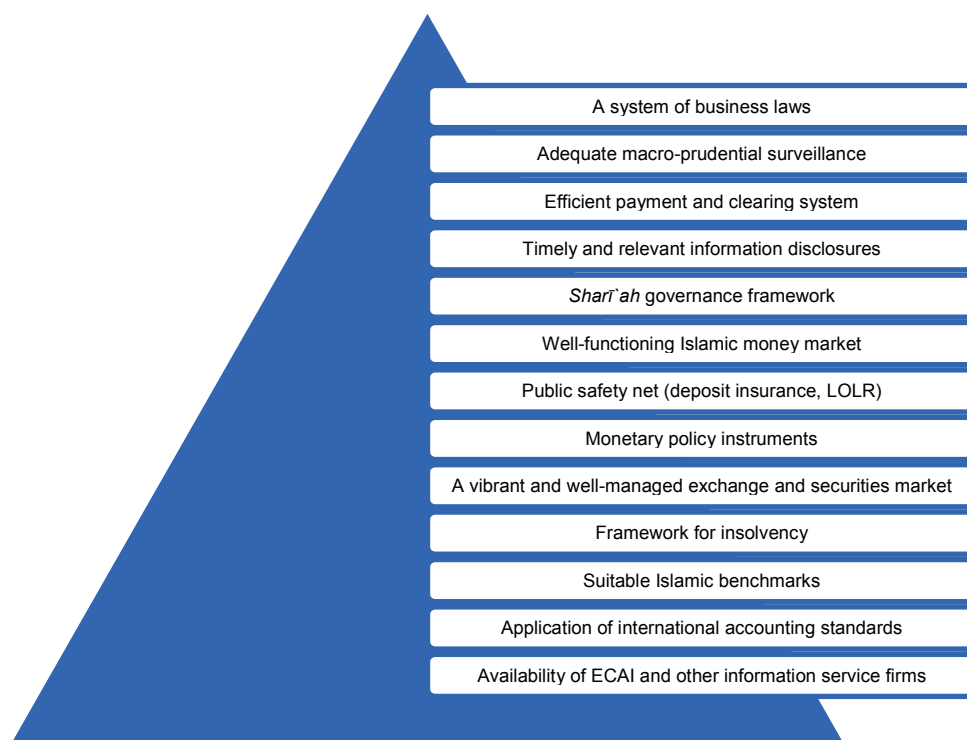
Since the issuance of the previous stability report, a number of positive developments have taken place in strengthening the three building blocks mentioned above. Whereas Section 3.2 elucidates the current status and some key issues and considerations with respect to the financial safety net mechanism for IFSI, the remaining part of this section will explain major developments in enhancing the national and international liquidity infrastructure. In addition, some key developments related to the issuance of new prudential standards and steps taken by supervisory authorities to strengthen the regulation and supervision of liquidity risk management of the IIFS will also be discussed. The section will highlight key vulnerabilities impacting the liquidity management of IIFS owing to the inflow of funds due to the deleveraging of banks in the Eurozone and ongoing threats to the growth of emerging market economies.

3.1.1 Liquidity Infrastructure

As defined by IFSB-12: *Guiding Principles on Liquidity Risk Management for IIFS*, the term “liquidity infrastructure” refers to a set of key institutional and operational arrangements which can provide a facilitating environment to financial institutions in that jurisdiction for managing their liquidity in normal and stressed times, as well as supporting market liquidity in the system. It has been emphasised that availability of the infrastructure elements (see Diagram 3.1.1.1 for the necessary elements of liquidity infrastructure, specified in IFSB-12) at the jurisdiction level not only provides a level playing field for IIFS – making them stronger, competitive and in tune with the international legal and regulatory environment – but also fosters avenues for international cooperation and the cross-border expansion

of IIFS. Similarly, liquidity infrastructure helps the IIFS to reduce their cost of intermediation, enhance the level of liquidity in the system, and improve their profitability by removing obstacles to the effective management of liquidity risk and the deployment of liquid funds in the market. From a macro-prudential stability viewpoint, these necessary building blocks enhance the ability of an IIFS to meet expected and unexpected cash-flow obligations, thus reducing the possibility of liquidity shortfalls and systemic contagion across the financial markets.

Diagram 3.1.1.1: Necessary Elements of Effective Liquidity Risk Management in the IFSI



Source: IFSB-12

An important element of liquidity infrastructure for the IIFS has been the availability of business laws that cover specific elements related to the issuance, trading and insolvency of *Shari'ah*-compliant instruments/*Sukūk*. The legal framework may need amendments to the current laws or the issuance of new statutes with respect to, *inter alia*, securities, capital market, trust, public debt, contract, taxation, bankruptcy and asset-recovery laws. The parliaments and supervisory authorities in a number of jurisdictions have taken steps to issue/revise legislation and regulations for the issuance and trading of *Sukūk* and other *Shari'ah*-compliant securities, some of which are mentioned below.

The Turkish government passed legislation in February 2011²⁷ to facilitate the issuance of leasing certificates (*Ijārah Sukūk*) that included tax neutrality measures consistent with equivalent conventional products. This law followed the Communiqué of the Capital Markets Board of Turkey in April 2010 on The Principles Regarding *Ijārah* Certificates and Asset Lease Companies.²⁸ The tax measures introduced in 2011 included, *inter alia*, exemption on corporate and value-added tax as well as tax neutrality measures related to stamp duty, real estate, registry fees, survey fees, notary public fees,

²⁷ See www.gep.gov.tr/tmp/_Gep4.pdf.

²⁸ See www.cmb.gov.tr/apps/teblig/displayteblig.aspx?id=424&ct=f&action=displayfile.

etc. On the market side, two asset lease companies were formed and the first cross-border issuance subject to regulation (Kuveyt Turk) was made in 2011. As the new Capital Markets Law came into effect on 30 December 2012, the regulation regarding *Ijārah* certificates and asset lease companies is being updated with more comprehensive guidance.

More recent development of new *Sukūk* laws can be observed in the North African region such as Egypt, Tunisia, Morocco and Libya. Egypt passed its *Sukūk* law in February 2013, whereas other countries are in the process of issuing such laws in the near future.

The Securities Commission Malaysia revised its Islamic Securities Guidelines, issued in July 2011, and issued new Guidelines on *Sukūk* in December 2012 that provide more comprehensive guidance on this subject, covering areas such as the approval process, applicable *Sharī'ah* rulings, rating and disclosure requirements, etc. The Securities and Exchange Commission of Pakistan also issued draft rules for the issuance of *Sukūk* in October 2012. Similarly, the Capital Market Authority of Oman issued its draft *Sukūk* Regulations in early 2013 to seek stakeholders' feedback.

Another important element of liquidity infrastructure is the availability of a vibrant and well-managed exchange and securities market in *Sharī'ah*-compliant government and corporate instruments. As elaborated in Section 1.3 earlier, while the record level of *Sukūk* issuances in 2012 by the sovereigns, public sector enterprises and corporates is encouraging, the secondary market trading in these instruments remains a challenge for the industry. There are a number of reasons for this trend, which include, *inter alia*: (i) limited supply of high-rated *Sukūk*, leading the Islamic asset managers and other investors to hold them until maturity, (ii) the major asset class consists of conventional instead of Islamic investors, thus confining the latter to settling for the available supply, and (iii) lack of a regular issuance programme for the sovereign and central bank *Sukūk*, leaving the investors wary of not finding a replacement, etc. The inactivity in the *Sukūk* market leads to difficulties in mark-to-market valuations of these instruments which is an impediment for price discovery, thus further straining the possibility of trading. Furthermore, in recent years, due to distress in the balance sheets of many *Sukūk* obligors, the restructuring of these *Sukūk* faced serious challenges due to the lack of a reliable valuation mechanism. Lack of valuation also impedes profit-making opportunities for traders in the secondary market.

While many *Sukūk* are listed on several exchanges, including Bursa Malaysia, NASDAQ Dubai, and the London Stock Exchange among others, the secondary market trading in these instruments is still not very active. Generally, most of the *Sukūk* being issued are considered tradable by the *Sharī'ah* supervisory boards of respective market players and supervisory authorities. Nevertheless, a considerable number of *Sukūk* are being traded over the counter, which results in low trading volumes and large bid-ask spreads in these instruments, while hampering the efficient price discovery. In the backdrop of the issuance of *Principles for Financial Market Infrastructures* by the BIS Committee on Payment and Settlement Systems and IOSCO in April 2012, it is vital for the players of IFSI to consider trading of *Sukūk* on exchange-based systems as a first step. These principles cover guidance on the financial market infrastructures that facilitate the clearing, settlement, and recording of monetary and other financial transactions that include, *inter alia*, central securities depositories, securities settlement systems, central counterparties and trade repositories. These components of financial market infrastructure are still underdeveloped in many developing economies. The implementation of

these principles can also greatly benefit the development of a secure and vibrant Islamic securities and hedging market.

Encouragingly, the IFSI has witnessed a number of developments on this front in recent years. The following are some notable examples: (i) Bursa Suq Al-Sila', established by Bursa Malaysia in 2009, is an international multi-currency and multi-commodity fully-electronic trading platform, (ii) Global Commodity Finance Ltd (GATE), established in Dubai International Financial Centre, UAE in 2007, provides an electronic Islamic interbank platform for short-term liquidity management through a proprietary scoring system, (iii) Islamic Finance Gateway by Thomson Reuters, established in 2010, is a global/neutral platform and directory bringing together "trading-ready" finance information and analytics that provides access to multi-asset class information on a wide range of Islamic finance tools, and (iv) the Islamic *Sukūk* Liquidity Instrument (ISLI) issued by the Central Bank of Bahrain on a Scripless Securities Settlement (SSS) System in 2010/2011, is an online real time settlement system for government securities transactions in the jurisdiction.

Another important element of liquidity infrastructure is the availability of a well-functioning Islamic money market and a sufficient number of *Shari'ah*-compliant instruments, players and trading mechanisms. On this front, the establishment of the Islamic Interbank Money Market (IIMM) in Malaysia in 1994 is the leading example of an intermediary providing a ready source of short-term investment outlets based on *Shari'ah* principles to the participating IIFS. Over the years, the IIMM has introduced a number of other programmes, such as *Muḍārabah* Interbank Investment, the Commodity *Murābahah* Programme, and standardised agreements for placement of funds by the interbank players or corporate customers. While supervisory authorities in many jurisdictions are taking steps to establish Islamic money markets in their jurisdictions, further consistent efforts by the IIFS and their supervisors will be needed.

A number of Islamic finance jurisdictions have introduced Islamic money market instruments to help address the limitations of Islamic money market capability, and the risk management requirements of the IIFS in their respective countries. Development of monetary instruments and securities markets can be achieved by integrating Islamic finance into public expenditure programmes. Bahrain, Indonesia, Malaysia and Sudan have made significant progress in integrating Islamic finance instruments into their public finance and expenditure frameworks through sovereign *Sukūk* issuance programmes. In the process, these countries are developing parallel capacities for the issuance of both long- and short-term government Islamic securities that can sustain developmental and project financing, and meet the need for liquidity management instruments by players of IFSI.

It is thus significant that both sovereign and quasi-sovereign entities are now planning for the future not through one-off Islamic financing solutions, but through medium-term *Sukūk* issuance programmes. This suggests that these economies have made significant progress towards developing a capacity to establish and deepen Islamic capital, money and interbank markets. These markets represent the critical missing link towards a fuller development of capacities for liquidity risk management within Islamic financial institutions. At the same time, they enhance the capacity of the authorities to strengthen the stability of the Islamic financial system through the provision of instruments and markets for monetary control. This is of critical importance in those economies in which there are significant prospects for expansion of Islamic banks, and of the wider IFSI. Other

jurisdictions, such as Turkey, are also encouraging interest in and development of *Sukūk*. Turkey's first sovereign *Sukūk* was issued against the back of a significant process of legal, tax and other reforms – all of which have been guided by a public policy commitment, framed over the medium to longer term.

Nevertheless, the issuance of new short-term *Sukūk* continues to be a major challenge for the industry. Lack of variety and too few options for alternatives to short-term commercial papers are another challenge. Nevertheless, the industry has witnessed some short-term issuances in recent years, such as short-term Central Bank of Bahrain's (CBB) *Salam Sukūk* with 91-day maturity and *Ijārah Sukūk* with 182-day maturity; and the Autoriti Monetari Brunei Darussalam's *Ijārah Sukūk* with 91-day maturity. Similarly, perpetual *Sukūk* issuances by Abu Dhabi Islamic Bank and Dubai Islamic Bank to increase their capital base are landmark transactions in terms of their innovative structures.

The infrastructural framework for dealing with insolvency by an IIFS or an obligor of a *Sukūk* remains a challenge for the industry. The insolvency regime needs to cover appropriate legislation, associated rules, rights and obligations for recovery of financing and that of parties to the transaction, including investors, financiers, shareholders and depositors.

The current status and initiatives of RSAs for providing a *Shari'ah*-compliant public safety net in the form of deposit insurance and LOLR are covered in Section 3.2.

3.1.2 Developments on Prudential Framework and Industry Initiatives for IIFS

Given the growing market share of IIFS in many jurisdictions and their potential significance for systemic soundness and stability of the overall financial system, the need for a robust liquidity risk management framework for IIFS cannot be overemphasised. This phenomenon has led to the growing systemic relevance of IIFS, and to their increasing interaction with other important financial institutions in their jurisdictions. Accordingly, a number of developments can be observed in the IFSI to improve the necessary framework on liquidity management by the IIFS. In addition to developments in terms of the liquidity risk infrastructure outlined in the previous sub-section, new steps were taken by stakeholders at all levels of the industry: international standard-setting organisations, supervisory authorities and the industry players. In the following we provide some insights into some of these developments and initiatives.

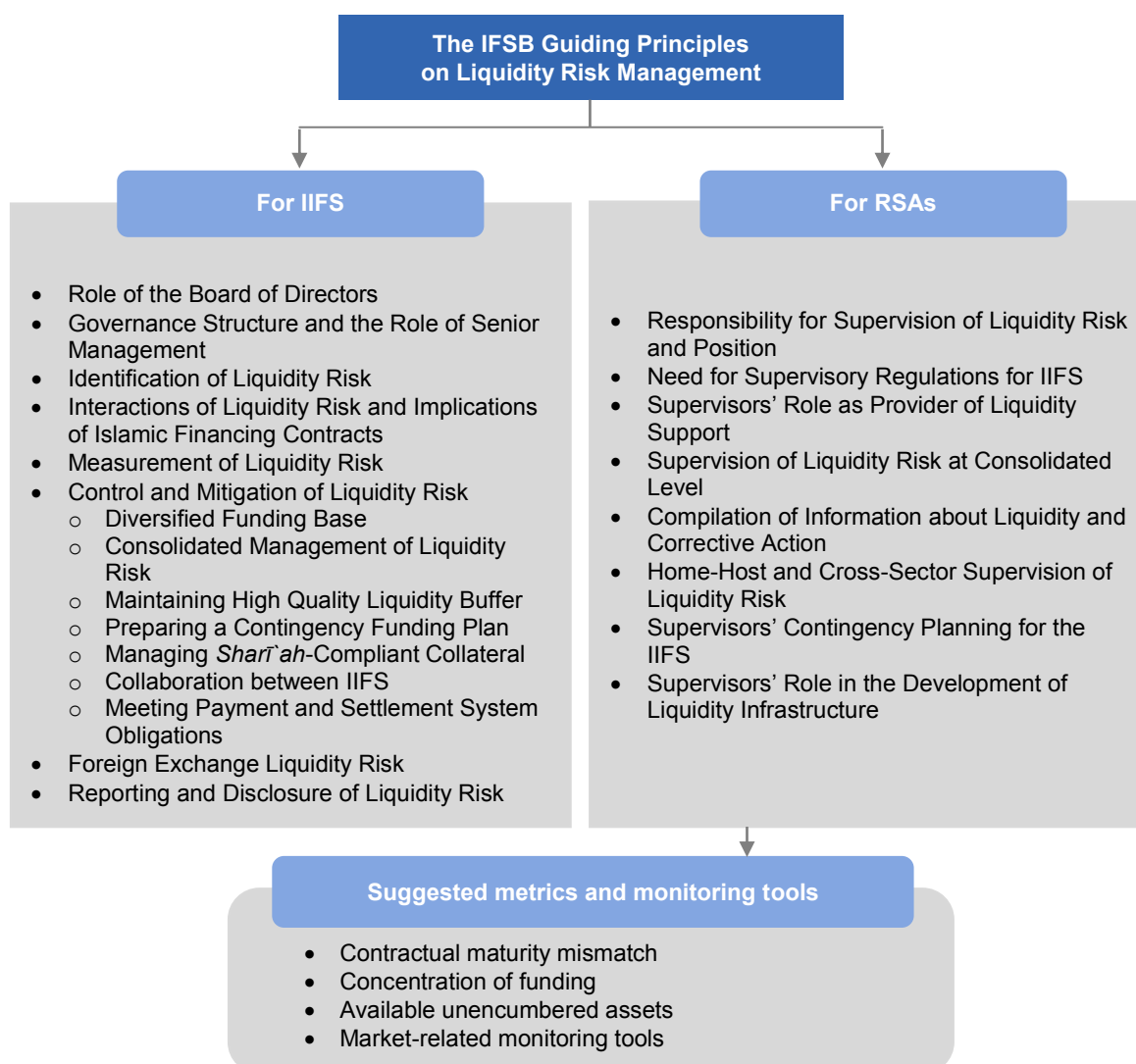
(a) International Developments

After the recent global financial crisis, which crippled the economies of a number of developed and developing nations in various regions, the international standard-setting bodies, supervisors and financial sector industry organisations responded by revising their standards, regulations and guidelines in different areas, including liquidity risk management. In line with these developments, the IFSB took a number of initiatives to provide guidance to the IIFS in the area of liquidity risk management.

IFSB-12: Guiding Principles on Liquidity Risk Management

The IFSB's *Guiding Principles on Liquidity Risk Management for IIFS*, issued in March 2012, endeavours to provide a set of principles for the robust management of liquidity risk by IIFS, and for its vigorous supervision and monitoring by the supervisory authorities, taking into consideration the specificities of the IIFS and complementing relevant existing and emerging international best practices. This document sets out 23 guiding principles in the area of liquidity risk management for IIFS mainly for banking institutions. Besides providing guidance on prudential aspects related to liquidity risk management in IIFS, the document outlines the necessary elements of effective liquidity risk management in the IFS. The RSAs are expected to start implementation of these Guiding Principles in their respective jurisdictions from 2013.

IFSB-12 (see Diagram 3.1.2.1 for the structure of this standard) emphasised that an IIFS should have in place a sound and comprehensive liquidity risk management framework, integrated into its enterprise risk process, in order to maintain sufficient liquidity to meet its daily funding needs and to cover both expected and unexpected deviations from normal operations for a reasonable time. Simultaneously, the IIFS should have an appropriate governance process, including board and senior management oversight, in order to identify, measure, monitor, report and control the liquidity risk in compliance with *Shari'ah* rules and principles and within the context of available *Shari'ah*-compliant instruments and markets. The Standard also underscored that in order to ensure robust monitoring and supervision, supervisory authorities should have a rigorous process for evaluating the liquidity risk management position and framework of IIFS and requiring prompt corrective action in case of any deficiency.

Diagram 3.1.2.1: The Structure of IFSB-12: Guiding Principles on Liquidity Risk Management for IIFS

Source: IFSB-12: Guiding Principles on Liquidity Risk Management for IIFS

Keeping in view the peculiar nature of the balance sheet structure of the IIFS and the unique nature of their interbank market, the Standard provided insights on measures to diversify the funding structure while highlighting the need for continuous monitoring of interactions between liquidity risk and other risks, some of which are unique to the IIFS. The Standard also stressed the need for better in-house monitoring of liquidity risk at the consolidated level when an IIFS is part of a financial group (e.g. a fully-fledged Islamic bank or Islamic investment bank) or part of a conventional bank (e.g. an Islamic window operation). In such structures, the management at the group/parent level should prepare a strategy, policies and procedures for the Islamic operations taking into account the position of such operations within the overall group/parent, with due consideration to the mutual independencies and constraints in transfers of liquidity on a *Shari'ah*-compliant basis between the group entities.

With due attention to the lack of well-developed Islamic interbank markets for effective liquidity risk management in a number of jurisdictions, the Standard underlined that IIFS should closely cooperate among themselves in order to develop *Shari'ah*-compliant arrangements, solutions and trading mechanisms for liquidity management purposes. Such collaboration may involve Islamic banking industry associations in the jurisdiction. These and other arrangements may be supported by the supervisory authorities in order to provide a robust platform and harmonised agreements for active trading between the IIFS, with availability of market makers in various trading instruments and mechanisms.

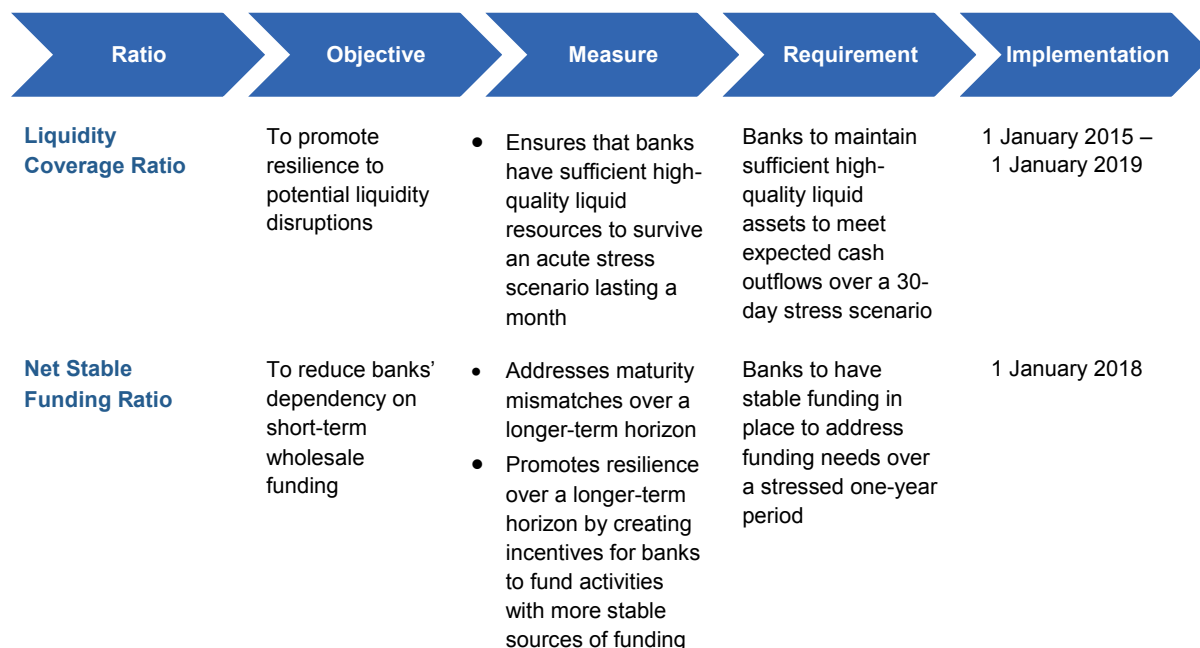
For the guidance of supervisory authorities, the principles in IFSB-12 suggested they make a regular evaluation of the overall liquidity positions and the liquidity risk management framework of the IIFS. The Standard recommended that supervisors develop regulations and guidelines for management of liquidity risk by IIFS, taking into account their specificities related to funding structure, financing and investment products, access to *Shari'ah*-compliant securities, and the stage of development of the Islamic money market in their jurisdiction. Furthermore, it asked the supervisors to provide maximum clarity of their roles as provider of liquidity support and seek to harmonise and expand the eligibility of *Shari'ah*-compliant collateral for providing such liquidity support to IIFS. As a part of their macro-prudential liquidity contingency framework for the financial sector, the Standard recommended that supervisors have a plan for identifying and dealing with liquidity stress in the IIFS sector. Such a framework should be supported by macro-level stress testing, taking into consideration the balance sheet exposures submitted by IIFS as well as other relevant macroeconomic, geographic and political factors.

Guidance Note on Quantitative Measures in Liquidity Risk Management of IIFS

The BCBS issued its package of global regulatory reforms for internationally active banking institutions (referred to as “Basel III”) in December 2010. These reforms introduced significant changes in the capital and liquidity framework of banking institutions. A major development related to liquidity risk management was the introduction of two internationally harmonised global liquidity standards – Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) – which are intended to become a necessary component of the global regulatory framework similar to Pillar 1 capital adequacy requirements (see Diagram 3.1.2.2).

The Basel Committee and its Working Group on Liquidity continued to work on the calibration and refinement of the LCR, and issued its final version on 7 January 2013. The implementation timeline for the LCR has been extended for four years. Instead of its final implementation on 1 January 2015 as proposed earlier, the revised version has staggered the implementation between 1 January 2015 and 1 January 2019, starting from the requirement of 60% LCR in 2015 and incrementing 10% each year until the requirement of maintaining 100% LCR is implemented at the start of 2019.

Diagram 3.1.2.2: Basel III: Liquidity Ratios



Source: BCBS

In analysing the significance of Basel liquidity standards for the IIFS, the IFSB Working Group on Liquidity Risk Management and the Technical Committee recommended a survey on adopting Basel III liquidity standards, which was conducted by the IFSB Secretariat in the third quarter of 2011. This survey covered selected IFSB member jurisdictions. A total of 64 IIFS and seven supervisory authorities responded to the survey. The survey feedback demonstrated, *inter alia*, that:

- (i) In the majority of sample jurisdictions, *Sharī'ah*-compliant instruments/*Sukūk* are not available in sufficient number and quality, which can meet the requirements of Level 1 and Level 2 assets as defined by the Basel III publication.
- (ii) Taking into account the constraints faced by IIFS in acquiring *Sharī'ah*-compliant HQLA, a gradual approach to the implementation of the LCR should be adopted such that the required ratio is less stringent in the initial phase, and becomes more rigorous in the subsequent years.
- (iii) Keeping in view the dearth of eligible HQLA in many jurisdictions, different alternative treatments suggested by the Basel III document should be considered, while keeping the door open for some additional measures, if needed.
- (iv) The shortage or unavailability of an effective (*Sharī'ah*-compliant) deposit insurance scheme or public guarantee for deposits and investment accounts offered by the IIFS in many jurisdictions will lead to treating the deposits/profit-sharing investment accounts

(PSIA) as being in the “unstable” category. This would make it harder for the IIFS to meet the LCR requirement.

- (v) The respondents concurred with the proposal that supervisory authorities should start collecting data on various components of these ratios at an early date, in order to calibrate these ratios and make further refinements over time.

It is relevant to mention the Financial Stability Board's report, *Effects of Regulatory Reforms on Emerging Market and Developing Economies (EMDEs)*, which was issued in June 2012 and submitted to the G-20 finance ministers and central bank governors. As most of the IIFS are operating in the EMDEs, it is pertinent to mention that the IIFS are mostly confronting problems that are similar to those faced by conventional banks in EMDEs, as highlighted in this report. The report noted that “a few EMDEs that have Islamic banks in their jurisdiction also indicated that *Sharī'ah*-compliant banks have more limited access to HQLA since they are not allowed to invest in interest-bearing securities” (pages 15-16).

Similarly, in the latest LCR version issued in January 2013 by the Basel Committee, the text mentions the “treatment for *Sharī'ah* compliant banks”. Paragraph 68 of this publication explains that:

Sharī'ah-compliant banks face a religious prohibition on holding certain types of assets, such as interest-bearing debt securities. Even in jurisdictions that have a sufficient supply of HQLA, an insurmountable impediment to the ability of Sharī'ah-compliant banks to meet the LCR requirement may still exist. In such cases, national supervisors in jurisdictions in which Sharī'ah-compliant banks operate have the discretion to define Sharī'ah-compliant financial products (such as Sukūk) as alternative HQLA applicable to such banks only, subject to such conditions or haircuts that the supervisors may require. It should be noted that the intention of this treatment is not to allow Sharī'ah-compliant banks to hold fewer HQLA. The minimum LCR standard, calculated based on alternative HQLA (post-haircut) recognised as HQLA for these banks, should not be lower than the minimum LCR standard applicable to other banks in the jurisdiction concerned. National supervisors applying such treatment for Sharī'ah-compliant banks should comply with supervisory monitoring and disclosure obligations similar to those set out above.

While it is encouraging that international standard-setting bodies such as the Basel committee have acknowledged the potential problems faced by the IIFS in accessing *Sharī'ah*-compliant HQLA such as *Sukūk*, the market conditions suggest that both the IIFS and their supervisory authorities will continue to struggle in improving the liquidity infrastructure – including *Sharī'ah*-compliant deposit insurance – and strive for sufficient availability of *Sharī'ah*-compliant HQLAs in the near future. An initial assessment on the issues related to adopting LCR for the IIFS is provided in the following box.

Despite these challenges, the IFSB and its member jurisdictions are continuing to work towards the adoption of global liquidity standards for the IIFS. Following the issuance of the updated LCR

framework by the Basel Committee in January 2013, the IFSB plans to issue a new Guidance Note to adapt the Basel III liquidity standards for IIFS, with appropriate calibration and necessary modifications that fully take into consideration the nature and specificities of their operations. The IFSB will conduct a Quantitative Impact Study (QIS)/survey in its member jurisdictions to calibrate the current status of liquidity positions at the IIFS and the supervisory support available to them. For the RSAs of the IFSI, the challenge is to intensify their efforts to review the structure and tenure of current Islamic funding sources to achieve a more stable funding base for Islamic banks. The Guidance Note is expected to be issued in 2014.

Box Article: Assessment of Final LCR Text from IIFS Perspective

Numerator (High-Quality Liquid Assets)

The final LCR rules have relatively softened the requirements with respect to both the numerator (HQLA) and the denominator (Net Cash Outflow). On the numerator side, though the stringent definition of HQLA has been retained, some respite has been provided to banking institutions such as:

- (a) Corporate debt securities rated A+ to BBB have been included as eligible HQLA with a 50% haircut;
- (b) Certain unencumbered equities have been included, subject to a 50% haircut;
- (c) Central bank reserves (as well as overnight and certain term deposits) can be considered part of HQLA;
- (d) Use of local rating scales has been allowed;
- (e) Inclusion of qualifying commercial paper in Level 2 assets; and
- (f) The utilisation of a HQLA pool has been allowed during stressed market conditions.

Naturally, IIFS will get some relief from the aforementioned changes made in various components of HQLA. Most importantly, the aforementioned points (a)–(d) could immensely benefit some IIFS that are operating in jurisdictions where corporate *Sukūk* are available in sufficient number and are of the desired quality. Similarly, IIFS operating in jurisdictions with active stock markets may also benefit.

Nevertheless, it needs to be taken into account that the revised LCR rules have not changed the “fundamental”, “market-related” and “operational” characteristics of HQLA outlined in the initial version. The new rules clearly mention that the HQLA should satisfy operational requirements outlined in the text. Similarly, the stress scenarios specified in the initial publications have been more or less retained in the final LCR rules. Thus, the LCR rules state that “the test of whether liquid assets are of high quality is that, by way of sale or repo, their liquidity-generating capacity is assumed to remain intact even in periods of severe idiosyncratic and market stress. Lower quality assets typically fail to meet that test.” Apart from constraints faced in the Islamic repo market, the IIFS will find it immensely difficult to find HQLA that could retain their liquidity-generating capacity through sale in severe idiosyncratic and market stress.

While the LCR rules have retained the requirements of “being traded in large, deep and active repo or cash markets”, as well as “having a proven record as a reliable source of liquidity in the

markets (repo or sale) even during stressed market conditions” for both Level 1 and Level 2 assets, the text acknowledges that in certain jurisdictions, large, deep and active repo markets do not exist for eligible asset classes, and therefore such assets are likely to be monetised through outright sale. In these circumstances, the text explains that a bank should exclude from the stock of HQLA those assets where there are impediments to sale, such as large fire-sale discounts which would cause it to breach minimum solvency or other statutory requirements. Yet again, the *Sukūk* or other *Sharīʿah*-compliant instruments maintained by the IIFS will fail – in the majority of cases – to meet the aforementioned condition.

Alternative Liquidity Approaches for Jurisdictions with Insufficient HQLA (ALA Treatment)

The three alternative options suggested for the jurisdictions with insufficient HQLA have been retained by the latest LCR rules. The problems faced by the IIFS in relation to the desired characteristics of HQLA and Net Cash Outflows will continue to be faced by the industry, which will require: (i) active collaboration between the IFSB and its member supervisory bodies in preparing updated guidelines for the IIFS that suit the specificities of their balance sheet structure, market dynamics and operational nature, and (ii) pro-active action by supervisory authorities in resolving problems related to liquidity infrastructure and availability of the appropriate *Sharīʿah*-compliant HQLA with the desired characteristics.

All three alternative liquidity approaches (ALA) suggested in the LCR rules could be suitable for the IIFS, which are subject to the decision of the relevant RSAs. Option 1 – *contractual committed liquidity facilities from the relevant central bank with a fee* – can be applied to IIFS without a major *Sharīʿah* concern, because the rules require that “a fee for this facility is charged regardless of the amount”. Option 2 – *foreign currency HQLA to cover domestic currency liquidity needs* – will also provide a useful mechanism for the supervisors to permit the IIFS in their jurisdictions to tap liquidity from outside the jurisdiction, if *Sharīʿah*-compliant HQLA are in short supply in the local market. In fact, this suggestion is in line with the suggestion made in IFSB-12 advising the supervisors to “expand the range of eligible collateral” for central bank facilities. Option 3 – *additional use of Level 2 assets with a higher haircut* – will be suitable for those jurisdictions where highly rated corporate *Sukūk* are available in good quantity, which can be used to fill the gap in the limited supply of Level 1 assets.

Denominator (Net Cash Outflows for 30-day Period)

The calculation parameters for Net Cash Outflows have been eased to a great extent in the LCR rules. Some major relaxations suggested in the rules include, *inter alia*:

- (a) The outflow rate (also called run-off rate) on certain fully insured retail deposits has been reduced from 5% to 3%.
- (b) The outflow on fully insured non-operational deposits from non-financial corporates, sovereigns, central banks and public sector entities (PSEs) has been lowered from 40% to 20%.
- (c) The outflow rate for “non-operational” deposits provided by non-financial corporates, sovereigns, central banks and PSEs decreased from 75% to 40%.
- (d) The drawdown rate on the unused portion of committed liquidity facilities to non-financial corporates, sovereigns, central banks and PSEs has been lowered from 100% to 30%.

- (e) For trade finance transactions, a low outflow rate (0% to 5%) is suggested.
- (f) The outflow rate on maturing secured funding transactions with central banks has been reduced from 25% to 0%.

Notwithstanding the importance of reductions in the “outflow rates” applicable to various banking transactions, the IIFS will continue to face a number of problems in terms of these parameters while calculating the LCR. Some of these issues where IIFS can be at a disadvantage include:

- (a) Due to the unavailability of *Shari'ah*-compliant deposit insurance or a reliable public guarantee in many IFSB member jurisdictions, most deposits and PSIA offered by the IIFS will not be eligible for lower run-off rates.
- (b) Unsecured wholesale funding provided by PSE and sovereigns is one of the most stable categories of deposits for many IIFS. Nevertheless, the LCR rules suggest a high run-off rate – for example, between 20% and 40%.
- (c) Due to the absence of a *Shari'ah*-compliant alternative to repurchase transactions in many jurisdictions, most of the interbank dealings between the IIFS are made on an “unsecured” basis – for example, interbank *Muḍārabah*, *Wakālah* or commodity *Murābahah*. Due to the vulnerability of such interbank transactions, the LCR rules suggest a very high run-off rate of 100%.

The LCR rules have also provided discretion to the supervisors on various factors such as deposit run-off rates and contingent funding obligations, etc. The supervisory decisions on these matters could have a significant impact on the calculation of the LCR in respective jurisdictions. The IFSB will provide further guidance in these areas in its Guidance Note, after analysing the results of the QIS/survey and looking into the nature of deposits/PSIA offered by the IIFS.

(b) Initiatives by RSAs

Global Financial Crisis and Supervisory Actions

Whereas IIFS were largely spared the initial impacts of the financial crisis due to, among other things, a ban on investments in excessively leveraged financial products and *Riba*-based equity investments in the form of shares, subsequent tightening of liquidity and credit in the global financial markets adversely impacted a large number of financial institutions, including IIFS. Accordingly, a number of steps were taken by the RSA to restore the confidence of stakeholders in their financial markets during and after the financial crisis. These steps have been quite successful, as noted by various reports issued by the RSAs as well as the *Financial System Stability Assessment Reports* published by the IMF. These measures included a wide range of tools placed at the disposal of RSAs, as summarised in Table 3.1.2.1. It can be noted that these measures included a combination of quantitative and qualitative measures. In addition, regulations and guidelines on liquidity risk management were strengthened, along with more detailed and frequent reporting to the RSAs. Some RSAs have already started adopting the global standards on liquidity risk management for IIFS. For example, the Central Bank of Oman adopted IFSB-12 in its Islamic Banking Regulatory Framework issued in December 2012. Banque Du Liban also adopted this standard in January 2013.

Table 3.1.2.1: Steps Taken by RSAs to Support Liquidity at IIFS and Overall Banking Sector

Jurisdiction	Reference report	Steps taken by RSAs
Bangladesh	Bangladesh Bank: press statement: "Economic context and rationale behind issuing new bank licenses", 9 April 2012	<ul style="list-style-type: none"> Some banks faced liquidity constraints in 2010 mainly due to shortage of cash money, attributable to high credit growth in the banking sector. The industry average advance-deposit ratio (ADR) was around 85% as against the ceiling of 85% for conventional banks and 90% for Islamic banks. In accordance with the instructions of Bangladesh Bank, banks brought down their ADR, resulting in an industry average ADR of 79.94% as at 22 March 2012. The average IDR of the Islamic banking industry was 95.67% as at December 2010. Banks were advised to prepare and submit the Structural Liquidity Profile monthly so that they can easily detect any maturity mismatch. Bangladesh Bank had provided the banks a simple tool to determine their available funds for investment. Bangladesh Bank had provided the banks a simple tool to determine their available funds for investment.
	Bangladesh Bank: Financial Stability Report 2011	<ul style="list-style-type: none"> In recognition of the low volume of <i>Shari'ah</i>-compliant Statutory Liquidity Requirement (SLR) eligible instruments, Bangladesh Bank has maintained concessionary SLR requirements for Islamic banks in comparison with conventional banks. Islamic banks comply with their SLR requirements at 11.5% of total demand and time liabilities in contrast to 19.0% required for conventional banks. Due to limited sources of <i>Shari'ah</i>-compliant funds, Islamic banks can borrow funds either from the Islamic interbank money market or from the "Islami Investment Bond's Fund" issued by the Bangladesh Government.
Kuwait	IMF: Financial System Stability Assessment on Kuwait 2010	<ul style="list-style-type: none"> The global financial crisis adversely affected the banking system. Tighter liquidity conditions and a sharp decline in asset prices worsened Kuwaiti banks' assets quality, with large increases in non-performing loans (NPLs) and provisions. The Kuwaiti authorities responded forcefully to adverse developments, which helped maintain financial stability. The response came in several forms: (a) the extension of blanket guarantees on all bank deposits, (b) liquidity injections through central bank repo operations, swaps, direct collateralised placements,

Jurisdiction	Reference report	Steps taken by RSAs
		and government deposits at commercial banks, (c) a reduction in repo and discount rates, (d) the enactment of the financial stability law (FSL) allowing for substantial financial sector guarantees, (e) an easing of the prudential loan-to-deposit ratio to facilitate credit growth, and (f) support to the Kuwaiti stock market through the establishment of a stabilisation fund (3% of GDP).
Lebanon	Banque du Liban (BDL): Presentation at IFSB FIS Workshop at Doha, February 2013	<ul style="list-style-type: none"> • Adoption of the IFSB's <i>Guiding Principles for Liquidity Risk Management</i> for Lebanese IIFS in January 2013. • Introduction of BDL's Commodity <i>Murābahah</i> Liquidity Scheme, which is a first <i>Sharī'ah</i>-compliant deposit scheme at BDL, based on commodity <i>Murābahah</i> transactions. It was originally launched in 2007 and restructured in January 2013. • Addressed to Lebanese IIFS in the context of the minimum required and excess investments. Also available for international institutional investors and regional Islamic banks willing to invest in Lebanon. Investment instrument uses platinum or palladium as the underlying traded assets.
Malaysia	Bank Negara Malaysia (BNM): Financial Stability and Payment Systems Report 2011	<ul style="list-style-type: none"> • The report highlighted "Advancements in Liquidity Management in Islamic Finance" in a separate whitebox. • The report covered a widerange of measures introduced by the BNM focusing on developing and strengthening six key components that support more (i) effective liquidity management for IIFS, namely: introducing wide-ranging <i>Sharī'ah</i>-compliant liquidity instruments, (ii) establishing an efficient infrastructure to facilitate the issuance of Islamic financial instruments, (iii) promoting an active secondary market, (iv) ensuring a sound regulatory, supervisory and <i>Sharī'ah</i> framework, (v) securing a strong financial safety net, and (vi) putting in place robust institutional policies and procedures.
Pakistan	State Bank of Pakistan (SBP): Financial Stability Review 2011	<ul style="list-style-type: none"> • On the liquidity front, the last year and a half has seen relatively frequent issues of large-sized <i>Sharī'ah</i>-compliant low-risk Government of Pakistan <i>Ijārah Sukūk</i>. • SBP is working to develop a comprehensive liquidity management solution that might include: (i) development of an Islamic interbank money market, (ii) development of an Islamic Interbank Offered Rate (IIBOR) for use as a benchmark for the pricing of Islamic finance products, (iii) transformation of a sizeable portion of conventional sovereign debt in the

Jurisdiction	Reference report	Steps taken by RSAs
		books of the central bank into <i>Sharī'ah</i> -compliant debt, (iv) allowing Islamic banking institutions to place surplus liquidity with the central bank to be remunerated based on the central bank's earnings on <i>Sharī'ah</i> -compliant assets and investment portfolio, and (v) a lender of last resort (LOLR) facility for Islamic banking institutions.
Qatar	Qatar Central Bank: Financial Stability Review Q3: 2011	<ul style="list-style-type: none"> The issuance of Government <i>Sukūk</i> provided the IIFS an additional investment opportunity. To fund this new investment opportunity (QR23 billion), these banks appear to have resorted mainly to domestic interbank funds (around QR13 billion).
Saudi Arabia	IMF: Financial System Stability Assessment on Saudi Arabia 2012	<ul style="list-style-type: none"> Rate cuts and reduction in reserve requirements <ul style="list-style-type: none"> Repo rate: The repo rate was cut by a cumulative 350 bps to 2% between October 2008 and January 2009. Reverse repo rate: The reverse repo rate was cut by a cumulative 175 bps to 0.25% between December 2008 and June 2009. Reserve requirements: Reserve requirements on demand deposits were cut by a cumulative 600 bps in October and November 2008. Liquidity injections/withdrawals <ul style="list-style-type: none"> Liquidity injection: Beginning in late 2008, USD3 billion in local and foreign currency was placed in banks, and about USD4 billion in swaps. Government agencies injected USD4.8 billion in long-term time deposits. Liquidity withdrawal: The Saudi Arabian Monetary Agency (SAMA) withdrew its time deposits and government entities' deposits with domestic banks, mostly by mid-2009. Safety of bank deposits <ul style="list-style-type: none"> Statement on bank soundness: The authorities announced that they continued to ensure the safety of local banks and bank deposits. However, they indicated that the statement should not be interpreted as an open-ended blanket guarantee for deposits in banks.

Jurisdiction	Reference report	Steps taken by RSAs
Turkey	Central Bank of the Republic of Turkey (CBRT): Financial Stability Report, November 2012	<ul style="list-style-type: none"> • <i>Extension of maturities of deposits and participation funds:</i> The <i>Regulation on Deposits and Participation Funds Subject to Insurance and Premiums Collected by Savings Deposit Insurance Fund</i> stipulated that the differentiation of insurance premiums will be set according to maturity by the Savings Deposit Insurance Fund in order to extend the maturities of deposits and participation funds.
	IMF: Financial System Stability Assessment on Turkey 2010	<ul style="list-style-type: none"> • The CBRT has in place an established and sound Emergency Liquidity Assistance (ELA) framework that allows for provision of temporary liquidity to solvent banks. Under the CBRT law, banks in need of temporary liquidity (available for up to one year, renewable every month) are eligible for ELA, subject to a finding by the CBRT that the bank is solvent. • The ELA is subject to relatively strict collateral and haircut rules which are explicitly specified in the relevant CBRT regulation.
United Arab Emirates (UAE)	<p>Central Bank of the United Arab Emirates (CBUAE): Financial Stability Review 2012</p> <p>and</p> <p>Notice No. 4119/2011, dated 22 June 2011 of the CBUAE</p>	<ul style="list-style-type: none"> • The Advances to Stable Resources Ratio (ASRR) is currently the only regulatory ratio related to liquidity with which banks must comply. This ratio indicates the level of stable resources being held by banks to back their advances. Banks operating in the UAE are required not to exceed an ASRR of 100%. As of December 2011, the ASRR stood at 88% supported by the substantial holding of stable resources and moderate credit growth. • In the UAE, certificates of deposit (CDs) issuance is not driven by monetary policy considerations. These instruments are a store of liquidity for banks that provide them with a risk-free return. • At the peak of the financial crisis during late 2008, the CBUAE intervened and provided the needed liquidity support to banks which ensured the stability of the UAE banking system. This was achieved by providing AED25 billion of collateralised loans to the system. This amount was about 2% of banks' total assets. • The collateralised liquidity provided by the CBUAE varied between AED5 and AED10 billion for the larger part of 2009, before gradually receding to the AED0.5 to AED3 billion range in the last 12 months, indicating that the banking system has reached a comfortable liquidity position. • Introduced a collateralised <i>Murābahah</i> facility to facilitate short-term trading and provide liquidity support to IIFS.

Macro-Level Stress Testing by RSAs and Liquidity Conditions of IIFS

In the persistent fragile macroeconomic conditions facing the global economy, it is imperative that the RSAs keep a close watch on the health of the institutions operating in their financial system. Thus many RSAs have started periodical (bi-annual or annual) issuance of Financial Stability Reviews of their financial systems. This includes many RSAs that are members of the IFSB. Due to increasing market share and significance of the IFSI in their jurisdictions, some RSAs also include a separate analysis of the financial condition of IIFS in their report on financial stability. An important feature of such financial stability reviews for IIFS is the stress testing exercise that is conducted to monitor the likely implications of deterioration in various macro-prudential indicators. The IMF-WB Financial Sector Assessment Programme reports also sometimes include the impact of stress testing exercises on the IIFS in jurisdictions where such institutions hold a significant market share. Table 3.1.2.2 summarises the findings of selected reports to provide an overview of the impact of stress testing exercises on the IIFS, with special reference to their condition in the scenario of a severe liquidity shock to the system.

Table 3.1.2.2: Macro-Level Stress Testing and Impact on Financial Condition of IIFS

Jurisdiction	Reference report	Stress testing results on liquidity position/other financial indicators of IIFS
Bangladesh	IMF: Financial System Stability Assessment 2010	<ul style="list-style-type: none"> Scenario analysis was used to assess Bangladesh's banking sector. Since the country relies heavily on the export sector – and garment exports account for 75% of all exports – a slowdown in economic activity would have a direct effect on banks' asset quality. Based upon a regression model, it was found that the proposed decline of GDP would have an effect on NPLs (20%), exchange rate (25% depreciation of the taka against the dollar) and interest rates (200bp decrease), due to the implementation of monetary policies consistent with a lower foreign exchange (FX) rate. The results indicated that 15 banks would fall below the regulatory requirements, including all state-owned commercial banks.
Indonesia	Bank Indonesia: Financial Stability Review, March 2012	<ul style="list-style-type: none"> Based on the results of stress tests, no individual bank had the potential to experience liquidity shortfalls under a scenario of a 5% decline in deposits. (During the 2008 crisis, average deposit withdrawals reached 5%.) Meanwhile, when compared to conditions at the end of December 2008, the position of individual banks in terms of covering the withdrawal of non-core deposits continued to improve. In this context, there remained many banks with a ratio of liquid assets to non-core deposits in excess of 100% and not one bank had a ratio below 50%.

Jurisdiction	Reference report	Stress testing results on liquidity position/other financial indicators of IIFS
Kuwait	IMF: Financial System Stability Assessment Update on Kuwait 2010	<ul style="list-style-type: none"> • The FSAP Update undertook a stress testing analysis to assess the Kuwaiti banking and Investment Companies (ICs) sectors' resilience to a set of extreme, but plausible shocks. The tests covered market, credit and liquidity risks using single-factor shocks and macroeconomic scenarios. • A liquidity stress test was carried out to test banks' capacity to withstand a deposit run over a period of five days without external financing. The results indicate that banks could withstand a substantial deposit run for the five days, without a need for external financing due to adequate liquidity buffers. • Stress tests indicate that, in contrast to the ICs, the banking system could broadly withstand significant shocks given its comfortable capital and liquidity buffers.
Malaysia	Financial System Stability Assessment on Malaysia 2013	<ul style="list-style-type: none"> • Both top-down (TD) and bottom-up (BU) stress tests were carried out. They used a forecast period to 2016, covering credit, market (interest rate, exchange rate and equity price moves) and liquidity risk. A total of 36 banks (commercial, Islamic and investment banks) including exposures of Labuan branches were included (83% of the banking system's assets). They indicate the banking system is well capitalised and resilient to stress, while highlighting a relative weakness in some smaller banks to credit losses. Exposure to market risk is limited, while liquidity risk indicates potential vulnerabilities arising from the high level of at-call deposits. • In terms of liquidity risk, the BU tests by the banking system indicated resilience towards adverse multi-factor ringgit liquidity shocks over a one-month horizon, but recorded a manageable net cumulative shortfall in USD. For ringgit assets and liabilities, banks on aggregate recorded a post-shock net surplus of RM24 billion (approx. USD8 billion) in available cumulative mismatch to accommodate further liquidity stress over the one-month horizon, while in terms of US dollar denominated assets and liabilities, the banking system recorded a shortfall of USD6.4 billion. In the context of a worsening of the eurozone/global financial crisis, Malaysian banks' access to USD liquidity could be severely impacted. Nevertheless, the BNM appears well placed to provide both ringgit and foreign exchange liquidity, should the need arise.

Jurisdiction	Reference report	Stress testing results on liquidity position/other financial indicators of IIFS
Qatar	Qatar Central Bank: Financial Stability Review Q3: 2011	<ul style="list-style-type: none"> A liquidity scenario test is conducted to assess the impact of a plausible liquidity stress. The stress scenario involves a deposit withdrawal and a non-roll-over of funded liabilities. The analysis indicates varying results across bank groups. None of the Islamic banks appear to be affected by the assumed stress under all scenarios, except for the first scenario. Issuance of domestic Islamic bonds (government bonds) during the year improved the holding of Islamic banks' liquid instruments, resulting in an improvement in liquidity management by these banks. On the contrary, two conventional banks appear to face a liquidity shortage in the event that they are subject to the assumed stress conditions.
Saudi Arabia	IMF: Financial System Stability Assessment on Saudi Arabia 2012	<ul style="list-style-type: none"> Liquidity stress tests suggest resilience to shocks. Only when 17% of general deposits are withdrawn does the regulatory liquidity ratio (liquid assets to deposit liabilities) drop below the 20% minimum, making a decline of this magnitude the threshold for systemic risk. For short-term deposits, this threshold is 31%. Thus, the combination of banks' own adequate liquidity and SAMA's large foreign assets should allow the system to withstand even large liquidity shocks.
Turkey	IMF: Financial System Stability Assessment 2012	<ul style="list-style-type: none"> The stress tests suggest that the sector currently has adequate liquidity buffers to meet funding shocks. Given the current prominent role of (relatively stable) deposit funding, a majority of systemic banks would be able to meet extreme, yet plausible outflows in short-term funding if a sudden-stop type event were to take place in the near term. While some banks would face a liquidity shortfall, most banks would be able to meet such outflows using a combination of existing liquid assets, repo sales of government securities and, to a lesser extent, through the freeing up of a proportion of required reserves corresponding to the volume of departing deposits.

(c) **Market Developments**

In most IFSB member jurisdictions, the IIFS continue to experience a comfortable liquidity position, after a brief stressed period in some jurisdictions in the aftermath of the global financial crisis. The steps taken by their RSAs also helped these institutions to improve their liquidity risk management capabilities. The steps included improving their information systems in order to

provide a better overview of their liquidity position with more granular reporting more effective oversight by the board of directors and senior management and a more active role taken by the risk management department. Nevertheless, the interbank market continues to face limitations due to the short supply of *Sharī'ah*-compliant HQLAs in most jurisdictions, the absence of supervisory support, and a lack of liquidity infrastructure as highlighted in Section 3.1.1.

Another persistent problem faced by the IIFS is fragmented infrastructure and the lack of consensus on *Sharī'ah*-compliant alternatives to repurchase transactions. The explanation of principle 7 in IFSB-12 has analysed in detail the issues faced by the IIFS due to their overwhelming reliance on uncollateralised transactions such as interbank *Muḍārabah*, commodity *Murābahah* and *Wakālah*. The Standard observes that these transactions are exposed to a number of risks: high counterparty exposure, maturity mismatches, high transaction costs, non-tradable and OTC transactions, unavailability of market makers and high documentation risk. Accordingly, in the case of general market disruption, the lower market liquidity can have potentially large negative implications for the availability of funds to the IIFS.

In recent years, however, various RSAs have issued some *Sharī'ah*-compliant alternatives to repurchase transactions, with the close cooperation of and consultation with IIFS. Some of these structures are summarised in Table 3.1.2.3.

Table 3.1.2.3: Some Mechanisms of Islamic Alternatives to Repurchase Transactions

RSA/Institution	Structure	Explanation
International Islamic Financial Market	Proposal for Tripartite Repo ²⁹	<ul style="list-style-type: none"> The IIFM issued its Reference Paper on <i>I'ādat al-Shirā'</i> (Repo Alternative) on 28 July 2010. The Reference Paper aims to provide general information on the concept, operational mechanism and uses of conventional repurchase agreements, and to explore the possibilities for <i>I'ādat al-Shirā'</i> (repurchase) as an alternative to Repo. Overview of structure: The major difference between a conventional Tri-Party repo and the Three Party '<i>IS</i>' <i>under consideration</i> is that, in the case of a conventional repo, the role of the third party is that of an Agent, while for the Three Party '<i>IS</i>' the third party will act as a principal even though It is acting in an intermediary capacity between the other two parties. Operating procedure: <ul style="list-style-type: none"> <i>Step 1</i>: Party A sells securities to a third party (who may be a broker, a clearing agent, a custodian or another third party) against the payment of cash. (Ideally, the aim should be to find an independent third party such as the clearing house of a stock exchange or a custodian bank.) <i>Step 2</i>: The third party immediately sells the

²⁹ "Islamic Repo & Collateralization Possibilities and the Role of *Sukūk*", Euroclear Treasury & Collateral Management Conference, 11 February 2010, Abu Dhabi, by Mr Ijlal Ahmed Alvi, Chief Executive Officer, IIFM.

RSA/Institution	Structure	Explanation
		<p>securities to Party B against the payment of cash.</p> <ul style="list-style-type: none"> Step 3: Party A undertakes to Party B to buy equivalent securities at maturity at a specified agreed price.
Bank Indonesia	Combination of <i>Qard</i> and <i>Rahn</i> Contracts ³⁰	<ul style="list-style-type: none"> <i>Sharī'ah</i>-based Bank Indonesia Certificate (SBIS) was announced and implemented based on Bank Indonesia banking regulation no. 10/11/PBI/2008. SBIS is the short-term Islamic monetary instrument, denominated in rupiah, operated under a <i>Jualah</i> contract with a tenure of between 1 and 12 months and offered with an auction mechanism. SBIS can be collateralised to Bank Indonesia but cannot be traded in the secondary market. Bank Indonesia rewards SBIS holders in the maturity date of SBIS. SBIS can be repurchased (repo) to Bank Indonesia based on <i>Qard</i> followed by <i>Rahn</i> contracts.
Bank Negara Malaysia	Collateralised Commodity <i>Murābahah</i> ³¹	<ul style="list-style-type: none"> BNM introduced collateralised <i>Murābahah</i> in July 2012. Operating procedure: <ul style="list-style-type: none"> Step 1: <i>Rahn</i> (Pledge) – tradable Islamic securities are pledged to BNM as security over the sale price of the commodities. Steps 2 & 3: BNM appoints and authorises the IIFS as a commodity agent to purchase <i>Sharī'ah</i>-compliant commodities from identified commodity vendors (brokers) at a specified value and commodities specifications. Steps 4 & 5: Upon full ownership of the commodities obtained, BNM sells the commodities to the IIFS as purchaser on deferred payment. Steps 6 & 7: IIFS sells the commodities to another commodity vendor to raise cash/liquidity.
	Sale and Buy-Back Agreement (SBBA) ³²	<ul style="list-style-type: none"> In this transaction, a party (SBBA seller) sells Islamic securities at an agreed price to the other party (SBBA buyer) and subsequently the SBBA buyer and SBBA seller enter into another agreement thereon whereby the former promises to sell and the latter to buy back the securities on a specified future date and at an agreed price. Operating procedure: <ul style="list-style-type: none"> At the initiation of an SBBA transaction, the SBBA seller may initiate the SBBA transaction where specified securities are sold and transferred to the SBBA buyer for an agreed cash consideration. Ownership of the securities shall be transferred to

³⁰ "Indonesian Islamic Banking: The Liquidity Instruments", presentation by Bank Indonesia at the IFSB Seminar on "Managing Liquidity of Islamic Financial Services in Emerging Markets", Maldives, 10 February 2011.

³¹ See www.bnm.gov.my/index.php?ch=en_press&pg=en_press_all&ac=2468&tpl_id=395

³² Guidance Notes on Sell and Buy Back Agreement Transactions, Bank Negara Malaysia, August 2002.

RSA/Institution	Structure	Explanation
		<p>the SBBA buyer upon conclusion of the first agreement on the SBBA.</p> <ul style="list-style-type: none"> ○ At maturity, the SBBA buyer shall perform the reversal of the initial SBBA transaction by selling back specified Islamic securities to the SBBA seller for an agreed cash consideration as promised.
Central Bank of the UAE	Collateralised <i>Murābahah</i> Facility (CMF) ³³	<ul style="list-style-type: none"> • The Collateralised <i>Murābahah</i> Facility was introduced by the Central Bank of UAE (CBUAE) in June 2011 to provide a source of liquidity to IIFS in the UAE. It is also a monetary policy tool for the CBUAE. • Operating procedure: <ul style="list-style-type: none"> ○ Bank in need of the Facility has to inform CBUAE of the details of the deal and collateral via the CBUAE Treasury Platform. ○ Should CBUAE agree to provide the Facility, CBUAE will inform the Bank, via the Central Bank of UAE Treasury Platform, of the required rate and instruct the Bank to conduct commodity transactions. ○ The Bank and CBUAE complete the commodity transaction before the funds are released to the Bank. ○ CBUAE requires the Bank to pledge collateral to cover any default of the deferred payment.

At the industry level, various initiatives for standardising interbank trading agreements are being taken. The Association of Islamic Banking Institutions, Malaysia has issued four master agreements for interbank as well as corporate *Murābahah* and *Wakālah* placements. In Pakistan, Islamic banks are using standardised contracts for two interbank trading agreements, namely interbank *Mushārahah* and interbank *Wakālah*.

With the support and guidance of the Central Bank of Sudan, the banking industry in Sudan has witnessed the establishment of four “alliance groups” that aim to effectively manage their liquidity risk through various mechanisms, along with meeting other objectives. One banking alliance established a portfolio to buy sovereign *Sukūk* with a high profitability rate. Another group created an investment portfolio to manage the excess and shortage of liquidity among the group members. The investment portfolio is managed by a separate entity fund, not listed on the stock exchange. The entity’s pool of assets comprises highly liquid assets such as *Sukūk*, current deposits and cash. The returns for the member banks are commensurate with the contributions made by each bank. At the end of each year, dividends are distributed to the entity’s members.

³³ Notice # 4119/2011, dated 22 June 2011, of the CBUAE on Collateralised *Murābahah* Facility.

3.1.3 The Way Forward

Liquidity management has been typically one of the most challenging tasks faced by the IIFS, which typically maintain higher liquidity buffers to address this risk. A record number of *Sukūk* issuances by sovereigns, quasi-sovereigns and corporates in 2012 has provided some respite to the IIFS, by widening opportunities to invest surplus funds and use them as collateral for interbank funding. The IIFS rely more on retail funding in the form of PSIA and other accounts, resulting in more stable sources of funds than their conventional counterparts. Section 3.1 provided an overview of the positive developments on many fronts in strengthening the liquidity infrastructure, while simultaneously highlighting the constraints faced by the IIFS. The next section sheds more light on this subject.

Since the issuance of IFSB-1: *Guiding Principles of Risk Management for IIFS* in December 2005, the IFSB has issued a series of publications to provide guidance for the IFSI on the resolution of liquidity problems faced by IIFS. They include: *IFSI Development: Ten-Year Framework and Strategies* (in May 2007); *IFSB Technical Note on Issues in Strengthening the Liquidity Management of IIFS* (in March 2008); and *Report on Islamic Finance and Global Financial Stability* (in April 2010). The most recent document on this subject has been IFSB-12: *Guiding Principles on Liquidity Risk Management*, issued in March 2012. Due to the persistent fragility in various financial systems, the RSAs have taken a number of steps to resolve the liquidity problems faced by their industry players, including IIFS. These initiatives have helped to improve the liquidity situation of their market players and to restore the confidence of stakeholders in their financial systems.

The regular issuance of financial stability reviews by some RSAs, and the dedicating of a part of their analysis to IIFS, is also a major development that bodes well for the future of the IFSI. It is also quite encouraging that many RSAs are now collecting a wider set of data on the financial position of their IIFS and consider them as significant players in their financial systems. Stress testing exercises carried out in many jurisdiction have confirmed that IIFS in these jurisdictions are sufficiently stable to face any untoward systemic risk. IIFS are also taking various steps to resolve liquidity management issues at their level by creating alliances and producing standardised agreements. Going forward, it is expected that all the stakeholders will continue to work together to resolve the liquidity issues faced by the industry.

3.2 Strengthening the Financial Safety Net: *Sharī'ah*-Compliant Lender of Last Resort (SLOLR)

This section complements Section 3.1 by examining the efforts being made to strengthen financial safety nets. Both SLOLR facilities and a *Sharī'ah*-compliant deposit insurance scheme are considered important components of financial safety nets. Nevertheless, this section reviews only the progress being made in the development and implementation of the selected building block; in particular, it focuses on the role of SLOLR facilities as a safety net in Islamic finance in promoting the stability and resilience of the IFSI.

3.2.1 Development of SLOLR

The global financial and economic crisis has underscored the importance of well-designed financial safety nets, particularly crisis prevention strategies, as part of the comprehensive regulatory and supervisory framework to ensure the soundness and stability of the financial system. LOLR capability has emerged as a key aspect of the crisis prevention supervisory framework. This concept and its operational mechanism has been widely addressed in the conventional literature.³⁴ However, the LOLR facilities, as they stand, **cannot be extended** to IIFS, due, in particular, to some *Sharī'ah* considerations (in terms of their structure or the arrangement used to provide liquidity to the IIFS), even though, in substance, the SLOLR is not much different than the LOLR. This topic is explored in this section.

Recent liquidity problems in the markets have tested supervisory authorities' ability to manage situations of stress, and highlight the need for an effective mechanism of providing SLOLR facilities to support both IIFS as well as the IFSI in situations of serious stress. It has also raised some **important questions**, such as: (a) Is an SLOLR mechanism available in the IFSI for IIFS? (b) What is the current assessment of the development of SLOLR facilities as a safety net? (c) How are SLOLR mechanisms structured by RSAs? (d) Have the monetary tools used by the RSAs been adapted to cater to the specificities of IIFS? (e) What are the key challenges and issues that need to be addressed before developing the SLOLR facilities as a safety net?

As Islamic finance is further integrated into the global financial system, it is critical to have an **integrated initiative** for both conventional and Islamic finance, which develops more effective LOLR and crisis management frameworks (Halim, 2011). The rapid growth in terms of the market share of the IIFS in many jurisdictions and their potential significance for systemic soundness and stability of the overall financial system raises the need for SLOLR facilities as an emergency financing mechanism for the IIFS. This subject has been highlighted in various IFSB publications and initiatives, including:

- (a) *Guiding Principles of Risk Management*, December 2005;
- (b) *Technical Note on Issues in Strengthening the Liquidity Management of IIFS: The Development of Islamic Money Markets*, March 2008;

³⁴ From classical literature through to contemporary studies, the principle of LOLR can be traced back to the work of Walter Bagehot (1873), Humphrey (1989), Bordo (1990), Kaufman (1991), Rochet (1996), Freixas (1998) and Kuttner (2010). To gain an Islamic perspective on LOLR, see Halim Alamsyah (2011), *Lender of Last Resort in Islamic Banking*, IFSB Forum Theme: Strengthening Financial Safety Nets in the Islamic Financial Services Industry, 4th Islamic Financial Stability Forum, Kuala Lumpur, Malaysia, 17 November 2011.

- (c) IFSB-IRTI-IDB *Report on Islamic Finance and Global Financial Stability*, April 2010;
- (d) *Guiding Principles on Liquidity Risk Management*, March 2012; and
- (e) 4th Islamic Financial Stability Forum on “Strengthening Financial Safety Nets: *Shari’ah*-compliant Lender of Last Resort Facilities and Emergency Financing Mechanisms as well as Deposit Insurance”, November 2011.

The main **objective of this sub-section is to provide a progress assessment, drawing on an ongoing IFSB study** on SLOLR³⁵ facilities across the IFSB member countries. It is structured as follows:

- (a) Liquidity management and tools for monetary operations of the central bank;
- (b) Current status of the development of SLOLR facilities across the jurisdictions;
- (c) Assessment of the pre-conditions for the development of SLOLR facilities across jurisdictions;
- (d) Key challenges and issues faced by RSAs in the development of an SLOLR as a safety net.

³⁵ The study included an industry-wide Survey Questionnaire, which was distributed to all 38 banking RSAs, including central banks, and monetary authorities who are members of the IFSB, between 19 June and 31 July 2012. As of January 2013, the IFSB received 36 responses out of the total of 38 RSAs – a response rate of 95%. Only the complete responses were analysed. The survey exercise covered all the major regions and countries with a significant level of Islamic finance (such as Saudi Arabia, Iran, Sudan, Malaysia, Bangladesh, Pakistan, Indonesia, UAE, Qatar, Kuwait, Jordan, Lebanon, etc.); countries with a low level of Islamic finance (e.g. Mauritius, Tajikistan, Egypt, Nigeria, Palestine, Morocco, Maldives, Senegal, etc.); and non-OIC (Organization of Islamic Conferences) member countries such as Korea, Luxembourg, Japan, Philippines, China, Hong Kong, Singapore, etc. with an emerging interest in Islamic finance. The full comprehensive study on SLOLR is expected to be published at the end of 2013.

3.2.2 Tools for Monetary Operations of the Central Bank

Both open market operations (OMOs) and standing facilities are **considered important tools** for RSAs for the monetary operations of a central bank. In analysing the SLOLR mechanism, we begin by identifying the tools. This will lead us to evaluate the challenges in developing SLOLR facilities. A discussion on Islamic monetary policy or the institutional structure of the Islamic financial system is beyond the scope of this section. The section looks only at the existing mechanisms available for RSAs for monetary operations and how they are adapted to cater to the Islamic finance.

- The term “**OMOs**” refers to the transactions in money market instruments (either primary or secondary markets) initiated by central banks and operated through a competitive mechanism with the purpose of adding (through liquidity injection operations) or withdrawing (through liquidity absorption operations) bank reserves to and from the banking system.
- **Standing facilities** (i.e. discretionary end-of-day lending or deposit facilities to provide or absorb overnight liquidity) being part of the LOLR mechanisms under usual circumstances are policy instruments that may be used at the initiative or discretion of banks, bearing pre-set charges and under certain pre-established conditions. Since banks are not expected to rely on these facilities, some jurisdictions restrict the number of banks that can have access to them, the frequency of access and the intervals between usages.

The RSAs were asked to identify the set of tools available for central banks/monetary authorities to conduct monetary operations and their liquidity support mechanisms as LOLR under Aspect A and Aspect B. **Aspect A** was on the existence of the following tools for monetary operations of the central bank in each jurisdiction. **Aspect B** was on whether each tool for monetary operations had been adapted to meet *Sharī'ah* requirements. Table 3.2.2.1 summarises the results on tools for monetary operations of a central bank. Overall, the findings suggest that although the majority of the respondents indicated that they use OMOs and standing facilities as tools for monetary operations, there is little evidence suggesting that such tools have been adapted to meet *Sharī'ah* requirements or to accommodate transactions with IIFS. This elucidates the challenges in developing the SLOLR facilities across jurisdictions.

Table 3.2.2.1: Tools for Monetary Operations of Central Bank

	Aspect A		Aspect B	
Open market operations (OMOs)	Yes	Base	Yes	Base
Buying and selling money market instruments outright on the secondary market.	20 (80%)	25	5 (23%)	22
Buying and selling assets under repurchase agreement (repo and reverse repo operations) in a secondary market to inject or absorb liquidity into or from the banking system.	21 (84%)	25	5 (23%)	22
Buying and selling of foreign exchange swaps.	16 (64%)	25	3 (15%)	20
OMO-type operations (conducted using specific central bank instruments)	Yes	Base	Yes	Base
Lending and borrowing on an auction basis against underlying assets as collateral.	11 (44%)	25	3 (14%)	21
Primary market issuance of central bank or government securities for monetary policy purposes.	18 (72%)	25	6 (29%)	21
Auctions of term deposits.	6 (25%)	24	1 (5%)	20
Foreign exchange auctions (as a tool for both banking system's liquidity management and foreign exchange).	7 (28%)	25	0 (0%)	20
Standing facilities (i.e. discretionary end-of-day lending or deposit facilities to provide or absorb overnight liquidity)	Yes	Base	Yes	Base
Discount window or refinance facilities (i.e. short-term borrowing of funds from central banks secured against government bonds or central bank securities as collateral, providing a ceiling for market interest rates).	21 (88%)	24	2 (10%)	20
Deposit facilities (i.e. short-term placement of banks' funds with central banks), providing a floor for market interest rates.	19 (79%)	24	5 (25%)	20
Fully collateralised Lombard facilities, secured against government bonds and loans on deeds, providing a ceiling for market interest rates.	7 (29%)	24	0 (0%)	19

Source: IFSB Survey on SLOLR (2012)

Under OMOs, **80% (20 out of 22) of the RSAs** buy and sell money market instruments outright on the secondary market, and **84% (21 out of 22)** of the RSAs are using buy and sell assets under a repurchase agreement (repo and reverse repo operations) in a secondary market to inject or absorb liquidity into or from the banking system. This indicates that the development of OMOs using “repos and outright” sale or purchase is considered “important” for efficient monetary operations by the RSAs. However, it is worth noting that **only 23% (five out of 22)** of the RSAs have adapted OMOs to accommodate transactions with IIFS.

The most pressing issues for RSAs seem to be the limited availability of instruments for OMOs and the limited tradability of existing instruments. Therefore, the designing of suitable instruments, particularly for “repo transactions”, is important for effective monetary operations with IIFS and for the development of Islamic money markets. Similarly, the majority of RSAs perceived Islamic government

investment certificates, Islamic Treasury bills, repos, interbank *Muḍārabah* investment, and commodity *Murābahah*³⁶ as particularly suitable for effective monetary operations.

Like OMOs, the majority of the RSAs have standing facilities such as a discount window (88% of the RSAs) and central bank deposit facilities (79% of the RSAs), but not the Lombard facilities (only 29% of the RSAs). **Only two jurisdictions (10%) seem to have adapted** discount window or refinance facilities, and five RSAs (25%) have adapted central bank deposit facilities, to accommodate specificities of Islamic finance. The findings on standing facilities also suggest the need for the development of new such facilities, or the adaptation of existing facilities, in line with the specificities of Islamic finance. The importance of such facilities is also reflected in IFSB-12, which demonstrates that country experiences have shown that a standing liquidity facility from the RSAs, both in normal and stressed market conditions, offers valuable flexibility with which to deal with temporary liquidity disruptions, which may be institution-specific or market-wide.

3.2.3 Current Status of Development of the SLOLR Facility

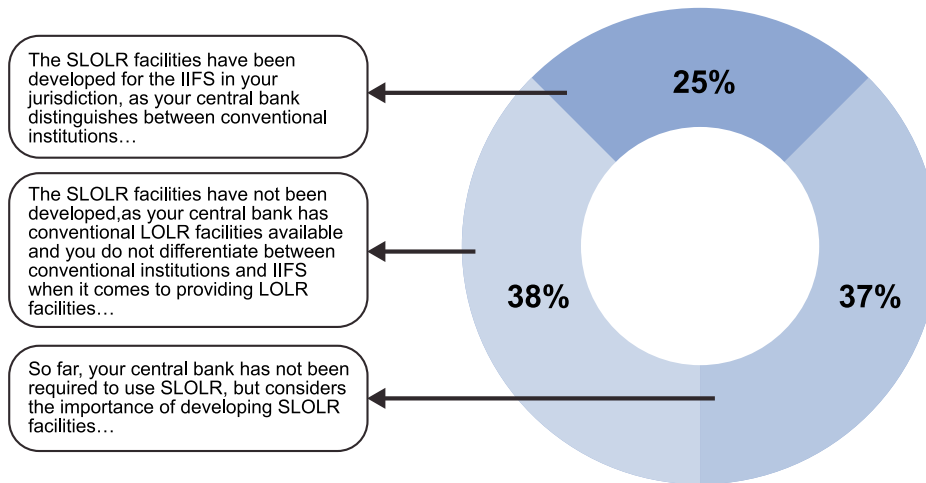
LOLR facilities for banking institutions are **available to almost all conventional** banks and are legally embedded in the scope of the respective central bank/monetary authority. These LOLR facilities are **granted exclusively to financial institutions** holding a banking licence issued by a central bank/monetary authority. However, such a provision is not available to all IIFS as it is not legally embedded in the scope of some RSAs (Diagram 3.2.3.1).

With respect to SLOLR, RSAs are at different stages of development (Diagram 3.2.3.1):

- (a) **Six RSAs** (out of 24) confirmed that SLOLR facilities **have been developed** for the IIFS in their jurisdiction, as **they distinguish** between conventional institutions and IIFS when it comes to providing LOLR facilities for *Sharī'ah* compliance reasons.
- (b) **Nine RSAs** (out of 24) revealed that the SLOLR facilities **have not been developed** in their respective jurisdiction, as they have conventional LOLR facilities available, and indicated they **do not differentiate between** conventional institutions and IIFS when it comes to providing LOLR facilities, due to prudential and stability reasons. Thus, some RSAs treat Islamic and commercial banks on an equal footing with respect to their importance in financial intermediation, and also due to the fact that legislation does not specify any requirement for the SLOLR. However, this raises *Sharī'ah* compliance issues in terms of the mechanisms used to provide LOLR to IIFS, which can create reputational risk for the IIFS.

³⁶ The term "commodity *Murābahah* transactions as a tool for liquidity management (CMT)" means a *Murābahah*-based purchase and sale transaction of *Sharī'ah*-compliant commodities, whether on cash or deferred payment terms.

Diagram 3.2.3.1: Current Status of SLOLR Development



Source: IFSB Survey on SLOLR (2012)

Base: 24 RSAs

- (c) On the other hand, some RSAs who have not been required to use SLOLR to date **place a high importance on developing SLOLR facilities** due to the increasing IIFS market share in the banking system. In a number of jurisdictions the unavailability of SLOLR is due to the lack of a legal and regulatory framework, and the small size of the IIFS (i.e. low penetration of IFSI in particular IIFS, and there being no systemically important IIFS in the country at present, thus linking the development of an SLOLR framework with developments in the market). Further, there is also an increasing recognition of a need to have a clear SLOLR policy document, properly defining the structure and mechanism and specific criteria for developing SLOLR facilities. Some RSAs also mentioned the approximate time frame to develop SLOLR facilities within their respective jurisdiction, which ranged from one to three years.

While in substance the **SLOLR is not much different from LOLR**, it requires that the structure or the arrangement used to provide liquidity to the IIFS is *Sharī'ah*-compliant. This requires that RSAs have in place the *Sharī'ah*-compliant financial contracts used to support the structure/arrangement. However to identify appropriate *Sharī'ah*-compliant financial contracts which satisfy the RSAs' requirements of providing liquidity to the IIFS, or which provide a level-playing field in the industry, is not a simple task as it has to ensure that the **central bank is not at a disadvantage when it comes to lending** to IIFS compared with conventional banks. The key issue is what could be the appropriate *Sharī'ah*-compliant financial contract that can be employed by the RSAs.

The RSAs who have developed a mechanism to provide SLOLR have used the following underlying **Sharī'ah-compliant structures**: *Muḍārabah*, *Mushārah*, *Murābahah*, Commodity *Murābahah*, *Tawarruq*, *Qarḍ* with *Rahn*, etc. (See Table 3.2.3.1 for details on how they are structured.) Furthermore, short-term *Ijārah Sukūk*, Islamic Treasury bills or the equivalent, Islamic government investment certificates, Islamic CDs and commodity *Murābahah*, and related *Sharī'ah*-compliant financial instruments, are **perceived as highly useful and suitable for the purpose of developing**

SLOLR support for IIFS. It must be stressed that finding suitable structures and instruments remains an ongoing challenge and is subject to further research.

It should be noted that each contract and structure has its **own merits and weaknesses**. For instance, for *Qard al-Hasan*, or free financing, the issue is that of a level playing field in terms of cost of funding. On the other hand, while commodity *Murabahah* offers a more certain monthly return than the bilaterally **negotiated profit-sharing ratio of the *Muḍārabah* interbank trade**, there is the **issue of tradability either** over-the-counter or through the formal interbank market or secondary market, which limits the use of such instruments: hence the instruments are kept until maturity. This is an important factor, since it has been challenging to develop an interbank **yield curve** (including the determination of a profit-sharing ratio for overnight funding) using the *Muḍārabah* structure.

Table 3.2.3.1: Details of Some SLOLR Facilities by RSAs: How They Are Structured

	Name of facility	Underlying <i>Shari'ah</i> -compliant structure	Tenure (short-term, overnight or intra-day, etc.)	Maximum amount (USD)	Eligible <i>Shari'ah</i> -compliant collaterals/securities	Currency (Local currency – LCY / Foreign currency – FCY)
1	Sale and Buy-Back Transaction (SBBA)	<i>Bay' al-'Inah</i>	Overnight		Locally denominated eligible securities such as central bank, government, multilateral bodies with AAA	Collateral in both LCY and FCY
2	Collateralised <i>Murabahah</i>	<i>Rahn</i> and <i>Murabahah</i>	Overnight		Similar to the above	Similar to the above
3	Interest-free loans	<i>Qarḍ al-Hasan</i>	Short-term	Due to policies approved	Cheques, deduction authorisation	LCY
4	Partnership	<i>Musharakah</i>	Short-, mid-, long-term	Due to policies approved	Cheques, deduction authorisation	LCY
5	Refinancing facility (standing facility)	Repo collateralised borrowing (<i>Qarḍ with Rahn</i>) Repo sale and buy-back (<i>Bay' with Wa'ḍ</i>)	Overnight	No limit	Islamic Central Bank certificate (SBIS)	LCY
			Overnight	No limit	Islamic government bonds (<i>Sukūk</i>)	LCY
6	Short-term financing facility	<i>Mudharabah</i>	14 days, and could be rolled over maximum 90 days	Subject to liquidity needs based on supervisor assessment	Islamic government bonds, Islamic Bank Indonesia certificate, Islamic corporate bonds, and financing assets	LCY
7	<i>Tawarruq</i> and reverse <i>Tawarruq</i>	<i>Murabahah</i>	Short-term	N/A	N/A	LCY
8	<i>Murabahah</i> Commodity Programme under <i>Tawarruq</i> structure	Ivory Coast cocoa and Niger uranium could be the underlying assets	At least six months			FCY
9	Central Bank <i>Ijārah</i> Certificate	<i>Ijārah Sukūk</i> issued by the central bank. Only Islamic banks can hold such certificates	It depends on the level of the liquidity. Generally, it takes within one year			

Source: IFSB Survey on SLOLR (2012)

3.2.4 Supervisory Assessment of the Development of SLOLR Facilities

The current status of SLOLR development indicates progress as well as significant gaps. A third of the total respondent RSAs indicated that the **relevant legal, tax and regulatory** aspects have been adapted or modified to accommodate the development of SLOLR facilities in their jurisdiction. More broadly, there is a continuing need to set out clear **procedures and processes** under which the central bank would act as a LOLR to IIFS covering, *inter alia*: (a) greater clarity of roles as provider of SLOLR facility; (b) having in place the appropriate techniques to value the underlying *Sharī'ah*-compliant asset; (c) identifying eligible collateral; (d) setting applicable limits to various types of collateral; (e) a process to ensure *Sharī'ah* compliance of SLOLR operations; and (f) minimum/maximum duration to utilise the SLOLR facility.

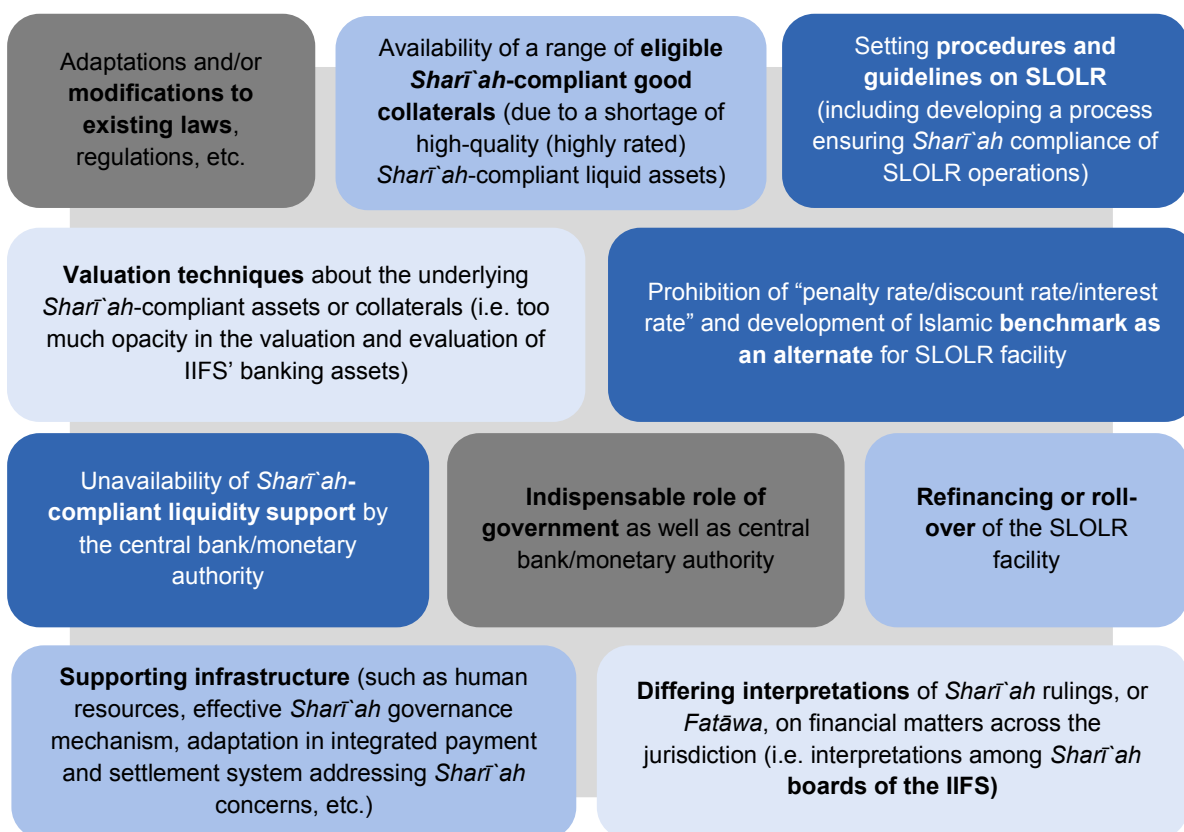
Sharī'ah constraints on SLOLR facility (e.g. issue of profit or penalty rate, refinancing or roll-over of SLOLR, eligibility of the collateral, eligibility of *Sharī'ah*-compliant assets to be used as collateral when issued in other jurisdictions and currencies, etc.) have been assessed only by six RSAs (out of 24). Likewise, the **necessary steps required to develop the SLOLR facility** (including a process that ensures *Sharī'ah* compliance of SLOLR operations through the presence of a *Sharī'ah* supervisory board) in accordance with *Sharī'ah* rules and principles have been assessed only by seven RSAs (out of 24).

With respect to the issues relating to **payment and settlement systems**, an assessment has been conducted by six RSAs (out of 25) to address its linkages with the SLOLR facility, whereas **cross-border Sharī'ah-compliant LOLR facilities** and the need for coordination among RSAs have been identified by only four RSAs. This area seems to be less prioritised by the RSAs.

With respect to the financial crisis, there is evidence that only a few RSAs have extended SLOLR facilities to the IIFS during or after the financial crisis, mainly by way of standing facilities through discount windows, or by offering emergency facilities. This highlights that the RSAs should provide greater clarity of their roles as provider of *Sharī'ah*-compliant liquidity support and an LOLR facility to the IIFS in both normal and stressed times.

3.2.5 Key Challenges and Issues in the Development of the SLOLR Facility

On the scale of **1 (the most significant)** to **10 (the least significant)**, it appeared from the findings that adaptations/modifications to existing laws/regulations, the availability of a range of eligible *Sharī'ah*-compliant good collaterals (due to a shortage of high-quality (highly rated) *Sharī'ah*-compliant liquid assets), and setting procedures and guidelines on SLOLR are considered the most significant challenges when developing SLOLR.

Diagram 3.2.5.1: Challenges Considered by the RSAs in Developing SLOLR Facilities in Their Respective Jurisdictions

Source: IFSB Survey on SLOLR (2012)

Other Key Issues: Expansion of Eligible Collaterals, Role of IILM, and Deposit Insurance

A significant majority of the RSAs agreed that in periods of particularly unusual market duress, the central bank/monetary authority **should be prepared to move beyond the normal** scope of operations to provide liquidity against a broader range of assets and over a longer maturity than might otherwise be considered. It is highlighted that in unusual circumstances, when the standard tools are unable to solve liquidity pressures, the RSAs should use other tools as needed to calm markets, including expanding **eligible collateral** and extending the maturity of liquidity injection based on prudent assessment.

In particular, with respect to **eligible Shari'ah-compliant collateral**, in one jurisdiction, funding is provided against unencumbered government securities.³⁷ However, if the borrowing institution runs out of these securities, as could occur in times of crisis, there is no effective instrument with which to meet liquidity needs and augment the capital base.

In respect of expanding eligible collateral, it is perceived by the RSAs that the **establishment of the International Islamic Liquidity Management Corporation (IILM)** would assist IIFS and supervisory authorities in addressing their liquidity management issues in times of stress (through issuing high-

³⁷ Most of the RSAs reflected that *Sukuk* is the key instruments that can be used as collateral to obtain an SLOLR facility. However, there is still only a limited secondary market in many jurisdictions. Although growing, the secondary market for Islamic securities/financial instruments – in particular, *Sukuk* – remains generally sparse, illiquid and inactive due to the tendency to hold them until maturity.

quality, liquid, tradable and low-risk *Sharī'ah*-compliant financial instruments at both the national level and across borders). However, it is recognised that this would largely depend on the success of the IILM's business model and the structure and market acceptability of its financial instruments.

There is also agreement by RSAs that **extending the existing safety nets to include *Sharī'ah*-compliant deposit insurance and developing the Islamic money markets** (formal or informal) will reduce the need to develop SLOLR facilities in their jurisdictions.

3.2.6 The Way Forward

The development of **SLOLR has become more important** to the IFSI as the industry becomes larger and more integrated with the global financial system. Such integration has fostered the spreading of risks, through contagion mechanisms, as evidenced in the financial and economic crisis, from the conventional financial system to the IFSI. Although the IIFS weathered the storm in the first phase, they were not immune from the significant impact at the second stage of the crisis. Different mechanisms have been used by the RSAs to inject liquidity into the market for liquidity management. In the absence of SLOLR, IIFS would become more vulnerable to liquidity problems as liquidity instruments in the interbank market dry up. With an effective SLOLR and a robust crisis management framework in place, market confidence in the IFSI will be strengthened.

In endorsing the above perspectives, IFSB-12 recommended that RSAs should **provide greater clarity of their roles** in both normal and stressed times. For instance, supervisory authorities can be more explicit regarding their response to a liquidity crisis, by defining the type of *Sharī'ah*-compliant collateral that can be pledged, the limits applicable to various types of eligible *Sharī'ah*-compliant collateral, and possible durations of the financing that would be provided.

It should be understood that the SLOLR facilities (as safety net) are not designed by the supervisory authorities for liquidity purposes under a normal setting; rather, they are a means to **provide liquidity to the eligible IIFS** in stressed market conditions. Nonetheless, it should be kept in mind that the virtual absence of a domestic Islamic money market, and the lack of tradable *Sharī'ah*-compliant, short-term money market instruments, have been seen as key challenges for both monetary operations (as a transmission channel for the implementation of central banks' monetary policy) and liquidity management of IIFS. The availability of various *Sharī'ah*-compliant instruments (such as short-term and long-term *Sukūk*, *Sharī'ah*-compliant repos) by the RSAs would strengthen the IIFS' liquidity.

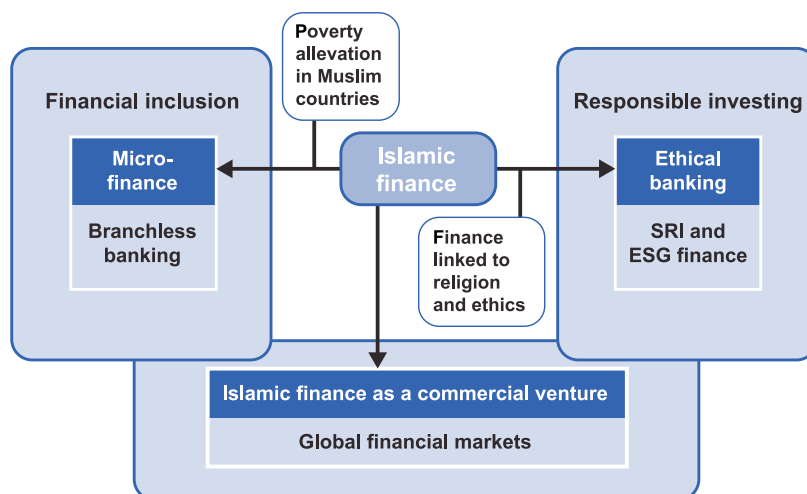
The development of both **SLOLR and *Sharī'ah*-compliant deposit insurance** (the latter is discussed at length in Section 4.1.3) is critical to promoting the resilience and stability of the IFSI. These schemes are crucial elements of financial safety nets and need to be supported by concurrent measures to strengthen licensing criteria, and prudential regulations and supervision, while further improving resolution and insolvency frameworks.

4.0 EMERGING ISSUES IN ISLAMIC FINANCE: FROM MICROFINANCE TO FINANCIAL INCLUSION AND BEYOND

The macro stability of a financial system depends on the solidity of its micro foundations. The consumers of the products of the IFSI are, in several respects, exposed to additional risks compared to the consumers of conventional financial products. For example, consumers who chose Islamic finance products for their compliance with Islamic law face a *Sharī'ah* non-compliance risk, especially when they use more complex and innovative products. In addition, and more importantly, customers who pay money into Islamic bank accounts for the purpose of financial gain usually do so on the basis of *Muḍārabah* contracts which, in principle, expose their funds to an investment risk. These are issues for consumer protection in Islamic banking, and the relevance for the systemic stability is most obvious in the case of uncovered losses passed on to *Muḍārabah* depositors: they could trigger a bank run which grows into a serious threat for Islamic finance in countries where liquidity management tools, Islamic interbank markets and SLOLR facilities are still lacking or underdeveloped. Preventive or curative consumer protection measures are required to mitigate stability threats resulting from adverse consumer reactions in critical situations.

Islamic finance continues to grow at a high rate, but in some countries this aggregate growth is partially achieved by the integration of new groups of customers into the financial system for whom financial services were not previously within reach, affordable or acceptable. In a number of countries, this financial inclusion does not simply “happen”; it is the result of a deliberate financial inclusion policy of the government. The policy is most successful where previously neglected market niches are penetrated by commercially oriented financial institutions. A considerable portion of the now included and previously unbanked customers are individuals or households with a low and unstable income. Successful microfinance initiatives will increase the number of customers of financial institutions and broaden the financial system. However, the economic vulnerability of these new customers requires not only consumer protection measures for individuals in stress, but also a regulatory framework which stabilises the microfinance sector as such. Although its size may not yet be very significant in financial terms, the stability of this sub-sector of the financial system is of great social, developmental and political relevance.

Diagram 4.1: Emerging Issues in Financial Stability



Source: Prof. Volker Nienhaus

4.1 Consumer Protection in Islamic Banking

Consumer protection ranks high on the agenda of regulators around the world. The financial crisis brought to light numerous mis-selling practices of bankers and brokers. The ballooning of sales of unsuitable or even fraudulent products to retail customers was abetted by ill-informed consumers who often were neither able to identify their financial needs nor to understand the risks of the financial products they bought. These concerns have led to a focus on measures to reduce the probability that such problems will resurface in the future – such as consumer education programmes and product regulations – and help to protect consumers and support the stability of the financial system.

The crisis also underscored the importance of consumer-related safety nets – in particular, effective deposit insurance schemes – to avoid a bank panic and further turmoil in the financial markets. In addition, conflict resolution and debt restructuring mechanisms are necessary to ensure the “financial survival” of many individual consumers.

This chapter will deal with some consumer protection measures and initiatives that are still being debated in Islamic banking but which do have some urgency in the light of the recent crisis experiences. Consumer protection measures which are already widely applied – such as licensing requirements for banks, prudential regulation and monitoring the financial soundness of banks – will not be covered in this chapter.

4.1.1 Consumer Education

The sub-prime crisis in the US and the following global financial crisis shared, amongst other things, the fact that bankers and brokers were able to sell to retail clients financial products that did not match their financial needs and overtaxed their financial capacities. Regulation of selling practices would be one way to ensure better consumer protection, but there is also a need to enhance the financial “literacy” and capabilities of consumers of financial products in general, and of less experienced, low-income and vulnerable groups of users of financial products in particular.

Information and Advice: The UK Example

The aim of financial education campaigns is to enhance consumers' understanding of financial products, to support the identification of their financial needs and capacities, and to facilitate informed choices in competitive markets. In countries with a dual financial system where both conventional and IIFS offer products and services, it is also important to create a basic understanding of the differences between conventional and Islamic finance and to increase awareness of the specific features of Islamic products and services. Regulators may leave this task to the market players, who, out of self-interest, should have a minimum level of consumer education in general and an incentive to increase customers' awareness of the special features of their own products in particular. But since market players may look at financial literacy mainly from a marketing perspective, it is by no means guaranteed that their efforts in the area of consumer education will be sufficiently comprehensive and unbiased. Therefore, regulators should at least observe and maybe coordinate the activities of market players and, where necessary, supplement or even correct their efforts.

But authorities could also take a more pro-active approach and start education campaigns themselves. A remarkable initiative was taken by the UK government in early 2007 (before the outbreak of the sub-prime crisis in the US).³⁸ In 2010, following the recommendations of a detailed study – the “Thoresen Review of Generic Financial Advice”³⁹ – the government gave a division of the FSA a separate identity and legal status as the Consumer Financial Education Body (CFEB), renamed the Money Advice Service in 2011. Its statutory objectives are “to enhance the understanding and knowledge of members of the public about financial matters (including the UK financial system), and to enhance the ability of members of the public to manage their own financial affairs”.⁴⁰ The CFEB and the Money Advice Service produced, *inter alia*, a wide range of information materials, including a series of brochures in award-winning plain English, to explain and familiarise retail consumers with financial products and services. This material includes Islamic retail products. For example, the existence of *Sharī'ah*-compliant products is briefly mentioned in a brochure entitled “Saving and investing”, and a separate brochure has been published on *Sharī'ah*-compliant home purchase plans.⁴¹

The UK example is noteworthy, as it indicates that a secular regulatory institution⁴² feels obliged to pay attention to financial products which owe their existence to the application of religious teachings in financial affairs. This is in line with the FSA's “level playing field” approach. By explaining the financial mechanics but refraining from commenting on the underlying religious concepts, the Money Advice Service abides by the FSA's self-conception as a financial regulator only.⁴³ In this respect, the initiatives of the UK authorities are an example of how regulators in countries with dual banking systems could become pro-active in consumer education without compromising their neutrality. It

³⁸ “As financial products become more sophisticated ... it becomes more important for consumers to engage with financial services with skill and assurance. However, the Financial Services Authority (FSA) has identified low levels of financial capability

³⁹ See Thoresen (2008). The review was expected to indicate, *inter alia*, “the most effective way of serving different groups of consumers, ensuring effective targeting of those most vulnerable to the consequences of poor financial decision-making” (p. 5).

⁴⁰ See <https://www.moneyadviceservice.org.uk/en/static/about-us>.

⁴¹ Both brochures can be downloaded from <https://www.moneyadviceservice.org.uk>. Aldohni (2011), pp. 163-170, points out that the publication of these brochures was a major achievement, but he criticises that other Islamic retail banking products were not covered and that some details in the publication on home purchase plans are inaccurate.

⁴² The Money Advice Service is not a regulator in the strict sense, but it can be seen as a specialised institution of the broader UK regulatory infrastructure with the FSA on top.

⁴³ “The FSA is ... a secular and not a religious regulator. It would not be appropriate, even if it were possible, for the FSA to judge between different interpretations of Sharia law.” FSA (2007), p. 13.

should also be noted that the services provided by the Money Advice Service to the general public, namely the consumers of financial products, go far beyond the production of brochures. In addition to this “traditional” form of consumer education, a wide range of advisory services are interactively delivered on demand to individual consumers through web- and phone-based, as well as face-to-face, communication.⁴⁴ For many Muslim countries with a low general educational level, such measures may be too advanced, but a motivated government or regulatory authority will find more suitable forms of financial literacy programmes and consumer support in financial matters.

Avoidance of Gharar: Comprehensible Contracts in Plain Language

Islamic finance must avert contractual uncertainty (*Gharar*). This requires that all terms and conditions of a contract should be fixed and written down. But the avoidance of *Gharar* in the retail business means not just putting everything in writing, but also that this writing is comprehensible for the average retail customer. Many contracts are lengthy with a lot of small print and juristic terms. One can expect that a businessperson would understand such documents, but not the average retail customer. Therefore, a movement that is gaining momentum in Western retail finance could also be promoted in the IFSI – namely, to scrap the fine print, trim the length of contracts, and to rephrase legal jargon in plain language. Only understandable documents can be free of *Gharar*.

4.1.2 Consumer Protection by Product Regulation

In the context of financial retail products, an explanation of rights and obligations in plain language may not even be enough. Proponents of Islamic finance underscore the removal of information asymmetries and the avoidance of injustice and the fairness of *Shari'ah*-compliant transactions. To achieve this, it may be necessary to structure the documents for a product such that it not only lists all terms and conditions but also clearly outlines risks for the customer in “irregular” situations.

Treatment of Defaulting Customers in Conventional and Islamic Banking

For example, if a bank uses *Murabahah* contracts for long-term home financing, the terms and conditions as such are relatively straightforward. The contract may specify that in case of the customer's default on one instalment, the bank can immediately claim the full outstanding amount of the stipulated purchase price. But even if this is phrased in clear terms, it is doubtful whether the customer fully understands the implications without an additional explanation. For example, if the contract is for 15 years and the default happens by the end of year 1, the bank can claim the purchase price which is calculated on the basis of capital provided at the beginning of year 1 for the purchase of the house plus a compensation for the use of the bank's capital over a period of 15 years. Suppose the benchmark for the use of capital is 7%, then the total financing costs are $15 \times 7\% = 105\%$ of the capital provided. So in the case of a default at the end of year 1, the customer still owes the bank roughly double the purchasing price of house – which he certainly cannot pay (otherwise he would not have entered into the financing contracts with the bank and would not have defaulted on one instalment). Or in another perspective, if he defaults and sells the house at the purchasing price, he

⁴⁴ For the full scope of the manifold advisory services, see the website of the Money Advice Service; for a performance assessment, see the “Directors’ report and financial statements for the year ended 31 March 2012”, <https://www.moneyadviceservice.org.uk/files/directors-report-and-financial-statements-20120712.pdf>

can pay only half of what he owes to the bank. Unless regulations stipulate something different, the restructuring of the debt of a defaulting customer is at the full discretion of the bank.

What has been outlined so far are implications or risks of a “classical” *Murābahah* contract applied in long-term financing, which should be explicated to retail customers. If the practice of the bank deviates from this (in a consumer-friendly manner), or if regulations stipulate a different treatment of a default case, then this should also be explained to the customer.

Regulators can react in different ways to this (rather extreme, but not totally unrealistic) case. For example:

- (a) They could prescribe that the Islamic bank provides a “risk disclosure for default scenarios” to retail customers.
- (b) They could provide such information by themselves (or issue “product guidelines”) in the context of consumer education and awareness initiatives for Islamic finance products.
- (c) They could decide that *Murābahah* contracts are not suitable for long-term consumer finance and rule out their use for this purpose (or take recourse to somewhat milder and conditional forms of restrictive product regulation).
- (d) They could enact procedures for retail clients’ debt restructuring (which may or may not be in full conformity with the *Sharī‘ah* requirements of *Murābahah* contracts) to ensure that the treatment of defaulting customers of Islamic banks is not less favourable than the treatment of defaulting customers of conventional banks.
- (e) They could install user-friendly systems for complaints handling, access to information and dispute resolution.

Regulators’ reactions can not only foster consumer protection, but can also contribute to the credibility of goals of fairness and non-exploitation in Islamic finance. What has been outlined for Islamic banking is, in principle, also of relevance for the Islamic capital market. In many jurisdictions, capital market products require an approval by the capital market regulator prior to their issuance, and the issuer must produce a prospectus which covers all relevant aspects of the security. It is up to the regulator to define what should be disclosed in the prospectus, and in what form. Experiences with prospectus guidelines could support the development of product-related information and disclosure templates for critical banking products that supplement contract forms in banks. By this, consumer protection elements would be embedded into the distribution channel of banking products.

Product Mapping and Clearance Certificates

Regulators, who are facing the problem that the observance of a particular *Sharī‘ah* opinion implies a less favourable treatment of Islamic bank clients compared to conventional bank clients, must be aware of some critical implications of the different reaction patterns.

- (a) Regulators who prescribe or provide a “risk disclosure for default scenarios” only, and leave to the customer the decision as to whether to accept or reject a potentially unfavourable contract, do not interfere in *Sharī‘ah* issues and retract to a position similar to the British FSA, which claims to be only a financial and not a religious regulator. However, this neutrality is vulnerable.

Suppose a customer has signed a contract, defaults on it, and the bank takes measures to execute the unfavourable conditions. The customer – who has little to lose but much to gain – takes his case to the court. The court may look at the intention of the contract (which is financing irrespective of the chosen juristic form of a sales contract) and may find the claims of the bank disproportionate; it will then pass a judgment in favour of the customer. After (or in anticipation of) such a judgment, the regulator has to rethink the “neutrality” position.

- (b) A product regulation that forces Islamic banks to restructure debts of defaulting *Murābahah* customers in a pre-determined manner implies that the regulator overrules *Sharī'ah* conditions of the contract, which most probably compromises its *Sharī'ah* compliance. This is hardly compatible with the position of a neutral and purely financial regulator. Factually, fairness criteria or a more favourable practice of conventional banks get priority over *Sharī'ah* considerations. Customers may welcome such a position, but *Sharī'ah* scholars may sharply criticise it.
- (c) The least interference into *Sharī'ah* matters follows from a general prohibition of particular types of contracts for specific purposes, such as *Murābahah* contracts for long-term home financing. Such a practice does not challenge any of the *Sharī'ah* conditions of a particular contract.

Restrictions on the use of particular contracts for specific purposes must not be made in an *ad hoc* manner. It should be done only after a thorough analysis of the potentially critical results of all contracts used in the retail business in cases where the customer cannot meet all their contractual obligations. Over the last decades, a considerable number of court rulings have accumulated in different jurisdictions, and an evaluation of these cases could lead to an evidence-based mapping of “critical” combinations of particular contracts and financing purposes.

Given that Islamic finance is not static and that product innovations will be launched in retail banking, regulators may consider the introduction of a kind of “clearance certificate” for new types of products. Banks would be required to provide information on the new features and possible risk dimensions of their innovative banking product – in a technical document for the regulator, and (after clearance) in an explanatory and illustrative format for the general public. Based on this information, the regulator could update the matrix of critical contract/purpose combinations, and the retail customers have the necessary ingredients for their “informed choice”. Transparency-enhancing measures which unfold risks and side effects of products must not inhibit competition or product innovation. This can be seen, for example, from developments in the markets for non-financial products such as pharmaceuticals, cosmetics or foodstuff, but also in financial markets with respect to insurance policies.

The background for the mapping and clearance certificate proposal was a rather extreme but not totally fictitious case. But the problems of consumer protection and the implications for the regulators are not specific to this case only. They can exist in many more (if not all) *Sharī'ah*-compliant retail products which are deployed by Islamic banks operating in mixed financial systems in predominantly secular (common or civil law) jurisdictions without a national *Sharī'ah* body with final authority.

Sharī'ah Disclosure for Retail Products

Most jurisdictions require that Islamic banks establish a *Sharī'ah* board that certifies the *Sharī'ah* compliance of the products and procedures of the bank. This certification is typically done in a very general statement for the whole bank and not differentiated by products. If *Sharī'ah* compliance were a simple and clear “yes/no” decision without divergent legal opinions, a differentiation would not be necessary: if the whole is compliant, then all of its parts must also be compliant. But if there could be different opinions on the *Sharī'ah* compliance of individual products, the assessment becomes more complicated. Strictly speaking, the statement of *Sharī'ah* compliance should be read as: “*Sharī'ah* compliant under the premise that the legal opinion A is accepted for product/procedure X, etc.” But a blanket compliance statement does not give any indication as to what product/procedure X (or Y, or ...) would be assessed differently if one follows opinion B (or C, or ...) instead of A.

While there is a wide consensus with respect to “standard” contracts,⁴⁵ this is not necessarily the case for more complex or innovative products (such as credit cards or capital-protected family *Takāful* contracts sold through banks to retail customers). The question is whether more *Sharī'ah* disclosure in these cases would contribute to better consumer protection or just add to the regulatory burden of banks without any substantial benefit for the retail customers. Disclosure for the sake of disclosure ignores its costs and ends in an avoidable waste of resources. There is also the issue of how much value retail customers place on differentiated *Sharī'ah* compliance statements. Many retail customers may not be very sensitive with regard to differences in legal opinions as long as a board with reputable *Sharī'ah* scholars has approved the products that they are using.

Nevertheless, regulators may revisit the issue: if there is no national *Sharī'ah* board with a final authority, and if the regulator tries to refrain from involvement in *Sharī'ah* issues as much as possible, it must be the users of innovative Islamic banking products who, in the final instance, decide on the acceptability of new *Sharī'ah* solutions. They may not be in a position to do so on their own as individual consumers, but what emerged in the Western finance industry could recur in Islamic finance: with the growing sophistication and diversification of the finance industry, consumer associations and specialised media (journals, television programmes, websites) emerged which analyse financial products, compare them in several dimensions, and condense the findings in “ratings” or “quality seals” which are clearly understandable for non-experts and are taken as guidance for financial decisions by many retail customers. Since *Sharī'ah* compliance is the outstanding and differentiating feature of Islamic banking products in competition with conventional banks, and since differences in legal opinions are sometimes even seen as an asset and not as a burden, similar retail-oriented associations or media could emerge in parallel with the growth, differentiation and emancipation of Islamic finance. They could analyse financial and, in particular, *Sharī'ah* qualities of products – provided they get access to the relevant information (i.e. the legal opinion of the banks’ *Sharī'ah* scholars on the individual products). Therefore, regulators in jurisdictions with substantial Islamic finance market shares and growing ranges of sophisticated retail products may consider a product-related minimum *Sharī'ah* disclosure. This would not only add an important dimension to consumer protection, but it may also help to reduce *Sharī'ah* non-compliance risks and thus contribute to the

⁴⁵ For standard contracts in retail banking, one can assume that, for example, the AAOIFI *Sharī'ah* Standards are generally accepted.

robustness of advancing Islamic finance markets. The necessary consumer-oriented information-processing infrastructure (with print and electronic media, online services, etc.) will emerge only where Islamic retail finance has reached a sufficient critical mass. This is probably not the case as long as market shares of Islamic banks are in the range of 10%. However, as mentioned in the first chapter, market shares in some countries have already surpassed this level by far, and continuously high growth rates in other countries should lead to more significant Islamic finance sectors there in the foreseeable future.

4.1.3 Deposit Insurance

The *Islamic Finance and Global Financial Stability Report* (2010) considered deposit insurance to be a key component of the financial safety-net arrangement for sustaining financial stability. The question was not whether a deposit insurance scheme should be implemented, but how it should be structured to be *Shari'ah* compliant.

Short-Term Benefits and Long-Term Risks of Deposit Insurance

Conventional deposit insurance schemes were quite effective in preventing retail bank runs where the coverage regarding the size of protected deposits (e.g. up to USD100,000) and the percentage of reimbursement (e.g. 100%) was sufficiently high. Deposit insurance prevents escalation of an individual bank failure into a banking sector crisis through contagion effects and a bank panic. That Islamic banks are not immune to contagion effects became apparent in the 2001 run on the participation banks (at that time called “special finance houses”) in Turkey.

While short-term benefits of crisis prevention are obvious, long-term costs are less clear but nevertheless relevant: an adverse effect of deposit insurance could be the erosion of market discipline. Protected depositors have no longer a vital interest in monitoring the risk position of their banks. On the contrary, if higher risks mean higher returns while losses are externalised, depositors may even welcome more risk-taking by their banks. This may increase the probability and frequency of financial crises in the future. There is a trade-off between actual private gains in an acute crisis today and potential public costs from more, or more severe, financial crises in the future.

- (a) The benefits of deposit insurance accrue to bank customers and bank managers who are rewarded for risk-taking and not seriously punished for losses, while losses of a systemic crisis – which can be a multiple of the gains – are widely dispersed throughout the financial sector and the real economy.
- (b) If a deposit insurance scheme is not financed by contributions of the potential beneficiaries (directly by the actual and future depositors, or indirectly through contributions of the insured banks) but from public funds, then negative externalities with regressive distributive implications exist in cases where depositors are on average richer than taxpayers.
- (c) Although other negative externalities are less clear and may occur only in the future, they could be more severe and must also not be ignored.

In short, proponents of deposit insurance must explain in some detail how possible negative effects in the future can be avoided or why they are of less importance than the present benefits. Recent empirical work has shown that it is possible, but not trivial, to design and implement an effective deposit insurance arrangement that prevents crisis escalations by bank runs and curtails the risk appetite (i.e. limits the moral hazard risk) of bank managers and customers in order to contain the threat of insurance-induced future crises.

Table 4.1.3.1: Six Principles of Good Deposit Insurance Design

Six Principles of Good Deposit Insurance Design	
1	Limited insurance coverage
2	Compulsory membership
3	Private sector (co-)responsibility for the scheme
4	No shifting of losses to the general taxpayer
5	Appropriate (risk sensitive) pricing of insurance services
6	Involvement of deposit insurer in bank insolvency resolution

Source: Demirgüç-Kunt, Kane and Laeven (2008), pp. 23-24

Deposit Insurance in Islamic Countries

IADI established an Islamic Deposit Insurance Group which conducted a Survey on Islamic Deposit Insurance and presented a discussion paper entitled “Deposit Insurance from the *Shari’ah* Perspective” in 2010.⁴⁶

According to the IADI, only five Islamic countries have some experience with Islamic deposit insurance schemes: Sudan (since 1996) in a fully Islamised financial system and Bahrain (since 1993), Turkey (since 2001/2005), Malaysia (since 2005) and Indonesia (since 2005) in mixed systems with conventional and Islamic banks. Bosnia and Herzegovina, Jordan, Kuwait, Singapore and the UK protect Islamic deposits under their conventional deposit insurance systems. General features of an Islamic deposit insurance scheme and differences between Islamic and conventional schemes are summarised in the following tables.

Table 4.1.3.2: Salient Features of Islamic Deposit Insurance

No.	Characteristics	Country		
		Yes	No	No answer
1	Mandatory membership	Bahrain, Indonesia, Malaysia, Singapore, Sudan, Turkey, UK	Jordan	Bosnia and Herzegovina, Kuwait
2	Separation of Islamic premiums from non-Islamic premiums ^a	Malaysia	Bosnia and Herzegovina, Indonesia, Singapore, Turkey, UK	Kuwait
3	Management of fund according to <i>Shari’ah</i> principles ^b	Malaysia, Sudan	Bosnia and Herzegovina, Indonesia, Singapore, Turkey, UK	Kuwait

⁴⁶ See IADI (2010, 2010a).

No.	Characteristics	Country		
		Yes	No	No answer
4	Similar coverage limit for Islamic and conventional deposits ^c	Bahrain, Indonesia, Jordan, Kuwait, Malaysia, Singapore, Turkey, UK	-	Bosnia and Herzegovina
5	Similar premium rates for Islamic and conventional deposits ^d	Indonesia, Malaysia, Singapore, Turkey, UK	-	Bosnia and Herzegovina, Kuwait
Notes: (a) Bahrain, Jordan and Sudan are excluded since Bahrain and Jordan have yet to collect Islamic premiums and Sudan collects only Islamic premiums. (b) Bahrain and Jordan are excluded since they have yet to collect Islamic premiums. (c) Sudan is excluded since all deposits are Islamic. (d) Bahrain, Jordan and Sudan are excluded since Bahrain and Jordan have yet to collect Islamic premiums, and Sudan collects only Islamic premiums.				

Source: IADI (2010a), p. 6

Table 4.1.3.3: Differences between Islamic and Conventional Deposit Insurance Systems

No.	Subject	Islamic deposit insurance system	Conventional deposit insurance system
1	Instruments covered	Islamic deposits (this may include PSIA's)	Interest-based deposits
2	Institutions covered	IBIs – i.e. Islamic banks and Islamic banking windows	Conventional banks
3	Premium payments	From the IBI's own funds. If the PSIA is protected, premiums may also be paid from returns on the PSIA's investments	From the conventional bank's own funds
4	Differential premium system	Key financial indicators for assessing risk profiles of IBIs (especially unique risks)	Key financial indicators for assessing risk profiles of conventional banks
5	Funds	Premiums received from IBIs maintained in Islamic deposit insurance fund (separate book if dual operation, and no commingling/cross-subsidisation)	Premiums received from conventional banks maintained in conventional deposit insurance fund
6	Expenses	Incurred for permissible activities only	Incurred for any activities
7	Investment	Investment in permissible business activities and instruments only	Investment in any business activity or instrument
8	Payments	Made from Islamic fund	Made from conventional fund
9	Priority of payments within deposit category	Payments for deposits and PSIA's are prioritised based on underlying contracts	There is no priority of payment for deposits
10	External funding (in case of deficit)	From the government or market based on <i>Shari'ah</i> principles	From the government or market

11	Liquidation	Assets funded by restricted PSIA's may be liquidated separately	Not applicable since there is no PSIA
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Source: IADI (2010), pp. 10-11

Sharī'ah and Deposit Protection

The design of an Islamic deposit insurance scheme has to come to grips with a number of *Sharī'ah* issues.

(a) Insurability of Financial Claims

The first *Sharī'ah* issue is whether financial claims can be insured at all. Today, most *Sharī'ah* scholars would answer in the affirmative provided the structure is based on either *Kafālah* or *Takāful* contracts.

- *Kafālah*⁴⁷ is a contract of guarantee with a fee: The deposit insurance institution assumes (as the guarantor) all responsibilities and obligations resulting from claims against the Islamic bank (as the guaranteed party) in cases where the bank fails to meet these claims. The bank has to pay a fee to the guarantor for the funding of its operations. However, a majority of *Sharī'ah* scholars insist that a guarantee is voluntary, and they reject the charging of a fee by the guarantor. Without a fee, a *Kafālah*-based deposit insurance scheme is commercially not viable. It could only be implemented if the operations (including compensations in cases of bank failures) are funded from public sources (with questionable distributional and operational implications).
- *Takāful* is a kind of solidarity contract where potential beneficiaries (participants) jointly contribute to a risk pool out of which claims would be settled in cases of specified events such as the failure of a participating bank. In this case, the pool would compensate claims of depositors of the failed bank. The contributions are classified as *Tabarru'* (conditional donations). The deposit insurance institution would act as the *Takāful* Operator who manages the scheme, and the banks or the depositors would be the participants who contribute to the risk pool. The funds of the pool have to be invested in a *Sharī'ah*-compliant manner. It is debatable whether the membership of a bank in a *Takāful* arrangement must be voluntary or can be enforced (e.g. by recourse to *Maslahah* arguments).

⁴⁷ More precisely: *Kafālah bi al-Ujr*.

(b) Types of “Deposits” in Islamic Banks

Islamic banks accept funds on accounts with different commercial and legal qualities. These differences are important even if – for brevity and for the lack of a better generic term – “deposit” is frequently used to denote all kinds of funds paid into accounts of Islamic banks.⁴⁸

- Islamic banks accept funds on *current accounts* which are commercially and legally full equivalents of current accounts of conventional banks – that is, they are deposits in the proper meaning of the word. These deposits are used mainly for transactional purposes, and the account holders do not receive a return on their balances. Current account deposits are liabilities of the Islamic bank and a claim of the account holders. It is generally accepted that these claims could be covered by an Islamic deposit insurance scheme.
- Islamic banks accept funds on *restricted investment accounts* on the basis of *Muḍārabah* (or *Mushārah*) contracts and invest them in specified projects. The account holders and the bank share profits according to an agreed ratio, while losses have to be borne by the capital providers – that is, only the account holders in a *Muḍārabah*. The bank provides information on the risk characteristics of the specified project, and the account holders are well aware of the possibility of a partial or total loss of their invested funds. Funds placed in these accounts share more characteristics with investment certificates or other forms of collective investment schemes than with bank deposits, and therefore they are usually excluded from the deposit insurance coverage.
- Islamic banks accept funds on *unrestricted profit-sharing and loss-bearing investment accounts (UPSIA)* on the basis of *Muḍārabah* (or *Mushārah*) contracts – for brevity: *Muḍārabah* deposits. The bulk of funds accepted by Islamic banks fall into this category. The banks are free to channel the funds into profitable investments at their discretion. Funds paid into unrestricted investment accounts are seen as similar to (or as *Sharī'ah*-compliant substitutes for) savings or term deposits in conventional banks. They pose the most serious challenges for Islamic deposit insurance schemes.

(c) Protection of *Muḍārabah* Deposits

There are different opinions on and approaches to the protection of *Muḍārabah* deposits. Three groups can be distinguished:

- (i) The full protection of the historical account value (principal amount) in a conventional scheme with an individual waiver option for *Muḍārabah* depositors.

Special and separate Islamic deposit insurance schemes are very rare. Most Muslim and all non-Muslim jurisdictions have only one scheme for both conventional and Islamic deposits. This causes problems in several respects. For example, compensations for

⁴⁸ The *Malaysia Deposit Insurance Corporation Act 2011* defines an Islamic deposit as “a sum of money or money’s worth received or paid on terms by any person, under which the receipt and repayment shall be in accordance with the terms of any agreement consistent with the *Sharī'ah* on any basis including custody or profit sharing”.

Islamic depositors would be paid out of a common pool with commingled funds of conventional and Islamic banks which were invested in interest-bearing assets. More important, conventional schemes treat all Islamic deposits as deposits in the conventional legal sense, meaning that the bank has to provide an insurance cover which guarantees the full repayment of the principal amount irrespective of investment losses in the case of a bank failure. Such a guarantee in a “gone concern” case can be *Sharīʿah* compliant if it is provided by an independent third party (such as a public-sector deposit insurance institution). The more challenging stipulation from a *Sharīʿah* perspective is that all licensed deposit-taking banks have to guarantee the full repayment of deposits under “normal” circumstances irrespective of investment profits or losses. A guarantee by the bank itself – that is, the *Muḍārib* – to the capital providers (*Rabb al-Māl*) in case of an ongoing concern is not in conformity with the *Sharīʿah* principles for *Muḍārabah*. A pragmatic solution for this problem has been found in the UK: The Islamic Bank of Britain (IBB) was licensed on the condition that it informs its customers about the obligation by the UK banking regulations to offer the full repayment of the principal amount and to make good any investment losses (and that the deposits are fully covered by the UK deposit insurance scheme in case the bank fails). But the bank also pointed out that customers who accept this offer do not comply with *Sharīʿah* principles.

This solution shifts the responsibility for the *Sharīʿah* compliance to the customer.⁴⁹ Such a scheme with a full guarantee of the principal and an individual waiver option for the compensation for investment losses has the potential to prevent a bank run as a consequence of the bankruptcy of the Islamic bank, especially if most Muslim depositors see Islamic investment accounts as functional equivalents to conventional savings or term deposits and would prefer not to waive the compensation offer in case of investment losses. Obviously, their individual perception of *Sharīʿah* compliance is more lax and not in accordance with that of each bank’s *Sharīʿah* scholars. These depositors will feel sufficiently protected against adverse consequences of a poor investment performance (going concern case) and a bank failure (gone concern). If investment account holders in other Islamic banks are not fundamentally different and subject to the same guarantee scheme, the threat of contagion effects and of a bank panic vanishes.

- (ii) The protection of the actual account value (principal amount adjusted for investment losses) by guarantees given by an Islamic deposit insurance institution.

The second approach – that is, the protection of only the actual account value of UPSIAs by a guarantee of an Islamic deposit insurance institution – would solve the problems of commingled funds. It requires the establishment of a separate Islamic deposit insurance scheme, either as an independent institution or as a segregated department with a firewall between the conventional and Islamic guarantees within one comprehensive deposit insurance institution. Malaysia has set up one institution with segregated funds to avoid commingling and to ensure *Sharīʿah*-compliant investments.

⁴⁹ See with quotations from IBB documents by Aldohni (2011), pp. 159-160.

The major difference between this and the first approach – besides the segregation of funds – should be the scope of depositors' protection in cases where the investment of *Muḍārabah* funds results in a loss before the bank fails. The first approach of a full protection with an individual waiver option would cover this investment loss and reimburse the principal amount paid into the *Muḍārabah* account (i.e. the actual value plus a compensation for the investment loss), while the second approach would not cover the investment loss. As explained by its Chief Operating Officer, the Malaysia Deposit Insurance Corporation (MDIC) “guarantees PSIA⁵⁰ (i.e. protects the current value of PSIA and not its principal) in the event of an IBI's⁵¹ failure and not during the normal course of business”.⁵² A guarantee scheme with similar results – that is, the guarantee of only the actual value of *Muḍārabah* funds (i.e. the initial amounts minus investment losses), with no segregated funds but special rules for Islamic banks within a comprehensive protection scheme – can be found in Turkey.

If the Islamic deposit insurance does not cover investment losses, it is debatable whether such a scheme can effectively prevent a bank run. It all depends on the behaviour of the IAHs. If they are not willing to take a loss, they do not have an *ex post* choice as in the first approach of a full protection with a waiver option. They can protect their deposits only by *ex ante* actions such as a withdrawal of as much money as soon as possible if they fear that losses will be allocated to their investment accounts. When losses are allocated to IAHs in one bank, this might induce a general run on Islamic banks if account holders of other banks assume that the investments of their own bank face similar difficulties. The contagion could be averted only if the IAHs of the other banks are convinced that their banks were more prudent in their investment decisions than the troubled bank. However, the recent crisis has shown an overexposure of many Islamic banks to bubble-prone real estate markets and similar deficiencies in risk management and risk diversification. With apparent similarities of the investment portfolios, it will be very difficult to convince IAHs that the prudence of the investment managers of their bank will shield them effectively from adverse market trends and potential losses.

That IAHs may withdraw funds in anticipation of losses is in principle recognised by regulators and standard setters: withdrawals in reaction of (anticipated or realised) performance deficits, let alone losses, are the basis of the displaced commercial risk of Islamic banks. For “milder” forms of performance deficits, the use of the bank's investment risk reserves and profit equalisation reserves, as well as the “sacrifice” of parts of the bank's profit shares, are recommended risk mitigation techniques.⁵³ However, these techniques may not be strong enough in cases of heavy losses.

⁵⁰ PSIA = profit-sharing investment accounts.

⁵¹ IBI = Islamic banking institution.

⁵² See Arshad (2011), p. 9.

⁵³ See IFSB-1: *Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services (IIFS)*.

So far, the allocation of losses to IAHs has occurred only in a very few extraordinary cases,⁵⁴ and a general run on Islamic banks has not happened.⁵⁵ But one cannot take it for granted that this will continue forever. For instance, IAHs may become more risk aware and risk sensitive in the future, and they may realise that the Islamic deposit insurance scheme in their jurisdiction would not shield them from investment losses. They may react faster and stronger on rumours of poor performance and imminent losses by making massive withdrawals. Thus, the deposit base of Islamic banks might become more volatile with adverse implications for their financing business and for the macroeconomic transformation performance of Islamic banks. Such movements become more probable the greater the range of capital-protected capital market products (such as capital-protected funds) for retail investors grows.

- (iii) The “self-protection” (without a formal guarantee) of *Muḍārabah* deposits in a *Takāful* scheme.

There is a third approach for a *Sharīʿah*-compliant deposit protection scheme which deserves closer examination, namely a “self-insurance” of the IAHs in a *Takāful* setting. Sudan is following such an approach: the Islamic deposit insurance was streamlined in 2011, and the core of the protection scheme for *Muḍārabah*-based investment deposits is a “*Takāful* Fund for guarantee of investments deposits and the like. Its resources are contributed by investors themselves.”⁵⁶ The banks – on behalf of their depositors – contribute a flat (i.e. not risk weighted) percentage rate of the insured deposits to the fund.

The structure of the fund resembles an industry-wide investment risk reserve (IRR): it is not only generally accepted but widely recommended that IIFS should create IRRs.⁵⁷ A bank builds up an IRR by retaining some of the IAHs’ profit shares in good years for the compensation of investment losses in bad years. The IRR “belongs” to the IAHs as a group – that is, the IRR is collectively owned and no individual can claim a payout of his or her particular share. It effectuates an intertemporal transfer of risks within the group of depositors. The composition of the group can change over time: new IAHs buy into the scheme, old IAHs leave, but all have agreed to participate in the IRR scheme which is managed by the Islamic bank.

The structure of the IRR is like a small *Takāful* scheme within a bank: the depositors are the *Takāful* participants, they make contributions (*Tabarruʿ*) to the participants’ risk pool (the IRR), and they receive collective compensations from this pool which prevent the erosion of their *Muḍārabah* capital in investment accounts in case of investment losses.

⁵⁴ During the real estate crisis in the GCC, central banks reportedly prevented bank failures or losses for IAHs by recourse to less well documented bail-out measures.

⁵⁵ Therefore, no solid empirical evidence of the IAHs’ behaviour in critical situations is available.

⁵⁶ Bank Deposit Security Fund 2011, p. 21; see also IADI (2010a), pp. 16-18.

⁵⁷ IFSB-1 defines the investment risk reserve as “the amount appropriated by IIFS out of income of IAH, after allocating the *Muḍārib* share, in order to cushion the effects of the risk of future investment losses on IAH”.

The bank's management acts like a *Takāful* operator and determines the premium and the compensation level.

One can take this structure one step further: suppose several banks pool their IRRs (with the consent of the IAHs), and they establish a separate institution to manage the scheme – that is, to calculate risk-equivalent reserves, to invest surpluses in *Sharī'ah*-compliant assets, to process claims, etc. The large size of the integrated risk pool allows a better risk diversification (compared to a number of individual pools of smaller sizes), but it may also change the incentive structure of bank managers: the risk appetite of individual banks may increase because possible losses would be dispersed more widely and would provoke less adverse reactions of the own depositors due to a wide externalisation of investment losses to depositors of other banks. Since all participating banks have the same incentives towards more risky investment strategies, the new institution which manages the pooled IRR (or the regulator) must take counter measures. For example, it could charge risk-weighted contributions to the IRR pool.

While the step from several separated individual IRR pools to one integrated IRR pool gives rise to some economic differences that require fine tuning, the *Sharī'ah* qualities do not change: if it is *Sharī'ah* compliant that the depositors of one bank today can make contributions to shield the depositors of the same bank tomorrow from investment losses up to an amount which is determined by the size of the IRR funds, then it should also be allowed that depositors of several banks jointly contribute to a common IRR pool today to shield the depositors of the contributing banks tomorrow from investment losses up to an amount which is determined by the size of the pooled IRR funds.

Such a deposit *Takāful* scheme does not use debatable forms of third-party guarantees to protect depositors, and it is not only triggered by the failure of a bank, but also compensates investment losses in “normal business”. The contributions may be set at such a level that, for example, a total protection of the *Muḍārabah* deposits of (at least) the largest participating bank or the smaller *Muḍārabah* deposits of all participating banks could be achieved in a worst case scenario, while moderate investment losses in the normal business of several banks could be fully absorbed.

Since the *Takāful* approach can protect (but not guarantee) the principal amount of *Muḍārabah* deposits and shield them from losses in the normal business, it substantially reduces – if not eliminates – the danger of a bank run in the Islamic system. By this it contributes to the stability of the financial system, and it is, at the same time, an effective instrument of curative consumer protection. In addition, the *Takāful* approach does not eliminate the risk-sharing substance of *Muḍārabah* contracts but shifts the risk from the individual IAH to the collective of all IAHs. Thus an effective market discipline will remain a concern of the collective of IAHs, and if the deposit *Takāful* operator is independent from the participating banks, this institution could take measures to uphold market discipline.

A *Sharī'ah*-compliant deposit protection scheme not only contributes to the systemic stability and to consumer protection, but also helps to create a level playing field for Islamic and conventional banks. The majority of jurisdictions have not yet implemented a *Sharī'ah*-compliant deposit insurance system, and those who have one in place follow very different operational models. Therefore the IFSB will prepare a study on this topic to comprehend the current status of *Sharī'ah*-compliant deposit insurance schemes, to identify key challenges encountered by RSAs that have implemented such a scheme, and to develop strategies for a wider operationalisation of *Sharī'ah*-compliant deposit insurance scheme in various jurisdictions.

4.2 Financial Inclusion

Islamic finance has come of age, and the industry has come under increasing pressure as a result of expectations about the qualitative potential of Islamic finance beyond the formal *Sharī'ah* compliance of products and techniques. Therefore, the interrelated topics of microfinance, financial inclusion and responsible investing have been chosen as the theme for the section on emerging issues.

4.2.1 Microfinance and Banking Regulation and Supervision

There is a wide range of operational models and legal forms of microfinance institutions (MFIs) – from non-bank, non-governmental organisations (NGOs) engaged in the disbursement of microcredits funded by international donors to deposit-taking microfinance banks operating on commercial terms. These various types conventional MFIs can be further enriched by Islamic microfinance institutions which may link up with *Zakat* schemes, take the legal form of a *Waqf*, or integrate religious institutions (in particular, mosques and local Muslim communities) into their operations. The multitude of species is further enhanced by huge differences in the socio-economic and legal environment in which microfinance activities take place – ranging from moderately rich to very poor Muslim countries with common or civil law regimes with or without explicit Islamic elements in their legal system.

In view of these diversities, one can question whether, why and how (Islamic) microfinance should be a concern for financial regulators. For microfinance in general, the BCBS has dealt with this topic and, in August 2010, published a paper entitled “Microfinance Activities and the Core Principles for Effective Banking Supervision”. It intends to give supervisory guidance for the application of the *Base/ Core Principles for Effective Banking Supervision* (BCP) to microfinance activities. The supervision should cover not only banks, but also non-banks taking deposits from the public. These MFIs “should be subject to regulation and supervision *commensurate to the type and size of their transactions*”.⁵⁸ The basic message of the BCBS is that depository MFIs should not be exempted from effective banking supervision.

⁵⁸ BCBS (2010), p. 1, *italics added*.

Microfinance can be covered by the general core principles (CPs)⁵⁹ and does not require additional principles. However, while most of the CPs are relevant for depository MFIs, only a few of the principles are directly applicable, while the majority require a tailored approach. Eight⁶⁰ CPs apply equally to banks and depository MFIs.⁶¹ They cover:

- (a) Responsibilities, objectives and powers of banking supervision;
- (b) Independence, accountability, resourcing and legal protection for supervisors;
- (c) Cooperation and collaboration between domestic authorities and with foreign supervisors;
- (d) Transfer of significant ownership in financial institutions;
- (e) Major acquisitions by banks;
- (f) Country and transfer risks in international lending and investment activities;
- (g) Consolidated supervision of banking groups; and
- (h) Home-host relationships of supervisors of cross-border banking groups.

The last three CPs in the list above would “apply equally, but the present state of development of most microfinance markets render the applicability of such Principles very limited”.⁶² For the remaining CPs, adjustments are suggested that take into consideration the type and size of the transactions of MFIs. This is of particular relevance for:

- (a) Initial capital requirements;
- (b) The definition of regulatory capital and capital adequacy ratios;
- (c) Risk management requirements;
- (d) The treatment of problem assets and related provisions and reserves;
- (e) Limits set to geographic or sector concentrations of large exposures in microloan portfolios;
- (f) The identification of operational risks (including operational risks resulting from the involvement of banking agents or telecommunication networks);
- (g) The specification of adequate or minimum accounting and disclosure requirements and internal control and audit arrangements; and
- (h) Limits to exposures to related parties and the prevention of the abuse of financial services.

The 2012 version of the BCP added a CP on corporate governance, according to which “(t)he supervisor determines that banks and banking groups have robust corporate governance policies and processes”. This new CP will certainly need some adjustment for microfinance, but it may gain particular relevance for Islamic MFIs in two respects:

- (a) *Sharī'ah* compliance is constitutive for an Islamic financial institution. Therefore, regulators may prescribe that an Islamic microfinance institution must implement structures that ensure the *Sharī'ah* compliance of its products and processes. Whether this structure should be based on a *Sharī'ah* board as in full-fledged Islamic banks or on case-by-case external *Sharī'ah* consultancy and auditing services may be decided with respect to the size and complexity of the

⁵⁹ The guidance paper is based on the 2006 version of the CPs; see Basel BCBS (2006). The CPs have since been revised. The 2012 version has increased the number of core principles from 25 to 29, and the structure (including the numbering) of the principles has been changed; see BCBS (2012), in particular annex 1 with a comparison between the 2012 and 2006 versions of the CPs.

⁶⁰ In the original BCBS document only six of the 25 CPs of 2006, which are equivalent to eight of the 29 CPs of 2012.

⁶¹ In the Basel terminology, depository MFIs fall under “other deposit taking institutions (ODTIs)”.

⁶² BCBS (2010), p. 2.

Islamic microfinance institution. But even a secular financial regulator should ensure, in the interests of consumer protection, that the institution acts “true to its label”.⁶³

- (b) In larger and more diversified Islamic MFIs the protection of the “ultimate risk bearers” – that is, depositors with *Muḍārabah* accounts or participants in *Takāful* schemes – may be a corporate governance concern for the regulator. Unless a microfinance institution follows a cooperative model, there is the problem that the interests of the risk bearers are not well, or not at all, represented in the decision-making bodies of the institution. This issue had been taken up by the IFSB, and three standards with guiding principles for corporate governance in banks, collective investment schemes and *Takāful* undertakings have been issued⁶⁴ and could be looked at in terms of adaptation to MFIs.

The tailoring or adjustment of core principles of banking supervision to the size and complexity of the microfinance industry in a particular jurisdiction does not mean that the resulting regulations should be vague or blurred. On the contrary, if regulations are prescribed, they should be as precise as possible and clearly define permissible activities from which one can deduce specific risk profiles, capital and provisioning requirements as quantifiable risk buffers, and mandatory features of the governance structure which determine operational risks (including *Sharīʿah* non-compliance risks).

On the other hand, regulations always cause costs for the regulated and the regulators. The costs of microfinance regulations in general and Islamic microfinance regulations in particular could be notably high for the regulators because they require specialised knowledge for the tailoring of the regulations as well as appropriate techniques for the supervision, both of which are probably not in the standard toolboxes of financial regulators. But even where microfinance is far too small in size to be a serious threat to the overall financial stability, the objective of consumer protection requires that regulators do not ignore this emerging niche of the finance industry completely. This growing sector integrates so far excluded groups of people into the formal financial system and serves particularly vulnerable groups of society. In jurisdictions where the microfinance industry is still small and not very complex, regulators could take a gradual approach and look first at licensing, accounting, disclosure and governance regulations. For other areas such as regulatory capital and risk management, the experiences of regulators in countries with larger and more diversified and complex (Islamic) microfinance sectors such as Bangladesh, Pakistan or Indonesia could be studied and best practice examples compiled.

⁶³ IFSB-10: *Guiding Principles on Sharīʿah Governance Systems for Institutions offering Islamic Financial Services* could be of relevance in this context.

⁶⁴ IFSB-3: *Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (Excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds)*; IFSB-6: *Guiding Principles on Governance for Islamic Collective Investment Schemes*; and IFSB-8: *Guiding Principles on Governance for Takāful (Islamic Insurance) Undertakings*.

Box Article: Microfinance Regulation in Pakistan

In January 2012, the Governor of the State Bank of Pakistan (SBP) pointed out that Pakistan has one of the lowest financial penetration levels in the world, with 56% of the adult population totally excluded from banking and another 32% only informally served.⁶⁵ Microfinance was started by NGOs and Rural Support Programmes (RSPs) in the 1980s, but the *Microfinance Institutions Ordinance* of 2001 (last amended 2007) was the first step towards a commercial orientation of the microfinance sector. The ordinance facilitated the establishment of Microfinance Banks (MFBs) as full-fledged banks under the supervision of the SBP. Microfinance services continued to be provided by RSPs (running microfinance operations as part of multi-dimensional programmes) and multi-sectoral NGOs. In addition, specialised MFIs have been set up. As non-banks, they are not regulated by SBP. Only MFBs are allowed to accept deposits from the general public, while the other microfinance providers are restricted to savings of their members which implies that their funding depends on donor funds (NGOs) and government subsidies (RSPs, MFIs). This is a serious challenge for financial sustainability in a commercially oriented microfinance system, but it also creates structural imbalances in a competitive environment. Therefore, SBP encourages the transformation of NGOs, MFIs and RSPs into MFBs – that is, the “transition from informal, non-profit and unregulated to a formal, for profit and regulated financial institution for the poor”.⁶⁶ The mainstreaming of microfinance into the formal banking system is a gradual process which will take more time.

As of 3Q 2012, microfinance in Pakistan comprises 10 MFBs (two of which started operations in 2012 only), 10 MFIs and five RSPs, plus approximately 15 multi-sectoral NGOs and a few others.⁶⁷ The Pakistan Microfinance Network (PMN) has calculated MFBs’ market share as 42% in terms of numbers of active borrowers (in total, 2.4 million people) and 56% in terms of gross loan portfolio (GLP) (in total, PKR38 billion). This indicates that the non-bank microfinance providers still have substantial market shares. The market penetration is low but on the rise and has reached 8.74% on average (with great regional differences). The number of savers (in total, 4.3 million people) exceeds the number of active borrowers by far, but the value of savings (PKR18.3 billion) is smaller than the GLP and the loan disbursement (PKR14.8 billion). MFBs (which accept deposits from the general public) have a share of 91% of the value of savings, while RSP have a share of 62% of the active savers. There is so far only one MFI providing Islamic microfinance products – Akhuwat – with a significant share of approximately 3% in terms of the number of active borrowers and less than 3% in

⁶⁵ Keynote Address by SBP Governor Mr Yaseen Anwar at the Launching Ceremony of the National Financial Literacy Programme in Karachi, 20 January 2012, p. 2 (www.sbp.org.pk/about/speech/Governors/Mr.Yaseen.Anwar/2012/20-Jan-2012.pdf).

⁶⁶ SBP, NGO/RSPs/Cooperatives – Transformation Guidelines, 2005, p. 1.

⁶⁷ A list of MFBs, MFIs and RSPs is given on the website of the Pakistan Microfinance Network (PMN), www.microfinanceconnect.info. The total number of microfinance providers in the MIX Market database (www.mixmarket.org/mfi/country/Pakistan) is 38, of which 21 can be identified as MFBs, MFIs and SPBs. Thus, the number of multi-sectoral NGOs would be 18, but it seems that some NGOs are no longer active; websites accessed 25 February 2013.

the GLP. A few other Islamic microfinance providers do exist, but they are much smaller with shares of 0.4% and less.⁶⁸

Given the clear vision of a commercially viable microfinance industry,⁶⁹ the SBP has developed a regulatory framework which structurally replicates the existing banking regulations but pays attention to the specificities of microfinance banks. For example, the minimum paid-up capital of PKR1 billion for MFBs operating nation-wide is reduced compared to PKR10 billion for commercial banks [by the end of 2013], but the minimum capital adequacy ratio of 15% for MFBs is higher than the 10% for commercial banks.

In addition to adapted prudential regulations for MFBs, SBP took further regulatory initiatives aimed at achieving better consumer protection and enhanced systemic stability. Strong consumer protection elements can be found in all MFB regulations. Given the low level of financial literacy, the requirement to explain terms and conditions of the contract to the customer implies the need for some consumer education by the banks. A more visible project was the creation of a microfinance-exclusive Credit Information Bureau (CIB) in 2012. The information that microfinance providers can obtain from the CIB shall reduce the risk of multiple borrowing and loan defaults, especially in districts with strong competition among microloan-providing institutions. Another initiative deals with branchless banking. To make microfinance commercially sustainable requires on the funding side the mobilisation of more deposits, and on the operational side a reduction of the costs per transaction. Branchless banking supports both sides. In 2011, SBP issued the *Branchless Banking Regulations*, which deal with the provision of financial services outside traditional bank premises by using delivery channels such as retail agents or mobile phones. Banks may enter into agreements with chain stores, fuel distributors, telecom operators, etc., and they can use a wide range of technologies from mobile phones to General Packet Radio Service (GPRS) or point-of-sale (POS) terminals. A bank has to team up with a strong non-bank partner for branchless banking, but the SBP has made it clear that only bank-led models are allowed, meaning that the bank must be in control of the branchless banking venture.

The SBP has not only adapted core principles of effective banking supervision to microfinance but also reacted in a timely manner to new trends in microfinance (starting with the commercial orientation of microfinance in 2001 and extending to the development of new delivery channels in 2011). The quality of the regulatory framework for microfinance is recognised in a ranking of the microfinance business environment in 55 countries by the Economist Intelligence Unit: Pakistan was for the last three consecutive years the highest-ranked Muslim country both with respect to the overall microfinance business environment (ranked 5 in the 2010 report, and 3 in the 2011 and 2012 reports) and regarding the regulatory framework and practices (ranked 1 in the 2010 and 2011 reports, and 3 in 2012).⁷⁰

⁶⁸ So far, there is no Islamic MFB. The SBP *Guidelines for Islamic Microfinance Business by Financial Institutions* of 2007 allow, in particular, conventional banks to operate Islamic microfinance counters in existing branches, standalone Islamic microfinance branches or mobile facilities, but these options have not been used so far.

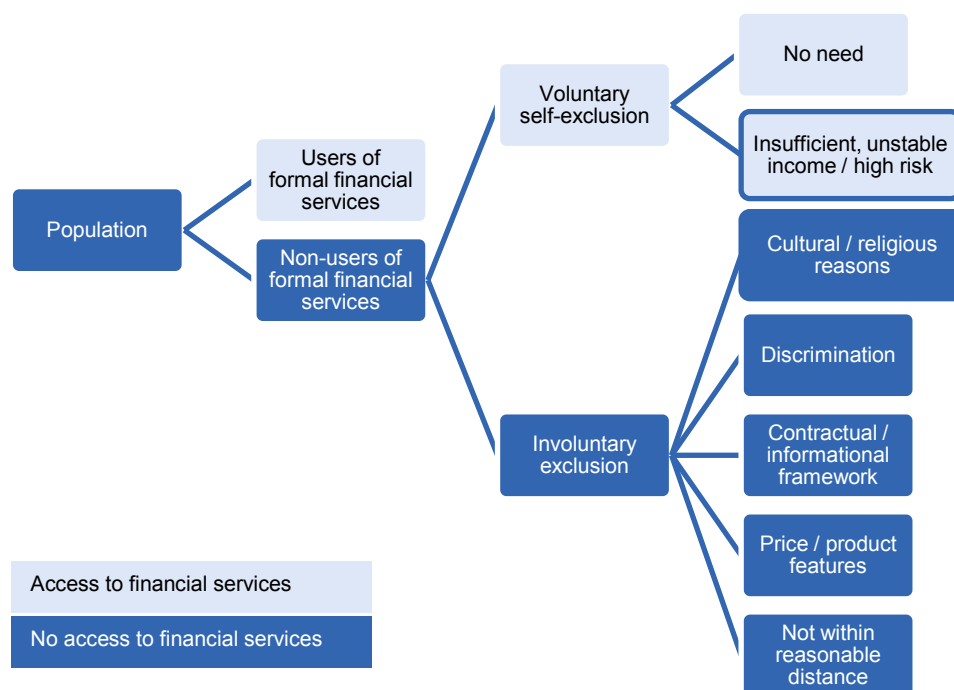
⁶⁹ The vision is to “transform microfinance into a dynamic industry, integrated with the overall financial system, which provides inclusive financial services to the underserved economic and geographic segments through self-sustaining business models and demand driven products, while maintaining high standards of governance and service delivery, supported by agile regulatory environment”; see SBP, *Strategic Framework for Sustainable Microfinance in Pakistan*, January 2011.

⁷⁰ See Economist Intelligence Unit, *Global Microscope on the Microfinance Business 2010/2011/2012*, London, 2010/2011/2012.

4.2.2 Financial Inclusion as a Core Concept

“In general terms, financial inclusion is about providing access to an adequate range of safe, convenient and affordable financial services to disadvantaged and other vulnerable groups, including low income, rural and undocumented persons, who have been underserved or excluded from the formal financial sector.”⁷¹ The exclusion from formal finance can be involuntary or voluntary. Muslims who reject *Riba* may voluntarily abstain from the use of conventional *Riba*-based financial services although they would have access to them.⁷²

Diagram 4.2.2.1: Types and Causes of Financial Exclusion



Source: Based on Demirgüç-Kunt, Beck and Honohan (2008), p. 29

It is remarkable that one of the earliest manifestations of Islamic finance had put principles of inclusive finance successfully into practice: the savings bank project of Ahmed El-Naggar in Mit-Ghamr in Egypt from 1963 to 1967.⁷³ El-Naggar had observed that even the poor segments of the rural population set aside parts of their current income for later use, but they did not use existing financial institutions for their savings. Branches of the post office savings bank were within reach for most people in rural areas, but they were not widely used. There was a voluntary self-exclusion from accessible formal financial institutions. Instead of saving money in a bank, rural people preferred to save in real assets to make provisions for lifetime events (marriage, education of children, old age, funerals, etc.). Popular “savings assets” were gold and jewellery, but also livestock and some durable consumer goods. This

⁷¹ See Financial Action Task Force (2011), p. 12.

⁷² The difference between access to and use of financial services is explicated by Demirgüç-Kunt, Beck and Honohan (2008), p. 29.

⁷³ See El-Naggar (1978), Ready (1967). For his seminal contribution as a pioneer of financial inclusion and Islamic banking Ahmed El-Naggar received posthumous recognition at the first Royal Award for Islamic Finance ceremony, held in Kuala Lumpur in 2010.

savings behaviour was very costly for the individual savers and very inefficient from a macroeconomic perspective.

- (a) Instead of receiving a return for their savings, the savers had to pay twice the profit margins of traders: when they first bought an asset and when they later liquidated it.
- (b) What was savings from an individual's perspective was consumption from a macroeconomic perspective. Resources not needed for immediate consumption were not available for productive investments in enterprises because they were used up in the production or import of the savings assets.

There could be substantial welfare gains both for the individuals and for the economy as a whole if the savings behaviour were changed from real assets to financial assets: the production of financial assets requires only a fraction of the resources that were not consumed by the savers, and the remaining free resources could be channelled through banks to entrepreneurs for productive use. The savers are not only spared the excessive transaction costs of real asset savings but can even enjoy some return for the abstention from actual consumption, and in a macroeconomic perspective, consumption is converted into savings and the economy gains additional investible funds without any additional reduction of "real" consumption.

The challenge was to create trustworthy financial institutions so that the savings behaviour would change (i.e. the voluntary self-exclusion would be terminated). El-Naggar's solution had two components:

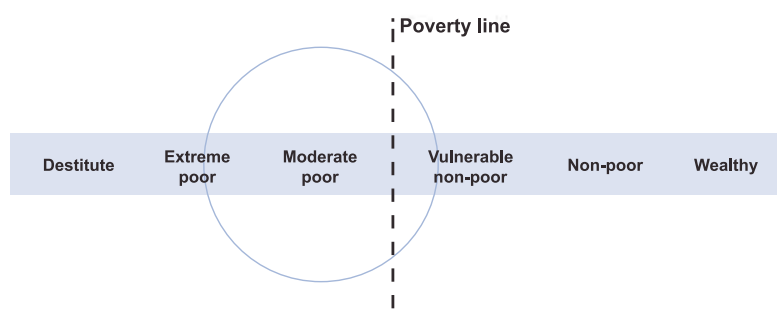
- (a) He recognised that religion was very important for many people and that the prohibition of *Riba* prevented them from using conventional financial institutions. Thus, a trustworthy bank had to operate *Riba*-free.
- (b) People wanted to see that their savings were being used in safe and productive projects. The existing postal banks collected money from all over Egypt and transferred it to Cairo where it was out of sight of the savers. Therefore, El-Naggar's *Riba*-free bank invested large and visible parts of the funds in the same region where they were collected.

Target Groups

Ideas and insights very similar to those underlying El-Naggar's approach gained popularity and attracted the attention of both the World Bank group and the United Nations (UN) system in the 2000s. The recent financial inclusion movement has "absorbed" an older, widely recognised movement with a similar developmental perspective but different target groups and mechanisms – microfinance.

- (a) While microfinance deals with the “moderate poor” – that is, with people below the poverty line (but not with the “extreme poor” or “destitute”)⁷⁴ – financial inclusion also addresses vulnerable groups above the poverty line; see Diagram 4.2.2.2.
- (b) Financial inclusion also pays attention to non-poor groups who voluntarily stayed outside the existing formal financial system – especially for religious reasons such as the prohibition of *Riba*.⁷⁵
- (c) Financial inclusion goes beyond consumer-oriented financial services (payment services, savings products, [micro-]funding, [micro-]protection) and includes products for SMEs.
- (d) The oldest microfinance ventures were “donor dependent”: early microcredit experiments were commercially not viable and required continuous support from external financiers (governments or private donors). Further, they often did not enhance the productive capacities of the clients – which is a pre-condition for the redemption of a relatively expensive loan – but just facilitated additional consumption. This led to an increasing indebtedness with no realistic prospects for debt reduction.⁷⁶

Diagram 4.2.2.2: How Poor Are Microfinance Clients?



Source: Helms (2006), p. 20, based on Cohen and Burjorjee (2003), p. 2

If one looks at financial inclusion from an Islamic and regulatory perspective, two other areas with strong links to economic development must be taken into account, namely SME financing and responsible investment.

Financing for SMEs differs from microfinance insofar as the focus is shifted from individuals or households as clients of financial institutions to enterprises as business partners (often still family run, but with a distinct – legal or commercial – personality). Financing of SMEs would be the next step for

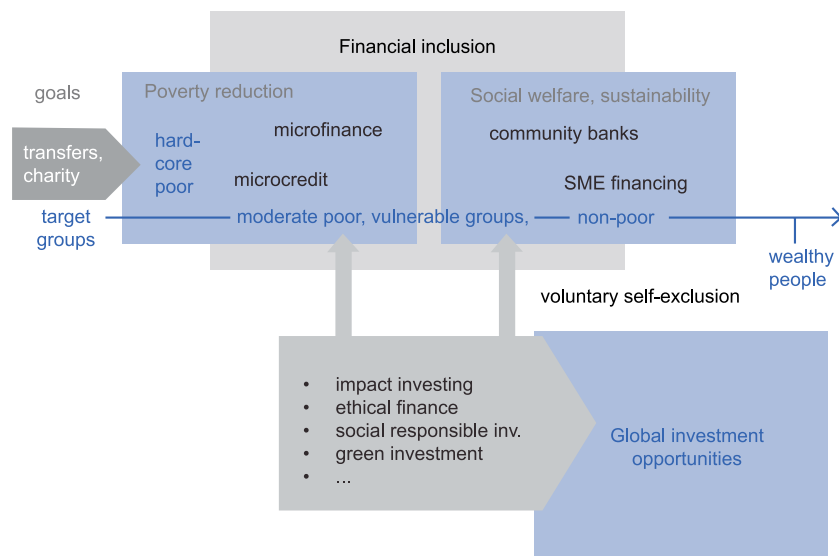
⁷⁴ The “extreme poor” and “destitute” – sometimes called “hardcore poor” – are typically supported by transfers from public funds or private donations. Their situation is such (e.g. due to poor health, physical or mental handicaps, or old age) that even microfinance is unable to improve their income-generating capacities. The destitute situation of the hardcore poor requires special attention beyond access to finance.

⁷⁵ There are no exact data on the size of those groups who stay voluntarily outside the *Riba*-based financial system. However, there are indications that this size could be considerable. In 2007, Consultative Group to Assist the Poor (CGAP) carried out a global survey on Islamic microfinance. “Surveys in Jordan, Algeria and Syria ... revealed that 20%-40% of respondents cite religious reasons for not accessing conventional microloans.” Karim, Tarazi and Reille (2008), p. 1.

⁷⁶ Such malpractices led to political actions in recent years (e.g. in India) and underscores the importance of a regulatory framework that pays due attention to consumer protection even in microfinance.

successful microenterprises which have grown in size and now qualify as SMEs.⁷⁷ These different types of enterprises differ in their financial needs and capabilities. The concept of Islamic finance, with its emphasis on participatory finance through financial institutions as well as capital market products such as *Muḍārabah* and *Mushārah Sukūk*, looks particularly appealing for enterprises with a solid financial history and good growth prospects. It can also conceptually easily interface with the more recent responsible investment movement which integrates different trends in “alternative finance” such as ethical banking, community banking, ecologically sustainable and socially responsible investment, and impact investing (see Section 4.3). What started as niche movements in the 20th century has become mainstream today and is now pushed not only by NGOs but also by the UN system, as well as by an increasing number of global market players of the conventional finance industry. Links between micro and SME finance and responsible investment became stronger once it had been shown how microfinance can be both commercially viable and poverty reducing. Since then, microfinance (apex) institutions have become a target for responsible investment funds. Further, sizeable deposits of responsible investment funds with community banks enhance their financial strength and can be a commercially viable strategy to improve the physical and economic environment of vulnerable population groups. “Green investors” can diversify their portfolios through the financing of the growth of ecologically oriented SMEs in emerging markets, etc. Diagram 4.2.2.3 summarises the structure of financial inclusion and its major links to new forms of alternative finance.

Diagram 4.2.2.3: Links between Financial Inclusion, Microfinance and Responsible Investing



Source: Prof. Volker Nienhaus

⁷⁷ The World Bank classifies enterprises with 1 to 10 employees, total assets of less than USD100,000 and an annual turnover of less than USD100,000 as micro-enterprises, and enterprises with 11 to 50 employees, total assets of between USD100,000 and USD3 million, and an annual turnover of between USD100,000 and USD3 million as small enterprises.

Rationale and Strategies for Financial Inclusion

There are strong arguments in favour of financial inclusion both on the micro-level of individual people and on the macro-level of the whole economy and society.

- (a) People who are excluded from the financial system have to manage their financial needs within the constraints of a cash economy: they receive cash for their products or services, and they have to use cash for payments as well as for their savings needs or take recourse to real asset savings. Cash holdings are exposed to the risks of loss and theft, and their value is eroded by inflation. A conversion of cash into real assets for savings purposes is rarely an attractive option due to the high transaction cost. People without access to the formal financial system are confined to their own (respectively, family) resources ("self-financing"), which severely restricts their ability to take and manage risks by diversification, to innovate, etc., or they have to use the services of money lenders at very high costs.
- (b) This implies in reverse that people with access to the financial system can smoothen their low, unstable and unreliable income stream and convert it into a more regular cash flow, accumulate funds for life-cycle events (such as expenses for education, marriage, funerals), to exploit economic opportunities (e.g. purchase inputs for their business at favourable prices) and to make provisions for emergencies (such as illness, accidents or unexpected unemployment). In short, they can enhance their productivity and develop a greater resilience against economic shocks.
- (c) There are also non-monetary disadvantages for people with no access to financial services: poor people have to spend much time and energy managing their money – from long travels to and queuing times in bank branches when they have to en cash a cheque or make a money transfer, to worrying about finding a safe place for their savings. Financial inclusion would substantially reduce the individual transaction costs of poor people and free up time and energy for more productive (i.e. income-generating) activities.
- (d) Access to finance (e.g. cheaper payment systems, superior savings products), micro-protection (micro-insurance or micro-*Takāful*) and micro-funding (conventional or *Sharī'ah*-compliant microcredit) would not only benefit the included individuals or families but also the economy as a whole through a better management of individual and social resources: There will be better options for diversifying and bearing risks, for productive employment and income generation, for intertemporal transfers of resources, etc. If successful, financial inclusion (especially as part of a financial sector development strategy) can promote a pro-poor growth and reduce poverty. If income growth is the highest at the bottom of the income pyramid, then this contributes to a reduction of inequality.

The individual advantages and social benefits of financial inclusion of moderately poor and vulnerable groups, but also of (often self-excluded) non-poor, are set out in detail in an impressive body of theoretical literature and are documented by a large number of empirical studies.⁷⁸ Besides the World Bank group and the UN system, the IDB (and its affiliates) deserve special attention as intergovernmental finance institutions with a global mandate and outreach. Diagram 4.2.2.1 listed insufficient income, high risk, contractual and informational deficits, product features, pricing and distance as major reasons for involuntary exclusion from financial services. This list could be extended, for example, by including the lack of collateral, missing documents, or excessive debt burdens from outstanding “loan shark” credits. Various solutions for such access barriers have been developed in microfinance – from new forms of collateral and risk mitigation (through group lending) to simplified products to sensible pricing and debt conversion schemes.

This “demand side” perspective has to be supplemented by a view from the “supply side”: large parts of the population, especially in sparsely populated rural areas or in regions with a very low and unstable average income, are unbanked because the costs of traditional bank branches exceed by far their potential revenues. Many fixed costs of bank branches and costs of transaction handling are independent of the transaction volume, while revenues are usually linked to the transaction volume. Cost-covering interest rates and transaction fees for small volumes would become prohibitively high – which means that the bank will not open a traditional bank branch in low-volume areas. A solution can come from more cost-effective bank access points. Branchless banking via bank agents and the use of communication technology (mobile phones, POS systems and automated teller machine (ATM) networks) can reduce costs per transaction drastically and help to overcome supply side obstacles (see 4.2.5 below).

4.2.3 Conventional and Islamic Microfinance

It is not necessary to list here all the merits and problems of conventional microfinance, which are well documented.⁷⁹ Instead, the focus is on those issues for which a specific Islamic perspective exists.⁸⁰

Mandate and Market

While Islamic microfinance is still an underdeveloped branch of Islamic finance, there is hope that its weight will increase in the foreseeable future. It is often asserted that Islamic financial institutions have

poverty reduction. If this is taken as the starting point, structures, techniques and procedures have to be developed to provide savings products and financing instruments for presently unbanked poor people – not as a charity, but as a business venture that at least recovers its costs or becomes a

⁷⁸ Empirical data is collected and disseminated by the Global Financial Inclusion (Global Findex) database of the World Bank; see Demirgüç-Kunt and Klapper (2012), Ardic, Chen and Latortue (2012); results of a survey on opportunities and obstacles to financial inclusion are presented by Gardeva and Rhyne (2011).

⁷⁹ See, for example, Ledgerwood (1998), Aghion and Morduch (2005), Sundaresan (2008); for a very critical view, see Bateman (2010, 2011).

⁸⁰ The literature on the theory and practice of Islamic microfinance (including conference papers) has grown rapidly over the last few years. Some of the more recent comprehensive works or collections are Obaidullah (2008), Obaidullah and Khan (2008), Obaidullah and Latiff (2011), KFH Research (2011), Ali (2012); see also a brief summary from CGAP staff: Karim, Tarazi and Reille (2008).

profitable undertaking.⁸¹ Conventional financial institutions have developed microfinance arrangements which are at the same time sustainable without external subsidies and profitable, and it seems that Islamic banks are on their way to examining such models and adding specific features in line with their background and operations as Islamic institutions.

Funding MFIs

Financial services should not only be accessible for poorer people but also affordable. One important cost driver is the costs of funds (or the [re]financing costs of the microcredit institution).

- (a) Conventional MFIs reduced these costs by recourse to subsidies from public sources and grants from private, often international donors. However, the efficiency and sustainability of this “solution” is questionable.
- (b) More sustainable, but limited in size, is the mobilisation of funds from the microfinance clients themselves, be it through savings products or through “forced” savings where actual and/or prospective users of microcredits are obliged to save small amounts on a regular basis.⁸²
- (c) In serving the poor, Islamic finance can take recourse to or be supplemented by specific Islamic institutions with built-in redistributive qualities, such as *Zakat*, *Sadaqah*, *Waqf* and *Qard al-Hasan* through which funds are channelled from the richer to the poorer segments of society.⁸³ The flow of such funds is not driven by profit motives but by religious duties or philanthropic engagement. They can support or supplement established microfinance practices – for example, as revolving funds in support of “non-bankable” people who cannot bear the costs of established microfinance products and require flexible repayment terms.⁸⁴ However, *Zakat*, *Sadaqah* and *Qard al-Hasan* payments are in general far less than what they should be, and this limits the availability of funds from these sources for the microfinance complex.⁸⁵
- (d) The use of *Qard al-Hasan* not only as a supplementary source of funding but as the basic underlying business model for an Islamic MFI is practised by Akhuwat in Pakistan. This unique and successful approach with completely cost-free loans with an extremely high recovery rate was started in 2001 by philanthropists and was registered in 2003. It has grown steadily ever since and is now opening up for cooperation with international donors. It uses mosques for the

⁸¹ Zarka (2012, p. 77) draws attention to the fact that *Muḍarabah*-based deposits (investment accounts) severely restrict the discretion of Islamic banks to employ depositors' funds in charitable activities: “This contract, jurists are unanimous, explicitly and for good reason, prevents the *Muḍarib* from engaging in non-profit-seeking activities. Woe to the *Muḍarib* who goes further astray and employs the funds received for charitable purposes!”

⁸² MFIs usually do not have a banking licence and therefore may not be allowed to accept such savings in the form of deposits.

⁸³ Wilson (2012, pp. 67-70) has proposed a *Wakālah* model as an operating structure which is particularly suitable for *Zakat*-based microfinance initiatives. For more commercial microfinance ventures he proposed a *Muḍarabah* model (pp. 72-74).

⁸⁴ See Mohieldin et al. (2011), pp. 46-48. *Zakat* may push individuals “out of dire poverty to levels, where they are no longer regarded as ‘unbankable’ by MFIs [MFIs]. A linkage if established between the MFIs and *Zakat* funds would enhance the effectiveness of microfinance towards achieving poverty alleviation.” Obaidullah (2011), p. 9.

⁸⁵ Mohieldin et al. (2011) have estimated average *Zakat* proceeds for a group of eight Muslim countries in the range of 1.8% to 4.3% of the GDP (based on different calculation rules of different schools of law). These figures are far beyond actual *Zakat* proceeds. According to Kahf (2009, p. 67), “[T]he ratio of *Zakat* proceeds to GDP is between 0.3% and 0.6% in countries that have obligatory payments to the government supported by strong administrations and law enforcement such as in Saudi Arabia, Pakistan, Sudan and Yemen. This percentage goes down to below 0.1% in Libya and Malaysia whereas in countries that depend on voluntary payments the proceeds of *Zakat* are negligible.”

disbursement of loans, combines elements of individual and group lending programmes, and supplements its *Qard al-Hasan* loans with guidance and non-financial support for its clients (“credit plus approach”).⁸⁶

- (e) A MFI could be set up as a *Waqf*. The implementation of the *Waqf* model requires a legal framework which does not yet exist in many Muslim countries. *Waqf* – like *Sadaqah* and *Qard al-Hasan* – can be seen as a manifestation of charity. The objective of the providers of the endowment funds is not the maximum return on their capital. Once the core capital is provided, a cash *Waqf* can attract further funds (for which a “reasonable” return may be expected) on a temporary basis.⁸⁷ The advantage of a *Waqf* over *Sadaqah* and *Qard al-Hasan* (and even “unregulated” *Zakat* payments) is that it is less volatile and more sustainable because it is based on a stock of income-generating assets whose capital value is to be maintained.⁸⁸ Cash *Waqf* could become incubators for micro and small enterprises because these should use *Muḍārabah* contracts to generate income from their assets (cash). Traditionally, *Waqf* have also been engaged in education of all types.⁸⁹ Thus, a modern cash *Waqf* could resume old traditions by combining *Muḍārabah* financing with measures to enhance the human capital in the poorer segments of society (e.g. through vocational training, accounting and management courses, promotion of entrepreneurial talents). A successful human capital formation in the context of a local social network would also reduce information asymmetries and the inherent risks of *Muḍārabah* financing.
- (f) For the support of the non-bankable hardcore poor, a practical proposal is to utilise “cleansing funds” such as penalties for late payments or money from dividends. Although Islamic MFIs may not use these non-*Shari’ah*-compliant funds for their regular business, they could utilise their information networks and distribution channels to target needy people who are eligible for benevolent loans. The positive side effect for the Islamic MFI is that the support is channelled to communities or groups where they also operate as commercial entities.⁹⁰

For conventional finance, it has been shown that microfinance can be commercially viable.⁹¹ Therefore, major funds could originate from for-profit financial institutions, in particular from banks which set up microfinance and SME financing subsidiaries and from institutional investors and funds which place some resources in the microfinance sector through “wholesale” or apex institutions of the

⁸⁶ For details, see www.akhuwat.org.pk and Akhuwat (2011). Siddiqi (2006, p. 22), Ahmed (2011, p. 207 and 2012, p. 29) and Mohieldin et al. (2011, p. 47) quote an unpublished conference paper of El-Gari of 2004 in which he proposed a *Qard al-Hasan* bank with striking similarities with the Akhuwat approach implemented earlier. The authors who quote El-Gari do not refer to the Akhuwat experience. This indicates the need for a better exchange on information and dissemination of best practice examples.

⁸⁷ See Zarka (2012); he outlines a model where depositors can authorise their banks to transfer temporarily unused funds on their current accounts (excess liquidity) to an account of a cash *Waqf* (until the depositor needs the funds, which would automatically be credited back to his current account). If many depositors give such an authorisation, MFIs set up as legally independent cash *Waqf* could utilise the average balance of accounts for which Islamic (and conventional) banks usually do not pay any return.

⁸⁸ On *Waqf*, poverty alleviation and microfinance, see the essays in Kahf and Mahamood (2011) – in particular, Ahmed (2011).

⁸⁹ See Cizakca (2011).

⁹⁰ See Ahmed (2012), p. 27.

⁹¹ A clear indication that microfinance has reached mainstream finance is that a profit-driven conventional institution (Deutsche Bank) has published a paper entitled “Microfinance: An Emerging Investment Opportunity”; see Dieckmann (2007). In a paper written for a conference in early 2007, Badawi and Grais (2012), p. 10, point out that “worldwide, the leading microfinance institutions are nearly twice as profitable as the leading commercial banks. In the last decade in emerging markets, microfinance has been a more stable business than commercial banking.”

microfinance industry. However, in contrast to conventional finance, it seems that “for-profit microfinance” does not find much support in the Islamic finance community. At first glance, one could argue that poverty alleviation is considered to be a religious duty of every Muslim and the society as a whole (to be rewarded in the hereafter), and this moral obligation should not “degenerate” into a commercial business. But if poverty alleviation is achieved by financing entrepreneurial activities of poor people, a return for the provider of finance is justified.⁹²

Collateral and Monitoring Problems

Microfinance is sometimes considered a risky business due to the lack of collateral for microcredits and the possibility of a redirection of funds from productive to consumptive use by the clients (with negative consequences for the debt servicing and repayment capacity).⁹³ Conventional MFIs have addressed these issues by group lending schemes and peer monitoring techniques. This creates a kind of “social collateral” which helps to reduce the impact of information asymmetries and to ensure high recovery rates. Such mechanisms can also be applied by Islamic MFIs where they may be even more effective because of the religious obligations of borrowers to honour their promises and meet their contractual obligations.

However, there are some additional reasons why Islamic institutions may be in a better position to deal with insufficient collateral and the risk of a non-contractual use of funds.

- (a) While conventional MFIs provide interest-bearing cash loans, Islamic institutions provide asset-related financings based on *Murābahah*, *Ijārah*, *Salam* or *Istisnā`* contracts. This limits, or even prevents, the chance of an undetected misuse of funds for other than the contractually agreed purposes. Thus, the provision of productive assets through Islamic financial institutions solves most of the monitoring problems and removes resulting moral hazard problems on the customer’s side. However, the financing of specific assets (instead of granting cash loans) alone does not eliminate the risk of over-indebtedness of a microfinance customer: A MFIs could finance too many assets so that the growth in debt exceeds the increase of the client’s income. There are different reasons for such a constellation. The customer may have obtained financing from several MFIs which do not know about the financing provided by the others. In such a case the over-indebtedness is the consequence of information asymmetries which could be removed by the establishment of a credit information bureau. But it could also be that a MFIs is informed about the existing debt burden. A profit-driven institution may still continue to provide assets for productive or consumptive purposes at high costs for the customer and high returns for itself as long as it has sufficient reason to assume that the customer will somehow be able to service his debts. Obviously the recourse to asset-specific financing alone does not guarantee effective consumer protection, and regulators will not become redundant by a switch to Islamic modes of financing.

⁹² Siddiqi (2006, p. 22) discusses “cash for the needy” and suggests a distinction between interest-free consumption loans for the needy (*Qard al-Hasan*) and loans for business (of needy people) where he suggests forms of finance that generate an income for the provider of funds.

⁹³ For the impact of outdated collateral laws on access to finance and for reform proposals, see Fleisig, Safavian and De La Peña (2006).

- (b) Islamic MFIs can hold ownership rights in provided assets (with more than a marginal market value). This implies a kind of “self-collateralisation” of Islamic finance contracts. Conventional MFIs provide cash loans and do not have direct access to assets of micro-entrepreneurs. This could mean an additional layer of risk (in particular, for the relatively larger loans) and higher transaction costs for conventional institutions.⁹⁴
- (c) *Muḍārabah*, *Ijārah*, *Salam* and *Istisnā`* contracts are very appropriate for microfinancing. Islamic banks apply these contracts in their regular business. They have gained much experience with these instruments, and a microfinance unit or subsidiary could draw on the accumulated knowledge and expertise of the staff of the Islamic bank. Conventional MFIs could use similar contracts, but it would be difficult, time consuming and costly for them to catch up with Islamic institutions. Thus, Islamic MFIs can gain and maintain a competitive edge.

Box Article: Debt Instruments vs. Partnership Contracts in Islamic Microfinance

Islamic finance is often criticised for mimicking conventional debt products and neglecting participatory instruments (which are often seen as the essence of Islamic finance). Thus, potential clients may question the “Islamicity” of Islamic MFIs which operate mainly with debt-creating instruments such as *Muḍārabah*, *Salam*, *Istisnā`* and *Ijārah*.

However, participatory finance requires entrepreneurial partners on *both sides* of the arrangement. Microfinance addresses *potential* talents in a pre-entrepreneurial phase. In an early stage of talent formation, non-participatory instruments are more appropriate. Although these are fixed-cost debt-creating instruments, there is one major difference from conventional microfinance: Islamic microfinance instruments provide *assets for entrepreneurial activities*, while conventional MFIs provide loans that are supposed to be used for productive purposes but could also be diverted into consumption. Loans have to be monitored more closely, and once misuses have been detected, they should be sanctioned. This is a delicate task both from a reputational and a legal perspective. Trade- and rent-based modes of Islamic finance require far less monitoring and eventually interference at later stages and signal more trust of the financier in its client who is supposed to become an independent entrepreneurial partner in the future.

Participatory modes of finance may be used at a later stage when *entrepreneurial qualities have been proven* and expertise and experience have been gained on both sides. Then the *socio-economic environment* of micro and small enterprises is more conducive to participatory finance than large anonymous markets because information asymmetries and

⁹⁴ It should be noted, however, that the users of microfinance products may prefer cash over assets; see Sultan (2012), p. 53, Wilson (2012), p. 67. This can become a problem where microfinance users have a choice of different institutions, and it is debatable whether Islamic institutions should also apply cash-providing techniques in combination with adequate control and monitoring mechanisms (considering social and religious networks and combinations of individual and group lending).

moral hazard problems are less probable or easier to handle. Thus one can expect that participatory modes of finance will become more prominent in the micro and SME sector over time.

Commercial Viability and Affordability of Microfinance

There has been long debate on the commercial viability of (conventional) microfinance without continuous inflows of subsidised funds from governments or private donors. The empirical results are mixed, but it seems clear that commercial viability often comes at a very high price for the clients: numerous case studies have shown that interest rates of profitable (or at least not loss-making) microcredit institutions may come close to the rates of informal money lenders which are often considered usurious. Thus, in order to be not only commercially viable but also affordable for clients, cost-containing measures are required on all fronts. Methods for reducing distribution costs are presented Section 4.2.5 below, and the issue of access to low-cost funds has been outlined above.

But it is not only the cost of funds for the users that determines the affordability of microfinance; it is also the impact of microfinance on the users' income. The primary goal of microfinance is not a temporary increase in consumption level but a lasting increase in the client's income through productivity enhancement. It is to a large degree the entrepreneurial talent of a client that determines the impact of microfunding on his or her income, and the larger this impact, the more affordable microfunding is. Therefore, MFIs should feel a strong incentive to support the development of the entrepreneurial talents of their clients by providing training programmes in the areas of technical and market knowledge, managerial skills, etc. Productivity-enhancing training can be provided by microfinance or other institutions (such as NGOs, government agencies, educational establishments), but it would be most effective when linked to the kind of projects for which the MFIs are willing to provide funding. With the experience of Islamic banks in financing various kinds of projects and ventures in the real economy, their MFIs could make a distinct contribution to the development of talent. This could give Islamic microfinance another competitive edge over conventional institutions.

There is a potentially large pool of talented people in the poorer segments of all societies. If talent development is successful, Islamic microfinance would prepare the ground for a large number of growing businesses. Many of these micro-businesses have the potential to graduate into SMEs and become clients of Islamic banks. If the microfinance units of Islamic banks have supported the emancipation into SMEs, they will have accumulated deep knowledge of these enterprises and entrepreneurs which reduces information asymmetries to a minimum. This may encourage the banks to apply partnership contracts which are attractive instruments for the financing of growth when moral hazard issues can be ruled out.

4.2.4 Regulatory Issues

MFIs – even if they were set up as subsidiaries of banks – usually do not have a banking licence and are not regulated as banks. Nevertheless, regulators must not ignore (conventional or Islamic) MFIs.⁹⁵ Successful Islamic microfinance will bring new groups of clients into the financial system whose economic position is particularly weak and vulnerable and whose financial knowledge is very limited. The inclusion of large groups of so far unbanked people into the financial system could boost economic development, but it could also end in a disaster if microfinance services were to come to an abrupt halt because, for example, a commercial MFIs went bankrupt or withdrew from the market due to insufficient returns.

Only few Muslim countries have incorporated Islamic microfinance into their existing accounting, reporting and regulatory framework. While a rapid growth of microfinance may be desirable from a developmental point of view, it may nevertheless be prudent to introduce some “speed controls” and “crash barriers” to ensure the commercial long-term viability and sustainability of this segment of the financial industry.⁹⁶

- (a) Regulators should ensure that financial education programmes are implemented (or organise such programmes themselves). This is in the interests not only of the so far unbanked people but also of the providers of financial services.
- (b) The high cost of microcredits implies the latent danger of overstressing microfinance clients’ ability to pay. In the interests of customer protection, conflict resolution procedures and restructuring options should be implemented and customised to the specificities of an Islamic microfinance market.
- (c) There is a lack of transparency with respect to credit histories and existing payment obligations (“debt burdens”) of microfinance clients. To prevent the overstressing of clients’ payment capacities through unknowingly providing additional finance, effective credit information systems should be installed. The reduction of information asymmetries is of particular relevance for SME financing and should prevent a cumulation of wrong funding decisions which could threaten the stability of the microfinance sector.
- (d) There is a large number of success stories of individual microfinance ventures, but also a considerable number of recorded failures. A rapid growth of microfinance is in itself not a guarantee for success. In the interests of systemic stability, measures should be taken to isolate defaults of Islamic MFIs in order to prevent contagion effects.

⁹⁵ “A MFI can, of course, apply for a banking license, but this would imply it was regulated as a bank, which would mean reduced flexibility over disbursements, less discretion over asset holdings and additional costs of developing robust systems for regulatory compliance, including possibly paying to be rated.” Wilson (2012), p. 71.

⁹⁶ Regulatory requirements and recommendations for microfinance in general (which are also relevant for Islamic microfinance) are compiled in G20 Financial Inclusion Experts Group (2010) and CGAP (2012); see also Klein and Mayer (2011).

- (e) Regulators must ensure that registered MFIs have implemented at least a basic accounting system, keep records of their transactions, and have established procedures to ensure that their products (and processes) are *Sharī'ah* compliant. Regulators should consider adequate standards for capital adequacy, liquidity, risk management, etc. for MFIs institutions which are run as commercial ventures (and for Islamic banks that get directly involved in microfinance), taking into consideration the fragility of the microfinance sector in the early stages of its development.
- (f) Only in a few countries do MFIs operate in a competitive market environment with a large number of market players. As a consequence, little is known about competitive processes in Islamic microfinance markets, the elasticity of supply and demand, the existence of feedback loops, possible contagion effects, positive and negative externalities, and so on. Therefore, regulations and procedures for an orderly unwinding of a venture and for a market exit, as well as safety nets for the users of Islamic microfinance services, are required to contain the systemic risk.
- (g) International standard setters (such as the IFSB) should provide a platform for the collection and exchange of country experiences, the “stress testing” of regulatory regimes for microfinance, and take the initiative to draft appropriate regulatory standards.
- (h) Financial inclusion should become a priority for governments and regulators in OIC countries (which so far is not the case).⁹⁷ The regulatory and supervisory framework shall support financial inclusion and give due weight to sound risk management and consumer protection in general and accommodate specificities of Islamic finance in particular.⁹⁸ Islamic financial inclusion should become a goal of the same importance as prudential regulation and systemic stability. Measures may include licensing of Islamic MFIs (not as banks, but as a separate class of financial intermediaries),⁹⁹ training and awareness programmes on Islamic (micro)finance for staff and consumers, guidelines for the licensing and appointment of *Sharī'ah* advisers, and implementation and enforcement of consumer protection laws and regulations (covering areas such as unfair or deceptive practices, disclosure and transparency, dispute settlement).
- (i) The legal and regulatory environment should facilitate financial engineering and innovation in support of financial inclusion and enhanced financial access. For example, microfinance clients and SMEs do not have access to the organised capital market.¹⁰⁰ However, financial engineers could securitise assets generated by microfinance and SMEs and structure a *Sukūk*. By pooling their assets, MFIs could issue marketable securities. Another example would be the design of *Awqaf* certificates for the financing of projects.

⁹⁷ This is a recommendation of the authors of the World Bank Policy Research Working Paper on the role of Islamic finance in enhancing financial inclusion in OIC countries; see Mohieldin et al. (2011).

⁹⁸ On consumer protection in microfinance, see Clark (2010), Mylenko (2010), Rozas et al. (2011), OECD (2012).

⁹⁹ This is of particular relevance when microfinance as a commercial venture and the provision of basic financial services through branchless banking for similar target groups converge and synergies could be realised.

¹⁰⁰ See Mohieldin et al. (2011), pp. 48–49.

- (j) If specificities of Islamic finance are taken into account, it may well be that a new type of financial institution such as a “*Shari’ah*-compliant finance company”¹⁰¹ with innovative services and distribution channels for microfunding and micro-*Takāful* (with an outreach to capital markets through securitised microfinance assets) may be the best organisational structure. The IFSB could become a platform for the collection and study of country experiences with unconventional products and structures of microfinance providers and for an analysis of regulatory implications and the compatibility with international standards.

The congruence with general policy recommendations allows a concentration of intellectual resources on the theoretical and empirical study of and regulatory design for Islamic specificities in microfinance. Given the growing interest of young academic talents in the topic, an institution such as IRTI or INCEIF could supplement IFSB and act as a clearing house for information and give guidance with respect to over- and under-researched areas of Islamic microfinance.

4.2.5 Branchless Banking

Initially, microfinance (micro-credit) was provided by institutions established for this specific purpose. They developed their own “distribution channels”, communication networks and monitoring techniques (mainly adapted to the new model of group lending). Most of these MFIs did not have banking licences. Later, when the idea of microfinance as a potentially profitable business reached the finance industry¹⁰² and the industry realised that non-poor groups without access to financial services could also be commercially attractive target groups, banks developed and implemented new techniques for reaching excluded prospective customers. It has already been mentioned that the costs for small-volume transactions which are handled by traditional bank branches are so high that cost-covering fees would become prohibitive. Therefore, new forms for the provision of financial services without traditional branches were developed.

Banking Agents

A widely applied model is that of banking agents.¹⁰³ Clients who want to make deposits, pay bills, transfer money and withdraw cash do not need a full-fledged branch but just a contact point where cash transactions can be handled (similar to versatile ATMs in technologically more advanced areas). National regulations regarding the eligibility to become a banking agent differ widely. In some countries, individuals (such as shop owners or retired teachers) are allowed but legal entities excluded, while it is the reverse in other countries; sometimes for-profit organisations are allowed and NGOs excluded, and sometimes the reverse.¹⁰⁴ For banks which target poor people in a larger area or even nationwide it could be best to enter into an agency agreement with one (private or public) cash-handling entity such as a grocery chain or the national post authority, which operates a wide network of stores or offices. However, in some jurisdictions competition laws or regulations might prevent this

¹⁰¹ See Mohieldin et al. (2011), p. 45.

¹⁰² As noted in note 92 above, a clear indication that microfinance has reached mainstream finance is that a profit-driven conventional institution (Deutsche Bank) has published a paper entitled “Microfinance: An Emerging Investment Opportunity”; see Dieckmann (2007).

¹⁰³ See Lyman, Ivatury and Staschen (2006).

¹⁰⁴ See, with examples, Tarazi and Breloff (2011); for the risk implications of different types of banking agents, risk management and risk mitigation options, and supervisory implications, see Lauer, Dias and Tarazi (2011).

and force banks to enter into a large number of separate agreements with dispersed agents. This is not only more time consuming and expensive; it also makes selection and supervision more difficult.

While basic cash-based services should not create any particular *Sharī'ah* problem, the selection and supervision of agents may become an issue for Islamic banks if they have to ensure the *Sharī'ah* compliance not only of their products but of the whole value chain, including distribution channels and service partners. Regulators may take a look at the respective processes in the interests of consumer protection – especially where clients have a choice between conventional and Islamic banking agents and the “*Sharī'ah* compliance” is advertised as a “unique selling point” by Islamic banks.

A relevant question for Islamic banks looking for agents is whether regulators allow the use of faith-based organisations (including mosques). This could substantially reduce *Sharī'ah* monitoring costs, but there are strong reservations from international bodies that are very sensitive regarding money laundering and terrorist financing. Even if faith-based organisations were excluded, the issue remains whether agents in remote areas should be allowed to open accounts for new clients. This implies that they are authorised to verify the customer's identity and conduct a customer due diligence – without much training and experience.¹⁰⁵ As a result, account opening may be reserved for a traditional bank branch.

Mobile Phone Banking

A modern form of branchless banking is mobile phone banking.¹⁰⁶ Mobile phone banking systems can provide the same basic cash-in/cash-out services as banking agents, but on a different technological platform and (at least in the beginning) under a different regulatory regime: successful phone banking systems – initially for cashless payments and money transfers – were launched not by banks but by mobile network operators (i.e. by non-bank entities without a banking licence). These non-banks are not subject to the same regulation and supervision as licensed financial institutions. If mobile phone banking is successful in terms of numbers of new (previously unbanked) clients and transaction volumes, then a growing share of the payment system (with particularly vulnerable groups as clients) will not be under the control of the banking supervision authorities. While this may be ignored or tolerated in the early stages, it can grow into a formidable problem if the system grows further and the clients demand more than basic payment services.

Suppose previously unbanked customers have used cash-in/cash-out services on a regular basis and realise that it is safer and more convenient to hold balances on their accounts instead of cash under their mattress. Such clients should get better savings products than credit balances on a current account. But a non-bank entity can hold customers' balances only as idle cash. The non-bank could pay a return to account holders only if it were authorised to invest the clients' funds, but this requires a licence as a financial institution. However, it is not a simple matter to grant a banking licence to a mobile network operator. It has a host of legal, accounting, reporting, taxation and risk management implications, and it could have a serious impact on competition both in the finance and the

¹⁰⁵ See Financial Action Task Force (2011).

¹⁰⁶ Technologically different but very similar from a regulatory point of view are payment systems with stored-value instruments such as prepaid cards. They are typically issued by non-banks and their use requires card-swipe or barcode reading POS terminals; see Lyman, Pickens and Porteous (2008). Today, many (even smaller) retail outlets are equipped with such devices.

telecommunications industry. But to reject a licence is not simple, either: it would put clients of a mobile phone banking system into an inferior position compared to clients of banking agents who are at the front end of licensed financial institutions which can invest clients' funds and offer a return on savings accounts.

The El-Naggar experience in the 1960s, the remarkable growth of Islamic MFIs in the 2000s, and the preferences for Islamic products articulated by people with no access to the banking system all point in the same direction – namely, that there is a huge growth potential for *Sharī'ah*-compliant finance in unbanked segments of Muslim populations. This could not only become a lucrative new niche market, but could also give a big push towards poverty alleviation and economic development. Branchless Islamic banking is still in its infancy, but chances are that, for example, globally oriented Islamic banks will team up with mobile network operators, contribute to their *Sharī'ah*-compliant financing, and develop a suite of financial services for actually unbanked people and neglected SMEs. Central banks and supervisory authorities should anticipate such developments and prepare a conducive legal and regulatory environment.

4.3 Responsible Investment

In recent years, the ethical banking and socially responsible investment (SRI) movement has rapidly increased in popularity, and responsible investment (RI) has grown into a multi-trillion dollar business.¹⁰⁷ The financial crisis and the calls for more morality in the economy gave it an additional boost. RI is of relevance for Islamic finance in two respects:

- (a) A segment of the RI deals with financial inclusion and may either become a competitor or a strategic partner for Islamic finance initiatives in this field.
- (b) It is often claimed that Islamic finance is ethical, socially responsible and sustainable. Insofar as Islamic finance could be considered part of the RI industry, this implies that regulatory issues related to RI may also be of relevance for Islamic finance. On the other hand, not all Islamic finance practices seem to meet more ambitious IR criteria.

4.3.1 Responsible Investment and Financial Inclusion

RI has become a major topic of the UN system, in particular the *United Nations Environment Programme Finance Initiative* (UNEP FI). An increasing number of empirical studies indicate that responsible investing does not necessarily imply a sacrifice of return; on the contrary, many studies found that the observance of environmental, social and corporate governance (ESG) criteria may be

¹⁰⁷ The authors of a report published by Robeco and Booz & Co. expected a few years ago “the RI market to become mainstream within asset management by 2015, reaching between 15%-20% of total global AuM (USD26.5 trillion)”; Liebert and Teschner (2008), p. 3. This may be somewhat exaggerated, as critical observers note that such a large volume and the “mainstreaming” is not the least owed to vague definitions and a lack of coherence. Therefore, figures should be taken with some caution; see, for example, Leys et al. (2011). “Mainstreaming Responsible Investment” was also on the agenda of the World Economic Forum; see Zadek, Merme and Samans (2005). For a critique of mainstreaming, see Joly (2011); for a summary of developments in the 20th century under the “old” label of SRI (which neglects – at least in name – the ecological dimension which has attracted more attention in the 21st century), see Sparkes (2002).

honoured externally by capital markets through lower costs of capital and internally by a higher productivity of the employees (with positive implications for profitability).¹⁰⁸

One of the projects of UNEP FI is the *Principles for Responsible Investment* (PRI) Initiative as a partnership between the UN and global investors with the goal of promoting and mainstreaming responsible investment practices. PRI started in 2006, has gained a remarkable acceptance¹⁰⁹ since then, and launched in 2011 the “Principles for Investors in Inclusive Finance”. The signatories commit to:

- (a) Actively support retail providers to innovate and expand the range of financial services available to low-income people in order to help them reduce their vulnerability, build assets, manage cash-flow and increase incomes;
- (b) Integrate client protection in investment policies and practices;
- (c) Treat investees fairly with appropriate financing that meets demand, clear and balanced contracts, and fair processes for resolving disputes;
- (d) Include environmental, social and corporate governance issues in investment policies and reporting;
- (e) Promote transparency in all aspects;
- (f) Strive for a balanced long-term social and financial risk-adjusted return that recognises the interests of clients, retail providers and investors; and
- (g) Set harmonised investor standards that support the further development of inclusive finance.¹¹⁰

These Principles link the UNEP FI initiatives with the CGAP activities of the World Bank system. It is noteworthy that the Principles express a perspective that is fully compatible with Islamic values and objectives, but IIFS are virtually absent from the list of PRI signatories. There could be value in leading global or regional Islamic players (including large institutional investors such as pension funds or pilgrim funds) in joining the PRI network, not only to gain knowledge for themselves but also to contribute their perspective to policies of the UN system.

In addition, regulators in Muslim countries could gain deeper insights into systemic and regulatory consequences of a stronger involvement of an increasing number of market player with large volumes of assets under management in the domain of RI in general and financial inclusion in particular.

4.3.2 Responsible Investment Approaches and Islamic Finance

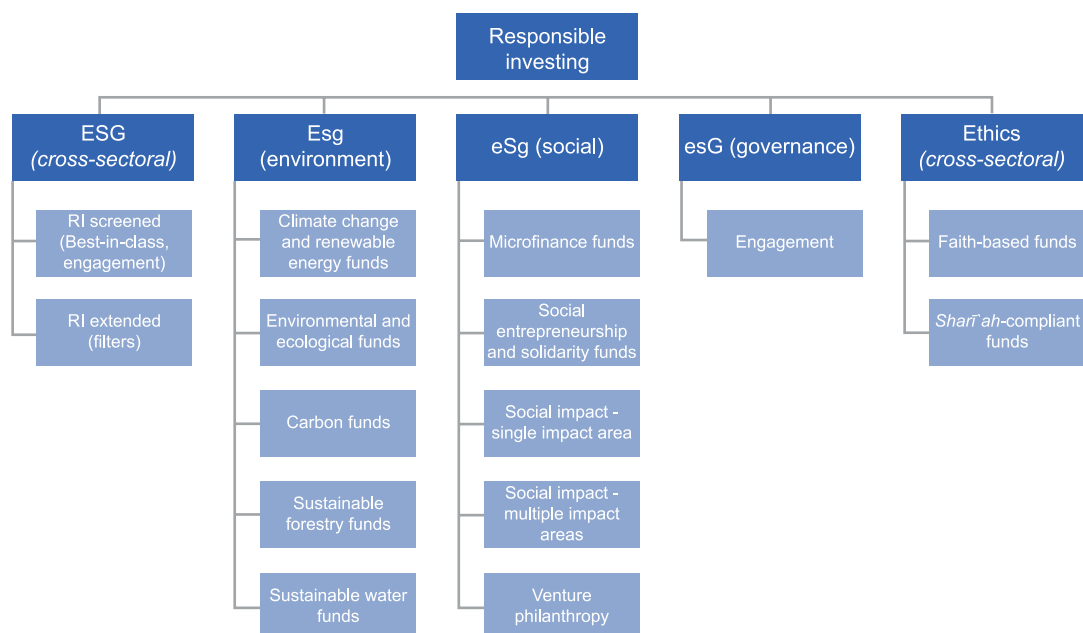
RI as a generic term comprises a wide range of different approaches and strategies. The Association of the Luxembourg Fund Industry (ALFI) categorises the different branches of RI as shown in Diagram 4.3.2.1.

¹⁰⁸ See, for example and with further references, Budde (2008) and DB Climate Change Advisors (2012).

¹⁰⁹ As at 2 December 2012 the webpage of PRI (www.unpri.org/signatories) lists the names of 1,129 signatories (685 investment managers, 269 asset owners and 175 professional service partners), including – besides smaller faith-based and regional or cooperative financial institutions – a growing number of well-known global investment banks as well as a considerable number of large institutional investors such as pension funds.

¹¹⁰ PRI (2012), p. 1.

Diagram 4.3.2.1: ALFI Responsible Investments Categorisation



Source: KPMG and ALFI (2012), p. 9

The most common strategies of responsible investing are:¹¹¹

- (a) The social and sustainability screening of investment options where in the simplest case “sin” stocks or bonds (prohibited items on a “negative list” such as alcohol, weapons, etc.¹¹²) are eliminated from the investment universe [“avoidance strategy”], while more demanding screens compare permissible alternatives with each other with respect to corporate social responsibility (CSR) or ESG indicators in order to pick the “best in class” (relatively best-performing) stocks or bonds [“inclusion strategy”].
- (b) Pro-active investing policies which give an explicit priority to investments on a “positive list” – for example, investments with an environmental [“green investment”] or social [“community development”] impact; a special form of pro-active investing is the programme- and mission-related investing of philanthropic foundations and institutional investors with specific missions (e.g. healthcare for the poor) or engagements in particular programmes (e.g. reduction of carbon dioxide emissions).
- (c) Shareholder activism, which means that shareholders use their voting rights and/or engage with the management in order to change the behaviour of companies towards more consideration of ESG criteria.

¹¹¹ See Budde (2008), pp. 2-5, Louche and Lydenberg (2011), pp. 24-33, KPMG and ALFI (2012).

¹¹² This can also include the temporary or open-ended boycott of individual companies or countries because of, for example, human rights violations (apartheid) or child labour.

Table 4.3.2.1 summarises the strategies of sustainable and RI according to definitions of the European Sustainable Investment Forum (Eurosif) and indicates the equivalents of the UN-driven PRI system.

Table 4.3.2.1: Strategies of Sustainable and Responsible Investment (SRI)

Eurosif strategy	Eurosif Definition	PRI equivalent
Sustainability themed Investment	Investment in themes or assets linked to the development of sustainability. Thematic funds focus on specific or multiple issues related to ESG.	ESG-themed Investments
Best-in-class investment selection	Approach where leading or best-performing investments within a universe, category or class are selected or weighted based on ESG criteria.	ESG Positive screening and Best-in-Class
Norms-based screening	Screening of investments according to their compliance with international standards and norms, in particular those of the OECD and the UN system (including Global Compact, ILO, UNICEF, UNHRC).	ESG Exclusions
Exclusion of holdings from investment universe	An approach that excludes specific investments or classes of investment from the investible universe, such as companies, sectors or countries engaged in weapons, pornography, tobacco and animal testing; this approach is also referred to as ethical- or values-based exclusions.	ESG Exclusions
Integration of ESG factors in financial analysis	The explicit inclusion by asset managers of ESG risks and opportunities into traditional financial analysis and investment decisions based on a systematic process and appropriate research sources.	ESG Integration
Engagement and voting on sustainability matters	Engagement activities and active ownership through voting of shares and engagement with companies on ESG matters. This is a long-term process, seeking to influence behaviour or increase disclosure.	Engagements (three types)
Impact investment	Impact investments are investments made into companies, organisations and funds with the intention to generate social and environmental impact alongside a financial return. Impact investments can be made in both emerging and developed markets, and target a range of returns from below market-to-market rate, depending upon the circumstances.	–
Although PRI-equivalents are similar to the Eurosif strategies, the definitions underpinning each strategy may differ between Eurosif and PRI. The PRI strategy “passive ESG tilted indices” does not have a direct Eurosif equivalent.		

Source: Based on Eurosif (2012), pp. 10-11

The RI business is meanwhile supported by a sophisticated infrastructure, including data and index providers, screening consultants, legal advisers, marketing firms, specialised asset managers, industry associations and lobby groups. Although the volume growth of the RI industry is mainly driven by an increasing engagement of institutional investors (especially pension funds), retail clients can find customisable and interactive web-based screenings of responsible investment funds and tests of their performance.¹¹³ Finally, it should be noted that governments of G-20 countries increasingly support

¹¹³ For 2011, the European Fund and Asset Management Association (EFAMA, 2012, p. 3) estimated a total of EUR13.8 trillion assets under management AuM in the European asset management industry (= 33% of the global AuM), and Eurosif (2012, p. 63) has calculated the total SRI volume at EUR6.8 trillion AuM (net of double counting), which is half of the total volume of the European asset management industry.

“impact investment” – that is, investment targeting a particular social and/or environmental impact alongside the financial return.¹¹⁴

An assessment of the elaborate screening techniques and differentiated strategies of Western SRI provides food for thought for further development of Islamic finance in these dimensions.

- (a) Both conventional RI and Islamic finance apply an “exclusion” filter (sometimes called “sector”, “industry” or “business” filter) on the first-level of their screening processes to exclude prohibited items.¹¹⁵
- (b) But the filters on the second level of the screening process differ substantially. In Islamic finance, the second-level screen is a financial one, and it is then at the discretion of the asset manager to compose a portfolio out of the non-*Harām* financially acceptable securities for a *Sharīʿah*-compliant fund or for the *Sharīʿah*-compliant financing business of an Islamic bank.¹¹⁶ Unless something different is explicitly specified (which is usually not the case), commercial criteria (and not impact criteria) will determine the risk/return characteristics of the portfolio or the financing business. In RI, the second screen is based on CSR or ESG criteria with a weighting that reflects the specific (usually published) responsibility profile or preferences of each financial institution. In the simplest case, the second screen may only exclude more securities from the investment universe (in addition to those “sin” securities which have already been excluded by the first screen) for a fund. That is structurally not different from the Islamic approach,¹¹⁷ but the criteria for the exclusion on the second level are not financial but – in the broadest sense – impact criteria. However, many RI screens go decisively further on the second level and use, for example, the CSR or ESG scores of the companies under examination and rank them accordingly to apply “best of class” selection criteria: They will pick those securities that rank highest, provided the expected financial performance exceeds a certain minimum. By this, impact criteria are the last instance for the composition of the portfolio or project to be financed.

Even if, on average, the returns of RIs are in line with the returns of conventional investments, there is probably a higher risk involved: for example, financing may be provided (directly or through investments in apex institutions) for vulnerable low-income groups, for companies with promising but untested new governance models (e.g. employees as co-owners, “democratic” management decisions, etc.), or for “green” projects with great ecological benefits on the basis of technologies in an experimental stage. However, if the financial volatility and genuine financial risks (in conventional finance) were reduced substantially by an appropriate regulatory framework, the economy could not only bear more entrepreneurial risks, but these risks could be much better managed and mitigated because established risk management techniques can operate more effectively in the real economy

¹¹⁴ For example, the UK government established *Big Society Capital* with potentially nearly USD1 billion in capital (which shall be leveraged by private capital), and the *US Overseas Private Investment Corporation* and the *US Small Business* will spend more than USD1 billion (over five years) for impact investment funds and initiatives; see Saltuk, Bouri and Leung (2011); see also O'Donohoe et al. (2010).

¹¹⁵ For example, so-called “sin stocks” (terminology of Christian groups) or stocks of *Harām* businesses (Muslim terminology). There is a remarkable overlap of excluded businesses or products in screens of Christian faith-based funds and IIFS: alcohol, tobacco, weapons, pornography, gambling, and sometimes even conventional financial institutions.

¹¹⁶ A survey of actual *Sharīʿah*-compliant screening methods is given by Ho et al. (2011).

¹¹⁷ In the terminology of Eurosif and PRI, *Sharīʿah*-compliant investing follows an “exclusion approach”.

than in speculative and volatile financial markets. Although the mainstreaming of responsible investing has blurred its contours, more limited SRI or wider RI concepts have not only drawn attention to imminent social and ecological threats but also shown how private investors – or more broadly, the civil society – can contribute to the management of global risks and to solutions of global problems. This corresponds with the basic tenets of Islam in general and Islamic finance in particular.

Banks have played an important role in financial intermediation, but if the world requires more risk-bearing capital to become sustainable, then traditional banks may lose some of their historical relevance. RI has shown that private and semi-public investors with a long-term orientation are willing and able to take more (real economy) risk if they see a value in it. However, they do not do it through the opaque banking system but through more transparent capital markets. A future model for sustainable financial intermediation and for the management of the risks of the real economy may rely mainly on transparent capital markets. Non-bank investment companies would be at the core of financial intermediation and risk management. They are not financed by guaranteed deposits but by the issuance of tradable investment certificates (*Sukūk*) of various investment funds. Each fund will publish a profile in which its investment strategies and risk characteristics are clearly spelled out, and investors can make informed choices from a wide range of funds.¹¹⁸ The investment companies will finance the real economy, but they cannot create money.¹¹⁹ From a regulators perspective it is noteworthy that a move towards this model with more transparency and informed consumer choices would not only enhance market discipline and strengthen effective competition, but would also disperse real economy risks among more investors and thus contribute to the stability of the financial sector.

The ethical dimensions of Islamic finance are consistent with, and may offer large scope to, the sophisticated screening techniques that are used in the SRI sector. The goal of attracting wider interest and participation in Islamic finance will be aided by frameworks that facilitate the assessment of the performance of IIFS against established standards in the Western ethical finance and SRI sector. There is a growing awareness that Islamic finance has not yet reached the level of detail and sophistication which is the standard in Western ethical finance and SRI. This is of potential relevance for the wider public appeal of Islamic finance. There is a considerable potential demand for Islamic finance products outside the Muslim world, but to tap into this segment requires additional efforts which may also be of benefit for Islamic finance itself. An adequate regulatory framework for advanced screening techniques, responsible investment strategies, ethical portfolio management and product innovation in the Muslim world would help, in particular, those Islamic institutions which are pioneers in tapping into wider Western markets beyond real estate and syndicated project financing.

¹¹⁸ The range may start with highly liquid money market funds with low yields, extend to funds with capital-protected *Shari'ah*-compliant securities with fixed returns, and equity funds with purely commercial targets or responsible impact investing funds, and end with highly speculative venture capital funds.

¹¹⁹ Such a system would have structural similarities with models of “narrow banking” or “limited purpose banking”; see Litan (1987), Kay (2009), Kotlikoff (2010), Nienhaus (2011).

5.0 CONCLUDING REMARKS

In spite of some setbacks in the depressed years after the global financial crisis, Islamic finance continued to grow in all its segments: banking, capital markets and *Takāful*. This growth was due to the entrance of new market players in an increasing number of jurisdictions, and to growing transaction volumes in established markets. Banking was and still is the most important segment of Islamic finance, and its continuing expansion brought it close to or even gave it a domestic systemic relevance in some jurisdictions.

Besides the observance of the prohibition of *Riba*, *Gharar* and *Maysir*, the most frequently quoted distinctive feature of Islamic banking is the replacement of interest-bearing savings or term deposits by profit-sharing investment accounts. The emphasis on PSIA as a distinctive feature characterises Islamic banks as retail banks. Investment account holders expect a return on their funds in the PSIA, but like depositors of conventional banks, they are typically risk averse. Thus, Islamic retail banks prefer modes of financing with pre-determined returns (mark-ups) and limited risk (e.g. *Murābahah* or *Ijārah*), and they hold medium- to long-term (preferably sovereign) *Sukūk* to maturity.

Retail consumer protection is the major concern of regulatory RSAs in this segment. On the one hand, they may take measures to ensure that Islamic banking products are “true to label” by the implementation of effective *Sharīʿah* governance structures by the banks. On the other hand, RSAs are searching for possibilities to extend financial safety nets to Islamic retail customers through *Sharīʿah*-compliant deposit insurance schemes. It is no easy task to reconcile the loss-bearing dimension of *Muḍārabah* contracts (which underlie the PSIA) with loss avoidance, not only in cases of a bank failure, which triggers the guarantees of a deposit insurance scheme, but also in cases of poor investment performance that do not threaten the existence of a bank but exceed investment risk reserves. While guarantees of the IAHs’ capital by independent third parties may be conceived in a *Sharīʿah*-compliant form, they would undermine the risk-bearing character of *Muḍārabah*-based investment accounts. Nevertheless, this issue has to be tackled – not only in the interests of a level playing field for Islamic and conventional retail banks, but also because of the systemic stability threat of a bank run triggered by (rumours of) loss allocations to IAHs.

The financial crisis has shown that systemic stability can also be threatened by developments in the capital market, and securitisation is of growing importance in Islamic banking. Securitisation is the prime domain of Islamic investment banks with more risky exposures in commercial real estate, large infrastructure projects and securities trading. Much – if not most – of the growth of Islamic banking over the last years was due to the rapid expansion of Islamic investment banks. In this field, effective risk management techniques and efficient liquidity management tools are of outstanding importance. Regulators of jurisdictions with a substantial market share of Islamic banks, the IFSB as well as the BCBS with a global outreach, have recognised the importance and urgent need for more *Sharīʿah*-compliant, high-quality liquid assets, both for a better functioning of the Islamic financial markets and in the context of the stricter Basel III liquidity requirements. Much work is actually being done in the IFSI on *Sharīʿah*-compliant alternatives or functional equivalents of repos, money market tools and open market instruments. In addition, as part of the safety net for Islamic banks, *Sharīʿah*-compliant LOLR facilities are called for and first practical models have been developed. The IFSB has found a number

of different approaches applied in practice, and the next step is to find out whether some “best practice” examples can be identified.

It would certainly be in the best interest of all if *Shari'ah*-compliant LOLR facilities never needed to be used because emergency situations were prevented from occurring. This is the aim of stress testing exercises, which will be extended to Islamic banks. The IFSB has published guidelines, some RSAs have initiated such exercises, and individual banks have run their own stress tests. In general, in jurisdictions tested, Islamic banks are sufficiently robust to stand periods of stress. However, stress tests have not been performed in all jurisdictions so that a comprehensive general statement cannot be made at this point in time.

Critical observers may point out that the efforts to integrate Islamic finance into the global financial system have led to the adoption of efficiency enhancing tools and protective measures which clearly follow conventional patterns and reduce the authenticity of Islamic banking to mere differences in the form of underlying contracts. In response to such comments, the IFSB has underlined that the form is not less relevant for the *Shari'ah* compliance of a transaction than its substance. The recent crisis years made it obvious that differences in form are much more than a mere “change of names”, as some critics had alleged. Differences in form had important and sometimes far-reaching legal implications which affected the substance of transactions. As long as IAHs are risk averse, the ground is not prepared for the “grand design” of an alternative model of Islamic financial intermediation through general risk-sharing practices on both the assets and liabilities sides of a bank's balance sheet (as explicated, for example, in the so-called two-tier *Muqārabah* model). In view of their fiduciary duties towards risk-averse IAHs, Islamic retail banks tend to use risk-mitigating techniques and focus on sales- and rent-based modes of finance.

Conventional banks had developed instruments for interbank transactions (i.e. transactions within the financial sector and beyond the real economy) which enhanced the efficiency of the overall system and benefited the real economy. Islamic banks operate in a competitive environment, and there can hardly be any doubt that efficient Islamic financial intermediation also requires tools for interbank transactions – in particular, for risk and liquidity management purposes. These tools do not have a direct link with, but nevertheless substantially support, the real economy. The development of a *Shari'ah*-compliant interbank market poses particular conceptual challenges because the classical Islamic law covers extensively all kinds of exchange contracts in the real economy but none in the financial sector (which was unknown during the formative period of classical *Shari'ah*).

The first and the last chapter of this report made it clear that Islamic finance is a much wider concept than Islamic banking. Besides banking, it encompasses capital markets for debt and equity securities with a wide range of maturities, the Islamic funds industry, and general and family *Takāful*. In addition, one has to add a growing variety of financial institutions with a specific and unique Islamic dimension, such as *Shari'ah*-compliant microfinance banks with branchless banking facilities, Islamic non-bank microfinance institutions, including *Qard al-Hasan* or *Sadaqah*-based financial institutions, cash *Waqf*, or *Zakat* structures in support of financial institutions. A good number of these innovative financial institutions which supplement “traditional” retail and investment banking have been briefly outlined in this report. These institutions, with or without a banking licence, meet sub-sets of those expectations

which were indiscernibly projected onto Islamic banks in the past. Their aims are, *inter alia*, financial inclusion and a funding of entrepreneurial talents which had been neglected by conventional banks in the past. There is no doubt that these Islamic initiatives go far beyond the form of finance and that they add new substance to the Islamic financial system. They are still in their infancy, but in order to flourish they need a well-established and efficient *Shari'ah*-compliant banking system, backed, *inter alia*, by a comprehensive and robust liquidity management infrastructure. Thus, there is no inherent or irresolvable contradiction between “high street banking” with Islamic money markets and securities trading in secondary markets, and the widening and deepening of the Islamic financial system. Instead of contradiction, the relation is one of complementarity and mutual stabilisation.

Even if the smaller sections of the IFSI (microfinance, philanthropic finance, cash *Waqf*, etc.) do not pose a threat to the financial stability in quantitative terms, RSAs should not ignore them because they have the potential to integrate previously un- or under-banked groups into the formal financial system, and these groups are particularly vulnerable. For customers already served by Islamic high street institutions, the range of products could be enhanced – in particular, by more explicitly socially responsible and sustainable investment products. This would not only substantiate the ethical claims of Islamic finance, but could also make Islamic finance more attractive to non-Muslim (and Muslim) customers and open up potential new markets. This may induce a further quantitative growth, and present new consumer protection issues, but RSAs should be able to handle these challenges because they have gained experience with similar business models in conventional finance.

In total, one can expect a further quantitative growth of Islamic finance, its further sectoral differentiation, institutional and product innovations, and more financial inclusion. Improved instruments for risk and liquidity management will help to prevent systemic crises and to stabilise the industry. More sophisticated safety nets will create a level playing field for Islamic and conventional financial institutions in an increasingly integrated financial world. This does not mean that Islamic finance specificities will be levelled off – to the contrary: efficient toolboxes of market players and regulators are pre-conditions for the unfolding of Islamic specificities in financial practice.

Appendix 1

Sample Methodology

Sample data were collected for Islamic banks in Bahrain, Kuwait, Malaysia, Qatar, Saudi Arabia, Turkey, the UAE, Pakistan, Bangladesh, Indonesia and Egypt. These countries were chosen because of the importance of Islamic banking in their banking systems and data availability. The database includes a total of 50 Islamic banks that covers over 60% of Islamic banking assets globally if Iran is excluded, and is not meant to be fully exhaustive. Islamic banking data for window operations is excluded from the sample due to lack of reliable data.

Data collected covers a period of between 2004 and 2011. However, for consistency, Islamic banks' data were used only where complete figures (i.e. all data necessary for this report) were available for the time series presented. In many instances, the most complete data range provided was between 2007 and 2011, which summed up to include 37 of the total 50 Islamic banks. For data beyond the availability of the sample, various primary and secondary market sources have been used to come to meaningful and comprehensive estimates.

List of banks selected for the sample	
Bahrain	
<ul style="list-style-type: none"> Al Salam Islamic Bank Bahrain Islamic Bank Ithmaar Bank Khaleeji Commercial Bank 	<ul style="list-style-type: none"> KFH Bahrain ABC Islamic Bank Albaraka Islamic Bank
Bangladesh	
<ul style="list-style-type: none"> Islami Bank Bangladesh Shahjalal Islami Bank 	<ul style="list-style-type: none"> First Security Islamic Bank Al-Arafah Islami Bank
Egypt	
<ul style="list-style-type: none"> Faisal Islamic Bank of Egypt 	
Indonesia	
<ul style="list-style-type: none"> Bank Syariah Mandiri Bank Muamalat Indonesia Bank BRI <i>Shar'ah</i> 	<ul style="list-style-type: none"> Bank <i>Shar'ah</i> Bukopin Bank <i>Shar'ah</i> Mega Indonesia
Kuwait	
<ul style="list-style-type: none"> Kuwait Finance House Boubyan Bank 	<ul style="list-style-type: none"> Ahli United Bank Kuwait International Bank
Malaysia	
<ul style="list-style-type: none"> Maybank Islamic CIMB Islamic Public Islamic RHB Islamic Bank Islam Bank Muamalat 	<ul style="list-style-type: none"> Hong Leong Islamic Bank Affin Islamic Bank Alliance Islamic Bank Asian Finance Bank KFH Malaysia

Pakistan	
• Meezan Bank	
Qatar	
• Qatar Islamic Bank • Qatar International Islamic Bank	• Barwa Bank • Masraf Al Rayan
Saudi Arabia	
• Al Rajhi Bank • Bank Aljazira	• Bank Al-Bilad • Alinma Bank
Turkey	
• Bank Aysa • Turkiye Finans	• Kuveyt Turk • Albaraka Turk
United Arab Emirates	
• Dubai Islamic Bank • Abu Dhabi Islamic Bank • Emirates Islamic Bank	• Emirates Islamic Bank • Sharjah Islamic Bank • Ajman Bank

For conventional banks, a sample of the top ten financial institutions by total asset size from various jurisdictions were selected. These are:

- Bank of America
- JP Morgan Chase
- Royal Bank of Scotland
- Barclays
- Credit Agricole
- International Commerce Bank of China
- BNP Paribas
- HSBC
- Mitsubishi UFJ Financial Group
- Deutsche Bank

The selection of mature conventional banks is taken in order to fairly represent the global conventional banking system, to which a comparison is made. The samples of banks allow a comparison in which the fundamental diversity in nature and business model between Islamic and conventional banking systems becomes highly visible. Additionally, it is hoped that this comparison will allow for greater continuity of the *Islamic Finance and Global Financial Stability Report* of 2010. Where conventional data are presented, aggregate figures for the 10 banks were taken for comparison purposes with the sample of Islamic banks.

Appendix 2

IFSB Standards and Guidelines

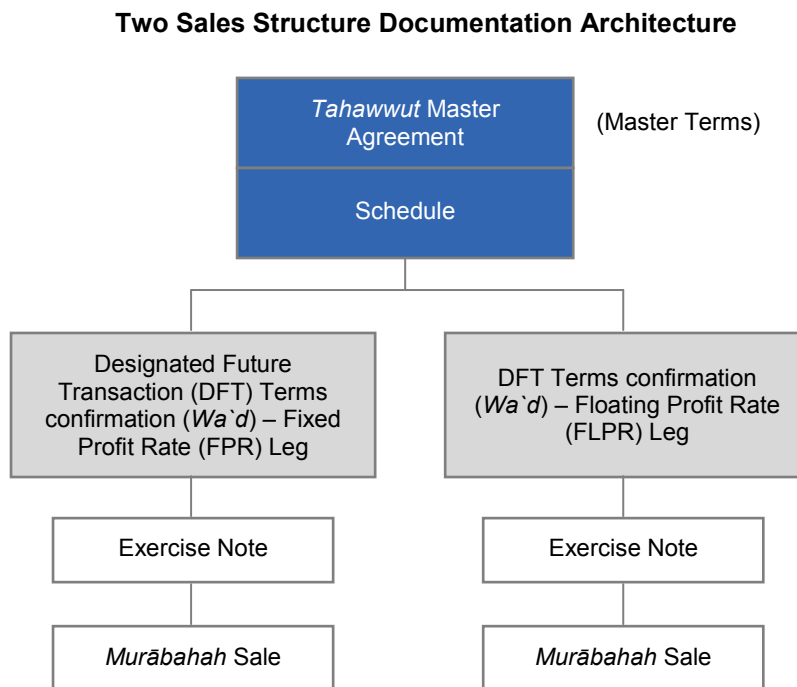
No.	Standards and Guidelines	Issuance date
1	IFSB-1: Guiding Principles of Risk Management for Institutions (other than Insurance Institutions) offering only Islamic Financial Services	2005
2	IFSB-2: Capital Adequacy Standard for Institutions (other than Insurance Institutions) offering only Islamic Financial Services	2005
3	IFSB-3: Guiding Principles on Corporate Governance for Institutions offering only Islamic Financial Services (excluding Islamic Insurance (<i>Takāful</i>) Institutions and Islamic Mutual Funds)	2006
4	IFSB-4: Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (excluding Islamic Insurance (<i>Takāful</i>) Institutions and Islamic Mutual Funds)	2007
5	IFSB-5: Guidance on Key Elements in the Supervisory Review Process of Institutions offering Islamic Financial Services (excluding Islamic Insurance (<i>Takāful</i>) Institutions and Islamic Mutual Funds)	2007
6	IFSB-6: Guiding Principles on Governance for Islamic Collective Investment Schemes	2008
7	IFSB-7: Capital Adequacy Requirements for <i>Sukūk</i> , Securitisations and Real Estate investment	2008
8	IFSB-8: Guiding Principles on Governance for <i>Takāful</i> (Islamic Insurance) Undertakings	2009
9	IFSB-9: Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services	2009
10	IFSB-10: Guiding Principles on Sharfah Governance Systems for Institutions offering Islamic Financial Services	2009
11	IFSB-11: Standard on Solvency Requirements for <i>Takāful</i> (Islamic Insurance) Undertakings	2010
12	IFSB-12: Guiding Principles on Liquidity Risk Management for Institutions offering Islamic Financial Services	2012
13	IFSB-13: Guiding Principles on Stress Testing for Institutions offering Islamic Financial Services	2012
14	GN-1: Guidance Note In Connection with the Capital Adequacy Standard: Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on <i>Sharī'ah</i> -Compliant Financial Instruments	2008
15	GN-2: Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity <i>Murābahah</i> Transactions	2010
16	GN-3: Guidance Note on the Practice of Smoothing the Profits Payout to Investment Account Holders	2010
17	GN-4: Guidance Note in Connection with the IFSB Capital Adequacy Standard: The Determination of Alpha in the Capital Adequacy Ratio for Institutions (other than Insurance Institutions) offering only Islamic Financial Services	2011
18	GN-5: Guidance Note on the Recognition of Ratings by External Credit Assessment Institutions (ECAIs) on <i>Takāful</i> and <i>ReTakāful</i> Undertakings	2011
19	TN-1: Technical Note on Issues in Strengthening Liquidity Management of Institutions Offering Islamic Financial Services: The Development of Islamic Money Markets	2008

Source: IFSB

Appendix 3

Mubādah al-Arba`ah Profit Rate Swap (PRS) Product Standard

(a) **Mubādah al-Arba`ah Two Sales Structure**



Source: IIFM

Wa`d Based

- Day 1: Fixed Profit Rate Payer (A) grants B multiple exercise *Wa`d*. If exercised, A will purchase commodity from B at cost plus Fixed Profit Rate amount.
- Day 1: Floating Profit Rate Payer (B) grants A multiple exercise *Wa`d*. If exercised, B will purchase commodity from A at cost plus Floating Profit Rate amount.
- Exercise dates for *Wa`d* are Day 1 and, say, every 6 months.
- When exercised, there will be immediate entry into *Murābahah* and immediate delivery of commodity; purchase price payment can be deferred for 6 months or spot.
- If purchase price payable under both is on the same day and in the same currency, the payments can be set off so that only net amount is paid.

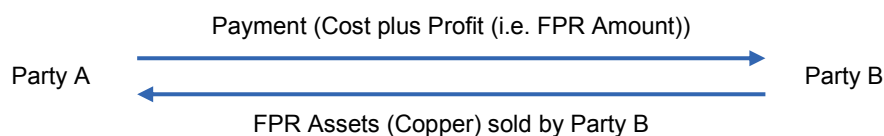
Exercise of Wa`d

- Each party may exercise the *Wa`d* granted to it by the Undertaking Party on an Exercise Date.
- On any Exercise Date, both *Wa`d* may be exercised in respect of the PRS.
- The *Wa`d* contained in the DFT Terms Agreement for the fixed rate leg is exercisable and the *Wa`d* contained in the DFT Terms Agreement for the floating rate leg is also exercisable.
- If a *Wa`d* is exercised, the Undertaking Party must buy Assets from the Exercising Party and execute a *Murābahah Sale Confirmation* evidencing the *Murābahah Sale* between the parties: there are two *Murābahah Sales* in respect of each Exercise Date in respect of a PRS with a Two Sales Structure.

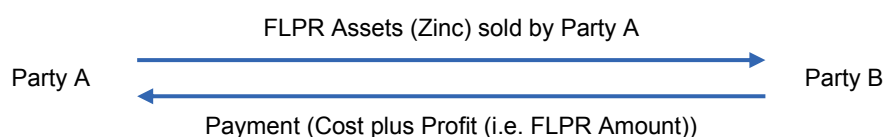
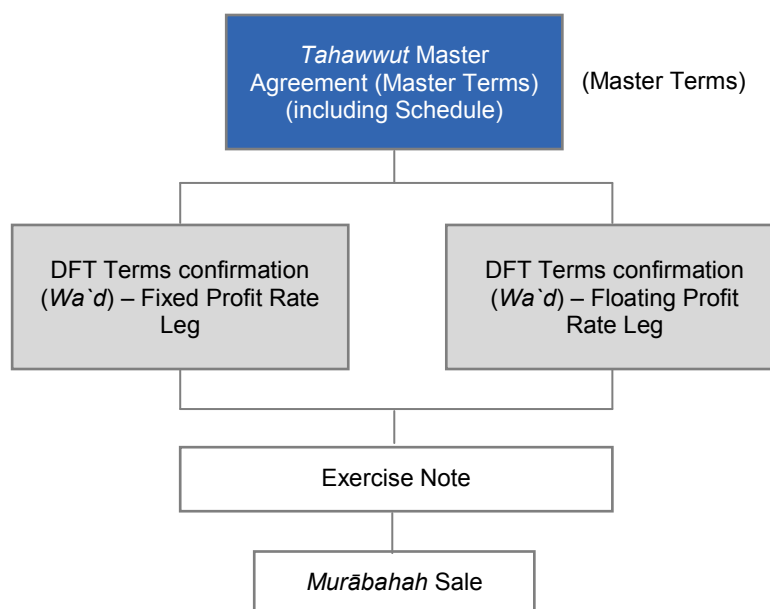
Exercise Condition for Wa`d

- The Calculation Agent determines Profit in relation to each leg of the PRS in respect of the first Calculation Period.

If Party B exercises Party A's FPR Wa`d, the cash and asset flows will be as follows:



If Party A exercises Party B's FLPR Wa`d, the cash and asset flows will be as follows:

**(b) Mubādah al-Arba`ah Single Sale Structure****Single Sale Structure Documentation Architecture**

Wa`d Based

- Day 1: Fixed Profit Rate Payer (A) grants B multiple exercise *Wa`d* exercisable where Fixed Profit Rate exceeds Floating Profit Rate. If exercised, A will purchase commodity from B at cost plus amount by which Fixed Profit Rate exceeds Floating Profit Rate.
- Day 1: Floating Profit Rate Payer (B) grants A multiple exercise *Wa`d* exercisable where Floating Profit Rate exceeds Fixed Profit Rate. If exercised, B will purchase commodity from A at cost plus amount by which Floating Profit Rate exceeds Fixed Profit Rate.

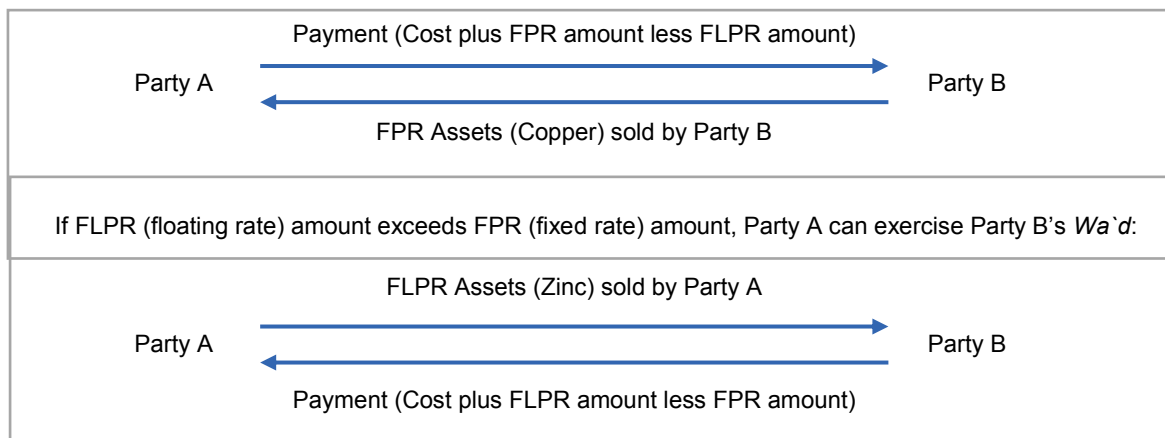
Exercise of Wa`d

- In the Single Sale Structure, a party may only exercise the *Wa`d* granted to it by the Undertaking Party on an Exercise Date if the Exercise Condition has been met.
- It is possible for the Exercise Condition to be met only in relation to one of the two *Wa`d* on any Exercise Date: only one *Wa`d* may be exercised in respect of the PRS.
- If the Exercise Condition is met in the fixed rate leg of the PRS (which means that it will not be met in the floating rate leg), the *Wa`d* contained in the DFT Terms Agreement for the fixed rate leg is exercisable (and the *Wa`d* contained in the floating rate leg will not be exercisable).
- If the Exercise Condition is met in the floating rate leg of the PRS (which means that it will not be met in the fixed rate leg), the *Wa`d* contained in the DFT Terms Agreement for the floating rate leg is exercisable (and the *Wa`d* contained in the fixed rate leg will not be exercisable).
- If a *Wa`d* is exercised, the Undertaking Party must buy Assets from the Exercising Party and execute a *Murābahah* Sale Confirmation evidencing the *Murābahah* Sale between the parties: there is only one *Murābahah* Sale in respect of each Exercise Date in respect of a PRS with a Single Sale Structure.

Exercise Condition for Wa`d

- Profit in respect of that leg of the PRS for a Calculation Period must be greater than zero in order to be exercisable.

If FPR (fixed rate) amount exceeds FLPR (floating rate) amount, Party B can exercise Party A's FPR *Wa`d*:



Source: IIFM

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