ISLAMIC FINANCIAL SERVICES BOARD

ISLAMIC FINANCIAL SERVICES INDUSTRY STABILITY REPORT 2014

ISLAMIC FINANCIAL SERVICES BOARD

ISLAMIC FINANCIAL SERVICES INDUSTRY
STABILITY REPORT
2014

May 2014

Published in 2014 by

Islamic Financial Services Board

Level 5, Sasana Kijang, Bank Negara Malaysia

2, Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia

ISBN 978-967-5687-32-7

ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include banking, capital markets, and insurance sectors. The standards prepared by the IFSB follow a lengthy due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involve, among others, the issuance of exposure drafts, holding of workshops and where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars, and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional, and national organisations, research/educational institutions, and market players.

For more information about the IFSB, please visit **www.ifsb.org**.

TABLE OF CONTENTS

BOXES

TABLES

CHARTS

DIAGRAMS

GLOSSARY

Bay` al-`Inah	A contract involving the sale and buy-back transaction of assets by a seller. A seller sells an asset to a buyer on a cash basis and later buys it back on a deferred payment basis where the price is higher than the cash price. It can also be applied when a seller sells an asset to a buyer on a deferred basis and later buys it back on a cash basis, at a price which is lower than the deferred price.
Commodity *Murābahah*	A *Murābahah*-based purchase and sale transaction of *Sharī`ah*-compliant commodities, whereby the buyer purchases the commodities on a deferred payment basis and subsequently sells them to a third party on a cash payment basis.
Darūrah	*Darūrah* 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 *Darūrah* is only applicable in exceptional circumstances where the avoidance of the specific necessary act shall ruin the said fundamentals.
Diminishing *Mushārakah*	A form of partnership in which one of the partners promises to buy the equity share of the other partner over a period of time until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, after which buying and selling of the other partner's equity takes place at market value or the price agreed upon at the time of entering into the contract. The 'buying and selling' is independent of the partnership contract and should not be stipulated in the partnership contract, since the buying partner is only allowed to promise to buy. It is also not permitted that one contract be entered into as a condition for concluding the other.
Gharar	Deceptive uncertainty where details concerning the sale contract are unknown or uncertain.
Hibah	A unilateral transfer of ownership of a property to another without any counter-value from the recipient.
Ijārah	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 rental. An *Ijārah* contract commences with a promise to lease that is binding on the part of the potential lessee prior to entering the *Ijārah* contract.
Ijārah Muntahia Bittamlīk (or *Ijārah wa Iqtina*)	A form of lease contract that provides a separate promise of the lessor giving the lessee an option to own the asset at the end of the lease period either by purchase of the asset through a token consideration or payment of the market value or by means of a *Hibah* contract.
Investment risk reserve	The amount appropriated by the institution offering Islamic financial services out of the income of investment account holders (IAHs), after deducting the *Muḍārib*'s share, in order to cushion against future investment losses for the IAHs.

Islamic window	An Islamic window is part of a conventional financial institution (which may be a branch or dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are *Sharī`ah* compliant, with separate funds.
Istisnā`	A contract of sale of specified objects to be manufactured or constructed, with an obligation on the part of the manufacturer or builder to deliver the objects to the customer upon completion.
Muḍārabah	A partnership contract between the capital provider (*Rabb al-Māl*) and an entrepreneur (*Muḍārib*) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to the entrepreneur's misconduct, negligence or breach of contracted terms.
Murābahah	A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin.
Mushārakah	A contract between the IIFS and a customer whereby both would contribute capital to an enterprise, whether existing or new, or to ownership of 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 *Mushārakah* agreement, while losses are shared in proportion to each partner's share of capital.
Profit equalisation reserve	The amount appropriated by the institution offering Islamic financial services out of the *Muḍārabah* income, before deducting the *Muḍārib's* share, in order to maintain a certain level of return on investment for investment account holders and to increase owners' equity.
Restricted investment accounts	The account holders authorise the institution offering Islamic financial services to invest their funds based on *Muḍārabah* or agency contracts with certain restrictions as to where, how and for what purpose these funds are to be invested.
Qarḍ/Qarḍ al-Hasan	A non-interest-bearing loan intended to allow the borrower to use the funds for a period with the understanding that this would be repaid at the end of the period, where it is not permissible for any increase in cash or benefit.
Salām	An agreement to purchase, at a pre-determined price, a specified kind of commodity not currently available to the seller, which is to be delivered on a specified future date as per agreed specifications and specified quality. The institution offering Islamic financial services as the buyer makes full payment of the purchase price upon conclusion of a *Salām* contract. The commodity may or may not be traded over-the-counter or on an exchange.

Sharī`ah	The practical divine laws deduced from its legitimate sources: the *Qur'an*, *Sunnah*, consensus (*Al-Ijma'*) and analogical reasoning (*Al-Qiyas*).
Sharī`ah board	An independent body set up or engaged by the institution offering Islamic financial services to supervise its *Sharī`ah* compliance and governance system.
Sukūk (singular *Sakk*)	Certificates that represent a proportional common ownership right in tangible assets, or a pool of assets that are *Sharī`ah* compliant.
Takāful	The term *'Takāful'* is derived from an Arabic word which means solidarity, whereby a group of participants agree among themselves to support one another jointly against a defined loss. In a *Takāful* arrangement, the participants contribute a sum of money as wholly or partially *Tabarru'* (donation) into a common fund, which will be used for mutual assistance for the members against a defined loss or damage, according to the terms and conditions of the *Takāful*.
Unrestricted investment accounts	The account holders authorise the IIFS to invest their funds based on *Muḍārabah* contracts without imposing any restrictions. The IIFS can commingle these funds with their own funds and invest them in a pooled portfolio.
Wadī`ah	The term *'Wadī`ah'* means custody or safe-keeping whereby the items are a trust for the safe-keeper. The items are not guaranteed by the safe-keeper, except in the case of misconduct, negligence or violation of the conditions. The safe-keeper may charge a fee for looking after the items or funds, and may pay *Hibāh* (gift) to the principal.
Wakālah	An agency contract where the customer (principal) appoints the IIFS as agent (*Wakīl*) to carry out the business on their behalf and where a fee (or no fee) is charged to the principal based on the contract agreement.
Waqf (plural *Awqāf*)	A property that produces income and that may have been deeded to benefit a community.

LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ACTs	Arab Countries in Transition
ADB	Asian Development Bank
AfDB	African Development Bank
AIDI	African Infrastructure Development Index
ALA	alternative liquidity approaches
AT1	Additional Tier 1
AuM	assets under management
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles
BCRs	basic capital requirements
BIBF	Bahrain Institute of Banking and Finance
BIS	Bank for International Settlements
BOD	board of directors
bps	basis points
BRSA	Banking Regulation and Supervision Agency
CAGR	compound annual growth rate
CAR	capital adequacy ratio
CBK	Central Bank of Kenya
CBN	Central Bank of Nigeria
CBRT	Central Bank of the Republic of Turkey
CCPs	central counterparties
CCR	counterparty credit risk
CDO	collateralised debt obligation
CEO	chief executive officer
CET1	Common Equity Tier 1
CGAP	Consultative Group to Assist the Poor
CIS	collective investment schemes
CMT	Commodity *Murābahah* Transactions
ComFrame	Common Framework
CPIFR	Core Principles for Islamic Finance Regulation
CPSS	Committee on Payment and Settlement Systems
CRM	credit risk mitigation
CRO	chief risk officer
DCR	displaced commercial risk
DJIM	Dow Jones Islamic Market
DOF	Department of Finance
D-SIBs	domestic systemically important banks
EBA	European Banking Authority
ECAI	external credit assessment institution
ED	Exposure Draft
ERM	enterprise risk management
ETF	Exchange-Traded Funds
FATF	Financial Action Task Force
FDR	financing-to-deposit ratio
FIS	Facilitating the Implementation of the IFSB Standards
FinRe	Financial *ReTakāful*
FISc	Financial Inclusion Subcommittee

FMI	Financial Market Infrastructure
FSAP	Financial Sector Assessment Program
FSB	Financial Stability Board
FX	foreign exchange
GCC	Gulf Cooperation Council
GDP	gross domestic product
GFC	global financial crisis
GIC	Government Investment Certificates
GNI	gross national income
GOP	Government of Pakistan
G-SIBs	global systemically important banks
G-SIFIs	global systemically important financial institutions
G-SIIs	global systemically important insurers
HDI	Human Development Index
HLA	Higher Loss Absorbency
HNWI	high-net-worth-individuals
HQLA	high-quality liquid assets
IAHs	Investment account holders
IADI	International Association of Deposit Insurers
IAIGs	Internationally Active Insurance Groups
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IBF	Islamic banking and finance
IBIs	Islamic banking institutions
ICAAP	internal capital adequacy assessment process
ICD	Islamic Corporation for the Development of the Private Sector
ICIS	Islamic collective investment scheme
ICM	Islamic capital market
ICPs	Insurance Core Principles
ICS	insurance capital standard
ICT	Information and communications technology
IDB	Islamic Development Bank
IFC	International Finance Corporation
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IIFM	International Islamic Financial Markets
IIFS	institutions offering Islamic financial services
IILM	International Islamic Liquidity Management Corporation
IIMM	Islamic Interbank Money Market
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
ISCU	internal *Sharī`ah* compliance unit
ISDA	International Swaps and Derivatives Association
ISRU	internal *Sharī`ah* review unit
KMI	Karachi-Meezan Index
LA	Loss Absorbency
LCR	Liquidity Coverage Ratio

LIBOR	London Interbank Offered Rate
LOLR	lender of last resort
MENA	Middle East and North Africa
MFIs	microfinance institutions
MIS	management information systems
MIX	Microfinance Information Exchange
MoUs	Memorandums of Understanding
MSMEs	micro, small and medium enterprises
NBFIs	non-bank financial institutions
NGOs	non-governmental organisations
NIFI	non-interest financial institution
NPF	non-performing financing
NPLs	non-performing loans
NSFR	Net Stable Funding Ratio
NTNI	Non-Traditional Insurance and Non-insurance
OECD	Organisation for Economic Co-operation and Development
OIC	Organisation of Islamic Cooperation
OTC	over-the-counter
PD	probability of default
PER	profit equalisation reserve
POS	point of sale
PRF	participants' risk fund
PSEs	Public Sector Entities
PSIA	Profit-Sharing Investment Accounts
QE	quantitative easing
QIS	Quantitative Impact Study
RMBS	residential mortgage-backed securities
ROA	return on assets
ROE	return on equity
ROSCs	Reports on the Observance of Standards and Codes
RPSIA	Restricted Profit-Sharing Investment Account
RRP	Recovery and Resolution Plans
RSAs	regulatory and supervisory authorities
RWA	risk-weighted assets
SBP	State Bank of Pakistan
SC	Securities Commission Malaysia
SEC	Securities and Exchange Commission of Nigeria
SESRIC	Statistical, Economic and Social Research and Training Centre for Islamic Countries
SFH	Special Finance Houses
SGF	*Sharī`ah* governance framework
SHG	Self Help Groups
SIFIs	systemically important financial institutions
SKBI	HSBC/NASDAQ Dubai US Dollar *Sukūk* Index
SKRAs	Strategic Key Result Areas
SLOLR	*Sharī`ah*-compliant lender of last resort
SM	Senior Management
SMEs	small- and medium-sized enterprises
SPP	Strategic Performance Plan
SREP	supervisory review and evaluation process

SRMP	Systemic Risk Management Plan
SSA	Sub-Saharan Africa
SSB	*Sharī`ah* Supervisory Board
S&C	Standards and Codes
TA	technical assistance
TIA	*Takāful* Insurance Africa
TRY	Turkish lira
TSM	Total Stock Market
UAE	United Arab Emirates
UK	United Kingdom
UPSIA	Unrestricted Profit-Sharing Investment Account
US	United States
USD	United States dollar

FOREWORD

The *Islamic Financial Services Industry Stability Report 2014* aims to provide a continuing evaluation of progress of the Islamic financial services industry (IFSI) in the face of challenges posed by the global financial environment. We hope thereby to contribute to a wider cross-border engagement on stability issues in Islamic finance, while helping to strengthen the building blocks needed for greater resilience.

Chapter 1 provides an overview of the trends and developments that were evident in the various segments of the IFSI in 2013, including Islamic banking, *Takāful,* the Islamic capital market and Islamic microfinance. Chapter 2 examines the initiatives undertaken by international standard-setting bodies to further ensure the stability of the financial institutions and markets, as well as the implications of such reforms for institutions offering Islamic financial services (IIFS). The chapter also reviews the progress of various projects and initiatives undertaken by the Islamic Financial Services Board (IFSB) to ensure soundness of the IFSI. It draws upon the Quantitative Impact Study conducted in 2013 on the preparedness of IFSI for key elements of the liquidity framework being introduced by Basel III. In addition, the chapter includes findings of the 2013 survey on the implementation of the IFSB Standards and Guidelines among IFSB members.

Chapter 3 takes up the issue of the resilience of the Islamic financial system through technical analysis of selected indicators for the three segments of the IFSI: Islamic banks, *Takāful* operators and Islamic capital markets. In addition, we include box articles in this chapter from two central banks on issues related to the performance of the IFSI in their respective jurisdictions. Thus, the Central Bank of the Republic of Turkey examines the resilience of participation banks in Turkey, while the State Bank of Pakistan analyses stability of the Islamic banking system in Pakistan. I am deeply grateful for the inputs provided by the two central banks, both of which are members of the IFSB Council. We hope that this form of collaboration with other institutions will lead to the development of a global network of expertise that can contribute to enhanced understanding of the performance and prospects of the IFSI.

Finally, Chapter 4 addresses emerging issues, such as the prospects and role of Islamic finance in contributing to the sustained economic growth and prosperity of new markets and locations, particularly Africa, through promoting financial inclusion and supporting infrastructure financing. It also stresses the need for legal and regulatory policies to be aligned in such a way that they support and strengthen this fast-growing sector at both national and regional levels.

This year's report is issued against the backdrop of a global economic environment in which continuing concerns focus around the prospective withdrawal, or "tapering", of quantitative easing in the United States, and a possible slowdown in the growth rates of emerging economies. There are legitimate questions about the potential impact of these various developments on Islamic finance. In the absence of more coordinated global policies, much will depend on the orderly rebalancing of economies in major emerging markets, such as China, which have significant trade linkages to economies in both Asia and the Gulf. At the same time, it is evident that economies which have the capability to manage the liquidity of both the conventional and Islamic finance sectors, and to achieve healthy balance sheets both at the macroeconomic level and within financial institutions, have proved to be resilient even in the face of substantial swings in gross capital flows.

The report was produced by a core team from the Technical and Research Division of the IFSB Secretariat, led by Mr Zahid ur Rehman Khokher, Assistant Secretary-General, and comprising Ms Noor Ashikin Ismail, who was the Project Leader, supported by Mr Jamshaid Anwar Chattha, Mrs Kartina Ariffin, Mr Mustafa Taşdemir, Mr Erdem Oz, and Mr Md. Salim Al Mamun, who were all involved in drafting Chapter 2 of the report. The IFSB team was further supported by Professor Volker

Nienhaus, who acted as lead consultant, and Mr Peter Casey, who read the entire document and provided useful comments throughout.

Mrs Baljeet Kaur Grewal, Managing Director of KFH Research, and her team at KFH Research, were responsible for writing Chapters 1 and 3. Chapter 4, on the prospects and role of Islamic finance in Africa, was authored by Professor Habib Ahmed. Mrs Siham Ismail, Head, and Ms Rosmawatie Abd Halim, of the Communications and Awareness Programmes at the IFSB, provided assistance in the formatting and publication of the final document.

We hope that the IFSI Stability Report 2014 will serve not only as a useful complement to the better understanding of issues by the various stakeholders of the IFSB, but also as a platform to generate discussions that will in turn help strengthen the IFSB's understanding of the challenges faced by the IFSI as a whole. We have been encouraged by the favourable response to last year's report. However, the project remains a work in progress.

Jaseem Ahmed
Secretary-General
Islamic Financial Services Board

May 2014

EXECUTIVE SUMMARY

The Islamic Financial Services Industry: Trends and Resilience

Total Islamic finance assets grew to an estimated USD1.8 trillion by the end of 2013. Islamic banking remains the dominant sector within the Islamic financial services industry (IFSI) with approximately 80% of the total Islamic financial assets. The industry is estimated to chart a compound annual growth rate (CAGR) of 17.04% between 2009 and 2013.

The pace of growth of the Islamic banking industry has been moderating recently, but the average growth rate of 20% after 2009 is still impressive. Islamic banking assets are concentrated in the Gulf Cooperation Council (GCC) and in Malaysia, but some non-GCC Middle East and North African (MENA) countries have experienced a rapid expansion or made a new entry (Jordan, Yemen, Tunisia, Libya and Morocco) last year. Further growth is also expected from populous Muslim countries such as Turkey, Pakistan, Bangladesh and Indonesia, and from Sub-Saharan Africa – in particular, Nigeria and Kenya.

The Islamic banking system as a whole was resilient during the financial crisis and in the post-crisis period. However, the global slowdown had an impact on performance indicators, and this was compounded in some countries by specific problems such as a real estate crisis or domestic political upheavals. Hence, the performance indicators across the Islamic banking industry are yet to revert to pre-crisis levels, but the recovery is progressing and 2013 had shown an improvement of profitability and liquidity indicators. In contrast, the average asset quality and capitalisation were gradually deteriorating, but they are in most cases still better for Islamic than for conventional banks. From a stability perspective it is noteworthy that Islamic banks have steadily reduced their average leverage ratio. While this trend can be observed in all countries, the performance indicators show a wide variance among the different jurisdictions so that the industry averages allow only a rough orientation. Chapter 3 provides more detailed data for ten selected countries to assess the resilience of their Islamic financial systems, taking into account specific domestic vulnerabilities and economic fundamentals.

The *Takāful* industry can, in principle, contribute to the stability of the banking sector through a reduction of asset and credit risks: general *Takāful* compensates for a ”deterioration” in financed assets, and family *Takāful* protects families with outstanding financing amounts (such as home financing) against default in case of an untimely death of the breadwinner. However, the size of the *Takāful* industry is still too small to make a significant contribution to the stability of Islamic banking. Regardless of regional differences, the further growth of *Takāful* would not only benefit from awareness campaigns but also from the availability of more fixed-income investment instruments such as *Sukūk* of longer tenures.

The Islamic capital market with long- and short-term *Sukūk* is also crucial for Islamic banking. The *Sukūk* market is the second fastest growing segment of Islamic finance with an annual growth rate of more than 40% from 2005 to 2012. But after a buoyant start, the market turned in mid-2013. The *Sukūk* market does not exist in isolation. It is inextricably linked with the global conventional capital markets: conventional corporations are active in the *Sukūk* market both as issuers and investors, and the pricing of *Sukūk* is largely dependent on demand and supply in the global market for debt securities. When a change in the US monetary policy was expected in late 2013, investors looked for opportunities in the US economy and withdrew funds from emerging markets. This reduced the demand for both conventional bond and *Sukūk* issuances in these markets, and as a consequence, *Sukūk* issuances – particularly corporate *Sukūk* – dropped significantly.

Islamic banking and *Takāful* require for their own resiliency a properly functioning Islamic capital market. *Sukūk* markets are of particular relevance for the systemic stability of the Islamic banking industry. Islamic banks use different *Sukūk* structures for liquidity management and capitalisation purposes (and for long-term investments). On the liquidity side, the challenge is to give *Sukūk* the features of high-quality liquid assets (HQLA) to meet Basel III requirements regarding the Liquidity Coverage Ratio (LCR). This necessitates a deep and liquid secondary market and fixed-income paper with no price risk. On the capitalisation side, the challenge is to give *Sukūk* the features of loss-absorbing capital to meet the Basel III requirements for Additional Tier 1 and Tier 2 capital. This necessitates a security with loss-absorbing characteristics in going concern and gone concern scenarios, respectively. IFSB-15: *Revised Capital Adequacy Standard for Institutions offering Islamic Financial Services*, issued in December 2013, provides guidance on types of *Sukūk* that could meet the criteria for various tiers of the capital of institutions offering Islamic financial services (IIFS). In any case, the *Sukūk* market will be exposed directly to shocks from the conventional debt securities market and from the equity market. Chapter 3 provides some empirical insights into these interrelations.

The Changing Global Financial Architecture: Implications for Islamic Finance

A reduction of the gross domestic product (GDP) growth in emerging markets, signs of a recovery of the US economy and continuing poor growth in Europe formed the backdrop of the ongoing overhaul of the global financial architecture in 2013. These changes in the global real economy had massive consequences for the financial markets in the 2H2013 which laid bare the vulnerability of emerging economies (including some Islamic Financial Services Board (IFSB) member countries) as a consequence of volatile capital flows. The availability of cheap credit had enabled some countries to refinance their debt and achieve a more prudent maturity structure, but in others capital inflows had financed a credit boom that exposed them to the threat of bursting bubbles and a depreciation of their currencies when capital flows reverse. The events since mid-2013 have underlined the need for a stability framework, including a prudent macroeconomic and monetary framework and microeconomic regulations of financial institutions. International standard setters and the IFSB continued their efforts in this respect.

The Financial Stability Board (FSB) laid a focus on better information about the business of globally active financial institutions and systemically important financial institutions (SIFIs) that are too big to fail. For the time being, no Islamic bank has been included in the list of global systemically important banks (G-SIBs). However, many Islamic banks could qualify for being considered as domestic systemically important banks (D-SIBs) in a few IFSB member and non-member countries. Better information on their activities is of relevance for regulatory and supervisory authorities (RSAs) in these countries. As an early warning system, stress testing should become a regular exercise, and IFSB-13 unfolds guiding principles for the IIFS on this subject. IFSB-15 deals with recovery plans and other supervisory aspects of D-SIBs. The FSB further dealt with shadow banking and risk appetite – both topics of equal relevance to IIFS. This Report provides some insights into the specific issues related to these subjects from an Islamic finance perspective.

The Basel Committee on Banking Supervision (BCBS) reported on the progress in the implementation of Basel III. The IFSB has adapted the Basel III capital adequacy regulations (including the leverage ratio requirements) for the IFSI and published the comprehensive IFSB-15 (see below). Besides capital adequacy and leverage, liquidity and risk management were the major topics covered by new BCBS guidelines during 2013. The IFSB explored members' views on liquidity regulation by means of a survey (addressing RSAs and IIFS) and a *Quantitative Impact Study* (addressing IIFS). Identified problems were the insufficient volume of *Sharī`ah*-compliant HQLA, and unclear or unfavourable treatments and run-off rates of Unrestricted Profit-Sharing Investment Accounts (UPSIA) in the calculation of the LCR and the Net Stable Funding Ratio (NSFR). Nevertheless, neither RSAs nor

IIFS reported major issues in adopting both LCR and NSFR requirements, with some further adjustments to reflect the specificities of IIFS. In the field of risk reporting and risk management, the IFSB transposed initiatives of the BCBS into the context of the IFSI, also referring to initiatives of other institutions such as the International Islamic Financial Markets (IIFM) to facilitate cross-border Islamic hedging, risk management and money market transactions.

In reaction to the London Interbank Offered Rate (LIBOR) fixing scandal, the International Organization of Securities Commissions (IOSCO) formulated principles for financial benchmarks. These should be reflected in the ongoing debate on benchmarks for the IFSI. In October 2013, IOSCO published the *Securities Markets Risk Outlook 2013–2014*, which highlights trends, vulnerabilities and risks in securities markets that may be of concern from a systemic perspective. These issues are also of relevance for the IFSI, and major problems have been addressed in Chapters 1 and 3. IOSCO, the Securities Commission Malaysia (SC) and IFSB jointly organised a roundtable on disclosure requirements for Islamic capital market products – in particular, *Sukūk* and collective investment schemes. The proceedings of this roundtable were jointly published in 2013.

The International Association of Insurance Supervisors (IAIS) supplemented the work of the FSB by the formulation of policy measures for global systemically important insurers (G-SIIs) which so far do not exist in Islamic finance. However, some *Takāful* and *ReTakāful* operators are part of systemically significant groups. In the field of (standards for) micro-*Takāful*, the IAIS and IFSB have agreed to develop a joint paper.

In December 2013, the IFSB has published two new standards (IFSB-14 and IFSB-15) and one exposure draft (ED-16). Preparations for more standards as well as guidance and technical notes will continue during 2014.

IFSB-14: Standard on Risk Management for Takāful Undertaking. IFSB-14 highlights three major risks which are specific to *Takāful*: (i) risks of *Sharī`ah* non-compliance, (ii) risks arising from the segregation of shareholders and participants funds, and (iii) risks relating to the use of *ReTakāful*. In addition, the Standard illustrates specific aspects of operational, underwriting, market, credit, liquidity, and legal and compliance risks from the perspective of the *Takāful* sector.

IFSB-15: Revised Capital Adequacy Standard for IIFS. IFSB-15 is a revised and enhanced version of IFSB-2 and IFSB-7. It includes key Basel III proposals on capital components, the leverage ratio and buffers for the IIFS. IFSB-15 is the pivotal standard for the implementation of the Basel III capital regulations in the IFSI. The Standard defines Tier 1 and Tier 2 capital of Islamic banks. This qualifies perpetual, unsecured, loss-absorbing *Mushārakah Sukūk* with the whole business of the bank as the underlying assets as Tier 1 capital; while *Muḍārabah* or *Wakālah Sukūk* with underlying assets which would be convertible into shares of common equity at the point of non-viability or insolvency qualify as Tier 2 capital. Profit-Sharing Investment Accounts (PSIA), investment risk reserves (IRR) and profit equalisation reserves (PERs) are not part of the IIFS' capital. The Standard provides guidance on capital buffers, the leverage ratio and capital adequacy of Islamic windows. IFSB-15 also provides detailed guidance on credit risk (including exposures in investments under profit-sharing modes) and risk mitigation, and it covers market and operational risk. The treatment of PSIA in the calculation of capital adequacy (including the "IFSB α") is explained, and the minimum capital requirements for nine widely used modes of Islamic financing (with variants) and for investment assets are outlined. IFSB-15 consolidates and clarifies previous standards (IFSB-2 and IFSB-7) on the capital adequacy treatment in the context of *Sukūk* holding and securitisation structures. Finally, the capital adequacy requirements for real estate activities have been updated.

ED-16: Revised Guidance on Key Elements in the Supervisory Review Process of IIFS. This is an update of IFSB-5 for authorities supervising IIFS. It draws lessons from the global financial crisis

(GFC) and complements the guidance issued by BCBS. ED-16 takes a risk-based approach and incorporates, inter alia, criteria and approaches for effective supervision of IIFS, the internal capital adequacy assessment process, securitisation risk and related off-balance sheet exposures, consolidated and home-host supervision, enterprise risk management (ERM), *Sharī`ah* governance and stress testing.

The other IFSB activities include: (1) the preparation of a new standard on *Core Principles for Islamic Finance Regulation*. A working group was formed with the participation of multilateral institutions including the Bank for International Settlements (BIS), International Monetary Fund (IMF), World Bank, Islamic Development Bank (IDB) and Asian Development Bank (ADB). (2) Another working group was set up to draft the *Guiding Principles for ReTakāful Undertakings*. (3) An expert group is to prepare a *Technical Note on Stress Testing for IIFS*. (4) As a follow-up of the IOSCO–SC–IFSB roundtable, the IFSB plans to establish a working group to prepare a standard on disclosure requirements specific to Islamic capital market products. (5) Compared to 2011, the (voluntary) implementation of IFSB standards has progressed. Most respondents to an IFSB survey have reported that the implementation of IFSB standards is either in progress or is being planned (mostly over a period of one to three years).

New Markets and New Frontiers for Islamic Finance: The Case of Sub-Saharan Africa

The share of Muslims in the population of Africa is 43% on average, but with a wide variance ranging from 97% in Northern Africa to 5% in Southern Africa. There are also very significant differences in the economic performance and development indicators between regions and individual countries in Africa, and they are spelled out in Chapter 4. Nevertheless, some generalisations regarding the role of Islamic finance can be made: Islamic finance has the potential of increasing financial inclusion for a large number of Muslims who would not avail themselves of conventional interest-based financial services due to religious convictions. In addition, Islamic finance can provide an alternative source of infrastructure financing that is a pre-requisite for sustained economic development.

Islamic financial institutions can use the same techniques as conventional counterparts to reduce the unit costs of microfinancing – for example, by the use of mobile phones, banking agents and other forms of branchless banking. But Islamic institutions may have comparative advantages besides their products and services being *Sharī`ah* compliant. On the one hand, sales- and rent-based financing techniques for micro-enterprises (mainly *Murābahah* and *Ijārah*) could reduce monitoring costs and the risk of a diversion of cash loans for non-productive purposes. On the other hand, additional resources from Islamic institutions that also aim at poverty reduction and social welfare – such as *Zakat* (alms giving), *Sadaqāt* (donation), *Qarḍ al-Hasan* or *Waqf* – could be channelled to Islamic microfinance institutions in order to reduce costs of funds and to improve the affordability and sustainability of Islamic microfinance schemes.

The African Development Bank's (AfDB) African Infrastructure Development Index (AIDI) indicates that the underinvestment in infrastructure is most apparent in Sub-Saharan Africa, with low index scores of between 11.6 and 35.1 (for 2010). The infrastructure is relatively best but still deficient in North Africa, with an index score of 63.8. The index gives an indication of the investment needs that are estimated for all of Africa at USD95 billion annually, compared to the actual spending of just USD45 billion. A lack of public resources has caused this wide infrastructure funding gap.

The sheer size of the funding needs indicates opportunities for Islamic finance with its emphasis on equity-based and asset-backed financing. Globally active IIFS have gained expertise in project financing through their activities in the GCC region. As African infrastructure projects will benefit communities at large, financing these projects by the Islamic financial sector is in line with its social aspirations. Governments can tap into domestic and international resources of the private sector by utilising instruments that satisfy the risk–return–maturity preferences of investors. With a suitable legal, regulatory and tax framework, *Sukūk* could be the instrument of choice for targeting broad categories of investors. Several African jurisdictions have already successfully issued *Sukūk*, and more are preparing the ground for their first issuance.

1.0 DEVELOPMENT OF THE ISLAMIC FINANCIAL SERVICES INDUSTRY

1.1 Overview of the Islamic Financial Services Industry

In the aftermath of the global financial crisis, financial regulators worldwide are undertaking various reforms to minimise the fragility of their domestic and regional financial systems. Efforts are also being enhanced to strengthen the stability of the global Islamic financial system. The various efforts include the development of appropriate global Islamic financial standards, strengthening the regulatory and supervisory framework to enhance the resilience of the system, and augmenting the building blocks of the overall ecosystem of Islamic finance.

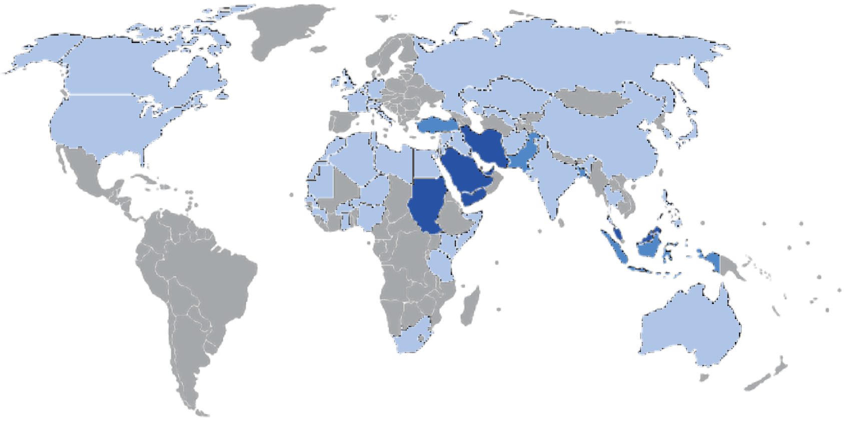
Since the landmark publication of the *Islamic Financial Services Industry Stability Report* in 2013, there have been a number of positive and encouraging developments in the Islamic financial services industry, solidifying the growing acceptance of Islamic finance globally. Notably, several non-Organisation of Islamic Cooperation (OIC) countries have pledged to undertake the necessary regulatory and tax reforms to facilitate the offerings of Islamic financial services in their territories. IFSI assets are expected to surpass USD2 trillion in 2014 from USD1.8 trillion estimated as at year-end 2013.

Total Islamic finance assets remain concentrated in the Middle East and Asia, with heavy concentration in the Islamic banking sector. At present, only Iran and Sudan operate an entirely *Sharī`ah*-compliant financial system, while in other jurisdictions, Islamic finance operates alongside conventional finance within a dual financial system. Apart from Iran, Sudan and selected GCC countries, Yemen, Brunei and Malaysia are the key markets where Islamic finance has systemic importance. (*This report considers the Islamic financial sector as systemically important when the total Islamic banking assets in a country comprise more than 20% of its total domestic banking sector assets, or the country's Islamic banking assets are at least 5% of the global portfolio of Islamic banking assets. The report uses the Islamic banking segment as the main criterion, given that almost 80% of Islamic financial assets are held in the banking sector.*)

In Malaysia, for instance, Islamic financial institutions hold 21.2% of total domestic banking system assets as at year-end2013[1] and the country holds a 10% share of the global Islamic banking assets. Breaking down the collective market share, the largest individual Islamic financial institution in the country contributes 4.8% to total domestic banking assets. In the GCC, the same measure generates higher proportions with the largest Islamic financial institution in Saudi Arabia representing 14.7% of banking system assets at 1H2013, while in Kuwait the largest Islamic financial institution holds 32.3% of the country's domestic banking system assets. In the GCC, total Islamic banking assets reached USD490 billion during 1H2013, with Saudi Arabia dominating the region with a 49% share followed by the United Arab Emirates (UAE) (19%), Kuwait (16%), Qatar (11%) and Bahrain (5%).

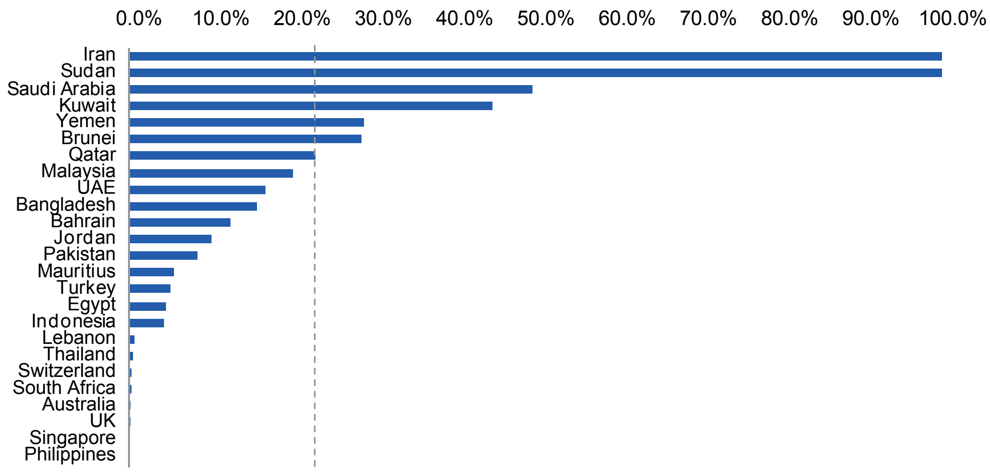
[1] Source: *BNM Monthly Statistical Bulletin*. This figure excludes the Islamic banking assets of the development financial institutions.

Diagram 1.1.1: Islamic Finance Markets by Systemic Significance



Source: KFHR

Chart 1.1.1: Islamic Banking Share in Total Banking Assets by Jurisdiction (1H2013)



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

Bangladesh, Pakistan, Turkey and Indonesia are emerging Islamic finance markets with significant potential for further growth of the Islamic banking industry. In these markets, Islamic finance also has the potential to become systemically important based on their Islamic banking sector growth prospects. Islamic banking has a 16.8% market share in Bangladesh (as at year-end 2012), 9% in Pakistan (as at 1H2013), 5.3% in Turkey (as at 1H2013) and 4.9% in Indonesia (as at 1H2013). Islamic banks in these countries, with their growth trajectory, could become instrumental in enhancing the qualitative aspects of the financial sector (such as improving financial inclusion). Strong support by the government and regulatory bodies in these countries can further accelerate the development of Islamic finance in these jurisdictions.

Other jurisdictions, such as Oman, Azerbaijan, Algeria and Egypt, are characterised by a nascent but peripheral Islamic finance industry. Islamic finance in these markets is expected to benefit from their demographic potential, but much will depend on sustained policy support. Among developed economies, the United Kingdom has renewed its pledge to support the expansion of Islamic finance in that country. Although Islamic finance in Britain is far from being of systemic importance in this jurisdiction, Britain's involvement as a global financial centre supports the further growth of Islamic finance globally.

In terms of global assets, Islamic finance grew from USD1.5 trillion as at year-end 2012 to USD1.62 trillion as at 1H2013. It is estimated to reach USD1.8 trillion as at year-end 2013, largely contributed by the Islamic banking sector, which represents approximately 80% of total Islamic financial assets. The Islamic finance assets grew at an estimated CAGR of 17.04% during 2009–2013.

Table 1.1.1: Breakdown of Islamic Financial Assets by Region (USD billion, 1H2013)

Region	Banking Assets	*Sukūk* Outstanding	Islamic Funds Assets	*Takāful* Contributions
Asia	192.3	166.0	24.2	3.5
GCC	490.3	74.9	30.6	7.6
MENA (excl. GCC)	518.3	1.2	0.4	7.1
Sub-Saharan Africa	20.6	2.2	1.6	0.2
Others	62.2	1.0	12.1	0.01
Total	**1283.7**	**245.3**	**68.9**	**18.3**

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

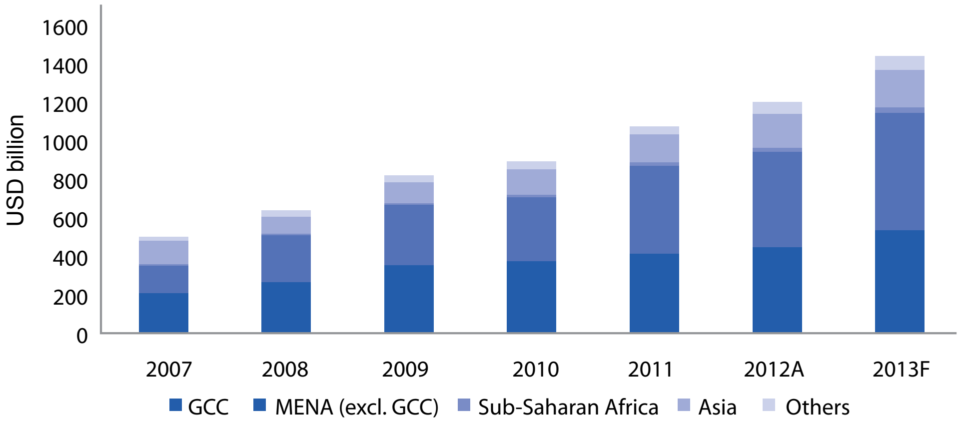
Note: Where available, data are taken from primary sources (regulatory authorities, annual reports, etc.). Where primary data are unavailable, third-party data providers have been used. Where there were still information gaps, data were estimated based on historical growth trends and country-specific assumptions. Takāful contributions are used as a basis to reflect the growth in the Takāful industry. The breakdown of Islamic funds' assets is by domicile of the funds.

The resilience of the IFSI during the GFC has garnered significant interest in non-Islamic markets on the principles of Islamic finance and whether claims that Islamic finance supports financial stability hold water. By and large, this has been the case. Nevertheless, the industry is vulnerable to the uncertainties in the macroeconomic environment. These include differential prospects for growth among developed and emerging economies and uncertainty over the impact of quantitative easing (QE) by the US Federal Reserve (the Fed). At present, the critical question relating to the financial stability of the IFSI is on how resilient is the Islamic financial system to withstand turbulences and volatilities in conventional financial markets, which then leads to another question of whether the growing use of Islamic financial instruments is in part a response to the challenging phase faced by the conventional financial markets.

1.2 Development Trends in Islamic Banking[2]

Assets with Islamic banks and Islamic banking windows grew at a CAGR of 19.1% between 2007 and 2012 to reach almost USD1.28 trillion as at 1H2013.[3] All regions have more than 80% of their Islamic financial assets concentrated in the Islamic banking sector except for Asia, which has a more balanced composition of Islamic banking and *Sukūk* assets. Thus, Islamic banks are the key providers of *Sharī`ah*-compliant services and this makes financial stability very much dependent on their performance.

Chart 1.2.1: Islamic Banking Assets Growth Trend (2007–2013F)



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

The expansion of the Islamic banking sector is taking place through a number of forms. New institutions are being established as full-fledged stand-alone banks, or as subsidiaries, or by the leveraging on an existing banking infrastructure through Islamic banking window operations by conventional banks (Box 1.1)

[2] The figures reported in this section of FSR2014 are not fully comparable with FSR2013 on account of differences in samples of banks under study; availability of data across indicators between FSR2013 and FSR2014; differences between estimated figures as reported in FSR2013 and actual figures reported in FSR2014; exchange rate variations affecting reported values in USD terms between FSR2013 and FSR2014; and other factors.

[3] The estimated figure for global Islamic banking assets as at year-end 2012 was reported as USD1.273 trillion in FSR2013. However, the actual figure for year-end 2012 is USD1.2 trillion, with the change largely on account of depreciation in the Iranian Riyals (Iran holds one-third of the global Islamic banking assets) which caused the actual global Islamic banking assets to decline in USD terms in 2012.

Box 1.1: Islamic Banking Windows Operations and Their Regulation

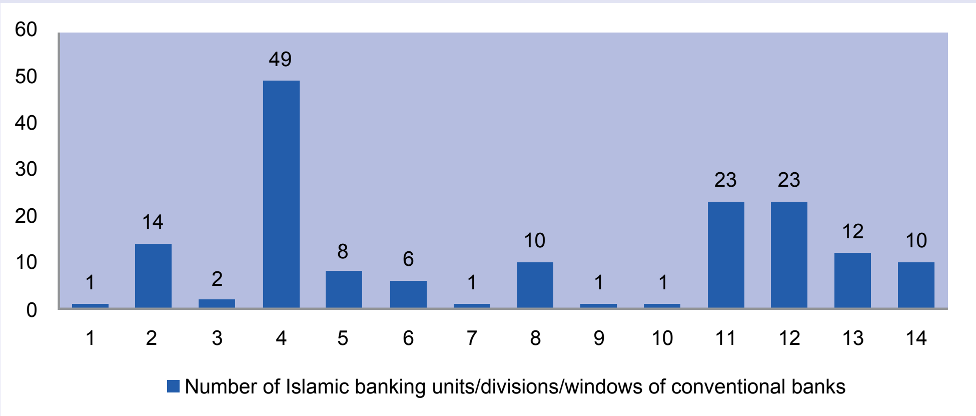
By: IFSB Secretariat

Islamic windows are present in a majority of the Islamic Financial Services Board member jurisdictions where Islamic finance is operating, and the supervisory practices for regulating them – in particular, relating to capital requirements – vary considerably across jurisdictions.

An Islamic window operation is defined as part of a conventional financial institution (which may be a branch or dedicated unit of that institution, but not a separate legal entity) that provides both fund management (investment accounts) and financing and investment that are *Sharī`ah* compliant. In principle, this type of window is called "self-contained" (or "full windows") in terms of *Sharī`ah*-compliant financial intermediation. On the other hand, the term "window" is also used in some jurisdictions to refer to an operation whereby an institution invests funds in *Sharī`ah*-compliant assets (such as home purchase plans based on *Ijārah Muntahia Bittamlīk*, Diminishing *Mushārakah* or *Murābahah*) without such funds having been mobilised on a *Sharī`ah*-compliant basis or specifically for *Sharī`ah*-compliant investment purposes. This type of window is referred to as "asset-side only window".

A survey undertaken by the IFSB in September 2013 identified 161 Islamic windows (comprising 49 windows from one jurisdiction alone and 23 in another jurisdiction) from 14 jurisdictions. The majority of these Islamic windows have been in operation for over 15 years. The distribution of these windows is presented in Chart 1. There are five regulatory and supervisory authorities that have more than ten Islamic banking windows in their respective territories, and two that have ten.

Chart 1: Islamic Banking Window Operations by Jurisdictions



Note: In this exhibit, the numbers on the x-axis represent individual RSAs, which have been assigned numbers rather than names to preserve anonymity.

This diversity of window operations raises a number of issues on supervision which are substantially the same as those raised by full-fledged institutions offering Islamic financial services. In responding to the survey, most of the RSAs expressed the wish that their concerns might be addressed in the IFSB Core Principles for Islamic Finance Regulation (CPIFR). The specific provisions relating to Islamic windows as suggested by the RSAs include having in place an appropriate *Sharī`ah* governance mechanism, accounting standards and financial reporting, management capabilities to offer Islamic financial services, and the segregation of funds and respective disclosures.

Box 1.1 *(continued)*

When the RSAs were asked to indicate how Islamic banking window operations are included in the supervision of IIFS in their jurisdiction, one RSA mentioned that conventional retail bank licensees may provide *Sharī`ah*-compliant services subject to the following conditions:

(i) *Sharī`ah*-compliant financing and funding have to be undertaken through a special counter or branch as deemed necessary by the bank;

(ii) the bank must maintain separate books for *Sharī`ah*-compliant banking activities to ensure no commingling of conventional and Islamic funds;

(iii) the bank must have a dedicated treasurer or senior trader for *Sharī`ah*-compliant business and a *Sharī`ah* compliance reviewer; and

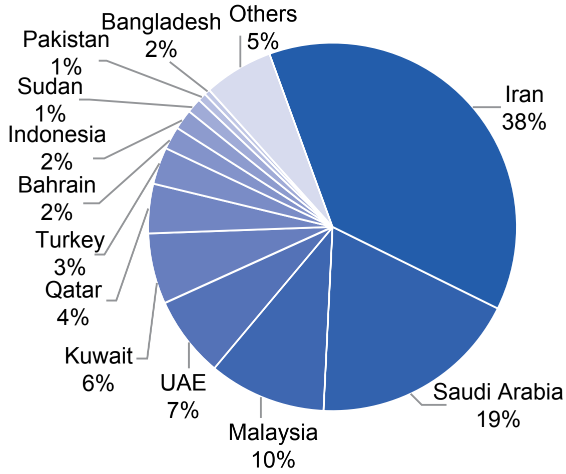
(iv) the bank must establish a *Sharī`ah* supervisory board (SSB) with a minimum of three board members. The SSB may have global authority for all *Sharī`ah*-compliant business, or may have authority purely for the Islamic business booked in the domestic jurisdiction.

The results also indicate that the assessment of Islamic window operations, in certain jurisdictions, is conducted on a consolidated basis as part of the parent conventional bank's assessment. In this respect, the supervisory authorities ensure that Islamic windows comply with the relevant regulatory requirements such as the minimum Islamic banking fund, *Sharī`ah* governance and segregation of funds. In addition, the supervisory authorities assess the effectiveness of functions of the Islamic windows, such as *Sharī`ah* governance, risk management, operations and documentation.

Source: IFSB CPIFR Working Group Survey, September 2013

Islamic banking in the early 2000s was a niche market in most jurisdictions and offered only basic depository and financing services. In terms of market outreach, the industry has now penetrated non-traditional jurisdictions to include new players from the Far East, Europe and Oceania, while the range of financial service offerings has widened to include Islamic trade financing, Islamic wealth management and Islamic structured products. The GCC markets and Malaysia remain the key driving jurisdictions sustaining the industry's growth trajectory. In recent years, Islamic banking markets from the MENA region such as Jordan and Yemen have also witnessed encouraging growth in their share of Islamic banking assets, while a number of new entrants such as Tunisia, Morocco and Libya are positioning themselves to facilitate the industry's growth within their respective jurisdictions.

Chart 1.2.2: Domicile of Islamic Banking Assets (1H2013)



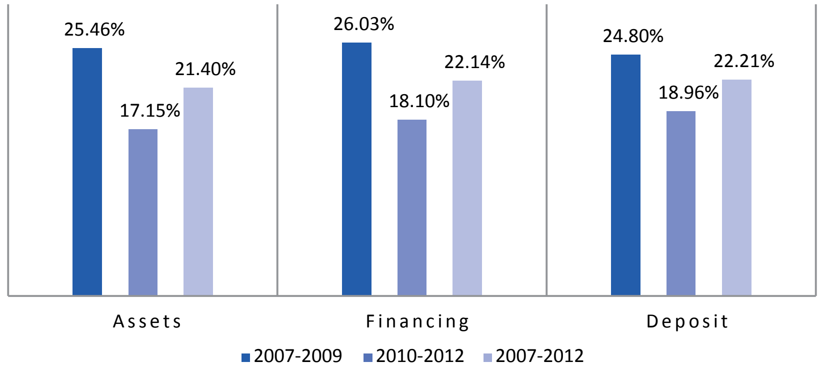
Source: Regulatory authorities, Bloomberg, Zawya, central banks, individual institutions, corporate communications, The Banker, KFHR

A sample of 52 Islamic banks[4] across the top ten Islamic banking countries by assets (excluding Iran) shows that the Islamic banking industry has grown substantially over the past six years, although the pace of growth has been moderating recently. The total assets of sample banks reached USD480.3 billion as at year-end2012, which represents 65.5% of the estimated total Islamic banking assets in 2012 (if Iran is excluded). Total assets of these Islamic banks have grown at a CAGR of 17.54% between 2007 and 2012.

In terms of financing and deposits,[5] the growth has moderated post-2009 although the average is still at a rate above 20%. The earlier year highs of approximately 40% were predominantly due to the strong growth of most Islamic banks in many jurisdictions where Islamic financing rapidly gained market acceptance. There is a noticeable dip in average financing growth during the year 2009 which is attributable to the knock-on effects of the GFC. Despite this, the average assets, financing and deposits growth has moved in tandem post-2010 at an impressive annual growth rate of over 20%.

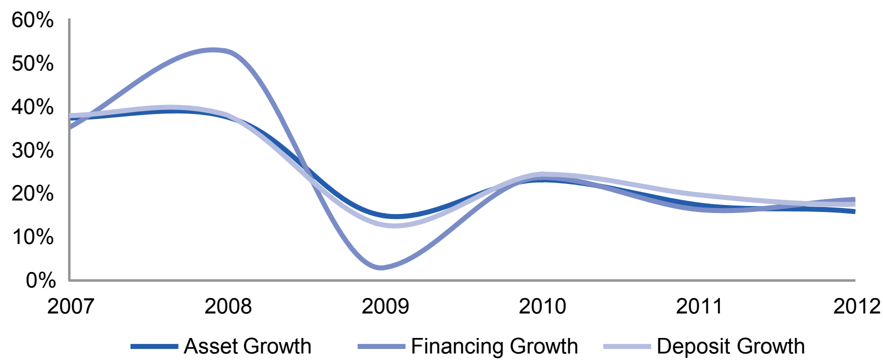
[4] The Islamic banking sample comprises full-fledged and subsidiary banks and excludes Islamic windows.
[5] The use of the term "deposit" in this section includes Unrestricted Profit-Sharing Investment Accounts, which are treated as equity in the financial statements of Islamic banks in some jurisdictions and as liabilities in others.

Chart 1.2.3: Compound Annual Growth of Key Islamic Banking Statistics



Source: Islamic banking sample, KFHR

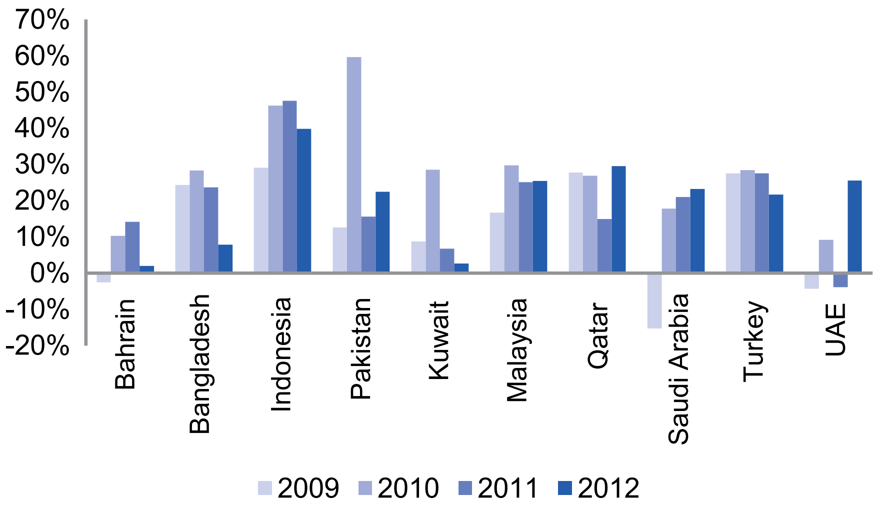
Chart 1.2.4: Islamic Banking Global Average Annual Growth Trends



Source: Islamic banking sample, KFHR

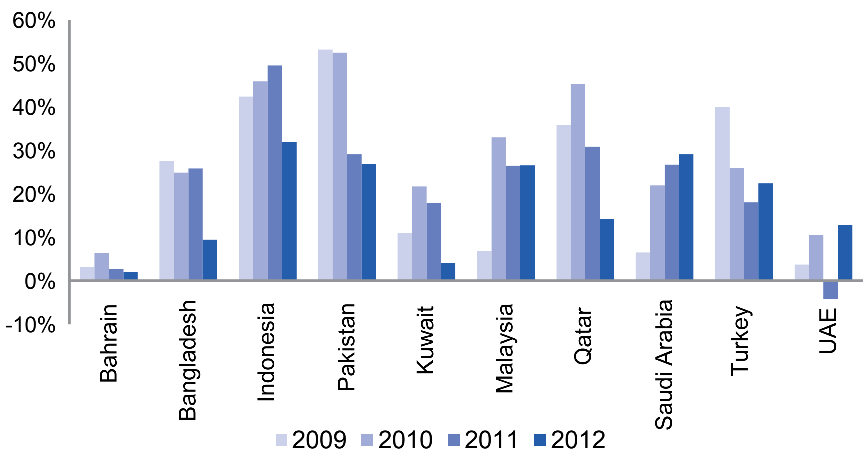
Analysing financing and deposits growth by individual countries reveals varying patterns across the sample. Fast-growing Islamic banking jurisdictions such as Turkey, Qatar, Indonesia and Bangladesh have demonstrated steady growth rates in financing and deposit during the years 2009–2012, supported by the wider acceptance of *Sharī`ah*-compliant financial solutions in these jurisdictions. In comparison, certain jurisdictions such as the UAE, Kuwait and Bahrain have witnessed lower, and at times negative, growth rates on account of various factors including, for example, a smaller domestic market in Bahrain, and increasing competition in highly competitive banking markets such as in the UAE. In addition, domestic political disturbances in Bahrain and a real-estate crisis in the UAE, where many Islamic banks had exposure to real estate investments, are factors contributing to the slow/negative growth in these Islamic banking jurisdictions. Countries such as Malaysia and Saudi Arabia witnessed a slowdown in deposit and financing growth during the year 2009 in comparison to earlier years, but have gradually recovered to experience higher growth rates since 2010.

Chart 1.2.5: Financing Growth Trend by Country



Source: Islamic banking sample, KFHR

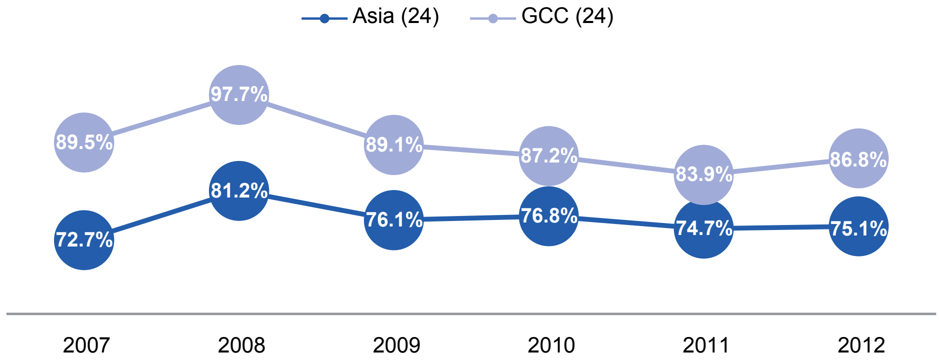
Chart 1.2.6: Deposit Growth Trend by Country



Source: Islamic banking sample, KFHR

In most countries, Islamic banks have remained resilient during, and in the immediate aftermath, of the GFC. However, their growth rates have not bounced back to pre-crisis levels. As at 2012, the financing-to-deposit ratio (FDR) remains below the pre-crisis 2008 level in both Asia and the GCC. However, both regions have shown small improvements in 2012 as compared to 2011 levels. Based on the sample set, the FDR in Asia ranged consistently between 74% and 76% during 2009–2012, led by stable levels of FDR ratios in all Asian countries included in the analysis, namely Malaysia, Bangladesh, Indonesia and Pakistan. Notable exceptions in Asia were Islamic banks in Pakistan, which differed from their peers by having low average FDR ratios, ranging between 40.5% and 44.7% during 2009–2012, down from 60.8% in 2008. This reflects subdued economic performance that has slowed business and financing activities. In contrast to Islamic banks domiciled in Asia, the FDR for GCC Islamic banks declined to a greater extent from 2009 onward, as higher non-performing financing (NPF) forced banks to be more prudent in their financing decisions. In 2012, GCC banks' FDR ratio had slightly rebounded, due mainly to improved financing growth in Qatar and the UAE.

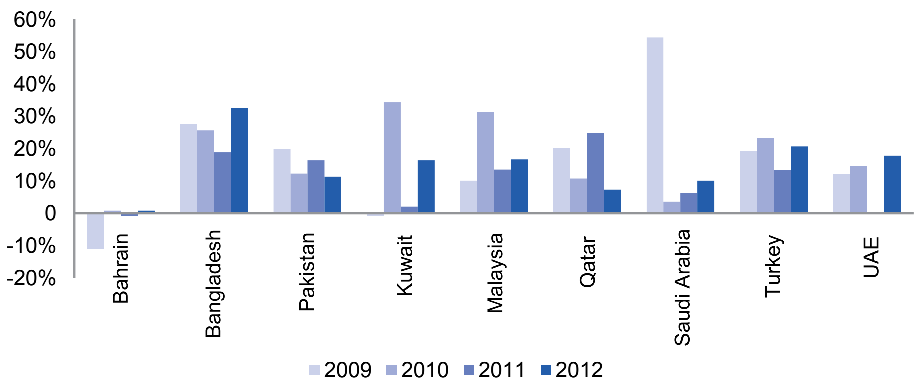
Chart 1.2.7: Financing-to-Deposit Ratio of Islamic Banks



Source: Islamic banking sample, KFHR

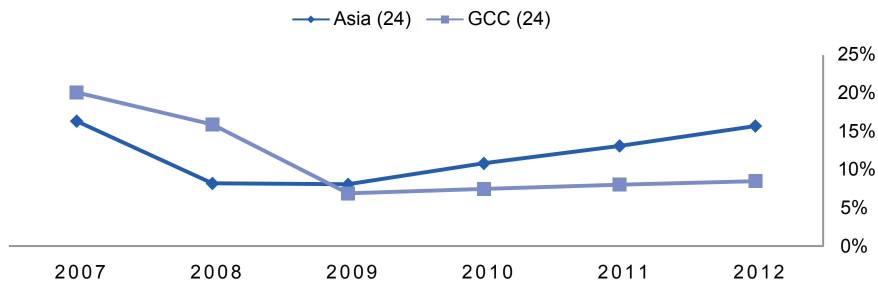
In terms of shareholders' equity, Islamic banks have been able to improve shareholders' value post-2009 as witnessed by the expanding overall equity values and net profit figures, albeit at a much slower pace. The growth in equity post-2008 was led by institutions in Asia (mainly in Bangladesh and Malaysia), while entry of new Islamic banks in the GCC countries of Saudi Arabia and Kuwait in recent years has helped to shore up Islamic banking equity in the region. Total average equity capital growth in 2008 stood at 34.8%,while the Islamic banking equity growth rate during 2009–2012 averaged 14.88% per annum.

Chart 1.2.8: Average Total Equity Growth of Islamic Banks



Source: Islamic banking sample, KFHR

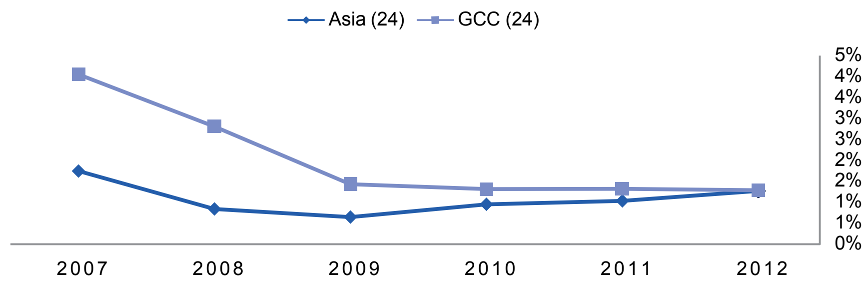
Chart 1.2.9: Average Return on Equity of Islamic Banks



Source: Islamic banking sample, KFHR

Asian Islamic banks, while experiencing a slowdown in returns during the peak crisis years of 2008-2009, have been able to recover moderately since then, exceeding the returns on equity performances of the GCC banks from 2010 onwards. Improved returns in Asia are also generated by a vibrant business climate in the region, as well as by Islamic banks' innovativeness in introducing Islamic hedging products and Islamic trade financing products in response to the needs of the market. Efforts from the various regulatory authorities to address challenges faced by Islamic banks – for example, for money market and interbank instruments to manage liquidity – have also been instrumental in enhancing the operational efficiency and resilience of Islamic banks in recent years.

Chart 1.2.10: Average Return on Assets of Islamic Banks



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, Pakistan and Bangladesh, where the increasing demand for alternative banking products and services through Islamic intermediation continues to drive growth. In particular, policy and regulatory support in Turkey is emerging as a strong factor in providing a conducive enabling environment for the development of the Islamic financial system.

Developments in Africa could add greater momentum to the overall Islamic banking industry. Africa has huge infrastructural development needs and, according to a special report by the World Bank on Africa, the continent faces an annual infrastructure funding gap worth USD35 billion. In addition, there are significant improvements being made in enhancing financial inclusion in the region, along with a growing awareness and acceptance among the demographics of the benefits of taking financing and loans from financial institutions. Such macroeconomic and socio-demographic changes provide tremendous opportunities for Islamic banks to capitalise on, and a number of Islamic banks in the

GCC have shown interest in expanding into the African region. Such a trend is already visible, as major Islamic banking institutions have announced plans to enter African markets through setting up branches in Kenya, Nigeria and other Sub-Saharan African countries. Islamic banks will also have opportunities in the continent as the industry awaits regulatory developments in North African countries such as Tunisia, Morocco and Libya that will help spur Islamic finance development in general.

In Asia, Islamic banking is expected to further support the region's economic growth and improve banking penetration based on its demographic potential and strong support from government agencies. A number of Asian countries such as India, Indonesia and Malaysia are home to substantial Muslim populations where Islamic banking institutions have opportunities to provide financial solutions aligned to faith-based preferences. In addition, funding gaps in economies such as India, where the government estimates a USD300 billion gap in meeting its infrastructure funding requirement by 2017, provide abundant opportunities for Islamic banks to engage in syndicated financing facilities to partly support the development plans. Particularly in the case of India, a landmark ruling by the Reserve Bank of India, which perhaps indicates its willingness to accommodate Islamic finance, was the approval given on 19 August 2013 to the state of Kerala to establish a non-banking finance company that would offer *Sharī`ah*-compliant services. Recent announcements by jurisdictions such as Hong Kong and mainland China that they intend to develop their Islamic financial systems are also positive developments in terms of the future growth trajectory of Islamic finance in Asia.

However, despite the positive developments and strong future growth prospects, the lacklustre global economic environment and limited awareness in many jurisdictions are among the challenges facing the Islamic banking industry over the coming years. A recently released report by the Islamic Corporation for the Development of the Private Sector (ICD) indicates that, in 2012, Malaysia leads, by far, the global Islamic finance industry in terms of awareness. (The awareness indicator of the report is based on the number of seminars, conferences and news articles related to Islamic finance in each country.) The remaining Islamic finance jurisdictions lag behind in terms of awareness. Malaysia ranked first in the awareness indicator, followed by UAE, other GCC countries, Turkey and Indonesia. Efforts should be directed at creating an enabling environment for Islamic banks to operate efficiently vis-à-vis conventional banks. Islamic banks need to be extended certain regulatory treatments – for example, in taxation and legal issues – that would enable them to compete with conventional banks on a level-playing field.

Although the core principles of Islamic finance should be able to shield IIFS from some risks, they may still be vulnerable to major systemic risks. Therefore, an important question is how to strengthen the resilience and stability of the Islamic financial system while maximising its true prospects. Diversification and enhancement of the business models of IIFS could further propel the growth of the industry. Pursuing dynamic business models and product innovation is vital to improving the profitability and sustainability of Islamic banks.

RSAs are introducing reforms to strengthen capital and liquidity standards to implement the Basel III regime and the IFSB standards. The recently published standard IFSB-15 provides guidance on adaptation of key aspects of Pillar 1 of Basel III to address the specificities of Islamic finance, and Exposure Draft 16: *Revised Guidance on Key Elements in the Supervisory Review Process of IIFS* (ED-16) addresses Pillar 2 issues. Meanwhile, the *Sharī`ah*-compliant lender of last resort (SLOLR) facility for IIFS in various jurisdictions still remains part of the agenda. Appropriate SLOLR mechanisms need to be developed to ensure that, in times of difficulty, IIFS would be able to access liquid funds. There is also a need for appropriate safety-net provisions, both to protect consumers and to make the IFSI less susceptible to systemic risks.

Internationalisation and cross-border linkages within the IFSI are themes that have been greatly emphasised in recent years. Responding to this, the industry has witnessed numerous efforts in creating financial and regulatory partnerships, cooperation and linkages at both the global and regional levels. The Islamic Development Bank has been instrumental in this regard and through numerous platforms has encouraged OIC countries to adopt intra-OIC friendly trade and financial policies to support the growth and development of cross-border linkages. Extending partnerships beyond OIC countries are, for example, the Memorandum of Understanding between the IFSB and the Asian Development Bank, joint workshops and seminars with international multilateral bodies such as the World Bank and International Monetary Fund, and the Islamic finance industry stakeholders. Such efforts by various Islamic finance multilateral bodies, central governments and others are intended to integrate Islamic finance into the global financial system. This trend will strengthen the international financial and economic inter-linkages between jurisdictions, bringing mutually reinforcing gains and more efficient mobilisation and allocation of funds across regions. At the same time, these trends must be supported by enhanced regulation to avoid contagion risks and financial instability at the global level.

1.3 Development Trends in Islamic Capital Markets

The Islamic capital market is an integral part of the Islamic financial system that facilitates access to capital. Developing *Sharī`ah*-compliant financial instruments is critically important in the Islamic financial system to fund capital requirements, grow wealth and assets, and provide short- to long-term liquidity. Since the early 2000s, the global Islamic capital market has been growing in depth and size across jurisdictions, with numerous entities across sectors raising capital in ways that comply with Islamic principles.

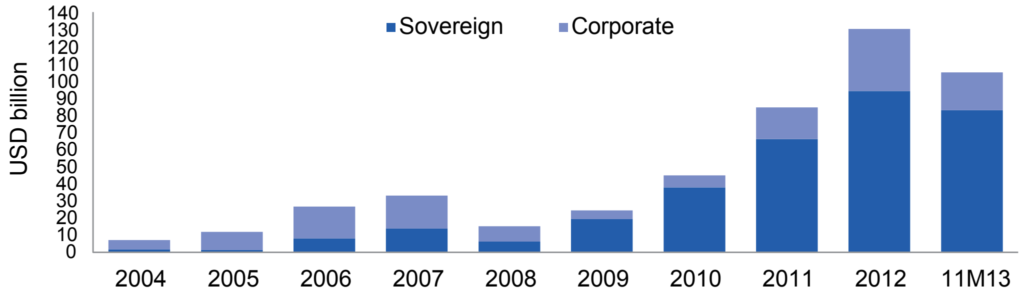
1.3.1 Sukūk

After Islamic banking, the *Sukūk* market is the second fastest growing segment of Islamic finance. *Sukūk* are certificates of investment in underlying assets, services or investment activities that generate fixed or floating returns according to Islamic principles. The instruments offer an alternative funding tool to conventional bonds that can be structured and utilised for a vast array of purposes. In recent years, *Sukūk* products have seen significant innovation with the introduction of hybrid, convertible, perpetual, retail and insurance-linked issuances. As such, *Sukūk* are being used for funding working capital requirements, liquidity management, risk management and investment purposes.

The market has attracted a large number of governments and corporations in South and Southeast Asia, as well as the GCC over the years. Since 2005, when issuances totalled only USD11.5 billion globally, the market has grown at an average rate of 41.6% annually till 2012. Most recently, annual *Sukūk* issuances recorded USD119.7 billion in 2013. This has in part been driven by new jurisdictions tapping the market, such as Turkey, Kazakhstan, Indonesia, Mauritius, and parts of Europe and Africa.

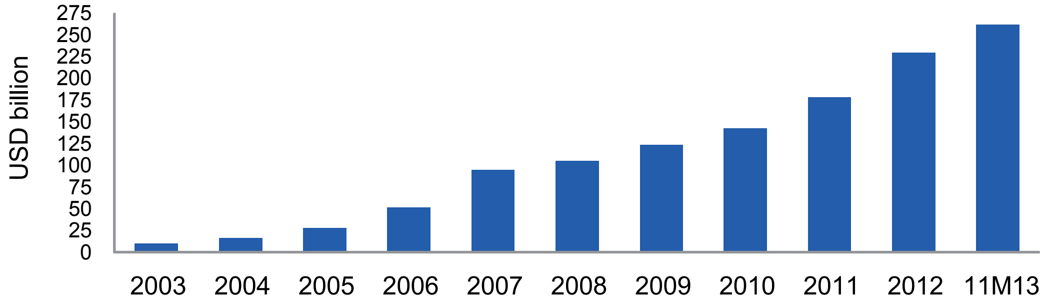
Despite the unique characteristics of *Sukūk*, they operate within a broader global financial system; thus, their risk profile and pricing are not decoupled from demand and supply conditions of the global market for debt securities. For this reason, *Sukūk* issuances dropped significantly in 2008 on the back of the GFC. In recent years, issuances have reflected the monetary policy operations in major markets, particularly in the US and Europe, which caused bond prices to rise and yields to reach historic lows, making the *Sukūk* market suitable for cost-efficient issuances across the globe. Investors looking for better yields also moved into the *Sukūk* market, adding to the demand and further stimulating new issuances.

Chart 1.3.1.1: *Sukūk* Issuance Trend



Source: Bloomberg, IFIS, Zawya, KFHR

Chart 1.3.1.2: *Sukūk* Outstanding Trend

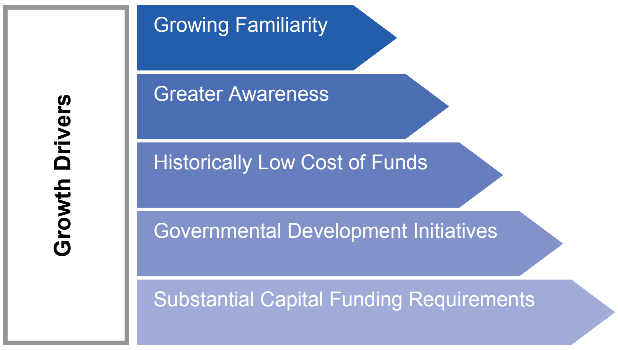


Source: Bloomberg, IFIS, Zawya, KFHR

The intended change in US monetary policy in mid-2013 has affected the global bond market which saw prices fall sharply as fears spread that the Fed's reduction in bond purchases would move investors out of the safe asset to higher-yielding assets on an improving US economy. This, in turn, led to funds being withdrawn from emerging markets, reducing demand for both conventional and Islamic bond issuances in these markets. As such, *Sukūk* issuances – particularly corporate *Sukūk*– declined to their lowest level in two years, with a notable stagnation after the Fed's announcement on a potential taper.

In the longer term, the industry is likely to witness greater involvement and issuances in developed financial markets given the recent interest and announcements by the likes of the UK and Hong Kong. A weaker global economy encourages funds to remain in safer assets such as *Sukūk*, also driven by a growing preference for *Sharī`ah*-compliant products at both the retail and institutional levels.

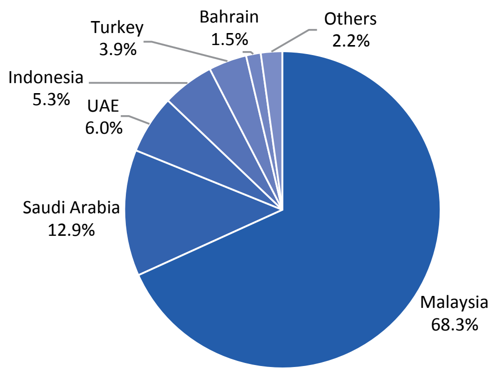
Diagram 1.3.1.1: Growth Drivers of the *Sukūk* Market



Source: KFHR

As at 11M13, issuances were subdued with a decline of 14.1% y-o-y in comparison to the corresponding period of 2012. *Sukūk* issuances of USD105.7 billion were issued over the 11 months. The GCC market, in particular, saw the biggest decline in issuance value, from almost USD6.8 billion in 2Q13 to just over USD1.4 billion in 3Q13, before climbing again in 4Q13. However, over the first 11 months of the year, the UAE saw an increase of 4.5% y-o-y. Malaysia saw a 19.6% y-o-y decline in the amount issued over the same period, due mainly to a high base effect in 2012. Turkey, meanwhile, has seen issuances rose by 69.3%. Malaysia still dominates the market with a share of 68.3% of the global issuance value (2012: 74%), followed by Saudi Arabia and the UAE at 12.9% and 6%, respectively.

Chart 1.3.1.3: *Sukūk* Issuances by Domicile and Share (11M13)

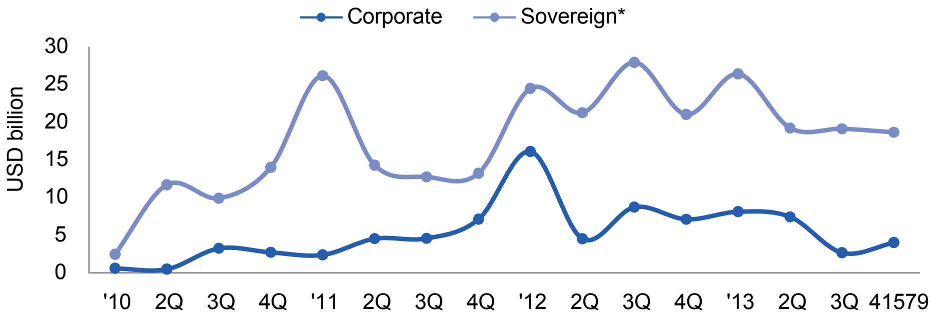


Source: KFHR

Note: Domicile is the location of the issuances, excluding offshore jurisdictions. The data for offshore jurisdiction issuances are accounted for under the jurisdiction of the obligor.

Given the prospects of a Fed taper since May 2013, the amount of corporate *Sukūk* issuances has decreased to an average of USD930 million per month, in comparison to an average of USD2.9 billion during the first five months of 2013. Sovereign and quasi-sovereign issuances fared slightly better, although still decreasing from an average of USD8.3 billion to USD5.8 billion over the same period.

Chart 1.3.1.4: *Sukūk* Issuance by Issuer Type

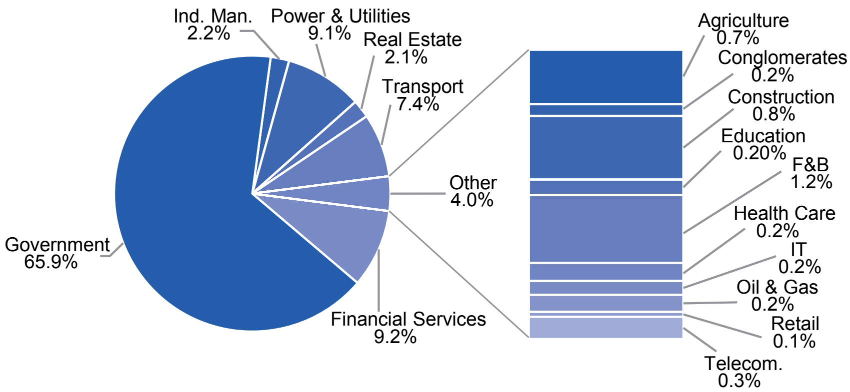


**Includes all government-related entities*

Source: Bloomberg, IFIS, Zawya, KFHR

Sovereigns accounted for the bulk of new papers issued during 11M13, accounting for 65.9% market share (2012: 61.8%), followed by financial services at 9.2% (2012: 5.1%), power and utilities with 9.1% (2012: 11.4%), and transport at 7.4% (2012: 13%).

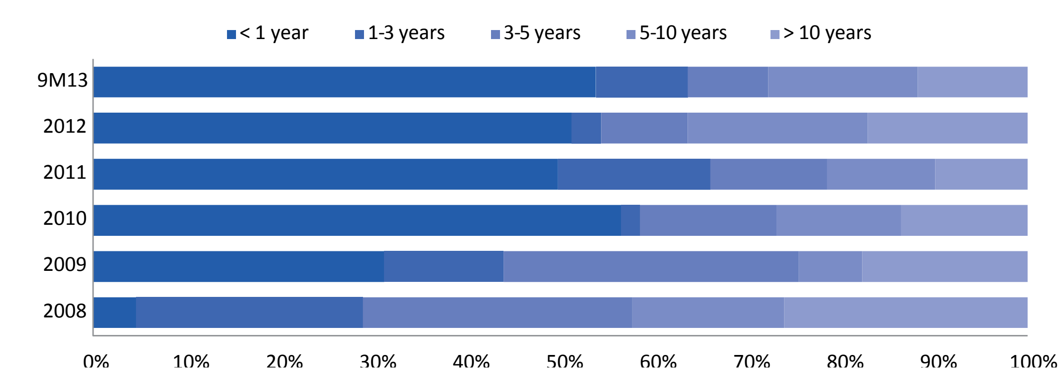
Chart 1.3.1.5: *Sukūk* Issuances by Sector (11M13)



Source: Bloomberg, IFIS, Zawya, KFHR

A lack of issuance volume during 3Q13 has meant that the amount maturing over the next five years increased only marginally. Minus any short-term papers that will be placed in 4Q13, the amount set to mature during the remainder of the year sums to USD14.8 billion. As at end-3Q13, the amount set to mature in 2014 is USD36.8 billion, 43.7% of which is five-year debt or longer.

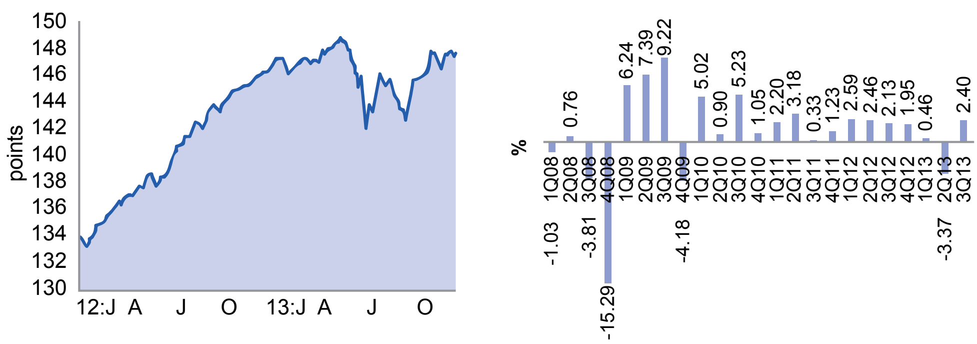
Chart 1.3.1.6: *Sukūk* Maturity Trend of New Issuances



Source: Bloomberg, IFIS, Zawya, KFHR

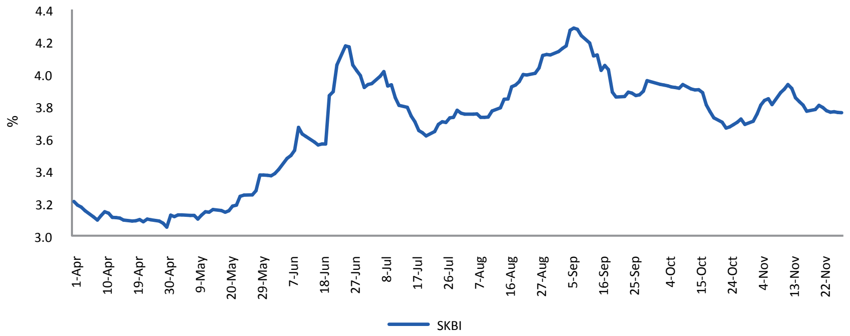
Major Islamic financial markets appear to be prone to vulnerabilities and economic characteristics that epitomise emerging markets. The HSBC/NASDAQ SKBI Total Return Index in 2Q13 witnessed a three-year record loss due to the potential Fed taper. The index, by contrast, gained by 1% on 19 September 2013, one day after the Fed announced it would not be tapering bond purchases until further improvements in US economic fundamentals. In particular, the Fed targets an unemployment rate of 6.5% and an inflation rate of 2% for the recovery of the US economy so that it can continue to grow without the existing high levels of stimulus. While there has been some improvement on these fronts, *Sukūk* and emerging market assets have been able to stabilise somewhat in terms of pricing, given that improvements in the US have been slower than expected.

Chart 1.3.1.7: HSBC/NASDAQ SKBI Total Return Index



Source: HSBC/NASDAQ, KFHR

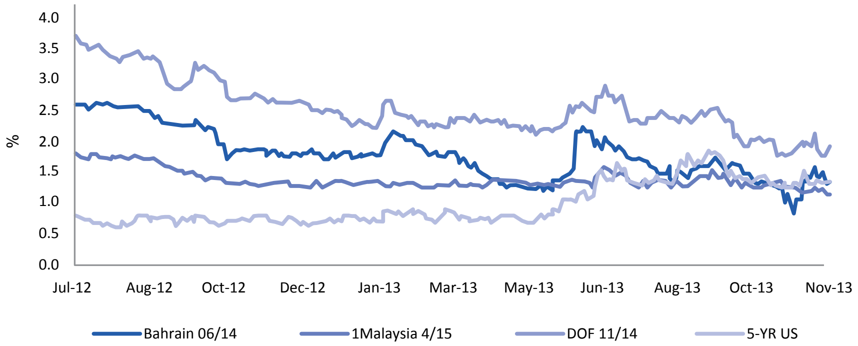
Chart 1.3.1.8: HSBC/NASDAQ *Sukūk* Yield Indices



Source: HSBC/NASDAQ, KFHR

In terms of *Sukūk yields*, the benchmark HSBC/NASDAQ Dubai US Dollar *Sukūk* Index (SKBI), which tracks returns of an emerging market *Sukūk* portfolio, spiked by 30.9% to peak at a yield of 4.174% as at 25 June 2013. The yields eventually lowered slightly during the month of July before once again climbing up on the expectations of a Fed tapering decision in September. The yields reached 4.238% as at 10 September 2013, the highest level in recent years, before experiencing a drop of 3.45% on a single day on 18 September.

Chart 1.3.1.9: Selected Sovereign *Sukūk* Yields vs. Five-Year US Government Securities Yield

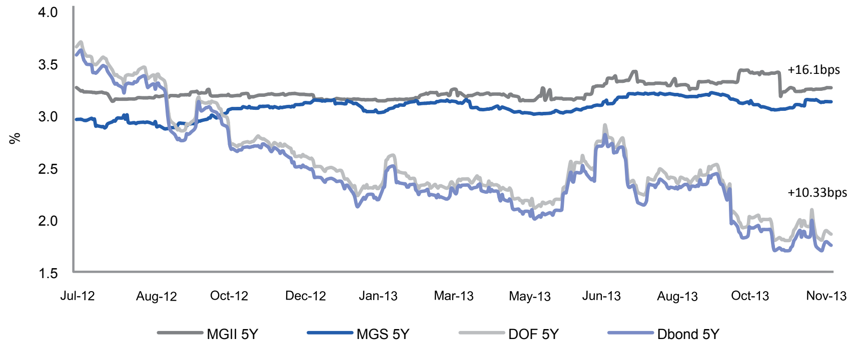


DOF = Dubai Department of Finance Sukūk

Source: Bloomberg, KFHR

A low interest rate environment has been factored in by investors when pricing financial instruments in the global capital markets. *Sukūk*, in particular, have been an attractive asset in this scenario, often offering higher yields than conventional bonds. As of 3Q13, the sovereign *Sukūk* yields in most countries, including Malaysia and Bahrain, closely mirrored US five-year Treasury notes yields. During the 2012–1H2013 period, the sovereign USD *Sukūk* yields were higher than the five-year US Treasury note yields.

Chart 1.3.1.10: Sovereign *Sukūk* Yields vs. Conventional Bond Yields



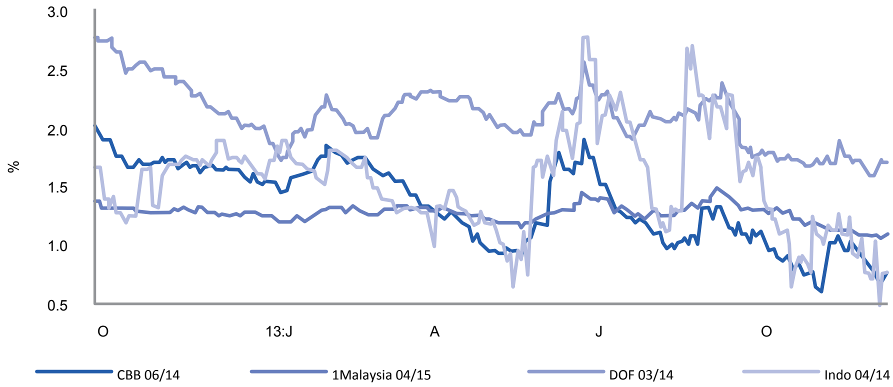
MGII = Malaysian Government Investment Issue Sukūk; MGS = Malaysian Government Sovereign Bond; DOF = Dubai Department of Finance Sukūk; Dbond = Dubai Government Bond

Note: In grey – Sukūk; in blue – conventional bond

Source: Bloomberg, KFHR

Comparing *Sukūk* yields and those of comparable conventional bonds, it is observed that *Sukūk* instruments have slightly higher yields as compared to the conventional papers. For example, Chart 1.3.1.10 illustrates Dubai Department of Finance (DOF) *Sukūk* having a slightly higher yield of 10.33 basis points (bps) as compared to the conventional Dubai government bond. This is mainly due to the fact that *Sukūk* instruments are less familiar than conventional instruments. However, this is gradually changing as investors become more aware of Islamic instruments. In some cases, *Sukūk* yields can be lower than yields of conventional instruments, given that Islamic institutions can only invest in Islamic instruments and these are often in short supply.

Chart 1.3.1.11: Selected Sovereign *Sukūk* Yields



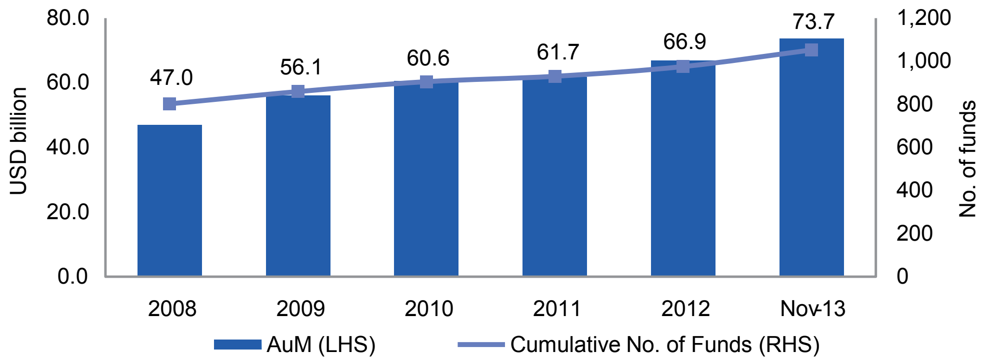
CBB = Central Bank of Bahrain; Indo = Indonesian Government Sukūk; DOF= Dubai Department of Finance Sukūk.

Source: Bloomberg, KFHR

1.3.2 Islamic Funds

Islamic asset management remains a niche sector of the global IFSI. Islamic funds' assets under management (AuM) grew at a CAGR of 9.4% for the period from 2008 to 2012. In 2013, despite the challenging global macroeconomic environment, the Islamic funds sector has posted a 10.2% year-to-date growth rate, with a number of conventional fund managers entering the market. As of 11M13, the AuM of Islamic funds had reached an estimated USD73.7 billion, while the cumulative number of Islamic funds stood at 1052.

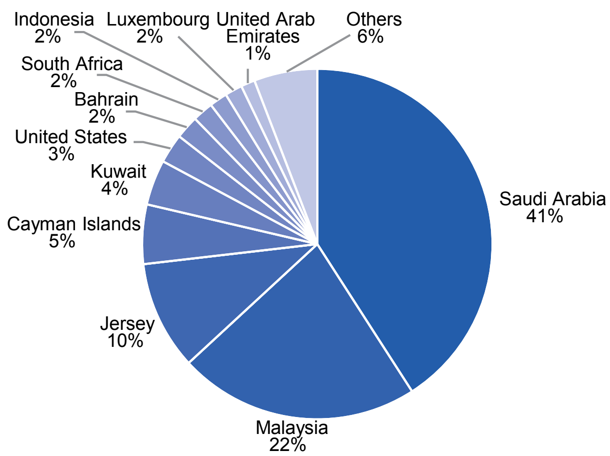
Chart 1.3.2.1: Growth in Assets under Management (AuM) and Number of Islamic Funds



Source: Bloomberg, Eurekahedge, KFHR

The first 11 months of 2013 witnessed the launching of 77 new funds. By domicile, it is estimated that about 73% of total AuM of Islamic funds is held in Saudi Arabia, Malaysia and Jersey. The main appeal of Saudi Arabia and Malaysia as domiciles lies in the accommodative regulations and the availability of a ready pool of Islamic investors in these jurisdictions. Jersey, along with the Cayman Islands and Luxembourg, has been registering a growing number of Islamic funds that seek the tax benefits of offshore locations. Other notable Islamic fund domiciles include Kuwait, the United States, Bahrain, South Africa and Indonesia.

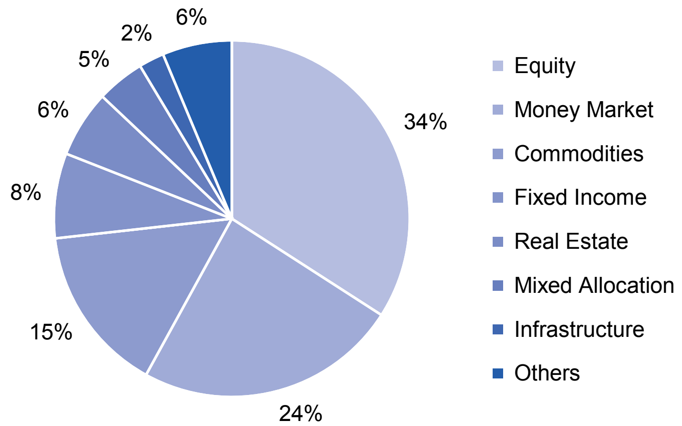
Chart 1.3.2.2: Islamic Fund Assets by Domicile (11M13)



Source: Bloomberg, Eurekahedge, KFHR

In terms of asset allocation, equity funds represent one-third of Islamic funds worldwide, reflecting rising investor confidence in *Sharī`ah*-compliant stock indices. Money market and *Sukūk* continue to be the asset classes of choice for Islamic funds catering to more risk-averse investors, and the two asset classes have a combined 32% share of total funds. Other significant asset classes include commodities and real estate. The newly launched funds in 2013 have followed a comparative asset allocation pattern and invested mostly in equities (80%) and fixed-income securities (14%).

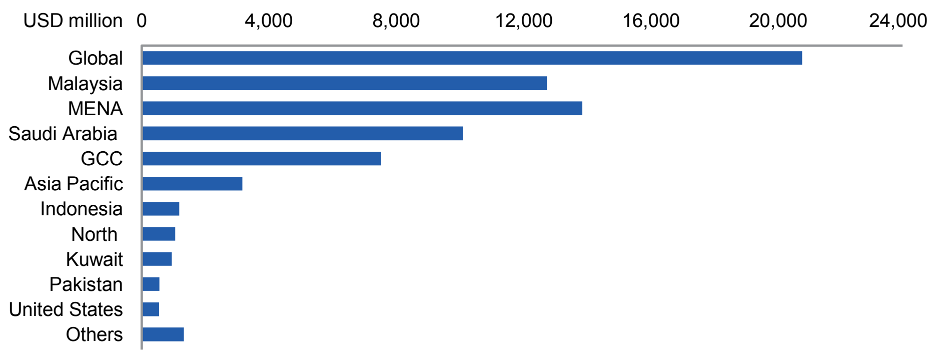
Chart 1.3.2.3: Islamic Fund Assets by Asset Class (11M13)



Source: Bloomberg, Eurekahedge, KFHR

The focus of Islamic fund managers is becoming increasingly global, with an estimated 28% of total Islamic AuM being invested internationally as at 11M13. Furthermore, the newly launched Islamic funds in 2013 have channelled almost 80% of their funds into global markets. Among individual countries, Malaysia is in the lead, attracting an estimated 16% of total Islamic AuM and becoming the market destination of 4% of the newly launched Islamic funds' assets. Saudi Arabia, whose Islamic funds invest mostly domestically, has received 13% of total Islamic AuM to date.

Chart 1.3.2.4: Islamic Fund Assets by Geographical Focus (11M13)



Source: Bloomberg, Eurekahedge, KFHR

Outlook and Challenges

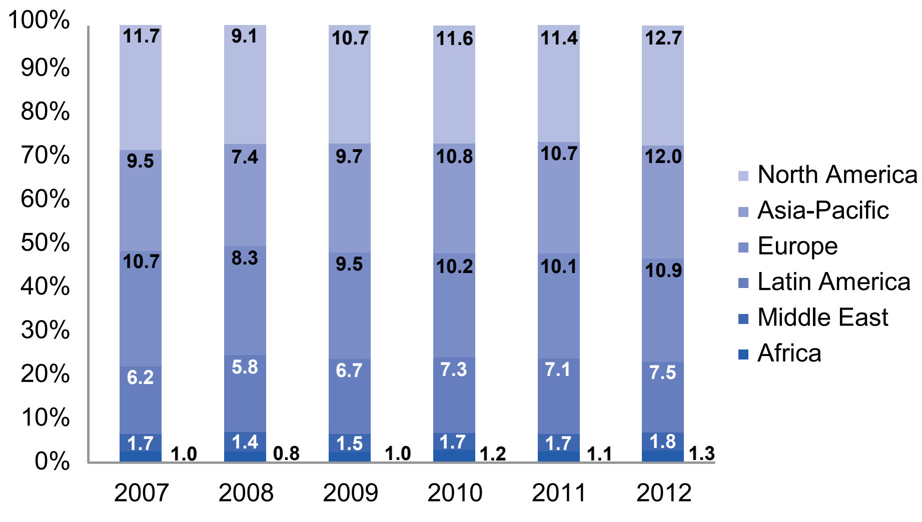
Currently, Islamic funds are heavily skewed towards equity funds. Moving forward, the industry needs to assess the feasibility of broadening the asset classes in Islamic funds so as to cater for the broader range of investors and hence provide more stability to the demand side.

In the light of changing regulatory environments and intensifying competition, Islamic fund managers are being called upon to revise their fund management strategies. In this regard, amassing scale through the attraction of institutional investors, by highlighting the ethical and real-sector linked benefits of the IFSI, is definitely an option for Islamic fund managers. For the purpose of sustaining the growth and resilience of the Islamic funds industry, there is a need to encourage more participation by long-term investors of funds such as sovereign wealth funds. At the same time, adding funds from high-net-worth investors – particularly from the Asia-Pacific region, which is expected to become the largest high-net-worth-individuals' (HNWI) wealth market, overtaking North America as early as 2014 – is another lucrative opportunity for the sector.

The Islamic asset management sector could also benefit by tapping into the rich pool of funds seeking socially responsible investments in Europe and the Americas. However, the attraction of this mostly non-Muslim group of investors will require Islamic fund managers, among other stakeholders, to articulate the value proposition of Islamic finance more clearly and more proactively to the global audience of conventional investors.

Still, in order for Islamic fund managers to make use of the available growth opportunities, other segments of the global IFSI – in particular, Islamic capital markets and *Takāful* – need to develop in tandem to support the Islamic asset management sector with more sophisticated investment products. Likewise, the proliferation of Islamic wealth management solutions (in the form of Islamic pension funds, foundations and trusts) should help Islamic funds become a greater part of the IFSI.

Chart 1.3.2.5: HNWI Wealth Distribution by Region (USD trillion)

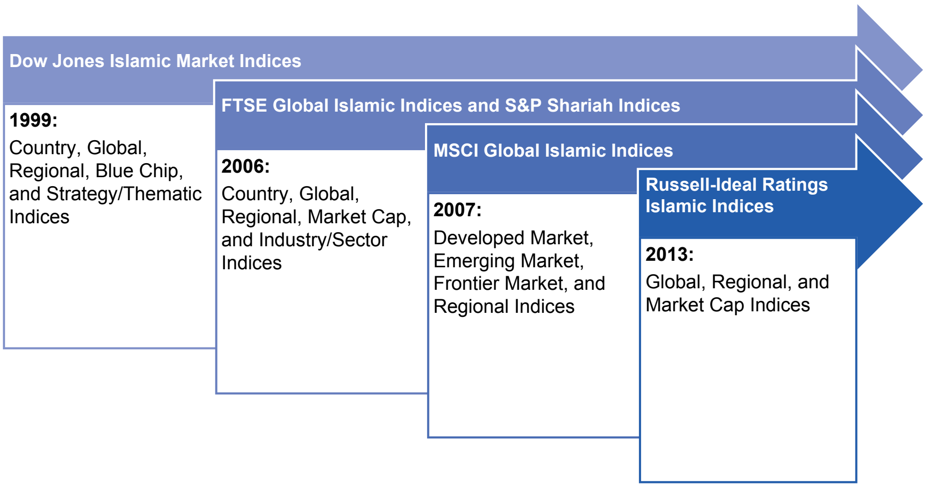


Source: Capgemini, KFHR

1.3.3 Islamic Indices

Islamic indices have played a pivotal role in building the global market infrastructure for the IFSI. They are meant to cater to the requirements of burgeoning Islamic investments in *Sharī`ah*-compliant equity, *Sukūk* and Islamic mutual fund markets. To date, such indices have been introduced by Dow Jones, Standard & Poor's (S&P), FTSE, MSCI, and most recently by Russell Investments in collaboration with Ideal Ratings. Islamic equity indices have proven to be especially valuable to Islamic fund managers, who have benefited from the standardisation of screening methodologies and the expanding universe of *Sharī`ah*-compliant securities, as well as to those investors searching for alternative portfolio exposures and ethical products.

Diagram 1.3.3.1: Major Islamic Indices for Equity Markets

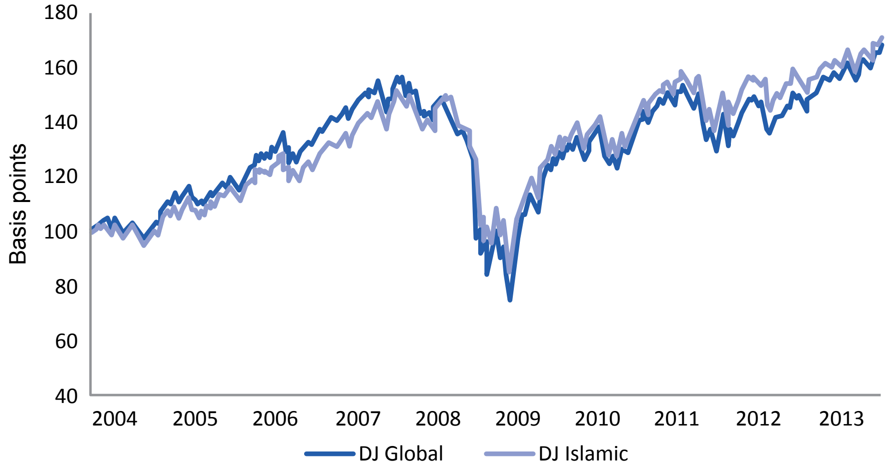


Source: Dow Jones, S&P, FTSE, MSCI, Russell Investments, KFHR

Considering the importance attached to Islamic equity indices in the Islamic financial system, it is of interest to see their comparative performance vis-à-vis conventional stock indices. As an example, the historical returns of the Dow Jones Global Total Stock Market Index (DJ Global TSM Index) have been set against those of the Dow Jones Islamic Market World Index (DJIM World Index). This showed that in the period from 2004 to mid-2008 the performance of the two indices was rather similar, despite varying compositions and methodologies, with the DJ Global TSM Index marginally outperforming the DJIM World Index by 0.8 percentage points. Since then, however, the Islamic index has been faring noticeably better, returning 15.7% for the period from mid-2008 to 10M13 (compared with13.9% for the DJ Global TSM Index). The difference in performance during the latter period may be explained by the asymmetrical performance of constituent stocks based on the indices' respective sector exposures.

It is known that the distinctive sector allocation in Islamic indices arises because of the addition of *Sharī`ah* screening to a basic methodology. The Dow Jones Global TSM Index's main component is the financial sector, with a 22.4% share, followed by the industrial sector, with a 13.4% share. In contrast, the two largest sectors in the DJIM World Index, with a combined 39.9% share of market capitalisation, are technology and healthcare. The historical performance of these sectors from 2008 onward has been divergent, as is evident from the five-year annualised returns of the Dow Jones industry indices taken as proxies for the component sectors: a 14.6% average for Financials and Industrials versus a 16.7% average for Technology and Healthcare. In addition, regionally, the conventional Dow Jones Index has a slightly higher share of cumulative market capitalisation coming from Europe (25.3%), where many believe the crisis is still ongoing, compared to 21.9% in the DJIM World Index.

Chart 1.3.3.1: Historical Performance of Selected Global Conventional and Islamic Equity Indices



Source: Bloomberg, KFHR

Chart 1.3.3.2: Number of Components (10M13)

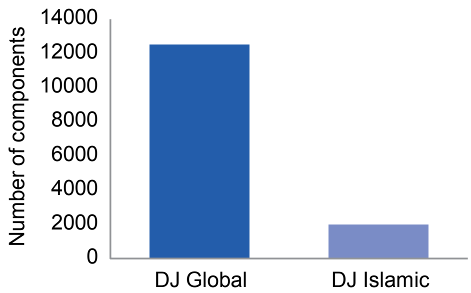
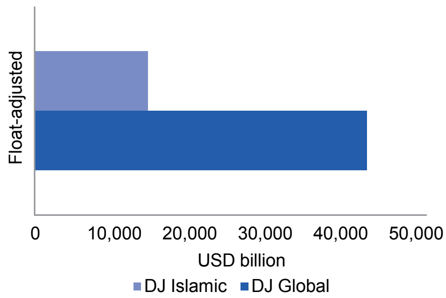


Chart 1.3.3.3: Market Capitalisation (10M13)[6]



Source: Dow Jones, KFHR

[6] The equity indices are float-weighted, where market capitalisation is calculated using only publicly available shares. Such a methodology allows for reflection of the true open market value of an index and certain operational efficiencies for index and Exchange-Traded Funds (ETF) fund managers.

Chart 1.3.3.4: Sector Allocation (10M13)

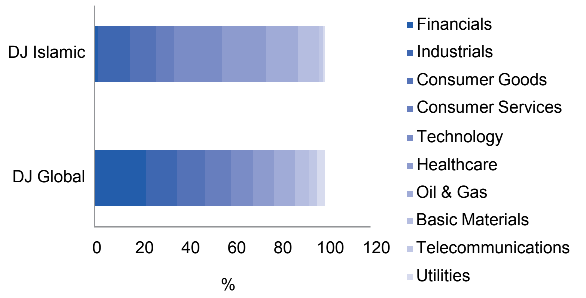
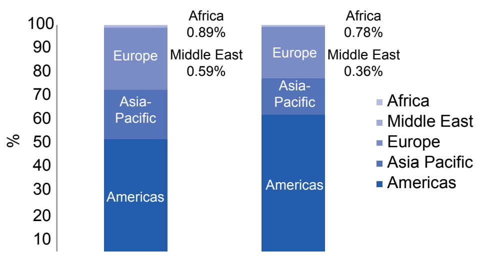


Chart 1.3.3.5: Regional Allocation (10M13)



Source: Dow Jones, KFHR

Outlook and Challenges

The Islamic capital markets are set to achieve remarkable growth rates in the near future with a growing number of OIC and non-OIC jurisdictions working to introduce enabling regulatory environments to allow Islamic capital market instruments – in particular, *Sukūk* – to flourish in their respective territories. In 2013, a number of countries – including the UK, Oman, Hong Kong and South Africa – have debuted or announced their plans for Islamic capital market instruments. Existing markets such as Malaysia, Saudi Arabia and the UAE are continuing their efforts in tapping and facilitating flows of funds using Islamic capital market instruments.

Among the various asset classes in Islamic capital markets, *Sukūk* are likely to be the main growth drivers in the near future as Islamic financial instruments have, for the most part, witnessed strong growth in recent years. Over the last two to three years, countries such as Azerbaijan, Hong Kong, Mauritius, France, Jordan, Gambia, Kazakhstan, Nigeria, Turkey and Yemen have entered the global *Sukūk* markets to tap into the fast-growing global pool of *Sharī`ah*-compliant liquidity funds. In the pipeline for issuances in 2014 are jurisdictions such as South Africa, the UK, Tunisia, Senegal, Maldives and Oman. There are also reports of a possible *Sukūk* issuance by the Islamic Bank of Thailand. The decision by the UK to enter the global *Sukūk* market with a sovereign issuance is likely to spur interest in *Sukūk* issuance among its European neighbours.

Despite the industry's great potential, there are significant and persistent macroeconomic risks. Slower global economic growth is likely to restrict fund-raising activities as lower-than-expected corporate earnings may hinder borrowing abilities. Emerging markets, in particular, continue to see an outflow of funds as the Fed begins tapering, which may threaten future economic growth. Subsequent currency corrections in these markets also make it difficult to raise funds, especially when coupled with domestic inflationary pressures. Interest rates are expected to rise, causing investors to demand higher yields. This would also influence the cost of raising funds through *Sukūk* and make it more costly for new jurisdictions to tap into the *Sukūk* market. In more developed and internationalised markets such as Malaysia and the GCC, the challenge will be to innovate new structures and investment vehicles that can further facilitate fund-raising options for cross-border activities, while complying with the regulatory requirements of each jurisdiction.

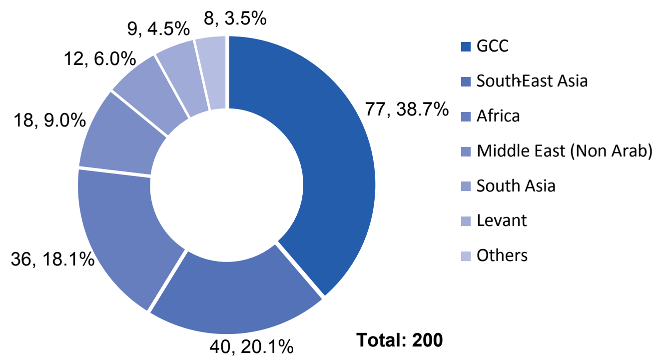
The Islamic funds sector is also expected to maintain its growth trend as the industry witnesses a surge in the number of *Sharī`ah*-compliant equities available to be included in Islamic fund portfolios. There are now a number of index providers that actively screen and provide *Sharī`ah*-compliant indices, and fund managers have a vast global universe of *Sharī`ah*-compliant stocks to choose from to be included in their fund portfolios. The listing of *Sharī`ah*-compliant equities and indices effectively allows the development of Islamic mutual funds and structured fund products. The UK's announcement that an Islamic index is to be made available at the London Stock Exchange is bound to bolster the Islamic fund management industry as fund managers would have options for a broader UK geo-focus.

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

1.4 Development Trends in *Takāful*

The global *Takāful* (or Islamic insurance) industry has experienced strong double-digit growth rates in recent years, with worldwide gross *Takāful* contributions estimated to have increased to USD18.3 billion[7] as at 1H2013, recording an impressive 18.06% CAGR during 2007–2012. Nonetheless, the global *Takāful* industry is still in its infancy, and its assets constitute only 1.1% of the global portfolio of Islamic finance assets. The number of *Takāful* operators increased from an estimated 133 in 2006 to 200 in 2012, with nearly two-thirds of the operators located in the GCC, Southeast Asia and Africa.

Chart 1.4.1: Number of *Takāful* Operators (2012)



Source: Takaful Re, KFHR

The potential for *Takāful* products to gain greater market share is enormous, given that large segments of the market in leading Islamic financial jurisdictions remain untapped and are mainly dominated by conventional insurance providers. Based on the latest statistics available, the key Islamic finance jurisdictions in the GCC, Southeast Asia and South Asia are characterised by low insurance penetration rates, averaging around 1% of the country's GDP, with the only exception being Malaysia which had an insurance penetration rate of 5% of GDP (see Table 1.4.1). As a benchmark for comparison, Japan and Hong Kong had insurance penetration rates of 10.1% and 11.5%, respectively, during the same year.

[7] Excludes *ReTakāful* contributions.

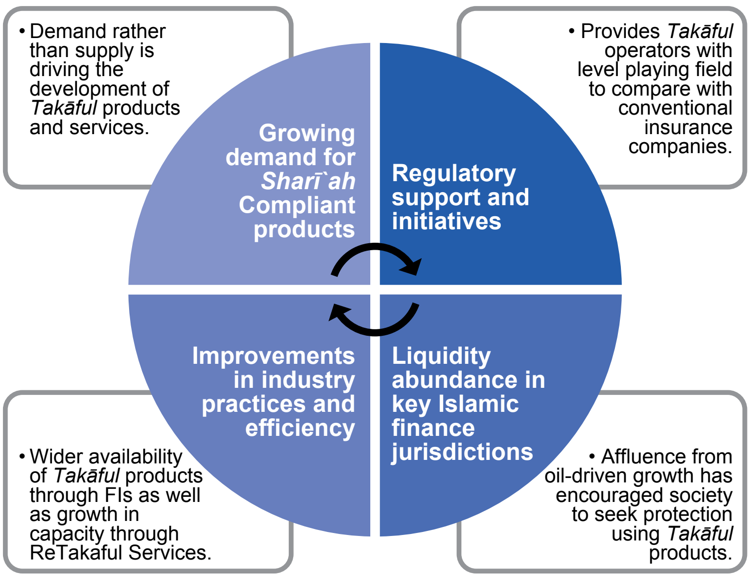
Takāful products are offered by operators according to two main business lines, namely: (a) family *Takāful*, which includes various life, medical and investment products; and (b) general *Takāful* products, which provide home, motor, personal accidents, marine and aviation protection products. The *Takāful* industry stands to benefit substantially from innovation and product development, as the increasing affluence among demographic segments in key Islamic finance markets has led to growing awareness of the benefits of subscribing to *Takāful* policies. Market participants are now seeking broader protection from *Takāful* insurance products, extending beyond traditional coverage to include segments such as wealth management, educational planning schemes and retirement plans. As a result, to some extent, growing demand for *Sharī`ah*-compliant insurance products is driving the development of the *Takāful* industry's products and services.

Table 1.4.1: Insurance Penetration Rates as a % of GDP in Selected Asian and GCC Countries (2011)

Country	Insurance Penetration	Country	Insurance Penetration
Kuwait	0.5%	**UAE**	2.0%
Pakistan	0.7%	**China**	3.8%
Qatar	0.8%	**Thailand**	4.3%
Saudi Arabia	0.8%	**India**	5.1%
Bangladesh	0.9%	**Malaysia**	5.1%
Oman	1.1%	**Singapore**	6.2%
Turkey	1.3%	**Japan**	10.1%
Indonesia	1.5%	**Hong Kong**	11.5%

Source: Arab Insurance Market Review, EY, KFHR

Diagram 1.4.1: Key Growth Drivers of the Global *Takāful* Industry



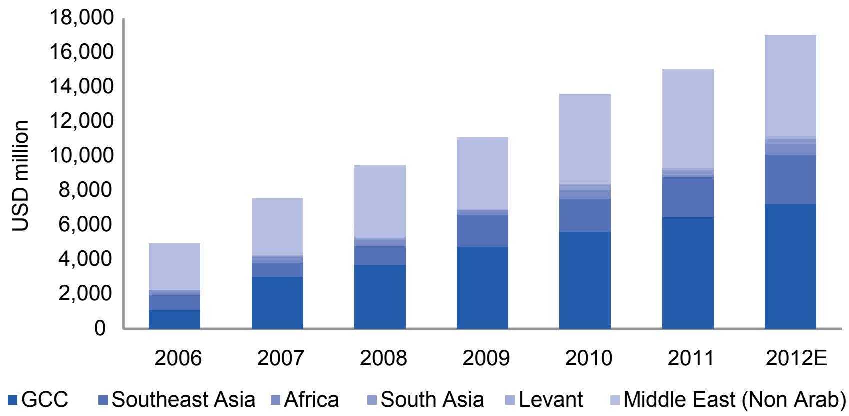
Source: KFHR

DEVELOPMENT OF THE ISLAMIC FINANCIAL SERVICES INDUSTRY

It is imperative to highlight here the importance of having sound and established *ReTakāful* operators to support the growth and development of a resilient and sustainable global *Takāful* industry. *ReTakāful* operators take on the critical role of spreading risks among the various subscribing *Takāful* operators, while providing underwriting capacity to them. If appropriately managed, *ReTakāful* is an effective way of spreading risks over different *Takāful* pools while being the risk absorber for any one *Takāful* operator that may run into difficulty. The underwriting capacity extended by the *ReTakāful* industry to *Takāful* operators can further drive the growth of the global *Takāful* industry, as it will allow operators to underwrite larger-scale industrial and mega-risk projects. Essentially, this may position *Takāful* operators favourably to compete with established conventional insurers, while reducing the need to raise huge amounts of capital. Currently, there are a limited number of *ReTakāful* operators in the industry, as the retail and corporate market *Takāful* operations have not yet grown to a scale in many jurisdictions except for GCC and Malaysia. Currently, the existing *ReTakāful* operators are located mainly in GCC and Malaysia, where the *Takāful* businesses are concentrated.

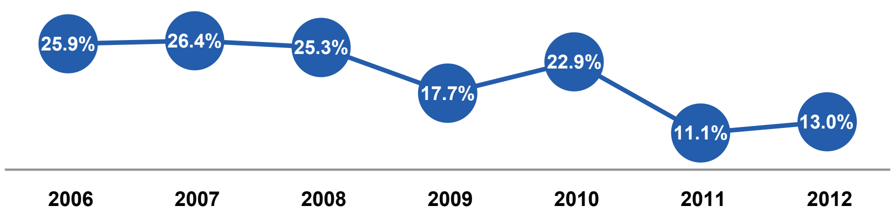
Between 2007 and 2012, global *Takāful* contributions grew at a CAGR of 18.06%, with strong growth contributions originating from the Levant and South Asian regions where countries such as Jordan and Bangladesh are witnessing strong demand for *Sharī`ah*-compliant financial solutions. However, overall growth in global *Takāful* contributions has witnessed a slowdown in the last two years. Nonetheless, the growth is expected to rebound in the medium term with a number of previously untapped countries, such as Afghanistan, Azerbaijan and Kyrgyzstan, working to introduce regulatory frameworks to enable *Takāful* operators to set up operations in those jurisdictions.

Chart 1.4.2: *Takāful* Total Gross Contribution Trend



Source: World Islamic Insurance Directory 2013, central banks and regulatory authorities, individual institutions, KFHR

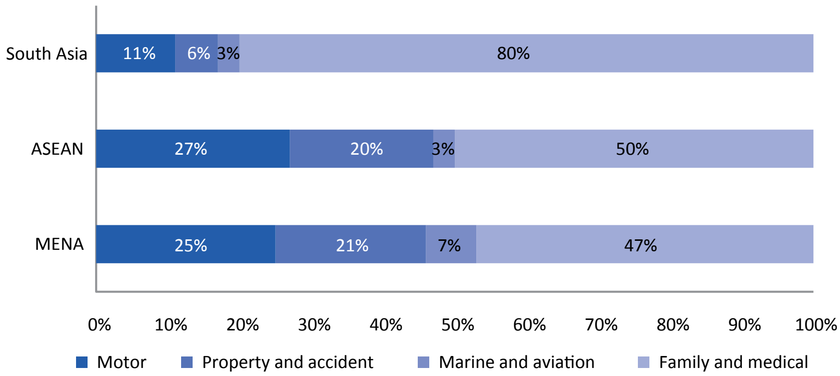
Chart 1.4.3: Global Year-to-Year *Takāful* Contribution Growth



Source: World Islamic Insurance Directory 2013, central banks and regulatory authorities, individual institutions, KFHR

Among the key *Takāful* business lines in major markets, based on 2011 estimates, family and medical *Takāful* business lines were leading across all regions, followed by motor, property and accident *Takāful*. The marine and aviation business line, which requires substantial amounts of coverage in value, remains a small sector possibly due to the small-scale operations of most operators which restrict their financial ability to provide protection to larger-value projects.

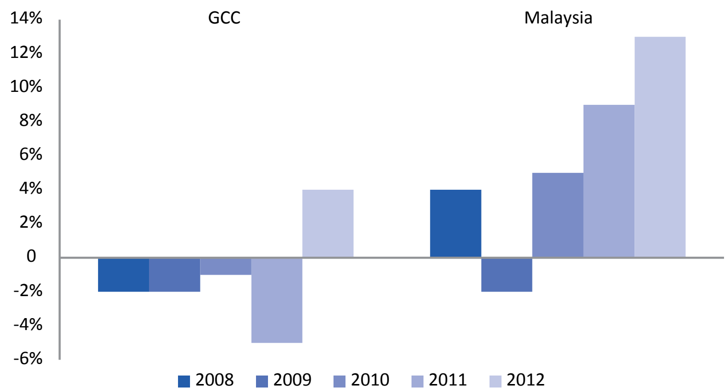
Chart 1.4.4: Key *Takāful* Business Lines in Major Markets (2011E)



Source: World Islamic Insurance Directory 2013, EY, KFHR (MENA includes GCC, Levant and North African countries)

To assess the profitability and performance of *Takāful* operators, information relating to *Takāful* operators' assets and profitability continues to remain scarce – and mostly irregular, where available – due to the varying accounting policies around the world and minimal disclosure requirements. In this regard, notable efforts are being made by independent data providers as well as certain regulators who publish annual *Takāful* data. For two of the largest *Takāful* markets, it appears that *Takāful* operators in Malaysia have performed considerably well over the years, whereas operators in the GCC are struggling to become profitable due to, *inter alia*, the erosion of margins as a result of excessive competition in the GCC insurance market.

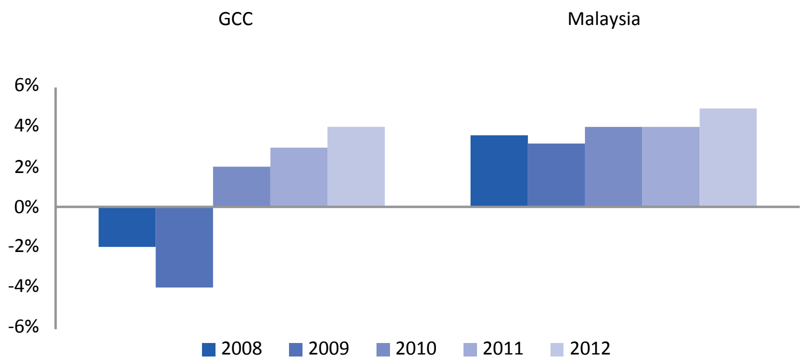
Chart 1.4.5: Average Return on Equity for a Sample of GCC and Malaysian *Takāful* Operators



Source: EY, KFHR

Following a negative return on equity (ROE) performance in 2009, Malaysian *Takāful* operators have rebounded considerably, posting an estimated average ROE of 13% as at year-end 2012, much higher than the figures recorded by their GCC peers. In contrast, although the ROE of GCC *Takāful* players recorded positive returns of 4% in 2012, negative returns characterised the preceding period from 2008. Similarly, in terms of return on investments, the sample of *Takāful* operators showed strong resilience in Malaysia from 2008 onwards, whereas *Takāful* operators in the GCC witnessed portfolio losses through 2008 and 2009 on account of steeply declining financial markets as an outcome of the GFC before returning to positive yields in 2010.

Chart 1.4.6: Average Yield on Investments for a Sample of GCC and Malaysian *Takāful* Operators



Source: EY, KFHR

With regards to solvency, prudential standards have only recently started to emerge, implemented by industry regulators in some jurisdictions to ensure that *Takāful* operators remain solvent and to sustain the *Takāful* business without having to depend on *Qarḍ* from shareholders. However, given the nascent stage of most *Takāful* undertakings and the smaller capital requirements imposed at the point of establishment, most *Takāful* undertakings will be able to build and maintain sufficient capital buffers as growth continues to improve.

Outlook and Challenges

The road ahead for the global *Takāful* industry is not without critical challenges, which will require the industry stakeholders to coordinate their efforts to find solutions. It is highlighted in many forums and *Takāful* conferences that the global *Takāful* operators need to improve on their scale of operations if they are to increase the profitability and efficiency of the industry.

One of the pressing challenges is the heavy concentration of the *Takāful* industry in only a few markets with a limited range of products. The *Takāful* industry needs to expand its scope of offerings, and the operators need to sharpen their business focus and expand beyond the traditional segment of insurance/*Takāful* products. The general *Takāful* operators need to venture into newer product lines and develop scale large enough to support underwritings with substantial coverage value, particularly in the aviation, marine and shipping lines where many institutions continue to rely on conventional insurance coverage due to the unavailability of *Takāful* protection. Similarly, in addition to financial/retirement planning and wealth management, family *Takāful* operators could consider developing additional products to offer a wider range of family *Takāful* solutions. *Takāful* operators that are proactive in understanding the changing dynamics of the global insurance industry, where financial crisis had compelled insurance providers to trim expenses, consolidate capital positions and look for newer markets in the face of highly competitive mature markets, will be at the forefront of the Islamic insurance industry.

On the regulatory side, while challenges remain in harmonising standards and regulations across the various countries, the IFSB prudential standards and guidelines for the sector could serve as a reference point for both the regulatory authorities and *Takāful* operators in the global markets. To shore up operational efficiency, the *Takāful* sector could benefit substantially from mergers and acquisitions between existing *Takāful* operators to introduce large-scale (and preferably cross-border) *Takāful* operators that can take leadership in the industry and drive improvements in tandem across several countries. Larger-scale and well-capitalised *Takāful* operators will have the ability to tap large specialised businesses that are currently largely underserved by *Sharī`ah*-compliant solutions. The key requirements for continued growth of the *Takāful* sector in the competitive environment of the global insurance industry include the development of customer-centric products, the use of wider and alternative distribution channels, and marked improvements in operational efficiencies leading to improved profitability.

Finally, *ReTakāful* has an important role to play in the overall development of the global *Takāful* industry. A healthy *ReTakāful* sector is vital to ensure sustainable growth and development of the *Takāful* industry, as it enables *Takāful* operators to take on higher-risk projects in a cost-effective manner without the need to raise additional capital. This segment needs further developmental support from the authorities and regulatory bodies, particularly in helping *ReTakāful* operators to improve on financial strength that would lead them to higher credit ratings and hence elevate them to a level playing field against more established reinsurance operators.

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

1.5 Development Trends in Islamic Microfinance

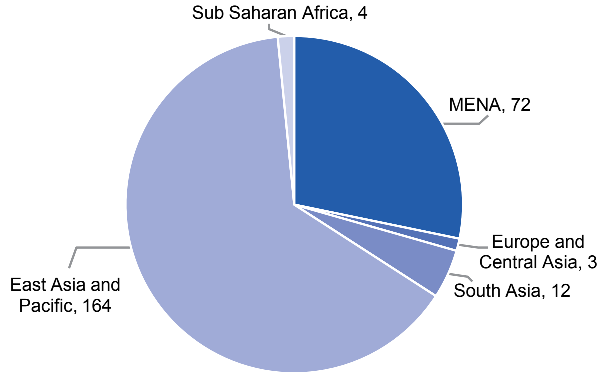
Microfinance is a powerful tool in alleviating poverty. It suggests the provision of financial services to low-income households that have limited access to formal financial services. Microfinance funding is usually extended to assist low-income groups in establishing, sustaining or expanding small self-supporting businesses. Microfinance is widely promoted in the modern era by multilateral bodies and international agencies such as the World Bank, the G20, and global financial standard-setting bodies such as the BCBS. As of 2012, the microcredit industry has over USD70 billion in assets and around 200 million clients around the world (World Bank Consultative Group to Assist the Poor (CGAP), 2012). Most microfinance institutions (MFIs) are found in South Asia, particularly India, as well as in Latin America and sub-Saharan Africa. Microfinance is relatively underdeveloped in the Middle East, Eastern Europe and Central Asia.

In Muslim countries, Islamic microfinance still accounts for only a very small portion of the total microfinance outreach. Islamic microfinance shares with conventional microfinance the basic aims to enhance financial inclusion with a view to curb poverty. However, Islamic microfinance schemes meet the principles of *Sharī`ah* compliance in their product structures. Notwithstanding the low penetration, it is estimated that approximately 1.28 million clients use *Sharī`ah*-compliant microfinance services, a four-fold increase since 2006 (according to a survey released in April 2013 by CGAP). There are now 255 Islamic microfinance institutions around the world, with a total outstanding financing portfolio amounting to USD628 million. Approximately 64% of the providers of Islamic microfinance services are located in the East Asia and Pacific region, 28% in MENA and 5% in South Asia. The most widely used Islamic microfinance products are *Murābahah* financing (cost plus profit financing), *Qarḍ al-Hasan* (interest-free loan) financing, and *Muḍārabah* financing (risk-sharing financing).

The number of conventional microfinance institutions is difficult to gauge, but reliable estimates put the number at 2,420 institutions, as verified by the Microfinance Information Exchange (MIX) in 2009. Of these, less than 3% were located in the MENA region (including GCC) and just under 10% were in

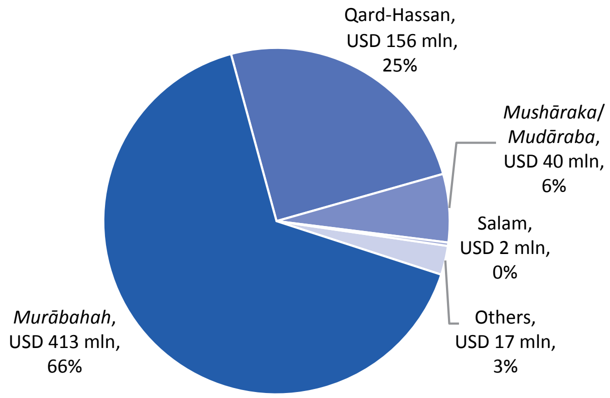
East Asia and the Pacific. In fact, most of the institutions were located in South Asia, which is estimated to have more than 600 conventional microfinance institutions. The Sub-Saharan Africa region followed next, accounting for approximately 22% of the institutions. This is in contrast to earlier statistics for the Islamic microfinance institutions, which indicated that a majority of them were located in East Asia and the Pacific region, predominantly in Indonesia. Conventional microfinance products are provided in the market by a combination of formal, semi-formal and informal institutions. Examples of formal institutions include banks such as ADOPEM (Dominican Republic), BancoSol (Bolivia), Grameen Bank (Bangladesh), NovoBanco (Angola) and XacBank (Mongolia). Most common semi-formal financial institutions are financial cooperatives (such as credit unions and saving and loan cooperatives), financial non-governmental organisations (NGOs), village/rural banks and registered Self Help Groups (SHG). Typically, informal microfinance service providers are not referred to as institutions, nor are they subject to special bank laws or general commercial law. A number of NGOs that operate in the microfinance business are still informal institutions dependent on subsidies and donors.

Chart 1.5.1: Number of Institutions Offering *Sharī`ah*-Compliant Microfinance Products – by Region



Source: CGAP – April 2013, KFHR

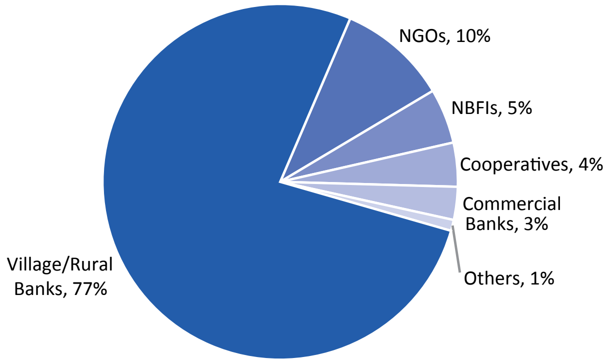
Chart 1.5.2: Types of Contracts Used in Offering *Sharī`ah*-Compliant Microfinance Products



Source: CGAP – 2013, KFHR

One of the key challenges limiting the widespread adoption of Islamic microfinance schemes is the lack of profitability combined with the higher risks associated with microfinance products. As a result, as Chart 1.5.3 indicates, Islamic microfinance is mainly being provided by specialised institutions such as village/rural banks and NGOs. Islamic banks have so far remained a negligible party in the provision of Islamic microfinance products in most countries. This institutional set-up is not conducive to the strong growth of Islamic microfinance.

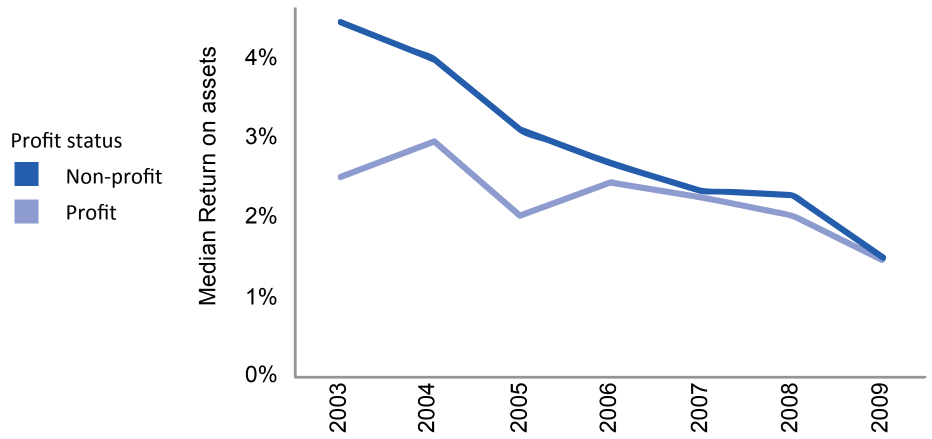
Chart 1.5.3: Types of Institutions Offering *Sharī`ah*-Compliant Microfinance Products



Source: CGAP, KFHR

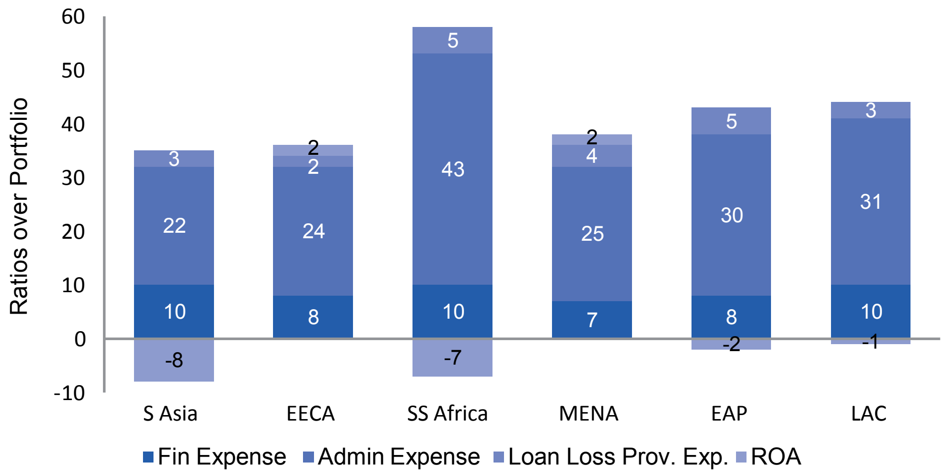
However, profitability has also been a concern for the conventional microfinance industry. Based on statistics released by MIX, the return on assets (ROA) of conventional microfinance institutions has been declining over the years among both for-profit and not-for-profit microfinance institutions (see Chart 1.5.4). Recent studies indicate that profit margins in microfinance institutions have been squeezed due to greater competition in many regions, including Asia, Africa and Latin America. In general, the microfinance model (conventional or Islamic) is a very cost-intensive operation despite the higher rates of margins charged on loans/financing. MFIs gain relatively little from economies of scale because microcredit is rather labour-intensive: salaries make up the majority of most MFIs' operating expenses and fixed costs are relatively low compared with variable costs. Operating expenses of MFIs include mostly personnel and administrative costs and represent a major part of charges to borrowers. Administrative costs of MFIs are a major cost component across all regions worldwide (see Chart 1.5.4) given that substantial efforts are required to record the frequent meetings with borrowers and to assist the loan application procedures for clients who may not be learned enough to document every microloan and repayment amount and other technical details. Hence, the microfinance model is perhaps to be taken on as a social responsibility, rather than as a way of seeking profits. Based on a study published in 2009, almost two-thirds of the sustainable MFIs in global markets were NGOs, cooperatives, public banks or other not-for-profit organisations.

Chart 1.5.4: Return on Assets of Conventional Microfinance Institutions (2003–2009)



Source: Microfinance Information Exchange (2011)

Chart 1.5.5: Costs and Returns Profiles of Microfinance Institutions (2005)



S Asia = South Asia; EECA = Eastern Europe and Central Asia; SS Africa = Sub-Saharan Africa; MENA = Middle East and North Africa; EAP = East Asia and Pacific; LAC = Latin American Countries.

Source: Microfinance Information Exchange (2011)

Based on the above, one solution in addressing the cost-intensive challenges facing the microfinance model is to incorporate the concept of "branchless banking", which is known to be active in the Philippines, South Africa and Colombia. An IMF report published in 2007 highlights how commercial players in these countries are using point-of-sale devices and mobile phones to connect with the rural poor, licensing local merchants and shop owners to make cash transactions on their behalf. The availability of such transfer services is especially important in areas where families rely on remittances from relatives working in economic centres or abroad. Technology will likely reduce transaction costs, allowing MFIs to grow and reach more customers.

Notwithstanding the above discussion, the potential for expanding the Islamic microfinance sector remains tremendous, as building an inclusive growth system through Islamic finance is now an area of interest to many policy-makers. Access to financial services plays a critical part in development by facilitating economic growth and reducing income inequality. Accessibility to products and services such as credit, venture capital, savings, insurance and remittances on a micro-scale is integral in fostering a sustainable living for low-income groups. The provision of financial services will help to increase such groups' household income and economic security, reduce their vulnerability and stimulate local economies. The adoption of Islamic microfinance is targeted primarily at combating poverty, particularly within Muslim countries.

At present, the supply of Islamic microfinance is concentrated mainly in a few countries, such as Indonesia and Bangladesh. Analysis of the experience of these countries illustrates that, although microfinance models are a flexible tool that can be replicated anywhere in the world, their success depends on their being tailored to suit the local socio-economic and cultural characteristics in a particular country. Studies have indicated that countries with large Muslim populations such as Afghanistan, Indonesia and Yemen have abundant potential for offering Islamic microfinance services, as low-income groups are likely to avail themselves of *Sharī`ah*-compliant financial products if they are made available.

Outlook and Challenges

Opportunities for Islamic microfinancing are vast, underpinned by strong economic growth in emerging markets and improved living standards of targeted groups – for example, small entrepreneurs, low income earners and unbanked people. However, in this process, some of the pressing challenges which need to be overcome include: (a) lack of awareness among the masses of the value propositions of Islamic microfinancing products and schemes; (b) the ability of Islamic microfinance providers to deliver Islamic microfinance products at competitive prices; (c) a shortage of expertise in Islamic banks on risk management for microfinance activities; and (d) the absence of regulations as well as effective policies to support the Islamic microfinance industry.

Moving forward, the industry is expected to further advance product and process innovation to offer best suited partnership financing to cater for the specific needs of the lower-income population. At the same time, it has to clearly define market segments and develop robust risk assessment models to better penetrate the unbanked segment. The growing popularity of the *Sharī`ah*-compliant financial sector in key emerging markets with an Islamic finance presence further adds to the potential for the growth of the Islamic microfinance sector. In addition, government support for financial inclusion, combined with innovative *Sharī`ah*-compliant product structuring by Islamic microfinance institutions, helps further in expanding the market potential for Islamic microfinance products.

2.0 ISLAMIC FINANCE AND THE CHANGING GLOBAL FINANCIAL ARCHITECTURE

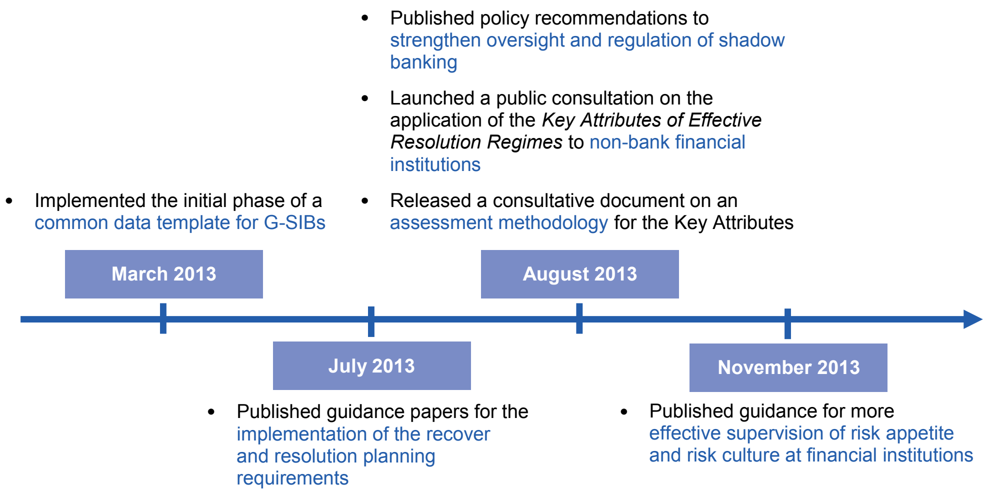
2.1 Global Initiatives to Promote Financial Stability

The global financial industry continues to witness a number of initiatives undertaken at the international level to further promote the industry's stability. The Financial Stability Board, together with international standard-setting bodies such as the Basel Committee on Banking Supervision, International Organization of Securities Commissions, and the International Association of Insurance Supervisors, have continued to publish several policy papers and recommendations for the financial sectors. The following sections highlight some of the main initiatives undertaken in the global financial industry since the publication of the IFSI Stability Report 2013, and the impact these may have on the IFSI.

2.1.1 Financial Stability Board

The recent financial crisis brought out a number of issues involving large globally active financial institutions as well as systemically important financial institutions that are too big to fail. Such issues include: (a) a lack of information that would help to identify risk concentrations and the build-up of systemic risks; (b) the absence of an effective risk appetite statement that is linked to strategy, capital and financial plans, and compensation programmes; (c) the risk of moral hazard arising from solvency support by taxpayers; (d) recovery and resolution regimes; and (e) systemic risk arising from shadow banking. To help address these issues, the Financial Stability Board has produced a number of documents, some of which are relevant to the IFSI.

Diagram 2.1.1.1: Financial Stability Board: Selected Initiatives in 2013



Source: FSB

(a) Global systemically important financial institutions

(i) ***Information gaps***

The financial crisis highlighted major gaps in information on financial institutions, in particular those that play a key role in the international financial system. To identify risk concentrations and the build-up of systemic risks arising out of these institutions, integrated information is required on interlinkages between such institutions and their common exposures and liabilities. Following this, in March 2013, the FSB implemented Phase 1[8] of the collation of improved consolidated data on bilateral counterparty credit exposures of global systemically important banks and their consolidated aggregated exposures.

Although currently none of the leading institutions offering Islamic financial services fall into the G-SIBs category, the issue of the information gap faced by the conventional counterparts is also relevant to the IIFS. Over the years, large IIFS have expanded internationally and are expected to continue to establish their presence in both existing and new Islamic finance jurisdictions, including in emerging markets. As these institutions expand to new jurisdictions as well as in new segments and product lines, this would not only increase their share of total sector assets, but could also result in increased complexity and interconnectedness and hence higher concentration risk and systemic risks. In this regard, there may be a need for regulatory and supervisory authorities to obtain and monitor relevant information and data on credit exposures of the IIFS in question. Examples include the banks' high levels of exposure to certain sectors of the economy – such as the real estate sector, as well as to a particular group of customers – such as consumer finance. Of equal importance is the ability to detect and address such anomalies as soon as they arise.

(ii) ***The problem of too big to fail***

To address the problem of global SIFIs (G-SIFIs) that are too big to fail, effective recovery and resolution planning is required, coupled with the development of credible resolution strategies to reduce the moral hazard associated with such institutions. To address this issue, the FSB published in July 2013 a number of guidance papers to assist authorities and institutions in implementing the recovery and resolution planning requirements under *Key Attributes of Effective Resolution Regimes for Financial Institutions*.[9] The papers include (a) *Guidance on Developing Effective Resolution Strategies*,[10] and (b) *Guidance on Recovery Triggers and Stress Scenarios*.[11]

Although the *Guidance on Developing Effective Resolution Strategies* is generally applicable to IIFS, at a more detailed level there are substantial technical difficulties. The resolution of IIFS is actually an area that has received limited study. In March 2011, the IFSB and the World Bank published a book entitled *Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance*, which aimed to enlighten industry stakeholders and provide them with a better understanding of the issues surrounding the insolvency regimes that should be developed for the IFSI. In essence, it (a) focused on the way insolvency issues affect *Sharī`ah*-compliant transactions, (b) highlighted the issues surrounding the recognition of *Sharī`ah* by courts in conventional legal systems, (c) discussed the need to consider the specificities of the

[8] For the context of the project, please see "Understanding Financial Linkages: A Common Data Template for Global Systematically Important Banks", www.financialstabilityboard.org/publications/r_120328j.pdf

[9] *Key Attributes of Effective Resolution Regimes for Financial Institutions* is the international standard for resolution regimes for financial institutions. The attributes are a key component of the FSB's policy framework to address the moral hazard and systemic risks associated with institutions that are too big to fail.

[10] www.financialstabilityboard.org/publications/r_130716b.pdf

[11] www.financialstabilityboard.org/publications/r_130716c.pdf

contracts used in *Sharī`ah*-compliant transactions when considering specific insolvency arrangements in Islamic finance, (d) discussed issues that would arise in the event of insolvency, (e) provided some recommendations on how to prevent disputes arising from insolvency, and (f) provided an analytical framework on challenges and issues relating to insolvency regimes in Islamic finance. This publication highlights the pressing need for the IFSI to undertake substantial work in the area of resolution.

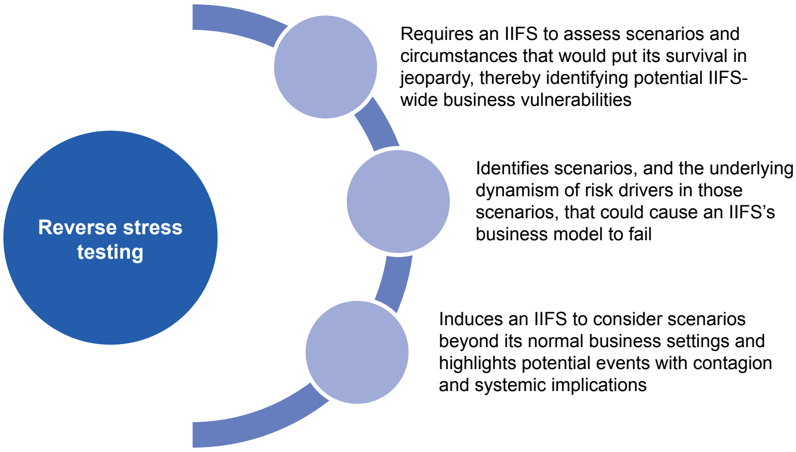
The issue of developing effective insolvency regimes for IIFS had also been discussed in the IFSB's fifth Islamic Financial Stability Forum, held in Manama, Bahrain on 29 March 2012 and entitled *Effective Crisis Management and Resolution Framework*.[12] The Forum highlighted, *inter alia*, the roles and responsibilities of RSAs, *Sharī`ah* governance and the legal regimes, as well as the need for RSAs to take into account the Islamic dimension to ensure that the particular features of Islamic finance do not come as a surprise in a crisis.

In terms of recovery, IFSB-15: *Revised Capital Adequacy Standard* stated that all D-SIBs should be required to prepare a recovery plan with more detailed guidelines on how the institution may restore the financial situation in the event of a material deterioration of its financial situation. RSAs should make an assessment of the recovery plan and, if necessary, may require that the institution prepares a revised plan. If the revised recovery plan fails to address the problems identified, the RSA may order the institution to launch various measures such as reduction of risks and change in business strategy.

The FSB's *Guidance on Recovery Triggers and Stress Scenarios* highlighted, *inter alia*, that reverse stress testing, which identifies scenarios that would lead to the non-viability of an institution's business model, can be utilised as a starting point for developing scenarios that would test the effectiveness of the menu of recovery options. IFSB-13: *Guiding Principles on Stress Testing*[13] stated, *inter alia*, that a stress testing programme that includes reverse stress testing should be an integral part of an IIFS's risk management framework, as this would help IIFS to identify and assess scenarios and circumstances that are within and beyond their normal business settings. In this respect, reverse stress testing serves as a failure prevention measure and assists institutions in developing scenarios for recovery plans, although the latter is not the primary function of such an exercise.

[12] IFSB, Fifth Islamic Financial Stability Forum: "Development of Effective Insolvency Regimes for Islamic Financial Institutions", Vijay Tata, 29 March 2012.
[13] www.ifsb.org/standard/eng_IFSB13%20Guiding%20Principles%20on%20Stress%20Testing%20_(Mar2012).pdf

Diagram 2.1.1.2: IFSB-13 – Guiding Principles on Stress Testing: Reverse Stress Testing



Source: IFSB-13: Guiding Principles on Stress Testing

IFSB-13 and IFSB-15 only deal with the Islamic banking sector, while the work of the FSB has been of wider application. There may in the future be opportunities for the IFSB to address the issue for the Islamic finance sector more widely, but the resolution of banks is likely to be the earliest priority.

(b) Resolution regimes for financial market infrastructure

To assist jurisdictions and authorities in implementing the Key Attributes with respect to resolution regimes for the Financial Market Infrastructure (FMI) (defined to include payment systems, central securities depositories, securities settlement systems, central counterparties and trade repositories), insurers and firms with holdings of client assets, the FSB launched in July 2012 a public consultation on the application of the Key Attributes to non-bank financial institutions.[14] Annexes[15] to the Key Attributes set out guidance on, *inter alia*, (a) resolution of FMI and resolution of systemically important FMI participants, and (b) resolution of insurers.[16]

In addition to a robust regulatory and supervisory regime and legal and *Sharī`ah* framework, having in place an FMI for Islamic finance that facilitates the recording, clearing, and settlement of monetary and other financial transactions is important in strengthening the Islamic financial market and supporting the sustainability of an Islamic financial system. Of equal importance is the need to manage the FMI well to ensure that it does not subject the financial system to significant risks and be a potential source of contagion, particularly in periods of unusual market duress.

Currently, the existence of an FMI for the Islamic financial system depends mainly on the development stage of the IFSI in that particular Islamic finance jurisdictions. In new Islamic finance jurisdictions, Islamic finance transactions may have to exist and operate within the context of conventional FMI and conventional laws, which were not designed for Islamic finance and had not been developed with Islamic finance in mind. If not properly managed, FMI can be

[14] www.financialstabilityboard.org/publications/r_130812a.pdf
[15] The Annexes were developed with the relevant standard-setters (Committee on Payment and Settlement Systems – CPSS, the International Association of Insurance Supervisors, and the International Organization of Securities Commissions).
[16] The guidance on resolution of insurers complements the policy measures for global systemically important insurers published by the IAIS on 18 July 2013, which include recovery and resolution planning requirements for G-SIIs.

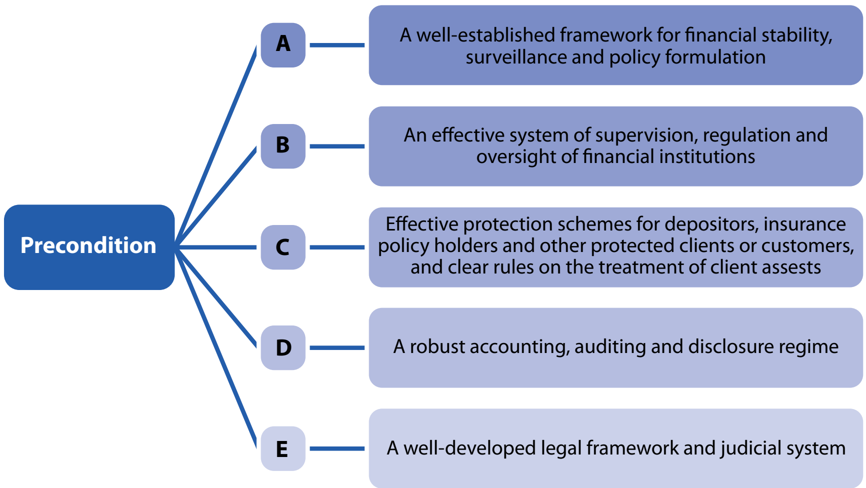
a source of financial shock, such as liquidity dislocations and credit losses, or a major channel through which these shocks are transmitted across domestic and international financial markets.

This remains an evolving area where some further development is expected in the coming years. It is to be noted that most of the transactions within the IIFS's trading book are through the over-the-counter (OTC) market. In addition, not all of the issues relating to counterparty credit risk (CCR) would appear to be of relevance to IIFS due to their limited use both of *Sharī`ah*-compliant hedging instruments and advanced approaches for capital adequacy ratio. However, so little work has been done on this subject for Islamic finance that conclusions are yet to be reached.

(c) Assessing the resolution regimes

For a jurisdiction to develop a resolution regime that is capable of managing components of the financial sector that could cause systemic problems if it were to fail, it must have a formal and rigorous assessment methodology that takes into consideration (a) the structure and complexity of the jurisdiction's financial system, and (b) the overall level of development of the financial system. Correspondingly, the FSB launched in August 2013 a public consultation on the *Assessment Methodology*[17] *for the Key Attributes of Effective Resolution Regimes for Financial Institutions.*[18] The methodology identifies a number of pre-conditions, as shown in Diagram 2.1.1.3. Although most of the pre-conditions are outside the direct responsibility and competence of the resolution authorities, inadequate implementation of these pre-conditions could adversely and directly impact the quality and effectiveness of resolution.

Diagram 2.1.1.3: Pre-conditions for Effective Resolution Regimes



Source: FSB Assessment Methodology for the Key Attributes of Effective Resolution Regimes for Financial Institutions, August 2013

[17] The draft methodology was developed with the involvement of the IMF, the World Bank and the relevant standard-setters (CPSS, International Association of Deposit Insurers – IADI, IAIS and IOSCO).
[18] www.financialstabilityboard.org/publications/r_130828.pdf

The single assessment methodology with suitable assessment criteria for all financial sectors is expected to assist jurisdictions in their legislative reforms to implement the Key Attributes. The FSB stated that once the methodology is finalised, this will enable the Key Attributes to be included in the FSB's list of key standards for sound financial systems and to be used in assessments by the IMF and World Bank under the Standards and Codes (S&C) Initiative.[19]

Key insolvency issues in Islamic finance relate to contracts, legislation and processes. Insolvencies of IIFS could arise in the following situations:[20]

(i) The incapability of the IIFS as the agent (*wakīl*) or *Muḍārib* to honour the obligations to the clients under special investment accounts, resulting in a bank run.
(ii) The incapability of the client, as the financed party, to honour the obligations to the financiers, such as between the lessor and the lessee.
(iii) The incapability of the special-purpose vehicle, acting either as the *Mushārik* (a partner) or the *wakīl*, to honour the obligations to the counterparty.
(iv) The inability of the Participants' Risk Fund of a *Takāful* operator to honour valid claims, on the back of poor underwriting decisions, the failure of *ReTakāful,* or unusual external events (for example, natural catastrophes).

There may be other forms of failure, especially if the IFSI develops its own financial markets infrastructure, such as central counterparties (CCPs). However, the possible modes of failure have been little studied as yet.

A number of IIFS in various regions have become significant players in their domestic markets, and hence may pose systemic risk to the financial systems in their respective jurisdictions. IIFS with cross-border activities could also potentially pose systemic and potential contagion risks to the system. Issues that would arise once an IIFS has entered resolution include:

(i) Recognition of *Sharī`ah* principles by courts in a conventional legal system where courts do not, on the face of it, recognise *Sharī`ah*.
(ii) Contractual techniques commonly used in Islamic finance, such as *Murābahah*, *Ijārah, Muḍārabah* and *Sukūk*, that need to be taken into account when considering specific insolvency arrangements.
(iii) Situations in which offset might be permitted, especially between transactions on different contractual bases.
(iv) The possibility of establishing priorities for depositors, investment account holders or *Takāful* contributors in insolvency.

RSAs of the IFSI should therefore assess the existing resolution regimes of their respective jurisdictions to reduce the fragility of the Islamic financial system and strengthen its resilience. The RSAs should also increase the intensity and effectiveness of supervision by assessing their existing methodology so as to reduce, if not prevent, such risks. Subsequently, this exercise may assist the jurisdictions in developing legislation related to the resolution regime for the IFSI. For new Islamic finance jurisdictions, this may also serve as a reference point in developing their resolution regimes for the various sectors of the IFSI in their respective jurisdictions.

[19] The S&C Initiative, launched in 1999, is designed to strengthen international financial architecture through the development, adoption and implementation of international standards and codes. The key standards are assessed by the IMF and World Bank as part of the Financial Sector Assessment Program (FSAP) or as stand-alone Reports on the Observance of Standards and Codes (ROSCs).

[20] IFSB and the World Bank, *Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance*, a chapter on Islamic Finance and the Impact of Solvency, by Dato' Dr Nik Ramlah Nik Mahmood and Wan Abdul Rahim Kamil, 2012.

There is a need to analyse the existing legal, institutional and regulatory frameworks that are in place for conventional financial institution insolvency, and to assess their applicability to IIFS in addressing the insolvency of IIFS in an effective and efficient manner that is compatible with *Sharī`ah*. For example, subjecting *Takāful* operators to the insolvency laws applicable to conventional financial institutions may undermine the basis of Islamic insurance, given that (a) the insolvency laws may not recognise that the nature of the relationship between the *Takāful* operator and the policyholders is fundamentally different from that in conventional insurance; and (b) the *Takāful* operator[21] is recognised as the only legal person having the right to sue and be sued, own property and enter into contracts.[22] Meanwhile, in formulating Islamic finance products and the related terms, the concept of insolvency must be viewed from the perspectives of *Sharī`ah*, accounting and corporate law, among others.

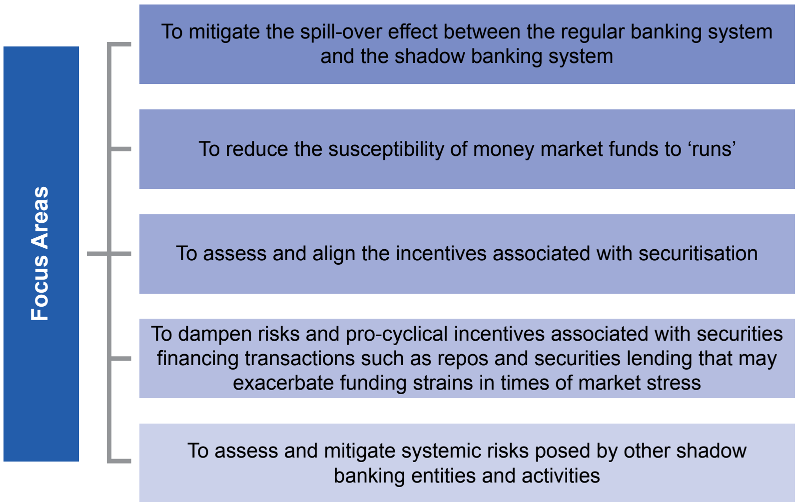
(d) Regulating the shadow banking industry[23]

As at year-end 2012, the global shadow banking industry was valued at USD71.2 trillion (compared to around USD60 trillion in both 2007 and 2010) accounting for around 24% of total financial assets, approximately 50% of banking system assets, and 117% of GDP.[24] Although the trends have stabilised somewhat since the crisis, tighter regulations on financial institutions may incentivise some risky activities to move to the shadow banking sector which is less tightly regulated. The recent financial crisis revealed that a key vulnerability of the system was its heavy reliance on the shadow banking sector which consists of, *inter alia*, securitisation vehicles, asset-backed commercial paper conduits, money market mutual funds, markets for repurchase agreements (repos), investment banks and mortgage companies.[25]

In an effort to strengthen the oversight and regulation of shadow banking, and to assist RSAs to better identify and address the financial stability risks associated with it, in August 2013 the FSB published policy recommendations focusing on five specific areas, as illustrated in Diagram 2.1.1.4.

[21] Rather than the Participants' Risk Fund.
[22] Adil A. Babiker, "Insolvency of Takaful Companies from Legal and *Sharī`ah* Perspectives", 5th IFSB Seminar on Legal Aspects of Islamic Asset Securitization and Insolvency Regimes, Jakarta, 2010.
[23] According to the FSB, shadow banking is broadly described as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system" – or non-bank credit intermediation, in short.
[24] Financial Stability Board, *Global Shadow Banking Monitoring Report 2013*, 14 November 2013.
[25] Ben Bernanke, Russell Sage Foundation and the Century Foundation Conference on "Rethinking Finance: Perspectives on the Crisis", New York, 13 April 2012.

Diagram 2.1.1.4: Policy Recommendations: Focus Areas



Source: FSB Strengthening Oversight and Regulation of Shadow Banking, August 2013

To mitigate the potential risks associated with shadow banking, the FSB published the following reports:

(i) *An Overview of Policy Recommendations.*[26] This report sets out the overall approach to addressing financial stability concerns associated with shadow banking, actions taken to date, and next steps.

(ii) *Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos.*[27] The report sets out recommendations for addressing financial stability risks in this area, including enhanced transparency, regulation of securities financing, and improvements to market structure.

(iii) *Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities.*[28] The report sets out a high-level policy framework for assessing and addressing risks posed by shadow banking entities other than money market funds.

Little research has as yet been carried out on the shadow banking aspects of the IFSI. However, drawing reference from the FSB documents, the concept of shadow banking for the IFSI should comprise not only entities but also activities within the industry. Relevant entities might include finance companies, mortgage companies, investment banks and certain types of non-banking financial institutions (NBFIs), but such activities could also be carried out by real estate and commodity firms. Over the years, the shadow banking sector has witnessed significant developments in terms of product innovation and diversity of IIFS, as well as a shift in orientation from domestic-centric to increasingly internationalised activities.

The *Sharī`ah* rulings have and will continue to ensure that Islamic financial transactions are supported by underlying productive activities, and that there is a close link between financial transactions and the real economy. However, many of the relevant institutions are not directly

[26] www.financialstabilityboard.org/publications/r_130829a.pdf
[27] www.financialstabilityboard.org/publications/r_130829b.pdf
[28] www.financialstabilityboard.org/publications/r_130829c.pdf

regulated or supervised by the main RSAs or, where regulations are available, they are not sufficiently robust. This could lead to excessive risk-taking activities and in turn subject the shadow banking sector to failures in the event of crisis. For these institutions, the major areas of concern include credit risk and liquidity risk management. The recent global financial crisis showed the vulnerability of such institutions in absorbing shocks. For example, a few NBFIs faced financial problems and either entered insolvency or had to be rescued following the crisis. A similar situation was faced by some Islamic investment companies, licensed as Islamic investment banks in the GCC. Recognising the adverse impact this could have on the Islamic financial system as a whole, there may be a need to:

(i) identify what are shadow banks in the IFSI and provide a definition of shadow banking in the IFSI;
(ii) introduce specific regulations for the shadow banking sector and heighten their surveillance over the sector – in particular, relevant parts of the real estate and commodity markets;
(iii) develop frameworks and assessment methodologies to identify systemic activities or entities, taking into consideration the size, interconnectedness, substitutability, complexity, and global activities of the shadow banking entities or activities; and
(iv) increase RSAs' understanding of the interrelationships between the financial and the real sector, including the potential for the second-round effects that are transmitted within and across sectors of the economy.[29]

However, challenges in undertaking the above exercise include the need to capture a wide range of business models and risk profiles. The lack of data on this sector is another concern for RSAs, which makes it difficult for them to formulate appropriate policies to control the risks emanating from shadow banking institutions.

(e) Risk: Supervision and culture

In November 2013, the FSB published *Principles for an Effective Risk Appetite Framework*[30] and a consultative document, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture*.[31]

(i) The document *Principles for an Effective Risk Appetite Framework* was issued to assist RSAs in strengthening risk management practices at financial institutions, particularly at SIFIs, and reinforcing a strong risk culture in financial institutions, which is critical to sound risk management. The principles, which are also relevant for the supervision of insurers, securities firms and other NBFIs, establish key elements for (a) an effective risk appetite framework, (b) an effective risk appetite statement, (c) risk limits, and (d) clearly defined roles and responsibilities of the board of directors (BOD) and senior management (SM).

(ii) The draft *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture* aims to assist RSAs in identifying the core practices and attitudes that may be indicators of a financial institution's risk culture, such as (a) the behaviour of the board of directors and senior management reflecting the values being espoused, (b) staff acceptance of risk-related goals and related values, (c) an environment of effective challenge with respect to decision-making processes, and (d) incentives to encourage and reinforce desired risk management behaviour.

[29] IFSB Seventh Islamic Financial Stability Forum: "Financial Reforms in Response to the Global Crisis: Lessons for Islamic Finance in Ensuring Financial Stability", Speech by Tan Sri Dato' Sri Dr Zeti Akhtar Aziz, Governor, Bank Negara Malaysia, 7 April 2013.
[30] www.financialstabilityboard.org/publications/r_131118.pdf
[31] www.financialstabilityboard.org/publications/c_131118.pdf

The two documents could also be applied to IIFS. However, in developing an *Effective Risk Appetite Framework* that is institution-specific and reflects its business model and organisation, IIFS and their RSAs should take into consideration the amount of risk an IIFS is willing to absorb, given that IIFS collect funds on the basis of *Muḍārabah* and most of their financing and investment activities are funded by these investment accounts. Therefore, any decision on an IIFS's risk appetite by its management should give due consideration to the risk profile of its fund providers, especially PSIA. Another dimension is the internal capability of the IIFS to manage and control a specified level of risk. Given the shortcomings in the risk culture of most IIFS, the RSAs should assess carefully whether an IIFS has the capacity to manage the level of risk defined as part of its risk appetite.

In addition to *Sharī`ah* risk, IIFS are confronted with other types of risks arising from their unique sets of products, documentation and associated legal risks, as well as a lack of hedging products and their OTC nature. If not addressed, these risks would eventually put significant pressure on the IIFS' bottom line, as witnessed during the GFC. Given that most financial statements of IIFS provide little information on the governance and organisation of risk management in their institutions, focus should be directed to providing strong oversight over various risks, such as concentration risk on products, sectors and geographical locations. The IFSB has issued its latest *Standard on Revised Supervisory Review Process of IIFS* in March 2014, which takes into consideration the specificities of the IIFS, and the lessons learned from the GFC. This Standard also complements the existing guidance on supervisory review process issued by the BCBS for the conventional banking sector.

IFSB-12: *Guiding Principles on Liquidity Risk Management*[32] has outlined the role of the board of directors in setting the risk appetite and managing liquidity risk. The Standard explains that ultimate responsibility for liquidity risk management oversight lies with the board of an IIFS, which should approve strategy and broad policies for liquidity risk management while balancing the trade-off between profit and risk. In formulating the strategy and significant policies, the board should translate the IIFS's overall risk appetite into a clear set of guidelines for tolerating liquidity risk, from the perspective of ERM. Such a strategy and policies should take into account the IIFS's business model, legal structure, complexity of products and operations, key lines of business and regulatory environment.

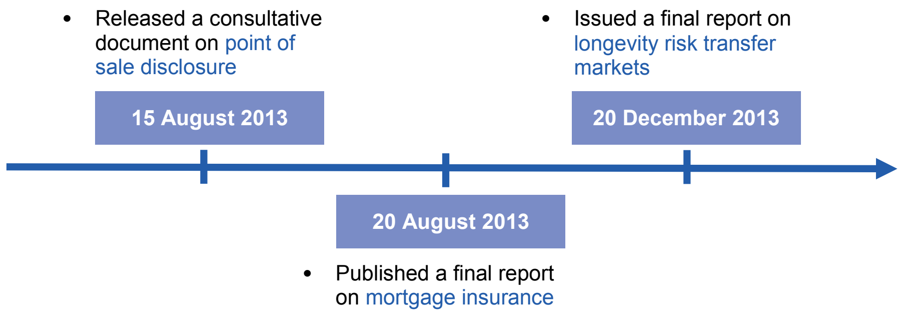
The above observations also reflect the current status of risk culture in IIFS. In essence, the IIFS are still lagging behind their conventional counterparts in dealing with the issue of risk culture.

2.1.2 Joint Forum

In 2013, the Joint Forum[33] released two final reports – *Mortgage Insurance: Market structure, Underwriting Cycle and Policy Implications*[34] and *Longevity Risk Transfer Markets: Market Structure, Growth Drivers and Impediments, and Potential Risks*[35] – and a consultative document, *Point of Sale Disclosure in the Insurance, Banking and Securities sectors.*[36] Given that mortgage insurance and longevity risk transfer may be only marginally relevant to the IFSI, the discussion here will focus on point of sale disclosure across the three financial sectors.

[32] www.ifsb.org/standard/eng_IFSB-12%20Guiding%20Principles%20on%20Liquidity%20Risk%20Mgmt%20_(March2012).pdf
[33] The Joint Forum was established in 1996 under the aegis of the BCBS, IOSCO and IAIS to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates.
[34] www.bis.org/publ/joint33.pdf
[35] www.bis.org/publ/joint34.pdf
[36] www.bis.org/publ/joint32.pdf

Diagram 2.1.2.1: Joint Forum: Selected Initiatives in 2013



Source: Joint Forum

The Joint Forum's 2010 *Review of the Differentiated Nature and Scope of Financial Regulation*[37] highlighted the risks to financial stability, as well as the opportunities for regulatory arbitrage, arising from variations in supervisory and regulatory standards for similar activities in different sectors. Its work on point of sale (POS) disclosure therefore aims to:

(i) identify and assess differences and gaps in regulatory approaches to POS disclosure in relation to investment or savings products in the insurance, banking and securities sectors; and

(ii) identify whether regulatory approaches to POS disclosure need to be further aligned across sectors, keeping in mind that differences in regulatory approaches can arise from legitimate differences in sectoral regulatory objectives as well as from differences in product features.

In addition, the Joint Forum focused on the selection of products that compete with collective investment schemes (CIS) for consumer savings or investments: structured notes, structured deposits, unit-linked life insurance, variable annuities and indexed annuities. It then identified differences in POS disclosure regimes across jurisdictions and among the sample products, considered the impact of those differences, and formulated recommendations for further action by IAIS, IOSCO and BCBS.

The Joint Forum identified important sectoral and interjurisdictional differences in POS disclosure requirements, and the consultation paper puts forward the draft recommendations set out in Diagram 2.1.2.2.

[37] www.bis.org/publ/joint24.pdf

Diagram 2.1.2.2: Joint Forum: Key Recommendations for Point of Sale Disclosure Regulations

Draft Recommendations

1. Jurisdictions should consider implementing a concise written or electronic POS disclosure document for the product sample identified in the Joint Forum report, taking into account the jurisdiction's regulatory regime.
2. The POS disclosure document should be provided to consumers free of charge, before the time of purchase.
3. A jurisdiction considering POS disclosure should consider requiring that a POS disclosure document disclose key characteristics including costs, risks and financial benefits or other features of a given product and any underlying or referenced assets, investments or indices, irrespective of the financial sector from which the products are derived.
4. The POS disclosure document should be clear, fair, not misleading and written in a plain language designed to be understandable by the consumer.
5. The POS disclosures should include the same type of information to facilitate comparison of competing products.
6. The POS disclosure document should be concise, set out key information about a product and may include, as appropriate, links or refer to other information. It should make clear that it does not provide exhaustive information.
7. Allocation of responsibility for preparing, making available and/or delivering the POS disclosure document should be clearly established, and the POS disclosure document should identify which entity is responsible for its content.
8. A jurisdiction considering POS disclosure should consider how to use its capabilities and powers to implement these POS recommendations, taking into account the jurisdiction's regulatory regime.

Source: Joint Forum

The issue of consumer protection had also been discussed in the IFSB's 6th Islamic Financial Stability Forum in Jeddah, Saudi Arabia in December 2012. Entitled "Promoting Resilience and Stability of the Islamic Financial Services Industry: Strengthening Consumer Protection and Business Conduct",[38] the Forum highlighted the importance of having in place an effective consumer protection framework, not only to facilitate the growth of the IFSI, but also to ensure confidence in, and the sustainability of, the industry. Various elements of Islamic finance, such as ensuring fairness and certainty and avoiding exploitation between the transacting parties, form the foundational values which help to ensure that consumers are not disadvantaged, misled or defrauded by the product or service providers, as well as to justify the need for meaningful and timely disclosure of information.

Although such elements provide Islamic finance with a strong foundation for consumer protection, they cannot guarantee sufficient protection for consumers of Islamic finance products, given various factors such as greed, commercial and competitive pressures, and consumers' lack of sophistication.

[38] IFSB, 6th Islamic Financial Stability Forum: "Developing a Platform for Consumer Protection in the Islamic Financial Services Industry", Dr Nik Ramlah Mahmood, 2012.

This is particularly true in the absence of a strong, transparent and effective *Sharī`ah* governance framework which includes *Sharī`ah* disclosures, *Sharī`ah* due diligence and *Sharī`ah* internal compliance aspects. Hence, *Sharī`ah* compliance should not be compromised at any stage of the product cycle. The Box 2.1 on regulating *Sharī`ah* non-compliance risk shares the IFSB's findings on the approach to *Sharī`ah* compliance of IIFS's operations/products in various jurisdictions.

The work of the Joint Forum is particularly important for the Islamic finance sector, since it has unique products – Profit Sharing Investment Accounts – which could also be regarded as competing for savings with CIS. While the IFSB has done significant work in this area,[39] it will consider carefully the final version of the Joint Forum report and any material developments in POS standards from the Joint Forum's parent bodies.

Box 2.1: Regulating *Sharī`ah* Non-compliance Risk

By: IFSB Secretariat

Sharī`ah* compliance of an IIFS's operations or products is an important consideration for the RSAs. In this respect, in a survey, the RSAs were asked several questions about the approach to *Sharī`ah compliance of IIFS's operations/products in their respective jurisdiction. The results for banking RSAs are summarised in the table below.

Overall, two questions received very substantial affirmative responses: (a) the requirement for an SSB or equivalent body in the governance structure of IIFS; and (b) the requirement to include *Sharī`ah* non-compliance risk as part of the supervisory review process, with 88% (23 out of 26) and 65% (17 out of 26) affirmative responses, respectively. The remaining possible measures all attracted an affirmative response of 50% or less in the sample jurisdictions.

Table 1: *Sharī`ah* Compliance of IIFS's Operations

		YES		NO		Total/Base
		No.	%	No.	%	No.
1	Is an SSB or equivalent body required in the governance structure of IIFS in order to promote *Sharī`ah* compliance?	23	88	3	12	26
2	Does your supervisory authority include *Sharī`ah* non-compliance risk as part of the supervisory review process?	17	65	9	35	26
3	Has your supervisory authority issued any guidelines on internal and/or external *Sharī`ah* audits?	13	50	13	50	26
4	Does your supervisory authority seek to enforce *Sharī`ah* audit standards (such as AAOIFI standards)?	13	50	13	50	26
5	Are the qualifications of the members of the SSB subject to the assessment and approval process of your supervisory authority?	12	46	14	54	26
6	Does your supervisory authority directly regulate *Sharī`ah* compliance of IIFS's operations/products?	11	42	15	58	26
7	Does your supervisory authority require ex-post *Sharī`ah* review to be conducted on all products used by IIFS on a periodic basis?	11	42	15	58	26
8	Is there any supervisory requirement for cooperation and communication between the risk management unit and the *Sharī`ah* governance unit of the IIFS?	8	31	18	69	26

[39] See, in particular, Section 4 of IFSB-4: *Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services*, and IFSB-9: *Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services.*

Box 2.1 *(continued)*

From the results it appears that for some RSAs the approach for IIFS is to ensure *Sharī`ah* compliance at all times with the decisions of a centralised *Sharī`ah* council and their own *Sharī`ah* Committee. On the other hand, two RSAs also indicated that their approach was that the product approval role is envisaged to be performed by the SSB of the IIFS, and hence all the products are reviewed and approved by the IIFS's *Sharī`ah* supervisory board. One RSA indicated that it does not prescribe what constitutes *Sharī`ah* compliance, nor does it endorse specific *Sharī`ah* rulings with respect to the Islamic products and services. Nevertheless, it expects IIFS to take into account *Sharī`ah* compliance matters and to manage the compliance risk as part of their overall risk management process.

The results also reflect that in some jurisdictions it is required for IIFS to set up an internal *Sharī`ah* audit and review function to conduct a *Sharī`ah*-compliance assessment, which includes the operationalisation of products approved. In this regard, an IIFS is required to report probable and actual *Sharī`ah* non-compliance cases quarterly to the RSA. An RSA following the approach just described will typically expect that there are adequate independent compliance reviews and internal audits performed periodically by qualified staff of the branches or the Head Office of the IIFS for all products launched. Similarly, the IIFS are required to demonstrate adequate arrangements to ensure the ongoing *Sharī`ah* compliance of the activities undertaken by or products offered under Islamic banking windows.

Source: IFSB CPIFR Working Group Survey, September 2013

2.1.3 Basel Committee on Banking Supervision

Progress in the Implementation of Basel III

In August 2013, the BCBS published its fourth Report to G20 Leaders on progress made in the implementation of Basel III regulatory reforms[40] – in particular, with respect to the adoption of the following Basel III standards:

- **Capital.** In terms of Basel III risk-based capital rules, of the 27 BCBS member jurisdictions, 11 have issued final rules that are legally in force.
- **Leverage.** Although the BCBS is still in the process of finalising the details of the Basel III leverage ratio standard, some member jurisdictions have already initiated steps in preparation for the introduction of this new requirement.
- **Liquidity.** A total of 11 member jurisdictions have issued the final rules for liquidity coverage ratio.
- **Systemically important banks.** Two member jurisdictions have issued and begun to enforce final regulatory rules with respect to the requirements of G-SIBs and D-SIBs.

[40] www.bis.org/publ/bcbs260.pdf

Table 2.1.3.1: The Adoption of Basel III by BCBS Member Jurisdictions

Basel III	Issued final rules that are legally in force	Issued final rules that have not yet been brought into force	Issued draft rules
Risk-based capital (Start date: 1 January 2013)	Australia, Canada, China, Hong Kong, India, Japan, Mexico, Saudi Arabia, Singapore, South Africa, Switzerland	Argentina, Belgium, Brazil, France, Germany, Italy, Korea, Luxembourg, Netherlands, Russia, Spain, Sweden, UK, US	Indonesia, Tukey
Leverage ratio standard* (Start date: 1 January 2015)	-	-	-
Liquidity coverage ratio (Start date: 1 January 2015)	-	Belgium, France, Germany, Italy, Luxembourg, Netherlands, South Africa, Spain, Sweden, Switzerland, UK	Australia, Hong Kong, India, Turkey
Systemically important banks (Start date: 1 January 2016; Reporting and disclosure requirements: 1 January 2014)	Canada, Switzerland	Belgium, France, Germany, Italy, Luxembourg, Netherlands, South Africa,Spain, Sweden, UK	-

**The BCBS is currently in the process of finalising the details of the leverage ratio standard.*

Source: BCBS Report to G20 Leaders on monitoring implementation of Basel III regulatory reforms, August 2013

The report also assessed the harmonisation of domestic regulations in implementing the Basel III risk-based capital standards, in terms of both substance and form. Jurisdictions are urged to address any material inconsistencies between the domestic regulations and the Basel III standards to ensure a more consistent domestic implementation of the Basel framework.

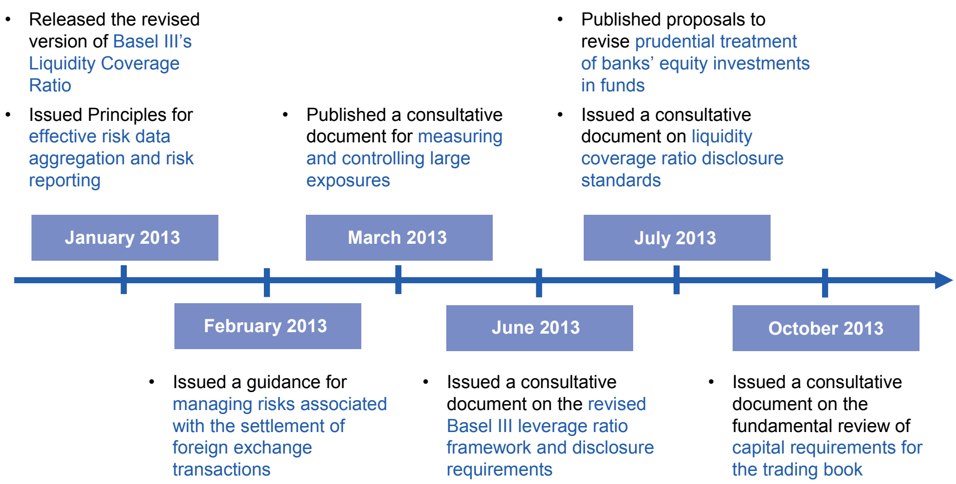
The IFSI has also taken the development of Basel III regulatory reforms into account. In December 2013, the IFSB published IFSB-15: *Revised Capital Adequacy Standard*, which is a revised and enhanced version of two previous IFSB standards on capital adequacy.[41] In particular, the Standard adopts key Basel III proposals on capital components and macroprudential tools, with necessary adaptations for IIFS. RSAs among the IFSB member countries are expected to start the implementation of IFSB-15 in their respective jurisdictions by January 2015.

In essence, the Standard aims to assist the implementation of a capital adequacy framework that will ensure effective coverage of risk exposures of the IIFS and allocation of appropriate capital to cover these risks. It also provides new guidance on tools such as capital buffers, leverage ratio and D-SIBs, as well as more elaborate guidance on capital adequacy treatment of various risk exposures related to *Sharī`ah*-compliant products and services, including *Sukūk*, securitisation and real estate. Further details on IFSB-15 are provided in Section 2.2.1 on published standards.

Policy Reforms Initiatives in 2013

In addition to Basel III's liquidity coverage ratio and disclosure, other policy reforms that are important for financial stability undertaken by the BCBS in 2013 include the introduction of various publications and consultative documents on, *inter alia*, risk data aggregation capabilities and internal risk reporting practices, banks' large exposures, as well as leverage ratio framework and disclosure requirements.

Diagram 2.1.3.1: Basel Committee on Banking Supervision: Selected Initiatives in 2013



Source: BCBS

[41] IFSB-2: *Capital Adequacy Standard for IIFS* (published in 2005), and IFSB-7: *Capital Adequacy Requirements for Sukūk, Securitisations and Real Estate Investments* (published in 2009).

(a) Basel III's liquidity coverage ratio

As a part of global financial reforms, the BCBS issued *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring*,[42] which introduced two internationally harmonised global liquidity standards:

- **Liquidity Coverage Ratio (LCR)**,which is aimed at promoting short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high-quality liquid resources to survive an acute stress scenario lasting for one month. In January 2013, the BCBS issued the final version of the LCR,[43] entitled *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools*.[44]
- **Net Stable Funding Ratio (NSFR)**, which is intended to provide a sustainable maturity structure of assets and liabilities over a one-year time horizon. In January 2014, the BCBS issued a consultative document, *Basel III: The Net Stable Funding Ratio*,[45] which sets out revised proposals for the details of the proposed NSFR standard.

Due to a number of concerns raised by the BCBS member jurisdictions after the first draft, the full implementation of the LCR has been postponed from 1 January 2015 to 1 January 2019, as shown in Table 2.1.3.2. Although the initial start date of 1 January 2015 has been maintained, there is a transitional period until 1 January 2019, during which the minimum level of liquidity coverage will gradually rise from 60% of the standard to the full 100%, at increments of 10 percentage points a year. For the NSFR, in the aforementioned consultative paper, BCBS maintains its previously proposed implementation date of 1 January 2018.

Table 2.1.3.2: Implementation of the Basel III Liquidity Coverage Ratio

Year	2015	2016	2017	2018	2019
LCR	60%	70%	80%	90%	100%

Source: BCBS

Under the 2010 liquidity framework, the stock of high-quality liquid assets was divided into Level 1 and Level 2 Assets. Under the new LCR standard, Level 2 Assets are split into two sub-categories – Level 2A Assets and Level 2B Assets. Level 2B Assets are subject to larger haircuts than Level 2A Assets and can count for no more than 15% of a bank's total HQLA. They must also be included in the 40% cap on Level 2 Assets. Unlike the 2010 version, the revised LCR standard expressly provides for the use of local rating scales.

[42] www.bis.org/publ/bcbs188.pdf
[43] www.bis.org/publ/bcbs238.pdf
[44] In January 2014, the BCBS finalised its work on Basel III's LCR which included some additional work on liquidity disclosure, the use of market-based indicators of liquidity within the regulatory framework, and the interaction between the LCR and the provision of central bank facilities.
[45] www.bis.org/publ/bcbs271.pdf

Stock of High-Quality Liquid Assets

Level 1 Assets Up to 100%	
Level 2 Assets Up to 40%	
Level 2A Assets	Level 2B Assets up to 15%

LCR = (Stock of High-Quality Liquid Assets) / (Total net cash outflows over the next 30 calendar days) ≥ 100%

Total net cash outflows over the next 30 calendar days =
Total expected cash outflows – Min (total expected cash inflows; 75% of total expected cash outflows)

One important inclusion in the revised rule on LCR is about the treatment for *Sharī`ah*-compliant banks in jurisdictions where there is an insufficient HQLA for Islamic banks due to prohibition of interest-based instruments. In the new rule for LCR, it was stated that:

> *"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."*[46]

In June 2013, the IFSB conducted a survey for IIFS and RSAs, as well as a Quantitative Impact Study (QIS) for IIFS, to ascertain the current situation regarding LCR in the IFSB member countries (details are given in Box 2.2). A total of 14 RSAs and 54 IIFS responded to the survey, and 32 QIS replies were received from IIFS from seven different jurisdictions. The findings showed that the market is now better prepared to take on the challenge of implementing these standards.[47] The QIS results showed that only 22% of the responding IIFS have an LCR below 100%, while the rest are found to have "excess liquidity" with an LCR of more than 200%.

Overall, the QIS findings also highlighted a number of major problems for the IIFS, such as:

- insufficient *Sharī`ah*-compliant HQLA in the Islamic finance jurisdictions, and lack of a deep and active secondary market for *Sharī`ah*-compliant HQLA for IIFS to manage their liquidity; and
- the treatment and run-off rate of unrestricted PSIA and how specificities of these accounts may impact the LCR and NSFR requirements.

In general, however, both RSAs and IIFS have no major issues in adopting both LCR and NSFR requirements, with some further adjustments which reflect the specificities of IIFS. The

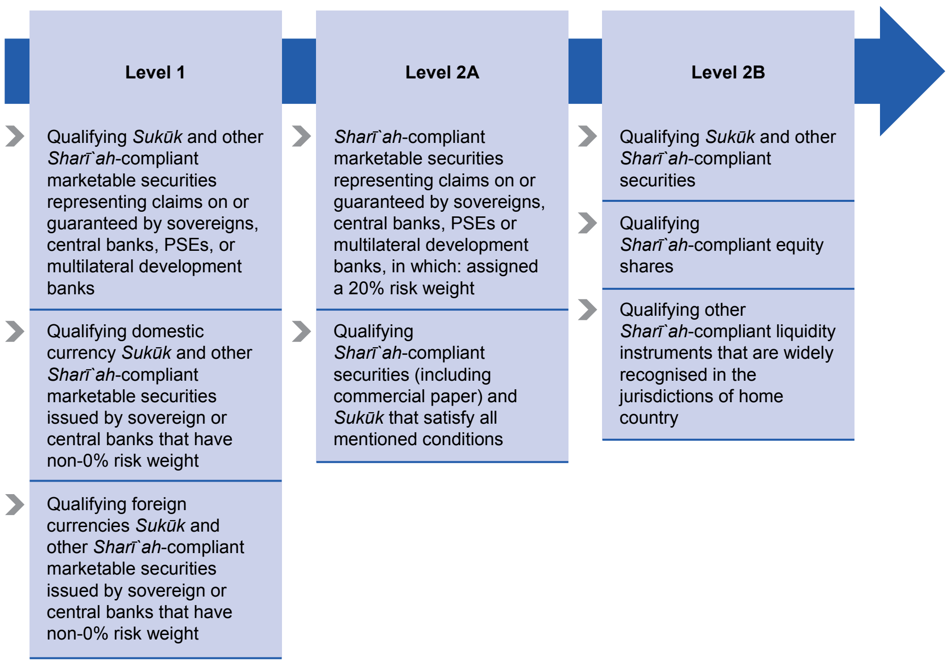
[46] Paragraph 68, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools*, January 2013, www.bis.org/publ/bcbs238.htm

[47] In 2011, the IFSB conducted a similar survey for supervisory authorities and IIFS to explore the availability of *Sharī`ah*-compliant HQLA and assess the readiness of supervisors and market players to implement these ratios. The survey report showed that there were major obstacles to implementing these ratios – on both the numerator and denominator sides.

adjustment can focus on simplification of LCR and NSFR components (as many factors proposed by the Basel III framework are not directly relevant to the IIFS), as well as revising some factors applied to the components, particularly to instruments that are specific to Islamic finance. Many IIFS have no investment and activities in most of the components of LCR – for both HQLA as numerator and net cash outflows as denominator. IIFS in some jurisdiction, however, were found to have a very high LCR.

Those assets which qualify as HQLA should have certain fundamental and market-related characteristics, particularly in terms of low risk, ease and certainty of valuation, and low volatility. IIFS that are operating in jurisdictions where *Sukūk* are available in sufficient number and with the desired quality are more advantageous when it comes to managing their liquidity. However, there is usually no active trading of these instruments in the secondary market as IIFS tend to hold such instruments until maturity. 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 availability of high-rated HQLA at the international level (such as the International Islamic Liquidity Management Corporation (IILM) and IDB *Sukūk*) may improve the conditions in the market and help IIFS meet their LCR requirement. The *Sharī`ah*-compliant instruments which meet the requirements for HQLA are summarised in Diagram 2.1.3.2.

Diagram 2.1.3.2: *Sharī`ah*-compliant Instruments that Meet Requirements for HQLA



Source: IFSB

The IFSB has been working on a Guidance Note on quantitative measures for IIFS which will provide necessary adjustments to LCR and NSFR. The Guidance Note, which is expected to be issued in early 2015, will also provide guidance to IIFS and their RSAs on the parameters and calculation of LCR and NSFR.

Box 2.2: Survey on Basel III Liquidity Framework and Quantitative Impact Study (QIS) for IIFS

By: IFSB Secretariat

In June 2013, the IFSB undertook a survey to explore RSAs' and IIFS' opinions about the Basel III Liquidity Framework and liquidity risk management, as well as a QIS to collect primary data to ascertain the current status of LCR and NSFR. The survey was addressed to all RSAs in the IFSB member countries and IIFS from selected IFSB member jurisdictions. A total of 54 IIFS from seven IFSB member countries and 14 RSAs responded to the questionnaire. Some 32 IIFS from seven jurisdictions submitted data for the QIS. The data presented in QIS were based on the IIFS' financial position as of 31 December 2012.

Results of the Survey

The findings showed that the market is now better prepared to take on the challenge of implementing these standards compared to a similar survey undertaken in 2011. However, significant challenges remain, as discussed in the following paragraphs.[48]

With regard to the risk factors mentioned in the Basel III LCR requirement, a majority of RSAs and IIFS agree to their application for the IIFS, while highlighting the need for some modification due to the features of various Islamic financial instruments. Some respondents also proposed various additional risk factors to be considered for this exercise.

Fundamental and Market-Related Characteristics of HQLA

Most RSAs agree to the "fundamental characteristic" of HQLA as proposed by the Basel III LCR requirement. A major concern of RSAs is the expectation for the HQLA to have a *low correlation with risky assets*, and for the asset to be *listed on a developed and recognised exchange market*. For "market-related characteristics", on the other hand, both RSAs and IIFS are of the view that there are insufficient *Sharī`ah*-compliant instruments that can meet market-related characteristics. These characteristics are: *active and sizeable market*, *low volatility* and *flight to quality*. The same pattern is found in response to stress scenario characteristics. Most RSAs believe that it is difficult for IIFS to have *Sharī`ah*-compliant HQLA that meet these criteria, or that the number and size of such assets is not large enough to meet LCR requirements. RSAs and IIFS are, nevertheless, less concerned about the criterion that *Sharī`ah*-compliant instruments be eligible for central banks facilities.

Availability of HQLA

There have been some concerns about *Sukūk and other Sharī`ah-compliant marketable securities representing claims on sovereign, central banks, Public Sector Entities (PSEs), Bank for International Settlements, IMF,* etc. Some RSAs responded that it is very difficult to have *0% risk-weighted sovereign, domestic sovereign, and central bank debt securities issued in local currency*. Some RSAs highlighted that not a single *Sukūk* is available in their jurisdiction that can meet the requirements of a Level 1 Asset. Similarly, some jurisdictions have no *Sharī`ah*-compliant instruments that meet the general requirements of Level 2 Assets, and some jurisdictions do have *corporate Sukūk and*

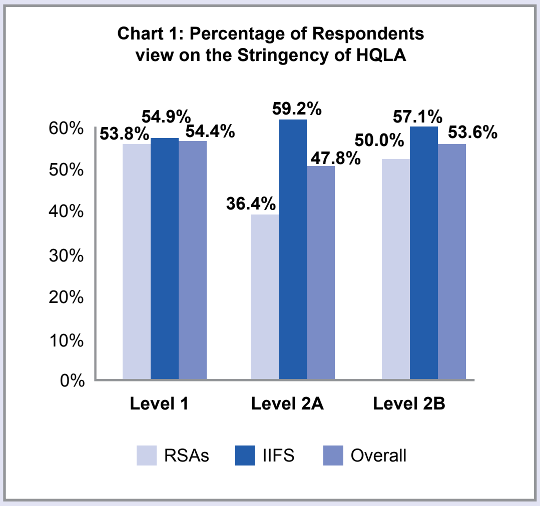
[48] In 2011, the IFSB conducted a similar survey for RSAs and IIFS to explore the availability of *Sharī`ah*-compliant HQLA and assess the readiness of supervisors and market players to implement these ratios. The survey report showed that there were major obstacles to implementing these ratios – on both the numerator and denominator sides.

Box 2.2 *(continued)*

Sharī`ah-compliant residential mortgage-backed securities, but these assets do not have an active, deep market.

Operational Requirements for HQLA

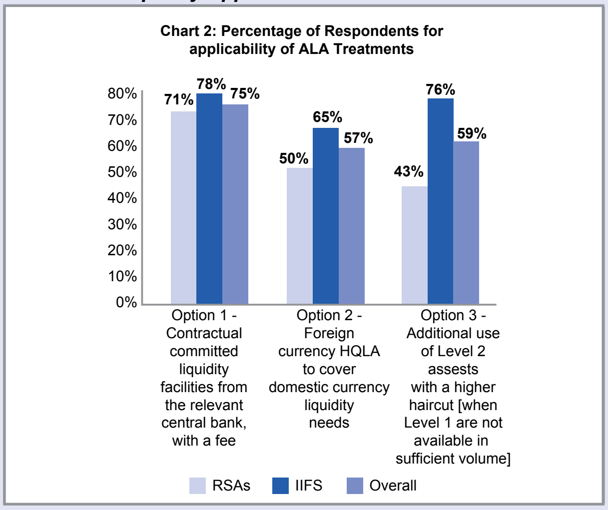
As shown in Chart 1, about 50% of the RSAs found the requirements for various types of assets quite stringent to meet. However, to what extent such assets are sufficient to meet the LCR requirements is a question that needs to be answered, and it is currently a concern to RSAs.



Being *traded in a large, deep and active repo market* is considered a major impediment. Having *external credit assessment institution (ECAI) ratings on securities*, and being *characterised by level of concentration* are other major impediments, according to the RSAs and IIFS. However, the RSAs and IIFS believed that there is no difficulty in finding HQLA that are *not an obligation of a financial institution or affiliated entity*.

According to the results, *Sukūk* and other *Sharī`ah*-compliant instruments which might qualify as Level 1 liquid assets may not be *traded in a large, deep and active market*; nor do they have a *proven record as a reliable source of liquidity during stressful market conditions*. To make it easy for IIFS to meet the liquidity requirements, central banks could provide more *Sharī`ah*-compliant short-term liquid instruments, and utilise various options under the alternative liquidity approaches (ALA).

Alternative Liquidity Approaches Treatment



As shown in Chart 2, there are three ALAs for resolving the problem of insufficient *Sharī`ah*-compliant HQLA. Most of the RSAs and IIFS argued that option 1 (Contractual committed liquidity facilities from the relevant central bank, with a fee) is applicable to overcome a shortage of HQLA to IIFS. However, RSAs are divided over option 2 (Foreign currency HQLA to cover domestic currency liquidity needs) because of restrictions on the transferability/ convertibility of foreign currencies to some extent and historic exchange rate volatility against domestic currency. Contrary to the RSAs, IIFS are more optimistic about resolving the insufficient *Sharī`ah*-compliant HQLA through options 2 and 3 (Additional use of Level 2 assets with a higher haircut).

Box 2.2 *(continued)*

Treatment of PSIA

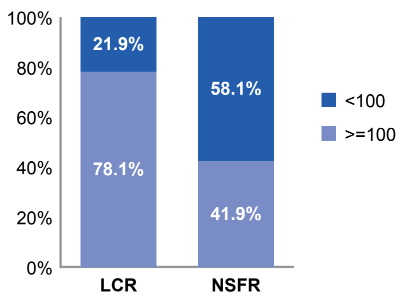
According to the respondents, the Restricted PSIA (RPSIA) should not be incorporated in the LCR and NSFR requirement if they are invested separately or not commingled with other sources of funds of the IIFS. For Unrestricted PSIA (UPSIA), if an IIFS allows an investment account holder (IAH) to withdraw such funds without applying a penalty, or without restraining IAH early withdrawal, the entire category of these funds would then have to be subject to a run-off rate in the same manner as deposits. On the other hand, if an IAH has no legal right to withdraw deposits within a 30-day horizon, or if early withdrawal results in a significant penalty that is materially greater than the expected profit for the period, then UPSIA may be excluded from LCR according to the RSAs' discretion. Some RSAs and IIFS have argued that UPSIA are supposed to be more stable than conventional deposits in the time of stress because a penalty would be applicable if the IAHs wish to withdraw their investment in fixed-term PSIA.

Results of the QIS

The QIS highlighted that a majority of RSAs and IIFS can meet the LCR and NSFR requirements, using mainly cash and bank notes or central bank reserves as their assets.

IIFS from seven IFSB member countries – namely Bahrain, Indonesia, Malaysia, Pakistan, Sudan, Turkey and UAE – participated in the study. The means of LCR and NSFR are 241 and 120, respectively. Many IIFS were found to have "excess liquidity", with LCR of more than 200%, and their HQLA mainly consisted of cash and central bank reserves. This fact confirms the market opinion that IIFS experience excess liquidity in a number of jurisdictions, but it is quite difficult for them to find *Sharī`ah*-compliant income-generating HQLA.

Chart 3: Respondents' Current status of LCR and NSFR



As shown in Chart 3, only 22% of the respondent IIFS had an LCR below 100%. Almost 60% of respondent IIFS had an NSFR below 100%. As LCR implementation will start at 2015 with 60% at international level, only 4 out of 32 IIFS have an LCR below 60%.

Table 1 shows that most of the IIFS responding to the QIS in all jurisdictions rely on Level 1 Assets, especially "Coins and banknotes" and "Total central bank reserves, part of which can be drawn in times of stress". Given the fact that some of the IIFS are over-liquid, there is a need for sufficient income-generating HQLA in all the categories for better diversification and investment income generation. Most IIFS did not provide data on their investment and other activities in most of the components of LCR for both HQLA as numerator and net cash outflows as denominator. Better diversification of HQLA is found in countries that have more IIFS, or which have relatively advanced Islamic capital markets. For the denominator side of the LCR, higher concentration risk is found in some IIFS.

Box 2.2 *(continued)*

Table 1: High-Quality Liquid Assets (HQLA) and Net Cash Outflow

Classification of Assets	Overall (%)
Level 1 Assets	**96.83**
Coins and banknotes	9.01
Total central bank reserves	30.73
Securities with a 0% risk weight	21.45
For non-0% risk-weighted sovereigns	35.64
Level 2A Assets	**2.97**
Guaranteed by sovereigns	0.39
Non-financial corporate bonds, rated AA- or better	2.58
Covered bonds, not self-issued, rated AA- or better	0.00
Level 2B Assets	**0.19**
Total stock of Level 2B RMBS assets	0.06
Total stock of Level 2B non-RMBS assets	0.13

Classification of Assets	Overall (%)
Cash Outflow	
Total retail deposits run-off	**46.42**
Total unsecured wholesale funding run-off	**38.78**
Total secured wholesale funding run-off	**0.00**
Total Additional Requirements and Other Contingent Funding Obligations	**14.79**
Cash Inflow	
Total inflows on reverse repo and securities borrowing transactions	**0.00**
Total of other inflows by counterparty	**80.84**
Total of other cash inflows	**19.16**

Conclusion

It can be concluded that the industry (both the IIFS and their RSAs) are getting ready to adopt the LCR and NFSR for IIFS. However, detailed guidance will be required to address the specific issues of the HQLA, ALA treatment, and run-off rates for the products offered by the IIFS, especially the treatment of PSIA. The guidance could focus on simplification of the LCR and NSFR components (as many factors proposed by the Basel III framework are not directly relevant for IIFS), as well as revising some factors applied to the components.

Source: IFSB Basel III Liquidity Framework and Quantitative Impact Study for IIFS Survey, June 2013

(b) Risk data aggregation and internal risk reporting

The global financial crisis highlighted the need for banks and bank groups to have in place adequate information technology and data architectures that would allow them to aggregate their risk exposures and identify concentrations fully, quickly and accurately at both the bank and bank group levels, across business lines and between legal entities, and enable them to take risk decisions in a timely manner. In return, this would help the banks to avoid a negative impact on their financial position and ultimately support the stability of the financial system as a whole in times of stress and crisis. To strengthen banks' risk data aggregation capabilities and internal risk reporting practices, in January 2013, the BCBS issued *Principles for Effective Risk Data Aggregation and Risk Reporting*.[49] National RSAs are also encouraged to apply these principles to (a) institutions identified as D-SIBs three years after their designation as such, and (b) a wider range of banks, in a way that is proportionate to their size, nature and complexity.

[49]www.bis.org/publ/bcbs239.pdf. G-SIBs are required to implement the principles in full by the beginning of 2016.

Although Islamic banks were relatively less affected by the financial crisis, high concentration in real estate and consumer financing had adversely impacted a number of banks in the GCC, which subsequently affected the asset quality of Islamic banks. As Islamic banks continue to grow and expand their businesses and operations, their risk management systems need to be enhanced to better identify, monitor and manage risks, and improve the decision-making processes. This is especially true for domestic systemically important Islamic banks. The following IFSB documents stress the need to have a fully integrated information system, in particular for the management of liquidity and credit risks:

- IFSB-12: *Guiding Principles on Liquidity Risk Management* stated, *inter alia*, that an IIFS should have a fully integrated information system, commensurate with its nature, size and complexity of operations, that provides clear, timely and accurate liquidity risk reports to its relevant functional units and senior management on the IIFS's liquidity risk exposures, its compliance with established policies and limits, and the appropriateness of management strategies with respect to approved risk tolerance.
- IFSB Exposure Draft-16: *Revised Guidance on Key Elements in the Supervisory Review Process*,[50] issued in October 2013, reiterates that IIFS should have in place effective internal policies, systems and controls to identify, measure, monitor and control their credit risk concentrations in a timely manner.

Although enhancing information technology systems, data and reporting processes would involve significant investments of financial and human resources, which may further stretch the IIFS' limited resources, the benefits to be realised are expected to far outweigh the costs, especially in terms of improved efficiency, reduced probability of losses, and enhanced strategic decision-making.

(c) Managing foreign exchange settlement-related risks

The rapid growth in foreign exchange (FX) trading activities and short-term investments in foreign securities may increase the risks associated with FX settlement during times of market duress. To further improve banks' management of FX settlement-related risks, the BCBS issued *Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions*[51] in February 2013. The guidance is based on the principle that a bank should manage FX settlement-related risks in a similar way as it would manage equivalent risks from other activities, taking into account any features that are specific to FX. It essentially focuses on seven areas – governance, principal risk, replacement cost risk, liquidity risk, operational risk, legal risk, and capital for FX transactions.

RSAs are to incorporate the guidelines into their framework and assess the banks' compliance in meeting the guidelines, taking into consideration the size, nature, complexity and risk profile of the banks' activities. The authorities should also undertake corrective measures should a bank's management of FX settlement-related risks be found to be insufficient.

The IFSI has witnessed rapid expansion over the years and has become increasingly globally integrated, including both Muslim and non-Muslim countries. An increase in the number of financial intermediaries has also helped to facilitate cross-border trade and financing activities. Leading Islamic banks from various jurisdictions are establishing their operations in other parts of the world, as witnessed in Asia, GCC, Europe and Africa. From the regulatory perspective, the IIFM has taken the initiative to develop standardisation of Islamic financial products, documentation and related processes that will facilitate cross-border Islamic hedging, risk management and money market activities. There are particular *Sharī`ah* issues around FX

[50] www.ifsb.org/docs/ED-16_Revised%20Standard%20on%20Supervisory%20Review%20Process%20%20(Final-31%20October%202013).pdf

[51] www.bis.org/publ/bcbs241.pdf. The document is an update and replacement of the BCBS's *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions* issued in 2000.

trading, other than on a spot basis, in Islamic finance, which the IIFM work – for example, the ISDA/IIFM *Tahawwut* Master Agreement for hedging – has sought to address. However, further research needs to be undertaken in relation to risk management and mitigation, liquidity management and hedging, in the management of FX settlement-related risks by Islamic banks.

(d) Measuring and controlling large exposures

In March 2013, the BCBS published a consultative document, *Supervisory Framework for Measuring and Controlling Large Exposures*,[52] to ensure that banks as well as RSAs adopt a more consistent approach in measuring, aggregating and controlling exposures to single private-sector counterparties and a group of connected counterparties. This framework would complement the BCBS's risk-based capital standard, as the latter does not address the issue of large losses resulting from the sudden default of a single counterparty. The scope of the proposed standard covers exposures to (a) counterparties across all operations and books, (b) providers of credit protection, and (c) components of the shadow banking system – namely, funds, securitisation structures and collective investment undertakings.

The IFSB's Exposure Draft-16: *Revised Guidance on Key Elements in the Supervisory Review Process* also addressed, *inter alia*, the issues of risk concentration.[53] RSAs have been advised to assess the extent of an IIFS's credit and counterparty risk concentrations, how they are managed, and the extent to which the IIFS considers them in its internal capital adequacy assessment process under Pillar 2 of the Basel II framework. Such assessments should also include reviews of the results of an IIFS's stress tests.[54] To mitigate concentration risk, IIFS should set limits to their exposures by having a limit specific to each particular counterparty or group of related counterparties (large exposure limit).

(e) Strengthening the capital adequacy framework

In June 2013, the BCBS published a consultative document, *Revised Basel III Leverage Ratio Framework and Disclosure Requirements*,[55] to serve as a supplementary measure to the risk-based capital requirements. The document provides a specific formulation for calculating the leverage ratio by banks subject to the Basel III framework, as well as a set of public disclosure requirements. The leverage ratio, which is set at a minimum of 3% during the parallel run period (2013–2017),[56] is expected to help limit the build-up of leverage in the banking system and protect against model risk and measurement error. Banks are expected to start disclosing their leverage ratio from 1 January 2015. The formulation of the leverage ratio achieves international consistency in exposure measurement so as to ensure that investors and other stakeholders have comparable data and information on the leverage of banks.

In general, Islamic finance is less prone to engage in highly leveraged products, mainly due to *Sharī`ah* requirements that all financing be linked to transactions in the real economy, and restrictions on debt trading and engaging in products involving undue and excessive speculation (*Gharar*). However, there are a few practices and structures which may subject IIFS to leveraged transactions, such as: (a) deposit based on reverse Commodity *Murābahah* transactions (CMT) and CMT-based term financing; (b) structured products that create cash-flow or delivery obligations linked to the performance of a defined underlying benchmark; (c)

[52] www.bis.org/publ/bcbs246.pdf. The consultative paper would replace the Basel Committee's 1991 guidance on *Measuring and Controlling Large Credit Exposures*.
[53] "Risk concentration" is defined as "any single exposure or group of similar exposures (e.g. to the same 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".
[54] For concentration risk-related stress testing, both IIFS and supervisory authorities should be guided by IFSB-13: *Guiding Principles on Stress Testing for Institutions offering Islamic Financial Services*.
[55] www.bis.org/publ/bcbs251.pdf
[56] Final adjustments to the definition and calibration of the leverage ratio will be made by 2017, with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration.

Sharī`ah-compliant hedging contracts such as profit rate swaps and foreign currency swaps which are mainly CMT- or *Wa'd*-based contracts; and (d) asset-based *Sukūk* with structures where the cash flows are de-linked from the underlying assets, while providing leverage to the originators and/or issuers.

In this regard, the IFSB, in its IFSB-15: *Revised Capital Adequacy Standard*, considers it prudent that RSAs apply the leverage ratio requirements to IIFS so as to provide a level playing field for IIFS vis-à-vis conventional institutions and be consistent with emerging international practices. The formula for calculation of the leverage ratio is:

Leverage ratio = Tier 1 Capital ÷ Total exposure ≥ 3%

where the numerator of the leverage ratio shall be Tier 1 Capital as defined in IFSB-15 and the calculation of total exposure for the leverage ratio should generally follow the accounting measures of exposures, as per parameters defined in the Standard.

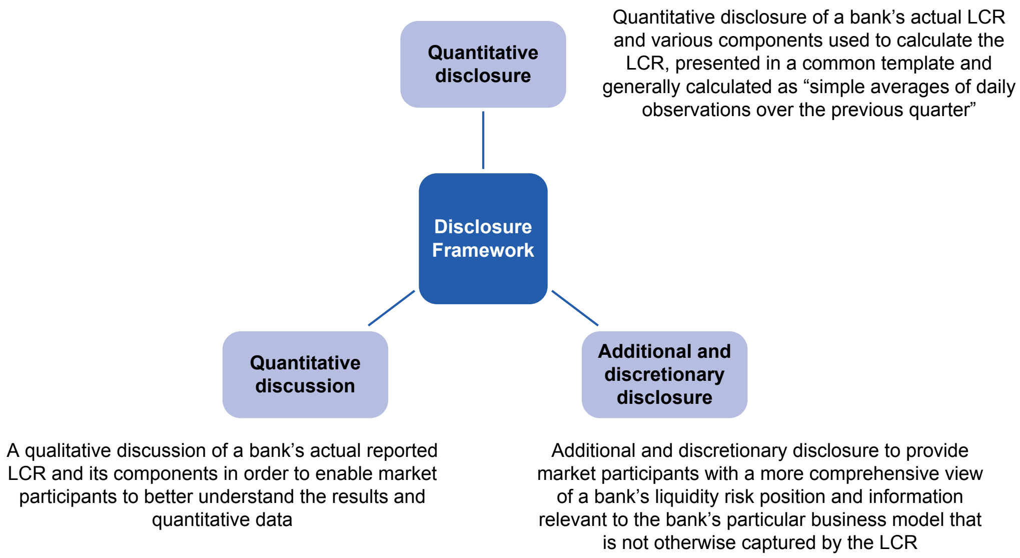
Many RSAs of IIFS will commence implementation of the leverage ratio from 1 January 2014, and the ratio will apply at the level of the individual IIFS (including Islamic investment banks) as well as on a consolidated basis. Moving forward, the IFSB will continue to work closely with the member RSAs to assess the parameters suggested in the IFSB Standard – numerator, denominator, overall ratio, accounting standards and practices, and interaction with capital requirements – and will consider making any adjustments to the leverage ratio at a suitable time.

(f) Liquidity coverage ratio disclosure standards

In January 2014, the BCBS published a final document, *Liquidity Coverage Ratio Disclosure Standards*,[57] which outlines new disclosure requirements with respect to the LCR. These requirements will improve the transparency of the LCR, reduce uncertainty, enhance market discipline, and educate market participants as the LCR is implemented. A common disclosure framework is important for market participants assessing the liquidity risk position of banks and promoting consistency and ease of use of disclosures related to the LCR. These requirements will apply to all internationally active banks. However, national RSAs may also apply these disclosure requirements to other banks to ensure greater consistency. The proposed disclosure framework consists of three main components, namely: (a) quantitative disclosure of a bank's actual LCR; (b) qualitative discussion of a bank's actual reported LCR; and (c) additional and discretionary disclosure, which may include governance of liquidity risk management, funding strategy, liquidity risk mitigation techniques, an explanation of how stress testing is used, and an outline of contingency funding plans.

[57] www.bis.org/publ/bcbs272.pdf. National authorities will give effect to the liquidity disclosure requirements by no later than 1 January 2015.

Diagram 2.1.3.3: The Three Main Components of the BCBS Proposed Disclosure Framework



Source: BCBS

Public disclosure improves transparency, reduces uncertainty in the markets and strengthens market discipline. It is important for both conventional banks and IIFS to adopt a common disclosure framework to help market participants consistently assess the liquidity risk position of both IIFS and the conventional counterparts. There are, however, some challenges related to disclosure of liquidity positions under certain circumstances – such as during market duress – including the potential for undesirable dynamics during stress. There is a need for an appropriate balance between the desirability of meaningful disclosure and the protection of proprietary and confidential information. The BCBS document suggests quantitative disclosure based on simple averages of daily observations over the previous 90 days, and that these should be disclosed on a regular basis through financial reports or other available methods according to the RSAs' discretion; these proposals are similar to the BCBS's disclosure requirements for LCR. In circumstances where a particular detailed disclosure might significantly jeopardise the position of the IIFS, a more general but adequately informative disclosure would be appropriate, subject to supervisory discretion in qualitative and additional disclosure. In addition to proprietary information, there are concerns about disclosure portraying a positive picture of the risk management practices and policies of an IIFS, which itself can be considered as a type of "misinformation". To address these undesirable results of disclosure, both on stress and normal times, RSAs should carefully formulate the disclosure framework. The IFSB will also provide details on disclosure of LCR for IIFS in the upcoming Guidance Notes on quantitative measures for IIFS.

(g) Trading book

In October 2013, the BCBS issued a second consultative paper – *Fundamental Review of the Trading Book: A Revised Market Risk Framework*[58] – as part of its effort to address weaknesses in risk measurement under the current internal models-based and standardised approaches. The paper comprises a detailed set of proposals for a comprehensive revision of the market risk framework. The key features of the proposed revised framework include: (a) a

[58] www.bis.org/publ/bcbs265.pdf

revised boundary between the trading book and banking book that aligns with banks' risk management practices; (b) a revised risk measurement approach and calibration; (c) the incorporation of the risk of market illiquidity; (d) a revised standardised approach that is sufficiently risk-sensitive to act as a credible fallback to internal models; (e) a revised internal models-based approach; (f) a strengthened relationship between the standardised and the models-based approaches; and (g) a closer alignment between the trading book and the banking book in the regulatory treatment of credit risk.

IFSB-15: *Revised Capital Adequacy Standard* states that the risks in IIFS that are subject to the market risk capital requirement are: (a) equity position risk in the trading book; (b) benchmark risk in trading positions in *Sukūk*; (c) foreign exchange risk; and (d) commodities and inventory risk. However, the calculation of market risk in IIFS is relatively less complex due to the non-utilisation of a number of sophisticated products commonly used by conventional banks. The IFSB will assess the need for any further guidance on this, taking into consideration the results of the BCBS consultations, when it reviews the final document in 2014.

(h) Prudential treatment of banks' equity investment in funds

In line with the FSB's initiatives to strengthen the oversight and regulation of shadow banking, in December 2013 the BCBS published *Capital Requirements for Banks' Equity Investments in Funds*,[59] which would revise the prudential treatment of banks' equity investments in funds to appropriately reflect the risk of a fund's underlying investments and its leverage. The framework, which is applicable to banks' equity investments in all types of funds (including off-balance sheet exposures) such as private equity and venture capital funds, is expected to help address risks associated with banks' interactions with shadow banking entities.

An IIFS may provide equity financing and hold investments made under profit- and loss-sharing modes (*Mushārakah*) or profit-sharing and loss-bearing modes (*Muḍārabah*) which may be used, *inter alia*, to invest in a number of ventures that are (a) not held with the intent of trading or short-term resale benefiting from actual or expected price movements, (b) not marked-to-market on a daily basis, (c) not actively monitored with reference to market sources, and (d) exposed to credit risk in the form of capital impairment risk.[60] To address this, IFSB-15: *Revised Capital Adequacy Standard* looks at the exposures of the IIFS that are held not for trading but for the purpose of earning investment returns from medium- to long-term financing (i.e. held in the banking book). The Standard contains a section on the exposures in investments made under the profit-sharing models, as well as the risk weight assigned to each type of investment.

[59] www.bis.org/publ/bcbs266.pdf. The revised policy framework will take effect from 1 January 2017 and will apply to investments in all types of funds (e.g. hedge funds, managed funds, investment funds).

[60] Under both *Mushārakah* and *Muḍārabah* financing, the capital invested by the provider of finance is not guaranteed as it is not a debt, but is explicitly exposed to impairment in the event of losses – that is, to capital impairment risk.

Table 2.1.3.3: Risk Weight Assigned for Equity Based Financing and Investment

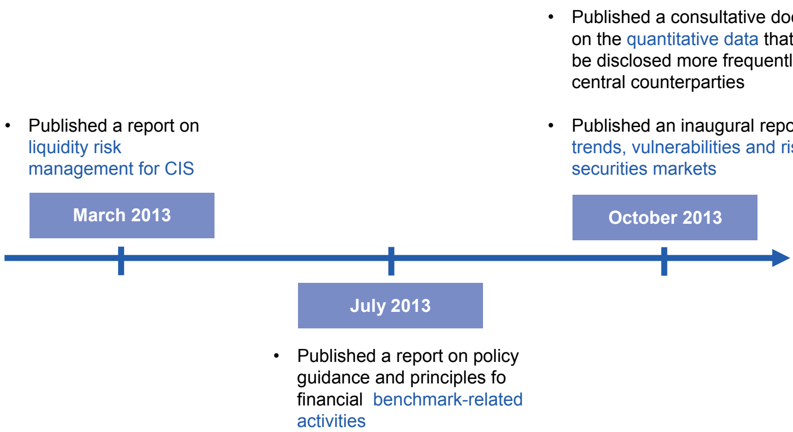
Profit-Sharing Investment	Risk Weight Assigned
(i) A **commercial enterprise to undertake a business venture** (with the intention of holding the investment for an indefinite period or with a view to eventual sale, such as venture capital investments or privately held equity)	• Simple risk-weight method: ○ For *Mushārakah* or *Muḍārabah* investments in commercial enterprises whose common shares are listed on a recognised security exchange, a 300% risk weight is to be applied. ○ For *Mushārakah* or *Muḍārabah* investments in all other enterprises, a 400% risk weight will be applicable. • Supervisory slotting method: ○ Employed in appropriate cases related mostly to project finance or business ventures. The risk weights include an additional fixed factor of 20% risk weight to cater for the potential decline in the *Muḍārabah*'s or *Mushārakah*'s net asset value Risk weights (%) Strong 90 Good 110 Satisfactory 135 Weak 270
(ii) **Diminishing *Mushārakah*** in which the share of the IIFS can be gradually reduced during the tenure of the contact until the asset is fully sold to the partner(s)	• When the contract is related to a specific fixed asset/real estate leased to a customer under an *Ijārah* contract, the *Mushārakah* investment shall be assigned a risk weight based on the credit standing of the counterparty/lessee, and a 100% risk weight on the residual value of an asset. In case the counterparty is unrated, a risk weight of 100% shall apply.
(iii) **Equity investments in a company or funds not held for short-term resale or trading purposes**	• Such a holding is not a trading book exposure, and thus the exposure is that of an equity position in the banking book. • However, if such an investment is in an entity or fund that is publicly listed, a 300% risk weight shall be applied. Likewise, a 400% risk weight shall be applied to all other equity holdings.
(iv) **A specific project**	• In a *Muḍārabah* structure where the IIFS (as investor) advances funds as *Rabbal-Māl* (capital owner) to the construction company (as *Muḍārib*) for the construction project, the IIFS is exposed to the risk on the amounts advanced to the *Muḍārib* (labour provider). As these amounts are made on a profit-sharing and loss-bearing basis, they are treated under credit risk as "equity positions in the 'banking book'". Here, the risk weight will be based entirely on the credit standing of the *Muḍārib*– i.e. say, 100%, rather than 400%.
(v) A joint ownership of real assets or moveable assets (such as cars and machinery) on a ***Mushārakah* basis for onward lease or sale on an *Ijārah* or a *Murābahah* basis**, respectively	• In the case of *Ijārah*, the *Mushārakah* investment shall be assigned a risk weight based on the credit standing of the counterparty/lessee, as rated by a supervisor-approved ECAI, and a 100% RW on the residual value of the *Ijārah* asset. In case the counterparty is unrated, a risk weight of 100% shall apply. • In the case of *Murābahah*, the *Mushārakah* investment shall be assigned a risk weight based on the credit standing of the counterparty/buyer, as rated by a supervisor-approved ECAI. In the event the counterparty is unrated, a risk weight of 100% shall apply.

Source: IFSB-15: Revised Capital Adequacy Standard

2.1.4 International Organization of Securities Commissions

Some of the initiatives undertaken by IOSCO in 2013 were in the areas of risks, transparency and disclosure, as shown in Diagram 2.1.4.1.

Diagram 2.1.4.1: International Organization of Securities Commissions: Selected Initiatives in 2013



Source: IOSCO

(a) Liquidity risk management for collective investment schemes

Since the outbreak of the GFC, the issue of liquidity has been a major concern for not only the RSAs of the banking sector, but also those of the capital market – in particular, in the context of the operation of a CIS. The right to redeem units/shares is a defining characteristic of open-ended CIS, and good liquidity risk management is therefore of particular importance to them; however, closed-ended funds may also face liquidity issues – for example, as a result of margin calls. In March 2013, IOSCO published *Principles of Liquidity Risk Management for Collective Investment Schemes*[61] to provide principles against which the industry and RSAs can assess the quality of regulation and industry practices concerning liquidity risk management for CIS.

ICIS face broadly the same issues in regard to liquidity as CIS. However, the limitations on short selling and leverage reduce the complexity of the issues and the likelihood of problems, except where the ICIS invests in inherently illiquid assets. On the other hand, the tools available to manage liquidity will also be limited by *Sharī`ah* considerations. At the level of principles, the IOSCO standards appear applicable to ICIS, and work in this area is not a high priority for the IFSB.

[61] www.iosco.org/library/pubdocs/pdf/IOSCOPD405.pdf

(b) Financial benchmarks

Benchmarks are important as they serve as a "core reference point" for the whole set of financing and products used in the global financial system. Given the problems arising from the fixing of the London Interbank Offered Rate in July 2013, IOSCO published *Principles for Financial Benchmarks*,[62] which articulates policy guidance and principles for benchmark-related activities that will address conflicts of interest in the benchmark-setting process, as well as transparency and openness when considering issues related to transition. The principles form an integral part of IOSCO´s efforts to enhance the integrity, reliability and oversight of benchmarks by establishing guidelines for benchmark administrators and other relevant bodies in the following areas:

- **Governance.** To ensure that administrators will have appropriate governance arrangements in place in order to protect the integrity of the benchmark determination process and to address conflicts of interest.
- **Quality of the benchmark.** To promote the quality and integrity of benchmark determinations through the application of design factors that result in a benchmark that reflects a credible market for an interest measured by that benchmark.
- **Quality of the methodology.** To promote the quality and integrity of methodologies by setting out minimum information that should be addressed within a methodology. These principles also call for credible transition policies in case a benchmark may cease to exist due to a market structure change.
- **Accountability mechanisms.** To establish compliant processes, documentation requirements and audit reviews in order to provide evidence of compliance by the administrator with its quality standards.

Benchmarks are crucial as they serve as reference points for the financial system. Currently, most of the benchmarks used by the IIFS for their *Sharī`ah*-compliant transactions are conventional benchmarks. While most *Sharī`ah* scholars allow this for the time being, there have been calls for new benchmarks for the IFSI, reflecting differences in principle from conventional finance, especially in the allocation of risk. To the extent that new benchmarks become significant, RSAs will need to take account of the IOSCO recommendations, especially in regard to their design and governance, to ensure their integrity and reliability.

(c) Disclosure of quantitative data by central counterparties

In October 2013, the CPSS and IOSCO published a consultative document entitled *Public Quantitative Disclosure Standards for Central Counterparties*[63] that set out guidance on the quantitative data that CCPs should disclose more frequently. Taken together with the CPSS–IOSCO *Disclosure Framework for Financial Market Infrastructures* (Disclosure Framework),[64] which was published in December 2012 to promote consistent and comprehensive public disclosure by FMIs in line with the requirements of the *Principles for Financial Market Infrastructures*, this document is expected to assist authorities, participants (direct, indirect and prospective), other stakeholders and the public to: (a) compare CCP risk controls, including financial condition and financial resources to withstand potential losses; (b) have a clear, accurate and full understanding of the risks associated with a CCP; (c) understand and assess a CCP's systemic importance and its impact on systemic risk; and (d) understand and assess the risks of participating in CCPs (directly and indirectly).

At present, the CCPs which serve the ICM also serve the conventional market and are generally structured as conventional institutions. In addition, because of the *Sharī`ah* limitations

[62] www.iosco.org/library/pubdocs/pdf/IOSCOPD415.pdf
[63] www.bis.org/publ/cpss114.pdf
[64] www.bis.org/publ/cpss106.pdf. The CPSS–IOSCO disclosure framework is intended to promote consistent and comprehensive public disclosure by FMIs in line with the requirements of the *Principles for Financial Market Infrastructures*.

on the instruments that IIFS may hold and trade, the transactions cleared through CCPs are somewhat restricted. No work has yet been done on the specific risks that CCPs structured as Islamic institutions might face, and until there is greater experience of structuring and managing such institutions it would be premature to undertake further regulatory work in this area.

(d) Trends, vulnerabilities and risks in securities markets

As the financial system moves towards a more market-based, interconnected, financing model, this necessitates strong, transparent and appropriately regulated securities markets to ensure the sound functioning of the global economy and its recovery. In relation to this, in October 2013, IOSCO published *Securities Markets Risk Outlook 2013–2014*,[65] the first of an annual series, which highlighted important trends, vulnerabilities and risks in securities markets that may be of concern from a systemic perspective. It also aimed to provide IOSCO members with relevant information required to adopt a forward-looking approach in dealing with potential vulnerabilities and risks to global securities markets and the global financial system as a whole. The report identified and analysed four main risks, as follows:

(i) **Risks related to low interest rate environment**. Expansionary monetary policies have reduced interest rates to the point that real rates are at times negative. This may create potential risks for securities markets. In particular, a search for yield is turning investors towards leverage products such as collateralised debt obligations (CDOs) and leveraged real estate investment funds.

(ii) **Risks related to collateral management.** In response to global policy requirements, demand from investment firms for high-quality collateral has increased significantly. This growing demand has altered the balance of collateral in the system, diminishing the availability of high-quality collateral, and could impact pricing.

(iii) **Risks related to derivatives markets:** OTC derivatives markets have undergone significant reform since the financial crisis. This reform entails the mandatory clearing of derivative contracts through CCPs. But shifting the risk from bilateral OTC contracts to a single point of infrastructure is a challenging balancing act.

(iv) **Risks related to capital flows of emerging markets:** Emerging market economies have experienced significant capital inflows in the post-crisis era. Debt securities and non-bank lending have overtaken foreign direct investment and banking lending as the main source of these capital inflows. After the announcement of the tapering of the expansionary monetary policies of the Fed, a sudden reversal in capital inflow occurred, highlighting the need for further structural reforms aimed at making securities markets more resilient.

The implications of these developments for the IFSI are in part analysed in Chapter 3. But they also inform the regulatory agenda – for example, in relation to the risks associated with CCPs.

(e) Disclosure requirements for Islamic capital market products

In view of the growing cross-border transactions and activities in the Islamic capital market (ICM) within the global financial landscape, the IFSB recognises the need to complement the increasing internationalisation of ICM with a favourable regulatory environment. It also highlights the need to approach investor protection and market integrity from a cross-jurisdictional perspective, and for some degree of standardisation, including disclosure requirements.

[65] www.iosco.org/library/pubdocs/pdf/IOSCOPD426.pdf

Given this background, on 18 September 2012, the IFSB collaborated with IOSCO and Securities Commission Malaysia to co-organise in Kuala Lumpur, Malaysia, a Roundtable on *Disclosure of Islamic Capital Market Products*. Following this, a joint publication, *Disclosure Requirements for Islamic Capital Market Products*,[66] was released at the IOSCO 38th Annual Conference in Luxembourg in September 2013[67] to help strengthen the disclosure regime for the ICM and promote overall investor confidence in the ICM segment. The publication, which is available for free download from the IFSB website, is a compilation of the Issues Papers and commentaries presented at the IFSB–IOSCO–SC Roundtable[68] and discusses the need to develop international regulatory standards and best practices relating to disclosure requirements for ICM products. It analyses the issues, risks and challenges arising from potential inadequate disclosure in the areas of *Sukūk* and Islamic CIS, and analyses ways to strengthen disclosure standards for such products.

The Roundtable highlighted several issues, namely on legal and regulatory matters, *Sharī`ah* compliance and governance, *Sukūk* structures, and ownership of assets (these issues are discussed in more detail below) that may require further study to strengthen the framework for disclosure requirements for ICM products. Greater collaboration and cooperation among international standard setters and regulatory authorities will also facilitate a better understanding of the challenges arising from inadequate disclosure, and the importance of a strong disclosure regime in encouraging cross-border activities in the ICM.

Introducing disclosure requirements specific to the ICM will help close the gaps that currently exist in the offering of related products and services, and achieve overall transparency in this market segment. Standardised disclosures across jurisdictions where ICM products and services are offered can also help to reduce systemic risks and strengthen confidence in the market. Such initiatives further underscore the importance of the ICM within the global financial landscape and reinforce the importance of issues surrounding investor protection and market integrity from a cross-jurisdictional perspective.

2.1.5 International Association of Insurance Supervisors

In October 2011, when the IAIS adopted the revised *Insurance Core Principles* (ICPs), a three-year development phase was subsequently initiated which included the issuance of the draft of the Common Framework (ComFrame) for the Supervision of Internationally Active Insurance Groups (IAIGs) in July 2012. While the objective of the revised ICPs was to provide an updated framework for insurance supervision generally, partly informed by issues identified during the financial crisis, ComFrame on the other hand was initiated as a basis for structured cooperation among RSAs of internationally active insurers.

[66] www.ifsb.org/docs/Disclosure%20Requirements%20for%20ICM%20Products-final%2017102013.pdf
[67] The book´s release follows earlier ICM initiatives by IOSCO: the publication of *Islamic Capital Market Fact Finding Report* in 2004 and *Analysis of the Application of IOSCO's Objectives and Principles of Securities Regulation for Islamic Securities Products* in 2008. The first report concluded that the IOSCO Objectives and Principles of Securities Regulation would apply equally to the ICM, a view supported by the 2008 report with recommendations that included the need for further thematic work on disclosure standards.
[68] www.ifsb.org/docs/Disclosure%20Requirements%20for%20ICM%20Products-final%2017102013.pdf

Diagram 2.1.5.1: International Association of Insurance Supervisors: Benchmark of Activities

July 2013	• Issued policy measure to assess conglomerates and insurance groups which would cause disruption to the insurance industry
End-2014	• To finalise the development of the backstop capital requirements for all group activities
End-2015	• To finalise the development of implementation details of HLA

Source: IAIS

In July 2013, the IAIS issued the global systemically important insurers (G-SIIs): Policy Measure in its effort to work together with the FSB in identifying G-SIFIs. The IAIS has developed an assessment methodology to assess conglomerates and insurance groups which, due to their size and complexity of framework, might cause disruption to the insurance industry. The purpose of these policy measures, among others, is to have the following:

(a) enhanced supervision of all G-SIIs around the globe;

(b) increased resolvability to help reduce the impact of a G-SII failing;

(c) Loss Absorbency (LA) capacity whereby G-SIIs will be required to hold regulatory capital for all group activities; and

(d) Higher Loss Absorbency (HLA) capacity if the G-SII is involved with Non-Traditional Insurance and Financial Non-insurance (NTNI) activities.

Diagram 2.1.5.2: Timeline for New Rules

Immediately	• Enhanced Supervision
July 2014	• Systemic Risk Management Plan (SRMP)
End 2014	• Recovery and Resolution Plans (RRP) and Liquidity Plans to be completed
2015	• Basic Capital Requirements (BCRs) for G-SII group activities
January 2019	• Higher Loss Absorbency (HLA) capacity to apply to November 2017 G-SIIs

Source: IAIS

Within this context, the IAIS expects that by the end of 2014, the development of the basic capital requirements (BCRs) for G-SII will be finalised. This will cover all activities of the relevant group, within a risk-based approach. The other components of the regulatory framework will follow. Using the IAIS assessment methodology based on 2011 data, the FSB has identified an initial list of nine G-SIIs[69] to which the new policy measures should apply (though, of course, the list may change prior to implementation).

The IAIS had announced its intention on 9 October 2013 to develop a risk-based global insurance capital standard (ICS) as part of the ComFrame. This reflected the IAIS's view that insurance is a global business and such global issues require global coordination and cooperation to ensure soundness and standardisation. The IAIS is committed to the full development of the ICS by 2016, in which case full implementation will begin in 2019 after two years of testing and refinement with IAIGs and its RSAs.

While the group-wide supervision regulations are strengthened through the development of ICS, the IAIS is at the same time working on regulating issues concerning inclusive insurance. The Financial Inclusion Subcommittee (FISc) was established in 2012 to address matters concerning financial inclusion and other specific forms of insurance for lower-income groups as well as addressing specific implementation issues in those areas. In addition, this committee aims to work with other standard-setting organisations, especially in the area of *Takāful* with the IFSB. While focusing on its mandate to promote the application of the IAIS Core Principles in emerging markets and developing economies, the FISc will enhance and promote the strengthening of the capacity of policymakers and supervisory authorities which are in the process of opening up access to insurance to lower-income consumers.

The IFSI holds its own niche in the global financial system. However, this does not relieve the IFSI from being impacted by the developments made by the conventional industry. Likewise for the *Takāful* industry, any initiatives taken by the IAIS are likely to impact the regulations set forth for the Islamic insurance, widely known as *Takāful* operators.

Although no *Takāful* or *ReTakāful* operations are themselves systemically significant as yet, some are parts of systemically significant groups. In addition, the experience of the Basel Accords suggests that the ICS may come to be applied more widely than the IAIGs for which it is being designed. The IFSB will therefore monitor its development carefully, and consider what work is needed to adapt it for the specificities of *Takāful* and *ReTakāful*.

Key aspects of these specificities have to do with the structure of *Takāful* undertakings, which must respect the principle of mutual sharing of risk. Although, in some jurisdictions, they may be operated as pure mutual, a more typical structure involves one or more funds belonging to the participants within a shareholder company. The contractual basis of the interactions between these, and in particular between participants' and shareholders' funds, varies within the IFSI.

The IFSB's work on *Takāful*, notably IFSB-11,[70] published in 2010, has defined a solvency framework for *Takāful* which is based on, and broadly consistent with, the current IAIS standards. It will, however, need to consider very carefully the implications of the ComFrame developments, and also to work on *ReTakāful* (see below).

From the perspective of financial inclusion, the IFSI sees a surge of interest throughout the industry to make financial services accessible by the lower-income group. This is evident as more focus has been directed towards the creation of products with affordable fees. This new phenomenon, however, has yet to be regulated consistently by RSAs. The initiative taken by the IAIS is hence echoed by the

[69] https://www.financialstabilityboard.org/publications/r_130718.pdf
[70] *Standard on Solvency Requirements for Takaful (Islamic Insurance) Undertakings.*

IFSB. Both organisations have agreed on developing an Application Paper for Micro-*Takāful.* With the Joint Application Paper, the IFSB envisions charting a direction for the Micro-*Takāful* regulatory areas in which guidance may be provided to RSAs of jurisdictions wishing to expand the supervisory framework specifically to cover Micro-*Takāful* activities.

2.2 Recent Initiatives Undertaken by the IFSB

2.2.1 Published Standards

In line with the mandate to develop prudential standards and guidelines to promote the soundness and stability of the IFSI, the Council of the IFSB in its 23rd meeting held in December 2013 resolved to approve the adoption of two new Standards, namely: (a) IFSB-14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings*, and (b) IFSB-15: *The Revised Capital Adequacy Standard for Institutions offering Islamic Financial Services*.

(a) IFSB-14: Standard on Risk Management for *Takāful* Undertakings

TheIFSB-14: *Standard on Risk Management for Takāful (Islamic Insurance) Undertakings* was developed to help the *Takāful* industry understand the types of risks faced by *Takāful* operators. It is envisioned that recommended minimum standards for developing a proper risk management framework will create a safe and prudent environment for sustainability and development of the *Takāful* industry. The document, which is applicable to all types of *Takāful* or Islamic insurance models, focuses on the risk management of individual *Takāful* undertakings.

Consistent with the minimum risk management standards of the conventional insurers, the document highlights the three major risks which are specific to the models of *Takāful*:

(i) **Risk of *Sharī`ah* non-compliance.** It is essential that each *Takāful* operator keeps in mind that the core reason for its existence is to uphold the principles of *Sharī`ah*. This is a risk that is unique to *Takāful* operators. Any breach of this requirement will render a contract invalid under *Sharī`ah*. It may also deprive a participant of *Takāful* protection, cause loss to the entity, damage its reputation and, to a certain extent, expose it to regulatory action.

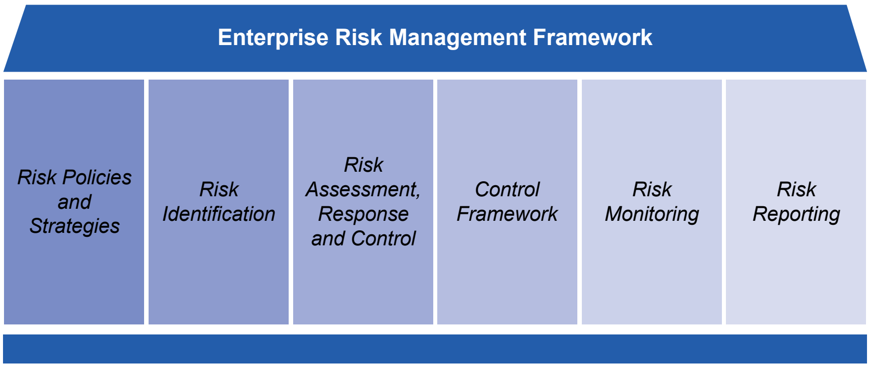
(ii) **Risks arising from segregation of funds.** *Takāful* operators need to ensure that shareholders' funds are kept separate from participants' risk/investment funds. The different fiduciary roles played by the *Takāful* operators requires them to strike the right balance to ensure that the interests of the shareholders, participants and all other stakeholders are taken into consideration in daily operational matters.

(iii) **Risks relating to the use of *ReTakāful.*** The development of the *Takāful* industry has been accompanied by differing views as to the validity under *Sharī`ah* of the use of conventional reinsurance by *Takāful* and *ReTakāful* undertakings. In addition, differences have emerged in the manner in which individual *Retakāful* contracts are effected and the attribution of revenues and expenses between funds. *Takāful* operators need to ensure both transparency and fairness in this attribution. A *Takāful* operator also needs to consider the financial status of any risk pool that will be used to share the risks. The selection of *ReTakāful* (or reinsurance) providers should therefore be subject to the due diligence and appropriate governance, with monitoring of exposures to individual providers and risk pools.

Subsequent to highlighting these three risks as being specific to *Takāful* undertakings, IFSB-14 further illustrates other common risks faced by *Takāful* operators, which share certain similarities with conventional insurers – namely, operational risk, underwriting risk, market risk, credit risk, liquidity risk, and legal and compliance risk. The document further elaborated on some of the sub-risks that fall under the six main categories which may be specific only to *Takāful* undertakings. These include credit risks due to the inability of the participants' risk fund (PRF) to repay *Qarḍ* to the shareholders of the *Takāful* undertaking, as well as reputational risk which may be due to inability to comply with *Sharī`ah* principles.

The document concludes by highlighting the need for a *Takāful* operator to have a comprehensive risk management framework. The main structure of the framework should consist of the main elements shown in Diagram 2.2.2.1.

Diagram 2.2.1.1: Sample Enterprise Risk Management Framework



Source: IFSB

With respect to the role of RSAs, the document recommends that they should pay particular attention to the existence and robustness of a risk management framework in every *Takāful* undertaking entity. Although it not normally the responsibility of the RSAs to give positive approval to a *Takāful* undertaking's risk management framework, it is advisable that attention is given to the qualitative aspects of risk governance to ensure that the risk governance functions are carried out by persons who are appropriately skilled for their functions. In addition, RSAs should consider the implementation of formal requirements for *Takāful* operators to report to the supervisory authority in respect of risk management. The frequency and scope of such reporting requirements may be responsive to the nature, scale and complexity of an individual *Takāful* undertaking's business.

(b) IFSB-15: Revised Capital Adequacy Standard for Institutions offering Islamic Financial Services

IFSB-15: *Revised Capital Adequacy Standard* is a revised and enhanced version of two previous IFSB standards on capital adequacy, namely IFSB-2: *Capital Adequacy Standard for IIFS* (2005) and IFSB-7: *Capital Adequacy Requirements for Sukūk, Securitisations and Real Estate Investments* (2009). The Standard also adopts key Basel III proposals on capital components, the leverage ratio and buffers for the IIFS.

IFSB-15 aims to assist the implementation of a capital adequacy framework that will ensure effective coverage of risk exposures of the IIFS and allocation of appropriate capital to cover these risks, based predominantly on the Standardised Approach. In order to achieve these objectives, the Standard provides guidance on the features and criteria for high-quality regulatory capital components, including Additional Tier 1 and Tier 2, which comply with *Sharī`ah* rules and principles. Similarly, IFSB-15 provides new guidance on tools such as capital buffers, leverage ratio and D-SIBs, which will facilitate supervisory authorities in achieving the goal of protecting the banking system and the real economy from system-wide shocks. The Standard has also expanded earlier guidance on the capital adequacy treatment of various *Sharī`ah*-compliant contracts. These contracts include Commodity *Murābahah, Wakālah and Qarḍ al-Hasan.*

IFSB-15 also provides more elaborate guidance on the capital adequacy treatment of various risk exposures related to *Sharī`ah*-compliant products and services, including *Sukūk*, securitisation and real estate. The Standard has revised and consolidated earlier guidance on the treatment of profit-sharing modes of financing, as well as expanded guidance on credit risk mitigation (CRM) techniques and the calculation of capital charges for various approaches of market and operational risks. These revisions endeavour to enhance the loss absorption capacity of the IIFS and to provide a more comprehensive framework for the application of risk weights aligned closely to the underlying risk exposures.

Components of Capital

Under the Basel II capital regime, loss absorbency under Tier 2 instruments was achieved through the subordination of capital instruments. In this structure, subordinated debt holders will only receive their repayment in liquidation if all depositors and senior creditors are repaid in full. Basel II also permitted the use of hybrid capital instruments which have the features of both debt and equity. The use of subordinated instruments, however, did not turn out to be as intended during the GFC, as holders of subordinated capital instruments did not suffer any loss as some major distressed banks were rescued by the injection of capital from the public sector. As a result, the focus of regulatory bodies has shifted from subordinated capital to Core Tier 1 Capital (common equity) – which is endowed with such characteristics as permanence and loss absorbency – and which has become the primary indicator of the soundness of a bank.

As a result, Basel III not only shifted its emphasis to better quality of capital through Common Equity Tier 1, which has qualities such as permanence and loss absorbency; it also tried to distinguish more clearly between the various components of regulatory capital from the standpoint of their effectiveness in going-concern and gone-concern situations. According to this regime, capital has a role in absorbing losses while the bank is still a going concern – both when it is in a state of financial health and during periods of financial stress – thereby maintaining confidence in the financial system and avoiding disruption to fund providers. It also plays a role in absorbing losses when the bank reaches the point of non-viability and in the event of winding up (a gone-concern scenario), thus protecting the fund providers. Another feature of the new regulatory reforms was the introduction of a “bail-in” feature in capital instruments through the elements of write-off or conversion to common equity upon the occurrence of some trigger events. This is to ensure that regulatory capital could absorb losses before government support, in the form of taxpayers’ money, is provided to the banking institutions.

IFSB-2 and later IFSB standards on capital adequacy did not offer guidance on regulatory capital components. However, some IIFS issued subordinated *Sukūk* that, under the Basel II regime, qualified as Tier-2 regulatory capital. Almost all such *Sukūk* were *Mushārakah*- or *Muḍārabah*-based *Sukūk* that were “general obligation ”*Sukūk*, in the sense that they were linked neither to any specific project nor to any underlying asset. Instead, the proceeds of the *Sukūk* were fully or partially commingled in the general pool of *Sharī`ah*-compliant assets of the IIFS. In the majority of these *Sukūk* structures, a partnership was formed between the *Sukūk* holders and the IIFS. In a few cases, however, a combination of *Mushārakah* and *Muḍārabah* principles was used, where the IIFS played the role of a *Muḍārib* (manager) of and a *Mushārik* (partner) in the ownership of the asset portfolio of the IIFS.

Consistent with Basel III, three components of capital have been included in IFSB-15. The eligible capital for IIFS is the sum of Tier 1 and Tier 2 capital. Tier 1 capital consists of Common Equity Tier 1 (CET1) and Additional Tier 1 (AT1). CET1 consists of common equity share capital, stock surplus, retained earnings and some other reserves. AT1 capital includes instruments issued by IIFS that meet the mentioned criteria, and any premium received on the issue of such instruments as well as those instruments or qualifying capital that are issued by consolidated subsidiaries of the IIFS to third-party investors. In terms of eligible structure, IFSB-15 proposes that perpetual, unsecured, *Mushārakah Sukūk* may be issued with the underlying assets as the whole business of the bank in order to absorb losses. In these M*ushārakah Sukūk*, the *Sukūk* holders are partners with the common shareholders in the equity capital of the IIFS, as per the terms of the *Mushārakah* agreement, and thus fully share the risks and rewards of the IIFS's operations.

For Tier 2 capital instruments, IFSB-15 proposed that, subject to *Sharī`ah* compliance, an IIFS can issue instruments in the form of *Muḍārabah* or *Wakālah Sukūk*, the underlying assets of which would be convertible into shares of common equity at the point of non-viability or insolvency. The Standard deems it essential that the terms of conversion, notably the trigger point and the conversion ratio, are clearly specified in the *Sukūk* contract so as to avoid *gharar*. Prior to conversion, the underlying assets of such *Sukūk* would not be available to meet the claims of the IIFS's current account holders or other creditors. After conversion of the *Sukūk* in case of the IIFS's non-viability or insolvency, Tier 2 capital would rank *pari passu* with CET1, along with AT1 capital.

IFSB-15 also clarified that PSIA of an IIFS are not classified as part of the IIFS's capital because they do not meet the criteria of various components of capital, including CET1. Similarly, the Standard also stated the reasons for not including smoothing reserves – investment risk reserve and profit equalisation reserve – as part of an IIFS's capital.

Capital Buffers

In order to achieve the goal of protecting the banking system and the real economy from system-wide risks, the Standard provides guidance on two capital buffers: the Capital Conservation Buffer and the Countercyclical Buffer. The former buffer stipulates that if the capital of an IIFS falls below the required buffer level, the relevant institution will be subject to various restrictions on discretionary distributions of profits, until the capital is restored to the required level. In addition, such an IIFS will be required to draw up and agree with the relevant supervisory authority a "capital conservation plan" in order to ensure that it has a credible strategy for early replenishment of the buffer.

The section on the Countercyclical Buffer provides thorough guidance on the application of this requirement as a new macroprudential measure. The Standard explains some micro- and system-level practices of the IIFS that can contribute to procyclical movements in the economy. However, system-wide risks are relatively less prominent for IIFS due to non-engagement in resecuritisation and highly speculative derivative trading transactions. Appendix B of this Standard sets out the guidelines for calculating various components of the credit-to-gross domestic product measure as a tool for implementing this buffer.

In view of the limitations of the aforementioned indicator, it has been proposed that this metric should be accompanied by other indicators of systemic risk, both of a national and an international origin. In view of that, Appendix B suggests a suite of metrics and indicators that can support the supervisory authorities in the decision related to imposition and release of this buffer in the jurisdiction.

Leverage Ratio

The Standard has provided initial guidance on the implementation of the leverage ratio for IIFS. It provides some insights on the factors leading to leverage in conventional banks. Taking a lead from these factors, the Standard scrutinises various practices of the IFS which may result in leveraged transactions. Based on the factors outlined in the Standard, it is proposed that supervisory authorities commence implementation of this ratio from January 2014. After implementation of this requirement, supervisory authorities shall assess various parameters of the ratio and evaluate their suitability for their jurisdictions. As discussed earlier in section 2.1.3, the IFSB will work closely with the member supervisory authorities, and based on the feedback shared by them, it will consider making any adjustments to the leverage ratio parameters at a suitable time in the future.

Capital Adequacy of Islamic Windows

Given that a number of institutional arrangements are being used by conventional banks to offer Islamic finance products and services across jurisdictions, generally referred to as "Islamic windows", the Standard endeavours to harmonise the capital adequacy treatment of the most common structures for such window operations. In some jurisdictions, supervisory authorities require Islamic windows to maintain a separate amount of capital and to follow the applicable minimum capital adequacy ratio requirements, while simultaneously requiring regulatory capital and CAR requirements to be met at the consolidated (i.e. parent) level. In other jurisdictions, there is no specific requirement for Islamic windows to maintain a separate amount of capital or to meet separate regulatory capital requirements. Instead, these requirements are only imposed at the overall bank level, which means that Islamic window operations are consolidated at the parent entity level. Similarly, there are capital adequacy issues related to the treatment of Islamic windows when the parent is based in another jurisdiction. The Standard explains the capital adequacy treatment for each of these structures.

Credit Risk

The revised standard IFSB-15 made a number of enhancements to the previous guidance included in IFSB-2 related to the credit risk calculation of the IIFS. Some of the major enrichments included:

- *Focus on Standardised Approach:* Due to the fact that an overwhelming majority of IIFS use the Standardised Approach for credit risk calculation, IFSB-15 has focused mainly on the risk weights under this approach. For the more advanced internal rating based approaches, the IFSB plans to issue a separate guideline in the future.

- *Profit-Sharing Modes:* The text on "exposures in the investments made under profit-sharing modes" was restructured to provide more clarity and insights on the credit risk underlying various financing and investments made by the IIFS under profit- and loss-sharing *Mushārakah* or profit-sharing and loss-bearing *Muḍārabah* contracts. The Standard notes that these *Sharī`ah*-compliant contracts can be offered either solely or in combination with other modes of financing such as *Murābahah* and *Ijārah*. Similarly, these profit-sharing modes may be used in a variety of other ways, such as to finance a commercial enterprise wishing to undertake a business venture or a specific project, to offer Diminishing *Mushārakah* financing, or to make an equity investment in a company or funds not held for short-term resale or trading purposes. Due to the difference in the underlying risk for each of these products, the Standard has provided guidance on the appropriate risk weights and capital adequacy treatment for each. Table 2.1.3.3 provides a summary of these risk weights. The Standard has also emphasised that any supervisory decision to suggest lower risk weights than those proposed should be subject to robust supervisory review of the factors, including infrastructure and capacity of the IIFS to monitor the performance and operations of the financed entity, quality of collateral, nature of business activities, valuation methods and exit strategies. The Standard has also emphasised that the role of CRM techniques should be duly considered when applying risk weights for profit-sharing modes of financing and investment, which may result in significant reduction of the IIFS's risk exposure.

- *Preferential Risk Weights:* Credit risk calculation of "preferential risk weights" has also been streamlined and enhanced for clearer guidance.

- *Risk Mitigation Approaches:* Earlier guidance on CRM approaches, especially the "comprehensive approach", has been significantly enhanced. Moreover, new guidance has been included on the treatment of an exposure covered by multiple CRM techniques.

- *Criteria for the Recognition of Rating Agencies*: IFSB's *Guidance Note on Recognition of Ratings by ECAIs on Sharī`ah-Compliant Financial Instruments* (IFSB GN-1) outlined criteria recommended to national RSAs for consideration when approving ECAIs for rating *Sharī`ah*-compliant financial instruments. These ratings are to be used by IIFS for calculating capital requirements under the Standardised Approach. Due to a number of regulatory reforms in recent years, the Standard has provided enhanced criteria for the consideration of supervisory authorities for recognition of eligible ECAIs in relation to *Sharī`ah*-compliant instruments and financial institutions. The Standard has also covered the use of unsolicited ratings and rating for securitisation exposures of the IIFS.

Market and Operational Risk

IFSB-15 expanded the earlier guidance on market risk included in IFSB-2 in a number of areas. In addition to including a precise definition and criteria for considering an exposure as market risk, the Standard delineated the need for clearly outlined policies and procedures for including, or not including, any position in the trading book. It also provided extended guidance on the valuation practices for the trading book positions of the IIFS. In this context, the Standard explicates the criteria and conditions for using the mark-to-market and mark-to-model valuation approaches. In terms of measurement, general market risk calculation for the "benchmark risk in trading positions in *Sukūk"* has been enhanced and computation by the more sophisticated "duration method" has been included in the Standard.

The operational risk calculation of the IIFS includes some new features. An explanation of Lines of Business in the context of IIFS has been included for the Standardised Approach. Moreover, a new sub-section on the Alternative Standardised Approach has been added. The Standard also includes new insights on the operational risk features of *Sharī`ah*-compliant modes of financing and investment.

Profit-Sharing Investment Accounts

An important variation on the calculation of capital adequacy for IIFS compared to their conventional counterparts is the way PSIA are offered and treated by the respective IIFS and their supervisory authorities. Following the issuance of IFSB-2, the IFSB also issued a number of Guidance Notes to provide additional guidance on this subject. An IFSB survey conducted during the preparation of IFSB-15 also disclosed that, apart from the commonly used

Muḍārabah contract for offering PSIA, some IIFS also consider the funds generated through *Mushārakah* or *Wakālah* contracts as a PSIA. Taking these developments into consideration, the section on PSIA has been reorganised with additional insights and better cross-referencing to other IFSB publications on this subject. The IFSB-15 has also maintained the determination of alpha (α)[71]– that is, the proportion of risk-weighted assets that needs to be included in the CAR to cater for the transfer of risk from IAH to IIFS.

Capital Requirements for Islamic Financing and Investment Assets

IFSB-2 covered the minimum capital requirements for the six classes of Islamic financing assets, taking into account both credit and market risk. Due to the increased use of some additional contracts, the revised Standard IFSB-15 added capital requirements for Commodity *Murābahah* transactions, *Qarḍ* and *Wakālah*. The Standard also enhanced and reorganised the sub-section on *Istisnā`* contracts to address the role an IIFS can play as a seller or a buyer in this arrangement. Similarly, an IIFS may incur an exposure either to the customer or the cash flows from the completed asset in this mode. The Standard suggests appropriate capital charges for various possible scenarios involving *Istisnā`* contracts.

Sukūk and Securitisation

IFSB-2 covered initial guidance on the capital adequacy treatment for IIFS as holders of *Sukūk* that assume all rights and obligations attached to the underlying asset or pool of assets. Subsequently, and in the light of industry developments, the IFSB issued a new standard, *Capital Adequacy Requirements for Sukūk, Securitisations and Real Estate Investment* (IFSB-7), which addressed the treatment of *Sukūk* and securitisation not covered by IFSB-2 as well as the role of IIFS in the origination, issuance, and credit enhancement or servicing of *Sukūk*.

IFSB-15 consolidated and enhanced the guidance covered in these two standards, reflecting a more structured approach to dealing with the subject. Consequently, the sub-section on the features and securitisation of *Sukūk* provides guidance for the parties in a securitisation structure or collateral security structure on the features of "true sale" and special-purpose entities from an IIFS perspective. This sub-section also explicates the capital adequacy treatment and underlying *Sharī`ah* conditions from the perspective of "ownership" of assets by the *Sukūk* holders. The sub-section on credit enhancement reflects on various permissible *Sharī`ah*-compliant arrangements for the issuance of *Sukūk*. A new sub-section on the capital requirements for *Sukūk* covers the concept, definition and proposed risk weights for seven major types of *Sukūk*.

Appendix D of the Standard includes some additional differences between *Sukūk*, conventional bonds and shares not previously covered in IFSB-7.

Real Estate Activities

The IFSB survey conducted during the preparation of IFSB-15 indicated that supervisory authorities in many jurisdictions have been quite pro-active in supervising the real estate portfolio of the IIFS in their jurisdictions. Most had updated their regulations and guidelines to align with the rapidly changing market conditions.

While retaining the earlier distinction between IIFS' "financing" and "investment" in real estate covered in IFSB-7, the revised Standard IFSB-15 also considers the "indirect" real estate activities of IIFS conducted through separate entities. Such exposure can take a number of forms. For example, an IIFS can: (i) be involved in real estate activities through a joint venture or equity participation with a property development company; (ii) establish a real estate

[71] In March 2011 the IFSB issued GN-4 (*Guidance Note on the Determination of Alpha in the CAR for IIFS*), which outlines a methodology for estimating the value of alpha to be used in the supervisory discretion formula in calculating the CAR of IIFS.

subsidiary to carry out related commercial activities; or (iii) accept real estate as collateral against its financing to customers. The Standard outlines the capital treatment for each of these scenarios.

Guidance on the “valuation” of real estate financing and investment by the IIFS has been improved, with an added emphasis on the necessity for supervisory authorities to satisfy themselves that the IIFS under their supervision have in place adequate valuation rules and proper valuation methodologies. Such methodologies should include the assessment of market value derived from chosen valuation models, and of the reliability of data used for the purpose of valuation. For this purpose, some appropriate controls for valuation by independent third parties or an in-house function are outlined.

2.2.2 Development of New Standards

The IFSB will also be developing new standards and guidelines, namely on (a) key elements in the supervisory review process of IIFS, (b) core principles for Islamic finance regulation, (c) *ReTakāful* undertakings, (d) stress testing for IIFS, and (e) Islamic capital market disclosure.

(a) Exposure Draft 16: Revised Guidance on Key Elements in the Supervisory Review Process of IIFS

In its 19th meeting, held on 17 November 2011, the Council approved the revision of the *Guidance on Key Elements in the Supervisory Review Process of IIFS [excluding Islamic Insurance (Takāful) Institutions and Islamic Mutual Funds]* (IFSB-5) and the formation of a working group.

In its 31st meeting, held on 24 October 2013, the Technical Committee of the IFSB approved the issuance of the Exposure Draft for public consultation. Accordingly, on 28 October 2013, the IFSB issued ED-16 for public consultation during the period from 28 October 2013 to 10 January 2014.

The overall aim of the revised standard is to update the earlier standard on this subject (IFSB-5) in terms of setting out guidance on the key elements in the supervisory review process for authorities supervising IIFS, taking into consideration the specificities of the IIFS and the lessons learned from the GFC, while at the same time complementing the existing international guidance on the supervisory review process issued by the BCBS.

ED-16, broadly analogous to Pillar 2 of the Basel accords, is about the supervisory process and how RSAs should supervise some specific areas pertinent to the IIFS. It ensures that the supervisory review process covering IIFS is consistent with those for conventional institutions and relevant to the current state of the industry, while catering for the specificities of *Sharī`ah*-compliant financial transactions and promoting the financial soundness of the IIFS. In this respect, it intends to foster convergence towards best practice among authorities supervising IIFS by establishing a minimum standard, enabling such supervisory authorities to meet their requirements when carrying out the roles expected of them in the light of IFSB standards.

ED-16, which takes a risk-based approach to the process of supervisory review, incorporates many elements of the supervisory review process, including supervisory pre-conditions, criteria and approaches for effective supervision of IIFS, securitisation risk and related off-balance sheet exposures, consolidated and home-host supervision, the internal capital adequacy assessment process (ICAAP) and enterprise risk management, *Sharī`ah* governance, liquidity, and stress testing, and Islamic windows. Two notable developments on ICAAP and ERM are briefly presented in Diagrams 2.2.2.1 and 2.2.2.2, respectively.

ED-16 notes that a thorough and comprehensive ICAAP is a vital component of a strong risk management programme, which produces a level of capital adequate to support the nature and level of an IIFS's risk exposures. The five main features which RSAs should look for in a rigorous process are presented in Diagram 2.2.2.1.

Diagram 2.2.2.1: ICAAP Framework for IIFS

The five main features RSAs should look for in a rigorous process are as follows:

Board and senior management (SM) oversight	• Board of Directors (BOD) has responsibility for setting the IIFS's tolerance for risks – that is, risk appetite and capital management framework for assessing the various risks. • SM ensures that ICAAP is conducted regularly.
Comprehensive assessment of risks	• All material risks faced by an IIFS should be addressed in the capital assessment process. o Types of risks captured under Pillar 1 o Types of risks not fully captured under Pillar 1 o Other types of risks not covered by Pillar 1
Sound capital assessment	• Quality and capacity of IIFS capital to absorb losses both on a going concern (Tier 1) and gone concern (Tier 2) basis.
Monitoring and reporting	• An IIFS should establish an adequate system for continuous monitoring and reporting of risk exposures and assessing how its changing risk profile affects the need for capital.
Internal control review	• Effective management of the ICAAP includes an independent review and, where appropriate, the involvement of internal or external audits.

The ICAAP also highlights:

- Use of buffers in Pillar 1 and Pillar 2, and interaction with ICAAP (i.e. avoiding double counting of risks).[72]
- Rigorous forward-looking stress testing to form an integral part of the IIFS's ICAAP.
- An ICAAP document (i.e. suggested format submission)[73] the purpose of which is to inform the supervisory authority and the board of the ongoing assessment of the IIFS's risks, how the IIFS intends to mitigate those risks, and how much current and future capital is necessary having considered other mitigating factors.

Source: IFSB ED-16

Recent market events underscore the importance of senior management taking an integrated, enterprise-wide perspective in considering an IIFS's risk exposures, in order to support its ability to identify and react to emerging and growing risks in a timely and effective manner. ED-

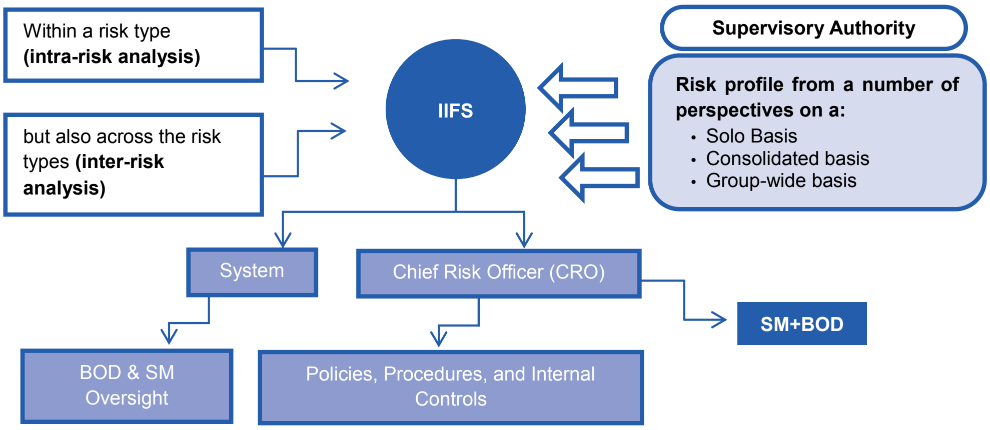
[72] ED-16 also states that, given the new regime's inclusion of capital conservation, countercyclical and systemic buffers, IIFS will have to reconcile their current use of capital buffers with the buffers outlined in IFSB-15, and supervisory authorities will need to be mindful that certain risks which previously would have been assessed as part of Pillar 2 now attract specific capital requirements through the use of buffers.

[73] This ICAAP document may cover an executive summary, background, current and projected financial and capital positions, capital adequacy, capital planning, liquidity planning, aggregation and diversification, challenge and adoption of the ICAAP, and use of the ICAAP within the IIFS.

16 reflects that a sound ERM framework consists of five key features: (a) board and senior management oversight; (b) appropriate policies, procedures and limits; (c) comprehensive and timely identification, measurement, mitigation, controlling, monitoring and reporting of risks; (d) appropriate management information systems (MIS) at the business and firm-wide level; and (e) comprehensive internal controls. Diagram 2.2.2.2 illustrates the ERM framework.

Diagram 2.2.2.2: Enterprise-wide Risk Management Framework

The ERM requires an **IIFS's personnel to understand every characteristic** of the products and requires the risk management function to study risks.



Enhance risk management and controls around an **IIFS's growing capital markets activities** including Securitisation, off-balance sheet exposures, structured credit and complex trading.

The ERM also highlights the following:

- The supervisory review process should include scrutinising the Interaction between ICAAP risks and ERM.
- An IIFS's risk management processes should be frequently monitored and tested by independent control areas and by internal, as well as external, auditors.

Source: IFSB ED-16

It may be noted from Diagram 2.2.2.2 that, for a comprehensive ERM framework and appropriate implementation of that framework, an IIFS needs to have an internal risk function and a chief risk officer (CRO) (or equivalent) who has a good understanding of the specificities of Islamic finance. The risk function and CRO should be independent of the individual business lines and report directly to the chief executive officer (CEO) and the institution's BOD. In addition, ED-16 highlights that a *Sharī`ah* governance mechanism should be incorporated into the ERM to promote effective implementation of an ERM framework that covers the specificities of IIFS. The important organs within an IIFS, such as an SSB, a Governance Committee, an internal *Sharī`ah* compliance unit (ISCU) and an internal *Sharī`ah* review unit (ISRU), where applicable, can provide input to the ERM process.

ED-16 also sets out guidance for supervisory authorities. In supervising an IIFS which is part of a corporate group, supervisory authorities need to consider the IIFS and its risk profile from a number of perspectives: (a) on a *solo basis* (but with both a micro and macro focus); (b) on a *consolidated basis* (in the sense of supervising the IIFS as a unit together with the other entities within the "banking group"); and (c) on a *group-wide basis* (taking into account the potential risks to the IIFS posed by other group entities outside of the banking group).

(b) Core Principles for Islamic Finance Regulation

In line with the mandate to develop prudential standards and guidelines to promote the soundness and stability of the IFSI, and in line with the development of the BCBS's revised core principles 2012, the Council of the IFSB in its 21st meeting, held on 12 December 2012, approved the preparation of a new standard on the IFSB's Core Principles for Islamic Finance Regulation and the formation of a working group for this purpose. The working group[74] was formed in March 2013 and has met three times: on 29 April, 16 September and 11 December 2013.[75] In accordance with the *IFSB Guidelines and Procedures for the Preparation of Standards/Guidelines*, the working group has conducted a survey of relevant RSAs.

The main objective of the CPIFR is to provide a set of core principles for the regulation and supervision of the IFSI, taking into consideration the specificities of the IIFS in the banking segment and the lessons learned from the financial crisis, as well as to complement the existing international standards on the supervisory review process. The working group has decided initially to work on core principles for the Islamic banking sector, which will be followed in due course by core principles for other sectors.

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 FSAP, to assess the effectiveness of countries' banking supervisory systems and practices across jurisdictions. In addition tothe IMF and World Bank FSAP, the core principles are used in the context of self-assessment, reviews conducted by private third parties such as consulting firms, and peer reviews conducted, for instance, within regional groupings of banking RSAs.

[74] This working group includes representatives from all three sectors (banking, capital markets and *Takaful*), including representatives of multilateral institutions and standard-setting institutions such as the BIS, the IMF and the ADB.
[75] In its first meeting, the working group discussed the Issues Paper, followed by the Initial Study Report and the draft survey in the second meeting. The third meeting deliberated on the results of a survey of banking supervisory authorities.

Basel Core Principles' Assessment of the Banking Regulatory Framework

The Basel Core Principles (BCPs) are mainly intended to help countries assess the quality of their systems and to provide input into their reform agenda. An assessment of the current situation of a country's compliance with the Core Principles can be considered a useful tool in a country's implementation of an effective system of banking supervision. According to the BCBS, the methodology can be used in multiple contexts: (i) self-assessments performed by banking supervisors themselves; (ii) IMF and World Bank assessments of the quality of supervisory systems – for example, in the context of FSAP; (iii) reviews conducted by private third parties such as consulting firms; or (iv) peer reviews conducted, for instance, within regional groupings of banking supervisors.

With respect to BCPs, 28 RSAs were asked whether any self-assessment, peer review or FSAP had been conducted on the banking regulatory framework in their respective jurisdiction. The results show that none of the RSAs has gone through peer review. On the other hand, 71% (20 out of 28) of the RSAs have gone through the IMF–WB FSAP exercise. Only five RSAs said that no assessment of any type has been conducted on any category in their respective jurisdictions.

Source: IFSB CPIFR Working Group Survey, September 2013

In a similar context, the CPIFR will aid IFSB member jurisdictions to assist: (a) the IMF and the World Bank FSAP; (b) self-assessment; (c) reviews conducted by private third parties; and (d) peer reviews conducted, for instance, within regional groupings of banking RSAs.The CPIFR will also bring implementation of the IFSB's standards within the global surveillance framework spearheaded by the IMF – World Bank and peer reviews, etc.

At the time of writing, key issues specific to Islamic finance which will need to be addressed in the CPIFR are as follows:

(i) Scope of supervision – covering cross-sector supervision perspectives.
(ii) Additional submission/admission criteria for IIFS.
(iii) On-site examinations and off-site surveillance.
(iv) Islamic windows operations.
(v) Regulating *Sharī`ah* non-compliance risk as part of the supervisory review process.
(vi) Treatment of IAHs/PSIA for calculation of CAR and risk management.
(vii) Requirement relating to *Sharī`ah* governance such as ex-ante and ex-post *Sharī`ah* review, SSB requirements, and internal and/or external *Sharī`ah* audits.
(viii) Assessment of rate of return risk in the supervisory assessment.

Some of the findings of the survey are reflected in Box 2.3.

The proposed CPIFR standard, which is expected to be issued in 2015, will draw on the existing internationally recognised regulatory framework issued by the BCBS and survey results deliberated in the working group meeting. In respect of the specificities of IIFS's operations, certain new principles will be developed while complementing the existing framework taking into account the specificities of the IIFS.

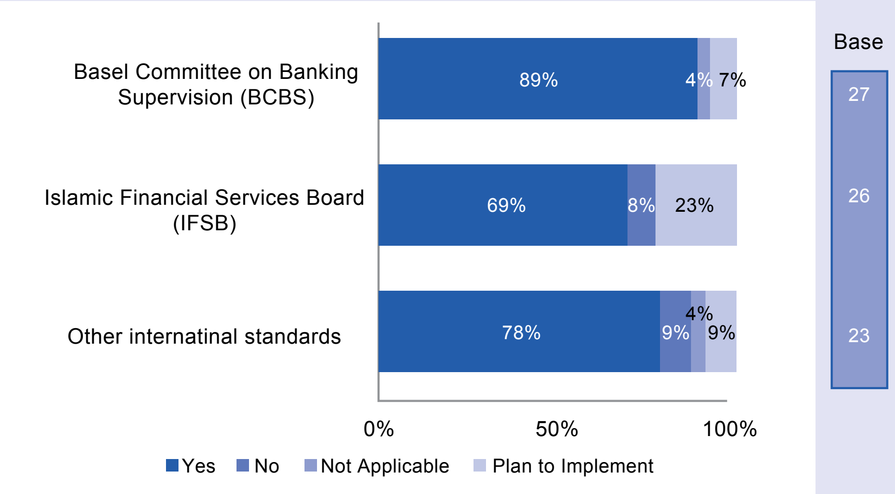
Box 2.3: International Standard-Setting Organisations Serving as Benchmarks for RSAs in the Banking Segment of the IFSI

By: IFSB Secretariat

As the IFSI is growing, in a survey, the RSAs were asked to specify which of the international standard-setting organisations serve as a benchmark for their jurisdictions' regulations and guidelines with respect to the IIFS under their supervision. Although this was a survey of banking regulators, it should be noted that some of these RSAs have wider responsibilities, and thus will draw on the work of standard setters for other sectors. The results indicated that 89% (24 out of 27) of the RSAs use Basel Committee on Banking Supervision (BCBS) standards as a benchmark for their regulations with respect to IIFS, and 7% of the RSAs indicated they are planning to implement BCBS standards in the near future.

On the other hand, with respect to the IFSB, there is also evidence suggesting that a significant majority of RSAs – 69% (18 out of 26) – uses IFSB standards as a benchmark for their regulations with respect to IIFS, and 23% of the RSAs indicated they are planning to implement IFSB standards in the near future. This seems to be in line with the results of the IFSB's Annual Standard Implementation Survey (which was conducted in September 2013).

Chart 1: International Standard-Setting Organisations Serving as Benchmarks



The results reflect that other international standard setters are also used by the RSAs as benchmarks for their regulations with respect to IIFS. This is as expected, since there are RSAs who regulate more than one sector; hence the reference to standard setters other than the BCBS and the IFSB. The different types of other international standard setters are discussed below.

In particular, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) standards are seen as an important benchmark used by the RSAs, as almost half of the RSAs – 45% (9 out of 20) – have used them in their jurisdiction. Other standard-setting organisations include: *IAIS, IOSCO, IASB, Organisation for Economic Co-operation and Development (OECD), Financial Action Task Force (on Money Laundering) (FATF), FSB and CGAP.*

It should be noted that some of the standard setters quoted above may be used by the RSAs only in limited areas of their work. This is particularly true for AAOIFI, where it is observed from other IFSB surveys that some RSAs use *Sharī`ah*, or *Sharī`ah* audit, standards but not accounting standards (and possibly *vice versa*).

Source: IFSB CPIFR Working Group Survey, September 2013

(c) Guiding Principles for ReTakāful Undertakings

The regulation of the *ReTakāful* industry remains a somewhat uncharted area. Although in conventional insurance regulation prudential frameworks for reinsurance often mirror closely those for direct insurance, for *ReTakāful* some fundamental questions remain unanswered. In its attempt to continuously support the industry via prudential standards, the Council approved the workplan for the IFSB to start work on *Guiding Principles for ReTakāful Undertakings* in its meeting in December 2013. Then in 2014, the IFSB formed a working group to address issues arising from *ReTakāful* activities. This working group aims to deliberate on the *ReTakāful* issues from the perspective of prudential supervision of *Takaful* and *ReTakāful* undertakings to ensure that these issues are highlighted and may in one way or another be addressed by the respective jurisdiction's RSAs. The following are some issues which have been raised by the industry and which the working group may need to consider:

(i) **Conventional business in *ReTakāful* operator pool.** A condition may arise where a *ReTakāful* operator may, for whatever reason, accept business from a conventional insurer. Questions have been raised as to whether this is acceptable and, if so, what controls need to be in place to ensure that the underlying risks are *Sharī`ah* compliant.

(ii) ***Use of conventional reinsurers.*** Because numbers and capacity of *ReTakāful* operators have been limited, the *Sharī`ah* scholars have allowed *Takāful* operators to use conventional reinsurers, on the basis of *Darūrah* (necessity). This practice continues, to a greater extent than the *ReTakāful* industry would wish. The question has been raised whether, although it is not a *Sharī`ah* standards body, the IFSB can give any guidance on what commercial conditions would be necessary for *Darūrah* to apply.

(iii) **Retro*Takāful*.** Retro*Takāful* is another area which requires careful deliberation by the RSAs. To date, *ReTakāful* operators rely heavily on the conventional market for retrocession. This is especially crucial for General *Takāful* insurance, since the capacity required to provide coverage for big projects normally exceeds the capacity of individual *ReTakāful* operators.

(iv) **Risk transfer vs. risk sharing.** The question here is fundamentally about the extent to which *ReTakāful* requires a real pooling of risk through the participants' risk funds. This reflects the fact that, in conventional reinsurance, it is common for insurers with good claims experience to receive a rebate of some kind at the end of the policy period. However, this implies that there is, in some sense, a private account for each insurer, rather than a merged risk pool. For example, could a *Takāful* operator receive a share of surplus on the business it had ceded, even if there were a deficit in the participants' risk fund?

(v) **Profit commission.** At first sight, this appears to be the same issue as that outlined previously. However, in the life insurance industry, in particular, it is common for reinsurers to provide substantial funding for direct insurers to help support the adverse cash flows ("new business strain") in the early years of a policy. This may be done under the guise of a "commission" for ceded reinsurance. In the case of *Takaful*/*ReTakāful* it raises a number of questions, including whether such a commission can be paid into shareholders' funds (from which the relevant expenses would normally have been paid).

(vi) ***Sharī`ah* governance.** The issues here will be similar to those for *Takāful* operators, but will need restatement.

(d) Technical Note on Stress Testing for IIFS

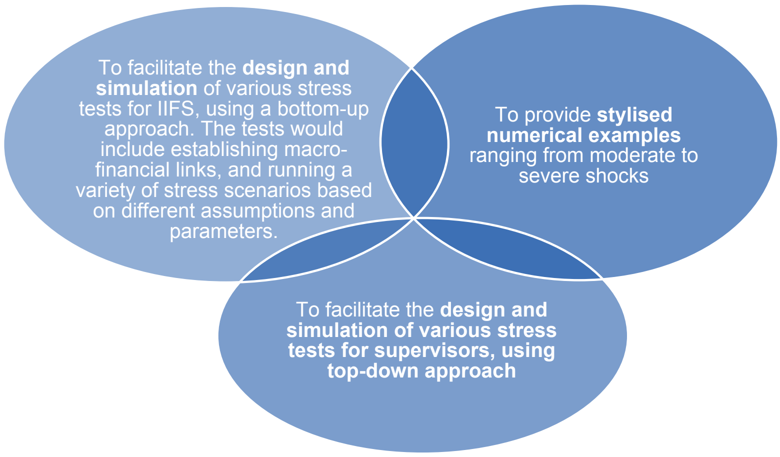
Stress testing is a key risk management tool within financial institutions and is an important part of the supervisory assessment under Pillar 2. In March 2012, the Council approved for adoption IFSB-13: *Guiding Principles on Stress Testing for Institutions offering Islamic Financial Services.*The IFSB-13 guidelines are intended to complement the existing international stress testing framework,[76] taking into consideration the specificities of IIFS as well as the lessons learned from the financial crisis so as to contribute to the soundness and stability of IIFS, in particular, as well as the IFSI as a whole. Therefore, these *Guiding Principles*, built mainly on the BCBS and the European Banking Authority (EBA) framework, have prescribed guidance on the issues that should be addressed by the IIFS and their respective RSAs in order to provide a level playing field to the market players.

It may be noted that, as such, the *Guiding Principles* do not provide detailed implementation guidance to IIFS on how to do stress testing. This highlights that operational guidance is needed, which can be used as a benchmark for simulating various types of risks under certain plausible defined scenarios in stress tests for IIFS. Further to this, following the issuance of IFSB-13, on the direction of the Council, the Secretariat has been conducting a series of "Facilitating the Implementation of the IFSB Standards (FIS)" workshops for IFSB-13, both for market players and RSAs. The workshops include a solvency simulation exercise, which has drawn attention to the need for a detailed toolkit or explanatory notes for other areas. In addition, the workshops have involved the IMF and some central banks sharing their experiences of stress testing, which has also underlined the importance of developing a detailed technical note for IIFS.

In line with the above developments, the IFSB Council, in its 23rd meeting held on 10 December 2013, approved the preparation of a technical note on stress testing for IIFS and the setting up of an Expert Group for this purpose. The Expert Group is tasked to develop operational guidance for the implementation of IFSB-13. Diagram 2.2.2.3 shows the key objectives of the proposed *Technical Note on Stress Testing for IIFS*.

[76] In particular, two seminal documents dealing with stress testing have been published in response to the financial crisis. In May 2009, the BCBS published its *Principles for Sound Stress Testing Practices and Supervision*, and in August 2010 the CEBS issued its *CEBS Guidelines on Stress Testing*. The BCBS document sets out 15 "principles" for banks and six for supervisors, while the CEBS document contains 17 "guidelines" for banks and five for supervisors.

Diagram 2.2.2.3: Key Objectives of the Proposed Technical Note on Stress Testing



Source: IFSB

The outcome of the proposed *Technical Note on Stress Testing for IIFS* is expected in 2015/2016. It is envisaged that it will be used by member countries as a benchmark for assessing the stress testing practices conducted under defined scenarios. The key areas that will be covered in the proposed Technical Note include, *inter alia*, (a) solvency stress testing, (b) liquidity risk stress testing, (c) *Sharī`ah* non-compliance stress testing under operational risk, (d) credit and market risk related stress testing, and (e) system-level stress testing.

(e) Islamic Capital Market Disclosure

The financial crisis shows the importance of disclosure of capital market products to help strengthen the overall regulatory environment, ensure investor protection, and promote greater cross-border activity by facilitating transparency and a greater understanding of the nature of investments and their related risks and rewards. The subject of disclosure and regulatory practices within the ICM sector, which is currently dominated by equities, collective investment funds and *Sukūk*, has long been a concern among supervisory authorities – in particular, following the global financial crisis.

Recognising the need to complement the increasing internationalisation of ICM with a conducive regulatory environment, the IFSB–IOSCO–SC conducted a “Roundtable on Disclosure of Islamic Capital Market Products” in September 2012, followed by a joint publication – *Disclosure Requirements for Islamic Capital Market Products* – which was released in 2013. These initiatives helped to identify a number of issues[77] that may require further study to strengthen the framework for disclosure requirements for ICM products. Such issues include the following:

(i) **Legal and regulatory.** Having in place a proper legal framework will assist local and international RSAs to strengthen the effectiveness of their disclosure regimes and ensure that investors in the respective markets have relevant information with which to make informed decisions. This would include, *inter alia*, having greater legal and regulatory clarity and transparency of *Sharī`ah* rulings.

[77] IFSB, IOSCO, SC, *Disclosure Requirements for Islamic Capital Market Products*, 2013. www.ifsb.org/docs/Disclosure%20Requirements%20for%20ICM%20Products-final%2017102013.pdf

(ii) ***Sharī`ah* compliance and governance.** The claim of *Sharī`ah* compliance is clearly important to investors or potential investors. However, it is common for an instrument that has been approved by a group of *Sharī`ah* scholars to then be regarded as unacceptable by the *Sharī`ah* supervisory boards of prospective major investors. This issue is raised frequently by lawyers advising on transaction structures, and is particularly significant for international transactions.[78]

(iii) ***Sukūk* structure.** *Sukūk* structures are often complex, and the base contract may be supplemented by multiple supporting contracts or undertakings that materially affect the nature of the transaction. This creates issues of comprehensibility for all but highly sophisticated investors, and also potential legal risk if the structure proves not to work as intended.

(iv) **Ownership of assets.** *Sukūk* are often structured around specific assets that are transferred to a special-purpose vehicle or to a joint venture structure. The question is to what extent the *Sukūk* holders have ownership of the assets, and whether they can take active control of and use or dispose of them.

While the IOSCO Principles of Securities Regulation were drafted with conventional securities markets in mind and are seen to be broadly applicable to the ICM, the sector may benefit from further consideration or guidance due to the specific nature and characteristics of ICM products. This issue may be addressed via the issuance of separate reports, recommendations or guidance notes by relevant standard setters.

In this regard, the IFSB plans to establish a working group for the preparation of a standard on disclosure requirements specific to ICM in 2014 to help close the gaps that currently exist in the offering of related products and services, and achieve overall transparency in the segment. Given the importance of investor protection and market integrity from cross-jurisdictional perspectives, having in place standardised disclosures across jurisdictions where ICM products and services are offered would help to reduce systemic risks and strengthen confidence in the products offered by the industry players.

2.2.3 Survey Findings on Implementation of the IFSB Standards

IFSB members implement IFSB standards and guidelines on a voluntary basis. Each member of the IFSB is entitled to determine its own timeline for implementation based on the market and industry dynamics in its territory/jurisdiction. In its Strategic Performance Plan (SPP) 2013–2015, the IFSB identifies four Strategic Key Result Areas (SKRAs), which include SKRA 1 – Formulation, Adoption and Implementation, Publicising and Promoting Prudential Standards for Islamic Finance, and SKRA 2 – Technical Assistance and Capacity Building. These two SKRAs require the IFSB Secretariat to conduct an annual survey on the implementation of standards among its member RSAs with the aim of following up on the progress of implementation and assessing the support required by the authorities in implementing the standards. In line with this, the IFSB undertook its second IFSB Standards Implementation Survey in 2013 ("2013 Survey") to assess the status of IFSB standards, with a view to formulating policy recommendations for the implementation process over the medium to longer term.

[78] Where an issue is purely domestic, there is at least the possibility of a regulator imposing some consistency of interpretation.

Diagram 2.2.3.1 The IFSB's Strategic Performance Plan, 2013–2015

SKRA 1	SKRA 2	SKRA 3	SKRA 4
Formulation, Adoption and Implementation, Publicising and Promoting Prudential Standards for Islamic Finance	**Technical Assistance and Capacity Building**	**Cooperation Enhancement (creating platform for cooperation)**	**Communication and Information Sharing**
• Increased adoption of the IFSB standards by the regulatory and supervisory authorities • Expansion of coverage of the IFSI issue areas	• Increased adoption of IFSB standards by the regulatory and supervisory authorities	• Improved cooperation with members of the IFSB • Improved cooperation with non-members of the IFSB	• Improved understanding of issues or problems faced by members of the IFSB • Increased utilisation of Islamic financial databases for quality decision-making by members • Increased satisfaction of members with the services provided by the IFSB

Source: IFSB Strategic Performance Plan, 2013–2015

In the 2013 Survey, the respondent RSAs numbered 33, including 23 IFSB full members, eight associate members, and two observer members from Asia, GCC, MENA, North Africa and Europe. The implementation of 13 IFSB standards, from IFSB-1 to IFSB-13 covering Islamic banking, *Takāful* and the Islamic capital market segments was assessed. The Survey did not include IFSB-14 and IFSB-15, as these standards were published after the survey period.

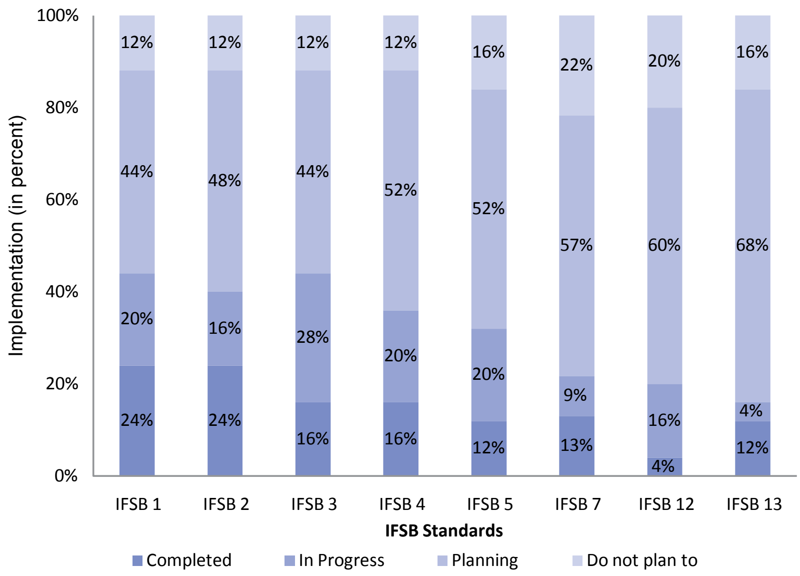
Overall, the 2013 Survey found that 13 RSAs (40%) out of the total of 33 implemented one or more IFSB standards, seven RSAs (21%) were already in progress, ten RSAs (30%) planned to implement at least one standard, and three RSAs (9%) did not plan to implement any of the standards, which is a considerable improvement from the 2011 Survey results as explained in the following paragraphs. Survey results were also analysed separately for those 18 RSAs where market share of Islamic finance in respective sectors is more than 5% of the total market. The analysis showed that the implementation of the IFSB standards is significantly higher for the jurisdictions with higher market shares than those with very small or negligible Islamic finance market.

The key findings of the 2013 Survey are presented below.

(a) Banking sector

- Based on the assessment of 25 respondent RSAs, a total of nine RSAs have implemented one or more standards in the banking sector, four RSAs were in progress, and nine RSAs were planning to implement the IFSB standards. IFSB-1 and IFSB-2 were completely implemented by 24% (six RSAs) of the RSAs. All the IFSB standards in the banking sector were already been fully implemented by at least one RSA.

Chart 2.2.3.1: Implementation Status of IFSB Standards in the Islamic Banking Sector



Standards	IFSB 1	IFSB 2	IFSB 3	IFSB 4	IFSB 5	IFSB 7	IFSB 12	IFSB 13
Base	25	25	25	25	25	23	25	25

Source: IFSB Standards Implementation Survey, 2013

- While analysing the implementation status of the IFSB standards, an important consideration is the market share of the Islamic segment of the respective sector. It is assumed that RSAs that are supervising an Islamic finance sector with more than 5% market share would have a higher incentive to implement the IFSB standards. Analysing the results based on this benchmark, the implementation status was found to be much higher. Out of the total 25 RSAs in the banking sector, 11 have more than 5% market share and are also full members of the IFSB. IFSB-1 and IFSB-2 are fully implemented by 45% (five of 11 RSAs) and 55% (six of 11 RSAs) of RSAs, respectively. About 27% (three of 11 RSAs) are fully implemented the remaining banking standards, with the exception of IFSB-12.

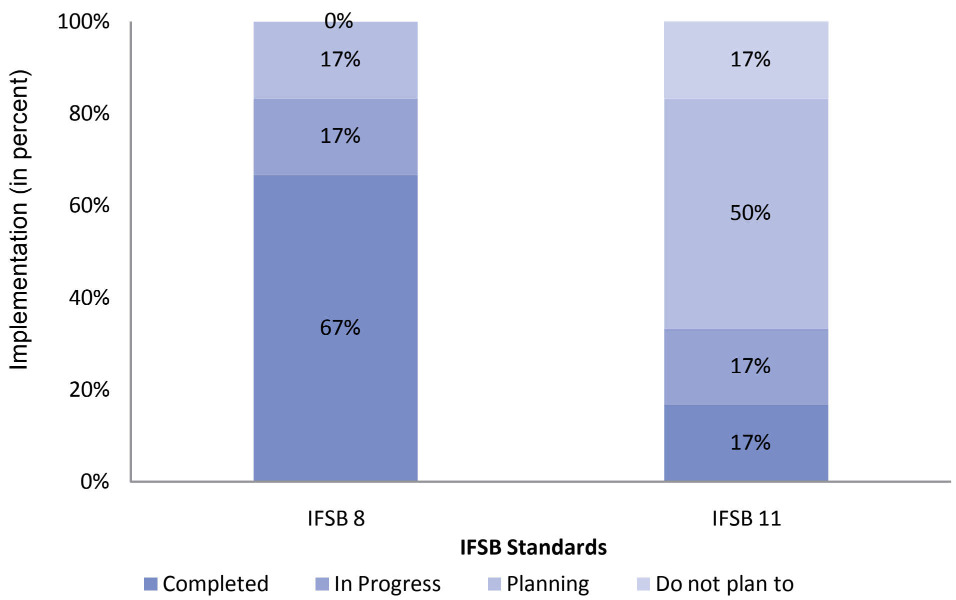
- There is a significant improvement for the banking sector in all dimensions of implementation of standards in 2013 as compared to that in 2011. This comparison considered only those jurisdictions (14 RSAs) that were surveyed by IFSB in both periods.
  - IFSB-1 was implemented by 36% (five of 14 RSAs) in 2013, compared with 15% (two of 14) in 2011.
  - The progress was also evident for IFSB-7, which was implemented by 21% (three of 14 RSAs) in 2013 vs. 8% (one of 14) in 2011.
  - The commendable progress in 2013 was due to the implementation of several new standards by three RSAs.
  - Out of 14 RSAs, 14–21% (two to three RSAs) did not plan to implement the standards in 2013, as compared to 23–46% (three to six RSAs) in 2011.

(b) *Takāful* sector

- Out of six RSAs supervising the *Takāful* sector, four respondents implemented one or more standards, one RSA was in progress, and one is planning to implement the standards. IFSB-8 was implemented by 67% (four RSAs). Another standard for the *Takāful* sector, IFSB-11, was planned for implementation by all but one RSA.

- The implementation status of *Takāful* standards was enhanced in 2013 as compared to 2011, based on a sample of similar jurisdictions in both periods.
  - 60% (three of five RSAs) completely implemented IFSB-8 in 2013 as against 40% (two of five) in 2011.
  - Improvement of IFSB-11 implementation was also observed in the "planning" category, which increased from 25% (one RSA) in 2011 to 50% (two RSAs) in 2013.

Chart 2.2.3.2: Implementation Status of IFSB Standards in the *Takāful* Sector (base: 6 RSAs)

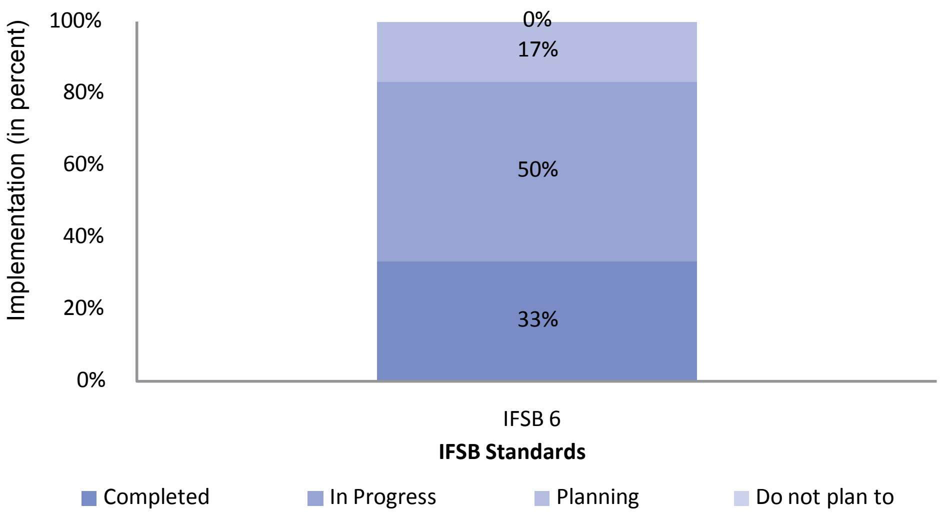


Source: IFSB Standards Implementation Survey, 2013

(c) Capital markets sector

- The capital markets sector observed that 33% (two of six RSAs) of the respondent RSAs fully implemented IFSB-6 in 2013. Moreover, 50% (three RSAs) were in the "in progress" category, followed by 17% of RSAs in the "planning" category.

Chart 2.2.3.3: Implementation Status of IFSB Standards in the Islamic Capital Market Sector (base: 6 RSAs)

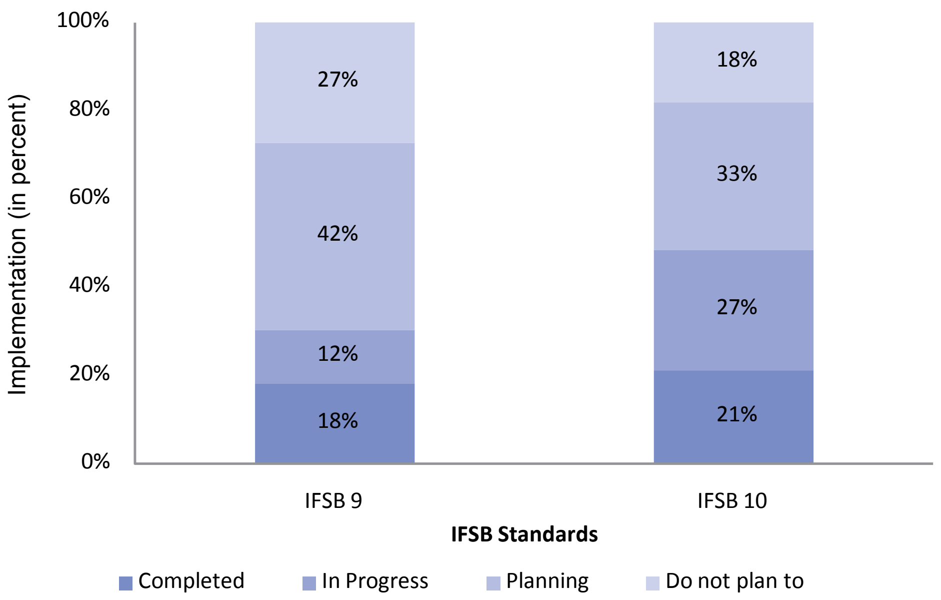


Source: IFSB Standards Implementation Survey, 2013

(d) Cross-sectoral standards:

- In total, eight out of 33 respondent RSAs have fully implemented standards IFSB-9 and IFSB-10, which are applicable for all sectors – banking, *Takāful* and capital markets. A total of nine RSAs were in progress and 12 RSAs were planning to implement the standards.

Chart 2.2.3.4: Implementation Status of Cross-sectoral IFSB Standards (base: 33 RSAs)



Source: IFSB Standards Implementation Survey, 2013

Table 2.2.3.1 summarises the implementation of IFSB standards with respect to all segments of the IFSI.

Table 2.2.3.1 Summary of Implementation of IFSB Standards by the Respondent RSAs

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

Legends:

1- *Complete (i.e. implementation is complete)*
2- *In progress (i.e. implementation is in progress)*
3- *Planning (i.e. not yet in progress, but we are planning to implement)*
4- *Do not plan to (i.e. not in progress and we do not plan to implement e.g. because not relevant to our supervisory authority).*

Note: Figures in parenthesis indicate percent of implementation with respect to base RSAs.

Source: IFSB Standards Implementation Survey, 2013

Table 2.2.3.2 summarises the implementation of IFSB standards with respect to respondent RSAs in all sectors, taking into consideration the jurisdictions that have a benchmark of 5% market share in IIFS.

Table 2.2.3.2 Summary of Implementation of IFSB Standards by the Respondent RSAs with a Minimum of 5% Market Share of Total Islamic Finance Assets

	IFSB-1	IFSB-2	IFSB-3	IFSB-4	IFSB-5	IFSB-6	IFSB-7	IFSB-8	IFSB-9	IFSB-10	IFSB-11	IFSB-12	IFSB-13
1- Completed	5 (45)	6 (55)	3 (27)	3 (27)	3 (27)	2 (40)	3 (30)	3 (60)	4 (22)	5 (28)	- -	1 (9)	3 (27)
2- In Progress	3 (27)	1 (9)	4 (36)	4 (36)	3 (27)	2 (40)	2 (20)	1 (20)	3 (17)	6 (33)	1 (20)	3 (27)	1 (9)
3- Planning	3 (27)	4 (36)	4 (36)	4 (36)	5 (45)	1 (20)	5 (50)	1 (20)	7 (39)	4 (22)	3 (60)	6 (55)	7 (64)
4- Do not plan to	- -	- -	- -	- -	- -	- -	- -	- -	4 (22)	3 (17)	1 (20)	1 (9)	- -
Base	**11**	**11**	**11**	**11**	**11**	**5**	**10**	**5**	**18**	**18**	**5**	**11**	**11**

Legends:

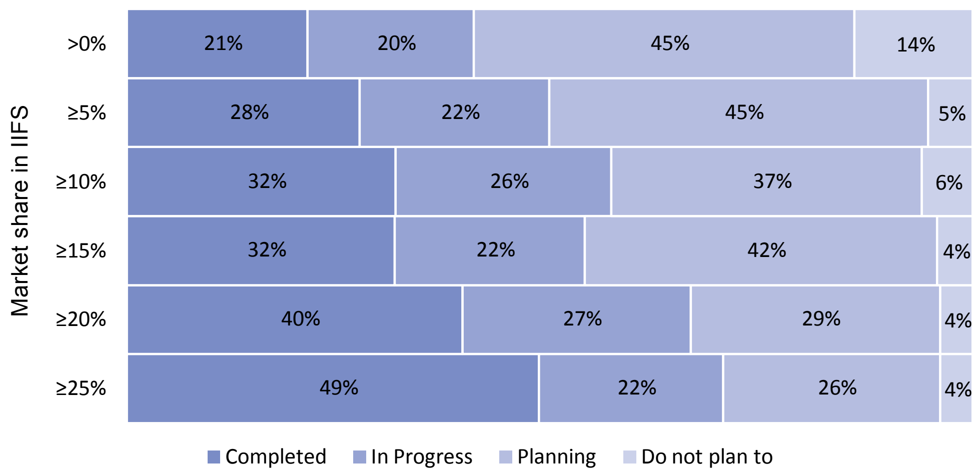
1- *Complete (i.e. implementation is complete)*
2- *In progress (i.e. implementation is in progress)*
3- *Planning (i.e. not yet in progress, but we are planning to implement)*
4- *Do not plan to (i.e. not in progress and we do not plan to implement e.g. because not relevant to our supervisory authority).*

Note: Figures in parenthesis indicate percent of implementation with respect to base RSAs.

Source: IFSB Standards Implementation Survey, 2013

The 2013 Survey also compiled respondent information on market shares of IIFS for each RSA and attempted to compare with the standard implementation status. The summary of correlation between implementation status of IFSB standards and market share of IIFS under the respondent RSAs' jurisdictions is shown in Chart 2.2.3.5. The chart clearly shows that there is a gradual upward trend in the "completed" status of RSAs for IFSB standards as the market share of Islamic assets in jurisdictions increases. For example, 21% of RSAs with more than a 0% market share in IIFS fully implemented the standards, while 49% of RSAs which have more than a 25% market share fully implemented the standards on average. On the other hand, there is a gradual downward trend in the "do not plan to [implement]" category for IFSB standards, the higher the market share. For example, 14% of RSAs with more than a 0% market share in IIFS do not plan to implement the standards, while only 4% of RSAs with more than a 25% market share fall under the "do not plan to [implement]" category. The correlation between the implementation status and the market share of the surveyed RSAs is found to be positive the higher the ratios of assets in IIFS in the jurisdictions.

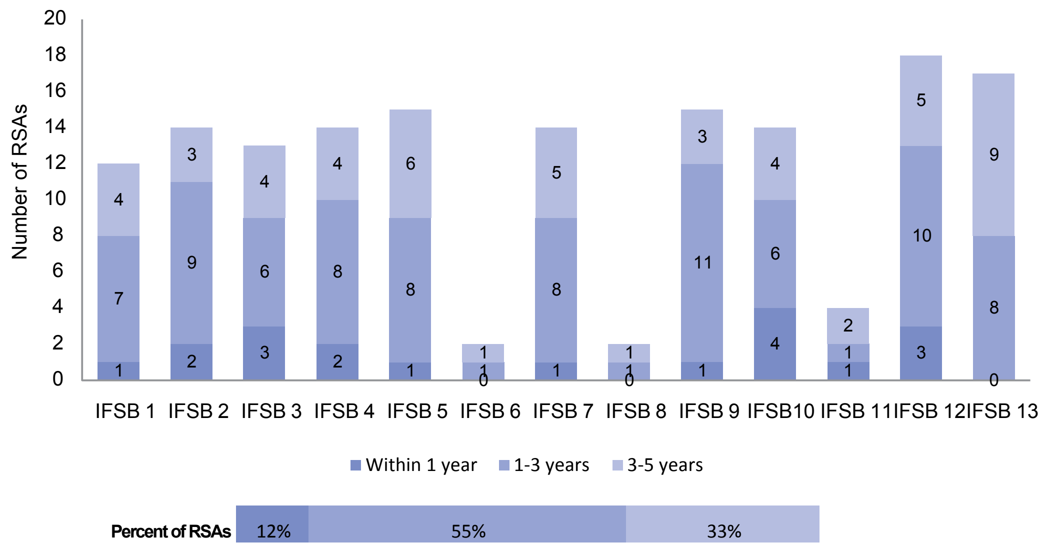
Chart 2.2.3.5: Implementation Status of IFSB Standards and Market Share of IIFS



Source: IFSB Standards Implementation Survey, 2013

In terms of the timeframe for the implementation of the IFSB standards, implementation plans are mostly scheduled to be undertaken over a period of 1–3 years (as shown in Chart 2.2.3.6).

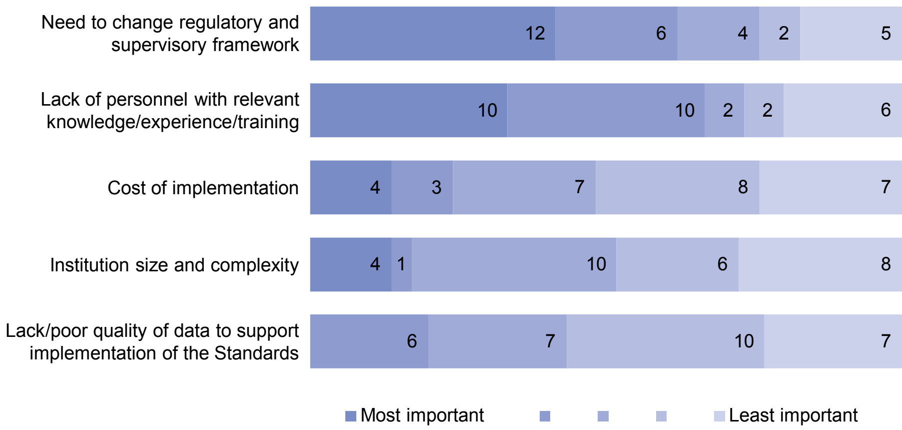
Chart 2.2.3.6: Approximate Time Frame for Implementation of IFSB Standards



Source: IFSB Standards Implementation Survey, 2013

In addition, the 2013 Survey gathered information on challenges faced by RSAs in implementing the IFSB standards. Chart 2.2.3.7 indicates that 12 RSAs considered that their most important challenge is the "need to change [their] regulatory and supervisory frameworks". On the other hand, ten RSAs considered the "lack of personnel with relevant knowledge/experience/training" as the most important challenge they faced.

Chart 2.2.3.7: Challenges to Implement IFSB Standards



Source: IFSB Standards Implementation Survey, 2013

The 2013 Survey also compiled the rank of challenges and estimated a mean value against each of the challenges based on its importance level. The lower the mean value, the higher is the importance level of any given challenge. Table 2.2.3.3 exhibits the ranking order of challenges based on the mean values and compares the results with the 2011 Survey. The results show that, in 2013, the rankings of the various challenges were mostly similar to those in the 2011 Survey. The need to change the regulatory and supervisory framework, and a lack of personnel with relevant knowledge/experience/training, are considered the two key challenges faced by RSAs, as depicted by the lower mean values compared to those of others reflected in both surveys.

Table 2.2.3.3 Rank of Challenges in Implementing the IFSB Standards

Challenges	2013 Survey			2011 Survey		
	Mean	Rank	Base	Mean	Rank	Base
Need to change regulatory and supervisory framework	2.40	**1**	29	2.70	**1**	25
Lack of personnel with relevant knowledge/ experience/ training	2.50	**2**	30	3.0	**2**	25
Cost of implementation	3.38	**3**	29	3.9	**3**	25
Institution size and complexity	3.45	**4**	29	4.1	**4**	25
Lack/poor quality of data to support implementation of the standards	3.60	**5**	30	4.1	**4**	25

Source: IFSB Standards Implementation Survey, 2013

The significant progress in the implementation of the IFSB standards gives a clear indication of the direction of future strategies of the IFSB over the medium to longer term in addressing the key challenges identified in this survey.

To facilitate the implementation process of these standards, the IFSB took numerous initiatives which include FIS workshops, public hearings, roundtables, seminars and conferences for RSAs and industry stakeholders over the years.

The IFSB has also signed Memorandums of Understanding (MoUs) with five strategic partners which are aimed at, inter alia, further penetration of its implementation efforts (Diagram 2.2.3.2). The MoU partner activities include providing technical assistance (TA) to facilitate the implementation of the IFSB standards and to promote the development of the IFSI.

Diagram 2.2.3.2 The IFSB's MoU Partner Activities (2012-2014)

Islamic Development Bank (IDB)	In 2013, the IDB provided TA, which mainly focused on supporting the FIS Regional programme on newly developed and existing *Takāful* standards.
Asian Development Bank (ADB)	The 2012 TA focused on facilitating the implementation of the IFSB Standards in common member countries and developing and e-learning programme to disseminate the Standard Implementation Initiative.
International Centre for Education in Islamic Finance (INCEIF)	In 2013, the IFSB and INCEIF jointly developed the high level"IFSB-INCEIF Executive Forum on Islamic Finance" which focused on issues related to the supervisory and prudential regulations.
Bahrain Institute of Banking and Finance (BIBF)	The IFSB and BIBF plan to organise a high level training programme in 2014.
Statistical, Economic and Social Research and Training Centre for Islamic Countries (SESRIC)	The IFSB plans to co-organise workshops with SESRICin 2014 in common member countries

Source: IFSB

To ensure a wider dissemination of the IFSB standards, the IFSB plans to complement the FIS workshops with e-learning programmes. The programmes are expected to foster (i) global awareness and understanding by regulators and supervisors, as well as market players and industrial experts, of the importance of the IFSB standards; and (ii) the implementation of the IFSB standards by the industry to promote the resilience and stability of the IFSI at the global level.

Currently, a comparative perspective on challenges faced during the implementation of the IFSB standards has been integrated into the FIS programme through the participation of experts from key Islamic finance jurisdictions that have already implemented the standards. The IFSB also plans to conduct comparative studies of three or four selected IFSB standards in order to draw lessons from their implementation in specific jurisdictions.

3.0 ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

3.1 Islamic Banking

The banking sector has always been one of the most highly regulated and supervised economic sectors. Any instability in banking institutions can cause tremendous systemic effects across various productive economic sectors of a domestic economy, with the potential to spill over into regional and global economies. In recent years, the global financial system has undergone a series of financial turbulences, beginning with the global financial crisis during the 2008–2009 period, followed by the Euro sovereign debt crisis involving the PIIGS (Portugal, Ireland, Italy, Greece and Spain) economies in 2010–2011, and the Cyprus banking crisis in 2012. In 2013, the recent volatilities in emerging markets on account of expected tapering in the Fed's quantitative easing programme heralded a significant flight-to-quality outflow of funds as investors searched for higher yields in the developed economies on the back of an improved US economy.

During the course of more than five years of QE support by the US Fed, emerging markets – in particular, those characterised by an economy open to international trade and capital flows, as well as by dependence on foreign capital inflows to meet balance of payments deficits – had become accustomed to receiving substantial amounts of foreign investments into their local equity and bond markets. Tapering by the Fed taper could potentially cause interest rates to increase, triggering a sell-off in emerging market assets while higher-yielding US assets attracted investments. The resulting effect has been sharp declines in emerging markets' equity indices along with spikes in bond yields. The impact on the financial markets and currencies of these emerging economies has been material, causing monetary authorities to intervene in various forms, including upward revisions in interest rates in Turkey and Indonesia and capital injections by government entities to stabilise financial markets. In the banking sector, changes to interest rates by the central banks would immediately impact financing and deposit portfolios as occurred, for example, in Turkey and Indonesia. In addition, after years of strong performance, an outflow of foreign investors from emerging markets could worsen the situation, especially for emerging economies that rely significantly on foreign investments. Box 3.1 elaborates the global economic conditions and normalisation of monetary policy.

Box 3.1: Global Economic Conditions and Normalisation of Monetary Policy

By: IFSB Secretariat

The global economic environment in 2013 was characterised by developments in both real and financial sectors, with longer-term consequences beginning to weigh on expectations. Real economic growth prospects acquired further redefinition with a slowing in GDP growth in emerging economies, a recovery in the US that appeared to have durable foundations, and continued low growth in Europe.

The possibility that growth in China could decline from historical 10% per annum to about 7.5% over the medium term suggests that growth rates in major commodities exporters to China could see repercussions, including GCC economies as well as Asian and African economies such as Nigeria and Indonesia.[79] At the same time, economic growth in the US, if sustained, would provide a welcome addition to global aggregate demand. Present economic conditions in the US pose challenges to disentangling the likely impact of US policy, particularly the policy of the US Fed, for emerging markets. With a significant and persistent output gap, and deflationary conditions, the Fed has been supporting a loose monetary policy stance. However, its announcement of the likely tapering of its quantitative easing caused considerable uncertainty, despite the Fed's assurance that underlying monetary conditions – as indicated by a Federal Funds rate that was considerably below its long-term average – would not be affected by tapering. This resulted in a significant sell-off of emerging market securities with sharp impacts on stock markets and exchange rates.

The wider set of issues for emerging markets concerns their short-term vulnerability to volatility in capital flows, the strength of the balance sheets at the macroeconomic, financial institution, and non-financial corporate levels. The global availability of cheap credit has enabled some countries to refinance their debt and achieve a more prudent maturity structure, but in others it has financed a credit boom that exposes them to exchange rate volatility and sudden stops in capital inflows. Among the latter, the most recent studies indicate that it is the large, open economies in emerging markets that are more likely to have had heightened vulnerability to volatility in portfolio flows in the short term.[80] More broadly, viewed over the medium term, stronger growth in the US, combined with tapering, is likely to see a rise in US interest rates but will have a relatively small impact on gross capital flows.[81]

Within emerging markets, the impact of these developments will vary across groups of countries, with those where domestic credit expansion has been fastest – based on short-term borrowing in foreign currencies – needing to be watchful over movements in exchange rates and overall debt levels. In still other countries, the key areas of concern are domestic credit quality in combination with a possible deterioration in current account balances.

The Islamic banking sector, representing approximately 80% of the global IFSI's assets in 2013, is of profound importance to the financial stability of the Islamic financial system. The Islamic banking system weathered the GFC better than the conventional banking system, as Islamic banks' balance sheets were free from exposures to securitised sub-prime loans, derivative products including credit-default swaps, collateralised debt obligations and other highly risky structured products, which were regarded widely as the cause of the banking system's instability during 2008–2009. Furthermore, the capitalisation levels of Islamic banks were much healthier than those of conventional banks, for reasons that will be expanded upon in this chapter. However, Islamic banks were not insulated from the crisis. Economic slowdown, declining trends of commodity prices, and real estate crises that

[79] IMF, *World Economic Outlook: Transitions and Tensions*, October 2013.
[80] B.Eichngreen and P.Gupta, "Tapering Talk: The Impact of Expectations of Reduced Federal Reserve Security Purchases on Emerging Markets", *VOX*, 19 December 2013.
[81] A. Burns*et al.*, "Unconventional Monetary Policy Normalisation and Emerging-Market Capital Flows", *VOX*, 21 January 2014.

emanated from the financial crisis also affected Islamic banking performance. As such, the potential slowdown of emerging markets (where Islamic banks are mostly located) would also pose a risk to the growth prospects of the IFSI.

Overall banking prospects (industry-wide, including Islamic banking) in the GCC remain stable and on an upward trend. Credit growth remains robust in the GCC, underpinned by aggressive government spending on infrastructure projects and growth in domestic consumption following increases in public salaries and state pensions. Islamic banking in Asia is also expected to maintain its current momentum supported by the infrastructure needs of the region as well as by robust consumer spending.

Drawing upon a sample size of 52 full-fledged Islamic banks[82] from the top ten Islamic banking jurisdictions (excluding Iran), this chapter analyses the Islamic banking sector's resilience during 2005–2012. Where possible, the analysis is extended to cover the performance in the 1H2013. The assets of these 52 Islamic banks represent approximately 66% of the global Islamic banking assets (excluding Iran) as at year-end 2012 and, as a result, are of critical significance for the industry's stability. This sample will be used as an indicative measure of the overall Islamic banking industry's performance by country in later sections of this chapter.

As an overview, the profitability of the Islamic banking sector subsided during the financial crisis years (for example, ROA declined from 2.46% in 2007 to 0.74% in 2009) for reasons that varied from country to country – for example, a real estate crisis in UAE, where Islamic banks had exposures to property financing domestic political problems in Bahrain, which had an impact on the overall economy; and an economic slowdown in Pakistan. However, the returns are gradually improving across the board on account of improving net profit margins on financing (2007: 2.90%; 2009: 0.87%; 2012: 1.06%) and operating efficiencies (cost-to-income ratio: 2007: 43.7%, 2009: 52.9%, 2012: 48%) as Islamic banks generated higher revenues and cut back on capital expenditures.

In terms of asset quality, non-performing financing across the sample generally increased from 2008 onwards to peak at 6.03% in 2010; however, this was still lower than the global non-performing loans' (NPLs) average of 6.44% in 2010, as reported by the IMF Stability Report for 2010. The worst-affected jurisdictions were the UAE, Bahrain, Kuwait and Pakistan, due to factors that will be discussed in this chapter. However, some jurisdictions such as Qatar and Malaysia experienced a minimal impact on their asset quality, as their domestic economies remained strong and performed resiliently, despite challenges on the international trade front as the global economies experienced slowdowns.

In terms of capitalisation, Islamic banks across the sample on average maintained over 15% of Tier 1 regulatory capital, higher than the major conventional banks' average of just under 13%[83] as at year-end 2012. The higher capitalisation of Islamic banks was driven, in part, by the absence of sufficient liquidity management facilities and Islamic capital market instruments needed to support the capital and liquidity requirements of most Islamic banking jurisdictions. The absence of these instruments compelled Islamic banks to maintain higher buffers of Tier 1 regulatory capital, mainly common equity. In addition, Islamic banks generally did not hold Tier 2 regulatory capital instruments such as preferred shares or subordinated debt (as per Basel II), since these types of instruments by and large do not comply with *Sharī`ah* for reasons such as the fixed and guaranteed nature of returns (absence of risk-sharing characteristics), *gharar*, and subordination features. Hence, Islamic banks hold most of their capital in the form of Tier 1 regulatory capital, which further explains the higher average Tier 1 regulatory capital ratio for Islamic banks in comparison to conventional banks. Industry-wide, GCC banks have maintained high capital ratios under Basel II, and some banks have also raised capital in

[82] For further details and a list of sample banks, please refer to the sample methodology for Islamic banking in Appendix 1.
[83] IMF Financial Stability Report (October 2013).

recent years to further strengthen their balance sheet positions. Similarly, in Asia's banking systems, high capital buffers in most jurisdictions are expected to provide ample protection against future shocks (if any) given the region's relatively low delinquency levels. Asset quality has been strong, underpinned by prudent provisioning practices by most Asian banks.

Despite its relatively resilient and stable performance, the Islamic banking system as a whole did experience an adverse impact during the GFC period and many of the performance indicators across the Islamic banking industry are yet to revert to levels recorded during the pre-crisis years. However, the adverse impact of the crisis on the Islamic banking sector in most sample countries is attributable to domestic vulnerabilities and economic fundamentals, rather than being considered a direct consequence of the GFC.[84] This indicates that the Islamic banking balance sheets in themselves were shielded from the direct shocks experienced by the conventional financial system in the US and European markets. However, the extent of the impact varies among the individual sample countries depending on their economic fundamentals, and this will be examined in this chapter.

As of 2013, the performance of Islamic banking has improved considerably across all banking indicators and remains at a healthier standard than in previous years. The following sections will also illustrate that Islamic banks have fared better than conventional banks in weathering the global economic and financial turbulences as measured across a number of banking indicators.

3.1.1 Profitability

The profitability ratios of the Islamic banking industry prior to the crisis years (2005–2007) were strong, with ROA and ROE averaging 2.5% and 15%, respectively, across the Islamic banking sample. The robust growth in financing and investment activities across most jurisdictions in various sectors (for example, real estate in UAE, oil and gas in Qatar, household financing in Malaysia, working capital and business financing in Turkey) has helped Islamic banks to record generous asset growth rates in their balance sheets. However, the returns became subdued during the financial crisis years of 2008–2009, reaching lows of ROA 0.74% and ROE 6.16% in 2009. The positive returns across the Islamic banking sample still fared better than the conventional banking system, where, in 2009, the European banks generated ROA and ROE of 0.1% and 4%, respectively, while the US banks generated –0.05% and –1%, respectively.[85] As such, during the crisis years, the Islamic banking system was more stable than the conventional system, in terms of generating returns.

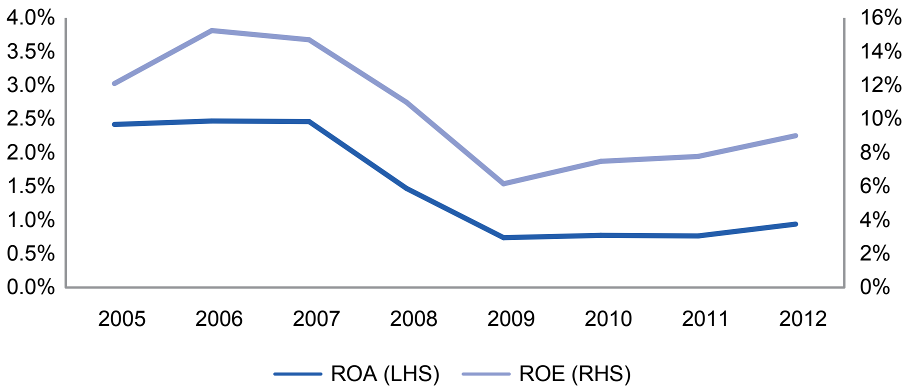
Among countries, the slowdown in returns during 2008–2010 was experienced most strongly by Islamic banks in Pakistan, Bahrain, UAE and Kuwait. In Bahrain, the Arab Spring protests and demonstrations calling for reforms impacted on the domestic economy, which saw subdued returns in various sectors, including banking. In Kuwait, the excessive exposures of Islamic banks in the real estate and property investment sectors impacted their profitability ratios. Similarly, in the UAE, significant declines in real estate prices contributed to the build-up of NPF and higher impairment reserves, which caused returns to fall. Among other jurisdictions, returns remained fairly stable in Malaysia, Turkey, Saudi Arabia and Bangladesh, whose economies were spearheaded by strong domestic consumption and economic performance which helped the financial sector to remain largely resilient to external shocks.

Overall, the improving domestic economic fundamentals in the sample countries, as well as appropriate responsive actions and support from the regulatory authorities, have contributed to the Islamic banking system's resilience and stability. The real estate markets in the GCC are on a

[84] In the literature [e.g. IMF Working Paper by Hasan and Dridi (2010), World Bank Working Paper by Beck, Kunt and Merrouche (2010)] it has been widely regarded that Islamic banks survived the first wave of the crisis during 2007–2008, and were only adversely impacted when the crisis hit the real economy in 2009 onwards, due to their excessive exposure to the real sector and limited reliance on risk-sharing instruments.
[85] Deutsche Bank, "Banks' Performance in US and Europe" (September 2013).

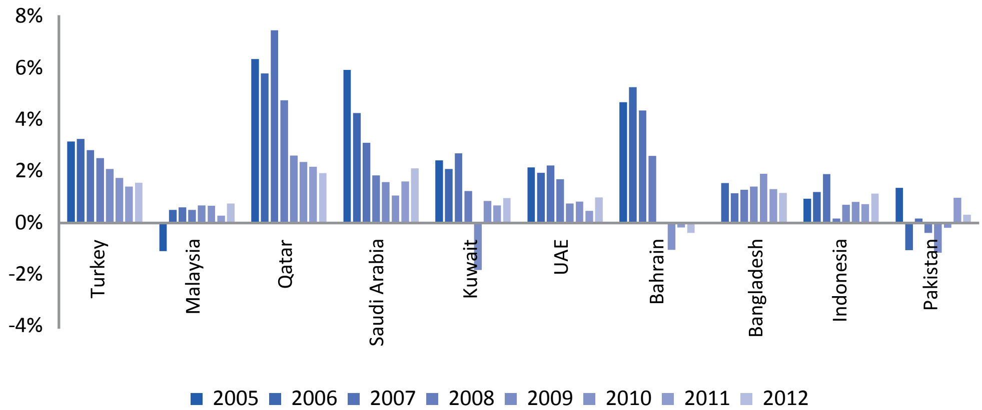
recovery path, contributing to the improved performance. Islamic banks have also taken the necessary actions to consolidate their positions while clearing their balance sheets of impaired financing. As at year-end 2012, the Islamic banking sample had an average ROA and ROE of 0.94% and 9.02%, respectively, compared to the ROA of 0.4% for the same period reported for large banks in the advanced economies.[86]

Chart 3.1.1.1: Islamic Banking Average Return on Assets and Equity



Source: Islamic Banking Sample, KFHR

Chart 3.1.1.2: Islamic Banking Average Return on Assets by Country

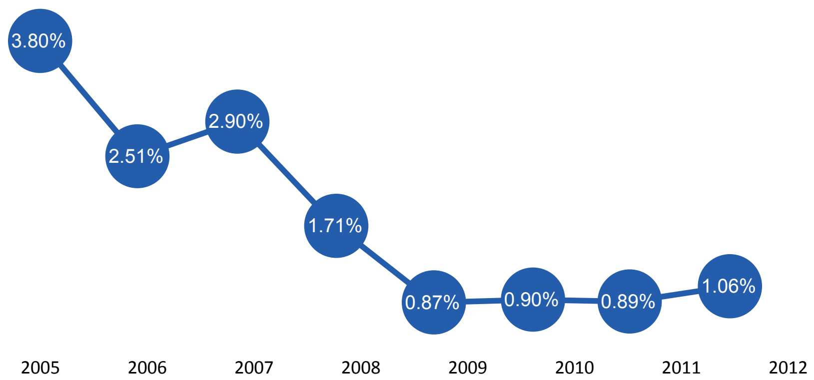


Source: Islamic Banking Sample, KFHR

As of 2012, the returns in most of the sample countries have improved on account of various factors including improvements in domestic economic fundamentals, recoveries in the real estate sector to which Islamic banks had significant exposures, as well as strong regulatory directives supporting the cleaning up of impaired banking balance sheets.

[86]Global Financial Stability Report, IMF, October 2013.

Chart 3.1.1.3: Islamic Banking Average Net Profit Margin



Source: Islamic Banking Sample, KFHR

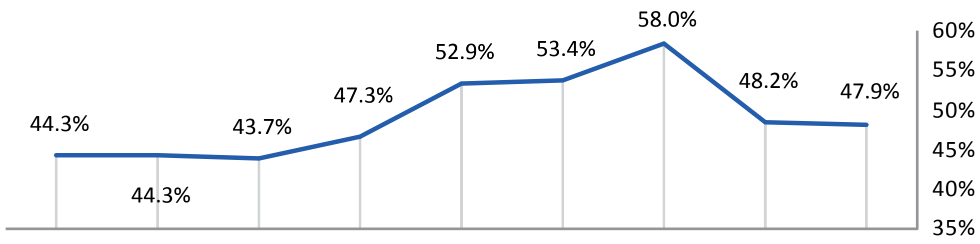
Following stagnation in net profit margins during 2009–2011, the Islamic banks' sample overall experienced an improved net profit margin of 1.06% in 2012 which, although lower than the pre-crisis high of 2.9% in 2007, was still higher than the conventional banking system's net income margin across many regions.

The net profit margins of Islamic banks further highlight how the industry was impacted post-financial crisis, reaching a low of 0.87% in 2009. The decline can be attributed to the low profit rate environment in most jurisdictions, highly competitive customer deposit markets, contracting non-core banking revenues, and relatively high credit losses stemming from the crisis years. As at year-end 2012, the net profit margin across the Islamic banking sample remained low (compared to the pre-crisis level of 2.90% in 2007) at 1.06%; however, this was much higher than the conventional banking system's net income margin for the various regions during the same period: Euro Area –0.2%, Other Advanced Europe 0.2%, North America 0.7%, Advanced Asia-Pacific 0.8% and Emerging Asia 0.9%.[87] The ability of the Islamic banking system to sustain higher and positive net profit margins during and following the crisis years, in comparison to the conventional banks that experienced deterioration and at times negative net income margins, further indicates the comparative stability of the Islamic banking system over the years.

For Islamic banks, on average, cost-to-income ratios increased to 58% in 2011 from a low of 43.7% in 2007 before once again reverting to a lower level of 47.9% as at 1H2013. As of 2007, many Islamic banks in the sample were relatively new entrants into the market, which saw them undertaking substantial capital expenditure to develop their infrastructure and expand their branch networks to enhance their market penetration and outreach. Among comparatively more mature banks, increasing competition in the Islamic banking sector led them to undertake capital spending to improve their quality of service through enhancements in information technology platforms, increasing distribution channels, recruiting and retaining skilled professionals, and organisational restructuring. These expenditures bode well from a financial stability perspective, as an enhanced infrastructure system and a wider branch network enables Islamic banks to be competitive and expand their market share, thus diversifying their risks across a greater geographical landscape and client base. Overall, as the Islamic banking sector has moved towards achieving greater market penetration, the cost-to-income ratios have correspondingly increased.

[87] IMF Financial Stability Report (October 2013).

Chart 3.1.1.4: Islamic Banking Average Cost to Income



Source: Islamic Banking Sample, KFHR

The average cost-to-income across the Islamic banking sample has reduced from 2012 onwards on account of higher revenue earnings, reduction in operating expenditures facilitated by cost-cutting measures, and postponement of further capital expenditures, among other reasons.

As of 2012, the cost-to-income ratio reverted to 48.2% on the back of higher revenue earnings, a postponement of further capital expenditure, and the optimisation of revenue expenditures as the impact from impairments accumulated during 2009–2010 began to be felt in the balance sheets of Islamic banks. The ratio reduced further, to 47.9%, as at 1H2013. This reflects prudency in decision-making by Islamic banks' management across the board in response to the macroeconomic conditions of the global and domestic markets, thus further boosting the financial stability of the Islamic banking sector. The UAE, Indonesia, Turkey and Saudi Arabia experienced substantial improvements in their cost-to-income ratios during 2012 and 1H2013, corresponding to the significant improvements recorded in these jurisdictions for their ROA, equities and net profit margins in the same year. (Box 3.2 illustrates the performance of participation banks in Turkey.) The reduction in 2012 can also partly be attributed to Islamic banks' cost-cutting measures through the substantive use of automation (being the result of major capital investments in information technology in earlier years) and better management of credit risk, as well as significant proportionate increases in income. Expected cost-cutting measures and improved distribution lines moving forward will help to improve operating efficiency and contribute to a more sustainable banking industry, although the risks of tougher competition and volatile global economic conditions may limit progress. Among other jurisdictions, the cost-to-income ratios experienced only moderate changes in 2012, reflecting a consistent performance for 2012.

A 2010 study by the IMF (*Islamic Banks and Financial Stability: An Empirical Analysis*) highlighted that large conventional banks tend to be financially stronger than large Islamic banks. Large conventional banks have higher liquidity levels and wider access to various interbank market or hedging instruments. In a dual financial environment such as we have today, where conventional banks, through window and subsidiary operations, are leveraging on their conventional set-up platforms, infrastructure and branches outreach to tap into potential Islamic finance markets, this poses a challenge to stand-alone Islamic banks. Such Islamic banks, most of which are relatively new compared to the established conventional banks, need delicate balancing strategies to achieve the two-prong objectives of being able to offer competitive financial products while at the same time putting in place the required infrastructure for long-term expansion. As seen in the above trends, during an economic slowdown, substantial capital expenditure needs to be strategically balanced with the banks' competitiveness in the market.

Box 3.2: Islamic Finance in Turkey: A Close Look at Participation Banks

By: The Central Bank of the Republic of Turkey

Introduction

The outlook for participation banks[88] in Turkey looks promising. Participation banks with nearly 5% asset share in the banking sector in Turkey have room for further growth, taking into consideration the relatively low degree of financial intermediation with their total assets to GDP ratio being only 6% as of 3Q13. Besides, they are expected to contribute to financial inclusion, thereby increasing financial depth by both presenting alternative financial instruments in addition to conventional peers and enabling savings to enter into the financial system. Looking from the financial stability dimension, on the other hand, the reasons that place participation banks into the front also reveal that vulnerabilities and potential systemic risks associated with them should be avoided to the extent possible.

Legal and Regulatory Framework

The financial sector in Turkey was deregulated in the early 1980s during the liberalisation process, and Islamic banks were first structured as Special Finance Houses (SFHs) in 1985. Albaraka Turk was established as the first SFH in 1985; Kuveyt Turk followed in 1989. SFHs initially were included in the 1999 Banking Law. Later, the current Banking Law No. 5411, which was enacted in 2005, gave the SFHs the status of banks and named them as "participation banks".[89] According to this law, regulations on the establishment and operation of participation banks are the same as for the conventional deposit and investment banks. Within this context, like all other banks, participation banks are being regulated and supervised by the Banking Regulation and Supervision Agency (BRSA).

Apart from the banking sector, the Islamic capital market and *Takāful* have not been well developed so far. However, important policy decisions have been taken in recent years to establish an Islamic capital market. The regulatory infrastructure for *Sukūk* issuance in Turkey has enabled the participation banks to tap the *Sukūk* market potential following the issuance of *Sukūk* Communiqué by the Capital Markets Board of Turkey in April 2010 and the amendment to allow the issuance of *Istisnā`*, *Murābahah*, *Muḍārabah*, *Mushārakah* and *Wakālah Sukūk* in June 2013. The first *Sukūk* of a participation bank was launched by the Kuveyt Turk in August 2010. The Turkish Treasury came into the *Sukūk* market by an initial sovereign *Sukūk* issuance in September 2012. Since then, there have been several *Sukūk* issuances by participation banks and the Treasury, reaching a total outstanding issuance amount of USD4.4 billion in the international and TRY5.13 billion (USD2.57 billion) in the domestic market by the end of 2013. Furthermore, in support of the Islamic funds industry, particularly mutual funds, an "Exchange-Traded Funds (ETF) and Equities Participation Index" (Turkish abbreviation: KATLM) was established in 2011 by the participation banks and Borsa Istanbul.

Though total financial assets have already reached 100% of GDP ratio in Turkey, there is still potential for participation banks to increase their market share in the financial system. In addition to this, there remains a huge market potential to tap for Islamic capital market instruments and *Takāful* in the Turkish financial system. In particular, participation banking and Islamic capital market instruments will grow even faster when the Istanbul Financial Center (IFC) project comes into full effect in the near future. The regulatory treatments consistent with the IFC project have already been undertaken, including those related to Islamic finance. The recent regulations on *Sukūk* issued by the Capital Markets Board of Turkey and the Treasury have been the most crucial milestones among those new treatments.

[88] Islamic banks are called 'participation banks' in Turkey.
[89] There are four participation banks currently operating in Turkey: Albaraka Türk, Bank Asya, Kuveyt Türk and Türkiye Finans.

Box 3.2 *(continued)*

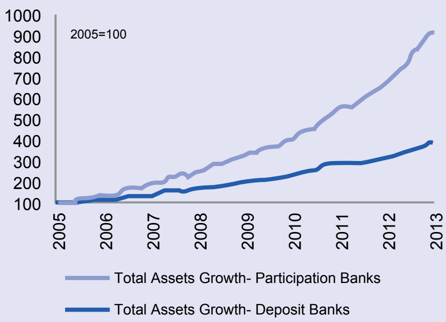
As for liquidity facilities, there is no available dedicated facility or lender of last resort (LOLR) mechanism through which the Central Bank of the Republic of Turkey (CBRT) can provide liquidity to participation banks. Nevertheless, they are able to participate in the open market operations of the CBRT directly. In terms of instruments, CBRT started in 2012 to accept government-issued rent certificates (*Sukūk*) from the participation banks as collateral in open market operations.

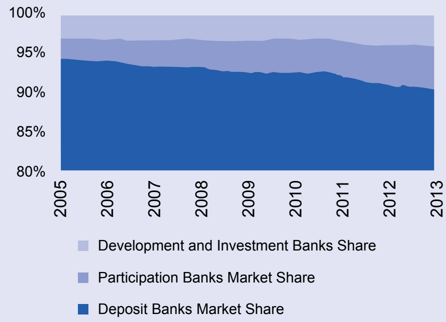
A Comparative Analysis of Participation Banks and Deposit Banks[90]

Growth and Market Share

The total asset size of participation banks reached TRY91 billion (USD45.5 billion, 6% of GDP) as of October 2013, having a 33% average yearly growth rate compared to the 19% growth rate of conventional deposit banks between 2005 and 2013. In the same period, participation banks have increased their market share of the total assets in the banking sector from 2.4% to 5.6%.

Chart 1: Asset Growth and Banking Sector Market Share





Source: CBRT, BRSA

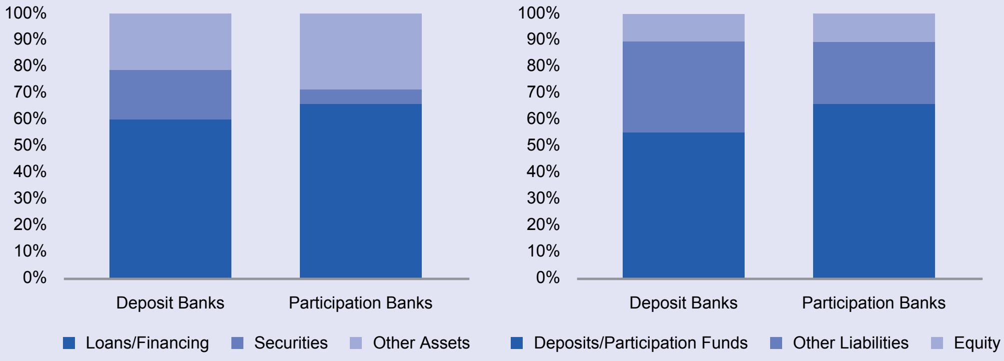
Asset and Liability Structures

The ratio of financing to total assets was 66% for the participation banks and 60% for the deposit banks as of October 2013. The ratio of participation funds to the total of the liabilities side of the balance sheet for participation banks and deposit banks was 65% and 57% for the same period, respectively. This indicates that participation banks are dependent less on wholesale funding and more on core funding.

[90] ‘Deposit banks’ refers to conventional banks.

Box 3.2 *(continued)*

Chart 2: Asset and Liability Composition of Banks

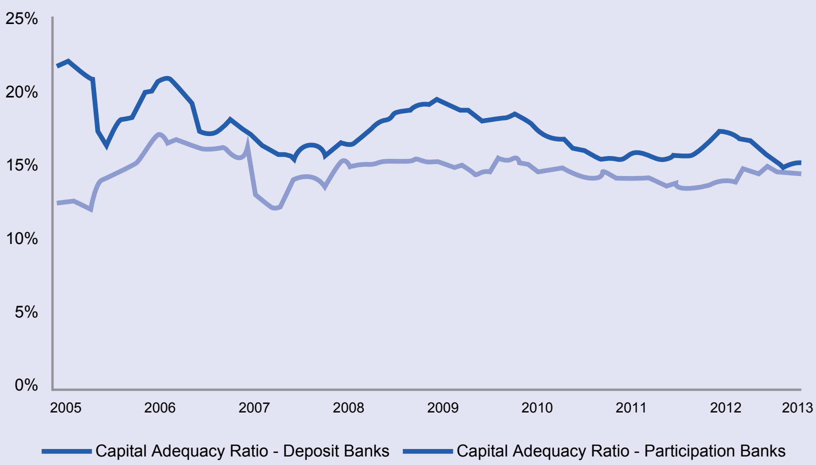


Source: CBRT, BRSA

Capital Adequacy

The capital adequacy ratios of participation banks have been lower than those of deposit banks since financing-oriented rapid asset growth has not resulted in sufficient profitability. As of October 2013, the capital adequacy ratio and Tier-1 capital ratio (based on the Basel II definitions) are 14.4% and 12% for the participation banks, whereas the same ratios for conventional banks are 15.1% and 12.5%. The lower capital adequacy ratios might place a further burden on the growth potential of participation banks.

Chart 3: Capital Adequacy Ratios of Banks in Turkey



Source: CBRT, BRSA

The Turkish banking sector is less vulnerable to risks arising from loans/financing in terms of shock scenarios (Table 1). Under both stress scenarios for capital adequacy ratios, it seems apparent that participation banks have the ability to sustain a capital adequacy level that is higher than the regulatory minimum.

Box 3.2 *(continued)*

Table 1: Stress Test Results – Capital Adequacy[91, 92]

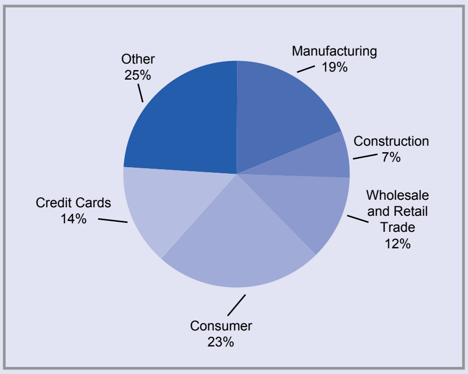
Participation Banks	Current	Scenario 1	Scenario 2
		1% of Performing Financing Becomes NPL	5% of Performing Financing Becomes NPL
Capital Adequacy Ratio (%)	14.41	13.62	10.39
Non-performing Financing (%)	3.29	4.25	8.12

Asset Quality

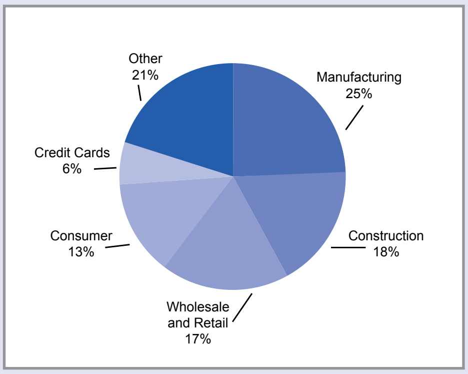
The asset growth of the participation banks is based primarily on an increase in financing. Over the period from 2005 to 2013, the share of commercial financing in total financing was higher for participation banks compared to deposit banks. Participation banks extend their commercial financing largely to small- and medium-sized enterprises (SMEs), having a 47% share of total financing, compared to 25% of loans of conventional banks as of 2013. The shares of total financing by participation banks for manufacturing, construction and commerce are 26%, 15% and 18%, respectively, as of October 2013. The comparable figures for conventional banks are 18%, 6% and 12%, respectively.

Chart 4: Sectoral Composition of Loans/Financing (October 2013)

Deposit Banks



Participation Banks



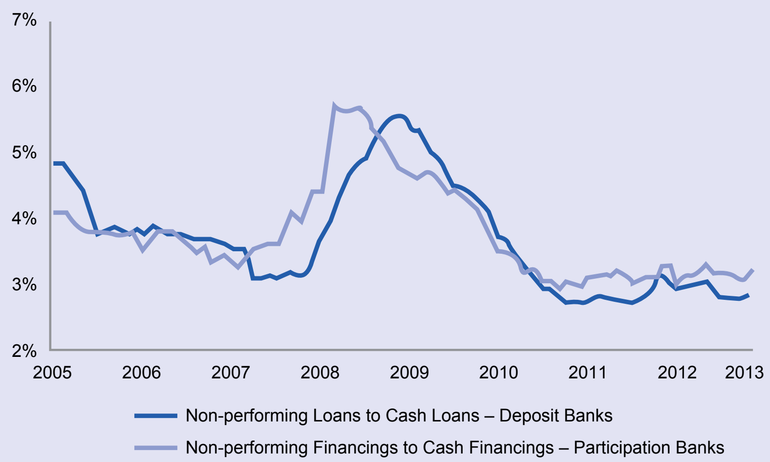
Source: CBRT, BRSA

The NPF/NPL ratio of both participation and deposit banks increased soon after the GDP reached its peak in 2009 and then began to decline. However, it has been following a flat course since 2011. The NPF/NPL to financing/cash loans ratio was 3.3% for participation banks and 2.8% for conventional banks as of October 2013 (Chart 5). Historically, the NPF/NPL to financing/cash loan ratios of deposit and participation banks have followed the same direction. However, for the past two years, deposit banks have shown slightly better performance than participation banks.

91 Stressed Capital Adequacy Ratio= (Regulatory Capital – Portion of Financings Becomes NPL)/(RWA – (Portion of Financings Becomes NPL*100%*0.7))
92 Risk weights are considered to be 70% of actual risk weight.

Box 3.2 *(continued)*

Chart 5: Non-Performing Loans/Financing to Cash Loans/Financing



Source: CBRT, BRSA

Management and Efficiency

The numbers of branches and staff of participation banks have increased from 292 to 942, and from 5747 to 16801, respectively, from 2005 to October 2013. From this perspective, participation banks in Turkey could further extend their branch network. Compared to their conventional peers, which had on average 340 branches per bank, TRY82 million (USD41 billion) of outstanding loans per branch, and TRY1.8 million (USD0.9 billion) net profit per branch for the first ten months of 2013, participation banks have on average 236 branches, TRY64 million (USD32 billion) of outstanding financing and TRY1 million (USD0.5 billion) profit per branch. Against this background, the productivity performance of participation banks per branch is expected to increase in coming period on the grounds that their branches have been in a start-up phase to tap economies of scale.

Earnings and Profitability

For a more comprehensive view of the performance of participation banks and conventional banks in Turkey, a comparison of profitability indicators plays a key role. Table 2 summarises the findings from a profitability performance comparison. The participation banks performed much better than deposit banks in terms of ROE before 2009, but this has turned around since 2009. ROE for participation banks and deposit banks was 13% and 15%, respectively, for 2013 October.[93] Participation banks' profitability performance was not as good as their growth performance.

Participation banks had both a lower return on asset ratio and a higher leverage ratio. In spite of a higher leverage, their return performance was below that of deposit banks. Even if participation banks performed slightly better than deposit banks in terms of generating revenues (asset utilisation) between 2009 and 2013 October, participation banks' low performance on controlling costs led to a lower return on asset performance.

[93] 2013 values are the annualised figures.

Box 3.2 *(continued)*

The low profit margin of participation banks is due to their higher operational and credit risk costs. The non-profit share/interest expense to total income ratio for participation banks and deposit banks was 57.3% and 52.9%, respectively, for 2013 October. Also, the financing/loan loss provision to total income ratio was 17.5% and 11.6%, respectively, in the same period. The difference is due mainly to scale and customer base. Since participation banks are smaller than deposit banks, they are not able to benefit from economies of scale as much as deposit banks. In addition, their credit risk cost was higher because participation banks' corporate financing is granted mainly to SMEs, which have a higher NPF/NPL ratio compared to large firms, the main corporate clients of deposit banks.

In terms of asset utilisation ratios, participation banks have performed slightly better than deposit banks. The ratios for participation and deposit banks were 6.41% and 6.29%, respectively, for 2013 October. The main contribution to better revenue generation performance of participation banks stems from non-interest income. On the other hand, net profit/interest margin of participation banks has been lower than that of deposit banks. The net profit/interest income to average assets was 3.54% and 3.91% for 2013 October for participation and deposit banks, respectively. Since participation banks lowered their financing–deposit spreads in order to increase their market shares after the crisis, they came up with a lower net profit/interest margin compared to deposit banks.

Table 2: Profitability Performance of the Banking Sector in Turkey

Deposit Banks	2006	2007	2008	2009	2010	2011	2012	2013/10
ROE= ROA*EM								
Net Profit/ Average Equity (ROE)%	20.9	23.4	17.4	22.3	19.7	15.3	15.4	15.0
Net Profit/ Average Assets (ROA)%	2.4	2.7	1.9	2.5	2.4	1.8	1.8	1.8
Average Assets/ Average Equity (EM)	8.7	8.8	9.0	8.8	8.2	8.6	8.4	8.5
ROA=PM*AU								
Net Profit/Total Income (PM)%	31.4	33.5	26.6	31.8	35.2	30.2	29.1	27.9
Total Income/Average Assets (AU)%	7.6	7.9	7.3	8.0	6.8	5.9	6.3	6.3
PM=1-((NIE+LLP+Tax)/TI)								
Non Interest Expense/Total Income (NIE/TI)%	53.6	51.8	55.4	44.4	47.9	55.3	53.1	52.9
Loan Loss Provisions/Total Income (LLP/TI)%	6.0	7.0	11.5	15.9	8.7	6.2	9.6	11.6
Tax/Total Income%	9.0	7.7	6.4	7.9	8.2	8.3	8.2	7.6
AU= (Net Interest Income+Non Interest Income)/Average Assets								
Net Interest Income/Average Assets%	4.6	4.7	4.6	5.3	4.2	3.5	4.0	3.9
Non Interest Income/Average Assets%	3.0	3.2	2.7	2.7	2.6	2.3	2.2	2.4

Participation Banks	2006	2007	2008	2009	2010	2011	2012	2013/10
ROE= ROA*EM								
Net Profit/ Average Equity (ROE)%	31.1	26.9	21.3	17.3	15.4	13.8	13.5	13.0
Net Profit/ Average Assets (ROA)%	3.3	3.2	2.9	2.4	2.0	1.6	1.4	1.3
Average Assets/ Average Equity (EM)	9.4	8.5	7.4	7.3	7.8	8.5	9.3	10.1
ROA=PM*AU								
Net Profit/Total Income (PM)%	30.0	30.3	27.0	24.2	26.0	23.5	21.0	20.1
Total Income/Average Assets (AU)%	11.0	10.5	10.6	9.8	7.6	6.9	6.9	6.4
PM=1-((NPSE+LLP+Tax)/TI)								
Non Profit Share Expense/Total Income (NIE/TI)%	59.0	55.3	55.7	49.6	57.1	58.8	56.6	57.3
Financing Loss Provisions/Total Income (LLP/TI)%	7.0	7.3	10.1	19.9	10.5	11.6	16.9	17.5
Tax/Total Income%	4.0	7.1	7.2	6.3	6.3	6.1	5.5	5.1
AU= (Net Profit Share Income+Non Interest Income)/Average Assets								
Net Profit Share Income/Average Assets%	5.5	5.5	5.5	5.2	3.9	3.7	3.9	3.5
Non Profit Share Income/Average Assets%	5.5	5.0	5.1	4.6	3.7	3.2	3.0	2.9

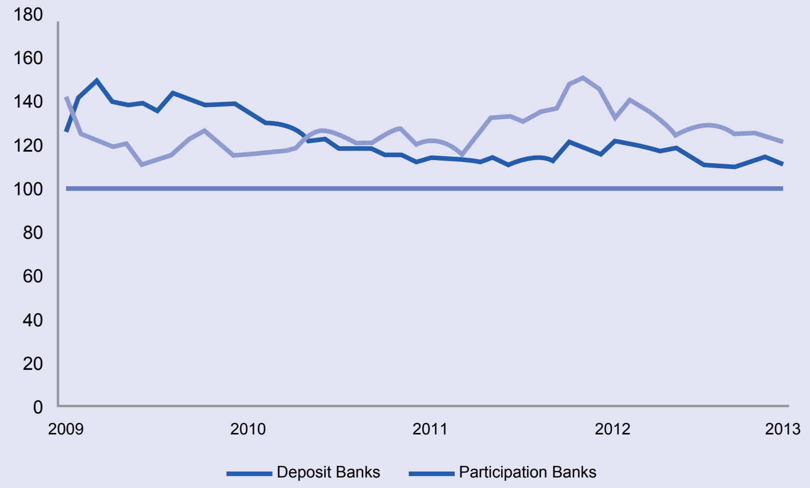
Source: CBRT Calculations

Box 3.2 *(continued)*

Liquidity

The liquidity position of both bank types stayed well above the legal minimum ratio even in the period after the global financial crisis (Chart 6).

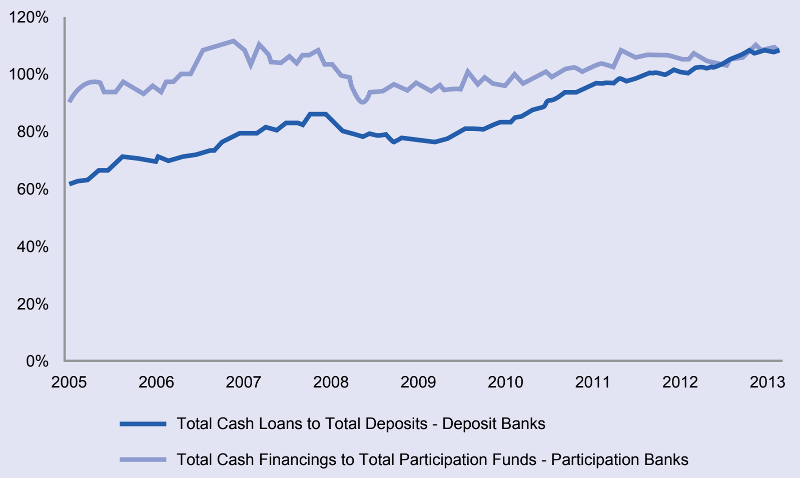
Chart 6: Liquidity Adequacy Ratios



Source: CBRT, BRSA

As for funding liquidity risk, the ratio of total cash financing to total deposits has converged since 2005 and is now more or less the same for both bank types (108% for participation banks, 109% for the conventional banks, see Chart 7). Although the participation banks' liquidity adequacy ratio and funding liquidity risk are at comfortable levels, the lack of liquid instruments that could be used in the money market as collateral inhibits their funding options.

Chart 7: Cash Loans/Financing to Total Deposits/Participation Funds Ratio



Source: CBRT, BRSA

Box 3.2 *(continued)*

According to the stress test results on liquidity, it seems that there is no liquidity gap for participation banks. For scenario 1, total assets and liabilities are taken into consideration, whereas foreign exchange balance sheet components only are considered for scenario 2. In both scenarios, there is no discount on liquid assets except those indicated in items 8, 9 and 10 with the ratio of 50%. Moreover, haircuts on participation funds and other sources are 50% for items 2 and 3, but 10% for item 1. In a nutshell, the results of scenario 1 and scenario 2 seem satisfactory, with levels of 1.07 and 1.25, respectively (Table 3).

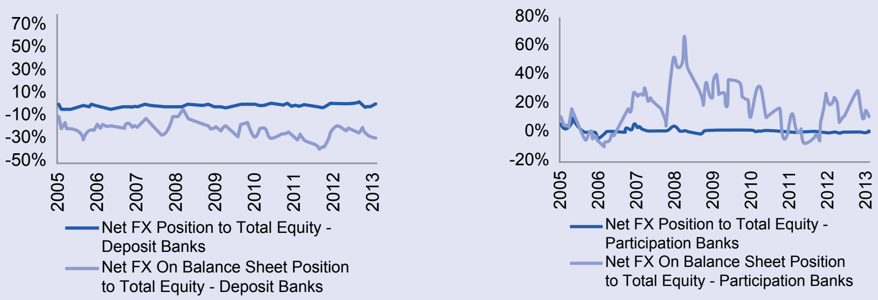
Table 3: Stress Test Results – Liquidity

Participation fund and other sources withdrawal rates	Scenario 1	Scenario 2
	Total	**FX**
1. Participation Funds	10%	10%
2. Payables to Banks	50%	50%
3. Funds from Repo Transactions	50%	50%
Discount rates on assets	**Scenario 1**	**Scenario 2**
	Total	**FX**
4. Cash	0%	0%
5. Receivables from Central Bank	0%	0%
6. Receivables from Money Market	0%	0%
7. Receivables from Banks	0%	0%
8. Securities Held for Trading	50%	50%
9. Securities Available for Sale	50%	50%
10. Required Reserves	50%	50%
11. Receivables from Reverse Repo	0%	0%
(Liquid Assets) / (Total Withdrawal) Ratio	**Scenario 1**	**Scenario 2**
	Total	**FX**
Participation Banks	1.07	1.25

Sensitivity to Market Risk

As for the currency risk of participation banks, the currency mismatch is less severe and there is almost no net FX open position (Chart 8). While deposit banks have negative foreign currency positions on their balance sheets, participation banks have positive foreign currency positions. This results from a high share of foreign currency and FX indexed financing. As of 2013, the share of foreign exchange assets to total assets was 46%, whereas conventional banks had a share of 35%.

Chart 8: FX Position of the Banking Sector



Source: CBRT, BRSA

Box 3.2 *(continued)*

The share of investment in securities in total assets was far lower for participation banks (5%) compared to deposit banks (19%) as of October 2013. This has been partly due to the business model of participation banks and the absence of sufficient *Sharī`ah*-compliant instruments in which to invest. In addition, as of 2013, the share of notional derivative amount to total assets was 16%, compared to conventional banks' 67%. As a result of having fewer securities and derivative transactions, participation banks' market risk and interest rate risk are far less than that of deposit banks.

To sum up, participation banks in Turkey perform traditional banking functions; that is, they provide *Sharī`ah*-compliant consumer and corporate financing on the basis of interest-free participation funds and refrain from investment banking activities. They have grown rapidly by widening their branch network and granting financing to corporate clients – in particular, to SMEs. However, their profitability performance has not matched their asset and participation fund growth. In other words, the growth of equity capital has been lagging behind that of assets, although participation banks have recorded significant expansion in assets. In the near future, it is likely that having better cost control and larger market shares will benefit participation banks and improve their profitability.

Financial Stability and Participation Banks

In Turkey, participation banks primarily collect participation funds and grant financing to real sector activities on a small scale. In fact, they introduce *Sharī`ah*-compliant financial instruments to different segments of the economy which contributes to deepening of the financial system through the inclusion of new savers and creditors, thus having a positive impact on long-term economic growth.

Sharī`ah stipulations prevent the extensive use of complex financial instruments such as derivatives. Also, the share of wholesale funding is comparatively low so that participation banks have a low degree of interconnectedness with the conventional segments of the financial system. In this framework, it is safe to say that participation banks have less potential to create systemic risk owing to their being less interconnected and less complex.

The data reveal that the credit growth figures of participation banks in Turkey are far less correlated with GDP growth compared to conventional banks (Table 4). One reason for this less pro-cyclical behaviour might be the eagerness of participation banks to increase their market share further in the period of economic downturn. Also, the standard deviation of the credit growth is lower for participation banks. From this perspective, the growth of financing by participation banks, even in the crisis period, was more stable than that of deposit banks. This is due to the fact that participation banks responded to the crisis environment by trying to increase their market share further. Adding to this, they emphasised the long-term relationship bonds with their customers during the period of economic downturn. Furthermore, their unique business model had restricted them from calling back their outstanding financing.

Table 4: Indicators on Real Credit and GDP Growth

2006Q1–2013Q3	Real Credit Growth		GDP Growth
	Deposit Banks	Participation Banks	
Mean	18.25	24.02	4.2
Standard Deviation	12.61	10.58	
Correlation	0.74	0.40	

Source: CBRT, BRSA

Box 3.2 *(continued)*

There remains a concern about macrofinancial risks which might originate from a build-up of systemic risks in the financial sector. In that sense, the business model of participation banks, being inherently consistent with financial stability, is of a vital importance. The challenge for participation banks is to continue their sound and robust growth while avoiding increasing their vulnerability. Islamic banking is still in a nascent stage in Turkey with a 5% market share; however, it has experienced robust growth over the past decade. There will be challenges in further expanding the market share of participation banks, due to the increasing competition with their conventional peers and potential new entrants. The deterioration of the capital adequacy ratio of participation banks from 15.2% to 14.4% between 2008 and October 2013 indicates that the participation banks have grown rapidly at the expense of their capital buffers. In this sense, it is crucial for participation banks to maintain a well-supported capital base while growing further. Product diversification on both the asset and liability side would improve the asset quality and support the growth of the financing business, and ultimately increase banks' profitability. It is important that profitability and productivity must not be overlooked while increasing the market share.

Conclusion

In recent years, Islamic finance and participation banking have experienced high growth in Turkey. The encouraging performance of participation banks is expected to continue. Although participation banks have operated in Turkey since the 1980s, Islamic finance has gained momentum in Turkey only since 2000, and there is plenty of scope for further expansion.

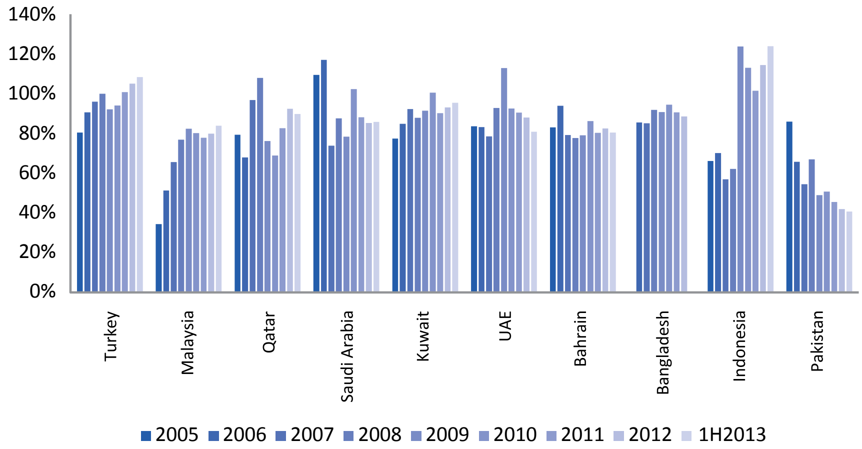
In general, participation banks have made good progress in the last decade, but they have further to go to ensure continuous and healthy growth. From the financial stability perspective, participation banks are contributors because of their less pro-cyclical financing behaviour, low degree of interconnectedness with volatile financial markets, and manageable complexity. However, fragilities still exist. Nevertheless, the participation banking model in Turkey, with its strong and stable growth potential, supports financial stability and has the power to contribute to financial inclusion.

3.1.2 Liquidity

In general, liquidity management has been a concern for Islamic financial institutions given the absence of Islamic money markets in most jurisdictions. Islamic interbank money markets play a critical role in allocating funds between surplus banks and deficit banks. In the absence of such markets and without LOLR facilities, Islamic banks face higher liquidity risks as any shortfall of liquid funds to meet withdrawal demands can cause a bank failure. As of 2013, an active and liquid Islamic money market exists in Malaysia, while efforts are underway to boost the Islamic money market in Indonesia. In addition, the global multilateral body IILM, headquartered in Malaysia, provides *Sharī`ah*-compliant instruments to address the liquidity management needs of Islamic financial institutions. As at end-January 2014, the IILM has issued USD1.84 billion worth of short-term *Sukūk* over three programmes since the inaugural USD490 million launch on 27 August 2013. The most recent issuance, on 20 January 2014, saw an increase in issuance size to USD860 million, and more frequent and larger-volume issuances are expected in future to further support the liquidity management of Islamic financial institutions. Islamic liquidity management instruments available in the Islamic financial industry today include Islamic negotiable notes of instruments, Islamic repurchase notes, Islamic certificates of deposit, short-term *Sukūk* instruments, Islamic Treasury bills, asset-based three-party buy-and-sale transactions (Commodity *Murābahah*) and Islamic deposits with central banks. The *Sharī`ah*-compliant contracts used in structuring these instruments include *Murābahah*, *Ijārah*, *Muḍārabah*, *Bay`al-`Inah* (in Malaysia), *Wadī`ah* and *Wakālah*.

A common indicator used to assess the liquidity of banks is the FDR, which indicates the proportion of financing extended in relation to the deposits mobilised. As an overview, the FDR appears to indicate comfortable liquidity positions for the overall Islamic banking sample during 2005–2012, as the ratio has remained under 90%. This presumption holds valid for most countries in the sample with the notable exception of Turkey and Indonesia, which have witnessed higher FDR – in excess of 100% – during the last few years.

Chart 3.1.2.1: Islamic Banking Average Total Financing to Deposits



Source: Islamic Banking Sample, KFHR

The FDR across the top ten Islamic banking jurisdictions (ex-Iran) indicates comfortable liquidity positions for the Islamic banks. Notable exceptions in recent years are Turkey and Indonesia, which have FDRs in excess of 100% due to unique peculiarities of the domestic banking sector.

In the case of Turkey, the economy is characterised by a low savings rate (savings to GDP ratio of 12%), and the banking environment as a whole generally operates on a deposit deficit framework whereby banks usually meet their funding gap via wholesale markets – in particular, international funding markets based mainly on USD and EUR. As a result, the Turkish banking sector generally is exposed to risks of adverse movement in the global funding markets, which is a critical risk from a financial stability perspective. Although the Turkish Islamic banks may be protected from such risks given that there is almost no net FX open position, they would still be impacted indirectly should a crisis occur. During the crisis years, the Turkish Islamic banking sample was observed to have moderated its financing activities to achieve cautious FDRs of below 100%. The Turkish conventional banking sector had a loan-to-deposit ratio of 110.1% as at October 2013, compared to the 102% FDR for the participation banking sector in the same time period.

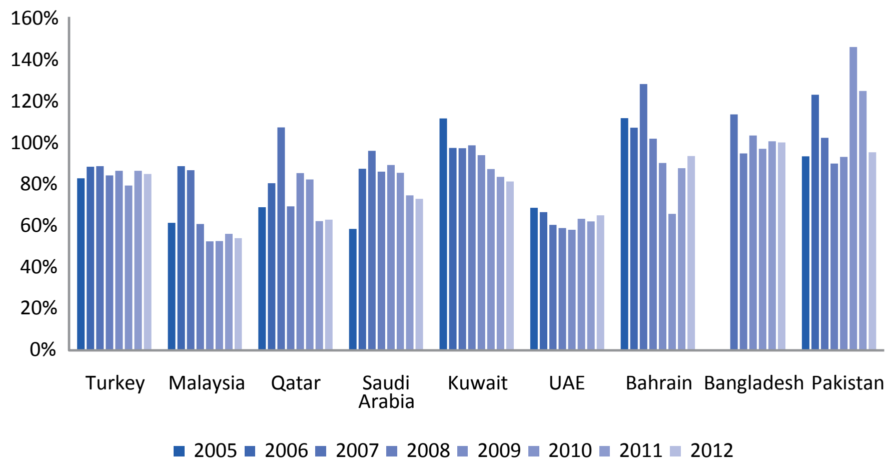
In the Indonesian context, the total loan growth in the banking sector has outpaced deposit growth during the 2006–2012 period, as indicated by statistics from Bank Indonesia ("central bank"). Therefore, the FDR in excess of 100% for Indonesia is on account of the domestic banking sector's trend, where financing extended is growing at a faster rate than deposits mobilisation. During the 2005–2011 period, the mining sector was the main driver of the growth in bank loans, as these years were characterised by a bull run on commodity prices – in particular, for crude palm oil and coal. These sectors were also supported by demand from fast-growing countries such as China and India. However, in 2012, the proportion of loans extended to the mining sector witnessed a decline given the falling commodity prices in world markets. The Islamic banking sample's FDR was 115.4%, compared with the overall banking sector's loans-to-deposit ratio of 98.2%, as at year-end 2012. This puts

Indonesian Islamic banks at a comparatively higher risk of financial instability from a liquidity point of view, given their greater reliance on funds markets to raise liquidity in order to support their portfolio of financing assets. The Islamic banking FDR in Indonesia further increased to 124.7% as at 1H2013, the highest among the jurisdictions in this study.

Another notable exception among the sample countries is Pakistan where the FDRs for Islamic banks were low, ranging between 42% and 50% during 2009–2012, declining from relatively higher levels in the previous years. Such a trend is also noticeable for the conventional banking sector, as the overall industry's loans-to-deposits ratio was just under 58% in July 2013, according to statistics from the State Bank of Pakistan. The decline in loan/financing ratio is largely due to the absence of profitable financing opportunities (in relationship to the risks) in the economy. The banks invested more funds in government Treasury bills and bonds, as well as in stocks and other approved securities. From a financial stability perspective, the Islamic banking sample fares better in Pakistan given its lower FDR, although the conclusion might be the opposite with respect to profitability and efficiency of utilising funds. Overall, the Islamic banking sample's FDR mirrored the trends witnessed in the conventional banking sector loans-to-deposits ratio for these countries. In general, the liquidity levels were reflective of unique country-specific characteristics, and the Islamic banks did not pose systemic stability risks any different from the risks posed by the conventional banks.

In terms of liquidity ratio,[94] the asset and liability management of Islamic banks in the sample has generally been prudent, with an average current ratio of 96.21% between 2005 and 2012. However, since reaching a high of 111.74% in 2007, the rate has been gradually decreasing to reach 82.84% as at year-end 2012. The declining average current ratio of sample Islamic banks is a concern, as it indicates Islamic banks have greater short-term deposit obligations to meet in respect to available short-term liquid assets. Among individual jurisdictions, Malaysia had the lowest levels of current ratios, which reflects the availability of a healthy and liquid Islamic interbank money market as well as the central bank, having *Sharī`ah*-compliant instruments, being available as the LOLR.

Chart 3.1.2.2: Islamic Banking Average Liquidity Ratio by Country



Source: Islamic Banking Sample, KFHR

[94] The liquidity ratio measures the amount of highly liquid assets held by financial institutions in order to meet short-term obligations. The analysis in this section, however, does not address liquidity from the perspective of the recently endorsed Basel III's LCR, given that it is yet to be implemented and many banks are currently not reporting based on these indicators. Basel III has introduced the LCR, which is designed to ensure that financial institutions have the necessary assets on hand to ride out short-term liquidity disruptions. Banks are required to hold an amount of highly liquid assets, such as cash or Treasury bonds, equal to or greater than their net cash over a 30-day period (having at least 100% coverage). The LCR has been endorsed as the global minimum standard for liquidity risk by the Basel Committee on 6 January 2013, with implementation to begin 1 January 2015, but the full 100% minimum will not be enforced until 2019.

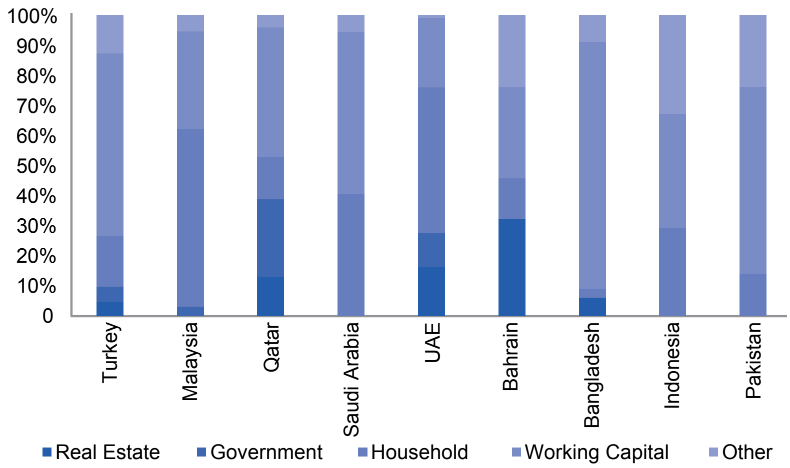
The Islamic banking industry is affected by several long-standing issues in relation to liquidity – insufficient liquidity instruments, less active interbank markets, and the non-existence of secondary markets for *Sharī`ah*-compliant securities in most jurisdictions. At present, only several advanced Islamic finance jurisdictions have developed reasonably comprehensive Islamic interbank and money markets; however, the behavioural trends of these markets during stress or liquidity events are yet to be tested. Insufficient liquidity can be an independent source of risk, and excessive holdings of non-income-generating assets such as cash would affect the profitability of the banks. In order to effectively manage their excess liquidity, Islamic banks should have access to a wider range of instruments. Another important issue is the lack of emergency liquidity during stress, which could lead Islamic banks to insolvency. Although Islamic banks have been able to navigate through the crisis, development of LOLR facilities is critical to ensure overall market confidence in Islamic banks. Furthermore, Islamic banks are now diversifying their businesses at both regional and global levels. As such, market confidence in the ability of Islamic banks to withstand any stress period is a crucial element in achieving this.

3.1.3 Financing Exposures

In categorising Islamic banks' composition of exposures into four broad sectors, it can be observed that there are variations across jurisdictions. Funds distributed and invested for working capital purposes account for a significantly large share of exposures in Turkey, Qatar, Bangladesh, Pakistan and Saudi Arabia. The widespread use of the banking channel for working capital purposes in these countries reflects the large number of SMEs located in these countries. These SMEs have to rely on banks for their financial needs, as tapping into the debt and *Sukūk* market is not feasible given the costs and lengthy processes involved in listing instruments on debt markets. Based on recent estimates, SMEs make up 99% of total enterprises registered in Turkey[95] and about 90% in Saudi Arabia,[96] Pakistan[97] and Qatar.[98] The SMEs are critical from a macroeconomic stability perspective, given their ability to create employment opportunities for large segments of an economy's workforce. During economic downturns, SMEs are likely to face the most severe forms of liquidity crunch as banking institutions generally cut back financing lines for the SMEs in periods of financial distress given the riskier profiles of SMEs due to their smaller asset and capital bases in comparison to the larger firms. Similarly, a slowdown in economic growth can also impede consumer spending and consumption in an economy, which may have a more material impact on the revenues and survival of SME firms as compared to large organisations. This may lead to instances of insolvency among the SME firms, which may contribute towards a high level of NPFs among the Islamic banks having exposures to this sector.

[95] European Commission, "SBA Fact Sheet: Turkey 2010/2011".
[96] Capitas Group International, "Importance of an SME Authority in Saudi Arabia".
[97] State Bank of Pakistan, *Special Report: SME Growth in Pakistan* (2010).
[98] Enterprise Qatar, "Overview of SME Sector in Qatar" (2013).

Chart 3.1.3.1: Islamic Banking Average Composition of Financing Exposures[99] (2012)



Source: Islamic Banking Sample, KFHR

As of 2012, business working capital financing had a significantly large share of exposures in Turkey, (62%), Qatar (40%), Bangladesh (81%), Pakistan (64%) and Saudi Arabia (49%), countries which are home to a large number of SMEs. In contrast, household debt exposures were more prominent for Islamic banks in Malaysia (56%) and the UAE (48%).

Household debt exposures are more prominent for Islamic banks in countries such as Malaysia and the UAE, where residential property financing among households has been growing at significant rates in recent years. Malaysia has a relatively well-developed and liquid Islamic capital market which is widely tapped into by the corporate sector, as opposed to the banking channel, for borrowings. The level of household debt in Malaysia has been increasing steadily in recent years given the domestic economy's resilience to the GFC. In July 2013, Bank Negara Malaysia introduced three new measures to curb the rising household debt to avoid any potential domestic financial vulnerability. This included reducing the maximum tenure for personal loans to ten years, restricting home loans to no more than 35 years, and prohibiting offers for pre-approved personal loans. These measures are expected to reduce potential risks due to concentration of credit in the households segment. Malaysia's household debt-to-GDP ratio rose from 75.8% in 2010 to 76.6% in 2011, and to 80.5% in 2012, which is one of the highest in the region.

In Qatar, there was also a sizeable exposure of Islamic banks to the government and public-sector entities. The government and its related entities have used the banking sector both to place sovereign and quasi-sovereign deposits as well as to undertake financing, partly to fund their huge infrastructural development plans on the road to the World Cup 2022. Islamic banks in the UAE and Malaysia also had exposures to the public sector, with the borrowings largely used to support the fiscal needs of these two economies where the national exchequer has relied on private commercial banks' borrowings to support their expenditure and debt-refinancing needs.

More critically, the Islamic banking sample in Bahrain, Kuwait,[100] UAE and Qatar indicates a material level of exposure to the real estate sector. Islamic banks in general are known to have higher exposures to the real estate sector vis-à-vis their conventional counterparts, given the asset-backed nature of the Islamic financial system where real estate fits in well with this principle. The Islamic

[99] Classifiications as disclosed in the financial statements of individual banks. In general, household exposure includes all forms of financing to individuals in addition to personal financing – for example, car financing. Government exposures include financing to government-related entities. Real estate exposures include direct holdings of property and investments in property companies.
[100] Central Bank of Kuwait – Annual Report Fiscal Year 2012/2013 – indicates real estate exposure of 26.4% for local banks in Kuwait.

banks with exposures to real estate were badly impacted by the real estate price crashes during the 2008–2009 period, particularly in the markets of the UAE, Bahrain and Kuwait where Islamic banks saw a rapid build-up of NPF (to be highlighted in the next section on asset quality). In the global markets, investors had shied away from real estate investments in the GCC markets during the financial crisis as individual and institutional investors encashed their investments in emerging markets to protect their positions and meet their debt obligations in the developed markets. This impacted on Islamic banks, which witnessed delinquencies and NPF build-ups. Notwithstanding this, Islamic banks so far have been resilient to any major instability and did not require substantial forms of government financial bail-outs as were needed by major banks in the US and Europe having exposures to sub-prime-related mortgage debts.

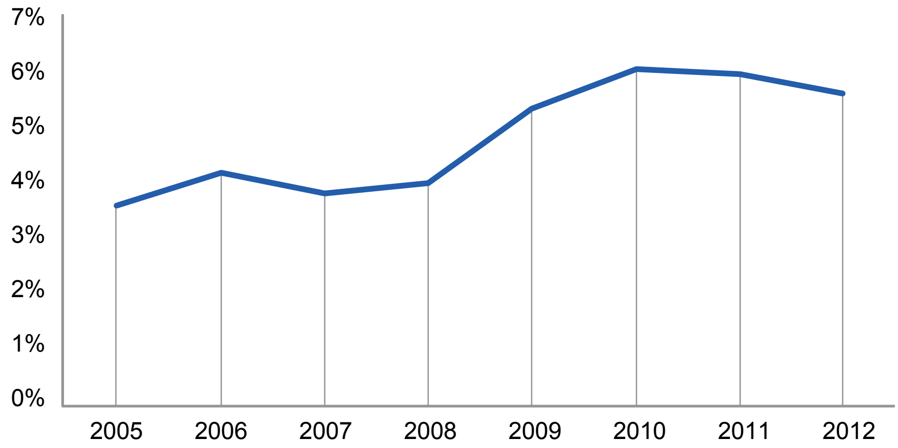
As of 2012, the exposures of Islamic banks to the real estate sector in Bahrain, the UAE, Kuwait and Qatar remain in double digits with no significant changes in position forecasted in 2013. However, the outlook for the real estate sector in the GCC for 2014 is positive, which will help the Islamic banks improve on their NPF build-up moving into the year 2014. In recent years, Saudi Arabia has undertaken many economic reforms that have added further clarity to its laws and regulations in order to attract foreign investment and provide direct impetus to the real estate sector. As real estate values are increasing on a relative income basis, there will be higher valuations once the mortgage law achieves a firmer footing. The implementation of the mortgage law will drive Saudi housing demand and prices, as more people will be able to access the market. This will propel the creation of private mortgage finance companies, estimated at USD32 billion a year for the next decade, and more active participation from financial institutions. Similarly, positive growth of the residential and property investment sector in Kuwait, on the basis of rising population, higher oil prices, low inflation and various fiscal measures implemented by the Kuwaiti government, is expected to boost the real estate sector's performance in 2014 and beyond. There are also proposals in place for a bill in Kuwait which may allow foreigners to own property in the country, which will further boost the real estate outlook in 2014. If the bill materialises, the real estate market will witness new demand from approximately 1.75 million expatriates. In Qatar, the outlook for real estate is regarded as favourable in the medium to long term in the context of hosting the World Cup 2022, which has increased domestic business optimism and business perceptions about Qatar's real estate market. Qatar's real estate market is also regarded as taking the right steps in terms of achieving transparency and complying with international benchmarks, which is being actively championed by the government. Dubai is also spearheading the UAE's re-emergence in the global economic sphere, particularly with its recently having won the right to host the World Expo 2020. The real estate market has also witnessed an upsurge in prices, in tandem with gradual improvements in the equity bourses of the country. Overall, with the positive real estate outlook for 2014 in the GCC markets, the Islamic banks are expected to fare well in terms of their real estate exposures in 2014, thus consolidating the Islamic banking system's characteristics of financial resilience and stability.

3.1.4 Asset Quality

In terms of asset quality, the NPF across the sample generally increased from 2008 onwards to peak at 6.03% in 2010; however, this was still lower than the global NPLs average of 6.44% in 2010.[101] Since then, the non-performing financing ratio has declined slightly across the sample to close at 5.62% in 2012, which is higher than the US banks' NPLs ratio of under 4% as at year-end 2012. The worst-affected jurisdictions during the sample years were the UAE, Bahrain, Kuwait and Pakistan. As was highlighted in the previous section, the real estate exposures of Islamic banks in the UAE, Bahrain and Kuwait must be factored in as reasons for the build-up of the NPF in these countries.

[101] IMF Financial Stability Report (2010).

Chart 3.1.4.1: Islamic Banking Average Gross Non-Performing Financing to Total Financing (%)



Source: Islamic Banking Sample, KFHR

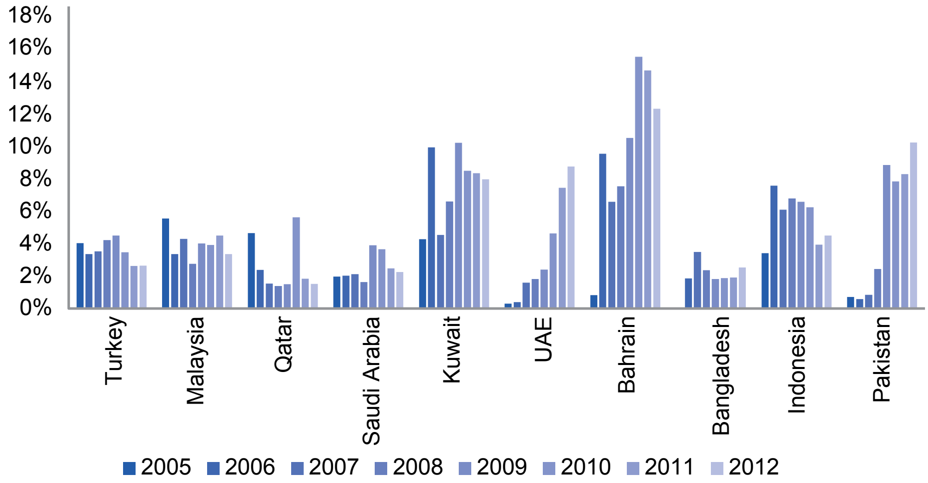
The NPF ratio across the Islamic banking industry peaked at 6.03% in 2010 before moving marginally lower to 5.62% as at 2012. In some jurisdictions, the Islamic banking NPF fared worse than the conventional banks' NPL ratio.

In comparison to the conventional banking system, Islamic banks in the UAE, Bahrain and Kuwait fared worse in terms of asset quality given their higher exposure to the real estate sector than the conventional banks. Bahrain's NPL ratio was estimated at 7.6%[102] in 2012, compared to 12.5% for the sample Islamic banks in Bahrain. In Kuwait, the NPL ratio for 2012 was reported to be 5.7%,[103] compared to the Kuwaiti Islamic banking sample's NPF ratio of 8%. Similarly, the UAE's NPL ratio for 2012 was reported at 7.6%,[104] compared to the 9.03% for the Islamic banking sample. Nonetheless, the Islamic banks in general maintained higher capital buffers (to be discussed next) by which they were able to absorb the impairments on their balance sheets. Moving into 2014, NPF of the Islamic banks in these countries is expected to begin improving gradually over the next few years. Although prospects look favourable in the real estate sector, particularly for the UAE, there exist other challenges in the GCC economies which will now be discussed.

For instance, in the case of Bahrain, continued political uncertainty may impact the country's economic growth and affect private-sector investments, while consecutive fiscal deficits in recent years have undermined Bahrain's public finances, with debt-to-GDP expected to rise to 46.5% by year-end 2014.[105] Bahrain is therefore dependent on subsidies from its GCC neighbours to support government spending and, indirectly, banks' financing of government-sponsored projects. In Kuwait, the NPF may improve marginally in 2014 on the back of positive GDP growth driven by high oil prices, strong fiscal position and sustained government spending, resilient domestic consumption following increases in public-sector salaries and pensions, and banks starting afresh with a substantial clean-up of their balance sheets. The UAE is expected to witness the strongest improvements among the GCC countries in 2014 underpinned by the positive prospects of the Dubai real estate sector which is forecasted to experience an increase of up to 15%[106] in real estate prices during 2014. As the economy witnesses a rebound following the shocks of 2008–2009, Islamic banks are likely to participate in the growth and should be able to begin clearing up the NPF build-up on the back of recovering house prices.

[102] *Fitch Ratings Report: Peer Review: Bahraini Banks* (2013).
[103] KFH Research Limited, "Kuwait Islamic Banking Outlook 2014".
[104] World Bank Development Indicators: http://data.worldbank.org/indicator/FB.AST.NPER.ZS
[105] *Fitch Ratings Report: Peer Review: Bahraini Banks* (2013).
[106] Knight Frank Property Consultants (2013).

Chart 3.1.4.2: Islamic Banking Average Gross Non-Performing Financing to Total Financing by Country (%)



Source: Islamic Banking Sample, KFHR

The worst-affected jurisdictions in terms of build-up of NPF were the UAE, Bahrain, Kuwait and Pakistan. The improvements in NPF in these countries are likely to extend over a few years as macroeconomic and other socio-political weaknesses continue to impact the domestic financial sector.

In contrast, Islamic banks in Qatar, Saudi Arabia and Malaysia have experienced only a minimal impact on their asset quality as their domestic economies remained strong and performed resiliently, despite challenges on the international trade front as the global economies experienced slowdowns. In the case of Qatar, the Islamic banking industry had an NPF of 1.39% as at year-end 2012, a figure lower than the overall industry NPL of 1.7%[107] in the same period. Notwithstanding this, Qatar's NPF or NPL ratio is the lowest among the GCC economies. It is likely to remain below 2% in 2013 because of the central bank's restrictions on personal loans, having introduced more stringent practices, and the establishment of a credit bureau in 2012. It is expected that these reforms will reduce the level of impaired loans in the retail segment. This view is also highlighted in Standard& Poor's Banking Industry Country Risk Assessment for Qatar in 2013.

In the case of Pakistan, the Islamic banking sample NPF is calculated as 10.37% as at year-end 2012, which is lower than the overall banking industry average NPL ratio of 14.8%.[108] Hence, the Islamic banking assets in Pakistan are regarded as having higher asset quality compared to their conventional peers. A plausible reason for such an observation is the fact that Islamic banks extended lower proportions of financing in relation to deposits as compared to conventional banks, as was highlighted earlier in the liquidity section of this chapter. As a result, Islamic banks held more of their assets in the form of government Treasury bills and *Sukūk*, and also in stocks and other approved securities which limited their exposures to NPF in comparison to their conventional peers (see Box 3.3 on "Financial Stability and Role of Islamic Banking and Finance in Pakistan").

Overall, the asset quality of Islamic banks varied across jurisdictions depending on the domestic industry characteristics and financing exposures of the banks, which had an impact on their NPFs. For jurisdictions with high real estate exposures such as the UAE, Kuwait and Bahrain, the NPF levels of these jurisdictions' Islamic banking sector were higher than the NPL levels of the conventional counterparts. Notwithstanding this, the Islamic banking system remained cushioned from major

[107] *Standard & Poor's Banking Industry Country Risk Assessment: Qatar* (2013).
[108] *State Bank of Pakistan Monthly Statistical Bulletin* (July 2013).

financial instability due to the asset-based nature of transactions as well as higher regulatory capital buffers maintained by the banks. In comparison, jurisdictions such as Pakistan and Qatar had lower NPF ratios compared to the industry average. On a global front, the Islamic banking industry had lower NPF ratios compared to the Eurozone countries which have witnessed high NPL ratios – at times over 10% in countries such as Italy, Portugal and Spain – while the sample's NPF ratio was higher than the average US banks' NPL of just under 4% in 2012.

Box 3.3: Financial Stability and Role of Islamic Banking and Finance in Pakistan

By: The State Bank of Pakistan

The global financial instability triggered by the sub-prime mortgage defaults in mid-2007 and the subsequent economic downturn called for unprecedented policy reactions by the fiscal and monetary authorities across the world. Monetary authorities implemented unconventional tools during severe financial problems, besides keeping the interest rates at exceptionally low levels.[109] On the other hand, several plans have been devised to make the financial system resilient to financial crisis. Some proposals consider restructuring of big financial institutions to reduce complexity in the financial system and suggested that financial conglomerates need to be converted into specialised financial entities. Others suggested that these institutions should move "back to basics" by following a client-centric strategy through relationship banking.[110] Regulations proposed in the Volcker rule, the Vickers initiatives, and the Liikanen proposals seek to end "too big to fail" implicit subsidies by reducing economies of scope.[111]

Moreover, suggestions have also been made to tighten the regulatory framework through implementing stringent capital and liquidity requirements, reinforcing market discipline, introducing financial reforms and promoting funding through equity and risk-sharing modes. Basel III recommended significantly strengthening the capital base of banks through applying rigorous criteria for eligibility of an instrument to be part of the capital, introduction of countercyclical and capital conservation buffers, and additive capital requirements for SIFIs. The leverage ratio is also aimed at enhancing the capital base and discouraging excessive leveraging. The LCR and NSFR, and more extensive supervision of the derivatives markets, are the other main reforms introduced post-crisis.

Recently, the European Commission put forward a proposal for a "Single Resolution Mechanism" covering the more important Eurozone banks, to minimise the cost of bank failures to taxpayers and the economy. The mechanism suggests, among other things, that a failing bank should be bailed-in through allocation of the bank's losses to the equity holders and then to certain creditors of the failing bank, including larger depositors. This means that absorption of losses would be ensured not only by capital but also by creditors ("burden sharing"). A broadly similar kind of exercise was carried out during the Cyprus crisis when Bank of Cyprus, the largest bank in Cyprus, changed around 60% of its uninsured major depositors (with a balance above 100,000 Euros) into its equity holders. The remaining 40% will be remunerated when the bank comes out of a distress situation and becomes profitable.[112]

[109] Major central banks, Federal Reserve System (Fed), Bank of England, European Central Bank (ECB) and Bank of Canada, for instance, set the interest rate as low as zero, rendering the real interest rate negative. The European Central Bank, for instance, initiated an "enhanced credit support" programme which ensured the provision of unlimited liquidity by the ECB to financial institutions at the refinancing (discount) rate against eligible collateral. For details, see "The ECB's Response to the Financial Crisis (2010)".
[110] See KPMG (2011).
[111] Gambacorta and Rixtel (2013).
[112] www.bbc.co.uk/news/world-europe-21992745

Box 3.3 *(continued)*

Taking a deeper look, most of these reforms are largely congruent with the strictures of Islamic banking and finance (IBF), as in Islamic banking the funds (except current accounts which are based on *Qarḍ*, *Wadī`ah*, etc. and receive no profit) are mobilised on a profit- and loss- (and thus risk) sharing basis. Thus, account holders share the risk with the bank in proportion to their saving or investment deposits. These are, in a sense, limited period equity investments by the depositors. A partial ban on short selling after the financial crisis of 2007–2009 in several jurisdictions is also a manifestation of IBF principles, as under *Sharī`ah* one cannot sell a thing unless one owns it. Similarly, at the macro level, issuance of a GDP-indexed bond by Greece in crisis can be seen to be highly consonant with IBF tenets in linking returns on a general government security with the performance of the overall economy.

Stability and Soundness of Islamic Banks in Pakistan

Due to its unprecedented growth spanning over a decade, Islamic banking institutions (IBIs), comprising five exclusively Islamic banks and 16 Islamic banking divisions/windows of conventional banks, have become an important component of the financial sector in Pakistan, with over an 11% share in the country's banking system based on assets. Future prospects of the IBIs are also very bright in Pakistan, as shown by a recent comprehensive survey conducted by the State Bank of Pakistan (SBP) covering 10,000 respondents (9,000 households and 1,000 corporate firms and SMEs; see Box A for details). The IBIs' assets by end-December 2013 registered a year-on-year growth of 25% in spite of an increasing base effect. This asset growth was mostly funded by customers' deposits, which grew by 24% y-o-y during the same period.[113]

Like elsewhere, IBIs in Pakistan relied mainly on trade-based financing modes, namely *Murābahah*, *Ijārah* and Diminishing *Mushārakah* cum *Ijārah*, which has a cumulative share of 82% in total financing. The other trade-based modes such as *Salām* and *Istisnā`* are also seen as gaining ground as the industry remains keen to diversify its product base considering the ever-changing business needs of its customers. The share of *Muḍārabah* and *Mushārakah* in total financing at 4% is, however, quite low; this can be attributed to high risk perception, moral hazard, adverse selection, higher monitoring cost, etc. A large bulk of IBIs' deposit base is low risk and short term in nature, which leaves little space for IBIs to invest these deposits in higher-risk and longer-tenor *Mushārakah*- and/or *Muḍārabah*-based avenues. The competition with conventional banks in a parallel banking system is another important reason for IBIs' reluctance to increase the share of equity natured financing in their financing portfolios. The competition forces IBIs to offer products having similar risk and reward features as conventional products, particularly on the asset side. *Mushārakah* and *Muḍārabah* financing and investments obviously have no similarity with conventional loan products and are thus not popular among IBIs. Notwithstanding these difficult ground realities for the development of *Mushārakah*-based financing and investment portfolios, the low share of such portfolios in IBIs' financing mix has been a source of reputational risk for the industry and may result in loss of public confidence in the *Sharī`ah* permissibility of IBIs' products and their distinction from conventional products. Thus, appropriate solutions will have to be developed to make equity natured and participatory financing attractive for IBIs as well as the business community.

The sector-wise distribution of the financing shows that around 75% of all funds go to the corporate sector in the form of fixed investment, working capital and trade finance. The remaining share is mostly directed to consumer finance (15%) and SMEs (5%). The share of agriculture in IBIs' financing

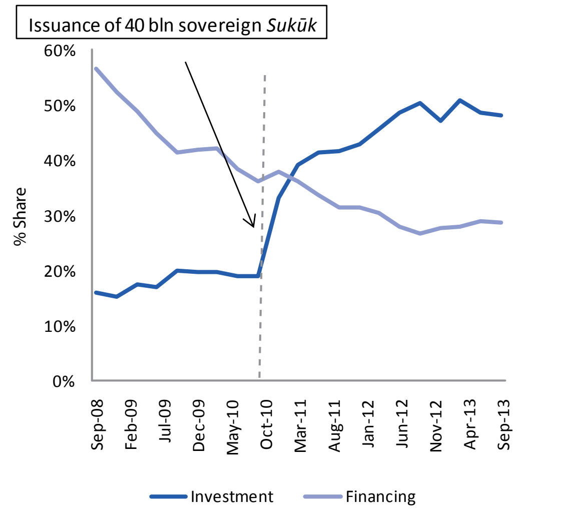
[113] The funding structure of the banks before and during the financial crisis in the developed world has been criticised, as most of the banks relied on short-term funding from the financial markets for extending long-term loans. Once the financial markets dried up due to the liquidity crunch, there was a run on "shadow banking" (for details see Brunnermeier (2009) and Mishkin (2011)). On the contrary, the funding structure of IBIs is similar to traditional commercial banks, relying mainly on deposits from the public.

Box 3.3 *(continued)*

is currently negligible, largely due to their limited presence in rural/semi-rural areas and a lack of suitably trained staff to develop and offer *Sharī`ah*-permissible agriculture finance products to the rural and farming community. There is huge potential to tap the rural market, however, due to the asset-backed nature of IBIs' products, which could largely address fund utilisation and portfolio quality issues faced by conventional banks.

The asset mix of IBIs has undergone a major change since September 2008, with the share of investments in *Sharī`ah*-compliant securities surging from 16% in 2008 to 48% in September 2013; financing declined from 57% to 28% during the same period. The change is attributable to the issuance of *Ijārah Sukūk* with a total value of over PKR500 billion (approx. USD5 billion) by the Government of Pakistan (GOP) since October 2010. This enabled IBIs to deploy the bulk of the deposits mobilised during this period in almost zero risk GOP *Ijārah Sukūk*. Besides the crowding-out impact of huge government borrowings and financing from the banking system, the deep decline in the share of financing in IBIs' portfolios is also attributed to an overall slowdown in economic activity, particularly in the private sector, and to a record low investment-to-GDP ratio during the period caused by law and order issues, the energy crisis and unfavourable business conditions. If this trend continues, IBIs would become merely a source of deficit financing for the government, crowding out private investment and leading to financial disintermediation, which would not be in conformity with the objectives of *Sharī`ah*.

Chart 1: Asset Portfolio of IBIs



The huge investments in GOP *Ijārah Sukūk* during the last three to four years by IBIs have also translated into a strong liquidity position, as evidenced by a low FDR of 34% as compared to 49% for conventional banks. However, the industry does not have short-term liquidity management instruments and the interbank Islamic money market is grossly underdeveloped. This forces IBIs to place most of their short-term liquidity in conventional banks through Commodity *Murābahah*. Further, a LOLR facility is not yet available to the industry, also forcing IBIs to maintain larger cash balances. The SBP is engaged in the development of a comprehensive liquidity management framework that includes the development of an Islamic interbank money market and the provision of a LOLR facility to IBIs.

The asset quality of IBIs portrays a far better position than for the overall banking industry. As of September 2013, NPFs of IBIs at 7% were less than half of the overall banking system's average of 14.3%; the significant difference between the NPFs of IBIs and the banking system as a whole is also attributable, among other reasons, to the relatively small average age of IBIs compared to the conventional banks. The NPFs of IBIs are also adequately provided for, as the provision coverage was 69.4% and capital at risk (net NPFs to total capital) was 11.1% as compared to the banking system averages of 76.5% and 15.7%, respectively. The ROA and ROE of IBIs at 0.9% and 11.6%, respectively, were lower than the banking system averages for ROA and ROE of 1.1% and 12.3%,

Box 3.3 *(continued)*

respectively, largely due to the evolutionary and expansionary phase of IBIs. Operating cost to gross income of IBIs was 70%, whereas that of the whole banking system was 57% (see Table 1). The higher operating cost to gross income ratio is attributable to the expansionary phase of IBIs: about 300 branches were opened during the last two years, and it will take some time to breakeven and start contributing to the IBIs' income streams.

Table 1: Asset Quality and Earnings 2013

Asset Quality (%)	IBIs			Industry	Earnings (%)	IBIs			Industry
	Mar	Jun	Sep	Sep		Mar	Jun	Sep	Sep
NPFs to Financing	7.9	7.1	7.0	14.3	ROA	0.8	0.8	0.9	1.1
Net NPFs to Net Financing	3.0	2.5	2.3	3.8	ROE	11.2	11.1	11.6	12.3
Provisions to NPFs	63.9	66.1	69.4	76.5	Operating Cost to Gross Income	70.7	71.7	70.0	56.7
Net NPAs to Total Capital	12.8	12.2	11.1	16.5					

At 14.9% as at September 2013, the CAR of full-fledged Islamic banks, though lower than the overall banking industry average of 15.5%, was much higher than the minimum regulatory requirement of 10%. The CAR of Islamic banks in fact decreased from 18.2% in December 2009, which is attributed to their expanding outreach and thus better leveraging of the capital base. Further, the bulk of the Islamic banks' capital comprised Tier I capital; the Tier I capital to total risk-weighted assets (RWA) of Islamic banks was 14.4% as compared to 13.2% for the overall banking system, reflecting a comparatively better capital base of Islamic banks compared with the overall banking system. It is pertinent to mention that Islamic banks are currently being treated at par with conventional banks with regard to capital adequacy requirements, and the existing CAR levels of Islamic banks are based on Basel II which does not allow any concession for the assets financed by largely risk-absorbent PSIA. The SBP is in the process of adopting the IFSB revised capital adequacy standard and determining an Alpha factor which, once adopted, would result in further improvement in IBIs' CAR and thus give IBIs further space to expand and leverage their capital base.

Key Regulatory Initiatives by State Bank of Pakistan

The SBP is actively engaged in the development and implementation of the necessary regulatory, supervisory and *Sharī`ah* compliance infrastructure for the Islamic finance industry in the country. During 2013 it took the following key initiatives to strengthen the regulatory framework.

Pool Management Framework and Profit and Loss Distribution

In order to improve transparency and disclosures and standardise the profit and loss distribution and pool management policies and practices of IBIs, the SBP issued detailed instructions on this subject. The instructions require IBIS to have in place a well-defined pool management framework for the creation and management of pools; each pool must have distinct objectives and risk–reward features, and be managed as a virtual enterprise having clearly identifiable assets, liabilities, income and expenses. The instructions also require IBIs to absorb the intermediation cost as *Muḍārib*, whereas credit and market risk is borne by depositors as *Rabbal-Māl*. Further, *Hibah* to smoothen the profit payout to the depositors is only allowed up to 60% of the *Muḍārib*'s share (likely to be increased to 80% soon to allow more flexibility to banks in profit smoothing); however, no *Hibah* is allowed from the IBIs capital, thus making the deposits largely risk absorbent and pass-through in nature. This will

Box 3.3 *(continued)*

provide the basis for the adoption of the IFSB capital adequacy standard in general and the determination of Alpha for the computation of IBIs CAR in particular. The instructions also cap the *Muḍārib*'s share at 50% and prescribe that the weightages assigned to different types of deposits in a pool, for the purposes of profit distribution, cannot have a range greater than one to three; that is, the highest weightage cannot exceed three times the minimum weightage.

Strengthening *Sharī`ah* Compliance

Sharī`ah Governance Framework

The development of a comprehensive *Sharī`ah* governance framework (SGF) to be put into effect soon was another key SBP initiative for strengthening and institutionalising the *Sharī`ah* compliance function. It explicitly defines and prescribes the *Sharī`ah* compliance-related roles and responsibilities of all key organs of IBIs, including the board of directors, executive management and *Sharī`ah* board. It emphasises that the ultimate and primary responsibility of *Sharī`ah* compliance lies with the BOD and that they as directors of an IBI should be fully aware of the importance of *Sharī`ah* compliance and of the reputational risk of weaknesses in the *Sharī`ah* compliance infrastructure. The framework also prescribes requirements for the *Sharī`ah* board, including a minimum of three *Sharī`ah* scholars and "fit and proper" criteria for *Sharī`ah* board members. It further mandates the installation of a *Sharī`ah* compliance department reporting to the *Sharī`ah* board, *Sharī`ah* review, and internal and external *Sharī`ah* audits. The issuance of this framework coupled with the code of corporate governance already in place would make SBP fully compliant with the recommendations of IFSB corporate governance and *Sharī`ah* governance standards. The SBP also has a *Sharī`ah* board having three *Sharī`ah* scholars, an accountant, a lawyer and a banker, which is the apex *Sharī`ah* body in the country for IBIs and whose decisions are binding on the IBIs. The SBP has prescribed the existing *Sharī`ah* compliance framework with the guidance and approval of its *Sharī`ah* board. In a major development in January 2014, prominent *Sharī`ah* scholar Mufti Taqi Usmani joined the board as its chairman, which will further improve its effectiveness and reputation.

Adoption of AAOIFI _Sharī`ah_ Standards

The SBP during the year also adopted the AAOIFI *Sharī`ah* Standard "*Sharikah* (*Mushārakah*) and Modern Corporations", with certain clarifications. This will harmonise the *Sharī`ah* practices of the industry with regard to offering *Mushārakah*-based products. While the AAOIFI's *Sharī`ah* Standard is based on *Shirkatu al-Aqd* (*Mushārakah* or partnership in business), SBP has developed and notified the *Sharī`ah* Standard on *Shirkatu al-Milk*[114] (Diminishing *Mushārakah*). This is one of the pioneering efforts made by SBP with regard to the development and promotion of Islamic banking. The *Shirkatu al-Milk* is a commonly used mode for corporate financing and housing finance, as Diminishing *Mushārakah* constitutes 33% of the IBIs' financing mix in Pakistan. Thus a separate standard on *Shirkatu Al-Milk* was issued to ensure *Sharī`ah* standardisation and harmonisation.

Strategic Plan for Islamic banking industry

The SBP, in consultation with IBIs, also developed a strategic plan for the Islamic banking industry over the next five years (2014–2018) which sets a consensus on the future direction of the industry, defines key strategic objectives, and outlines strategies and action plans to take the industry to the next level of growth and development. The key areas of focus of the plan are: (i) making the policy, regulatory and taxation environment more enabling through necessary amendments in the legal,

[114] *Shirkatu al-Milk* is a partnership where two partners jointly own the property/asset. Under this *Mushārakah*, one partner sells his share in the property to the other over a certain period of time at a fixed price. As per *Fuqahā'*, the partners in *Shirkatu al-Milk* hold independent positions; hence they can guarantee the other partner and the same does not raise any *Sharī`ah* concern. A bulk of longer-term corporate financing and all the housing (mortgage) financing in Pakistan is undertaken through the *Shirkatu al-Milk* cum *Ijārah* mode.

Box 3.3 *(continued)*

regulatory and taxation frameworks; (ii) *Sharī`ah* harmonisation and standardisation and improvement of the *Sharī`ah* compliance infrastructure and environment in IBIs; (iii) deepening and broadening of Islamic banking through product and market diversification; (iv) improving perception and awareness about Islamic finance by intensifying awareness creation efforts and leveraging print, electronic and digital media; (v) industry capacity building initiatives; and (vi) outreach expansion to second- and third-tier cities and rural areas. The plan also envisages the industry having a 17% share in the country's overall banking system by 2018 and 20% by 2020.

Conclusion

The enhanced emphasis on the stability of the financial system is the hallmark of the changing financial landscape in the post-financial crisis world. New measures for guaranteeing the sustainability of the global financial system are mainly congruent with the basic tenets of Islamic finance. The development of the IFSI with its specific value proposition has the power to enhance the soundness of the overall financial system. The Islamic banking industry in Pakistan is heading from being a niche player towards becoming an integral component of the overall banking industry. It has already reached a market share of over 10% and is expected to continue to grow at above-average rates. During the last decade, Islamic banks achieved tremendous growth with better asset quality, but a recent trend towards the dominance of investments in government *Sukūk* has to be reversed and the financing of the private sector must be improved significantly. The actual FDR levels are too low and a source of negative repute for the industry. Similarly, the share of equity natured financing also needs to be significantly enhanced. This will sharpen IBIs' distinct profile in contrast to conventional banks and establish them as practicing true risk and reward sharing.

Box A: SBP Survey on Knowledge, Attitude and Practices of Islamic Banking in Pakistan

SBP conducted a survey-based study to quantify the demand for Islamic banking and to assess if there exists a demand–supply gap in the Islamic banking market. The survey was comprehensive with a sample of 10,000 household (retail) and corporate respondents, both banked and non-banked, from all regions of Pakistan. The respondents' sample was selected from 28 randomly chosen districts, seven provincial/state capitals and six industrial cities. Further, 100 structured interviews of the management of Islamic banking institutions were carried out to identify and assess the supply-side issues and trends in the industry.

The survey comprised three questionnaires (for banked and non-banked households and corporates)* aimed at extracting information to be used for quantifying the demand for Islamic banking in Pakistan. However, for analysis purposes the household data for banked and non-banked households were combined, while the data for corporates was treated separately as it is expected that the financial needs of corporates are distinct from those of households, and hence their demand structure should also be different. The demand index was developed using the technique of *factor analysis*.

$$Demand = \sum_{i=1}^{n} \alpha_i X_i$$

Where α_i are the weights given to different factors X_i.

* *'Corporates' includes micro, small and medium enterprises.*

Box 3.3 *(continued)*

Results

The study suggests that there exists an overwhelming demand for Islamic banking in Pakistan for both retail and corporate sectors; the retail sector exhibited more than 94% demand, while for corporates the figure was 73%. This is despite a high level of unawareness of the Islamic banking model, products and operations. In contrast to the general perception, the report findings identify that demand is evenly distributed between urban and rural areas, and also among people from different income strata and with varying education levels.

The study depicted Islamic banking primarily as a religious phenomenon on both the demand and supply side. The study also revealed that more than 80% of Islamic banking clients are satisfied with their banking services, primarily due to the Islamicity of the products.

The survey also indicates an 18% incidence of voluntary exclusion along with significant involuntary financial exclusion. No single factor presented itself as a dominating reason for opting out of the financial system; however, among these factors, religion appears to be the most important reason followed by lack of awareness, the cost of commuting to a bank, cultural reasons, and other reasons.

While awareness, development of human resources for the industry, improvement in *Sharī`ah* authenticity and all other suggestions are important, perhaps the most important need is for product development. Innovative products catering to unconventional sectors and un-served regions of the industry can be an effective instrument for reducing financial exclusion and developing sectors deemed vital for the broad-based development of the country. Given the supply–demand gaps, there is huge potential for further development of Islamic banking in Pakistan.

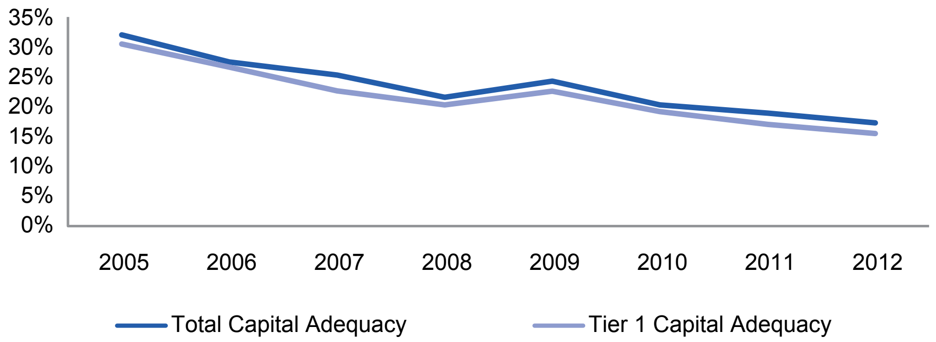
3.1.5 Capitalisation

Capitalisation levels have always been healthy for the Islamic banking system as Islamic banks are known to have generally maintained higher regulatory capital levels compared to their conventional counterparts. Within the Islamic banking industry, the presumption is once again established as the overall total regulatory capital remained in excess of 15% during 2005–2012. In terms of the Tier 1 regulatory capital ratio, the Islamic banking sample averaged 15.6%[115] in 2012, well over the current regulatory requirements. In comparison, an asset-weighted average across 113 large conventional banks across the world indicated a Tier 1 regulatory capital ratio of under 13% as at year-end 2012.[116] Islamic banks have generally maintained higher levels of regulatory capital, in part, due to an absence of well-functioning and healthy Islamic interbank money markets. In addition, Islamic banks do not hold Tier 2 regulatory capital instruments such as preferred shares or subordinated debt, since these types of instruments do not comply with *Sharī`ah* due to the fixed and guaranteed nature of their returns and the absence of risk-sharing characteristics. Hence, Islamic banks hold most of their capital in the form of Tier 1 regulatory capital, which further explains the higher average Tier 1 regulatory capital ratio for Islamic banks in comparison to conventional banks. Nonetheless, higher regulatory capital buffers ensured the Islamic banking system prevailed as a resilient and stable system throughout the various periods of financial turbulence.

[115] The CARs reported for both Islamic and conventional banks are not adjusted for Basel III.
[116] IMF Financial Stability Report (2013).

The stability of the Islamic banking system is further evidenced by the fact that no major government bail-outs were necessary for Islamic banks during the financial crisis as was witnessed for the mega conventional banks across North America and Europe. The Islamic banking system's resilience is also highlighted by the eager willingness of investors to purchase Islamic banking *Sukūk* issued for institutional capitalisation purposes. A major Islamic bank from the UAE issued the world's first Basel III-compliant perpetual *Sukūk* in 2012 and the *Sukūk* was fully subscribed by investors ahead of issuance. During the 2005–2012 period, the regulatory capital held by Islamic banks across the sample gradually declined, partly on account of vast improvements made in the availability of Islamic financial instruments (such as long-term *Sukūk*) needed to support the capitalisation requirements of Islamic banks in various jurisdictions. The need for higher regulatory capital to be held as a substitute for liquidity has also been partly addressed on account of improvements made in the liquidity management facilities available. Notable improvements include the launch of the world's first *Sharī`ah*-compliant commodity trading platform, Bursa Suq al-Sila in Malaysia, as well as the inaugural USD490 million short-term *Sukūk* programme by the IILM on 27 August 2013. IILM has further expanded its *Sukūk* programme in its third issuance with a USD860 million issue on 20 January 2014, which was fully subscribed by its primary dealers. In addition, unilateral initiatives by various central banks – for example, in the UAE, Qatar and Saudi Arabia – that offer bilateral Islamic liquidity management facilities to individual Islamic banks – for example, through Commodity *Murābahah* – has helped Islamic financial institutions to better manage their liquidity and, thus, their regulatory capital levels.

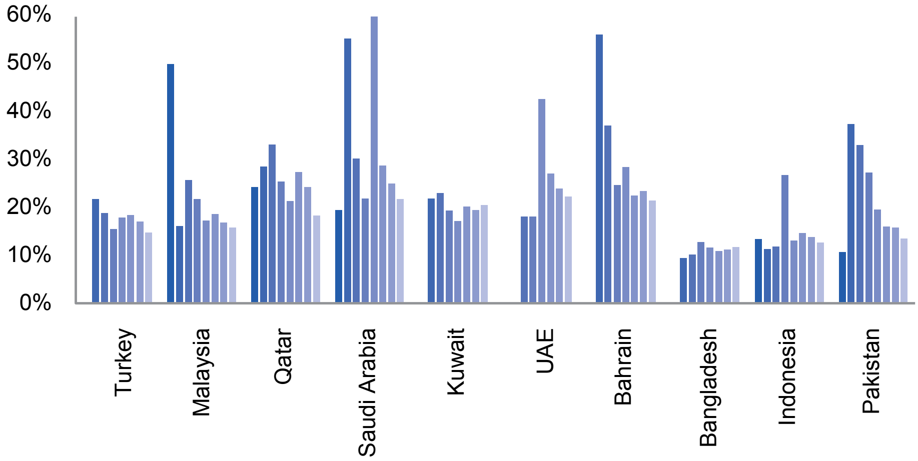
Chart 3.1.5.1: Islamic Banking Average Capital Adequacy Ratios



Source: Islamic Banking Sample, KFHR

The level of regulatory capital held by Islamic banks has been declining over the years as improvements made in terms of availability of Sharī`ah-compliant capital instruments and liquidity management facilities have allowed Islamic banks to optimise on regulatory capital. However, since 2009, regulatory capital in certain jurisdictions has also experienced a decline due to the absorption of write-offs and NPF accumulated in the balance sheets during the financial crisis years. Notwithstanding this, as of 2012, the regulatory capital held by Islamic banks still exceeds the minimum regulatory requirements by a comfortable margin.

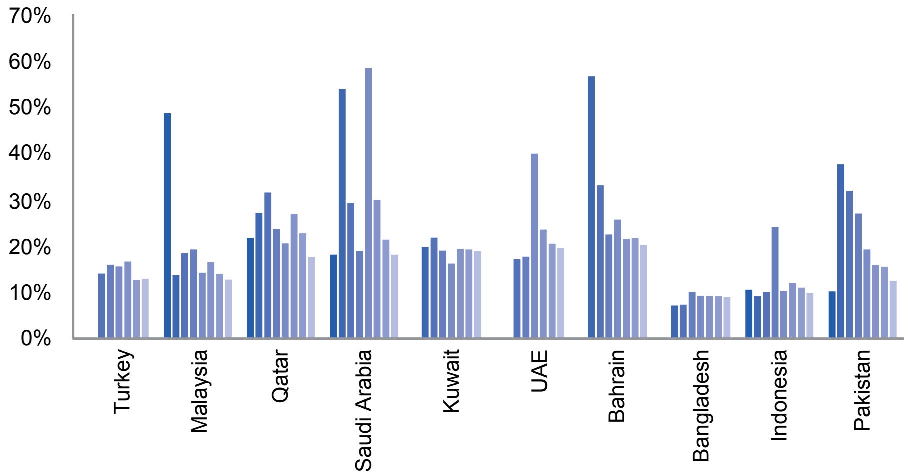
Chart 3.1.5.2: Islamic Banking Average Total Capital Adequacy Ratio by Country



Source: Islamic Banking Sample, KFHR

Islamic banks in all jurisdictions maintained regulatory capital in excess of the minimum requirements throughout the sample years. GCC Islamic banks, in general, held the highest regulatory capital as compared to the other jurisdictions.

Chart 3.1.5.3: Islamic Banking Average Tier-1 Capital Adequacy Ratio by Country



Source: Islamic Banking Sample, KFHR

The Tier 1 Capital Adequacy Ratios remained above the minimum regulatory requirements throughout the sample years. However, with the implementation of Basel III accords beginning January 2013, Islamic banks in some jurisdictions with lower Tier 1 regulatory capital may need to adjust their capital compositions to meet the requirements of the new standards.

Analysing individual countries, Islamic banks in the GCC had the highest regulatory capital levels across the sample as the regulatory capital requirements set by domestic authorities, in general, are higher for banks in this region. The decline in capitalisation levels of some GCC markets such as the UAE and Bahrain, in part, is also due to the absorption of losses accumulated in these banks in the post-financial crisis years. Islamic banks in Pakistan report Tier 1 CAR levels of more than 20% from

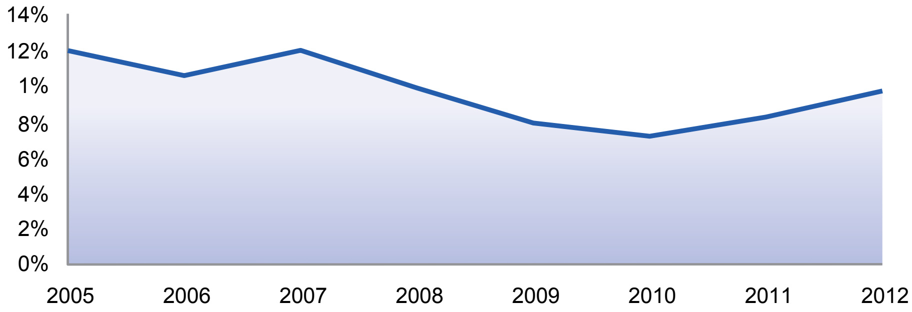
2006 to 2008, mainly on account of the new entry of certain Islamic banks which on commencement had very high capitalisation levels against their low portfolios of risk-weighted assets during the early years of inception. However, given the adverse performance of Pakistan's economy and the banking sector in general since 2008, the capital levels of the Islamic banking industry have deteriorated somewhat. Nonetheless, the Tier 1 capital ratio remains at 13.01% as at year-end 2012, much higher than the current regulatory standard of 8%. Relatively stable capital levels were maintained by Islamic banks in Turkey, Malaysia, Bangladesh and Indonesia. Bangladesh held the lowest levels of regulatory capital across the Islamic banking sample and, at 8.97%, its Tier 1 regulatory capital just satisfies the standards set by the country's regulatory authority. Critically, the implementation of Basel III standards began in January 2013. The Islamic banking industry, while is already satisfying the regulatory capital requirements in absolute terms, may need to restructure its capital instruments in accordance with the new standards introduced by Basel III. In terms of Tier 1 capital, total common equity must be stepped up to 4.5% of risk-weighted assets by January 2015 and total Tier 1 capital, which may also include additional Tier 1 capital, stepped up to 6%. Islamic banks, particularly in Bangladesh with a comparatively lower level of Tier1 and total regulatory capital, need to start responding to the implementation of Basel III standards which are being adopted by regulators globally.

Despite Islamic banks' healthy levels of capitalisation across various jurisdictions, concerns about asset quality remain due to the excessive exposure to the property market and inadequacy of the risk management framework. To this end, some jurisdictions in the GCC are still contending with the effects of high impairment charges and provisions for doubtful debts on financing, which is one of the main reasons for the decline in capitalisation levels. Greater emphasis needs to be placed on diversifying the business exposure that underpins the growth of Islamic banks. Based on a survey conducted by IFSB, following the last financial crisis, supervisory authorities in many jurisdictions have called for the supervision of real estate portfolios of financial institutions in their jurisdictions to prevent excessive exposures. This is key to financial stability, as the delinquency rate becomes a critical issue during an economic downturn for Islamic banks that are highly exposed to real estate activities.

3.1.6 Structure of Funding

The ability to provide foreign currency deposits allows Islamic banks to expand their depositor base, tapping funds from foreign sources in the country as well as multinational funds. In addition, Islamic banks can enable domestic companies with business exposures abroad to access accounts that are tied to the currencies to which they are exposed. Across countries that were included in the sample, the share of foreign currency deposits in Islamic banks remains small, with less than 10% of the total Islamic deposits across all countries except for Turkey and UAE.

Chart 3.1.6.1: Islamic Banking Average Foreign Currency Deposit Share to Total Deposits

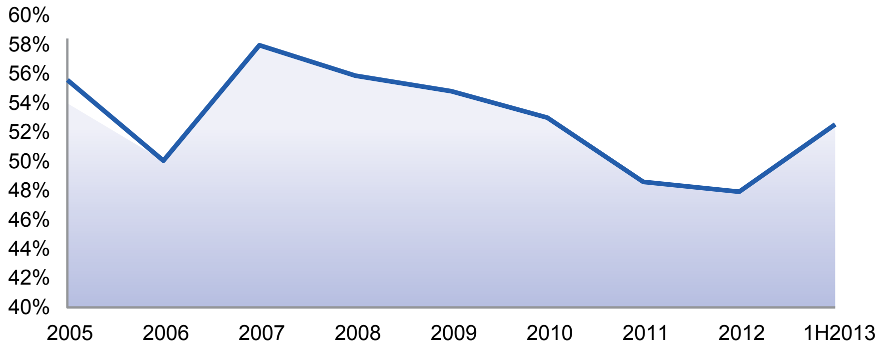


Source: Islamic Banking Sample, KFHR

With the exception of Turkey and the UAE, the share of foreign currency deposits in Islamic banks has generally remained lower than 10% during the sample years.

The average share of foreign currency deposits in total deposits in Turkey during 2005–2012 ranged from 33% to 46%, the highest averages in all countries of the sample. The specific case of Turkey highlights the point made earlier, that Turkey operates a deposit deficit environment where its domestic financing exceeds its domestic deposit mobilisation and Turkish banks rely on international funds markets, particularly the US Dollar and Euro markets, to meet their liquidity needs. Ranked second in terms of foreign currency deposits is the UAE, with a share ranging from 17% to 24%. Unlike Turkey, the UAE operates on a pegged exchange rate to the US Dollar, which it has maintained successfully for decades on the back of high inflows of foreign exchange for petroleum exports. As a result, from a financial stability perspective, Islamic banks may not be at risk from any major currency fluctuations given the strong foreign exchange reserves buffer of the UAE central bank, which could allow it to sustain the USD–UAE Dirham (AED) peg in the long term depending on its policy objectives. The composition of foreign currency deposits was not disclosed in the balance sheets of Islamic banks in Malaysia, Bahrain, Qatar and Bangladesh.

Chart 3.1.6.2: Average Profit Sharing Investment Accounts Share to Total Deposits



Source: Islamic Banking Sample, KFHR

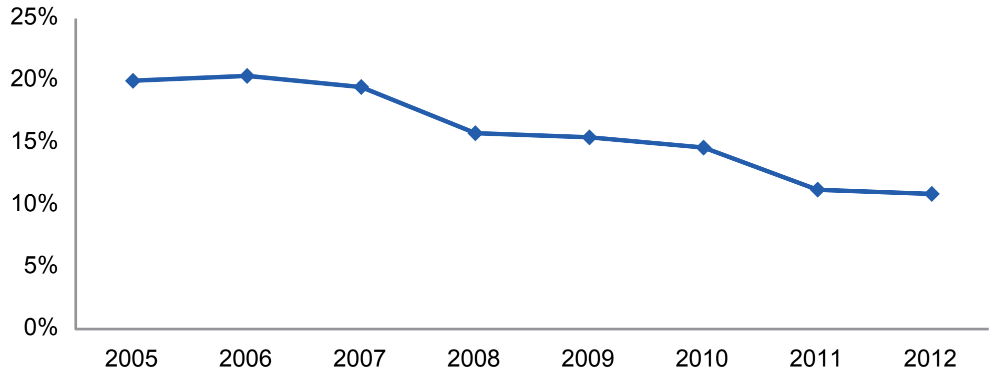
As of 2012, most Islamic banks in the sample countries held more than 50% of customer deposits in the form of PSIAs, with Bangladesh having the highest proportion at 89.5%.

The PSIA[117] is one of the distinctive features of Islamic banks, reflecting the profit-sharing principles promoted by Islamic finance. The fundamental *Sharī`ah* requirement of PSIA is to ensure that profits are linked to the real returns of investments instead of the interest rates, as is the practice of conventional banks. Depositors, known as investment account holders, are expected to bear the risks of the assets funded from these accounts. However, a peculiar risk for Islamic banks in the context of PSIA is the displaced commercial risk (DCR), which arises when the actual returns generated by investments are below PSIA holders' expectations, which are usually benchmarked to the interest rates for deposits in similar accounts at conventional banks. To prevent withdrawals, the Islamic banks top up the returns to the PSIA holders from PERs. The PSIA profiles in Islamic banks vary among jurisdictions. Islamic banks in Bangladesh have had the highest averages of PSIA share (PSIA deposits share to total Islamic deposits) for the past six years, ranging from 87% to 91%, consistently above the total sample averages as reflected in Chart 3.1.6.2. During the years from 2005 to 2012, Malaysia, Turkey, Pakistan, UAE and Qatar have had more than 50% share of PSIA accounts out of their total Islamic deposits. The expansion in the proportion of PSIAs emphasises the need for robust consumer protection regulations and financial safety nets for Islamic retail customers. Appropriate risk management mechanisms and infrastructures in Islamic banks must be emphasised by the RSAs to ensure that Islamic banks are able to manage the displaced commercial risks. This is vital in order for Islamic banks to remain sustainable and competitive in a dual financial environment.

3.1.7 Leverage Ratio

Islamic banks have managed to lower their leverage ratio steadily over the years to reach an average of 12.06% as at year-end 2012. This trend can be seen across all jurisdictions and is a result of strong operating cash flows and equity growth. As such, Islamic banks have contributed to financial stability, as the use of less debt to finance asset acquisitions provides a reduced risk of default on liabilities.

Chart 3.1.7.1: Islamic Banking Average Leverage Ratio

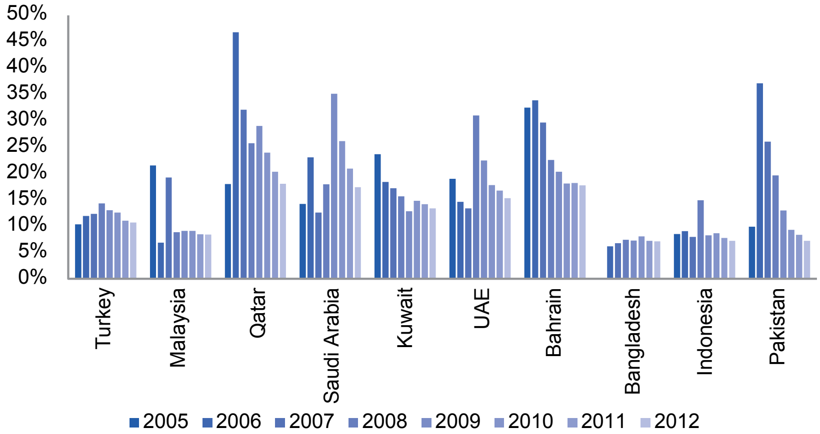


Source: Islamic Banking Sample, KFHR

The Islamic banking sample over the years has, on average, gradually lowered its leverage ratios on account of strong operating cash flows and equity growth.

[117] "PSIA" in this analysis includes saving and term deposits that are based on profit-sharing principles – that is, *Muḍārabah.*

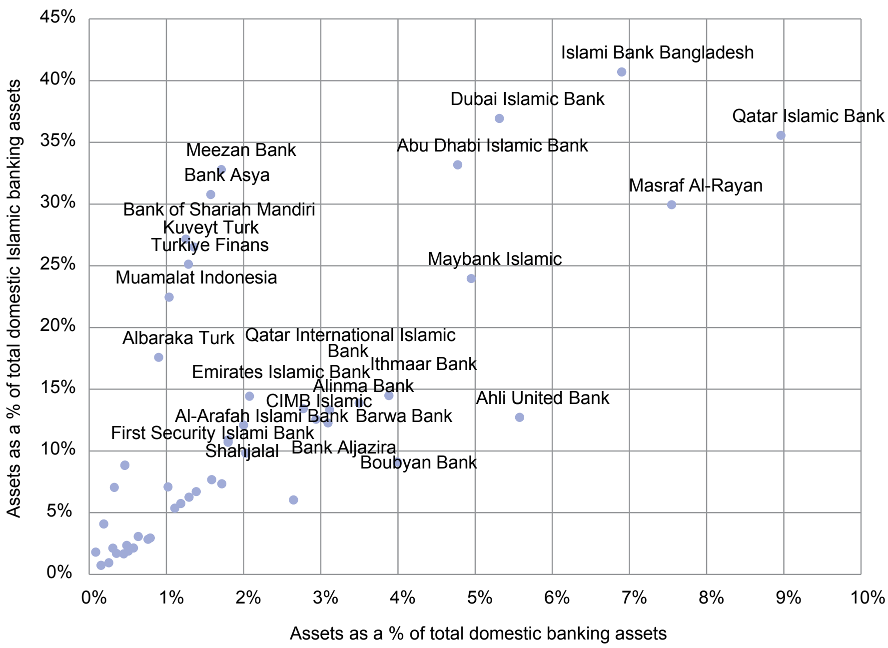
Chart 3.1.7.2: Islamic Banking Average Leverage Ratio by Country



Source: Islamic Banking Sample, KFHR

In 2012, the FSB and the BCBS published a framework for identifying and dealing with D-SIBs. As reported in the previous year, 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 would become relevant in the context of IIFS in various jurisdictions. In addition to the two largest Islamic banks (Al Rajhi and Kuwait Finance House) by total asset size (outside Iran), which account for 15.42% and 31.15%, respectively, of total domestic banking assets and 65.97% and 71.03%, respectively, of domestic Islamic banking shares, there are 27 Islamic banks with significant market shares, as plotted below.

Chart 3.1.7.3: Sample of Potential Domestic Systemically Important Banks*



**Sample of Islamic Banks with Assets > 3% of Total Domestic Banking Assets (2012) and/or >10% of Total Domestic Islamic Banking Assets (2012)*

Source: Islamic Banking Sample, CEIC, Annual Reports, KFHR

The global financial crisis resulted in an economic slowdown which has affected the Islamic finance industry, although not as severely as conventional banks. The impact of the drying up of the interbank market was mild due to high cash reserve buffers in Islamic banks. The performances of Islamic banks varied across countries and depended, to a considerable degree, on each country's economic and political stability. In Asia, credit expansion and the easy access to funding has enabled the region to generate growth, but this may also expose the region to domestic financial vulnerabilities. As per quarterly reports from the BIS, the Asian banking sector (with the exception of Indonesia) was largely funded by domestic deposits and, as a result, countries in the region were insulated from impact on their domestic credit expansion abilities as global banks practised deleveraging in the aftermath of the GFC. Nonetheless, the fact that Islamic finance is not insulated from global trends, the complexities of economic conditions and the contagion risk at the global level emphasise the need to develop frameworks to assess macroeconomic vulnerabilities and their impact on the stability of Islamic finance at both the domestic and global levels.

Islamic finance emphasises real economic activities as the underlying factors that should drive financial intermediation. The materiality of Islamic financial transactions must be supported by productive flows to the economy, and this has to be closely linked with the macroeconomic fundamentals of a country as well as the world's economic growth. The pursuit of Islamic finance must not deviate from this fundamental. As such, apart from financial risks, innovation and *Sharī`ah* risks must also be an utmost priority. Unbridled innovation has put the global financial system at systemic risk and has severely affected overall confidence in the financial system. Islamic banks must ensure that this part of risk is mitigated through a strong and robust *Sharī`ah* governance framework and robust product approval process. Regulatory and supervisory frameworks must correspond to the distinctive nature of Islamic finance product structures.

In terms of growth, Islamic banks have certainly made an impact, particularly in the key Islamic finance jurisdictions, as the growth rates of Islamic banking assets have outpaced those of their conventional counterparts, resulting in an increased market share of Islamic banking in various jurisdictions. For example, based on the CAGR between 2008 and 2012, Islamic banking assets in Saudi Arabia grew by 23.1%, outpacing the growth rate of conventional banking which was only 10.7%. Indonesia, as one of Asia's rapidly growing markets, experienced a 40.5% growth in its Islamic banking assets, based on CAGR, over the same period, whereas conventional banking assets in Indonesia grew by only 15.9%. The future prospects of Islamic finance – banking, in particular – require robust efforts in the overall ecosystem of Islamic finance, including the regulatory and supervisory framework, a strong *Sharī`ah* governance and legal system, equality in tax treatment, and the development of talent and diversified professional services.

3.2 *Takāful*[118]

Takāful is the *Sharī`ah*-compliant alternative to conventional insurance based on the principles of cooperative risk sharing, mutual responsibility, mutual protection, and solidarity among groups of participants. The risk pool is managed by the *Takāful* operator, which is run on a commercial basis with corporate responsibility to its stakeholders – that is, the participants, employees and shareholders. As a result, *Takāful* provides valuable *Sharī`ah*-compliant insurance coverage, which is

[118] *The financial performance of the global Takāful industry remains challenging to gauge as information concerning Takāful operations is irregular and scant for most operators. Where data are available, differences in reporting standards and accounting policies create hurdles in providing consistent performance analysis across a sample of operators. Nonetheless, annual reports of 27 Takāful operators across the two main Takāful markets of GCC (ex-Oman) and Malaysia, and including Pakistan, provided insights into the variability of the investment management and underwriting performances of the Takāful operators across the sample markets. The analysis in this section is based on financial statements for the years 2007–2012. Being the two largest markets, Malaysia and Saudi Arabia are reported separately along with Pakistan, while the remaining GCC countries are aggregated into a GCC (ex-Saudi) segment. See the sample methodology for Takāful in Appendix 1.*

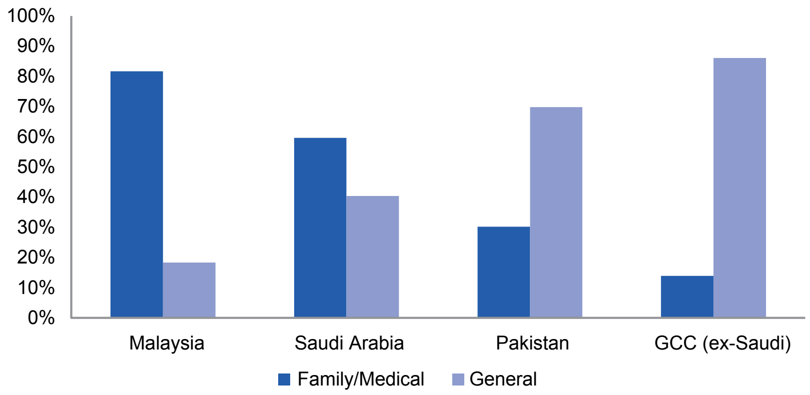
essential for risk management of assets and savings/protection of individuals in the real economy. A holistic Islamic financial system requires *Sharī`ah* compliance across all aspects of operations. Without a robust *Takāful* industry to support real economic transactions and underlying activities, the Islamic financial institutions and other stakeholders that utilise Islamic financing and related services are at a disadvantage compared to the users of the conventional finance system. Conventional finance has a wide array of insurance products on offer that mitigate risk exposures of the covered assets and contribute towards the savings and welfare of individual subscribers.

As has been discussed in Chapter 1 of this report, despite its double-digit CAGR of 18.06% during 2007–2012, the *Takāful* sector is still a nascent segment representing a 1.13% share of the global Islamic financial industry estimated as at year-end 2013. The *Takāful* sector has tremendous potential to expand given its critical role in supporting risk management in the real sectors of the economy through the provision of *Sharī`ah*-compliant insurance services. An expansion in the assets of the Islamic banking sector – for example, through business infrastructure financing or consumer house financing – is likely to spur demand in tandem for general *Takāful* coverage for these financed assets. Meanwhile, an expansion of the family *Takāful* sector would spur demand for Islamic funds and *Sukūk* instruments as the *Takāful* operators look for profitable *Sharī`ah*-compliant investment opportunities. As a result, the *Takāful* sector, despite its nascence, has a crucial role in supporting the overall growth of the Islamic financial industry. In this section, the operational performances of the *Takāful* operators are gauged across the two main *Takāful* markets of GCC and Malaysia, and additionally including Pakistan.

Malaysian *Takāful* operators continue to focus on family *Takāful* as compared to the other GCC (ex-Saudi) countries and Pakistan where general *Takāful* generates the bulk of the gross contributions (see Chart 3.2.1). As at year-end 2012, the Malaysian *Takāful* operators generated approximately 80% of their gross contributions from the family *Takāful* sector (based on the sample of *Takāful* operators included) as demand for retirement savings as well as medical/health *Takāful* products remained strong in the country. In comparison, the GCC (ex-Saudi) segment had a less than 20% share of contributions from the family *Takāful* sector, due mainly to the generous welfare state provisions as well as health and retirement schemes available from the GCC governments. This leaves little incentive for the citizens to subscribe to private family *Takāful* schemes. In the case of Pakistan, lack of awareness and understanding of family *Takāful* products, as well as the lower population income levels, are among the factors behind the smaller share of the family *Takāful* sector in comparison to the general *Takāful* products. According to market research conducted by the largest life insurance operator in Pakistan, 90% of the people surveyed did not consider life insurance was a priority for them, which response was attributed to a lack of awareness.[119] As illustrated in Chart 3.2.2, motor *Takāful* products were the most popular in Pakistan in 2012, generating the bulk of the gross *Takāful*. The family *Takāful* sector was prominent in Saudi Arabia, which has lower provision of state-sponsored welfare and retirement benefits schemes compared to other GCC countries, and this encourages citizens to subscribe to private family *Takāful* schemes.

[119] Market research by EPU Life Assurance – Pakistan (2013).

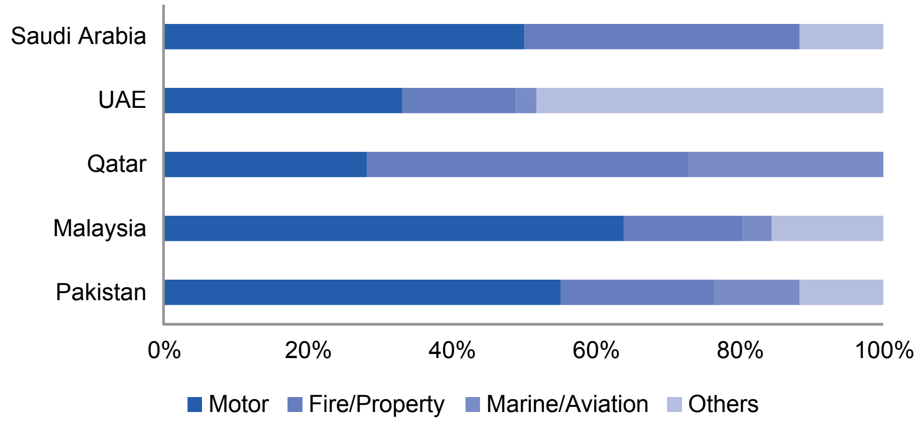
Chart 3.2.1: Key *Takāful* Business Lines in Sample Markets (2012)



Source: Takāful Operators Sample, KFHR

Regulatory regimes commonly allow medical insurance to be underwritten by either general or life insurance providers. To the extent that a similar practice is applicable in the Takāful industry; the comparison between family and general Takāful segments across jurisdictions may somewhat be distorted by the effect of aggregating medical contributions into the family Takāful segment.

Chart 3.2.2: Breakdown of Key General *Takāful* Business Lines in Sample Markets (2012)

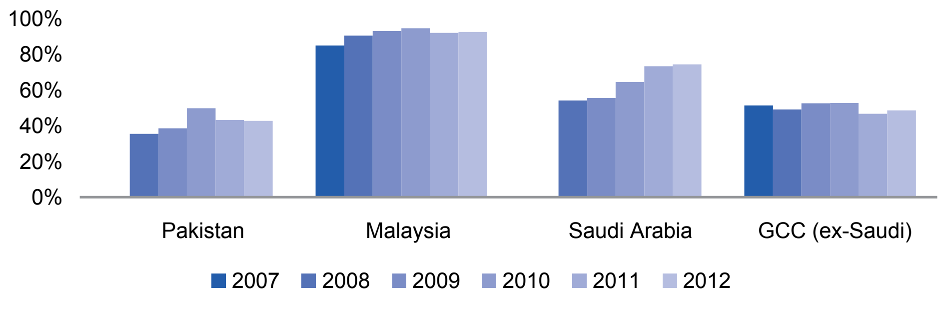


Source: Takāful Operators Sample, KFHR

Within the general *Takāful* products segment, specialised business lines such as marine and aviation constitute a nascent segment (see Chart 3.2.2) as many *Takāful* operators lack sufficient capitalisation levels to enable them to underwrite much larger value projects such as those involved in marine and aviation. The same observation highlights the critical role which *ReTakāful* schemes could play in the form of absorbing some of the underwriting risk from individual *Takāful* operators while providing them with underwriting capacity that could enable them to expand their market share. The motor and fire, property and casualty segments are the most popular general *Takāful* products subscribed to by participants in the sample countries as at year-end 2012. The popularity of these general *Takāful* products is attributed to their similarity to the conventional offerings, albeit with differences in underlying structures to ensure compliance with *Sharī`ah* principles. As a result, these products are easily understood by market participants, and this enables them to compare the available offerings and select the product that best aligns with their needs and preferences.

Corresponding to the specialisation of *Takāful* operators between family and general *Takāful* segments, the patterns in the risk retention ratio also indicate that Malaysian *Takāful* operators retain greater proportionate *Takāful* risk compared to operators in the GCC, which cede the bulk of their contributions to *ReTakāful*/reinsurance operators. During 2008–2012, Malaysian *Takāful* operators have consistently retained more than 80% of the *Takāful* contributions underwritten which reflects the greater proportion of risk undertaken by these operators as opposed to ceding the risk to *ReTakāful* reinsurance operators. Such a trend corresponds with the dominance of the family *Takāful* sector in Malaysia, which is exposed more to investment risks than to underwriting risks that are passed onto *ReTakāful* reinsurance operators. Chart 3.2.1 further corroborates that the family/medical sector represented nearly 80% of the gross contributions in 2012. From an industry stability perspective, a higher level of risk retention potentially reflects on the greater capacity available among *Takāful* operators to maintain and manage the risk pools (Chart 3.2.3). It is essential for *Takāful* operators to gain a firm understanding of the risk exposures and develop the necessary capacity and capital buffers to preserve long-term survival of *Takāful* operations, thus in turn contributing to the industry's stability. On a critical note, a low level of risk retention due to greater ceding of contributions to *ReTakāful* reinsurance operators could potentially expose *Takāful* operators to price sensitivities and dependencies on the *ReTakāful* reinsurance markets, and any disturbances/instabilities in the latter could have implications for the stability of the pricing structures and revenues of the *Takāful* operators.

Chart 3.2.3: Risk Retention Ratio in Sample Markets[120] (2008–2012)



Source: Takāful Operators Sample, KFHR

[120] Risk retention ratio = net contributions/gross contributions.

Saudi Arabia also had a higher risk retention ratio than other GCC countries, averaging between 60% and 70%, during 2008–2012, highlighting the greater role of family *Takāful* in the domestic industry. As at 2012, family/medical *Takāful* represented approximately 60% of the *Takāful* gross contributions in Saudi Arabia. In comparison, the GCC (ex-Saudi) and Pakistan had risk retention ratios averaging around 50% and 40%, respectively, over the period, which indicates the prominence of the general *Takāful* products in these markets. General *Takāful* products are exposed to underwriting risks, which can then be transmitted by the *Takāful* operators to *ReTakāful* operators. The presence of financially healthy and well-capitalised *ReTakāful* operators iscritical for promoting resilience and financial stability in the *Takāful* sector, as these *ReTakāful* operators take on the critical role of spreading risks among the various subscribing *Takāful* operators. If appropriately managed, *ReTakāful* is an effective way of sharing risks over different *Takāful* pools and provides mutual protection for any one *Takāful* operator that may run into difficulty.

Analysing *Takāful* operators in terms of operating profits, the Malaysian *Takāful* operators emerge as the best performers consistently during the years 2007–2012. The Malaysian sample average *Takāful* operating profits to total assets ratio was consistently higher than 5% during 2007–2012. Such an observation is substantially backed by the claims and operating ratios for Malaysia, which are the lowest among the sample. The Malaysian claims ratio averaged approximately 30% during 2007–2012, while it had one of the most efficient operating ratios – averaging just over 50% during the sample years. Saudi Arabian *Takāful* operators had a higher claims ratio, averaging just over 60%, but they also generated positive returns to assets during the sample years, averaging just over 3%. Their overheads remained low, which brought the operating ratio below 100%. An underwriting surplus coupled with additional income from other sources helped the Saudi *Takāful* operators to generate positive returns on assets.

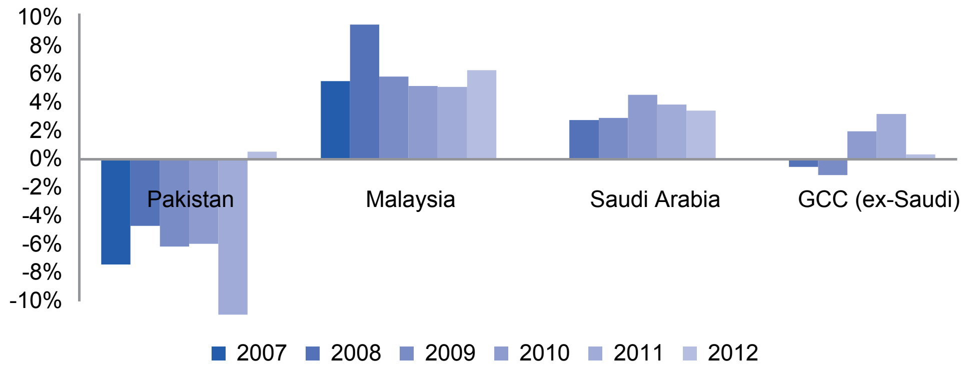
The GCC (ex-Saudi) segment has managed to post positive returns in recent years, averaging about 2%. It posits claims and operating ratios very similar to those for the Saudi sample, with average claims just under 60% while the operating ratios averaged around the 90% mark. However, it yielded lower returns and, at times, negative returns as compared to the Saudi Arabian operators, since the GCC (ex-Saudi) *Takāful* operating profit figures were reported net of *Wakālah* fees before distributions of *Muḍārib* shares.[121] Finally, the Pakistani sample fared the least favourably, as most of the sample *Takāful* operators had only entered the market in 2007 and hence faced relatively higher operating and claims ratios. The higher operating ratio was a result of the start-up costs incurred by these operators; while the higher claims ratio was, in part, driven by the lower amount of contributions to the risk pool, thus yielding a smaller numerical base from which to absorb annual claims. The claims ratio has improved significantly during the period 2010–2012 as the operators gained market share and generated larger amounts of net contributions to absorb the annual net claims incurred. However, its operating ratio remains above 100%, which contributes to a deficit in *Takāful* underwriting operations, thus yielding negative returns on assets.

Overall, healthy returns performances were witnessed in the two main and established *Takāful* markets of Malaysia and Saudi Arabia, while the GCC (ex-Saudi) and Pakistani *Takāful* markets have been improving steadily over the years. The differences in returns performances between the sample markets could also be attributable to the varying compositions of family and general *Takāful* segments in the respective sample *Takāful* markets.[122] In general, the family *Takāful* segment, consisting of savings and retirement products, is regarded as more profitable – given its investment-based and profit-sharing product characteristics – than the general *Takāful* segment, which is an incident-driven product (for example, motor *Takāful*, property *Takāful* and others) that provides protection to

[121] *Wakālah* fees are agency fees charged by the *Takāful* operators from the *Takāful* participants' fund in exchange for the management services rendered. *Muḍārib* share represents the portion of underwriting profits attributable to the *Takāful* operator as per the profit-sharing agreement with the *Takāful* participants.
[122] Data segregating returns performances between the family and general *Takāful* segment in the sample markets are currently not available to give absolute credence to this assertion.

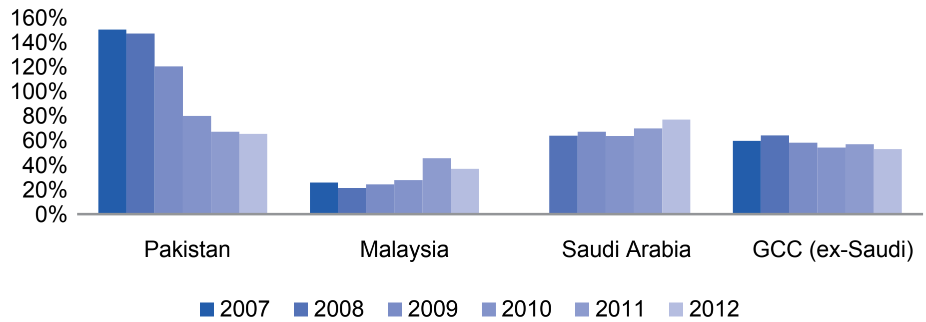
members from losses arising from the covered incidents. Consequently, the Malaysian and Saudi Arabian samples of *Takāful* operators yielded higher returns, coinciding with the higher proportions of the family *Takāful* segment in their domestic markets, compared to the GCC (ex-Saudi) and Pakistan markets, which had a higher composition of the general *Takāful* segment.

Chart 3.2.4: Return on Assets[123] (2007–2012)



Source: Takāful Operators Sample, KFHR

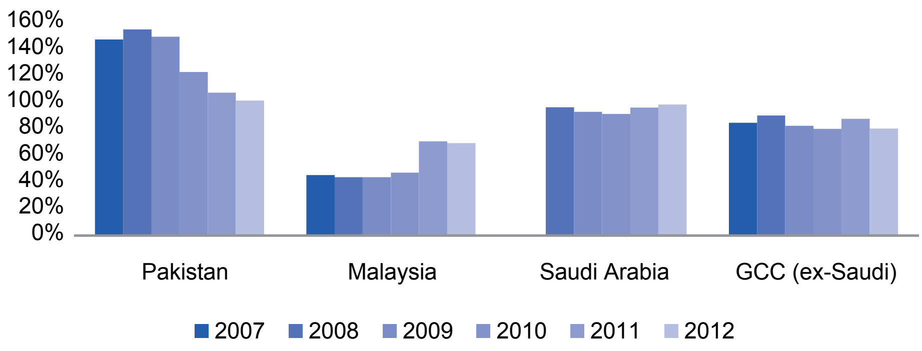
Chart 3.2.5: Claims Ratio[124] (2007–2012)



Source: Takāful Operators Sample, KFHR

[123] Return on assets = *Takāful* operating profit before distributions/total assets.
[124] Claims ratio = net claims incurred/net contributions.

Chart 3.2.6: Operating Ratio[125] (2007–2012)



Source: Takāful Operators Sample, KFHR

Finally, there are significant differences in investment compositions of *Takāful* operators across the sample regions. In Malaysia, *Sukūk* and money market instruments represent the bulk of the investments of the *Takāful* operators, which epitomises the healthy and liquid *Sukūk* and Islamic interbank money market in Malaysia. Malaysia has a wide variety of *Sharī`ah*-compliant money market instruments as the country is the largest domicile for *Sukūk* issuances in terms of both number of issuances and amounts outstanding. As at year-end 2012, Malaysian *Takāful* operators held more than 60% of the investments in the form of *Sukūk* and money market instruments, followed by cash and bank deposits, equities, and then funds and other investments. A similar observation is witnessed in Saudi Arabia, where nearly 40% of the investments were held in the form of *Sukūk* and money market instruments by the *Takāful* operators, followed by funds and other investments, cash and deposits, and finally equities (accounting for the lowest proportion of less than 8% of investments).

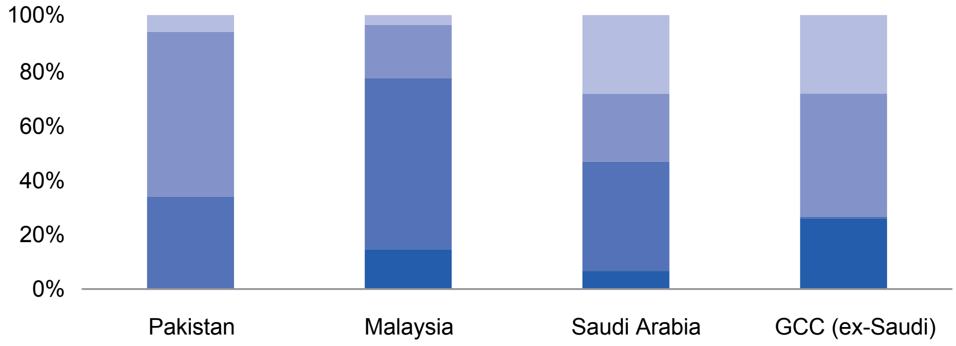
By contrast, the GCC (ex-Saudi) segment held more in the form of cash and deposits and funds and other investments. Most of the *Takāful* operators in GCC (ex-Saudi) did not disclose separate holdings for *Sukūk* and money market instruments, and it is suspected that *Sukūk* investments are lumped together into the funds and other segments in these operators' financial reports. Interestingly, equities constitute approximately 27% of the investment composition in this region, the highest among the sample countries. In Pakistan the *Takāful* operators held more than 90% of the investments in the form of cash, deposits, and *Sukūk* and money market instruments, with a very minor share for funds and equities. This indicates the risk averseness of the *Takāful* operators in the country, given that the bulk of the business is in the form of general *Takāful* products and very little is accounted for by the family *Takāful* sector, where healthy returns require riskier exposures. On a critical note, the placement of funds as cash, bank deposits and short-term money market instruments by *Takāful* operators could be due to the unavailability of sufficient long-term *Sukūk* papers. It is commonly observed that *Sukūk* issuances are always oversubscribed by investors, and post-issuance are held to maturity with limited trading activity due to the excess of demand for *Sukūk* instruments over supply. This point is discussed further in the Islamic capital market section of this chapter.

In summary, the *Takāful* sector has a critical role to play in providing *Sharī`ah*-compliant insurance coverage to an Islamic economic system, which is essential for risk management of assets and savings/protection of individuals in the real economy. However, its share in the global Islamic finance industry remains at a nascent stage. Challenges in the widespread expansion of the *Takāful* sector are many, including a lack of standardisation in *Takāful* accounting and disclosure, especially related to capital adequacy and solvency disclosure, the need for product innovation, a lack of awareness and understanding of *Takāful* products by the population, and insufficient qualified human resources

[125] Operating ratio = claims ratio + expense ratio [overheads/net contributions].

with experience in the *Takāful* business. Challenges in the *Takāful* sector are also linked to the development and expansion of other Islamic financial sectors. For example, one of the most critical challenges facing the *Takāful* industry is the limited availability of Islamic instruments such as *Sukūk*, which are the most suitable type of investment for *Takāful* companies.

Chart 3.2.7: Investment Composition (2012)



Source: Takāful Operators Sample, KFHR

Overall, robust growth of the *Takāful* industry in tandem with growth in other sectors of the Islamic finance industry is required to promote greater levels of resilience and financial stability of the Islamic finance system. Notable efforts have been made by the IFSB and other regulatory bodies of various Islamic finance jurisdictions to provide the support needed by the sector to overcome challenges impeding its growth and widespread expansion. The future prospects of the *Takāful* industry will depend on the combined efforts of all the relevant parties, including regulators and market players, in overcoming the various challenges that are impeding the growth and expansion of the *Takāful* industry, and expending the effort required to shape the future strategic direction of the industry.

3.3 Islamic Capital Market

3.3.1 *Sukūk* Market

The *Sukūk* market has been one of the fastest growing segments of the IFSI, with annual issuances increasing from just under USD11.5 billion globally in 2005 to a record USD119 billion in 2013, expanding at an average y-o-y growth rate of more than 40%. More critically, the popularity of *Sukūk* as a financing instrument rapidly gained momentum in the post-financial crisis period, with more than 61% y-o-y growth in global *Sukūk* issuances in 2010. *Sukūk* has become a vital instrument that has gained rapid international attention as a means of tapping into the fast-expanding pool of *Sharī`ah*-compliant liquid funds, particularly at a time when liquidity in global international markets has dried up. Importantly, *Sukūk* has emerged as an important source of funding for long-term projects such as transportation, infrastructure building and healthcare.

Sukūk became popular instruments notably among the sovereign issuers as a means to raise liquidity in order to support their various infrastructure and fiscal spending requirements. The trend is clearly visible since 2009, with sovereign *Sukūk* having become the main component of global annual *Sukūk* issuances, far overtaking the corporate issuances to date. Following 2012's record-breaking achievement in new *Sukūk* issuances in the primary market which amounted to USD131.2 billion, a

54.2% y-o-y increase, in 2013, *Sukūk* volume once again surpassed the USD100 billion mark, closing at USD119.7 billion, 8.8% short of the previous year's record amount. (This decline in value of *Sukūk* issuances will be discussed later in this section.) Against a backdrop of global macroeconomic challenges and dried-up liquidity in the international markets, the fast-expanding pool of global *Sharī`ah*-compliant liquidity funds post-financial crisis has become an attractive alternative source of financing for various sovereign and government-related entities, as well as corporates. Some new and emerging jurisdictions that have tapped into the global corporate and sovereign *Sukūk* markets following the financial crisis include Azerbaijan, Turkey and the UK in 2010; Hong Kong, Jordan and Yemen in 2011; France, Germany and Kazakhstan in 2012; and Luxembourg, Mauritius, Nigeria and Oman in 2013. The momentum is all set to continue into 2014, as a number of high-profile debut sovereign issuances are expected to take place this year. Announced sovereign *Sukūk* in the pipeline for 2014 include the likes of the UK, Luxembourg, Ireland, South Africa, Tunisia, Mauritania, Senegal and Oman.

A systemic risk is broadly defined as a risk of disruption to financial services that is (i) caused by an impairment of all or parts of the financial system, and (ii) has the potential to have serious negative consequences for the real economy.[126] In this context, the development of the Islamic capital market as a whole is critical to the stability and resilience of the Islamic finance system. In order to support the healthy growth of banking and *Takāful* sectors, Islamic capital markets, apart from providing an alternative for fundraising, also provide the instruments needed for liquidity and capitalisation purposes of Islamic financial institutions. Islamic banks need to hold *Sharī`ah*-compliant instruments, and similarly *Takāful* operators are investing their funds in *Sharī`ah*-compliant investment avenues. *Sukūk*, for example, are widely subscribed by Islamic funds and *Takāful* institutions looking for *Sharī`ah*-compliant fixed-income investment avenues. In this light, it is important to develop the Islamic capital market as a whole to support an orderly and sustainable Islamic finance system. Equal emphasis should be directed to developing a comprehensive system for Islamic banks to manage their risk and comply with the regulatory requirements set by financial regulators. As the world's banking sector begins implementation of the Basel III standards, *Sukūk* markets need to evolve and play a critical role so as to enable Islamic banks to satisfy the regulatory requirements concerning liquidity and capitalisation, as stipulated by the domestic regulators. The BCBS document *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* highlighted that, even in jurisdictions that have a sufficient supply of high-quality liquid assets, an insurmountable impediment to the ability of *Sharī`ah*-compliant banks to meet the LCR requirement may still exist. Importantly, the development of the *Sukūk* market needs to correspond with the expectations of the financial regulators to ensure the demand for high-quality and liquid instruments is met. The presence of a deep and liquid *Sukūk* market is vital to ensure the stability of the financial system, apart from its importance in creating a competitive Islamic banking system vis-à-vis the conventional system. Islamic banks need to mobilise the funds available, and the dearth of *Sharī`ah*-compliant securities could potentially affect the performance and competitiveness of Islamic banks if they continue to maintain a higher level of cash and non-earning liquid assets than the conventional institutions.

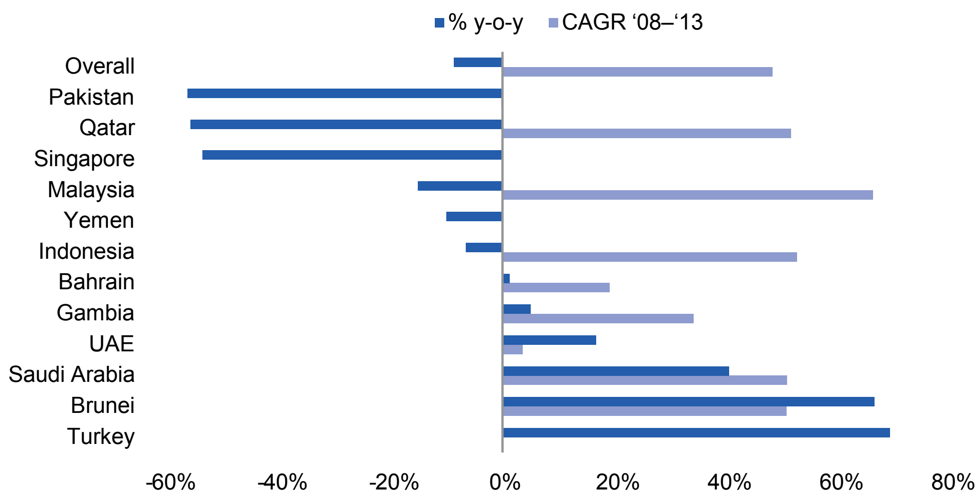
Financial regulators are increasingly focusing on macro-financial linkages, including global macroeconomic policy on securities markets. Similarly, this is an area that requires greater research from an Islamic finance perspective in order to better understand the impact of global economic conditions on the changing dynamics of Islamic financial instruments. The *Sukūk* industry, being a sub-set of the broader global capital market, is exposed to underlying risks resulting from developments and changes in major financial and economic locations. The global *Sukūk* market has been influenced, particularly in recent years, by the same broad factors, such as the financial and sovereign debt crises, capital flows to and from emerging markets, and a potential tapering of the monthly US stimulus programme by the Federal Reserve, which have affected the global capital

[126] "Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations", *Report to the G-20 Finance Ministers and Central Bank Governors* (FSB, IMF and BIS), October 2009.

markets. The interconnected global economy makes it difficult to delink the Islamic capital market in general, the *Sukūk* market specifically, from many of the externalities that trigger investment/divestment, capital inflow/outflow and/or monetary/fiscal policy changes.

The impact of the Federal Reserve tapering debate was noticeable in the primary *Sukūk* market where overall issuances for 2013 declined 8.7% y-o-y, despite strong growth momentum of 48.3% (CAGR) per year since 2008. Between May and September (when the tapering announcement was made and delayed, respectively), issuances were almost half the volume of the year prior (–46.1% y-o-y) as issuers stepped back to monitor monetary policy direction. Countries that saw the biggest decline included Pakistan, Qatar and Singapore, although by weightage, Malaysia and Indonesia represented the most significant share in the decline. Malaysia had a drop in sovereign issuances of 4.8% in 2013 (despite a y-o-y growth of 15.3% until the end of May) as compared to a growth of 44% in 2012.

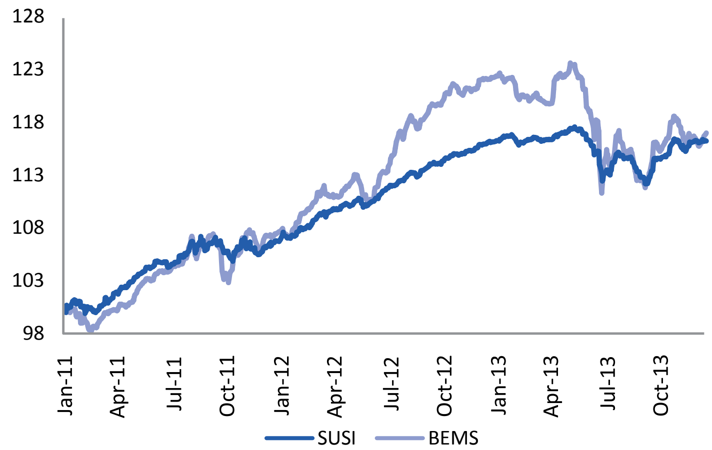
Chart 3.3.1.1: Changes in *Sukūk* Issuances (2013 y-o-y and CAGR)



Source: Bloomberg, IFIS, Zawya, KFHR

Back in late 2011, fears of a European contagion crippling a fragile and fragmented economic recovery pushed investors into safer assets. *Sukūk* was an attractive asset at that time, as was the case for most emerging markets' debt, which offered higher yield than developed markets that were experiencing economic stagnation. Simultaneously, the credit rating of the US was downgraded by S&P to AA+, while the Federal Reserve continued its second round of quantitative easing, causing interest rates to remain low. Throughout 2012, the European sovereign debt crisis worsened, with multiple bail-outs and rating cuts for numerous euro-member countries. The crisis in Europe and the generous monetary stimulus in the US sustained a debt market rally until the start of 2013. Both *Sukūk* and emerging market bond yields reduced to historic lows during this period. In 2013, optimism concerning economic recoveries in the US (which compelled the US Fed to consider tapering its QE programme) and also improvements among the Eurozone economies (Ireland has recently returned to international bond markets, marking an end to its EU/IMF bail-out programme and setting a precedent for Greece, Portugal and Cyprus, the Eurozone states still under sovereign bail-out programmes) led to a slow but steady shift from safe, fixed return assets to higher-yielding assets. The discontinued growth in demand for *Sukūk* and bonds meant prices and yields moderated slightly until 2Q13. Subsequently, the Federal Reserve's May announcement that it might taper its QE programme brought *Sukūk* prices tumbling as investors took flight from emerging markets. A taper of bond purchases sends interest rates higher, making US assets (except tapered assets) relatively more attractive to investors. Post the September 2013 delay in tapering – which signalled that the US economy was not quite ready for a cut in stimulus – *Sukūk* prices rebounded somewhat. These trends show that *Sukūk* markets are not isolated from global macroeconomic policy factors. In a low interest rate environment, *Sukūk* appeals to global investors. However, with prospects of higher yields on the back of an improved global economy, there are considerable risks of an outflow of funds from the *Sukūk* market in search of higher yields in the other asset classes.

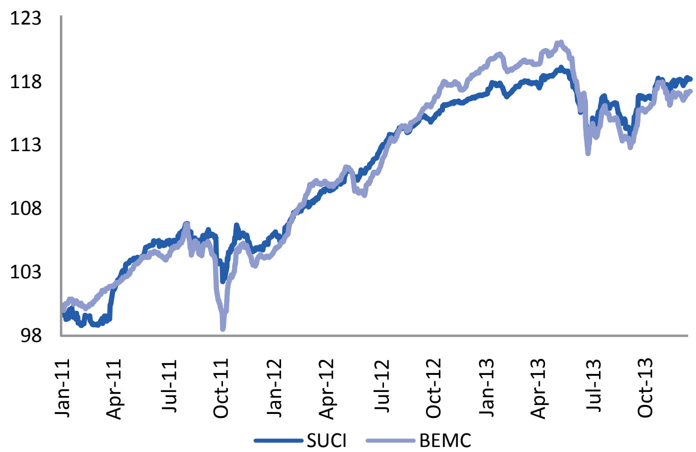
Chart 3.3.1.2: Sovereign *Sukūk* and Emerging Market Bond Indices



SUSI – Sovereign Benchmark; BEMS – Bloomberg Emerging Market Sovereign Bond Index

Source: HSBC/NASDAQ Dubai, KFHR

Chart 3.3.1.3: Corporate *Sukūk* and Emerging Market Bond Indices



SUCI – Corporate Sukūk Benchmark; BEMC – Bloomberg Emerging Market Corporate Bond Index

Source: HSBC/NASDAQ Dubai, KFHR

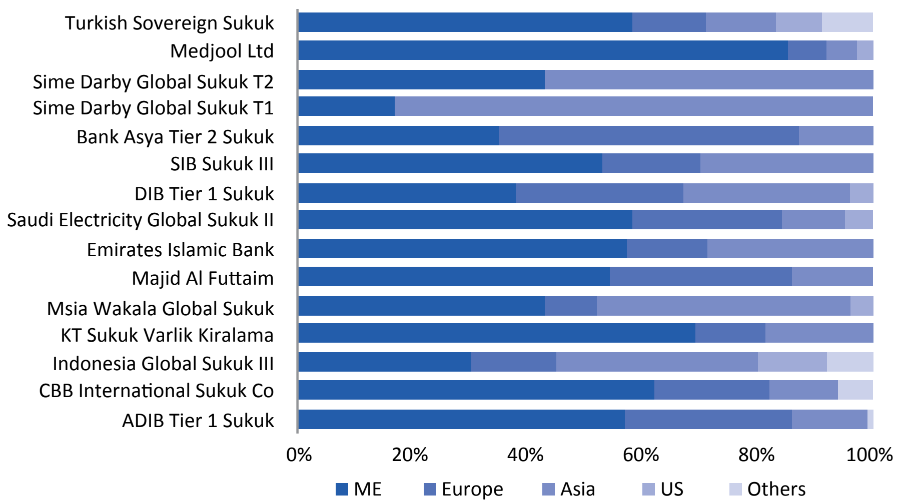
A significant factor contributing to the growth of *Sukūk* issuances and their competitiveness (vis-à-vis secondary market performance and returns) is the fact that demand for the instruments has often outweighed supply, especially given market developments in recent years. The tremendous expansion in the other sectors of the Islamic finance industry (banking, funds and *Takāful*) has warranted an increase in demand for *Sukūk* instruments by institutions in these other sectors, outpacing the number of issuers tapping into the industry. Moreover, the demand is not restricted to the IIFS alone, as a number of conventional finance institutions are also found to be active investors in *Sukūk* instruments (to be discussed below). As shown below, in the past *Sukūk* have had strong bid-to-cover ratios.

Table 3.3.1.1: Demand Comparison for *Sukūk* Issued in Recent Years

Sukūk Name	Issue Size (USD million)	Issuer Type	Tenure (Years)	Oversubscription (Times)
Government of Indonesia maturing in November 2014	650	Sovereign	5	7x
Government of Indonesia maturing in November 2018	1000	Sovereign	7	6.5x
Government of Indonesia maturing in November 2022	1000	Sovereign	10	5.3x
Sime Darby Global *Sukūk* (Tranches 1 & 2)	800	Quasi-sovereign	5, 10	10x
Dubai DOF *Sukūk* (Tranche 3)	750	Sovereign	10	12x
DEWA *Sukūk* 2018	1000	Quasi-sovereign	5	5.5x
SIB *Sukūk* III	500	Corporate	6	6.48x
DIB Tier 1 *Sukūk*	1000	Corporate	6	14x
Malaysia's Wakālah Global *Sukūk* (Tranches 1 & 2)	2000	Sovereign	5, 10	4.5x
General Authority of Civil Aviation *Sukūk*	3199.7	Sovereign	10	3x
Turkey Sovereign *Sukūk* 2018	1500	Sovereign	5.5	5.33x
Khazanah Nasional Exchangeable *Sukūk* IV	357.8	Quasi-sovereign	7	3.4x

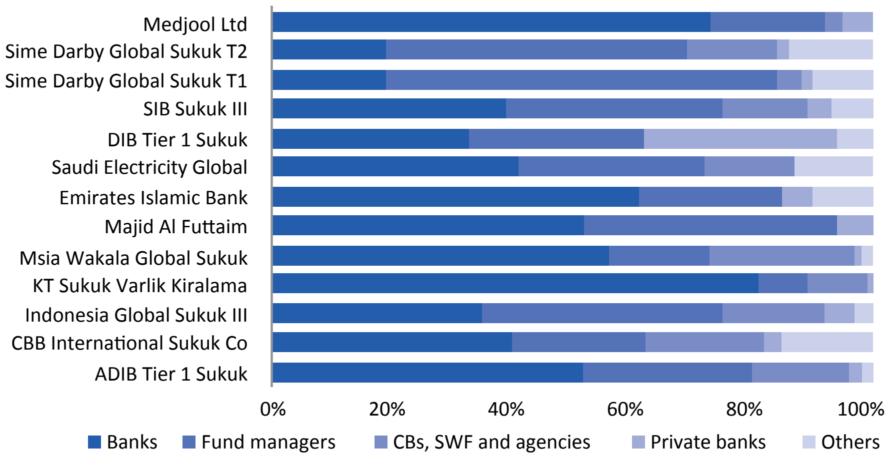
Source: Various references, Bloomberg, Zawya, KFHR

Chart 3.3.1.4: Geographical Distribution of Selected *Sukūk* Papers



Source: Media, Bloomberg, Zawya, KFHR

Chart 3.3.1.5: Investor Distribution of Selected *Sukūk* Papers



Source: Media, Bloomberg, Zawya, KFHR

While the Middle East and rest of Asia regions often account for the majority share of investors in *Sukūk* sales, there is a significant investment from Europe, the US and elsewhere, which indicates the wider international appeal of the *Sukūk* industry (see Chart 3.3.1.4). It is common to find banks, fund managers, central banks, sovereign wealth funds and other financial institutions, including Western conventional banks and institutional investors, holding *Sukūk* and other Islamic financial instruments in their portfolios (see Chart 3.3.1.5). The appeal for institutional investors, particularly Western institutions, of holding *Sukūk* is partly driven by the higher yields of some *Sukūk* instruments compared to the yields on comparable conventional bonds. For example, in Chapter 1, Chart 1.3.1.10 showed that the Dubai DOF *Sukūk* had a yield of 10.33bps, slightly higher than that of the conventional Dubai government bond. Meanwhile, institutional investors are also attracted to *Sukūk* intruments because of the lower incidence of default in the *Sukūk* industry. Larger volumes of *Sukūk* issuances over the years in certain jurisdictions – for example, in Malaysia, where more than 60% of the total debt instruments issued are Islamic – have also attracted greater institutional investments from institutions seeking exposures to the Malaysian debt markets. Moreover, it has been a common trend for investors to hold *Sukūk* papers until maturity, given their limited supply (as was discussed earlier and presented in Table 3.3.1.1).

Notwithstanding the above, even though the trend over the years has been for investors to hold *Sukūk* instruments until maturity, the *Sukūk* industry is potentially exposed to instability if investors with no specific *Sharī`ah*-compliant investments mandate (for example, conventional institutions that are not obligated to hold Islamic instruments) withdraw from *Sukūk* investments in favour of higher-yielding conventional instruments issued in markets around the world. The recent volatility in the emerging markets had an impact on the yields of the *Sukūk* industry as well when investors exited the emerging markets, and this gives credence to the potential risk faced by the industry. Further research is vital in order to evaluate the potential risks for *Sukūk* issuers – and the Islamic capital markets industry in general – in the event that conventional investors withdraw from exposures in Islamic instruments in favour of higher-yielding conventional investments elsewhere. Islamic banks and other Islamic financial institutions have a tendency to hold financial insturments to maturity given the *Sharī`ah*-compliant mandate governing their operations, whereas conventional investors have wider choices and continue to search for better returns. This could be a reflection of potential risk (in terms both of returns to the *Sukūk* holders and the lower demand for *Sukūk* issues) should the conventional investors change direction and search for higher-yielding instruments (not limited to Islamic) in the rest of the world.

In summary, the *Sukūk* market is of strategic importance for the global Islamic financial system and its stability, given the widespread use of the instruments as tools of sovereign and corporate financing. *Sukūk* are demanded by all sectors of the Islamic financial system. The Islamic banking system demands *Sukūk* for managing their liquidity and capital needs; the funds industry demands *Sukūk* to provide *Sharī`ah*-compliant fixed-income investment opportunities to investors; and the *Takāful* industry prefers *Sukūk* investments given its need for certain and steady streams of returns. *Sukūk* is also much in demand from the conventional financial institutions that want to benefit from its lower volatility and stable return characteristics, as has been highlighed earlier in this chapter. Hence, the *Sukūk* market is vital to the broader financial stability of the global Islamic financial system.

To further enhance the role of *Sukūk* as instruments that promote resilience and financial stability of the Islamic financial system, the following matters need to be considered in the near future.

(a) A wider choice of structures for *Sukūk* instruments
The *Sukūk* market needs to develop new structures for *Sukūk* instruments that reflect the dynamic needs of the market. The issuers need to expand beyond traditional structures as currently adopted in the markets andcome up with innovative *Sukūk* instruments that meet the changing needs of the market. An example of one such innovation is the issuance in 2012 of the world's first *Sharī`ah*-compliant Basel III *Sukūk* with perpetual maturity.

(b) A wider range of maturities for *Sukūk* instruments
The Islamic finance industry also needs *Sukūk* of various tenors to meet different purposes. For instance, while the Malaysian *Sukūk* market has a wide variety of short-, medium- and long-term *Sukūk* issuances, the GCC markets generally do not have *Sukūk* issuances exceeding seven years in maturity. Moreover, 93% of all short-term *Sukūk* issuances are locally domiciled in Malaysia, which highlights the gap in short-term *Sukūk* instruments in other Islamic finance markets that can help the liquidity management of Islamic banks.

(c) A wider range of *Sukūk* exposures by sector and by type
The *Sukūk* issuers need to extend beyond traditional sectors of financing to enable more sectors of the economy to receive *Sharī`ah*-compliant financing. *Sukūk* have diversified from being corporate and asset financing instruments to become popular tools for sovereign and infrastructure financing. *Sukūk* also need to expand further as instruments for the provision of project financing through *Sukūk al-Istisnā`*, seed financing for agriculture through *Sukūk al-Salām*, and other sectors of the economy. The availability of financing through *Sukūk* for more sectors can be instrumental in achieving greater macroeconomic stability of an economy.

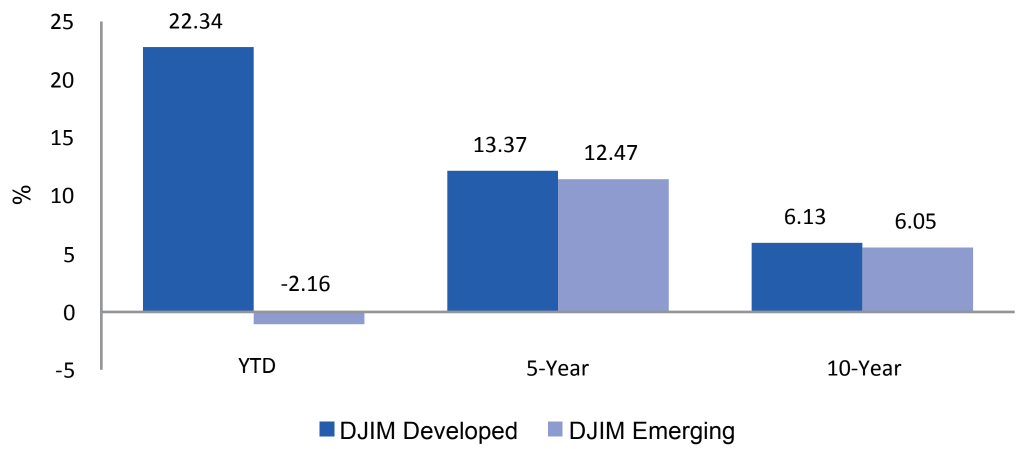
(d) Ratings
The *Sukūk* market needs appropriate rating agencies to be available in various jurisdictions to ensure that *Sukūk* instruments are rated appropriately depending upon their unique *Sharī`ah*-compliant structures. Malaysia has two rating agencies that rate locally issued papers. The importance of rating agencies has been highlighted following the default of *Sukūk* instruments in the past few years. The defaults were largely an outcome of poor credit quality of the issuer, as opposed to fundamental problems in the *Sukūk* design and structure.

3.3.2 Islamic Equity and Funds Market

The equity market is a vital component of the financial system; inversely, a stable financial system is key for a healthy corporate sector. Islamic equities have developed into an investment class for investors. In particular, Islamic equities have proven to be integral to investment allocation decisions in both individual and collective *Sharī`ah*-compliant investor schemes and now shape the global Islamic investment landscape in a significant way.

Sharī`ah-compliant indices composed of stocks traded in developed market countries have largely outperformed their peers from developing countries, based on the Dow Jones Islamic Market (DJIM) indices taken as proxies. In 2013, the DJIM Developed Markets Index returned 22.34% versus –2.16% for the DJIM Emerging Markets Index. The latter negative result was due to the (actual or anticipated) economic slowdown in major Asian developing economies such as China and India, which (together with South Korea and Taiwan) are domiciles of 61% of the components of the index. Historically, too, the DJIM Developed Markets Index performed slightly better and recorded an annualised return of 6.79%, while the DJIM Emerging Markets Index has returned 4.32% since its inception in December 1995. Overall, an increasing number of stocks passed *Sharī`ah* investment screens as the result of a reduced leverage in the financing structure of corporations. The reduced leverage and other related operational benefits have contributed positively to financial stability in both developed and emerging economies.

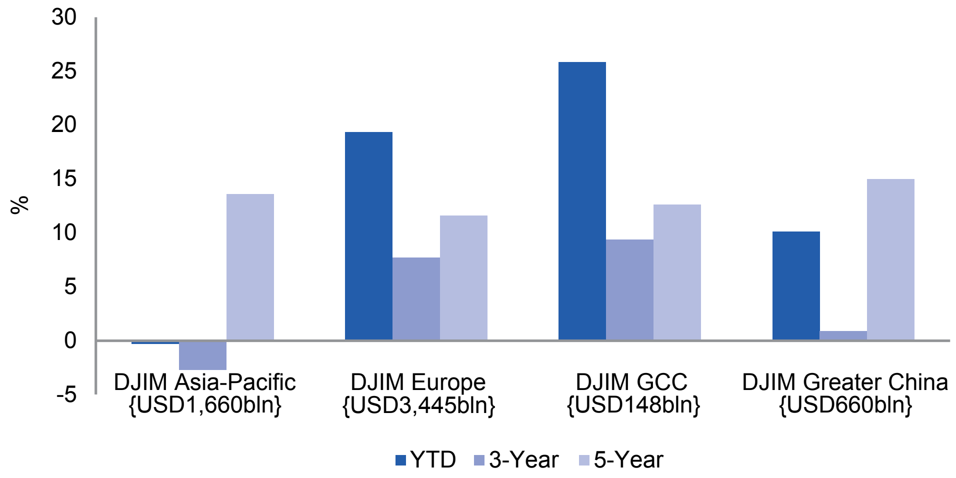
Chart 3.3.2.1: Price Returns of DJIM Developed Markets and DJIM Emerging Markets Indices (31 December 2013)



Source: S&P, Dow Jones, KFHR

Regionally, DJIM stocks in the GCC rose by 25.84% in 2013 on the back of sustained economic activity and migration of investment funds into this politically stable sub-region of greater MENA. Improved economic prospects for developed Europe have helped DJIM Europe to achieve a 19.35% return in the past year; the index exhibited a historical trend of moderate price returns with 70% of components coming from the financially stable markets of the UK, Switzerland and Germany. DJIM Greater China returned 10.12%, while DJIM Asia Pacific (ex-Japan) delivered a negative price change in 2013 in line with weaker performance of developing economies in the region during the year.

Chart 3.3.2.2: Price Returns of DJIM Markets Indices by Region (31 December 2013)



Note: Figures in { } are float-adjusted market capitalisation figures for the respective indices.

Source: S&P, Dow Jones, KFHR

Several regulatory initiatives launched in 2013 are expected to enhance the framework of Islamic equity markets. The most significant developments took place in Malaysia, where the regulator has revised the *Sharī`ah* screening methodology for the country's listed entities, hoping in part that the more stringent *Sharī`ah*-compliance listing criteria will attract greater foreign investment flows, in particular from the more conservative Gulf-based investors. The inclusion of financial ratio benchmarks has been a practice of global *Sharī`ah* index providers such as Dow-Jones, MSCI and FTSE. With this revision, the Malaysian Islamic capital market is likely to widen its international investor base and hence experience a surge in capital inflows. Both SC's and DJIM's screenings incorporate a benchmark of less than 33% for financial ratios. The S&P *Sharī`ah* Indices methodology applies financial ratios on a trailing 36-month average market value of equity, while the benchmark for account receivables is set at less than 49%. In comparison, some other screeners may adopt slightly different benchmarks: for example, the Karachi-Meezan Index 30 (KMI-30) screening methodology incorporates a higher benchmark of less than 37% for interest-bearing debt over total assets ratio.

Elsewhere, the stock market regulator in the UAE has issued rules curbing margin lending which should limit downward volatility for the country's large base of *Sharī`ah*-compliant public companies. Despite the regulatory driven developments, however, many further comprehensive rules and amendments pertaining to *Sharī`ah*-compliant stocks and their subsequent harmonisation will be required to support robust Islamic investment activities within jurisdictions with a vested interest in Islamic finance as well as enhance cross-border flows.

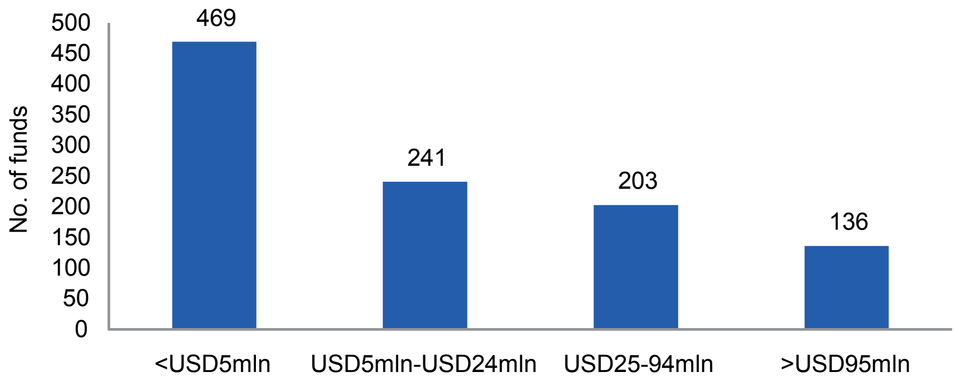
The growth in the Islamic funds sector has been supported by the surge in availability of *Sharī`ah*-compliant capital market instruments which essentially provide fund managers a wide range of *Sharī`ah*-compliant financial instruments for fund portfolio management. The availability of listed Islamic equities, fixed-income instruments, money market instruments and other structured investment products has enabled fund management companies to prosper in meeting the varied needs of Islamic investors based on their risk appetite. Islamic funds are shifting their focus from mobilising retail investor funds towards attracting institutional players into the realm of *Sharī`ah*-compliant investing.

The global Islamic funds industry has progressed tremendously, having grown from a USD29.2 billion AuM market in 2004 to one valued at more than USD70 billion as at December 2013. From 2007 to

2012, the total assets managed by Islamic funds increased by a CAGR of 7.3%, while the mature conventional funds industry grew by 1.8% during the same period. Nonetheless, during the recession, many Islamic fund managers did alter their asset allocation patterns in favour of recession-proof commodity and secure money market investments. This has been helped by continuous liberalisation of cross-border capital flows in developing countries which also contributed to the enhancement of investment portfolios internationally and the growth of asset volumes managed by Islamic collective investment schemes in recipient destinations across Asia, GCC, Europe and the Americas.

The most pertinent risk management issue for Islamic funds at this stage is liquidity, or the lack thereof. About 68% of all Islamic funds manage less than USD25 million in assets individually, resulting in deficient levels of capitalisation. Despite Islamic fund managers' recognition of the need to expand their investor bases, the majority of investors who buy into *Sharī`ah*-compliant funds are retail clients, while the assets of institutional and private/HNWI investors remain largely untapped. Furthermore, the sector is reliant on a broadly homogeneous base of investors, this being explained by mostly localised investing and marketing activities of Islamic fund managers. To sustain the positive growth trend in the future, however, the sector will likely need to undergo a number of structural and strategic changes in order to, most importantly, gain critical scale and ensure compliance with impending stricter regulatory rules.

Chart 3.3.2.3: Number of Islamic Funds by Asset Size (20 December 2013)

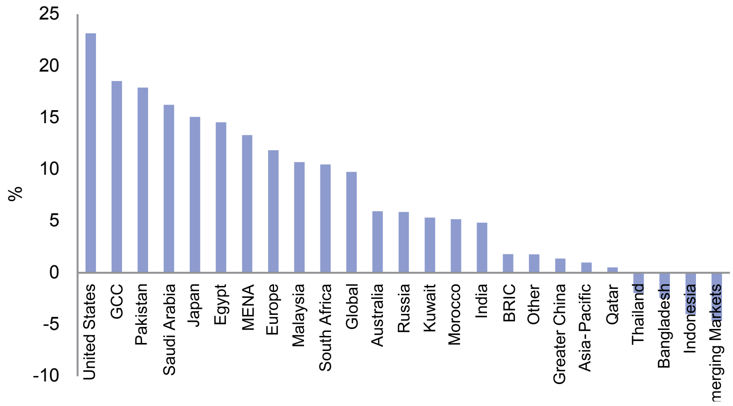


Source: Bloomberg, Eurekahedge, KFHR

In the wake of the financial crisis, the industry has been transforming in consideration of developments in the global investment environment. Although Islamic funds were affected by the crisis-driven performance pitfalls to a lesser extent than conventional funds, they are being equally challenged by resultant post-crisis changes. Primarily, these changes stem from increased investor and regulator awareness of potential threat that funds could pose to systemic financial stability. In light of this, both investors and regulators across jurisdictions are demanding that fund managers implement stricter and more transparent risk monitoring.

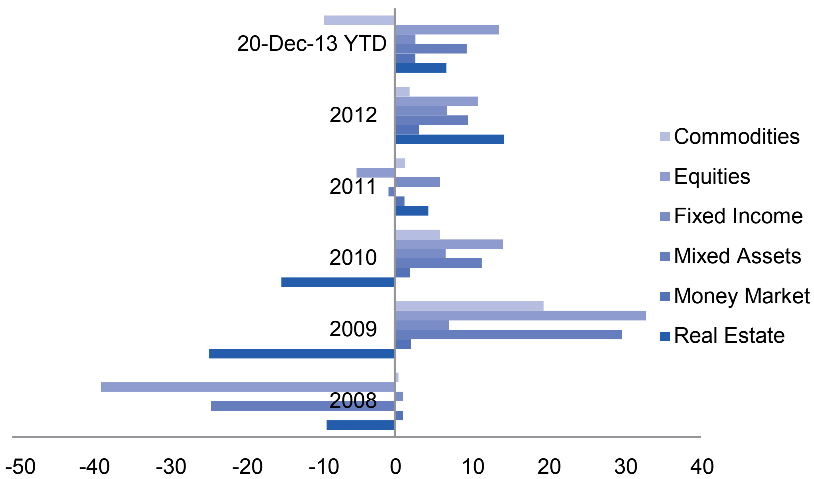
The performance of Islamic funds has varied vastly among Islamic fund managers specialising in different geographical focus areas and asset types. The highest average returns in 2013 have been generated by Islamic funds in the US, GCC and Pakistan: in the former, Islamic funds of mostly an equity type have benefited from domestic stock market rallies; while in the latter two countries, Islamic funds have held balanced portfolios of equity and fixed-income securities. Islamic funds invested in some of the emerging markets, such as those in the Asia-Pacific, have witnessed their returns take a blow from a recent reversal in commodity prices, bearish investor sentiments on developing economies and sporadic political instability.

Chart 3.3.2.4: Returns of Islamic Funds by Geographical Focus (20 December 2013)



Source: Bloomberg, Eurekahedge, KFHR

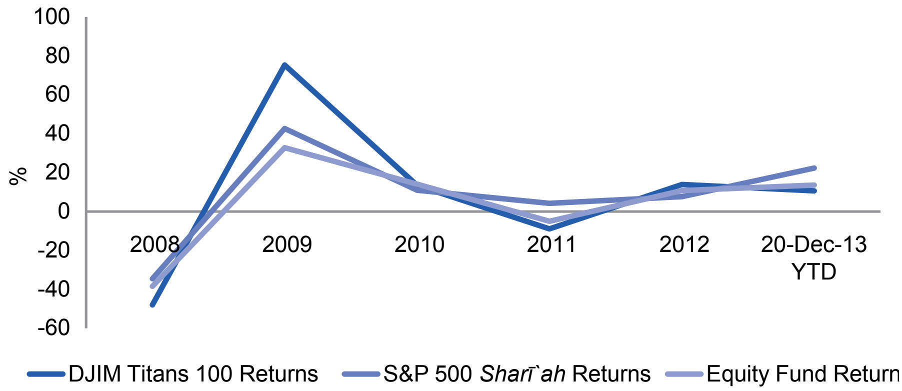
Chart 3.3.2.5: Historical Returns of Islamic Funds by Asset Type



Source: Bloomberg, Eurekahedge, KFHR

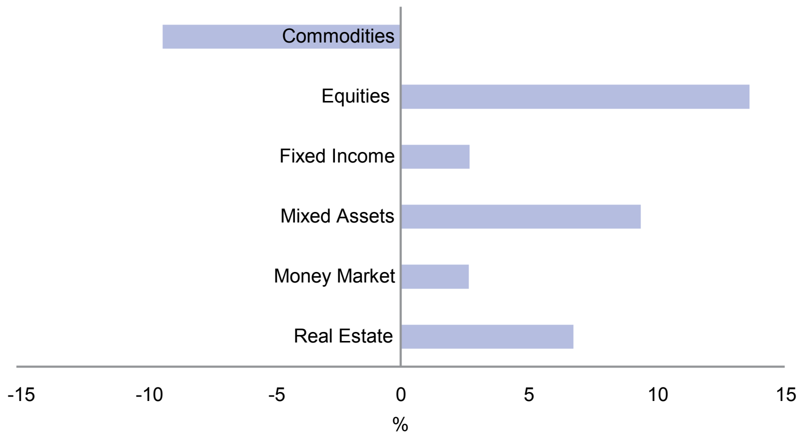
The historical performance of Islamic funds in terms of returns has been mixed. The performance has in general stabilised on the back of widespread economic improvements in 2012 and 2013, except for commodities funds in 2013.

Chart 3.3.2.6: Historical Returns of S&P 500 *Sharī`ah* Index and Islamic Equity Funds



Source: Bloomberg, Eurekahedge, KFHR

Chart 3.3.2.7: Returns of Islamic Funds by Asset Type (20 December 2013)



Source: Bloomberg, Eurekahedge, KFHR

In 2013, commodity funds posted the lowest average return of –9.29% as commodity prices tumbled in a correction following a large sell-off in metals and energy. Equity funds, by contrast, delivered an exceptionally high average return of 13.62% due to bullish investor sentiments that have propped up indices in both developed and emerging markets. The returns of money market Islamic funds have remained largely consistent across the years and stood at 2.66% on 20 December 2013. Fixed-income Islamic funds with an average positive return of about 2.69% took a noticeable dip in comparison to previous periods. Mixed assets Islamic funds yielded a moderate 9.38% average return. Finally, real estate Islamic funds have begun recovering with a 6.75% average return, mainly as a result of rising consumer confidence and government expenditure in the GCC region.

3.4 Overall Summary

The development of Islamic finance over the last four decades has been phenomenal, having grown from a modest USD150 billion worth of assets in the mid-1990s to an estimated USD1.8 trillion as at year-end2013. The industry's double-digit growth rates over the past decade promise strong future potential. Despite some impact on the profitability and capitalisation levels of Islamic banks, the industry has been able to sustain itself and remain resilient during the global financial crisis of 2008-2009 which depleted the assets of major conventional finance institutions. Importantly, the industry is operating within the current liberalised and globalised financial environment. The various economic and financial characteristics of emerging markets are important and worth the attention of the Islamic finance industry players given that eight out of the top nine Islamic finance jurisdictions (in terms of assets) are classified as emerging markets by major multilateral institutions and financial index providers (for example, IMF, S&P, Dow Jones). The Islamic capital markets were not immune to the recent jitters witnessed in the emerging market equity and bond indices. For instance, the *Sukūk* yields mirrored upward trends as noted in the bond market yields, while Islamic equity indices experienced volatility akin to that impacting the comparative conventional bourses.

Post-financial crisis, regulatory bodies around the world have intensified their efforts to preserve financial stability, including the stability of the Islamic finance industry. Substantial work has already been done, including the development of global liquidity standards, the adoption of leverage ratios, and the significant strengthening of capital regulations. Islamic finance, being a nascent industry, has also witnessed intensified efforts by its stakeholders to expand the outreach and availability of *Sharī`ah*-compliant financial solutions across various jurisdictions. A critical role in this regard has been played by various government and monetary/regulatory institutions that have facilitated legislative advancements to minimise issues within the industry.

The growing interest of conventional banks in tapping the potential of Islamic finance is evidenced by the number of Islamic banking subsidiaries and windows being operated by parent conventional banks, as well as by the Islamic investment banking, funds and capital market products being offered by conventional players. This sets up a new dynamic for the Islamic finance system, not least by increasing competition. However, it could potentially also increase the risks to the stability of the Islamic financial system, particularly in the Islamic capital markets. It is imperative to highlight that *Sharī`ah* laws do not apply to the conventional players, and that they are not limited to operating only within the *Sharī`ah*-compliant financial sector. Thus, should the conventional players withdraw from the Islamic capital markets (equity, funds and *Sukūk* investments) – for instance, to capture more profitable opportunities in the conventional sector elsewhere – their disposal of Islamic capital market instruments could trigger instability in the Islamic finance industry. The assertion is more critical if the conventional players, by virtue of the sheer volume of their capital and assets, undertake material exposures in the Islamic capital markets. The volatility experienced by the Islamic financial markets during the recent emerging markets funds outflows give some credence to these concerns. The positive dynamics of this trend should be supported by extensive research in order to understand the potential risks and vulnerabilities of the Islamic finance system as a whole.

In addition, while Islamic finance was previously domestic-centric, its progressive liberalisation and the growing international interest in participating in this industry have spurred its internationalisation in the last decade. Its transition into greater sophistication requires an enabling legal and regulatory framework that could facilitate the transition, while ensuring that financial stability is not compromised. A notable benchmark to gauge this is the global *Sukūk* industry. As at year-end 2013, excluding offshore jurisdictions, issuers from a total of 27 domiciles have tapped into the global pool of *Sharī`ah*-compliant funds through *Sukūk*. This number is set to increase in 2014 with a number of maiden issuances planned in countries such as South Africa, Mauritania, Egypt and Senegal. Considerable progress has also been made in terms of reduced timelines needed for planning, structuring, listing and launching of *Sukūk* papers, including cross-border issuances. During the initial periods of the *Sukūk* industry, it was common for a *Sukūk* issuance to take as long as six months starting from its announcement to the day when the papers went on sale to investors. However, in the current market, the whole process can take as little as two weeks, and this indicates the progress made in achieving standardisation on many fronts across different jurisdictions. Overall, Islamic finance is no different from the conventional system in that it aims to provide financial intermediation services. However, in Islamic finance, this intermediation has to be achieved by complying with the principles of *Sharī`ah*, as these principles serve as inbuilt strengths to prevent the divergence of finance from the real sector.

4.0 NEW MARKETS, NEW FRONTIERS: PROSPECTS AND ROLE OF ISLAMIC FINANCE IN AFRICA

4.1 Introduction

While many countries in the developed world are recovering from one of the worst economic crises since the Great Depression, growth experiences in many regions of the emerging/developing world have been much better. One region that was not directly affected by the crisis and has shown strong performance is the African continent. Although the economic performance of most African countries in the 20th century was poor, in the recent past the continent has experienced high growth rates and is showing promising prospects of future growth. Earnings from exports of commodities and natural resources are expected to grow with the high demand from emerging markets. As crop yields in most countries are relatively low compared to global yields, there are opportunities for growth in the sector if the right investments such as irrigation and use of fertilisers are made. Increases in population and the labour force in Sub-Saharan Africa (SSA) can provide opportunities if the challenge of job creation can be appropriately met. While there have been some advances in the manufacturing sector, low wages in SSA mean the region can potentially produce labour-intensive products (Mlachila *et al.,* 2013).

While Africa has great potential for growth, it is starting from a relatively low base. Due to its colonial history and weak performance in the past, the economic indicators of poverty and development for the continent are among the lowest in the world. Some 48.5% of the SSA population live below the poverty level, measured at USD1.25 per day, which is the highest rate in the world. Many African countries face challenges in sustaining high-enough levels of inclusive growth to lift the bulk of the population out of poverty. Among the measures needed to reduce the high poverty levels in the SSA region are the promotion of agriculture and micro, small and medium enterprises (MSMEs). A key factor that can limit economic development on the continent is the lack of physical and social infrastructure to support production, commerce and trade. Bringing the levels of infrastructure to that of Mauritius, the country with the best infrastructure on the continent, would increase the GDP per-capita growth rates of the continent by an additional 2.2% (Foster and Briceno-Garmendia 2010).

The realisation of inclusive development in Africa would, therefore, require huge amounts of financial resources and investments in both the MSME and infrastructure sectors. However, as the developed world, which was the traditional source of international funding, is mired in the aftermath of the GFC and requires investments to bring its own economies out of recession, there is a need to consider other sources of financing. In this respect, Islamic finance has the potential to mobilise resources both domestically and globally to fill some of the continent's financing gaps. Given the above, Islamic finance can play two key roles in the context of the development of Africa. First, at the micro-level, it has the potential to increase financial inclusion for a large number of Muslims who would not avail themselves of conventional interest-based financial services due to their religious convictions. Muslims account for 43% of the population of Africa; thus, Islamic finance can promote financial inclusion by providing services to this large group. While the Muslim population would be the primary beneficiaries of Islamic finance, it can also serve all sections of the population given the huge financing gap in Africa. The second role that Islamic finance can play in Africa is at a macro-level. It can provide alternative source of the infrastructure financing that is a pre-requisite for economic development.

This chapter is organised as follows. The next section provides an historical overview of the continent, discusses its past and present economic status, and describes the features of its financial system. Section 4.3 first outlines the elements of a financial infrastructure for sound development of Islamic finance and then discusses specific issues related to the expansion of Islamic microfinance to serve the poor and micro-entrepreneurs, and the scope of Islamic finance for supporting investments in infrastructure development. Introduction of Islamic finance to facilitate the development of the MSME and infrastructure on the African continent would require dealing with certain financial infrastructure-related issues. Specifically, a legal framework that can support Islamic financial transactions would be needed both for financial institutions and markets. To determine the appropriate regulatory parameters, regulators should be able to understand the risks arising not only in Islamic finance but also in other initiatives that can be used to provide innovative products to MSMEs. After identifying the prospects and challenges of Islamic finance in different regions, the section discusses the role of human capital in the future growth of the industry on the continent. The last section highlights some key issues that need to be addressed to move the Islamic finance industry forward in Africa. These would include, *inter alia*, a sound financial infrastructure to support Islamic finance at the national level.

4.2 Historical Background and Socio-economic Landscape[127]

Though there were attempts by European countries to colonise different parts of Africa and the slave trade flourished from the 15th century CE, the new imperialism on the continent began in the later part of the 19th century. Starting with the colonisation of Tunisia by France in 1881 and Egypt by Britain in 1882, almost the entire African continent was colonised by various European countries by the end of the 19th century (Collins 2005). By 1914, the continent was divided among various European countries dominated by the British mainly in the Eastern and Southern regions, the French in Western and Central Africa, and other powers (Italy, Belgium, Portugal, Spain and Germany) had pockets under their jurisdictions across the continent. Whereas the British took the least disruptive approach to ruling the colonies, sought the cooperation of the traditional authorities and employed local laws and customs, the French pursued a policy of assimilation and imposing French culture and institutions on the colonies.

After the defeat of Germany in World War I, its African colonies were transferred to France, Belgium and Britain. The end of colonial rule in Africa started in the middle of the 20th century when Libya became independent in 1951, followed by Sudan, Tunisia and Morocco in 1956, and Ghana in 1957. Eventually, 54 independent nation-states emerged from the imperial empires of Africa. One of the legacies of colonial rule was the adoption of Western legal systems by the independent countries. As Table 4.2.1.1 shows, 34 countries on the continent (mainly in the Northern, Central and Western regions) have origins in the French legal system and 20 countries (mainly in the Eastern and Southern regions) have English legal regimes.[128]

4.2.1 African Economies: Past, Present and Future Prospects

Two distinct economic features define the European colonisation of Africa. First, the colonial economies were expected to generate adequate revenue to cover the administrative costs so that they would not become a burden on the coloniser’s economy. Thus, collecting adequate taxes was a key concern of the colonial rulers. Second, the colonies were considered a source of cheap food and raw materials to be exported to sustain the European workers and industries, on the one hand, and a market for the manufactured goods produced in these factories, on the other hand. In order to sustain and enhance the trade flows, the European governments encouraged their citizens to emigrate to the colonies and invest in agriculture. They were provided with large land grants that resulted in the creation of expansive plantations. The agricultural sector was encouraged to produce cash crops such as cocoa, peanuts, rubber, tobacco, palm oil and cotton to serve the dual purposes of feeding the European industries and generating revenue to sustain the administrative activities in the colonies.

[127] The historical overview of Africa has been taken from Collins (2005), Jerven (2013) and Sharkey (2013).
[128] See Appendix 2 for the legal origins of different countries.

Other than introducing new European ideologies, technologies and public administration models, one of the outcomes of imperialism was the construction of the infrastructure to accomplish the colonisers' economic goals. This was often done by controlling and coercing labour to build roads, bridges, railways and government buildings. The start of World War I increased the demand for raw materials from the African colonies to sustain the war-related industries and intensified the forceful recruitment of soldiers to fight the war. While there was some manufacturing in a few colonies such as South Africa, Algeria, Kenya and Belgian Congo, to satisfy the domestic demand for consumer goods, the bulk of the industrialisation occurred on the continent after World War II. The growth rates of GDP per capita in Africa are estimated to be 0.3% during 1820–1870, 0.6% during 1870–1900, 0.4% during 1900–1913 and 0.9% during 1913–1950. However, aggregate figures of per-capita income growth can be misleading, as most of the growth occurred in the Northern and Southern regions. As a result, on the eve of independence there were large differences in income and growth levels across different countries and regions of the African continent.

The economic performance of the countries in SSA in the post-independence period was diverse and generally weak. After experiencing crises and stagnation during the 1970s and 1980s, in the 1990s most of the African countries adopted the World Bank/IMF-driven structural adjustment reforms that resulted in liberalisation of economies and expansion of exports. These changes produced the economic growth that most of the continent experienced in the later part of the 20th century and which continued through the recent global financial crisis.

Due to historical reasons and different growth experiences, the economic status of the various countries and regions of African is diverse. As shown in Table 4.2.1.1, the Northern and Southern regions of the continent are relatively better off, with an average per-capita gross national income (GNI) of more than USD3,000, compared to the poorer regions of Central and Eastern Africa with a per-capita GNI of less than USD1,000. This feature also appears in poverty indicators (daily per-capita calorie supply), showing relatively higher figures for the former regions and lower figures for the latter. The Human Development Index (HDI) also show the same pattern, with the highest value being for the Northern region (0.662), followed by the Southern region (0.497) and Western region (0.444). Central Africa has the lowest value for HDI at 0.360, followed by East Africa at 0.438.

Table 4.2.1.1: Income and Poverty Levels

Region	Legal Systems No. of Countries French/ English	GNI per Capita (USD) (2011)	Daily Calorie Supply per Capita (2009)	HDI Value (Scale 0–1) (2012)
Africa	34/20	1579	2481	0.478
Central Africa	8/0	728	1856	0.360
Eastern Africa	6/7	644	2069	0.438
Northern Africa	6/0	3140	3290	0.662
Southern Africa	4/8	3130	2412	0.497
Western Africa	10/5	1056	2667	0.444

Source: World Bank (2004) and La Porta et al. (1999) for legal systems; AfDB (2013b) for other indicators

Table 4.2.2.2 shows the relative economic performance of SSA compared to other regions of the world. With a population of close to 875 million, SSA has the lowest regional average per-capita income of USD1258. The poverty level, in terms of the percentage of the population living under USD1.25 a day, is also significantly higher (48.5%) for the SSA compared to the other regional blocs. The GDP growth rate of SSA, however, shows a high of 4.6% during 2011–2012, which exceeds all other regions of the world except for Asia. Note, however, that the growth in the MENA region, which includes North Africa, was very low (0.2%) during the year.

Table 4.2.1.2: Economic Indicators of Different Regions

Regions	Population (millions) (2011)	GNI per Capita (USD) (2011)	Poverty Headcount Ratio at USD1.25 a day (PPP) (% of Population)	Annual GDP Growth Rate (%) (2011-2012)
High Income	1,135	39,861	-	1.3
East Asia and Pacific	1,974.2	4,248	12.5	7.5
Europe and Central Asia	408.1	7,734	0.7	3.0
Latin America and the Caribbean	589.0	8,574	5.5	3.0
Middle East and North Africa	336.5	3,866	2.4	0.2
South Asia	1,656.5	1,313	31.0	5.4
Sub-Saharan Africa	874.8	1,258	48.5	4.6

Source: World Bank (2013b); AfDB (2013b)

The resource-rich continent has achieved high levels of growth during the past decade, partly due to the high global prices of commodities. Most countries of Africa were not affected directly during the GFC and are performing well in the post-crisis period. Table 4.2.2.3 shows that the growth rates are expected to continue in the near future across all regions of the continent. It is notable that the regions that are relatively under-developed in terms of GDP per capita (Central, Eastern and Western) are those showing promising signs of growth, with expected growth rates of 5.4%, 5.6% and 7.4%, respectively, in 2014.

Table 4.2.1.3: GDP Growth Rates in Africa

Region	2011	2012 (e)	2013 (p)	2014 (p)
Africa	3.5	6.6	4.8	5.3
Sub-Saharan Africa	5.5	5.2	5.4	5.8
Central Africa	5.2	5.7	5.7	5.4
Eastern Africa	6.3	4.5	5.2	5.6
Northern Africa	-0.1	9.5	3.9	4.3
Southern Africa	4.0	3.7	4.2	4.6
Western Africa	6.8	6.6	6.8	7.4

Source: AfDB (2013a); OECD, UNDP, ECA (2013)

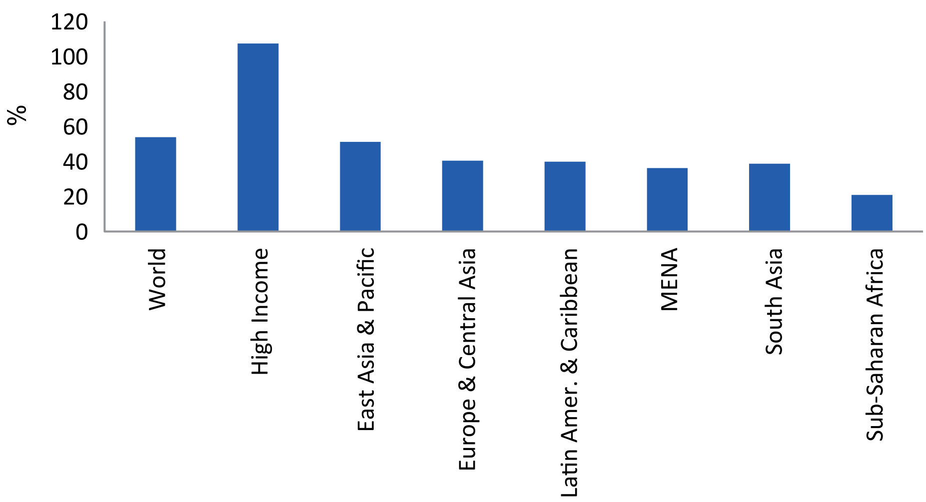
4.2.2 Financial Sector Features in Africa

The financial sector adopted in post-colonial Africa was one dominated by government. This continued until the 1980s with most of the banks state-owned and operating under regulatory regimes that imposed interest ceilings and credit quotas (Beck and Cull 2013). During this period the African financial sector experienced several crises. It was after the financial liberalisation and regulatory changes that the financial institutions and markets became deeper and more stable. While, overall, the financial sector in Africa is still under-developed, there are variations in the financial structure across countries. Lukonga (2010) classifies the financial sectors of African countries as emerging market economies, the frontier market economies, and finally developing economies. Excluding some of the countries in Southern Africa and Mauritius, the overall financial sector in SSA is dominated by a relatively under-developed banking industry (Mlachila *et al.* 2013). In most of the African countries the banking sector accounts for more than 75% of financial sector assets. Prior to the crisis, the capital markets in SSA in general, and South Africa in particular, showed signs of vitality with strong growth in equities, structured debt products and hedge funds (Lukonga 2010). However, uncertainties associated with the GFC led overseas investors to exit from African markets, resulting in major capital outflows out of the continent. The features of the African financial sector in terms of the institutions and markets relative to other regions of the world are presented next.

Financial Institutions

Chart 4.2.2.1 shows the depth of financial institutions in terms of private credit provided by deposit taking as a percentage of GDP for different regions of the world.[129] The depth of financial institutions in SSA is 20.9%, which is less than half the world average of 53.8% and the lowest among all the regions of the world. The corresponding figure for East Asia and Pacific is 51.2%, for Latin America 39.8%, the Middle East and North Africa 36.3% and South Asia 38.8%.

Chart 4.2.2.1: Financial Institutions Depth: Deposit Money Banks' Private Credit to GDP (%)



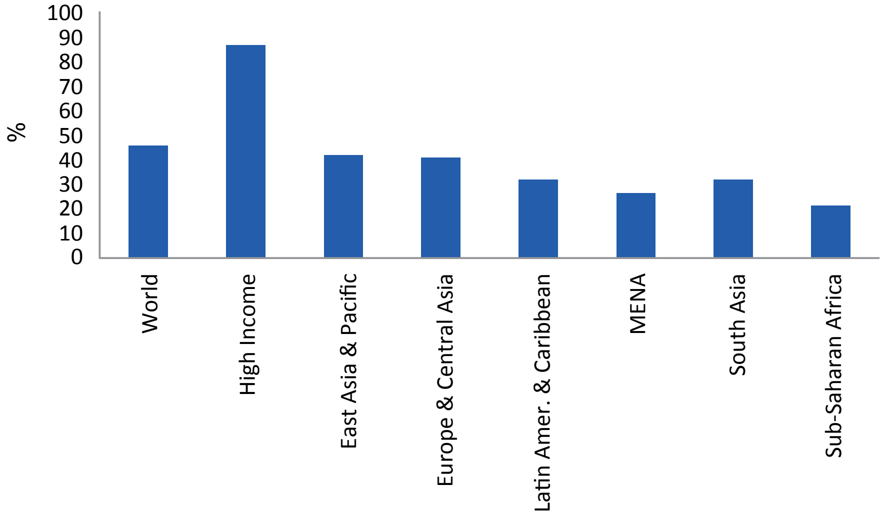
Source: World Bank (2013a)

Access to finance, defined as the percentage of the adult population having an account at a formal financial institution, is shown for different regions of the world in Chart 4.2.2.2. Access to financial services stands at 21% for SSA, which is again the lowest in the world and less than half the world

[129] While the information on depth and access is provided here, other characteristics of financial institutions of different regions are presented in Appendix 3(A).

average of 45.7%.The corresponding figures for East Asia and Pacific, Latin America, Middle East and North Africa, and South Asia are 42%, 32%, 26.6% and 31.3%, respectively. The low levels of depth and access to financial institutions imply that the financial sector is relatively under-developed in Africa compared to other regions of the world.

Chart 4.2.2.2: Access of Financial Institutions: Account at a Formal Financial Institution (% age 15+)



Source: World Bank (2013a)

Most of the major banks in Africa with the largest market shares are foreign owned. As many countries in SSA are small, banks can face problems of market size and economies of scale. One of the features of SSA banking is the existence of pan-African banking groups operating in several countries. For example, Ecobank operates in 33 countries and Bank of Africa has a presence in 11 countries (Mlachila *et al.* 2013). The pan-African banks contribute to the introduction of technology, improve competition, and provide general banking services compared to those of the multinational non-African banks. The African banks are based on domestic economies, both in terms of sources and uses of funds. However, the limited number of creditworthy borrowers acts as a constraint on bank financing in most of the countries (Mlachila *et al.* 2013). As many banks operate in small economies, they face problems of economies of scale that can negatively impact their outreach and the provision of long-term financing (Beck 2011: 202).

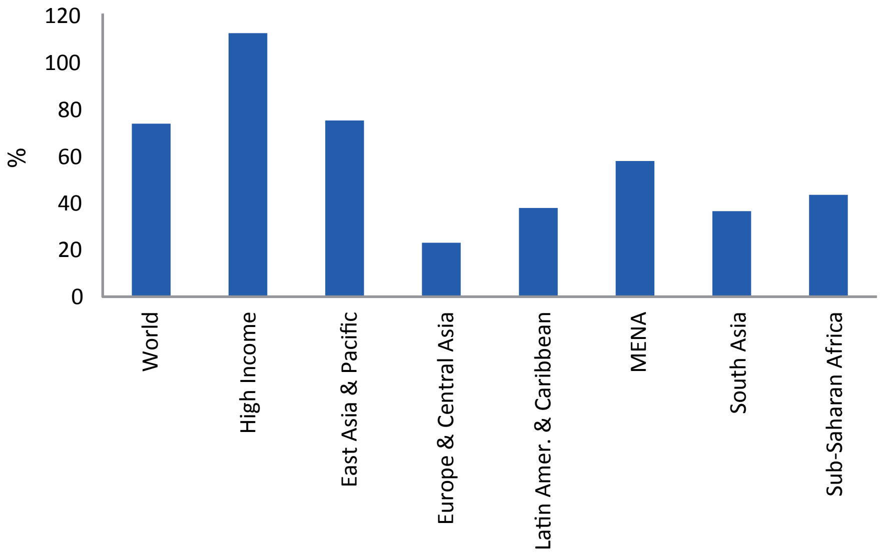
An interesting feature of the SSA banking system is the use of information and communications technology (ICT) to provide access to financial services for a large section of the population. For example, Fengler (2012) reports that more than 80% of adults in Kenya have used mobile phones for basic financial services. However, the financial services using mobile technology are of a basic nature (such as exchanging different forms of money,[130] storage of money for safe-keeping, and money transfer) and do not include developed financial transactions such as depositing and investment of money.

[130] Dittus and Klein (2011) identify money in the form of book-entry money and cash. The former can be recorded on paper or electronically, and the later can come in different forms such as bills or e-money stored in smart cards. The exchange of money referred to here is between book-entry money and cash.

Financial Markets

The depth of the financial markets, defined as the sum of stock-market capitalisation and outstanding domestic private debt securities as a percentage of GDP, is shown for different regions of the world in Chart 4.2.2.3.[131] SSA has a reasonably good standing (41.8%) compared to some other regions such as Europe and Central Asia (22.6), Latin America (34.5%) and South Asia (32.7%). However, this may be misleading as only 12 countries are considered in the sample and a few of these have large capital markets while others have very small markets.

Chart 4.2.2.3: Depth of Financial Markets: Stock Market Capitalisation and Outstanding Domestic Private Debt Securities to GDP (%)



Source: World Bank (2013a)

The lopsided sizes of the capital markets is reflected in Table 4.2.2.1, which shows that capitalisation of government and corporate securities was more than 50% for only two African countries, and was low for most other countries, during 2001–2010. The average market capitalisation of government securities for 28 countries was 18.8% of GDP, and 1.12% for corporate bonds. Whereas in financially developing countries most of the securities in the capital markets are government bonds, in frontier markets equities and corporate banks are also traded. South Africa has the largest, deepest and most liquid capital market on the continent, with active bonds, equities and derivatives markets.

[131] Other characteristics of financial markets of different regions are discussed in Appendix 3(B).

Table 4.2.2.1: Sub-Saharan African Bond Market Capitalisation (2001–2010)

Percentage of GDP	Government Securities Market Capitalisation (No. of countries)	Corporate Bond Market Capitalisation (No. of countries)
0%		8
0–1%		13
1–5%	4	6
5–10%	8	
10–20%	6	1
20–50%	8	
More than 50%	2	
Total	**28**	**28**
Average	**18.83%**	**1.12%**

Source: Mu, Phelps and Stotsky (2013)

Access to financial markets, measured as market capitalisation of top ten companies as a percentage of GDP in is relatively good in SSA, with a ranking of 55%, compared to, for example, East Asia and Pacific (60.3%) and South Asia (64.3%). However, the figure for SSA is not representative as it includes only two countries in the sample.

4.2.3 Regulatory Framework for Finance in SSA

Lukonga (2010) identifies three key types of regulatory framework for the financial sector in different African countries. The first type includes WAEMU and CEMAC, which have regional supra-national regulatory structures dealing with prudential regulations and supervision. One issue arising from banks operating in different countries is the differences in each country's regulatory environment. The second group consists of countries where the regulatory role is separate according to functional features, with different supervisors overseeing the banking sector, non-banking sector (such as insurance and pension schemes) and capital markets. The central bank regulates the deposit-taking institutions, including the banking industry and money market intermediaries, and a separate supervisor oversees the capital markets and non-banking sector. Countries in this category include Ghana, Kenya, Malawi, Nigeria and Zambia. The final group of countries have a hybrid or semi-integrated regulator structure where a single regulator oversees different segments of the financial sector. Countries with this regulatory framework include Botswana, Mauritius, South Africa and Swaziland.

After experiencing several banking crises in the 1980s and 1990s arising mainly from poor governance practices, many countries in SSA initiated reform programmes (Beck *et al.* 2011). The reforms included reduction in the role of state-owned banks, strengthening of the capital requirements and improved risk management practices (Mlambo, Kasekende and Murinde 2011). These changes strengthened the banking sector significantly, so that SSA has experienced only one major financial crisis since 1995 – in 2007. The financial health of the banking sector in SSA was evident when almost all domestic banks weathered the recent global financial crisis of 2008 without significant problems. Only a few banks in Nigeria, and some major international banks operating in Africa, experienced stress during the crisis. Presently, most banks in Africa are well capitalised, have adequate liquidity and are deemed relatively stable. However, the SSA economies are still exposed to other significant risks that require regulatory responses. These risks include macroeconomic risks, external shocks (such as trade-related disruptions), contagion from parent banks and country-specific political risks (Lukonga 2010).

While most countries in SSA have the basic legal, regulatory and supervisory frameworks (such as licensing, prudential regulation, financial supervisory information, and safety and soundness concerns), the implementation of the Basel Core Principles in some countries is weak (Lukonga 2010). All the SSA countries with the exception of Mauritius and South Africa use Basel I capital standards (Beck *et al*. 2011). Most countries did not adopt Basel II due to its complexities, and the adoption of Basel III standards will be even more challenging. However, given the under-developed nature of banking, it may be more prudent to examine the costs and benefits of implementing international standards in the SSA countries.

A key weakness of the regulatory regimes in SSA is enforcement. For example, the UEMOA Banking Commission does not have sufficient powers to enforce regulatory compliance by banks (Beck *et al*. 2011).There is a need, in many countries, to provide legal powers to supervisors and to protect and enhance their supervisory capacity (Mlachila *et al.* 2013). Another regulatory issue relating to banks operating in different jurisdictions is cross-border supervision. There is the potential for regulatory arbitrage by banks operating in different countries with different regulatory environments. This would require close monitoring and cooperation by the relevant supervisory authorities.

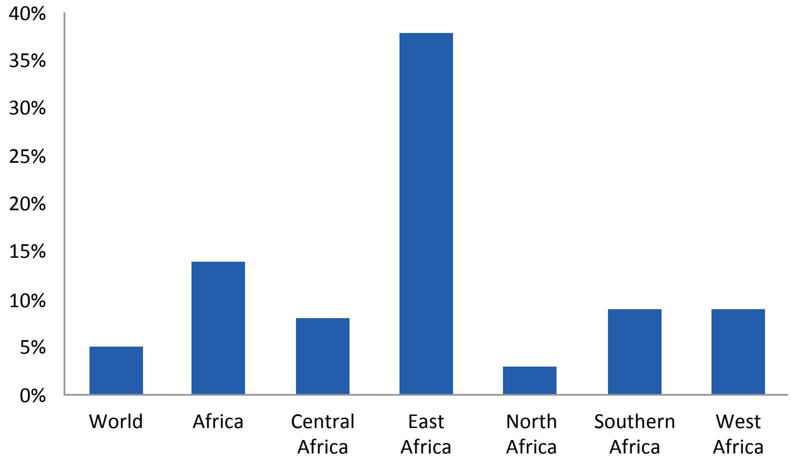
As the capital markets in most African countries are diverse and evolving, the regulatory frameworks are generally not well developed, with the exception of a few countries such as South Africa. In countries that have relatively developed capital markets, appropriate laws and regulatory frameworks exist, but sometimes their enforcement is weak (Lukonga 2010: 173). A problem in many countries is that the regulators do not have the adequate skills and means to implement the laws and regulations.

Inclusive Finance, Innovation and Regulation

Inclusive finance has a broader perspective than microfinance and entails providing a variety of financial services to the poor, including savings, credit and insurance facilities (Matin, Hulme and Rutherford 2002; UN 2006). These financial services enable the poor to acquire capital to engage in productive ventures, manage risks, increase their income and savings, and move out of poverty. The impact of finance on poverty can be enhanced if the depth of outreach of financial services can be expanded. However, provision of financial services to the poor can face both supply- and demand-side constraints (see IFSB 2013). On the supply side, the poor may not have access to formal financial institutions due to low income, high risk, price, and the lack of information framework (World Bank 2008). On the demand side, some poor may voluntarily choose not to avail themselves of financial services for religious or cultural reasons. Some Muslim poor would fall in this category, as they would choose not to deal with conventional interest-based financial institutions due to their religious convictions. In these societies, the provision of inclusive finance would therefore require the development of innovative Islamic financial business models and products that reduce the costs and risks.

Institutions providing inclusive financial services include informal organisations, cooperatives, non-government organisations, rural banks and large commercial banks. Many organisations provide microfinancial services using innovative delivery mechanisms. Africa has been more successful than some other regions in introducing mobile technology to provide basic financial services. As Chart 4.2.3.1 shows, the use of mobile technology for financial services is much higher, on average, for the African continent (14%) than the world average of 5%. However, as the chart also shows, there is variation in the use of mobile technology, with the highest use being in East Africa (38%) and the lowest in North Africa (3%). Incidentally, many people using mobile technology for financial services indicate that they do not deal with the formal financial sector. For example, 43% of adults in Kenya and 92% of those in Sudan using mobile money do not have a formal account (Demergus-Kunt and Klapper 2013: 49).

Chart 4.2.3.1: Adults Using Mobile Money in the Past Year (%)



Source: Demergus-Kunt and Klapper (2013: 60)

While using ICT to provide financial services can lower the cost and provide access for many more consumers, it also has the potential to create problems of financial instability and consumer protection (Mlachila *et al.* 2013). The challenge that regulatory authorities face is to balance the objective of financial stability with that of financial development and inclusion. Furthermore, there is a need to protect small depositors and customers who, in many cases, are not financially literate. If financial services are provided by different financial institutions, then the risks that these institutions face and the products they deal with will determine the scope of regulation. Indonesia has one of the most diversified microfinance sectors, with a variety of institutions providing a wide range of financial services.[132] Whereas the commercial banks and rural banks are regulated by Bank Indonesia, the country's central bank, the cooperatives are overseen by the Ministry of Cooperatives.

Dittus and Klein (2011) provide a framework for how to approach innovation from a regulatory perspective, particularly for inclusive finance. They suggest that each financial service be examined according to its risk characteristics, with appropriate regulatory measures introduced to deal with them. For financial inclusion, they identify the basic financial services as exchanging different forms of money, storage of money for safe-keeping, money transfer, and investment of money. The levels of regulation are distinguished as commercial law governing exchanges, enforcement and resolution systems, business conduct regulation (including consumer protection and anti-money laundering), prudential regulation and supervision, and fostering competition and interconnectedness. Given the two broad goals of protecting consumers and financial stability, the intensity of regulations will depend on the nature of risks arising that affect these goals. For example, while transfer of money services would require commercial law enforcement and business conduct regulation, investing money would also necessitate prudential regulations as it introduces credit, market and operational risks (Dittus and Klein 2011; Klein and Mayer 2011).

Dittus and Klein (2011) suggest that new innovative initiatives where unbundled financial services are provided by various players should be encouraged without too much regulatory overview during the initial stages of their development as the risks are local and not systematic. When some of these initiatives expand and grow to take on systemic importance, the extent of regulation should be increased. This is what seems to have happened in the case of Kenya, where mobile-based financial

[132] Institutions providing microfinance in Indonesia include commercial banks (mainly BRI, or *Bank Rakyat Indonesia*), rural and village banks (BPR, or *Bank Perkreditan Rakyat*) and the Village Banks (BKDs, or *Badan Kredit Desa*), non-bank MFIs (rural funding and credit institutions, or LDKPs – *Lembaga Dana dan Kredit Pedesaan*), credit cooperatives and Islamic MFIs (Pouchous 2012).

services by M-PESA were allowed to grow. Now that its range of services has growth and is being diversified, the Central Bank of Kenya has introduced new regulations governing these services.[133] A similar approach is being taken in India, where a three-tiered regulatory framework is used for financial institutions providing services to the poor. While a non-Basel regulatory approach applies for rural cooperatives and regional rural banks, Basel I is used for urban cooperative banks and Basel II for commercial banks (Thorat 2010).

In Pakistan the microfinance sector has been brought under the regulatory overview of the Microfinance Institutions Ordinance of 2001. One of the regulatory objectives is to convert informal, non-profit and unregulated institutions into regulated microfinance banks (IFSB 2013). In 2011 the State Bank of Pakistan issued the Branchless Banking Regulations to regulate the provision of financial services through alternative channels. The initial regulatory approach to the innovative use of technology to reach the country's poor has been liberal (SPB 2011). Under this regime, Tameer Microfinance Bank is offering services such as bill payment, inland remittances and P2P payments. Another private–public partnership involves First Micro Finance Bank and Pakistan Post, whereby financial services are offered through post offices in areas that are difficult to access. The regulations also allow microfinance banks to open up kiosks and service centres at third-party premises.

CGAP (2012) provides the basic elements of a framework for regulating branchless banking and suggests the inclusion of the following:

(i) "conditions for banks' and nonbanks' use of agents or other third parties as a customer interface;
(ii) a flexible, risk-based AML/CFT regime;
(iii) a clear regulatory regime for nonbanks to issue electronically stored value;
(iv) consumer protection tailored to the branchless context; and
(v) payments system regulation that allows (at least in the long term) broad interoperability and interconnection." (CGAP 2012: 72)

4.3 Further Development of Islamic Finance in Africa: Prospects and Challenges

Although the first contemporary Islamic financial institution originated in North Africa (Egypt) in 1963, the industry is relatively new and remains under-developed in much of SSA. It is estimated that, in 2011, SSA had only 1% of the total global *Sharī`ah*-compliant assets of USD1.1 trillion (SESRIC 2012). Except for some countries in North Africa and Sudan, Islamic finance is present in a handful of countries in SSA. Countries that have initiated Islamic finance recently include Kenya in the East and Nigeria in the West.

The seeds of Islamic banking were sown in Kenya by the introduction of a *Sharī`ah*-compliant product by Barclays Bank Kenya in 2005.[134] Thereafter, the Central Bank of Kenya (CBK) undertook a study on Islamic banking and approached the Ministry of Finance for permission to allow Islamic banking under the country's existing Banking Act. Upon gaining approval, CBK sought applications for Islamic banks. By the end of 2007, Gulf African Bank, which had investments from the Arab world, started operations. In 2008, First Community Bank was granted a licence to provide *Sharī`ah*-compliant financial services through a window. Furthermore, CBK has also issued licences to several conventional banks to open Islamic windows. By the end of 2012, the total *Sharī`ah*-compliant deposits in the country reached USD315.27 million, of which around USD221.14 million is deposited in two Islamic banks. Established in 2011, *Takāful* Insurance Africa (TIA) became the first and only

[133] The regulations relate to Electronic retain Transfers and E-money (Dittus and Klein 2013).
[134] The information on Kenya is taken from Laving (2013).

Takāful provider in East and Central Africa. The institution was well received by the community as shown by a 240% growth rate in premiums, reaching a total of USD4.87 million in 2012. TIA also has plans to venture into offering micro-*Takāful* services.

Nigeria, home to the largest Muslim population in SSA, has also taken initiatives to introduce Islamic finance.[135] Jaiz Bank, which started operations in 2012 as the first Islamic bank in the country, is planning to open 100 branches by 2017, and also to offer services beyond the borders of Nigeria. Subsequently, Stanbic IBTC is offering *Sharī`ah*-compliant products, while in December 2013, Sterling Bank Plc was licensed by the Central Bank of Nigeria to offer *Sharī`ah*-compliant products through a window. The insurance regulator issued guidelines on *Takāful* in November 2013 and three windows have already been established, with another five showing interest. After the Securities and Exchange Commission (SEC) of Nigeria approved the issuance of *Sukūk* in March 2103, Osun State issued its *Sukūk* (USD68 million) in September 2013, which was over-subscribed. The return of the *Sukūk* is 14.75%, according to the prospectus. Since January 2011, the SEC Nigeria has also issued rules on Islamic fund management and has licensed two Islamic fund management entities, one of which was the lead arranger for the Osun State *Sukūk* issuance. The Nigerian Deposit Insurance Corporation (NDIC) has released a draft Non-Interest Deposit Insurance Scheme which is awaiting ratification. Currently, the NDIC takes part in the routine on-site examination of the non-interest banking institutions. The Federal Inland Revenue Service has finalised public consultation on a draft tax treatment of non-interest financial products and instruments which is awaiting ratification by the Federal Ministry of Finance.

Although different countries in Africa are taking initiatives to introduce Islamic finance, the future prospects of the industry will depend on the development of a supportive infrastructure for it. The elements of a financial infrastructure to support Islamic finance in Africa are discussed next.

4.3.1 Building the Legal and Regulatory Framework for Islamic Finance

The World Bank–IMF (2005) identifies three key elements of a financial system infrastructure. The first is the legal infrastructure, which includes appropriate financial laws related to financial institutions and markets, an appropriate framework for insolvency regimes and creditor rights, and financial safety nets. The second element is the systemic liquidity infrastructure needed to support monetary and exchange operations. Finally, an appropriate information infrastructure, to enhance transparency and improve governance in financial institutions and markets, would be required. While some elements of the information infrastructure for the Islamic financial sector will be the same as those required for its conventional counterpart, there are certain specific issues under the legal/regulatory and liquidity infrastructures that need to be addressed for Islamic financial institutions. The infrastructural elements relevant for the sound development of the Islamic financial sector with reference to Africa are presented next.

Statutes and Laws

As the African countries have adopted either the English common law framework or the French civil law tradition,[136] laws related to financial institutions and markets entail conventional financial principles. Conventional banking and financial laws, however, are based on creditor–debtor relationships and do not allow banks to trade, hold assets for leasing, or hold equity in enterprises. As most of the *Sharī`ah*-compliant instruments use sale and equity based modes of financing, it becomes difficult for Islamic banks to operate under conventional banking and financial laws. Thus, there is a need for financial laws to accommodate *Sharī`ah*-compliant finance. Specifically, the laws and regulations of the country should recognise that the principles of Islamic banking, *Takāful* and capital markets operate, so that these institutions and markets have legal bases for their operations.

[135] Information on Islamic finance in Nigeria is taken from Ohuocha and Vizcaino (2013).
[136] See Appendix 1 for the legal regimes in different African countries.

The governments of some African countries have taken initiatives to change the laws to promote Islamic finance. For example, in Kenya the Banking Act, Central Bank Act and Capital Markets Act have been adjusted to accommodate Islamic finance (Laving 2013). Note that, in some cases, minor changes were made in the banking and financial laws and the regulatory authorities filled the gaps by introducing detailed rules for the industry. This happened in Nigeria, where the Banks and Other Financial Institutions Act 1991 was amended to permit the establishment of profit/loss-sharing banks in the country. The Central Bank of Nigeria (CBN) then came up with 'The Guidelines for the Regulation and Supervision of Non-interest Financial Institutions in Nigeria', which defines what a non-interest financial institution (NIFI, or an Islamic bank) is and the types of organisational formats it can take. The regulatory framework provides for the legal basis and licensing requirements for authorising NIFIs in Nigeria (Sanusi 2011).

As Islamic financial products involve purchase and sale, leasing and equity-based investments, they have sales and capital-gains tax implications. For example, in a *Murābahah* when assets are first bought by the bank and then sold to the client, sales tax or stamp duty has to be paid twice. If the tax laws are not adjusted to level the playing field for Islamic banks, the products are expected to be more costly, making it difficult for Islamic financial institutions to compete with their conventional counterparts. One way to resolve this problem is to consider the economic substance of the financial transactions, instead of their legal standing. Certain other legal/regulatory stipulations can also put Islamic finance at a disadvantage. For example, in Kenya the law requires insurance companies to hold 10% of the premiums in government interest-based Treasury bills. As no *Sharī`ah*-compliant Treasury papers exist, the lone *Takāful* company in the country, *Takāful* Insurance Africa, has to hold conventional government bills (Laving 2013). However, not being *Sharī`ah* compliant, the interest earnings from the securities are given away to charity, depriving the participants and *Takāful* operator of income that conventional insurance companies earn. This demonstrates not only that the laws should be flexible, but also that there is a need to develop *Sharī`ah*-compliant securities that Islamic financial institutions can hold.

Enabling Regulatory and Supervision Framework

The goals of regulators are to ensure a well-functioning and stable financial system by using prudential and non-prudential regulations and protecting consumers. Whereas macroprudential regulation focuses on mitigating systemic risks to protect the financial system, the goal of microprudential regulation is to deal with institutional-level risk to ensure the solvency of financial institutions and thereby protect the depositors/clients. The goals of non-prudential regulations would include improving market conduct by requiring financial institutions to have disclosure standards and rules of conduct of business, as well as ensuring the performance of governance and fiduciary responsibilities (Carmichael and Pomoleano 2002). One way to protect consumers is to require that minimum standards of transparency be maintained through the periodic disclosure of accurate and relevant information. An important issue discussed under regulations is to ascertain the regulatory parameters in terms of the scale of oversight and supervision of different financial institutions and their activities. The parameters and the extent of regulations would depend on the associated systemic risks and client types.

For the regulators to develop appropriate regulatory standards and fulfil the regulatory goals for Islamic finance, they need to understand the risks faced by Islamic financial institutions. As the nature of liabilities and assets change due to *Sharī`ah* compliance requirements, institutions face new dimensions of risks such as *Sharī`ah* compliance, fiduciary, displaced commercial and equity investment risk. The regulations for Islamic banks need to consider these risks in framing requirements for capital adequacy and liquidity management, and to protect depositors (including the investment account holders). In this regard, different regulatory standards and guiding principles issued by the IFSB can be used as a framework for regulating the Islamic financial sector.

As Islamic finance is new in the SSA region, the regulatory framework of the industry is evolving and diverse. Nigeria has adopted a centralised model of regulating Islamic finance, whereby the products and operational issues have regulatory oversight. In this regard, the CBN issued a regulatory and supervisory framework document for non-interest banks in 2011 (Sanusi 2011). While the financial laws related to banks and capital markets have been adjusted to accommodate Islamic finance in Kenya, a wholesome regulatory environment for the industry does not exist (Laving 2013).

Courts and Dispute Settlement Institutions

Ensuring ex-post implementation of contracts and enforcement of property rights in the event of a breach of contract requires a sound dispute-settlement framework. The absence of supporting laws for Islamic finance creates legal uncertainty in disputes and can inhibit the growth of the industry. Dispute resolution becomes complicated due to the duality of laws in play in Islamic finance transactions. While in Islamic finance products use Islamic contracts, the courts in most jurisdictions use some variant of Western commercial law to adjudicate disputes, which can create legal uncertainty.

The implications of dispute resolution are different in English common law countries and the French civil law regimes. While Islamic contracts and transactions under the common law regime may have problems of interpretation, as no precedents on these activities may exist, these regimes are expected to be more accommodating than the civil law systems. This is because the common law system will give more weight to the provisions in the contract. In the civil law systems, the court will interpret the contracts on the basis of codes, reasonableness and fairness. Thus, to protect financiers who provide funds using Islamic modes of financing in civil law countries would require specific Islamic finance laws and statutes that protect their rights and accommodate *Sharī`ah*-compliant transactions.

As Islamic finance is new in SSA, it is not yet clear how disputes involving Islamic finance would be treated in the courts. However, court cases involving Islamic finance in common law countries (UK and Malaysia) and civil law countries (UAE) give some indication of how such cases might be treated in different legal systems in Africa. One way to resolve the duality of laws and reduce legal uncertainty is to include choice-of-law and dispute settlement clauses. If Islamic law is chosen as the law of choice to settle disputes, the contracts can opt for commercial arbitration and be shielded from the national legal environment.

Sharī`ah Governance Framework

Given that the uniqueness of Islamic finance lies in its compliance with *Sharī`ah* principles, the *Sharī`ah* governance framework becomes an important aspect of Islamic financial practices. The IFSB's *Sharī`ah Governance Guidelines* (2008) proposes four functions that a *Sharī`ah* governance system should perform at the level of Islamic financial institutions. These are: (1) issuing *Sharī`ah* pronouncements; (2) ensuring day-to-day compliance with the *Sharī`ah* pronouncements; (3) conducting internal *Sharī`ah* compliance reviews and audits; and (4) conducting annual *Sharī`ah* compliance audits to ensure that the internal *Sharī`ah* compliance review has been properly carried out. The IFSB has identified different *Sharī`ah* organs to undertake these functions, including in-house *Sharī`ah* compliance unit/departments, internal *Sharī`ah* review/audit units and *Sharī`ah* supervisory boards. The IFSB (2009) leaves the responsibility for *Sharī`ah* governance at the level of organisations, without any firm commitment for regulatory overview. However, to reduce *Sharī`ah* compliance risks and ensure that the Islamic banks fulfil their fiduciary duties of conducting business according to *Sharī`ah* principles, there may be a need for the regulatory bodies to provide *Sharī`ah* a governance framework and guidelines. The guidelines would identify the need to appoint *Sharī`ah* advisers, among other requirements that can lead to sound *Sharī`ah* governance regimes.

The *Sharī`ah* governance regime varies in those African countries where Islamic finance has been introduced. For example, in Kenya there are no specific guidelines on the nature and functions of SSBs at the institutional level, making it difficult to control the *Sharī`ah* compliance of the products offered (Laving 2013). A key constraint for *Sharī`ah* governance in the African context is the lack of qualified *Sharī`ah* scholars, in the various countries, who understand the legal issues related to finance and can provide guidance to the industry. One way to resolve this issue may be to create a national *Sharī`ah* board that deals will all issues related to *Sharī`ah* compliance in a jurisdiction. The Central Bank of Nigeria has established an Advisory Council of Experts to oversee *Sharī`ah* compliance issues, in addition to advisory committees of experts at the level of individual financial institutions (Ohuocha and Vizcaino 2013).

Liquidity Infrastructure Framework

One major problem facing Islamic financial institutions is the lack of liquidity infrastructure and products which facilitate the management of liquidity and efficient handling of balance sheets. The liquidity needs of banks can be met from either other financial institutions or interbank money markets. As interest-based loans are prohibited by *Sharī`ah*, Islamic banks cannot borrow funds to meet their liquidity requirement in case of need. Furthermore, there are no organised Islamic money markets in most jurisdictions from which funds can be sought in times of need. Liquidity can be sought from markets by selling liquid assets in the securities markets. Most assets of Islamic banks, being predominantly debt-based, are illiquid, as *Sharī`ah* prohibits sale of debt in most jurisdictions and there is a lack of markets. The source of public funds to facilitate provision of liquidity is also limited for Islamic banks. One possible safety net is to get emergency funds from the central bank in the form of LOLR. Islamic banks, however, can face problems in availing themselves of this facility, as most of the existing LOLR facilities are interest based.

Promotion of Islamic finance would therefore require development of the Islamic capital market in general and money markets in particular. This can be done by undertaking proactive initiatives from the relevant national authorities to develop these markets. One option for mitigating the liquidity shortage in countries that do not have domestic Islamic securities and *Sukūk* is to use global Islamic instruments. For example, the Nigerian Central Bank has issued guidelines for accepting *Sukūk* issued by IILM, an international body issuing Islamic certificates as collateral (Ohuocha and Vizcaino 2013).

4.3.2 The Role of Islamic Finance in Enhancing Financial Inclusion

This section examines the role Islamic finance can play in promoting financial inclusion by providing financial services to micro, small and medium enterprises in general and the poor in particular. The extent of financial exclusion and the financial/credit gap in Africa relative to other regions of the world is explored. The Islamic products and approaches that can be used to fill the gap are then presented and the regulatory issues related to microfinance identified.

The International Finance Corporation (IFC) (2013a) reports that there are about 420–510 million informal and formal MSMEs in the world, of which only 15–19% are formal microenterprises; the other 70–80% are informal. The corresponding number of MSMEs in the developing world is 360–440 million. IFC (undated) estimates that the value of the credit gap for the global MSMEs is between USD3.2 trillion and USD3.9 trillion, of which between USD2.1 trillion and USD2.6 trillion is in the developing world.

Table 4.3.2.1 shows the breakdown of the formal and informal MSMEs for the developing regions and their access to financial services. While the bulk of the MSMEs can be found in Asia, Africa has 40 million enterprises of which 22 million are either not served or under-served by the financial sector. In terms of the percentage of unserved and under-served enterprises, SSA show the highest financial exclusion (at 55% of the total) compared to other regions.

Table 4.3.2.1: Total Formal and Informal MSMEs and Financial Services

Regions	Number (in millions)	Unserved and Under-served (in millions)	Unserved and Under-served (% of total)
East Asia and Pacific	188	92	0.49
Europe and Central Asia	20	10	0.50
Latin America and the Caribbean	52	27	0.52
Middle East and North Africa	21	10	0.48
South Asia	78	36	0.46
Sub-Saharan Africa	40	22	0.55

Source: IFC (2013a)

Table 4.3.2.2 reveals the credit gap for the formal SMEs in different regions. Whereas the formal SMEs in Africa number between 3.5 and 4.3 million, the credit provided to these enterprises from formal financial institutions constitutes only between USD25 billion and USD39 billion. The total credit gap for this sector for Africa is estimated to be in the range of USD80 billion to USD100 billion, which is equivalent to between 300% and 360% of the outstanding credit. With the total credit gap for the world estimated at only 8–10%, the gap for Africa is proportionately multiples of the gap faced by other regions.

Table 4.3.2.2: Credit Gap Relative to the Outstanding Credit for the Formal SMEs

Regions	Number (in millions)	Total Formal SME Outstanding Credit (USD billion)	Formal SME Credit Gap (USD billion)	Gap as % of current Outstanding SME Credit
Total	25.0–30.0	14000–17000	1300–1600	8–10
East Asia	11.2–13.7	2000–2500	250–310	11–14
Latin America	3.1–3.7	180–230	125–155	60–75
Middle East and North Africa	1.9–2.3	80–100	110–140	125–150
South Asia	2.1–2.6	95–115	30–40	29–35
Sub-Saharan Africa	3.5–4.3	25–30	80–100	300–360

Source: IFC (2013b); Stein et al. (2010)

Outreach, Sustainability and Technology

Providing microfinance to micro-entrepreneurs and the poor can potentially lead to a trade-off between outreach and sustainability. On the supply side, the key constraints in providing financial services to the poor arise due to asymmetric information problems and the costs involved with the size of the financial service and scale of production. With extreme information problems, markets tend either to break down or function poorly due to costly state verifications (Holzmann and Jorgensen 2000). Furthermore, as financial services for the poor are small in scale, the per-unit costs of the financial services are high. Another factor that can increase the cost of operations and delivery of financial services is the lack of physical infrastructure. Given the high risks and costs, sustainability becomes an important issue for organisations providing financial services to the poor.

The trade-off between outreach and sustainability is closely related to the organisational features used to deliver the financial services to the poor. Depending on the missions of organisations, two broad approaches can be identified in delivering financial services. The first is the poverty approach, in which the financial institutions operate as non-profits with the goal of providing finance to the poor and core-poor (Schreiner 2002). Under this approach, financial services are provided by NGOs, government agencies, cooperatives and development finance institutions (Bennett 1998). As it is costly to finance the poor, long-term sustainability of the operations of these organisations without subsidies becomes an issue.

The second approach focuses on self-sufficiency and operates like other for-profit institutions (Schreiner 2002). The operations of financial institutions are sustained by providing larger loans to the less-poor at higher interest rates. One way this is done is by the linking approach, whereby formal financial institutions provide services to the poor through intermediaries or special programmes (Bennett 1998). While a commercial approach to providing financial services can help the growth of microenterprises, it may fail as a tool for eliminating core poverty (Weiss and Montgomery 2005).

An option for overcoming the costs of delivery of microfinance is to use technology to provide financial services. As indicated, a unique feature of some African countries is the use of mobile money and financial services. Africa is the second most connected region in the world in terms of subscriptions, with 640 million mobile phone subscribers in 2012 (Faye and Triki 2013: 106). Faye and Triki (2013) identify the first-generation financial services used through mobile technology as paying bills, sending money and receiving payments. The second-generation mobile financial services include savings services, credit and micro-insurance services. While the former services are being used extensively in Africa, use of the latter type of services is limited. While technical problems of mobile technology can limit its use for providing inclusive financial services in an efficient way, its potential use is also constrained by regulations and low levels of financial literacy and income (Faye and Triki 2013).

Islamic Finance and Financial Inclusion: Approaches and Models

The huge finance gap for the MSME sector in Africa identified above can be partly filled by Islamic finance. An important demand-side factor that can hinder access to finance by the Muslim poor is cultural norms, whereby people choose to exclude themselves voluntarily from financial services due to religious reasons. Many poor people in Muslim countries would not deal with conventional interest-based financial institutions due to the prohibition of *riba* (interest) by Islamic law. This is confirmed in a study by Karim *et al.* (2008), who found that an estimated 72% of the people living in Muslim countries do not use formal financial services and a large percentage of the population (ranging from 20% to more than 40%) do not avail themselves of conventional microfinance, to avoid interest. Thus, providing the poor in many Muslim communities with access to finance would require the provision of *Sharī`ah*-compliant services. However, compared to the size of the potential market, with around 43% of the population being Muslims, the supply of Islamic microfinance on the continent has been scant. In a survey of Islamic microfinance institutions globally, El-Zoghbi and Tarazi (2013) found only four MFIs from SSA in a sample of 225, accounting for around 1.5% of the total. The approaches and models that can be used to provide Islamic microfinance are discussed next.

While most Islamic MFIs will have organisational features similar to those of their conventional counterparts, the modes of financing used to raise and use funds would be *Sharī`ah* compliant. Principles of Islamic financing are many and varied. The type of financing instrument will depend on the type of activity for which funds are granted. Interest being prohibited in Islam, Islamic MFIs' assets and liabilities will be comprised of different types of non-interest-bearing financial instruments.

As mentioned, a large segment of the poor population is excluded from formal financial services involuntarily due to low income, high risk, price and lack of information framework, etc. (World Bank 2008). The key constraints on providing financial services to the poor are problems of asymmetric information and the high per-unit costs involved given the small size of financial services and the scale of production. Given the high risks and costs, sustainability becomes an important issue for organisations providing financial services to the poor. Sustainability in the long run relates to providing the services without subsidies.

One way to resolve the problem of financing the core poor in Islamic finance is to use religious instruments of *Zakat* (obligatory alms) and *Waqf* (Islamic endowments). *Zakat* is one of the fundamentals of Islam and has a direct economic bearing on others. It requires Muslims to distribute a part of their wealth among the specified heads in order to achieve economic emancipation of the poor. Similarly, *Waqf* is a voluntary charitable act that has wide economic implications. Various models are suggested to integrate these instruments in microfinance. For example, Cizakca (2004) suggests a model in which the concept of cash *Waqf* can be used to serve the society's social objectives. One use of cash *Waqf* could be to provide microfinance to the poor. Similarly, Elgari (2004) proposes establishing a non-profit financial intermediary, the *Qarḍ al-Hasan* bank, to provide interest-free loans to finance the poor. The capital of the bank would come from monetary (cash) *Waqf* donated by wealthy Muslims. Kahf (2004) and Ahmed (2004) propose establishing microfinance institutions based on *Zakat and Waqf*. They suggest that the returns from *Waqf* can be used to finance productive microenterprises at subsidised rates.

Integrating *Zakat* and income from *Waqf* into microfinancing can prevent fund diversions for non-productive purposes and benefit the poorest beneficiaries (Ahmed 2002). *Zakat* given to the poor can be used for consumption, asset building and production purposes to complement the funds of Islamic MFIs. As these complementary funds will reduce the need to divert money for consumption and/or purchase of assets, it is expected that the funds taken for productive activities from MFIs will be invested accordingly. As a result, the overall return on invested funds is expected to be higher and the probability of default relatively lower.

The instruments of *Zakat* and *Awqāf* can be used to resolve, to some extent, the problem of the trade-off between outreach and sustainability. For non-profit organisations focusing on poverty, charitable funds from these sources can provide support to sustain their activities. For commercial for-profit organisations, *Zakat* and *Awqāf* can provide subsidised sources to funds that can be used to expand their outreach to the poor.

Regulating Microfinance

CGAP (2012) specifies the guidelines for regulating the microfinance sector. Recognising that regulation can be costly for both the regulated and the regulators, and also that there are different types of organisations providing a variety of financial services, the guidelines take an approach that the regulatory framework should be proportionate to the risks involved. The consensus is that while deposit-taking institutions should be regulated, prudential regulation should be avoided in cases where the depositors' safety or financial stability is not an issue (CGAP 2012). If not managed well, providing microfinance using conventional banks can lead to instability. In such cases, non-bank financial institutions that are not systematically interlinked and have better macroprudential features should be encouraged to provide microfinance.

Many countries in Africa have, or are in the process of coming up with, regulatory standards for MFIs. Gallardo *et al.* (2005) identify the features of tiered regulatory regimes for microfinance depending on their activities in selected African countries. These are: simple registration as a legal entity, non-prudential regulation (standards for consumer protection and financial oversight, such as requiring submission of financial reports), and full prudential supervision (compliance with mandatory standards such as capital adequacy and liquidity ratio requirements). One of the key variables triggering different levels of regulations is the nature of liabilities. In the first type of MFI, the funds are received either as grants or through borrowing. In the second type, the MFI may collect deposits from members to whom the loans are made. The last type of MFI accepts wholesale and retail public deposits.

As microfinance involves dealing with the poor, consumer protection would be an important part of MFI regulation. Among others measures taken, predatory lending should be prohibited, clear and correct information of the services provided should be required, and restrictions on abusive collection practices should be implemented. Financial literacy is an essential element of financial inclusion and consumer protection (Thorat 2010). Educating the poor who are financially illiterate should be an essential part of any financial inclusion programme. Another issue that should be taken care of on the demand side is the over-indebtedness of households. (Sub-prime lending led to the global financial crisis, and to suicides in India due to difficulties in paying off debts.) This calls for regulations that can protect unsophisticated consumers by restricting over-indebtedness (Beck et al. 2011).

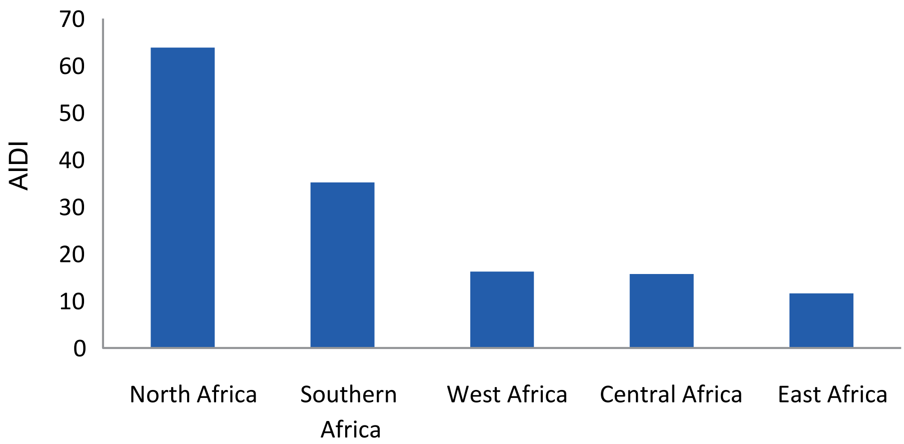
Whereas the basic principles and approaches for regulating Islamic microfinance institutions would be similar to those regulating their conventional counterparts, the risks arising in Islamic financial transactions need to be considered to make adjustments for the former. Furthermore, issues of *Sharī`ah* compliance also need to be dealt with at some level.

4.3.3 Opportunities for Islamic Project and Infrastructure Financing

A key constraint, and a factor that will determine the future growth of the African continent, is investment in the region's capital stock and infrastructure. Infrastructure facilities provide the basic foundations for commerce and trade, enhance competitiveness, and are important determinants of long-term growth of economies. Infrastructure investment is vital for economic growth and poverty reduction as it provides essential products and services such as power, water and sanitation to the citizens, and also expands capital stock (such as roads, ports and railways), which reduces the costs of production in other sectors. A direct implication of lack of infrastructure is the high cost of services such as power, water, freight and mobile telephony compared to other developing countries. This makes the countries less competitive and retards their economic growth. For example, if the levels of infrastructure in Africa can be brought up to the levels of South Korea, GDP per capita can be increased by 2.6% (Foster and Briceno-Garmendia 2010). Sector-wise, the funding gap is highest in the power sector (60% of the total), followed by water and irrigation. Lack of public resources calls for filling the infrastructure funding gap from other sources. Since the mid-1990s, there has been some involvement of the private sector in sectors such as mobile telephones, power plants and container terminals.

Due to the under-investment in infrastructure in the past, Africa faces huge infrastructure deficits. The African Development Bank's African Infrastructure Development Index (AIDI) consists of four key sectors: transport, electricity, ICT, and water and sanitation (AfDB 2013a). The AIDI uses nine indicators in these sectors to come up with an objective measurement of the status of infrastructure for different countries on the continent. The regional status of infrastructure for 2010 is shown in Chart 4.3.3.1. The infrastructure in North Africa is the best, scoring 63.8, followed by Southern Africa at 35.15. The remaining three regions have a serious shortage of infrastructure, with AIDIs for West, Central and East Africa of 16.26, 15.7 and 11.58, respectively.

Chart 4.3.3.1: African Infrastructure Development Index (AIDI) (2010)



Source: AfDB (2013a)

One factors contributing to the lack of infrastructure and constraints on its growth in Africa is the deficit in the availability of long-term financing. The total infrastructure investment amount needed for Africa is estimated to be USD93 billion per year against current spending of USD45 billion annually (Foster and Briceno-Garmendia 2010; Beck *et al.* 2011). The bulk of the USD45 billion spent on infrastructure is financed by domestic sources (Foster and Briceno-Garmendia 2010). Whereas the public investments are financed by taxes, operating and maintenance expenditure is financed by user charges. As around USD33 billion per annum is required for the operation and maintenance of existing infrastructure, the net contribution to the development of new infrastructure is much smaller.

Islamic Finance and Infrastructure Financing

Islamic finance has great potential to be used for developing infrastructure projects. Given its emphasis on equity-based and asset-backed financing, Islamic finance can play an important role in this vital sector. Furthermore, as many infrastructure projects benefit the community at large, financing of these projects would comply with the Islamic financial sector's ideological standing.[137] The relationships and contracts used between the different stakeholders in an infrastructure development under Islamic finance will depend on the specific project type and financing modes used. In the case of Islamic finance, the modes used will depend on the features of the project and the preferences of the sponsors and financiers. For example, *Istisnā`, Ijārah and Mushārakah* can be used to finance the project. The modes of financing used will determine the project's capital structure.

Whereas in some countries governments have been proactive in issuing Islamic financial instruments to finance their expenditures, in other countries the corporate sector has taken the lead and raised funds to invest in projects (IFSB 2008). Governments can tap into the vast resources residing in the private sector by coming up with innovative instruments that satisfy the varying risk–return–maturity preferences of different investors in the economy. One way to do this is to issue various public-sector *Sukūk* to raise funds for investment in infrastructure assets. Experiences in some countries indicate the success of using different securities, including *Sukūk*, to raise funds. Islamic securities are already being used by governments in some countries. In Iran, the Bank Milli (Central Bank of Iran) has issued participation bonds to finance, *inter alia*, the construction of infrastructure projects.[138] The Malaysian government has introduced Government Investment Issues based on the concept of *Bay` al-`Inah* and *Sukūk* Bank Negara Malaysia *Ijārah* based on sale and lease-back concepts. In Sudan,

[137] Miller and Morris (2008).
[138] Siddiqi (1999).

the government has introduced *Muḍārabah*-based Government Investment Certificates (GIC), the proceeds of which are used to finance procurement, trade and development projects (Ali 2005). The successful experience of public and private *Sukūk* issues has opened the door to issuing government *Sukūk* to raise funds from private-sector players and markets to finance public-sector infrastructure projects.

Issuing *Sukūk* to finance infrastructure is complementary to Islamic banking and *Takāful*. Islamic banks and *Takāful* companies do not have *Sharī`ah*-compliant assets in which they can invest or park their funds for short periods of time. One consequence of raising funds to finance infrastructure projects using *Sukūk* would be to support the establishment of a viable liquid secondary market. As mentioned, future investment needs in the infrastructure sector in many countries are expected to be huge. If a large percentage of the new projects is financed by *Sukūk* issued by both the private and public sectors, it can potentially lead to a large, viable, secondary *Sukūk* market. This will not only help develop an important Islamic capital market institution, but also will help Islamic banks and *Takāful* companies to investment in *Sharī`ah*-compliant assets. An efficient market in which *Sukūk* are readily tradable will enable Islamic financial institutions to buy/sell Islamic securities to manage their liquidity needs and risks.

Faye *et al.* (2013) report that Africa issued *Sukūk* worth USD1.6 billion in international markets and received at least USD14 billion for project financing during 2005–2012. However, the investments from these sources were uneven, with *Sukūk* being issued by only three African countries and 82% of the project financing being concentrated in North Africa. More recently, some countries are planning to develop the framework and issue *Sukūk* to raise funds for infrastructure development. For example, Senegal has plans to issue USD200 million in *Sukūk* to finance energy projects. The initiative has been supported by the Central Bank of West African States, which agreed to accept the *Sukūk* for its repurchase operations (Vizcaino 2013). Similarly, a joint committee on alternative finance formed between the Central Bank of Nigeria, the Infrastructure Concession Regulatory Commission, the Securities and Exchange Commission and the Debt Management Office has produced a blueprint for using Islamic finance as alternative finance for infrastructure financing and presented it to the relevant authorities in Nigeria.

Legal and Regulatory Environments

The huge funding needs and complex features of infrastructure finance require the participation of both the public and private sectors. The private sector, however, will only participate if the right environment and incentives structures exist. To have private-sector involvement in infrastructure development, there is a need to have laws that protect the interests of the stakeholders. Most developed countries have a concession law that defines the rights and obligations of different parties at various stages of the transaction. Among others, the concession law should have clear rules providing a stable and predictable legal framework; promote transparency and fairness; protect the rights of different stakeholders, including financiers; and provide state support in the form of guarantees and undertakings.[139] Not only are concession laws needed, but the Islamic perspective on these laws also must be clearly understood.[140]

As infrastructure finance involves many parties and a cobweb of contracts, there is a need to have a legal system that can enforce those contracts. If the enforceability of contracts is weak, private-sector financing of infrastructure finance will not be forthcoming. The problem can arise for Islamic finance, since most countries have either a common law or civil law legal system. As discussed, problems may

[139] See EBRD (2006) for a list of core principles for a modern concession law.
[140] While a concession law may enable the use of Islamic financing for infrastructure projects, some *Sharī`ah* issues can arise with the arrangement. As concessions involve the transfer of assets for a limited period of time, issues related to transfer of ownership and/or lease of the asset and the responsibilities of the parties involved need to be addressed from a *Sharī`ah* perspective.

arise in settling disputes involving Islamic contracts in jurisdictions that do not have supporting Islamic laws, thereby creating uncertainty about Islamic financial transactions. A stable legal and regulatory environment would give investors confidence that their rights are protected and that, in the event of disputes, contracts will be enforced through a fair judicial process.[141] Given the long-term nature of most infrastructure projects, investors also need to be confident of the constancy of the rules and laws governing the project.

There also need to be securities regulations that protect investors; ensure fair, efficient and transparent markets; and reduce systemic risks.[142] IOSCO has identified the following key issues necessary for an Islamic capital market to develop: an appropriate regulatory framework; *Sharī`ah* compliance and convergence; a range of products; low transaction costs; development of market professionals; investor education; and knowledge sharing.[143] To have a *Sukūk* market, detailed codified securities, disclosure and bankruptcy laws from an Islamic framework are also required. These laws should include specific rules related to *Sukūk* holders' rights, and reorganisation and liquidation rights (of creditors), and ensure transparency, disclosure, and comprehensive accounting standards.

Pre-requisites for a *Sukūk* market are an increase in the scale and the existence of standardised securities that are well understood by the relevant stakeholders, including investors.[144] The range of products in a *Sukūk* market will vary, incorporating both debt-like and equity-type securities. This will require effort at the regulatory level to standardise some of the transactions to minimise uncertainty and legal risks. While the infrastructure sector has the potential to take the *Sukūk* market beyond a threshold level that makes it viable, there are other requisites that need to be in place for the market to function. Other than providers and users of funds, there is a need for liquidity providers, as they act as agents, facilitating transactions in secondary markets.[145] Liquidity providers, such as brokers and dealers, buy and sell securities and help trading in the markets. There is need for a threshold level of *Sukūk* to provide for a flourishing secondary market. Governments can facilitate the process by providing the necessary legal and regulatory frameworks and market infrastructure.

Several African countries have changed their regulatory and tax regimes to accommodate issuance of *Sukūk*. For example, the South African government is reviewing its regulatory framework to enable issuance of *Sukūk* in the country. In 2011 the tax laws were amended to accommodate securities that would be based on *Sharī`ah* arrangements. Similarly, Kenya and Senegal are making changes to their regulatory frameworks to accommodate Islamic securities (Ibechukwu and Fondufe 2013). The SEC Nigeria issued Rules on *Sukūk* Issuance in February 2013 that will make it possible to issue *Sukūk* in the country (Ibechukwu and Fondufe 2013). Osun has taken initiatives to issue the first NGN10 billion (USD61.4 million) domestic *Sukūk* to fund schools in the state. This debut *Sukūk*, which was rated A by a local rating agency, will pay a return of between 14.25% and 14.75%. The success of the *Sukūk* demonstrates the potential of Islamic finance to fund infrastructure projects not only in Nigeria, but also in the SSA as a whole.

---

[141] Chami *et al.* (2009).
[142] These are broad objectives of the International Organization of Securities Commissions. See IOSCO (2003).
[143] IOSCO (2004).
[144] Merton and Bodie (1995) assert that as the products offered by financial intermediaries increase in scale by serving a larger customer base, they can be standardised and sold in financial markets.
[145] Chami, Fullenkamp and Sharma (2009) assert the important role of liquidity providers in the efficient functioning of financial markets. In the absence of these agents, markets tend to become "buy and hold" and inactive.

4.3.4 Key Regional Markets: Comparative Evaluation of Prospects and Challenges

Although Islamic finance can play an important role in contributing to Africa's development, its prospects and potential will differ for various regions of the continent due to their different demographics, economic status and level of development. In countries with a large Muslim population, demand for Islamic finance is expected to be higher and its provision can increase financial inclusion for people who would not avail themselves of conventional interest-based financing services due to their religious convictions. As Table 4.3.4.1 shows, the Muslim population in Africa is significant, amounting to 43% of the population. Whereas Northern Africa is predominantly Muslim (96.9%), Western and Eastern Africa also have large Muslim populations (52.8% and 34.4%, respectively).

Table 4.3.4.1: Muslim Population in Africa (2010)

Region	Total Population (million)	Muslim Population (million)	Muslim Population as % of Total
Africa	1,016.6	438.5	43.1
Central Africa	124.12	11.96	9.6
Eastern Africa	280.56	96.54	34.4
Northern Africa	168.84	163.66	96.9
Southern Africa	142.28	7.43	5.2
Western Africa	300.8	158.91	52.8

Source: Estimated from Pew (2012)

Table 4.3.4.2 shows the extent of financial exclusion with respect to various types of financial products in different regions of Africa. Overall, fewer people in Africa use a formal financial institution for savings and credit compared to the world average. Within the region, North Africa, which has the highest percentage of Muslim population (96.9%), appears to have the least developed formal financial sector with only 4% of adults having savings in and originating a loan from a formal financial institution. West Africa, with a Muslim population of 52.8%, has relatively better figures for those using a formal account (17%), but the lowest percentage (3%) for formal loans. With a Muslim population of 34.4%, East Africa has a relatively better result for engagement with the formal financial institution, with 14% of adults saving with, and 7% getting loans from, these institutions.

Table 4.3.4.2: Characteristics of Financial Inclusion: Savings and Credit, and Insurance

Regions	Adults Saving in the Past Year		Adults Originating a New Loan in the Past Year	
	Using a Formal Account (%)	Using a Community-Based Method (%)	From a Financial Institution (%)	From Friends or Family (%)
World	0.22	0.05	0.09	0.23
Africa	0.13	0.17	0.05	0.38
Central Africa	0.04	0.13	0.03	0.33
East Africa	0.14	0.12	0.07	0.48
North Africa	0.04	0.04	0.04	0.29
Southern Africa	0.18	0.13	0.08	0.37
West Africa	0.17	0.29	0.03	0.39

Source: Demerguc-Kunt and Klapper (2013: 61)

On the supply side, Faye *et al.* (2013) provide a map of the Islamic financial sector on the African continent. As Table 4.3.4.3 shows, there are a total of 116 Islamic financial institutions spread across four regions and 21 countries of Africa. In terms of institutions, Islamic banks dominate the scene, with a total of 56 institutions, followed by 33 *Takāful* institutions. The four Islamic funds on the continent are located in South Africa. Examining the regional dispersion shows that North Africa has a total of 25 Islamic financial institutions of which 14 provide banking services and 11 are *Takāful* companies. There are no Islamic microfinance institutions identified in the region. With a population of 158.91 million Muslims, West Africa has 14 Islamic financial institutions, three of which are microfinance institutions. Although East African has 65 Islamic financial institutions, this number is inflated due mainly to Sudan, which has a total of 49 institutions, leaving 16 for the remaining countries. The two microfinance institutions in East Africa are also in Sudan. Note that there are no Islamic financial institutions identified from Central Africa. The absence of Islamic finance can be attributed to the small Muslim population size, lack of awareness, and political instability in some countries of the region (Faye *et al.,* 2013).

Table 4.3.4.3: Islamic Financial Sector in Africa

Financial Sectors	North Africa (6)[a]	West Africa (9)	East Africa (4)	Southern Africa (2)	Total (21)
Muslim Population (% of total)	96.9	52.8	34.4	5.2	43.1
Islamic Banks	9	6	39	2	56
Banks with Islamic Windows	5	1	9	3	18
Takāful Operators	11	4	15	3	33
Islamic Funds	0	0	0	4	4
Islamic Microfinance	0	3	2	0	5
Total	25	14	65[b]	12	116

Source: Faye et al. (2013); Pew (2012)

Note: [a] Numbers in parentheses indicate number of countries. [b] Sudan has a total of 49 institutions (32 Islamic banks, 15 Takāful operators and 2 microfinance institutions).

Market and Prospects

The market for Islamic finance is promising in North, West and East Africa due to these regions' larger Muslim populations. The data, however, show low levels of engagement with the formal financial institutions in these regions, which may be due partly to religious reasons. As Islamic finance is relatively new in Africa, only a few Islamic financial institutions are operating in these regions. Even North Africa, where Islamic finance has had a presence since the 1960s, remains under-developed compared to some other regions such as GCC and Southeast Asia (see Box 4.1). Given the huge financing gaps and low levels of financial development, there is an opportunity for Islamic finance to serve the untapped markets not only for Muslims, but also for all sections of the population.

The markets for Islamic finance may be limited in many African countries due to their small economies and its unfamiliarity. One way to increase the provision of Islamic finance may be to have larger Islamic banks serving many countries in their respective region. This will make the provision of Islamic finance relatively easier in newer markets compared to creating new Islamic banks, on the one hand, and may also increase the efficiency of provision of these services due to better economies of scale, on the other hand. Given the head-start of Islamic finance in some countries, the existing Islamic banks can potentially take the lead in creating pan-regional banks. In particular, Islamic banks in Kenya could expand their operations in East Africa; those in Nigeria could expand in English-speaking

West Africa; Islamic banks in Northern Africa and Senegal could operate in French-speaking countries; and financial institutions in South Africa could expand in Southern Africa.

Another option for providing Islamic financial services is through non-bank financial institutions. This is particularly true for microfinance, which, as pointed out, is experiencing large credit gaps in Africa (see Table 4.3.2.2). A part of this large financing gap can be filled by Islamic finance, thereby not only providing alternative sources of funds but also improving access to financial services for Muslims who shun conventional finance due to religious reasons. Furthermore, the instruments of *Zakat* and *Awqāf* can be integrated with microfinance to cater to the financial needs of the core poor.

Islamic finance can play an important role in the development of infrastructure in the regions that have low infrastructure stock. As Chart 4.3.3.1 shows, infrastructure is relatively more developed in North and Southern Africa and has very low levels in the remaining regions. In particular, the Western region has an AIDI of 16.26 and the Eastern region an index of 11.58. Given that some countries in these regions have taken initiatives to introduce Islamic finance, there appears to be a clear case for seeking *Sharī`ah*-compliant financing for infrastructure development from both domestic and foreign sources. As investments in infrastructure are long-term in nature, private-sector participation would require not only coming up with an enabling legal and regulatory framework for Islamic finance, but also a regime that clearly defines investors' rights and reduces legal uncertainty in the event of disputes.

Issuance of *Sukūk* to finance infrastructure has the potential to serve many purposes. *Sukūk* issues with the right risk–return features would attract investments from overseas, particularly from investors from the oil-rich Gulf countries seeking alternative *Sharī`ah*-compliant instruments and markets. Domestically, experience shows that many governments are taking a pro-active role in other parts of the world to issue government finance instruments (IFSB 2008). Issuance of these instruments can help stimulate the capital markets, on the one hand, and also enable Islamic financial institutions to hold *Sharī`ah*-compliant assets and manage their liquidity, on the other hand.

Box 4.1: Islamic Finance in North Africa

By: Professor Habib Ahmed

Among the top 500 Islamic financial institutions in 2010, only five banks were located in North Africa – two of them in Egypt (Faisal Islamic Bank, ranking 43rd globally with assets worth USD5.08 billion, and Al Baraka Bank, ranking 81st with USD2.13 billion in assets), and one each in Algeria (Al Baraka Bank, ranking 116th with assets of USD1.01 billion), Mauritania (Banque Al Wava, ranked 118th with USD0.99 billion in assets) and Tunisia (Al Baraka Bank, ranking 163rd in the world with USD0.42 billion in assets) (AFD 2012). Due to changes in the political climate in recent years, however, many countries in the region are opening up to Islamic finance. With a Muslim population of 97%, changes in the legal and regulatory framework have the potential to unleash demand-driven growth in the Islamic financial sector.

Almost all countries in the region have made some changes in the legal and regulatory environments in the past to accommodate Islamic finance. Whereas conventional banks have been offering Islamic financial products through windows in Morocco since 2010, steps were taken in 2012 to introduce an Islamic banking law to allow full-fledged Islamic banks to operate in the country. The most dramatic change has occurred in Libya, where the General National Congress passed a law in 2012 that will prohibit interest from the banking sector by 2015. This law makes Libya the third country in the world with a full Islamic financial system after Iran and Sudan.

In Tunisia, the government is taking a gradual approach. In 2012, a draft law was completed and is waiting review and implementation (IRTI *et al.,* 2013). Tunisia has 21 banks, of which three are Islamic (Al Baraka Tunisia, Noor Bank and Bank Zitouna). A recent survey in the country found that 46% of those who are using conventional banks would be interested in Islamic banking (IRTI *et al.,* 2013). Many conventional banks in the country have shown interest in opening up Islamic windows. The study shows that Islamic financial assets have the potential to reach 40% of the total financial assets within five years. However, a key constraint that can inhibit this growth is the large gap in the public understanding of what Islamic finance is, which indicates the need to educate prospective Islamic banking clients.

Most of the *Sukūk* issuances in North Africa to date have been confined to Egypt. In 2010, four *Sukūk* were issued in the country, one by AlBaraka and three by Al-Tawfeeq (AfDB 2012). The government of Egypt has been trying to pass a *Sukūk* law to facilitate the future issuances of *Sukūk*. With implementation of the draft law being delayed due to political uncertainty, the Egyptian Financial Services Authority plans to include a chapter under the securities law that will cover *Sukūk* issuance (Ahram 2014). Elsewhere in the region, Morocco changed its securities law in 2012 to enable issuance of *Sukūk*. The law is being amended to allow corporations and the government to issue *Sukūk* and raise funds both from domestic and foreign investors. A survey conducted by the Moroccan financial market authority revealed that nine out of ten corporations indicated they would use *Sukūk* to raise funds if the law permitted it (Al Ansari 2013). In 2013, the Tunisian parliament passed a law that would allow the government to issue *Sukūk*. The government plans to issue a USD700 million sovereign *Sukūk* to diversify funding sources to cover part of its large budget deficit (Amara 2013).

4.3.5 Human Capital Development and Awareness

While the African continent has great potential for Islamic finance, one of the key constraints limiting its development is the lack of human capital to sustain the industry. The knowledge and skill sets needed for Islamic finance are complex, as it requires an understanding of finance, Islamic commercial law, and national laws and regulations. Whereas there are numerous educational institutions providing education in Islamic finance globally, the industry has also gathered a wealth of tacit knowledge through practice over the years. In the case of Africa, the shortage of human resources in relation to the development of Islamic finance can be identified at three levels.

Regulatory

In order to regulate Islamic finance, the regulators need to understand the nature of risks arising from adherence to *Sharī`ah*. In this regard, various IFSB standards and guidelines provide a good overview of the regulatory issues arising in Islamic finance and ways to deal with them. Furthermore, some initiatives by international multilateral organisations such as the IFSB, IDB, the World Bank and IMF for increasing the regulatory capacity of supervisory authorities and industry players also exist. One possible way to enhance the talents and capabilities of the Islamic financial sector is to seek the cooperation of international institutions and countries that have advanced Islamic financial sectors. For example, in 2010 the Islamic Development Bank provided Nigeria with technical assistance for capacity building in Islamic banking under which officials from CBN visited Bahrain for two weeks to become acquainted with its Islamic banking regulatory and operating practices (Sanusi 2011). Ahmed (2012) suggests that human capital and expertise related to implementation of IFSB standards at the regulatory level can be enhanced by receiving technical assistance and participating in the IFSB's awareness-enhancing events such as workshops, roundtables, conferences and seminars.

Banking professionals

Given that the Islamic financial sector is a relatively new industry, there is a shortage of people with the appropriate knowledge and skills in the industry globally. When Islamic banks were initially established, they were managed by officials from conventional banks. While these officials had expertise in financial matters, they lacked knowledge of *Sharī`ah*-related matters. Over time, Islamic banking officials have accumulated useful knowledge of *Sharī`ah*-compliant products and processes. However, as Islamic finance is relatively new in Africa the knowledge and skills gap is expected to be acute in these countries.

One obvious way to enhance expertise in Islamic finance is to send prospective employees for training in this area. There are numerous Islamic finance knowledge providers and training centres located in Asia, Europe and the MENA region, providing academic and professional degrees and qualifications (Yurizk 2103). While individuals can avail themselves of the opportunities provided by these institutions in the short run, there will be a need for indigenous initiatives to educate and train professionals working in the Islamic financial sector as the industry grows over time.

At the government level, bilateral cooperation between the African states and countries with developed Islamic financial sectors can also help develop skills and expertise in the former. For example, the Bank of Mauritius and Bank Negara Malaysia have signed a Memorandum of Understanding to collaborate to enhance mutual cooperation on capacity building and human capital development in the financial services industries in general, which includes the Islamic financial services sector.

Sharī`ah Scholars

As *Sharī`ah* compliance forms the defining feature of Islamic finance, there is a need for *Sharī`ah* scholars to examine and approve the products and operations of Islamic financial institutions. However, scholars who are trained in traditional religious educational institutions may not have the knowledge and expertise to comprehend the legal issues arising from complex financial products. There is a scarcity of *Sharī`ah* scholars globally who can provide advisory services to the industry, as is evident from the number of boards on which the leading scholars sit.

The problem of a lack of *Sharī`ah* scholars who can provide advice to the evolving Islamic financial sector in Africa can be resolved by creating a pool of qualified local scholars in different countries. However, this is a long-term process. In the short term, the Islamic financial sector can use the expertise of scholars from other countries. Another way of resolving the scarcity of scholars may be to establish a national *Sharī`ah* board that can oversee matters related to Islamic banking and finance. This model can use the services of the limited number of scholars more efficiently and broadly on the one hand, and minimise the diversity of opinions in the nascent industry. Nigeria has established a *Sharī`ah* advisory committee at the national level to provide advice on *Sharī`ah*-related issues. The Central Bank of Nigeria in conjunction with the UK's Islamic Finance Council and Enhancing Financial Innovation and Access (EFInA), a local initiative, recently (February 2014) held a capacity-building programme on a train-the-trainer basis for 35 Nigerian *Sharī`ah* scholars, similar to that held for *Sharī`ah* scholars from Bahrain by the UK's IFC.

Public Awareness

On the demand side, awareness of Islamic financial products can be a challenge for the growth of the industry. As the Islamic finance industry is new in Africa, the products are unfamiliar to most people. Increasing public awareness of Islamic finance would require initiatives at both the institutional and regulatory levels. The incentive to invest in raising awareness at the institutional level could be partly economic-driven and partly social responsibility. A portion of the tainted income that Islamic financial institutions give away to charity could also be used to educate people about Islamic finance. As most African countries have different religious communities, the products offered by Islamic financial institutions should also target non-Muslims. Educating them about the ethical features of Islamic finance can provide opportunities for them to satisfy their financial needs from alternative sources. From a regulatory perspective, raising awareness can be a component of the financial literacy programme (Thorat 2010). Educating the financially illiterate in general and the poor in particular should be an essential part of any financial inclusion and consumer protection scheme.

4.4 The Way Forward

The colonial past and lost years of growth during the post-colonial period have left the Sub-Saharan African region with low levels of economic development indicators relative to other regions of the world. After poor performance in the last century, the continent has turned a corner in the new millennium and is showing much better performance and prospects for future growth. However, to achieve development and reduce poverty, private-sector growth must keep pace with and absorb the expanding labour force. One way in which the high poverty levels can be lowered in the SSA region is by using a broad-based inclusive growth, which would assist the development of MSMEs. Another area that needs to be addressed to promote development in SSA is the formulation of strategies for investing heavily in infrastructure.

This chapter has discussed the role of Islamic finance in furthering inclusive finance to mitigate poverty and promote the development of infrastructure in Africa. The chapter first identified some financial infrastructure requirements that would enable the Islamic finance sector to grow on the continent. The pillars of a well-functioning and stable financial sector include sound financial system infrastructure and regulatory and supervisory regimes. Development of the Islamic financial sector would require a supporting legal infrastructure for finance, systemic liquidity infrastructure, and transparency, governance and information infrastructures. Under the former, supporting laws and regulations, a dispute resolution framework and *Sharī`ah* governance regimes are necessary for the development of the Islamic financial sector. In terms of liquidity infrastructure, Islamic financial institutions would require *Sharī`ah*-compliant liquidity markets and safety nets in terms of lender of last resort from the central bank.

The chapter discussed ways in which Islamic finance can fill the gaps in financing MSMEs at the micro level. Encouraging the growth of the MSME sector would require creating incentives to increase the supply of services and decreasing existing barriers (Stein *et al.*, 2010). The approach suggested by IFC (2009) for financing SMEs can be used for structuring a financing model for MSMEs in Africa. The document identifies five success factors for sustainable financing of SMEs: strategy focus and execution capabilities; market segmentation, products and services; sales culture and delivery channels; credit risk management; and information technology and management information systems. DCED (2013) proposes to incorporate developing the business environment and transforming the informal sector into a formal one in national industrial policy reforms. While facilitative regulation can be helpful in increasing access to and inclusion of financial services, the market conditions must be met on both the demand and supply sides (Calice 2013). On the supply side, the economics of providing microfinancing is an issue. On the demand side, the different barriers (social, cultural, literacy, etc.) can be inhibiting factors.

The chapter also argued that Islamic finance can be an additional source of financing for the development of infrastructure in Africa. The laws of a country need to be adjusted to support the transactions of the Islamic financial sector, which uses contracts that are *Sharī`ah* compliant. One essential legal requirement that may increase private-sector participation in general and Islamic finance in particular, is to have a concession law that would allow granting the use of public assets to private enterprises for a specified period of time. Furthermore, there needs to be in place certain laws that govern contracts in infrastructure financing. This would require having a legal/regulatory regime that secures investors' rights and has appropriate bankruptcy systems.

The economic/financial aspect of securing government support to encourage investments in infrastructure is to ensure that projects satisfy appropriate risk–return profiles for investors. To minimise risks, governments can provide guarantees that reduce the costs of financing. There may also be a need for support in terms of subsidies and tax incentives to make the projects viable. Care needs to be taken to identify the risks that can be managed by private entrepreneurs and those that government should mitigate (Irvin 2007). However, there is a need to balance the support provided to private-sector projects to avoid operational inefficiencies.

One way of using Islamic finance to finance infrastructure is by issuing *Sukūk*. This would not only provide alternative financing for the huge investment requirements needed to develop the sector, but would also complement the development of the Islamic finance industry and markets. An efficient market in which *Sukūk* are readily tradable will enable Islamic financial institutions to buy/sell Islamic securities to manage liquidity and *Takāful* companies to invest in *Sharī`ah*-compliant assets.

The growth of Islamic finance in Africa will ultimately depend on whether financial institutions are able to provide competitive products relative to their conventional counterparts. While this will partly be determined by the level of innovation at the institutional level, it will also be affected by the external environment in terms of a legal and regulatory framework that can level the playing field. Another factor that will be key to the future development of the Islamic financial industry on the continent is ensuring adequate human capital and talents in terms of banking professionals and *Sharī`ah* scholars who can manage and supervise these institutions.

5.0 CONCLUDING REMARKS

In 2013 Islamic finance has received more recognition by global governments and regulators, and attracted more new market participants, than in previous years. A growing number of RSAs are applying the IFSB Standards. In so doing, they are helping to create a level playing field for Islamic finance and putting it on an equal regulatory footing with conventional finance. The application of the same regulatory standards by regulators in different jurisdictions facilitates cross-border activities and supports the gradual emergence of a truly global Islamic finance industry. It is noteworthy that the IFSB has established regular links with global standard setters for banking, insurance and capital markets to ensure a timely exchange of views on Islamic specificities in the respective sectors. The IFSB has also teamed up with international institutions such as the IDB and ADB for joint capacity-building measures. Legislators and governments in a growing number of jurisdictions supplement IFSB standards by their own initiatives to create a conducive legal and tax environment for Islamic finance.

Sukūk are increasingly considered an alternative approach for corporate and infrastructure funding. The year 2013 was notable for the growing number of Muslim-majority and -minority countries where first-time public and corporate issuances have been announced. The Islamic capital market could play a pivotal role in the further development of the Islamic finance industry as a whole.

The issuance of IFSB-15 in December 2013 was a milestone for the development of the microprudential framework of the IFSI. IFSB-15 updated and extended previous standards and transposed the key elements of Pillar 1 of Basel III on capital, risk coverage and leverage, and the supplementing liquidity regulations into Islamic finance. The Standard has clarified, *inter alia*, the requirements for the recognition of specific types of *Sukūk* as regulatory Tier 1 or Tier 2 capital. Earlier successful *Sukūk* issuances have proved the market's acceptance of structures in line with these requirements, and it is expected that Islamic banks will take more recourse to such *Sukūk* to strengthen their capital base in the future.

Work by the IFSB on Pillar 2 of Basel III on risk management and supervision is in progress. The adaptation of the revisions of Pillar 3 on market discipline with respect to disclosure requirements (for securitisation exposures, sponsorship of off-balance sheet vehicles, and the components of regulatory capital) should not be a significant problem in Islamic finance. However, a more fundamental systemic issue related to market behaviour became apparent during recent months when emerging markets experienced substantial capital outflows and exchange rate pressures – namely, a vulnerability of Islamic finance that emanates from volatile *Sukūk* markets with the potential to "infect" Islamic banks and thus spread throughout the whole IFSI.

The volume growth of the *Sukūk* market over the last couple of years was spurred by conventional market players on the supply side as issuers of Islamic bonds, but even more on the demand side by institutional investors as subscribers of new issuances. They found *Sukūk* to be attractive papers with competitive yields compared to bonds in the depressed US and European economies where interest rates were close to zero as a result of the expansionary monetary policies of central banks – in particular, the quantitative easing policy of the US Federal Reserve. The financial markets became turbulent on the US Fed's announcement, by Ben Bernanke, of the possibility of a tapering (reduction) of the bond purchasing programme (thus far amounting to USD85 billion per month) as the beginning of a gradual phasing out of the quantitative easing policy. Actual decisions on the tapering were taken only since December 2013, but investors had anticipated this and had already started to restructure their portfolios. They unwound positions in emerging markets, which led to capital outflows and exchange rate pressures. Within developed economies, the quantitative easing lowered long-term interest rates but not, at least initially, the threshold rate of return for new investment. Underlying these developments is the relative attractiveness of bank or indirect financing versus direct financing of real investments (such as by *Sukūk* issuance). Deleveraging by global banks helped to fuel direct investment financing which spurred, to some extent, *Sukūk* issuances.

A thorough analysis of data for recent months could provide evidence as to whether *Sukūk* markets were shielded from turbulence to some degree or were as much affected as conventional bond markets in the emerging economies. A first look suggests that there was an impact on *Sukūk* markets. Conventional investors may have appreciated the asset-backed or asset-based *Sharī`ah*-compliant structure of *Sukūk*, but may still withdraw from *Sukūk* investments in favour of higher-yielding conventional instruments. Sizeable disposals of *Sukūk* could pose a potential risk to the IFSI (and also capital outflows) that would be reflected in the market data. Research based on the recent experiences should be undertaken to explore the strength of these interdependencies.

A particular stability concern results from the quantitative asymmetry between the global conventional industry and the Islamic finance industry: movements that are minor on the global conventional finance scale can have major destabilising effects for the much smaller Islamic finance industry. Recent market turbulence that resulted in capital outflows and pressures on the exchange rates of some IFSB member countries are powerful reminders of the importance of macroprudential oversight for the timely identification and assessment of systemic risks and for appropriate policy measures whenever necessary. The quantitative asymmetry suggests that macroprudential supervision is of greater importance for the Islamic segment of the financial system.

The recent experiences also support initiatives for an explicit inclusion of Islamic finance in the Financial Sector Assessment Programmes of the IMF and the World Bank. Finally, the results of the suggested quantitative research could provide data for the calibration of stress-testing models for Islamic financial institutions. All these issues have been on the IFSB's agenda for quite some time and have been dealt with in the IFSI Stability Report 2013. The IFSB's strategic partnerships with the IMF and the World Bank, and with academic institutions with research capacities, as well as its access to RSAs, provide the best platform for further work on crisis prevention and shock absorption in the Islamic finance industry.

It seems at first sight that the challenges on the macro level are relevant only for jurisdictions where Islamic finance has already gained a noticeable market share. However, some new frontier countries – that is, jurisdictions that are just opening up for Islamic finance – expect a rapid expansion of this new sector. This could be the case in some Sub-Saharan African countries and in Arab Countries in Transition (ACTs) in North Africa. The chapter on the potential and prospects for Islamic finance in Africa explained that Islamic finance can make a significant contribution to poverty reduction through financial inclusion. Although this would be a very important achievement, Islamic microfinance can hardly be the main driver of quantitative growth. Instead, larger transaction volumes and Islamic asset values can be expected from *Sukūk* issuances of private corporations and, in particular, governments and public-sector entities. The financing of huge infrastructure projects (for example, in the energy sector) could attract funds not only from domestic but also international investors. Many African countries hope for capital inflows from the oil-rich Muslim countries. However, a strong risk aversion of Arab investors may limit the inflow from Muslim investors from the GCC region. Instead, African *Sukūk* issuances may be absorbed in large part by conventional investors with a more pronounced risk appetite. If this happens, then even frontier countries with a nascent Islamic finance sector could suffer from an "imported" vulnerability and volatility. Hence, a second look reveals that size alone is not the best indicator for the importance of macroprudential supervision of Islamic finance. What matters more is the share of participation of profit-oriented conventional (domestic and international) investors in the *Sukūk* market, and the interdependencies between Islamic banking and the *Sukūk* market.

Along with the most important microprudential regulations issued for the banking sector, the market turbulence of 2013 suggests the need to intensify or initiate more work on cross-sectoral regulations and macro-surveillance. With the BCBS as the main strategic partner of the IFSB for microprudential issues, the cooperation between the IFSB and the IMF could help to link the latter's macroprudential initiatives with the work of the IFSB, hence contributing to the IFSI's greater stability and resilience.

APPENDICES

Appendix 1

Sample Methodology

Islamic banking

Sample data were collected from 52 full-fledged Islamic banks in Bahrain, Bangladesh, Indonesia, Kuwait, Malaysia, Pakistan, Qatar, Saudi Arabia, Turkey and UAE. These countries were chosen due to the importance of Islamic banking in their respective banking systems, as well as data availability. Total assets of the sample Islamic banks amounted to USD480.3 billion in 2012, or 66% of global Islamic banking assets (excluding Iran). Data collected covered a period from 2005 to 1H2013. For some indicators, Islamic banks in certain jurisdictions did not disclose the relevant data in their financial statements. These banks had to be excluded from the analysis with a mention of their exclusion in the text of the chapter. For example, the composition of foreign currency deposits was not disclosed in balance sheets of Islamic banks in Malaysia, Bahrain, Qatar and Bangladesh.

List of Islamic Banks Selected for the Sample	
Bahrain	
ABC Islamic Bank	KFH Bahrain
Al Baraka Islamic Bank	Khaleeji Commercial Bank
Al Salam Islamic Bank	Ithmaar Bank
Bahrain Islamic Bank	
Bangladesh	
Al-Arafah Islami Bank	Islami Bank Bangladesh
First Security Islami Bank	Shahjalal Islami Bank
Indonesia	
Bank BRISyariah	Bank Syariah Mandiri
Bank Muamalat Indonesia	Bank Syariah Mega Indonesia
Bank Syariah Bukopin	
Kuwait	
Ahli United Bank	Kuwait Finance House
Boubyan Bank	Kuwait International Bank
Malaysia	
Affin Islamic Bank	CIMB Islamic Bank
Alliance Islamic Bank	Hong Leong Islamic Bank
AmIslamic Bank	KFH Malaysia
Asian Finance Bank	Maybank Islamic Bank
Bank Islam	Public Islamic Bank
Bank Muamalat	RHB Islamic Bank
Pakistan	
Al Baraka Bank (Pakistan)	Meezan Bank
BankIslami	
Qatar	
Barwa Bank	Qatar Islamic Bank
Masraf Al Rayan	Qatar International Islamic Bank
Saudi Arabia	
Alinma Bank	Bank AlBilad
Al Rajhi Bank	Bank AlJazira
Turkey	
Al Baraka Turk Participation Bank	Kuveyt Turk Participation Bank
Bank Asya Participation Bank	Turkiye Finans Participation Bank
United Arab Emirates	
Abu Dhabi Islamic Bank	Emirates Islamic Bank
Ajman Bank	Sharjah Islamic Bank
Dubai Islamic Bank	

Takāful

Sample data were collected for 27 full-fledged *Takāful* operators in Bahrain, Kuwait, Malaysia, Pakistan, Qatar, Saudi Arabia and UAE. These countries were chosen due to the relative importance of *Takāful* in their respective insurance markets and, more importantly, data availability. Total gross contributions of the sample *Takāful* operators amounted to USD358.6 million in 2012. Data collected covered the period from 2007 to 2012.

List of *Takāful* Operators Selected for the Sample	
Bahrain	
Takaful International Co.	
Kuwait	
Gulf Takaful Insurance Co.	Wethaq Takaful Insurance Co.
Malaysia	
Etiqa Insurance & Takaful	Prudential BSN Takaful
Great Eastern Takaful	Takaful Ikhlas
Hong Leong MSIG Takaful	Takaful Malaysia
Pakistan	
Dawood Family Takaful	Pak Qatar Family & General Takaful
Pak Kuwait Takaful Co.	
Qatar	
Doha Insurance	Qatar Islamic Insurance Co.
Saudi Arabia	
Al-Ahli Takaful Co.	Gulf Union Insurance and Risk Management Co.
Allianz Saudi Fransi	SABB Takaful Co.
Allied Cooperative Insurance Group	Saudi Arabian Cooperative Insurance Co.
Al Sagr Cooperative Insurance Co.	Saudi United Co-operative Insurance Co.
BUPA Arabia for Cooperative Insurance	The Company for Cooperative Insurance (Tawuniya)
United Arab Emirates	
Abu Dhabi National Takaful Co.	Islamic Arab Insurance Co. Salama
Dar Al Takaful	

Appendix 2

Legal Origins of Selected Regions/Countries

REGIONS/COUNTRIES	Legal Origin	Population (million)	Muslims (million)	% of Population
North				
Algeria	French	35.47	34.73	0.979
Egypt	French	81.12	76.99	0.949
Libya	French	6.36	6.14	0.965
Mauritania	French	3.46	3.43	0.991
Morocco	French	31.95	31.94	1.000
Tunisia	French	10.48	10.43	0.995
West				
Benin	French	8.85	2.11	0.238
Burkina Faso	French	16.47	10.15	0.616
Cape Verde	French	0.5		0.000
Ivory Coast	French	19.74	7.39	0.374
Gambia	English	1.73	1.64	0.948
Ghana	English	24.39	3.86	0.158
Guinea	French	9.98	8.43	0.845
Guinea-Bissau	French	1.52	0.68	0.447
Liberia	English	3.99	0.48	0.120
Mali	French	15.37	14.2	0.924
Niger	French	15.51	15.27	0.985
Nigeria	English	158.42	77.3	0.488
Senagal	French	12.43	11.98	0.964
Sierra Leone	English	5.87	4.58	0.780
Togo	French	6.03	0.84	0.139
East				
Burundi	French	8.38	0.23	0.027
Comoros	French	0.73	0.72	0.986
Djibouti	French	0.89	0.86	0.966
Eritrea	French	5.25	1.92	0.366
Ethiopia	English	82.95	28.68	0.346
Kenya	English	40.51	3.92	0.097
Rwanda	French	10.62	0.19	0.018
Seychelles	French	0.09		0.000
Somalia	English	9.33	9.31	0.998
Sudan	English	33.6	30.49	0.907
South Sudan	English	9.95	0.61	0.061
Tanzania	English	44.84	15.77	0.352
Uganda	English	33.42	3.84	0.115

Central				
Cameroon	French	19.6	3.59	0.183
Central African Republic	French	4.4	0.37	0.084
Chad	French	11.23	6.21	0.553
Congo Democratic Republic	French	65.97	0.97	0.015
Equatorial Guinea	French	0.7	0.03	0.043
Gabon	French	1.51	0.17	0.113
Madagascar	French	20.71	0.62	0.030
Southern				
Angola	French	19.08	0.04	0.002
Botswana	English	2.01		0.000
Lesotho	English	2.17		0.000
Malawi	English	14.9	1.93	0.130
Mauritius	French	1.3	0.22	0.169
Mozambique	French	23.39	4.2	0.180
Namibia	English	2.28		0.000
Sao Tome & Principe	French	0.17		0.000
South Africa	English	50.13	0.86	0.017
Swaziland	English	1.19		0.000
Zambia	English	13.09	0.07	0.005
Zimbabwe	English	12.57	0.11	0.009

Source: World Bank (2004); La Porta et al. (1999)

Appendix 3

Characteristics of Financial Institutions and Financial Markets

(A) Characteristics of Financial Institutions

Regions	Depth	Access	Efficiency	Stability
World	53.8 (163)	45.7 (147)	7.9 (126)	15.5 (175)
High Income	107.4 (43)	87.1 (40)	4.2 (26)	16.3 (54)
East Asia and Pacific	51.2 (16)	42.0 (9)	7.2 (17)	14.6 (15)
Europe and Central Asia	40.4 (16)	40.7 (23)	8.2 (17)	9.6 (22)
Latin America and the Caribbean	39.8 (28)	32.0 (20)	9.7 (26)	15.2 (27)
Middle East and North Africa	36.3 (12)	26.6 (12)	4.7 (9)	28.7 (12)
South Asia	38.8 (8)	31.3 (6)	6.2 (6)	18.1 (7)
Sub-Saharan Africa	20.9 (40)	21.0 (37)	11.5 (25)	13.7 (38)

Notes: The figures in parentheses are number of countries.

Depth: Private credit by deposit money banks to GDP (%); Access: Account at a formal financial institution (% age 15+); Efficiency: Bank lending deposit spread (%); Stability: Z-score=[ROA+ (equity/assets)]/st. dev. of ROA.

Source: World Bank (2013a)

(B) Characteristics of Financial Markets

Regions	Depth	Access	Efficiency	Stability
World	66.5 (107)	45.7 (46)	43.7 (106)	25.3 (83)
High Income	101.7 (45)	43.1 (25)	66.5 (45)	26.8 (38)
East Asia and Pacific	68.2 (9)	60.3 (5)	54.6 (9)	25.2 (7)
Europe and Central Asia	22.6 (14)	44.5 (2)	25.7 (14)	31.0 (12)
Latin America and the Caribbean	34.5 (16)	37.1 (6)	11.1 (15)	21.8 (10)
Middle East and North Africa	53.1 (6)	42.9 (4)	24.9 (6)	19.0 (6)
South Asia	32.7 (5)	64.3 (2)	61.6 (5)	23.9 (3)
Sub-Saharan Africa	41.8 (12)	55.0 (2)	8.9 (12)	17.7 (7)

Notes: The figures in parentheses are number of countries.

Depth: Stock market capitalisation + outstanding domestic private debt securities to GDP (%); Access: Market capitalisation excluding top 10 companies to total market capitalisation (%); Efficiency: Stock market turnover ratio (%); Stability: Stock price volatility.

Source: World Bank (2013a)

REFERENCES

AfDB (2012): *Islamic Banking and Finance in North Africa: Past Development and Future Potential*, African Development Bank, Tunis.

AfDB (2013a): *The African Infrastructure Development Index (AIDI)*, African Development Bank, Tunis,www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/Economic%20Brief%20%20The%20Africa%20Infrastructure%20Development%20Index_01.pdf

AfDb (2013b): *Gender, Poverty and Environmental Indicators on African Countries*, African Development Bank, Tunis, www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/Gender%20Poverty%20and%20Environmental%20Indicators%20on%20African%20Countries%202013.pdf

AfDB, OECD, UNDP and ECA (2013): *African Economic Outlook 2013*,www.africaneconomicoutlook.org/fileadmin/uploads/aeo/PDF/Pocket%20Edition%20AEO2013-EN.web.pdf, accessed 15 December 2013.

Ahmed, Habib (2002): "Financing Microenterprises: An Analytical Study of Islamic Microfinance Institutions", *Islamic Economic Studies* 9(2): 27–64.

Ahmed, Habib (2011): *Product Development in Islamic Banks*, Edinburgh University Press, Edinburgh.

Ahmed, Jaseem (2012): *Seminar on The Role of Islamic Finance in the Development of Africa*: Speech, Mauritius, 6 September.

Ahram (2014): "Egypt's *Sukūk* law to be replaced with chapter in the existing securities law: EFSA", *Ahram online*, 13 January, http://english.ahram.org.eg/NewsContent/3/12/91502/Business/Economy/Egypts-sukuk-law-to-be-replaced-with-chapter-in-ex.aspx

Al-ansari, Redha (2013): "Morocco Paving the Way for *Sukūk*", *Finance islamique*, 20 November, http://financeislamiquemaroc.wordpress.com/2013/11/30/morocco-paving-the-way-for-sukuk/

Ali, Salman Syed (2005): *Islamic Capital Market Products – Developments and Challenges*, Islamic Research and Training Institute, Islamic Development Bank Group, Jeddah.

Amara, Tarek (2013): "Tunisian Parliament Approves Islamic *Sukūk* Bond Issues", *Reuters*, 18 July.

Asian Development Bank, www.adb.org

Babiker, Adil A. (2010): "Insolvency of *Takāful* Companies from Legal and *Sharī`ah* Perspectives", 5th IFSB Seminar on Legal Aspects of Islamic Asset Securitization and Insolvency Regimes, Jakarta.

Basel Committee on Banking Supervision (2013): *Capital Requirements for Banks' Equity Investments in Funds*.

Basel Committee on Banking Supervision (2013): *Consultative Document: Fundamental Review of the Trading Book: A Revised Market Risk Framework*.

Basel Committee on Banking Supervision (2013): *Report to G20 Leaders on Monitoring Implementation of Basel III Regulatory Reforms*.

Basel Committee on Banking Supervision (2013): *Consultative Document: Liquidity Coverage Ratio Disclosure Standards*.

Basel Committee on Banking Supervision (2013): *Consultative Document: Revised Basel III Leverage Ratio Framework and Disclosure Requirements*.

Basel Committee on Banking Supervision (2013): *Consultative Document: Supervisory Framework for Measuring and Controlling Large Exposures*.

Basel Committee on Banking Supervision (2013): *Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions*.

Basel Committee on Banking Supervision (2013): *Principles for Effective Risk Data Aggregation and Risk Reporting*.

Basel Committee on Banking Supervision, Basel III (2013): *The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools*.

Basel Committee on Banking Supervision, Joint Forum (2010): *Review of the Differentiated Nature and Scope of Financial Regulation: Key Issues and Recommendations*.

Basel Committee on Banking Supervision, Joint Forum (2013): *Point of Sale Disclosure in the Insurance, Banking and Securities Sectors*.

Beck, Thorsten and Robert Cull (2013): *Banking in Africa*, CSAE Working Paper WPS/2013-16, Centre for Study of African Economies, University of Oxford.

Beck, Thorsten, Samuel Muzele Maimbo, Issa Faye and Thouraya Triki (2011): *Financing Africa: Through the Crisis and Beyond*, The World Bank, Washington, DC.

Bennett, Lynn (1998): "Combining Social and Financial Intermediation to Reach the Poor: The Necessity and the Dangers", in Mwangi S. Kimenyi, Robert C. Wieland and J.D.V. Pischke (eds), *Strategic Issues in Microfinance*, Ahsgate Publishing Ltd, Hants, UK.

Bernanke, Ben, Russell Sage Foundation and the Century Foundation Conference (2012): "Rethinking Finance: Perspectives on the Crisis", New York, 13 April.

Boot, Arnoud W. A. (2011): "Banking at the Crossroads: How to Deal with Marketability and Complexity?",*Review of Development Finance* 1, 167–183.

Brunnermeier, Markus K. (2009): "Deciphering the Liquidity and Credit Crunch 2007–2008", *Journal of Economic Perspectives* 23, 77–100.

Burns, Andrew, Mizuho Kida, Jamus Lim, Sanket Mohapatra and Marc Stocker (2014):"Unconventional Monetary Policy Normalisation and Emerging-Market Capital Flows", *VOX*, 21 January.

Calice, Pietro (2013): "The Trade-off between Financial Inclusion and Financial Stability", in Thouraya Triki and Issa Faye (eds), *Financial Inclusion in Africa*, African Development Bank, Tunis.

Campbell, John Y., Howell E. Jackson, Brigitte C. Madrian and Peter Tufano (2010): *The Regulation of Consumer Financial Products: An Introductory Essay with Four Case Studies*, HKS Faculty Research Working Paper Series RWP 10-040, Harvard Kennedy School.

Carmichael, Jeffrey and Michael Pomerleano (2002): *The Development and Regulation of Non-Bank Financial Institutions*, The World Bank, Washington, DC.

CGAP (2012): *A Guide to Regulation and Supervision of Microfinance: Consensus Guidelines*, World Bank, Washington, DC.

CGAP (2013): *Trends in Sharia-Compliant Financial Inclusion*, World Bank, Washington, DC.

Chami, Ralph, Connel Fullenkamp and Sunil Sharma (2009): *A Framework for Financial Market Developmen*t, IMF Working Paper No. WP/09/156, International Monetary Fund, Washington, DC.

Christen, Robert Peck, Timothy R. Lyman and Richard Rosenberg (2003): *Microfinance Consensus Guidelines: Guiding Principles on Regulation and Supervision of Microfinance*, Consultative Group to Assist the Poor, Washington, DC.

Çizakça, Murat (2004): "Cash *Waqf* as Alternative to NBFIs Bank", Paper presented at the International Seminar on Nonbank Financial Institutions: Islamic Alternatives, jointly organised by Islamic Research and Training Institute, Islamic Development Bank, and Islamic Banking and Finance Institute Malaysia, Kuala Lumpur, 1–3 March.

Collins, Robert O. (2005): *Africa: A Short History*, Markus Wiener, Princeton.

Committee on Payment and Settlement Systems and the International Organization of Securities Commissions (2012): *Principles for Financial Market Infrastructures: Disclosure Framework and Assessment Methodology*.

Committee on Payment and Settlement Systems and the International Organization of Securities Commissions (2013): *Consultative Report: Public Quantitative Disclosure Standards for Central Counterparties*.

DCED (Donor Committee for Enterprise Development) (2013): *Supporting Business Environment Reforms: Practical Guide for Development Agencies*, Donor Committee for Enterprise Development.

de Lima, Pedro, Sabina Zajc, Anna Schumacher and Robert Schmitz (eds) (2013): *Banking in Sub-Saharan Africa: Challenges and Opportunities*, European Investment Bank.

Demirgus-Kunt, Asli and Leora Klapper (2013): "Financial Inclusion in Africa: A Snapshot", in Thouraya Triki and Issa Faye (eds), *Financial Inclusion in Africa*, African Development Bank, Tunis.

Dittus, Peter and Michael Klein (2011): *On Harnessing the Potential of Financial Inclusion*, BIS Working Paper No. 347, Bank for International Settlements.

EBRD (2006): *EBRD Core Principles for a Modern Concessions Law – Selection and Justification of Principles*.

Eichngreen, Barry and Poonam Gupta (2013): "Tapering Talk: The Impact of Expectations of Reduced Federal Reserve Security Purchases on Emerging Markets", *VOX*, 19 December.

El-Gari, Mohamed A. (2004): "The *Qarḍ* Hassan Bank", Paper presented at the International Seminar on Nonbank Financial Institutions: Islamic Alternatives, jointly organised by Islamic Research and Training Institute, Islamic Development Bank, and Islamic Banking and Finance Institute Malaysia, Kuala Lumpur, 1–3 March.

El-Zoghbi, Mayada and Michael Tarazi (2013): *Trends in Sharī`ah-Compliant Financial Inclusion*, CGAP Focus Note No. 84, March.

Ernst & Young (2013): *Global Takāful Insights*.

European Central Bank (2010): "The ECB Response to the Financial Crisis", *Monthly Bulletin*, October.

Farooq, Moazzam and Sajjad Zaheer (2012): *Business Model, Stability, Asset Quality and Efficiency of Conventional and Islamic Banking Institutions: Evidence from an Emerging Economy*, Working Paper.

Faye, Issa and Thouraya Triki (2013): "Financial Inclusion in Africa: The Transformative Role of Technology", in Thouraya Triki and Issa Faye (eds), *Financial Inclusion in Africa*, African Development Bank, Tunis.

Faye, Issa, Thouraya Triki and Thierry Kangoye (2013): "The Islamic Finance Promise: Evidence from Africa", *Review of Development Finance* 3, 136–151.

Fengler, Wolfgang (2012): "How Kenya Became a World Leader for Mobile Money", *blogs.worldbank.org*, 16 July.

Financial Stability Board (2013): *Principles for an Effective Risk Appetite Framework*.

Financial Stability Board (2013): *Consultative Document: Increasing the Intensity and Effectiveness of Supervision*.

Financial Stability Board (2013): *Global Shadow Banking Monitoring Report 2013*.

Financial Stability Board (2013): *FSB Publishes Policy Recommendations to Strengthen Oversight and Regulation of Shadow Banking*, www.financialstabilityboard.org/press/pr_130829a.pdf, 29 August.

Financial Stability Board (2013): *Consultative Document: Assessment Methodology for Key Attributes of Effective Resolution Regimes for Financial Institutions*.

Financial Stability Board (2013): *Consultative Document: Implementation of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions*.

Financial Stability Board (2013): *FSB Releases Guidance Papers on Recovery and Resolution Planning*, www.financialstabilityboard.org/press/pr_130716.pdf, 16 July.

Financial Stability Board (2013): *FSB Data Gaps Initiative on a Common Data Template for G-SIBs*.

Foster, Vivien and Cecilia Briceno-Garmendia (2010): *Africa's Infrastructure: A Time for Transformation*, The World Bank, Washington, DC.

Francavilla, Chiara (2013): "*Morocco to Enact Sukūk Law*", *This is Africa*, 17 May, www.thisisafricaonline.com/News/Morocco-to-enact-sukuk-law?ct=true

Gallardo, Joselito, Korotoumou Ouattara, Bikki Randhawa and William F. Steel (2005): *Comparative Review of Microfinance Regulatory Framework Issues in Benin, Ghana, and Tanzania*, World Bank Policy Research Working Paper 3585, World Bank, Washington, DC.

Gambacorta, Leonardo and Adrian van Rixtel (2013): *Structural Bank Regulation Initiatives: Approaches and Implications*, BIS Working Paper No. 412.

Holzmann, Robert and Teen Jorgensen (2000): *Social Risk Management: A New Conceptual Framework for Social Protection and Beyond*, Social Protection Discussion Paper Series No. 006, World Bank, Washington, DC.

Ibechukwu, Chuks and Clement Fondufe (2013): "Meeting Africa's Infrastructure Needs", *Islamic Finance News*, 25 September.

International Finance Corporation (2009): *The SME Banking Knowledge Guide*, International Finance Corporation, Washington, DC.

International Finance Corporation (2013a): *Access to Credit among Micro, Small, and Medium Enterprises*, International Finance Corporation, Washington, DC.

International Finance Corporation (2013b): *Closing the Credit Gap for Formal and Informal Micro, Small, and Medium Enterprises*, International Finance Corporation, Washington, DC.

International Monetary Fund (2013): *World Economic Outlook: Transitions and Tensions*.

International Organization of Securities Commissions (2003): *Objectives and Principles of Securities Regulation*, International Organization of Securities Commissions, www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf

International Organization of Securities Commissions (2004): *Islamic Capital Market Fact Finding Report*, Report of the Islamic Capital Market Task Force of the International Organization of Securities Commissions.

International Organization of Securities Commissions (2010): *Objectives and Principles of Securities Regulation International Organization of Securities Commissions*, June, www.compliance-exchange.com/governance/library/ioscoprinciples2010.pdf

International Organization of Securities Commissions (2013): *Securities Markets Risk Outlook 2013–2014*.

International Organization of Securities Commissions (2013): *Principles for Financial Benchmarks*.

International Organization of Securities Commissions (2013): *Principles of Liquidity Risk Management for Collective Investment Schemes*.

Irwin, Timothy C. (2007): *Government Guarantees: Allocating and Valuing Risk in Privately Financed Infrastructure Projects*, The World Bank, Washington, DC.

Islamic Financial Services Board (2009): *IFSB-10: Guiding Principles on Sharī`ah Governance Systems for Institutions offering Islamic Financial Services*.

Islamic Financial Services Board (2011): *Standards Implementation Survey*.
Islamic Financial Services Board (2012): 5thIslamic Financial Stability Forum: *Development of Effective Insolvency Regimes for Islamic Financial Institutions*, Vijay Tata.

Islamic Financial Services Board (2012): 6th Islamic Financial Stability Forum: *Developing a Platform for Consumer Protection in the Islamic Financial Services Industry,* Dr Nik Ramlah Mahmood.

Islamic Financial Services Board (2012): *IFSB-12: Guiding Principles on Liquidity Risk Management for Institutions offering Islamic Financial Services [Excluding Islamic Insurance (Takāful) Institutions and Islamic Collective Investment Schemes]*.

Islamic Financial Services Board (2012): *IFSB-13: Guiding Principles on Stress Testing for Institutions offering Islamic Financial Services*.

Islamic Financial Services Board (2013): Proceedings of the 10th IFSB Summit: *The Future of the Islamic Financial Services Industry: Resilience, Stability and Inclusive Growth*.

Islamic Financial Services Board (2013): 7th Islamic Financial Stability Forum: *Financial Reforms in Response to the Global Crisis: Lessons for Islamic Finance in Ensuring Financial Stability*, Speech by Tan Sri Dato' Sri Dr Zeti Akhtar Aziz, Governor, Bank Negara Malaysia, 7 April.

Islamic Financial Services Board (2013): *Islamic Financial Services Industry Stability Report 2013*.

Islamic Financial Services Board (2013): *Strategic Performance Plan 2013–2015*.

Islamic Financial Services Board (2013): *Standards Implementation Survey*.

Islamic Financial Services Board (2013): *IFSB-15*: *Standard on Revised Capital Adequacy for Institutions offering Islamic Financial Services*.

Islamic Financial Services Board (2013): *IFSB ED-16:* Exposure Draft-16: *Revised Guidance on Key Elements in the Supervisory Review Process for Institutions offering Islamic Financial Services*.

Islamic Financial Services Board, International Organization of Securities Commissions and Securities Commission Malaysia (2013): *Disclosure Requirements for Islamic Capital Market Products*.

Islamic Financial Services Board and The World Bank (2011): *Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance*.

Islamic Research and Training Institute, Thompson Reuters and General Council for Islamic Banks and Financial Institutions (2013): *Islamic Finance Country Report: Tunisia Cautiously Optimistic*, June 2013,
www.irti.org/irj/portal/anonymous?NavigationTarget=navurl://2d28885660471e954e9527d938aa2998&LightDTNKnobID=-304292658&guest_user=irti_eng

Jerven, Morten (2013): "Economic Growth", in John Parker and Richard Reid (eds), *The Oxford Handbook of Modern African History*, Oxford University Press, Oxford, pp. 414–433.

Kahf, Monzer (2004): *Sharī`ah and Historical Aspects of Zakah and Awqaf*, Background paper prepared for Islamic Research and Training Institute, Islamic Development Bank.

Karan, Soujail (2012): "Morocco Eyes First Islamic Bank Launch in 2013", *Reuters*, 26 March,www.reuters.com/article/2012/03/26/ozabs-morocco-islamicfinance-idAFJOE82P06W20120326

Karim, Nimrah, Michael Tarazi and Xavier Reille (2008): *Islamic Microfinance: An Emerging Market Niche*, CGAP Focus Note No. 49, Consultative Group Against Poverty, Washington, DC.

Klein, Michael and Colin Mayer (2011): *Mobile Banking and Financial Inclusion: The Regulatory Lessons*, Frankfurt School Working Paper Series No. 166, Frankfurt School of Finance and Management, Frankfurt an Main.

KPMG (2011): "UK Banks: Performance Benchmarking Report",in *Full Year Results 2010*, KPMG.

Laessing, Ulf (2014): "Libya Says Aims to Run Economy, Banking System on Islamic Lines", *Reuters*, 6 January, www.reuters.com/article/2012/10/01/libya-islamicfinance-idUSL6E8L15KW20121001

LaPorta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny (1999): "The Quality of Government", *Journal of Law, Economics and Organization* 15 (1) : 222–279.

Laving, Bilal Abdulaziz (2013): "Islamic Finance in Africa", *Islamic Finance News*, 30 December.

Lukonga, Inutu (2010): "Regulatory Frameworks in Sub-Saharan Africa: Ensuring Efficiency and Soundness", in Marc Quintyn and Genevieve Verdier (eds), *African Finance in the 21st Century*, Palgrave Macmillan, New York.

Matin, Imran, David Hulme and Stuart Rutherford (2002): "Finance for the Poor: From Microcredit to Microfinancial Services", *Journal of International Development* 14: 273–294.

Merton, Robert C. and Zvi Bodie (1995): "A Conceptual Framework for Analysing the Financial Environment", in D.B. Crane, R.C. Merton, K.A. Froot, Z. Bodie, S.P. Mason, E.R. Sirri, A.E. Perold and P. Tufana (Contributors), *The Global Financial System, A Functional Perspective*, Harvard Business School Press, Boston.

Mezui, Cedric, Achille Mbeng and Bim Hundal (2013): *Structured Finance: Conditions for Infrastructure Project Bonds in African Markets*, African Development Bank Group, Tunis.

Miller, Neil D. and Mark Morris (2008): "Application of Islamic Finance to Project Finance", in Ruhail Ali (ed.), *Islamic Finance: A Practical Guide*, Globe Law and Business, London.

Mishkin, Frederic S. (2011): "Over the Cliff: From the Subprime to the Global Financial Crisis", *Journal of Economic Perspectives* 25(1), 49–70.

Mlachila, Montfort, Seok Gil Park and Masafumi Yabara (2013): "Banking in Sub-Saharan Africa: The Macroeconomic Context", in Pedro de Lima, Sabina Zajc, Anna Schumacher and Robert Schmitz (eds), *Banking in Sub-Saharan Africa: Challenges and Opportunities*, European Investment Bank, January, www.eib.org/attachments/efs/economic_report_banking_africa_en.pdf

Mlambo, Kupukile, Louis Kasekende and Victor Murinde (2011): “Comparative Overview of Bank Regulatory Experiences and the Impact on Bank Competition and Intermediation Efficiency in Africa”, inV. Murinde (ed.), *Bank Regulatory Reforms in Africa*, Palgrave Macmillan.

Mu, Yibin, Peter Phelps and Janet G. Stotsky (2013): *Bonds Market in Africa*, IMF Working Paper WP/13/12, International Monetary Fund, Washington, DC.

Ohuocha, Chijioke and Bernardo Vizcaino (2013): “New Rules, Products Lay Groundwork for Nigeria Islamic Finance Sector”, *Reuters*, 6 August.

Parker, John and Richard Reid (eds) (2013): *The Oxford Handbook of Modern African History*, Oxford University Press, Oxford.

Pew (2012): *The Global Religious Landscape: A Report on the Size and Distribution of the World’s Major Religious Groups as of 2010*, Pew Forum on Religion & Public Life, Washington, DC,www.pewforum.org/files/2012/12/globalReligion-full.pdf

PIDA (undated): *Closing the Infrastructure Gap Vital for Africa’s Transformation*, African Development Bank.

Pouchous, Anne (2012*): The Regulation of and Supervision of Microfinance: Main Issues and Progress*, TKN Report, International Institute for Sustainable Development, Winnipeg.

Sanusi, Sanusi Lamido (2011): “Islamic Finance in Nigeria: Issues and Challenges”, Lecture at Markfield Institute of Higher Education, Leicester, UK, 17 June.

Schreiner, Mark (2002): “Aspects of Outreach: A Framework for Discussion of the Social Benefits of Microfinance”, *Journal of International Development* 14: 591–603.

SESRIC (2012): *Islamic Finance in OIC Member Countries*, OIC Outlook Series, Statistical, Economic and Social Research and Training Centre for Islamic Countries, Ankara, May.

Sharkey, Heater J. (2013): “African Colonial States”, in John Parker and Richard Reid (eds), *The Oxford Handbook of Modern African History*, Oxford University Press, Oxford, pp. 151–170.

Siddiqi, M.N. (1999): “Role of Islamic Financial Institutions in Financing Economic Projects”, Paper presented at King Abdulaziz University Seminar on Cooperation between Private Sector and Government, Jeddah.

State Bank of Pakistan (2011): *Strategy Framework for Sustainable Microfinance in Pakistan*, State Bank of Pakistan, www.sbp.org.pk/MFD/Strategic-Framework-SM-24-Jan-2011.pdf

Stein, Peer, Tony Goland and Rober Schiff (2010): *Two Trillion and Counting: Accessing the Credit Gap for Micro, Small, and Medium-Size Enterprises in the Developing World*, IFC and McKinsey & Company.

Takāful Re (2013): *World Islamic Insurance Directory*.

Thani, Nik Norzrul Thani Nik Hassan and Aida Othman (2008): “The Effectiveness of the Legal and Regulatory Framework for Islamic Financial Services”, in *Islamic Finance: Global Legal Issues and Challenges*, Islamic Financial Services Board, Kuala Lumpur, pp. 3-45.

The Banker (2013): Top Islamic Financial Institutions.

Thorat, Usha (2010): "Financial Regulation and Financial Inclusion – Working Together or at Cross-Purposes?", Speech delivered at the Tenth Annual International Seminar on Policy Challenges for the Financial Sector co-hosted by the Board of Governors of the Federal Reserve System, the International Monetary Fund, and the World Bank, Washington, 2–4 June, www.rbi.org.in/scripts/BS_SpeechesView.aspx?id=507

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

Vickers, John (2012): "Some Economics of Banking Reform", University of Oxford, Department of Economics, Discussion Paper Series, 632.

Vizcaino, Bernardo (2013): "Senegal Revives $200 mln *Sukūk* Plan, to Launch in 2014", *Reuters*, 13 October.

Weiss, John and Heather Montgomery (2005): "Great Expectations: Microfinance and Poverty Reduction in Asia and Latin America", *Oxford Development Studies* 33(3&4): 412.

World Bank (2004): *Doing Business in 2004: Understanding Regulation*, Oxford University Press, Washington, DC.

World Bank (2008): *Finance for All? Policies and Pitfalls in Expanding Access*, World Bank Policy Research Report, World Bank, Washington, DC.

World Bank (2013a): *Global Financial Sector Development Report 2014*, World Bank, Washington, DC.

World Bank (2013b), *World Development Indicators 2013*, World Bank, Washington, DC.

World Bank and International Monetary Fund (2005): *FSAP (2005), Financial Sector Assessment: A Handbook*, World Bank and International Monetary Fund, Washington, DC.web.worldbank.org/WBSITE/EXTERNAL/WBI/WBIPROGRAMS/FSLP/0,,contentMDK:20656885~pagePK:64156158~piPK:64152884~theSitePK:461005,00.html

International Association of Insurance Supervisors *(2014)* Financial Stability & Macroprudential Policy & Surveillance Page,www.iaisweb.org/G-SIIs-988

Yurizk (2013): *Global Islamic Finance Education 2013 (GIFE 2013)*, http://reports.yurizk.com/GIFE2013/wp-content/uploads/2013/11/GIFE-2013-Look-Inside.pdf

9 789675 687327

http://www.ifsb.org