



**ISLAMIC FINANCIAL
SERVICES BOARD**

**ISLAMIC FINANCIAL
SERVICES INDUSTRY
STABILITY REPORT
2018**



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Published by: Islamic Financial Services Board
Level 5, Sasana Kijang, Bank Negara Malaysia
2, Jalan Dato' Onn, 50480 Kuala Lumpur, Malaysia

Email: ifsb_sec@ifsb.org

ISBN 978-967-5687-63-1

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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 stringent due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which includes holding several Working Group meetings, the issuance of exposure drafts and organising public hearings/webinars and reviews by the IFSB's Shari'ah Board and Technical Committee. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/educational institutions and market players.

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



LIST OF MEMBERS

As at May 2018, the 185 members of the IFSB comprise 75 regulatory and supervisory authorities, 8 international inter-governmental organisations, and 102 market players (financial institutions, professional firms, industry associations and stock exchanges) operating in 57 jurisdictions.

FULL MEMBERS	
1.	Islamic Development Bank
2.	Central Bank of Bahrain
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5.	Banque Centrale De Djibouti
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17.	Securities Commission Malaysia
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20.	Bank Al-Maghrib, Morocco
21.	Central Bank of Nigeria
22.	National Insurance Commission, Nigeria
23.	State Bank of Pakistan
24.	Qatar Central Bank
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26.	Capital Market Authority, Saudi Arabia
27.	Monetary Authority of Singapore
28.	Central Bank of Sudan
29.	Banking Regulation and Supervision Agency, Republic of Turkey
30.	Central Bank of the Republic of Turkey
31.	Capital Markets Board of Turkey
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33.	Dubai Financial Services Authority, United Arab Emirates

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34.	Asian Development Bank
35.	Bank for International Settlements
36.	International Monetary Fund
37.	World Bank
38.	People's Bank of China
39.	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), Germany
40.	Hong Kong Monetary Authority
41.	Indonesia Deposit Insurance Corporation
42.	Capital Markets Authority, Kenya
43.	Bank of Korea
44.	Capital Markets Authority, Kuwait
45.	Banque du Liban, Lebanon
46.	Central Bank of Libya
47.	Banque Centrale du Luxembourg
48.	Bursa Malaysia
49.	Labuan Financial Services Authority, Malaysia
50.	Malaysia Deposit Insurance Corporation
51.	Banco de Mocambique, Mozambique
52.	Capital Market Authority, Oman
53.	Palestine Monetary Authority
54.	Bangko Sentral ng Pilipinas, Philippines
55.	Qatar Financial Centre Regulatory Authority
56.	Qatar Financial Markets Authority
57.	Insurance Supervisory Authority, Sudan
58.	Khartoum Stock Exchange, Sudan
59.	Bank of Tanzania
60.	Undersecretariat of Treasury, Republic of Turkey
61.	Central Bank of Tunisia
62.	Abu Dhabi Global Market – Financial Services Regulatory Authority, United Arab Emirates
63.	Emirates Securities and Commodities Authority, United Arab Emirates
64.	Bank of Uganda
65.	Bank of England

66.	Banque Centrale Des Etats de L'Afrique de L'Ouest (BCEAO), West African Monetary Union
67.	Conseil Régional de l'Epargne Publique et des Marchés Financiers (CREPMF), West African Monetary Union
68.	Bank of Zambia

OBSERVER MEMBERS**INTERNATIONAL INTER-GOVERNMENTAL ORGANISATIONS**

69.	Banque Ouest Africaine de Développement (BOAD)
70.	Islamic Corporation for the Development of the Private Sector (ICD)
71.	Islamic Corporation for the Insurance of Investment and Export Credit (ICIEC)

AFGHANISTAN

72.	Da Afghanistan Bank
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BAHRAIN

73.	Al Salam Bank
74.	Bahrain Islamic Bank
75.	Bank Alkhair B.S.C.(c)
76.	First Energy Bank B.S.C.
77.	Khaleeji Commercial Bank B.S.C.
78.	Kuwait Finance House
79.	Seera Investment Bank

BANGLADESH

80.	Islami Bank Bangladesh Ltd
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BRUNEI

81.	Bank Islam Brunei Darussalam Berhad
82.	Perbadanan Tabung Amanah Islam Brunei

EGYPT

83.	Al Baraka Bank
84.	Faisal Islamic Bank of Egypt

GERMANY

85.	FWU Group
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HONG KONG

86.	Securities and Futures Commission
87.	Prudential Corporation Asia
88.	Hong Kong Association of Banks

INDONESIA

89.	Bank Muamalat Indonesia
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IRAN

90.	Bank Keshavarzi, Islamic Republic of Iran
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JAPAN

91.	Bank of Japan
92.	Japan Bank for International Cooperation

93.	Japan Securities Dealers Association
94.	Mizuho Bank Ltd
95.	Sumitomo Mitsui Banking Corporation

JORDAN

96.	Ministry of Industry, Trade and Supply
97.	Islamic International Arab Bank
98.	Jordan Islamic Bank

KAZAKHSTAN

99.	Association for Development of Islamic Finance (ADIF)
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KENYA

100.	Chase Bank (Kenya) Limited
101.	First Community Bank

KOREA

102.	Financial Services Commission & Financial Supervisory Service
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KUWAIT

103.	Boubyan Bank K.S.C.
104.	Kuwait Finance House K.S.C.
105.	Kuwait International Bank K.S.C.
106.	KFH Capital Investment Company K.S.C.C.
107.	National Bank of the Kyrgyz Republic

LEBANON

108.	Al Baraka Bank Lebanon
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MALAYSIA

109.	Affin Islamic Bank Berhad
110.	Al Rajhi Banking and Investment Corporation (Malaysia) Berhad
111.	AmBank Islamic Berhad
112.	Bank Islam Malaysia Berhad
113.	Bank Kerjasama Rakyat Malaysia Berhad
114.	Bank Muamalat Malaysia Berhad
115.	Bank of Tokyo-Mitsubishi UFJ (Malaysia) Berhad
116.	Cagamas
117.	CIMB Group Holdings Berhad
118.	Etiqa Takaful Berhad
119.	Export-Import Bank of Malaysia Berhad
120.	Finance Accreditation Agency Berhad
121.	Hong Leong Islamic Bank
122.	International Centre for Education in Islamic Finance (INCEIF)
123.	Kuwait Finance House (Malaysia) Berhad
124.	Maybank Islamic Berhad
125.	MBSB Bank Berhad
126.	Nomura Asset Management Malaysia Sdn Bhd



127.	OCBC Al-Amin Bank Berhad
128.	Prudential BSN Takaful Berhad
129.	RAM Rating Services Berhad
130.	RHB Islamic Bank Berhad
131.	RUSD Investment Bank
132.	Takaful Ikhlas Berhad
MALDIVES	
133.	Maldives Monetary Authority
NIGERIA	
134.	Lotus Capital Ltd
OMAN	
135.	Central Bank of Oman
136.	Bank Muscat S.A.O.G.
137.	Bank Nizwa S.A.O.G.
PAKISTAN	
138.	Securities and Exchange Commission of Pakistan
139.	Habib Bank Limited
QATAR	
140.	Barwa Bank
141.	Masraf Al Rayan
142.	Qatar International Islamic Bank
143.	Qatar Islamic Bank
144.	Qatar National Bank
SAUDI ARABIA	
145.	Al Rajhi Banking and Investment Corporation
146.	Bank AlJazira
147.	National Commercial Bank
148.	Saudi British Bank
SENEGAL	
149.	Ministry of Economy, Finances and Planning
150.	Tamweel Africa Holding
SINGAPORE	
151.	S&P Global Ratings
SOMALIA	
152.	Dahabshil Bank International
SOUTH AFRICA	
153.	Oasis Crescent Capital (Pty) Ltd
SRI LANKA	
154.	Amana Bank
SUDAN	
155.	Al Jazeera Sudanese Jordanian Bank
156.	Al Salam Bank
157.	Bank of Khartoum
158.	Byblos Bank Africa

159.	Faisal Islamic Bank
160.	Islamic Insurance Company
161.	Omdurman National Bank
162.	Shiekan Insurance and Reinsurance Co. Ltd
163.	Sudan Financial Services Company
164.	Sudanese French Bank
165.	Tadamon Islamic Bank
166.	United Insurance Company
TAJIKISTAN	
167.	National Bank of Tajikistan
TURKEY	
168.	Albaraka Turk Participation Bank
169.	Borsa Istanbul
170.	Kuwait Turkish Participation Bank
171.	Turkish Capital Markets Association
172.	Turkiye Finans Katilim Bankasi
173.	Ziraat Katilim Bankasi
TURKISH REPUBLIC OF NORTHERN CYPRUS	
174.	Central Bank of the Turkish Republic of Northern Cyprus
UNITED ARAB EMIRATES	
175.	Insurance Authority
176.	Abu Dhabi Islamic Bank
177.	Al Hilal Bank
178.	Dubai Islamic Bank
179.	Emirates Islamic Bank PJSC
180.	Mashreq Al Islami
181.	Moody's Investors Service Middle East Limited
182.	SALAMA – Islamic Arab Insurance Co.
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UNITED KINGDOM	
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LIST OF ABBREVIATIONS

ABBREVIATIONS	
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ABA	Activities-Based Approach
ABCP	Asset-Backed Commercial Paper
AI	Artificial Intelligence
ALM	Asset Liability Management
AML	Anti-Money Laundering
AuM	Assets Under Management
BCBS	Basel Committee on Banking Supervision
BCO	Banking Companies Ordinance
BDSC	Banking Disputes Settlement Committee
BFSO	Banking and Financial Services (Amendment of Laws) Ordinance
BOFIA	Banks and Other Financial Institutions Act
CAGR	Compound Annual Growth Rate
CAR	Capital Adequacy Ratio
CCL	Commercial Court Law
CDD	Customer Due Diligence
CEBS	Committee of European Banking Supervisors
CFT	Combating the Financing of Terrorism
CI	Cost-to-Income
CIS	Collective Investment Scheme
CMB	Capital Markets Board
CML	Capital Market Law
CPICM	Core Principles for Islamic Finance Regulation [Islamic Capital Market Segment]
CPIFR	Core Principles for Islamic Finance Regulation [Banking Segment]
CRAR	Capital to Risk-weighted Asset Ratio
CSB	Central Shari'ah Board
CSC	Central Bank of Nigeria Shari'ah Council
CVA	Credit Valuation Adjustment
DCR	Displaced Commercial Risk
DJIM	Dow Jones Islamic Market
DLT	Distributed Ledger Technology
EBA	European Banking Authority
ECB	European Central Bank
ECF	Equity Crowdfunding
ECL	Expected Credit Loss
ED	Exposure Draft
ELAR	Eligible Liquid Assets Ratio
ETF	Exchange-Traded Fund
EU	European Union

FAPC	Fit and Proper Criteria
FAS	Financial Accounting Standard
FATF	Financial Action Task Force
FDR	Financing-to-Deposits Ratio
FFR	Financing-to-Funding Ratio
Fintech	Financial Technology
FIS	Facilitating the Implementation of Standards
FKSSK	Financial Stability Coordination Forum
FMI	Financial Market Infrastructure
FMRA	Financial Markets Regulation Authority
FSA	Financial Services Act
FSAP	Financial Sector Assessment Programme
FSB	Financial Stability Board
FSC	Federal Shari'ah Court
FSI	Financial Soundness Indicators
FX	Foreign Exchange
GAAP	Generally Accepted Accounting Principles
GCC	Gulf Cooperation Council
GFC	Global Financial Crisis
GIMAR	Global Insurance Market Report
GP	General Provisions
GRE	Government Related Entities
G-SIB	Global Systemically Important Bank
G-SIFI	Global Systemically Important Financial Institution
G-SII	Global Systemically Important Insurer
HQLA	High-Quality Liquid Assets
HSSA	High Shari'ah Supervisory Authority
IAH	Investment Account Holders
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IBs	Islamic Banks
IBE	Islamic Banking Entity
IBRF	Islamic Banking Regulatory Framework
IC	Insurance Control
ICD	Islamic Corporation for the Development of the Private Sector
ICIS	Islamic Collective Investment Schemes
ICM	Islamic Capital Market
ICPs	Insurance Core Principles
ICS	Insurance Capital Standard
IDB	Islamic Development Bank
IFRS	International Financial Reporting Standards
IFSA	Islamic Financial Services Act
IFSB	Islamic Financial Services Board
IFSI	Islamic Financial Services Industry
IIFS	Institutions offering Islamic Financial Services

IILM	International Islamic Liquidity Management Corporation
IMF	International Monetary Fund
IO	International Organisations
IOSCO	International Organisation of Securities Commissions
IRB	Internal Ratings-Based
IRR	Investment Risk Reserve
IRRBB	Interest Rate Risk in the Banking Book
ISAU	Internal Shari'ah Audit Unit
ISC	Insurance Supervision and Control
SCU	Shari'ah Compliance Unit
ISRU	Internal Shari'ah Review/Audit Unit/Department
LA/SL	Liquid Assets to Short-term Liabilities Ratio
LCR	Liquidity Coverage Ratio
LSCIC	Law on Supervision of Cooperative Insurance Companies
LSPB	Law of Settlement Preventing Bankruptcy
M&A	Mergers and Acquisitions
MAV	Market Adjusted Valuation
MCCOs	Mutuals, Cooperatives and Community-based Organisations
MCR	Minimum Capital Requirement
MDB	Multilateral Development Banks
MENA	Middle East and North Africa
ML/FT	Money Laundering and Financing of Terrorism
MTPL	Motor Third Party Liability
NIFI	Non-Interest Financial Institutions
NPF	Non-Performing Financing
NPL	Non-Performing Loans
NSFR	Net Stable Funding Ratio
OECD	Organization for Economic Cooperation and Development
OIC	Organisation of Islamic Cooperation
OMR	Omani Rial
OPEC	Organization of the Petroleum Exporting Countries
ORSA	Own Risk and Solvency Assessment
OTC	Over the Counter
P2P	Peer to Peer
PCR	Prescribed Capital Requirement
PD	Primary Dealer
PER	Profit Equalisation Reserve
PIF	Participants' Investment Fund
PRF	Participants' Risk Fund
PSIA	Profit Sharing Investment Accounts
PSIFIs	Prudential and Structural Islamic Financial Indicators
PVA	Prudent Valuation Adjustment
RAP	Resolvability Assessment Process
RBA	Risk-Based Approach
REIT	Real Estate Investment Trust

ROA	Return on Assets
ROE	Return on Equity
RRP	Resolution and Recovery Plan
RSA	Regulatory and Supervisory Authority
RSBM	Resident Shari'ah Board Member
R-SbM	Reduced Sensitivities-based Method
RTO	<i>Retakāful</i> Operator
RTU	<i>Retakāful</i> Undertaking
RWA	Risk-Weighted Assets
SA	Standardised Approach
SAC	Shari'ah Advisory Council
SAGs	Standards and Guidelines
SB	Shari'ah Boards
SbM	Sensitivities-Based Method
SCD	Shari'ah Compliance Division
SCDIS	Shari'ah-Compliant Deposit Insurance Scheme
SDIF	Saving Deposit Insurance Fund
SEC	Securities and Exchange Commission
SGF	Shari'ah Governance Framework
SGS	Shari'ah Governance Systems
SHF	Shareholders' Fund
SME	Small and Medium-size Enterprises
SP	Specific Provisions
SPV	Special Purpose Vehicle
SRI	Social Responsible Investment
SRP	Supervisory Review Process
SSB	Shari'ah Supervisory Board
STC	Simple, Transparent and Comparable
TA	Technical Assistance
TFC	Term Finance Certificate
TLAC	Total Loss-Absorbing Capacity
TN	Technical Note
TO	<i>Takāful</i> Operator
TOR	Terms of Reference
TU	<i>Takāful</i> Undertaking
UAE	United Arab Emirates
WAEMU	West African Economic and Monetary Union

GLOSSARY

<i>Ar-Rahnu</i>	A contract to withhold an asset for the benefit of the creditor as a security against a debt whereby the creditor (murtahin) is entitled to hold custody of the asset actually or constructively. In the event of default by the debtor (<i>rāhin</i>), the creditor has the right to sell the asset.
<i>Commodity Murābaḥah or Tawarruq</i>	A <i>murābaḥah</i> transaction based on the purchase of a commodity from a seller or a broker and its resale to the customer on the basis of deferred <i>murābaḥah</i> , followed by the sale of the commodity by the customer for a spot price to a third party for the purpose of obtaining liquidity, provided that there are no links between the two contracts.
<i>Diminishing Mushārakah</i>	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 at 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.
<i>Fatāwa</i>	A juristic opinion given by the Sharī'ah board, on any matter pertinent to Sharī'ah issues, based on the appropriate methodology.
<i>Fiqh</i>	Knowledge of the legal rulings pertaining to conduct, which have been derived from specific evidence.
<i>Ijārah</i>	A contract made to lease the usufruct of a specified asset for an agreed period against a specified rental. It could be preceded by a unilateral binding promise from one of the contracting parties. As for the <i>Ijārah</i> contract, it is binding on both contracting parties.
Islamic window	That part of a conventional financial institution (which may be a branch or a dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are Sharī'ah-compliant, with separate funds. It could also provide <i>Takāful</i> or <i>Retakāful</i> services.
<i>Istiṣnā'</i>	The sale of a specified asset, with an obligation on the part of the seller to manufacture/construct it using his own materials and to deliver it on a specific date in return for a specific price to be paid in one lump sum or instalments.
<i>Maqāṣid al-Sharī'ah</i>	The fundamental principles of Sharī'ah, which aim to promote and protect the interests of all human beings and avert all harm that impairs their interests.
<i>Muḍārabah</i>	A partnership contract between the capital provider (<i>Rabb al-Māl</i>) and an entrepreneur (<i>Muḍārib</i>) 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 misconduct, negligence or breach of contracted terms.
<i>Murābaḥah</i>	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.
<i>Mushārakah (Sharikat al-'Aqd)</i>	A partnership contract in which the partners agree to contribute capital to an enterprise, whether existing or new. Profits generated by that enterprise are shared in accordance with the percentage specified in the <i>mushārakah</i> contract, while losses are shared in proportion to each partner's share of capital.
<i>Qarḍ</i>	The payment of money to someone who will benefit from it provided that its equivalent is repaid. The repayment of the money is due at any point in time, even if it is deferred.

<i>Retakāful</i>	An arrangement whereby a <i>takāful</i> undertaking cedes a portion of its risks on the basis of treaty or facultative <i>retakāful</i> as a representative of participants under a <i>takāful</i> contract, whereby it would contribute a portion of the contribution as <i>tabarru'</i> into a common fund to cover against specified loss or damage.
Sharī'ah	The practical divine law deduced from its legitimate sources: the Qur'ān, Sunnah, consensus (<i>Ijmā'</i>), analogy (<i>Qiyās</i>) and other approved sources of the Sharī'ah.
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.
Sharī'ah non-compliance risk	An operational risk resulting from non-compliance of the institution with the rules and principles of Sharī'ah in its products and services.
<i>Ṣukūk</i>	Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of tangible assets and other types of assets. These assets could be in a specific project or specific investment activity that is Sharī'ah-compliant.
<i>Tabarru'</i>	The amount of contribution that the <i>takāful/retakāful</i> participant commits to donate in order to fulfil the obligation of mutual help in bearing the risks and paying the claims of eligible claimants.
<i>Takāful</i>	A mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the participants' risk fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.
<i>Tawarruq</i>	A <i>murābaḥah</i> transaction based on the purchase of a commodity from a seller or a broker and its resale to the customer on the basis of deferred <i>murābaḥah</i> , followed by the sale of the commodity by the customer for a spot price to a third party for the purpose of obtaining liquidity, provided that there are no links between the two contracts.
<i>Wadī'ah</i>	A contract for the safekeeping of assets on a trust basis and their return upon the demand of their owners. The contract can be for a fee or without a fee. The assets are held on a trust basis by the safekeeper and are not guaranteed by the safekeeper, except in the case of misconduct, negligence or breach of the conditions.
<i>Wakālah</i>	An agency contract where the customer (principal) appoints an institution as agent (<i>wakīl</i>) to carry out the business on his behalf. The contract can be for a fee or without a fee.
<i>Zakāh</i>	An obligatory contribution or tax which is prescribed by Islam on all Muslims having wealth above an exemption limit at a rate fixed by the Sharī'ah. The objective is to make available to the state a proportion of the wealth of the well-to-do for distribution to the poor and needy.

FOREWORD

The sixth edition of the Islamic Financial Services Board's (IFSB) Islamic Financial Services Industry Stability Report takes place against a better than expected global economic performance in 2017, marking its most promising sign of recovery since the global financial crisis of 2007-08. This recovery was broadly led by a notable rebound in global trade as well as investment recovery in advanced economies.

Amid a partial recovery in commodity prices, several commodities exporting countries also experienced a positive upturn. The progress in 2018 so far, appears to be threatened on account of an increasingly volatile global economic environment led by considerable downside risks emanating from tit-for-tat implementation of protectionist policies amongst the world's major economies and trading partners. The political landscape remains ever challenging with wider implications for regional instability and ensuing economic challenges. The broader international trade and tariffs-related disputes also risk currency wars leading unto foreign exchange and other market-risk considerations by the financial sector stakeholders.

However, there is growing market share and rising domestic systemic importance of Islamic finance which underscores the importance of developing strong regulatory frameworks for prudential regulation and supervision in Islamic finance jurisdictions, supported by proactive stress testing and an enhanced set of capabilities for macroprudential surveillance. In line with its mandate, the IFSB has responded on a number of fronts to such international developments with a series of next-generation prudential standards and guiding principles that align global regulatory frameworks with the specificities of Islamic finance. Aside from Standards and Guidance/Technical Notes, the IFSB Work Plan in recent years has also included working papers on diverse topics of emerging issues in Islamic finance including financial safety-nets, consumer protection, Shari'ah non-compliance risk, resolution and recovery regimes, systemic links and macroprudential issues, and so on. Going forward, along with strengthening its standards implementation programme by adding impact and consistency assessment dimension, the IFSB will continue to develop new standards and guiding principles for covering all sectors of IFSI.

Against this backdrop, the IFSI Stability Report 2018 examines the implications on the global Islamic financial services industry (IFSI) of recent economic developments and changes in the global regulatory and supervisory frameworks. Despite two years of assets' growth stagnation, the global IFSI – covering Islamic banking, Islamic capital market and Islamic insurance (*Takāful*) sector – has surpassed the milestone USD 2 trillion mark in 2017, marking an 8.3% growth in assets in US Dollar terms. The robust growth was contributed actively by all three sectors of the IFSI, but the key rebound in performance was experienced by the Islamic capital markets.

The IFSI Stability Report 2018 was produced by a core team from the Technical and Research Department of the IFSB Secretariat, led by Mr. Zahid Ur Rehman Khokher, Assistant Secretary-General, and comprising Mr. Syed Faiq Najeeb, Ms. Aminath Amany Ahmed, Mr. Tarig Mohamed Taha Abdelgadir, Dr. Dauda Adeyinka Asafa, Mr. Md Salim Al Mamun and Mr. Esam Osama Al-Aghbari. External contributors are Professor Habib Ahmed, Professor Volker Nienhaus and Mr. Peter Casey. Dr. Abideen Adeyemi Adewale and Ms. Rosmawatie Abdul Halim also from IFSB, provided assistance in the formatting and publication of the final document.

As always, we hope that the IFSI Stability Report 2018 will serve not only as a useful complement to the better understanding of issues by the various stakeholders of the IFSB, but also contribute to a wider cross-border engagement on stability issues in Islamic finance, while helping to strengthen the building blocks needed for greater resilience.

Dr. Bello Lawal Danbatta
Secretary-General
Islamic Financial Services Board
June 2018

EXECUTIVE SUMMARY

PREAMBLE

The IFSB's IFSI Stability Report 2018 seeks to illuminate issues that posed current and future challenges to the stability of the global Islamic finance services industry especially in IFSB's member jurisdictions for the best interest of IFSB's wide membership, as well as for all those who have a substantive interest in the stability and resilience of Islamic finance. The broad themes and coverage in each of the four chapters of the IFSI Stability Report 2018 are as follows:

Chapter 1 provides an overview of the global IFSI as well as updates on trends, growth and developments in the three main sectors of the industry - Islamic banking, Islamic capital market and *takāful*.

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 IIFS. It also reviews the progress of various projects and initiatives undertaken by the IFSB to enhance the supervisory framework so as to ensure stability and soundness of the IFSI. These initiatives include updates on the development of new standards for the IFSI, surveys on existing regulatory and market principles and practices implemented, and also research undertaken for IFSB working paper series. This chapter also provides an update on the implementation progress of the IFSB Standards in 2017 across various member jurisdictions.

Chapter 3 assesses the resilience of the Islamic financial system, which includes technical analysis of selected indicators as well as assessment of risks, vulnerabilities and stability issues in the three main sectors of IFSI: Islamic banking, Islamic capital market and *takāful*.

This report also includes a box article each by Autoriti Monetari Brunei Darussalam and the Central Bank of Oman, examining the development of the Islamic financial sector in the respective jurisdictions. A further box article is contributed by the International Islamic Liquidity Management Corporation (IILM) discussing regulators' response towards specific market enhancement. The IFSB hopes that this form of collaboration with other institutions will lead to the development of a global network of expertise that can help to increase awareness and understanding of emerging issues faced by the IFSI.

Finally, Chapter 4 addresses emerging issues in Islamic finance and conducts a comprehensive analysis into the diversity of the legal infrastructure and Sharī'ah governance frameworks as applied in various jurisdictions. The chapter looks into a number of areas including legal systems for Islamic finance, resolution framework for Islamic banks and Sharī'ah governance regimes.

A synopsis of the key contents of the *IFSI Stability Report 2018* is provided below.

SIZE AND RESILIENCE OF THE IFSI

After two years of marginal increases, the Islamic financial services industry (IFSI) returned to strong (8.3%) growth, and its total worth slightly surpassed the USD 2 trillion mark. The main growth drivers were *ṣukūk* issuances by sovereigns and multilateral institutions. The volume of *ṣukūk* outstanding grew by 25.6%, and assets of Islamic funds grew by almost 19%. Islamic banking assets grew by only 4.3%, reducing the share of Islamic banking in the total value of the IFSI to 76%; while the share of the Islamic capital market (ICM; *ṣukūk* outstanding plus Islamic funds' assets) increased to nearly 23%. *Takāful* contributions increased by 4% and retained a 1.3% share of the total IFSI value.

ISLAMIC BANKING

Size, Structure and Trends: The market shares of Islamic banks (i.e. shares in the total domestic banking assets) increased in at least 19 jurisdictions and remained constant in seven others. Declines of market shares were reported in six jurisdictions. Islamic banking is categorised as systemically important in 12 jurisdictions where the market shares have reached 15%. Collectively, they account for 92% of the global Islamic banking assets. Apart from two jurisdictions with market shares of 100% (Iran, Sudan), the shares in most of the ten jurisdictions with dual banking systems increased, while it decreased in only one country (Qatar). Collectively, these 12 jurisdictions account for 92% of the global Islamic banking assets. The largest are Iran (34.4% of global Islamic banking assets), Saudi Arabia (20.4%), United Arab Emirates (UAE) (9.3%), Malaysia (9.1%), Kuwait (6.0%) and Qatar (6.0%).

While the average growth rate of Islamic banking assets was in the moderate single digits, more than half of

the jurisdictions for which detailed data were available achieved double-digit growth rates of assets (8 of 15), financing (8 of 15), and deposits (9 of 13). Most Asian countries reported growth rates of between close to 10% and well above 20%. On the other hand, Gulf Cooperation Council (GCC) economies are feeling the strain from persistently low oil prices, with most Islamic banking growth rates below the average of 4%. Several countries in North and sub-Saharan Africa are making efforts to introduce Islamic banking services which would enhance the industry's growth prospects in the future.

Resilience: Global Islamic banking has sustained its resilience, and most of its stability indicators are in comfortable compliance with the minimum international regulatory requirements. However, global Islamic banking can no longer claim to be superior to conventional banking in all the stability dimensions. For example, Islamic banks clearly outperform European Union (EU) banks in terms of return on assets (ROA), return on equity (ROE) and cost-to-income, but the capitalisation of EU banks is now stronger than that of Islamic banks and the non-performing loans ratio of EU banks is better than the non-performing financing (NPF) ratio of Islamic banks.

It should be noted that such averages are the result of very divergent developments in different markets. In some large markets, Islamic banks have experienced a squeeze in their profit margins and persistently high rates of NPF, while banks with smaller financial bases have suffered from a volatility of key fundamentals. Islamic banks in a number of countries are also increasingly exposed to foreign exchange rate fluctuations.

The IFSI Stability Report provides detailed information on key stability indicators such as aggregate global Islamic banking ROA and ROE, country-specific ROA, cost-to-income ratios, comparisons between Islamic stand-alone banks and windows, trends of gross NPF, financing and funding in foreign currency, financing-to-deposit ratios, and liquid assets to short-term liabilities ratios.

ISLAMIC CAPITAL MARKET

The Islamic capital markets saw positive developments during 2017 in all segments: the sizeable growth of the *shukūk* market was driven by large sovereign issuances, Islamic equities had a strong performance, and the volume of assets under management in Islamic funds has increased.

Shukūk: Total annual *shukūk* issuances grew by 23% to USD 92 billion as at the end of 2017. The drivers were large sovereign issuances from the GCC region, where governments had to finance substantial budget deficits

caused by the persistently low oil prices. Conventional bonds were the instruments of choice in 2015 and 2016, as the structuring of *shukūk* is more complex and time-consuming. In 2017, sovereigns and government-related entities (GREs) diversified their funding mix and investor base and responded to the strong demand for *shukūk* by Islamic banks. Sovereigns, including GREs and multilaterals across 16 jurisdictions – with Hong Kong being the only non-member of the Organisation of Islamic Cooperation (OIC) – issued USD 76 billion of sovereign *shukūk*. Saudi Arabia alone (excluding the multilateral Islamic Development Bank) raised nearly USD 27 billion consisting of both international and domestic *shukūk* issuances. The share of short-term *shukūk* in total sovereign issuances was considerably less in 2017 (6.3%) than in previous years. Out of a total of USD 4.8 billion of short-term *shukūk*, the International Islamic Liquidity Management Corporation (IILM) alone issued USD 3 billion.

The volume of corporate *shukūk* issuances had decreased from 2012 to 2016, but saw a modest growth of 2.3% – to a total of USD 16 billion – in 2017. Of this, 61% was issued by Malaysian corporates, and 39% by corporates in eight other jurisdictions.

Combining sovereign and corporate *shukūk* issuances, and attributing issuances of multilateral development banks (MDBs) and international organisations (IOs) to their countries of domicile, Malaysia (with the IILM) was the largest issuer with 38% of total issuances in 2017, followed by Saudi Arabia (with the IDB) with 33%. All the other 14 jurisdictions have shares of 6% and less. In terms of issuances by sectors, government was dominant (with 57%), followed by financial services (with 18%) and real estate (with 6%). In terms of maturity profiles, the five–ten years bracket has reached 45%, and the three–five years bracket 31%. *Shukūk* with a maturity of less than one year shrank to their lowest share (6%) since 2009.

From a pricing perspective, in 2017 there has been an apparent squeezing of premiums payable between financial risk-identical *shukūk* and bond instruments at the point of issuance. Across a sample of domestic sovereign *shukūk* issuers, the spread between *shukūk* and bonds was reduced to 0.1 percentage points or less. Within these, at least one jurisdiction is now pricing *shukūk* and bonds equally, while another is pricing *shukūk* at a discount in contrast to risk-identical bonds. However, in secondary markets, across the various sample jurisdictions, investors were trading *shukūk* at higher returns in contrast to risk-identical bonds.

Equity Indices: Most Islamic equity indices performed better than conventional benchmarks, due mainly to their greater exposure to the technology sector which was the top performer in 2017. Other large sectors that performed well on Islamic indices are health care,

industrials and materials. From a regional perspective, the performance of both Islamic and conventional indices in the GCC was weaker than in previous years due to the negative macroeconomic impacts of low oil prices and geopolitical instability in the region.

Islamic Funds: The number of Islamic funds has decreased marginally to 1,161 in 2017, but assets under management (AuM) increased by 19% to USD 67 billion. Saudi Arabia accounts for 37% of the funds, while 32% are domiciled in Malaysia. 20 of the 34 domiciles of Islamic funds are non-OIC countries, such as Ireland, the United States or Luxembourg, with combined AuM of nearly 20% of the total. Nearly half (42%) of the AuM are invested in equity funds, 26% in money market funds, and 14% in commodity funds. Although the average size of active Islamic funds has grown to USD 80 million, they were still significantly smaller than conventional funds (i.e. the issue of sufficient scale is still on the agenda for Islamic funds).

TAKĀFUL

The global *takāful* contributions continued to grow by 12.5% in 2016 (13% in 2015) to a total of USD 26 billion. The four largest *takāful* markets are Saudi Arabia (38% of global *takāful* contributions), Iran (34%), Malaysia (7%) and the UAE (6%). The growth in Saudi Arabia dropped to 2.1% as a result of the economic slowdown due to low oil prices. In contrast, the growth rate in Iran was 23.3%. Out of 305 *takāful* operators and windows, 107 are licensed for general *takāful* and 57 for family *takāful*, 116 hold composite licences, and 25 are *retakāful* operators. General *takāful* (primarily health and motor insurance) is the dominant segment of the industry (particularly in the GCC and MENA region) with a share of 88% of total global contributions. However, in South-East Asia (Malaysia, Indonesia, and Brunei) family *takāful* is the larger business segment.

The retention ratio has improved across the markets as a result of better risk management capabilities and the growth of general *takāful* business lines with more predictable loss experiences (such as motor *takāful*).

Performance measures for *takāful* undertakings include the ROE and ROA. These profitability ratios are also indicators for the resilience of the sector. Overall, the *takāful* industry was profitable in 2016 with positive ROE and ROA in all 10 countries for which data were available. Compared to the average of 2012-2015, ROE in 2016 has increased in seven and decreased in three countries; ROA increased in four and decreased in five countries and did not change in one. A variety of factors (some of which were singularities) have contributed to these results, for example the introduction of mandatory insurance, a macroeconomic contraction, new insurance regulations, mergers and acquisitions, tariff

interventions, or better pricing techniques. This makes generalisations and industry-wide forecasts difficult, but a few factors can be identified: The low insurance penetration, the growing population and the increasing wealth in Muslim countries indicate growth potentials for larger scale operations with improved efficiency and stronger resilience of the industry.

CHANGES IN THE GLOBAL FINANCIAL ARCHITECTURE

A number of developments in the global regulatory systems have had, or will have, an impact on the IFSI and the work of the Islamic Financial Services Board (IFSB).

Financial Stability Board (FSB): The FSB has published several documents on resolution and recovery of financial institutions, dealing with – among others – key attributes of effective resolution regimes, access to financial market infrastructures for a firm in resolution, principles on bail-in execution, and resolution funding. The FSB emphasises the operationalisation of resolution plans, and has addressed issues related to global systemically important banks (G-SIBs). G-SIBs do not exist in Islamic banking, but the IFSB has worked on insolvency, resolution and recovery of institutions offering Islamic financial services (IIFS), has published a working paper on this topic in December 2017 (see below), and will consider the applicability of the recent FSB guidance in Islamic finance.

Basel Committee on Banking Supervision (BCBS): The BCBS finalised the Basel III reforms to address observed weaknesses regarding, in particular, the calculation of risk-weighted assets (RWAs) by banks and the comparability of their capital ratios. The final version of the standardised approaches for credit risk, credit valuation adjustment risk and operational risks will impact Islamic finance, especially the approaches for credit and operational risks in IFSB-15 which will have to be revised in line with the final version of Basel III. There is other relevant work, covering issues such as a simplified alternative to the standardised approach for market risk capital requirements, criteria for simple, transparent and comparable (STC) short-term securitisations and their capital treatment, and the definition of non-performing exposures and forbearance, which will be considered as part of the same revision.

The BCBS issued a consolidated and enhanced framework for Pillar 3 disclosure requirements which will be considered in the ongoing revision of IFSB-4 on disclosure to promote transparency and market discipline for IIFS (see below).

A new version of the BCBS's principles for sound stress testing practices, which incorporates the principle of proportionality, has been released for consultation. The

IFSB will consider a revision of its standards on stress testing for IIFS (IFSB-13 and TN-2) to incorporate the revised BCBS guidelines.

International Organization of Securities Commissions (IOSCO): IOSCO has published an update of its objectives and principles of securities regulation, as well as its corresponding methodology for assessing their implementation. The IFSB is currently developing a complementary standard and assessment methodology for the Islamic securities sector (see below).

A report on the liquidity of the secondary corporate bond markets identifies several structural changes related to, for example, the inventory levels of dealers, electronic trading, and the shift of dealers towards an agency model. The limited liquidity and infrequent trading in the secondary *shukūk* market is a long-standing concern in the ICM. The IFSB finds merit in enhanced regulatory reporting and public transparency for secondary corporate *shukūk* markets in line with recommendations of IOSCO (although the *shukūk* market is largely dominated by sovereign *shukūk* issuances).

Liquidity risks of collective investment schemes (CIS) have been addressed in IOSCO consultation papers. They are also relevant in the Islamic funds industry – in particular, for operators that invest in unlisted or relatively illiquid assets. They have only limited options for raising emergency liquidity as Sharī'ah-compliant money markets are generally non-existent in most jurisdictions.

International Association of Insurance Supervisors (IAIS): A major concern of the IAIS is its development of an insurance capital standard (ICS). The IFSB is monitoring closely the development of the ICS. Although the ICS is intended for internationally active insurance groups, it may be applied more widely and will point to the direction for a revision of the standard on solvency requirements for *takāful* undertakings (IFSB-11).

The IAIS is conducting a rolling revision of its insurance core principles (ICPs). When the text of these stabilises, the IFSB will consider the development of a complementary set of principles for the *takāful* sector.

The IAIS is also working on the development of an activities-based approach to systemic risk assessment in the insurance sector. This, and activities elsewhere, suggests that thinking on systemic risk outside the banking sector is moving away from an entity-based approach towards one based on activities across markets. This will be significant for the IFSI as its scale grows.

Financial Action Task Force (FATF): The FATF has published a guidance note on anti-money laundering

and terrorist financing measures in financial inclusion. This will directly inform the IFSB's current work in developing a technical note on financial inclusion and Islamic finance. Issues of money laundering and terrorist financing in relation to IIFS will also be studied in a joint research paper by the IFSB, the IMF and the Arab Monetary Fund.

Fintech: Fintech has become an issue for several standard-setting bodies, each of them focusing on different aspects of innovative financial technologies that can be applied in conventional as well as Islamic finance.

The FSB has focused on the financial stability implications of Fintech. A report found that there are currently no financial stability risks, since Fintech is still small in size, but that can change quickly. Another report found that artificial intelligence and machine learning can support financial stability by improving efficiency in the provision of financial services and regulatory and systemic risk surveillance. However, network effects and third-party dependencies on a few technology firms may create a new type of stability risk.

IOSCO has identified regulatory challenges regarding platforms for (i) financing (including peer-to-peer, or P2P, lending and equity crowdfunding), (ii) retail trading and investment (including robo-advisers and social trading/investing), and (iii) institutional trading (especially bond trading). Compliance software and surveillance tools can support regulators in monitoring platform activities and detecting misconduct.

An IAIS report has developed scenarios on Fintech's potential to transform existing business models and generate new ones in the insurance industry. Fintech can change the competitive environment in insurance markets: tech-savvy firms may become dominant, technical efficiency may increase, and products will be more individualised, and insurers may become dependent on a small number of technology providers. Fintech activities in the IFSI are still relatively modest, but the IFSB will continue to monitor developments. The IFSB is also actively exploring the utilisation of Fintech and other digital platforms to promote financial inclusion in its on-going work in a technical note on financial inclusion and Islamic finance.

RECENT INITIATIVES OF THE IFSB

Development of New Standards: The standard-setting activities of the IFSB in 2017 cover all three sectors of the IFSI: a standard on the supervisory review process for the *takāful* sector; a revised standard on disclosures to promote transparency and market discipline for the Islamic banking sector; and the core principles for Islamic finance regulation for the ICM segment. For all

these three standards, the exposure drafts were issued in March 2018 with the final standards adoption expected by end-2018 (subject to IFSB Council approval). In addition, work on a technical note on financial inclusion and Islamic finance is ongoing.

The coming standard, Guiding Principles on Key Elements in the Supervisory Review Process of *Takāful/Retakāful* (ED-20), builds on the previously issued standards IFSB-8, 11, 14 and 18. It identifies seven areas for supervisory review: corporate governance, Shari'ah governance, *takāful* operational framework, capital adequacy, *retakāful*, risk management, and *takāful/retakāful* windows. The standard recommends a risk-based approach to the process of supervision. Tools for the detection and handling of significant risks include supervisory reporting, off-site monitoring, on-site inspection, supervisory follow-up, enforcement, event-based supervision, and thematic review. A primary concern of regulatory and supervisory agencies (RSAs) is the ability of *takāful/retakāful* undertakings to meet regulatory solvency requirements in a Shari'ah-compliant manner. A risk-based prescribed capital requirement (PCR) is calculated as a trigger of supervisory interventions if the financial strength deteriorates, and falling short of the minimum capital requirement (MCR) may trigger the withdrawal of authorisation due to inadequate capital. In supervising *takāful/retakāful* windows, RSAs have to observe whether appropriate Shari'ah governance is in place. The standard also discusses issues of group supervision, conduct of business, and *takāful* undertakings under run-off.

The Core Principles for Islamic Finance Regulation [Islamic Capital Market Segment] (CPICM) [ED-21] will be a complementary standard to IOSCO's Objectives and Principles of Securities Regulation and Its Assessment Methodology. The objectives of the CPICM are: (i) to provide a minimum international standard for sound supervisory practices for the ICM; (ii) to protect consumers and other stakeholders to whom claims of Shari'ah compliance have been made; and (iii) to enhance the soundness and stability of the ICM by improving the quality of supervisory systems. The IFSB standards already published will be reflected in the CPICM, which can be used as a benchmark for assessing the quality of regulatory and supervisory systems. The CPICM may also help the IFSB members in the International Monetary Fund (IMF) and the World Bank financial sector assessment programmes (FSAP) or peer reviews within regional groupings of RSAs.

The disclosure and transparency standard IFSB-4 was adopted in 2007. In response to the Global Financial Crisis (GFC), the BCBS has made far-reaching revisions in its standards for banking regulation. The Revised Standard on Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial

Services [Banking Segment] (ED-22) shall bring the disclosure regulations for Islamic banking to the current level of Pillar 3 disclosure requirements of Basel III. The main objectives of the standard are: (i) to facilitate access to relevant, reliable and timely information by market participants – in particular, investment account holders (IAH); (ii) to improve the comparability and consistency of all disclosures made by IIFS; and (iii) to support financial consumer protection. The new standard will widen the scope of IFSB-4 and include disclosures on, among other things, regulatory risk metrics, macroprudential measures, remuneration practices, profit-smoothing techniques, profitability indicators and the utilisation of profit-sharing investment accounts (PSIA) funds, *Zakāh* policies, and Shari'ah governance and compliance arrangements.

IFSB Implementation Survey 2017: The IFSB conducted its sixth implementation survey, covering 12 standards for banking, one for ICM, four for *takāful*, and two cross-sectoral standards. Forty-two RSAs participated, representing 28 jurisdictions. The results are very similar to those obtained in 2016. For Islamic banking, one jurisdiction has implemented 100% of the standards, while another four jurisdictions have implemented more than 75% of the standards. For *takāful*, seven jurisdictions have implemented all IFSB standards; while for ICM, four jurisdictions have implemented the standard.

The most significant challenges faced by the RSAs, according to the survey, are the need for detailed knowledge of Islamic finance in order to transform standards into regulations and rulebooks. African and European RSAs see the small size of the industry as a challenge in making implementation viable. For all sectors, workshops on facilitating the implementation of standards (FIS) were the most required form of support requested by RSAs from the IFSB Secretariat, followed by "Preparing more Technical Notes" and "Providing Technical Assistance".

Other IFSB Initiatives:

- A working paper on "Recovery, Resolution and Insolvency Issues for Institutions Offering Islamic Financial Services" examines what an effective recovery and resolution framework should look like from the perspective of regulatory and Shari'ah principles. Key issues that need to be addressed include: the need to harmonise Shari'ah principles of recovery and resolution with secular bankruptcy and insolvency frameworks; bail-in features of shareholder equity and Additional Tier 1 (AT1) *mushārakah shukūk* from regulatory and Shari'ah perspectives; and the treatment of IAH and of funds in the profit equalisation reserve (PER) and investment risk reserve (IRR) in an insolvency scenario.

- Changes in insurance capital requirements, including the development of the ICS will have implications for the capital requirements in the *takāful* sector as presently prescribed in IFSB-11. A survey of market and regulatory practices has identified a number of critical issues. Appropriate capital requirement regulations have to be implemented to protect the soundness and stability of the *takāful* sector.
- The accounting standard IFRS-9 on financial instruments introduced the ECL approach for the calculation of impairment provisions with implications for Islamic finance. The IFSB conducted a survey on current practices and the handling of IFRS-9 in member jurisdictions. Most respondent RSAs will require additional disclosure from banks. The general expectation was that IFRS-9 will impact capital ratios of Islamic and conventional banks negatively, but in a similar way. The IFSB will consider the disclosure implications in the revision of IFSB-4 and changes to capital and credit risk management frameworks in the revision of IFSB-15.
- The results of a survey confirmed that it is possible to extend the “Prudential and Structural Islamic Financial Indicators (PSIFIs)” programme – which currently covers only Islamic banking – to the ICM and *takāful* sector.
- The research paper on consumer protection in the *takāful* sector, will undertake a survey that will explore the treatment of unfair practices, misrepresentations or unwarranted risks in *takāful* transactions, and the implementation of consumer protection regulations in member jurisdictions.

EMERGING ISSUES IN ISLAMIC FINANCE

A comprehensive analysis of the diversity of the legal infrastructure and Shari'ah governance frameworks provides background information and insights for emerging issues in Islamic finance.

Legal systems in OIC member jurisdictions: The three key components of a legal system are: (i) statutes and laws, (ii) regulators, and (iii) courts and other dispute resolution institutions. A unique feature of Islamic finance is the use of Shari'ah principles in products and operations. Only three of 57 OIC member jurisdictions have legal systems with a significant presence of Islamic law within their judicial systems, while the legal regimes of the other jurisdictions are based on civil law (41) or common law (13). In these regimes, a strong Shari'ah governance framework has to ensure the proper application of Islamic law elements in finance. A detailed analysis of the variety of legal environments for Islamic finance has been conducted for a sample of 12 countries. Legal basis for Islamic finance: Three different types of legal regimes for Islamic finance (in banking, *takāful*, *shukūk*) are in existence: (i) specific Islamic finance laws, (ii) provisions for Islamic finance in existing finance laws,

and (iii) no explicit legal provisions for Islamic finance. In the last case, the interpretation and application of existing laws by regulators is of particular relevance for Islamic finance.

Dispute resolution: Three distinct models are practised: (i) specific Islamic dispute resolution institutions such as religious courts and Islamic arbitration centres that apply Islamic law to adjudicate Islamic finance cases; (ii) civil courts with arrangements for getting Shari'ah input for Islamic finance cases; and (iii) civil courts deciding under secular law without any reference to Shari'ah.

Resolution framework for Islamic banks: Insolvency systems are more complex for Islamic than for conventional banks because of specificities of the industry and particular Shari'ah requirements. The legal basis for insolvency or resolution of banks in general could be specific bankruptcy laws or clauses in other laws (e.g. banking law or company law). Specific bankruptcy laws for Islamic banks are rare. Jurisdictions usually apply the same laws to conventional and Islamic banks.

Shari'ah governance regimes: Standards for Shari'ah governance systems (SGS) are laid out in IFSB-10. Many countries provide a legal basis for SGS in the statutes related to the banking sector, but significant structural and procedural differences can be observed among jurisdictions. In some countries, Shari'ah governance is not covered in the laws. There, regulators usually issue mandatory requirements and guidelines for Shari'ah governance, but sometimes only non-binding recommendations. The key organ of SGS on the level of the IIFS is an (independent) Shari'ah supervisory board (SSB). Some countries provide detailed terms of reference (TOR) for its establishment and practices, but in other countries the TOR are of only a general nature. Regulations for an operational unit within the IIFS in charge of Shari'ah compliance and/or internal Shari'ah audit exist in only some jurisdictions. Some countries have established national Shari'ah supervision mechanisms through the creation of Shari'ah boards on the level of regulatory authorities. Their role can range from dispute resolution to promoting the broader goals of Shari'ah in finance.

1.0 DEVELOPMENT OF THE ISLAMIC FINANCIAL SERVICES INDUSTRY

1.1 SIZE OF THE INDUSTRY AND JURISDICTIONS WITH SYSTEMICALLY IMPORTANT IFSI

The global economy in 2017 has witnessed its most assured sign of recovery since the GFC, showing an optimistic momentum and improving business confidence among market participants. An estimated 120 economies that account for three-quarters of the world GDP have experienced an acceleration in growth in year-on-year (y-o-y) terms in 2017.¹ The upside in a number of advanced, emerging and developing economies alike has been contributed by several factors, with notably stronger-than-expected performances in Europe and Asia on the back of an increase in investment activities and manufacturing output. In the sphere of financial markets, the progress towards normalisation of interest rates has also gathered steam; aside from the US Federal Reserve's rates increases, the Bank of England raised its policy rate for the first time since 2008, while the European Central Bank (ECB) also indicated that it will taper its net asset purchases in 2018. Meanwhile, the oil-producing and emerging-exporting countries had some respite following an improvement in crude oil prices towards the second half of 2017. The US economy

has also continued its strengthening trajectory, and the recent tax policy changes are likely to further drive investment activities by corporates in the short term which, in turn, may stimulate global economic activity further in 2018–19.

Global IFSI Surpasses the USD 2 Trillion Mark ...

Corresponding to the favourable economic sentiments above, the global IFSI has also reverted to its positive growth trajectory as the industry's assets have surpassed the USD 2 trillion mark. The industry's total worth² across its three main sectors (banking, capital markets and *takāful*) is estimated at USD 2.05 trillion in 2017³ (see Table 1.1.1), marking an 8.3% growth in assets in US Dollar terms and reversing the preceding two years of assets' growth stagnation (SR2017⁴: USD 1.89 trillion, SR2016: USD 1.88 trillion). The robust growth was contributed actively by all three sectors of the IFSI, but the key rebound in performance was experienced by the Islamic capital markets. Meanwhile, the gradual reversals in previously steep depreciation of several emerging market currencies in 2017 has also contributed towards better asset values in US Dollar terms.

Table 1.1.1 Breakdown of Global IFSI by Sector and by Region⁵ (USD billion, 2017*)

Region	Banking Assets	Shukūk Outstanding	Islamic Funds' Assets	Takāful Contributions	Total	Share (%)
Asia	232.0	239.5	24.8	3.3	499.6	24.4
GCC	683.0	139.2	26.8	12.6	861.6	42.0
MENA (ex. GCC)	569.0	17.8	0.1	9.5	596.4	29.1
Africa (ex-North)	27.1	2.0	1.6	0.7	31.4	1.5
Others	46.4	1.5	13.3	0.0	61.3	3.0
Total	1,557.5	399.9	66.7	26.1	2,050.2	100.0

*Data for shukūk outstanding and Islamic funds' assets are for the full year 2017; data for Islamic banking are for the six months ended June 2017 (1H2017); and data for takāful are as at end-2016.

Source: IFSB Secretariat Workings

Note: Data are mostly taken from primary sources (regulatory authorities' statistical databases, annual reports and financial stability reports, official press releases and speeches, etc. and including IFSB's PSIFI database). Where primary data are unavailable, third-party data providers have been used, including Bloomberg. 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, while shukūk outstanding is broken down by domicile of the obligor.

¹ IMF World Economic Outlook Update, January 2018.

² The figure quoted here is in fact a composite made up by adding assets in the banking sector and Islamic funds to the value of shukūk outstanding and to takāful contributions. The latter is a measure of income rather than assets, and elsewhere there may be elements of double-counting – for example, if a bank holds shukūk. The figure is nevertheless the best measure we can offer in the current state of data availability.

³ Data for Islamic capital markets is for full year 2017; data for Islamic banking is for the six months ended June 2017 (1H2017); and data for takāful is as at end of 2016. See Table 1.1.1 and its explanatory notes for more details.

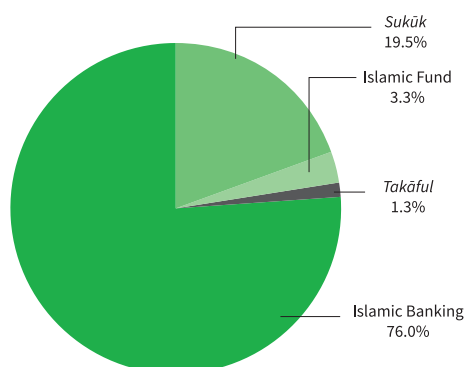
⁴ SR2017 = IFSB IFSI Stability Report 2017; SR2016 = IFSB IFSI Stability Report 2016.

⁵ For purposes of regional classification, Iran is included in "MENA (ex. GCC)" (Middle East and North Africa) while Turkey is included in "Others".

Global *shukūk* outstanding surged by a record 25.6% to close at USD 399.9 billion as at end-2017 [2016: USD 318.5 billion] on the back of strong sovereign and multilateral issuances in key Islamic finance markets to support respective budgetary expenditures. This included debut entries into the sovereign *shukūk* market by Saudi Arabia and Nigeria, as well as the pan-African multilateral development finance institution, Africa Finance Corporation. In tandem with the equity markets rally in both advanced and emerging market equity indices in 2017, the assets of Islamic funds⁶ have also increased by almost 19% to close at USD 66.7 billion as at end-2017 [2016: USD 56.1 billion]. Combined, the two sectors of the ICM now represent 22.8% of the global IFSI assets [2016: 19.8%] – entrenching the ICM further as a key and viable component of the global IFSI (see Chart 1.1.1).

The global Islamic banking industry also experienced a 4.3% expansion in assets to close at approximately USD 1.56 trillion [1H2016: USD 1.49 trillion]. However, its share in the overall IFSI has contracted slightly to 76% [2016: 78.9%]. Key asset increases were experienced across all major regions, including the GCC, MENA (ex. GCC) and Asia. Starting January 2018, Islamic banking has also now established its footprint in South America, following the successful conversion of a conventional secondary bank in Suriname to a full-fledged Shari'ah-compliant bank. With this, Islamic banking products are now offered across all six habitable continents of the world. The gross contributions of the global *takāful* industry also recorded a 4.0% increase to close at USD 26.1 billion as at end-2016 [2015: USD 25.1 billion], with the share in the global IFSI still small at 1.3% [SR2017: 1.3%].

Chart 1.1.1
Sectoral Composition of the Global IFSI (2017)

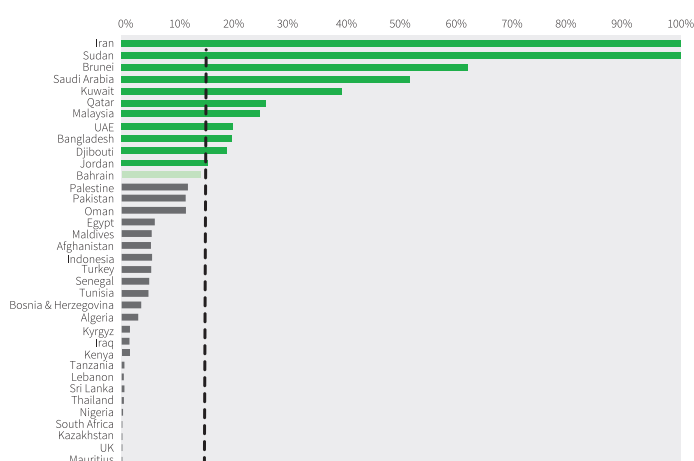


Source: IFSB Secretariat Workings

...Achieves Further Domestic Market Share Consolidation

In line with the improved asset growth performance, the domestic market share for Islamic banking in relation to the total banking sector has continued to increase in a large number of countries, further deepening the sector's penetration. Between 1H2016 and 1H2017, tracking an expanded list of 36 jurisdictions⁷ (see Chart 1.1.2), Islamic banking experienced an increase in domestic market share in 19 countries while remaining constant in seven others (including Iran and Sudan, which have 100% market shares). Only six jurisdictions experienced declines in market share; however, they include Qatar and Egypt, which are two key Islamic banking markets.⁸ The four newly added jurisdictions in the Islamic banking market-share tracker are Senegal (5%), Bosnia and Herzegovina (3.6%), Kyrgyz Republic (1.5%) and Tanzania (0.7%).

Chart 1.1.2
Islamic Banking Share in Total Banking Assets by Jurisdiction (1H2017)



*The countries indicated in dark green coloured bars satisfy the criterion of having a more than 15% share of Islamic banking assets in its total domestic banking sector assets and, hence, are categorised as systemically important (see footnotes 9, 10 and 11). A recognition of systemic importance is considered for jurisdictions that are within one percentage point of the 15% benchmark provided they have active involvement (are among the top 10 jurisdictions) in the other two sectors of the IFSI – Islamic capital markets and *takāful*; these are shaded in medium green bars. Yemen, which has previously been classified as having achieved domestic systemic importance, is not included in this IFSI Stability Report 2018, due to a lack of availability of credible data. Source: IFSB Secretariat Workings (see note in Table 1.1.1)

Based on the above, the list of jurisdictions where Islamic finance has achieved domestic systemic importance⁹

⁶ Funds that are marketed and offered generally with their data publicly available, and excluding private equity funds.

⁷ SR2017: 35 jurisdictions. SR2018 has introduced four new jurisdictions, while three previously included jurisdictions – Yemen, Azerbaijan and Singapore – are now excluded due to lack of availability of credible and/or latest data on Islamic banking assets.

⁸ The six jurisdictions with a decline in domestic Islamic banking market shares are Qatar, Egypt, Afghanistan, Kenya, Lebanon and Kazakhstan.

⁹ This report considers the Islamic financial sector as being systemically important when the total Islamic banking assets in a country comprise more than 15% of its total domestic banking sector assets. The report uses the Islamic banking segment as the criterion for systemic importance of Islamic finance, since about 76% of Islamic financial assets are held within the banking sector. A recognition of systemic importance is considered for jurisdictions that are within one percentage point of the 15% benchmark provided they have active involvement (among the top 10) in the other two sectors of the IFSI – Islamic capital markets and *takāful*.

numbered 12¹⁰ in 1H2017. The latest addition is Bahrain,¹¹ which now has a 14.1% market share for Islamic banking in relation to its total domestic banking sector [1H2016: 13.3%]. Furthermore, the two jurisdictions with more than a 50% share for Islamic banking – aside from Iran and Sudan – have further increased their market penetration. Brunei continues as the most prominent jurisdiction, with Islamic banking now accounting for 61.8% [1H2016: 57%] of the domestic market, followed by Saudi Arabia with a 51.5% share in 1H2017 [1H2016: 51.1%].

Improvements in market share were also made across other systemically important jurisdictions, including Kuwait at 39.3% (1H2016: 39%), Malaysia¹² 24.9% (1H2016: 23.8%), United Arab Emirates 20% (1H2016: 19.6%), Bangladesh 19.8% (1H2016: 19.4%), Djibouti 19% (1H2016: 16.2%) and Jordan 15.5% (1H2016: 15.2%). Qatar is the only systemically important jurisdiction that experienced a decline in market share (to 25.7%) (1H2016: 26.6%). Collectively, the 12 systemically important Islamic finance jurisdictions are now host to an increased 92% of the global Islamic banking assets (1H2016: 88%) and a slightly decreased 82% of the global *shukūk* outstanding (1H2016: 84%) (See Charts 1.1.3 and 1.1.4).

Regionally, the Gulf Cooperation Council continues as the largest domicile for Islamic finance assets (see Chart 1.1.5). In 2017, the region experienced a slight moderation in market share to 42% of the global IFSI (SR2017: 42.3%). The share of MENA (ex-GCC) has also slightly decreased, to 29.1% (SR2017: 29.9%). Asia has the most improved market share, increasing to 24.4% of the global IFSI (SR2017: 22.5%), with expansions in key markets such as Malaysia, Indonesia, Pakistan and Bangladesh. Islamic finance penetration in other regions including Africa (ex-North Africa), the Americas, Australia and Europe, while slowly picking up, remains nascent.

Chart 1.1.3
Islamic Banking Assets in Jurisdictions with an Islamic Finance Sector of Systemic Importance (1H2017)

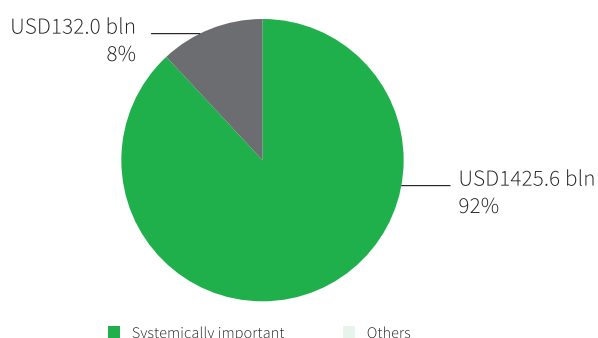
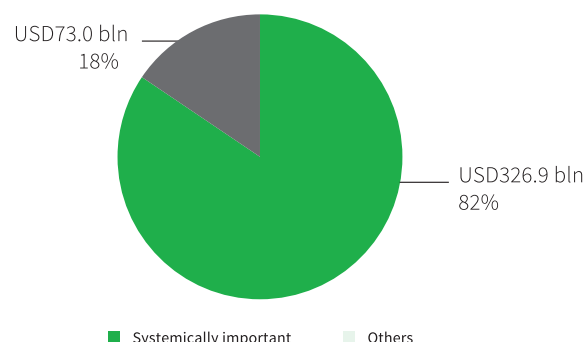
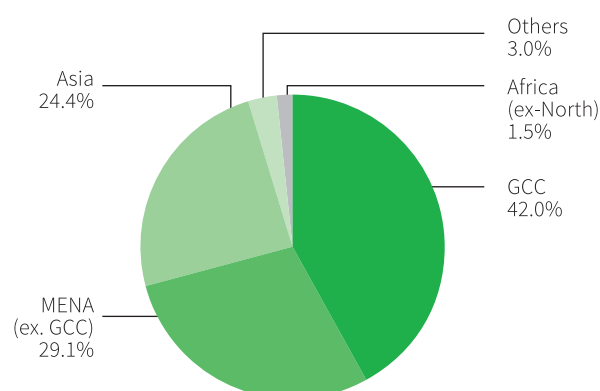


Chart 1.1.4
***Shukūk* Outstanding in Jurisdictions* with an Islamic Finance Sector of Systemic Importance (2017)**



*Based on the domicile of obligors.
Source: IFSB Secretariat Workings

Chart 1.1.5
Breakdown of IFSI by Region (%) (2017)



Source: IFSB Secretariat Workings

In terms of the top jurisdictions for Islamic banking assets, Iran sustains its historical position as the largest market, accounting for a slightly increased 34.4% of the global Islamic banking industry in 1H2017 (see Chart 1.1.6); this share reverses a steady decline in the preceding three years¹³ (1H2016: 33%; 1H2015: 37.3%; 1H2014: 40.2%) but is still below Iran's global share in 2014. Saudi Arabia at 20.4% (1H2016: 20.6%), UAE at 9.3% (1H2016: 9%), Malaysia at 9.1% (1H2016: 9.3%) and Kuwait at 6% (1H2016: 6.1%) complete the top 5. Malaysia, in particular, has benefited in US Dollar terms in 2017 following a gradual appreciation of its local currency during the year, which reverses a previous steep depreciation during the emerging markets assets sell-off spree between 2014 and 2016. The other countries in the top 10 Islamic banking jurisdictions are Qatar, Turkey, Bangladesh, Indonesia and Bahrain.

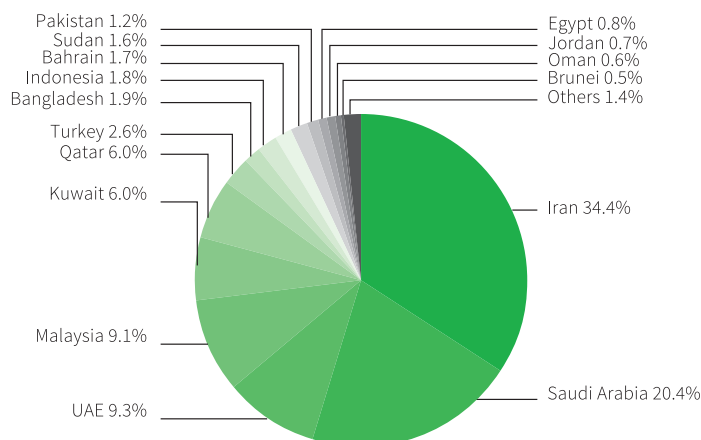
¹⁰ Yemen, which has previously been classified as having achieved domestic systemic importance, is not included in IFSI Stability Report 2018, due to a lack of availability of credible data.

¹¹ Bahrain, while not having crossed the 15% benchmark for domestic systemic importance, is elevated as such given its positioning as among the top 10 jurisdictions in terms of global *shukūk* outstanding and annual global gross *takāful* contributions, and given that its domestic Islamic banking share, at 14.1%, is within one percentage point of the 15% benchmark.

¹² Based on Islamic banks regulated by the central bank of Malaysia and excluding development finance institutions (DFIs) regulated by the Ministry of Finance, Malaysia. The share for Islamic banking in Malaysia is almost 30% if DFIs are included in the banking sector pool of assets.

¹³ Iran's global market share has been declining on account of a steep depreciation in its local currency – the official exchange rate on 1 July 2013 was USD 1 = IRR 12,283. This value had declined to USD 1 = IRR 32,501 as of 30 June 2017.

Chart 1.1.6
Shares of Global Islamic Banking Assets* (1H2017)



*The shares are apportioned in US Dollar terms.
Source: IFSB Secretariat Workings

Overall, the global IFSI has reverted to its positive growth trajectory, experiencing asset increases across all three of its main component markets. The market passed the USD 2 trillion mark in 2017 and further gained domestic market share entrenchment for its Islamic banking sector in at least 19 countries. The rest of Chapter 1 analyses in detail the growth and developments of the three key sectors of the global IFSI. Further analyses from a stability and resilience perspective are provided in Chapter 3 of this report.

1.2 TRENDS IN THE DEVELOPMENT OF ISLAMIC BANKING

Islamic Banking Overview in Key Markets

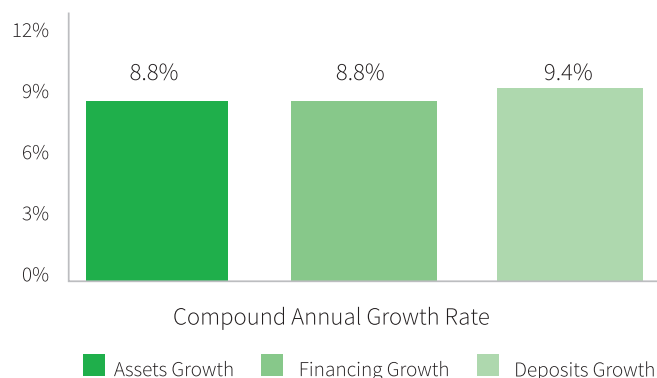
Following last year's very marginal decline (0.2%), the aggregate US Dollar value of global Islamic banking assets increased by 4.3% in 2Q2017 (y-o-y).¹⁴ This was in spite of the continued decline (between 2Q2016 and 2Q2017) in the value of currencies of key Islamic banking markets, including Iran, Malaysia and Turkey, against the US Dollar. The decline in these currencies is reflected in asset expansion rates calculated in US Dollar terms, where Iran, Malaysia and Turkey registered 8.6%, 2.4% and -6.8%, at a time when asset growth rates in local currencies in these countries were 15.6%, 9.3% and 13.6%, respectively. The following paragraphs highlight growth rates in key Islamic banking indicators across various jurisdictions as at 2Q2017.

In US Dollar terms, and across 15 jurisdictions,¹⁵ Islamic banking assets expanded at a compound annual growth rate (CAGR) of 8.8% between 4Q2013 and 2Q2017, declining from 9.9% reported in SR2017 (for the period from 4Q2013 to 2Q2016) and continuing a trend of moderate growth rates (see chart 1.2.1).

As stated in SR2017, annual asset growth rates rebounded in the first two quarters of 2016, growing at 9.6% and 11%, respectively following a slowdown in 2015 when the Islamic banking sector grew at a modest 5.7% on average. The third quarter of 2016 witnessed the highest level of annual asset growth rates throughout the observation period among sample countries, followed by a slowdown in the subsequent three quarters to 2Q2017 (see chart 1.2.2).

Growth rates for financing followed a similar pattern, with financing CAGR standing at 8.8% between 4Q2013 and 2Q2017 (9.4% between 4Q2013 and 2Q2016). Annual financing growth rates stood at 6.8% in 2Q2017 following a rebound to 14.3% in 3Q2016 – their highest level since 4Q2013, after registering 6.7% in 2015. Deposits, on the other hand, recorded a CAGR of 9.4% with an annual growth rate of 9.2%, influenced primarily by high deposit figures from the largest Islamic banking markets.

Chart 1.2.1
Compound Average Growth of Key Islamic Banking Statistics¹⁶ (4Q2013–2Q2017)



Source: PSIFIs, IFSB Secretariat Workings

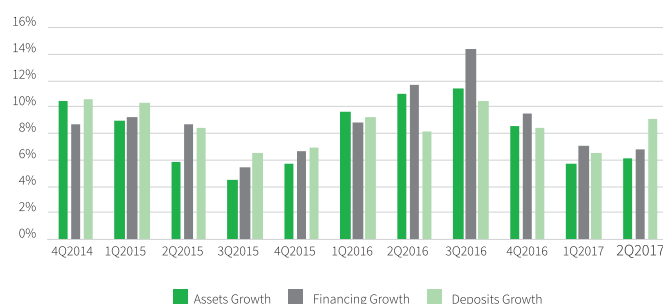
¹⁴ Growth rates (other than compound annual growth rate) for assets, financing and deposits are calculated on a year-over-year (y-o-y) basis.

¹⁵ Data used in calculating CAGR, as well as growth rates for assets, financing and deposits, were received from local banking regulatory authorities in the relevant jurisdictions and include data from both Islamic banks and windows in Bangladesh, Indonesia, Malaysia, Oman, Pakistan and Saudi Arabia, and from Islamic banks only in Brunei, Iran, Jordan, Kuwait, Nigeria, Sudan, Turkey, and the UAE in addition to Qatar, whose data were collected separately by the IFSB Secretariat. Aggregate growth rates for deposits, including CAGR, exclude Brunei and Kuwait due to data limitations.

¹⁶ The term "deposits" in this section includes remunerative funding (*murābahah*, commodity *murābahah*, etc.), non-remunerative (current accounts, *wad'iah*), and unrestricted profit-sharing investment accounts (UPSIs), which are treated as equity in the financial statements of Islamic banks in some jurisdictions and as liabilities in others.

(Where this report makes jurisdiction-specific analysis of the expansion in domestic market share of Islamic banking assets, and assesses growth rates in key Islamic banking indicators, such as financing and deposits, it therefore does so using domestic currencies.)

Chart 1.2.2
Islamic Banking Average Annual Growth Trends (y-o-y)
(4Q2014–2Q2017)¹⁷



Source: PSIFIs, IFSB Secretariat Workings

Analysis of country-level growth rates¹⁸ shows eight jurisdictions, out of 15 in the sample, achieving double-digit asset growth rates in the year to 2Q2017, with the same number of countries recording financing growth rates above 10%, and nine countries, out of 13 providing deposit data, growing their deposit bases by at least 10.8% each (see chart 1.2.3). Nigeria and Oman continue to register rapid expansions in assets, financing and deposits, largely due to the smaller Islamic banking base in the two countries. Oman has increased each of its asset, financing and deposit portfolios by at least 30% in 2Q2017, similar to 4Q2016 levels. These rates, however, and relative to the figures between 4Q2014 and 2Q2016, appear to show a trend of moderate growth as the industry in the Sultanate heads towards maturity. It remains to be seen whether Islamic banks in Oman can sustain this level of growth against the backdrop of economic headwinds which have led to downgrades in the Sultanate's credit rating by two major credit rating agencies in 2017.

Other GCC economies continue to feel the strain from persistently low oil prices, with Islamic banking growth rates noticeably lower in 2Q2017 in comparison to 4Q2014 and 2Q2015 levels. Following the Saudi Arabian Monetary Authority's capital injections in the banking system in the third quarter of 2016, Saudi Arabia's banking industry (Islamic and conventional) recovered from a decline in its aggregate deposits reported in 2Q2016, registering 2.69% growth in the 12 months to 2Q2017, with deposits for Islamic banks and windows expanding at 3%. The Kingdom's Islamic banking assets grew moderately, at 2.7%, while financing appears to have stagnated from a year earlier, registering a 0.6% increase. Nevertheless, asset and deposit growth figures for the Saudi Islamic banking system compare favourably to the country's overall banking industry, whose assets

and deposits increased by 1.1% and 1.6%, respectively. Kuwaiti Islamic banks increased their assets by 3.6%, up from 2.5% reported in 2Q2016, while the UAE's growth rates were the second highest among its GCC peers, after Oman, at 7.4% for both assets and financing (2Q2016: 10.8% and 13.7%, respectively) and exceeding average asset growth of conventional banks there (4.9%). Qatar, on the other hand, experienced its lowest level of asset and deposit growth rates throughout the period under review, with assets expanding at 6.9%, and deposits at 3.6%.

Turkish participation banks maintained their double-digit asset and deposit growth rates in 2Q2017, while financing was 8.3% higher than a year earlier. In Iran, while the inflation rate dropped from 11.9% in March 2016 to 9% in March 2017, the banking sector continued its strong growth performance, increasing its deposit base by 23.5% in the year to 2Q2017, contributing to a 15.6% expansion in assets and 21.6% growth in financing during the same period while continuing a trend of double-digit growth rates in the country's assets, financing and deposits throughout the analysis period. Similarly in Sudan, assets and financing increased by 31.7% and 22.5%, respectively, while deposits climbed 42.8% primarily due to a rise in public-sector deposits in 2016. These figures, however, come on the back of inflation rates that have climbed gradually from 14.3% in 2Q2016 to 34.7% in 1Q2017.

Malaysian Islamic banks and windows continued to expand their aggregate assets, which increased by 9.3% between 2Q2016 and 2Q2017, contributing to a 1.1% increase in their domestic market share. The Islamic banking industry in Malaysia is focused on technology-driven business diversification to sustain this level of growth. To support this, Bank Negara Malaysia is encouraging innovative application of Shari'ah contracts in financing, funding and investment activities of Islamic banking operations. Indonesian Islamic banks and windows recorded their highest growth levels throughout the period under review, with assets growing at 23.5%, while financing and deposits registered 19.4% and 25.1% growth rates, respectively. In the third quarter of 2017, Indonesia established a National Committee for Islamic Finance. This high-level committee, chaired by the country's President, is expected to strengthen Islamic financial institutions through the formulation of a regulatory system and incentives for the industry.

Pakistan's Islamic banking industry continued its rapid financing expansion, which increased by 41.4%. This

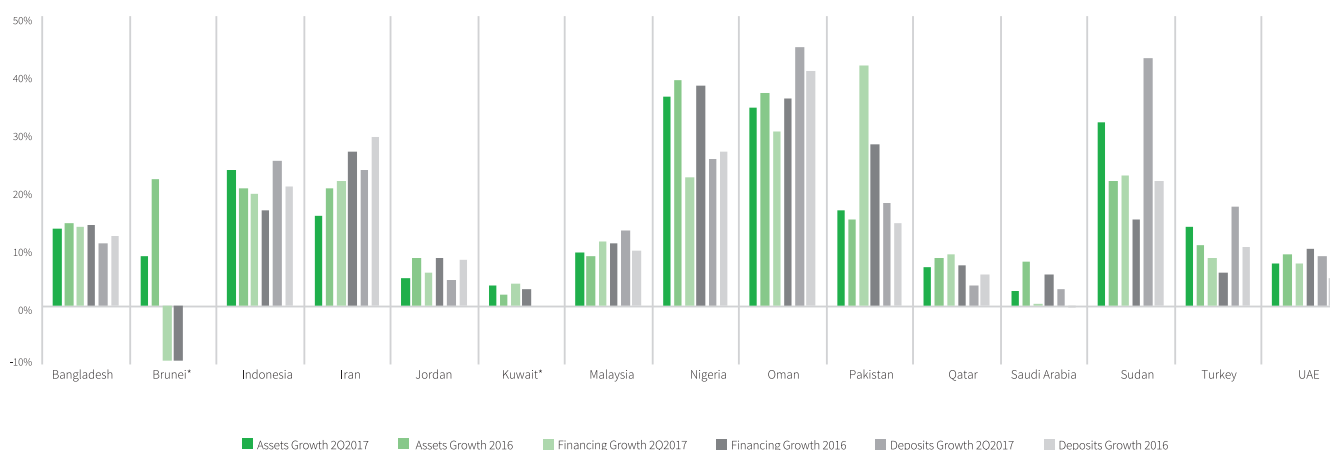
¹⁷ As stated earlier, growth rates in this subsection, other than CAGR, are calculated on a y-o-y basis, comparing figures at the end of a quarter with figures of the same indicator in the same quarter of the previous year. Therefore, as an example, a 9.4% deposit growth in 2Q2017 indicates that total deposits as at the end of 2Q2017 were 9.4% higher than the deposits figure as at the end of 2Q2016. In keeping with the IFSB's PSIFIs database, from which data were obtained for this analysis, quarterly notations (1Q, 2Q, 3Q and 4Q) are used to display the time series.

¹⁸ This analysis is performed using local currency assets, financing and deposit figures for each jurisdiction to eliminate the impact of exchange rate fluctuations.

increase was accompanied by a reduction in the *shukūk* holdings of the Islamic banking industry in the country, as significant amounts of deferred-sale *shukūk* issued by the Pakistan government matured in November 2016. Assets' growth rate was also in double-digit territory – though relatively lower, at 16.6%. This continues a trend of financing growth rates outpacing those of assets in

a country where aggregate financing by Islamic banks and windows constitutes less than 50% of total Islamic banking assets. Bangladesh has also shown healthy, but declining, levels of growth in assets, financing and deposits, all growing at no less than 10.75%. These growth levels were, however, also the lowest for Bangladesh throughout the analysis period.

Chart 1.2.3 Islamic Banking Average Annual Growth by Country (y-o-y) (2Q2017 and 2016)



Source: PSIFIs, IFSB Secretariat Workings

*Deposit data for Islamic banks in Brunei and Kuwait were not available.

The majority of countries in the sample have translated increases in their assets into domestic market-share gains for the Islamic banking sector (see chart 1.2.4), with only one country – Qatar – losing market share in the year to 2Q2017. Qatar's asset growth rates were exceeded by the progress of conventional banks there.

The Islamic banking industry in Malaysia accounts for 24.9% of the country's banking assets as at 2Q2017 (SR2016: 23.8%), while Bangladesh and Indonesia improved their shares of Islamic banking services, registering 19.8% (SR2017: 19.4%) and 5.4% (SR2016: 4.7%), respectively, as at 2Q2017. Brunei was the only country in the sample to experience a decline in its financing figures, dropping by 9.4% in 2Q2017. However, this decline appears to have affected both Islamic and conventional banks, with Autoriti Monetari Brunei Darussalam (AMBD) figures suggesting that the overall loans/financing to households and corporates in Brunei shrank by a combined 11.8% in 2016 (the comparative decline for Islamic banking financing sector is 9.5%), with a large proportion of the decrease attributed to a contraction in the manufacturing and services sectors. Nevertheless, this decline has not stopped the Islamic banking sector from gaining market share there, as it saw its assets climb to 61.8% of the total Bruneian banking industry (SR2017: 57%). Brunei has thus far maintained the highest domestic share of Islamic banking assets after Iran and Sudan, which remain the only jurisdictions operating fully Shari'ah-compliant banking systems.

Assets of Islamic banks and windows in Pakistan continued to sustain their market share in the domestic market, standing at 11.6% in 2Q2017 (SR2017: 11.4%). As highlighted earlier, Pakistan's Islamic banking industry continues to grow at double-digit rates, and the marginal improvement in market share highlights the overall banking industry's strong growth performance in light of a relatively stable economic environment.

In spite of recording the lowest asset growth rate among sample countries (2.7%), the Saudi Islamic banking sector maintained its domestic market share above the 50% mark, with its assets accounting for 51.5% of the domestic banking sector at 2Q2017 (SR2017: 51.1%). The Kingdom's overall banking system expanded by 1.6%. Kuwait and Qatar maintained their positions behind Saudi Arabia as the largest Islamic banking markets in the GCC by market share. However, while Kuwait marginally improved its share to 39.3% (SR2017: 39%), Qatari Islamic banks lost 0.9% of their market share to their conventional counterparts, ending 2Q2017 with a 25.7% share of the banking industry amid talks of a three-way merger involving a conventional bank and two of the country's four Islamic banks – a merger aimed at operational efficiency in light of macroeconomic headwinds and government efforts to diversify the country's economy. The UAE's Islamic banking assets now represent 19.9% of its domestic banking sector, up from 19.6% in 2Q2016.

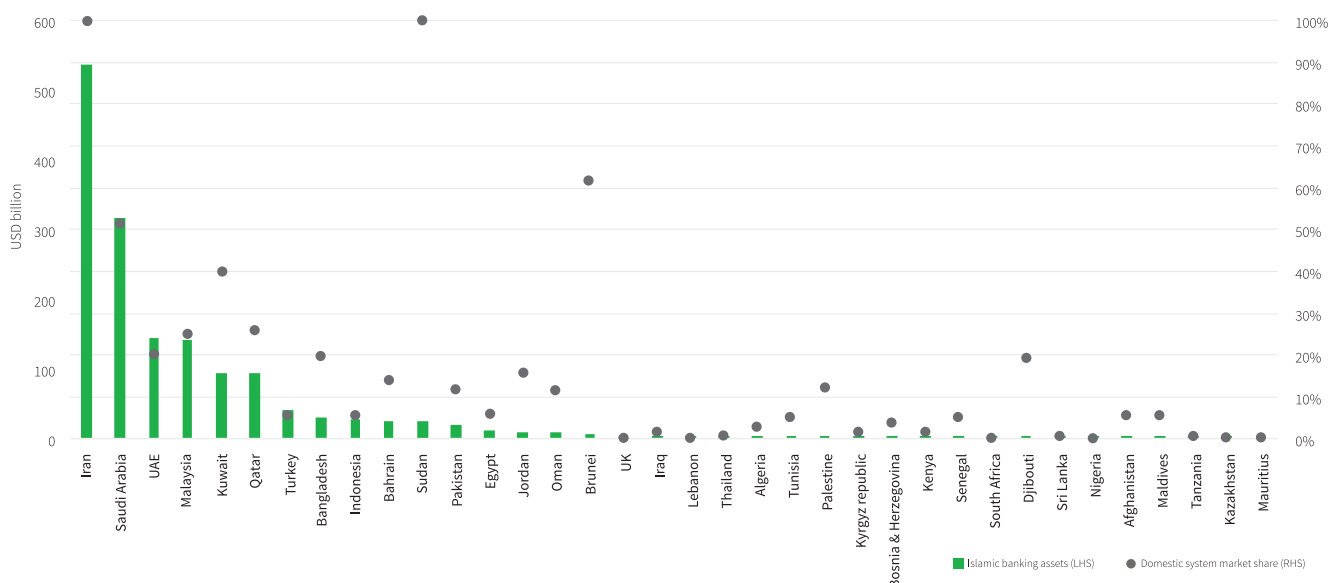
Bahrain, on the other hand, saw its Islamic banking industry recover following last year's marginal decline. The Kingdom's Islamic banking system had 14.1% of the country's banking assets as at 2Q2017 – a 0.9% increase from a year earlier. In the third quarter of 2017, the Central Bank of Bahrain issued a Shari'ah governance module aimed at improving Shari'ah compliance and governance standards among Islamic banks in the country, and making it mandatory for retail and wholesale banks to undergo an independent Shari'ah compliance audit from the year 2020. Also in the GCC, Oman's Islamic banking industry gained 3.1 percentage points, to represent 11.5% of the domestic banking system in the Sultanate as at 2Q2017. This level of growth, achieved in just five years of Islamic banking operations, brings the Islamic banking industry closer to achieving systemic importance.

Elsewhere in the Middle East, Jordan maintained its position in the list of jurisdictions in which the Islamic financial sector is regarded as systemically important, with the Kingdom's Islamic banking share now standing at 15.5% of its total banking sector assets, up from 15% in 2Q2016. This follows a moderate increase in Jordan's Islamic banking asset base (4.9%) exceeding growth in the overall Jordanian banking sector, which registered 1.9% growth between 2Q2016 and 2Q2017.

In North Africa, Morocco has seen its first participative bank open its doors in May 2017 after Bank Al-Maghrib's approval for the establishment of five participative banks earlier in the year. This follows the introduction of a law in 2015 to regulate participative financial products in the Kingdom and the establishment of a centralised Shari'ah Committee for Participative Finance tasked with the provision of preliminary approval for Islamic transactions. Tunisia is considering allowing conventional banks to run Islamic windows alongside three Islamic banks already operating in the country, which could potentially improve the Islamic banking outlook and market share there.

Nigeria's non-interest banking has marginally increased its share of total domestic banking assets, to stand at 0.3% in 2Q2017 (SR2017: 0.2%). The Central Bank of Nigeria set up two new financial instruments during the year to support the liquidity of the country's non-interest banking industry. Uganda continues to make efforts to approve regulations covering Islamic banking, while the government of Malawi has approved the establishment of windows by conventional banks to provide Shari'ah-compliant products in the country.

Chart 1.2.4 Islamic Banking Assets and Market Share (2Q2017)



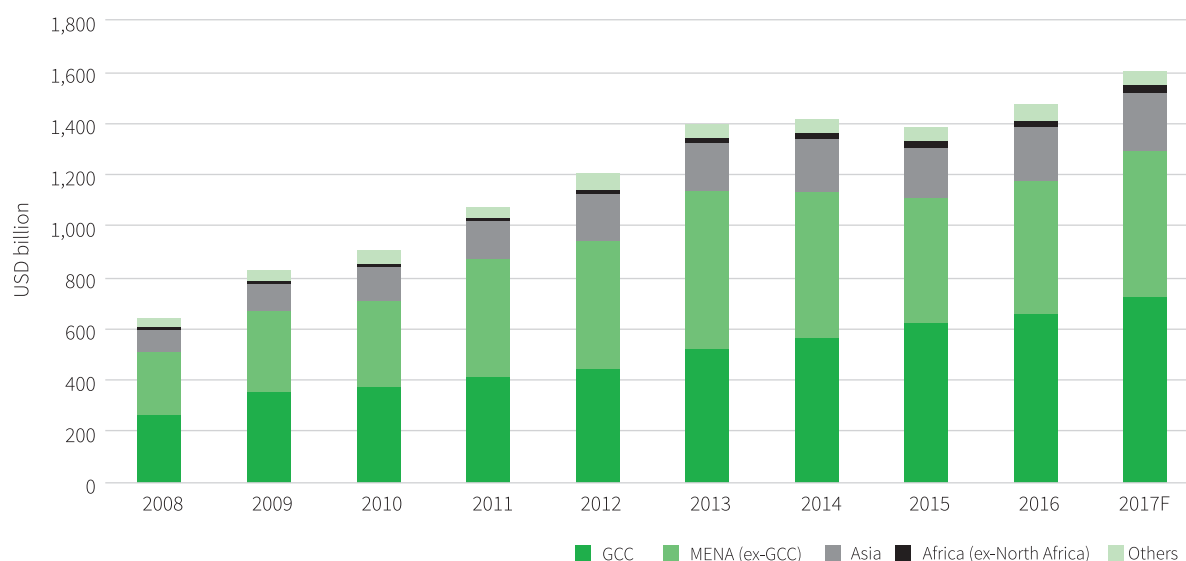
Source: PSIFs, IFSB Secretariat Workings

Islamic banking assets globally are forecast to climb to approximately USD 1.61 trillion in 2017¹⁹ (see Chart 1.2.5). Currency exchange rates, particularly in key Islamic banking markets where exchange rates are not pegged to the US Dollar, continue to influence the value of global Islamic banking assets and other indicators of the industry. Geographical concentration of Islamic banking assets remains substantial, with 91.5% of these assets now in countries in which the Islamic financial sector is considered systemically important, up from

88% reported in 2Q2016. The increase is partly explained by the inclusion of Bahrain as a new addition to the list of systemically important jurisdictions for Islamic finance in this year's report. The top 10 Islamic banking jurisdictions by asset size²⁰ now account for 93.2% of the global Islamic banking industry, up from 91.8% in 2Q2016, while four countries – namely, Iran, Saudi Arabia, the UAE and Malaysia – hold more than 73% of the industry's assets globally.

¹⁹ This forecast was derived by projecting forward jurisdiction-specific average year-end asset growth rates (2016 and 2015) and adjusting for applicable end-2017 exchange rates. Data was obtained from jurisdictions covering approximately 98% of the global Islamic banking industry by asset size (2Q2017).

²⁰ These jurisdictions are Iran, Saudi Arabia, the UAE, Malaysia, Kuwait, Qatar, Turkey, Bangladesh, Indonesia and Bahrain.

Chart 1.2.5 Islamic Banking Assets (2008–2017F)

Source: PSIFIs, IFSB Secretariat Workings

Overall, several countries recorded robust levels of growth in key Islamic banking indicators, with many increasing their assets, financing and deposit portfolios at double-digit rates. Nevertheless, trends from 2Q2016 continue to prevail, with challenging economic conditions, reduced government revenues and the need for economic diversification in many jurisdictions. These prolonged macroeconomic challenges appear to restrain progress in the development of the Islamic banking sector, particularly where Islamic banking assets are concentrated. Growth rates in the GCC have generally declined, as governments there continue to

address budget deficits and macroeconomic headwinds. Meanwhile, several countries in North and sub-Saharan Africa are making efforts to introduce Islamic banking services – developments that would enhance the industry's growth prospects in the future. Islamic banks and windows in several jurisdictions have noticeably lower growth rates for financing than deposits, possibly reflecting a relatively cautious approach as they invest in safer, albeit less profitable, instruments. Further assessments on the fundamentals and resilience of the IFSI are covered in Chapter 3 of this report.

BOX 1.1
DEVELOPMENT OF THE ISLAMIC BANKING SECTOR IN OMAN

OVERVIEW

Background

In 2011 the Central Bank of Oman (CBO) announced consideration of the initiative to allow Shari'ah-compliant banking as a parallel approach ('dual banking system'). Islamic banking was formally facilitated in Oman with the issuance of a Royal Decree, in December 2012, effecting certain amendments to the Banking Law. Among other things, the amendments required Islamic Banking Entities (IBEs) (full-fledged Islamic banks and Islamic banking windows) to establish their own Shari'ah supervisory boards (SSBs) and authorised the board of governors of the CBO to establish a High Shari'ah Supervisory Authority (HSSA) in the CBO.

The amendments were followed by the issuance of a comprehensive Islamic Banking Regulatory Framework (IBRF) and a regulation on establishing the HSSA.

The timing of the authorisation was relevant to Oman's financial aspirations, in the context of growing requirements of the economy and increasing focus on the all-important areas of financial inclusion and diversification, as well as providing the ability to make the right start, with many of the Standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and the IFSB's Guidelines already in place.

The Focus on Shari'ah Compliance in Reality and Perception

The IBEs were required to acknowledge, appreciate and rigidly enforce the factor that differentiates Islamic banking – that is, Shari'ah compliance. Equally importantly, transparency and conviction must be maintained for the sector to remain credible and to succeed in the long run. Hence, Oman has placed great emphasis on formulating an appropriate, comprehensive Shari'ah governance framework so as to ensure Shari'ah compliance both in reality, by way of its operational and control aspects, and in terms of perception, by way of diligent customer contracts and disclosures to the market.

Regulatory Thrust

The CBO, aware of the market potential, also confirmed by independent study, was convinced that IBEs are best served in the long run (in terms of their independence, robustness and confidence) by being left to establish themselves on their own. Accordingly, the CBO's role was focused on providing requirements for an effective Shari'ah governance framework. It

did, of course, concede certain regulatory relaxations deemed to be necessary for start-ups competing with established players.

Approach and Contents of the Islamic Banking Regulatory Framework (IBRF) in Brief

The following may be noted as a matter of special interest, highlighting the approach taken by the CBO.

Decision as to Whether or Not to Authorise Islamic Banking Windows

Windows are sometimes seen as promoting uneven playing fields (since they draw liberally upon parents' resources), however, with scope of Shari'ah non-compliance and credibility issues by mixing Islamic banking with the conventional banking sector. Oman had a long history of a well-established conventional banking sector with a wide network of branches. Denying it a "window" of opportunity would have meant denying conventional banks the opportunity to set up separate outlets to serve some of their existing clients, as they wished to do, while also denying the general public access to Islamic banking until such time as full-fledged Islamic banks were able to set up new branches. In deciding to allow Islamic banking business to operate through windows, Oman took care to mitigate the attendant risks. Windows now have a higher number of branches (53, as against 19 branches of full-fledged Islamic banks), 33 of which are outside the Muscat governorate (compared with 12 of the full-fledged Islamic banks), and account for almost two-thirds of the total IBEs' business. However, the gap is being bridged.

Among other things, it was stipulated that Islamic banking windows shall offer only Islamic banking products and services. Conventional bank branches shall not carry out Islamic banking business. There was to be no co-mingling at all, with windows prohibited from providing finance to or making placement with parent banks (or other conventional banks). They are to have an independent and compliant core banking IT system and interfaces. The system should be capable of capturing the unique nature of Islamic banking contracts, transactions and processes, and requires certification by a credible third party. In addition, windows need to have a dedicated treasurer/senior trader to manage Shari'ah-compliant instruments for their treasury functions. Business and control functions are to be in-house, and any shared support services are to be limited and transparent, with an appropriate cost allocation mechanism.

Yet another concern about windows is their small size and the constraints of prudential limitations based

upon their net worth. This was taken cognisance of, and on balance it was decided that windows will be constrained in relation to their net worth for various prudential limitations/entitlements; however, their single obligor limit will be related to the consolidated net worth provided that the respective banks, as a whole, are in compliance. The above approach addressed possible Shari'ah non-compliance and credibility issues relating to windows, while providing a restricted but competitive landscape for the industry that augured well for windows to have diversified and corporate assets.

Windows are required to have a clear business vision and plans, including a road map. The CBO shall, from time to time, review its approvals given to windows to conduct Islamic banking.

In spite of possible misgivings and apprehensions about their scope for robust business and proximity risks, windows have been amicably received by the market.

Conduct of Business and Shari'ah Focus

The emphasis was on the conduct of business in accordance with Shari'ah principles and in line with contemporary professional standards. The hallmarks, thereunder, shall include strong ethical principles, practices and conviction. In addition, the critical importance of Islamic banking's collaborative nature, financial inclusion, fairness, honesty, truthfulness, risk sharing and disclosure has been highlighted. The IBRF has noted: "Islamic banking is not profit making per se but profit sharing with values where principle comes before profit."

The board of the licensee has ultimate responsibility for creating and maintaining a robust Shari'ah governance framework for the licensee. Within that framework, the Shari'ah supervisory board (SSB) shall be the ultimate responsible authority within the licensee for all Shari'ah-related matters.

The key components of the Shari'ah governance framework will include the SSB, an internal Shari'ah reviewer, and Shari'ah compliance and Shari'ah audit units. "Fit and proper" criteria, and the roles and responsibilities of SSB members, have been based broadly on IFSB guidelines with scope for development and progressive engagement of domestic resources. The SSB is to be an independent body with required specialisations. Elaborations provide a typical charter for an SSB, and a specimen of an SSB's annually mandated Shari'ah compliance report.

It is the shareholders who will consider and approve the nominees suggested by the board as SSB members. The SSB, in addition to a minimum of three Shari'ah scholars, may include non-voting members with expertise in related fields. It will be the SSB's ultimate responsibility to guide and oversee the entities so far as Shari'ah matters are concerned.

The SSB was envisaged to be the fulcrum in an entity, supporting Shari'ah compliance within and providing comfort to the customers accordingly. The IBRF has drawn liberally upon guidelines from the IFSB and leading industry practices to emphasise authenticity in the functioning of SSBs. Thus, the Shari'ah governance framework serves the twin objectives of ensuring and displaying Shari'ah compliance.

The scope of the charter for an SSB is to be comprehensive. The responsibilities shall include not only prior approvals, but also periodical checks thereafter, review of the work carried out by Shari'ah compliance and audit functions, and submission of a report on Shari'ah compliance to be published as part of the bank's annual report.

The report is required, among other things, to cover confirmation of a reasonable review, Shari'ah compliance (or otherwise) of IBEs, acceptability of the basis for allocation of funds, weightages, profit-sharing ratios and disposal of non-compliant earnings to charity. In the case of continuation of non-compliant activities in a systematic manner, an SSB is required to escalate the issue to the CBO and the public through the report. The report is to have an appendix listing the fatawa given and the basis thereof (religious evidence).

The banking relationships between SSB members and their respective IBEs will be at arm's length, without scope (real or perceived) for interference in their independent judgment. While an SSB member can have a maximum of two consecutive tenures of three years only, he cannot be a member of an SSB in any other competing institution or of more than four non-competing institutions. SSBs have been encouraged to adhere to the Basic Professional Ethics and Conduct of Members of the Shari'ah Board, as proposed by the IFSB's Guiding Principles on Shari'ah Governance Systems for Institutions Offering Islamic Financial Services.

High Shari'ah Supervisory Authority

The establishment of the HSSA in the Central Bank, at quite an early stage, has been an important addition to the Islamic banking landscape in Oman. While SSBs and the innovative initiatives of IBEs are of the utmost importance, the very presence of the HSSA and its role in guiding the CBO on Shari'ah matters can be expected to inspire overall market confidence and harmony.

The relevant regulation highlights the HSSA's functions, in the exercise of which it shall have full independence, as follows:

- to give opinion and submit advice to the Central Bank on Shari'ah issues related to Islamic banking business
- to give opinion to the Central Bank on Shari'ah compliance of the transactions between the Central Bank and licensees
- to decide, bindingly, on the issues submitted to it through the Central Bank, which are the subject of a Fiqh dispute between SSBs.

In regards to the HSSA, the emphasis is again on independence and effectiveness, backed by appropriate suitability criteria and due diligence norms. It is an apex reference point for the CBO on Shari'ah-related issues, and it is clear that the regulatory responsibilities of the CBO and the Shari'ah governance roles of the HSSA are distinct.

The HSSA has been active, providing guidance to the CBO on subjects such as a proposed deposit *takāful* scheme and liquidity management tools, ownership- and registration-related issues for *ijarah*, the sale and lease-back mode of finance, the first *shukūk* issuance from the banking sector, etc. referred by the CBO. The HSSA has also looked into market practices, based upon a survey report submitted at its behest, on prevalent credit card products and features, and has given its valuable guidance.

Competent Human Resources and Effective Compliance

Human inputs are most important in a service industry such as banking, and even more so in the Islamic banking sector. It was stipulated accordingly that all staff must be relevantly proficient and committed. There should be separate front-office staff for dealing with customers, ensuring the required care and competence. All senior management incumbents require prior approval of the CBO, and the Head of the window should be of Assistant General Manager (AGM) or above cadre.

Accounting Standards and Audit

Full-fledged Islamic banks in Oman shall follow accounting standards issued by the AAOIFI. In accordance with the requirements of AAOIFI, for matters where no AAOIFI standards exist, the licensees can use the relevant International Financial Reporting Standards (IFRS).

Windows, too, shall follow AAOIFI's accounting and auditing standards. The parent conventional bank shall consolidate the financial statements in accordance with the IFRS. Disclosures with regard to consolidation shall be covered in the notes to accounts. Supplementary information from the windows shall cover transactions with parents (and other conventional banks).

There shall be an independent annual external Shari'ah audit.

Risks of Shari'ah Non-compliance

If Shari'ah rules and principles are not complied with, there is a risk of relative transactions being cancelled and income going to charity, putting the very reputation and sustainability of IBEs at stake. Hence, the CBO tends to take a firm stand on compliance and to penalise non-compliant IBEs sternly. Any outsourcing arrangements must be agreed with the SSB so as to mitigate any Shari'ah non-compliance/operational risks.

Liquidity Risk

IBEs should have a sound and comprehensive liquidity risk management framework, integrated into their enterprise risk process. The governance process should be in a position to identify, measure, monitor, report and control the liquidity risk in compliance with Shari'ah rules and principles within the available context of Shari'ah-compliant products and markets. Reliance of windows on parent banks' funds has to be Shari'ah-compliant in structure and limited in quantum. There should be a real need, and it can be a permanent capital increase, an interest-free loan for a specified period, or an interbank *musharakah* or *mudārabah* for a specified period of not more than six months.

As explicitly stated, commodity *murābahah* transactions or *tawarruq*, by whatever name they are called, are not allowed for IBEs as a general rule (except in stated emergency situations).

PERFORMANCE OF THE ISLAMIC BANKING SECTOR IN OMAN

Two full-fledged Islamic banks and six Islamic banking windows (established by six of the seven local conventional banks) have been licensed and are in operation. As of 30 June 2017, there were a total of 72 branches (19 branches of the dedicated Islamic banks and 53 branches of the Islamic banking windows).

Comparative data from the last four and half years (i.e. from January 2013 to June 2017) reveals that

the Islamic banking sector has been doing well, both by itself and in comparison with the conventional banking sector, in terms of growth in assets as well as deposits and financing.

Total assets of the IBEs stood at RO 3,484 million as of 30 June 2017, of which financing constituted 77.8%, indicating their predominant direct contribution to the economy.

Position as of	Entities	Capital	Deposits	Gross Loans/ Financing	Assets
31 Dec 13	IBEs	327	170	435	811
	Conv. Banks	3,551	15,445	15,196	21,282
	Total	3,878	15,615	15,631	22,093
31 Dec 14	IBEs	350	688	1,038	1,346
	Conv. Banks	3,769	16,700	16,957	23,251
	Total	4,119	17,388	17,995	24,597
31 Dec 15	IBEs	388	1,530	1,764	2,203
	Conv. Banks	4,316	17,909	18,378	27,353
	Total	4,704	19,439	20,142	29,556
31 Dec 16	IBEs	430	2,151	2,398	3,013
	Conv. Banks	4,506	18,269	19,727	26,119
	Total	4,936	20,419	22,124	29,133
31 Dec 17	IBEs	433	2,636	2,712	3,484
	Conv. Banks	4,386	18,736	20,107	26,394
	Total	4,819	21,372	22,819	29,878

Financing

Total financing by IBEs grew by RO 2,277 million from December 2013 as against RO 4,911 million of conventional banks, implying that their contribution was almost one-third of the total growth.

There is significant tapering of the initial growth trajectory, but the 2017 annualised growth rate of IBEs is still outpacing the growth rate in the conventional banking sector.

Total Financing of Islamic vs Conventional Banks			RO in Millions
Position as of	Islamic	Conventional	Total Financing
31 Dec 13	435	15,196	15,631
31 Dec 14	1,038	16,957	17,995
31 Dec 15	1,764	18,378	20,142
31 Dec 16	2,398	19,727	22,124
30 Jun 17	2,712	20,107	22,819

Growth Rate of Financing Figures of Entire Banking vs. IBEs			
Period	IBEs	Conventional Banks	All Banks
2014	139%	12%	15%
2015	70%	8%	12%
2016	36%	7%	10%
2017*	13%	2%	3%

* The data is for the first six months of year 2017. For proper comparison on an annual basis, the growth rate should be considered as 26% for IBEs and 4% for conventional banks

Product-wise Financing Portfolio

The breakdown shows a major concentration in Diminishing *Mushārah* and *Ijārah* financing products, which together account for 76.5% of total financing as of 30 June 2017. These modes have been predominantly used in retail (consumer) financing, particularly for housing finance.

Product-Wise Total Financing as of 30 June 2017		
Product	RO in Millions	Percentage of total (%)
Diminishing <i>Mushārah</i>	1,162	42.9
<i>Ijārah/Ijārah Muntahia Bittamlik</i>	911	33.6
<i>Murābaḥah</i>	371	13.7
<i>Wakālah</i>	210	7.8
Others (<i>Istiṣnāʿ, Ujrah</i>)	57	2.1
Total	2,712	100.0
Wholesale and retail trade; repair of motor vehicles and motorcycles	76.43	2.8
Accommodation and food service activities	49.30	1.8
Others	34.75	1.3
Total	2,712.01	100.0

Sector-wise Financing Portfolio:

Sector-wise financing shows a major concentration in financing of households (retail/ consumer) – 50.7% and construction – 20.4%, which together account for nearly 71% of total financing as of 30 June 2017

Sector-Wise Total Financing as of 30 June 2017		
Sector	RO in Millions	Percentage of Total (%)
Financing of households (retail/ consumer)	1,374.77	50.7
Construction	553.38	20.4
Transportation and storage	213.96	7.9
Other service activities (exports)	177.58	6.5
Real estate activities	136.86	5.0
Manufacturing	94.98	3.5
Wholesale and retail trade; repair of motor vehicles and motorcycles	76.43	2.8
Accommodation and food service activities	49.30	1.8
Others	34.75	1.3
Total	2,712.01	100.0

Key Factors behind High Growth Rate of Financing by IBEs

- i. Base effect and market enthusiasm were the foremost and most obvious factors accounting for higher growth.
- ii. Capital as source of liquidity: At the start of operations, IBEs, especially full-fledged Islamic banks, had relatively larger funds available to them in the form of capital and they were expected to deploy capital and other funds within the earliest possible time frame to start earning. They were extending financing facilities at lower rates in comparison to conventional banks to convert available funds into earning assets. This helped them to grow their financing portfolios at a good pace, though the spread was comparatively low and so were the profits.
- iii. Regulatory relaxations
 - a. The CBO recognised the need for some initial support by the nascent sector and some regulatory relaxations were allowed to IBEs to kick-start their competition with well-established conventional banks. Banks in Oman had been limited to 15% of total credit for housing finance and to 35% for non-housing personal finance. Following relaxation of the regulations, IBEs were permitted until the end of March 2015 to exceed the former limits up to a combined maximum of 75%. This relaxation has been gradually

reduced, so as to be substantially within the limits by end December 2017. IBEs were, thus, able to build a considerable housing finance portfolio in the retail sector. With the prohibition of tawarruq and similar products, Islamic banking entities could otherwise have faced even more problems in building a personal finance portfolio.

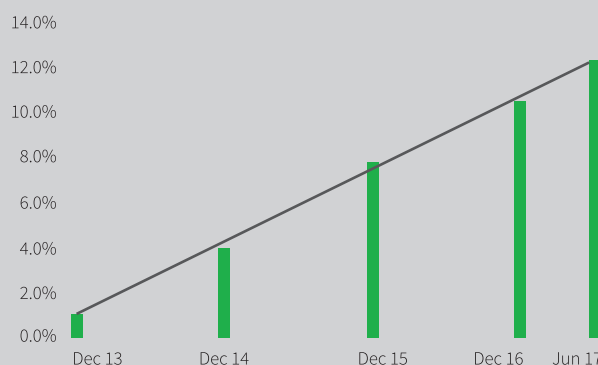
- b. IBEs sought and availed themselves of relaxation of regulatory limits, initially in overseas investment limits, since Shari'ah-compliant investment opportunities were not available at that time in Oman.
- c. There is a relaxation allowed to windows for reckoning the single obligor limit (of 15%) based on the net worth of parent banks instead of their own (though constrained in leveraging by their own net worth). Windows were, hence, able to extend a higher amount of financing facilities to big-ticket customers (targeting the corporate sector).
- iv. Market enthusiasm was buoyant, and IBEs made good efforts with the support of their respective SSBs. The IBRF avoided regulatory, operational and compliance uncertainties
- v. IBEs were tech-savvy and were ready for business from day 1. Customers were pleased that they were not required to visit branches frequently to consummate banking relationships.

Deposits

In four and a half years, the deposits of IBEs have grown impressively to RO 2,636 million, a market share of about 12% as of 30 June 2017.

It is noteworthy that reservations often voiced by government and public-sector enterprises in switching over to variable profit-based deposits was not relevant in Oman. Their deposits grew to RO 1,361 million as of 30 June 2017. This undermines the need for diversified growth of deposits and IAs.

Share of Islamic Banking in Total (%age)



Profitability Analysis

Four of the windows passed breakeven within a short span of two years. Islamic banks faced challenges due to their higher set-up costs and cost of operations. One achieved profitability in the year 2016. The Islamic banking sector posted a profit (before tax) of RO 12.518 million in the first half of 2017.

The annualised return on assets (ROA) and return on equity (ROE) of the sector would be at 0.8% and 5.8%, respectively, for the year 2017. These returns are lower than those of conventional banks, on account of the focus being more on business rather than profitability, and the larger gestation period required for banks.

It is noteworthy in this connection that, in spite of fast-paced growth, there has been no dilution of finance norms and asset quality concerns. Non-performing loans for IBEs stood at 0.35% as of 30 June 2017.

Implementation of Basel III by IBEs in Oman

IBEs have kept pace with the evolving and more rigorous norms under Basel and other dispensations. The Basel III accord was adopted in 2013 and, as per guidelines issued by the CBO, the minimum prescribed capital adequacy ratio (CAR) as of 30 June 2017 is 13.25% (including a capital conservation buffer of 1.25%).

All IBEs have been in compliance, and the overall CAR of the Islamic banking sector stood at 16.33%, and the Tier-1 ratio at 15.23%, as of 30 June 2017. The high CAR evidences the sound health of the sector. The IBRF provides the option of using the IFSB capital adequacy formula for assets funded by profit-sharing investment accounts (PSIA), and the alpha factor (α) is prescribed at 30% to cater for profit smoothing practice. But for now, and at the

Return on Assets and Equity for IBEs					
	2013	2014	2015	2016	2017
ROA	-5.8%	-4.1%	0.0%	0.5%	0.4%
ROE	-7.3%	-6.7%	-0.1%	3.3%	2.9%

CBO's instance, IBEs are following the conservative approach by maintaining capital for the entire risk-weighted assets (RWA) funded by PSIA. The IBEs, however, are undertaking profit-smoothing practices due to the highly competitive deposits market as well as the scope for a liquidity squeeze resulting from any external vulnerability.

Liquidity and Stable Funding

Oman rightly recognised *ṣukūk*'s popularity and ability to meet large financing needs. The Oman government's first Shari'ah-compliant sovereign *ṣukūk* for OMR 200 million was oversubscribed by 70%, and the government decided to accept subscription requests for RO 250 million. The Oman government's second international issue, for USD 2 billion, was also oversubscribed. There have been some private issues as well – with one of the issues in dual currencies. One of the IBEs has already issued *mushārakah*-based *ṣukūk*, while another is in process.

Short-term liquidity management, as of now, is being done through interbank transactions, mostly *wakālah* based. IBEs may make use of the secondary market in *ṣukūk* to address short-term liquidity management needs.

Under the Basel III regime, the liquidity coverage ratio (LCR) requirement has been progressively implemented in Oman with effect from 1 January 2015. The Standard for Net Stable Funding Ratio (NSFR) is to come into effect from 1 January 2018. All the IBEs are maintaining the LCR well above the minimum prescribed ratio and are not expected to have difficulty in complying with the NSFR ratio. The CBO is currently evaluating options to launch short- to medium-term liquidity management tools for IBEs.

Solvency Stress Testing

Banks are subject to close reviews in terms of performance, compliance, and the impact of potential risk, on-site, off-site and external.

The solvency stress-testing exercise conducted by the CBO simulates the impact of combined credit, equity, profit rate and forex shocks over a horizon of one year on the bank's capital to risk-weighted asset ratio (CRAR). The four different shocks are assumed to occur simultaneously, and the total impact is charged to the capital of the banks. The RWA are assumed to be adjusted for losses.

The results of recent stress testing on Islamic banks in Oman show that Islamic banks displayed high resilience to comfortably absorbing the assumed

losses. The post-impact CRAR for Islamic banks in Oman of 15.76% is above the CBO's requirement (13.25%) and that of the Bank for International Settlements (9.25%).

Implementation of IFRS-9

IFRS-9 is to be effective from 1 January 2018. Islamic banks have already started submitting their parallel pro forma financial statements under IFRS-9 to the CBO with effect from 30 September 2017. Common IFRS-9 guidelines would apply to Islamic banks and Islamic windows. Banks have been advised to be guided by the principle of substance over form while applying IFRS-9 to their Islamic banking activities. The CBO is looking into the relevant AAOIFI standard to set up a road map for adoption.

Future Plans and Prospects

In the context of market dynamics, including a possible tightening of global liquidity conditions and a rise in cost of funds and competition, IBEs will need to make more strenuous efforts to reach out and grow, availing themselves of opportunities for economic diversification and to enter areas such as the small and medium-size enterprise (SME) segment.

A strategic priorities and action plan for the period 2017–2019 includes the following:

- i. Facilitating IBEs to have wider reach by creating greater awareness and collaboration with various stakeholders.
- ii. Encouraging the further development of Shari'ah-compliant/innovative Islamic finance products, particularly in the corporate banking segment.
- iii. Encouraging more diversified growth, with SMEs reaching at least 5% of total finance.
- iv. Introducing liquidity management tools for interbank and central bank interface.
- v. Adopting a deposit protection scheme for IBEs to be based on *takāful*.

1.3 ISLAMIC CAPITAL MARKETS: DEVELOPMENT REVIEW

Recent trends in global capital markets have been driven by a gradual pick-up in economic conditions worldwide, as well as by some lessening of global policy uncertainties since the early part of 2017. The year also saw an increase in investors' risk appetite, strengthening of the stock market in many jurisdictions, and a moderation in financial volatility amid a generally optimistic global financial and liquidity environment.²¹ However, there were still lingering policy uncertainties in the international environment, amid a rise in protectionism as well as political risks in some economies against the backdrop of rising geopolitical tensions as a result of ongoing conflicts in the Middle East and rising US–North Korea tensions.

Within this broader context, Islamic capital markets saw positive developments during 2017, including sizeable growth in *ṣukūk* markets driven by large sovereign issuances, an increase in the volume of Islamic assets under management (albeit with a drop in the overall number of funds), as well as strong performances by Islamic equities.

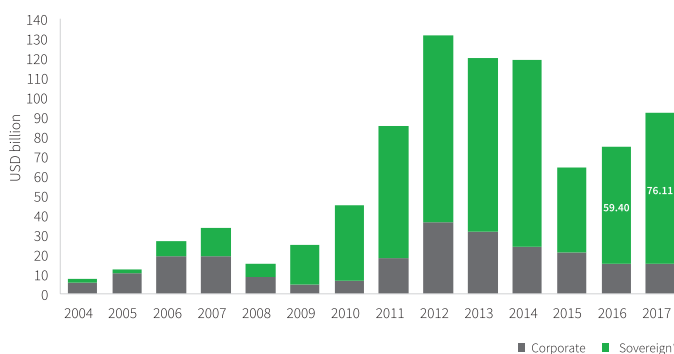
1.3.1 *Ṣukūk*²²

Global *ṣukūk* issuances in 2017 saw a growth of 22.8%, with the total volume of annual issuances reaching USD 91.9 billion as at end-2017, compared to USD 74.8 billion in 2016. This continues the gradual recovery of *ṣukūk* markets over the past two years following the sharp contraction observed in 2015.²³ At the end of 2017, the total volume of *ṣukūk* outstanding stood at USD 399.92 billion, which represents a 10% growth in volume of *ṣukūk* outstanding from 2016. However, total issuances for 2017 still remain below the USD 131 billion mark – the highest annual volume of *ṣukūk* issuances to date²⁴ – although the recent growth trajectory indicates a gradual closing of this gap.

The upward trend in *ṣukūk* issuances and a corresponding increase in *ṣukūk* outstanding is a reflection of large issuances in both foreign and local currency from the GCC region, primarily with medium to long-term maturities (within the 3–10 year range), which has been driven in large part by material budget deficits in the region resulting from low oil prices. In 2015 and 2016, GCC sovereigns turned predominantly to bond issuances to ease liquidity pressure and finance budget deficits. However, 2017 saw GCC sovereigns that did not rely as heavily on *ṣukūk* in previous years turning to the

ṣukūk market to diversify their funding mix and expand their investor base in addition to continued issuance of conventional sovereign bonds.

Chart 1.3.1.1 *Ṣukūk* Issuance Trend



*Includes all government-related entities, multilateral development banks and international organisations. For the purposes of this report, "GREs" refers to *ṣukūk* obligors with a shareholding structure representing more than two-thirds (66.67%) of government ownership through either ministries, authorities, etc. or other GREs such as sovereign wealth funds.

Source: IFSB Secretariat Workings

This subsection analyses the growth and development trends of the *ṣukūk* market over the past year, while section 3.3 (in Chapter 3) assesses the *ṣukūk* market's resilience fundamentals.

Sovereign *Ṣukūk*

Sovereigns underpinned the growth in volume of *ṣukūk* issuances in 2017. This was driven by a number of factors including the higher funding needs of GCC sovereigns, the generally good global liquidity conditions during 2017 and the growing demand for *ṣukūk* from domestic retail banks in the GCC as well as other major Islamic finance jurisdictions such as Malaysia and Indonesia.

Sovereign issuances, including GREs and multilateral issuers, accounted for approximately USD 76.11 billion, or 82.9% of the total issuances volume in 2017 [2016: USD 59.4 billion, or 79.4%; 2015: USD 43.6 billion, or 67.8%]. This represents a 28.1% increase in volume compared to last year.

In 2017, sovereigns across 16 jurisdictions issued *ṣukūk* [2016: 16 jurisdictions; 2015: 13 jurisdictions] which notably included an issuance by a non-OIC member country, Hong Kong, which came back to the market with its third US Dollar-denominated *ṣukūk*, a 10-year USD 1 billion sovereign issuance under a *wakālah* structure (see Chart 1.3.1.2).

²¹ U.N. (2018).

²² *Ṣukūk* 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, *ṣukūk* products have seen significant innovation with the introduction of hybrid, convertible, perpetual, retail and regulatory capital *ṣukūk*.

²³ An analysis of the subdued performance of the *ṣukūk* market in 2015 was covered in IFSI Stability Report 2016.

²⁴ In 2012.

The total sovereign issuances in 2017 also included about USD 4.8 billion (6.3%) of liquidity raised through short-term *ṣukūk* (i.e. less than one-year maturity), which is considerably lower than in previous years [2016: 19.7%; USD 11.7 billion]. Compared to the previous year, almost all jurisdictions that issue short-term *ṣukūk* have curtailed their short-term *ṣukūk* issuances this year. Possible reasons include that Islamic banks are adequately managing their liquidity requirements; there is a potentially lower demand for short-term *ṣukūk*; and governments are either not needing to raise short-term funding or are preferring other means of raising such funding.

Saudi Arabia dominated the sovereign market in 2017, with its debut US Dollar-denominated *ṣukūk* issuance during the first quarter of 2017, which is the largest US Dollar *ṣukūk* to date. It raised USD 9 billion through the issuance of two tranches, a 5-year and 10-year tranche, consisting of USD 4.5 billion each. The *ṣukūk* were structured using a hybrid model comprising a combination of *muḍārabah* and *murābahah* structures. This followed a similar hybrid structure to Saudi Aramco's maiden quasi-sovereign *ṣukūk*, which raised USD 3 billion in early 2017, and reflects an increasing trend this year of using hybrid structures. Notably, the complexity of the structure did not affect investor appetite or subscription levels. Saudi Arabia also launched a number of domestic local currency-denominated issuances in July 2017, with the tranches also seeing significant oversubscription and investor interest. One of the drivers of the Saudi *ṣukūk* market is the huge appetite for Saudi sovereign risk from local investors. The total volume of sovereign issuances in 2017 from Saudi Arabia amounted to a total of USD 29.9 billion, which also include issuances by multilaterals including the Saudi-based IDB, as well as its affiliated entity Islamic Corporation for the Development of the Private Sector (ICD), in addition to an issuance by the Arab Petroleum Investments Corporation (APICORP).

While there has been a decline in the number of new entrants into the *ṣukūk* market this year, Nigeria debuted in the sovereign *ṣukūk* market with a 7-year 100 billion Naira (USD 328 million) *Ijārah ṣukūk*. The *ṣukūk* attracted an oversubscription of 105.9 billion Naira, indicating sufficient investor appetite and demand for *ṣukūk* that can be tapped into by Nigerian issuers. The proceeds from Nigeria's first *ṣukūk* issuance are intended to be used to finance infrastructure development in the country – in particular, the construction and rehabilitation of road infrastructure. The addition of *ṣukūk* to Nigeria's debt portfolio also provides the potential to help plug a budget deficit caused by low oil revenues, which constitute about 70% of the government's revenue.

Among the regular issuers, Malaysia was the second-largest sovereign issuer, behind Saudi Arabia, accounting for USD 25.3 billion, or 32.89% of total sovereign

issuances, in 2017 [2016: 50.8%; 2015: 57.6%]. This figure includes multilateral issuances of USD 3 billion by the IILM, headquartered in Malaysia. The Malaysian government raised almost USD 9.9 billion through local currency issuances with varying tenors. GREs also continued to be highly active in 2017, particularly across the infrastructure, real estate, power and utilities, and transportation sectors, with the issuances raising funds mostly in local currency (Malaysian Ringgit), with one issuance in Singapore dollars and one US Dollar *ṣukūk*.

Malaysia's overall share of sovereign *ṣukūk* issuance is considerably lower in 2017, owing to an increase in issuances by other sovereigns as well as a decline in Malaysia's own borrowing needs amid ongoing fiscal consolidation. However, Malaysia still remains one of the largest *ṣukūk* markets, with about USD 187.7 billion in volume of *ṣukūk* outstanding. The Malaysian market is also more advanced than other *ṣukūk* markets in terms of public policy, regulatory framework, infrastructure, diversity of *ṣukūk* structures, secondary trading and so on, and is expected to continue to remain as a dominant issuer of *ṣukūk*.

Indonesia was the third-largest sovereign issuer, continuing to be highly active in the sovereign market, raising almost USD 5.1 billion, or 6.66% of total sovereign issuances in 2017 [2016: USD 8.75 billion 14.7%; 2015: USD 7.22 billion, or 17.5%]. The Indonesian government raised USD 3 billion through two tranches of US Dollar-denominated *ṣukūk*; a 10-year USD 2 billion *ṣukūk al-Ijārah* offering a profit rate of 4.15%, and a 5-year USD 1 billion *ṣukūk al-Ijārah* offering a profit rate of 3.4%. Indonesian sovereign issuances also included regular local currency issuances of varying tenors and types, including long-term *ṣukūk* for project financing and short-term *ṣukūk* for capital and liquidity management. The year 2017 also saw an issuance by an Indonesian GRE from the power and utilities sector, Perusahaan Listrik Negara PT, which is a government-owned corporation responsible for the majority of electrical power supply in Indonesia.

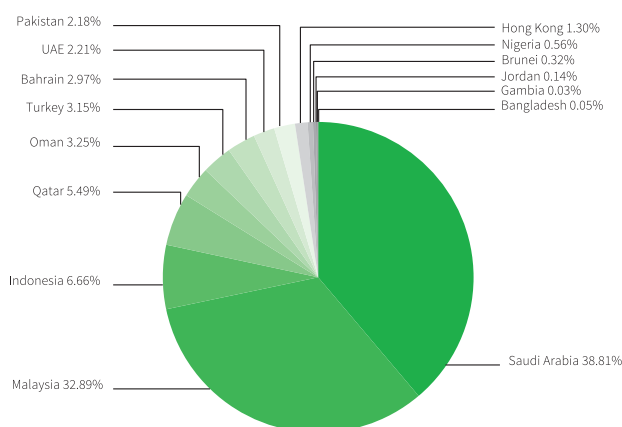
Other sovereigns that tapped the market in 2017 with large issuances include Qatar, Bahrain and Oman. Turkey raised approximately USD 2.4 billion in 2017 [2016: USD 3.1 billion; 2015: USD 1.3 billion], through one US Dollar-denominated *ṣukūk* of USD 1.25 billion, with a 5-year tenor offering a profit rate of 5%, as well as four local currency-denominated *ṣukūk al-Ijārah* certificates with maturities ranging from two to five years.

The Government of Pakistan also tapped the *ṣukūk* market through two *ṣukūk al-Ijārah*, raising a total of approximately USD 1.7 billion which included a 5-year US Dollar-denominated tranche of USD 1 billion offering a profit rate of 5.63% and a 3-year local currency issuance of about USD 677.2 million, offering a profit rate of 5.24%.

Among the *shukūk* issuances by multilaterals, a new entrant was the Africa Finance Corporation (AFC) with a USD 150 million, 3-year *shukūk*. This represented the first *shukūk* issued by an African supranational entity and which saw high levels of investor interest.

Notably, the increase in sovereign issuances during 2017 is largely attributable to an increase in the volume of sovereign issuances by four jurisdictions from the GCC region – Saudi Arabia, Qatar, Oman and Bahrain. There was a marked decline in sovereign issuances from the UAE, Pakistan and Indonesia in comparison to the previous year's issuances, as well as a drop – in terms of overall volume – of issuances from Malaysia, Turkey, Brunei and Jordan.

Chart 1.3.1.2
Sovereign[^] *Shukūk* Issuance by Jurisdiction (2017)



[^] Includes all GREs, MDBs and IOs.

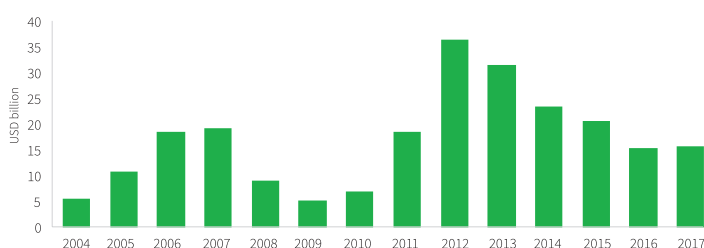
*MDBs and IOs for 2017 include *shukūk* issuances by the Islamic Development Bank, the Islamic Cooperation for the Development of the Private Sector, the International Islamic Liquidity Management Corporation, the Arab Petroleum Investments Corporation and the Africa Finance Corporation. These *shukūk* issued have been traced to their headquarter jurisdictions – namely, Saudi Arabia for IDB, ICD and APICORP; Malaysia for IILM; and Nigeria for AFC.

Source: IFSB Secretariat Workings

Corporate *Shukūk*

Corporate *shukūk* issuances saw a modest improvement in 2017, breaking the steady downward trend observed in corporate issuances from 2012 onwards.²⁵ Issuances by corporates amounted to a total of USD 15.75 billion in 2017, which represents a 2.3% increase from the previous year [2016: USD 15.4 billion; 2015: USD 20.7 billion].

Chart 1.3.1.3 Corporate *Shukūk* Issuance Trend



Source: IFSB Secretariat Workings

In 2017, nine jurisdictions raised funds in the corporate *shukūk* market, which consisted of a similar composition of jurisdictions compared to 2016, with an issuance this year by a corporate from Bahrain which did not have any corporate *shukūk* issuances during the previous year [2016: nine jurisdictions; 2015: eight jurisdictions]. Notably, there were no issuances by corporates from non-OIC member countries during 2017 as compared to 2016, which saw one corporate issuance from Europe.

In keeping with the past trend, Malaysian obligors still hold the largest share of corporate *shukūk* volume, accounting for 60.6% share in volume of corporate issuances and amounting to a total of USD 9.5 billion in 2017 [2016: USD 7.7 billion, or 50.2%; 2015: USD 7.1 billion, or 33.7%]. This considerable increase in issuances by Malaysian corporates reflects issuers taking advantage of a still favourable interest rate environment, as well as a more positive economic outlook. Ringgit-denominated corporate *shukūk* increased by 50% in 2017, spurred by increases in both the rated and unrated segments. The structures of Malaysian issuances were comparatively more diverse than other jurisdictions and varied across a range of Shari'ah-compliant contract types, including *murābahah*, *muḍārabah*, *musharakah*, *ijārah* and *wakālah*, as well as hybrid structures that combined more than one type of contract, which were issued across a range of short-, medium- and long-term maturities.

Corporate issuers from Malaysia also represented a very broad range of sectors, including power and utilities, retail, telecommunication, real estate, infrastructure, financial services, transportation, industrial conglomerates, education, agriculture, oil and gas, as well as the property and construction sectors. Notably, the year's issuances involved the landmark first issuance of a "green" SRI *shukūk* by a Malaysian corporate issuer, Tadau Energy, in June 2017, amounting to RM 250 million to finance a large-scale solar project. Subsequently, in October 2017, Quantum Solar Park Malaysia also issued a green SRI *shukūk* worth RM 1 billion, which is the world's largest to date, to finance the construction of three large-scale solar photovoltaic plants.

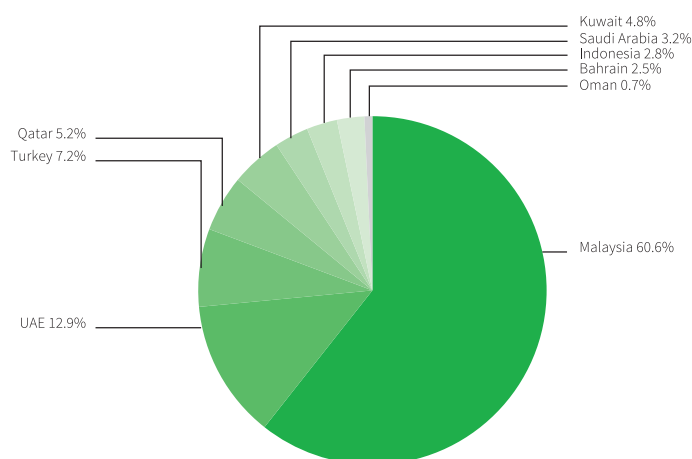
The second-largest share in volume of corporate *shukūk* issuances in 2017 was held once again by the UAE, amounting to USD 2.03 billion, or 12.9% of total corporate issuances, which is a 27.5% decline in volume of corporate issuances from the UAE compared to 2016 [2016: USD 2.8 billion, or 18.3% of total corporate issuances; 2015: USD 3.4 billion, or 18.9% of total corporate issuances]. The issuances included a 5-year USD 1 billion *shukūk* issued by Dubai Islamic Bank carrying a profit rate of 3.66%, which was the largest senior *shukūk* issuance by a financial institution. The remaining issuances were by the real estate developer DAMAC and the Dubai-based Emirates REIT, a Shari'ah-compliant real estate investment trust.

²⁵ Reasons for the decline in corporate *shukūk* issuances since 2013 are discussed in IFSI Stability Report 2017.

All corporate issuances by the UAE in 2017 were US Dollar-denominated *shukūk*, with maturities ranging from 1.5 to 5 years under *wakālah* and *ijārah* structures.

Turkey moved up to third-largest issuer in terms of volume of corporate issuances in 2017, accounting for about 7.2% of issuances, or USD 1.1 billion [2016: 8.2%, or USD 1.3 billion]. The majority of issuances were local currency-denominated short-term *shukūk* issued by financial institutions, with the exception of one US Dollar-denominated 7-year *shukūk* issued by Aktif Bank. All *shukūk* issuances from Turkey continue to be structured under an *Ijārah* concept, with *shukūk* transactions being conducted via asset leasing companies. Although the tax exemptions introduced in Turkey which allow corporate income tax and value-added tax exemptions in sale and leaseback structures (i.e., *shukūk al-Ijārah*) were extended to other types of *shukūk* contracts from August 2016, corporates in Turkey have not issued *shukūk* under any other structure.

Chart 1.3.1.4
Corporate *Shukūk* Issuance by Jurisdiction (2017)



Source: IFSB Secretariat Workings

Across other GCC countries, corporate issuances by Saudi Arabia declined considerably, from third-largest issuer to seventh place during 2017, accounting for only 3.2% of all corporate issuances [2016: 11.6%]. Qatar's share in volume of issuances dropped slightly to 5.2%, or USD 824.26 billion, and has seen a year-on-year decline in corporate issuances of 20.4% since 2015 [2016: USD 973 million; 2015: USD 1.3 billion]. All corporate issuances from Qatar during 2017 were by Qatar Islamic Bank, which included *shukūk* issuances across a range of currencies – including US Dollar-, Japanese Yen- and Australian Dollar-denominated *shukūk*, with maturities ranging across two- to five-year tenors. Kuwait's overall share in volume of issuances in 2017 increased slightly from the previous year, on the back of two *shukūk* issuances – Warba Bank issued its maiden USD 250 million perpetual Tier-1 *mudārabah* capital certificates in 2017, while the second issuance was a debut USD 500 million 7-year *shukūk*

offering by EQUATE, under a USD 2 billion Trust Certificate (*shukūk*) Issuance Program. Notably, the EQUATE *shukūk* is also the first issuance approved for a Kuwaiti corporate by the Capital Market Authority of Kuwait in accordance with the new CMA law. The issuance was well received globally by banks, financial institutions and fund managers, and was oversubscribed to an amount of USD 3.7 billion. Oman saw only one corporate issuance during 2017, constituting a debut issuance by Meethaq, which is the first Islamic banking entity to obtain approval by the Capital Market Authority of Oman for a *shukūk* issuance aimed at retail investors in Oman.

Indonesia's corporate *shukūk* issuances grew from the previous year, raising a total of USD 446.66 million, which represents 2.8% share of total volume of corporate issuances during 2017 [2016: USD 280.7 million, or 1.8% share; 2015: USD 569.1 million, or 3.2%]. The sectoral distribution of corporate issuers was diverse, consisting of issuances from the telecommunication, manufacturing, financial services, media, and oil and gas sectors. All corporate issuances were structured under *ijārah* or *muḍārabah* contracts, across maturities ranging from one- to 10-year tenors. Consistent with the previous trend, all issuances were denominated in local currency. *Shukūk* issuance by Indonesian corporates has been comparatively smaller in terms of issuers and outstanding issuances. In contrast, the local conventional bond market has outstanding issuances of more than IDR 320 trillion in 2016 and is over 20 times larger. This indicates significant room for growth in the Indonesian corporate *shukūk* market, which remains under-penetrated given its large Muslim investor base.

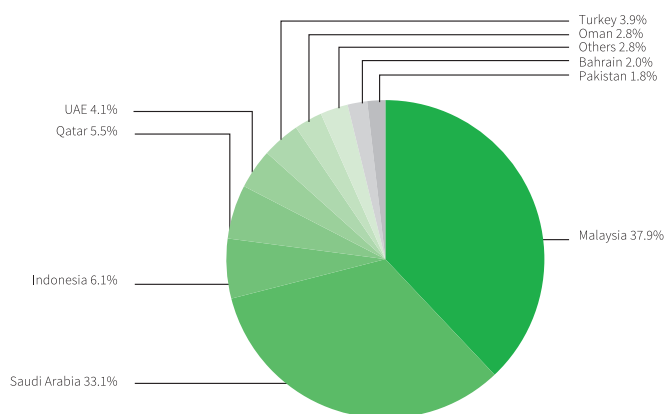
While the overall volume of corporate issuances declined in most jurisdictions, the modest overall increase in corporate issuances was a result of increases in issuance by corporates from Malaysia, Indonesia, Kuwait and Oman. The low levels of corporate issuances from many jurisdictions are due to a number of factors, including a higher cost of issuance of *shukūk*, complex legal structures, lack of standardisation of *shukūk* and a lack of suitable assets, in addition to lack of fiscal incentives and a level playing field in many jurisdictions for *shukūk* issuance compared to bonds.

Overall Analysis

Looking at *shukūk* issuance activity across both the sovereign (including GREs/MDBs/IOs) and corporate *shukūk* markets, issuances took place in 17 jurisdictions in 2017 [2016: 17 jurisdictions; 2015: 14 jurisdictions]. Malaysia retained its position as the overall largest issuer of *shukūk* in terms of volume, accounting for 37.9% [2016: 50.6%; 2015: 50.4%]; while Saudi Arabia moved up to second place owing to its substantial sovereign issuances during 2017, accounting for an overall global market share of 33.1% [2016: 7.7%; 2015: 11.8%]. On the other

hand, Indonesia's share in volume of total issuances saw it drop to third-largest issuer in 2017, accounting for 6.1% [2016: 12.1] (see Chart 1.3.1.5(a)). Qatar and UAE were the fourth- and fifth-largest issuers, accounting for 5.5% and 4.1%, respectively [2016: 4.1% and 10.5% respectively]. Notably again, all six GCC member states issued *shukūk* during 2017, accounting for a total of USD 40.79 billion (excluding MDB and IOs), or 44.4% of total volume of *shukūk* issuances [2016: 25.9%; 2015: 29.8%]. The only non-OIC member to issue *shukūk* this year was Hong Kong [2016: one non-OIC issuance from Europe; 2015: issuances from Hong Kong and the US-headquartered World Bank].

Chart 1.3.1.5(a)
***Shukūk* Issuances by Jurisdiction and Share (2017)**



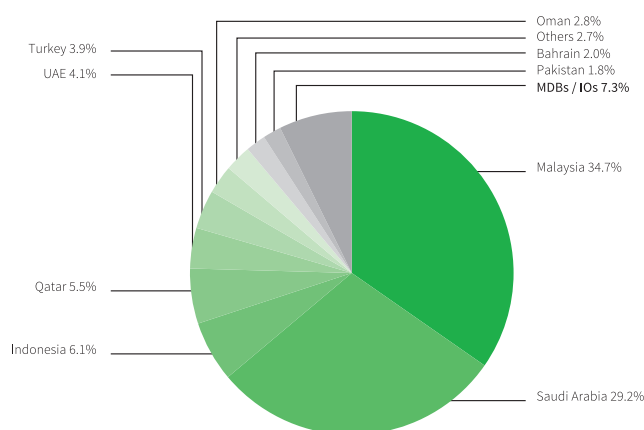
**Based on obligor's domicile.
Source: IFSB Secretariat Workings*

The share of issuances by MDBs and IOs decreased in 2017 to USD 6.7 billion, or 6.2% of all issuances [2016: USD 13.4 billion, or 17.9%; 2015: USD 8.3 billion, or 14%]. Five MDBs/IOs participated in the *shukūk* market in 2017, which included a debut issuance by the Nigeria-based AFC. The Malaysia-based IILM continued its short-term liquidity management *shukūk* programme, issuing a total of USD 3 billion in 2017. The Saudi-based IDB raised USD 2.98 billion in 2017 through its regular issuance programme, which included two US Dollar-denominated tranches with five-year tenors and two Euro-denominated tranches with seven-year tenors [2016: USD 3.26 billion; 2015: USD 1.56 billion]. Following its debut *shukūk* in 2016, the IDB-affiliated entity–Saudi-based ICD also issued a USD 80 million 2-year *shukūk* in 2017. Additionally, the Saudi-based APICORP issued a USD 500 million 5-year *shukūk* as part of its USD 3 billion trust certificate programme.

Chart 1.3.1.5(b) shows the ranking of jurisdictions by volume, excluding the share of issuances by MDBs and IOs. In 2017, Malaysia retained the largest share of volume at USD 31.86 billion, or 34.7% [2016: USD 28.6 billion, or 38.2%] after excluding issuances by IILM, followed by

Saudi Arabia accounting for 29.2% of total issuances in 2017, or USD 26.8 billion [2016: USD 1.8 billion, or 2.4%], after exclusion of issuances by IDB, ICD and APICORP.

Chart 1.3.1.5(b) *Shukūk* Issuances by Jurisdiction and Share [Ex-MDBs and IOs] (2017)

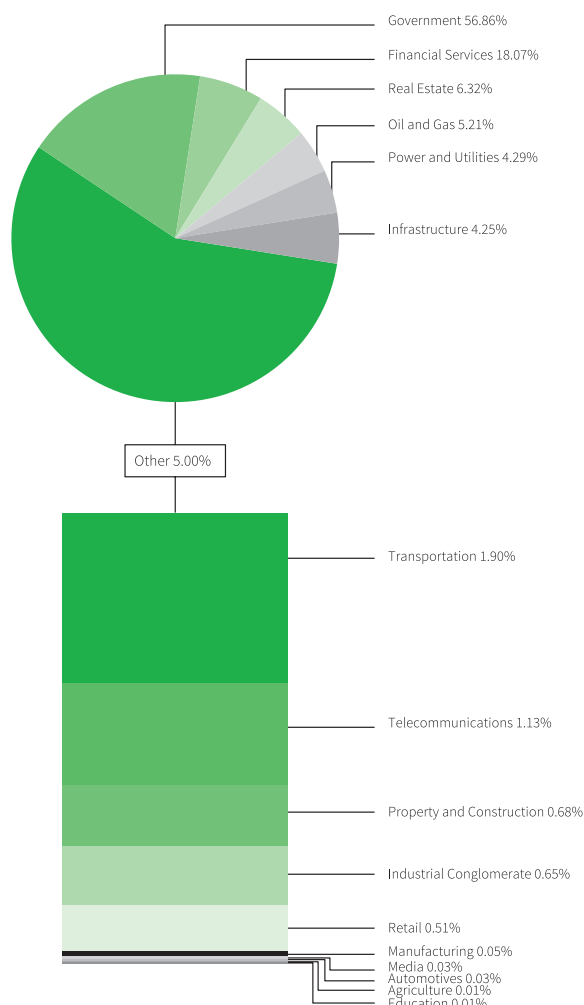


Based on obligor's domicile.

Source: IFSB Secretariat Workings

Analysing *shukūk* issuances in 2017 by sector, the government and financial services sectors continue to be the two main sectors with the largest volume of *shukūk* issuances (see Chart 1.3.1.6). The share of the government sector in the volume of total *shukūk* issuances increased in 2017, accounting for 56.86% [2016: 42.9%; 2015: 43.5%]. On the other hand, the financial services sector's overall share of volume declined, accounting for 18.07% [2016: 31%; 2015: 34.4%]. Notably, *shukūk* issuances from the oil and gas sector increased relative to previous years, accounting for 5.21%, compared to 0.78% in 2016. Likewise, *shukūk* issuances by the real estate sector continue to grow, increasing its share in volume of issuances to 6.32%, or USD 5.8 billion [2016: USD 3.1 billion, or 4.1%; 2015: USD 1.3 billion, or 2.2%].

Consistent with previous years, there was significant participation by infrastructure-linked issuers across the power and utilities, infrastructure, telecommunication and transportation sectors, as well as an increase in issuances by the property and construction sector compared to last year. The aforementioned sectors collectively accounted for USD 11.25 billion, or 11.57% of total issuances. Distribution across other sectors comprised industrial conglomerates (0.65%), retail (0.51%) and manufacturing (0.05%). Notably, issuances from the education and agriculture sectors decreased in 2017 to 0.01%, or USD 11.31 million and USD 6.79 million, respectively [2016: 1.15%, or USD 857.35 million and 1.13%, or USD 840.99 million, respectively].

Chart 1.3.1.6 *Shukūk* Issuances by Sector (2017)

Source: IFSB Secretariat Workings

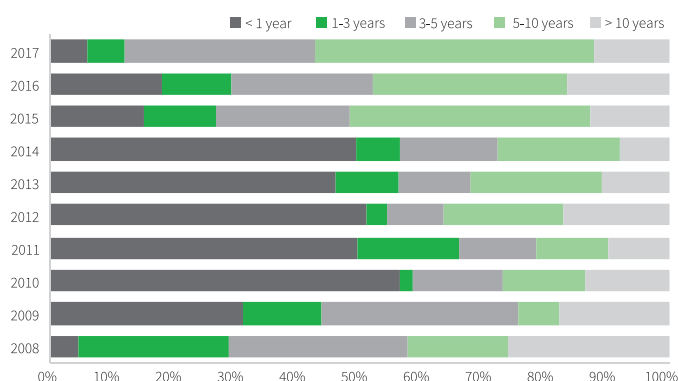
Consistent with the trend in the last two years, the maturity profile of *shukūk* expanded in the five-ten year maturity bracket which accounted for 45.02% of *shukūk* issued in 2017 [2016: 31.4%; 2015: 38.8%], followed by the three-five year maturity bracket which accounted for 30.75% [2016: 22.8%; 2015: 21.8%]. *Shukūk* in the 10+ years' maturity bracket have, however, decreased to 12.12% [2016: 16.5%; 2015: 12.8%].

Longer-term *shukūk* beyond the 10-year maturity mark were predominantly issued by Malaysian obligors, with two *shukūk* being issued by Indonesian obligors with a 15- and 30-year maturity. *Shukūk* with shorter maturities – that is, in the less than one year bracket and in the one-three year maturity bracket – declined further in 2017, to 6.16% and 5.96%, respectively [2016: 18% and 11.3%, respectively; 2015: 15.2% and 11.6%, respectively].

The shifting trend towards long-term *shukūk*, with even further contraction in the volume of *shukūk* issuances with short-term maturities (i.e. less than one year, and one-three years) is, in part, attributable to the significant shift resulting from Central Bank of Malaysia's cut in short-term *shukūk* issuance in 2014, which has been replaced by

other liquidity management instruments such as short-term Shari'ah-compliant financing aimed at its domestic Islamic banks. *Shukūk* issuances this year also saw a drop in issuances with more than 10 years' maturity. The shift has been towards tenors in the three-five year and five-ten year range, which signals a shift in investors' appetite for medium- to long-term issuances (less than 10 years) as a result of the supply/demand imbalance for *shukūk*, as well as an increase in *shukūk* issuances for projects such as infrastructure with long-term funding requirements. In particular, the growth in the volume of *shukūk* in the five-ten year period is also reflective of tenors for Islamic banks' Basel III-compliant capital adequacy issuances.

Analysing maturity trends across individual jurisdictions, the average *shukūk* maturity across all issuances by Malaysia was 7 years and 8 months in 2017, while issuances by Oman averaged about 7 years and 3 months. *Shukūk* issuances by Saudi Arabia, Qatar, Indonesia and Pakistan had average maturities ranging between four and six years. The remaining jurisdictions had an average maturity of about one year across all issuances.

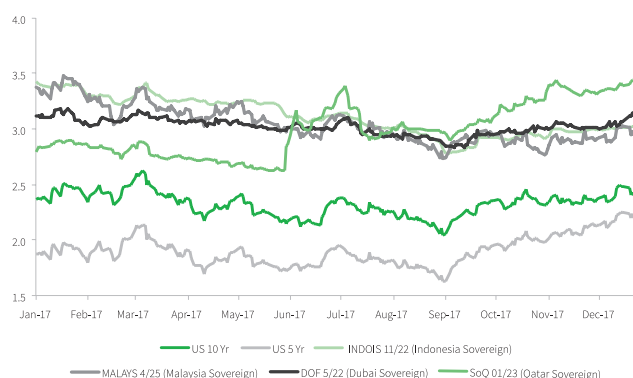
Chart 1.3.1.7 *Shukūk* Maturity Trend of New Issuances

Source: Bloomberg, IFSB

Lastly, secondary market performances of *shukūk* yields experienced some degree of volatility during the course of 2017 due to a number of global, regional and national events. On the global front, yields on US Dollar *shukūk* instruments decreased in various jurisdictions in anticipation of a US interest rate hike, with US 5- and 10-year yields pressing down in September 2017 to their lowest level since the 2016 US election (see Chart 1.3.1.8). The political rift in the GCC in June 2017 also resulted in a sudden spike in *shukūk* yields, most apparently for Qatar's US Dollar-denominated *shukūk* issuance, but which normalised by late August.

Shukūk pricing and yields in comparison to bonds is explored in further detail in Chapter 3 of this report.

Chart 1.3.1.8
Selected USD *ṣukūk* Yields vs. US Government Securities Yield (2017)



Source: Bloomberg, IFSB

Summary and Challenges

Ṣukūk issuances saw a strong recovery in 2017, with the highest volume of issuances since 2015, boosted by an increase in sovereign issuances from some jurisdictions. There was a marked growth in quasi-sovereign issuances by GREs, amounting to USD 18.15 billion in 2017, a 24.5% increase from the previous year. The *ṣukūk* market also saw an increased utilisation of hybrid structures by a number of issuers. The complexity of such structures was not observed to deter investors' appetite. Also observed was the continuation of the trend of growing *ṣukūk* issuances that have longer-term tenors, while short-term *ṣukūk* issuances contracted even further, owing to a number of factors discussed earlier. Notably, the supply of *ṣukūk* is still considerably below the demand, which has reduced the demand for high credit ratings as well as shifting investor preference towards holding *ṣukūk* with longer-term tenors until maturity.

Sovereigns underpinned the recovery in the global *ṣukūk* market in 2017, which is expected to grow as governments continue to explore alternative ways to diversify their funding base and satisfy the liquidity requirements of retail banks. Saudi Arabia surpassed other markets in sovereign issuances this year with the issuance of the largest international *ṣukūk* to date, which also qualifies as a high-quality liquid asset (HQLA) under Basel III, along with several domestic *ṣukūk* as the country takes steps to bolster its finances as part of an economic overhaul. Notably, issuances from the GCC accounted for over 50% of sovereign issuances in 2017. Investors' appetite for such issuances has been strengthened by the stabilisation in oil prices, as well as by active efforts in the region towards fiscal consolidation and capital market reform. The broader structural changes being implemented by GCC governments have also contributed towards assuaging investor fears about oil-dependent economies.

Malaysia continues to maintain its dominance of the *ṣukūk* market in terms of overall issuances, reflecting its more advanced Islamic finance architecture. However, while in the recent past Malaysia has attracted a number of foreign issuers to issue *ṣukūk* in the ringgit market, this was not the case in 2017 owing to a number of factors, including the fall in oil prices and the volatility in the value of the ringgit against the US Dollar.

Corporate issuances, mostly by financial institutions, still face challenges, although they saw a slight improvement in 2017. However, they continue to lag behind sovereign issuances, accounting for only 18.1% of total *ṣukūk* issuances, with many of the challenges faced by issuers still remaining. *Ṣukūk* has not yet managed to achieve the efficiency of conventional bond issuance, which continues to deter some issuers. A further challenge is that smaller corporate issuers face weaker investor appetite compared to sovereign issuers, in addition to higher relative costs for arranging and rating smaller issuances.

Overall, the *ṣukūk* markets remained fairly resilient to geopolitical and economic events in 2017. *Ṣukūk* market activity was also supported by favourable global liquidity conditions during 2017. However, *ṣukūk* issuances still remain concentrated within the traditional regions of South-East Asia, the Middle East and Turkey. The number of non-OIC member countries issuing *ṣukūk* has been minimal, with only one sovereign issuance this year by Hong Kong. There has also been a decline in the overall number of new entrants into the *ṣukūk* market since 2014. However, a number of new African sovereigns have expressed their intention to tap the *ṣukūk* market for infrastructure development projects, which indicates a positive prospect for new entrants to the *ṣukūk* market in the near term.

1.3.2 Islamic Equity Indices and Funds

Islamic equity markets performed well in 2017, with the majority of Islamic equity indices showing better performances against conventional benchmarks. Analysis of the 2017 year-to-date (YTD) returns of Islamic equity indices versus conventional equity indices, and of the total returns over three-year and five-year horizons, indicates that the S&P Global 1200 Shari'ah Index outperformed the S&P Global 1200 Index in 2017 (see Table 1.3.2.1.a). Likewise, the Dow Jones Islamic Markets (DJIM) World Index outperformed the DJ Global Index, with an annual total return of 25.2% compared to returns of 21.8% by DJ Global, which is a turnaround from last year, when conventional indices performed better (see Table 1.3.2.1.b).

Table 1.3.2.1(a)
Total Returns of S&P Global 1200 Index vs S&P Global 1200 Shari'ah Index

	S&P Global 1200 Index	S&P Global 1200 Shari'ah Index
2017	23.84%	25.91%
3 Yr	10.16%	10.66%
5 Yr	12.14%	12.68%
10 Yr	5.67%	6.93%

Table 1.3.2.1(b)
Total Returns of DJ Global Index vs DJIM World Index

	DJ Global Index	DJ Islamic Markets World Index
2017	21.8%	25.2%
3 Yr	7.4%	8.3%
5 Yr	8.8%	9.6%

Regional Islamic equity indices also showed a strong performance, with DJIM developed markets, DJIM Asia Pacific, DJIM Europe and DJIM emerging markets all performing better than their conventional equivalents in terms of total annual returns. Islamic indices outperformed their conventional counterparts due largely to their greater relative exposure to the technology sector, which was the top-performing sector for the year, as well as large exposures to the health-care, industrials and materials sectors, which performed well in 2017. They also had lower exposures to financials, which lagged in the first half of the year, trailing the broader market.²⁶

However, notably, equity markets in the GCC, both Islamic and conventional, were weaker during 2017,²⁷ driven mainly by low oil prices and geopolitical instability in the region. While the GCC indices are not significantly exposed to the energy sector (0.3%), predominant state ownership in this sector means that oil prices remain a key driver of economic performance in the region.

On a longer-term trend basis, over a 10-year horizon from 2008 to 2018, S&P Global 1200 Shari'ah also outperformed, generating higher returns at 6.93% compared to 5.67% returns generated by S&P Global 1200 during the same period (see Chart 1.3.2.2 and Table 1.3.2.1a).

In terms of both components and market capitalisation, S&P Global 1200 substantially outnumbers S&P Global 1200 Shari'ah (see Charts 1.3.2.3 and 1.3.2.4). The average market capitalisation of S&P Global 1200 Shari'ah is also relatively lower at USD 20.86 billion from 497 stocks,

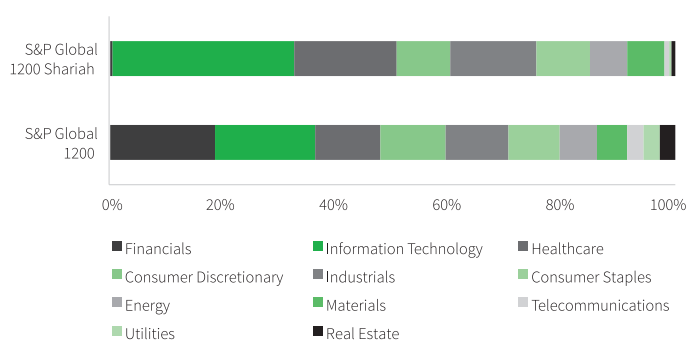
compared to S&P Global 1200 at USD 44.99 billion from 1,220 stocks. S&P Global 1200 Shari'ah's major exposure was to the technology (32.1%) and health-care (18%) sectors, whereas S&P Global's major exposure was to the financial (18.6%) and technology (17.7%) sectors, which contributed to the performance of the respective indices during the year (see Chart 1.3.2.2).

Chart 1.3.2.1
10-Year Historical Performance of S&P Global 1200 vs S&P Global 1200 Shari'ah Index



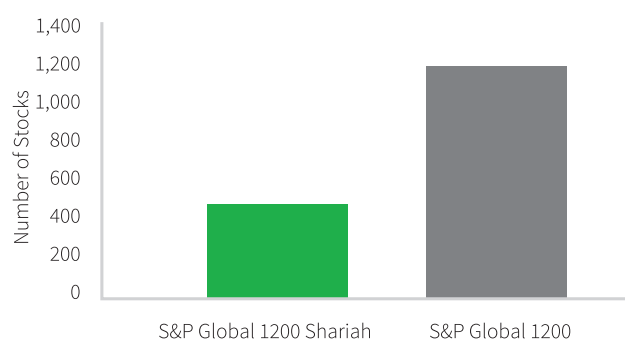
*The two indices are standardised at a scale of 100 for comparative purposes.
Source: Bloomberg, IFSB

Chart 1.3.2.2
Sector Allocation (2017)



Source: Dow Jones, IFSB

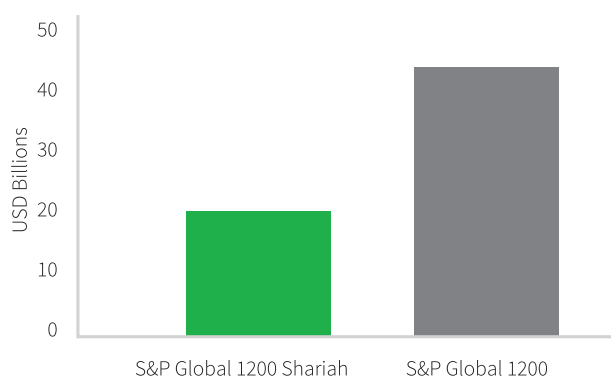
Chart 1.3.2.3
Number of Constituents (2017)



²⁶ S&P Global Equity Indices Monthly Updates.

²⁷ S&P Shari'ah Indices Dow Jones Islamic Market Indices, 31 December 2017.

Chart 1.3.2.4 Market Capitalisation (2017)

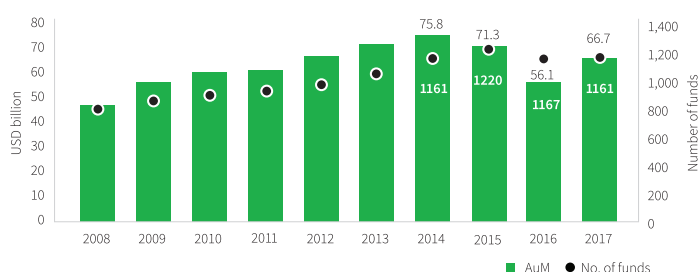


Source: Dow Jones, IFSB

In terms of the Islamic funds industry, there were 1,161 Islamic funds holding about USD 66.7 billion of assets under management at the end of 2017 [2016: 1,167 Islamic funds, USD 56.1 billion AuM] (see Chart 1.3.2.5). Notably, while the number of Islamic funds dropped slightly, the total AuM increased by 18.8%, a marked improvement from the steady decline in total AuM observed from 2014 onwards. Out of the total number of Islamic funds, 821 funds are classified as active, holding about USD 61.6 billion AuM [2016: 826 active funds, USD 51.2 billion AuM]. This is an indication that while the number of funds has declined, the overall size of funds has increased in 2017, with the average AuM of all active funds standing at USD 79.8 million as at the end of 2017 [2016: USD 64.9 million]. This is a positive development given the need for Islamic funds to achieve greater mass and economies of scale, which has been a significant challenge in this sector. The number of Islamic funds that have become inactive amounted to 29%, or 341 funds, holding approximately USD 5.1 billion AuM in total, or an average of USD 15 million per fund, which also suggests that smaller Islamic funds may be facing challenges.

Chart 1.3.2.5

Growth in Assets under Management and Number of Islamic Funds



Source: IFSB Secretariat Workings

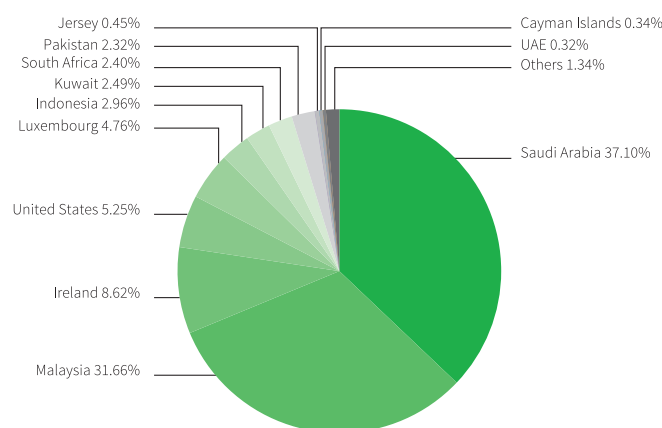
The distribution of Islamic funds by domicile and by share of total AuM in 2017 across the top five jurisdictions remains consistent with 2016. Funds based in five

jurisdictions account for about 88% of the total Islamic funds' AuM in 2017 [2016: 85%; 2015: 87%]. The remaining 12% AuM, worth USD 8.4 billion, is distributed across 29 jurisdictions (including offshore domiciles) [2016: 85%, USD 8.2 billion across 32 jurisdictions]. However, the number of jurisdictions where Islamic funds are domiciled decreased to 34 in 2017, compared to 37 in 2016, but with an overall increase in total AuM to USD 66.7 billion [2016: USD 56.1 billion].

The two key domiciles for Islamic funds are Saudi Arabia and Malaysia, which collectively account for about 69% of total AuM. Saudi Arabia still remains the largest domicile, holding 37.1% of the total Islamic funds AuM, although its share has declined slightly over the last three years [2016: 38%; 2015: 40%]. Malaysia, as the second-largest domicile in terms of volume, held about 31.7% of total AuM in 2017 [2016: 29%; 2015: 28%] (see Chart 1.3.2.6). The focus of funds differed between jurisdictions, with funds' domains in Malaysia being largely concentrated on equity (59%), followed by money market (24%) and fixed income (12%), with a few focusing on mixed allocation (5%). The majority of Malaysian funds had a local or Asia-Pacific focus, followed by funds that have a global focus. On the other hand, fund domains in Saudi Arabia were primarily money market-focused (46%), followed by commodity- (19%) and equity-focused funds (16%), with a limited number of funds focusing on fixed income (9%), mixed allocation (7%) and real estate (3%). Saudi Arabia's funds had a wider geographical focus, with funds focusing on the local, GCC and MENA regions, as well as funds with a global focus and others, to a lesser extent, focusing on the European, US and Asia-Pacific regions.

Notably, out of the 34 jurisdictions that were domiciles for Islamic funds in 2017, 20 jurisdictions are non-OIC countries, with the largest domiciles for Islamic funds in this category being Ireland, the United States and Luxembourg.

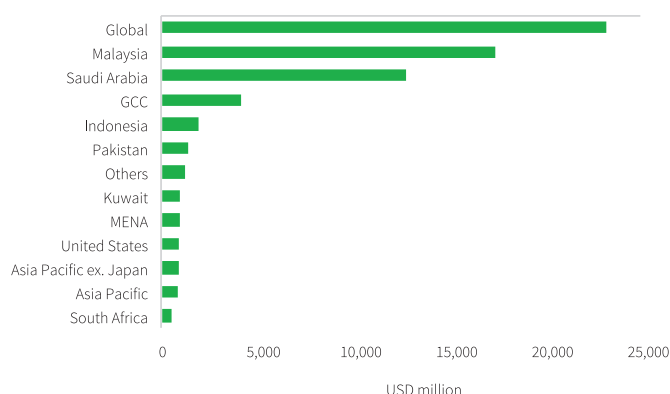
Chart 1.3.2.6 Islamic Fund Assets by Domicile (2017)



Source: IFSB Secretariat Workings

In 2017, the top three categories for geographical focus of investments of Islamic funds remain largely unchanged from 2016, with funds that have a global investment focus continuing to be the largest category, amounting to 35% of total AuM in 2017, or USD 23.2 billion in absolute dollar terms [2016: 34%, USD 18.9 billion] (see Chart 1.3.2.7). The growing global focus of Islamic funds is indicative of the need for funds to achieve greater portfolio diversification given the unpredictability and volatility of recent geopolitical and economic conditions. Funds with a Malaysian focus were the second-largest category, which also increased in 2017, accounting for 26% of total AuM, or USD 17.4 billion in absolute dollar terms, compared to 25% of total AuM, or USD 14.2 billion, in 2016. The Saudi market once again represented the third-largest focus, accounting for 19% of total AuM [2016: 21%; 2015: 31%].

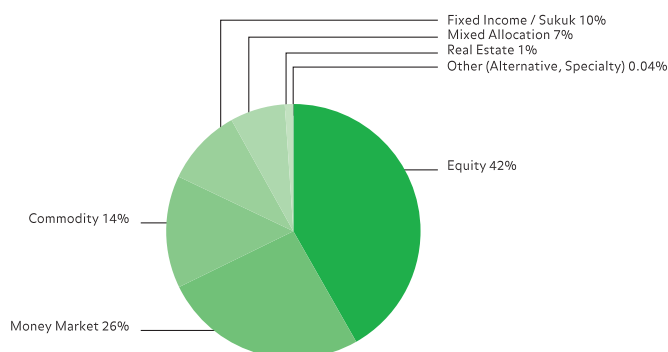
Chart 1.3.2.7
Islamic Fund Assets by Geographical Focus (2017)



Source: IFSB Secretariat Workings

Looking generally at the overall asset-class focus of global Islamic funds' AuM, equity, money market and commodity-focused funds continue to dominate in 2017, driven largely by Saudi Arabia and Malaysia. The share of equity-based funds stood at 42% in 2017, increasing in absolute dollar terms to USD 27.8 billion [2016: 43%, USD 24.0 billion] (see Chart 1.3.2.8). Likewise, the market share of money market-based funds increased to 26% of total AuM, or USD 17.3 billion [2016: 25%, USD 13.9 billion]. Commodity-based funds also showed growth in share, accounting for 14% of total AuM, or USD 9.5 billion [2016: 10%, USD 6.8 billion]. Other significant asset classes include fixed-income/*ṣukūk* funds and mixed allocation funds.

Chart 1.3.2.8
Islamic Fund Assets by Asset Class (2017)



Source: IFSB Secretariat Workings

1.3.3 Conclusion

The global Islamic funds market continues to be a relatively small sector with two jurisdictions accounting for 69% of the total AuM of the industry. Malaysia and Saudi Arabia remain the key domiciles for Islamic funds, holding the largest market share across the global Islamic funds industry. The remaining 31% of AuM is spread across the 32 remaining jurisdictions that are Islamic fund domiciles. This indicates that Islamic funds are still small and have not seen significant growth in many key Islamic finance jurisdictions. However, despite this, the prospects for the global Islamic funds industry remain positive due to the largely untapped potential investor base and expanding investment preferences, and is expected to see growth in the coming years with a projected growth of about 5.05% per annum, reaching USD77 billion by 2019.²⁸

Although 2017 saw a slight drop in the overall number of Islamic funds, the total AuM of funds increased, indicating overall growth in the size of funds. Notably, out of the 1,161 Islamic funds, about 29% were inactive in 2017. The funds that were active recorded an average AuM of USD 80 million per fund, which, while representing growth in the size of funds relative to 2016, still remains small in contrast to the conventional market, which had an estimated global AuM for mutual funds of USD 33.2 trillion at the end of 2015.²⁹

The challenges faced by and resilience of the global asset management industry, and of the Islamic funds market in particular, will be discussed further in Chapter 3 of this report.

²⁸ Thompson Reuters Projection, 2015.

²⁹ PwC Market Research Centre analysis (2016).

BOX 1.2
THE DEVELOPMENT OF ISLAMIC FINANCE IN BRUNEI
DARUSSALAM

The Islamic finance concept was implemented in Brunei Darussalam in 1991 with the introduction of the Perbadanan Tabung Amanah Islam Brunei Act, Cap 163.

By virtue of the TAIB Act, a body corporate of the same name, called Perbadanan Tabung Amanah Islam Brunei (TAIB), was established. Among its principal objectives was to manage a fund, Tabung, established under section 22 of the said Act, to perform all banking, financing, commercial and investment operations and to establish and participate in industrial and economic development projects, either in or outside of Brunei Darussalam. Therefore, although TAIB is an Islamic trust fund by virtue of its own legislation, it is recognised as an Islamic bank due to its deposit-taking and financing activities.

Following the establishment of TAIB, the International Bank of Brunei Berhad, a conventional bank, was converted to become the first Islamic bank to operate in the country. Commencing in January 1993, it was named Islamic Bank of Brunei (IBB).

A further addition to this development took place in July 2000 with the conversion of the Development Bank of Brunei (DBB) to become the Islamic Development Bank of Brunei Berhad (IDBB).

In March 1993, TAIB established its *takāful* subsidiary, the Insurans Islam TAIB Sdn Bhd (IITSB) making it the first *takāful* operator in Brunei Darussalam. This move was followed by IBB, with the introduction of Takaful IBB Berhad to the market in 1993, and by IDBB, which established Takaful Bank Pembangunan Islam Sdn Bhd in 2001.

The vibrancy of the Islamic finance sector was intensified with the launch of the first Islamic finance company, IBB At-Tamwil, a subsidiary of IBB and IBB Ar-Rahnu, an Islamic pawn-broking company.

On 1 February 2006, IBB and IDBB merged to form Bank Islam Brunei Darussalam Berhad (BIBD), which included the merging of their management, operations, assets and employees, as well as their subsidiary companies.

In the drive towards further developing the Islamic finance sector, the Brunei Darussalam government introduced a BND 150 million three-month *shukūk Al-Ijārah* programme in April 2006. The objective of the

program was primarily to activate the capital market activities in the country. To support this initiative, the regulatory authorities recognise *shukūk* holding as part of the mandatory capital requirement of the banking institutions.

Since the maiden offering in 2006, the Brunei government has issued over BND 11.2 billion of short-term *shukūk Al-Ijārah* securities with BND 338.2 million outstanding as of September 2017.

The Islamic financial products and services in Brunei Darussalam are offered in line with the Shari'ah-based legal system, operating alongside the common law-based legal system. While the Banking Order 2006, and Insurance Order 2006, constitute the regulatory framework for conventional finance, the Islamic Banking Order 2008 and *Takāful* Order 2008 serve as the regulatory framework for Islamic finance. The Securities Markets Order 2013 covers both conventional and Islamic securities business.

BANKING SECTOR

The legislation provides the framework for licensing, supervision and regulation of both Islamic and conventional banks. Brunei Darussalam operates a dual banking system. There are two Islamic deposit-taking institutions – Bank Islam Brunei Darussalam Berhad (BIBD) and Perbadanan Tabung Amanah Islam Brunei Berhad (TAIB). The combined total assets of both entities account for 61.4% of the banking industry assets.

BANKING SECTOR DEVELOPMENTS

In efforts to strengthen the resilience of the banking sector and to ensure financial stability through best international practices and standards, AMBD is committed to implementing the Basel Core Principles for Effective Banking Supervision and the Basel standards. In this regard, AMBD has issued the following:

- (a) Guidelines on Corporate Governance for Banks and Notice on Disclosure of Corporate Governance Arrangements. With the objective of promoting high standards of corporate governance in the banking sector, the Guidelines outline minimum standards to be complied with by all banks. The Notice requires all banks to follow guidelines to the fullest extent – effective from 1 January 2018 – with banks expected to make disclosures in the annual report for the year ending 31 December 2018.

- (b) Notice on Maintenance of Capital Adequacy Ratio for Islamic Banks. The Notice serves as a methodology for banks to compute their minimum required capital adequacy ratio (CAR) of 10%. The Notices set out the minimum capital adequacy ratios a bank must meet, and the methodology it shall use for calculating these ratios under the Basel II, Pillar 1 framework.
- (c) Notice on Classification of Impaired Credit/Financing Facilities and Financial Assets for Provisioning Purposes. This Notice sets out the minimum levels of provisioning required to be maintained by the banks and finance companies for impaired credit/financing facilities and financial assets. It provides guidance on the assessment of fit and proper criteria for the appointment of key responsible persons by banks and finance companies. The expectations on the suitability of key responsible persons are also an extension of the corporate governance framework.
- (d) Notice on Appointment of Key Responsible Persons. This Notice provides guidance on the assessment of fit and proper criteria for the appointment of key responsible persons by banks and finance companies.

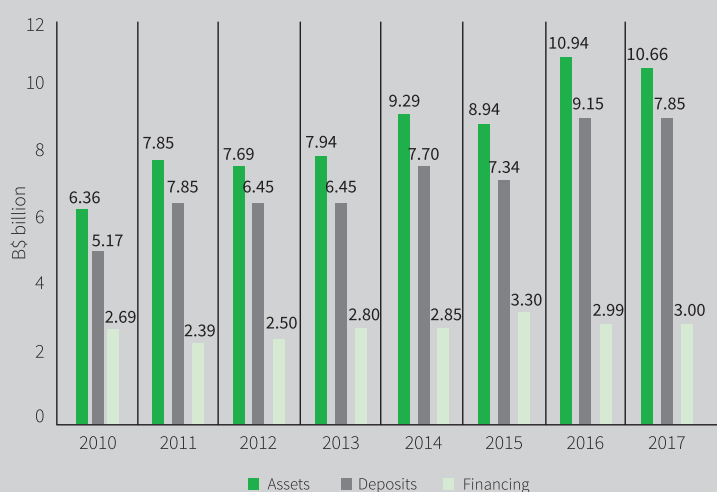
In the context of the Islamic banking system, the key financial soundness indicators were maintained at healthy levels, showing strong capitals, high liquidity levels and increased profitability. In Q32017, the net non-performing financing ratio of Islamic banks is maintained at 2.7%. Although the provision cover for financing losses ratio stood at just 41.3%, it is sufficient to mitigate the credit risks, given the strong capital position of the Islamic banking sector.

Table 1: Selected Financial Soundness Indicators for Islamic Banks

Financial Soundness Indicators (%)	Q32016	Q32017
Capital Adequacy		
Regulatory Capital to Risk-Weighted Assets	20.8	17.5
Tier 1 Capital to Risk-Weighted Assets	22.4	18.9
Assets Quality		
Net Non-Performing Financing Ratio	2.7	2.7
Provision Coverage	58.2	41.3
Profitability (Annualised)		
Return on Assets	1.4	2.5
Return on Equity	8.5	16.9
Efficiency Ratio	34.7	32.4
Liquidity		
Liquid Assets to Total Assets	52.1	48.9
Financing to Total Deposits	36.8	33.2

Source: Banking Unit, AMBD

Chart 1: Islamic Banking Assets, Deposits and Financing (Q32017)



Source: Banking, AMBD

Household debt continued to be the predominant sector at 66.5% of total financing, with personal financing still representing the largest sector at 40.4%.

Table 2: Islamic Banking: Distribution of Financing

Sector	Q32016		Q32017		Percentage (%) Change
	Amount (BND million)	% of Total Financing	Amount (BND million)	% of Total Financing	
HOUSEHOLD SECTOR	1,940	58.7	1,997	66.5	3.0
Personal Financing (incl. credit cards)	1,164	35.3	1,215	40.4	4.4
Residential Housing	776	23.5	782	26.0	0.8
CORPORATE SECTOR	1,362	41.3	1,007	33.5	-26.1
Commercial Property	155	4.7	132	4.4	-14.8
Traders	132	4.0	120	4.0	-8.7
Manufacturing	347	10.5	104	3.4	-70.2
Transportation	72	2.2	55	1.8	-23.6
Services	526	15.9	492	16.4	-6.6
Others	130	3.9	104	3.5	-19.5
Total Financing	3,301	100.0	3,004	100.0	-9.0

Source: Banking, AMBD

TAKĀFUL AND INSURANCE SECTORS

Table 3: Takāful and Insurance Sectors (in BND million)

	Q32016	Q3 2017		Q32016	Q32017
TOTAL ASSETS	1,474.5	1,601.3	TOTAL GROSS PREMIUMS	228.0	231.3
Total Life	1,061.6	1,109.4	Total Life	96.0	84.1
Conventional Life	866.3	922.7	Conventional Life	58.5	57.4
Family Takāful	195.3	186.7	Family Takāful I	37.5	26.7
Total Non-Life	412.9	491.9	Total Non-Life	132.0	147.2
Conventional Non-Life	156.6	161.2	Conventional Non-Life	50.3	50.2
General Takāful	256.3	330.7	General Takāful	81.7	97.0
Total Conventional	1,022.9	1,083.9	Total Conventional	108.8	107.6
Total Takāful	451.6	517.3	Total Takāful	119.2	123.7

As at Q32017, total industry assets had increased by 8.6% y-o-y, from BND 1.47 billion in Q32016 to BND 1.60 billion, due to increase in both the life and non-life sectors by 4.5% and 19.1%, respectively. The increase is due mainly to the increase in cash and investments in bonds and common shares. However, 67.7% of industry assets are dominated by the conventional insurance sector, of which 85.1% are made up of life insurance assets as their policies are long-tailed and consist of higher value cases.

During the period, total gross written premiums of the industry has increased slightly by 1.4% from B\$228.0 million in Q3 2016 to B\$231.3 million in

Q3 2017 contributed by property, liability, energy and workmen compensation within general takāful business.

On the other hand, total gross written contributions for takāful operators have increased by 3.8% y-o-y, from BND 119.2 million in Q32016 to BND 123.7 million in Q32017. This is due to the 18.7% increase in general takāful business contributed by the property, energy and personal accident business.

AMBD is also focusing on enhancing the regulatory and supervisory frameworks for the takāful and insurance industry to meet international standards. In 2014,

financial institutions including Islamic finance institutions (IFIs) were required to adopt IFRS accounting standards. Subsequently, the supervisory framework was altered through the introduction of risk-based supervision for the *takāful* and insurance industry in 2015. Additionally, further required documents were added for regulatory reporting, such as the actuarial valuation and actuary's report from general insurers and *takāful* operators, board of directors' minutes, Shari'ah Advisory Board minutes and annual corporate information.

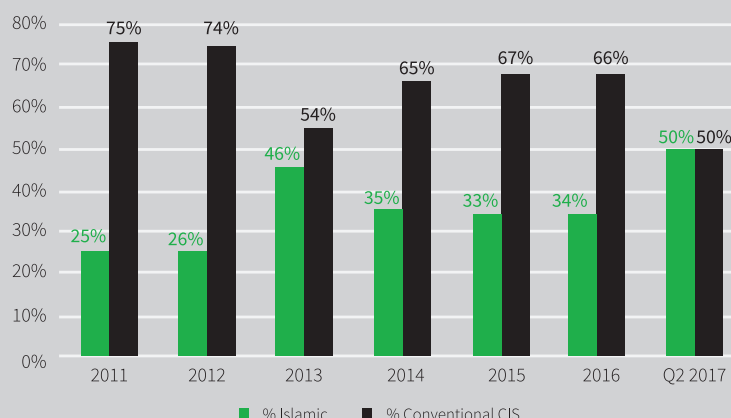
To supplement the risk-based supervisory framework, AMBD also introduced several notices (effective in 2018), including corporate governance, public disclosure and criteria for key responsible persons. With respect to IFIs, a draft Shari'ah Governance Framework is being developed to ensure Shari'ah compliance in terms of IFIs' structures, processes, products and services.

Alongside these initiatives, AMBD will continue to review its compliance with international best practices benchmarked by the Islamic Financial Services Board and the International Association of Insurance Supervisors. This had led to a review of current Insurance and *takāful* laws on which extensive industry consultation was carried out in 2017. It is hoped that the established laws and regulations will allow long-term growth and development of the *takāful* and insurance industry.

Capital Market Sector

As at Q22017, the capital market industry has 10 licensed capital market intermediaries, two of which are full-fledged Islamic capital market intermediaries conducting regulated activities ranging from handling securities to providing fund management services. Additionally, there are collective investment schemes registered for distribution in Brunei Darussalam, of which four are public conventional, four are public Islamic and two are private Islamic. As at Q22017, Islamic CIS account for 50% of the total size of the sector (refer to Chart 2).

Chart 2: Islamic CIS compared to Conventional CIS



Other initiatives include collaborations towards establishing a stock exchange that would allow the listing of Shari'ah-compliant securities. AMBD is also making necessary amendments to the Securities Markets Order 2013 to enable Islamic securities to be offered while having a clear and transparent legal and regulatory framework to support varied Islamic investments.

On 14 December 2017, AMBD published guidelines called "Application to Carry on Islamic Investment Business and Guidelines for Conducting Islamic Investment Business – Dealing and Arranging Deals in Investments" as a means to provide guidance on Islamic investment business application processes and to outline requirements for conducting regulated activities in investments in Islamic securities. The guidelines will facilitate stakeholders' participation in relation to Islamic finance and encourage healthy competition among market players.

Conclusion

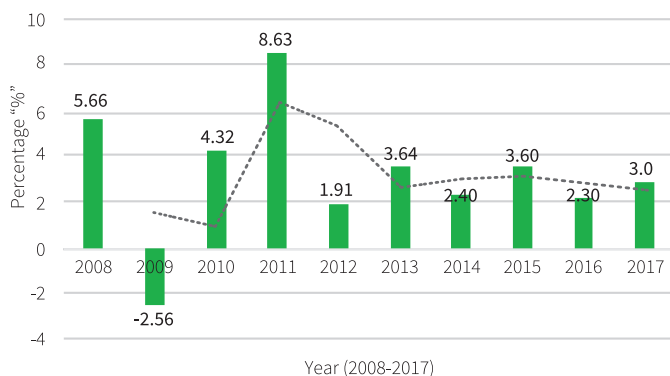
Brunei Darussalam has affirmed the growing importance of a diverse and foreign presence and higher participation in the domestic Islamic financial markets. Thus, the key focus in developing the financial sector during the coming decade is to make Brunei Darussalam an international Islamic financial hub. This will involve the introduction of more innovative Shari'ah-compliant financial products and services that will meet the more diverse global demands for Shari'ah-compliant financial solutions. In this regard, AMBD will continue to strengthen the necessary regulatory and supervisory frameworks to ensure alignment with international best practices, as well as introducing the necessary ecosystem to support the continuous development of Islamic finance. These initiatives are aimed at accelerating the internalisation of Islamic finance, thereby establishing a more significant role for the financial system in the intermediation of international financial flows.

1.4 TAKĀFUL: DEVELOPMENT REVIEW

Overview of the global insurance industry

Insurance markets worldwide reported a moderate growth rate in 2017, on the strength of improved economic activity in key global economies.³⁰ Both advanced and emerging markets reported improvements in premium volumes in 2017, mostly contributed by growth in motor premiums reported in North America, Western Europe and advanced Asian markets.³¹ According to Swiss Re report findings in 2017, global non-life premiums grew by 3% in real terms, slightly above their 2.3% gain in 2016 (see Chart 1.4.1).³² Emerging markets retain their position as a key driver of global insurance premium growth, with non-life premiums estimated to have grown by 6% in 2017, slightly higher than the 5.5% rise of 2016 (see Chart 1.4.1). The report identifies the top four countries with the highest growth; these are Indonesia (24.2%), Hong Kong (23.2%), Turkey (17%) and China (15.8%).³³

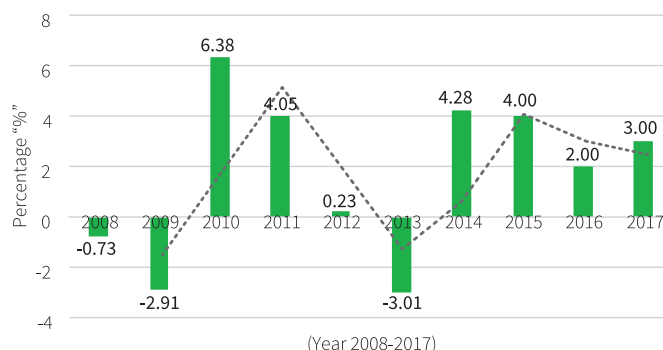
Chart 1.4.1
Growth Rate of Non-Life Premiums in the Insurance Sector (% y-o-y) (2008–2017)



Source: Swiss Re Institute Economic Research & Consulting (2017)

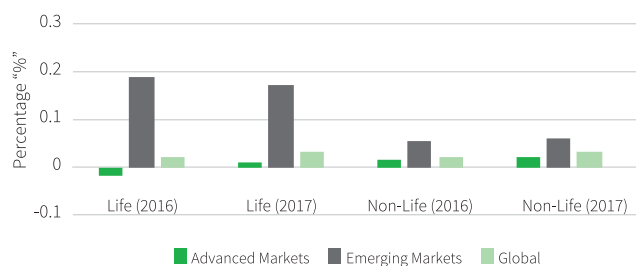
Global primary life insurance premiums are estimated to have risen by about 3% in 2017 in real terms, up from 2% in 2016 (see Chart 1.4.2).³⁴ This growth rate is more than double the compound annual growth rate of 1.3% of the last five years. In the life insurance business, Morocco was ranked third globally with a 34.3% growth, behind Russia's 51.1% and Costa Rica's 40.1%, but ahead of Emerging Asia (China, Indonesia, Hong Kong and Singapore), which showed an average growth of 27.2% in 2017.³⁵ Emerging Asia accounted for about three-quarters (76%) of the emerging markets' life premiums in 2017, underpinned by robust and economic growth, expanding populations, urbanisation, and a rising middle class.

Chart 1.4.2
Growth Rate of Life Premiums in the Insurance Sector (% y-o-y) (2008–2017)



Source: Swiss Re Institute Economic Research & Consulting (2017).

Chart 1.4.3
Global Real Premium Growth Rates (2016–2017)



Source: Swiss Re Institute Economic Research & Consulting (2017)

In the health insurance segment, 4% growth is reported for the global premium, slightly lower than 5% in the previous year. Growth in the emerging market segment is estimated at 10.7%, supported by a supplementary health insurance scheme introduced in China.³⁶ In the UAE, a premium growth of 40% is reported for this segment, aided by the full implementation of a medical and health insurance scheme, particularly in Dubai. Other countries in the region with impressive growth in the medical and health insurance segments are Oman and Iran, with estimated growth of 28% and 23.3%, respectively.³⁷ Oman has announced the introduction of mandatory health insurance scheme for private employees commencing from January 2018.³⁸

Global Takāful Industry

Amid challenges in the operating environments brought about by uncertainties in the global economic landscape and changing policy directions, total contributions written in the global Islamic insurance markets are

³⁰ Swiss Re Institute's report, "Global Insurance Review 2017 and Outlook 2018/19".

³¹ Ibid.

³² Ibid.

³³ Ibid.

³⁴ Ibid.

³⁵ Ibid.; "Global: Life insurance growth driven by Asian markets", Asia Insurance Review, 23 November 2017.

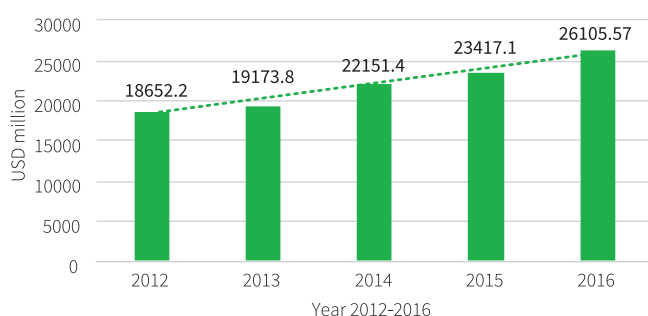
³⁶ xxxxx

³⁷ Central Insurance of Iran, Annual Report 2016/17; Capital Market Authority Oman, Annual Report 2017.

³⁸ Capital Market Authority Oman, Annual Report 2016.

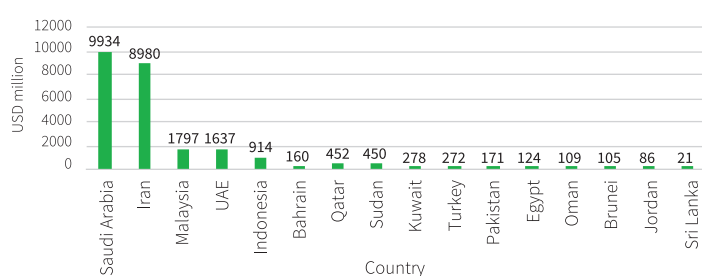
estimated to have reached USD 26.11 billion in 2016, up 12.5% y-o-y, slightly slower than the 13% reported in 2015.³⁹ Given this figure, the compound average growth rate over the last five years is 8.77% (see Chart 1.4.4). Country-wise, decomposition of gross contributions shows that Saudi Arabia, Iran, Malaysia and the UAE are the top four domiciles, accounting for 85.6% of the total global *takāful* contribution in 2016. Their respective shares in the global contributions are: Saudi Arabia 38%; Iran 34.4%; Malaysia 6.9%; and UAE 6.3%. The contributions written in other countries are relatively small; in aggregate, it is less than USD 1 billion (Chart 1.4.5). Sudan, which is one of only three countries (the others are Saudi Arabia and Iran) deemed to have a wholly Islamic insurance market, reported a CAGR of 20% in contributions written over the last five years, to reach an estimated USD 450 million in 2016.⁴⁰

Chart 1.4.4 Global Contributions Growth



Source: IFSB Secretariat Workings

Chart 1.4.5
Takāful Gross Contributions by Country (2016)



Source: IFSB Secretariat Workings

By region, GCC markets generated estimated contributions of USD 12.57 billion, with approximate growth of 7.4%, slower than the 21% rate experienced in 2015. Factors that supported the growth are the mandatory motor covers and the implementation of health insurance in Saudi Arabia and major markets of the UAE. Moreover, non-life business has been the dominant

business segment in the region over the past years, and the trend continued in 2016. The prominent business lines are motor, health and property/fire constituting more than 80% of the total contributions written (Chart 1.4.6), aided by mandatory covers particularly in the motor and health lines.

Saudi Arabia, the largest market, reported contributions of USD 9.9 billion in 2016, up by 2.1% compared to 19.7% reported in the preceding year.⁴¹ According to the Saudi Arabia Monetary Authority (SAMA), the slowdown in growth reflects the slowing trend in overall economic activities constrained by low oil prices and the ensuing fiscal adjustment measures. This resulted in a decline in the demand for motor and health covers, which constitute 86% of the contributions in the non-life business segment. In the same way, a slowdown is observed in other GCC markets. For example, in Bahrain, the total gross contributions of *takāful* operators dipped by 4.4% to USD 160.723 million in 2016, down from the USD 168 million reported in 2015.⁴² In contrast, within the same period, Iran, the second-largest Islamic insurance market, showed a premium growth of 23.3% (in rial terms).⁴³

In contrast to the GCC and MENA region, family business dominates the *takāful* industry in South-East Asia-Pacific (comprising mainly Malaysia, Indonesia and Brunei). In 2016, over 70% of USD 2.82 billion in contributions written in the region are attributed to the family *takāful* business. The region accounted for 36.5% of the global *takāful* market share (Chart 1.4.5). Malaysia leads the *takāful* market in the region with total contributions of USD 1,798 million, supported by favourable structural factors such as robust regulations and government supports. Indonesia, the second-largest *takāful* market in the region, reported contributions estimated at USD 915 million with an approximate growth rate of 14.2% in 2016, slower than conventional life insurance, which recorded a growth rate of 23.7% in the same period.⁴⁴ Family *takāful* business growth (new business) is largely driven by group term policies, in addition to credit-related term policies, which provide relatively higher protection benefits without a savings or investment component. Unit-linked products are also expanding rapidly to be counted among important products in the market.⁴⁵ Within the MENA region, family *takāful* is assuming a significant market share in Egypt. Combined with life insurance, family *takāful* constitutes approximately 70% of the total premium written (USD 1,367.27 million) in 2016.⁴⁶ The family *takāful* business is comparatively small in size

³⁹ The estimate is derived from the country-level data collected from the annual reports of insurance authorities of 15 countries, including Saudi Arabia and Iran where the respective insurance authority declared the model adopted "Shari'ah-compliant". Moreover, the available country-level data, particularly in Indonesia and Pakistan, are inclusive of *takāful* windows.

⁴⁰ Ministry of Finance and Economic Planning, Sudan: Annual Report 2017.

⁴¹ All insurance companies in Saudi Arabia follow the cooperatives model, which requires being Shari'ah-compliant.

⁴² Central Bank of Bahrain, Annual Report 2016.

⁴³ Central Insurance of Iran, Annual Report 2016/17.

⁴⁴ Indonesia Financial Services Authority, Annual Report 2017.

⁴⁵ BNM Financial Stability Report 2017.

⁴⁶ Egypt Financial Services Authority, Annual Report 2017.

in the GCC market, though it achieved a record growth of approximately 20% in 2016. For instance, in Saudi Arabia, the protection and savings segment reported contributions of USD 249.3 million, representing 2.7% of the total contributions for the overall market. In the same way, the family *takāful* business is reported to have shown strong growth of 18% in Oman.

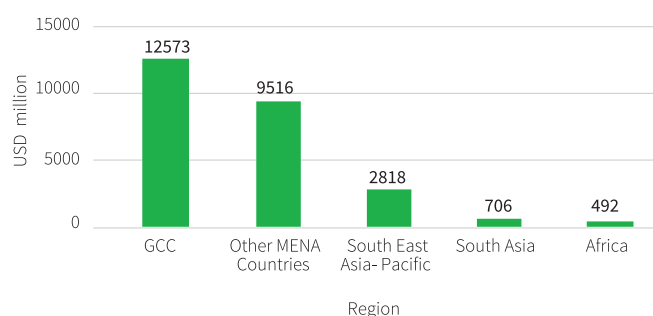
In spite of the impressive growth reported in the *takāful* sector over the past years, particularly in the GCC and some South-East Asian countries, the growth is not evenly distributed across the product lines. The expansion of general *takāful* business outpaced that of family product line, aided mainly by mandatory covers in the medical and motor businesses. According to Swiss Re, the market remains underpenetrated at an average of 1.9% in 2016, below the emerging markets average of 3.2% and the global average of 6.3%.⁴⁷ Family *takāful*'s share of the market is very small, with a penetration rate of 0.3% in 2016, relatively lower than the 1.7% seen in the emerging markets for life insurance.⁴⁸ According to Bank Negara Malaysia's (BNM's) definition,⁴⁹ the family *takāful* penetration rate is relatively high, estimated at 14.6% in 2016, down slightly from 14.7% in 2015.⁵⁰

The low penetration level presents opportunities for *takāful* to expand, backed by rapid population expansion, the improved regulatory environment, and the introduction of mandatory covers such as motor and health. Furthermore, the sector is expanding rapidly, with rising income levels, increasing awareness and a growing preference for Shariah-compliant insurance products. Moreover, structural factors, such as the expansion of private-sector employment, are expected to enhance demand and increase the penetration rate. Bancassurance is evolving rapidly to become the preferred channel for sales of family *takāful* products,⁵¹ as other financial sector market players are viewing the *takāful* sector as an avenue for new revenue streams and diversification of products.

Recent developments in some African countries (such as Morocco, Algeria, Nigeria, Kenya and Tanzania⁵²) where *takāful* regulations are being drafted and reviewed with the aim of introducing *takāful* business reinforce the view that the *takāful* industry can present a platform for financial inclusion. Similar development is currently ongoing in Turkey (although some of the insurance firms in the country have been offering "participatory insurance products" as a window operation). Furthermore, the insurance authority in Indonesia acknowledges that the *takāful* sector in that country is lagging behind the conventional insurance industry. As a result, the

government has launched a national master plan to develop the industry. An awareness campaign and educational programmes aimed at expanding *takāful*'s market share have commenced in Indonesia.⁵³ Currently, Indonesia has the world's greatest number of *takāful* institutions (58 *takāful* operators).

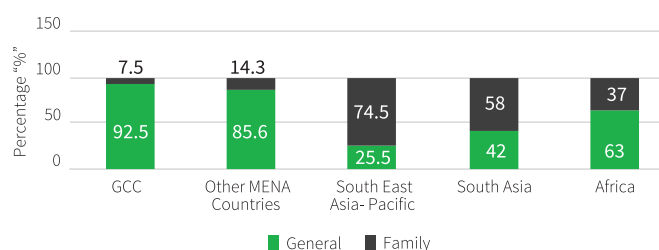
Chart 1.4.6
Gross *Takāful* Contributions by Key Regions*



Source: IFSB Secretariat Workings 2018

*Data base on 21 countries

Chart 1.4.7
Share of General and Family *Takāful* by Key Region (2016)



Source: IFSB Workings 2018

Quite a number of mergers and acquisitions (M&A) activities were reported between 2016 and 2017 across the *takāful* markets. In Bahrain, Bahrain Kuwait Insurance Company has finalised the acquisition of 67.3% of *Takāful* International Company. In another move, Solidarity Holding Company acquired 71% of Al Ahlia Insurance Company (AAIC), with the aim of transferring the assets and liabilities of Solidarity General Takaful to AAIC through a merger and converting AAIC to a *takāful* operator. This move is expected to create the largest *takāful* operator in Bahrain, with an estimated market share of approximately 15%.⁵⁴ In another development, American International Group in the Middle East and North Africa region has launched the first Shari'ah-compliant insurance policy for M&A activities. AIG, in partnership with Shari'ah-compliant managing general agent Cobalt Underwriting, is offering

⁴⁷ Swiss Re, "Global Insurance Review 2017 and Outlook 2018/2019"; Swiss Re, "Re/insurance in the Middle East and Pakistan (2016)".

⁴⁸ Swiss Re, "Global Insurance Review 2017 and Outlook 2018/2019".

⁴⁹ BNM defines the insurance penetration rate as the ratio of the total number of family *takāful* policies in force relative to the total population.

⁵⁰ Insurance Services Malaysia (ISM), Annual Report, 2017.

⁵¹ SAMA Financial Stability Report, 2017; Security Commission of Pakistan (SECP), Annual Report 2017; Middle East Insurance Review, September 2017.

⁵² Middle East Insurance Reviews.

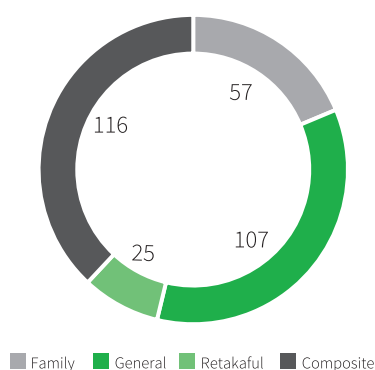
⁵³ Indonesia Financial Services Authority, Annual Report 2017.

⁵⁴ Central Bank of Bahrain (CBB), Insurance Market Review 2016.

a range of market-leading Islamic insurance solutions for M&A transactions. Dubai-based Islamic insurance company *Takāful* Emarat has commenced the process of acquiring UAE-based *takāful* and conventional insurance in an attempt to shore up its market share. In Malaysia, Syarikat Takaful Malaysia Bhd (STMB), one of the leading *takāful* operators, is currently undergoing restructuring, changing its name to Syarikat Takaful Malaysia Keluarga Bhd and establishing a new wholly owned subsidiary. A similar restructuring exercise has been consummated in Qatar. A Qatar-based Doha insurance company has spun-off its *takāful* segment into a full-scale Shari'ah-compliant insurance company.⁵⁵

The total number of *takāful* operators has not changed significantly over the last two years. The structure remains the same, apart from a few changes reported in Iran,⁵⁶ UAE and some African countries where new *takāful* operators have been licensed to commence operations. Overall, there are 305 *takāful* operators, including 25 *retakāful* companies (Chart 1.4.8).

Chart 1.4.8
Number of *Takāful* Operators and Windows Globally (2016)



Source: Middle East Insurance Review: World Islamic Insurance Directory 2015; Finance Forward, World *Takāful* Report 2016; "Connecting the Dots, Forging the Future", ICD Thomson Reuters (2015)

The outlook for the *takāful* industry across all the markets remains positive, despite the challenges experienced in some of the core markets. Against the backdrop of low oil prices, economic diversification efforts by the respective governments are expected to reduce the dependence on oil and to switch the focus to a private-sector led economy that is likely to provide impetus to businesses across the markets.

A notable number of jurisdictions such as Saudi Arabia, the UAE, Malaysia, Oman and Pakistan have been providing a robust regulatory framework to the *takāful* sector. Recent initiatives by the insurance authority in Indonesia to promote *takāful* are a welcome

development. In Malaysia, a series of ongoing initiatives aim to improve the regulatory framework and boost the sector's attractiveness, as well as to continue to cement Malaysia's position as one of the leading centres for the *takāful* industry. Recently, BNM announced its plan to phase in a de-tariffication environment in general *takāful*. In addition, the phased implementation of the Life Insurance and Family Takaful (LIFE) framework and the requirements to split composite companies by 2018 is expected to have a material impact on the market. Indonesia has enhanced its regulations for its Shari'ah business (the market is referred to as Shari'ah business in Indonesia), indicating its commitment to develop the *takāful* industry along with the conventional industry.

Takāful operators need to realign their strategic focus and increase their capability to retain more risks. They also need to optimise their approach towards delivering robust performance, in the light of a series of regulatory guidelines evolving across the markets. Appropriate market conduct regulations and enforcement of regulations are necessary to eradicate fraud, corruption and other abuses that could limit the growth of this sector.

1.5 OVERALL SUMMARY

The global IFSI has reverted to its positive growth trajectory in 2017, reversing its two preceding years of stagnation in assets growth in US Dollar terms. The industry's total worth across its three main sectors (banking, capital markets and *takāful*) experienced an 8.3% growth, enabling the sector to surpass the USD 2 trillion mark.

Islamic Banking

The global Islamic banking segment posted a 4.3% growth in assets between 1H2016 and 1H2017. During this period, the Islamic banking market share in at least 19 countries experienced an increase market share in the overall domestic banking sector, further entrenching its presence in these countries, while the share remained constant in seven others. However, six jurisdictions also experienced declines in market share, among which are Qatar and Egypt – two key Islamic banking markets. There are also 12⁵⁷ countries that hold domestic systemic importance for Islamic banking, with the latest addition in 2017 being Bahrain; among these, four countries boast a share in excess of 50% for Islamic banking in the domestic market (Iran, Sudan, Brunei and Saudi Arabia). Islamic banking is also now officially available across all six habitable continents following the successful conversion of a conventional secondary bank in Suriname to a full-fledged Shari'ah-compliant bank

⁵⁵ Middle East Insurance Review.

⁵⁶ Central Insurance of Iran, Annual Report 2017.

⁵⁷ The previously considered domestic systemically important jurisdiction of Yemen is no longer included in the sample due to lack of availability of credible data.

in January 2018. However, the overall share of Islamic banking in the global IFSI has contracted slightly, to 76% [2016: 78.9%], following a strong performance by the Islamic capital markets in 2017.

Islamic Capital Markets

The global Islamic capital markets exhibited a strong performance in 2017. *Shukūk* issuances in the primary market increased by nearly 23% on the back of strong sovereign and multilateral issuances in key Islamic finance markets. Amid partial support from improved exchange rates in some emerging markets, the global *shukūk* outstanding has also surged by over 25% – its strongest increase⁵⁸ since 2012. Debut sovereign and multilateral issuances in 2017 were by Saudi Arabia and Nigeria, as well as by the pan-African multilateral development finance institution, Africa Finance Corporation. Corporate *shukūk* issuances saw a modest 2.3% improvement in annual volume raised from the previous year while Hong Kong was the only non-OIC issuer in the primary market in 2017.

The global stock markets rally in many advanced and emerging markets continued in 2017, also enabling Sharī'ah-compliant listed equities and associated Islamic funds to record positive returns. While the preceding year saw conventional listed-equity generate better returns, the Islamic listed-equity markets rebounded sufficiently well in 2017, enabling the majority of Islamic equity indices to outperform the conventional benchmarks. The Islamic funds⁵⁹ assets have also increased by almost 19% although, on a downside, some 29% of the Islamic funds (based on number of funds) are recorded as 'inactive' as at end-2017. Overall, the strong performance in the ICM has enabled its two sectors combined to now represent 22.8% of the global IFSI assets [2016: 19.8%] – entrenching the ICM further as a key and viable component of the global IFSI.

Takāful

The global *takāful* sector, which has traditionally posted double-digit growth rates for its gross contributions, recorded a 12.5% increase as at end-2016. While low growth rates were also recorded for the insurance sector in 2016 (non-life: 2.3%; life: 2%), the *takāful* sector builds from a much smaller base [2015: USD 23.4 billion gross contributions]. The sector is still very nascent, with only four countries accounting for nearly 86.4% of the global *takāful* contributions in 2016; as a result, its share in the global IFSI is unchanged at 1.3% as of 2017. There are some initiatives being undertaken by a number of regulators in different jurisdictions (particularly in Africa) to draft *takāful* regulations with a view to commencing *takāful* services. The sector has a much untapped potential as most of the potential markets show very low insurance penetration rates for both general and family *takāful* businesses. On a positive note, some mergers and acquisition activities were reported in the *takāful* industry between 2016 and 2017. This is critical for the industry, as larger-scale merged/acquired *takāful* operators will have the capacity to undertake bigger exposures on their books while providing relevant coverage to larger-volume transactions.

In summary, the global IFSI has had a positive year in 2017 on the back of an improved global economic recovery trajectory. While geopolitical conditions persist in some regions, threatening a stall in the growth of the IFSI, the markets have generally remained resilient. The momentum is upbeat moving into 2018, although some new economic and political realities, stemming from threats concerning currency and trade wars, are likely to pose downside risks to the global economic recovery. These will impact the global financial markets in general, with relevance and spillover for the IFSI as well. This chapter has analysed the growth and development of the three key sectors of the global IFSI (Islamic banking, Islamic capital markets and *takāful*) in detail. Chapter 3 offers an analysis of the stability and resilience of the same three sectors of the global IFSI.

⁵⁸ In percentage terms, based on US Dollar *Shukūk* outstanding value as at end of each respective year.

⁵⁹ Funds that are marketed and offered, generally with their data publicly available, and excluding private equity funds.

2.0 ISLAMIC FINANCE AND THE CHANGING GLOBAL FINANCIAL ARCHITECTURE

2.1 GLOBAL DEVELOPMENTS AND IMPACT ON THE ISLAMIC FINANCIAL SERVICES INDUSTRY

The global regulatory landscape continues to develop, though the pace of change has slowed somewhat, reflecting the completion of the most urgent elements of the reform agenda created following the GFC. Nevertheless, there have been some important developments in the course of the year which are likely to impact on the IFSI, and on the work of the IFSB.

2.1.1 Financial Stability Board

During 2017, the FSB expressed the view that the work coordinated by the Board to agree on the international post-GFC policy reform agenda is nearly complete. Nevertheless, it believes that in some cases, important policies have yet to be fully operationalised. It therefore sees monitoring and publicly reporting on member jurisdictions' implementation of agreed reforms as a priority. The FSB also noted that implementation has progressed in a number of areas to a stage where post-implementation evaluation of the effects of the reforms is becoming possible. This includes monitoring impacts on emerging markets and developing economies, some of which have expressed concerns about implementation challenges and reduced activity by global banks in their markets. In addition, the FSB continues to monitor new and emerging risks, and to address them where appropriate.

Some of the FSB's work in 2017 was in areas that are only marginally relevant to the IFSI – for example, over-the-counter derivatives markets. Nevertheless, there are several areas of activity that may have a material effect on the IFSI.

(a) Corporate Governance

In April 2017, the FSB published its Thematic Review on Corporate Governance Peer Review Report,⁶⁰ which examines the implementation of the G20/Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance. The peer review takes stock of how FSB member jurisdictions have applied these Principles to publicly listed, regulated financial institutions, and identifies effective practices and areas where progress has been made thus far, as well as the remaining gaps and areas of possible weakness. It

was also an input to the OECD's updated methodology for assessing implementation of its principles, published in March 2017.

The peer review provides 12 recommendations mainly to FSB member jurisdictions, but also to standard-setting bodies (principally the OECD) and financial institutions. The recommendations focus on six key areas: effective corporate governance frameworks, disclosure and transparency, responsibilities of the board, rights and equitable treatment of shareholders, the role of stakeholders in corporate governance, and other recommendations.

The recommendations with respect to the basis for an effective corporate governance framework focus on identifying and addressing the gaps or inconsistencies in cases where corporate governance frameworks are found in multiple sources (e.g. laws, regulations, etc.). The recommendations also focus on augmenting the enforcement powers that are available to supervisory authorities to address weaknesses in corporate governance regimes or non-compliance with corporate governance requirements.

The recommendations related to disclosure and transparency focus on improving disclosures related to governance structures, voting arrangements, shareholder agreements, and significant cross-shareholdings and cross-guarantees, as well as on identifying remuneration information that could be usefully provided to shareholders.

Recommendations in respect of the responsibilities of the board consider the adoption, implementation and disclosure of codes of ethics or conduct, and encouraging boards to undertake regular assessments of their effectiveness.

The report also provides recommendations in relation to the rights and equitable treatment of shareholders, and suggests that shareholders should have the opportunity to vote on remuneration policies and the total value of compensation for the board and senior management.

Other recommendations include reviewing practices with respect to: the effectiveness of rules regarding the duties, responsibilities and composition of boards within group

⁶⁰ FSB (2017), Thematic Review on Corporate Governance Peer Review Report. Available at: www.fsb.org/wp-content/uploads/Thematic-Review-on-Corporate-Governance.pdf.

structures; the framework for related party transactions; and the role and responsibilities of independent directors on the board and board committees.

There are particular issues related to corporate governance in IIFS, stemming partly from its interaction with Shari'ah governance and partly from differences between Islamic finance structures and products and their nearest conventional analogues. The IFSB has published three standards specifically on corporate governance: IFSB-3: Corporate Governance for IIFS (Banking Segment); IFSB-8: Corporate Governance for *Takāful* Institutions; and IFSB-6: Governance of Islamic Collective Investment Schemes. It has also covered aspects of it in several other standards – for example, IFSB-17: Core Principles for Islamic Finance Regulation (Banking Sector). It is clear that the subject continues to develop, and it is likely that the IFSB will need to revise its standards, taking account of post-crisis developments.

(b) Addressing Structural Vulnerabilities from Asset Management Activities

In 2017, the FSB issued its Recommendations on Addressing Structural Vulnerabilities from Asset Management Activities,⁶¹ which sets out 14 policy recommendations for addressing the structural vulnerabilities arising from asset management activities that could potentially present financial stability risks. The structural vulnerabilities addressed by the recommendations are:

- liquidity mismatch between fund investments and redemption terms and conditions for open-ended fund units;
- leverage within investment funds;
- operational risk and challenges at asset managers in stressed conditions; and
- securities lending activities of asset managers and funds.

The recommendations in the report are provided within the context of the growth in asset management activities, including open-ended funds that offer daily redemptions to their investors. While these funds have not created any financial stability concerns in recent periods of stress, the growth in the sector and increasing holdings of less liquid assets by investment funds suggests the potential for an increase in risks in recent years.

In the case of liquidity mismatch, the recommendations provided are designed to increase information and transparency to authorities and investors with regard to open-ended funds, as well as to strengthen liquidity risk management frameworks and practices of those funds. They also address the potential use of system-wide stress testing by authorities.

The recommendations on leverage focus on the measurement and monitoring of leverage within investment funds.

In relation to operational risk, the recommendations are intended to help ensure that risk management frameworks and practices are commensurate with the level of risk that the activities of an asset manager pose to the financial system. The securities lending recommendation focuses on situations where indemnifications are provided by asset managers to their clients in relation to securities lending activities.

In the area of liquidity mismatch, the recommendations are designed to increase information and transparency to both authorities and investors with respect to open-ended funds, as well as to strengthen liquidity risk management frameworks and practices of those funds. They also address the potential use of system-wide stress testing by authorities. Leverage recommendations focus on the measurement and monitoring of leverage within investment funds.

Some of the recommendations made in the report are to be operationalised by IOSCO, which will complete its work on the liquidity recommendations by the end of 2017 and on leverage measures by the end of 2018, while the FSB will undertake the role of reviewing progress in the operationalisation and implementation of the recommendations.

The findings of this report will inform the FSB's continuing work on systemic significance in asset management, particularly the assessment methodologies for non-bank/non-insurer global systemically important financial institutions conducted jointly with IOSCO. However, notably, both this report, and the corresponding work for the insurance sector, indicate that, outside the banking sector, the thinking is increasingly moving away from systemically significant institutions towards systemically significant behaviours.

The recommendations made in the report do not have major immediate implications for the IFSI given that this sector of the IFSI, owing to its smaller relative size, does not yet have characteristics that would lead to systemic risk. However, as the sector grows, continued monitoring and assessment will remain important with respect to the need for implementation of the recommendations.

(c) Recovery and Resolution

Resolution and recovery, which is a key topic on the agenda of the IFSB, also continues to be an important theme for the FSB, and there have been several significant publications over the course of the year.

⁶¹ FSB (2017), Recommendations on Addressing Structural Vulnerabilities from Asset Management Activities. Available at: www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf.

The FSB's sixth report on the implementation of resolution reforms, titled "Ten Years On: Taking Stock of Post-Crisis Resolution Reforms",⁶² which was published in July 2017, reviews the progress that has been made in implementing the agreed resolution policies for systemically important financial institutions (SIFIs) and provides an update on the implementation of the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions, which are the internationally agreed standards for resolution of SIFIs.

It also reports the findings from the Resolvability Assessment Processes for global systemically important banks (G-SIBs) and global systemically important insurers (G-SIIs), further setting out actions necessary to fully implement the Key Attributes and to ensure that all global systemically important financial institutions (G-SIFIs) are resolvable, with a focus on comprehensive and consistent implementation of agreed resolution policies and on the evaluation of the effects of resolution reforms.

The report shows sustained progress in addressing barriers to the resolvability of SIFIs, but highlights that significant work remains in removing obstacles to cross-border resolution and in implementing the resolution reforms in a comprehensive and consistent manner across all sectors, including for central counterparties and insurers.

Among other things, the report notes that significant work remains to address cross-border resolution, highlighting that authorities should continue their efforts to address the remaining obstacles to adoption of institution-specific cross-border cooperation agreements, including effective information-sharing arrangements, which are not yet in place for all G-SIBs.

It also noted that, while a few jurisdictions are undertaking reforms of resolution regimes for insurers and central counterparties, progress in the non-bank sector has been slower than in the banking sector.

The FSB's focus going forward, as highlighted in the report, is on the implementation of agreed resolution policies, and on examining and evaluating the effects of resolution reforms. The finalisation of the Key Attributes Assessment Methodology for the banking sector has also now enabled the inclusion of the Key Attributes in standards assessments carried out under the IMF–World Bank Standards & Code Initiative. FSB members have agreed to undergo an assessment of their bank resolution regimes against the Key Attributes and to publish the findings. The FSB has also developed a framework for the post-implementation evaluation of the effects of G20 reforms. Going forward, the FSB will develop approaches

to evaluate the effectiveness and gauge the broader effects of resolution reforms.

Other reports published in 2017 are discussed below.

- *Guiding Principles on the Internal Total Loss-Absorbing Capacity of G-SIBs ("Internal TLAC")*

The TLAC standard defines a minimum requirement for the instruments and liabilities that should be held by G-SIBs and readily available for bail-in within resolution. It also requires a certain amount of those loss-absorbing resources to be committed to subsidiaries or subgroups that are located in host jurisdictions and deemed material for the resolution of the G-SIB as a whole ("internal TLAC"). The guiding principles support the implementation of the internal TLAC requirement, and provide guidance on the size and composition of the internal TLAC requirement, cooperation and coordination between home and host authorities, and the trigger mechanism for internal TLAC.

- *Guidance on Continuity of Access to Financial Market Infrastructures (FMIs) for a Firm in Resolution*

The Guidance sets out arrangements and safeguards to facilitate continuity of access to financial market infrastructures (FMIs), such as clearing, payment, settlement and custody services for a firm in resolution.

- *Principles on Bail-in Execution*

In November 2017, the FSB issued a consultative document, 'Principles on Bail-In Execution', which proposes a set of principles on the execution of bail-in, to assist authorities as they continue work on operationalising resolution strategies and plans.

The Key Attributes set out the bail-in powers that authorities should have in order to achieve, or help to achieve, continuity of critical functions. While the Key Attributes require jurisdictions to provide for the powers and tools to achieve bail-in, the FSB's standard on TLAC defines a minimum requirement for the instruments and liabilities that should be readily available for bail-in within resolution at G-SIBs. However, the Key Attributes and the standard on TLAC do not address the operational aspects of executing a bail-in transaction. In this regard, the newly issued consultative document on the principles on bail-in execution cover a range of actions and processes required to: (i) identify the instruments and liabilities within the scope of bail-in; (ii) conduct valuations to inform and support the application of bail-in; (iii) develop a bail-in process that meets applicable securities law and securities exchange requirements; (iv) transfer governance and control rights and obtain regulatory approvals and authorisations; and (v) communicate effectively

⁶² FSB (2017), Ten Years On: Taking Stock of Post-Crisis Resolution Reforms. Available at: www.fsb.org/2017/07/ten-years-on-taking-stock-of-post-crisis-resolution-reforms/

with creditors and market participants more broadly in the course of the bail-in process.

- *Funding Strategy Elements of an Implementable Resolution Plan*

The FSB issued another consultative document in November 2017, *Funding Strategy Elements of an Implementable Resolution Plan*, which provides further guidance on the development of an implementable resolution funding plan. The development of such a plan as part of the overall resolution plan is a key component of the ongoing work of authorities to operationalise resolution strategies and plans. The consultative document identifies a set of key funding strategy elements that address a number of areas, including: (i) firm capabilities to support monitoring, reporting and estimating funding needs in resolution, and to facilitate execution of the funding strategy; (ii) the development of the resolution funding plan by authorities; (iii) firm assets and private sources of resolution funding; (iv) temporary public-sector backstop funding mechanisms and ordinary central bank facilities; and (v) information sharing and coordination between authorities.

- *Key Attributes Assessment Methodology for the Insurance Sector*

In December 2017, the FSB published a consultative document on the methodology for assessment of the implementation of Key Attributes of Effective Resolution Regimes for Financial Institutions in the insurance sector. The document sets out the criteria for assessing the compliance of a jurisdiction's insurance resolution framework against the requirements set out in the Key Attributes. While many aspects of the methodology are similar to the corresponding methodology for banking, key issues for the insurance sector relate to the position of reinsurers, such as the transferability of reinsurance contracts, set-off, and over-riding any rights to terminate or not reinstate coverage under existing contracts of reinsurance in connection with resolution.

The methodology is intended to be used for regular assessments undertaken by the IMF and the World Bank. While the Key Attributes provide a comprehensive standard for resolution regimes covering financial institutions of all types, the FSB adopts a modular approach, by developing independent or free-standing methodologies tailored for each sector to facilitate sector-specific assessments of the Key Attributes. While the methodology for the banking sector was published in October 2016, the methodology for the insurance sector that has now been issued for consultation has been developed by the FSB in cooperation with the IMF, the World Bank and the IAIS.

Overall, in relation to recovery and resolution, the emphasis is now moving towards the operationalisation of resolution plans, with additional guidance and standards being issued to this effect. The applicability of these standards and guidance to IIFS, and any additional considerations with respect to Islamic finance, would need to be further studied by the IFSB.

The IFSB has, in the past, worked on a number of issues related to bank insolvency, resolution and recovery in relation to the specific considerations for IIFS. In 2011, the IFSB issued a joint publication with the World Bank as an outcome of roundtable discussions on the issues surrounding the insolvency regimes for the IFSI, titled "Effective Insolvency Regimes: Institutional, Regulatory and Legal Issues Relating to Islamic Finance". More recently, a working paper has been issued on resolution, recovery and insolvency issues in Islamic finance, which is discussed further in section 2.2.3.1 of this publication. This paper makes clear that there are real issues specific to Islamic finance that would need to be addressed in trying to implement the Key Attributes for either the banking or the *takāful* sector; these may also extend to financial market infrastructures.

While the IFSI does not yet have institutions categorised as globally systemically significant, authorities may well, as part of their resolution strategies, seek to apply the approaches defined by the FSB to other types of firms, including IIFS. There is thus a need for continuing work on the issues that would be raised by doing so.

2.1.2 Basel Committee on Banking Supervision

The BCBS has issued a number of standards, guidelines and consultation papers since the publication of the IFSB's IFSI Stability Report 2017. This section looks at new publications of particular relevance to Islamic banking by the BCBS, including some consultative documents discussed in the 2017 IFSI Stability Report which have now been finalised and published. These include: Pillar 3 Disclosure Requirements – Consolidated and Enhanced Framework (March 2017) and Regulatory Treatment of Accounting Provisions – Interim Approach and Transitional Arrangements (March 2017). Some of the key documents relevant to Islamic banking that have been issued in the past year by the BCBS are discussed below.

(a) Basel III: Finalising Post-Crisis Reforms

The BCBS has issued a further package of reforms to the Basel III regime, which it now regards as being in its final form. The revisions seek to restore credibility in the calculation of RWAs and to improve the comparability of banks' capital ratios by:

- enhancing the robustness and risk sensitivity of the standardised approaches for credit risk, credit valuation adjustment (CVA) risk and operational risk;
- constraining the use of the internal model approaches, by placing limits on certain inputs used to calculate capital requirements under the internal ratings-based approach for credit risk and by removing the use of the internal model approaches for CVA risk and for operational risk;
- introducing a leverage ratio buffer to further limit the leverage of G-SIBs; and
- replacing the existing Basel II output floor with a more robust risk-sensitive floor based on the Committee's revised Basel III standardised approaches.

The revisions to the standardised approach for credit risk, as well as the introduction of a single risk-sensitive standardised approach to replace the existing three approaches for operational risk, will be highly relevant to the IFSI. IFSB-15 prescribed (as one of the approaches) the Standardised Approach for determining capital charge for credit risk and the Basic Indicator Approach for operational risk. With these changes, the approaches for credit and operational risks will have to be reviewed to align with the latest update of the Basel III reforms.

More specifically, the package introduces a revised treatment for real estate exposures, linked very strongly to the loan-to-value ratio. Real estate exposures have in the past been very significant for Islamic banks, and the IFSB has treated them at some length, currently in IFSB-15. There are also revised treatments for project finance and equity (or equity-like) investments in corporates.

The IFSB will consider reflecting these development in its planned revision of IFSB-15, GN-4 and other related guidance notes.

(b) Pillar 3 Disclosure Requirements – Consolidated and Enhanced Framework

The BCBS issued its Pillar 3 Disclosure Requirements – Consolidated and Enhanced Framework in March 2017.⁶³ This framework builds upon the Revised Pillar 3 Disclosure Requirements published by the committee in January 2015.⁶⁴ The key enhancements introduced in the standard are as follows:

1. Consolidation of all existing disclosure requirements issued by the BCBS into the Pillar 3 framework, including the composition of capital, the leverage ratio, the liquidity coverage ratio (LCR), the net stable funding ratio (NSFR), the indicators for determining G-SIBs, the countercyclical capital buffer, interest rate risk in the banking book and remuneration.

2. Introduction of a "dashboard" of banks' key prudential metrics which will provide users of Pillar 3 data with an overview of a bank's prudential position.
3. A new disclosure requirement for banks that record prudent valuation adjustments (PVAs) to provide users with a granular breakdown of their calculation of PVAs.
4. Updates to reflect ongoing reforms to the regulatory framework, such as new disclosure requirements in respect of the TLAC regime for G-SIBs and revised disclosure requirements for market risk built on the revised market risk framework⁶⁵ published by the BCBS in January 2016.

The IFSB has commenced its revision of IFSB-4: Disclosures to Promote Transparency and Market Discipline for IIFS in line with the latest regulatory developments in Pillar 3 disclosures. The enhancements in the BCBS's standards are taken into account as part of this revision. The Exposure Draft (ED) of revised IFSB-4 will be ready for public consultation in March 2018 following approval by the IFSB Technical Committee.

(c) Regulatory Treatment of Accounting Provisions – Interim Approach and Transitional Arrangements

In response to the introduction of a forward-looking, expected credit loss approach to asset impairment in accounting standard IFRS-9: Financial Instruments, the BCBS released, in March 2017, its standard on the interim approach for the regulatory treatment of accounting provisions and the use of transitional arrangements.⁶⁶

Given the diversity of accounting practices in relation to provisioning across jurisdictions and the uncertainty about the effects arising from the introduction of ECL accounting on regulatory capital, the BCBS has decided to retain the current regulatory treatment of accounting provisions as applied under both the standardised approach (SA) and internal ratings-based (IRB) approaches for an interim period. This is to allow thorough consideration of the longer-term approach for the regulatory treatment of provisions as outlined in the October 2016 discussion paper⁶⁷ through conducting quantitative impact assessments.

The BCBS has also set out a number of requirements and approaches for jurisdictions choosing to adopt transitional arrangements. These transitional arrangements aim to avoid a "capital shock", by giving banks adequate time to rebuild their capital resources following a potentially significant negative impact arising from the change to the ECL accounting model.

⁶³ BCBS (2017), Pillar 3 Disclosure Requirements – Consolidated and Enhanced Framework. Available at: <https://www.bis.org/bcbs/publ/d400.htm>

⁶⁴ BCBS (2016), Revised Pillar 3 Disclosure Requirements. Available at: <https://www.bis.org/bcbs/publ/d309.htm>

⁶⁵ BCBS (2016), Minimum Capital Requirement for Market Risk. Available at: <https://www.bis.org/bcbs/publ/d352.htm>

⁶⁶ BCBS (2017), Regulatory Treatment of Accounting Provisions – Interim Approach and Transitional Arrangements. Available at: <https://www.bis.org/bcbs/publ/d386.htm>

⁶⁷ BCBS (2016), Regulatory Treatment of Accounting Provisions – Discussion Paper. Available at: <https://www.bis.org/bcbs/publ/d385.htm>

The IFSB has conducted a survey on IFRS-9 with the aim of understanding the possible implications of the ECL approach to Islamic banks. The survey results indicate that only approximately 19% of the respondents intend to implement a transitional arrangement for both conventional and Islamic banks in order to avoid abrupt changes in the banks' capital ratios. A summary of the survey findings is presented in section 2.2.3.3 of this report. Meanwhile, the AAOIFI issued a new financial accounting standard (FAS) 30: Impairment, Credit Losses and Onerous Commitments, aimed at prescribing the accounting rules and principles for impairment and credit losses, covering both incurred and expected credit loss models, in line with the global accounting practices from a Shari'ah point of view.

(d) Global Systemically Important Banks – Revised Assessment Framework – Consultative Document

The BCBS published the G-SIBs assessment framework in July 2013.⁶⁸ The framework provides a methodology to identify G-SIBs by assessing the relative systemic importance of a large sample of internationally active banks based on 12 indicators in five equally weighted categories on an annual basis.

In ensuring the framework remains consistent with its objectives in light of any structural changes in the global banking system and newly emerged dimensions of systemic risk, the BCBS has decided to review the framework every three years. A consultative document⁶⁹ that sought feedback from the public on the proposed changes to the framework was issued in March 2017.

The proposed changes to the G-SIBs assessment framework were drafted and assessed against three high-level principles: (1) changes should be consistent with the fundamental principles of the G-SIBs framework; (2) changes should be both sound and implementable; and (3) changes should be consistent with the objectives of the BCBS's overall regulatory framework.

The proposed changes to the G-SIBs framework include:

- removal of the cap on the substitutability category;
- expansion of the scope of consolidation to include insurance subsidiaries;
- amendments to the definition of cross-jurisdictional activity;
- modification of the weights in the substitutability category and introduction of a trading volume indicator;
- revisions to the disclosure requirements;
- further guidance on bucket migration and the associated surcharge; and
- a transition schedule.

The BCBS also solicited feedback on the inclusion of a new indicator for short-term wholesale funding in the interconnectedness category.

IIFS are currently not large enough to be considered G-SIBs. However, some IIFS are of domestic systemic importance in several jurisdictions, and RSAs in these jurisdictions may consider extending some elements of the revised G-SIBs assessment framework to their domestic systemically important banks (D-SIBs). Also, notably, some G-SIBs operate Islamic banking windows in various jurisdictions, and the application of the revisions, if eventually issued, may have capital implications for them.

(e) Simplified Alternative to the Standardised Approach to Market Risk Capital Requirements – Consultative Document

Following the issuance of the revised market risk framework⁷⁰ by the BCBS in January 2016, a consultative document⁷¹ that proposes a simplified alternative to the sensitivities-based method (SbM), which is the primary component of the market risk standardised approach, was issued by the BCBS in June 2017. The committee's proposal for the reduced SbM (R-SbM) is intended to address implementation challenges faced by banks with simpler trading books due to the complexity of the SbM. Banks intending to use the R-SbM must fulfil a number of quantitative and qualitative criteria, and be subject to supervisory approval and oversight.

The proposed significant simplifications relative to the SbM include:

- removal of capital requirements for vega and curvature risks;
- simplification of the basis risk calculation; and
- reduction in risk factor granularity and the correlation scenarios to be applied in the associated calculations.

The BCBS also sought feedback as to whether retaining a recalibrated version of the Basel II standardised approach to market risk would serve as a better alternative compared to the proposed simplified alternative to the market risk standardised approach.

The BCBS's proposals are relevant to IIFS, as they have limited exposures to market risk in general, reflecting the fact that they do not run substantial trading books. Currently, IFSB-15 considers only the standardised approach to market risk. Should the R-SbM be finalised and issued as a standard by the BCBS, the IFSB will consider reflecting the development in its market risk framework as part of the revision to IFSB-15.

⁶⁸ BCBS (2013), Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement. Available at: <https://www.bis.org/publ/bcbst255.htm>

⁶⁹ BCBS (2017), Global Systemically Important Banks – Revised Assessment Framework Consultative Document. Available at: <https://www.bis.org/bcbst/publ/d402.htm>

⁷⁰ BCBS (2016), Minimum Capital Requirements for Market Risk. Available at: <https://www.bis.org/bcbst/publ/d352.htm>

⁷¹ BCBS (2017), Simplified Alternative to the Standardised Approach to Market Risk Capital Requirements – Consultative Document. Available at <https://www.bis.org/bcbst/publ/d408.htm>

(f) Simple, Transparent and Comparable Short-Term Securitisations – Consultative Documents **Criteria for Identifying STC**

Following their earlier publication in July 2015, Criteria for Identifying Simple, Transparent and Comparable Securitisations⁷² (“STC criteria”), the BCBS and IOSCO released a consultative document titled Criteria for Identifying Simple, Transparent and Comparable Short-Term Securitisations (“short-term STC criteria”). The short-term STC criteria maintain and build on the principles of the earlier publication and extend the scope to short-term securitisations – in particular, asset-backed commercial paper (ABCP),⁷³ whose structures differ significantly from those of longer-term securitisations.⁷⁴

The criteria aim to assist the financial industry in its development of simple, transparent and comparable short-term securitisations. They were designed to help the parties to such transactions to evaluate the risks of a particular securitisation across similar products and to assist investors with their conduct of due diligence on securitisations.

Capital Treatment for STC

The BCBS issued concurrently another consultative document titled Capital Treatment for Simple, Transparent and Comparable Short-Term Securitisations⁷⁵ outlining how the short-term STC criteria could be incorporated into the regulatory capital framework for banks.

The consultative document sets out additional guidance and requirements for the purpose of applying preferential regulatory capital treatment for banks acting as investors in or as sponsors of STC short-term securitisations, typically in ABCP structures. The additional guidance and requirements include:

- Investors have access to key monthly information on the performance and key characteristics of the ABCP structure.
- The redemption risk of the underlying assets is addressed from the sponsor's perspective.
- The transactions funded by the conduit have an enforceable legal structure, and the relevant information is disclosed by the sponsor to investors.

The securitisations discussed in these papers are primarily of financial assets, rather than the physical assets (or their usufructs) which are commonly securitised in Islamic finance. While there have been various initiatives and discussions by some experts to promote the use of securitised instruments in Islamic finance, securitisations

of the kind discussed (whether long- or short-term) are still not widely practised in the ICM. In general, IIFS have limited securitisation exposures and these are mainly on *shukūk*, which have been discussed in IFSB-15.

Therefore, the IFSB will continue to monitor securitisation activities in the Islamic finance industry and respond appropriately in its standard-setting work as and when the need arises. It will also incorporate the proposed capital requirements for short-term STC as appropriate in its planned revision of IFSB-15.

(g) Prudential Treatment of Problem Assets – Definitions of Non-Performing Exposures and Forbearance

In view of fostering consistency in the supervisory reporting and disclosures by banks, the BCBS issued, in April 2017, guidelines for common definitions of “non-performing exposures” and “forbearance” that would promote harmonisation in the measurement and comparability of asset quality across jurisdictions.⁷⁶ The guidelines are intended to complement the existing accounting and regulatory framework in relation to asset categorisation.

The definitions harmonise the scope, recognition criteria and level of application of both terms, and provide benchmarks to be used in some contexts, including:

- supervisory asset quality monitoring;
- banks’ internal credit categorisation systems for credit risk management purposes;
- Pillar 3 disclosure on asset quality; and
- dissemination of data for asset quality indicators and international assessments of financial systems.

The IFSB will consider making adjustments to IFSB-15 to reflect the guidelines for common definitions by the BCBS, particularly in relation to the specific characteristics of credit risk exposure of IIFS’ products. Additional disclosure requirements in this area will also be taken into account as part of the revised IFSB-4, which is expected to be issued in late 2018.

(h) Sound Management of Risks Related to Money Laundering and Financing of Terrorism: Revisions to Correspondent Banking Annex – Final Document

In June 2017, the BCBS issued its final revisions to the annex on correspondent banking⁷⁷ in the latest revised version of the guidelines on the sound management

⁷² BCBS (2015), Criteria for Identifying Simple, Transparent and Comparable Securitisations. Available at: <https://www.bis.org/bcbs/publ/d332.htm>

⁷³ The characteristics of ABCP that were taken into account in developing the short-term STC criteria include: (i) the short maturity of the commercial paper issued by ABCP conduits; (ii) different forms of programme structures; and (iii) the existence of multiple forms of liquidity and credit support facilities on different levels of the ABCP structure (e.g. conduit level or transaction level)

⁷⁴ BCBS (2017), Criteria for Identifying Simple, Transparent and Comparable Short-Term Securitisations – Consultative Document. Available at: <https://www.bis.org/bcbs/publ/d332.htm>; BCBS (2017), Capital Treatment for Simple, Transparent and Comparable Short-Term Securitisations – Consultative Document. Available at: <https://www.bis.org/bcbs/publ/d413.htm>

⁷⁵ BCBS (2017), Capital Treatment for Simple, Transparent and Comparable Short-Term Securitisations – Consultative Document. Available at: <https://www.bis.org/bcbs/publ/d413.htm>

⁷⁶ BCBS (2017), Prudential Treatment of Problem Assets – Definitions of Non-Performing Exposures and Forbearance. Available at: <https://www.bis.org/bcbs/publ/d367.htm>

⁷⁷ BCBS (2016), Revisions to the Annex on Correspondent Banking. Available at: <https://www.bis.org/bcbs/publ/d389.htm>

of risks related to money laundering and financing of terrorism.⁷⁸ The revisions are consistent with the FATF guidance on correspondent banking services⁷⁹ and is intended to clarify rules for banks conducting correspondent banking activities.

The key enhancements introduced in this latest BCBS document on anti-money laundering/combating the financing of terrorism (AML/CFT) include revisions to Annex II (correspondent banking) and Annex IV (general guide to account opening). These revisions guide banks in the application of the risk-based approach for correspondent banking relationships, recognising that not all correspondent banking relationships bear the same level of risk. The guidelines also provide an updated list of risk indicators, including money laundering and financing of terrorism (ML/FT) risks that banks engaging in correspondent banking should consider in their overall risk assessment as contained on page 3 of the consultative document on this matter.⁸⁰

Notably, the IFSB is currently undertaking a Working Paper on AML/CFT and Islamic finance jointly with the IMF and the Arab Monetary Fund (AMF), which aims to identify if there are any specific AML/CFT risks applicable to Islamic banking and whether the current international regulations are sufficient and equally applicable to IIFS.

(i) Identification and Management of Step-In Risk – Final Document

Following two consultative documents issued in December 2015⁸¹ and March 2017,⁸² the BCBS finalised its guidelines on the identification and management of step-in risk. This framework is intended to mitigate potential effects to banks of spillover arising from the shadow banking system and is a part of the G20 initiative to strengthen the oversight and regulation of the shadow banking system to mitigate potential systemic risks.

Step-in risk is recognised in the guidelines as a possible source of reputational risk that could adversely affect a bank's capital and liquidity positions. The guidelines define step-in risk as the risk that a bank decides to provide financial support to an unconsolidated entity that is facing stress, in the absence of, or in excess of, any contractual obligations to provide such support.

These guidelines also provide banks and supervisors with indicators for identifying entities bearing step-in risk for them and with a list of possible responses to step-in risk. The guidelines entail no automatic Pillar 1 capital or liquidity charge additional to the existing Basel standards, but rather leverage existing prudential tools by informing or supplementing them.

In respect of bank-specific assessment conducted by supervisors, the BCBS has recognised the necessity of a tailored, rather than a standardised, approach.

Few studies have been conducted on the shadow banking system in Islamic finance. However, this is an important area of concern in some developing markets in IFSB member countries. The IFSB will consider studying the implications of the shadow banking sector in its future work programme.

(j) Stress Testing Principles – Consultative Document

Given the evolution of stress testing in recent years, the BCBS undertook a review of current supervisory and bank stress-testing practices in 2017, followed by the issuance of a consultative document on stress-testing principles in December 2017. The document aims to replace the existing set of stress-testing principles issued by the committee in May 2009. The current principles were designed to address weaknesses in stress-testing practices highlighted by the GFC.

The consultative document introduces a new, streamlined version of the principles covering sound stress-testing practices, which are stated at a high level to ensure that they can be used by jurisdictions to guide all elements of a sound stress-testing framework. The principles are formulated with a view towards application to large, internationally active banks and RSAs, but could also be of benefit to smaller banks using simpler methods. The committee stresses the proportionality basis on which these principles apply, taking into consideration the size, complexity and risk profile of the bank/banking sector for which the RSA is responsible.

Unlike the current set of principles, the new principles apply to both authorities and banks, rather than being split between the two. Furthermore, the committee removed overlaps by reducing the amount of descriptive text that accompanies each principle and focused the new principles on high-level concepts, such as governance, thereby making them more enduring and less dependent on the current stress-testing context.

In December 2016, the IFSB issued TN-2: Technical Note on Stress Testing for Institutions Offering Islamic Financial Services which intends to facilitate the design and simulation of various stress tests for IIFS, and highlight the specificities of risk exposures in IIFS and the manner in which they could be captured in stress-testing exercises. The technical note further provides numerical examples of IIFS stress testing under different shock scenarios. Prior to that, in March 2012, the IFSB issued IFSB-13: Guiding Principles on Stress Testing

⁷⁸ BCBS (2017), Sound Management of Risks Related to Money Laundering and Financing of Terrorism: Revisions to Correspondent Banking Annex – Final Document. Available at: <https://www.bis.org/bcbs/publ/d405.htm>

⁷⁹ FATF (2016), Correspondent Banking Services. Available at: www.fatf-gafi.org/.../Guidance-Correspondent-Banking-Services.pdf

⁸⁰ BCBS (2016), Revisions to the Annex on Correspondent Banking, p. 3. Available at: <https://www.bis.org/bcbs/publ/d389.pdf>

⁸¹ BCBS (2015), Identification and Measurement of Step-in Risk – Consultative Document. Available at: <https://www.bis.org/bcbs/publ/d349.htm>

⁸² BCBS (2017), Identification and Measurement of Step-in Risk – Second Consultative Document. Available at: <https://www.bis.org/bcbs/publ/d398.htm>

for Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (*Takāful*) Institutions and Islamic Collective Investment Schemes]. This document incorporated the BCBS's 2009 stress-testing principles, as well as the Guidelines on Stress Testing issued by the Committee of European Banking Supervisors (CEBS) while making appropriate adaptations taking into account the specificities of IIFS' risk exposures.

The IFSB will consider revising IFSB-13⁸³ and TN-2⁸⁴ to incorporate the revised BCBS guidelines on stress-testing principles in its future work programme once these guidelines are finalised.

2.1.3 International Organization of Securities Commissions

IOSCO is the global standard setter for the securities sector and, since the launch of the IFSI Stability Report 2017, has released a number of publications, including final reports, consultation reports, thematic review updates and survey reports. The IFSB, being the complementary global standard setter for the Islamic securities sector, monitors the IOSCO work stream closely, and this section provides an update on those IOSCO reports that have key relevance for the IFSB's standard-setting work.

(a) IOSCO Objectives and Principles of Securities Regulation (Updated May 2017)

In May 2017, IOSCO released the latest update for its Objectives and Principles of Securities Regulation⁸⁵ and its corresponding Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation.⁸⁶ In this latest update, the objectives of securities regulation have been retained, as have the existing 38 principles, with no new additions or exclusions (last updated June 2010) aside from the shifting of IOSCO Principle No. 38 to its own category of principles, namely 'Principles Relating to Clearing and Settlement'. In terms of assessment methodology, the revisions now incorporate a number of new IOSCO standards issued since the last revision of the Methodology in August 2013. The more material changes in the methodology are additions regarding derivatives markets intermediaries and over-the-counter (OTC) and commodity derivatives markets, which reflect international developments since 2011.

The IFSB is currently developing a standard and assessment methodology that is complementary to the IOSCO's Objectives and Principles of Securities Regulation (as updated in May 2017) for the Islamic securities sector. The IFSB expects to complete this standard-setting work,

entitled Core Principles for Islamic Finance Regulation (Islamic Capital Market Segment), by December 2018. Meanwhile, the exposure draft for this standard has been released in March 2018 for public consultation, inviting comments from interested stakeholders.⁸⁷

(b) Examination of Liquidity of the Secondary Corporate Bond Markets – Final Report

IOSCO Committee 2 on Regulation of the Secondary Markets was mandated by the IOSCO Board to assess the impact of structural and regulatory developments on the liquidity of the secondary corporate bond market in its member jurisdictions, with a specific focus on the period from just prior to the GFC to 2015. A consultation report was published in 2016, and the Committee's Final Report was approved and released by the Board in February 2017.⁸⁸

The findings of the report indicate several salient changes to the characteristics and structure of the secondary corporate bond markets, including changing dealer inventory levels, increased use of technology and electronic trading venues, and changes in the role of participants and execution models (i.e. dealers shifting from a principal model to an agency model). Based on the totality of information collected and analysed, IOSCO did not find substantial evidence showing that liquidity in the secondary corporate bond markets has deteriorated markedly from historic norms for non-crisis periods.

IOSCO also notes in the conclusion to this report that the level of post-trade transparency (i.e. publicly released data concerning executed trades) in the corporate bond markets may impact liquidity. Moreover, the data disclosed through transparency requirements, along with relevant non-public data reported to regulators concerning corporate bond trades, can provide regulators with valuable data that can be used to create liquidity metrics. For this reason, the IOSCO Board mandated Committee 2 to update its 2004 report on regulatory reporting and transparency in the corporate bond markets. A consultative document was published in August 2017; see below.

The issue of liquidity (and infrequent trading) in the secondary market for *ṣukūk* (both corporate and non-corporate) has been a longstanding concern in the ICM. *Ṣukūk* investors are generally known to hold *ṣukūk* certificates until maturity due to a number of factors including, among others, the demand for adequately rated *ṣukūk* instruments far outstripping supply; Shari'ah considerations that may restrict the ability of a *ṣukūk* to be traded at values other than par; and the unavailability

⁸³ IFSB (2012), IFSB-13: Guiding Principles on Stress Testing for Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (*Takāful*) Institutions and Islamic Collective Investment Schemes]. Available at: [http://ifsb.org/standard/eng_IFSB13%20Guiding%20Principles%20on%20Stress%20Testing%20\(Mar2012\).pdf](http://ifsb.org/standard/eng_IFSB13%20Guiding%20Principles%20on%20Stress%20Testing%20(Mar2012).pdf)

⁸⁴ IFSB (2017), TN-2: Technical Note on Stress Testing for IIFS. Available at: [www.ifsb.org/docs/TN-2%20on%20Stress%20Testing%20\(final\).pdf](http://www.ifsb.org/docs/TN-2%20on%20Stress%20Testing%20(final).pdf)

⁸⁵ IOSCO (2017), Objectives and Principles of Securities Regulation.

⁸⁶ IOSCO (2017), Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation.

⁸⁷ For more details on this IFSB standard-setting work, see discussion in section 2.2.3 of this report.

⁸⁸ IOSCO (2017), Examination of Liquidity of the Secondary Corporate Bond Markets – Final Report

of benchmark *ṣukūk* price yield curves to establish appropriate pricing for secondary market trading of *ṣukūk*. The IFSB has continued to monitor this factor and duly raise awareness of both it and its corresponding risks in its annual IFSI Stability Reports using various metrics and data proxies, as available for the *ṣukūk* market.⁸⁹

(c) Regulatory Reporting and Public Transparency in the Secondary Corporate Bond Markets – Consultation Report

Published in August 2017,⁹⁰ this consultation report outlines seven proposed recommendations for enhancing transparency in the secondary corporate bond markets and in the information available to both regulators and the public. It also updates IOSCO's 2004 report on transparency of corporate bond markets.⁹¹ The recommendations revolve around the need for regulators to have sufficient information to perform their regulatory and supervisory functions, and for enhancement of pre- and post-trade transparency in corporate bond markets. IOSCO also concludes in the report that an increase in publicly available information on corporate bond trading would facilitate the price discovery process and assist investors in making more informed investment decisions.

For the ICM, the *ṣukūk* market is still largely dominated by sovereign *ṣukūk* issuances;⁹² nonetheless, there is still merit in considering enhancing regulatory reporting and public transparency for secondary corporate *ṣukūk* markets. A particular problem in the *ṣukūk* market generally is the lack of data on secondary market activities, as most transactions are OTC. This is in addition to the issue of liquidity (and infrequent trading) in the secondary market for *ṣukūk* (both corporate and non-corporate) as discussed above under section 2.1.4(c). It is thus likely that developments that enhance transparency in the corporate bond market would be beneficial if they were also extended to the corporate *ṣukūk* market.

(d) Consultation on Collective Investment Schemes Liquidity Risk Management Recommendations

IOSCO has also issued a consultation paper entitled Consultation on CIS Liquidity Risk Management Recommendations ("the 2017 Recommendations"), published in July 2017,⁹³ on key enhancements to its 2013 report on liquidity risk management for CIS.⁹⁴ The report also includes IOSCO's responses to the FSB's views with regard to structural vulnerabilities arising in the asset management industry, published in its final recommendations in January 2017.⁹⁵ One of the key recommendations addressed by the FSB to IOSCO revolves around the issue of mismatch between fund

investments and redemption terms for open-ended funds.

The topics covered in the consultation paper include disclosure to investors, the alignment between asset portfolio and redemption terms, availability and effectiveness of liquidity risk management tools, and fund-level stress testing. The report includes an additional chapter detailing recommendations on contingency planning. IOSCO specifically requested public comments on issues related to exchange-traded funds (ETFs).

The concerns raised regarding structural vulnerabilities in the asset management industry are also relevant for the Islamic funds industry – specifically, the IFSB has duly highlighted in its various stability reports the particular risks of the small scale and size of Islamic funds. In addition, while Islamic funds are less likely, for Shari'ah reasons, to invest in some potentially illiquid financial instruments, they may also have a reduced set of liquidity management tools available to them.

(e) Open-Ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration – Consultation Report

IOSCO simultaneously published another consultation paper on open-ended fund liquidity and risk management in July 2017⁹⁶ which supplements the Consultation on CIS Liquidity Risk Management Recommendations (discussed above). This consultation report provides practical information on measures that may be taken by regulators, industry and investors to enhance their liquidity risk management.

Specifically for the regulators, this document serves as a useful reference that illustrates how liquidity risk practices are regulated in various jurisdictions within their remit. For the industry groups, this document describes good practices for liquidity risk management throughout the entire life cycle of a fund. Meanwhile, for investors, the document outlines scenarios in which the investor could expect an asset manager to use liquidity management tools to manage liquidity issues in certain funds.

In general, effective liquidity risk management is also an important factor for consideration by Islamic collective investment schemes (ICIS) operators and their regulators. Particularly for ICIS operators that may invest in unlisted or relatively illiquid assets, the liquidity risk management framework needs to be cognisant of the

⁸⁹ See discussion in Chapter 3 of this stability report of the latest trends and issues in liquidity of the *ṣukūk* market.

⁹⁰ IOSCO (2017), Examination of Liquidity of the Secondary Corporate Bond Markets – Final Report.

⁹¹ IOSCO (2004), Transparency of Corporate Bond Markets.

⁹² As discussed in Chapter 1 of this stability report.

⁹³ IOSCO (2017), Consultation on CIS Liquidity Risk Management Recommendations.

⁹⁴ In March 2013, the Board of IOSCO published a report entitled Principles of Liquidity Risk Management for Collective Investment Schemes that serves as a practical guide for regulators in assessing the quality of regulation and market practices concerning liquidity risk management of CIS.

⁹⁵ FSB (2017), Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities.

⁹⁶ IOSCO (2017), Open-ended Fund Liquidity and Risk Management – Good Practices and Issues for Consideration – Consultation Report.

emergency liquidity options available (or a lack of such) in case of withdrawal pressures. This is particularly the case since the two main sources of fund generation for liquidity purposes used by conventional financial institutions are not applicable to IIFS: (1) interest-based financing from the money market; and (2) wide availability of conventional instruments for supporting liquidity management. Overall, the inability to quickly raise alternative funding due to an absence of established Shari'ah-compliant money markets may expose ICIS to substantial liquidity risks.

(f) IOSCO Task Force Report on Wholesale Market Conduct

As part of the broader international efforts to reduce the risk of misconduct in wholesale financial markets, IOSCO established a Market Conduct Task Force ("the Task Force") in September 2015 to review IOSCO members' existing conduct approaches and the work IOSCO has completed in this area. In June 2017, the board of IOSCO published a Task Force Report on Wholesale Market Conduct, describing the tools and approaches taken by IOSCO members to discourage, identify, prevent and sanction misconduct by individuals.⁹⁷ These misconduct risks could potentially arise from particular characteristics of wholesale markets, including a decentralised market structure, opacity, conflicts of interest among market makers, size and organisational complexity of market participants, and increased automation.

The findings of the task force report indicate continuous efforts that are undertaken by market regulators at a national level in enhancing their existing regulatory frameworks to address conduct issues in financial markets. These include the use of risk-mitigating tools by market regulators, such as tailored enforcement and remedial sanctions, surveillance and data analysis to identify suspicious trades, and enhanced protection of whistle-blowers. By implementing these tools, it is anticipated that market regulators are able to:

- share information to track "bad apples" (individuals with poor conduct records who move frequently from one company to another);
- ensure individual responsibility and accountability; and
- address concerns over increased automation through the imposition of regulation of high-frequency electronic trading and the establishment of legal certainty on abuses related to computer-based trading.

Meanwhile, at the international level, initiatives taken by standard-setting bodies in the provision of detailed guidance and sound practices are imperative to improve standards of conduct in wholesale markets. The report also outlines the regulatory requirements for market participants in wholesale markets, which are based on broad expectations of market conduct including honesty, integrity and competence.

The above discussion in relation to risk of misconduct in wholesale financial markets is also applicable to the ICM, and the IFSB has covered generally various aspects of conduct and integrity at both the institutional and individual level in its three IFSB standards dedicated to the ICM – namely, IFSB-6: Guiding Principles on Governance for Islamic Collective Investment Schemes,⁹⁸ IFSB-19: Guiding Principles on Disclosure Requirements for Islamic Capital Market Products, and ED-21: Core Principles for Islamic Finance Regulation (ICM Segment).⁹⁹ Other cross-sectoral IFSB standards – IFSB-9: Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services¹⁰⁰ and IFSB-10: Guiding Principles on Shari'ah Governance Systems for Institutions offering Islamic Financial Services¹⁰¹ – are also relevant in this context. While most of these have focused primarily on retail rather than wholesale markets, and on the conduct of firms rather than individuals, ED-21 does cover the risk-mitigating tools that regulators should have at their disposal.

(g) Criteria for Identifying Simple, Transparent and Comparable Short-Term Securitisations – Consultative Document

In July 2015, BCBS and IOSCO jointly released the final criteria for identifying STC term securitisations.¹⁰² In July 2016, the BCBS published revisions to its securitisation framework that incorporated the regulatory capital treatment of STC term securitisations. The purpose of these criteria and associated regulatory capital treatment is to assist the financial industry in its development of STC securitisation structures.

In July 2017, BCBS-IOSCO released a consultative document¹⁰³ that extends the scope of the STC criteria to short-term securitisations – in particular, the criteria of asset-backed commercial paper.¹⁰⁴ The amendments made to the STC criteria are necessary to apply them to short-term securitisations – typically, those using an ABCP conduit to issue forms of commercial paper – as these differ significantly in structure from term securitisations.

⁹⁷ IOSCO (2017), IOSCO Task Force Report on Wholesale Market Conduct.

⁹⁸ www.ifsb.org/standard/ifsb6.pdf

⁹⁹ <https://www.ifsb.org/download.php?id=4684&lang=English&pg=/exposure.php>

¹⁰⁰ www.ifsb.org/standard/IFSB-9_Guiding%20Principles%20on%20Conduct%20of%20Business.pdf

¹⁰¹ www.ifsb.org/standard/IFSB-10%20Shariah%20Governance.pdf

¹⁰² BCBS (2015), Criteria for Identifying Simple, Transparent and Comparable Securitisations.

¹⁰³ BCBS (2017), Criteria for Identifying Simple, Transparent and Comparable Short-Term Securitisations – Consultative Document.

¹⁰⁴ The characteristics of ABCP that were taken into account in developing the short-term STC criteria include: (i) the short maturity of the commercial paper issued by ABCP conduits; (ii) different forms of programme structures; and (iii) the existence of multiple forms of liquidity and credit support facilities on different levels of the ABCP structure (e.g. conduit level or transaction level).

In this consultative document, BCBS-IOSCO have developed a set of 17 STC criteria specifically catering to short-term securitisations, focusing on exposures related to ABCP conduits. The development of the short-term STC criteria is intended to help transaction parties to evaluate the risks of a particular securitisation across similar products and to assist investors in their conduct of due diligence on short-term securitisations. One of the key amendments proposed in the short-term STC criteria was to split the short-term STC criteria between transaction level and conduit level. This is to ensure a consistent standard of underwriting by highlighting different roles to be played by the sponsor at each level.

While there have been various initiatives and discussions by some experts to promote the use of securitised instruments in Islamic finance, securitisations (whether long- or short-term) are still not widely practised in the ICM. The IFSB has previously discussed the securitisation framework and its associated regulatory capital treatment in its capital adequacy standard IFSB-15: Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services.¹⁰⁵ The IFSB will continue to monitor the securitisation activities in the Islamic finance industry and correspondingly respond appropriately in its standard-setting work as and when the need arises.

2.1.4 International Association of Insurance Supervisors

The insurance core principles of the International Association of Insurance Supervisors are the globally accepted requirements for the supervision of the insurance sector. The structure of the ICPs also includes more detailed standards and guidance. They are structured to allow a wide range of regulatory approaches and supervisory processes in order to suit different markets and the range of insurance entities and groups operating within these markets. However, internationally active insurance groups (IAIGs) need tailored and more coordinated supervision across jurisdictions, and for these the IAIS has been developing ComFrame, the common framework for supervising IAIGs. One very important component of ComFrame, currently under development, is an Insurance Capital Standard (ICS), there being no detailed international standard at present for the insurance sector. This section reports on key developments in these areas relevant to the *takāful* and *retakāful* sector, as well as some other significant work by the IAIS. Its work on Fintech is discussed, with other work on that subject, in section 2.1.6.

(a) Insurance Capital Standard

The development of the ICS has been reported in previous IFSI stability reports (i.e. 2015, 2016 and 2017).

In July 2017, the IAIS published ICS Version 1.0 for extended field testing. This version covers all aspects of ICS, including valuation, capital resources and capital requirements. However, it maintains two possible valuation approaches. The aim of field testing is to gather inputs from stakeholders to inform the development of ICS Version 2.0, which is the first version that will be intended for implementation.

In November 2017, the IAIS announced a “unified path to convergence” on ICS Version 2.0, representing the resolution of long-running differences between Europe and the US in particular. The IAIS has agreed that implementation of ICS Version 2.0 will be conducted in two phases – a five-year monitoring phase followed by an implementation phase.¹⁰⁶ Implementation of ICS Version 2.0 will have two equally important components. The first is mandatory confidential reporting by all IAIGs of a reference ICS which is based on market-adjusted valuation (MAV), the standard method for capital requirements and converged criteria for qualifying capital resources; and additional reporting, at the option of the group-wide supervisor, of ICS based on GAAP Plus valuation and/or an internal model-based capital requirement calculation. In addition, the IAIS has further agreed to collect data to allow it to assess by the end of the monitoring period whether or not the aggregation-based group capital calculation method suggested by members from the United States provides comparable results to the ICS, which is based on group consolidation. The development of the ICS has interacted with the long-running development of the accounting standard IFRS-17 on insurance contracts, which was finally published as a standard in May 2017 and is due to take effect from 1 January 2021. This is important to the ICS, since valuation issues have been among the most difficult in its development. The use of this standard can be expected to underpin the MAV approach in the ICS.

The IFSB is monitoring closely the development of the ICS. Although the ICS is intended for IAIGs, it may well, like the Basel Accords, be applied more widely. As emphasised in previous stability reports, the ICS for the conventional industry will guide an appropriate revision of IFSB-11.¹⁰⁷ The findings from the ongoing research paper entitled “Issues Arising from Changes in *Takāful* Capital Requirements” will further enrich the future revision of the *takāful* solvency capital standard in line with the best supervisory and market practices.

(b) Revision of Insurance Core Principles/ComFrame-Related Material Consultation Package

The IAIS has been conducting a rolling review of its ICPs. In March 2017, it launched a major consultation covering proposed revision to a set of ICPs¹⁰⁸ and ComFrame-related material integrated with ICPs

¹⁰⁵ [www.ifsb.org/standard/2014-01_28_eng_IFSB15%20Revised%20Capital%20Adequacy_\(Jan%202014\).pdf](http://www.ifsb.org/standard/2014-01_28_eng_IFSB15%20Revised%20Capital%20Adequacy_(Jan%202014).pdf)

¹⁰⁶ IAIS, Press Release, November 2017: “IAIS Announces Unified Path to Convergence on ICS Version 2.0”.

¹⁰⁷ IFSB-11: Standard on Solvency Requirements for *Takāful* (Islamic Insurance) Undertakings.

¹⁰⁸ Revision of ICPs 1, 2, 18 and 19; ICP 13; ICP 24; ICPs 8, 15 and 16.

covering the following themes: governance; supervisor and supervisory measures; supervisory cooperation and coordination; resolution; as well as the revised introduction to both ICPs and ComFrame.¹⁰⁹ This development is based on the 2016 IAIS decision to integrate the ComFrame-specific material into the ICPs. Therefore, this consultation document is the first to reflect the new structure for integrating ComFrame material into the ICP structure. The complete version of ComFrame (including ICS Version 2.0) integrated with the ICPs is planned for adoption in 2019, but with public consultations scheduled for 2018.

Three revised ICPs were approved by the IAIS general meeting in November 2017. These include: ICP 13 (Reinsurance and Other Forms of Risk Transfer); ICP 18 (Intermediaries); and 19 (Conduct of Business). In the same month, the IAIS launched a further consultation covering revisions to ICP 8 (Risk Management and Internal Controls), ICP 15 (Investments) and ICP 16 (Enterprise Risk Management for Solvency Purposes).

The IFSB has developed Core Principles for Islamic Finance Regulation covering the Banking Sector and Islamic Capital Markets (currently an Exposure Draft). It may in the future develop similar core principles for the *takāful* sector, but the timing of such work is likely to depend on the time at which the ICPs reach stability.

(c) Systemic Risk Assessment

In February 2017, the IAIS announced that it is developing an activities-based approach (ABA) to systemic risk assessment in the insurance sector as part of a review of its approach to evaluating and mitigating systemic risk assessment.¹¹⁰ Following this announcement, an interim public consultation paper on ABA was published by the IAIS in December 2017. The paper highlights the proposed steps that the IAIS will follow in its work on deriving activities-based policy measures, and seeks comments from stakeholders.¹¹¹

The move towards an ABA marks an important change in the understanding of systemic risk in the insurance sector, with the focus moving from individual institutions, which may be assessed as G-SIIs, to activities that may be undertaken broadly within the sector. The IAIS defines an ABA as an approach to mitigate systemic risk through broadly applicable policy measures addressing potentially systemic activities. It is based on a horizontal (i.e. across firms) assessment of the risk transmission owing to activities that either in themselves or as a result of common behaviours of firms may be

systemically relevant. The term “activity” is broadly used to encompass business lines and operations that have potentially systemically relevant characteristics. As such, it potentially includes insurance, reinsurance and non-insurance activities. Furthermore, the activity is interpreted substantively based on the risk exposure stemming from the activity, rather than narrowly based on its legal form. The consultation paper deals in more detail with liquidity risk and macroeconomic risk, but it is primarily concerned at this stage with addressing how potentially risky activities should be identified and how policy measures should be deployed to mitigate the risks. Although companies in the *takāful* sector are in general not systemically significant, the IAIS’s work is important for the way in which it may be appropriate to think about systemic issues as the sector grows. In addition, the IAIS’s thinking about indicators of systemic risk may influence the IFSB’s work in defining the data on the *takāful* industry to be included in the prudential and structural Islamic financial indicators (PSIFIs) scheduled to commence in 2018.

(d) Other IAIS Activities

In addition to the materials discussed above, the IAIS also issued three application papers and one issues paper that may be of relevance to the IFSI. Application papers provide additional material about how the ICPs may be applied in particular situations. Issues papers provide background on particular topics, and often form part of the preparatory work for developing standards.

(i) *Application Paper on the Regulation and Supervision of Mutuals, Cooperatives and Community-Based Organisations in Increasing Access to Insurance Markets* The application paper titled Regulation and Supervision of Mutuals, Cooperatives and Community-Based Organisations in Increasing Access to Insurance Markets (MCCOs) was issued by IAIS in September 2017.¹¹² The paper provides a general description of the MCCO sector, particularly those MCCOs operating as insurers. It addresses areas in which the specific nature of MCCOs manifests itself; notably, formalisation and licensing; corporate governance; capital requirements and capital resources; portfolio transfers, mergers, demutualisations and wind-ups; supervision general, supervision and supervisory review.

While some MCCOs operate as insurers, some also provide administrative, educational and distribution services. Others play intermediary roles. Some MCCOs can be considered “aggregators” – that is, entities that bring together people for non-insurance purposes. These may

¹⁰⁹ International Association of Insurance Supervisor Newsletter (February 2017), www.iaisweb.org/page/news/newsletter

¹¹⁰ International Association of Insurance Supervisors Newsletter (March 2017), www.iaisweb.org/page/news/newsletter.

¹¹¹ International Association of Insurance Supervisors Newsletter (December 2017), www.iaisweb.org/page/news/newsletter.

¹¹² IAIS (2017), Application Paper on the Regulation and Supervision of Mutuals, Cooperatives and Community-Based Organisations in Increasing Access to Insurance Markets: www.iaisweb.org/page/supervisory-material/application-papers/file/68822/application-paper-on-mutuals-cooperatives-and-community-based-organisations-september-2017.

include retailers, service providers, utility companies, membership-based organisations or civil society organisations. Insurers, with or without the intervention of agents or brokers, then use these “aggregators” to distribute insurance and – depending on the model – fulfil additional functions such as administration and/or claims pay-outs.

Often, MCCOs play a role in increasing access to insurance in jurisdictions challenged in distributing insurance products to un(der)served segments of the population. In these cases, the ability of MCCOs to operate independently as stand-alone entities in remote and rural areas without long distribution lines makes them a potentially important business model for improving access to insurance.

While the paper explicitly excludes the *takāful* sector from its consideration, its thinking on the role of mutual organisations in financial inclusion, and how the specific regulatory issues may be addressed, will be taken into account in the preparation of the Technical Note on Financial Inclusion and Islamic Finance discussed below.

(ii) *Application Guidance for Product Oversight in Inclusive Insurance*

The Application Paper on Product Oversight in Inclusive Insurance was issued in November 2017.¹¹³ This paper builds on the Issues Paper on Conduct of Business in Inclusive Insurance (“Issues Paper”), dated 2015, which dealt extensively with the fair treatment of customers in inclusive insurance markets, particularly when designing, advertising, selling and exercising other rights and obligations arising out of insurance products. The paper provides guidance on the application of product oversight in markets in which a significant part of the population does not have access to suitable insurance products (also known as inclusive insurance markets).

The paper stresses the importance of the proportionality principle in tailoring regulation and supervision. This will help to avoid unnecessary barriers for market development and will promote access to insurance products for customers.

The paper identifies three main approaches to product oversight for insurance supervisors:

- principle-based;
- file-and-use; and
- prior approval.

A combination of these approaches exists in many jurisdictions. Direct supervisory approval of contract conditions or pricing is likely to be more appropriate in

specific circumstances (e.g. where the insurer is dealing with less financially capable or vulnerable customers, where products are new to the market or complex, or for insurance contracts required by law such as motor liability insurance). Product oversight needs to recognise the vulnerability of the typical inclusive insurance customer with low or no education, an irregular and low income, particular needs for protection, typical and sometimes remote living conditions, and no experience with or a negative perception of insurance. The paper gives examples of approaches used in different countries, and the considerations that may inform the choice of approaches in particular markets.

This paper is also relevant to the IFSB’s work on financial inclusion and Islamic finance. In addition, it will be relevant to the ongoing research project on consumer protection in the *takāful* sector.

(iii) *Application Paper on Group Corporate Governance*

Application Paper on Group Corporate Governance was also issued in November 2017¹¹⁴ and builds on an earlier Issues Paper. Whereas the corporate governance material in the ICPs is focused on governance at the individual entity level, this application paper deals with how these principles can be applied to the governance of a group. It aims to provide good supervisory practices related to group governance as relevant to:

- supervision of the corporate governance framework (ICP 7);
- supervision of the risk management system and the reporting lines between the control functions within the group (ICP 8);
- the allocation of responsibilities between the group-wide supervisor and the other involved supervisor (ICP 23); and
- cooperation and coordination between involved supervisors with regard to groups (ICP 25).

This work will be relevant to any future IFSB work either on corporate governance specifically or on issues of group supervision.

(iv) *Draft Issues Paper on Index-Based Insurances*

In December 2017, the IAIS launched a draft document for public consultation entitled Draft Issues Paper on Index-Based Insurance.¹¹⁵ Index-based insurance is a relatively new, innovative concept in insurance provision. It involves contracts where a claim is defined with reference to a predetermined index (sometimes also referred to as parametric insurance). It is increasingly considered for agriculture for protection from natural catastrophes. Related products may also be targeted at catastrophic health or life insurance risks such as pandemics.

¹¹³ IAIS (2017), Application Paper on Product Oversight in Inclusive Insurance: www.iaisweb.org/page/supervisory-material/application-papers/file/70163/application-paper-on-product-oversight-in-inclusive-insurance.

¹¹⁴ IAIS (2017), Application Paper on Group Corporate Governance: www.iaisweb.org/page/supervisory-material/application-papers/file/69940/application-paper-on-group-corporate-governance.

¹¹⁵ IAIS (2017), Draft Issues Paper on Index-Based Insurances: www.iaisweb.org/page/consultations/current-consultations/draft-issues-paper-on-index-based-insurances.

This issues paper focuses on index-based insurances as a means to manage weather and catastrophic events, support food security and enhance access to insurance. Their main advantage in these situations is that individual losses do not need to be assessed, thus avoiding the cost and administrative delay from traditional insurance claims assessment. They may therefore reduce the barriers to providing effective and affordable insurance, particularly for lower income groups that tend to be more vulnerable to such events.

However, index-based insurance programs directed at low-income clients do face challenges. These include the need to overcome cost barriers in service delivery, ensure rapid claim payment, and have customer service delivery that takes account of the possibility that clients have limited financial literacy. In order to overcome these challenges, the index itself needs to be well structured and functional. Like other microinsurance programs, an index-based insurance scheme may depend on having a very large number of clients so as to maintain low costs, but the specific nature of the risk index might make it more difficult to broaden the programme. In fact, the more broadly an index is applied to increase the potential number of covered clients, the more challenging it is to reduce the risk that the index will not be sufficiently responsive to reflect the circumstances of local clients (basis risk).

This work will also be relevant to the IFSB's work on financial inclusion and Islamic finance.

2.1.5 Financial Action Task Force

The FATF published Guidance on Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion, with a Supplement on Customer Due Diligence¹¹⁶ in November 2017, to provide support in designing AML/CFT measures that meet the goal of financial inclusion without compromising the measures that exist for combating financial crime.

The Guidance focuses on facilitating access to financial services for financially excluded and underserved groups, including low-income, rural sectors and undocumented groups. It also extensively explores the initiatives taken in developing countries where the biggest challenges exist in this respect. The Guidance is based upon the assumption that financially excluded and underserved groups in both developing and developed countries should not be automatically classified as lower risk for ML/TF.

The Guidance provides an overview of the risk-based approach (RBA), the application of which will be based

on an assessment of risks which will assist countries and financial institutions to understand, identify and assess risks, and apply mitigation and management measures that are risk-sensitive. The Guidance reviews the different steps of the AML/CFT process – customer due diligence (CDD), record-keeping requirements, report of suspicious transactions, use of agents, internal controls – and how, for each of these steps, the FATF standards can be read and interpreted to support financial inclusion.

The Guidance will directly inform the work currently being done by the IFSB in developing a technical note on financial inclusion and Islamic finance, which also takes into consideration the associated AML/CFT issues from a financial inclusion perspective for IIFS.

In addition, a joint research paper is planned for 2018, which aims to study the potential AML/CFT issues in relation to IIFS, and how the current AML/CFT regulations are being applied to IIFS as well as any additional risks that IIFS may be exposed to, by analysing empirical data for this purpose. While there is limited evidence on ML/FT risks associated with Islamic finance, the study expects to provide an informed discussion on the topic, working jointly with international organisations that have common interests in this area, including the IMF and the AMF.

2.1.6 Fintech

Financial technologies (“Fintech”) have been widely considered by various financial sector standard-setting bodies in 2017, and the various initiatives are discussed collectively in this section.

(a) Financial Stability Implications from Fintech

The FSB's report Financial Stability Implications from Fintech¹¹⁷ published in June 2017, analyses the potential financial stability implications of Fintech, with a view to identifying issues that merit the attention of regulatory and supervisory authorities. The report is concerned specifically with stability, rather than with consumer and investor protection, market integrity, competition or financial inclusion, though it recognised that these were issues being considered by others. In this respect, the report identified 10 key areas that require the attention of authorities, three of which were noted as priorities for international collaboration. These were: (1) management of operational risk from third-party service providers; (2) mitigating cyber risk; and (3) monitoring of macrofinancial risks that might emerge with increased Fintech activities. Addressing these three priority areas was noted as essential in supporting RSAs' efforts to safeguard financial stability while fostering inclusive and sustainable finance.

¹¹⁶ FATF (2017), Anti-Money Laundering and Terrorist Financing Measures and Financial Inclusion. Available at: www.fatf-gafi.org/media/fatf/content/images/Updated-2017-FATF-2013-Guidance.pdf

¹¹⁷ FSB (2017), Financial Stability Implications from Fintech. Available at www.fsb.org/wp-content/uploads/R270617.pdf.

The report notes that there are currently no compelling financial stability risks arising from Fintech given its small size relative to the financial system; however, it cautions that past precedent indicates that risks can emerge quickly if left unchecked.

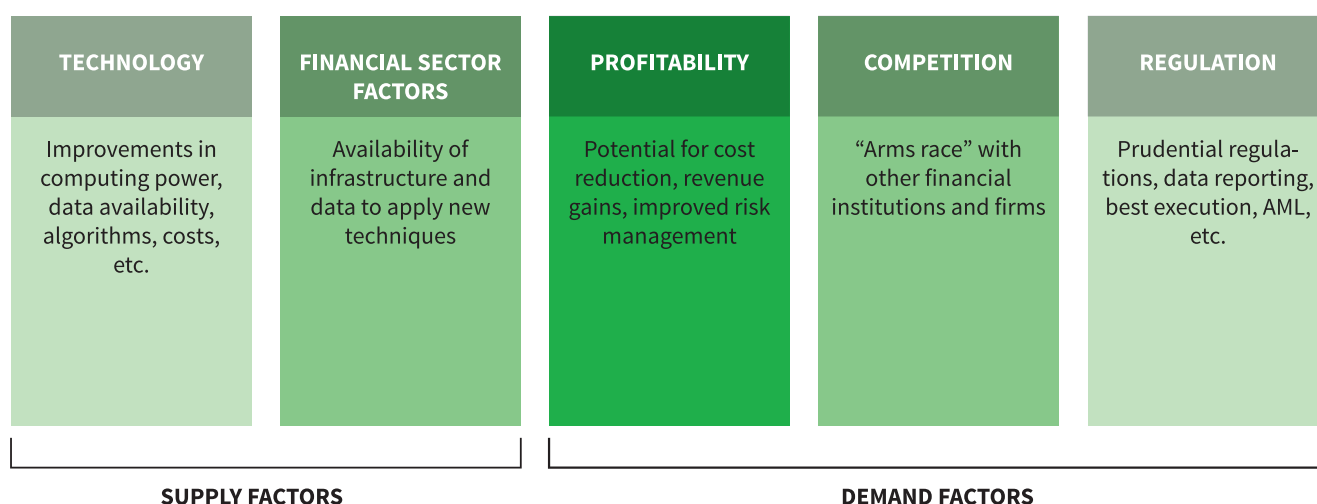
(b) Artificial Intelligence and Machine Learning in Financial Services: Market Developments and Financial Stability Implications

A second FSB report, published in November 2017 and titled Artificial Intelligence and Machine Learning in Financial Services: Market Developments and Financial Stability Implications,¹¹⁸ considers the increasing

adoption of artificial intelligence (AI) and machine learning in the financial services industry and its financial stability implications. Once again, the focus was on stability, though the report did touch on other issues of concern to regulators.

The report recognises that the use of AI and machine learning technology is altering the way some financial services are provided. It noted the growing use of these technologies in some segments of the financial services industry, particularly in fraud detection, capital optimisation, and portfolio management applications.

Chart 2.1.6.1
Supply and demand factors of financial adoption of AI and machine learning¹¹⁹



Source: IOSCO report

The report notes that the use of AI and machine learning in financial services may provide some key benefits for financial stability in the form of efficiencies in the provision of financial services and regulatory and systemic risk surveillance. In addition, the use of these technologies by regulators and supervisors provides potential to increase supervisory effectiveness and to improve systemic risk analysis in financial markets. At the same time, network effects and scalability of new technologies may in the future give rise to additional third-party dependencies from technology firms (those that develop algorithms, provide application software, etc.), which could in turn lead to the emergence of new, systemically important players outside the realm of regulated financial institutions. This could be translated into financial stability risks if technology firms have a large market share in specific financial market segments. These third-party dependencies and interconnections could have systemic effects if such a large firm were to face a major disruption or insolvency.

Overall, the report concludes that AI and machine learning applications show significant potential, if their specific risks are managed effectively, and that their use should continue to be closely monitored and further assessed in terms of financial stability implications as the underlying technologies develop further and their use becomes more widespread. The report also points out a number of unsettled legal issues, such as liability for losses caused by AI-based investment decisions, which may also be relevant from an Islamic law perspective.

(c) IOSCO Research Report on Financial Technologies

In February 2017, IOSCO published a research report on Fintech, highlighting the impact of the increasingly important intersection between Fintech and securities market regulation.¹²⁰ The study describes a variety of innovative business models, emerging technologies and Fintech products/services, together with their perceived benefits in transforming the financial services industry, including:

¹¹⁸ FSB (2017), Artificial Intelligence and Machine Learning in Financial Services: Market Developments and Financial Stability Implications. Available at: www.fsb.org/wp-content/uploads/P011117.pdf.

¹¹⁹ FSB (2017), Artificial Intelligence and Machine Learning in Financial Services: Market Developments and Financial Stability implications, p. 9.

¹²⁰ IOSCO (2017), IOSCO Research Report on Financial Technologies (Fintech).

- Financing platforms, including peer-to-peer (P2P) lending and equity crowdfunding (ECF);
- Retail trading and investment platforms, including robo-advisers and social trading and investing platforms;
- Institutional trading platforms, with a specific focus on innovation in bond trading platforms; and
- Distributed ledger technologies (DLT), including application of blockchain technology and shared ledgers to the securities markets.

The report notes that regulators are facing challenges in terms of enhanced monitoring of Fintech platforms, and suggests exploring the development of new compliance software and surveillance tools that can facilitate monitoring of Fintech trading activities and detection of misconduct (if any).

(d) IAIS Report on Fintech Developments in the Insurance Industry

The IAIS released a report in February 2017 entitled “Fintech Development in the Insurance Industry” The report highlights the potential impact of Fintech innovation on areas of the insurance value chain, and discusses new opportunities and challenges for both the insurance industry and insurance supervision.

It notes that innovative business models driven by technological development are changing the insurance landscape and the expectations of customers. The most relevant technological developments with the potential to transform the insurance business are digital platforms, internet of things, telematics, big data and data analytics, comparators and robo advisers, machine learning and artificial intelligence, distributed ledger technology (DLT) – including blockchain and smart chain contracts – and business models such as P2P, usage-based and on-demand insurance. (These technologies are sometimes referred to in this context as InsurTech.) The report considered several scenarios for the way these technologies might impact on the insurance business, from which a number of main themes emerged:

- Reduced competitiveness through market domination of tech-savvy firms with competitive advantage. In the longer term, smaller and more traditional insurers may disappear from the market.
- Reduced consumer choice because: (1) technology is expected to lead to greater customisation of the product to the individual, leading to a reduction in comparability between product providers; and (2) existing insurance providers will benefit from increasing individual policyholder data. In the absence of data transferability, competitors may be reluctant to quote.
- The use of a limited number of technological platforms (e.g. cloud-based or software providers)

may increase interconnectedness and create new vulnerabilities within the insurance sector.

- Increased use of technology to optimise processes and analytics is expected to add more participants in the insurance value chain, which in turn is expected to reduce the scope for regulatory oversight. In some models, the impact could be significant, as risk carriers may be one or more steps removed from the policyholder.
- Underlying business models are expected to adapt, although the extent to which incumbents are able to adapt will depend on the speed of change. However, over the longer term there is potential for a reduction in business model resilience.
- Improvements in technology are expected to result in insurers or technology firms providing more bespoke products to policyholders. However, fragmentation of the value chain may lead to undisclosed conflicts of interest.
- The rise in use of internet-connected devices is expected to exponentially increase the data collected and analysed from policyholders. This may affect the treatment of customers, possibly creating issues around the affordability of insurance products or even increased financial exclusion. Additionally, issues may arise around the use, ownership and protection of data.

(e) BCBS Sound Practices on the Implications of Fintech Developments for Banks and Bank Supervisors

The BCBS published its Sound Practices on the Implications of Fintech Developments for Banks and Bank Supervisors,¹²¹ which assesses how technology-driven innovation in financial services, or Fintech, may affect the banking industry and the activities of supervisors in the near to medium term. It is based on the analysis of various potential future scenarios and draws on surveys of banking supervisors’ frameworks and practices in relation to Fintech matters. A number of stylised scenarios are identified in the paper, which describes the potential impact of Fintech on banks, with their specific risks and opportunities, as part of an industry-wide scenario analysis:

- The better bank: modernisation and digitisation of incumbent players.
- The new bank: replacement of incumbents by challenger banks.
- The distributed bank: fragmentation of financial services among specialised Fintech firms and incumbent banks.
- The relegated bank: incumbent banks become commoditised service providers and customer relationships are owned by new intermediaries.
- The disintermediated bank: banks have become irrelevant, as customers interact directly with individual financial service providers.

¹²¹ BCBS (2018), Sound Practices: Implications of Fintech Developments for Banks and Bank Supervisors. Available at: <https://www.bis.org/bcbs/publ/d431.pdf>

In addition to the banking industry scenarios, the paper also provides three case studies focusing on three areas of technology developments – namely, big data, distributed ledger technology and cloud computing – as well as three case studies on Fintech business models, which are innovative payment services, lending platforms and neo-banks.

The paper concludes that current observations suggest that the rapid adoption of enabling technologies and the emergence of new business models pose various opportunities and risks to incumbent banks in almost all of the banking industry scenarios that were considered. It further notes that banking standards and supervisory expectations should be adaptive to new innovations while maintaining appropriate prudential standards.

Based on this work, the BCBS identified 10 key implications and related considerations for banks and bank supervisors:

- (a) the overarching need to ensure safety and soundness and high compliance standards without inhibiting beneficial innovation in the banking sector;
- (b) the key risks for banks related to Fintech developments, including strategic/profitability risks, operational, cyber- and compliance risks;
- (c) the implications for banks of the use of innovative enabling technologies;
- (d) the implications for banks of the growing use of third parties, via outsourcing and/or partnerships;
- (e) cross-sectoral cooperation between bank supervisors and other relevant authorities;
- (f) international cooperation between bank supervisors;
- (g) adaptation of the supervisory skill set;
- (h) potential opportunities for supervisors to use innovative technologies ("Suptech");
- (i) relevance of existing regulatory frameworks for new innovative business models; and
- (j) key features of regulatory initiatives set up to facilitate Fintech innovation.

While Fintech activities in the IFSI are still relatively small in scale, they are growing and developing rapidly. Along with new risks, there are also new opportunities – for example, for financial inclusion, and for more participative business models that better reflect the values of Islamic finance. The IFSB will continue to monitor developments in the Fintech space in relation to the IFSI, and may take up more work on various aspects of Fintech as the need arises.

The IFSB has explored a number of relevant issues in the IFSI Stability Report 2017, which identified some of the leading elements of Fintech – for example, cryptocurrencies and crowdfunding – and assessed their

Sharī'ah compatibility and application to Islamic finance, financial inclusion and the relevant regulatory issues.

Notably, the IFSB is also currently developing a technical note on financial inclusion and Islamic finance where Fintech firms are featured as tools for enhancing financial inclusion. The technical note¹²² approaches Fintech from both regulatory and policymaking perspectives with the goal of enhancing financial inclusion through Islamic finance.

The IFSB Summit 2017 also discussed the role of Fintech in Islamic finance under the theme "The Fintech Innovative Progression: Boon or Bane for Traditional Financial Institutions?". The discussions during this session centred on Fintech developments in various jurisdictions in the Islamic finance sector, the regulatory approaches being adopted towards Fintech, and whether it is likely to result in any disruption of traditional financial institutions.

2.2 RECENT INITIATIVES UNDERTAKEN BY THE IFSB

2.2.1 Development of New Standards

The IFSB is in the process of developing a number of new standards in all three sectors, including a standard on the supervisory review process for the *takāful* sector, a revised standard on disclosures to promote transparency and market discipline for the Islamic banking sector, and the core principles for Islamic finance regulation for the ICM segment. These three standards, which were initiated in 2016, are targeted for issuance in 2018. In addition, the IFSB initiated a new technical note in 2017 on financial inclusion and Islamic finance, which is targeted for issuance in early 2019.

2.2.1.1 ED-20: Guiding Principles on Key Elements in the Supervisory Review Process of *Takāful/Retakāful*

The work on guiding principles on key elements in the supervisory review process (SRP) of *takāful/retakāful* undertakings (TUs/RTUs) commenced following the IFSB Council's approval on 8 December 2015. While this standard represents the first initiative on SRP for the *takāful* and *retakāful* industry, it is not the first of its kind to be issued by the IFSB. Two documents have been issued previously to address issues pertaining to the SRP of the Islamic banking industry.¹²³ However, ED-20 emphasises the actions of the RSAs responsible for overseeing the *takāful* and *retakāful* sector.

Four substantive *takāful* standards have been adopted by the IFSB Council:

- (a) IFSB-8: Guiding Principles on Governance for *Takāful* (Islamic Insurance) Undertakings [December 2009]

¹²² For more details on this IFSB standard-setting work, see discussion in section 2.3.1.1.

¹²³ IFSB-5 and IFSB-16.

- (b) IFSB-11: Standard on Solvency Requirements for *Takāful* (Islamic Insurance) Undertakings [December 2010]
- (c) IFSB-14: Standard on Risk Management for *Takāful* (Islamic Insurance) Undertakings [December 2013]
- (d) IFSB-18: Guiding Principles for *Retakāful* (Islamic Reinsurance) [April 2016].

The principal focus of these published standards has been on the requirements to be applied to TUs/RTUs and *takāful* and *retakāful* operators (TOs/RTOs), rather than on the actions of the RSAs responsible for overseeing the *takāful* and *retakāful* sector. However, various sections in these standards emphasise the importance of having in place an effective supervisory review process:

- (a) In IFSB-8, paragraph 79 states: “Besides good governance, other areas that the IFSB may address through appropriate standards and guidelines on best practices for the *takāful/retakāful* industry include solvency, financial and prudential regulation, transparency and disclosure, conduct of business and supervisory review process.”
- (b) In IFSB-11, Key Feature 6 mentions the need to ensure adequate supervisory assessment of risk management arrangements of TOs.
- (c) In IFSB-14, Section D of the document outlines Key Elements in the Supervisory Review Process of Risk Management for TUs.
- (d) In IFSB-18, Principle 5.1 provides guidance on “Supervision of *Retakāful*/Reinsurance Programmes”.

Therefore, it is important to have specific standards to scope on this subject. ED-20 is primarily intended to guide the firm-level supervision of TUs/RTUs. It aims to provide guidance and to support the implementation of common approaches to the supervision of the *takāful* and *retakāful* industry, while addressing the specificities of these institutions. This is to protect the interests of the contracting parties in the TUs/RTUs and the long-term stability of the *takāful* system. In particular, ED-20 is developed around the following objectives:

- (a) to provide guidance to supervisors on minimum standards for an effective and efficient supervisory review process for TUs and RTUs, addressing the unique elements of these institutions;
- (b) to promote, by means of supervisory review, fair, safe and stable *takāful* and *retakāful* markets for the benefit and protection of participants; and
- (c) to promote harmonisation of supervision internationally, and hence to enhance cooperation among supervisors.

Following the approach taken by the IFSB’s Articles of Agreement, this document sets out principles for regulatory supervision to be applied by the RSAs to the

takāful/retakāful industry, in parallel with perspectives set out by the IAIS, in order to provide for effective supervision of the industry, consistent in quality with that applicable to the conventional insurance industry, subject always to the requirements of Shari’ah principles. So far as features of regulatory supervision that are in common with conventional insurance are concerned, users of this standard should have regard to the Insurance Core Principles¹²⁴ and other standards issued by the IAIS. Where relevant, this document makes reference to those standards. The central focus of ED-20 is on the specific characteristics of TUs and RTUs and the manner in which the supervisory review process of RSAs addresses those specific characteristics such as TO/RTO’s ownership structure, segregation of funds and Shari’ah-compliant investment.

Chart 2.2.1.1.1 The Main Sections of ED-20 Guiding Principles on Key Elements in the Supervisory Review Process of *Takāful/Retakāful*

SECTION B: Supervisory approach for effective supervision of <i>takāful/retakāful</i>	• Risk-based approach • Supervisory tools
SECTION C: Key elements of supervisory review process for <i>takāful/retakāful</i> undertakings	• Corporate governance • Shari’ah governance • <i>Takāful</i> operational framework • Capital adequacy • <i>Retakāful</i> • Risk management • <i>Takāful</i> and <i>retakāful</i> windows
SECTION D: Additional specific issues to be addressed under supervisory review process of <i>takāful/retakāful</i>	• Group supervision • Conduct of business • Run-off

The ED-20 comprises three main sections.

Section B discusses supervisory approaches with reference to a risk-based approach to the process of supervision. The risk-based approach is described as a structured method that allow RSAs to understand and assess key risks inherent in a TO/RTO’s activities with the aim of detecting any issues that may constitute a significant risk. Seven different supervisory tools are identified by RSAs for this approach. These supervisory tools are to be applied in an integrated manner such that information derived from one will be used to inform the use of others. They include supervisory reporting, off-site

¹²⁴ In particular, ICPs 9, 10, 11 and 12.

monitoring, on-site inspections, supervisory follow-up, enforcements, event-based supervision, and thematic review.

Supervisory reporting allows RSAs to access reliable information needed to examine the state of each firm and, more generally, the market situation. The contents in supervisory reporting are defined in regulation. Off-site monitoring¹²⁵ and on-site inspections¹²⁶ are important supervisory tools in the SRP. Off-site monitoring is performed through collection and analysis of information provided by the TOs/RTOs. It provides useful data for RSAs which may not be readily obtained through on-site visits. On-site inspections draw on the findings of the off-site monitoring process and in turn influence the focus of off-site supervision. Thus, they provide additional information to supplement the analysis of the data submitted to the RSA by TOs/RTOs.

In some cases, supervisory follow-up or monitoring might be required to ensure adequate implementation of plans submitted by TOs/RTOs to deal with the issues raised by their RSAs. Supervisory enforcement action is usually undertaken when a firm's response to supervisory action is judged inadequate, or where breach is so severe that the supervisor considers that enforcement action is warranted. Enforcement action is an integral part of a risk-based supervision system. In addition to a planned programme of off-site and on-site supervision, an RSA will need to respond to events as they occur. A common example is a change in the ownership of the TO/RTU, or a change in the membership of the board of directors. Thematic review is not itself a part of the SRP for an individual entity; rather, it is undertaken at the sector level.

Section C of ED-20 describes key elements of the SRP for TUs/RTUs. The SRP is made up of seven essential elements for supervision of TUs/RTUs. These elements present a clear overview on issues involved in the supervision of the *takāful* and *retakāful* sector in an integrated form:

- (i) In performing a comprehensive evaluation of a TO/RTU's overall corporate governance policies and practices, the RSA needs first to ensure that it comprehends the TO/RTU's ownership structure based on the general framework of the operating model, which should have the effect of ensuring a clear segregation of funds as required by relevant Shari'ah rules and principles.¹²⁷ This will facilitate subsequent understanding of the sources of capital through which the rights and obligations of various stakeholders will be ascertained. The RSA should

further assure itself that the TO/RTU has robust corporate governance policies and processes that are commensurate with its risk profile and systemic importance. This may be done through the review of internal policies, procedures, systems and controls in order to assess the adequacy of these in light of the TO/RTU's risk profile.

- (ii) In evaluating the effectiveness of the Shari'ah governance framework of a TO/RTU, RSAs should verify that the Shari'ah board is adequately knowledgeable with respect to the business and is independent, giving consideration to the suitability, background and qualification of its members. In addition, the RSAs should evaluate the independence of Shari'ah board members through considering their experience, reporting lines, other duties and remuneration arrangements; examining and analysing the minutes of meetings of the Shari'ah board; and reviewing internal and/or external Shari'ah audit reports.
- (iii) *Takāful* operational framework: ED-20 does not provide detailed guidance to the RSAs on the mechanism for review of *takāful* models operated by TOs/RTOs. It is, however, envisaged that RSAs should, during their review of the TOs/RTOs, ensure the existence of some basic elements required in a *takāful* operational framework. The RSA should ensure that the model has been the subject of proper Shari'ah consideration and approval. It should have a clear understanding of how the model is intended to operate. It should be alert to any divergences between the model as designed or prescribed and actual practice within the TU/RTU. If actual practice is different from that prescribed by regulation, the RSA should take appropriate action. The RSA needs to satisfy itself that its review of a TO/RTU's *takāful* model is backed by a clear understanding of what the model implies, particularly in terms of segregation of funds and assignment of receipts and payments to those funds. The RSA should assess the adequacy of the TO/RTU's compliance in terms of the investment activities of the various funds of the TU/RTU.

ED-20 consists four subsections under capital adequacy:

1. Available capital: A primary concern of the RSA will be the ability of TUs/RTUs to meet regulatory solvency requirements in a manner compliant with Shari'ah rules and principles. In the supervisory review process, the RSA should assess the processes of the TO/RTU for determining appropriate technical provisions separately for each Participant Risk Fund (PRF). TOs/RTOs should maintain a properly documented basis for setting technical provisions

¹²⁵ The process of RSAs reviewing the information provided by the TOs/RTOs.

¹²⁶ Provides further information to supplement the analysis of the data submitted and should be integrated with other activities such as the off-site monitoring process.

¹²⁷ This segregation may not be mandatory in the case of undertakings operating other than on the hybrid model.

for each class or type of business. In addition, the RSA should assess the processes of the TO/RTO for estimating the future claims and expenses attributable to contracts that are in force at valuation date, and for establishing additional technical provisions¹²⁸ or writing off deferred expenses, where necessary. The RSA should consider the assumptions used by the TO/RTO. Furthermore, RSAs will need to ensure that the assets backing the technical provisions or otherwise supporting solvency are correctly valued. RSAs should establish a hierarchy of acceptable methods of valuation and require the use of the most reliable ones where possible.

2. Eligibility of capital: The RSA will need to be conscious of what assets are admissible against the liabilities. In particular, they will need to consider the status of any qard advanced to the PRF, or any assets outside the PRF earmarked for any qard facility. In addition, RSAs need to ascertain that the assessment of the solvency at the PRF level has properly taken into consideration any limitations on the transferability of funds within the undertaking. Furthermore, in assessing the financial strength of the various funds of TUs/RTUs, the RSAs need to verify the existence of any financial assistance mechanism that may be used to assist the PRFs that does not meet the minimum regulatory solvency requirements.
3. Determination of capital requirements: IFSB-11 comprises two specific solvency control levels – namely, a risk-based prescribed capital requirement (PCR) and a minimum capital requirement (MCR). The RSA should monitor the level of the PCR for a TU/RTU and its PRFs, and consider the range of solvency coverage that should be considered normal for the undertaking. The RSA should look at trends in the level of PCR coverage, both over time and relative to peer undertakings. In addition, in determining the level of solvency monitoring to which a TU/RTU is to be subject, an RSA should consider both the likelihood and impact of failure of the TU/RTU, and subject the TUs/RTUs to closer and more frequent monitoring.
4. Own risk and solvency assessment (ORSA): The primary purpose of the ORSA is to assess whether the undertaking's risk management and solvency position is currently adequate, and is likely to remain so in the future. Moreover, the RSA should consider whether the ORSA has been performed with appropriate governance, including validation of data, assumptions and parameters used, and strong critical assessment by members of senior management.

With regard to *retakāful*, the emphasis is on the supervision of outward *retakāful* arrangements. The aim of the SRP is to ensure a clear understanding of the *retakāful* contract and agreement, and to subject the proposed transaction to appropriate Shari'ah scrutiny. It also includes TOs/RTOs' policy regarding the attribution of cash flows under *retakāful*/reinsurance contracts. In this respect, RSAs need to ensure proper attribution of cash flows between funds owned by TOs/RTOs and participant funds under its management. In terms of risk management, TUs carry out some specific risks – that is, Shari'ah non-compliance risks, risks arising from segregation of funds, and risks relating to the use of *retakāful* whereby it requires an effective risk management framework. RSAs should check that the risk management framework reflects clear separation of funds between PRF, Participant Investment Fund (PIF) and Shareholder's Fund (SHF), and that risks in each of these funds are identified, assessed and addressed by management based on each fund's distinct nature, function and attribution. In addition, the RSA should expect a TO/RTO's risk management framework to address the risk of non-compliance, as this matter is critical to the TO/RTO's holding itself out as Shari'ah-compliant. RSAs should therefore review the risk management framework concerning the risk of Shari'ah non-compliance.

In supervising *takāful/retakāful* windows, ED-20 emphasises that attention should be paid to the relationship of the window with the host undertaking. An important consideration for RSAs is to observe whether appropriate Shari'ah governance is in place to secure end-to-end Shari'ah compliance. Another important consideration for RSA is the existence of policies and processes to prevent the commingling of conventional and *takāful/retakāful* funds.

Section D discusses three additional issues for the SRP of TUs/RTUs:

- group supervision;
- conduct of business;
- and run-off.

Under group supervision, an RSA needs to be mindful of risks arising from the group's perspective, which might include: systemic risk; liquidity risks; diversification/concentration risk; and contagion and reputational risk where *takāful*/insurance, market, credit and operational risks seem to have an adverse impact on certain areas. Particular issues of interest to *takāful/retakāful* supervisors will include the Shari'ah governance arrangements in place with other group companies with which their undertaking may have significant intragroup transactions, and the extent to which any group-level assessment of capital resources assumes fungibility of the assets held in PRFs or PIFs.

¹²⁸ Commonly referred to as an unexpired risk provision, though other terminology is also used.

In terms of conduct of business, there are many aspects in common between conventional insurance and *takāful* in this area. Where RSAs do have responsibility for conduct of business, especially in the offering and acceptance process, two broad approaches are followed, one based on disclosure and the other on concepts of suitability. The balance between the two approaches varies between jurisdictions, and indeed between types of *takāful*. More stringent requirements are usually imposed for longer-term and investment-based products than for straightforward general *takāful* products such as motor coverage. However, the avoidance of *gharar* means that the contract between the participant and the TU needs to be clear and understandable, and to disclose key aspects of the *takāful* relationship, including such aspects as relevant fees. Where suitability forms a part of the regime, it must be assumed that a high proportion of *takāful* customers, or potential customers, will be sensitive to Shari'ah compliance. This sensitivity will need to be taken into account in any assessment of the suitability of competing products.

Regarding run-off, the RSA should require a formal run-off plan from the TU/RTU, and ensure that it covers the following issues:

- the current and forecast solvency position of both PRF and SHF, taking into account any recognition of business expenses;
- treatment of *qard* in a run-off, and possible arrangements that may exist to provide additional *qard* should the solvency position of the PRF deteriorate;
- the governance arrangements during the run-off period – in particular, in respect of risk management and claims handling; and
- the possibilities that may exist to transfer some or all of the undertaking's run-off liabilities to a third-party company.

2.2.1.2 ED-21: Core Principles for Islamic Finance Regulation (Islamic Capital Market Segment)

The development of a standard on Core Principles for Islamic Finance Regulation [Islamic Capital Market Segment] (CPICM) in 2016, informed by the IOSCO's Objectives and Principles of Securities Regulation and its Assessment Methodology,¹²⁹ along with a gap analysis of the IOSCO principles to identify where they, or their associated assessment methodologies, do not deal, or deal inadequately, with the specificities of the ICM. The work was further informed by a survey of RSAs that have oversight of Islamic capital markets in their jurisdictions. The main aim of the CPICM is to provide a set of core principles for the regulation and supervision of the ICM, taking into consideration the specificities of Islamic finance, while complementing the existing international

standards, principally the IOSCO document mentioned above. The objectives of the CPICM are to:

- provide a minimum international standard for sound supervisory practices for the regulation and assessment of the ICM;
- protect consumers and other stakeholders by ensuring that the claim to Shari'ah compliance made explicitly or implicitly to any ICM product or service is sound and supported by appropriate disclosures;
- enhance the soundness and stability of the ICM – as an integral part of the IFSI and the global financial system – by helping RSAs to assess the quality of their relevant supervisory systems and identify areas for improvement as an input to their reform agenda.

The starting point for development of the CPICM was the careful analysis of the areas in which the IOSCO principles did not adequately address the specificities of Islamic finance in general, and Islamic capital markets in particular. The analysis and deliberations of the working group led to 38 CPICM, with the development of two new CPICM, while two IOSCO principles have been omitted. The two new CPICM are related to Shari'ah governance in the ICM (CPICM 10) and issuance of *shukūk* (CPICM 20). The two IOSCO principles omitted are: Principle 28 on hedge funds, which reflects the fact that, due to Shari'ah restrictions on, for example, short selling and the use of derivatives, hedge funds make it generally impossible within the ICM to structure a hedge fund as commonly understood; and Principle 38 on clearing and settlement, since it is currently not assessed as part of IOSCO's principles; assessments in this area are done against the Principles for Financial Market Infrastructures (PFMI), to which Principle 38 refers. In addition, there has been insufficient work as yet on clearing and settlement in an ICM context to allow a standard to be drafted covering this area.

In addition to the above additions and deletions to the principles themselves, some IOSCO principles were amended, generally at the level of the supporting text and key questions rather than at the level of the principles. Most of the changes have been minor, but in two areas significant amounts of text have been omitted. Some of this concerns derivatives, which are, for Shari'ah reasons, not a common feature of Islamic markets. In addition, the IOSCO principles deal with stable net asset value (SNAV) money market funds, which – due to strong Shari'ah concerns – are not a feature of the ICM (in contrast to variable net asset value funds (VNAV)).

However, most IOSCO principles have been retained in view of their common applicability to both conventional and Islamic finance, and the text of these is unchanged.

¹²⁹ <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD562.pdf>

In addition, the general approach of the CPICM was to group issues related to Shari'ah governance and *sukūk* in the two new CPICM introduced – that is, CPICM 10 and CPICM 20, respectively; this has reduced the number of changes needing to be made elsewhere.

The main areas where changes have been made to the assessment methodology are as follows:

- Principles relating to the regulator, where additions to key questions were made in CPICM 2 and 3 (IOSCO Principles 2 and 3) to account for regulators' accountability on matters of Shari'ah compliance where the regulator has functional responsibility and power in relation to this, and to factor in sufficiency of the powers, resources and competence of the regulator.
- Principles relating to cooperation, where additions were made to key questions for CPICM 16 (IOSCO Principle 15) to include the ability of the regulator to offer effective and timely assistance to foreign regulators in obtaining reports from a competent Shari'ah authority on Shari'ah compliance of the underlying assets/projects – that is, backing a security sold/listed/issued cross border.
- Principles relating to issuers, where additions were made to key questions in CPICM 17 (IOSCO Principle 15) for *sukūk* listing by foreign issuers to be consistent with IFSB-19's guiding principles on disclosure requirements – specifically guiding principle 2.2 for *sukūk*.
- Principles for auditors, credit ratings agencies, and other information service providers, where additions were made to key questions in CPICM 24 (IOSCO Principle 22) in relation to Credit Rating Agencies (CRAs) that claim to have a specialised approach for ICM assessment, with regard to appropriate recognition criteria for such CRAs and in relation to consistency and comparability of methodologies used.
- Principles relating to Islamic collective investment schemes, where additions were made to key questions for CPICM 26 (IOSCO Principle 24) in relation to eligibility criteria for ICIS operators and Shari'ah-compliance arrangements in line with IFSB-6, as well as new key questions to CPICM 28 (IOSCO Principle 26) related to disclosure requirements for ICIS in line with IFSB-19. In addition, CPICM 29 (IOSCO Principle 27) excludes content related to SNAV money market funds.
- Principles relating to market intermediaries, where an additional key question was included in CPICM 30 (IOSCO Principle 29) in relation to authorisation or licensing requirements for market intermediaries involved in Islamic capital market activity with respect to Islamic finance and Shari'ah principles, as well as an additional key question in CPICM 32 (Principle 31) with respect to ensuring continuing compliance of the market intermediary with the rulings of a Shari'ah board or similar body.
- Principles relating to secondary markets and other markets, where additions were included in CPICM 34 (IOSCO Principle 33) with respect to the operator of an exchange that is responsible for determining Shari'ah compliance of a product in relation to the requirement for necessary resources, competency and knowledge, while in CPICM 37 (IOSCO Principle 36) key questions were excluded that related to commodity derivatives markets. In addition, for CPICM 38 (IOSCO Principle 37), changes were made to key questions with respect to short selling as well as further exclusions, again in this CPICM with respect to those relating to commodity derivatives markets.

Where the IFSB has already published standards in a relevant area, these are reflected at a high level in the CPICM. In some areas, the IFSB has done limited work, in which case the CPICM are its first definitive standards; in such areas, the IFSB may define standards in more detail in the future.

The IFSB envisages that the CPICM will be used by jurisdictions as a benchmark for assessing the quality of their regulatory and supervisory systems, and for identifying future work to achieve a baseline level of sound regulations and practices for ICM products and services. The CPICM will promote further integration of Islamic finance with the international architecture for financial stability, while simultaneously providing incentives for improving the prudential framework across jurisdictions so that it is harmonised and consistently implemented across the globe. Furthermore, the CPICM may also assist IFSB member jurisdictions in (a) the IMF and the World Bank financial sector assessment programme FSAP; (b) self-assessment; (c) reviews conducted by private third parties; and (d) peer reviews conducted, for instance, within regional groupings of capital market RSAs.

An exposure draft of the standard was issued for public consultation in March 2018 following approval by the IFSB Technical Committee.

2.2.1.3 ED-22: Revised Standard on Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services [Banking Segment]

In 2007, the Council of the IFSB approved the adoption of IFSB-4: Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (Excluding Islamic Insurance (*Takāful*) Institutions and Islamic Mutual Funds]. The purpose of IFSB-4 was to specify a set of key principles and practices complementing international standards on disclosure requirements to be followed by IIFS in making disclosures, with a view to achieving transparency and promoting market discipline in regard to these institutions.

Following the issuance of IFSB-4, the financial industry, particularly the banking segment, witnessed several regulatory developments to deal with the prudential concerns resulting from the Global Financial Crisis GFC. In response to the crisis, the BCBS issued Basel 2.5 in 2009 and Basel III in 2010. The BCBS also issued a series of other documents covering disclosure-related amendments, culminating in the issuance of Pillar 3 disclosure requirements – consolidated and enhanced framework in March 2017.

In line with the IFSB's mandate to develop prudential standards and guidelines (SAGs) to promote the soundness and stability of the IFSI, it was resolved by the Council of the IFSB that IFSB-4 would be revised subsequent to the issuance of the IFSB's revised standards for the other two pillars – namely, capital adequacy and supervisory review process.

In addition to aligning the IFSB SAGs with global regulatory standards, the revision to IFSB-4 aims to address areas not previously covered by IFSB SAGs related to disclosure, and to promote consistency and comparability of disclosures among IIFS by introducing harmonised templates for the disclosure of quantitative information relevant to key risk areas relevant to IIFS.

Issues of information asymmetry and consumer protection attracted attention from governments and international standard setters after the GFC, particularly as consumers face more sophisticated and complex financial products and markets. Information disclosure, including standardised and prescribed information, supports the decision-making process of financial consumers and allows them to make informed assessments of the financial products and services on offer. Accordingly, the revised standard considers disclosure aspects relevant to consumer protection and sets key point-of-sale disclosure requirements aimed at supporting the decision-making process of financial consumers.

Overall, the objectives of the draft standard are as follows:

- (a) to facilitate access to relevant, reliable and timely information by market participants generally, and by investment account holders in particular, thereby enhancing their capacity to monitor and assess the performance of IIFS;
- (b) to improve comparability and consistency of all disclosures made by IIFS;
- (c) to support financial consumer protection by helping IIFS offer useful information on Islamic banking products; and
- (d) to enable market participants to complement and support, through their actions in the market, the implementation of the IFSB standards.

The draft standard aims to update IFSB-4 in line with the revised Pillar 3 disclosure requirements as issued by BCBS in January 2015, and the committee's consolidated and enhanced framework for Pillar 3 disclosure requirements issued in March 2017. The draft standard is intended for application by Islamic banks, including Islamic funds managed by IIFS in the form of restricted investment accounts, and Islamic window operations of conventional banks (with both asset and funding facilities).

Disclosure principles and practices required and recommended by the draft standard widen the scope of IFSB-4 and are designed to enable market participants generally, and IAH in particular, to assess key information on IIFS' regulatory risk metrics, capital adequacy, macroprudential measures such as the countercyclical capital buffer and the leverage ratio, linkages between financial statements and regulatory scope of consolidation, as well as remuneration practices.

The draft standard also focuses on disclosures addressing IAH, requiring consumer-friendly disclosures for restricted and unrestricted profit-sharing investment accounts covering IIFS' policies and management of PSIA, and quantitative information on profit-smoothing techniques used (if any), profitability indicators of PSIA funds, and utilisation of PSIA funds on the asset side of IIFS' balance sheets. The draft standard introduces templates for quantitative disclosures made to IAH to ensure consistency and comparability of IIFS disclosures. IIFS' Zakāh policies and distributions, and Shari'ah governance and compliance arrangements, are required for disclosure by the draft standard, which further provides templates for the disclosure of quantitative details on Shari'ah non-compliance events, among others.

One of the key focus areas in the draft standard is consumer protection, where disclosures are required to be made to consumers on product attributes, terms and conditions, mediation and advice bureaus, and usage charges and fees at the point of sale, while changes to terms and conditions should be communicated to affected consumers as soon as practicable. The availability, or lack thereof, of deposit insurance for offered products is an important element of consumer protection that the draft standard requires for disclosure to consumers. The draft standard further requires IIFS to inform consumers on trigger point(s) of available deposit insurance schemes, whether the scheme is Shari'ah-compliant, and amounts covered by the insurance, among others.

Overall, the draft standard includes disclosure requirements on areas shown in Table 2.2.1.3.1.

Table 2.2.1.3.1 Scope of Coverage of Draft Standard on Disclosures to Promote Transparency and Market Discipline for Institutions offering Islamic Financial Services (Banking Segment)

Financial and Risk Disclosure Principles					
Corporate Information	Capital Structure and Overview of Risk Management		Capital Adequacy		Countercyclical Capital Buffer
Disclosures for Investment Account Holders					
Linkages between Financial Statements and Regulatory Risk Exposures					
Risk Management, Risk Exposures and Risk Mitigation					
Credit Risk	Counterparty Credit Risk	Securitisation	Liquidity Risk	Market Risk	Operational Risk
Rate of Return Risk	Leverage Ratio	Remuneration	Contract-Specific Risk	Displaced Commercial Risk	
General Governance and Sharī'ah Governance Disclosures					
Islamic Windows					
Consumer Protection					
Social, Economic and Environmental Impact Disclosures					

These disclosures, when combined with adequate market and legal infrastructures, can improve consumer protection practices among IIFS, enable market forces to enhance the stability and soundness of Islamic finance, and reinforce other IFSB standards.

An exposure draft of the standard will be ready for public consultation following approval by the Technical Committee of the IFSB in March 2018.

2.2.2 IFSB Implementation Survey 2017

IFSB members implement the IFSB's 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.

The IFSB Secretariat conducts an annual survey on the implementation of standards among its member RSAs, with the aims of assessing the progress made in implementing IFSB's published standards, and of understanding the major challenges and constraints faced in this regard. It also helps in identifying strategies that can assist in accelerating and strengthening the process of implementing the IFSB's standards.

Since 2012, the IFSB Secretariat has conducted five surveys on standards implementation. In its sixth such survey, conducted in 2017, a total of 42 RSA members participated, compared to 36 respondents in 2016, some of them covering more than one sector. The Islamic banking sector had 30 responses, while the *takāful* and Islamic capital markets sectors had 26 and 14 responses, respectively.

2.2.2.1 IFSB Standards Covered in the 2017 Survey

Table 2.2.2.1.1 illustrates the complete list of IFSB Standards and Guidelines that were covered in the survey. IFSB-1, 2, 3, 4, 5, 7, 12, 13, 15, 16, 17 and GN-6 are relevant for RSAs that regulate Islamic banking. IFSB-6 is applicable to RSAs governing capital markets. Finally, IFSB-8, 11, 14 and 18 are applicable to RSAs governing the *takāful* sector. IFSB-9 and IFSB-10 are applicable across sectors. IFSB-19, published in April 2017, was considered too recent to be included.

Table 2.2.2.1.1
List of IFSB Standards

BANKING SECTOR
- IFSB-1: Risk Management for IIFS (2005) - IFSB-2: Capital Adequacy Standard for IIFS (2005) - IFSB-3: Corporate Governance for IIFS (2005) - IFSB-4: Disclosures to Promote Transparency and Market Discipline for IIFS (2007) - IFSB-5: Key Elements in the Supervisory Review Process of IIFS (2007) - IFSB-7: Capital Adequacy Requirements for <i>Shukūk</i>, Securitisation and Real Estate Investments (2009) - IFSB-12: Liquidity Risk Management for IIFS (2012) - IFSB-13: Stress Testing for IIFS (2012) - IFSB-15: Revised Capital Adequacy Standard for IIFS (2013) - IFSB-16: Revised Guidance on Key Elements in the Supervisory Review Process for IIFS (2014) - GN-6: Guidance Note on Quantitative Measures for Liquidity Risk Management (2015) - IFSB-17: Core Principles for Islamic Finance Regulation (2015)
ISLAMIC CAPITAL MARKET
IFSB-6: Governance for Islamic Collective Investment Schemes (2008)
TAKĀFUL SECTOR
- IFSB-8: Governance for <i>Takāful</i> Undertakings (2009) - IFSB-11: Solvency Requirements for <i>Takāful</i> Undertakings (2010) - IFSB-14: Risk Management for <i>Takāful</i> Undertakings (2013) - IFSB-18: Guiding Principles for <i>Retakāful</i> (April 2016)
CROSS SECTOR
- IFSB-9: Conduct of Business for IIFS (2009) - IFSB-10: Shari'ah Governance Systems for IIFS (2009)

Source: IFSB Secretariat

(a) IFSB Implementation Status by Different RSAs

Table 2.2.2.1.2 shows the implementation of IFSB standards, among different RSAs, with the size of market share of the respective sector they supervise. For the Islamic banking sector, five RSAs have implemented at least 70% of the standards. For the *takāful* and ICM sectors, seven and four RSAs, respectively, have completed implementation of 100% of the standards.

Table 2.2.2.1.2
Implementation of Standards vs Market Share

ISLAMIC BANKING		
Market Share	Implemented	Clusters
12%	100%	71% - 100%
20%	83%	
16%	75%	
39%	75%	
0%	75%	
5%	67%	21% - 70%
29%	67%	
14%	58%	
14%	42%	
5%	42%	
100%	33%	
12%	25%	
100%	25%	
28%	25%	
25%	17%	
0%	17%	0% - 20%
5%	8%	
2%	8%	
18%	0%	
61%	0%	
4%	0%	
0%	0%	
0%	0%	
0%	0%	
51%	0%	
-%	0%	
6%	0%	
0%	0%	
5%	0%	
0%	0%	

TAKĀFUL		
Market Share	Implemented	Clusters
7%	100%	71%- 100%
5%	100%	
11%	100%	
0%	100%	
51%	100%	
100%	100%	
9%	100%	21% - 70%
32%	25%	
10%	25%	
-%	0%	0% - 20%
100%	0%	
-%	0%	
3%	0%	
0%	0%	
-%	0%	
-%	0%	
2.70%	0%	

ISLAMIC CAPITAL MARKET		
Market Share	Implemented	Clusters
30%	100%	71%- 100%
39%	100%	
59%	100%	
34%	100%	
50%	0%	0% - 20%
100%	0%	
0%	0%	
4%	0%	
-%	0%	
15%	0%	
-%	0%	
0%	0%	
22%	0%	
61%	0%	

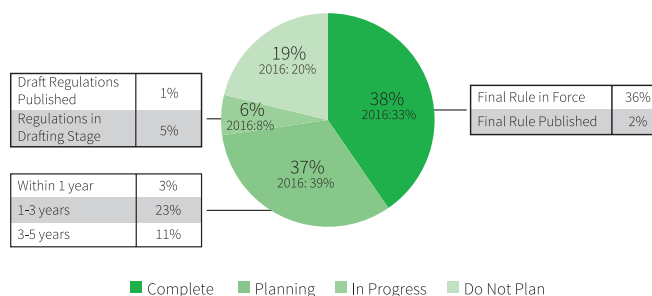
(b) Implementation Status Progress

The number of standards considered in the analysis of the 2017 survey is more than that covered in 2016, with the addition of IFSB-18 in this year's questionnaire. The overall implementation status shows improvement in terms of completion of implementation of various standards by RSAs.

The "Complete" status has increased by 5%, while the "In Progress" and "Planning" statuses have both decreased

by 2% compared to last year. The "Do Not Plan" status has shown an improvement, with a slight decrease of 1%. It is also observable that the "final rule in force" in the "Complete" status has increased by 4%, while the "final rule published" increased by 1% compared to last year.

Chart 2.2.2.1. RSA Overall Implementation Status

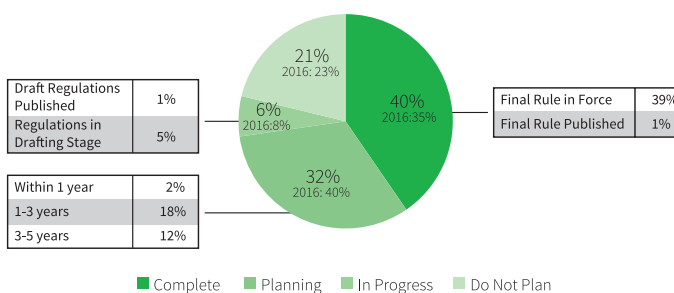


Base: All Respondents, n=42.

Source: IFSB Standards Implementation Survey, 2017. Data are in response to survey Q4: "Please record the most applicable implementation status."

Excluding those members who did not participate last year, the "Completed" status is higher by 5% and the "Planning" status has decreased by 8%. On the other hand, the "Do Not Plan" status and the "In Progress Status" have declined by 2%, as indicated in Chart 2.2.2.1.2.

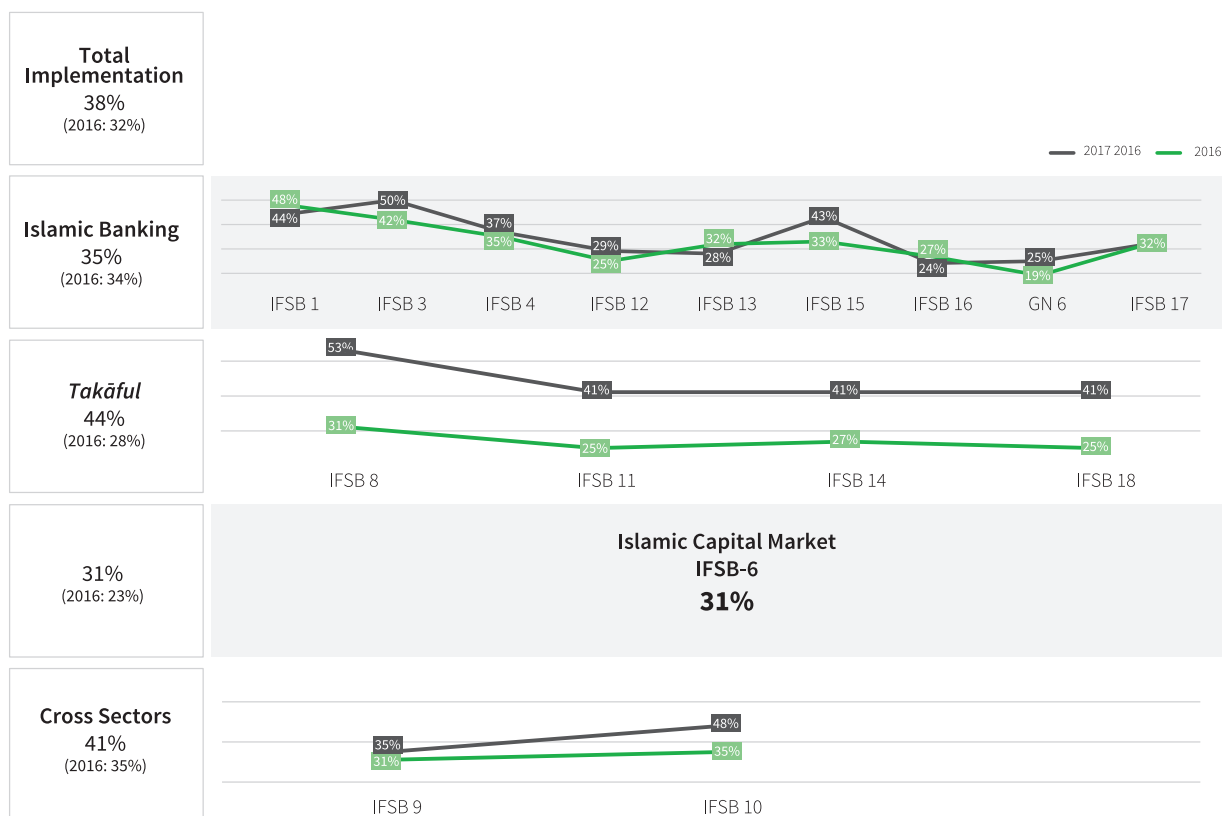
Chart 2.2.2.1.2 Consistent RSA Members – Overall Implementation Status



Base: All Respondents, n=32.

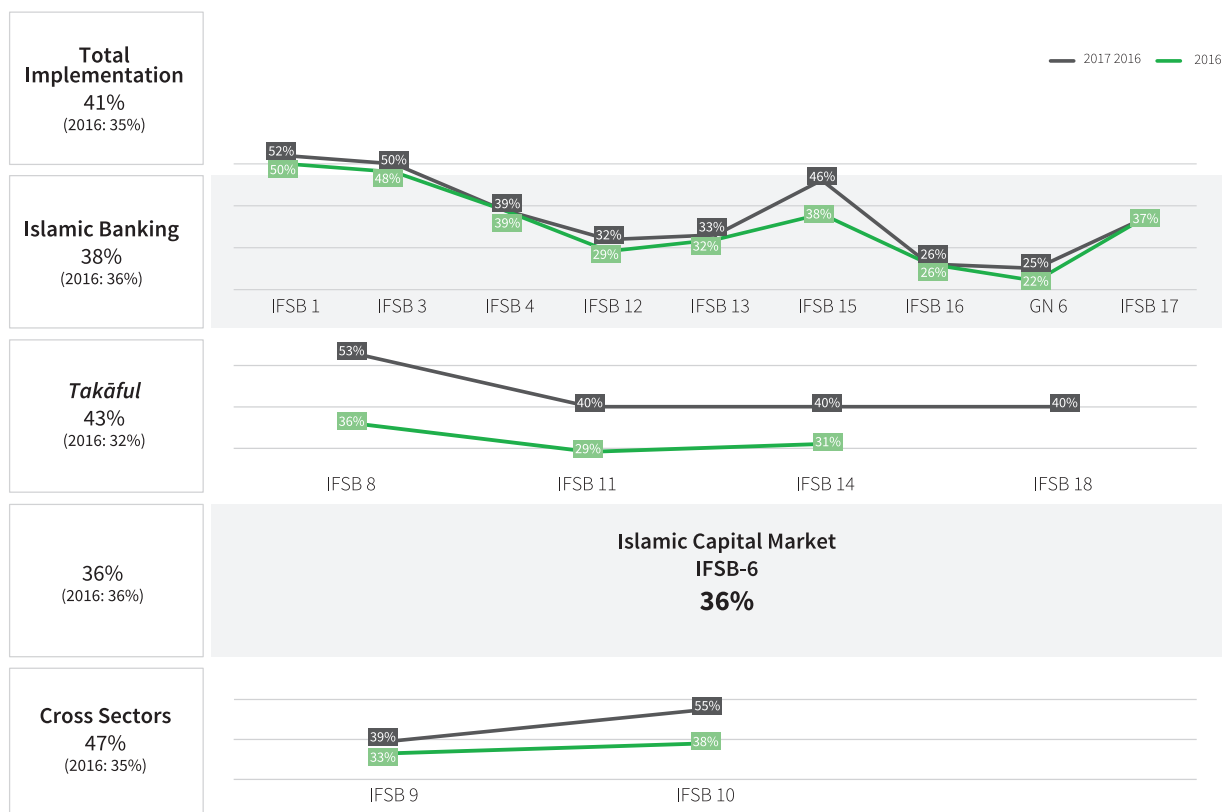
Source: IFSB Standards Implementation Survey, 2017. Data are in response to survey Q4: "Please record the most applicable implementation status."

In terms of Implementation rate of individual standards, the *takāful* standards have experienced a remarkable increase of 16% compared to last year. In addition, both cross sectors and Islamic banking standards have increased by 6% and 1%, respectively.

Chart 2.2.2.1.3 RSA Members and Implementation by “Complete” Status

Base: All Respondents, n=42.

Source: IFSB Standards Implementation Survey, 2017. Data are in response to survey Q4: "Please record the most applicable implementation status."

Chart 2.2.2.1.4 RSA Consistent Members and Implementation by “Complete” Status

Base: All Respondents, n=32 (only RSA Members who also participated in 2016).

Source: IFSB Standards Implementation Survey, 2017. Data are in response to survey Q4: "Please record the most applicable implementation status."

A similar type of analysis is carried out for Chart 2.2.2.1.4; however, the base size is reduced to n=32 RSAs that also responded to the previous year's survey, to ensure a fair and equivalent comparison. The overall implementation rate has increased by 6% compared to last year. The analysis demonstrates that the standard implementation rate has increased for the Islamic banking, *takāful* and cross sectors standards, while the Islamic capital market rate remains the same.

Chart 2.2.2.1.5 shows there has been a higher speed of implementation for recently issued standards compared to those issued prior to 2013 – that is, IFSB-1 to IFSB-13.

All standards published post-2013, with the exception of IFSB-16 (i.e. IFSB-14, IFSB-15, GN-6, IFSB-17 and IFSB-18) have a higher take-up rate, where the take-up rate is defined as the implementation rate of a standard in relation to the number of years since its issuance. It should be noted, however, that some standards in the banking sector have replaced earlier ones. For instance, IFSB-15 replaced IFSB-2 and IFSB-7, and IFSB-16 replaced IFSB-5. It is therefore possible that, in the future, some RSAs will skip over the earlier standards in favour of the later replacements.

Chart 2.2.2.1.5 Standards Completed by Timeline



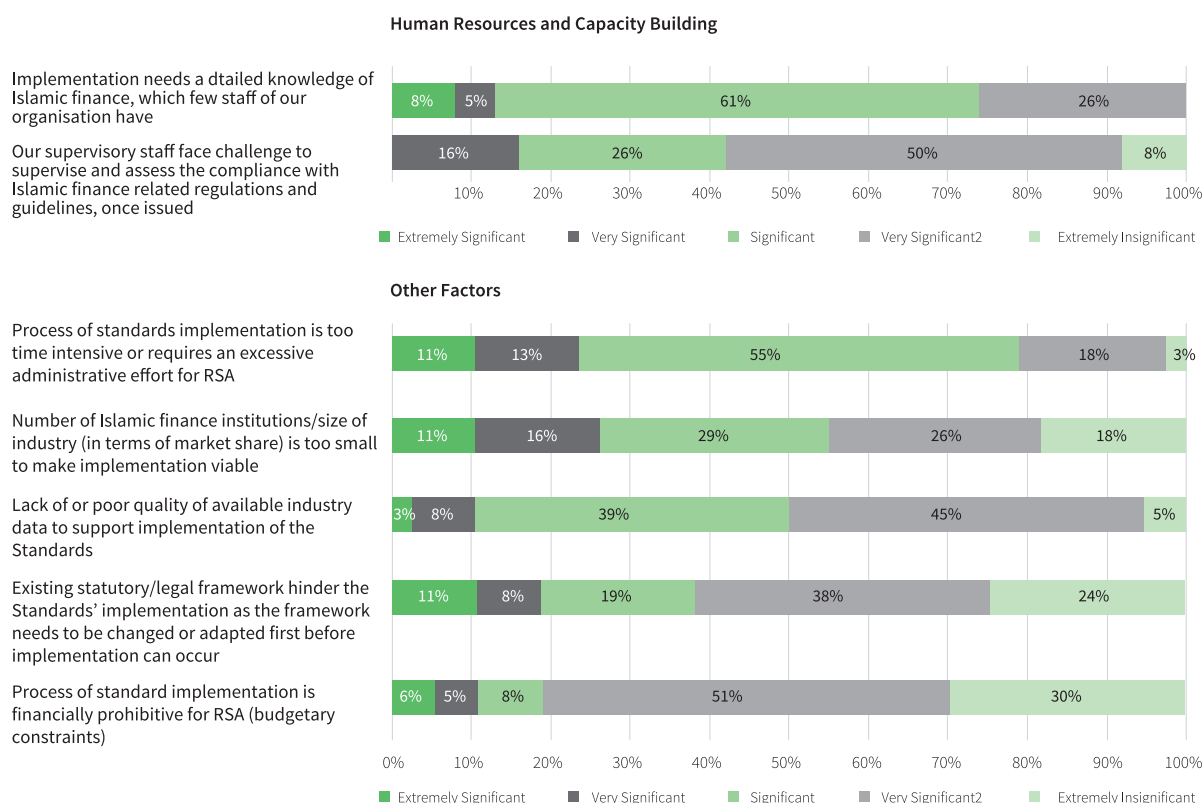
Average Take-up Rate of IFSB Standards¹³⁰

3 3 4 4 3 3 3 6 4 6 5 6 5 8 8 6 8 10 22

Base: All Respondents, n=42.

Source: IFSB Standards Implementation Survey, 2017. Data are in response to survey Q4: "Please record the most applicable implementation status."

Chart 2.2.2.1.6 Challenges in Implementation



Base: All Respondents, n=38. (*Four RSA Members did not respond.)

Source: IFSB Standards Implementation Survey, 2017. Data are in response to survey Q5: "How significant are the following challenges in terms of implementation of the IFSB standards?"

¹³⁰ Take-up rate = $\frac{\text{Implementation rate \%}}{\text{Number of years since issuance}}$

(c) Challenges Faced by RSAs in Implementing IFSB Standards

Challenges in Implementation

The survey asked respondents to indicate the various challenges they faced in implementing IFSB standards. Chart 2.2.2.1.6 illustrates respondents' ratings of the significance of the various challenges faced by RSAs. The two major challenges noted were the lack of "detailed knowledge of Islamic finance" and the length of time taken for the "process of standards implementation".

On the other hand, "budget constraints" was indicated as the least important challenge faced by the respondents,

followed by absence or limitations in the "legal framework which hinders standards implementation".

Looking at Chart 2.2.2.1.7, in general, "size of industry (interms of market share) is too small to make implementation viable" seems to be a significant challenge among a majority of respondents, with European and African RSAs finding it the most significant challenge. However, this could be a result of the small number of European and African RSAs that participated in the survey. Middle Eastern RSAs nominated "process of standards implementation is too time intensive" as their most significant challenge.

Chart 2.2.2.1.7 Challenges in Implementation
(Breakdown by Region, Considering Extremely Significant and Very Significant Responses)

Challenge	Total n=38	Africa ¹³¹ n=7	Asia ¹³² n=11	Europe ¹³³ n=3	Middle East ¹³⁴ n=17
Human Resources and Capacity Building					
Implementation needs a detailed knowledge of Islamic finance, which few staff of our organisation have	13%	14%	18%	33%	6%
Our supervisory staff face challenge to supervise and assess the compliance with Islamic finance related regulations and guidelines, once issued	16%	14%	18%	33%	12%
Other Factors					
Lack of, or poor quality of, available industry data to support implementation of the standards	11%	14%	9%	0%	12%
Process of standards implementation is too time intensive or requires an excessive administrative effort by the RSA	24%	29%	18%	33%	24%
Process of standards implementation is financially prohibitive for the RSA (budgetary constraints)	11%	29%	9%	0%	6%
Number of Islamic finance institutions/size of industry (in terms of market share) is too small to make implementation viable	26%	43%	36%	67%	6%
Existing statutory/legal framework hinders implementation of standards implementation and needs to be changed or adapted before implementation can occur.	19%	33%	27%	33%	6%

Base: All Respondents, n=38. (*Four RSA Members did not respond.)

Source: IFSB Standards Implementation Survey, 2017. Data are in response to survey Q5: "How significant are the following challenges in terms of implementation of the IFSB standards?"

Type of Support Desired by RSAs

Survey participants were asked to rate the form of support they require from the Secretariat to implement the standards. Chart 2.2.2.1.8 illustrates that the most desired form of support by RSAs is organising more "Facilitating the Implementation of IFSB Standards (FIS)" Workshops, with 21% of the respondents finding it extremely significant and 41% very significant. Preparing more technical notes and providing direct technical assistance (TA) to RSAs were rated the second and third most significant types of support.

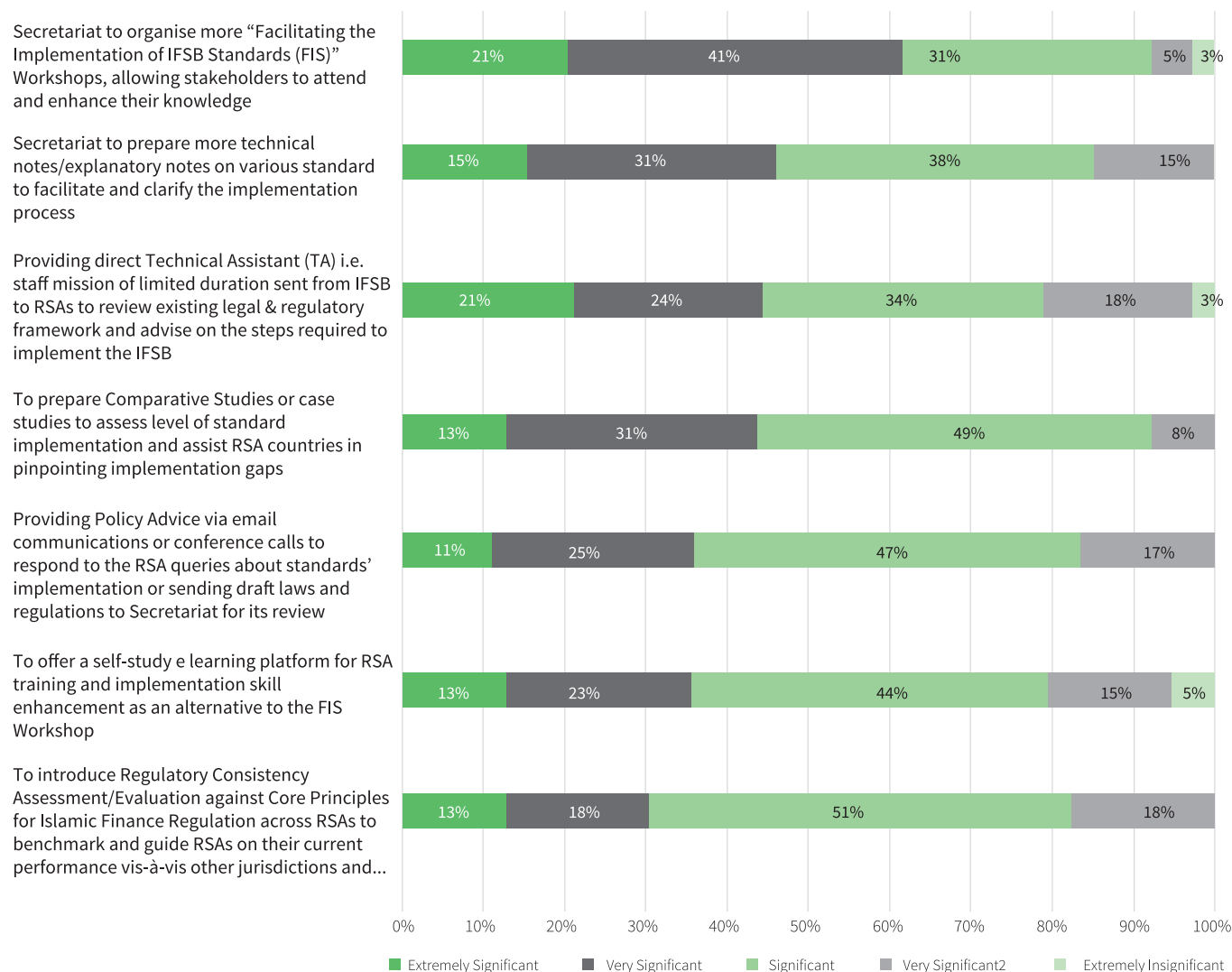
¹³¹ African countries include: Egypt, Sudan, Nigeria, Mauritius, Tunisia and Ivory Coast.

¹³² Asian countries include: Malaysia, Singapore, Brunei, Indonesia, Pakistan, Bangladesh, Afghanistan, Philippines and Kyrgyzstan.

¹³³ European countries include: Turkey and United Kingdom.

¹³⁴ Middle Eastern countries include: Bahrain, Iran, Kuwait, Iraq, Saudi Arabia, Oman, Qatar, United Arab Emirates, Jordan, Lebanon and Palestine.

Chart 2.2.2.1.8 Support in Implementing Standards



Base: All IFSB Respondents, n=39. (Three RSA Members did not respond.)

Source: IFSB Standards Implementation Survey, 2017. Data are in response to survey Q7: “How significant are the following activities to support implementation of the IFSB standards?”

Looking at Chart 2.2.2.1.9, the majority of the respondents (62%) believe that organising more (FIS) Workshops is very significant in assisting RSAs to implement the standards. This was also identified by all regional clusters to be the most significant mode of support. In addition, African RSAs find providing direct technical assistance as significant as conducting more FIS Workshops. European RSAs consider providing policy advice and preparing more technical notes also to be significant.

**Chart 2.2.2.1.9 Support in Implementing Standards – Regional Cluster
(Considering Extremely Significant and Very Significant Responses)**

Strategies	Total (n=39)	Middle East (n=18)	Asia (n=11)	Africa (n=8)	Europe (n=2)
Secretariat to organise more “Facilitating the Implementation of IFSB Standards (FIS)” Workshops, allowing stakeholders to attend and enhance their knowledge	62%	50%	73%	75%	50%
Providing direct technical assistance (TA) – i.e. staff missions of limited duration sent from IFSB to RSAs to review existing legal and regulatory framework and advise on the steps required to implement IFSB standards.	45%	35%	45%	75%	0%
Providing policy advice via email communications or conference calls to respond to RSA queries about standard implementation or sending draft laws and regulations to Secretariat for its review	36%	35%	30%	43%	50%
Secretariat to prepare more technical notes/explanatory notes on various standards to facilitate and clarify the implementation process	46%	50%	55%	25%	50%
To prepare comparative studies or case studies to assess level of standard implementation and assist RSA countries in pinpointing implementation gaps	44%	39%	55%	50%	0%
To introduce regulatory consistency assessment/evaluation against core principles for Islamic finance regulation across RSAs to benchmark and guide RSAs on their current performance vis-à-vis other jurisdictions and to highlight gaps in their supervisory framework	31%	33%	27%	38%	0%
To offer a self-study e-learning platform for RSA training and implementation skill enhancement as an alternative to the FIS Workshops	36%	28%	36%	63%	0%

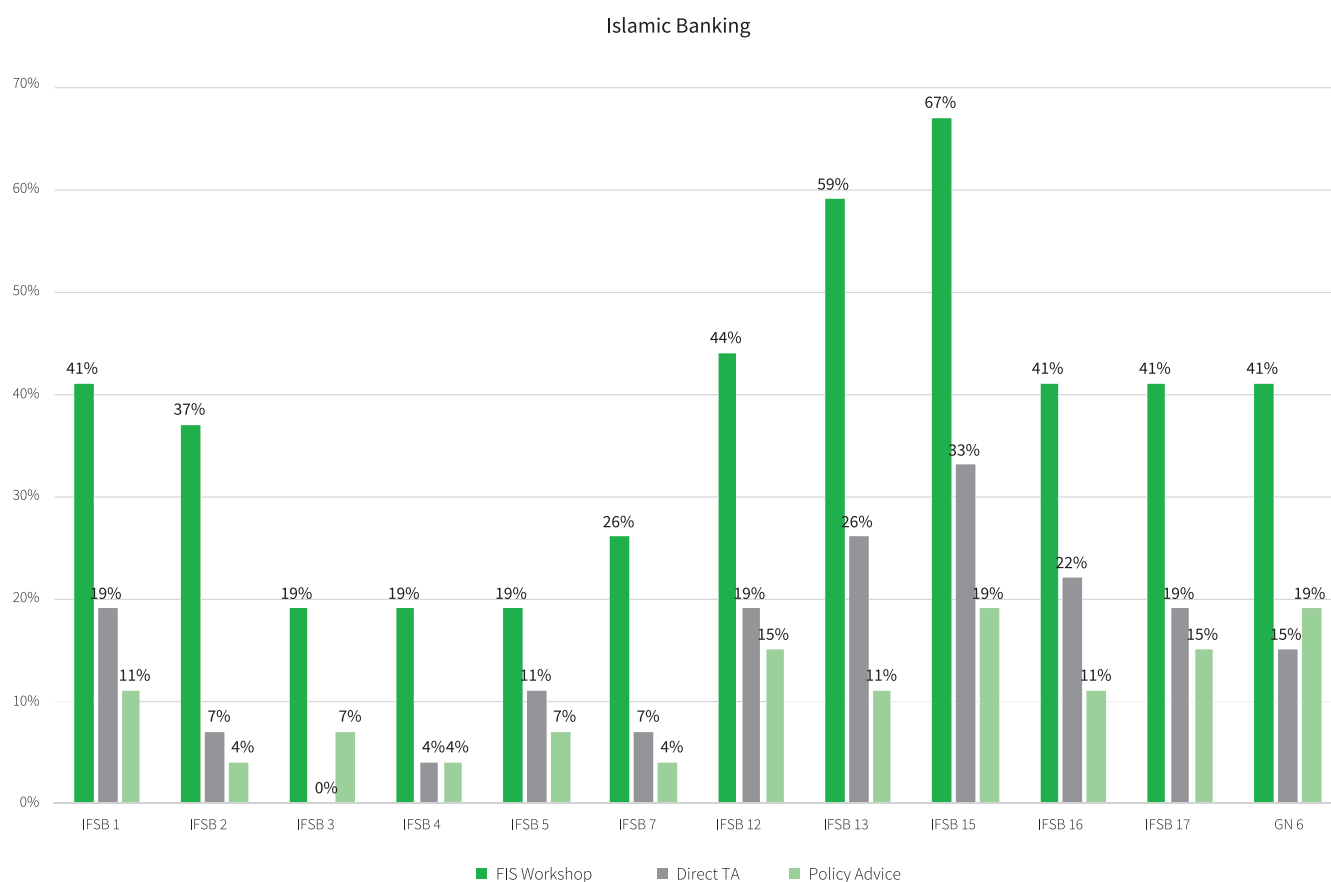
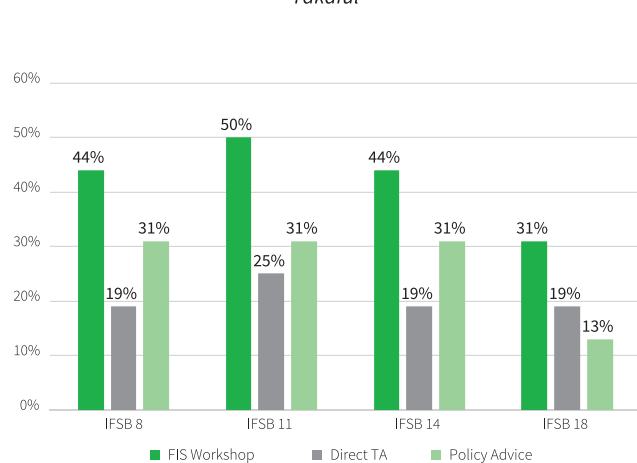
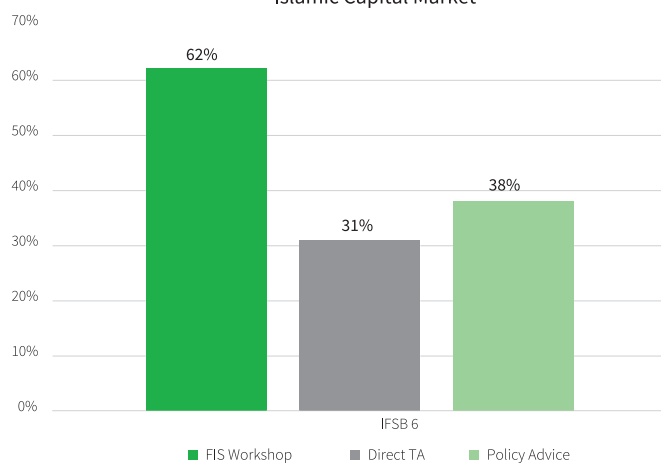
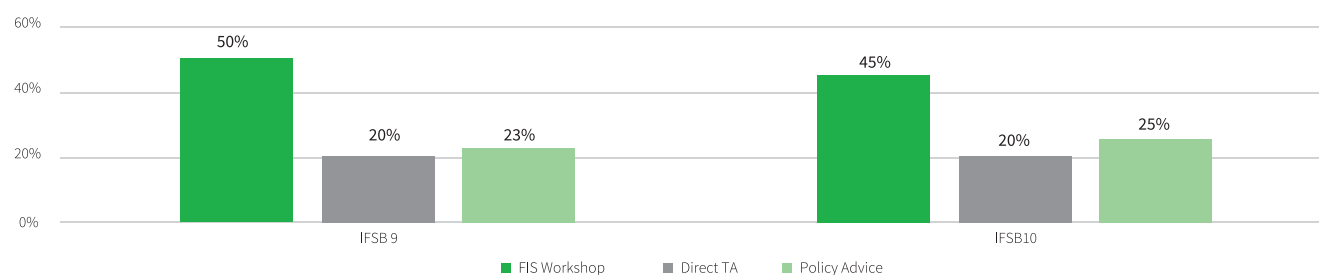
Base: All IFSB Respondents, n=39. (Three RSA Members did not respond.)

Source: IFSB Standards Implementation Survey, 2017. Data are in response to survey Q8: “How significant are the following activities to support implementation of the IFSB standards?”

It is observable that, primarily, the more complex standards require more support (Chart 2.2.2.1.10), with capital adequacy and liquidity-related standards requiring the most support. In the Islamic banking sector, IFSB-15 has the highest rate, followed by IFSB-13, IFSB-12 and GN-6. Among the *takāful* sector standards, IFSB-11 requires more support than other standards. For cross-sector standards, IFSB-9 has a higher rate than IFSB-10.

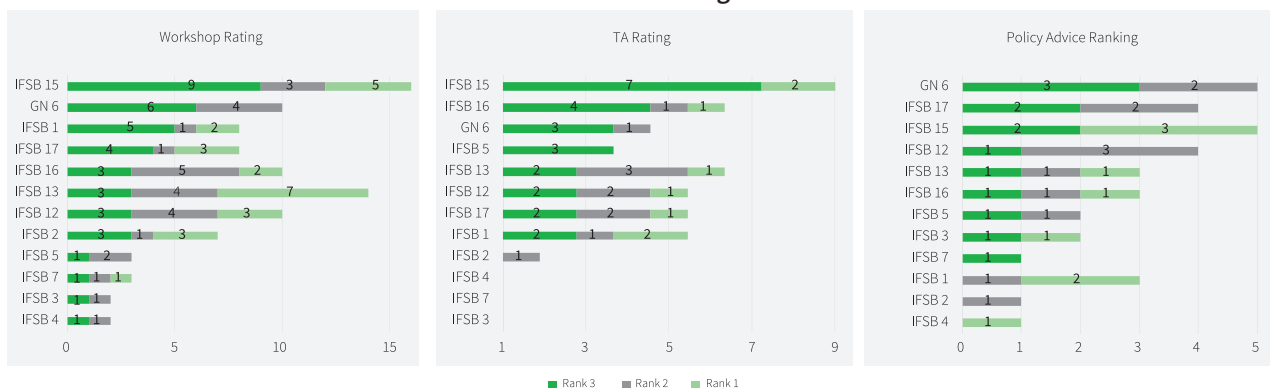
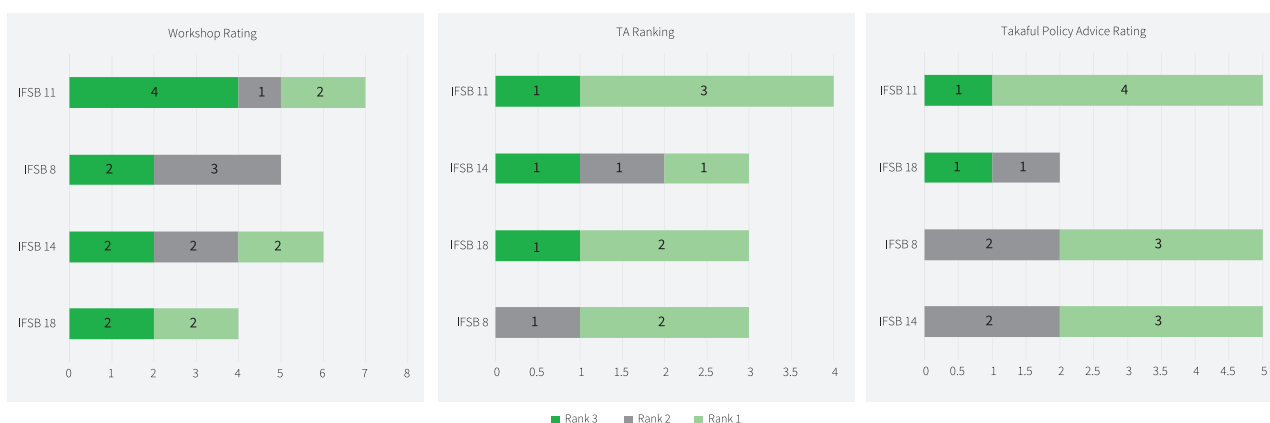
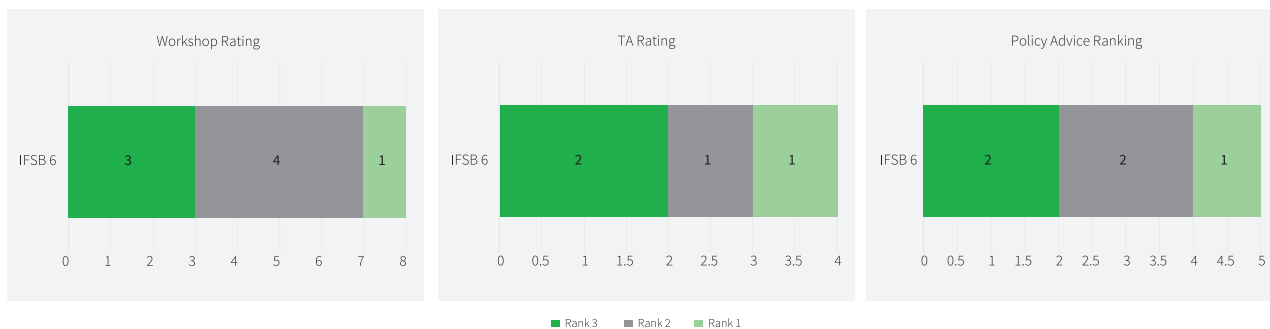
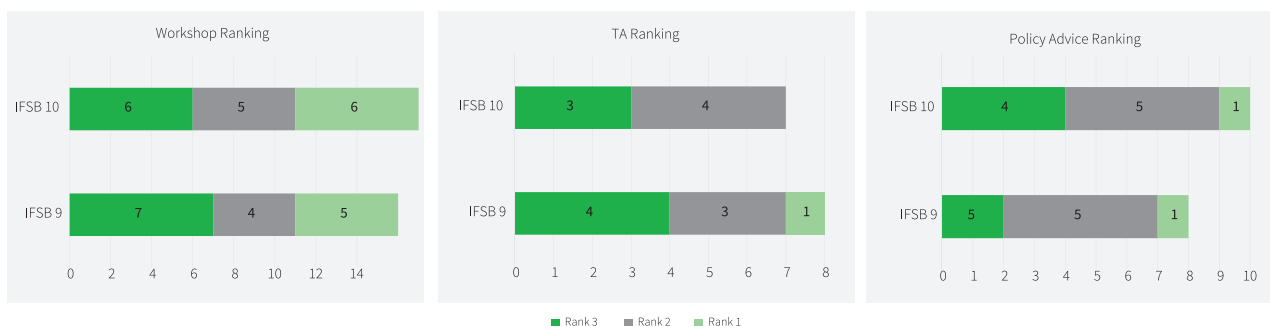
Across all sectors, FIS Workshops are the most required form of support. In the Islamic banking sector, providing technical assistance is considered to be more important than providing policy advice. However in the *takāful*, Islamic capital market and cross-sector standards, policy advice seems to be more required than technical assistance as a mode of support by the Secretariat.

Chart 2.2.2.1.10 FIS Workshop, Direct TA and Policy Advice

**Takāful****Islamic Capital Market****Cross Sectors**

Base: All IFSB Respondents, n=38. (Four RSAs did not respond to the questions.)

Source: IFSB Standards Implementation Survey, 2016. Data are in response to survey Q8: "Please select five standards which require the support, and provide the ranking of their importance from 1 to 5 (1 being the least important and 5 being the most important)."

Chart 2.2.2.1.11 Standards' Priority for Workshop, Direct TA and Policy Advice**Islamic Banking :****Takaful :****Islamic Capital Market :****Cross Sector :**

Base: All IFSB Respondents, n=38. (*Four RSA Members did not rank their priorities.)

Source: IFSB Standards Implementation Survey, 2017. Data are in response to survey Q8: "Please select five standards which require the support, and provide the ranking of their importance from 1 to 5 (1 being the least important and 5 being the most important)."

Chart 2.2.2.1.11 shows the ranking of standards' priority for support, with Rank 3 considered the highest priority and Rank 1 the lowest. The ranking was considered for three modes of support provided by the Secretariat, being Workshop, TA and Policy Advice. For the Islamic banking sector, IFSB-15 had the highest ranking for Workshop and TA, while GN-6 had the highest ranking for Policy Advice. In the *takāful* sector, IFSB-11 was ranked the most important for all modes of support. For the cross-sector standards, IFSB-10 appears to be relatively more important than IFSB-9 in terms of the three modes of support.

KEY CONCLUSIONS

1. The overall implementation status has been consistent with last year's survey, with an increase of 5% in the "Complete" status and a decrease of 1% in the "Do Not Plan" status.
2. The "Complete" status among members who participated in the last survey also increased by 5% compared to the previous year. The increase can be witnessed in every Islamic financial sector except for the Islamic capital market, which didn't experience any change.
3. In terms of implementing Islamic banking standards, one jurisdiction has implemented 100% of the standards, while another four jurisdictions have implemented more than 75% of the standards.
4. In terms of other sectors in the Islamic financial services industry, seven jurisdictions have implemented all IFSB standards on *takāful*, while four jurisdictions have implemented the Islamic capital market standards.
5. The average rate of adopting standards is also consistent with last year. The results show more complex standards requiring more support, with capital adequacy and liquidity-related standards requiring the most support.
6. The most significant challenges faced by RSAs are "Detailed knowledge in Islamic Finance", which is required to transform standards into regulations and rulebooks. Another major challenge is the length of time required to implement the standards.
7. African and European RSAs see the small size of the industry as a challenge in making the implementation viable.
8. RSAs identified IFSB-15, GN-6, IFSB-12, IFSB-13 and IFSB-16 as presenting significant challenges in terms of implementation. Consequently, all of these standards were also selected as standards most needing support from the Secretariat.
9. Among all the sectors, "Facilitating the Implementation of Standards (FIS)" Workshops were the most required form of support, followed by "Preparing more Technical Notes" and "Providing Technical Assistance".

2.2.3 Other IFSB Initiatives

Other initiatives of the IFSB include three research/working papers: Recovery, Resolution and Insolvency Issues for IIFS (WP-07); Issues Arising from Changes in *Takāful* Capital Requirements; and Consumer Protection in *Takāful*. The latter involved a survey, the findings of which are summarised in this report. Surveys were also conducted on the compilation and dissemination of data for the Islamic capital markets and *takāful* sectors, in addition to a survey on IFRS-9 and its implications for Islamic finance.

2.2.3.1 Resolution, Recovery and Insolvency of IIFS

In its December 2015 meeting, the IFSB Council approved the preparation of a research paper on recovery, resolution and insolvency Issues for IIFS. In line with the work plan, the IFSB published a working paper in December 2017 on recovery and resolution issues, aimed at highlighting the existing regulations and practices across selected jurisdictions. The key objectives of the working paper are as follows:

- (a) to review the requirements of a robust recovery and resolution framework through literature review and jurisdictional analysis;
- (b) to consider and analyse key recovery, resolution and bankruptcy principles in the context of Islamic finance industry practices and Shari'ah requirements; and
- (c) to indicate specific issues that require further consideration by regulatory authorities/policymakers and IIFS regarding recovery, resolution and bankruptcy.

The paper examines what an effective recovery and resolution framework looks like for IIFS from the perspectives of regulatory and Shari'ah principles. The starting point is the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions ("Key Attributes"). This 2014 publication emphasises the importance of an appointed resolution authority, consolidating within it specific regulatory powers and tools. Examining the European and US regulatory landscape further, the paper finds that a wider framework of recovery and resolution planning is a key requirement before processing any actual recovery and resolution event.

The overarching issue for the IFSI, from a structural, procedural and juridical perspective, is the requirements of Shari'ah. The FSB's Key Attributes framework has been written for the conventional financial services industry and takes no cognisance of Shari'ah considerations. The recovery of capital and liquidity positions, the resolution framework and tools that a recovery and resolution authority should consider with respect to IIFS, and other complexities, such as recognising the Shari'ah principles of an IIFS operating in a secular system, are also not considered by the FSB and other conventional organisations and authorities. Similarly, no national

legal system exists that incorporates Shari'ah principles pertaining to *iflās*¹³⁵ (even in Muslim-majority countries that may derive some of their national law from Shari'ah as a primary source). In this respect, the paper considers specific recovery options, resolution tools, and bankruptcy/insolvency issues in the context of Islamic finance structures and Shari'ah principles, taking into account the global requirements (namely, the FSB's Key Attributes) and current supervisory practices.

The scope of the paper is cross-sectoral and considers Islamic banking, capital markets and *takāful*. With regards to capital markets, the paper remains focused on recovery, resolution and bankruptcy/insolvency issues as they pertain to *shukūk* and relates them back to the banking sector in the context of capital-qualifying components.

The IFSB Secretariat conducted a survey in December 2016 with the objective of collecting background information on the current state of recovery and resolution frameworks, the legal powers of recovery and resolution authorities in jurisdictions where Islamic finance is present, and the landscape of the Islamic finance industry with regards to issues specific to recovery and resolution and insolvency and bankruptcy. With regards to discontinuance of some critical economic functions, if any, which may lead to disruption of financial stability in the jurisdiction, the survey responses indicate that payment, settlement and clearing (indicated by eight RSAs), and intra-financial system borrowing and lending (indicated by six RSAs), are the two most important critical economic functions, as shown in Chart 2.2.3.1.1.

If a financial institution encounters stress and the resolution authority is required or authorised to step in, a total of 18 jurisdictions mentioned in their survey responses that they can remove or replace senior management and appoint an administrator, receiver or other authority to take control of the firm (Table 2.2.3.1.1).

Chart 2.2.3.1.1
Critical Economic Functions in Jurisdictions

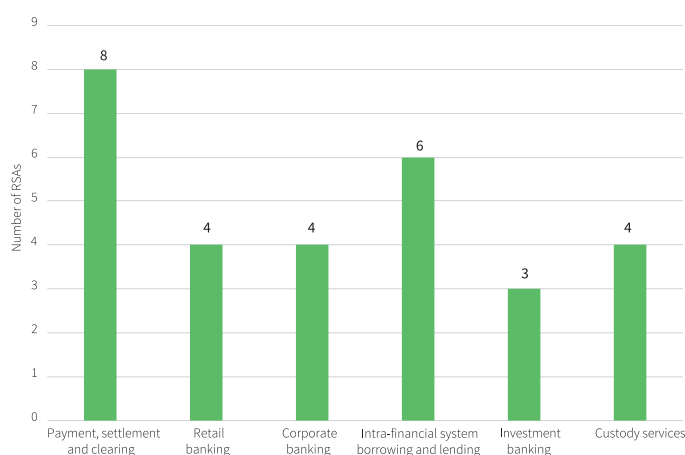


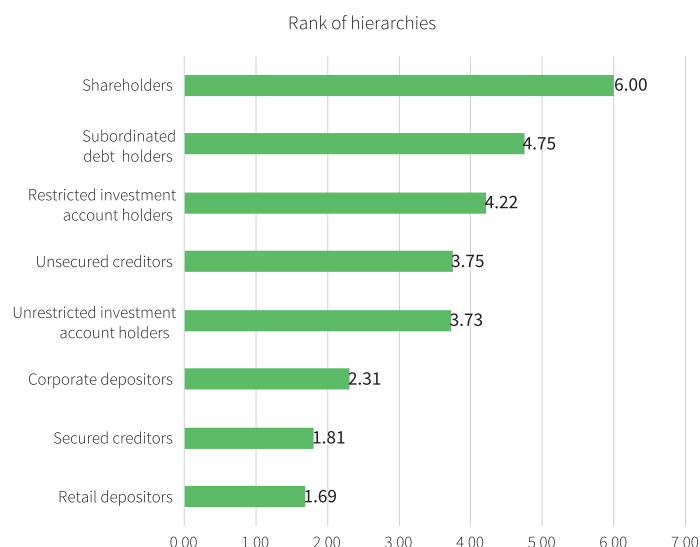
Table 2.2.3.1.1 Powers of Resolution Authority if a Financial Institution Encounters Stress

	Power	Mentioned by Number of RSAs
1	To remove/replace senior management	18
2	To appoint an administrator, receiver or other authority to take control of the firm	18
3	To transfer/sell assets and/or liabilities, legal rights and obligations to a solvent third party	15
4	To effect the closure and orderly wind-down of the whole or part of a failing firm	14
5	To override the rights of shareholders of the firm	13
6	To operate and resolve a firm (including terminating/assigning contracts and writing down debt)	12
7	To temporarily stay the exercise of early termination rights that may be otherwise triggered	11
8	To impose a moratorium with a suspension of payments to unsecured creditors and customers	11
9	To establish a temporary bridge institution to undertake sale/transfer of assets to another institution	10
10	To carry out mandatory bail-ins within resolution (on bondholders and/or <i>shukūk</i> holders)	9
11	To require other companies in the group to continue to provide essential services to the entity being resolved	7

The survey attempts to determine how different jurisdictions rank the claims of different types of creditors, depositors and investors relative to one another. Based on the responses of RSAs, Chart 2.2.3.1.2 indicates the ranking of hierarchies on the claims of creditors/depositors from 1 to 8, with 1 being the most protected. The paper also discusses issues around regulatory capital *shukūk* in terms of recovery and resolution of the issuer and finds that there may be conflicts around what Shari'ah law allows and dictates on conversions, write-downs, haircuts and subordination, and what the generally accepted and currently used recovery and resolution powers are with respect to different components of the entity capital stack.

¹³⁵ *Iflās* is when a person's debt exceeds his or her assets (insolvency).

**Chart 2.2.3.1.2 Rank of Hierarchies of the Creditors
(Ranked from 1 to 8, with 1 Being the Most Protected)**



The key issues being addressed by the working paper are as follows:

- There is a need to harmonise Shari'ah principles of RRP with bankruptcy and insolvency frameworks that are currently embodied in secular legal systems, and to offer guidance and solutions on this area to relevant authorities.
- Insolvency may be either of two things: (i) a debtor's inability to pay his or her creditors as their claims fall due; or (ii) an excess of liabilities over assets. The key issue with regards to Islamic finance insolvency and Shari'ah compliance is the possible failure to consider the underlying Shari'ah principles and the contractual intent of parties, as embodied in the contract. Bankruptcy is a legal declaration of one's inability to pay off debts owed. The legal proceeding that follows may be intended either to reorganise/restructure the failed entity, or to liquidate the assets for the benefit of the creditors. The paper looks at Shari'ah compliance during the bankruptcy or insolvency proceeding, which becomes critical in upholding overall Shari'ah principles and differentiating Islamic finance transactions from other forms of finance while adopting conventional regulatory and supervisory frameworks.
- The paper highlights the following issues with regards to asset sales that may arise in the Islamic model: (i) the Shari'ah acceptability of sales at less than face value; and (ii) determination of who may purchase such assets.
- The paper also focuses on recovery and resolutions aspects for debt-based contracts in Islamic finance, since a majority (66.1%) of global Islamic banking assets are made up of the following contracts: *murabahah*, commodity *murabahah*, and *al-bay' bi al-thaman al-ajil*.¹³⁶

- The paper examines the possibilities of adopting self-insured structures and mechanisms to help safeguard the IFSI. It discusses bail-in features of shareholder equity (Common Equity Tier 1, or CET1) and AT1 *musharakah shukuk* from regulatory and Shari'ah perspectives and finds that there are unlikely to be any conflicts with Shari'ah for the resolution authority to enforce a bail-in. The paper also attempts to investigate whether the bail-in concept of a mandatory debt write-down by a resolution authority is compatible with Shari'ah.
- PSIAs represent a unique Islamic banking product with a number of balance sheet and legal complexities. It can be argued that IAH have contracted into an investment product and so should bear the full risk of that decision – that is, the risks from the investment of their funds, but not of other bank risks. This paper focuses on the treatment of IAH in an insolvency and the treatment of the PER and IRR funds in an insolvency scenario.
- Another issue that is considered in this paper is that of deposit insurance. Some jurisdictions may have a Shari'ah-compliant deposit insurance scheme (SCDIS), and some may not.¹³⁷ The discussions highlight Shari'ah debates as to whether any PSIAs should be afforded SCDIS, given their risk-sharing nature.

Ultimately, this paper has been written with the aim of shedding light on a number of legal, structural and operational issues in the context of recovery, resolution and insolvency for IIFS, and of making policymakers aware of these challenges. It represents the final paper in the IFSB's working paper series on financial safety nets. The IFSB may, moving forward, look to issue a guidance note on this subject, offering more specific advice in this area.

2.2.3.2 Survey on IFRS-9 and its Implications for Islamic Finance

Following developments in the banking regulatory landscape regarding the treatment of accounting provisions, and the issuance of a standard on the subject by the BCBS (see section 2.1.1 of this report), the IFSB Secretariat conducted a survey in IFSB member jurisdictions regarding the implementation of IFRS Standard 9: Financial Instruments issued by the International Accounting Standards Board (IASB). The survey was conducted between 11 July and 18 August 2017, and was sent to banking regulators and supervisors who are members of the IFSB. Twenty members responded to the survey questionnaire.

The primary objectives of the survey were to (a) understand current practices of impairment provisions among Islamic banks in different jurisdictions; (b) obtain feedback from RSAs on the additional disclosures arising from the expected credit loss approach; (c) assess the

¹³⁶ www.ifsfb.org/psifi_02.php

¹³⁷ S. F. Najeeb and M. M. Mustafa (2016). Strengthening the Financial Safety Net: The Role and Mechanisms of Shari'ah-Compliant Deposit Insurance Schemes (SCDIS), WP-06/03/2016, Islamic Financial Services Board.

possible impact of new impairment rules on provisions, capital adequacy and profitability of Islamic banks vis-à-vis conventional banks; (d) evaluate whether transitional arrangements for capital calculation, and any associated disclosures, are needed for Islamic banks; and (e) gauge RSA views on the need for further direction by the IFSB on the implementation of the ECL approach to asset impairment.

The survey showed that nearly 90% of respondent jurisdictions implement the International Financial Reporting Standards, while all jurisdictions that plan to implement IFRS-9 indicated that Islamic banks would be expected to begin implementation of IFRS-9 alongside their conventional counterparts from the year 2018.

More than half the jurisdictions responding have conducted studies relevant to the assessment of IFRS-9's implications for their domestic banking sectors, out

of which three countries provided the IFSB with data assessing the possible impact of the ECL approach to asset impairment on capital ratios of banks, and two supplied data specifically on its impact on their Islamic banking sector. At least one jurisdiction concluded that, based on its preliminary assessment, the ECL approach would not have a significant impact on its overall banking sector's capital ratios. It must be highlighted, therefore, that quantitative data collected by this study on the impact on provisions and capital were limited and, with only two jurisdictions providing this data for Islamic banks, it is not feasible to determine the possible quantitative implications of IFRS-9 on the global Islamic banking industry.

A summary of the potential impact of the ECL approach on a few quantitative banking measures is provided in Table 2.2.3.2.1.

Table 2.2.3.2.1 Impact Data of IFRS 9¹³⁸

Impact item and jurisdiction		Islamic banks	Conventional banks	Overall banking industry
Change in specific provisions	Jurisdiction 1	-23.70%	-55.69%	-40.44%
	Jurisdiction 2	+6%	+5%	+5%
	Average ¹³⁹	-8.85%	-25.35%	-17.72%
Change in general provisions	Jurisdiction 1	+75.49%	+429.05%	+158.03%
	Jurisdiction 2	+9%	+5%	+2%
	Average	+42.25%	+217.03%	+80.02%
Change in CET1 ratio	Jurisdiction 1	N/A	N/A	N/A
	Jurisdiction 2	-0.45%	-0.35%	-0.40%
	Jurisdiction 3	N/A	N/A	-0.64%
	Average	-0.45%	-0.35%	-0.52%
Change in total capital ratio	Jurisdiction 1	-1.70%	+3.44%	+0.36%
	Jurisdiction 2	-0.40%	-0.25%	-0.30%
	Jurisdiction 3	N/A	N/A	-0.56%
	Average	-1.05%	+1.60%	-0.17%

Both jurisdictions reporting on profitability implications indicated a possible average decline in profitability of their Islamic banks resulting from increased levels of provision. Profitability indicators used to assess the impact differed between the two jurisdictions: one jurisdiction used profit before tax (-43%; +17% for conventional banks), while the other used profit after tax (-11%; -9% for conventional banks).

Supervisors identified several areas of high concern to them, and to Islamic and conventional banks in their jurisdictions, particularly the availability of data and

resources to compute ECL provisions, highlighting the development of an ECL model as a complex process, with smaller banks set to face a bigger challenge in comparison to bigger banks.

Under the regulatory standardised approach prescribed by the BCBS, accounting provisions must be classified as either general or specific provisions. IFRS-9 does not make a distinction between general provisions (GP) and specific provisions (SP), which may lead to inconsistency as jurisdictions apply different methods in making these distinctions.

¹³⁸ As highlighted earlier, the sample size in this study does not allow for an industry-wide conclusion. Nevertheless, the Islamic banking industry is generally well-capitalised, with an average CAR of 17.3% as at 30 June 2016. The effect of IFRS-9 on capital ratios of Islamic banks would be limited if capital levels are still similar to their mid-2016 levels, and if the levels of decline in capital ratios reported by the two participating jurisdictions prevail in the majority of jurisdictions in which Islamic banking assets are concentrated. The calculation of Islamic banking's CAR as at 30 June 2016 is based on data from 17 jurisdictions contributing to the IFSB's PSIFs database (excluding Afghanistan, Egypt, Iran, Kuwait and Pakistan) and was published in section 3.2 of IFSB Stability Report 2017, available at <http://ifsb.org/docs/IFSB%20IFSI%20Stability%20Report%202017.pdf>

¹³⁹ Simple average used. Due to the small sample size, data do not reflect industry averages.

The majority of respondents (>89%) indicated that banks in their jurisdictions distinguished between GP and SP. However, about 36% of jurisdictions requiring GP/SP classification are uncertain that this distinction would continue after the implementation of IFRS-9. Similarly, half the respondents were unsure whether the GP definitions they used would remain unchanged after the implementation of IFRS-9, while 22% of them prepared for changes in how GPs are defined in line with the new rules of IFRS-9.¹⁴⁰

Survey participants were asked whether they planned to implement transitional arrangements to avoid a “capital shock” on day 1 of implementation of IFRS-9 by giving banks time to rebuild their capital resources.¹⁴¹ More than 80% of respondents to this question, including both regulators who submitted data regarding the impact of IFRS-9 on Islamic banks, had no plans to implement a transitional arrangement, implying that the majority of supervisors were comfortable with the general capitalisation levels of banks in their domestic banking systems.

More than half the respondent RSAs indicated that implementation of IFRS-9 would lead them to require additional disclosures from banks (Islamic and conventional) in their jurisdictions. Of the four jurisdictions that planned to implement IFRS-9 and in which Islamic banking is considered “systemically important”, three indicated that they would require additional disclosure from banks upon the implementation of the ECL approach. The nature of disclosures highlighted by respondents revolved around the models used to estimate provisions and governance aspects of these models – disclosures that are likely to be within the remit of accounting/auditing standard setters. Several jurisdictions, most of which were still conducting surveys on the impact of IFRS-9, would require disclosures from banks around transitional arrangements if those measures are implemented, while seven jurisdictions do not plan to require additional disclosures, with three of them indicating that banks are already making sufficient disclosures through existing accounting or regulatory disclosure standards.

RSAs who did not conduct any studies related to the implications of IFRS-9 were asked to indicate the relative impact of IFRS-9 on Islamic banks in comparison to conventional banks. All five RSAs responding to this question did not foresee any differences between the effects on Islamic bank vis-à-vis conventional banks.

A total of 63% of the respondents believe that Islamic banks would need guidance beyond currently available standards by BCBS and other standard setters on the

implementation of IFRS-9. Primary areas indicated for further guidance included the manner of conducting supervisory assessment, the distinction between GP and SP, and changes to credit risk management frameworks, which relate to trigger points of moving assets between different stages of IFRS-9, assessment of “significant increases in credit risk”, the definition of “default”, among others.

Given the differences in reported figures between the two countries submitting capital impact data on Islamic banks, it is possible that the implications would be contingent on the idiosyncratic environment of each jurisdiction. Quantitative impact data collected by this study were limited, with only two jurisdictions providing this data; thus, it is not feasible to determine the possible quantitative implications of IFRS-9 on the global Islamic banking industry.

Taking into consideration these results, the regulatory disclosure implications of IFRS-9 are being considered in the IFSB’s ongoing revision of its standard on disclosures and transparency for Islamic banks (IFSB-4). The Technical Committee of the IFSB has also approved for the IFSB to incorporate any changes to capital and credit risk management frameworks for Islamic banks in its revision of IFSB-15: Revised Capital Adequacy Standard scheduled as per the IFSB’s Strategic Performance Plan 2016–2018.

2.2.3.3 Survey on Compilation and Dissemination of Indicators for the Islamic Capital Market and *Takāful* Sectors

The IFSB work plan for the coming year envisages expanding its Prudential and Structural Islamic Financial Indicators (PSIFI) programme (which at the present stage covers only the banking sector) to cover other sectors. This will involve extending coverage of the database to the ICM and *takāful* sectors.

The IFSB began this process of expansion of the database in 2017 by conducting two surveys which were distributed to 43 regulatory and supervisory authorities in IFSB member jurisdictions, who are responsible for oversight of the insurance and capital market sectors in their respective jurisdiction. A total of 39 responses were received, comprising 23 responses to the survey on Islamic capital markets, and 16 responses to the survey on the *takāful* sector.

The primary objectives of the surveys were to: (a) gain insight into the current status of collection and compilation of ICM and *takāful* data; (b) gather information on the data compilation practices and methodologies used; (c) identify important indicators of financial soundness and of financial structures in ICM

¹⁴⁰ This is an area on which the BCBS issued a discussion paper in October 2016, titled Regulatory Treatment of Accounting Provisions, which outlined possible long-term treatment to address these issues, while noting the differences in the application of GP/SP distinction among jurisdictions. Available at: <https://www.bis.org/bcbs/publ/d385.pdf>

¹⁴¹ The BCBS acknowledged in its standard Regulatory Treatment of Accounting Provisions – Interim Approach and Transitional Arrangements that the transition to ECL accounting will, in many cases, reduce the capital ratios of those banks making the transition. The standard is available at: <https://www.bis.org/bcbs/publ/d401.pdf>

and *takāful*; (d) assess the availability of the data and challenges in collecting data; and (e) finalise a set of Islamic finance-specific indicators for ICM and *takāful*.

The surveys solicited information on a number of aspects, including the presence of ICM and *takāful* activities in the surveyed jurisdictions, the level of development and size of the sector, the structure and composition of the sector, the scope of regulation and supervision,

as well as the Shari'ah governance approach taken in the jurisdiction. The survey also gathered information on the data compilation and dissemination practices in jurisdictions, including national financial reporting and compilation practices, whether any specific data is currently being collected on the ICM and the *takāful* sector, the institutional arrangements for data collection, and national dissemination policies.

Chart 2.2.3.3.1 Availability of Indicators (*Shukūk*)

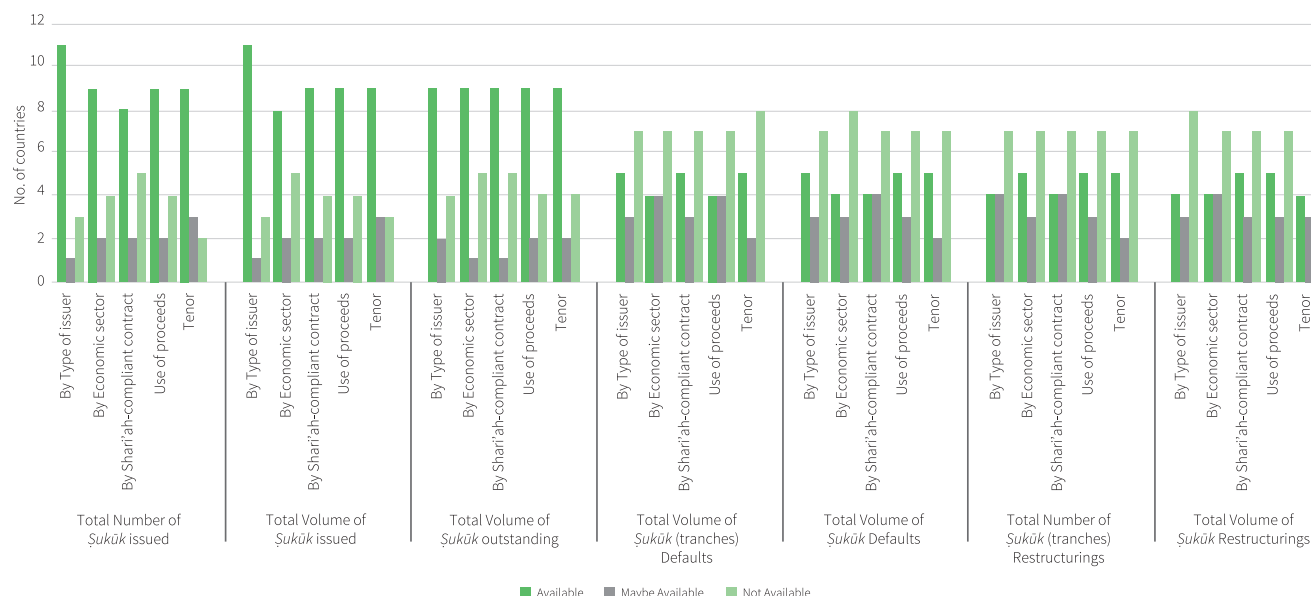
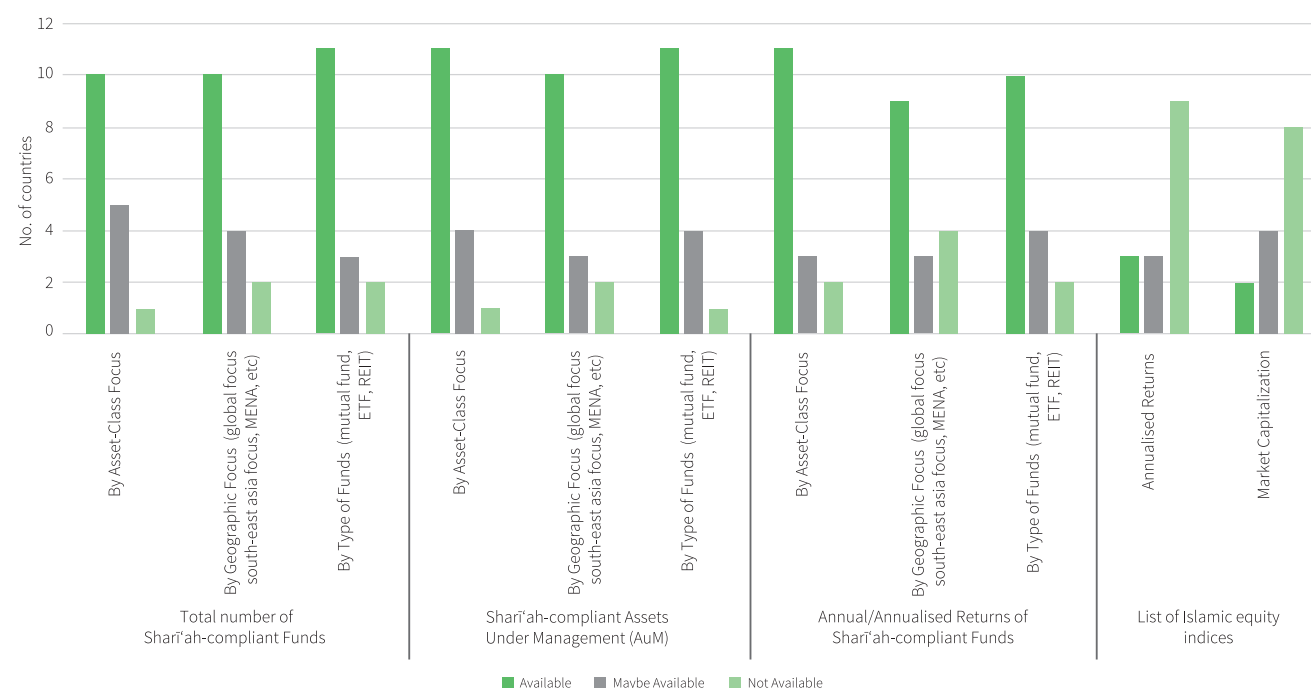


Chart 2.2.3.3.2 Availability of Indicators (Islamic Fund Management)



The responses provided insight into the varying national practices, regulatory requirements and standards applied in the compilation of data. This provides a preliminary understanding of the methodological issues that will need to be addressed in the preparation of a compilation guide to help in the collection and compilation of a set of PSIFI data that is comparable across countries and to assist the public in understanding and using the data.

In addition to the above information, the survey included a list of indicators that are measures of the soundness and stability of the two sectors and asked respondents to rate their analytical significance and usefulness, as well as the availability of indicators in their jurisdiction and the periodicity of the data available (see Charts 2.2.3.3.1 and 2.2.3.3.2).

The list of indicators for both the ICM and the *takāful* sector focused on aggregate prudential and structural information – that is, summations at the national level. The list of indicators on ICM included data on *ṣukūk*, Islamic fund management and Shari’ah-compliant equity. The list of indicators for the *takāful* sector focused on aggregate sector-level indicators of prudential and structural soundness of the sector. The prudential indicators were based on the CAMELS framework, which includes indicators measuring capital adequacy, asset quality, management soundness, earnings and profitability, liquidity, and sensitivity to market risks.

The survey results enabled the identification of a broad set of indicators that are ranked by respondents as highly relevant and analytically significant, from which it was possible to narrow down the indicators to those that are widely available and feasible for most jurisdictions to compile and disseminate. Following the survey, the Secretariat will work with the Task Force on PSIFs to finalise a set of indicators that will be collected from participating countries, followed by the preparation of a detailed compilation guide, planned for issuance in 2018.

2.2.3.4 Consumer Protection in *Takāful*

Recognising a significant challenge faced by supervisors in developing and regulating *takāful* markets, the Council of the IFSB approved the development of a research paper on consumer protection in the *takāful* sector as part of the IFSB Work Plan for 2017. The study aims to examine how current consumer protection regulations are being applied at different phases of *takāful* consumers’ engagements, from product design to sales, complaints handling and dispute resolution. It also intended to identify challenges faced by RSAs in designing and implementing effective and efficient consumer protection regulations.

The IFSB’s first consumer protection standard¹⁴² dealt with priority issues of consumer protection across the three sectors (i.e. banking, capital markets and *takāful*). The new research focuses in more detail on consumer protection in the *takāful* sector specifically, and may lay the ground for future standards initiatives. The *takāful* sector, as an important growing segment of wider insurance markets, deserves special attention on consumer protection due to its claim to offer a just, fair and equitable alternative to the conventional options, and because *takāful* products have distinctive features – for example, in respect of the underlying Islamic contracts, any possible entitlement to surplus distribution, and their special claim to meet the requirements of some religiously sensitive consumers. The approach that a *takāful* operator adopts in the sale of its products and services is at the core of consumer confidence and may in some cases have implications for *takāful* undertakings’ financial soundness.

The study focuses on relationships between *takāful* undertakings and their customers in consumer markets, where customers are generally individuals or smaller businesses, and which are characterised by large asymmetries of information and bargaining power. It involves a survey exercise in early 2018 looking at how jurisdictions deal with so-called conduct of business issues in *takāful*. The survey will include supervisors’ approach to the product development process, product marketing, suitability assessment, complaints handling and dispute resolution, with a particular focus on how the specificities of *takāful* are handled in these areas. It will also look at the existence and coverage of insurance guarantee schemes, in the event that a *takāful* undertaking becomes unable to pay claims as they fall due. From this survey and other work, it is hoped to identify the key issues around consumer protection in *takāful*, ways in which jurisdictions are already addressing them, and possible approaches for the future.

¹⁴² See IFSB Working Paper Series WP/03/10/2015.

3.0 ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

3.1 INTRODUCTION

The global economy has performed better than expected in the past year, with annual growth for 2017 estimated at 3.7%.¹⁴³ The outlook is also generally optimistic, supported by the continued recovery in investment, manufacturing and trade across many jurisdictions in both advanced and emerging markets. However, some very recent events have stirred up concerns regarding a potential trade and/or currency war in the global economy that threatens to stall the continued recovery. The new US administration has continued to push for a protectionist US economic policy and has implemented certain tariffs on steel and aluminium imports to the US. This decision has drawn a strong response from the rest of the world, including retaliatory tariffs by China as well as similar plans by the European Union. Meanwhile, conflicts and geopolitical risks are deepening in a number of countries, including across the Middle East and Central Asia, where the global IFSI has a strong presence. Aside from sanctions and war, these risks also involve political events that have seen aid and funding cuts to some countries, as well as their addition to FATF watch lists because of AML/CFT concerns. Most recently, the US has also pulled out of the six-nation UN-backed nuclear accord and reimposed sanctions on Iran.

The global financial sector, following its relatively successful performance in 2017, awaits the next set of developments as uncertainties are arising which will have some implications for the financial markets. Aside from the broader political aspects discussed above, an important aspect is the pace of the gradual normalisation of interest rates, as any untoward or hasty changes could disrupt the financial market. Meanwhile, the financial sector is also vulnerable to volatile downward movements in the global equity and debt markets in response to any shock triggers in the global economy; a particular risk here is the deterioration in credit quality, which has experienced some improvements in 2017 due to generally improving collateral prices. Amid concerns of currency and trade wars in 2018, the financial sector is exposed to foreign-exchange and other related market risks, and participants need to undertake appropriate solvency and liquidity stress tests to risk manage their exposures. Most of the traditional Islamic are oil-exporting, and although oil prices have recovered somewhat in the first quarter of 2018, the key oil-producing and energy-exporting economies are still expected to post budget deficits,

which will likely constrain the overall financial system's liquidity in these economies.

Against this backdrop, this chapter analyses the stability and resilience of the three main sectors of the global IFSI. While Chapter 1 highlighted the positive growth and development of the IFSI across each of its sectors, this chapter identifies the vulnerabilities of those sectors in line with recent global economic and financial developments.

3.2 ISLAMIC BANKING: ASSESSMENT OF RESILIENCE

Ten years since the onset of the GFC, the global banking industry has recovered considerably, posting healthier capital adequacy ratios and more streamlined liquidity and other risk management functions. Recent analysis¹⁴⁴ indicates that the largest 200 banks globally have improved their aggregate Tier 1 capital by more than 200% between 2007 and 2017; during the same period, the ratio of aggregate Tier 1 capital as a percentage of risk-weighted assets in these banks has doubled to almost 12%. This improvement in the financial health of banks globally is largely due to the implementation of regulatory reforms in the years following the crisis. While concerns were initially raised regarding the increased costs of regulatory compliance resulting from the need to adapt to the post-crisis prudential regulatory framework, most of the advanced and some emerging economies have already stabilised their frameworks with supportive guidelines and infrastructure.

Sustaining resilience despite challenges ...

The global Islamic banking industry, operating alongside conventional financial institutions, has also weathered several systemic and idiosyncratic challenges over the past several years, ranging from risks emanating from declining prices of real assets and commodities, volatilities and adverse shifts in macroeconomic fundamentals, and geopolitical tensions and regional conflicts, to deteriorating credit quality risks on the assets side and funding pressures from the liabilities side. Nonetheless, a bird's-eye view of the sector at an aggregate industry-wide level suggests that global Islamic banking¹⁴⁵ is continuing to sustain its resilience, and most of its indicators are in comfortable compliance with minimum international regulatory requirements.

¹⁴³ IMF, World Economic Outlook, January 2018.

¹⁴⁴ EY, Global Banking Outlook 2018.

Table 3.2.1
Selected Islamic Finance Stability Indicators: A Snapshot as of 1H2017

	Tier-1 Capital (%)	NPF/ NPL (%)	ROA (%)	ROE (%)	Cost-to-Income Ratio (%)
Islamic Banks ^a	9.82	5.2	1.71	14.72	51.5
World Top 200 Banks ^b	12.0	n.a.	n.a.	11.0	56.0
World Top 1000 Banks ^c	6.50	n.a.	0.85	13.04*	n.a.
EU Banks ^d	15.7	4.5	0.45	7.0	61.5

a: Based on a sample of 18 countries representing over 95% of the global Islamic banking assets as of 1H2017. See footnote 146.

b: Based on results reported in EY: Global Banking Outlook 2018.

c: Based on results reported in The Banker: "Top 1000 World Banks 2017".

d: Based on results reported in EBA: Risk Dashboard – data as of Q22017

* This ROE is calculated as percentage to Tier 1 capital, as opposed to shareholders' capital.

As of 1H2017, the capitalisation of the Islamic banking industry¹⁴⁶ reports a total capital ratio of 12.38% of which Tier-1 capital accounts for 9.82% (see Table 3.2.1). This reflects better capital adequacy compared to the top 1000 banks globally,¹⁴⁷ which reported a Tier-1 capital ratio of 6.5% in the same period, but is significantly lower than the EU-banks' Tier-1 ratio of 15.7%.¹⁴⁸ From an asset-quality perspective, gross non-performing financing was recorded at 5.2%, which is slightly higher than the 4.5% non-performing loan (NPL) ratio reported for the EU banks. The profitability of the Islamic banking industry is at an improved 1.71% ROA, which contrasts favourably with ROAs of 0.85% and 0.45% for the top 1000 banks globally and the EU banks, respectively, in the same period. From an efficiency perspective, the Islamic banking industry posted a cost-to-income (CI) ratio of 51.5%, compared to 61.5% for EU banks and over 55% for the world's largest 200 banks.¹⁴⁹

... however, no longer the most healthy

Despite meeting the minimum international regulatory requirements and favourable profitability/efficiency indicators, the global Islamic banking industry is no longer in a position to claim the most sound financial health vis-à-vis other conventional banking sector comparators. Some of the global conventional banks – in particular, EU banks and the world's top 200 banks – have substantially improved their capitalisation and asset quality in the aftermath of the GFC. This is partly reflective of the post-crisis regulatory reforms, which mandate that global systemically important banks (G-SIBs) and in

some instances, at the discretion of national regulators, domestic systemically important banks (D-SIBs) comply with more stringent prudential requirements.

Meanwhile, there are some disparities in performance and financial results between the respective Islamic banking industries of the sample countries. For instance, a number of traditional (and relatively larger asset-base) Islamic banking markets have experienced a squeeze in their profit margins and persistent high rates of NPF in recent times that have contributed adversely towards the overall industry-wide ratios. In contrast, the relatively newer entrants and/or less traditional Islamic banking markets have experienced more volatile fluctuations in key fundamentals given their small financial bases and gradually growing balance sheets. Some Islamic banking markets are also materially engaged in foreign-exchange exposures that require implementation of sound risk management principles to mitigate net exposed positions – this is particularly relevant for the emerging and developing markets in the light of recent concerns about the development of a new currency war¹⁵⁰ in the global economy.

In terms of financing concentration, the household and personal financing segment is the most important exposure for the Islamic banking industry given the consumer-led demand for Islamic banking products. This may indicate for some countries their greater susceptibility to the current economic slowdown and resulting contraction in disposable incomes, including due to welfare spending cuts and removal of subsidies

¹⁴⁵ Based on a sample of 18 countries – namely: Afghanistan, Bahrain, Bangladesh, Brunei, Egypt, Indonesia, Iran, Jordan, Kuwait, Malaysia, Nigeria, Oman, Pakistan, Qatar, Saudi Arabia, Sudan, Turkey and the United Arab Emirates. These 18 countries collectively represent over 95% of the global Islamic banking assets as of 1H2017. With the exception of Qatar, the data for all remaining countries is extracted from the IFSB's PSIFI database. The data for Qatar is extracted from the financial statements of its four Islamic banks; there are no Islamic banking windows in Qatar. Data was not available from all 18 countries for all indicators; across this subsection, respective indicators duly clarify the number of countries that have contributed towards its calculation.

¹⁴⁶ Here and elsewhere in this chapter, the financial indicators represent weighted averages based on data from the 18 sample countries – unless otherwise indicated for any specific ratio.

¹⁴⁷ The Banker: "Top 1000 World Banks 2017".

¹⁴⁸ EBA: Risk Dashboard – data as of Q22017.

¹⁴⁹ EY: Global Banking Outlook 2018.

¹⁵⁰ See reports by Nikkei Asian Review: "Trump currency war increases risks for Asia", 29 January 2018; and Financial Times: "ECB's Cœuré: we would push back if US starts currency war", 1 February 2018.

amid austerity measures. On the other hand, Islamic banks' financing exposures to the market-sensitive real estate sector and the related construction sector are much contained, and collectively these two sectors represent about 12% of the total financing exposure; nonetheless, these are responsible for 22% of the Islamic banking industry's NPF.

Finally, on the critical aspect of liquidity, while not all sample countries report the latest Basel III/IFSB GN-6 liquidity ratios to the IFSB's PSIFI database, using the liquid assets to short-term liabilities ratio as proxy, most countries experienced some worsening in the ratio moving into 2017. This is reflective both of the downturn of liquidity conditions in the financial sector of these countries on account of geopolitical conditions, and of the persistent low energy-export prices over the last two to three years, which have dried up the previously available excess liquidity. Additionally, to some extent, the challenges in making available tradable high-quality liquidity instruments to support the Islamic banking industry have contributed to the worsening of liquidity ratios.

Overall, a number of downside risks persist moving into 2018 that will continue to challenge the resilience of the Islamic banking industry. While there has been some recovery in energy-export prices,¹⁵¹ the forecasts for 2018 continue to envision budget deficits in key Islamic banking domiciles which will continue to lend support to their respective public expenditure rationalisation policies. At least three key Islamic banking domiciles also expect general elections to be held in the near future, which may affect the pace of economic activities in the jurisdiction as stakeholders assess whether there will be a return of the incumbent or a change in the ruling government. Meanwhile, geopolitical tensions and bilateral/multilateral conflicts, afflicting most Islamic banking domiciles, also threaten overall economic progress and stability. From a more micro-perspective, Islamic banking risk management functions need to be cautious in their restructuring/reorganising strategies for troubled assets, to avoid further entrenching banks' exposures and the build-up of legacy NPFs. Instead, painful measures may be needed to enhance provisions coverage of these stressed assets with a view to gradually cleaning up the balance sheets.

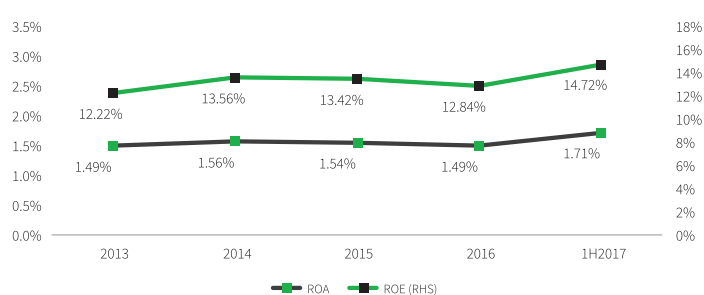
These and other factors further reinforce the need for implementation of strong risk management and stress-testing frameworks by Islamic banks to assess their vulnerabilities and strength to withstand adverse shocks. The following subsections, covering profitability, asset quality and financing concentration, foreign

exchange position, and liquidity, assess trends of various technical indicators across the Islamic banking industry and discuss country-specific contexts. These focused analyses are then followed by a critical summary of the overall risk factors challenging Islamic banking resilience in the near future.

Profitability

Profitability of the global Islamic banking industry has remained resolute in recent years, averaging a rate of 1.55% ROA and 13.4% ROE between 2013 and 1H2017 (see Chart 3.2.1) – this is well above the 0.7% ROA and 6.3% ROE recorded in 2009¹⁵² in the aftermath of the GFC. The returns of 1.71% ROA and 14.72% ROE during 1H2017 are the most improved during the analysis period, far outreaching those generated by the world's top 1000 banks (ROA: 0.85%; ROE: 13.04%) and the EU banks (ROA: 0.45%; ROE: 7.00%) in the same period. This is partly attributable to stabilising, and/or “factored-in”, macroeconomic fundamentals of key Islamic banking markets, backed by improving energy-export prices as well as increasing consumer-led demand for Islamic banking products. The overall financial sector has also benefited from improved profit margins due to an increase in the underlying benchmark rates as implemented by the respective RSAs following the US Federal Reserve's move to raise its Fed rate over various stages since December 2015. A number of individual country-specific factors have also contributed to the overall industry's improved profitability in 2017 (see Chart 3.2.2).

Chart 3.2.1
Global Islamic Banking Returns on Assets and Equity¹
(2013 to 1H2017)



1: Calculations of weighted average ROA and ROE are based on data of stand-alone Islamic banks from 15 jurisdictions and exclude Egypt and Iran, due to data limitations, and Afghanistan, which has no stand-alone Islamic banks. “Stand-alone Islamic banks” refers to full-fledged Islamic banks, and Islamic subsidiaries of conventional banks, but excludes Islamic windows of conventional banks.

Source: PSIFI, IFSB Secretariat Workings

The Sudanese banking sector, which is fully Shari'ah-compliant, generated the best returns on assets among

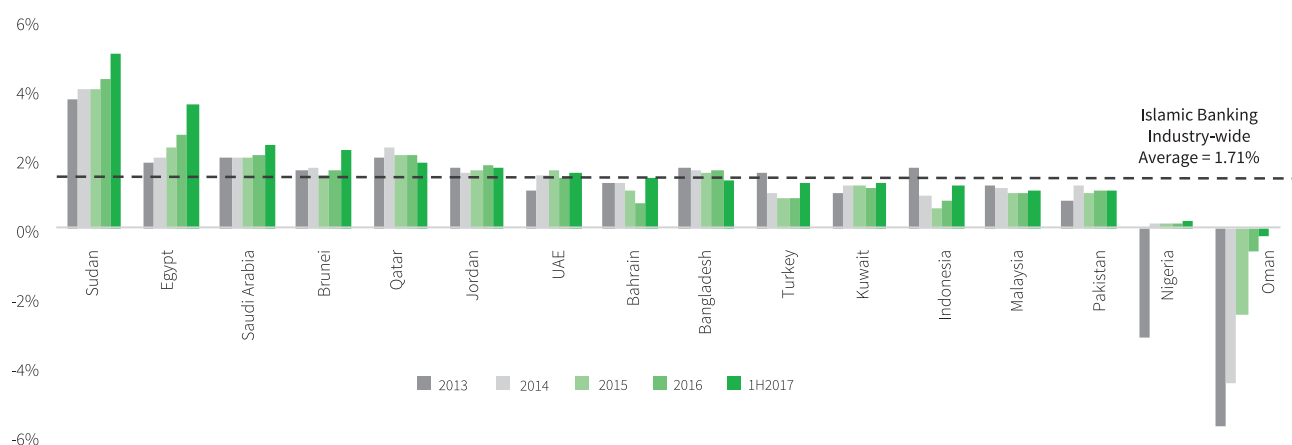
¹⁵¹ See World Bank: Commodity Markets Outlook, October 2017.

¹⁵² As reported and discussed in the IFSB's PSIFI Stability Report 2015.

the sample countries (1H2017: ROA 5.04%); although, notably, the country is grappling with high rates of domestic inflation and steep depreciation of the Sudanese Pound.¹⁵³ Nonetheless, the country's banking sector stands to benefit from increased efforts by the authorities to enhance financial inclusion in the economy, as well as from the recent lifting of economic sanctions by the US, enabling its gradual return to the world trade and financial system.¹⁵⁴ The Sudanese banking sector is expected to play a key role going forward in facilitating banking operations and procedures for exports and imports, which is likely to contribute towards further profit-making avenues.¹⁵⁵ The Egyptian banking sector

overall is also benefiting from an improved economic outlook following rising foreign investment, resilient domestic consumption and the gradual recovery of the tourism industry. Egyptian Islamic banks (1H2017: ROA 3.52%), in particular, have the advantage of relatively stable and low-cost domestic deposits, mainly from households, which further supports banks' profit margins. Both Sudanese and Egyptian Islamic banking sectors have also managed to improve their asset quality over time, which further contributes to improved profitability ratios amid a reduction in provisioning costs (discussed later in the 'Asset quality and financing concentration' section).

Chart 3.2.2 Islamic Banking Returns on Assets by Country (2013 to 1H2017)



Source: PSIFI, IFSB Secretariat Workings

Returns among the other traditional Islamic banking markets have mostly improved across the board, with higher ROAs in 1H2017 than the industry-wide average of 1.55% recorded in Saudi Arabia (2.4%), Brunei (2.24%), Qatar (1.84%), Jordan (1.75) and the UAE (1.61%). All GCC countries, with the exception of Qatar, improved on their returns during 1H2017. A number of GCC countries had recently experienced a downturn in returns in 2016 on the back of increased funding costs as well specific provisions as a consequence of asset quality deteriorations. However, active restructuring of exposures by GCC banks has enabled them to keep the NPF rates in check, as well as to contain specific provisioning costs which have enabled an improvement in profitability ratios.¹⁵⁶ Meanwhile, Qatar faces idiosyncratic challenges on account of the regional diplomatic conflict that will continue to strain and challenge its banking sector's financial health.

The Islamic banking sector in the emerging market countries (e.g. Turkey, Pakistan and Indonesia) has also experienced improvements in profitability. This follows significant volatilities during the post-2014 era when the US Federal Reserve began tapering its quantitative easing programme, sending emerging market financial indicators into a downward spiral. The Turkish participation banking sector (1H2017: ROA 1.32%) has almost reverted to its pre-2014 returns on assets following a number of adverse economic and political events between 2014 and 2016. The Pakistani Islamic banking sector, which has traditionally placed most funds in low-risk government securities for stable returns, has begun increasing its private-sector exposures (discussed later in the 'Liquidity' section), and this has enabled it to slightly improve its profitability to 1.04% in 1H2017.

¹⁵³ Over 35% as of May 2017 – see Reuters: “Sudan inflation hits 35.52% in May”, 12 June 2017.

¹⁵⁴ AFDB: African Economic Outlook – Sudan 2017.

¹⁵⁵ Moody's: “Egyptian banking system outlook is stable as economic growth picks up”, Global Credit Research, 11 October 2017.

¹⁵⁶ S&P: Islamic Finance Outlook 2018.

The Indonesian Islamic banks, still accounting for less than 6% of the country's total banking sector, have also improved profitability (1H2017: ROA 1.25%) on the back of improved profit margins of around 5.3%, the widest among its regional peers¹⁵⁷ in terms of the overall banking sector (both Islamic and conventional). In contrast, the more established Islamic banking market of Malaysia (in terms of domestic market share) has largely sustained its profitability (1H2017: ROA 1.08%) with slight improvement moving into 2017.

On the other hand, Islamic banks in Nigeria and Oman were the only ones to post, on average, negative/near-zero ROAs during the analysis period on the back of their very recent entry into the Islamic banking industry. Islamic banking in both these countries commenced only approximately five years earlier, and the sector has done remarkably well during this time to eliminate losses and move into the profitability zone. The banking sector regulators of both these countries are active members of the IFSB, looking to implement and improve upon their regulatory and market infrastructure to further support and facilitate the orderly expansion of their respective Islamic banking industries.

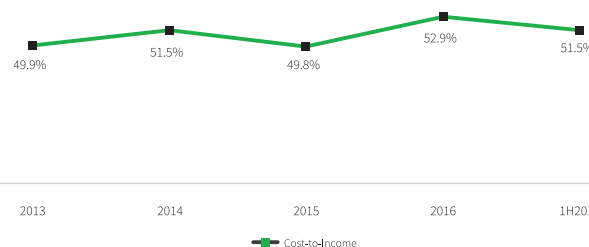
Supporting the improved profitability and returns on Islamic banking assets is the contained costs-to-income ratio¹⁵⁸ of Islamic banks. During the analysis period between 2013 and 1H2017, the ratio has varied within a narrow band of 50–53% (see Chart 3.2.3). The global Islamic banking ratio of 51.5% as of 1H2017 compares quite favourably to cost-to-income ratios of EU banks at 61.5%¹⁵⁹ and the 56% ratio for the world's largest 200 banks¹⁶⁰ in the same period. However, as with the returns indicator, there is quite a bit of variation in the cost-to-income ratios among the individual Islamic banking countries (see Chart 3.2.4).

The Indonesian Islamic banks have the highest cost-to-income ratios, well over 80% in the sample period,

followed by Bahrain and Nigeria with ratios at just under 74% in 1H2017. This indicates that a substantial portion of gross income is consumed to meet operating expenditures and assets provisioning. These high ratios also reciprocate the lower ROAs in these countries, in contrast to their peers. Altogether, six countries (including Pakistan 69.7%, Oman 68.7% and the UAE 65.1%) have posted cost-to-income ratios above the industry-wide average of 51.5% as of 1H2017.

A high cost-to-income ratio does not necessarily indicate inefficiencies, particularly if it is due to branch expansion and business development expenditures (as is expected to be the case for Nigeria, Oman and Pakistan, where rapid Islamic banking expansion is in progress). However, other reasons for a higher cost-to-income ratio may include operational inefficiencies, lack of economies of scale and considerable asset quality deterioration, and non-performing financing build-up leading to increased provisioning costs. Some of these adverse factors are likely affecting Islamic banks in Bahrain and the UAE (as is evident from their high rates of NPF – discussed later in the 'Asset quality and financing concentration' section).

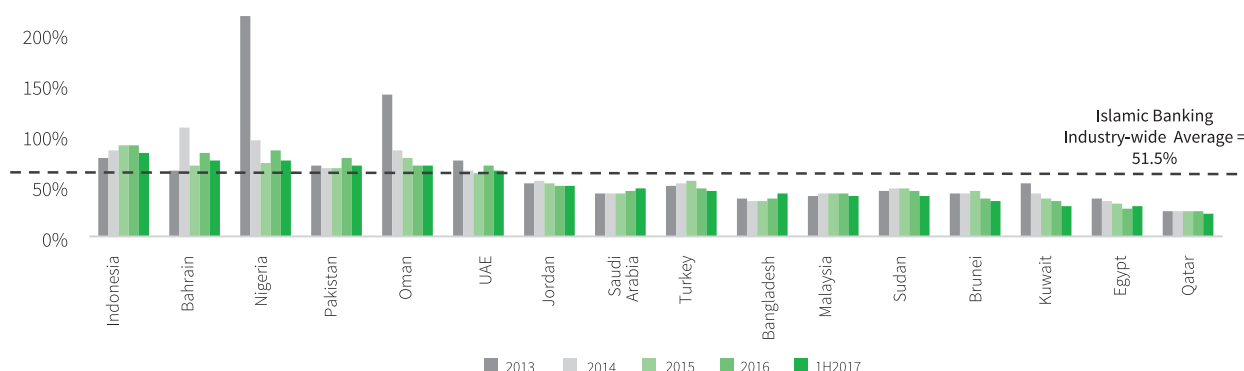
Chart 3.2.3
Global Islamic Banking Cost-to-Income Ratio¹
(2013 to 1H2017)



1: Calculation of weighted average cost-to-income ratio is based on data from 17 jurisdictions and excludes Iran, due to data limitations.

Source: PSIFI, IFSB Secretariat Workings

Chart 3.2.4 Islamic Banking Cost-to-Income Ratio by Country (2013 to 1H2017)



Source: PSIFI, IFSB Secretariat Workings

¹⁵⁷ Moody's: "Outlook for Indonesian banking system to positive from stable", 13 June 2017.

¹⁵⁸ Cost to income = operating costs / gross income.

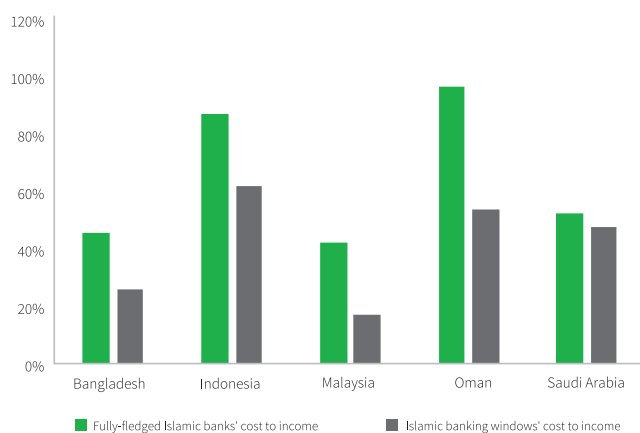
¹⁵⁹ EBA: Risk Dashboard – data as of Q22017.

¹⁶⁰ EY: Global Banking Outlook 2018.

Among other jurisdictions, Jordan (51.1%), Saudi Arabia (46.7%) and Malaysia (40.7%) have been sustaining consistent ratios without any major fluctuations during the analysis period. Turkey did experience upward cost pressures in 2014–15 before gradually improving and achieving its most improved cost-to-income ratio of 45.8% in 1H2017. Improvements in this ratio were also witnessed in Sudan, Brunei, Kuwait and Egypt during the analysis period, mainly on the back of improved returns on assets as well as material declines in NPFs leading to lower provisioning costs. Finally, Qatari Islamic banks have consistently enjoyed the lowest cost-to-income ratios throughout the analysis period. With consistent record-low NPF rates, asset returns above the Islamic banking industry average, and provisions set-aside covering over 80% of NPF, the Qatari Islamic banking cost-to-income ratio has ranged between 22% and 24% during the sample period.

Finally, analysis of cost-to-income ratios between stand-alone Islamic banks and Islamic banking windows shows that Islamic banking windows are continuing to leverage on their conventional parents' banking infrastructure, hence keeping their operating costs at a comparatively lower level (see Chart 3.2.5). For instance, in Bangladesh, while cost-to-income ratio of stand-alone Islamic banks rose from 34.8% in 4Q2013 to 45.7% in 2Q2017, its Islamic windows experienced a significant decline in their ratio – from 59.3% in 4Q2013 to 25.7% in 2Q2017. In Saudi Arabia, on the other hand, the average cost-to-income ratio of Islamic windows (47.3%) stood almost on par with that of full-fledged Islamic banks (52.5%) as at 2Q2017. However, this is largely due to reduced gross income of the Islamic windows by 23.15% (from 45,343.6 million Saudi Riyal in 2Q2016 to 34,848.2 million in 2Q2017), rather than the burden of rising operating costs. In contrast, the stand-alone Islamic banks in Saudi Arabia experienced an increase in gross income of 34.3% during the same period.

Chart 3.2.5
Cost to Income (Stand-Alone Islamic Banks and Islamic Banking Windows) as at 1H2017



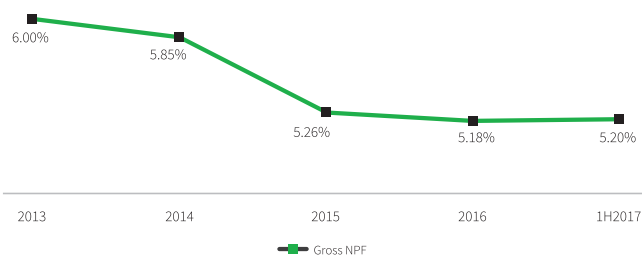
Source: PSIFI, IFSB Secretariat Workings

Overall, the Islamic banking profitability has remained resilient moving into 2017, with sustained cost-to-income ratios. While strong consumer-led demand and improving economic fundamentals (including through lifting of sanctions in some countries) provide avenues for further profitability improvements and costs consolidation through economies of scale, there are some potential downside risks going forward – mainly in the form of increased provisioning costs due to potential asset quality deterioration and squeeze in profit margins should it not be possible to pass on the rising benchmark rates to customers. The profitability outlook in 2018 and beyond is discussed and assessed further, along with the outlook for other technical indicators, in the summary at the end of this subsection.

Asset Quality and Financing Concentration

Despite concerns about credit quality and collateral pricing downside risks in recent years, the global Islamic banking industry's asset quality has continued to improve during the analysis period. As of 1H2017, the gross NPF as a weighted-average industry-wide level is recorded as 5.2% (see Chart 3.2.6), below the emerging markets (excluding China) banking sector NPL ratio of over 6% in 2016,¹⁶¹ but higher than the average EU banks' NPL ratio of 4.5%¹⁶² and much higher than the US and Chinese banking sectors, where the NPL ratios were below 2% as of 1H2017.¹⁶³ However, only a handful of Islamic banking domiciles have pushed up the relatively higher industry-wide weighted-average NPF ratio (see Chart 3.2.7).

Chart 3.2.6
Global Islamic Banking Gross NPF¹ (2013 to 1H2017)



1: Calculation of gross NPF is based on data from 17 jurisdictions and excludes Afghanistan, due to data limitations.

Source: PSIFI, IFSB Secretariat Workings

Iran is now the only jurisdiction with a double-digit NPF ratio remaining in its banks' balance sheet. As of 1H2017, its NPF at 11.81% is still favourably compares to earlier figures of nearly 15%. The NPF build-up in the Iranian banking system has been inherited due to previous fundamental weaknesses – for example, a regulatory environment characterised by low capital adequacy requirements, high financing rates on assets and a scarcity of well-trained auditors. Decades of sanctions had further excluded Iranian banks from learning from,

¹⁶¹ IMF: Global Financial Stability Report, April 2017

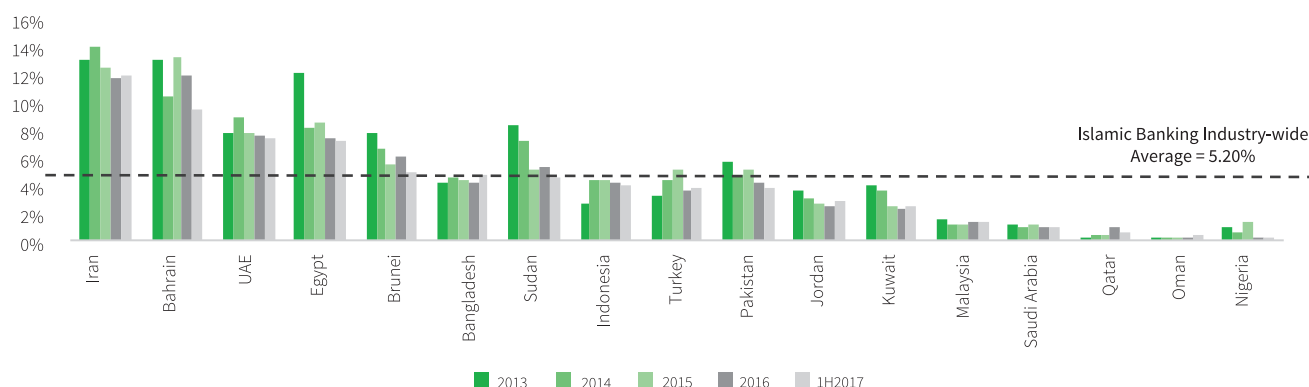
¹⁶² EBA: Risk Dashboard – data as of Q22017.

¹⁶³ US NPL ratio: KPMG: "Reducing Non-Performing Loans (NPLs) in the EU Banking sector", 20 February 2017; China NPL ratio: China Daily: "Banks' NPL ratio stays stable at 1.74 percent", 16 August 2017.

and complying with, international regulatory standards. The Central Bank of Iran is actively pursuing reforms, by collaborating and learning from relevant stakeholders at the international front following the lifting of many sanctions in 2016, as well as domestically by way of

introducing state support for NPF restructuring and debt recovering mechanisms and support, including non-payment penalty fee waivers for exposures amounting to IRR 1 billion (USD28,178).¹⁶⁴

Chart 3.2.7 Islamic Banking Gross NPF by Country (2013 to 1H2017)



Source: PSIFI, IFSB Secretariat Workings

Bahrain, the UAE and Egypt are the other three countries with Islamic banking NPF ratios above the industry average of 5.2%. Bahrain's Islamic banks have significantly improved their NPF ratios in the same period to close at 9.39% in 1H2017; however, this figure is still higher than the overall Bahraini banking sector's NPL ratio, estimated at 7% in 2017.¹⁶⁵ The UAE is also grappling with high NPF ratios for Islamic banks in recent years and, like Bahrain, the position at 7.4% in 1H2017 is higher than the overall UAE banking sector NPL ratio of 5.3% in the same period.¹⁶⁶ Both UAE and Bahraini Islamic banks suffer from legacy non-performing financing issues, with high concentrations on a few large borrowers that are under stress.

The Egyptian Islamic banking sector, as was noted in the 'Profitability' discussion, has improved its asset quality significantly, lowering NPF from over 12% at end-2013 to just over 7% in 1H2017. The political stability combined with economic reform efforts implemented post-2013 have yielded results as the overall economy moves towards stability, and the banking sector also moves favourably in tandem with it. Sudan is the other country which has substantially improved its gross NPF ratio, from 8.23% to 4.57%, as of 1H2017. However, it is pertinent to note that the IMF Article IV consultation (2016) found that equity injections to recapitalise weak banks have led to the Central Bank of Sudan and the Sudanese government fully or partially owning 41% of the banks.¹⁶⁷

Among other jurisdictions, Brunei's Islamic banking sector NPF, although improved at 4.83% in 1H2017, is still higher than its regional peers, particularly due to exposures in unsecured personal financing in the household sector.¹⁶⁸ Indonesia and Turkey have experienced volatilities between 2014 and 2016 in their NPF ratios, reflective of the economic and/or political challenges affecting each of them; however, moving into 2017, the ratios have improved to 3.99% and 3.86%, respectively.

Pakistan and Kuwait have also materially improved on their NPF ratios, with reductions of nearly 2 percentage points during the analysis period to 3.74% and 2.37%, respectively, in 1H2017. Kuwait's banking sector, which was hard-hit during the financial crisis, has been successful in cleaning up its financing/loan books to achieve an NPL ratio of 2.1% in 2016, significantly less than the 7.3% recorded in 2011.¹⁶⁹

Five countries have consistently reported below 1.5% NPF ratios for their Islamic banking systems throughout the analysis period: As of 1H2017, the respective NPF rates were Malaysia (1.36%), Saudi Arabia (0.95%), Qatar (0.52%), Oman (0.35%) and Nigeria (0.06%). Qatar has improved its NPF ratio over time, and its Islamic banking NPF at 0.52% is much lower than the overall banking sector NPL ratio of 1.3% (as of end-2016).¹⁷⁰ Oman and Nigeria are relatively new entrants into Islamic banking and have so far been able to manage largely performing financing portfolios.

¹⁶⁴ Financial Tribune: "Iranian bank NPLs at 10%", 20 May 2017.

¹⁶⁵ Moody's: "Negative outlook on Bahrain's banking system due to weaker economy and government debt exposure", 31 May 2017.

¹⁶⁶ Moody's: "Stable outlook on UAE's banking system on economic resilience, solid bank financial fundamentals", 9 October 2017.

¹⁶⁷ AfDB: African Economic Outlook – Sudan 2017.

¹⁶⁸ AMBD: Policy Statement 2/2017, 22 December 2017.

¹⁶⁹ Reuters: "Fitch: Kuwaiti banks' asset quality improving; Highest reserve coverage in GCC", 30 August 2017.

¹⁷⁰ QCB: Banks' Performance Indicators – accessed 5 February 2018.

Meanwhile, Bangladesh is the only jurisdiction in the sample that has failed to improve on its Islamic banking NPF during the sample period; the NPF has in fact increased from 4.18% to 4.73% between 2013 and 1H2017. The IMF, in its latest Article IV report on Bangladesh, identifies weaknesses in the banking sector owing largely to the legacy of loans to large borrowers, who lack incentives to repay, and legal limitations that hamper recoveries.¹⁷¹

A related discussion to asset quality is the risk of financing concentration to specific sectors and the resulting NPF from these sectors. Based on data available from several key Islamic finance jurisdictions, not surprisingly, financing to household and/or personal financing is the most important exposure for Islamic banks – plausible given the generally strong consumer-led demand for Islamic banking products in the sample markets. This sector represented almost 42% of total Islamic banks' financing exposures as of 1H2017 (see Chart 3.2.8).

Following next were the manufacturing and the wholesale and retail trade segments, which collectively represented 21% of the Islamic banks' financing exposures as of 1H2017. The exposure to these two sectors is high, partly due to the presence of a large number of small and medium enterprises (SMEs) that rely on bank funding for their financing needs.

The exposure to two of the market-sensitive sectors of real estate and construction is much contained and collectively represents about 12% of the total Islamic banks' financing exposure as of 1H2017. This is a marked reduction since the GFC, when large exposures to these sectors, particularly in the Middle East, led to the first wave of defaults and NPF build-ups in the Islamic banking industry.¹⁷² The reduction is an outcome of a number of reform initiatives implemented by the regulators in the affected markets, including macroprudential policies to restrict loans/financing growth and value to the real estate sector. Meanwhile, almost a quarter of the Islamic banks' financing exposures were to other sectors, including power and utilities, transportation, other financial institutions and public-sector enterprises.

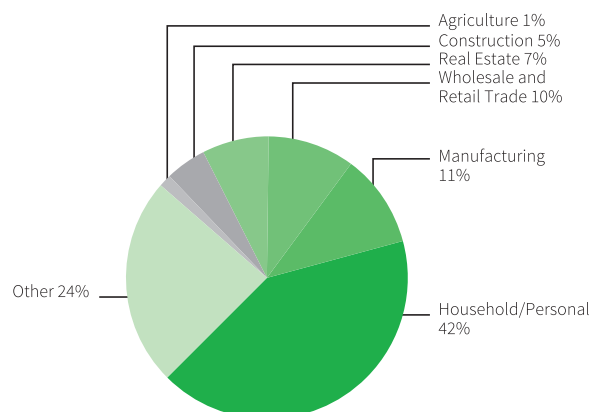
However, on inspection of Islamic banks' NPF concentration by economic sectors, the wholesale and retail trade and manufacturing sectors combined represent one-third of all Islamic banks' NPF (see Chart 3.2.9). This is followed by the real estate and construction sectors, which account for almost 22% of the Islamic banking NPF – indicating a continued problem of legacy loans and troubled real estate assets in some countries.

The household and personal segment represents a 23% NPF ratio, which is nearly half of the total financing exposure to this segment.

These findings indicate the presence of specific sectoral concentration in the Islamic banks' financing exposures and NPF ratios. In particular, significant exposure to private-sector businesses and SMEs, as well as a high level of household and personal indebtedness, exposes Islamic banks to macroeconomic downturn vulnerabilities and instability risks. This is particularly true in the light of recent macroeconomic pressures on most Islamic banking jurisdictions due to various factors¹⁷³ that may strain corporate profitability and business confidence index. The economic slowdown also adversely affects disposable incomes, including due to welfare spending cuts and removal of subsidies amid austerity measures, which further add non-performance risks to household exposures.

Overall, identification of these economic-sector concentrations requires proactive macroprudential checks and monitoring by the regulatory and supervisory authorities. These and other factors related to asset quality and financing concentration outlook in 2018 and beyond are discussed and assessed further in the summary and outlook write-up at the end of this subsection

Chart 3.2.8 Islamic Banking Sectoral¹ Financing Concentration² (1H2017)



1: Sectoral financing exposures are based on reporting structure by RSAs in the PSIFIs database. Hence, some variation of categorisation is expected, and specific exposures may be aggregated in two or more different categories. For example, retail home financing exposures may be recorded under the "Household/Personal" category or the "Real Estate" category.

2: Calculation is based on data from eight jurisdictions, namely: Bahrain, Bangladesh, Brunei, Indonesia, Jordan, Malaysia, Oman and Saudi Arabia. Others are excluded due to data limitations.

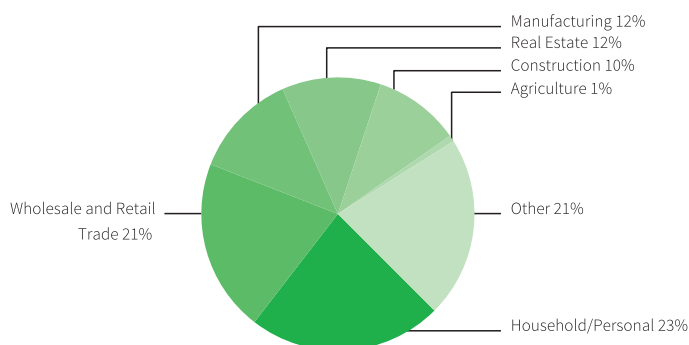
Source: PSIFI, IFSB Secretariat Workings

¹⁷¹ EIU: "Bangladesh banking sector faces challenges", 26 June 2017.

¹⁷² As discussed in the IFSB's IFSI Stability Report 2014.

¹⁷³ For example, depressed oil prices, rapid inflation rates, geopolitical tensions and regional conflicts, depreciating exchange rates leading to imported inflation, etc.

Chart 3.2.9
Islamic Banking NPF Concentration¹ by Economic Sectors² (1H2017)



1: Sectoral financing NPF is based on reporting structure by RSAs in the PSIFs database. Hence, some variation of categorisation is expected, and specific NPF may be aggregated in two or more different categories. For example, retail home financing NPF may be recorded under the “Household/Personal” category or the “Real Estate” category.

2: Calculation is based on data from eight jurisdictions, namely: Bahrain, Bangladesh, Brunei, Indonesia, Jordan, Malaysia, Oman and Saudi Arabia. Others are excluded due to data limitations.

Source: PSIFI, IFSB Secretariat Workings

Foreign Exchange Position

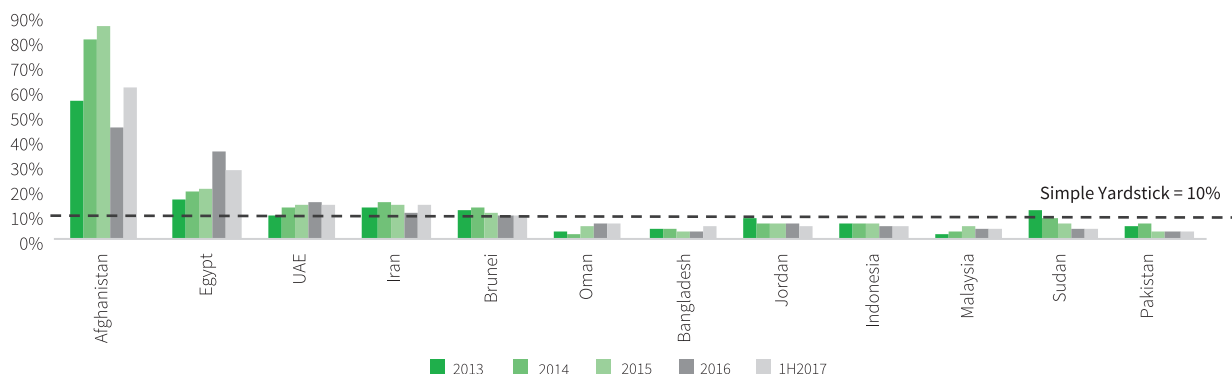
Foreign exchange is a critical risk factor that has at times been profound enough to cause entire economies to face crises and move towards recession.¹⁷⁴ The banking sectors of the afflicted economies suffer tremendously in this process, particularly when they have material unhedged exposed net positions in foreign currency-denominated transactions, including short-term liabilities. Past experience has also demonstrated that maintaining fixed or tightly managed exchange rate regimes also offers no guarantees against downside pressures on foreign-exchange pricing, compelling authorities to abandon the pegs or readjust them to a deflated level. Most recently,

exchange-rate volatilities have been afflicting emerging markets since mid-2013 following the first indications by the US Federal Reserve that it would begin tapering its quantitative easing programme initiated in the aftermath of the GFC.¹⁷⁵

The Islamic banking jurisdictions maintain various types of currency regimes, including fixed exchange-rate, managed exchange-rate, and relatively free-floating exchange-rate regimes. Based on available data, as of 1H2017, there are a number of Islamic banking jurisdictions with material engagements in foreign-exchange transactions (based on domestically consolidated data). Using a simple yardstick limit, at least four jurisdictions (Afghanistan, Egypt, UAE and Iran) are identified where their Islamic banks, on average, have more than 10% exposure in foreign currency-denominated financing as a ratio of total financing (see Chart 3.2.10); while at least six jurisdictions (Afghanistan, Egypt, Sudan, UAE, Oman and Brunei) are identified where their Islamic banks, on average, have more than 10% funding in foreign currency-denominated funds as a ratio of total funding (see Chart 3.2.11).

The case of foreign currency-denominated funds can be more concerning for the regulators, particularly when the funds mobilised in foreign currencies are short-term in nature, which are then converted into local currency financing transactions.¹⁷⁶ However, upon inspection, most of these countries have carefully managed their foreign currency denominated financing-to-funding ratio (FFR). This is reflective of regulations in many countries where banks have to enforce strict ALM guidelines, which include that any foreign currency positions on the assets side must be matched by positions on the liabilities side, and vice versa.

Chart 3.2.10
Islamic Banks' Foreign Currency Financing to Total Financing by Country (2013 to 1H2017)

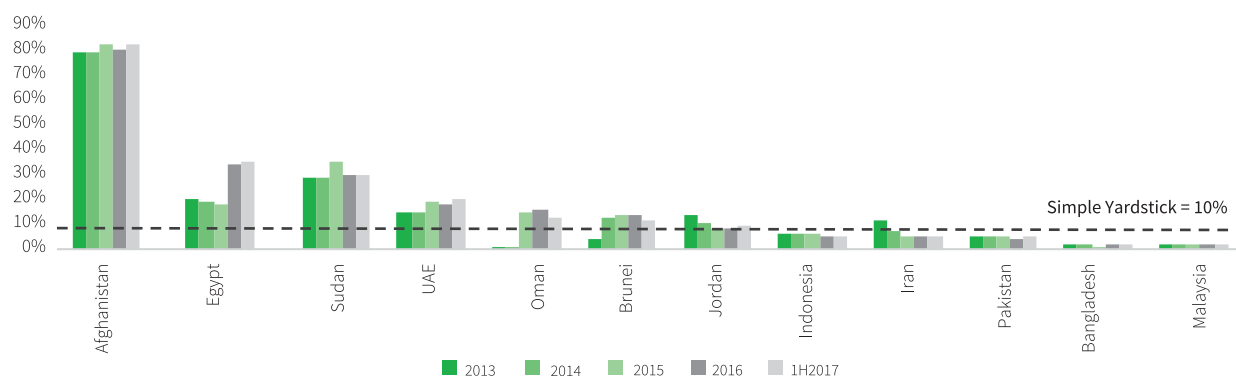


Source: PSIFI, IFSB Secretariat Workings

¹⁷⁴ For instance, in the recent past, foreign exchange price volatilities, commonly termed “currency crises”, have been named as the cause of the Latin American debt crises in the 1980s, the financial crisis in Asia in the 1990s, the Argentine economic crisis in the early 2000s and the very recent Argentine sovereign default in 2017.

¹⁷⁵ Council on Foreign Relations: “Currency Crises in Emerging Markets”, 28 October 2015.

¹⁷⁶ Such was observed during the Asian Financial Crisis of 1997–98, when the banking sector in the affected Asian countries had relied on short-term foreign capital funding to expand their financing portfolios and the massive exchange rate depreciations during the crisis impeded their ability to repay, causing a systemic financial meltdown in the region.

Chart 3.2.11 Islamic Banks' Foreign Currency Funding to Total Funding by Country (2013 to 1H2017)

Source: PSIFI, IFSB Secretariat Workings

The Afghan Islamic banks have the highest level of engagement in foreign currency financing (1H2017: 61.1%) and deposits (1H2017: 82.2%); however, this is reflective of the country's financial practices. Major commercial transactions in Afghanistan, such as sale of autos or property, are frequently conducted in US Dollars or in the currencies of neighbouring countries; hence, the Afghan banking sector correspondingly maintains deposits in foreign currencies, and extends financing in the same. Afghanistan also does not maintain a dual-exchange-rate policy, currency controls, capital controls, or any other restrictions on the free flow of funds abroad.¹⁷⁷ The Afghan Islamic banking sector maintains a foreign currency FFR ratio of over 73%, which reflects a good utilisation of foreign currency funding to support foreign currency financing transactions.

Among other countries, Egypt (1H2017: financing 27.3% and funding 35.4%) and UAE (1H2017: financing 14.3% and funding 19.7%) have material engagements in foreign currencies on both the financing and funding sides of Islamic banks. Among these, the UAE Dirham is fixed to the US Dollar. However, the Egyptian Pound, which is managed by the government, was allowed to depreciate in November 2016; since then, the US Dollar has appreciated against it by nearly 125%. Nonetheless, the Islamic banks in these countries maintain a good FFR ratio: as of 1H2017, Egypt had a 77.2% foreign currency financing to funding ratio; and the UAE 72.3%.

Meanwhile, Oman (1H2017: financing 6.7% and deposits 12.7%) and Sudan (1H2017: financing 4.3% and deposits 29.9%) have a greater share of foreign currency deposits, while Iran (1H2017: financing 13.9% and deposits 4.8%) has a greater share of foreign currency financing. In the case of Oman, the Islamic banks are new entrants since 2013 and the FFR ratio as of 1H2017 was a comparatively lower 52.3%; however, both foreign currency financing and funding have been gradually increasing over time.

Furthermore, the Omani Rial is also pegged to the US Dollar and this peg, despite recent downward pressures, is expected to sustain in the near future on the back of several US Dollar fund-raising activities by the government, and thus offering some risk management comfort to the banking sector. Sudan, however, has a substantially much lower FFR ratio: 14.3% as of 1H2017. Foreign currency financing in Sudan has consistently been declining during the analysis period, while nearly one-third of all funding is being maintained in foreign currency. This trend appears to be a direct reflection of the deep pressure on the Sudanese Pound, which had lost materially its value to the appreciating US Dollar by February 2018. Careful risk management needs to be undertaken, particularly if foreign funding is being used to finance local currency assets. Depreciation of the local currency risks erosion of profitability on all finances extended using foreign currency funds.

The Iranian banking sector has a much larger FFR ratio, of 292.6% – an unusual position where, as an example, nearly every \$3 of foreign currency financing is supported by only \$1 of foreign currency funds. This gap needs to be filled with local currency funding and, given that the Iranian Rial has been gradually losing its value to the US Dollar during the analysis period, would require substantial liquidity risk management. While such a position in the light of currency depreciation can be a profitable strategy, it will be very risky when foreign currency financing non-performs and would require substantial amounts as provisions and reserves in local currency terms to meet the regulatory requirements. Aside from Iran, Bangladesh (1H2017: financing 5.6% and funding 2%) and Malaysia (1H2017: financing 4.5% and funding 1.9%) have FFR ratios of 275.8% and 236.8%, respectively. However, in contrast to the total financing and total funding portfolios, their foreign currency exposures are much smaller (below the 6% mark).

¹⁷⁷ US Department of Commerce: "Afghanistan Conversion and Transfer Policies", 2 November 2016. Available: <https://www.export.gov/article?id=Afghanistan-conversion-and-transfer-policies>

Among the remaining countries, overall exposures to total financing/funding were below the yardstick limit and/or with appropriate FFR ratios: Brunei (1H2017: financing 9.2% and funding 12.1%) has an FFR ratio of approximately 76%; Jordan (1H2017: financing 5% and funding 9.8%) FFR ratio 50.8%; Indonesia (1H2017: financing 4.7% and funding 5.6%) FFR ratio 83.9%; and Pakistan (1H2017: financing 3.4% and funding 4.7%) FFR ratio 72.3%.

Liquidity

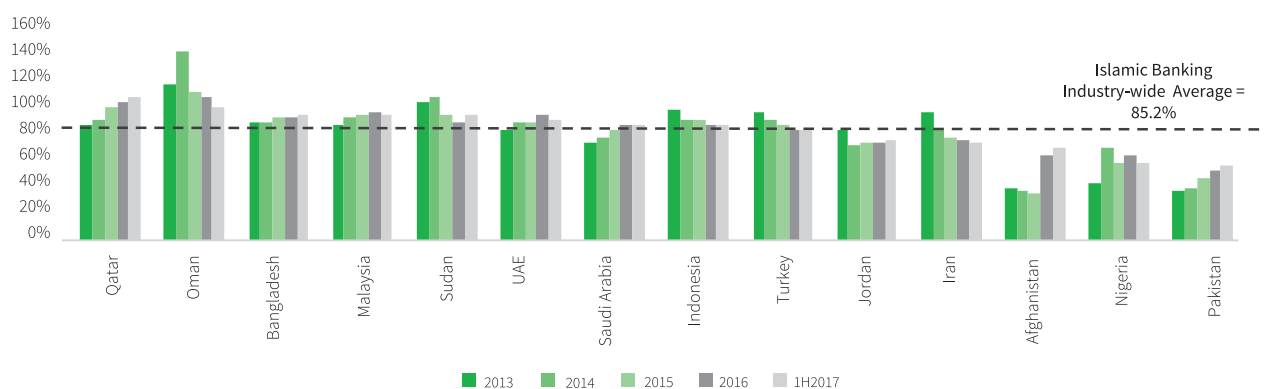
Liquidity management has been a long-standing concern across the various sectors of the global Islamic finance industry. The recently issued multi-country report by the IMF, Ensuring Financial Stability in Countries with Islamic Banking, stressed the need for enhancing liquidity management frameworks for the Islamic banking industry given the shortage of tradable Shari'ah-compliant capital and interbank instruments that are comparable to the ones traded in the conventional markets. In the earlier stages of development, Islamic banks have maintained high levels of liquidity by holding cash and cash-equivalent reserves in the absence of sufficient profit-earning liquidity management instruments and options. Since then, some developments to mitigate liquidity risk were undertaken, mainly in the form of bilateral investment-based (*muḍārabah*) deposit placements by Islamic banks with each other to settle liquidity surplus and deficit conditions. Some jurisdictions also utilised commodity-based mark-up sale (commodity *murābahah*) transactions to manage liquidity requirements. The challenge in both these types of liquidity management

tools is that these placements and deposits are not tradable instruments, thus restricting secondary market liquidity.

Recent regulatory reforms have introduced the liquidity coverage ratio and net stable funding ratio for the liquidity management of the banking sector. The LCR parameter, in particular, requires Islamic banks to hold high-quality liquid assets, with the most attractive form of this HQLA being high-quality tradable *shukūk*. As a consequence to this regulatory development, the IFSB supported the establishment of the International Islamic Liquidity Management Corporation, which issues short-term *shukūk* backed by sovereign assets of its shareholders. IILM *shukūk*, rated A-1 by Standard & Poor's, facilitate Islamic banks to meet the LCR requirements (see Box 3.1).

In the light of these post-crisis regulatory reforms, the traditional financing-to-deposit (FDR) ratio is no longer the best indicator for assessing the liquidity conditions of banks. Instead, LCR and NSFR are more suitable ratios for assessing liquidity health. However, among the various Islamic banking markets, not all have implemented Basel III/IFSB GN-6 guidelines; hence, not all countries report LCR calculations in the IFSB's PSIFI database, and even fewer report NSFR since its effective date of implementation (1 January 2018) was later than that of LCR (whose gradual implementation began on 1 January 2015). As a result, the FDR ratio is still reported and discussed in this stability report.

Chart 3.2.12 Islamic Banking Financing-to-Deposit Ratio by Country (2013 to 1H2017)



Source: PSIFI, IFSB Secretariat Workings

As of 1H2017, a majority of the Islamic banking markets had an FDR¹⁷⁸ ratio of between 75% and 95%.¹⁷⁹ These countries, including Bangladesh (96.3%), Malaysia (96.3%), Sudan (95.9%), UAE (92.3%), Saudi Arabia (88%), Indonesia (87.9%), Turkey (83.7%) and Jordan

(76.5%), had FDR ratios close to the Islamic banking industry's weighted-average FDR of 85.2%. Indonesia has considerably improved its FDR ratio for both conventional and Islamic banks during the analysis period. The country's central bank has recently introduced a new

¹⁷⁸ Deposits for the purposes of FDR calculation include unrestricted profit-sharing investment accounts, remunerative funding (*murābahah*, commodity *murābahah*) and non-remunerative funding (current accounts, *wadī'ah* accounts), and exclude interbank funding.

¹⁷⁹ Arguably, there is no ideal FDR position, and it is subject to regulatory expectations and limits based on prevailing market conditions. However, FDR of 80–90% is considered a comfortable position and many regulators recommend FDR to be below 95–100%.

measure, the macroprudential intermediation ratio,¹⁸⁰ issued in January 2018 with a view to enhancing liquidity in the country's banking system. The Saudi Arabian Islamic banking sector's FDR ratio has also been gradually increasing, partly on account of the decision by the country's central bank to allow an increase in the FDR limit from 85% to 90% in January 2016 that enabled banks to continue to expand credit while limiting competition between banks for deposits.

Another major fluctuation during the analysis period has occurred in Qatar, where the FDR ratio has surged from under 90% to over 110% as of 1H2017. Qatar's banking sector as a whole has experienced significant pressure on its funding profile following the regional diplomatic tensions, and a prolonged dispute could trigger further outflows of foreign deposits and other external funding.¹⁸¹ Qatar has so far been able to manage liquidity pressure on its banking system by way of higher government deposits, as well as funding diversification by banks through sourcing funds from bank branches abroad and foreign financial institutions.¹⁸²

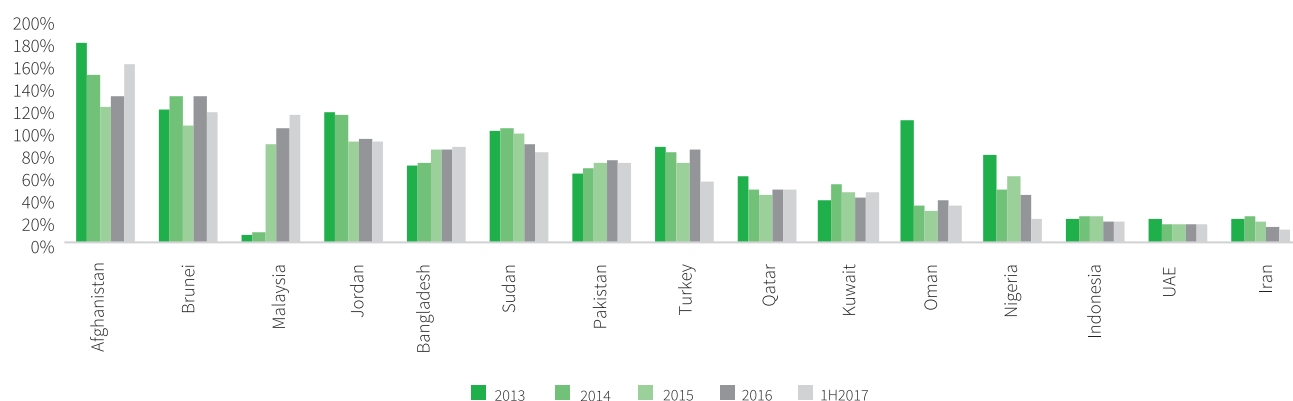
Pakistan, which has traditionally maintained very modest FDR ratios below 50% has also experienced an improvement in its Islamic banking sector FDR to approximately 58% as of 1H2017. This FDR is an exception, rather the norm, and is peculiar to the Pakistani banking sector where banks place a major chunk of their loanable/

financing funds in government-issued bonds and *shukūk*. This enables a relatively safe strategy and assures profits for the banks. The Iranian banking sector has also been improving its FDR ratio (1H2017: 74.6%), due mainly to strategies employed to clean up bad and non-performing financing and limited avenues for credit growth under prevailing economic conditions characterised by high financing rates.

Among the remaining countries, the Sudanese FDR has been improving due mainly to the significant component of foreign currency funding in the balance sheets coupled with the depreciation of the local Sudanese Pound. This trend has the effect of inflating the local currency deposit values, in contrast to financing. Meanwhile, the FDRs of Islamic banks in Oman and Nigeria have been fluctuating over a wider band due to their infancy in the Islamic banking industry and ongoing gradual growth and business development.

Although LCR data are not available for most countries, a proxy employed in this report is the liquid assets to short-term liabilities ratio (LA/SL). The LA/SL ratio measures the amount of assets held by banks that are readily convertible to cash in order to meet obligations payable within a period of 90 days.¹⁸³ Based on available data, it appears that the majority of the countries have experienced worsening in the LA/SL ratio of their Islamic banks during the analysis period.

Chart 3.2.13 Islamic Banking Liquid-Assets to Short-Term Liabilities Ratio (LA/SL) by Country (2013 to 1H2017)



Source: PSIFI, IFSB Secretariat Workings

¹⁸⁰ To encourage bank intermediation function and liquidity management, the Board of Governors of Bank Indonesia in January 2018 decided to refine the macroprudential policy by implementing two regulations. First, it converted the loan-to-funding ratio (LFR) policy for conventional commercial banks and the FDR policy for *Shari'ah* commercial banks and *Shari'ah* business units into a macroprudential intermediation ratio (MIR) within the target range of 80–92% while also broadening credit/financing components that incorporate deposit components by including bank-purchased securities and broadening deposit components by including securities published by *Shari'ah* commercial banks and business units. Second, it converted the secondary minimum reserve requirement for conventional commercial banks into a macroprudential liquidity buffer (MLB) and applied MLB for *Shari'ah* commercial banks at 4% of deposit, allowing 2% of deposit to be used as repo to Bank Indonesia in certain conditions to fulfil banks' liquidity. Both macroprudential instruments have countercyclical qualities that can be adjusted in line with the economic and financial cycle.

¹⁸¹ Moody's estimates that Qatar's foreign deposits and other external funding represents around 36% of total banking system liabilities as of May 2017. See Moody's: "Outlook on Qatar's banking system negative from stable owing to weakening operating conditions", 8 August 2017.

¹⁸² Qatar Central Bank: 8th Financial Stability Review, 2017.

¹⁸³ This ratio is calculated as liquid assets / short-term liabilities. However, there is a possibility that regulatory definitions between countries may vary on what constitutes liquid assets and short-term liabilities. Hence, from that perspective, this ratio may not offer a perfect comparability between jurisdictions.

Key contractions are witnessed in Turkey and Qatar where the ratios have declined nearly 30% and 15%, respectively, to close at 55.4% and 46.9%, respectively, as of 1H2017. The Turkish financial sector has been suffering from domestic political and geopolitical tensions, which have contributed towards a weakening of overall investor confidence that has likely affected the value and tradability of liquid assets in the banking sector.¹⁸⁴ In the case of Qatar, liquidity in the banking sector in general (both Islamic and conventional) has been tightening on account of lower deposit flows. This situation is likely to be exacerbated in the second half of 2017 following the culmination of the regional dispute.¹⁸⁵

Other major contractions were experienced by Omani and Nigerian Islamic banks, but that is mainly due to business expansion of the relatively infant Islamic banks which are gradually converting their cash and cash-equivalent deposits, long-term liabilities and equity funds into financing activities. Nonetheless, the regulators of both countries are active members of the IFSB and are working hard to develop robust liquidity management frameworks for their Islamic banks.

Three countries report LA/SL ratios of over 100% as of 1H2017 – namely, Afghanistan (160.5%), Brunei (115.5%) and Malaysia (114.7%). Brunei, although currently not in process to implement Basel III guidelines, is characterised by a highly liquid banking sector. However, this high level of liquidity held by the banks in Brunei is at the cost of low levels of credit in the economy; as a result, credit growth is the priority of the central bank.¹⁸⁶ Meanwhile, the Malaysian banks and Islamic banks have already begun implementation of LCR to comply with the regulatory requirements; as a result, the enhanced Islamic banks' liquidity reflects the country's successful adoption of the LCR as well as ongoing efforts to implement the NSFR, expected in 2019.¹⁸⁷

Bangladesh and Pakistan have also begun the implementation of LCR, and hence, the LA/SL ratio has improved in both countries. For instance, the State Bank of Pakistan requires all banks to maintain an LCR of 90% by 31 December 2017. Similarly, Bangladesh Bank requires banks to maintain an LCR of 100% or more, effective from January 2015. As of 1H2017, the LA/SL ratio for Islamic banks in Pakistan increased to 70.3%, while that in Bangladesh increased to 84.3%. Improvements were also witnessed in Kuwait, where the LA/SL ratio increased to 43.7% as of 1H2017. The LA/SL ratio declined in Jordan during the sample period, but still represented a high 90.8% as of 1H2017.

The lowest levels, however, were witnessed in Indonesia (17.4%), the UAE (17.2%) and Iran (11.2%). The specific case of Indonesia represents a structural issue concerning the type of banks being assessed (e.g. commercial banks, rural banks, development finance institutions, etc.). For instance, it is estimated that Indonesia's banking sector overall is liquid, with government securities and other liquid assets comprising 27% of banking system assets at end-March 2017. While this liquidity ratio for the overall banking sector is low, Indonesia's rated banks appear to be comfortably meeting minimum LCR requirements.¹⁸⁸ In the case of the UAE, the central bank allows two types of liquidity ratios – either the LCR, with gradual implementation starting January 2016, or the eligible liquid assets ratio (ELAR), starting 1 July 2015. The initial compliance level for this ELAR is set at 10%, with periodic reviews by the central bank to ensure consistency between banks in the application of liquidity requirements in the UAE. Hence, from the perspective of the ELAR, the LA/SL ratio at 17.2% is plausible. The ELAR is understood to be seen as the first step in what will be a gradual transition to the full implementation of Basel III's liquidity standards.

Overall, most countries' regulators are actively implementing the latest international standards for liquidity risk management. The Islamic banking industry is no different, and the regulators are actively pursuing reforms and development on a number of fronts, including developing liquidity management infrastructure and instruments that will enable Islamic banks to comply with liquidity requirements. While some Islamic banking countries are experiencing an unfavourable environment, with deterioration in liquidity buffers in recent times, most countries still maintain a comfortable FDR ratio as well as a somewhat adequate LA/SL ratio. With the full implementation date of the LCR nearing (starting 1 January 2019), it is expected that reporting of LCR to the PSIFs database will expand, enabling future stability reports to analyse LCR conditions of Islamic banks in sample countries.

Summary and Challenges

In summary, the global Islamic banking industry has sustained its resilience moving into 2018 with most of its financial indicators, as of 1H2017, observed to be in comfortable compliance with minimum international regulatory requirements. However, in contrast to earlier trends, some of its financial indicators are no longer the most sound among the global banking sector. Analysis indicates that some of the top global conventional banks have successfully turned around since the financial crisis to substantially improve their capitalisation and

¹⁸⁴ Moody's: "Moody's maintains negative outlook on the Turkish banking system amid challenging operating conditions", 3 May 2017.

¹⁸⁵ Moody's: "Outlook on Qatar's banking system negative from stable owing to weakening operating conditions", 8 August 2017.

¹⁸⁶ SEACEN: "Basel III Implementation – Challenges and Opportunities in Brunei Darussalam". Available: <https://www.seacen.org/file/file/2014/RP92/BASEL%20-%20chapter%202.pdf>

¹⁸⁷ Bank Negara Malaysia: Net Stable Funding Ratio – Exposure Draft, 27 September 2017.

¹⁸⁸ Moody's: "Outlook for Indonesian banking system to positive from stable", 13 June 2017.

asset quality beyond the current weighted-average levels witnessed in the global Islamic banking industry. This improvement is partly reflective of the successful implementation of the post-crisis regulatory reforms by these top banks which most likely fall under the G-SIBs categorisation and are required to comply with more stringent prudential requirements by the national regulators.

In 2018, a number of international developments will affect the global banking sector in general, with direct implications for the Islamic banking industry. Recent forecasts for 2018–19 by major international organisations have indicated an upbeat momentum in global economic recovery which is expected to contribute towards improved solvency conditions in the financial sector. The positive performance in the global equity and debt markets in 2017 has also likely contributed towards improved collateral prices. However, any unexpected downturn or shocks to the global economy can heighten default risks and, hence, banks are expected to exercise caution and to be prepared to conduct adequate solvency stress testing.

The profitability of the banking sector is also likely to be affected depending upon the pace of the rates normalisation in global markets; a benchmark rates increase stands to benefit banks with a positive gap between rate-sensitive assets and liabilities. However, the risk management function also needs to be cognisant of an impact from rates increases on performing financing, since higher rates would also potentially lead to a rise in non-performing financing and possibly to financial asset impairments. The Islamic banking industry is particularly susceptible to such downside risks considering that the household and personal financing segment is its most important exposure.

Amid concerns of currency and trade wars¹⁸⁹ in 2018, Islamic banks with material exposures to foreign currency financing and funding activities need to exercise caution. Although most Islamic banking domiciles were found to be maintaining narrow gaps between their financing–funding exposures, a few jurisdictions had wide gaps between the two which can expose their Islamic banks to severe vulnerabilities from unfavourable movements in exchange rates.

On a related note, although oil prices have recovered somewhat and maintained prices above USD 60 a barrel in the first quarter of 2018, the key oil-producing and energy-exporting economies are still expected to post

budget deficits, which will likely constrain the overall financial system's liquidity in these economies. Other things remaining equal, the various indicators discussed above will affect the capitalisation of the Islamic banking industry.

Among other challenges, the traditional banks are facing increased competition following the entry of new digital-based service providers in the financial marketplace. These include completely new platforms comprising Fintechs and digital banks, as well as some of the existing financial institutions that have introduced digital services in their operations. While the extent of this “disruption” from Fintech to traditional banks is not homogenous among different jurisdictions, recent reports have begun to highlight that the risk of customer leakages to Fintech from traditional banks is growing in line with rapidly changing customer expectations.¹⁹⁰

The rapid introduction of digital platforms in banks itself leads to newer risks – for instance, cyber risk – and the global standard-setting bodies are increasingly focusing on effective regulation and supervision of Fintech activities.¹⁹¹ The global post-crisis regulatory reforms are in their implementation phase, but further regulatory developments should be expected, particularly from a Fintech perspective. There are also some additional regulatory scrutiny pressures, particularly from an AML/CFT and tax evasion perspective, as recent incidents such as the Panama leaks have increased focus on offshore banking and shadow banking activities. The banking sector is likely to face increased compliance costs in the near future as regulatory developments introduce new requirements for managing such activities and their risks. Overall, the traditional banking sector, including Islamic banks, will have the challenge of customer retention that is expected to be at least somewhat disrupted by the alternative digital-based offerings. Many traditional banks have already begun investing in their own digital platforms and this, at least in the medium term, is likely to increase their investment and operational expenditure. However, the new and improved use of technology also offers an opportunity for banks to lower their costs and improve operational efficiency.

3.3 ISLAMIC CAPITAL MARKET: ASSESSMENT OF RESILIENCE

3.3.1 *Ṣukūk* Market

The global *ṣukūk* market has rebounded considerably in 2017, with primary market issuances increasing

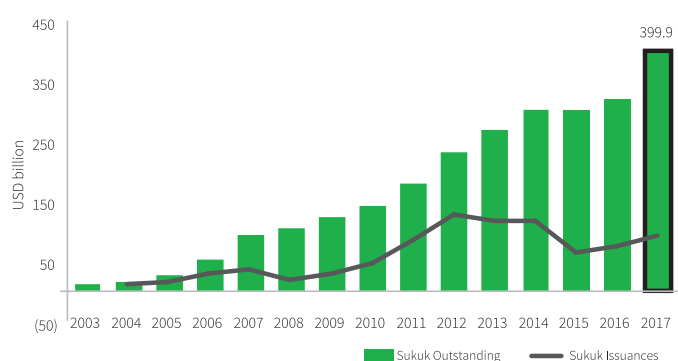
¹⁸⁹ For example, see Reuters: “Oil prices fall as Trump adviser's exit stokes trade war fears”, 7 March 2018.

¹⁹⁰ For instance, EY's FinTech Adoption Index 2017 notes that the adoption of Fintech as providers of money transfer and payment services rose from 18% in 2015 to 50% in 2017. Such disruption was not restricted to emerging markets that lack traditional banking infrastructure; banks in developed markets are equally at risk.

¹⁹¹ See related discussion on Fintech initiatives by standard-setting bodies in Chapter 2.

by nearly 23% on the back of strong sovereign and multilateral issuances in key Islamic finance markets.¹⁹² Correspondingly, and amid partial benefits from improved exchange rates in some emerging markets, the global *shukūk* outstanding has also surged by over 25% – its strongest increase¹⁹³ since 2012 – to close in at a record USD 400 billion as of end-2017 (see Chart 3.3.1.1). This increase is duly supported by an expansion in the *shukūk* tranches outstanding which number 2,645 across 27 jurisdictions as at end-2017 [2016: 2,569 *shukūk* tranches across 28 jurisdictions¹⁹⁵].

Chart 3.3.1.1
Global *Shukūk* Outstanding Trend (2017)



Source: IFSB Secretariat Workings

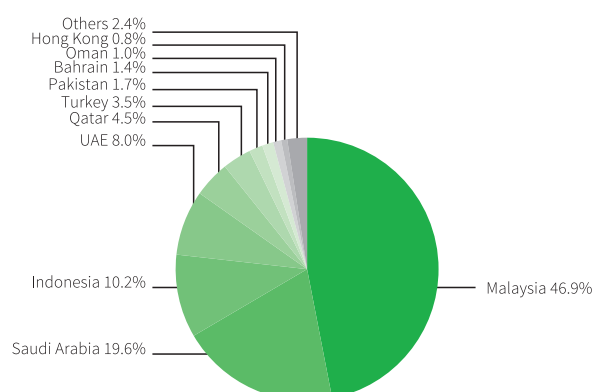
Malaysia has once again sustained its historical position as the jurisdiction with the largest volume of *shukūk* outstanding (see Chart 3.3.2), accounting in 2017 for a slightly improved 46.9% share of the total market [2016: 46.4%]. Notably, gradual appreciation in the country's exchange rate with the US Dollar has enabled it to improve on outstanding values in US Dollar terms. However, key improvements in the share of total *shukūk* outstanding were witnessed in Saudi Arabia and Indonesia.

The debut of Saudi Arabia in the sovereign *shukūk* market has pushed its *shukūk* outstanding share upwards to 19.6% [2016: 17.4%] with over USD 30 billion of primary issuances added into this volume in 2017. Since 2009, the active Indonesian sovereign and public-sector *shukūk* issuances with expanding volumes of funds raised have also enabled the jurisdiction to expand and position itself as the third-largest *shukūk* outstanding market, with a 10.2% market share in 2017 [2016: 7.8%]. The market share improvements in Malaysia, Saudi Arabia and Indonesia have, in turn, reduced the share of others in 2017, with the UAE at 8% [2016: 10.5%] and Qatar at 4.5% [2016: 5.9%]. Overall, the top five jurisdictions now account for a further increased 89.3% [2016: 88%] of the global *shukūk* outstanding, while the remaining

10.7%, or USD43 billion, is dispersed between 22 other jurisdictions.

Consistent with earlier years, Hong Kong is the only non-OIC member state that features in the top 10 global *shukūk* outstanding jurisdictions on the back of its three USD 1 billion each sovereign *shukūk* issuances in 2014, 2015 and 2017. Altogether, there are now seven non-OIC member states with *shukūk* outstanding, including three from the European Union (Germany, Luxembourg and the United Kingdom); two in Asia (Singapore and Hong Kong); and one each in Africa (South Africa) and North America (the United States). Collectively, the seven non-OIC jurisdictions account for 1.5% of the global *shukūk* outstanding as at end-2017. The demand for new *shukūk* issued in the primary market, as measured by times oversubscription, has remained moderate. Most international *shukūk* issued in 2017 were oversubscribed (see Table 3.3.1.1); however, the levels were well below those seen in 2015 and earlier years. The Additional Tier 1 regulatory capital *shukūk* were the most oversubscribed in 2017 (e.g. Kuwait's Warba Bank Tier 1 *shukūk* [USD 250 million] was oversubscribed by 5.2 times, and Bahrain's Al-Baraka Banking Group Tier 1 *shukūk* [USD 400 million] was oversubscribed by 4 times); this contrasts with the more than 13 times oversubscription recorded for Dubai Investments Park *shukūk* (USD 300 million) in 2014 and 7.2 times oversubscription for Sharjah Islamic Bank *shukūk* (USD 500 million) in 2015. However, in terms of the volume of order book generated, the combined USD 9 billion 5-year and 10-year Saudi sovereign *shukūk* tranches generated an order book of over USD 33 billion (3.67 times oversubscription), the largest in *shukūk* market history.

Chart 3.3.1.2
Top 10 Global *Shukūk* Outstanding Jurisdictions* (2017)



*Based on domicile of the *shukūk* obligor. Source: IFSB Secretariat Workings

¹⁹² See Chapter 1's subsection on *shukūk* market developments for a detailed coverage of the factors leading to this structural shift.

¹⁹³ In percentage terms, based on US Dollar *shukūk* outstanding value as at the end of each respective year.

¹⁹⁴ Based on domicile of the *shukūk* obligor.

¹⁹⁵ Based on domicile of the *shukūk* obligor.

¹⁹⁶ One new country – Bangladesh – is added in the 2017 data, while Kazakhstan and France are no longer in the list following maturity of their respective *shukūk* outstanding at different stages during the year 2017.

Table 3.3.1.1 Demand Comparison for Selected* *Shukūk* Issued in 2017

<i>Shukūk</i> Name** (USD million)	Issue Size	Issuer Type	Tenure (Years)	Rating	Oversubscription (Times)
Warba Bank Tier 1 (Kuwait)	250	Corporate	Perp	Baa2 (Moody's)	5.20
Al-Baraka Banking Group Tier 1 (Bahrain)	400	Corporate	Perp	BB+ (S&P)	4.00
Saudi Sovereign <i>shukūk</i> 4/22 & 4/27	9,000	Sovereign	5 & 10	A+ (Fitch)	3.67
Indonesia Sovereign <i>shukūk</i> 3/22 & 3/27	3,000	Sovereign	5 & 10	Baa3 (Moody's)	3.61
Oman Sovereign <i>shukūk</i> 6/24	2,000	Sovereign	7	Baa1 (Moody's)	3.45
QIB <i>shukūk</i> 5/22 (Qatar)	750	Corporate	5	A- (S&P)	2.93
Emirates REIT <i>shukūk</i> 12/22	400	Corporate	10	BB+ (Fitch)	2.75
DIB <i>shukūk</i> 2/22 (UAE)	1,000	Corporate	5	Baa1 (Moody's)	2.20
Dar Al Arkan 4/22 (Saudi Arabia)	500	Corporate	5	B1 (Moody's)	2.10
Hong Kong Sovereign <i>shukūk</i> 2/27	1,000	Sovereign	10	AAA (S&P)	1.72

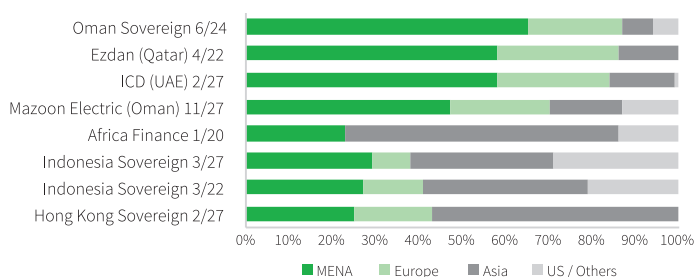
Perp = perpetual.

**Shukūk* were selected to ensure some diversity by types, ratings, issuance size and jurisdictions (of obligors).

**Numbers in "*Shukūk* Name" indicate maturity date mm/yy.

Source: Various references, IFSB

The "regional bias" in investors' allocations, as observed in the geographical distribution of international *shukūk* subscriptions in 2017, has also continued since the preceding year (see Chart 3.3.3). *Shukūk* issued in the Middle East region were mainly subscribed and allocated to investors within the region; while Asian investors were the main buyers of *shukūk* issued out of Asia. This is in contrast to 2015 and earlier when the Middle East was an important source for *shukūk* subscriptions (e.g. 40% and above) generally across the board and without any evident region-specific bias. In 2017, the MENA subscriptions were generally below 30% in non-regional issuances. Investors from the US and other parts of the world were mainly active in the uptake of high-yield emerging market *shukūk* (both sovereign and corporate), attracted by the better dollar returns on these instruments. Europe has also become a prominent source of *shukūk* subscriptions, partly due to the presence of several Islamic funds which are domiciled in the region. The multilateral Africa Finance Corporation *shukūk* was mainly bought by Asian investors (63%), followed by investors from the Middle East (23%). The involvement of African accounts in this multilateral *shukūk* was only about 13%.

Chart 3.3.1.3
Geographical Distribution of Selected *Shukūk* Papers Issued in 2017

MENA = Middle East and North Africa; US = United States.

*Numbers in "*Shukūk* Name" indicate maturity date mm/yy.

Source: Various references, IFSB

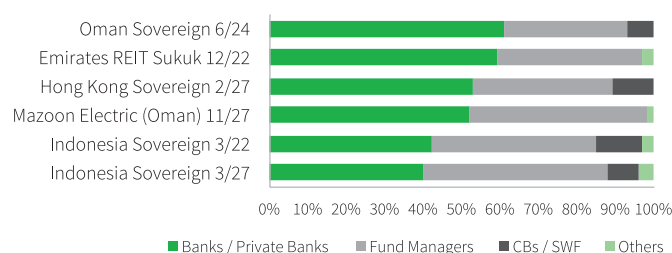
In terms of distribution of new *shukūk* issued by investor types, based on readily available information (see Chart 3.3.1.4), banks/private banks¹⁹⁶ and fund managers were the key buyers – with the former actively holding *shukūk* for regulatory capital and liquidity management purposes as well as for returns generation; while the fund managers investing in *shukūk* to support their Shari'ah-compliant funds offered, as well as to diversify their investments for their general funds. Combined, these two types of investors accounted for 85% or more of the *shukūk* subscriptions based on the sample analysed.

¹⁹⁶ Comprising commercial banks, investment banks and private banks.

Meanwhile, central banks and sovereign wealth funds, in line with their organisational mandates and risk appetites, only bought sovereign *shukūk* and were absent from subscriptions in the corporate issuances.

Chart 3.3.1.4

Investors' Breakdown of Selected *Shukūk* Papers Issued in 2017



CBs / SWF = Central Banks / Sovereign Wealth Funds; Others = Pension Funds, Takāful/Insurance Funds, etc.
Source: Various references, IFSB

Shukūk defaults have also occurred in 2017 with three tranches by two issuers failing to make scheduled payments to investors. In the UAE, a gas-producing obligor has defaulted on its two outstanding *shukūk* instruments, although allegedly not due to solvency issues but rather as a declaration by the obligor itself that its two outstanding *shukūk* were “no longer considered Shari’ah-compliant” under the country’s prevailing law. Meanwhile, a marine services provider in Malaysia has defaulted on its scheduled *shukūk* principal repayment to investors and the obligor has engaged in negotiations to restructure the repayment terms and conditions of all its existing loans/financing facilities and *shukūk* programme. Overall, the defaults have not seriously shifted the resilience of the industry; since the recorded inception of the global *shukūk* market, out of almost USD 1.3 trillion raised by *shukūk*, only USD 2.9 billion, or 0.22%, of the total issuances volume has defaulted as at end-2017 (see Table 3.3.1.2). In terms of the number of *shukūk* tranches issued to date, 13,261, 1 in every 100 has defaulted. However, a particular risk is the “reputation implications” that followed the action by the obligor in the UAE to declare its own *shukūk* as Shari’ah non-compliant, despite its having been approved by a reputable Shari’ah board.

Table 3.3.1.2

Defaulted and Restructured *Shukūk* (1990 to 2017)

	No. of <i>Shukūk</i> Tranches	No. of Issuers	Total Volume (USD billion)
Total issued	13,261	698	1,291.12
Total defaulted or restructured	134	29	2.88

Source: Bloomberg, IFSB

On a favourable note, the traditional practice of premium pricing of new *shukūk*¹⁹⁷ in contrast to conventional bonds (which are comparable from a financial risk perspective), while still prevalent, has seen a squeeze in the spread between the two in 2017. Based on an analysis of a sample of domestically issued sovereign *shukūk* and bonds across jurisdictions in diverse regions (see Table 3.3.1.3), the pricing spread between the financial risk-identical *shukūk* and bonds has seen a reduction, with most countries having a spread of 0.1 percentage points or less. Within this, Qatar’s *shukūk* and bond instruments have been consistently priced identically across various different tenors, while in the case of Pakistan, due to excess demand by Islamic financial institutions, *shukūk* have been priced at lower rates of return compared to bonds.

Table 3.3.1.3

Pricing of Selected Sovereign *Shukūk* and Bonds Issued in 2017 (Domestic Market)

Jurisdiction and Instrument Maturity*	<i>Shukūk</i> Profit Rate (%) [a]	Bond Coupon Rate (%) [b]	Spread (%) [a] – [b]
Pakistan (<i>Shukūk</i> 3/19 and Bond 4/19)	5.60	7.00	–1.40
Qatar (<i>Shukūk</i> 4/24 and Bond 4/24)	4.00	4.00	0
Turkey (<i>Shukūk</i> 8/22 and Bond 8/22)	10.76	10.70	0.06
Malaysia (<i>Shukūk</i> 4/22 and Bond 3/22)	3.95	3.88	0.07
Jordan (<i>Shukūk</i> 3/22 and Bond 3/22)	4.10	4.00	0.10
Indonesia (<i>Shukūk</i> 7/47 and Bond 5/48)	8.00	7.40	0.60

* Maturity of the sample underlying *shukūk* and bond instruments indicated by mm/yy. The sample instruments were selected to ensure both had identical tenors; however, each may be issued on different dates within the year. Percentages in red (green) indicate higher (lower) of the two, while those in black indicate equality.
Source: Bloomberg, IFSB

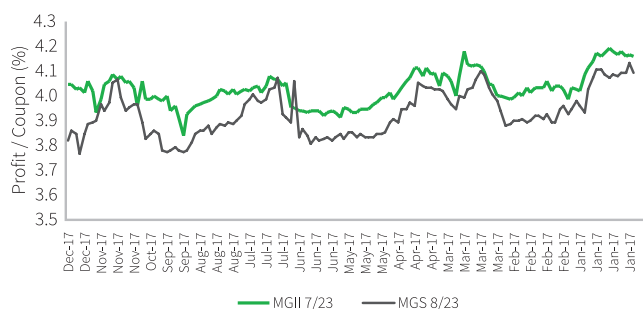
However, in a somewhat adverse movement, the analysis of secondary market yields in 2017 indicates that investors expected higher returns on *shukūk* in contrast to financial risk-identical bond instruments. This trend, while prevailing historically, was understood to have evolved in 2016 when there was no consistent pattern in secondary market yields to indicate that *shukūk* investors demanded higher yields than identical bonds.¹⁹⁸ However, taking a sample of identical domestically issued *shukūk* and bonds outstanding in four jurisdictions (see Charts 3.3.1.5(a), 3.3.1.5(b), 3.3.1.5(c) and 3.3.1.5(d)),

¹⁹⁷ *Shukūk* have generally been priced at higher rates of return to investors. This is despite both *shukūk* and bond instruments of identical tenor being issued by the same issuer in local currency and for the domestic market. The traditional understanding of such premiums on *shukūk* is basically to compensate investors for the comparative lack of familiarity and liquidity of *shukūk* vis-à-vis bonds.

¹⁹⁸ See analysis and discussion in IFSB IFSI Stability Report 2017.

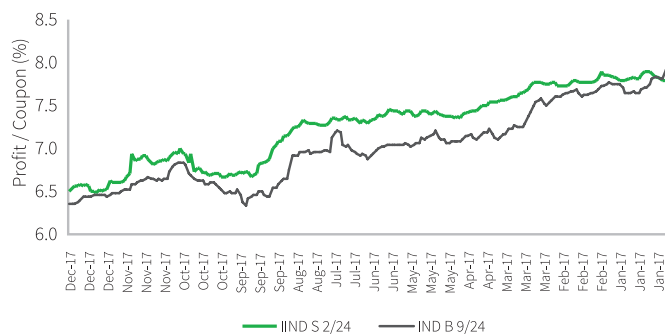
the trend is clear that *shukūk* have been traded at higher yields, including in Pakistan and Qatar where at least the primary issuance pricing has achieved parity or is lower than conventional bonds.

Chart 3.3.1.5(a)
Shukūk and Bond Yields Comparison in the Malaysian Secondary Market (2017)



*Numbers in name indicate maturity date mm/yy.
MGII = Malaysian Government Investment Issue *shukūk*; MGS = Malaysian Government Security Bond.
Source: Bloomberg, IFSB

Chart 3.3.1.5(b)
Shukūk and Bond Yields Comparison in the Indonesian Secondary Market (2017)

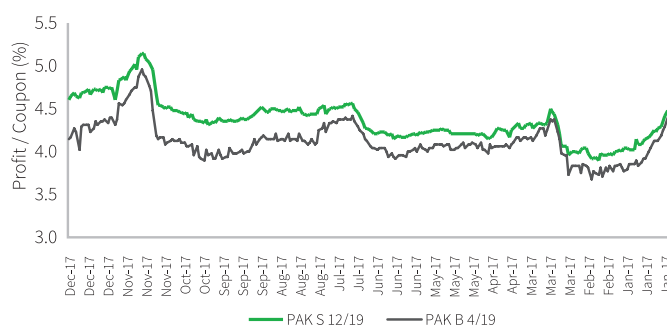


*Numbers in name indicate maturity date mm/yy.
S = *Shukūk*; B = Bond.
Source: Bloomberg, IFSB

Finally, in terms of Shari'ah contracts of new *shukūk* issuances, hybrid structures combining various contracts (e.g. *wakālah-murābahah*, *murābahah-muḍārabah*, etc.) were the most prominent, accounting for 30.3% of all issuances in 2017, propelled particularly by the large volume of Saudi S=sovereign *shukūk* issuances which were structured as *muḍārabah-murābahah* (51%–49%) hybrids (see chart 3.3.1.6). *Murābahah* contracts were the second most prominent, accounting for 27.7% of all issuances by volume, although notably all *murābahah shukūk* were issued in a single jurisdiction, Malaysia.¹⁹⁹ The only exception was the multilateral Africa Finance

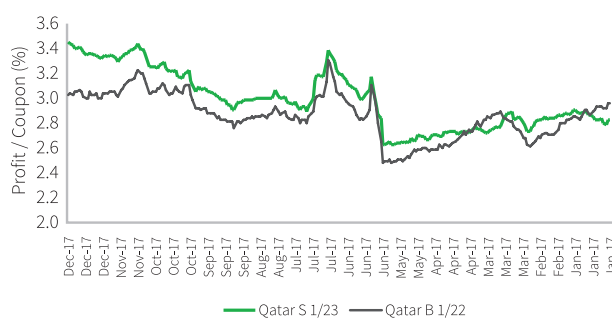
Corporation *shukūk*, which was issued as a privately placed 100% *Murābahah shukūk*. The contracts of *ijārah* and *wakālah*, which in the preceding year were the most prominent, accounted for a lower percentage – 38.2% – of the total issuance volume in 2017. Meanwhile, *mushārah* (2.5%) and *muḍārabah* (1.2%) contracts were used mainly by financial institutions to issue regulatory-compliant *shukūk*,²⁰⁰ as well as by some corporates in Malaysia. *Salām* contracts were used entirely to facilitate short-term liquidity management *shukūk* instruments for Islamic financial institutions.

Chart 3.3.1.5(c)
Shukūk and Bond Yields Comparison in the Pakistani Secondary Market (2017)



*Numbers in name indicate maturity date mm/yy.
S = *Shukūk*; B = Bond.
Source: Bloomberg, IFSB

Chart 3.3.1.5(d)
Shukūk and Bond Yields Comparison in the Qatari Secondary Market (2017)

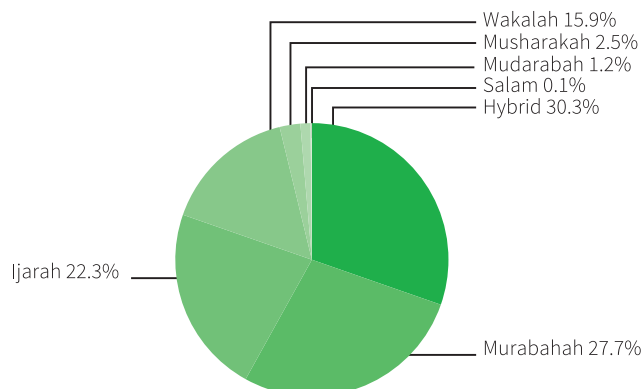


*Numbers in name indicate maturity date mm/yy.
S = *Shukūk*; B = Bond.
Source: Bloomberg, IFSB

¹⁹⁹ The *murābahah* contract is popular among issuers in Malaysia, whereas hybrids, *wakālah* and *ijārah* are popular among the rest of the world issuers. The difference in preference draws upon the respective Shari'ah interpretations in these markets; for instance, the *murābahah shukūk* is generally not perceived to be permissible to be traded at values other than par by the Shari'ah scholars in the GCC, whereas in Malaysia the Shari'ah Advisory Council of Bank Negara Malaysia permits *shukūk* structured on 100% receivables to be traded at values other than par.

²⁰⁰ IFSB-15 outlines details on regulatory-compliant banking *shukūk* and the appropriate regulatory and Shari'ah parameters.

Chart 3.3.1.6
Global New *Shukūk* Issuances by Structure (2017)



Source: IFSB Secretariat Workings

Summary and Challenges

In summary, the *shukūk* market is gradually revitalising its potential, particularly as an economically viable financial instrument to support developmental expenditure. In 2017, sovereign *shukūk* issuances by both existing and new issuers are once again pushing annual issuances activity to close to the USD 100 billion mark, with the momentum coming from the Gulf region where sovereigns have now embraced *shukūk* as a way to meet their fiscal deficit and other budgetary needs. The *shukūk* market has also, so far, proven to be resilient to various geopolitical risk events in 2017.

From a pricing perspective, a welcome development in 2017 has been the apparent squeezing of premiums payable between financial risk-identical *shukūk* and bond instruments at the point of issuance. Across a sample of six domestic sovereign *shukūk* issuers, the spread between *shukūk* and bonds has been reduced to 0.1 percentage points or less – within these, at least one jurisdiction is now pricing *shukūk* and bonds equally, while another was in fact pricing *shukūk* at a discount compared to identical bonds. However, a disappointing and rather contradictory development is in the secondary markets where, across the various sample jurisdictions, investors were trading *shukūk* at higher returns than risk-identical bond instruments.

Another adverse development is in the default of three *shukūk* tranches by two issuers in 2017 – only the second year when defaults have occurred since a relatively default-free record of the *shukūk* market starting in 2010. While defaults are unavoidable in capital markets, a particularly concerning situation is in the case of one obligor that has unilaterally declared its own *shukūk* as Shari'ah non-compliant and defaulted on its scheduled payments on this basis. This unilateral action has the possibility of setting up a very adverse precedent which

could have severe “reputation implications” for the *shukūk* market.

The demand for new *shukūk* issued in the primary market has remained resolute, and oversubscriptions were witnessed in the order books in 2017; however, the easing of exuberance as measured by times oversubscription has continued from the preceding year. The demand factor is likely to be tested further in 2018 as global liquidity is expected to be tightened. The progress towards normalisation of interest rates has already gathered steam as, aside from the US Federal Reserve's rates increases in 2017, the Bank of England raised its policy rate for the first time since 2008, while the European Central Bank also indicated that it will taper its net asset purchases in 2018. A number of central banks globally, particularly those with exchange rates pegged to the US dollar, mirror such rate increases. The implications of such rate increases will also be felt on the supply side of the *shukūk* market, as they result in higher funding costs for issuers.

Overall, the *shukūk* market momentum in recent years has largely been in the sovereign and multilateral *shukūk* market. The involvement of corporates is still subdued; the volume of funds raised by corporates in 2017 was half of what was raised in 2012 and 2013. This may well be an indication that *shukūk* issuances are more suited for larger issuers that can absorb the additional costs and time associated with *shukūk* issuances in contrast to conventional bonds.²⁰¹ In recent times, innovation has taken place to push forward the retail *shukūk* and green *shukūk* agenda, enabling investors to participate in larger government-led infrastructural and green projects. While the uptake has been limited to a few countries (e.g. Malaysia and Indonesia), it does necessitate implementation of sound non-prudential regulations to ensure consumer protection.²⁰²

3.3.2 Islamic Equity and Funds Market

The global equity markets (and, consequently, the funds market) had a positive year in 2017, carrying forward the momentum built up in late 2016 following the outcome of the November US elections as well as the potential for the recovery of oil prices on the back of a supply-cut deal in December between OPEC and major non-OPEC countries.²⁰³ The positive sentiments were further reinforced throughout 2017 on the back of improving global economic fundamentals and many markets benefiting from rising commodities and energy-export prices. While geopolitical risks persisted in some regions in 2017, the global financial markets have so far proven to be largely resilient to them.²⁰⁴ Towards the end of the year, the enactment of the US tax reform has further boosted financial markets momentum; an

²⁰¹ See detailed discussion regarding the challenges associated with corporate *shukūk* issuances in the IFSB's IFSI Stability Report 2017.

²⁰² IFSB-19: Guiding Principles on Disclosure Requirements for Islamic Capital Market Products discusses retail investors and their protection under various guiding principles.

²⁰³ Detailed coverage of the Islamic equity and funds market for year 2016 is available in IFSI Stability Report 2017.

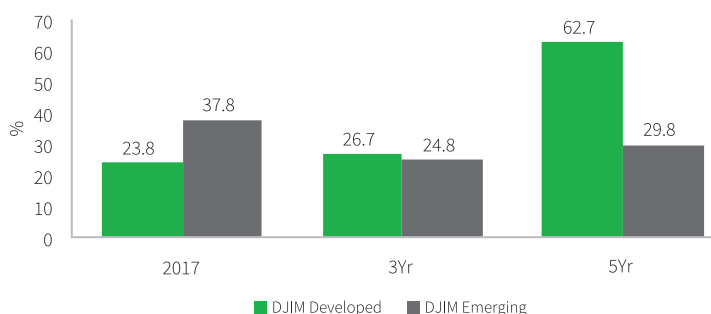
²⁰⁴ The impact, however, was on regional markets where geopolitical conditions existed, and this is discussed in the analysis below related to Chart 3.3.2.2.

increased aggregate expenditure in the US following the fiscal stimulus is beneficial for the global economy, with an immediate upside potential to be experienced by the United States' trading partners.

The global Shari'ah-compliant equity and funds markets have also continued their positive trends since the second half of 2016. The DJIM Emerging Markets Index and DJIM Developed Markets Index returned 37.8% and 23.8%, respectively, in 2017 (see Chart 3.3.2.1), far outperforming the preceding year's returns [2016: 4.5% and 3.8%, respectively; 2015: -13.3% and -0.7%, respectively]. The emerging markets had an exceptional rally in 2017, driven by generally strong economic fundamentals characterised by low inflation, steady growth, and improving profitability and currency valuations. The equity markets in 2017 also shrugged off Venezuela's expected default on its international obligations, which contrasts with the panic sell-off that occurred during the previous crisis events in emerging markets (e.g. the Asian Financial Crisis in 1997).

On a three-year and five-year basis, the emerging market Islamic equity returns have still not overtaken those generated by the developed markets;²⁰⁵ however, the gap is gradually narrowing.

Chart 3.3.2.1
Price Returns of DJIM Developed Markets and DJIM Emerging Markets Indices (2017)

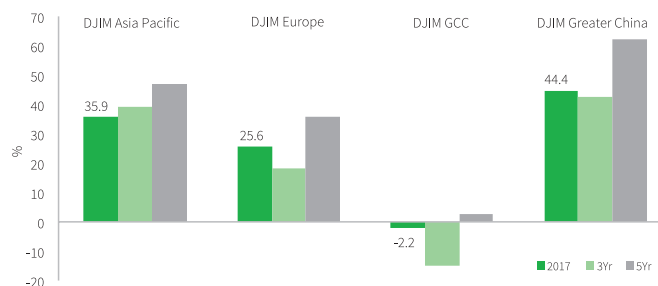


Source: Bloomberg, IFSB

The developed markets have continued to rise on the strong momentum in the US markets, while Europe as a region has also returned to profitability after several years of subdued returns. This is further confirmed by an analysis of the regional equity indices (see Chart 3.3.2.2). The DJIM Europe index generated a 25.6% return in 2017, in contrast to its -3.5% return in 2016 and -1.5% return in 2015. However, the GCC region has reverted back into the negative zone as the DJIM GCC index returned -2.2% in 2017 (2016: 6.2%; 2015: -18.3%), pulled down mainly by equities in Saudi Arabia and Qatar where foreign investors have generally been net sellers. Meanwhile, the DJIM Asia-Pacific (35.9%) and Greater China (44.4%) posted exceptional returns on the back of the emerging markets rally in 2017 [2016: 2% and 3.8%, respectively].

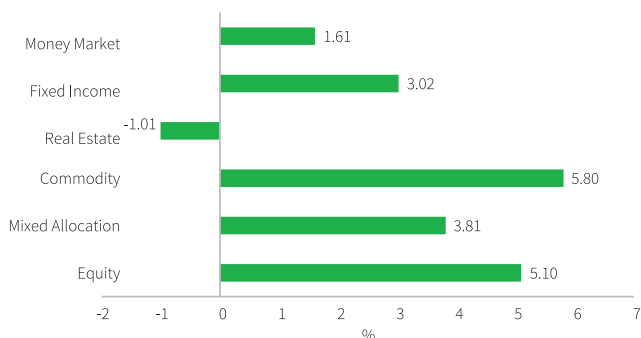
The positive returns generated by the equity markets, in turn, led to a second consecutive year of strong performance by the Islamic funds; in 2017, all types of Islamic fund asset classes generated positive returns with the exception of real estate (see Chart 3.3.2.3). In contrast, nearly all types of Islamic fund asset classes (except money market and fixed-income) generated negative returns in 2015 (see Chart 3.3.2.4).

Chart 3.3.2.2
Price Returns of DJIM Equity Indices by Region (2017)



Source: Bloomberg, IFSB

Chart 3.3.2.3
Returns of Islamic Funds* by Asset Type (2017)**



*Funds that are marketed and offered generally with their data publicly available, and excluding private equity funds.

**There may be some similarities, or even possibly overlaps, between the asset classes to the extent that a fund is qualified to be listed in more than one category (e.g. funds that invest in actual commodities vis-à-vis funds that invest in equities of the commodities sector). For the purposes of this report, the funds are categorised by asset class based on classifications as provided by Bloomberg.

Source: Bloomberg, IFSB

The commodities asset class (which includes the oil and gas sector as well as funds invested in commodities trading) was the best performer for a second consecutive year, yielding 5.8% in 2017 on the back of improving global prices [2016: 12.7%; 2015: -8.5%]. The equities funds and mixed allocations funds were the next best performers, yielding 5.1% and 3.8%, respectively, in 2017 [2016: 5.1% and 4.6%, respectively]. The mixed allocation returns were down slightly in 2017 on account of lower returns posted by money market and fixed-income funds [2017: 1.6% and 3% vs 2016: 2.2% and 4%] on account of funds diversion towards the rallying equities and commodities markets. Meanwhile, the real estate asset class, the once

²⁰⁵ Since mid-2013, the emerging market returns have lagged behind the developed markets, reeling from the heightened funds outflows and currency depreciation challenges on account of tapering and curtailment of its post-financial crisis quantitative easing programme by the US Federal Reserve.

key performing asset class in the Islamic funds industry (see Chart 3.3.2.4), has remained a poor performer for a third consecutive year with -1% return in 2017 [2016: 0.1%; 2015: -0.5%].

Chart 3.3.2.4
Historical Returns of Islamic Funds by Asset Type

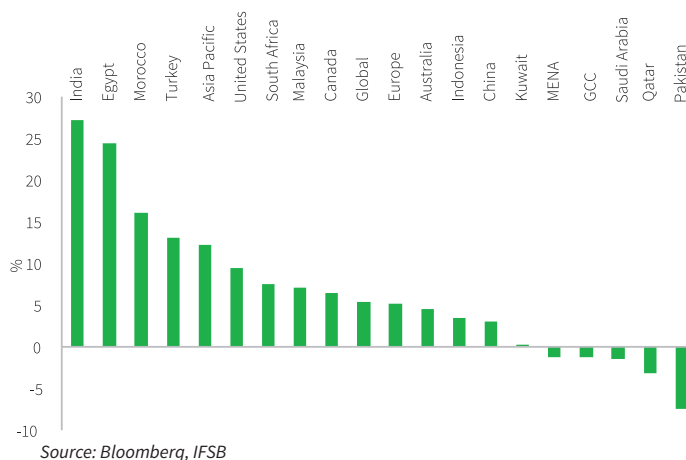


Source: Bloomberg, IFSB

In terms of returns by geographical focus of funds' investments, as expected, emerging market-focused funds generated the best returns in 2017 (see Chart 3.3.2.5). India (27.3%), Egypt (24.4%), Morocco (16%) and Turkey (13.1%) yielded the best returns for specific-country focused Islamic funds, while a broader Asia-Pacific geo-focus returned 12.1% in 2017. The Islamic funds with a United States geo-focus also yielded an improved 9.5% in 2017 [2016: 7.7%]. The preceding year's best performer, Pakistan-focused funds, yielded the least with a -7.35% return in 2017 [2016: 15.1%] as the country's main stock market yielded its worst performance since the GFC due to various internal country-specific factors. Among others, negative returns were also yielded by Islamic funds focused on investments in the GCC countries, with a specific downturn in returns in the Saudi Arabian and Qatar financial markets.

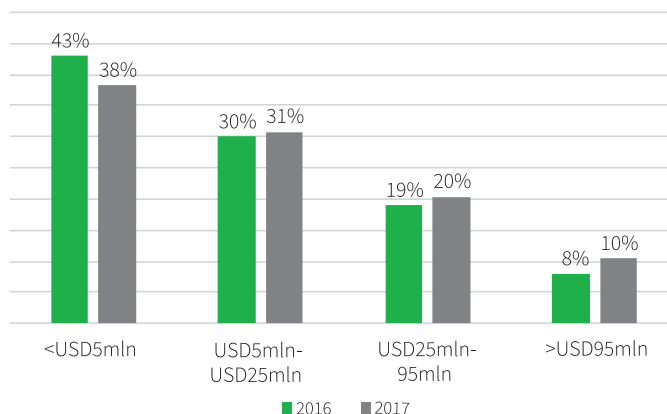
Finally, on the long-standing issue of scale and size of Islamic funds, there is a slight improvement in the composition of Islamic funds in 2017 (see Chart 3.3.2.6), propelled partly by improved economic fundamentals and returns generation by the equity markets. As of end-2017, the number of funds with AuM of less than USD 5 million has declined and represents 38.3% of the total number of funds (2016: 43%). The proportion has increased across all the larger fund size ranges: for the AuM range of USD 5–25 million (2017: 30.9% vs 2016: 30%); USD 25–95 million (2017: 20.4% vs 2016: 19%); and, finally, AuM of more than USD95 million (2017: 10.4% vs 2016: 8%). Overall, as of 2017, 69% of Islamic funds have an AuM of less than USD 25 million; in contrast, the average AuM of conventional funds is estimated to be in the tune of USD 400 million.

Chart 3.3.2.5
Returns of Islamic Funds by Geographical Focus (2017)



Source: Bloomberg, IFSB

Chart 3.3.2.6
Composition of Islamic Funds by Asset Size (2017)



Source: Bloomberg, IFSB

Summary and Challenges

In summary, the continued equity markets rally in 2017 has enabled the Islamic equity and funds market to post a second consecutive year of positive performance. While the relatively bright global economic prospects for 2018 indicate that this performance will be sustained, some volatility risks are likely depending upon the pace of the normalisation of interest rates globally. Specific to the Islamic equity and funds market, geopolitical risks have dented returns and performances of the most affected regions and foreign investors have already initiated flight to quality strategies. Although such risks are more quickly visible in the capital markets, there is a concern that such contagion may spread into the banking and *takāful* sectors of the Islamic finance industry.

Otherwise, in general, the sentiments across the board are generally positive for 2018 – and Islamic fund managers are likely to leverage upon this optimism. The development of financial technology has opened up new opportunities for global asset managers. For instance, in the European Union, MiFID II, which has come into effect

starting January 2018, is leading to greater transparency of fees. As a result, asset managers are responding by relying on Fintech to lower costs and fees (e.g. through use of robo-advisors). Shari'ah-compliant Fintech activities are still in their infancy, but will likely be instrumental in achieving cost economies that can enable Islamic funds to be competitive against their larger conventional counterparts.

BOX 3.1
**REGULATORS' RESPONSE TOWARDS SPECIFIC MARKET
ENHANCEMENT: A CASE STUDY OF THE INTERNATIONAL
ISLAMIC LIQUIDITY MANAGEMENT CORPORATION**

Introduction

Islamic finance has increasingly expanded globally, in some jurisdictions outpacing the growth of conventional banks. Such rapid growth has highlighted the importance of a well-functioning Islamic money market, as a precondition for supervision and risk management of Islamic banks (IBs).

The need for liquidity management for banks is grounded in monetary policy, financial stability and policy incentives, particularly post the GFC. In particular, new regulatory requirements under Basel III require banks to hold sufficient HQLA.

One of the several challenges that IIFS face is the lack of creation and supply of instruments that serve the same needs as conventional instruments for managing excess liquidity for IIFS. Lack of Shari'ah-compliant liquidity instruments will steer IBs to rely on cash and central bank placements as their main liquidity management tools, which tend to offer lower returns and are not tradable. Placements in interbank money market products may offer higher returns; however, the financial crises demonstrated how quickly interbank lending can decline.

In response to such concerns, the International Islamic Liquidity Management Corporation (IILM) was established in 2010 by nine central banks and a multilateral development organisation with the objective of addressing liquidity management challenges faced by IBs by offering a new liquidity instrument through the issuance of high-quality, short-term, tradable *shukūk* in US Dollars.

The Need for Liquidity Management

The GFC, which began in 2007, had a significant impact on many banks, which struggled to maintain adequate liquidity at the time principally due to the substantial decline in interbank liquidity. Central banks of major jurisdictions had to provide emergency liquidity aid to sustain the financial system; however, a number of banks were beyond rescuing while others were forced into mergers or required resolution.

The crisis indicates banks' predisposition to liquidity risk and the systemic impact of this risk on the banking sector as well as the wider economy as a whole.

Although liquidity instruments are most naturally thought of during illiquid markets, higher standards for liquidity as demanded under Basel III call into sharper focus the lack of Shari'ah-compliant money market instruments for IBs.

Available options for IBs, such as long-term *shukūk*, commodity *murābahah*, central bank Islamic tools and idle cash, though generally useful, have various shortcomings, including counterparty risk, non-tradability and negative carry. The key challenge for Islamic banks is the lack of Shari'ah-compliant, properly structured and easily transferable instruments to invest at sufficient yields.

How the IILM Facilitates Cross-Border Liquidity Management for IIFS

The International Islamic Liquidity Management Corporation was established in 2010 for the specific purpose of issuing Shari'ah-compliant financial instruments for liquidity management needs of institutions offering Islamic financial services (IIFS).

With a diverse membership comprising central banks of Indonesia, Kuwait, Luxembourg, Malaysia, Mauritius, Nigeria, Qatar, Turkey and the United Arab Emirates, as well as the Islamic Corporation for the Development of the Private Sector (ICD), the IILM paves the way for a unique collaborative, cross-border solution to a common, cross-border concern. There are several important features of the IILM *shukūk* that are intended to assist the establishment of a liquid, cross-border market for IIFS.

- IILM *shukūk* are tradable, Shari'ah-compliant US Dollar-denominated short-term financial instruments issued at varying maturities of up to one year. The IILM has the flexibility to design tenors to cater to market demand. Since its inaugural issuance in August 2013, the IILM has issued across two-, three-, four- and six-month tenors.
- IILM *shukūk* are money-market instruments backed by a pool of sovereign and supranational assets.
- They are distributed and tradable globally via a multi-jurisdictional primary dealer network. There are currently 11 primary dealers spanning South-East Asia, the Middle East and other regions supporting both primary and secondary market-making activities of the IILM programme.
- IILM *shukūk* are strongly supported globally, as they represent a unique collaboration between several central banks and a multilateral development organisation with the aim of enhancing the financial stability and the efficient functioning of Islamic financial markets.
- IILM *shukūk* are highly-rated. The IILM short-term programme obtained a short-term rating by Standard & Poor's (S&P) Rating Services of 'A-1'. This involves a combination of aspects of structured finance rating methodology, Islamic finance and distribution channels more akin to how central banks distribute their own short-term papers.

In addition, the IILM *ṣukūk* programme has achieved wide Shari'ah acceptance with an asset portfolio comprising at least 51% tangible assets. The IILM is guided and supervised by well-known and respected international Islamic scholars to ensure wide Shari'ah acceptance of its instrument.

The IILM Programme Structure

Under the IILM programme, two special purpose vehicle (SPV) companies are set up in Luxembourg, in accordance with local securitisation laws. One SPV will raise funding and issue short-term *ṣukūk* ("International Islamic Liquidity Management 2 SA", or "Issuer"), while the other will acquire and hold programme assets ("IILM Holding 2 SA", or "Holding"). The IILM *ṣukūk* programme is structured as a *ṣukūk al-wakālah*, whereby under the *wakālah* deed, the Issuer acts as the *wakil* (agent) on behalf of the *ṣukūk* holders to apply *ṣukūk* issuance proceeds towards making investments by the Holding.

The two SPVs are structured to ring-fence assets for the benefit of certificate holders under the *wakālah* issuance structure.

Ṣukūk issued by the Issuer represent an undivided beneficial ownership interest in a specified Shari'ah-compliant pool of assets acquired and held by the Holding.

The programme's main components include:

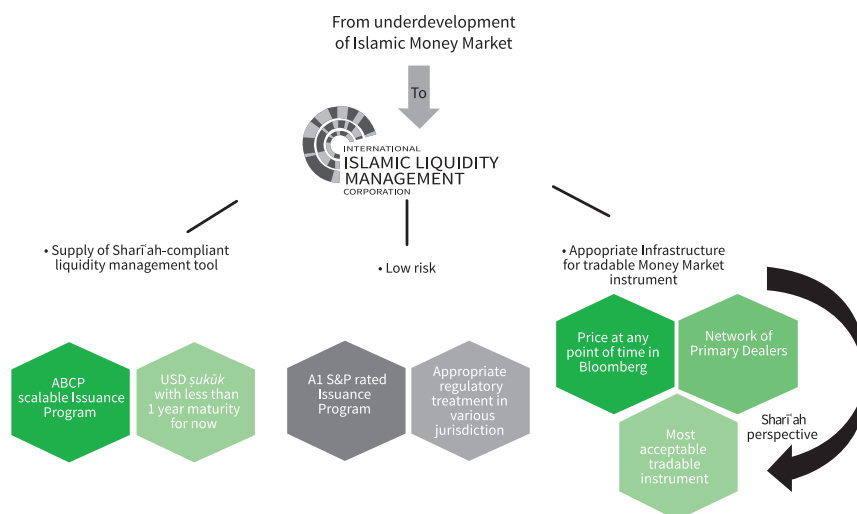
- (i) Assets: The underlying programme assets consist of *sukūk* issued by sovereign, sovereign-linked and supranational entities. Assets will be

new issuances of medium- to long-term *ṣukūk* created for and privately issued solely to the Holding, rather than market purchases. Such assets are held to maturity and are not intended to be traded. Assets comprise market-standard *ṣukūk* structures such as *ijārah* and *murābahah*, as approved by the IILM's Shari'ah Committee. In addition, such assets must comply with the IILM Asset Eligibility Criteria and Credit & Investment Guidelines, and must bear a minimum long-term rating of "A" by S&P.

- (ii) Distribution infrastructure: The IILM distributes its short-term *ṣukūk* through a network of primary dealers (PDs), which are typically nominated by IILM member central banks. Such PDs have the exclusive right to distribute the IILM *ṣukūk* and are required to maintain a secondary market presence for the paper.
- (iii) Timing reserve: To comply with structured finance criteria, the programme is required to maintain a timing reserve equivalent to 2% of outstanding IILM *ṣukūk*, to mitigate cash flow timing mismatches under the programme.

Since its inaugural issuance, the IILM *ṣukūk* programme has been successful in diversifying Shari'ah-compliant liquidity tools available for IIFS. IILM *ṣukūk* issuance complements the existing options currently available in the market and should enable IIFS to compete on a more level playing field with their conventional counterparts.

Chart 1: IILM Value Proposition



Regulatory Treatment of the IILM *Shukūk*

The monetary and regulatory authorities have a role to play in relieving the shortage of Sharī'ah-compliant liquidity instruments for Islamic banks within their jurisdiction, including by:

- granting highly rated and tradable short-term *shukūk*, such as the IILM *shukūk*, the status of HQLA;
- taking steps to deepen local *shukūk* and money markets; and
- adopting the Basel III liquidity coverage ratio framework at a pace that is commensurate with local systemic risks.

Under Basel III standards, the IILM *shukūk* are generally expected to qualify at least as Level 2A HQLA. Presently, a majority of the IILM member regulators have afforded regulatory treatment of the IILM *shukūk* as either:

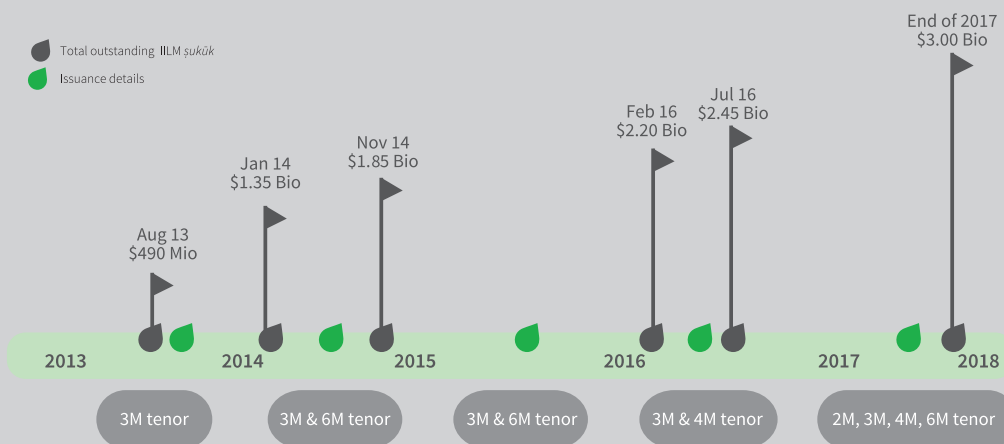
- Level 2A or better assets for liquidity purposes;
- a 20% or better risk-weighting for capital adequacy purposes;
- eligible for reserve management; or
- or eligible collateral.

The IILM Growth Trajectory

Since its inaugural issuance in 2013, the IILM *shukūk* programme has become a worthy option in addressing the shortage of USD-denominated liquidity tools for IIFS. This has helped to further strengthen Islamic financial markets, allowing IIFS to be more competitive. Successively, this will foster and enhance regional and international integration of the Islamic interbank market.

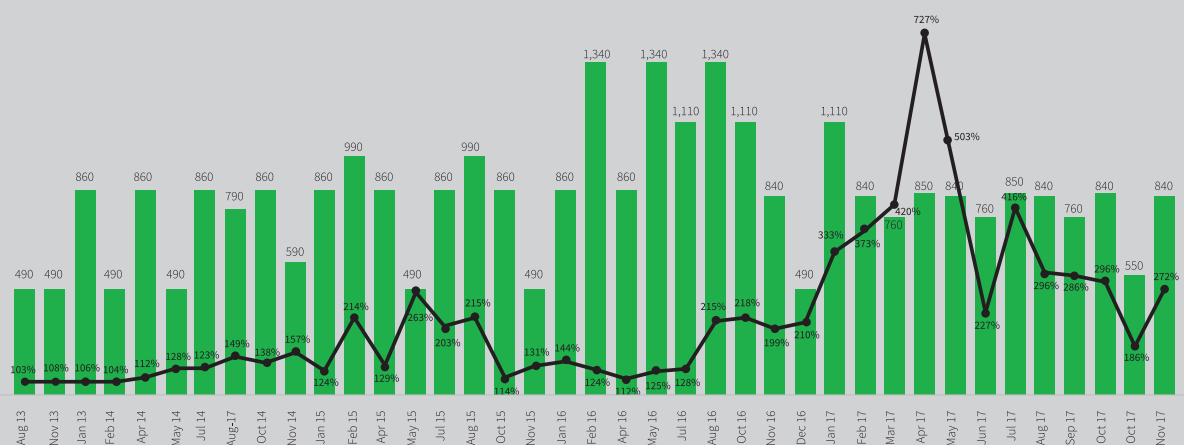
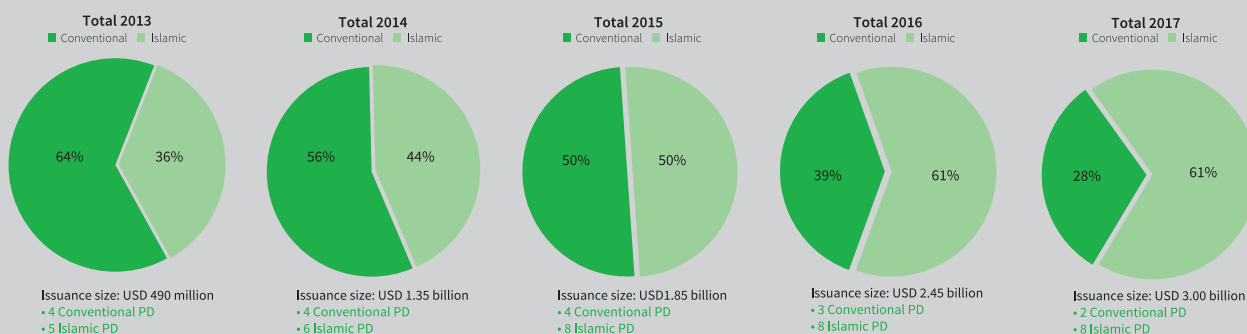
The IILM *shukūk* programme began with a USD 490 million issuance and has reached USD 3 billion in total outstanding *shukūk* as at the end of 2017. Issuance size has grown significantly in response to the market demand since the inaugural issuance. The tapped market has also shown demand for various tenors, including two-, three-, four- and six-month tenors, to suit their varying liquidity management needs.

Chart 2: Growth in Size of the IILM *Shukūk* Programme



Since its inception, the IILM has been a key provider of a highly-rated, short-term, tradable *shukūk* in the global Islamic finance industry. These *shukūk* have been successfully issued and re-issued at their maturities, with subscription levels reaching a 215% average for every issuance. It must be noted that these *shukūk* are not rolled over but re-issued at their maturity, whereby PDs would purchase the

shukūk at a different price from the previous one at each auction. For this reason, PDs would receive an allocation of the amount of *shukūk* that would differ from what they had received previously or for which they had bid. Each *shukūk* issuance will then bear a profit rate based on the auction results.

Chart 3: IILM *Shukūk* Issuances and Subscription Levels (August 2013 – November 2017)Chart 4: Take-up Rate of IIFS of IILM *Shukūk* since Inception

As mandated in its Articles of Agreement upon its establishment, among the primary objectives of the IILM is to facilitate cross-border liquidity management among the IIFS by making available a variety of Shari'ah-compliant instruments, on commercial terms, to suit the varying liquidity needs of the IIFS. In this respect, the onus is on the IILM to ensure that its papers are being utilised by its intended beneficiaries – in particular, IIFS.

Chart 4 describes how IIFS have acquired IILM *shukūk* for their liquidity management solutions since its inaugural issuance. The number of Islamic PDs has almost doubled, with the take-up rate increasing from 36% to 72%. Increasing awareness of IILM *shukūk* has also contributed to this growth.

Challenges and Next Steps for the IILM

The IILM has quickly gained acceptance by IIFS in core Islamic financial markets. Approximately 60% of demand for IILM *shukūk* comes from the Gulf region, with the rest split across Asia and international banks. Its policy-driven approach and consultation of its Shari'ah committee members from across the

globe have been crucial in helping the organisation to achieve its mandate in supporting IIFS in all Islamic finance jurisdictions.

As different types of instruments serve different types of needs, the IILM looks to address other needs in the Islamic capital market and may introduce new structures based on substantial market demand.

Another core objective of the IILM is to foster regional and international cooperation to build robust liquidity management infrastructure at national, regional and international levels. In line with this, the IILM sees potential in reaching out to, and collaborating with, financial centres and regions with a critical size of Islamic banks to widen the distribution of IILM *shukūk*. This will further support a robust secondary market for IILM *shukūk* and consequently promote an efficient and effective liquidity management infrastructure that would contribute to global capital flows and stabilising Islamic capital markets in the years to come.

3.4 TAKĀFUL: ASSESSMENT OF RESILIENCE

As highlighted earlier in the discussion of *takāful* market development, the growth and resilience of the *takāful* sector is driven by key developments in the global economy and financial markets, as well as by domestic developments. According to the Swiss Re publication Global Insurance Review 2017 and Outlook 2018/2019, the improved economic outlook across all countries and regions enhanced the demand for insurance products in 2017. Besides emerging markets,²⁰⁶ which have been a major driver of global premium growth trend over the years, real growth has been experienced in the US, Euro area and Japanese economies in 2017. Moreover, the IAIS Global Insurance Market Report (GIMAR) 2017 highlights that, while the global insurance industry has remained stable, it faces an increasingly difficult macroeconomic and financial environment characterised by weak global demand, low inflation rates and low interest rates. Increasing competition has continued to subject non-life (re)insurance to soft market conditions, while investment yields are declining gradually.

Against this background, the global *takāful* industry continued its upward trend in most countries that were analysed, achieving a modest performance in 2016. This performance was possible through growth in contributions in these countries exceeding gross claims payments and expenses. One factor that drives the market is customers' positive perception of *takāful* products (relevant for both family and general business). The impact of macroeconomics is noticeable in some markets, and thus has a significant impact on industry performance, leading to a slowdown because of lower demand.

This section examines some key indicators of resilience across the selected countries which are key *takāful* markets. The *takāful* industry across the selected countries remains profitable in 2016, with positive returns observed on both asset and shareholders' equity (Charts 3.4.2 and 3.4.3, further below). *Takāful* companies that previously encountered difficulties in generating positive returns (such as in Oman), as illustrated in the charts, have shown improvement in performance and profitability. Contributing to the improved performance are various regulatory initiatives by insurance supervisors across jurisdictions. These include actuarial pricing on motor and medical, actuarial verification of technical reserves, as well as minimum motor tariffs, which are expected to reduced unfair competitive pricing and instil discipline into the market. For instance, in Saudi Arabia, the underwriting result grew rapidly by 120%, translating to improvements in the return on assets and return on equity.²⁰⁷ However, the growth in profitability has not

been evenly distributed, and a number of operators have reported losses. A. M. Best, in a report on the GCC, noted that competitive pressure due to fragmentation of the market with a number of small operators resulted in accumulated losses, erosion of capital strength and deterioration of credit profiles.²⁰⁸

Based on the data available, 10 countries were selected for the analysis. They include the six GCC countries, Iran, Malaysia, and other emerging *takāful* markets such as Pakistan, Indonesia and Jordan. The data sample of *takāful* companies is derived from different sources, including published annual reports and financial statements of *takāful* companies, and respective insurance supervisors, as well as the Thomson Reuters EIKON database. It is important to note that all the data used in this report are publicly available. The countries selected have a notable presence in the *takāful* market, and overall represent a significant proportion of the global *takāful* market. Data include *takāful* windows, especially in jurisdictions such as Indonesia and Pakistan where they exist in significant numbers (however, to the exclusion of stand-alone *retakāful* companies). The following ratios – the retention ratio, ROA and ROE, claims ratio and expense ratio – illustrate the resilience of the *takāful* industry in 2016.

Retention ratio

Takāful operators have been able to underwrite and retain a majority of risks in some personal business lines, which represent a significant proportion of the general *takāful* business segment. A lower percentage indicates a high level of dependence by *takāful* operators on *retakāful*/reinsurance for their risk underwritings. The retention ratio²⁰⁹ has improved across the markets in the past five years due to the growing proportion of motor, medical/health and other personalised business lines, which exhibit lower volatility in loss experience while maintaining reasonably diversified risk pools (chart 3.4.1). In 2016, Malaysia has the highest retention ratio, with 90.4%. In the top category, Saudi Arabia, Bahrain and Iran, with ratios above 70%. (Chart 3.4.1). Other countries in the sample recorded a ratio of between 50% and 60%, indicating that a significant proportion of the contributions written have been ceded to the *retakāful*/reinsurance (i.e. on average, 40%). Regardless of the average retention ratio for the respective country, some *takāful* operators in the UAE reported high retention ratios in their 2016 financial result. For example, Methaq Takaful reported a retention ratio of 84%. In contrast, Dubai Islamic insurance reported the lowest retention ratio of 23%.

Motor is the largest business line across the market, representing more than 30% of the gross contributions.

²⁰⁶ The major driver will remain the emerging markets, where stable, robust economic growth, expanding populations, urbanisation and a rising middle class underpin the positive outlook.

²⁰⁷ Saudi Arabia Monetary Authority (SAMA): Financial Stability Report 2017.

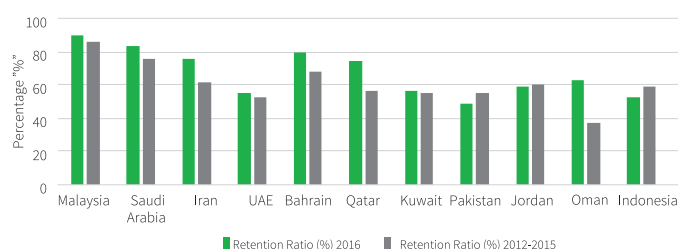
²⁰⁸ A. M. Best's Market Segment Outlook: "Gulf Cooperation Council Market Outlook is Negative", 6 February 2018.

²⁰⁹ Retention ratio represents the proportion of the total gross premium retained after a proportion has been ceded to *retakāful*/reinsurance companies.

In addition, the medical and health line has grown steadily in recent years to become the second-largest business class, on average accounting for more than 15% of total *takāful* gross contributions. In 2016, medical and health accounted for 52% and 47%, respectively, in Saudi Arabia and the UAE. The retention ratio for motor is high compared to other line of business, averaging more than 85%; for some operators, the rate is almost 100%.²¹⁰ However, the commercial business lines still command a high cession rate (in some cases, more than 50%) due to the large risks involved and low risk appetite of the local operators in underwriting. More importantly, the capability of *takāful* operators to underwrite and retain larger and more complex risks, such as the marine, aviation and energy segments of business, is still low. This explains why a larger proportion of the contributions written in these classes of business are ceded to RTUs/reinsurers. The contributions from these business classes accounted for the bulk of *retakāful*/reinsurance premium outflows in 2016.

Takāful operators with a greater share of family *takāful* business comparatively have a higher retention ratio, above 90%,²¹¹ mainly because a significant proportion of family *takāful* policies are investment-linked rather than risk protection, and the low variability of the underlying risks covered allows *takāful* operators to retain a high portion of these risks. On the other hand, a very high-risk retention level in a volatile business class would suggest that the undertaking might be vulnerable to adverse results in that class.

Chart 3.4.1
Risk Retention Ratio by Country
(General *Takāful*) 2016 and 2012)



Source: IFSB Secretariat Workings

Profitability ratios

The performance of the *takāful* market is measured by the profitability ratios: return on assets and return on equity. The profitability ratios showed a positive outlook in 2016, although results differ substantially across the countries in the sample. By jurisdiction, Oman recorded the highest ROA in the sample, with an average of 15% mainly contributed by the motor and medical lines of

business. However, this is an impressive performance compared to the weighted average of -13.4% in the last four years (Chart 3.4.2). The negative weighted average return on assets reported in 2014 and 2015 reflects the initial cost incurred by these companies at the commencement of their operations. Next is Malaysia with an average ROA of 7.4% reported for the *takāful* segment, lower than the average of 9.5% reported in the previous years (2012–15). Consistently high return on assets averaging above 7% reported by Malaysian *takāful* operators reflects the strength of policies and initiatives implemented in 2016, which continued to strengthen the underwriting operations, and high growth in gross contributions and rising income because of an increase in the outreach of family *takāful* business. For example, the implementation of phased liberalisation of motor and fire tariffs which commenced in July 2016 is expected to provide flexibility for more equitable pricing of risk and reinforces better risk management in the form of responsible driving habits and adoption of road safety measures. In addition, improvement in underwriting results from motor business *takāful* is supported by a release of claims reserves in 2016, including reserves held against risks underwritten through the Malaysian Motor Insurance Pool (MMIP), due to more stable claims development patterns.²¹²

Notwithstanding the slowdown in economic activity experienced in all the GCC countries in 2016, Saudi Arabia reported an average ROA of 3.7%, a significant performance compared to the preceding four years' ROA of 1%. The increase in profits is attributed to adoption of a risk-based pricing model, implementation of mandatory health covers, and strategies to boost business which have enabled operators to report strong profits.²¹³ The marginal performance shown by the UAE, Bahrain and Kuwait was because of persistent low global prices for oil and the resultant restraints on public spending, leading to contraction in the contributions received from respective policies. In the same way, the marginal ROA reported by *takāful* operators in Kuwait is perhaps a reflection of a 30% decline in net profit posted by listed *takāful* operators. Presently, a significant proportion of the country's market share is controlled by just six operators including both *takāful* operators and conventional insurers (approximately 65%), while more than 30 operators compete for the remaining market share (35%). An increase of 60% in the expense ratio suggests either massive price cuts (unlikely), in a situation where pricing will be largely driven by the big firms or an actual increase in expenses, but the data are not sufficient to reach a clear conclusion as to what is happening.²¹⁴

²¹⁰ Based on the analysis of data available from the Thomson Reuters EIKON database, available information from insurance supervisors, and annual reports and financial statements of a number of *takāful* companies in the GCC, Pakistan and Malaysia.

²¹¹ Based on the analysis of data available from the Thomson Reuters EIKON database, and annual reports and financial statements of a number of *takāful* companies in Malaysia, Indonesia and Pakistan.

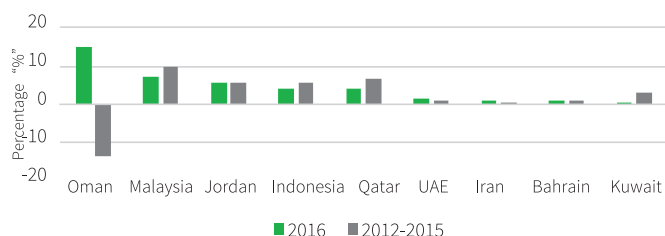
²¹² Bank Negara Malaysia: Financial Stability and Payment Systems Report 2016.

²¹³ SAMA: Financial Stability Report 2017.

²¹⁴ Kuwait Insurance Federation: Annual Report 2017.

In some of these markets, profitability remains the key concern for *takāful* operators. Underwriting performance has been under stress, especially in the general business segment where motor business accounts for more than 30% of the contributions. The pressure on price has dragged down the premium of general business, something which supervisors in some markets have taken seriously thereby pushing for regulatory reforms, which are expected to have a positive impact in the long term. Another essential point is the resulting volatility in investment return caused by a number of factors such as fluctuation in global equity and commodity prices. These and a host of other factors could widen the gap between large-scale *takāful* operators, who are often more diversified and profitable, and their smaller counterparts.²¹⁵

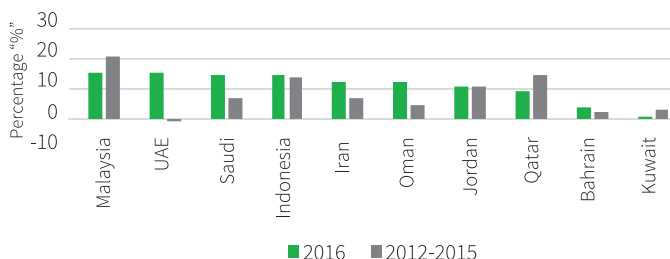
Chart 3.4.2
Return on Assets 2016, (2012–2015)



Source: IFSB Secretariat Workings

In 2016, Malaysia topped the chart of return on equity with 15.8% (see Chart 3.4.3), although this result was lower than the weighted average of 21% in the last four years. The high average ROE recorded in the UAE in 2016 was attributed to an improvement in technical performance across lines of business, as a consequence of various strategies adopted aimed at improving risk selection and pricing policy. For example, the Insurance Authority (IA) in the UAE has introduced a Unified Motor Policy for third-party cover, which has reduced price-led competition and allowed for more realistic rates to be charged. Regardless of fluctuations in performance of some operators, the UAE showed an impressive performance of 15.1% over a weighted average of -0.15% reported between 2012 and 2015. Among the *takāful* companies in the UAE, Abu Dhabi National Takaful showed the highest ROE at 20%; its performance is largely influenced by improvement in technical performance. As a consequence of policies and initiatives by the UAE insurance authority, *takāful* operators in the UAE showed an average loss ratio of 71% combined with a declining expense ratio which reflects better overall performance.

Chart 3.4.3
Return on Equity 2016, (2012–2015)



Source: IFSB Secretariat Workings

Claims ratio

The claims ratio measures the total claims paid by an insurer against the actual premiums earned.²¹⁶ A low ratio signifies operators' ability to underwrite premiums higher than the amount paid in claims. At the same time, a high ratio (i.e. more than 100%) reflects that the company's premiums are not enough to cover claims. Especially in a period of low investment returns, it can be expected to be associated with low profitability, or even losses. A comparative trend in the claims ratio for both general and family *takāful* segments is illustrated in Charts 3.4.4 and 3.4.5. Operators in Iran and Pakistan incurred the highest claims ratio of 84% in 2016 for the general *takāful* segment. Presently, the Securities and Exchange Commission of Pakistan (SECP) has proposed several amendment to the Motor Third Party Liability (MTPL) provisions to replace the existing provision enacted several decades ago.²¹⁷ Other countries with a claims ratio above 60% for general *takāful* are Saudi Arabia, Jordan and the UAE. With the introduction of a unified insurance database in Saudi Arabia that enables operators to conduct background checks on the history of claimants, it is expected to reduce the motor loss ratio and preserve a healthy and better risk selection. Malaysian and Oman operators reported the lowest average claims ratios at 49% (Chart 3.4.4). The release of claims reserves by Bank Negara Malaysia (BNM) to *takāful* operators was attributed to a more stable claims development patterns in motor business.

A rise in claims ratios is observed over the past four years in Brunei, Malaysia and Jordan. In 2016, Brunei reported the highest claims ratio of 68% for the family *takāful* segment, higher than the average 43% in the last five years. The claims ratio in Indonesia is approximately 65%, compared to an average of 60% reported in the last four years. The lowest claims ratio in this business segment was Pakistan, with only 8%. This is surprising, and the reasons for it are unclear.

²¹⁵ "GCC: Gap between large and small insurers to grow", S&P Global Ratings (Insurance market report, 2018). Published by Middle East Insurance Review, 20 February 2018.

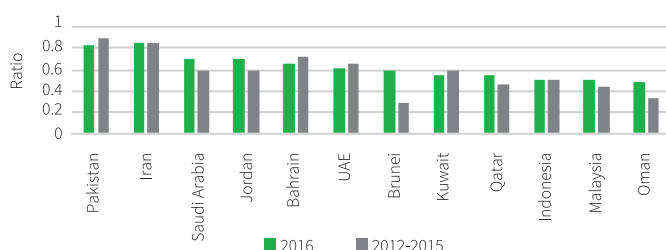
²¹⁶ Claims ratio is a key indicator of the profitability of an insurer.

²¹⁷ Securities Commission of Pakistan (SECP): Annual Report 2017.

Expense ratio

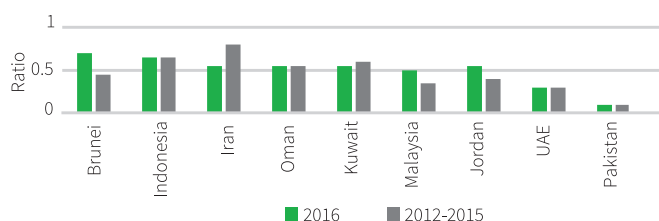
The expense ratio (illustrated in Chart 3.4.6) shows that Indonesia, the UAE and Kuwait incurred the highest ratio among the countries in the sample. However, a decreasing trend is observed across these countries. The operators in Oman show the largest improvement in the expense ratio, which has reduced from over 70% in 2014 to less than 30% in 2016. The average high expense ratio shown by Omani operators in the preceding periods reflects the initial overhead costs incurred at the commencement of the business. The Omani *takāful* operators were licensed to commence operation in 2014. Effective management of the expense ratio is necessary for operators to cut costs, and to improve on resource use efficiency and performance.

Chart 3.4.4
Claim Ratio, General *Takāful* 2016 (2015–2012)



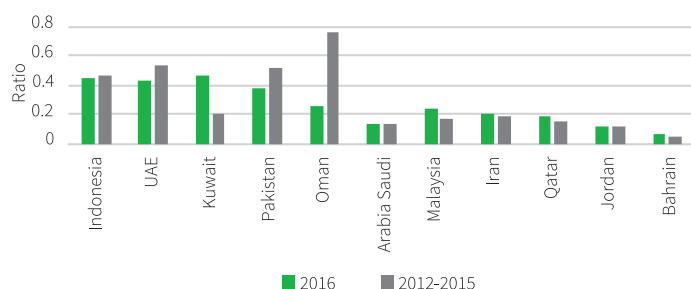
Source: IFSB Secretariat Workings

Chart 3.4.5
Claim Ratio, Family *Takāful* 2016 (2015–2012)



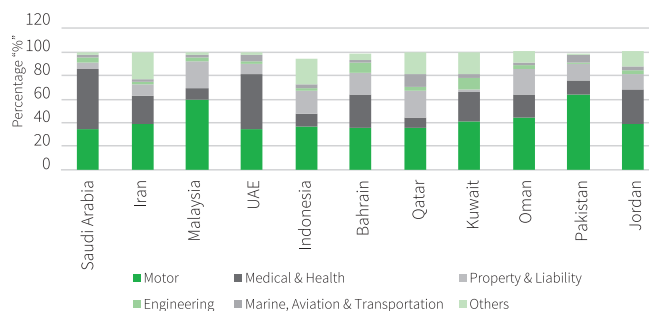
Source: IFSB Secretariat Workings

Chart 3.4.6
Expense Ratio 2016 (2012–2015)



Source: IFSB Secretariat Workings

Chart 3.4.7
Composition of General *Takāful* by Country (2016)



Source: IFSB Secretariat Workings

The investment choice of *takāful* operators should reflect the needs of different *takāful* funds. The market conditions and instruments available in the respective markets also determine the investments mix. This indicates that the investments mix of family *takāful* business should differ from that of general *takāful*. Moreover, in more established Islamic finance markets such as Malaysia and Saudi Arabia, *ṣukūk* is the dominant investment instrument. As at the end of 2017, Malaysia is the leading *ṣukūk* market, accounting for 46.9% of the global *ṣukūk* outstanding, followed by Saudi Arabia with 19.6%.²¹⁸ *Ṣukūk* constitutes the highest percentage in the investment portfolios of *takāful* operators in Malaysia (see Charts 3.4.7 and 3.4.8). Operators in Saudi Arabia hold more cash holdings and deposits compared to other instruments. This might be due to regulatory requirements, or may possibly be because of a high share of the non-life business, whose relatively short-term claims development profiles dictate that the assets are in correspondingly short-term investments.

Qatar and the UAE, on the other hand, hold a high proportion of equities in their funds portfolio. The high share of the equity instruments generates concern, because general *takāful* business dominates the market, which demands short-term investment instruments. Although the preference for equities is supported by fairly active and liquid stock markets in the region, profits from equity trading remain vulnerable to market volatilities in the short run, given renewed concerns about growth and sharp declines in oil prices. In Pakistan, the investment portfolio of family *takāful* is more distributed compared to general *takāful* investment funds. *Ṣukūk* and mutual funds account for quite a high percentage of the family *takāful* portfolio as a reflection of the long-term investment needs of these funds.

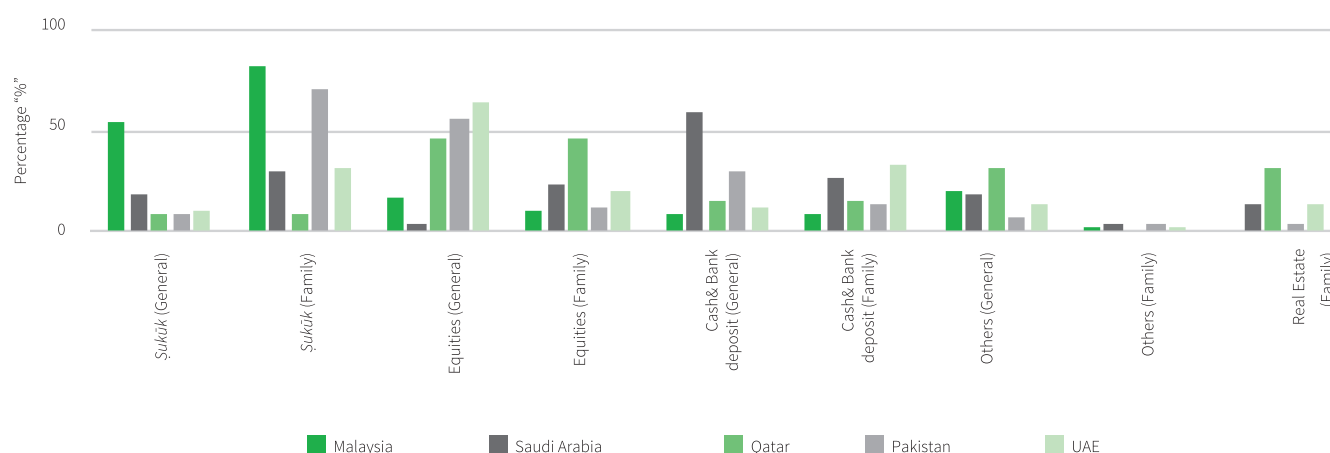
The trend across the countries shows regulatory policies and initiatives being implemented with bias on technical pricing in motor and medical. This is expected to improve the loss ratios – of course, with full enforcement of the

²¹⁸ See discussion in subsection 3.2 of this report.

regulations. On a positive note, the overall trends for *takāful* across the markets show an increasing focus on risk management; in particular, the balance sheets of *takāful* operators in Malaysia and the GCC remain well-capitalised, although they remain more vulnerable to shocks in the financial markets, which may become more severe in the face of economic and political uncertainty.

Therefore, the resilience of the *takāful* industry lies in its capability to deal with the shocks that can affect profits, balance sheets and investment decisions, and to recover from the effects of this shock in a timely and efficient manner, while maintaining its ability to pay valid claims.

Chart 3.4.8 Investment Composition of General and Family *Takāful* by Country (2016)



Source: IFSB Secretariat Workings

3.5 OVERALL SUMMARY

In a relatively positive year for global economic recovery, the global IFSI has continued to sustain its resilience in 2017 with most of its indicators in comfortable compliance with minimum international regulatory requirements and/or comparable benchmarks from the conventional markets. However, the systemic and idiosyncratic challenges of recent years have somewhat weakened the traditionally strong fundamentals of the global IFSI.

Islamic Banking

The global Islamic banking sector has seen improved profitability, with ROA and ROE at their best levels in the past five years; most of the sampled countries experienced an improvement in their profitability indicators moving into 2017. A similar observation can be made in terms of asset quality, with the broader industry NPF continuing to improve during the analysis period; however, at least four countries had Islamic banking NPF ratios above the overall industry average on account of legacy non-performing assets in these countries. A new focused indicator in this report has been the foreign currency denominated financing-to-funding ratio (FFR); based on available data, a number of Islamic banking jurisdictions are identified as having material engagements in foreign exchange transactions. However, closer analysis indicates that most of these countries have appropriately balanced FFR ratios,

reflective of regulations in many countries where banks have to enforce strict ALM guidelines; nonetheless, one country with an under-pressure exchange rates regime is specifically vulnerable given its near 300% FFR ratio. Liquidity conditions have generally worsened, although there is heterogeneity between countries. Islamic banking jurisdictions that have begun implementation of LCR have generally reported improved liquidity conditions, while for others conditions have worsened – notably, two countries have experienced a worsening in liquidity flows, and in the value and tradability of the liquid assets in their banking sector, due to domestic political and geopolitical tensions. Overall, the capitalisation of the industry at a Tier-1 level has improved slightly, to 9.82% in 1H2017, which, while being above the Basel III / IFSB-15 minimum regulatory requirements of 6%, is worse than that of some of the global conventional banking group (e.g. EU banks, World Top 200 Banks) comparators.

Islamic Capital Markets

Although the ICM marked a strong performance in 2017, some underlying weaknesses have persisted from the previous year. The exuberant demand for new *shukūk* in the primary market, as measured by times oversubscription, has continued to remain moderate in 2017, with a notable decline in subscriptions by Middle East investors in non-regionally issued *shukūk*; this is reflective of a general drying up of liquidity in the Middle East due to the persisting low oil prices. In contrast, Europe is gradually becoming a prominent source of

subscriptions for *shukūk* issued across the world. The year also marks a second consecutive year (since a relatively default-free record starting late 2010) when default has occurred in the *shukūk* market; three *shukūk* tranches by two issuers defaulted in 2017. In one particularly concerning situation, an obligor has unilaterally declared its own *shukūkas* Shari'ah non-compliant (despite it being approved by a reputable Shari'ah board) and defaulted on its scheduled payments on this basis. From a pricing perspective, primary market issuances experienced a squeeze in the practice of premiums payable on pricing of new *shukūk* in contrast to financially-risk conventional bonds; however, when analysing yields on *shukūk* traded in the secondary market – based on a sample of domestic *shukūk* in four jurisdictions – investors were trading *shukūk* at higher returns in contrast to financially risk-identical bond instruments.

In the Shari'ah-compliant listed equities and Islamic funds market, the returns have continued on a positive trajectory in 2017, carrying forward the momentum started in late 2016. The commodities asset class (which includes the oil and gas sector as well as funds invested in commodities trading) was again the best performing Islamic fund for a second consecutive year in 2017; on the other hand, the real estate asset class, the once key performing asset class in the Islamic funds industry, has remained a poor performer for a third consecutive year with a negative return yielded in 2017. Regionally, the GCC was also a poor performer in 2017, pulled down mainly by equities in Saudi Arabia and Qatar, where foreign investors have generally been net sellers. On a positive note, from an efficiency and scale perspective, there is a slight improvement as funds with less than USD 5 million AuM have reduced and represent 38.3% of the total number of funds (2016: 43%). On the larger fund size ranges, the proportion has increased across all; however, on an overall basis, as of 2017, 69% of Islamic funds have an AuM of less than USD 25 million; in contrast, the average AuM of conventional funds is estimated to be in the tune of USD 400 million.

Takāful

The *takāful* sector, given its nascent size, continues to face a difficult operating environment on account of stiff competition from the larger and more established insurance companies. The profitability of the *takāful* operators varies by jurisdiction; in general, most sample markets experienced an improvement in returns on equity in 2016, in contrast to the average ROE generated during 2012–15. Saudi Arabia and the UAE were two such markets where returns generated were better than the preceding average, on account of strategic initiatives that include implementation of risk-based pricing models by the operators as well as an increase in contributions on account of implementation of mandatory health covers by the government. Most of the markets also experienced an increase in retention ratios for their general *takāful* in

2016, in contrast to the average ratio during 2012–15. From a risk management perspective, this implies the operators are retaining risk on their balance sheets, rather than transferring it out to *retakāful* operators.

In general, the *takāful* industry will continue to be influenced by the developing economic and political environment in its key markets. Government policies regarding compulsory insurance covers play an instrumental role in affecting insurance penetration rates, and the *takāful* operators are also impacted by these strategic decisions. Furthermore, some major infrastructural development projects, particularly in the GCC, also provide an opportunity for the *takāful* operators to expand their business lines into projects and physical assets protection; however, a particular constraint is the limited size of the *takāful* operators that impedes their ability to provide coverage and protection to much larger-volume transactions and undertakings. In this regard, some mergers and acquisitions activity in the GCC is a welcome development, although much more is possibly needed to address the continued concern regarding the small size of many *takāful* undertakings.

Overall, the global IFSI needs to build long-term resilience as, despite strong performances recently, all three sectors still appear to be worse-off in some respects than their conventional comparators. While improvements in capitalisation, liquidity and clean-up of legacy NPFs is a priority in the Islamic banking segment, operational scale and efficiency appears to be a primary concern in the Islamic capital market and *takāful* segments.

4.0 EMERGING ISSUES IN ISLAMIC FINANCE: LEGAL INFRASTRUCTURE AND SHARĪ'AH GOVERNANCE FRAMEWORK

4.1 INTRODUCTION

A well-developed legal system is essential for the development and stability of the financial sector. Three key components of a sound legal infrastructure can be identified.²¹⁹ The first component constitutes the statutes and laws that specify relevant formal rules. Enabling laws for the financial sector can be broadly classified as financial laws (such as banking, insurance and capital markets laws), supporting commercial laws (such as laws related to companies, corporate governance and consumer protection) and laws that protect creditors' rights and deal with insolvencies. Since laws are usually stated in general terms not covering all aspects of activities in a comprehensive way, legal systems vest powers in regulators and courts to complete the laws.

Forming the second component of the legal infrastructure, the regulators play a proactive role with their law-making and supervisory powers. Not only do they develop detailed and specific regulatory rules ex-ante, but they also ensure compliance through supervision ex-post. Statutes such as central banking laws or securities commission laws establish and vest powers in the regulatory bodies to regulate and supervise different financial institutions and markets.

The final component of the legal infrastructure constitutes the courts and other dispute-resolution institutions which act as law enforcers in response to the initiation of legal proceedings. The institutional setup of courts and other dispute settlement institutions ensure ex-post enforcement of property rights and implementation of contracts in case of any breach of contracts or exercise of rights by one of the parties.

Akin to conventional finance, efficient and effective functioning of Islamic financial institutions and markets would require a sound and supporting legal infrastructure. However, there is an additional legal dimension that affects the latter. A unique feature of Islamic finance is the use of Sharī'ah (Islamic law) and principles in its products and operations. Since most countries in which Islamic finance operates are variations of either common law or civil law regimes, a couple of issues arise in using Sharī'ah-compliant contracts in these jurisdictions. First,

a robust Sharī'ah governance regime would be required to ensure that financial products and operations comply with Islamic law to reduce Sharī'ah non-compliance and reputational risks. Second, there is a need to resolve issues arising in dispute resolutions when using Islamic financial contracts in non-Islamic legal jurisdictions to mitigate legal risks and frictions.

The World Bank and the International Monetary Fund²²⁰ identify the key elements of a financial sector legal environment to include central banking law, financial laws related to banking insurance and capital markets, payments systems, financial safety nets, and a host of supporting commercial laws such as company law, corporate governance, consumer protection, creditors' rights and insolvency systems, and the judicial system.²²¹ While some elements of the legal infrastructure are applicable to both Islamic and conventional financial sectors (such as central banking law, companies law, corporate governance law, etc.), a few unique legal challenges arise for the sound development of the former. This chapter examines some elements of enabling legal framework for Islamic finance and issues related to Sharī'ah governance affecting the development of the Islamic financial industry. Topics in the former include financial laws related to different Islamic finance sectors as essential constituents of the ex-ante legal framework and dispute resolution institutions and resolution framework for Islamic banks as ex-post structures.

The chapter is organised as follows. The next section presents an overview of legal systems and a brief outline of the legal systems in countries belonging to the Organization of Islamic Cooperation (OIC). Section 4.3 covers financial laws related to Islamic banking, *takāful* and capital markets in a sample of 12 countries. Section 4.4 assesses the nature of dispute resolution systems, and is followed by a section discussing the status of resolution and insolvency processes relevant to Islamic banks in these countries. After reviewing the elements of a sound Sharī'ah governance framework proposed by international standard setting bodies, Section 4.6 presents its status in selected countries. The concluding section highlights some examples related to legal infrastructure and Sharī'ah governance.

²¹⁹ Pistor and Xu (2003). For a discussion on the legal infrastructure and laws for a sound financial sector, see also World Bank and IMF (2005).

²²⁰ World Bank and IMF (2005).

²²¹ World Bank and IMF (2005).

4.2 LEGAL SYSTEMS: AN OVERVIEW

With a few exceptions, most Muslim countries have adopted some variant of Western legal systems either due to colonisation or to imitation. Western legal regimes can be broadly classified as civil law and common law systems. Key features of these legal systems, along with Islamic law, are presented below.²²²

With roots in Justinian's Roman law code of the sixth century AD, the civil legal system developed in continental Europe in the 19th century. The civil laws are codified and written in complete and coherent codes and present general principles systematically and exhaustively leaving little gaps. The role of statutes is to complement and complete these codes. Judges apply law based on a doctrine that provides guidance to interpret the general codes and statutes. Whereas they enjoy authority of reason to interpret the codes and rules for specific cases, judgments of one court usually do not have any bearing on other courts. With the contemporary origins of civil law in France, the tradition was also adopted in the rest of continental Europe such as Germany, Italy, Poland and Scandinavia. The legal system was later adopted in the Near East, and Northern and Sub-Saharan Africa mainly through colonisation. Most countries in the Arab world adopted variants of the Egyptian legal system, which has a legal code based on the French and European civil laws. The common law developed in England in the 11th century with an emphasis on property rights and assertion of the law over the state (king). The principal source of law in common law system is jurisprudence, whereby case law forms the core of the law. Since new rules can sometimes be proposed to cover cases that have not yet occurred, judges can interpret and create laws as the circumstances change and demand. In common law system, reason of authority exists whereby lower courts are bound to follow decisions of higher courts (termed the doctrine of *stare decisis*). In this legal tradition, the statutes complete the case law by specifying the specific parts of the law that either need reform or are not covered in the case law. It should be noted, however, that the statutes and regulations related to the financial sector are extensive, covering minor details of operations and practices. Most of the Commonwealth countries that were British colonies have adopted the English common law framework.

Starting with the origins of Islam, the sources of Islamic law can be broadly classified into two: revealed

and derived. The revealed knowledge, the Shari'ah, constitutes the primary source of Islamic principles and rulings.²²³ Shari'ah can be further divided as the recited revelation (the Quran) and the non-recited revelation (the Sunnah) (Al Alwani, 1990).²²⁴ The second source of Islamic law is derived from human intellect through *ijtihad* (exertion), which is a process of independent reasoning by qualified scholars to obtain legal rules from Shari'ah.²²⁵ The scholars/jurists come up with resolutions (*fatāwa*) using Islamic legal theory (*usul al fiqh*) and Shari'ah principles to expand the body of Islamic law. The derived knowledge resulting from *ijtihad* is referred to as *fiqh*.²²⁶ Other than jurists, the office of qadi (judgeship) also affected Islamic law by interpreting and applying the law in courts (Masud, 1995).²²⁷ Although most Muslim countries have retained Islamic personal law, commercial courts in most jurisdictions use national laws that are based on either civil or common law to adjudicate cases.

The legal systems of 57 OIC member countries across different geographical regions are shown in Table 4.2.1. The table shows that the majority of the countries (41) have civil law systems, while 13 countries have adopted common law systems. Only three countries (Iran, Saudi Arabia and Sudan) have mixed legal systems with significant presence of Islamic law.²²⁸

Table 4.2.1
Legal Regimes of OIC Member Countries across Regions

Region	Legal System			
	Civil	Common	Mixed	Total
East Asia & Pacific	1	2	–	3
Europe & Central Asia	9	–	–	9
Latin America & Caribbean	1	1	–	2
Middle East & North Africa	15	2	2	19
South Asia	1	3	–	4
Sub-Saharan Africa	14	5	1	20
Total	41	13	3	57

Source: World Bank (2004) and La Porta et al. (1999).

²²² Information on civil and common law systems is taken from Tetley (2000) and Owsia (1995).

²²³ Sometimes the word "Shari'ah" is used to mean the whole body of Islamic law. In this paper, it is defined more narrowly, as is usually done in Arabic usage.

²²⁴ Al Alwani (1990).

²²⁵ For a discussion of the other sources and methodology of Islamic law, see Kharoufa (2000) and Rayner (1991).

²²⁶ Hassan (1992).

²²⁷ Masud (1995).

²²⁸ While the classifications of legal systems in World Bank (2004) and La Porta et al. (1999) do not include the "Islamic" category, these countries are classified as such since they are known to have Islamic legal systems. CIA World Factbook identifies the legal systems of these countries as follows: Iran has a religious legal system based on Islamic law and secular law; Saudi Arabia has an Islamic (Shari'ah) legal system with some elements of Egyptian, French and customary law; and Sudan has a mixed legal system of Islamic law and English common law.

One way to identify a supportive legal system for the financial sector is to examine the legal rights index (LRI), which shows the strength of legal regimes in protecting the rights of creditors that can facilitate lending. Ranging from 0 to 12, Table 4.2.2 shows the average LRI for different regions of the world along with the OIC member countries. The table shows that the Middle East & North African region has the lowest LRI, at just 1.9. The LRI for the OIC average is 4.1, which is less than the world average of 5.4. Among the OIC members, countries with mixed legal systems have the lowest LRI score (2.3) and those belonging to common law systems perform best with an average LRI of 4.9.

To examine different aspects of the legal environment for Islamic finance, a sample of 12 countries belonging to different regions and legal systems is considered in this chapter.²²⁹ The countries are listed in Table 4.2.3. The countries included in the sample also represent different levels of development of the Islamic financial sector. Whereas Sudan's financial sector is fully Islamic, several countries have an Islamic banking sector that is systemically important in size.²³⁰ These countries include Saudi Arabia, the UAE, Malaysia and Bangladesh. Other countries such as Pakistan, Oman, Egypt, Turkey and Indonesia also have significant Islamic financial sectors. Senegal and Nigeria represent emerging markets for Islamic finance in Africa.

4.3 ISLAMIC FINANCIAL LAWS

This section presents the status of Islamic financial laws and regulations which form a key element of the legal infrastructure as they define the features and scope of different financial institutions and markets. The unique nature of Islamic financial products and organisations that are not covered by conventional financial laws necessitates coming up with laws that can facilitate the activities and operations of the former. A robust legal infrastructure for Islamic finance industry would, therefore, have laws that facilitate Islamic banking, *takāful* and capital markets. In assessing the status of financial laws for different sectors, the jurisdictions are classified into three broad categories: (1) countries that have enacted separate Islamic financial laws;

Table 4.2.2
Strength of Legal Rights Index in Selected Country Groupings and OIC MCs (2017)

Region	LRI	OIC MCs	LRI
East Asia & Pacific	7.3	OIC All	4.1
Europe & Central Asia	6.0	OIC Civil Law	4.0
Latin America & Caribbean	5.3	OIC Common Law	4.9
Middle East & North Africa	1.9	OIC Mixed Law	2.3
North America	10.0		
South Asia	5.3		
Sub-Saharan Africa	5.1		
World	5.4		

Strength of Legal Rights Index (LRI): The LRI measures the degree to which collateral and bankruptcy laws protect the rights of borrowers and lenders and thus facilitate lending. The index ranges from 0 to 12, with higher scores indicating that these laws are better designed to expand access to credit (Source: <https://data.worldbank.org/indicator/IC.LGL.CRED.XQ>)

Table 4.2.3 Sample of Countries Used in the Study

Regions	Legal Systems			Total
	Common	Civil	Mixed	
East Asia & Pacific	Malaysia	Indonesia		2
Middle East & North Africa		UAE Egypt Oman Turkey*	Saudi Arabia	5
South Asia	Bangladesh Pakistan			2
Sub-Saharan Africa	Nigeria	Senegal	Sudan	3
Total	4	6	2	12

**Note: While Turkey belongs to Europe and Central Asian countries, it is included in the Middle East & North Africa region since it would be the only country in the former region.*

(2) countries that have incorporated elements of Islamic finance in their existing financial laws; and (3) countries that do not have any reference to Islamic finance in their existing financial laws. The legal foundations for Islamic finance are absent in the third category of countries and, as such, have the weakest enabling environment for the industry. The statuses of Islamic financial laws for the sample of 12 countries identified in Table 4.2.3 are examined next.

4.3.1 Islamic Banking Law

Banking law covers issues related to the formation and operations of banks. Among other things, it details the requirements for opening a bank, the provisions with respect to terminating licences, the powers

²²⁹ The countries considered are included in a recently published manuscript entitled, "National and Global Islamic Financial Architecture: Problems and Possible Solutions for the OIC Member Countries", published by the Standing Committee for Economic and Commercial Cooperation of the Organization of Islamic Cooperation (COMCEC).

²³⁰ IFSB (2017a).

of banks to accept deposits and to carry on banking business, and the prudential supervision of banks'.²³¹ A key feature of a typical banking law is that it defines what banking products are and what constitutes banking businesses. The law not only specifies the transactions that banks may undertake, but also identifies those they are not permitted to engage in. For example, a typical conventional banking law might stipulate that banks cannot engage in trade of commodities or hold assets other than those it uses.

In developing an Islamic banking law, the features of Shari'ah-based contracts need to be considered and incorporated in the statute. As products of Islamic banks involve dealings with real goods and services, the law has to provide for these institutions to carry out trading, leasing and investment activities. Since conventional banking laws do not recognise Islamic banking transactions due to their different conceptual nature, practising Islamic banking under conventional banking laws is commonly difficult, or even impossible. For example, whereas Islamic banks' main activities typically include trading (*murabahah*) and equity-like investments (*musharakah* and *muḍārabah*), the conventional banking law does not acknowledge them and may prevent banks from undertaking such activities. Similarly, banking law defines deposits in a way that would inhibit offering profit/loss-sharing investment accounts with true risk-sharing features. An example of an Islamic banking law that provides a sound framework for Islamic banks by considering the features of Islamic financial contracts is Malaysia's Islamic Financial Services Act 2013 (IFSA) (see Box 4.1).

4.3.1.1 Status of Islamic Banking Law in Selected Countries

The legal regimes under which Islamic banking operates are discussed under the three categories identified above. Countries included in the first category have specific Islamic banking law. For example, Sudan's banking sector was transformed into an Islamic system with the enactment of the Islamic Transactions Law in 1984. The Banking Business (Organization) Act 2003 sets out the rules for granting and withdrawing banking licences, and established the Shari'ah High Supervisory Board to supervise and monitor the implementation of Shari'ah in the banking sector. Furthermore, the Bank of Sudan Act 2002, including its 2006 and 2012 amendments, defines various roles and objectives of the Central Bank of Sudan and stipulates that institutions must fully adhere to Shari'ah principles.

²³¹ World Bank and IMF (2005), p. 225.

BOX 4.1**ISLAMIC FINANCIAL SERVICES ACT 2013:
A CONTRACT-BASED BANKING LAW FOR
THE PROMOTION OF A SOUND ISLAMIC
BANKING SECTOR IN MALAYSIA**

Malaysia promulgated the Financial Services Act 2013 (FSA) and the Islamic Financial Services Act 2013 (IFSA) to provide a sound legal basis for the development of a stable financial sector. The Acts were the result of six years spent reviewing the financial sector legislation and modernising the financial laws to promote the development of an efficient and stable financial sector. IFSA consolidated and updated the legal framework for Islamic banks and *takāful* sectors by repealing six statutes, including the Islamic Banking Act 1983 and the *Takāful* Act 1984. Along with other laws (such as the Central Bank of Malaysia Act 2009, the Anti-Money Laundering and Anti-Terrorism Act 2001, the Money Service Business Act 2011 and the Malaysia Deposit Insurance Corporation Act 2011), these statutes provide a sound framework for a robust Islamic financial sector that can sustain operations in a more complex and globalised world.

Constituting 177 pages, IFSA is divided into 18 parts covering various aspects of the Islamic banking and *takāful* sectors. Beyond setting out the legal basis for Islamic banks, the Act provides a comprehensive legal infrastructure to support the industry, as indicated in the opening statement of the statute: ‘An Act to provide for the regulation and supervision of Islamic financial institutions, payment systems and other relevant entities and the oversight of the Islamic money market and Islamic foreign exchange market to promote financial stability and compliance with Shari’ah and for related, consequential or incidental matters.’ IFSA strengthens the legal and regulatory framework by covering the following supporting relevant elements that promote a stable and healthy Islamic financial sector: deterrence of financial crime, fair responsible and professional business conduct, prudential regulation and supervision, tools for crisis management and prevention, financial safety nets, orderly financial markets and payments systems, and Shari’ah compliance (BNM, 2012).

The IFSA acknowledges the specific features of Shari’ah-compliant contracts in providing an end-to-end legal and regulatory framework for Islamic banks. At the operational level, Part IV, entitled “Shari’ah

Requirements” (divided into three divisions of Shari’ah compliance, Shari’ah governance, and audit and Shari’ah compliance), provides the operational standards of governance and oversight to ensure compliance with Shari’ah standards. At the product level, the law makes Shari’ah non-compliance an offence that is punishable and gives Bank Negara Malaysia extensive powers to intervene when any breach takes place. Specifically, Article 28(1) of IFSA requires that a financial institution should ensure that “its aim and operations, business, affairs and activities are in compliance with Shari’ah”, and Articles 28(5) and 29(6) stipulate that a person who contravenes Shari’ah principles and is non-compliant with standards of SAC “commits an offence and shall, on conviction, be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or to both”.

The IFSA defines the scope of products on both liability and assets sides of the balance sheet by considering the underlying features of Islamic contracts. For example, the Act distinguishes between deposits and investment accounts based on the underlying contracts used. Specifically, the former would be structured using *wadi’ah*, *murābahah* and *qard* contracts, and the latter would be based on *musharakah*, *muḍārabah* and *wakālah*. Since the contracts used for deposits imply guarantee of capital, they are covered by the deposit insurance scheme of Perbadanan Insurans Deposit Malaysia (PIDM) up to an amount of RM 250,000 per depositor. However, since underlying contracts used in investment accounts are risk-sharing/bearing accounts, they are not protected by deposit insurance (BNM, 2014).

The Act provides a legal framework for resolution of Islamic banks by recognising the underlying contractual rights and obligations of Shari’ah-compliant contracts. Given the dissimilar risk features implied by contractual differences for deposits and investment accounts, IFSA requires that assets financed by investment accounts are ring-fenced to avoid comingling with assets financed by deposits. Similarly, the priority of claims for stakeholders in case of bank resolution is also different for deposits and investment accounts. Specifically, if an Islamic bank winds up, the funds and assets underlying investment accounts would be used to meet the claims of the investment account holders only after paying for winding-up costs and other expenses related to the account, taxes, and other fees or remuneration due to the bank.

Whereas Malaysia enacted its Islamic Banking Act in 1983, the more recent Islamic Financial Services Act 2013 was promulgated to provide a comprehensive framework for the development of Islamic banking in the country (see Box 4.1). Indonesia introduced the Islamic Banking Act, No. 10 of 1992 (amended in 1998), by endorsing the unique operations of Islamic banking, including its “profit-sharing” features. The legal infrastructure continued to develop with the amendment of the Banking Act in 1998, which allowed conversion of conventional banks to Islamic and also permitted conventional banks to establish Islamic business units.²³² The legal framework of Islamic banking was further strengthened by Islamic Banking Act, No. 21 of 2008, which provided a comprehensive legal basis to support the growth of the Islamic banking industry and reflected the political will of the government and regulators to support Islamic finance. In the UAE, Federal Law No. 6 of 1985 Regarding Islamic Banks, Financial Institutions and Investment Companies defines Islamic financial institutions, and Article 4 of the Law exempted Islamic banks and financial institutions from certain of the prohibitions imposed on conventional banks.

The second category of countries includes those in which provisions of Islamic banking are included in the existing banking laws. Pakistan accommodated Islamic finance with the enactment of the Banking and Finance Services (Amendment of Laws) Ordinance 1984 (“BFS Ordinance”) and the Banking Tribunal Ordinance 1984 (“Tribunals Ordinance”). The BFS Ordinance amended seven laws to make provision for the new modes of financing permitted by the State Bank, and the Tribunals Ordinance defined “finance” to include various modes of financing, such as *musharakah*, *muḍārabah*, *murābaḥah*, *Istiṣnāʾ*, etc. In Bangladesh, the Banking Companies Act 1991 (“BCA 1991”), amended in 2003, governs the banking sector in the country and incorporates some provisions of Islamic banking.

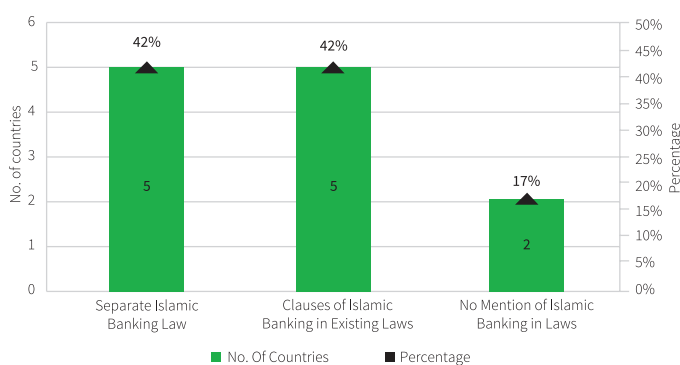
Oman’s Banking Law, No. 114 of 2000, was amended by Royal Decree 69/2012 to include a chapter entitled “Islamic Banking”, making Islamic banking an integral part of the banking law. The new chapter has six articles setting out the basic elements of a legal framework. After the enactment of the Act, the Central Bank of Oman published in 2012 the Islamic Banking Regulatory Framework, which provides an extensive regulatory framework covering various aspects of Islamic banking practices. The banking sector in Senegal is governed by the common West African Economic and Monetary Union (WAEMU) Banking Law, which allows Shari’ah-compliant banking activities. The Central Bank of West African States endorsed Islamic banking in its conventional legal and regulatory framework, allowing Islamic banks to operate

under the label “financial institutions not using interest rates”. In Turkey, the Banking Act, No. 5411 of 2005, transformed the status of Islamic financial institutions, which were called “Special Finance Houses”, into Participation Banks. While the former were considered non-bank financial institutions and were not regulated as banks by the Banking Regulation and Supervision Agency and not covered by deposit insurance, the latter have the status of banks and have the same regulatory treatment as conventional banks.²³³

In some countries, while there are no laws related to Islamic banking, other statutes give authority to the regulatory bodies to define and regulate Islamic financial institutions. Nigeria, a common law country, has no dedicated laws for Islamic finance. However, the legal framework for Islamic finance is derived from the existing conventional finance laws by leveraging on some provisions to establish Islamic financial institutions. Provisions in the Banks and Other Financial Institutions Act 1991 (BOFIA) and the Central Bank of Nigeria Act 2007 empower the Governor of the Central Bank of Nigeria (CBN) to make rules and regulations, and to issue guidelines, for the operation and control of all institutions under the supervision of the CBN. The provisions also empower the CBN to supervise and regulate the activities of specialised banks and to exempt profit- and loss-sharing banks from the Act’s provisions.

The final group includes countries that do not have any legal basis for Islamic banking. Islamic banks are established under the existing legal framework, and Islamic banking practices are possible due to the regulatory authorities’ accommodation of Islamic finance. Though Saudi Arabia has a traditional Islamic legal system, its Banking Control Law 1966 reflects conventional banking principles and there are no specific stipulations related to Islamic banking. Similarly, Egypt’s amended Banking Law, No. 88 of 2003, has no provisions for Islamic finance, yet Islamic banks operate in the country.

Chart 4.3.1.1.1 Status of Islamic Banking Laws



²³² The Islamic Banking Act, No. 21 of 2008, defines an Islamic business unit as “a working unit of the Conventional Commercial Bank head office functioning as head office of offices or units conducting business activities based on the Sharia Principle, or working unit in a branch office of a Bank located overseas conducting conventional business activities functioning as a head office of sub-Sharia (Islamic) branches and/or sharia (Islamic) unit” (p. 3).

²³³ Ayse et al. (2012).

Chart 4.3.1.1.1 shows the overall status of laws related to Islamic banking in the sample countries. While five countries have supporting Islamic banking laws, in a similar number of countries Islamic banking-related clauses are included in other laws. In two countries, there is no mention of Islamic banking in the banking laws. While Islamic banks operate in these jurisdictions due to the permissive approach of the regulators, the lack of a specific law can impose certain restrictions on the operations of banks. For example, it may be difficult to offer profit/loss-sharing investment accounts since the definition of deposits includes “capital certain”, which is a feature that these accounts lack.²³⁴

4.3.2 *Takāful* Law

As in the case with Islamic banks, *takāful* operations are conceptually different from conventional insurance. Based on the concepts of charitable donations (*tabarru'*) and cooperation or mutual help (*ta'awun*), various models of *takāful* are developed having elements of both cooperative and commercial insurance schemes.²³⁵ One key feature of *takāful* is that the capital of the *takāful* operator is separated from the participants' risk fund (PRF) and the participants have certain rights that are not recognised by conventional insurance laws. For example, shareholders do not have claims on the surplus in the PRF, which belongs to the participants and should be distributed to them. Furthermore, there is a need to ensure that the investments made by *takāful* operators are Shari'ah-compliant, which would require a robust Shari'ah governance framework.

4.3.2.1 Status of *Takāful* Law in Selected Countries

As indicated, the status of the legal environments is categorised into three types. The first category of countries with separate *takāful* Acts includes Malaysia, Oman and the Sudan. While Malaysia enacted the *Takāful* Act 1984, the Islamic Financial Services Act 2013 updated the legal framework for the *takāful* sector by repealing the Act. Oman enacted a detailed *takāful* law, with Royal Decree No. 11 of 2016 giving regulatory powers to the Capital Market Authority. The *takāful* law complies with *takāful* standards issued by the Accounting and Auditing Organization for Islamic Financial Institutions. In the Sudan, the Insurance Supervision and Control Act 1992 (“ISC 1992”) and the Insurance Control Act 2001 (“IC 2001”) were enacted to Islamise the insurance sector.²³⁶ The Insurance and *Takāful* Act 2003 was initiated to fill some of the gaps and to identify the range, subject matter, and parties to insurance and *takāful* contracts that should be used as a reference before courts.

Bangladesh, Pakistan, Saudi Arabia and the UAE belong to the second group of countries where *takāful* stipulations

are included in the existing laws. In Bangladesh, the Insurance Act 2010 and the Insurance Development and Regulatory Authority (IDRA) Act 2010 provide the legal framework for the insurance industry. The Insurance Act 2010 stipulates forming a five-member board of Shari'ah consultants for the regulatory body IDRA to provide advice on *takāful* matters. Similarly, the Insurance Ordinance 2000 in Pakistan identifies *takāful* as one form of insurance. Details on the regulatory framework of *takāful* appear in *Takāful* Rules 2005, issued by the insurance regulatory body, the Securities and Exchange Commission of Pakistan.

Insurance in the UAE is governed at a federal level by the Insurance Authority established under Federal Law No. 6 of 2007 (“Insurance Law”), which replaced Federal Law No. 9 of 1984. The law applies to cooperative insurance, *takāful* insurance, reinsurance and insurance in general.²³⁷ The Insurance Authority has issued Board of Directors' Decision Number (26) of 2014 Pertinent to Financial Regulations for *Takāful* Insurance Companies. In Saudi Arabia, the Law on Supervision of Cooperative Insurance Companies (“LSCIC 2003”), approved by Royal Decree No. M/32 dated 1 August 2003, sets the stage for the legal framework of the cooperative insurance companies sector in Saudi Arabia. LSCIC articulates in Article 1 that offering insurance services should be in accordance with the principles of Islamic law. The cooperative insurance law and its implementing regulations gave the Saudi Arabian Monetary Authority wide-ranging powers, such as the power to license, regulate and supervise the insurance sector.

While no specific *takāful* law exists in Nigeria, the National Insurance Commission (NAICOM) Act 1997 (“NAICOM Act”) governing the insurance industry gives regulators the authority to provide a regulatory framework for *takāful*. Section 7 of the NAICOM Act empowers the Commission to establish and approve standards, conditions and warranties applicable to all classes of insurance business in Nigeria. Based on this provision, *takāful* business becomes feasible.

The third group of countries are those in which there is no mention of *takāful* in the insurance laws. For example, in Egypt, the Regulation for the Law of the Control and Supervision of Insurance and its Amendments (Law No. 10 of 1981, amended Law No. 91 of 1995 and Law No. 118 of 2008) governs the insurance industry. There is no mention of *takāful* in these laws. In Indonesia, the Insurance Act, No. 40 of 2014, governs the entire insurance industry. Since there is no specific *takāful* law, the sector is regulated similarly to the conventional insurance under the Insurance Act. With no *takāful*-related law or regulation in Senegal, the lone *takāful* company in the country operates under the conventional insurance

²³⁴ For a discussion on regulatory problems related to PSIA, see Archer and Karim (2009).

²³⁵ IFSB (2017b).

²³⁶ (Suliman, 2013).

²³⁷ See Article 2 of the Federal Law No. 6 of 2007, and Panchal and Agarwal (2016).

law.²³⁸ Similarly, in Turkey both Islamic and conventional insurance companies are subject to the provisions of the Insurance Law.²³⁹

Chart 4.3.2.1.1 Status of *Takāful* Laws

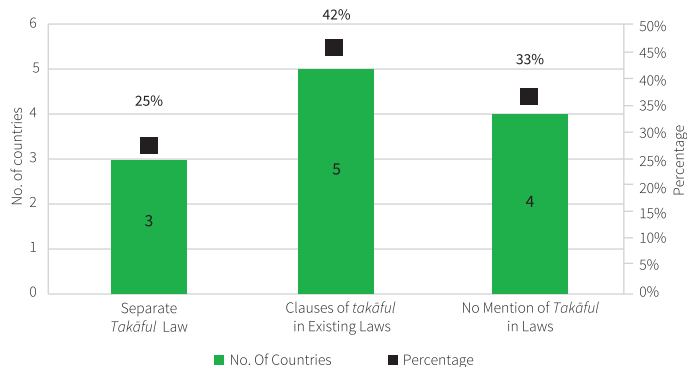


Chart 4.3.2.1.1 summarises the status of *takāful* laws for the sample countries. While three countries have separate laws for the *takāful* sector, five countries have *takāful* included in some laws that acknowledge *takāful* practices. Four countries in the sample did not have separate *takāful* laws for establishing *takāful* operators.

4.3.3 *Shukūk*

IOSCO has acknowledged the need to establish an appropriate and effective legal, tax and accounting framework within which securities markets can operate.²⁴⁰ While development of a sound securities market would require complex legal and market institutions, the capital market law is one of the key statutes covering various aspects to ensure the smooth functioning of the securities markets. The law encompasses issues such as conditions to issue securities to the public, their registration and trading, and regulations related to organisations dealing with the securities market, such as brokers, dealers, etc. Securities law reduces problems associated with raising funds from markets by clearly specifying a contracting framework for issuing securities. These laws also prevent self-dealing by instituting rules, incentives and penalties to prevent such activities. An important feature of securities law is the protection of investors by disclosing all relevant quantitative and non-quantitative information of listed companies.

The legal environment for Islamic capital markets includes stock markets, collective investment schemes

and *shukūk*. Shari'ah-compliant stocks constitute a subset of the conventional stock derived through sector-specific and financial screenings.²⁴¹ Thus, the legal/regulatory framework for Islamic stock markets would entail identifying the screening criteria and processes that would distinguish an Islamic stock from a conventional one.²⁴² Islamic stocks, whether identified through official or private screens, together with other Islamic investments, may form the basis of Islamic collective investment schemes. *Shukūk*, however, can take various forms and can have different risk-return features compared to interest-bearing bonds. Specifically, AAOIFI identifies 14 types of *shukūk* that can be classified broadly as debt, assets, equity and investment agency based.²⁴³ While several aspects of a legal environment for *shukūk* would entail the elements of a conventional securities law, there is a need to recognise the unique features that arise in the former due to Shari'ah compliance. There is, thus, a need for statutes that cover the nature of Islamic securities and *shukūk*, not only in order to protect investors and stakeholders but also to enable the sustainable growth of the Islamic capital markets.²⁴⁴ Countries have adopted different strategies to enable *shukūk* issuances under their legal frameworks. While some countries have introduced specific *shukūk* laws, others have incorporated clauses or interpretations that would enable issuance of *shukūk*.²⁴⁵

4.3.3.1 Status of *Shukūk* Law in Selected Countries

As in the case of Islamic banking and *takāful* laws, countries are classified into three types according to the status of their *shukūk* laws. The first group of countries have specific laws related to *shukūk*. Capital markets in Sudan are governed by the Khartoum Stock Exchange (KSE) Act of 1994 ("KSE Act 1994") and the Financial Markets Regulation Authority Act of 2015 ("FMRA Act 2015"). The legal framework of the KSE Act 1994 is also supported by other related laws, such as the *Shukūk* Act of 1995 and the Civil Transactions Act of 1984. In Indonesia, the legal foundations for *shukūk* instruments, market and transactions were laid with the *Shukūk* Act, No. 19 of 2008. In the second category of countries, *shukūk* stipulations are included in existing capital market laws. In Malaysia, the Capital Markets and Services Act 2007 (Act No. 671) governs various aspects of the capital markets in the country. Securities Commission Malaysia has further developed various guidelines related to *shukūk* as embedded in the Guidelines on Unlisted Capital Market Products under the Lodge and Launch Framework 2015

²³⁸ Faye et al. (2013).

²³⁹ Batur (2014).

²⁴⁰ Some important areas of coverage are set out in Appendix 1 to its Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation, 2017.

²⁴¹ BinMahfouz and Ahmed (2014).

²⁴² Regulatory authorities of some countries such as Malaysia and Indonesia have come up with Islamic screening criteria for Islamic stocks. For an overview of Shari'ah screening criteria used in the former, see https://www.sc.com.my/wp-content/uploads/eng/html/icm/11_1Q_msianicm.pdf, and in the latter see www.ojk.go.id/en/kanal/syariah/tentang-syariah/pages/pasar-modal-syariah.aspx.

²⁴³ AAOIFI (2010).

²⁴⁴ For a discussion on the legal issues related to sovereign *shukūk*, see Awadzi (2015).

²⁴⁵ For example, while Luxembourg introduced a *Shukūk* Law in 2014, in the UK the Finance Act 2008 and the Government Alternative Finance Arrangement Regulations 2014 were introduced to facilitate *shukūk* issuance. See Awadzi (2015).

and Guidelines on Trust Deeds 2011. In Pakistan, the Securities Act of 2015 recognises *ṣukūk* as one of the instruments of capital markets. Furthermore, some general laws (such as the Companies Ordinance 1984, the REIT Regulations 2015; the Guidelines for the Issue of Term Finance Certificates (TFCs) to General Public, and the Listed Companies [Prohibition of Insider Trading] Guidelines) affect both conventional and Islamic capital markets. In addition, some specific regulations issued by regulatory bodies affect the latter only – for example, the Government of Pakistan *Ijārah Ṣukūk* Rules 2008 (State Bank of Pakistan), the *Ṣukūk* Regulations 2015 and the *Ṣukūk* (Privately Placed) Regulations 2017.

Islamic capital market issues were incorporated in the Capital Market Law in Oman by amendment by Royal Decree No. 59 of 2014, issued on 10 November 2014. The amended Law authorises the Capital Market Authority of Oman to issue *ṣukūk* regulations. In June 2012, an amendment to the Public Finance and Debt Management Law, No. 4749, provided the necessary legislation for sovereign *ṣukūk*, resulting in the first sovereign *ṣukūk* issues by the Republic of Turkey on 18 September 2012 in the domestic and international capital markets. A communiqué by the Capital Markets Board (CMB) facilitated issuance of the first *ṣukūk* (offshore) by Kuveyt-Türk in 2010.

There are countries in which there are no specific *ṣukūk* laws, but where the regulators are given authority to regulate and supervise *ṣukūk*. In Nigeria, provisions of the Investment and Securities Act 2007 give power to the Securities and Exchange Commission to register and regulate securities exchanges, corporate and individual capital market operators, and collective investment schemes. The Act also empowers the SEC to establish specialised departments for the purpose of regulating and developing the Nigerian capital market, as well as to make rules and regulations that will ensure the smooth working of the capital market. Under these provisions, the establishment of an Islamic fund and listing of the *ṣukūk* by the SEC becomes possible.

The Capital Markets Law 2003 (“CML 2003”) issued by Royal Decree No. M/30, dated 2 July 2003, governs the activities of capital markets in Saudi Arabia. While *ṣukūk* are regulated and governed by the Capital Markets Authority (CMA) under the code “Offers of Securities Regulations”, the rules mainly cover the procedures for issuing securities, rather than focusing on their form and type. The CMA regulates *ṣukūk* and bonds, and both are subject to the same rules and principles. The Federal Law No. 4 of 2000 established the UAE Securities and Commodities Authority (SCA) and empowers it to issue regulations, regulate the securities and commodities markets, receive reports and complaints relevant to the

activities of the markets, and impose penalties for non-compliance. The SCA has issued the Authority’s Board of Directors’ Decision No. 16 of 2014 Concerning the Regulation of *Ṣukūk*, which regulates issues related to the *ṣukūk* market.

The final group of countries has no laws related to *ṣukūk*. In Bangladesh, the Securities and Exchange Commission Act 1993 (amended in 2012) governs the capital markets. While Bangladesh has securities and trust laws, there are currently no specific provisions to accommodate *ṣukūk* issuance. Egypt’s capital markets are governed by the Capital Markets Law (Law No. 95 of 1992) which recognises “bonds, financial notes and other securities” as instruments that can be listed and traded in Egyptian capital markets. There are no specific clauses on Islamic securities or *ṣukūk* in the law.

Chart 4.3.3.1.1 Status of *Ṣukūk* Laws

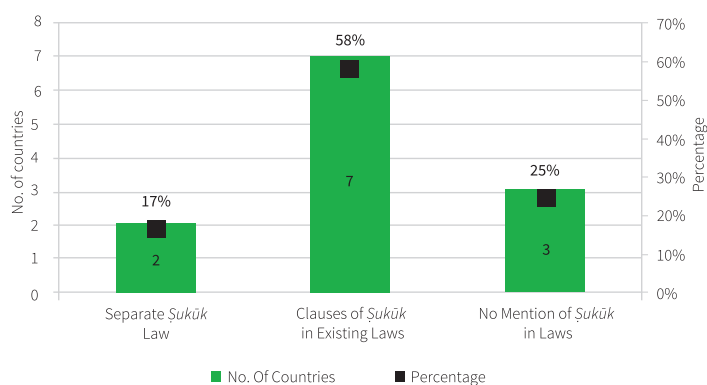


Chart 4.3.3.1.1 shows the status of *ṣukūk* laws in sample countries used in this study. While two countries in the sample have specific laws related to *ṣukūk*, in seven countries clauses related to *ṣukūk* are included in the existing laws. However, 25% of the countries in the sample do not have any reference to *ṣukūk* in their laws.

4.4. DISPUTE SETTLEMENT INSTITUTIONS

While contracts at the transactions level are Shari’ah-compliant, the courts in most jurisdictions would use some variant of Western commercial law to adjudicate cases. This would mean using non-Islamic legal principles to resolve disputes involving contemporary Islamic financial contracts. This can be a problem, particularly in countries with civil law systems, since the courts will interpret the contracts on the basis of national codes and statutes. Courts in common law jurisdictions will give the provisions of the legal contract more weight and, therefore, provide more predictable results since outcomes are based on precedents.²⁴⁶ However, Islamic transactions under the common law regime may have problems of interpretation since a contract would be

²⁴⁶ See Ercanbrack (2011), p. 386 and Al-Amine (2014), p. 372.

interpreted strictly according to its terms, and Shari'ah perspectives will not be considered.

One way to resolve the issue of duality of laws is to include choice-of-law and dispute settlement clauses in Islamic financial contracts to reduce legal risks.²⁴⁷ If Islamic law is chosen as the law of choice to settle disputes, the parties can opt for commercial arbitration and be shielded from the national legal environment. Whereas some Islamic arbitration centres exist, parties are reluctant to take disputes to these institutions due to lack of precedents. Furthermore, there is uncertainty regarding the outcome due to the differences of opinion among the various scholars and schools and the absence of a standardised codified Islamic law. As such, parties avoid using Islamic law as applicable law as they want to avoid the "impracticalities or the uncertainty of applying classical Islamic law".²⁴⁸

To reduce legal risks arising from the absence of Islamic courts and arbitration centres, the dispute resolution clauses in most international Islamic financial transactions usually choose English law as the preferred governing law. Doing so, however, makes the English common law dominant over the principles of Shari'ah, with the rules of the English law determining the outcome.²⁴⁹ To avoid the problem of interpretation and enforcement of Islamic contracts, the documentation of contracts used in different products must conform to Shari'ah and be prepared so as to make them enforceable under English law. A contract that elaborates all main elements of the transactions that make it Islamic will most likely be honoured in an English common law court.

4.4.1 Status of Dispute Settlement Framework for Islamic Finance in Selected Countries

Dispute resolution regimes for Islamic finance can be categorised into three different types. First, countries that have specific Islamic dispute resolution institutions such as courts and arbitration centres apply Islamic law in cases involving Islamic finance. The judicial structure in Sudan has specialised courts to deal with specific issues. The Khartoum Commercial and Intellectual Property Court (KCIPC) established in 2002 following the Judiciary Law 1986 deals with all business-related disputes. In disputes involving Islamic financial institutions, the court refers Shari'ah-related issues to the SHSB of the Central Bank of Sudan (CBOS). While Saudi Arabia has an Islamic legal system, some special quasi-judicial committees are established to deal with cases outside the scope of competence of the Shari'ah court. Accordingly, the Royal Order 729/8 established the Banking Disputes Settlement Committee (BDSC) under the SAMA in 1987 for resolving legal issues relating to banking disputes.

Other countries in this category are those that do not have Islamic legal systems, but have established special dispute resolution institutions that use Islamic law to adjudicate cases related to Islamic finance. Under the Religious Court Act, No. 3 of 2006, in Indonesia, parties to an Islamic finance dispute can take the case to either the national civil courts or a religious court. The role of the religious court in mediating and settling disputes related to Islamic financial transactions is also recognised by Article 55 of the Islamic Banking Act, No. 21 of 2008. However, the law also allows the parties of the contract to choose to settle disputes outside the religious courts.

Another option for dispute settlement is to use Islamic arbitration centres that use Shari'ah to adjudicate cases. While disputes involving Islamic financial transactions in the UAE would be adjudicated in civil courts under the existing laws of the country, cases can be taken to the International Islamic Centre for Reconciliation and Commercial Arbitration (IICRCA) if parties opt for it in the dispute resolution clauses. In Malaysia, the Kuala Lumpur Regional Centre for Arbitration (KLRC) also made room for Islamic arbitration in 2012 (revised in 2017) with the publication of its Arbitration Rules to facilitate resolution of disputes related to Islamic finance.²⁵⁰

The second category of countries has mixed systems, whereby civil courts are not Islamic but have arrangements for getting Shari'ah input for cases involving Islamic finance. While Pakistan has a Federal Shari'ah Court (FSC) with the jurisdiction of a High Court, and a Shari'ah Appellate Bench (SAB) in the Supreme Court of Pakistan, there are no separate courts for Islamic banking and finance. As such, the civil courts deal with Islamic banking and finance disputes and refer Shari'ah-related issues to the decisions of the Central Shari'ah Board (CSB) of the State Bank of Pakistan. Similarly in Malaysia, a dedicated judge in the High Court is assigned to deal with disputes related to Islamic finance (Hasan and Asutay, 2011, p. 66) and the Central Banking Act 2009 gives a prominent role to BNM's Shari'ah Advisory Council (SAC) in dealing with Shari'ah-related issues in disputes. Judges are required to refer Shari'ah issues to SAC, and the rulings made by the central Shari'ah body are binding on courts or arbitral tribunals.²⁵¹

In some other countries, the civil courts use contract laws of the country that recognise Shari'ah-based contracts to adjudicate disputes in Islamic finance. The Commercial Court in Oman has jurisdiction over commercial disputes that include banking and finance. Other than settling disputes using Shari'ah, the courts apply Omani laws established by Royal Decree. Although disputes related to Islamic finance are dealt with and adjudicated under the existing laws of the country, they are not treated as

²⁴⁷ Vogel and Hayes (1998).

²⁴⁸ Ibid, p. 51.

²⁴⁹ This is evident in some of the Islamic finance-related cases tried in English courts. For a discussion of some of these cases, see Hasan and Asutay (2011).

²⁵⁰ For KLRC i-Arbitration Rules, see https://klrca.org/arbitration/i-arbitration/rules_iarb_en/PDF-Flip/PDF.pdf.

²⁵¹ Oseni and Ahmad (2015).

other cases. The courts apply the principles of Shari'ah in disputes involving the Islamic financial contracts along with the general rules of contract, provided the latter do not contradict Shari'ah principles.

In the third category of countries, Islamic finance disputes are adjudicated in civil courts under the laws and statutes of the particular country without any reference to Shari'ah. Five countries in the sample (Bangladesh, Egypt, Nigeria, Senegal and Turkey) belong to this category, whereby courts do not distinguish between disputes involving Islamic and conventional finance.

Chart 4.4.1.1
Dispute Resolution Framework for Islamic Finance

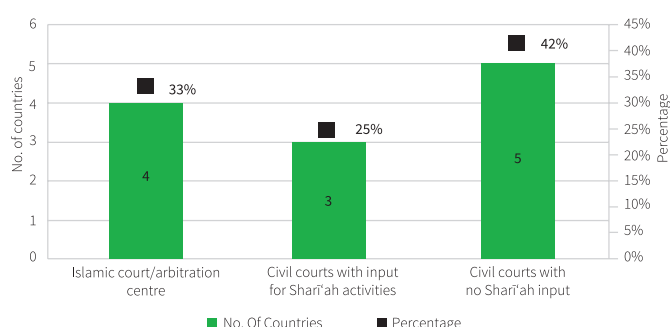


Chart 4.4.1.1 shows the status of dispute resolution frameworks for the sample countries. Whereas four countries have arrangements for Islamic courts or arbitration centres, in three other countries there are arrangements in civil courts to consider Shari'ah principles in dealing with Islamic finance disputes. In the remaining five countries, the laws of the country are used to resolve disputes involving Islamic financial transactions with no specific Shari'ah inputs.

4.5 RESOLUTION FRAMEWORK FOR ISLAMIC BANKS

Effective insolvency systems play an important role in sustaining the soundness of financial systems as they protect creditors' rights and build confidence among stakeholders by resolving risks of default and non-performance.²⁵² Bankruptcy laws along with insolvency systems set out the rules and regulations that govern access, protection, risk management and recovery of dues by providers of debt. Other than supporting quick and optimal resolutions of financial distress for businesses, sound insolvency systems also promote good corporate governance and mitigate assets deterioration through fast and reliable enforcement. An important factor in determining the rights of investors in bankruptcies is to have a sound insolvency system with an efficient enforcement process of the claims

arising from bankruptcy proceedings.²⁵³ A key element of the insolvency framework is the bankruptcy law, which addresses defaults and restructuring by enforcing property rights of different stakeholders in an appropriate way when firms become bankrupt.

The Global Financial Crisis of 2007–08, which resulted in bankruptcies of households, businesses and financial institutions, highlighted the need for a sound legal framework for insolvency, recovery and resolution processes for financial institutions. Certain specific issues arise in bankruptcies related to the banking sector. On the assets side, a key factor is the quality of the collateral and creditors' rights in regard to it following a bankruptcy. This is relevant in financial securities, whereby the structure determines the risks the investors face in the event that the issuer becomes insolvent. Since inefficient bankruptcy regimes create uncertainty about creditors' rights and can adversely affect the growth of the financial sector, different multilateral organisations have produced guiding documents to support a sound insolvency system. The World Bank updated the Principles for Effective Insolvency and Creditor/Debtor Regimes in 2016, and the Financial Stability Board published its Key Attributes of Effective Resolution Regimes for Financial Institutions in 2014 ("FSB 2014") specifically to deal with resolution issues of financial institutions.

FSB (2014) provides a framework for an effective recovery and resolution regime to deal with situations in which financial institutions are under extreme stress. Interacting with other schemes for protecting depositors, retail investors and insurance policyholders, the goal is to ensure continuity of systemically important financial services and of payment, clearing and settlement functions. The framework ensures that non-viable firms can exit the market in an orderly fashion by advanced planning, and by providing a quick, transparent and predictable legal and procedural clarity for orderly resolution. The framework attempts to minimise the overall costs of resolution by avoiding unnecessary destruction of value and losses for creditors. The scheme allocates losses in a way that respects the hierarchy of claims on the one hand, and reduces expectations and reliance on public solvency support on the other hand.

Certain specific issues that arise in Islamic financial transactions due to compliance with Shari'ah are discussed in IFSB WP-07.²⁵⁴ For example, a key difference between conventional and Islamic banks is the *muḍārabah*-based profit-sharing investment account. Not only is there a need to identify its status in the hierarchy of claims, but also in terms of deposit insurance, since Shari'ah principles inhibit these accounts to be guaranteed.²⁵⁵ Further complications can arise in *shukūk*

²⁵² World Bank and IMF (2005).

²⁵³ Ibid, p. 230.

²⁵⁴ See Ali and Al Mamun (2017). Also see Abdelhady (2013) for a detailed discussion on the specific issues arising in bank resolution of Islamic banks.

whereby their underlying structures would determine the risks and rights of the investors. While investors of asset-backed *shukūk* have a claim on the assets underlying the issuance, in an asset-based *shukūk* they have a claim on the issuer with no recourse to the assets.

4.5.1 Status of Resolution Framework for Islamic Banks in Selected Countries

The legal basis for insolvency and resolution of banks can be incorporated in a specific bankruptcy law, or as clauses in other laws such as banking, companies or deposit insurance laws. The legal framework for an insolvency and resolution framework for Islamic banks can be broken into two categories: countries that have specific laws dealing with insolvency and resolution of Islamic banks; and those that do not have any specific laws governing Islamic banks resolution. In the latter category of countries, the bankruptcy issues of Islamic banks and conventional banks would be similar.

The first group of countries that have a specific legal/regulatory framework for Islamic banks resolution in the sample countries includes Malaysia, Oman and Sudan. In the former, while the Companies Act 1965 (“CA 1965”) and the Company Winding-Up Rules 1972 (“CR 1972”) apply to insolvencies of companies, IFSA 2013 (Part XIV, Division 3) in Malaysia refers to the Company Act 1965 and provides specific insolvency-related stipulations for Islamic banks and *takāful* companies. Specifically, Part XIV, Division 3 of IFSA, titled “Winding Up”, deals with Islamic banks and *takāful* operators. Section 217 of Division 3 identifies the priority of payments to different stakeholders in case of winding up of a licensed Islamic bank.

Similarly, bankruptcy of companies is covered in the Commercial Law, No. 55 of 1990, in Oman; while Article 85 of the Banking Law, No. 114 of 2000, deals with bankruptcies of banking institutions. Chapter 7 of Oman’s Banking Law details procedures for dissolution, liquidation and termination of banks. Article 87 identifies the priority of claims as follows: salaries; depositors according to the deposit insurance scheme; premium paid to the Bank Deposits Insurance Scheme Fund; claims to the central bank; and claims to other creditors, including depositors. The Islamic Banking Resolution Framework (Title 1, Section 8) further provides specific guidelines on dissolution of Islamic banks. Interestingly, the guidelines stipulate that an Islamic bank can be dissolved involuntarily by the board of governors of the Central Bank of Oman if it violates Shari’ah rules and principles (Title 1, 8.2.1.8). In Sudan, bankruptcy of individuals is governed by the Bankruptcy Act of 1929; while bankruptcy of companies, including banks, is governed by the Companies Act of 1925 (amended in

2015). The amendments made to the Companies Act 2015 include clauses that comply with the contemporary bankruptcy rules and practices. The Banking Act 2003 (Clause 51.1) provides the precedence for payments on winding up of a bank as: depositors, then employees, followed by different types of debtors.

The second category of countries have laws/regulations on resolution that apply to both Islamic and conventional banks. In Bangladesh, the Bankruptcy Act of 1997 covers individuals as well as companies; while the Companies Act (Bangladesh) 1994 (Act No. 18 of 1994) (GOB, 1997b) highlights procedures for the winding-up of companies during insolvencies, and the Banking Companies Act 1991 also elaborates on dissolution and insolvency issues. The provisions of these statutes apply equally to both conventional as well as Islamic banks. Regulation of bankruptcy and of bank failure in Indonesia is stipulated in the Indonesian Deposit Insurance Corporation (LPS) Regulation No. 2/PLPS/2011, 2011. Furthermore, the Financial Stability Coordination Forum (FKSSK), chaired by the Minister of Finance and the members (governors of Bank Indonesia and Chairman of the LPS), deals with issues related to bank failure, bankruptcy and systemic financial system instability. The goal of FKSSK is not only to maintain financial stability, but also to anticipate and prevent instability in the banking system by avoiding bank failure and bankruptcy (Republic of Indonesia, 2011).

In Nigeria, the laws guiding bankruptcy and resolution of banks are embedded in BOFIA 1991 (Sections 35–42) and the Nigerian Deposit Insurance Corporation (NDIC) Act (Sections 2, 37–44). Banks in distress are managed by NDIC; if they cannot be rehabilitated, NDIC can recommend to the Central Bank of Nigeria to undertake other resolution measures that may include revocation of the bank’s licence. When a bank is liquidated, the NDIC Act stipulates that, after deducting the deposit insurance claims from the amount realised, NDIC should pay depositors and other creditors the net amount available. This bankruptcy and resolution framework applies to Islamic banks as well, and there is no separate framework for dealing with them.

In Pakistan, the Banking Companies Ordinance 1962 (“BCO 1962”) applies to both conventional and Islamic banks, with the Banking and Financial Services (Amendment of Laws) Ordinance 1984 (“BFSO 1984”) amending part of BCO 1962 to accommodate Islamic banking practices. Part III of the BCO 1962 deals with “Suspension of Business and Winding up of Banking Companies” and Part IV covers “Special Provisions for Speedy Disposal of Winding up Proceedings”. As the amendments in BFSO 1984 do not deal with these

²⁵⁵ For a detailed discussion on issues related to deposit insurance related to PSIA, see Najeeb and Mustafa (2016).

sections, the bankruptcy and resolutions procedures and processes of Islamic banks and conventional banks are similar.

Bank resolution in Turkey is incorporated in the Banking Law, No. 5411 of 2005. In the case of a bank failure in Turkey, if the Banking Regulation and Supervisory Agency (BRSA) Board decides to proceed under Article 106 of the Banking Law, the Saving Deposit Insurance Fund (SDIF) immediately starts to pay out the insured deposits, including the insured participation funds, and subsequently applies the bankruptcy and liquidation procedures and processes. If the BRSA Board decides to transfer the shareholder rights (except dividend) and management and control of a bank to SDIF, according to Article 107 of the Banking Law, the SDIF initiates the bank resolution process. In the resolution process, SDIF has the authority to suspend banking activities temporarily. With the Banking Law, the participation banks are subject to the bankruptcy and resolution processes under the operation of SDIF.

Three laws govern bankruptcies in Egypt: (1) Trade Law, No. 17 of 1999, the provisions of which dictate the principles and processes to follow in relation to bankruptcy; (2) Law No. 120 of 2009, which endows the recently created economic courts with the exclusive judicial competence to adjudicate bankruptcy cases; and (3) the criminal law (found in the Egyptian Criminal Code), which allows for the filing of criminal charges against the bankrupt entity, its directors, managers, etc. if bad faith or fraud is suspected. The bankruptcy process for both conventional and Islamic banks is controlled by the Central Bank of Egypt.

A separate insolvency and resolution framework for banks does not exist in Saudi Arabia (FSB, 2015). Insolvency is covered by two statutory provisions: (1) the Commercial Court Law (CCL), issued by Royal Decree No. (M/2), dated 15/1/1390H, which has embedded clauses in Chapter 10 to deal with insolvency cases; and (2) Royal Decree M/16 of 1416, which deals with the Law of Settlement Preventing Bankruptcy (LSPB). Both laws are applied to banks, finance houses and insurance companies. Recently, the regulator has been working to introduce a new Insolvency Law, and has released its Insolvency Law Policy (Ministry of Commerce and Industry). SAMA has also interpreted Article 22 of BCL 1966 to deal with failing banks either by merging a troubled institution with a sound bank or by shareholder recapitalisation (FSB, 2015).

While there is no specific insolvency law in the UAE, the government has plans to introduce it. Article 306 of the Federal Law No. 2 of 2015 on Commercial Companies ("Companies Law 2015") stipulates that companies can

provide the methods of liquidation in their Memorandum of Association. In case this is not done, Chapter 2 of the law provides the process for liquidating a company. No separate framework of resolution of banks exists if they declare bankruptcy, which includes Islamic financial institutions.

Chart 4.5.1.1 Resolution for Islamic Banks

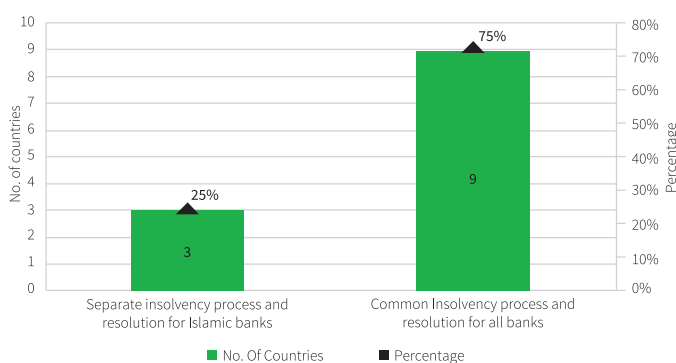


Chart 4.5.1.1 summarises the status of resolution of Islamic banks in the sample countries. Only three countries in the sample had specific laws that deal with insolvency regimes for Islamic banks. The bulk of the countries have general rules of resolution of banks that apply to both Islamic and conventional banks.²⁵⁶

4.6 SHARĪ'AH GOVERNANCE REGIMES

The primary mission of an Islamic financial institution is to “meet its stakeholders’ desire to conduct their financial business according to Shari’ah principles” (Grais and Pellegrini, 2006a). To fulfil the desire of stakeholders to comply with Shari’ah requirements, there is a need to have a Shari’ah governance framework in place. A Shari’ah governance framework constitutes the structures and processes to ensure that the principles and requirements of Islamic law are fulfilled in all contractual and operational aspects of an IIFS. Among others, contracts and all supporting documentations, including legal papers, forms and processes, have to be Shari’ah-compliant during the development phase of products. There is also a need to ensure that the procedures and processes are implemented in accordance with approved Shari’ah guidelines after products are launched in the market.

While traditionally the shareholders are considered to be the key stakeholders, the depositors and investors form the second important stakeholders of Islamic financial institutions as they provide the bulk of the funds in the form of demand deposits and profit-sharing investment accounts. The funds are provided with the expectations of good services, competitive returns and compliance

²⁵⁶ The IFSB has recently published a working paper, WP-07, that provides a detailed exposition on various aspects of Islamic bank resolution. See Ali and Al Mamun (2017).

with the principles of Islamic law. IFSB-3 identifies additional stakeholders for the Islamic financial sector in a broader perspective and includes employees, customers, suppliers, the Muslim community (ummah), supervisors and the government.²⁵⁷ The Muslim community is represented by individuals, civil societies and organisations that desire a financial system based on Islamic values and principles to produce a just, stable and resilient Islamic financial industry fulfilling the goals of Shari'ah.

While various Shari'ah governance models exist, the common goal is to provide a framework that ensures the Shari'ah requirements are fulfilled. A key element of the Shari'ah governance framework is the Shari'ah supervisory board constituting scholars/jurists who oversee and validate the Shari'ah compliance of products and operations of IIFS. Even in the absence of regulatory requirements, IIFS would establish SSBs to enhance the legitimacy and credibility of their operations. A key element of the Shari'ah governance regime is the existence of terms of reference for the organisational-level SSB. The issues under purview can include the terms of reference of the SSB, defining the duties and role of SSB members, approving the appointment of SSB members, specifying the qualifications and minimum number of members in the SSB, and identifying the position of the SSB in the governance structure. The code of conduct of SSB members can include limiting the number of banks they can serve in, avoiding conflicts of interest, maintaining independence, etc. The operational issues related to Shari'ah governance would be to ensure information disclosure related to products and proper use of charity funds.

There also must be clarity in terms of the status of Shari'ah governance in general, and of the role of the SSB in particular within the overall governance framework. The SSB is an independent body appointed for a limited period of time by either the shareholders (through the annual general meeting) or the board of directors (BOD) upon the recommendation of the senior management. While the terms of reference define the roles of the SSB, its key responsibility is to make decisions on Shari'ah-related issues that become binding on the management and board. Thus, a possibility of conflict of authority can arise between the board, which has the overall governance power, and the SSB, which can impose restrictions on the products and operations of IIFS.

There are, however, some concerns related to Shari'ah governance that relies on SSBs at the organisational levels only. Without regulatory guidelines, the selection of Shari'ah scholars and the functions of SSBs are

determined by the senior management and BOD of the financial institutions. As Shari'ah governance and supervision becomes a subsystem of the overall governance system of a bank, it is likely that the SSB members are selected to serve the interests of the BOD and management. A critical issue that can arise in Shari'ah governance of Islamic banks is the use by the BOD and management of control and authority to serve their own needs. Since the BOD and senior management of Islamic banks decide who can sit on the SSB, and the members are paid by banks, situations of conflict of interests can arise that can lead to situations whereby the independence of the SSB may be compromised. SSB members who are not inclined to fulfil the economic objectives of the Islamic banks can create incentives for "fatwa shopping" and limit and compromise the role of SSBs.²⁵⁸

As the approach of the Islamic banking industry has been predominantly to design products by taking conventional products as benchmarks, cases can arise when there may be trade-offs between the Shari'ah requirements and economic factors. If the SSB is permissive, the economic factors will be given more weight at the cost of Shari'ah principles, which may result in opting for controversial Islamic products. For example, even though the Islamic Fiqh Academy, an organ of the OIC and recognised as the highest international authoritative body for contemporary Islamic jurisprudence, issued an edict in 2009 that declared organised tawarruq unlawful as it has elements of forbidden riba, it is practised widely in some jurisdictions.²⁵⁹ While it is recognised that there can be differences of Shari'ah opinions, "fishing for *fatwā*" by asking for Shari'ah opinions from different scholars and then choosing one that is convenient should be avoided.²⁶⁰

The above concerns of objectivity and conflict of interests of the SSB at the organisational level may necessitate regulatory intervention. In a well-functioning financial system, the regulators are stakeholders acting on behalf of society at large. Three core objectives of regulation can be identified: "to sustain systemic stability, to maintain the safety and soundness of financial institutions, and to protect the consumer".²⁶¹ An important aspect of bringing stability and efficiency to the banking sector is to require good governance practices and structures. To reduce Shari'ah compliance and reputational risks and ensure that the Islamic banks fulfil their fiduciary duties of conducting business according to Shari'ah principles to protect consumers, the regulator bodies can introduce a Shari'ah governance framework and guidelines.

²⁵⁷ IFSB (2006), p. 27.

²⁵⁸ Grais and Pellergrini (2006c).

²⁵⁹ The ruling was issued by the International Fiqh Academy in its 19th session which was held in Sharjah, United Arab Emirates, during 26–30 April 2009. While the Islamic Fiqh Academy is an Islamic jurisprudential body of OIC and its rulings are considered to reflect the overall reference for Shariah judgments on contemporary issues, they are not binding.

²⁶⁰ IFSB (2006), p. 25.

²⁶¹ Llewellyn (1999), p. 9.

One key reason for a regulatory oversight of the Shari'ah governance process is to protect the rights of other stakeholders such as depositors and PSIA holders, who expect the industry to conduct all its operations in a Shari'ah-compliant manner. Shari'ah governance goals from the regulators' perspective will reflect the interests of all stakeholders, including depositors and PSIA holders, whose perspectives may not always be recognised at the bank level. From a regulatory standpoint, there are additional reasons to have a Shari'ah overview at the national level. Leaving Shari'ah governance at the bank level can generate different risks that can adversely affect the stability and growth of the industry. Shari'ah non-compliance not only results in loss of income in the short term, but can also lead to reputation risk, which can cause systemic risk and instability over the longer run.²⁶²

Another type of risk that may require regulatory attention is the legal risks arising from diversity of fatwas issued by various SSBs within the same country. Since SSBs produce *fatāwa* by interpreting different legal sources and using different methodologies, there is a strong likelihood that conflicting opinions will exist. With the expansion of the industry, the possibility of conflicting fatwas can undermine customers' confidence in the industry.²⁶³ This calls for maintaining consistency of the edicts issued within a jurisdiction by harmonising the Shari'ah rulings at the national level. A sound Shari'ah governance framework would enhance acceptability among different stakeholders by not only considering their interests in a balanced way but also incorporating the broader goals of *maqasid* (*maqasid al Shari'ah*).

4.6.1 Shari'ah Governance: International Guidelines

The IFSB provides guidelines for a sound Shari'ah governance regime for IIFS. IFSB-10 defines the Shari'ah Governance System (SGS) as "the set of institutional and organisational arrangements through which an IIFS ensures that there is effective independent oversight (of the structures and processes) of Shari'ah compliance".²⁶⁴ Principle 16 of IFSB-17 (Core Principles for Islamic Finance Regulation [Banking Segment]) (CPIFR) recommends that the supervisory authority should determine "the general approach to Shari'ah governance in its jurisdiction, and [lay] down key elements of the process" and ascertain that "IIFS have a robust Shari'ah governance system in order to ensure an effective independent oversight of Shari'ah compliance over various structures and processes within the organisational framework".²⁶⁵ Furthermore, the CPIFR asserts that "laws, regulations or the supervisory authority determine that the IIFS are under an obligation to ensure that their products and

services comply with Shari'ah rules and principles". IFSB-10 further asserts that IIFS should choose Shari'ah governance structures "so that they appropriately safeguard the fulfilment of fiduciary duties including good faith, care, skill and diligence towards all their stakeholders". IFSB-10 identifies the following structures and processes as being key to the SGS.²⁶⁶

1. Issuance of Shari'ah pronouncements: This is a key aspect of Shari'ah governance which establishes the due processes and mechanisms through which an SSB provides juristic opinions in the form of Shari'ah pronouncements/resolutions on products and operations of Islamic financial institutions. Depending on the Shari'ah governance regime, this can either be done by a national Shari'ah authority or a Shari'ah board at the organisational level. The Shari'ah board is also responsible for examining and approving the legal documentations relevant to the products and operations.
2. Dissemination and ensuring implementation and compliance with Shari'ah pronouncements: An independent department within the IIFS, the internal Shari'ah compliance unit (ISCU), should be responsible for implementing and monitoring the application of the Shari'ah pronouncements.
3. Internal Shari'ah compliance review and audit: There is a need to ascertain that the pronouncements of the Shari'ah board are strictly adhered to. In this regard, an internal Shari'ah review/audit unit/department (ISRU) may be established to review/audit Shari'ah compliance on an ongoing basis. The ISRU should report to the Shari'ah board and produce review/audit reports highlighting the Shari'ah compliance issues so that management can take steps to rectify them.
4. Annual Shari'ah compliance audit: An annual audit on Shari'ah compliance should be carried out either under the supervision of the Shari'ah board or by an external Shari'ah advisory/audit firm to review and report on the Shari'ah compliance of the operations of IIFS during the entire financial year. A general report on the compliance should be included in the annual report and a detailed report provided to the supervisors.

Furthermore, IFSB-10²⁶⁷ provides nine guiding principles under the following five parts:

- General Approach to the Shari'ah Governance System: Identifies principles related to ex-ante and ex-post processes considered essential for good and strong governance, such as having precise terms of reference for Shari'ah boards, appropriate alignment

²⁶² Qattan (2006).

²⁶³ Grais and Pellergrini (2006c).

²⁶⁴ IFSB (2009a), p. 2.

²⁶⁵ IFSB (2015).

²⁶⁶ IFSB (2009a).

²⁶⁷ IFSB (2009a).

of incentives, proper record-keeping, adoption of a professional code of ethics, etc.

- **Competence:** Suggests measures to ensure expertise and skill-sets in Shari'ah boards and to evaluate their performance and professionalism.
- **Independence:** Recommends ways to uphold the independence of the Shari'ah board from the management of IIFS and manage potential conflicts of interest that can arise.
- **Confidentiality:** Highlights the importance of preserving the confidentiality by different Shari'ah governance organs.
- **Consistency:** Suggests improving consistency of professionalism among Shari'ah board members through a set of best practices to enhance their integrity and credibility.

IFSB-10 takes a "no 'one-size-fits-all' approach" and recognises that there is no single acceptable structure for Shari'ah governance. While acknowledging the existence of central Shari'ah boards in certain jurisdictions, a governance framework without a central Shari'ah board is acceptable within the boundaries of the standard.

AAOIFI published governance standards for the Central Shari'ah Board in 2017 with the aim of standardising global regulatory practices for the governance of CSBs and reducing conflicting rulings and practices that are affecting the credibility of the Islamic finance industry.²⁶⁸ The goals of the CSB's standards are to "establish an advanced degree of harmonisation and convergence in the work of Shari'ah Supervisory Boards (SSBs) of Islamic financial institutions to iron out the situations of contradiction and differences between the *fatāwa*, rulings, decisions, and applications by such entity-level boards, allowing consistency in products and services offered by Islamic Financial Institutions (IFIs) and the promotion of standardized practices".²⁶⁹ The standard encourages the creation of CSBs and distinguishes between national and regulatory CSBs, with the former formed at the national level with oversight of different regulatory regimes and the latter formed by a regulatory or self-regulatory body to deal with a specific sector of the industry. The specific items identified in governance standards for CSB are discussed under the following broad headings: appointment, composition and dismissal, functions of the central Shari'ah board, responsibilities of the appointing authority, fit and proper criteria, and independence.

4.6.2 Status of Shari'ah Governance Regimes in Selected Countries

Given the above discussions, the Shari'ah governance framework can be discussed at two levels: national and

organisational. At the national level, several elements for a sound Shari'ah governance regime can be identified: (1) the existence of an appropriate legal basis of Shari'ah governance whereby some law or statute recognises the relevance of Shari'ah governance in the operations of IIFS; and (2) a regulatory framework that provides detailed requirements or guidelines for Shari'ah governance. Using IFSB-10 and IFSB-17 as guidelines, three elements of a sound Shari'ah governance framework at the organisational level can be identified: terms of reference for establishing the SSB at the organisational level; establishing a Shari'ah unit/department to oversee the Shari'ah compliance function; and carrying out an internal/external Shari'ah audit to ensure Shari'ah compliance. Given the above, the Shari'ah governance regimes are assessed for a sample of 12 countries using the following criteria.²⁷⁰

- legal basis for Shari'ah governance;
- regulatory requirements/guidelines for Shari'ah governance;
- terms of reference for SSBs;
- unit/department for Shari'ah compliance function; and
- Shari'ah audit.

4.6.2.1 Legal Basis for Shari'ah Governance

Whereas the legal basis of Shari'ah governance is laid down in the statutes related to the banking sector in some countries, the details covering different aspects of Shari'ah governance differ significantly. In Malaysia, the Islamic Financial Services Act 2013 emphasises strengthening the Shari'ah governance framework to promote Shari'ah compliance in the Islamic financial sector. The Act covers features of Shari'ah governance in three divisions: Shari'ah compliance; Shari'ah governance; and audit Shari'ah compliance. The law makes Shari'ah non-compliance an offence that is punishable and gives Bank Negara Malaysia extensive powers to intervene when any breach takes place. Sudan's Banking Business (Organization) Act 2003 created the Shari'ah Control Higher Commission, which is delegated with the authority to issue Shari'ah edicts and is responsible for supervision and the accomplishment of Shari'ah rules within the Central Bank of Sudan and all other banks. However, there is no specific mention of different aspects of Shari'ah governance at the organisational level in the Act.

In some countries, Shari'ah governance-related issues are not covered in detail in the laws. For example, Article 32 of Indonesia's Islamic Banking Act 2008 mandates Islamic financial institutions to have SSBs to deal with Shari'ah issues in banking operations; while in Oman the Banking Law of 2012 requires financial institutions

²⁶⁸ AAOIFI (2017).

²⁶⁹ Ibid, p. 5.

²⁷⁰ Since banking constitutes the dominant sector, different aspects of the Shari'ah governance regime for the Islamic banking sector are discussed below.

dealing with Islamic banking to have an SSB. Similarly, the Federal Law No. 6 of 1985 of the UAE stipulates that Islamic financial institutions must establish a Shari'ah committee of not less than three persons who will ensure the adherence by such companies to Shari'ah principles in their operations and contracts. However, there are no details on the Shari'ah governance framework required by licensed Islamic banks in the law.

4.6.2.2 Regulatory Requirements/Guidelines for Shari'ah Governance

The second layer of legal framework for Shari'ah governance comes from the regulatory bodies in the form of regulations and guidelines. Though some regulations are mandatory, others are provided as guidelines that IIFIs are encouraged to follow. After the enactment of the Central Banking Act 2009 in Malaysia, BNM produced a regulatory note entitled "Shari'ah Governance Framework for Islamic Financial Institutions" in 2010. The guidelines outline the two-tier Shari'ah governance infrastructure: the first tier deals with the Shari'ah Advisory Council at the central bank level, while the second tier relates to Shari'ah committees at the financial institution level. The BNM guidelines provide details on the Shari'ah governance framework for IIFS that includes issues related to SSBs and operational matters such as Shari'ah review, audit, research and risk management. Bank Indonesia Regulation No. 6/24/PBI/2004 provides guidelines on different aspect of the operations of IIFS. The focus of the regulatory document with regards to Shari'ah governance is the terms of reference of SSBs.

Central Bank of Nigeria (CBN) has issued Guidelines on Shari'ah Governance for Non-Interest Financial Institutions (NIFI) in Nigeria covering four key areas: (1) setting out the rules, regulations and procedures in the establishment of a Shari'ah Advisory Committee of an NIFI; (2) defining the role, scope of duties and responsibilities of the Committee and its members; (3) outlining the functions relating to Shari'ah review and audit processes; and (4) defining the relationship and working arrangement between the Committee and the CBN Shari'ah Council (CSC).

The State Bank of Pakistan (SBP) first issued a detailed set of instructions and guidelines for Shari'ah compliance and governance in the IBD Circular No. 2 of 2008. These instructions were revisited and a comprehensive Shari'ah Governance Framework (SGF) was introduced in July 2015. The SGF 2015 provides for central Shari'ah boards at the level of the SBP and Shari'ah boards (SB) in Islamic banking institutions (IBIs), that include Islamic banks, Islamic banking subsidiaries or the stand-alone Islamic banking divisions of the conventional banks.

The Central Bank of Oman (CBO) issued its Islamic Banking Regulatory Framework (IBRF), which provides

a comprehensive Shari'ah governance framework as a requirement for licensing Islamic financial institutions (Islamic banks, *takaful* and Islamic capital markets institutions). IBRF has a whole section on Shari'ah governance providing details on Shari'ah supervisory boards, internal Shari'ah reviewers, Shari'ah compliance units and Shari'ah audit units. The comprehensive Shari'ah governance framework provides a broader perspective that takes into consideration the interests of different stakeholders and the broader goals of Shari'ah. Bangladesh Bank's Guidelines for Islamic Banking 2009 emphasise promoting the Shari'ah compliance of the Islamic financial sector by strengthening the Shari'ah governance framework. However, the guidelines do not provide a detailed Shari'ah governance framework for IFIs that includes issues related to Shari'ah review and audit. Other than issuing the Guidelines, the role of the Bangladesh Bank in controlling, guiding and supervising the Islamic banks in Bangladesh in accordance with Islamic Shari'ah is minimal. In observing the Shari'ah implementation status of the Islamic banks, Bangladesh Bank examines only the report of the respective banks' Shari'ah boards.²⁷¹

4.6.2.3 Terms of Reference for Shari'ah Supervisory Boards

As indicated, one of the key organs of Shari'ah governance is IIFS' Shari'ah supervisory boards. Countries provide their own terms of reference for establishing an SSB, the details of which differ. Malaysia has a robust legal and regulatory framework for Shari'ah boards. Part IV of IFSA 2013 covers Shari'ah requirements, and is divided into three divisions: Shari'ah compliance; Shari'ah governance; and audit Shari'ah compliance. Furthermore BNM's Guidelines on Shari'ah Governance Framework for Islamic Financial Institutions 2010 provide details of the requirements of an independent Shari'ah committee at the bank level. Among other things, the guidelines provide "fit and proper" criteria for the Shari'ah committee members and outline their duties, responsibilities and accountability.

Oman's Islamic Banking Regulatory Framework (IBRF) provides a comprehensive framework of the terms of reference for SSBs at the bank level. Article 2.2 (Shari'ah Supervisory Board) in Title 2 (General Obligations and Governance) in the IBRF covers various aspects of SSBs under the following headings: Appointment and composition; Rules and responsibilities of SSB; "Fit and proper" criteria for the members of SSB; Grounds for the disqualification of SSB members; Management duties to SSB; and Miscellaneous issues. Some of the features of an SSB include having at least three Shari'ah scholars who are independent and specialised in *Fiqh al-mu'amalat* (Islamic commercial jurisprudence). SSB members are appointed for a maximum initial term of three years, and can serve a maximum of two consecutive terms in

²⁷¹ Sarker (2012).

an institution. However, no SSB member can be on the SSB of more than one competing financial institution in Oman.

In Pakistan, the SBP's comprehensive Shari'ah Governance Framework ("SGF 2015") introduced in 2015 outlines the governance activities at the bank level that are to be performed by the BOD, the Shari'ah board, the resident Shari'ah board member (RSBM), Head of the Shari'ah Compliance Division (SCD), Head of the Shari'ah Compliance Department, In-charge of the Shari'ah Audit Department and In-charge of the Shari'ah Research/Review Department of the respective IBIs. The roles of internal and external auditors have also been defined. The BOD of each IBI must constitute a Shari'ah board comprising at least three Shari'ah scholars appointed as per the SBP's "Fit and Proper Criteria" (FAPC) and subject to prior written approval of SBP. The IBI, in consultation with the SB, can also engage professionals such as lawyers, accountants and economists to act as SB members, but such non-Shari'ah scholar members shall not have voting rights in the SB meetings. The SB is expected to discharge its duties independently and objectively and decisions/fatāwa of the SB are binding on the bank. Every executive of the IBI shall ensure that all the procedural manuals, product programs, checklists, etc., as approved by the SB, are made available to and understood by everyone working in their respective group/functional area. Nigeria also has a detailed terms of reference for establishing the Shari'ah Advisory Committee (SAC) in financial institutions. Guidelines on Shari'ah Governance issued by the Central Bank of Nigeria in 2010 clearly state that all licensed Islamic financial institutions should establish an SAC that must be approved by the regulators.

In some other countries, though some regulatory guidelines on SSB exist, the terms of reference are not detailed. Bank Indonesia Regulation No. 6/24/PBI/2004 provides guidelines on different aspects of operations of IIFS that includes sections on Shari'ah governance. Though not detailed, the regulation requires establishment of an SSB in Islamic banks and identifies the requisites of the board members and the structure and functions of the board. The Guidelines for Islamic Banking 2009 issued by Bangladesh Bank make the boards of directors of the respective banks responsible for ensuring that the activities of the banks and their products are Shari'ah-compliant by forming an independent SSB with experienced and knowledgeable persons in Islamic jurisprudence. The guidelines (Appendix I) also provide fit and proper criteria for selection of members of the SSC which include relevant educational qualifications, experience and exposure, track record, solvency and financial integrity, honesty, integrity and reputation. In Sudan, all banks are required to establish an SSB. Regulations related to Shari'ah supervisions for banks provide the rules for SSBs at the organisational levels. These issues identified include

ascertaining the position of the SSB in the governance structure, defining the role of SSB members, approving the appointment of SSB members and the qualifications, and the minimum number of members in the SSB.

4.6.2.4 Unit/Department for Shari'ah Compliance Function

Other than the SSB, another key organ of Shari'ah governance identified by the IFSB is a department/unit within the IIFS that is responsible for carrying out the Shari'ah compliance function. In Malaysia, BNM's Shari'ah Governance Framework for Islamic Financial Institutions 2010 provides a wholesome framework for Shari'ah governance that includes, among others, the Shari'ah risk management control function, Shari'ah review function, Shari'ah research function and Shari'ah audit function. The Shari'ah review function entails reviewing activities and operations of the IIFS on a regular basis by qualified Shari'ah officers to ensure Shari'ah compliance. Similarly, Oman's Islamic Banking Regulatory Framework identifies the key components of the Shari'ah governance framework as consisting of: an SSB, an Internal Shari'ah reviewer, a Shari'ah compliance unit and a Shari'ah Audit unit to ensure Shari'ah compliance at all times and at all levels. Reporting to the SSB and the CEO, the internal Shari'ah reviewer heads the Shari'ah compliance and Shari'ah audit unit of Islamic banks.

The guidelines issued by the CBN in Nigeria require that there should be a dedicated internal Shari'ah compliance unit comprised of officer(s) with appropriate qualifications and experience in Islamic commercial jurisprudence and conventional finance to serve as the first point of reference for Shari'ah compliance issues. The Shari'ah compliance unit also serves as the secretariat to the SAC. In Pakistan, the SBP issued the Shari'ah Governance Framework for Islamic banking Institutions that identifies various aspects of Shari'ah governance. Other than requiring a resident Shari'ah board member to oversee the activities of the Shari'ah board, the guidelines also require Islamic banks to have a Shari'ah compliance department to act as the secretariat of the Shari'ah board, be a conduit between management and the Shari'ah board, carry out Shari'ah compliance review, deal with issues arising in Shari'ah audit reports and carry out training on Shari'ah compliance.

4.6.2.5 Shari'ah Audit

Shari'ah audit is another key function identified by the IFSB to ensure that the products and operations comply with Shari'ah. In Malaysia, IFSA 2013 gives the option to the central bank, Bank Negara Malaysia, to carry out an audit on Shari'ah compliance at the bank level and to submit the audit report to the regulator. BNM's Shari'ah Governance Framework for Islamic Financial Institutions in 2010 includes issues related to Shari'ah committees and operational matters such as Shari'ah review, audit, research and risk management.

In Pakistan, the SBP guidelines²⁷² outline the governance activities of the internal Shari'ah audit unit (ISAU) and of the respective IBIs. The ISAU is required to prepare an internal Shari'ah audit plan which is reviewed by the Shari'ah board and approved by the board audit committee. The internal Shari'ah audit report should be submitted to the Shari'ah board for consideration and corrective actions, if needed. The guidelines further refer to the scope of the external audit, and specify that it should include independent assessment of the Shari'ah governance and compliance environment.

In Oman, the Islamic Banking Regulatory Framework identifies the key aspects of the Shari'ah audit functions in Islamic banks, including identifying the roles of the Shari'ah audit unit and the fit and proper criteria of the staff members working in the units. After carrying out an audit, the Shari'ah audit unit is required to draft a report that is presented to the SSB and the BOD's Audit Committee. The central bank will also examine the Shari'ah audit report as part of its annual audit and examination of licensed Islamic banks. The Central Bank of Nigeria's Guidelines on Shari'ah Governance for Non-Interest Financial Institutions defines one of the roles of the Shari'ah Advisory Committee as: "[to] assist the internal audit of the NIFI on Shari'ah compliance audit."²⁷³ However, no further details are provided on the requirements for carrying out a Shari'ah audit.

4.7 LESSONS LEARNED

The stability and resilience of financial systems depend partly on the ability of the legal system to support the contractual agreements used by markets and institutions. Some relevant aspects of the legal infrastructure that are necessary for a well-functioning and stable Islamic financial sector were examined in this chapter for 12 countries from different regions and legal systems. The results show diverse statuses of Islamic financial laws, dispute resolution institutions, bank resolution frameworks and Shari'ah governance regimes. While some countries have relatively better legal institutions to support the Islamic financial industry, in other countries they are still evolving. Since financial transactions are legally constructed, there is a need to provide the legal foundations and other supporting institutions for sound development of the Islamic financial sector. Based on the discussion on different countries presented, this section highlights the lessons learnt in terms of strengths of the legal infrastructure elements and Shari'ah governance framework.

4.7.1 Financial Laws

A key element in the legal infrastructure is to have supporting financial laws for different Islamic financial

sectors, as they provide the legal basis for different financial institutions and transactions. Since Islamic finance entails unique features due to compliance with Shari'ah, there is a need for countries to enact appropriate financial laws that can support different financial sectors. The experiences of the countries examined in the chapter show that the legal basis for Islamic finance can be introduced in different ways. A few countries have separate Islamic financial laws that recognise the unique nature of Shari'ah-compliant contracts. These regimes establish a sound legal basis for Islamic financial institutions and markets and provide a framework for dispute settlement and resolution of financial institutions. IFSA 2013, in Malaysia, is a good example of a banking and *takāful* law that incorporates features of different Islamic contracts (see Box 4.1 in Section 4). Similarly, the *shukūk* law that recognises different Islamic contractual structures would provide a sound basis for the development of the *shukūk* markets.

In some countries, such as Pakistan and Bangladesh, clauses related to Islamic banking and *takāful* have been added to the existing financial laws. In some other countries, the regulators are given authority to provide regulations related to Islamic finance and they play an important role in providing a framework under which Islamic financial practices can take place. Nigeria belongs to this category whereby the regulatory bodies are accommodating Islamic financial practices by providing the necessary regulations.

4.7.2 Dispute Settlement Institutions

With the exception of a few countries that have Islamic legal systems, most of the OIC member countries have adopted some variant of civil or common law systems. Unless there is some arrangement to use Shari'ah principles in Islamic finance disputes, the civil courts in these countries would use national laws to adjudicate the cases creating legal risks. Experience from the countries examined show that there are different ways in which disputes in Islamic finance can be dealt with in light of Shari'ah principles. Some countries such as Indonesia have established special Islamic courts that also deal with Islamic finance-related disputes. While some countries have a separate Shari'ah bench within the civil courts, others refer Shari'ah issues to an external Shari'ah board or authority for advice. Malaysia and Pakistan has taken this approach. Alternatively, arbitration centres that use Islamic law to adjudicate cases can be used for disputes arising in the Islamic financial sector. Depending on what is feasible in the legal environment, countries can adopt one of the above frameworks to reduce legal uncertainty arising from adjudicating Islamic finance disputes in non-Islamic civil courts. Countries where it is difficult to change the legal system can opt for arbitration centres

²⁷² www.sbp.org.pk/ibd/2015/C1-Annex.pdf

²⁷³ Central Bank of Nigeria Guidelines on Shari'ah Governance for Non-Interest Financial Institutions, p. 7.

that have the option of using Shari'ah to deal with cases related to Islamic finance.

4.7.3 Bank Resolution

Since the Global Financial Crisis of 2007–08, the emphasis has been on developing a framework for bank resolution to reduce disruptions in economies when financial institutions fail. The resolution framework for Islamic banks, however, is “more complex due to the specificities of the industry, its structural nuances, and the overarching demands of Shari'ah on how contracts and transactions must be structured and implemented”.²⁷⁴ IFSB WP-07²⁷⁵ identifies some factors that need to be considered in framing a sound resolution framework for Islamic banks. Other than clarifying issues such as the implications of Islamic financial contracts with regard to the rights and obligations of different stakeholders, there is also a need for a supportive institutional setup that can prevent bank resolutions. These facilities include access to liquidity from financial institutions and markets on the one hand, and supportive regimes for lender of last resort and deposit insurance that Islamic banks can use in times of distress. IFSB WP-07 further asserts that there is a need to consult with the Shari'ah experts to develop a Shari'ah-compliant framework to deal with abnormal situations of winding-up of banks.

The experiences of 12 countries examined in the chapter show that a small number of countries (25%) have a specific resolution framework for Islamic banks. There is, thus, a need to come up with an Islamic bankruptcy framework that can deal with insolvencies and resolutions involving Islamic financial institutions in a way that protects the various stakeholders and mitigates their legal risks. In this regard, the resolution framework of IFSA 2013 for Islamic banks and *takāful* in Malaysia, which considers the features of Shari'ah-based contracts to determine the priority of claims of different stakeholders, would be a good example to follow. Furthermore, IFSB WP-07²⁷⁶ can also serve as a useful reference document for examining the issues and providing recommendations for the development of a sound Islamic banking resolution framework.

4.7.4 Shari'ah Governance Framework

Since compliance with Shari'ah principles is a unique feature of Islamic finance, a Shari'ah governance regime is an essential requirement to ensure that the products and operations of Islamic financial institutions do not contradict Shari'ah principles. The discussion on Shari'ah governance indicates that measures for improving Shari'ah governance for the industry can be identified

at two levels. At the national, regulatory level, there is a need to establish a complementary Shari'ah supervision mechanism to achieve the broader Shari'ah requirements and objectives. The experiences of the 12 countries examined show that while laws and regulations of some countries provide a framework for Shari'ah governance, in many other jurisdictions this is not the case. In the absence of legal or regulatory requirements for Shari'ah governance, market practices may arise that give economic factors priority over compliance with Shari'ah. Thus, a key factor that can ensure a sound Shari'ah governance framework is to incorporate the requirement of Shari'ah governance in financial institutions in either existing Islamic financial laws or in regulatory guidelines. This is confirmed by IFSB-17, which asserts that laws, regulations or the supervisory authority should ensure that “the IIFS are under an obligation to ensure that their products and services comply with Shari'ah rules and principles.”

At the second level, there is a need to improve the overall Shari'ah governance framework by introducing regulatory guidelines relating to strengthening the organisational Shari'ah governance structures and processes. This can be done by providing terms of reference related to the SSB at the bank level, and by having an appropriate structure and processes to ensure Shari'ah compliance of the operations of Islamic banks. Countries studied in this chapter show that Malaysia, Nigeria, Oman and Pakistan have relatively better regulatory frameworks for Shari'ah governance. The experiences of the countries, however, also show that while a majority of the countries have regulatory guidelines on terms of reference for SSB, guidance on other operational elements of Shari'ah governance (such as Shari'ah compliance and Shari'ah audit functions) are absent in many countries. Thus, there is a need to strengthen the overall Shari'ah governance framework in different jurisdictions by including Shari'ah compliance and Shari'ah audit functions in the regulatory guidelines. In this regard, IFSB-10 and IFSB-17 (CPIFR 16) provide specific guidance on various aspects of a Shari'ah governance framework at the organisational level and provide a good basis that regulators can adopt.

²⁷⁴ Ali and Al Mamun (2017).

²⁷⁵ Ibid.

²⁷⁶ Ibid.

5.0 CONCLUSION

For the first time, the total assets of the Islamic finance industry have surpassed USD 2 trillion. The industry has also returned to strong growth after two years of near stagnation. With only one exception, Islamic banks in all jurisdictions where Islamic finance is systemically important and in many other countries have been able to increase their market shares. But the future of Islamic finance does not depend only on market shares, but also on the development of market volume, which is determined by the fundamentals of those economies in which Islamic financial institutions operate. While diversified economies in Asia and elsewhere can benefit from the improving health of the global economy, revivals of the oil industry in the United States and revised energy policies in other parts of the world may put a ceiling on the upward movement of oil and gas prices.

It seems that the resilience of Islamic finance will be put to the test in some key markets in the foreseeable future. While the strong growth of the *shukūk* market can be seen as a positive development for Islamic finance, the drivers of this growth – substantial budget deficits in major Islamic finance jurisdictions – give cause for concern. With some time lag, a decline in the overall economic activity can also dampen the business of IIFS. Islamic banks with a significant exposure to the real estate and construction industries may be disproportionately affected by a slowdown. These sectors plus the wholesale/retail and trade sectors have shown high non-performing financing ratios in 2017. Economic downside risks are accumulating and may well persist in 2018 and beyond. Furthermore, upcoming elections in key Islamic banking domiciles, as well as continuing geopolitical tensions, are perceived as potential threats to economic stability. Islamic banks are well advised to reinforce their risk management systems and stress-testing frameworks.

The BCBS has finalised its Basel III reforms, and the IFSB is working on new and revisions of older standards. A general objective of this complementary work is the creation of a level playing field that ensures a fair treatment of IIFS and prevents regulatory arbitrage. However, guidance by IFSB standards will not only encourage good practices in the industry, but will also help it to cope with bad practices. In some jurisdictions, for example, *takāful* underwriting surpluses are treated as a form of income that can be distributed even when the participants' risk funds lack adequate reserves so that *takāful* undertakings become excessively dependent on interest-free loans from the *takāful* operator. Deficiency positions of many PRFs can also be attributed

to excessive *wakālah* fees and *mudārabah* commissions charged to the fund. Such practices not only threaten the stability of *takāful* undertakings but also undermine the reputation of the industry and therefore become a systemic concern.

The Islamic finance industry is not an integrated global market yet, but a conglomerate of national markets with different legal and regulatory environments and Shari'ah governance systems. Over time, this diversity has grown even further. Market players and regulators recognise the need for more standardisation, but progress in this regard is at best limited. The current status regarding legal and Shari'ah governance frameworks is documented in this IFSI Stability Report, and the results of the IFSB implementation survey do not indicate any breakthrough. The market fragmentation implies that the Islamic finance industry is in many respects not self-reliant and still substantially dependent on interactions with conventional finance – from benchmarking to liquidity management and securities transactions. A standardisation, or at least an approximation, of legal environments, governance systems and transactional practices could help the industry to realise economies of scale and network effects not only in routine operations but also in consumer education, marketing, brand recognition and product development. Progress in market integration would strengthen the competitive position of Islamic finance in an increasingly tougher macroeconomic environment.

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ISBN 978-967-5687-63-1



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