ISLAMIC FINANCIAL SERVICES BOARD

ISLAMIC FINANCIAL SERVICES INDUSTRY STABILITY REPORT 2023

ISLAMIC FINANCIAL SERVICES BOARD

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STABILITY REPORT 2023

Navigating a Challenging Global Financial Condition

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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 comprehensive due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, but is not limited to, the issuance of exposure drafts, holding workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars, and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional, and national organisations, research and educational institutions, and market players.

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

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FOREWORD

The eleventh issue of the Islamic Financial Services Board (IFSB) Stability Report is taking place when the IFSB is celebrating its 20th Anniversary, marking an important milestone for the IFSB. Since its inception, with outstanding commitment and unwavering support of all its members, particularly the governing bodies; the Council, Executive Committee and Technical Committee, the IFSB in line with its core mandate, continues issuing standards, guiding documents, and working papers to promote the stability and resilience of the key segments of the Islamic Financial Services Industry (IFSI). The IFSB has issued 41 standards, guiding principles and technical notes for the IFSI in Islamic banking, Islamic capital markets and takaful sectors in addition to numerous research working papers. The IFSB closely monitors developments in the global financial system generally and specifically in its member jurisdictions.

The eleventh edition of the IFSI Stability Report also takes place at a time when the global financial system is witnessing tightening monetary conditions amid high inflationary pressure. This has substantially increased market volatility, especially in the rates space, contributing to a deterioration in market liquidity conditions, and financial stability risks have also risen from events such as the Russia–Ukraine conflict. As such, the balance of risks tilts towards the downside.

Notwithstanding, the value of the global IFSI increased to an estimated USD 3.25 trillion in 2022 (from USD 3.06 trillion in 2021). The IFSI sustained its growth momentum with a rate of 6.2% year-on-year (y-o-y) based on significant improvement, especially in the Islamic banking and Islamic capital markets segments in some key markets. Furthermore, the financial stability indicators remained satisfactory, especially when compared with previous years' performance, conventional peers, and assessment criteria used by international standard-setting bodies. Based on cautious optimism in view of the downside risks, positive growth in IFSI assets, financial soundness, and resilience indicators are envisaged in many jurisdictions of the Islamic finance industry in 2023.

As always, it is my fervent hope that the IFSI Stability Report 2023 will provide a better understanding of current trends, structural developments, prudential issues, and other related matters in the IFSI across jurisdictions and sectors, as well as of the workings of the IFSB and of both the extant and emerging issues that affect the stability and resilience of the IFSI, while helping to strengthen the building blocks needed for greater resilience.

Dr. Bello Lawal Danbatta

Secretary-General,
Islamic Financial Services Board, August 2023

EXECUTIVE SUMMARY

The IFSB's Islamic Financial Services Industry (IFSI) Stability Report 2023 presents an assessment of the key vulnerabilities, resilience, and future outlook of the global IFSI in general and in the IFSB member jurisdictions in particular across three key segments: Islamic banking, Islamic capital market and *takāful*. Since its maiden edition was published in 2013, the report has attracted interest beyond the IFSB's member jurisdictions. The report's broad coverage, in-depth analysis of pertinent issues based mainly on data extracted from the IFSB's Prudential and Structural Islamic Financial Indicators (PSIFIs) database, and indicative outlook for the IFSI make it a prime reference for key information on the stability and resilience of Islamic finance globally and across jurisdictions.

Unlike its previous editions, the IFSI Stability Report 2023 is divided into three chapters. It is noteworthy to mention that in addition to a rearrangement of the chapters, for most of the jurisdictions the period of coverage for all the key segments' data is for the full year 2022.

Chapter One of the report as in previous editions provides updates on the key trends in growth and developments, analytical and structural outlooks across the Islamic banking, Islamic capital market and *takāful* sectors since the last IFSI Stability Report 2022.

In Chapter Two, a detailed assessment of the resilience of the three sectors of the IFSI is provided based on technical analyses and interpretation of the likely implications of the selected stability indicators. These indicators are interpreted and analysed in comparison to the previous years' report, conventional financial institutions in the respective jurisdictions, as well as international benchmarks. Recognition is given to the effectiveness of various policy measures adopted in various jurisdictions to ensure the stability and resilience of the IFSI.

Chapter Three covers critical issues in the IFSI with a particular focus on liquidity management tools in Islamic banking, Islamic non-banking financial institutions, and lessons learned from the Silicon Valley Bank collapse.

In addition, the report includes box article contributions from five IFSB members: Central Bank of Nigeria (CBN), Bank Indonesia (BI), Islamic International Rating Agency (IIRA), S&P Global Ratings, and Central Bank of the United Arab Emirates (CBUAE).

In 2022, the global IFSI showed strength and resilience despite challenging global financial conditions. The industry experienced structural development and was estimated to be USD 3.25 trillion. However, the recovery of the global economy faced obstacles such as rising global inflation, soaring oil and commodity prices, disruptions in supply chains, and geopolitical uncertainties.

The balance of risks tilted towards the downside as several factors impacted financial stability. These factors included a COVID-19 resurgence in China, the Russia-Ukraine crisis, rising debt levels, and limited fiscal support. Financial stability risks increased, and the risk of a financial recession grew globally. Central banks faced the challenge of balancing post-COVID-19 economic recovery with financial stability, leading to tightened global financial conditions.

Within the IFSI, Islamic banking remained dominant, with an asset size of USD 2.25 trillion, accounting for 69.3% of the global IFSI assets. The Islamic capital market segment, including sukuk (Islamic bonds), Islamic funds, and Islamic equities, experienced slower growth rates compared to previous years. The sukuk sub-segment, which retained its dominance, grew by 7.0% in 2022, while Islamic funds grew marginally by 1.0%. Unfavourable global economic conditions and reduced sovereign issuances affected the growth of sukuk, while Islamic equities and funds were impacted by market volatility and liquidity strain.

Notwithstanding, the *takāful* segment of the IFSI demonstrated resilience in the face of tightened global financial conditions. It remained strong despite financial market volatility, natural disasters, and their impact on the segment's investment portfolio.

Overall, the global IFSI showed soundness and resilience in 2022 but faced significant challenges due to the dynamics of economic recovery, financial stability, and the peculiarities of different jurisdictions practising Islamic finance.

KEY IFSI HIGHLIGHTS

2020		2021		2022
$ 2.75 Trillion	11.3%	$ 3.06 Trillion	6.2%	$ 3.25 Trillion

Islamic Banking
Growth (y-o-y): 6.9%
Share of IFSI: 69.3%

Islamic Capital Markets
Growth (y-o-y): 6.1%
Share of IFSI: 29.8%

Takāful
Growth (y-o-y): 16.1%
Share of IFSI: 0.9%

GLOBAL ISLAMIC BANKING GROWTH

	ASSETS	FINANCIAL	DEPOSITS
CAGR (2018-2022)	2.5%	10.5%	8.6%
Year-on-Year (4Q'22)	6.9%	13.0%	6.0%

GLOBAL GROWTH OF THE ISLAMIC CAPITAL MARKETS

2.3% growth in *Ṣukūk* Issuances	USD 830 billion *Ṣukūk* Outstanding	1% Growth in Islamic Funds	Market corrections in Equity Markets
Primary market issuances rose to USD 190 billion in 2022	Outstanding *ṣukūk* rose by only 7%	Growth moderated in the Islamic Funds Market	Islamic indices, like their counterparts, experienced volatility, and negative returns

The projected sense of optimism for further growth in 2023 is expected to be impacted by a number of Headwinds and Tailwinds.

HEADWINDS

- Spillover of the effect of financial tightening in advanced economies
- Rising oil and commodity prices amid inflation concerns
- Russia-Ukraine conflict
- Exchange rate volatility
- Financial stability risk
- Political impasse, social unrest and civil conflict
- Climate change risk

TAILWINDS

- Broadened fiscal space in key jurisdictions
- Increased digitalisation and financial inclusion
- Increased sustainability-linked investments
- Increased mergers and acquisitions
- Limited direct exposure to Russia-Ukraine conflict

1.0 DEVELOPMENT IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

1.1 Global Macroeconomic and Financial Market Developments

In 2022, the global economy faced weakened momentum in its post-COVID-19 recovery, [1] and was susceptible to a number of headwinds. The growth of the global economy slowed to 3.2% in 2022 due to a rise in global inflation rate to 8.8%. Core inflation rates remained higher than their pre-pandemic levels and persisted in many countries. This was mainly due to soaring oil, energy, food, and commodity prices, disruptions in global supply chains as the war in Ukraine escalated, [2] and the after-effect of the cost shocks recorded in 2021.

Amid numerous other headwinds, the balance of risks tilted towards the downside in 2022. There was a COVID-19 resurgence in China, escalation in the Russia-Ukraine crises, geopolitical uncertainties, rising debt levels, [3] and limited sovereign fiscal space. [4] Worsening fundamentals and constrained fiscal support have already heightened bankruptcy risks among corporates that rely on leveraged finance but are faced with declining margins. Financial stability risks worsened, and the risk of a financial recession heightened globally. Central banks faced a challenge in maintaining a delicate balance between accelerating post-COVID-19 economic recovery and ensuring financial stability. This led to tightened global financial conditions, reflected mainly in an upward review in policy rates to achieve price stability objectives. This further resulted in currency depreciation, restrained capital flows, a slowdown in international bank financing, and wider spreads on external funding, especially in those emerging and developing countries facing debt-sustainability issues.

The volatility in both the financial and commodities market intensified in 2022 due to recession fears and an uncertain global economic outlook, especially since 3Q'22. This eroded the market rally of risky assets recorded in 1H'22 and led to sharp declines in equity and corporate bond prices. The solvency risks in both the retail and corporate sectors also contributed to the decline in prices. Market liquidity deteriorated across different asset classes and countries, resulting in increased liquidity premiums and declined market depth. Tightening financial conditions led to the shift in market structure, where banks have reduced capital allocations to market-making, which was essential during market volatility as experienced in 2022. The market volatility also had implications for the investment portfolio of *takāful* operators with many opting for a defensive strategy that tilted in favour of value overgrowth.

The resilience of open-end funds and money market funds amid global economic uncertainty and tightened financial conditions remains an issue of global concern. For instance, open-end funds that offer daily redemptions while holding illiquid assets can amplify the effects of adverse shocks by

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[1] Reasons for this include a resurgence in the COVID-19 pandemic initially through the Delta variant and later the Omicron variant, which triggered the reintroduction of lockdown measures, travel restrictions, and supply chain disruption in some countries.

[2] Food prices are expected to soar again due to the botched extension of the Black Sea grain initiative signed on 27 July 2022 to allow for commercial food and fertilizer exports from three key Ukrainian ports in the Black Sea.

[3] Around 25% of emerging countries are estimated to be at high risk of debt distress borrowing costs, and 15% of low-income countries are already in a debt-stress situation, while another 45% are facing a high risk of debt distress. *https://www.imf.org/en/Blogs/Articles/2023/01/16/Confronting-fragmentation-where-it-matters-most-trade-debt-and-climate-action*

[4] Limited fiscal space constrained the extent of subsidies as a means to reduce the impact of inflation pass-through from rising food, energy, and commodity prices.

raising the likelihood of investor runs and asset fire sales, especially in situations of liquidity imbalances archetypal of stressed situations. This can contribute to volatility in asset markets and potentially threaten financial stability via the transmission of risks to other parts of the financial system.

The recent failure of some banks in the United States of America highlights the risk of a sudden loss of confidence in a banking system. The collapse of the Silicon Valley Bank (SVB) and Signature Bank in the US, the fire sale of First Republic Bank to JP Morgan, and the takeover of Credit Suisse, a systemically important financial institution, by UBS are some of the notable manifestations of the effect of the global financial tightening to combat inflationary pressure. The continuous increase in policy rates after an extended period of near-zero interest rates is exerting significant pressure on the global financial system. Although Islamic banks have neither a similar funding profile as SVB nor significant direct exposure to the situation, [5] the action taken by the financial authorities in the US has also reduced the possibility of contagion risk. Nonetheless, there is a possibility of an indirect effect through likely institutional investors' risk aversion leading to a shortage of funding and an increase in funding costs in the global financial system amid market volatility and financial fragilities.

In 2022, technological advancements presented new challenges for financial sector regulators. Regulatory and Supervisory Authorities were cautious about ensuring that technological financial innovation did not compromise financial market integrity, stability, and consumer protection. The rise of crypto assets, which have exhibited extraordinary volatility and correlation with equities, [6] poses significant risks to financial stability if not subjected to exchange restrictions or capital flow management and regulatory oversight for disclosure and transparency practices. Therefore, regulators need to balance innovation and risk management while implementing appropriate regulations to ensure market integrity and stability.[7]

Nonetheless, in many jurisdictions, financial digitalisation has proven crucial for quickening post-COVID-19 recovery via enhanced financial intermediation and broadened financial inclusion.[8] RSAs are adopting different regulatory approaches to support broader policy objectives, such as financial inclusion, contestability, competition, and customer value. Depending on the policy objectives, market maturity, and availability of both financial and non-financial enablers, some jurisdictions have bespoke regulations while others have adopted and applied related extant regulations. [9] The Central Bank of the United Arab Emirates (CBUAE) recently launched the initial phase of its Financial Infrastructure Transformation (FIT) programme to quicken the digital transformation of the financial services sector in the country. Mainly reflected in digital payment initiatives, the FIT aims to enhance the security and efficiency of financial operations, encourage payment innovation to drive a cashless society, and thereby promote financial inclusion. [10] Similarly, the Qatar Central Bank (QCB) also recently launched its National Fintech Strategy, which among other objectives is to reinforce the leading role of Qatar in the Islamic banking industry and insurance by ensuring a seamless financial service operation leveraging the massive investment in technological advancement in the country.

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[5] For instance, so far, among Islamic banks only Kuwait Finance House stated it has an exposure of about KWD 381,000 to the SVB, which remains immaterial to its financial position.

[6] For instance, recent volatility saw Bitcoin losing more than 50 percent of its value, Terra, a non-collateralised algorithmic stablecoin, and Tether a collateralised stablecoin experienced a below parity value.

[7] In 2022, IOSCO published a roadmap for crypto-asset regulation with the intent that it would become applicable sometime between 2023 and 2024.

[8] The Maldives Islamic Bank recently launched its new and improved internet banking platform called FaisalNet 2.0. which is expected to enhance its operational efficiency while providing customers with more seamless and secure Islamic banking services.

[9] As part of its strategic work plan for 2023, the IFSB will issue working papers on the regulation of Islamic digital banking, as well as the regulation of Islamic P2P financing and Islamic equity crowdfunding.

[10] The next phase of the CBUAE FIT programme will focus on other pertinent aspects of digital transformation including the electronic Know-Your-Customer (e-KYC), financial cloud services, open finance platform etc.

While Central Bank Digital Currencies (CBDCs) remain outrightly banned in some countries where Islamic finance is practised, notable developments were recorded in some others in 2022. For instance, in Indonesia, CBDCs are not allowed for Islamic finance transactions as per the ruling by the Majelis Ulama Indonesia (MUI) due to the element of gharar contained in the digital currencies. Morocco and Algeria are other examples where CBDCs are not currently permitted. Nonetheless, some countries where Islamic finance is practised mainly in Nigeria (See Box Article 1), and in the GCC have already commenced activities toward implementing CBDCs. For instance, the CBUAE has its CBDC, digital dirham included in its first stage of the FIT programme to enhance both cross-border and domestic payments. Both Saudi Arabia and Malaysia have an ongoing deployment of pilot projects, while Bahrain, Bangladesh, Indonesia, Oman, Pakistan, Qatar, and Türkiye are having various ongoing activities relating to CBDC development. These jurisdictions are running pilot projects alongside developing a regulatory framework, revising legislation, and exploring the possibility of enhancing existing alternative digital payment systems.

Despite its many benefits, Central Bank Digital Currencies (CBDCs) also pose significant risks. Especially in countries where the banking system is less developed, macroeconomic fundamentals are weak, and the level of digital payment is low. As such, CBDCs' implications for monetary policy via changes in retail, wholesale, and cross-border payments could be significant. [11] Moreover, a higher proportion of unremunerated deposits in Islamic banking as opposed to conventional banking might make the former more vulnerable to disintermediation in the event that people decide to hold CBDCs in a substantial volume. This would not only compress banks' margins, but also increase their funding costs. Moreover, according to CIBAFI, [12] Islamic banks would be disadvantaged where a central bank deploys CBDCs for monetary policy but with an embedded interest-bearing design. This is in addition to the need to develop an equivalent Sharī'ah-compliant monetary and financial safety net as done for the extant forms of money.

Environmental, social, and governance (ESG) factors continue to receive global attention. However, global inflation and the Russia–Ukraine conflict continue to moderate the dynamics of the magnitude and speed of transition to a low-carbon economy. This is due to rising gas and energy prices, supply disruptions, and the substantial investment required for renewable alternatives amid a tightened global financial condition. At the United Nations Climate Change Conference COP 27 held in Cairo Egypt in 2022, it was highlighted that the global transformation to a low-carbon economy would require between USD 4-6 trillion a year. It is expected that sustainability-linked financing would continue to gain prominence and help to attract funding for ESG activities. Also, the proposed setting of an international carbon price floor among major emitters, and a "just energy transition partnership" between some countries, for instance, South Africa and Indonesia are among the positive developments expected to complement the Paris Agreement. Nonetheless, challenges remain in the areas of the lack of universal guidelines and taxonomies that would facilitate integrating the consideration of nature and climate change in the financing arrangements, screening, reporting and disclosure. As mentioned in the IFSI SR 2022, in this regard, regulatory and supervisory authorities (RSAs) would need to broaden their capacity towards ESG risk management to moderate the ESG market susceptibility to greenwashing from both sovereigns and corporates.[13]

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[11] Inutu Lukonga (2023). Monetary Policy Implications Central Bank Digital Currencies: Perspectives on Jurisdictions with Conventional and Islamic Banking Systems. IMF Working Paper No. WP/23/60. *https://www.imf.org/-/media/Files/Publications/WP/2023/English/wpiea2023060-print-pdf.ashx*

[12] General Council for Islamic Banks and Financial Institutions.

[13] In November 2021, the International Sustainability Standards Board (ISSB) was created to cater to this need. *https://www.ifrs.org/groups/international-sustainability-standards-board/*. The IFSB has included limited climate and sustainability-related disclosures in some of its standards, based on those recommended by the Task Force on Climate-Related Financial Disclosures, and is currently working on a guidance note on sustainability in Islamic capital markets.

Given the presence of several potential downside risks, global growth projection for 2023 is lower at 2.9% compared to the pre-pandemic 20-year average of 3.8%. Although the conflict in Ukraine is yet to have a worldwide systemic effect, it has also persisted causing increased commodity and energy prices, supply chain disruption, the after-effect of the COVID-19 pandemic, and general economic uncertainty. If the war in Ukraine prolongs and the botched Black Sea initiative is not revived on time, it may cause a further rise in commodity prices, thus fuelling global inflation. The IMF forecasts that this would make major central banks to further tighten monetary policy, amid the earlier listed risks that the global financial system has had to deal with in 2023.

In 2023, the recovery in advanced economies and emerging markets is expected to be slow. The ASEAN region is expected to experience modest growth due to increased domestic demand and export of nonfuel commodities, while the GCC and other oil exporting countries may experience a slowdown due to lower oil production. However, efforts to diversify the economy and pursue various economic and development agendas are expected to stimulate growth in the region. In Africa, growth is expected to remain moderate as countries focus on recovering from the after-effects of the COVID-19 pandemic and inflationary pressures due to tightening global financial conditions and the Russia-Ukraine conflict.

1.2 Overview of the developments in the global and regional IFSI

Navigating through what remains a challenging global financial condition, the global Islamic financial services industry (IFSI) in 2022 demonstrated soundness and resilience and also recorded structural development. Yet, the dynamics of economic recovery and financial stability offer a test of resilience based on the structural, political, economic, and financial peculiarities of the various jurisdictions where Islamic finance is practised. The global IFSI is estimated to be USD 3.25 trillion in 2022 [14] (see Table 1.2.1), marking a slower growth of 6.2% year-on-year (y-o-y) in assets in USD terms (2021: USD 3.06 trillion).

Table 1.2.1 Breakdown of the Global IFSI by Sector and Region (USD billion) (2022)

Region	Islamic Banking Assets	*Ṣukūk* Outstanding	Islamic Funds Assets	*Takāful* Contributions	Total	Share (%)
Gulf Cooperation Council (GCC)	1342.9	356.6	24.1	16.7	1740.4	53.6%
South-East Asia (SEA)	307.2	411.4	32.8	6.0	757.4	23.3%
Middle East and South Asia (MESA)	478.3	57.8	62.9	5.9	604.9	18.6%
Africa	49.6	2.9	1.9	0.8	55.2	1.7%
Others	71.2	1.0	14.9	0.6	87.7	2.7%
Total	2249.2	829.7	136.6	30.0	3245.5	100.0%
Share %	69.3%	25.6%	4.2%	0.9%	100%	

Source: IFSB Secretariat workings

[14] 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 *ṣukūk* outstanding and *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 *ṣukūk*. The figure is nevertheless the best measure we can offer in the current state of data availability.

Notes:

a) Data are mostly taken from primary sources (regulatory authorities' statistical databases, annual reports and financial stability reports, official press releases and speeches, etc.) and from the IFSBs Prudential and Structural Islamic Financial Indicators (PSIFIs) database.
b) Where primary data is unavailable, third-party data providers have been used, including: Eikon-Refinitiv, Bloomberg, IMF database, etc.
c) In all cases, the latest data available to the IFSB Secretariat have been used.
d) *Takāful* contributions are used as a basis to reflect the growth in the *takāful* industry.
e) The breakdown of Islamic funds' assets is by domicile of the funds, while that for *ṣukūk* outstanding is by domicile of the obligor.
f) The regional classification is the same as that used in the previous IFSI stability reports. Other than the GCC and SEA regions, other jurisdictions in Asia are classified as Middle East and South Asia (MESA). The Africa region includes both North Africa and Sub-Saharan Africa. Jurisdictions not belonging to any of the four regions are classified as "Others", specifically countries located in Europe, North America, South America and the Commonwealth of Independent States (CIS).

Sectoral Analysis

Keeping with the structure of the IFSI in the previous years, the Islamic banking segment retained its dominance in terms of asset size of USD 2.25 trillion as of the end of 2022 (2021: USD 2.10 trillion) accounting for 69.3% of the value of global IFSI assets (2021: 68.7%). In 2022, the segment recorded a 6.9% y-o-y growth in assets. It remained highly capitalised, profitable, and liquid, providing financing to both households and corporates, and supporting economic recovery. The Islamic banking segment also benefited from increased margins on financing due to an increase in monetary policy rates, economic diversification drive, significant mergers and acquisitions, supportive government initiatives and development agendas, and operational efficiency due to accelerated digital transformation following the COVID-19 pandemic.

The overall Islamic capital market (ICM) segment, consisting of *ṣukūk*, Islamic funds, and Islamic equities registered a slower, single-digit, growth rate for the first time in five years. ICM's value of USD 966.3 billion (2021: USD 910.9 billion) accounted for a share of 29.8% of global IFSI assets as of the end of 2022 (2021: USD 30.5 billion). The *ṣukūk* sub-segment retained its dominance within the ICM segment registering a growth of 7.0% y-o-y in 2022 (12.5%: 2021), while Islamic funds grew marginally by 1.0% y-o-y during the same period.

In 2022, the growth of the *ṣukūk* sub-segment was moderate due to unfavourable global economic conditions and reduced sovereign issuances. [15] Sovereign funding needs in the GCC region were low, and there was a narrow domestic investor base, lack of market depth, and secondary market activities in other jurisdictions. However, there was a slight positive impact from sustainability-linked *ṣukūk* issuances for development projects and new sovereign issuances in response to the global economic recovery. The Islamic equities indices were affected by global market volatility and negative returns, while Islamic funds contracted due to liquidity strain and susceptibility to runs during stressed conditions.

[15] The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) standard 59 which it recently published is envisaged to have a direct impact on the numbers of outstanding *ṣukūk* and *ṣukūk* that are going to be issued to the market. It is interesting to see the reaction of the market players be they investors or the issuers to the new standard and continuous concern over the high reliance on the commodity *murābahah*-based instrument.

Based on available data for 2022, the *takāful* segment demonstrated resilience to the tightened global financial conditions. This was despite financial market volatility and its impact on the segment's investment portfolio, and a spate of natural disasters that occurred during the year. The segment registered a growth of 16.1% y-o-y to reach USD 30.0 billion (2022: USD 25.8 billion) as of the end of 2021. Notwithstanding, the segment's share of global IFSI assets remains 0.9%.

The growth in the *takāful* segment was achieved due to improved economic conditions as the economic fundamentals improved in some key markets that benefited from the increasing prices of oil and energy. Other contributing factors include increased digital transformation activities through which *takāful* operators leveraged technology to capture the growth potential in health and family *takāful* business lines as compulsory health cover was implemented in some jurisdictions. Additional factors include (but are not limited to) an improved regulatory environment,[16] a growing trend of mergers and acquisitions to build critical mass, increased public awareness and appreciation for *takāful* offerings, and the positive impact of the various COVID-19 policy support measures taken by the various governments.

Regional Analysis

There was a slight modification in the regional distribution of global IFSI assets. The GCC region registered a slight improvement to end 2022 with an asset value of USD 1,740.4 billion (2021: USD 1,603.5 billion) and accounted for the largest share of 53.6% of global Islamic finance assets in 2022 (2021: 52.4%). All segments registered improved performance in the region, with the GCC Islamic banking registering a 10.8% y-o-y growth.

The GCC countries experienced accelerated reopening and economic recovery in 2022, driven by increased revenue from soaring oil prices and numerous mega projects and events.[17] This broadened fiscal space and reduced sovereign issuances, supporting various economic transformation initiatives aimed at economic diversification from oil and gas and advancing technological development. As ambitious economic diversification initiatives in the region approach the construction stage, the positive effects of mergers and acquisitions in the region's Islamic financial services industry (IFSI) would become more apparent, given the cultural and religious affinity and large market share of the IFSI in the region.[18] The impact of both inflation and exchange rate volatility was also mild in the GCC region in 2022, as the countries maintain a US dollar-pegged exchange regime, which helps to mitigate imported inflation and preserve price stability.

In 2022, the South-East Asia region retained its second position in terms of regional IFSI market share of 23.4% (2021: 23.5%). Specifically, the region accounted for USD 757.4 billion (2020: USD 720.0), and a marginal 5.2% y-o-y growth. The same as in the GCC region, all key segments registered significant improvement on a y-o-y basis save for the Islamic funds sub-segment of the ICM. Specifically, the region benefited from the reopening of the economy which saw significant improvements in manufacturing, tourism, etc. While net exporters of oil in the region also benefited-

[16] See box article 5 for details on the regulatory development in the UAE takāful sector contributed by the Central Bank of the UAE.
[17] The Dubai Expo 2020 was postponed due to COVID-19 and eventually held in 2022. The FIFA World Cup was also hosted in the region for the first time by Qatar in 2022.
[18] For instance, all six GCC countries have a systemically significant Islamic banking segment accounting for at least 15% of domestic banking assets. The various M&A initiatives continue to enhance Islamic banks' operational synergies in terms of human capital and digital transformation, as well as the funding requirements needed for their participation in large corporate deals and infrastructural projects relating to ESG, technology, healthcare, and the development of small and medium-sized enterprises (SMEs) as part of the economic diversification drive in the region.

from the impact of rising oil prices,[19] net importers of refined crude oil [20] also benefited from increased exports of commodities, such as palm oil and metals, which have seen rising prices as a result of the war in Ukraine. There were some pressures on commodity prices and currency depreciation in certain countries, but overall, the Islamic finance industry in the region is expected to play a significant role in economic growth, as all three key jurisdictions have master plans in place to drive this growth.[21]

The Middle East and South Asia regions constituted the third-largest share, accounting for 18.9% of global IFSI assets in 2022 (2021: 17.4%). With a 13.8% y-o-y growth in assets valued at USD 604.9 billion, only the MESA region registered improvements across all the key segments of the IFSI. This was despite economic sanctions, political instability, and natural calamities in the region. Rising inflation due to high oil and commodity prices had a knock-on effect on economic recovery in some countries. Iran's access to international trade was limited due to economic sanctions, and the financial meltdown in Lebanon continued. In Pakistan, the impact of unprecedented floods[22] recorded in the summer of 2022 affected the country's economy and post-COVID-19 economic recovery.

Although the Africa region's share of the global IFSI value remained small, it also declined to 1.7% (2021: 2.1%). Notwithstanding the establishment of new Islamic banks in the region, as well as the debut of *ṣukūk* issuances by some African countries, most countries in the region faced significant inflationary pressure. This is due to the import-dependent nature of the region's economy, which makes it prone to imported inflation from commodity prices as well as exchange rate volatility.

The "Others" region, which includes Türkiye, the United Kingdom (UK), and countries from the CIS region, accounted for the remaining 2.7% of total global IFSI assets in 2022 (2020: 4.5%). Specifically, Türkiye as a key Islamic finance jurisdiction in the region, registered increased assets among its participation banks in Turkish Lira terms. It is expected that the participation banking sector in Türkiye will continue to grow, especially among the key three state-owned banks, and on the back of the Turkish government's intent to grow the sector to a double-digit share of domestic banking as outlined in the recently published Participation Finance Strategy Document. The CIS countries, such as Kyrgyz Republic, Uzbekistan, Tajikistan, and Kazakhstan, have opportunities to increase commodity supply due to the conflict in Ukraine. However, they are also vulnerable to inflation, currency depreciation, and slow economic growth due to limited shipping activities in the region.

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[19] Brunei Darussalam and Malaysia, for instance.
[20] Indonesia, for instance.
[21] Notable examples include Malaysia's Halal Industry Master Plan 2030 *https://www.hdcglobal.com/wp-content/uploads/2020/02/Halal-Industri-Master-Plan-2030.pdf, and Financial Sector Blueprint 2022-26 https://www.bnm.gov.my/publications/fsb3. Indonesia Islamic Economic Masterplan 2019-2024* Indonesia Islamic Economic Masterplan 2019-2024 *https://kneks.go.id/storage/upload/1560308022-Indonesia%20Islamic%20Economic%20Masterplan%202019-2024.pdf*, and the Financial Sector Blueprint 2016-2025 in Brunei Darussalam https://www.bdcb.gov.bn/development/financial-sector-blueprint
[22] In addition to over 1,700 people that died from the flooding that affected about a third of the country, losses and damages are estimated to be about USD 32 billion.

BOX ARTICLE 1:

AFRIGO: A National Domestic Card Scheme and Its Implication for the Growth of the Non-Interest Banking Sector in Nigeria

Contributed by:
Central Bank of Nigeria

Introduction

Nigeria is the largest economy and most populus nation in Africa (over 200 million people) with market size and depth, a diverse economy, and dynamic banking and payments system. The innovation, significant growth, and transformation witnessed in the Nigerian banking and payments space in recent years were enabled by rapid technological advancement and the proactive policies of the Central Bank of Nigeria (CBN). These achievements have been globally celebrated and continue to attract landmark investments.

The CBN, as the primary regulator for both the banking and payments systems, developed the Payments System Vision (PSV) 2020 in 2007 to serve as a roadmap for the development of the payments system and to drive the adoption of electronic payments in Nigeria. Some of the successes recorded in the payments system were attributable to initiatives such as the Bank Verification Number, NIBSS Instant Payment (NIP), Real Time Gross Settlement, adoption of mobile banking, USSD, the Cashless Policy and the CBN Digital Currency (eNaira) amongst others.

In November 2022, a new payments system vision, PSV 2025, was launched to further leverage the achievements of PSV 2020 and benefit from the untapped opportunities in the financial services industry. Key recommendations in PSV 2025 include the adoption of emerging technologies such as Blockchain to provide solutions to the challenges of the payments system.

Card Schemes

A card scheme comprises a central payment network linked to payment cards, such as debit or credit cards, which are used to process payments. The centrally controlled processing system facilitates the smooth operations of the scheme, including clearing and settlement of transactions with transactions managed through a set of rules and procedures that enable cardholders to use their cards to pay for services offered by accepting third parties such as merchants and service providers. Card schemes play a critical role in enabling successful cashless economies.

Parties to a card scheme include the cardholder, the card issuer, the merchant and the acquiring bank. Secondary intermediaries such as the payment gateway and payment processor are also necessary to process payments, authenticate and facilitate transaction flow and transmit data from a merchant's Point of Sale (PoS) machine to the card networks and the banks.

Over time, card schemes have evolved beyond physical cards and can be used to facilitate different types of payments, such as local and international remittances, or other payment types, such as QR codes that can operate on the same payment rails with established operating rules.

Card Schemes in Nigeria

Currently, major international card associations operate in Nigeria. These include Mastercard, Visa, American Express and Union Pay. Verve started its operation as a domestic private-sector-led card scheme but has since attracted foreign investment and gone international.

As of the end of 2021, about 500 million Naira (USD 1.09 million) denominated cards and USD 3 million foreign currency-denominated cards had been issued by banks and other financial institutions, indicating the potential for continued growth. The annual value of card transactions in the card and payments market was estimated at USD 18.2 billion in 2021, and the market is predicted to grow at a compound annual growth rate of more than 18% up to 2025 (Globaldata, 2022).

The benefits of card-based transactions include the following:

I. Reduction or elimination of the need to hold cash for transactional reasons.
II. Convenience and elimination of the risks of using cash, such as theft, loss of cash and counterfeits.
III. Reduction in cost-of-service delivery to consumers through the elimination of cash handling expenses for production, distribution and storage.
IV. Leveraging data on customers transactions to determine their credit worthiness and capability to pay, and consequent increase in micro-loan schemes.
V. Increase in financial inclusion and the associated benefits such as access to finance, savings, ease of transaction consummation, and improved standard of living.
VI. Reduction in money laundering associated with reduced cash usage and increased ability to monitor transactions.

Nigeria has not been able to fully exploit the associated benefits of card-based schemes due to the following challenges, amongst others:

1. **High cost of transactions** – Because the major card schemes operating in Nigeria are foreign-owned, they charge Nigerian banks in foreign currency to process domestic transactions with the consequent impact of increasing the cost of service to the final consumer.

2. **Challenges with obtaining foreign currency** – The local banks who sign up with the foreign card schemes have to source for foreign exchange within the country to pay for the services of the foreign card schemes; thus, putting pressure on the domestic foreign exchange market.

3. **Challenges with Interoperability** – Some foreign card schemes have operational modalities that discourage effective interoperability, hence challenging the fundamental principle upon which the Nigerian payments system operates.

4. **Sovereignty of data** – The law requires key national data, such as personal and financial data of citizens, to be hosted locally. The foreign card schemes find this requirement onerous to comply with, as setting up data centres locally will increase their cost of operations.

5. **Financial exclusion** – Although significant penetration has been achieved with cards, many Nigerians still do not have access to the existing card products.

6. **Difficulty with customisation** – Because the card schemes are mainly foreign-owned, there are challenges with customising the card products to take cognizance of the peculiarities of the Nigerian market.

Overview of the National Domestic Card Scheme - AfriGo

AfriGo, conceived as a fully homegrown national domestic card scheme that will address some of the challenges associated with the operations of the foreign-owned card schemes, was launched on 26 January 2023. The AfriGo card scheme is deployed and managed by AfriGo Pay Financial Services Limited (AFSL), an affiliate of the Nigeria Inter-Bank Settlement System (NIBSS) Plc. AFSL is a local card scheme duly licensed by the CBN.

NIBSS is owned by the CBN and all licensed Deposit Money Banks (DMBs) in Nigeria and provides the mechanism for same day clearing and settlement of inter-bank transfers and payments. Its infrastructure facilitates the automated processing and settlement of transactions between banks. It is critical for the success of AfriGo as it continues to push the boundaries in central switching, payments, and enabling payment platforms.

The value proposition of AfriGo includes driving card acceptance, reducing operating costs with affordable pricing, building shared infrastructure, enhancing trust in cashless payment methods, improving data security, as well as providing a platform for unique payment innovation in locally relevant ways, particularly for the unbanked. In addition, the domestic card scheme will leverage features such as QR codes, Open Banking,

Off-line Payments, tokenisation, and loyalty schemes to deepen financial inclusion. It also offers Nigeria the opportunity to grow its card penetration numbers from its current position of 75th and 114th in the world for debit and credit cards, respectively, and to explore card reciprocal and cross acceptance agreements to drive global acceptance and adoption of AfriGo.

Non-Interest (Islamic) Banking in Nigeria

Islam is one of the dominant religions in Nigeria and Muslims account for about 53% of the country's over 200 million population[23] with Nigeria ranked as having the fifth largest Muslim population in the world.[24] This shows the potential of Islamic finance in Nigeria especially in closing the financial exclusion gap which is highest in the Northern region that is predominantly Muslim. Whereas the average exclusion rate is around 22% in the Southern part of Nigeria, the Northern part records an average exclusion rate of 48%, according to the EFInA Access to Financial Services in Nigeria 2020 survey results. Studies have shown that religious beliefs and the abhorrence of interest are responsible for the high rate of exclusion recorded in the Northern part of the country.

In its effort to reverse the trend of financial exclusion and to bring into the formal sector citizens that were hitherto excluded from financial services and also provide alternative financing options, the CBN, in 2011, established a committee to review the possibility of introducing Islamic banking and finance in the country. As a result of the Committee's recommendation, the CBN issued the Guidelines for the Regulation and Supervision of Institutions Offering Non-Interest Financial Services in the country.

Following the introduction of non-interest banking in 2011 by the CBN, Jaiz Bank was granted a licence to operate as a non-interest (Islamic) bank with regional and, subsequently, national authorisation in 2016, enabling it to operate in all states of the country. Currently, three non-interest banks are operating in Nigeria, namely Jaiz Bank, Taj Bank and Lotus Bank, while Sterling Bank and Sun Trust Bank operate non-interest (Islamic) banking windows. These banks offer a variety of products and accounts allowed in Islamic banking and finance. Other Islamic financial institutions have continued to emerge in Nigeria, including non-bank financial institutions such as *takāful* insurance companies and Islamic finance advisory firms.

The CBN has created specialist *Sharī'ah* Councils to address the unique management and regulatory needs of non-interest banks, both at the CBN and individual bank levels. These councils ensure that the products and services of the banks comply with Islamic commercial jurisprudence. Additionally,

[23] Nigeria: distribution of religions. Statista. Retrieved 21/02/2023
[24] https://worldpopulationreview.com/country-rankings/muslim-majority-countries

the CBN has developed *Sharī'ah*-compliant instruments, such as the Intra-day facility (IDF), Funding for Liquidity Facility (FfLF), and CBN Safe Custody account (CSCA) to improve liquidity and deepen the financial market for Islamic banks in Nigeria. The issuance of *ṣukūk* by the Federal Government has also increased awareness of Islamic Banking among the public.

The total assets of non-interest banks as of the end of June 2022 stood at ₦547.08 billion (USD 1.189 billion), representing 0.84% of total banking industry assets. The total deposits and total credits stood at ₦199.35 billion (USD 432 million) and ₦208.20 billion (USD 452 million), respectively, representing 0.47% and 0.77% of the banking industry deposit and credit, respectively.

Islamic banking in Nigeria still faces challenges such as low awareness among the public, limited product offerings, dearth of *Sharī'ah*-compliant liquidity management instruments, shortage of qualified Islamic finance professionals, and inadequate awareness of its value proposition. These have contributed to the low proportion of Islamic banks' numbers relative to the total banking industry.

Integration of Islamic Banks with the Payments System

The non-interest (Islamic) banks have integrated seamlessly with the electronic payments and settlement system to the extent that is allowable under their operational principles. In this regard, they issue payment cards tied to customers' accounts and have installed acquiring devices such as ATMs and PoS terminals to ensure their platforms are fully interoperable.

Recent developments in the payments system indicate that incumbent banks (conventional and Islamic banks) are facing unprecedented challenges as FinTechs disrupt and penetrate the market. In addition, the CBN continues to provide the enabling environment for the increased digitisation of payments in Nigeria. The high consumer appetite for card-driven transactions has resulted in the explosion of transaction volumes on PoS and web transactions, with an ever-increasing rate of growth reported by operators. For instance, the value of Electronic Banking transactions in Nigeria rose from ₦48.9 trillion (USD 106.304 Billion) in 2015 to ₦447 trillion (USD 971.739 billion) in 2022 (NIBSS, 2022).

AfriGo and Non-Interest (Islamic) Banks – Value propositions

The domestic card scheme, AfriGo, provides a great opportunity for non-interest (Islamic) banks to expand in Nigeria and across the African continent. These opportunities include the following:

1. **Lower cost of operations** – Reduction in foreign exchange costs associated with foreign card schemes will translate to lower transaction costs for customers and higher earnings for the banks.

2. **Deployment of innovative products to enhance financial inclusion** - The card scheme will help reduce the current exclusion gaps and support the CBN in achieving its financial inclusion target of 95% by 2024.

3. **Meeting the needs of customers** – With the uniqueness of Islamic banking, the flexibility offered by AfriGo will help ensure that customers' needs are met, and the overall customer experience is improved.

4. **Customisation** – Card products can be customised for *Sharī'ah*-compliant transactions leveraging *Sharī'ah*-compliant merchants who offer products in predominantly Muslim states in Nigeria. This is expected to encourage adoption amongst the unbanked, who may be wary of conventional banking practices.

5. **Growth in customer base** – The implementation of the cashless policy nationwide in Nigeria is expected to increase financial inclusion and encourage the unbanked Muslim population to enter the financial system to benefit from the plethora of alternative banking channels. This is expected to lead to increased adoption of card services, particularly those offered by *Sharī'ah*-compliant banks.

The Councils of Experts oversee the activities of Islamic banks to ensure that they maintain Islamic commercial jurisprudence. Domestic card schemes, such as AfriGo cards, can be tailored to local needs, such as configuring them for only *Sharī'ah*-compliant transactions and merchants. A strict screening process can be established for transactions with AfriGo cards, which is not possible with international card schemes. In a domestic scheme, it is possible to have full visibility from the issuer to the acquirer and to know the nature of the merchant.

Conclusion

As the Nigerian payments system continues to evolve, the operation of Islamic banks in Nigeria, complemented by the benefits expected from the national domestic card scheme, AfriGo, will further serve as a catalyst to achieve the CBN's 95% financial inclusion target by 2024. The CBN remains committed to leveraging digital electronic payments to deepen and significantly grow card penetration numbers in Nigeria, ensuring continued stability and resilience in the payments and financial system, including Islamic banks.

We believe that the national domestic card scheme offers Islamic banks in Nigeria positive long-term growth prospects, particularly as the unbanked population in the predominantly Northern part of the country becomes financially included. The value proposition of AfriGo in terms of intra-African trade is also numerous as it creates the avenue to offer a payment card scheme that serves the universe of *Sharī'ah*-compliant trade partners across the continent.

2.0 STRUCTURE, SOUNDNESS, AND RESILIENCE OF THE GLOBAL IFSI

2.1 Global Macroeconomic and Financial Market Developments

GLOBAL ISLAMIC BANKING SIZE

2019	2020	2021	2022
$ 1.77 Trillion	$ 1.89 Trillion	$ 2.10 Trillion	$ 2.25 Trillion

GLOBAL ISLAMIC BANKING GROWTH

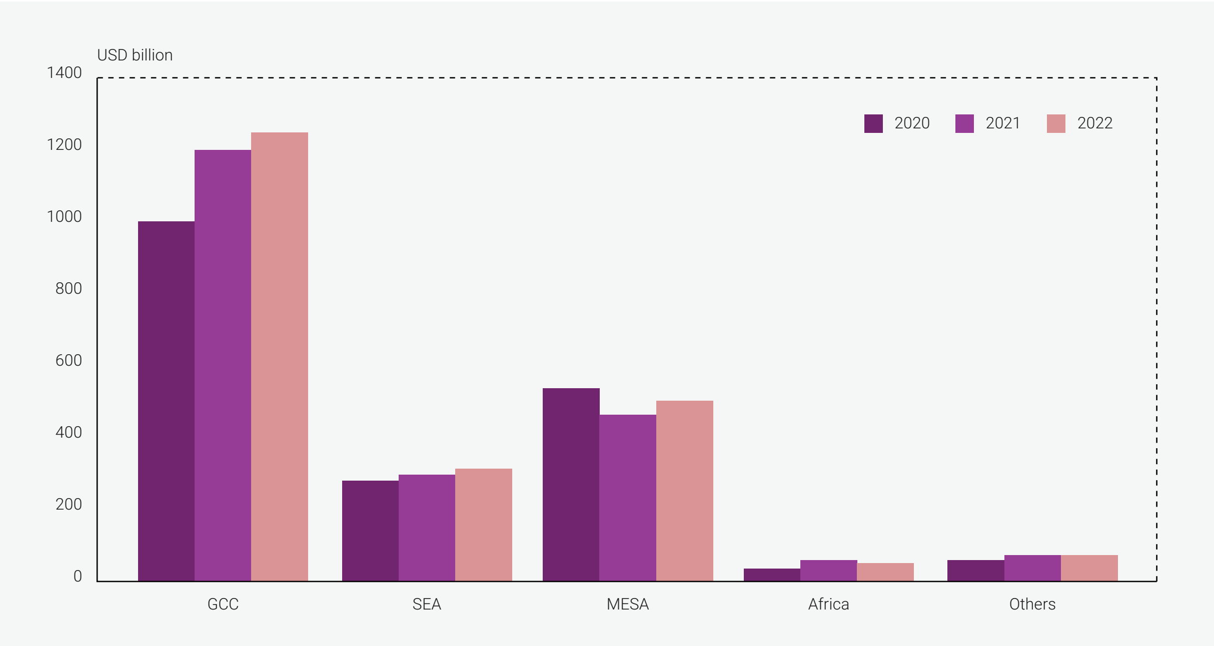
	ASSETS	FINANCIAL	DEPOSITS
CAGR (2018-2022)^	2.5%	10.5%	8.6%
Year-on-Year (2022)^	6.9%	13.0%	6.0%

^ Compound annual growth rate (June 2018 – December 2022). Data used in calculating CAGR, as well as growth rates for assets, financing and deposits, were obtained from the IFSB PSIFIs, and include data from both Islamic banks and windows in Afghanistan, Bangladesh, Indonesia, Malaysia, Oman, Pakistan and Saudi Arabia, and (where available) from stand-alone Islamic banks in Bahrain, Brunei, Egypt, Iraq, Jordan, Kyrgyz Republic, Kuwait, Lebanon, Libya, Morocco, Nigeria, Palestine, Qatar, Sudan, Türkiye, the United Arab Emirates (UAE) and the UK. Some Islamic banking jurisdictions, such as Iran and Kazakhstan, were excluded due to data limitations.

In 2022, the global Islamic banking sector showed growth in assets, deposits, and financing, despite global headwinds. The compound annual growth rate (CAGR) for Islamic banking assets in USD terms was 2.5%, while financing and deposits had a CAGR of 10.5% and 8.6%, respectively. Asset growth in most countries tracked for the computation of the CAGR also reflected financing and deposit growth despite tightening global financial conditions and economic uncertainty. The growth in assets in some jurisdictions was due to a boost in export revenue from oil and commodities, as well as hospitality and tourism as economic reopening became widespread globally. Other factors include the establishment of new Islamic banks in some jurisdictions, and mergers and acquisitions in others to explore growth opportunities in funding development projects or to cope with possible capital adequacy, profitability, and asset quality pressure. The GCC region, in particular, is focused on achieving greater scale and boosting revenues through consolidation to play a role in economic diversification from oil and other economic transformation plans. The concentration of the sector in the region and the strong economic fundamentals of various GCC states have facilitated this consolidation. Considerable investments in digital transformation in the region have helped to attenuate the effect of compliance costs and other expenses.

Despite the slowdown in the global economy, the assets of the Islamic banking segment in the GCC region exhibited a growth rate of 10.8% y-o-y by the end of 2022 (compared to 16.3% in 2021), The SEA region also retained its second position albeit with an assets-growth of 6.9% y-o-y at the end of 2022. (2021: 11.4%). In a rebound from the negative growth of -4.0% registered in 2021. MESA region Islamic banking assets grew by a marginal 0.1% y-o-y at the end of 2022. While the “others” region grew by 3.6%. The Africa region registered a decline of -14.8% y-o-y in 2022, compared to the 19.2% growth registered in 2021, mainly due to Sudan, which experienced a drastic currency depreciation.

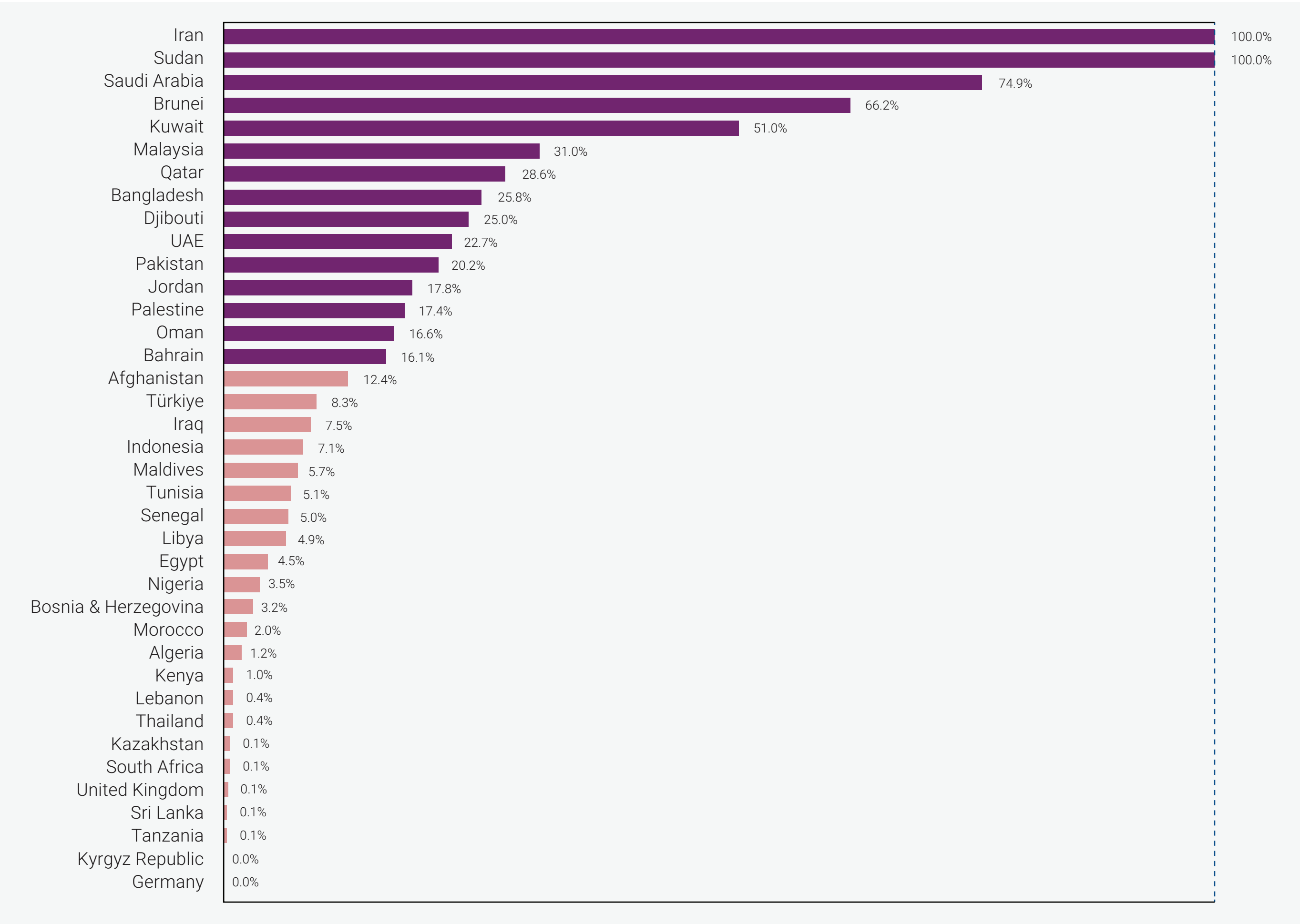
Chart 2.1.1 Regional Islamic Banking Assets (USD billion) (2020–22)



Source: IFSB Secretariat workings based on PSIFIs, data culled from various RSAs’ websites, and annual financial reports of Islamic banks.

Notably, despite the headwinds, the number of jurisdictions where Islamic banking has achieved domestic systemic importance[25] remained at 15, the same number since 2020 (see Chart 2.1.2). These jurisdictions jointly account for USD 2,071.9 billion or 92.1% of global Islamic banking assets. The Islamic banking sector is still very much concentrated among the top six jurisdictions with each having more than 5% of the share of global Islamic banking assets (see Chart 2.1.3). There was also an increase in these jurisdictions' cumulative share of Islamic banking assets by 17.6% y-o-y from USD 1,719.2 billion in 2021 to USD 1,883.9 billion as of 2022, and which represents an increase in their combined share of total Islamic banking assets from 81.7% as of the end of 2021 to 83.8% as of the end of 2022.

Chart 2.1.2 Islamic Banking Share in Total Banking Assets by Jurisdiction (%) (2022)



Source: IFSB Secretariat workings based on PSIFIs, data culled from various RSAs' websites, and annual financial reports of Islamic banks.

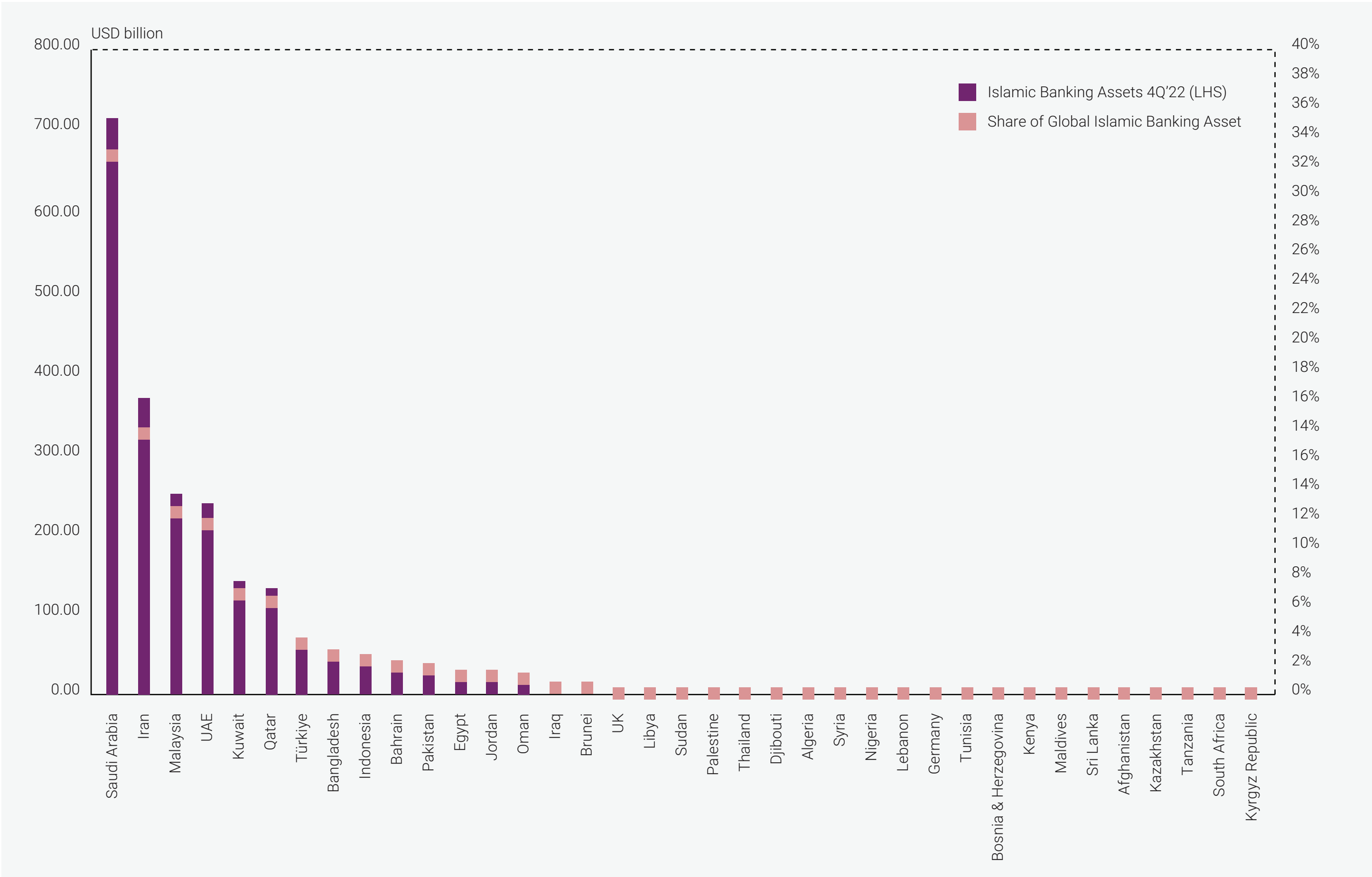
Notes: The countries shown by dark-blue-coloured bars satisfy the criterion of having a more than 15% share of Islamic banking assets in their total domestic banking sector assets and, hence, are categorised as systemically important.

Saudi Arabia accounted for 32.9% (2021: 30.6%), indicating an increase in its relative share while also retaining its position as the key leading Islamic banking jurisdiction. Due to the impact of economic sanctions and currency depreciation, Iran's share of global Islamic banking assets declined further and

[25] 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 the systemic importance of Islamic finance, since about 68% of Islamic financial assets are held within the banking sector.

accounted for 16.2% (2021: 17.0%). Malaysia retained its third position, at an 11.1% growth rate, with a slight decline compared to 2021 at 11.2%. Malaysia continues to experience growth in its banking assets, despite a slightly lower rate of growth owing to a smaller share of Islamic banking assets compared to other jurisdictions, such as Saudi Arabia at the first position, with an increase in growth rates compared to 2021. Slight improvements were recorded in the other three jurisdictions: the jurisdictions the UAE for 10.8% (2021: 10.0%), Kuwait for 6.6% (2021: 6.3%), and Qatar for 6.6% (2021: 6.6%), making up the top six jurisdictions in 2022. Nonetheless, the economic situation and labour conditions improved, and domestic demand remained strong in these jurisdictions.

Chart 2.1.3 Domestic Islamic Banking Assets (USD billion) and the Share of Global Islamic Banking Market (percent) (2022)



Source: IFSB Secretariat workings based on PSIFIs, data culled from various RSAs' websites, and annual financial reports of Islamic banks.

The other countries in the top 10 Islamic banking jurisdictions, in order of their share of global Islamic banking assets, were Bahrain, Türkiye, Bangladesh and Indonesia (see Chart 2.1.3). Generally, the growth in the share of Islamic banking across many jurisdictions is expected to improve in 2023 due to expected Islamic banking consolidation, the establishment of both new traditional and digital Islamic banks, increased Islamic banking windows activities[26] to take advantage of a sizeable public demand, and a supportive framework in some key markets.[27]

[26] The Islamic banking windows as key growth drivers account for a significant share of Islamic banking assets in many jurisdictions as they also benefit from the extant franchise and infrastructure of their conventional parent banks.

[27] For instance, in Oman, the CBO introduced an Islamic liquidity management instrument based on *wakālah*, while the Bangladesh Bank also introduced the *mudārabah* liquidity support.

2.2 Assessment of the Soundness of the Islamic Banking Sector Across Regions

Notwithstanding the headwinds in the global financial system, the analysis of the Islamic banking data for the period 2021 to 2022[28] across IFSB member jurisdictions[29] reveal that the Islamic banking segment of the IFSI remains sound and resilient. Based on many financial soundness indicators across jurisdictions, there were notable improvements; in some cases, reflecting sustained momentum in economic recovery experienced since 2021 due to post-COVID-19 economic reopening in many jurisdictions. Other notable factors include increased domestic demand, increased oil and non-oil export revenue, operational synergy and cost efficiency from mergers and acquisitions, and the positive impact of the digital transformation, which accelerated at the outbreak of the COVID-19 pandemic.

Nonetheless, the soundness and resilience of the Islamic banking sector across jurisdictions need to be viewed with cautious optimism. This is given the uneven post-pandemic economic recovery and exposure to the heightened global economic uncertainty arising from the various headwinds highlighted in Chapter One, especially rising inflation and further financial tightening in advanced economies.[30]

The following subsections present analyses of the soundness of the Islamic banking industry across IFSB member jurisdictions. The analyses are based on various key indicators[31] from the IFSB PSIFIs database highlighted in Figure 2.2.1.

Figure 2.2.1 Key Indicators for the Assessment of Islamic Banking Resilience

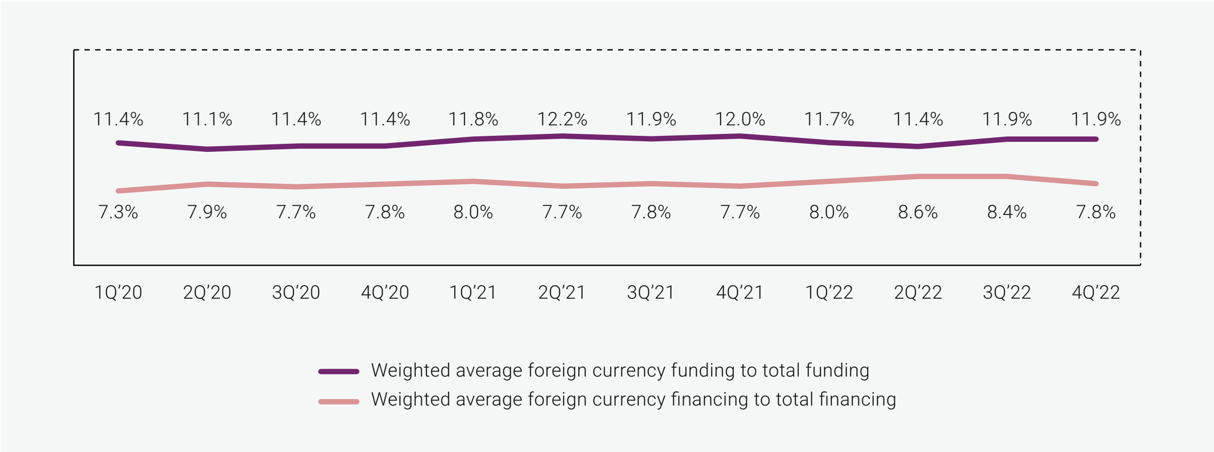
Profitability	Return on Assets / Return on Equity / Net Profit / Margin / Cost-to-Income Ratio
Liquidity	Financing to Deposit Ratio / Liquid Assets to Short-term Liabilities Ratio / Liquidity Coverage Ratio / Net Stable Funding Ratio
Funding Structure	Foreign Currency Funding to Total Funding / Foreign Currency Financing to Total Financing
Financing Exposures	Economic Sector Exposure of Financing
Asset Quality	Non-Performing Financing / Non-Performing Financing Coverage
Capital Adequacy	Capital Adequacy Ratio / Tier-1 Capital to Risk-Weighted Asset Ratio
Leverage	Leverage Ratio

28 In some cases, and where indicated, the data used was the most recent available to the IFSB at the time of drafting this report.
29 Differences may be observed in the figures contained in this section and those reported in IFSI Stability Reports of previous years. Such differences arise from backdated inclusion of data from new jurisdictions in this year's report, as well as from revisions of previously reported data in PSIFIs by some jurisdictions.
30 Although no notable impact of the Silicon Valley Bank and similar cases in the US is envisaged for the Islamic banking segment, such developments and their contagion effects, given balance sheet idiosyncrasies, call for cautious optimism on the projection of soundness and resilience of a financial services industry.
31 In a few instances, indicators' data based on calculations by respective RSAs have been used where such are available and more current. Due to non-availability, some key jurisdictions are not included in the assessment.

2.2.1 Funding Structure and Liquidity

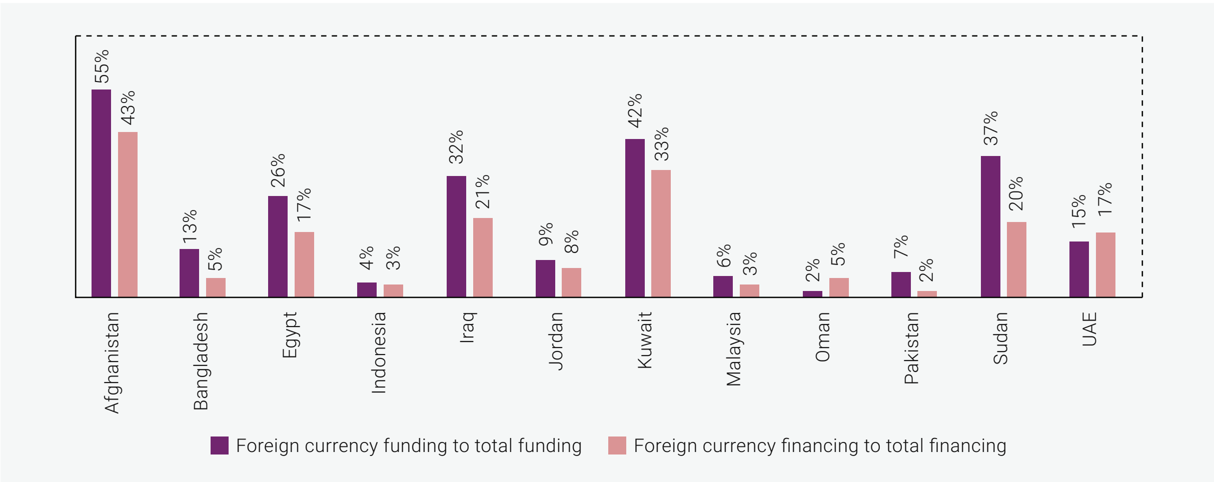
The proportion of foreign currency funding and foreign currency financing vis-à-vis total funding and total financing is shown in Chart 2.2.1.1. Except for a few, across jurisdictions, Islamic banks' foreign currency funding is higher than foreign currency financing (see Chart 2.2.1.2), reflecting the diverse net foreign exchange exposures across jurisdictions moderated by a number of factors. These include but are not limited to global financial tightening in advanced economies that have constrained fund flow into emerging and developing economies, including those where Islamic banking is practised, state of post-COVID-19 economic recovery, exchange rate regimes, political stability, remittances incentives and digitalisation, and the effectiveness of the stabilisation measures to ensure capital inflows across jurisdictions. In the absence of a robust foreign currency regulation, such foreign exchange exposure portends high susceptibility to exchange rate volatility which in turn would reduce the value of Islamic banks' assets, especially in jurisdictions where financing provided is mostly in local currency.

Chart 2.2.1.1 Global Islamic Banking Average Foreign Currency Funding and Financing as a Proportion of Total Funding and Financing (1Q20 – 4Q22)



Source: PSIFIs

Chart 2.2.1.2 Islamic Banking Share of Foreign Currency Funding and Share of Foreign Currency Financing as a Proportion of Total Funding and Financing by Country (2022)



Source: PSIFIs

Central banks in the GCC region monitor unhedged foreign currency positions, and approval is required if these positions exceed a certain threshold. Moreover, the GCC currencies are pegged to the USD. As such, Islamic banks in the GCC region are not expected to face significant foreign exchange risk based on their net exposure to foreign currency funding or financing. The Islamic banking sector in the SEA region also has relatively low net foreign currency exposures compared to other countries analysed in the study, and also has strong systems in place to manage foreign exchange risks. For instance, Malaysia granted an exemption to exporters from converting forex proceeds below MYR 200,000 (USD 45,300) per transaction and also extended the hedging of foreign financing obligations to the duration of the underlying tenure. Indonesia implements stabilisation measures to ensure foreign capital inflows to provide foreign currency liquidity through reduced foreign currency reserve requirements. In addition, Bank Indonesia developed a hedging instrument under *Sharī'ah* principles to maintain Rupiah stability through exchange rate risk management and to encourage a deepening of the *Sharī'ah* finance market (see box article 2).

Bangladesh banks, including those offering Islamic financial services, also faced a myriad of liquidity challenges. Remittance inflow which remains an important source of foreign exchange, registered a decline during the year[32] amid a spike in settlement of letters of credit for the importation of machinery and equipment needed to cope with the boost in manufacturing activities as the economy reopened post-COVID-19. The resulting shortfall created a liquidity strain as banks have had to sell Bangladeshi Taka to buy US dollars. Islamic banks were more affected due to a lower liquidity buffer relative to their conventional counterparts. This was aggravated by the fact that the Bangladesh Bank imposes more liquidity requirements on Islamic banks even as they are constrained by limited *Sharī'ah*-compliant liquidity management instruments.

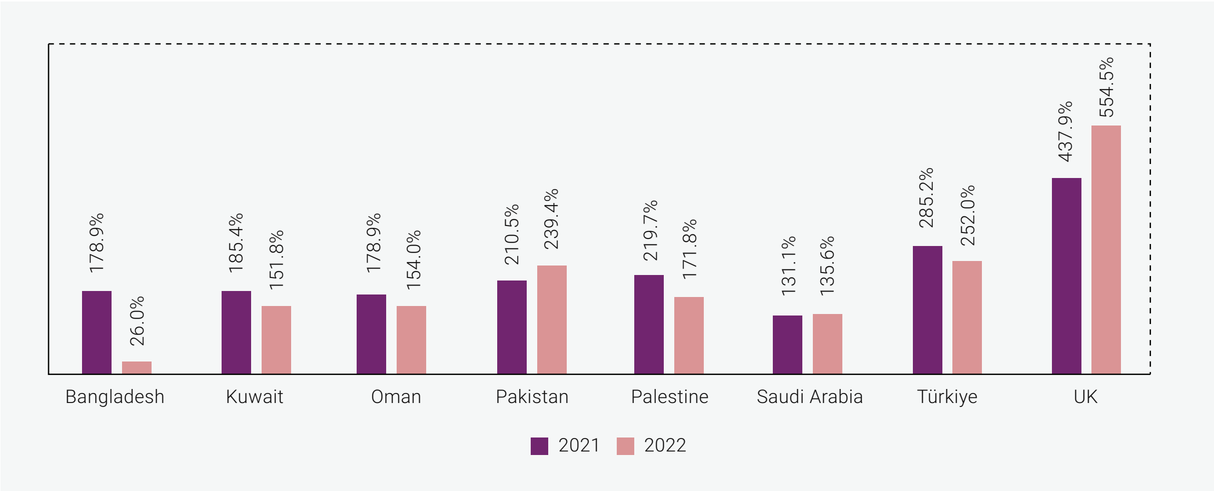
Although Islamic banking sectors in both Afghanistan and Sudan registered a net positive foreign exposure, they also recorded the highest foreign currency funding and financing levels. Islamic banks in Iraq also registered high levels of foreign exchange exposure. It is important that the levels are brought to within the regulatory limits in the respective countries, especially given the volatility of their currencies, political instability, and economic sanctions facing them.

The liquidity position of the Islamic banking sector mostly remained strong, both in the short and long term and across various jurisdictions during the review period (see Charts 2.2.1.3 to 2.2.1.4). Most jurisdictions, especially those that report both LCR and NSFR, were able to manage liquidity pressure despite tightened liquidity conditions due to rising inflation, slow global economic recovery, and the lack of *Sharī'ah*-compliant liquidity management instruments. In many cases, liquidity indicators fluctuated on a yearly basis but remained above regulatory thresholds. Bangladesh, however, had a significantly low level of LCR in 2H 22, indicating vulnerability to short-term liquidity challenges due to declining bank deposits, inflow of remittances, and continuous net sale of foreign currency by the Bangladesh Bank. However, an improvement is expected in 2022 due to policy support and liquidity instruments introduced by the Bangladesh Bank.

The high FDR observed in some jurisdictions reflects improved financial intermediation activities rather than susceptibility to liquidity pressure during unexpected contingencies amid inflationary pressure and economic uncertainties. Likewise, fluctuations observed in the LASLR across various jurisdictions may not necessarily reflect a potential incidence of short-term structural funding gaps during the period.

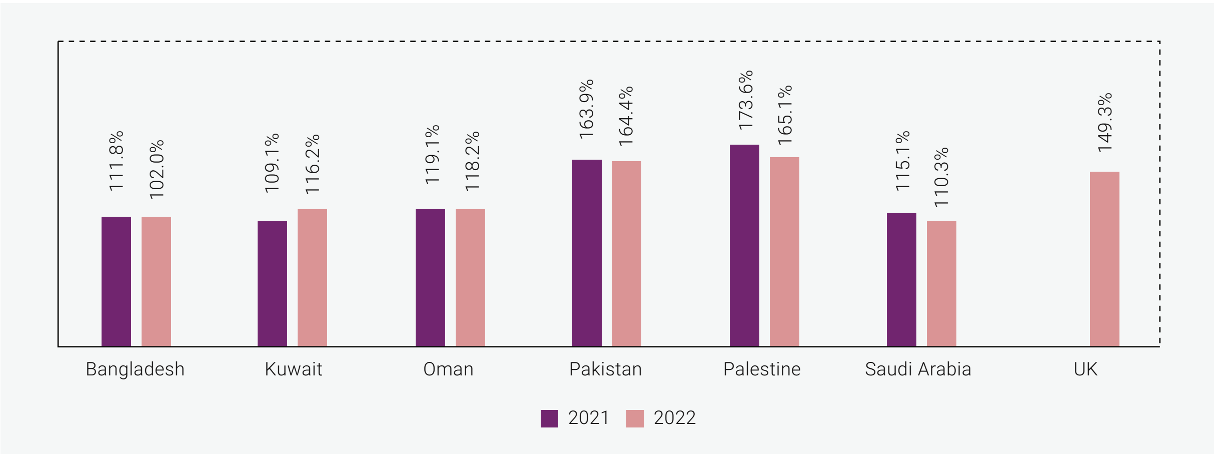
[32] This was due to an increase in "black market" activities wherein unregistered money changers offered a higher exchange rate relative to the banks that were constrained by the cap placed by the Bangladesh Bank to mitigate forex market instability.

Chart 2.2.1.3 Liquidity Coverage Ratio for Stand-Alone Islamic Banks by Country (2021–22)



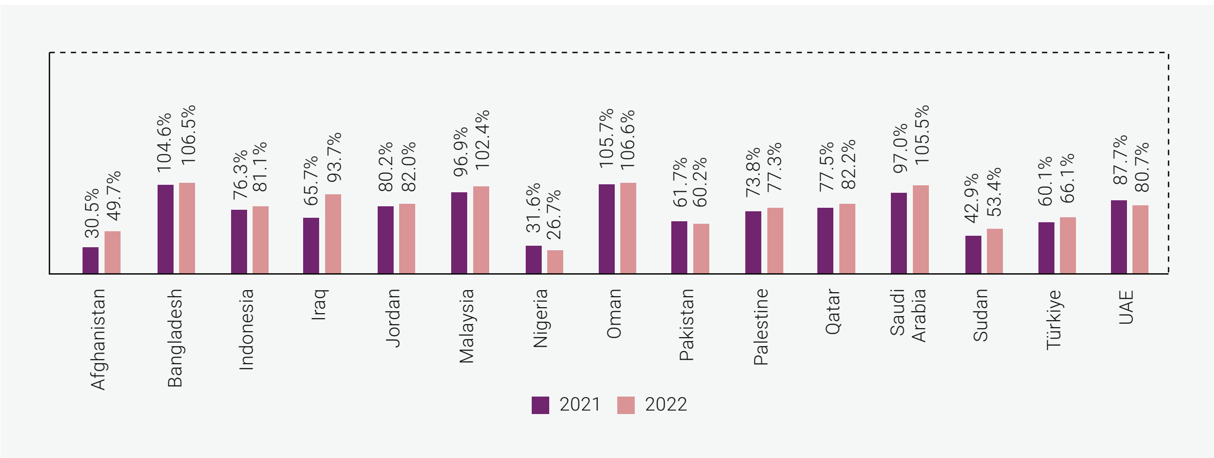
Source: PSIFIs

Chart 2.2.1.4 Net Stable Funding Ratio for Stand-Alone Islamic Banks by Country (2021–22)



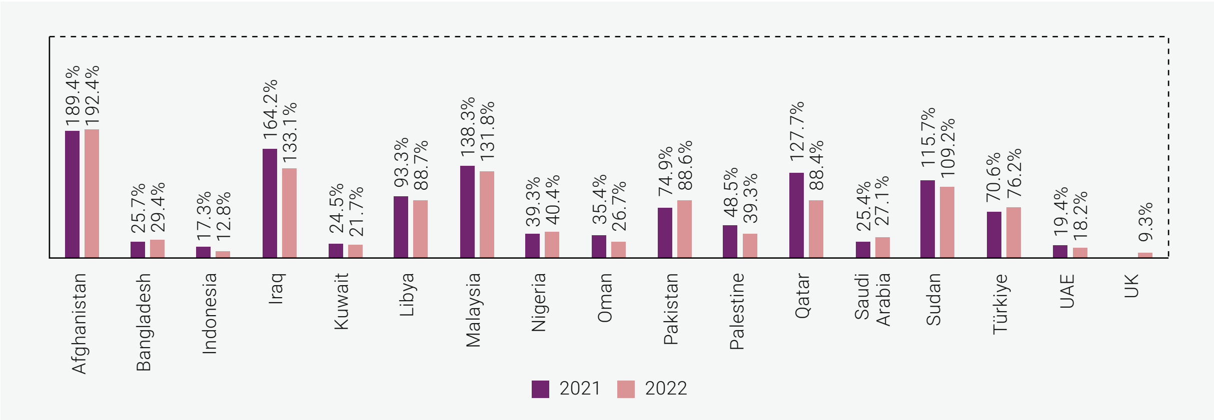
Source: PSIFIs

Chart 2.2.1.5 Financing-to-Deposit Ratio by Country (2021–22)



Source: PSIFIs

Chart 2.2.1.6 Liquid Assets to Short-Term Liabilities Ratio by Country (2021–22)



Source: PSIFIs

The strong liquidity position of Islamic banks across jurisdictions was due to a number of reasons. An example is the positive outcome of the various liquidity support measures adopted in some jurisdictions to mitigate the effect of liquidity pressures due to the tightening global financial condition. In Indonesia, the Bank Indonesia policy mix aimed at accelerating economic recovery included a liquidity policy that allows for an incremental raising of the reserve requirements to provide incentives to banks that finance priority sectors. In the UAE, the liquidity position of the Islamic banking sector remained strong in 2022 due to solid growth in deposits across most key sectors. This is notwithstanding the extension of the Zero Cost Funding (ZCF) facility until June 2022 as a precautionary measure to support liquidity.[33] The strong liquidity position observed in Oman could be linked to the positive effects of the initiative of the Central Bank of Oman (CBO) to create central bank *Sharīʿah*-compliant liquidity tools for Islamic banking entities. The Islamic banks and windows in the country were able to place their mobilised remunerative deposits in the *wakālah* money market instrument for a period ranging from 1 to 90 days. However, in some other Islamic finance jurisdictions, the continued scarcity of Islamic alternatives to repo transactions and short-term government *ṣukūk*, presents significant liquidity management challenges.

Another notable reason for the strong liquidity position in Islamic banks is the increase in public-sector deposits, especially in the oil-exporting countries of the GCC region amid increasing revenue from oil, thus providing stable funding. Islamic banks in some countries also benefited from cash inflows from both households and businesses due to the gradual suspension of payment moratoria and slower credit growth, which also reduced the need for market funds.

Islamic banks in Malaysia maintained strong liquidity during the period on the back of sustained retail deposits, even as a gradual shift to high-yielding deposits was noted due to a rise in policy rates. Islamic banks also leveraged Bank Negara Malaysia (BNM)'s lower statutory reserve requirements (SRR) ratio and the permission for principal dealers to use both Malaysia Government Securities (MGS) and Malaysia Government Investment Issues (MGII) of up to MYR 1 billion for the purpose of meeting SRR requirements up until 31 December 2022.[34] The liquidity position of Islamic banks in Malaysia is expected to remain strong if the policy rates remain high thus leading to a moderation in financing growth. Moreover, in Malaysia, the capacity and willingness of the government to support the financial sector in times of stress is expected to remain strong.

[33] The TESS programme also allows banks to reduce NSFR to 90%, increase the advances to stable resources ratio (ASRR) to 110%, and treat the ZCF facility as a stable funding source.
[34] This policy has created a liquidity injection of about MYR 46 billion into the banking system.

The Bangladesh Bank introduced a 14-day tenure Islamic bank liquidity facility against *Ṣukūk* in December 2022, in a bid to enhance the liquidity management of Islamic banks operating in the country. Recently, the Bangladesh Bank also introduced the *Mudārabah* Liquidity Support (MLS) instrument. With a minimum of BDT 100 million (USD 1.07 million) or multiples thereof, and a tenure of either 7, 14, or 28 days, the MLS, is based on a *mudārabah* contract between the Bangladesh Bank as the Rabb Al Maal and an Islamic bank as the *mudārib*. The Instrument is expected to be used in exceptional circumstances to meet liquidity shortages.[35]

The State Bank of Pakistan injected PKR 4.7 trillion (USD 20.8 billion) in 2022 to improve liquidity. However, both short-term and long-term yields have increased, and inflation remains high due to the impact of floods, rising fuel prices, currency depreciation, and a hike in electricity tariffs. These factors, along with depleted foreign exchange reserves, may lead to further financial tightening and negatively impact funding costs. The Roshan Digital Account has been effective in providing efficient banking services to Pakistanis in the diaspora.

Islamic banks are primarily funded by customer deposits, which are insured and have shown stability during previous economic shocks. The reopening and recovery of economies, along with the economic uncertainty caused by rising inflation, have led to an increase in liquid deposits and precautionary savings among households and businesses. Islamic banks' domestic retail funding structure helps reduce funding concentration, and their limited exposure to external funding reduces susceptibility to financial tightening and exchange rate volatility. Jurisdictions with a significant proportion of restricted profit-sharing investment accounts and similar deposits also have reduced the likelihood of large withdrawals, allowing for effective asset-liability management.

Generally, the liquidity position of Islamic banks across key jurisdictions is expected to remain stable. This is hinged on a number of factors, mainly the availability of *Sharī'ah*-compliant liquidity management instruments, strong liquidity buffers that were built by implementing the various Basel reforms[36] but rarely used even at the peak of the COVID-19 pandemic, retail funding focus with a sticky deposit funding, and sizeable high-quality liquid assets (HQLA) that can be easily deployed to meet short-term liquidity needs.[37] The increased revenue from oil would also impact Islamic banks of oil-exporting countries, especially in the GCC region through stable sovereign funding support, and the growth of the non-oil economy in the region.

Notwithstanding, a few other jurisdictions face liquidity challenges stemming from a lack of *Sharī'ah*-compliant liquidity instruments to manage excess liquidity, which puts Islamic banks at a disadvantage compared to the country's conventional banks. There is a likelihood of a growing demand for Islamic capital market products in this regard. In response, RSAs have been introducing Islamic liquidity management tools in their respective local currencies to address the local capital market needs.

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35 In addition to the agreed profit-sharing ratio between the Bangladesh Bank and an Islamic bank using the facility, the former is also entitle to a claim on remittance or financial stimulus incentives from the latter due to its proven negligence, misconduct, or breach of contract.

36 For instance, Saudi Central Bank rules for the implementation of the Basel reforms were finalised and issued on the 1st of January 2023 ahead of their effective implementation dates.

37 The failure of the SVB bank despite significant HQLA holdings highlights the importance of considering the susceptibility of certain HQLA securities to unrealised losses or whether they are long- or short-dated securities when computing the LCR. The concentration and held-to-maturity nature of HQLA securities should also be factored into the computation of the LCR. The failure of a small bank like SVB and the response by the FED shows that even small banks can trigger contagion risk or a system-wide confidence crisis if not well-managed, and the threshold of what constitutes a small bank may need to be revisited, especially since most Islamic banks are not even domestically systemically significant.

Although Islamic banks across jurisdictions also have no notable exposure to the bank failure of the SVB and Signature bank in the US, those that hold significant held-to-maturity securities may be exposed to unrealised losses as financial tightening persists.[38] Moreover, Islamic banks would have to manage the shortening of the maturity of liabilities likely motivated by continuous financial tightening and increased rates. Moreover, Islamic banks would need to strengthen their risk management framework, encompassing both peculiar risks and general risks, such as liquidity risk management (diversification of funding sources and identification of liquidity risk). Moreover, the accounting methodology employed should accurately reflect the inherent risks associated with banks.

[38] This is expected to be manageable, especially in jurisdictions where Islamic banks hold a significant level of government securities.

BOX ARTICLE 2:

Development of *Sharī'ah* Hedging Swap Transaction in Indonesia

Contributed by:
Bank Indonesia

Introduction

To maintain rupiah stability through exchange rate risk management and to encourage *Sharī'ah* finance market deepening, Bank Indonesia developed a hedging instrument under *Sharī'ah* principles in the form of *Sharī'ah* hedging swap transactions to Bank Indonesia. This is a complex hedging purchase transaction by BUS/UUS to Bank Indonesia. It involves a sequence of a selling spot transaction by BUS/UUS to Bank Indonesia and a forward agreement followed by a purchase spot transaction by BUS/UUS to Bank Indonesia when the forward agreement is due, and its settlement is in the form of a currency handover. Forward Agreement (*al-Muwa'adat li 'Aqd al- Sharf al-Fawri fi al-Mustaqbal*) means a promise (*muwa'adah*) for a spot transaction in a certain amount in the future at an exchange rate, or exchange rate calculation agreed during the agreement. *Sharī'ah* hedging swap transactions to Bank Indonesia use the *al-tahawwuth al-murakkab* agreement under the Fatwa of DSN MUI No.96/DSN-MUI/IV/2015 on *Sharī'ah* Hedging Transaction (*Al-Tahawwuth Al-Islami /Islamic Hedging*) on Exchange Rates.

Characteristics of *Sharī'ah* hedging swap transactions to Bank Indonesia

The characteristics include:

I. conducted in a foreign currency against rupiah;
II. conducted by using an underlying transaction;
III. conducted under a *Sharī'ah* hedging contract, namely information from the bank conveyed to Bank Indonesia containing the planned period and amount of underlying transactions used as the basis for *Sharī'ah* hedging swap transactions to Bank Indonesia. This is done through means of communication determined by Bank Indonesia, with the maximum *Sharī'ah* hedging contract term of three years;
IV. maximum term of 12 (twelve) months, starting from 1 (one) day after a value date or settlement date until the due date;
V. may be extended; and
VI. early termination is not permitted.

Underlying transactions for *Sharī'ah* swap hedging to Bank Indonesia

A *Sharī'ah* bank must meet underlying transaction requirements which may be in the form of underlying transactions owned by a bank or customer. If a *Sharī'ah* bank uses an underlying transaction of a customer, the *Sharī'ah* bank will ensure to mitigate risks of *Sharī'ah* hedging transactions received by the customer. An underlying transaction for a *Sharī'ah* hedging swap transaction to Bank Indonesia includes:

I. current account,
II. financial account,
III. capital account,
IV. financing from *Sharī'ah* Bank to people for commerce and investments,
V. trade of domestic goods and services; and
VI. any other underlying transaction determined by Bank Indonesia.

An underlying transaction excludes:

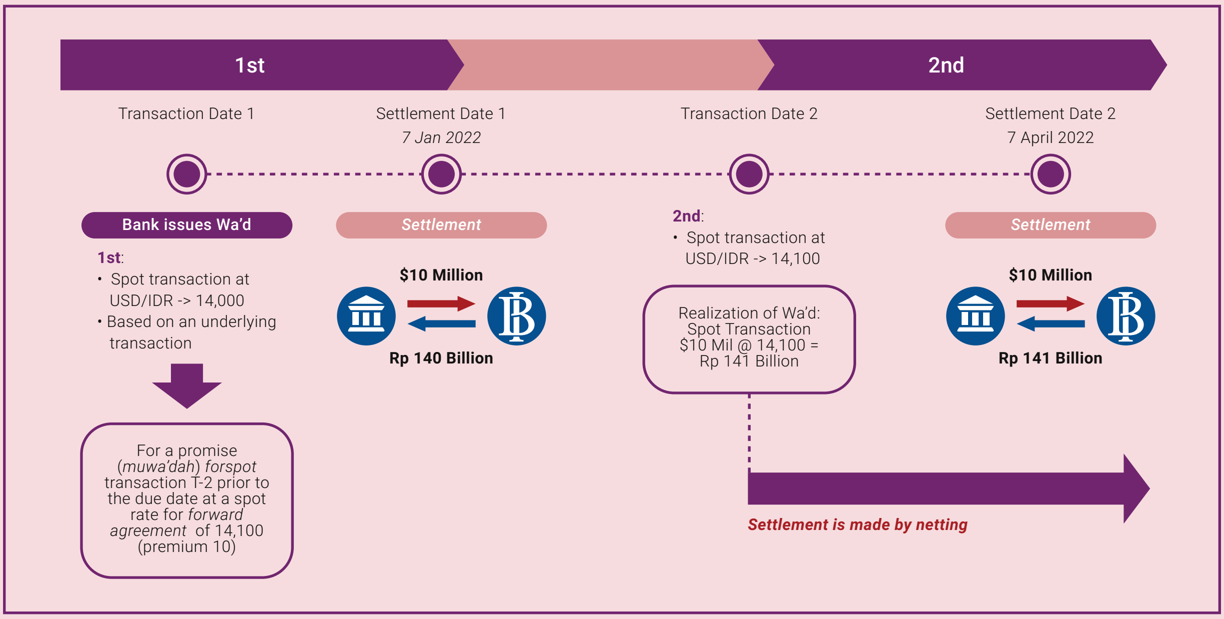
I. securities issued by Bank Indonesia;
II. fund placement;
III. un-withdrawn financing facility; or
IV. crypto assets.

Requirements for a *Sharī'ah* bank that can propose a *Sharī'ah* hedging swap transaction to Bank Indonesia

Sharī'ah hedging swap transactions to Bank Indonesia are conducted bilaterally, on Bank Indonesia's business days. A *Sharī'ah* bank which proposes a *Sharī'ah* hedging swap transaction to Bank Indonesia must meet the following requirements:

I. has a permit as a *Sharī'ah* monetary operation participant in foreign currencies;
II. has a certain level of bank health;
III. is not imposed with any temporary sanction by Bank Indonesia to participate in any monetary operation activity; and
IV. is not being sanctioned with participation restriction in monetary operations by Bank Indonesia.

Extension of Sharī'ah hedging swap transactions to Bank Indonesia.



Source: Bank Indonesia

Banks may propose an extension of *Sharī'ah* hedging swap transactions to Bank Indonesia by meeting requirements as a qualified *Sharī'ah* bank, which proposes a *Sharī'ah* hedging swap transaction to Bank Indonesia. In addition, *Sharī'ah* banks also need to ensure that the extension uses an effective *Sharī'ah* hedging contract, an extension term according to the remaining *Sharī'ah* hedging contract term and a maximum of 12 (twelve) months, and a maximum extension nominal value equivalent to the underlying transaction value.

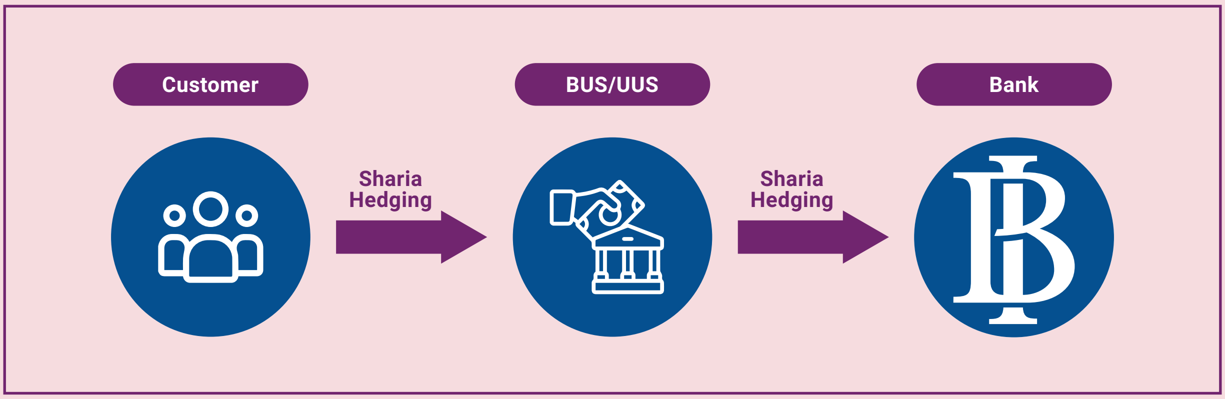
Settlement of *Sharī'ah* hedging swap transactions to Bank Indonesia

A *Sharī'ah* bank must settle *Sharī'ah* hedging swap transactions with Bank Indonesia via fund transfer in the foreign currency according to the transaction value and to the account designated by Bank Indonesia. Funds must be received by Bank Indonesia on a date determined by Bank Indonesia while a *Sharī'ah* bank ensures it provides sufficient funds in the Bank's giro account with Bank Indonesia (funds must be provided on a date determined by Bank Indonesia). Meanwhile, the transaction settlement of *Sharī'ah* hedging swap transaction extension to Bank Indonesia may be conducted by netting.

The availability of *Sharī'ah* hedging swap transactions to Bank Indonesia is expected to boost the increase in foreign currency transactions in the *Sharī'ah* money market. There is a limited number of *Sharī'ah* banks that may conduct foreign currency transactions. Therefore, it is expected that the availability of good hedging instruments existing in the market and the efforts of both the *Sharī'ah* banks and Bank Indonesia in this regard would support efforts to achieve a liquid, efficient, and transparent financial market with integrity.

This in turn is expected to boost an increase in foreign currency transactions by *Sharī'ah* banks thus supporting economic activities in Indonesia.

Flow of *Sharī'ah* Hedging Transaction



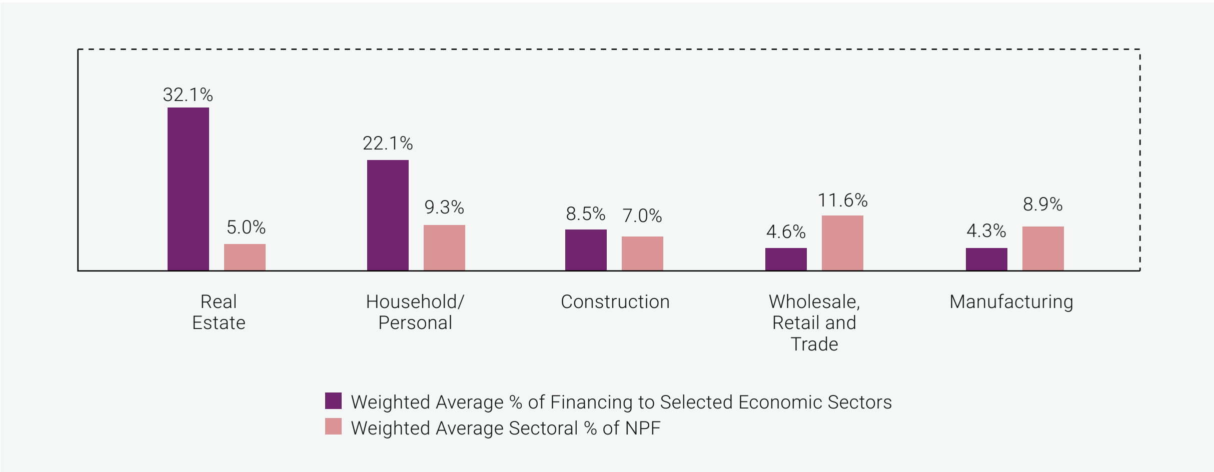
Source: Bank Indonesia

2.2.2 Financing and Assets Quality

Islamic banking demonstrated sustained growth in financing across multiple countries, supporting the continuity of financial intermediation. Asset quality remained stable on the back of sufficiently frontloaded provisioning for non-performing assets and improving and favourable risk perception as economic activities picked up significantly. Other factors include improved corporate and household repayment capacity and availability of supportive targeted lending incentives to certain sectors crucial to economic recovery,[39] especially in countries with strong fundamentals and increased revenue that expanded their fiscal space.

The pattern of the full-fledged Islamic banks and Islamic banking windows' financing activities remained largely similar to that witnessed since 2021. Except for a slight switch in proportion, financing remained concentrated in the real estate, household, and construction sectors, followed by the wholesale and retail trade sectors (See Charts 2.2.2.1 and 2.2.2.2 for the sectoral composition of financing by country).

Chart 2.2.2.1 Weighted Average Percentage of Financing and Non-Performing Financing to Selected Economic Sectors (2022)

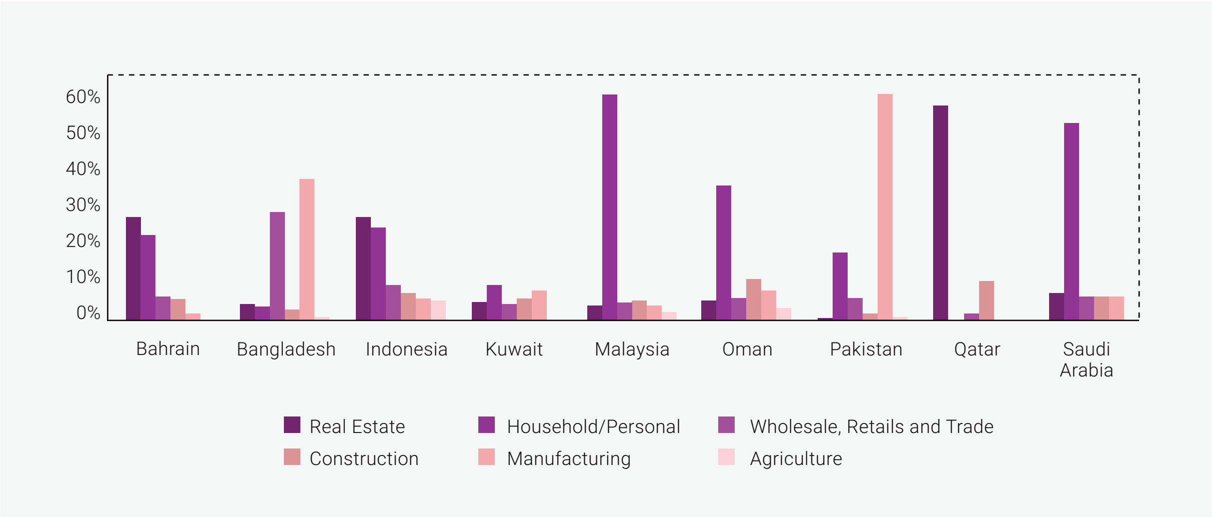


Source: PSIFIs

Across jurisdictions, Islamic banking sector financing remained concentrated mainly in the real estate, household and personal financing, and construction sectors (see Chart 2.2.2.2). This is expected given that Islamic banks' financing is essentially linked to the real estate sector and limited to *Sharī'ah*-compliant activities. While the financing to these key segments was mainly due to the economic reopening and recovery, in specific cases, it was also due to deliberate government policies across jurisdictions.

[39] In addition to the agreed profit-sharing ratio between the Bangladesh Bank and an Islamic bank using the facility, the former is also entitled to a claim on remittance or financial stimulus incentives from the latter due to its proven negligence, misconduct, or breach of contract.

Chart 2.2.2.2 Islamic Banking Sectoral Composition of Financing by Country (2022)



Source: PSIFIs

In addition to Saudi Arabia and Oman in the GCC region, financing provided by Islamic banks in the SEA region in 2022 was mainly to the household sector.[40] Moreover, a large proportion of the workforce is employed in the public sector in both regions, whereby job security and a stable household income helped to prevent default post-pandemic, thus creating a lower perceived risk of the sector. The real estate sector also picked up due to both supportive government initiatives to increase home ownership and the benefits from the introduction of the real estate transaction tax (RETT)[41] introduced in Saudi Arabia. This trend is expected to continue due to the recently signed portfolio purchase agreement between Al-Rajhi Bank and Saudi Real Estate Refinance Company. The agreement, which is worth SAR 5 billion, is specifically meant to support mortgage financiers and originators to provide Saudi citizens with access to affordable and flexible home financing products.

In Indonesia, Otoritas Jasa Keuangan (OJK) maintained its policy of a looser risk-weighted assets, extended looser financing restructuring policy until March 2023, and encouraged banks in the country to cut rates in order to help stimulate economic activity. Moreover, in addition to a looser risk-weighted assets policy for automotive financing, financing-to-value on housing financing was increased to 100% on both residential and business properties. This is understandable as the economic recovery in the country is stimulated by increasing domestic consumption.

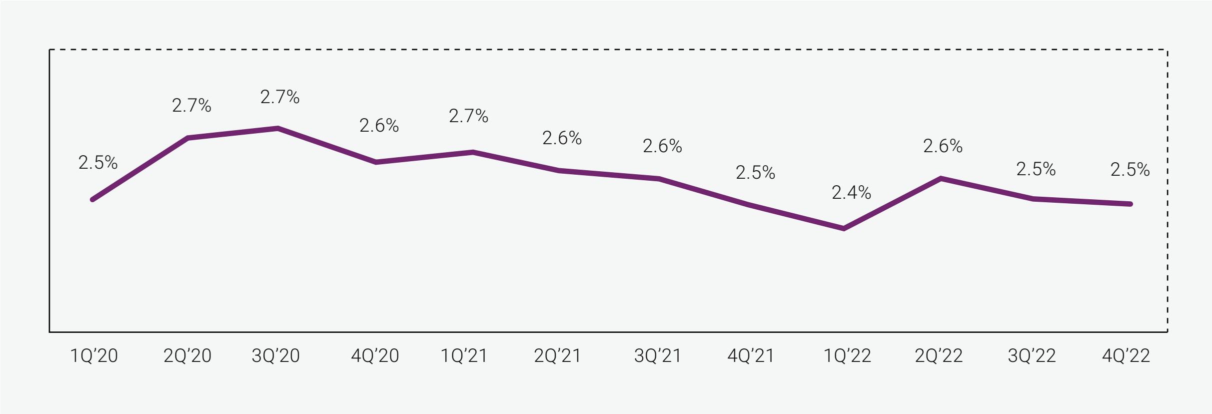
In both Bangladesh and Pakistan, the financing exposure of Islamic banks was mainly to the manufacturing sector. This was due to the prominence of the sector for the countries' economic development on the back of competitive labour costs, large quantity of garment exports, and expansion into the leather, automobile, and pharmaceutical industries.

Notwithstanding the fact that the various forbearance measures put in place across many jurisdictions have been unwound, the asset quality of Islamic banks and windows measured by the average non-performing financing (NPF) ratio indicate a declining trend after a temporary surge from 1Q22 to

40 In some jurisdictions, personal and household financing may also include financing for real estate.
41 The RETT, which is intended to give a boost to the real estate sector, is fixed at 5% of real estate transactions and applies to all such transactions in lieu of the value added tax. The government gave the commitment to pay the RETT on behalf of Saudi nationals who are buying their first home worth up to SAR 1 million.

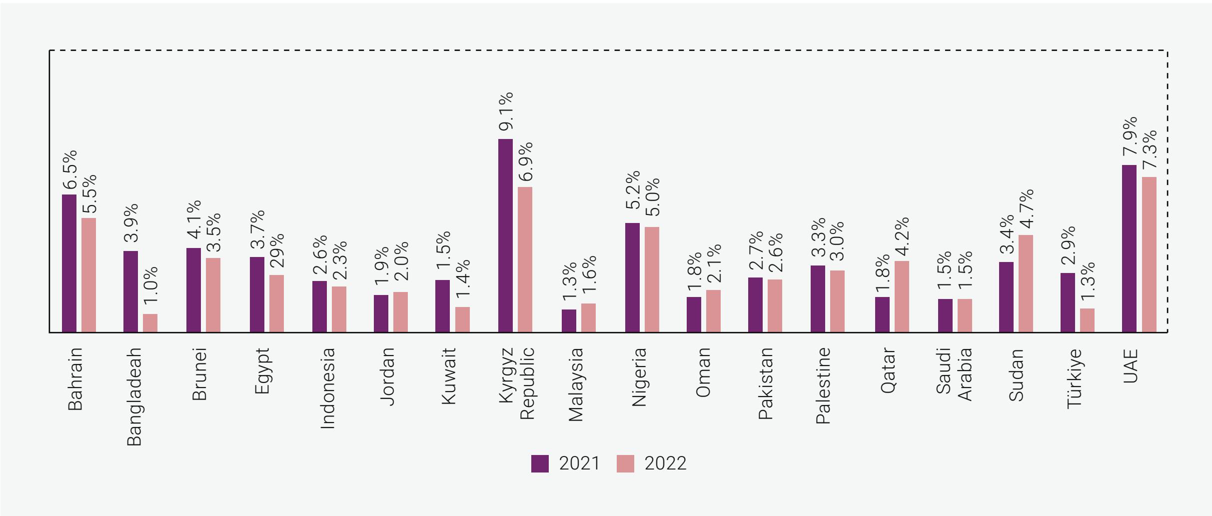
2Q22 (see Chart 2.2.2.3). Also, despite the concentrated exposure of Islamic banks to the real estate and household sectors, their corresponding share of the total NPF is lesser. This is in stark contrast to the manufacturing sector. The sectoral composition of both financing and NPF varied greatly between countries and regions, and the weighted average may not reflect a balanced view of global economic sector financing for Islamic banking across different jurisdictions. Such specific financing is shown on a country-by-country basis in Chart 2.2.2.4 and on a sectoral basis in Chart 2.2.2.5.

Chart 2.2.2.3 Global Islamic Banking Average Gross Non-Performing Financing to Total Financing (1Q20–4Q22)[42]



Source: PSIFIs

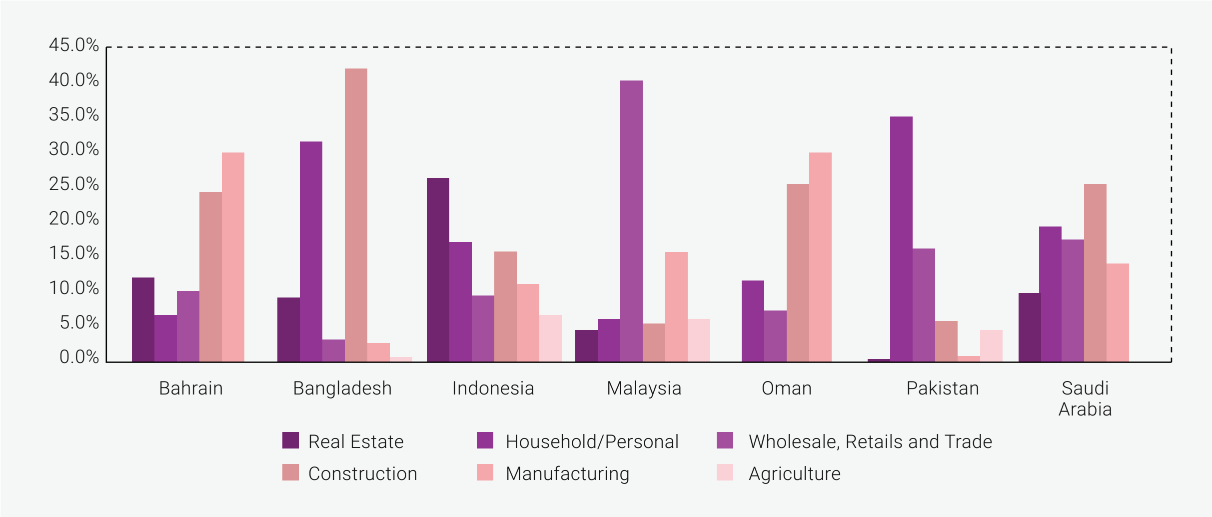
Chart 2.2.2.4 Islamic Banking Average Gross Non-Performing Financing to Total Financing by Country (2021–22)



Source: PSIFIs

[42] Average non-performing financing to total financing calculation is based on data from jurisdictions contributing to the IFSB's PSIFIs database (excluding Afghanistan, Egypt, Iran, Iraq, Jordan, Kazakhstan, Lebanon and Libya) due to data limitations.

Chart 2.2.2.5 Sectoral Composition of NPF of Islamic Banking by Country (2022)



Source: PSIFIs

In most jurisdictions covered, the asset quality of Islamic banks sustained its improvement recorded from 2021 through 2022 in terms of the non-performing financing ratio. The impairment in deferred financing after the forbearance measure was withdrawn was not as significant as anticipated. This was a result of the improved economic conditions following the reopening of many economies in the middle of 2021, which in turn boosted repayment capacity, especially of businesses and households.

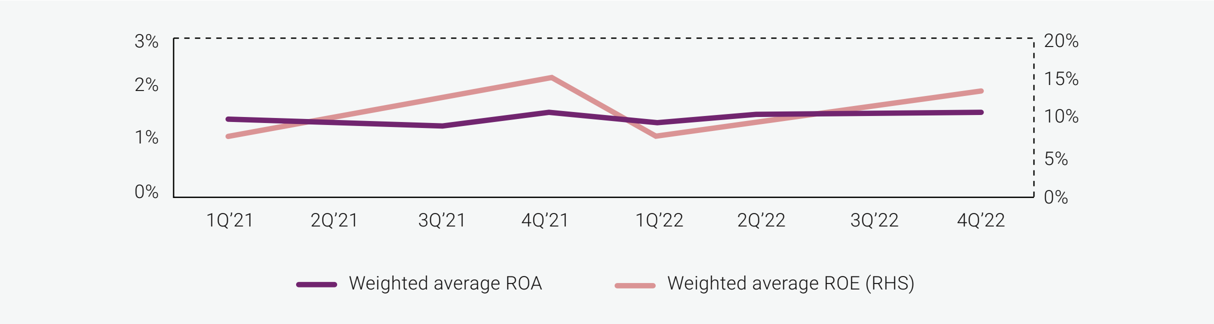
Despite the implementation of the IFRS 9 in many jurisdictions, asset quality also improved due to front-loaded and continuously adjusted provisions for NPF, in some cases with a significant percentage overlay in excess of the provisioning required as per the expected credit losses (ECL) model. This also provided adequate coverage for the credit risk that may crystalise given the tightening global financial conditions and macroeconomic uncertainty. In some other jurisdictions, the partially relaxed financing classification that allowed banks in those countries not to immediately reclassify restructured financing as substandard had seen the NPF ratios continue to decline during the period under review.

As financial conditions tighten further amid a likely higher for longer interest rates and a slowdown in global economic growth, it is expected that asset quality in Islamic banks will come under pressure in 2023, and financing standards will be more stringent. For instance, the repayment capacity of low-income households will be constrained by increasing inflation, while small businesses would also be affected by the price elasticity of demand for their products, despite the increased cost of funding due to rising policy rates to curb inflation. Similarly, house developers and contractors would likely be faced with a supply glut, thus constraining their repayment capacity, given the fact that Islamic banks have a substantial concentration of their financing to the real estate sector.

2.2.3 Profitability

The global Islamic banking industry sustained its profitability levels in 2022. Specifically, on average, stand-alone Islamic banks[43] recorded a rate of 1.7% as of 2022 (2021:1.6%) for return on assets (ROA) and 17.5% as of 2022 (2021:15.9%) for return on equity (ROE) (Chart 2.2.3.1).[44] Both the average ROA and ROE of global Islamic banking compare favourably with those of conventional banks[45] in various IFSB jurisdictions, as well as with banks in advanced economies.

Chart 2.2.3.1 Global Islamic Banking Weighted Average ROA and ROE (1Q21–4Q22)



Source: PSIFIs

The profitability performance across jurisdictions indicates that all other jurisdictions registered positive ROA, ROE, and NPM in 2022, except for Afghanistan and Lebanon.[46] This improvement was due to diverse reasons across jurisdictions, including lower operating expenses and higher operating income resulting in higher profit. Other factors include the normalisation of operating income (especially on both financing and fee-based activities), reduction in the cost of risk, provisioning, and impairment losses as the general economic situation improved in most countries, albeit slowly, thus increasing demand for Islamic banking products.

Except for a few jurisdictions, the CTI also decreased in most when compared to their 2021 performance. Perhaps, increased digitalisation has enhanced operational efficiency such that operating income has increased at a faster pace than operating expenses. Notwithstanding the fact that increasing monetary policy rates have boosted the short-term profitability of Islamic banks, profitability may attenuate in the medium term. This is due to slower economic growth experienced, especially since the second half of 2022. Moreover, Islamic banks' cost of risk could rise, given the need for more provisions and the adverse effect from a likely decline in financing volume if the global economic condition deteriorates further.

In order to get a more granular view of the profitability performance of the Islamic banks across jurisdictions, the ROA and ROE are for fully-fledged Islamic banks only, and NPM and CTI ratios for the entire Islamic banking sector in the countries covered. Data are shown in Charts 2.2.3.2 to 2.2.3.5.

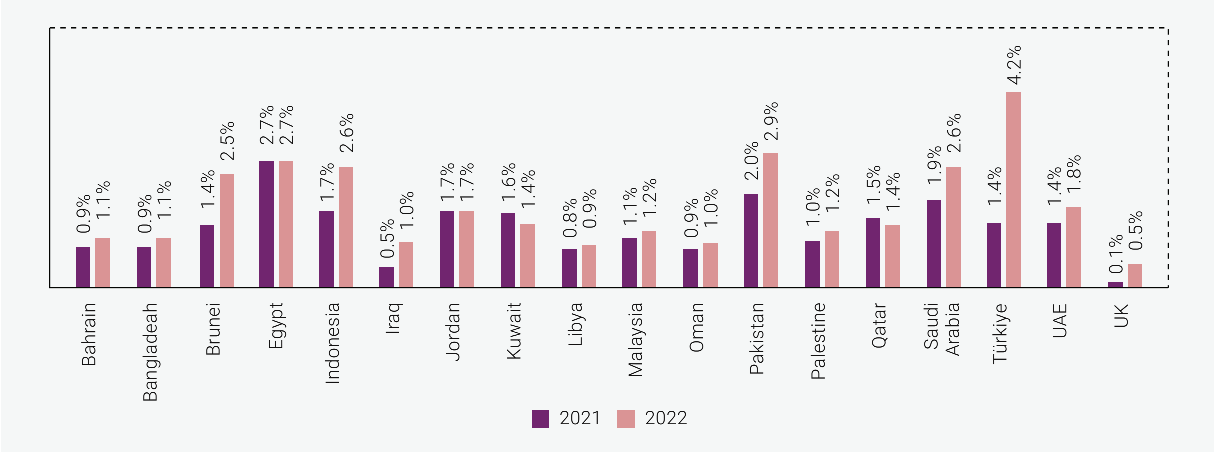
43 "Stand-alone Islamic banks" refers to full-fledged Islamic banks and Islamic subsidiaries of conventional banks but excludes Islamic windows of conventional banks.

44 In the computation of both the ROA and ROE, the net income is before extraordinary items, zakat and taxes. The figures for both ROA and ROE for Saudi Arabia are for both the fully-fledged and Islamic banking windows in the country.

45 The comparison made in the statement is incomplete as it does not account for the treatment of PSIAs as on-balance-sheet or off-balance-sheet and the effect of applying the IFSB alpha on the equity of Islamic banks. Restricted profit-sharing investment accounts (RPSIA) are generally considered off-balance-sheet as Islamic banks do not have an unconditional right to use or dispose of these funds. However, new consolidation standards in IFRS 10 require RPSIAs to be controlled by an IIFS and the income of the IIFS to be treated as on-balance-sheet.

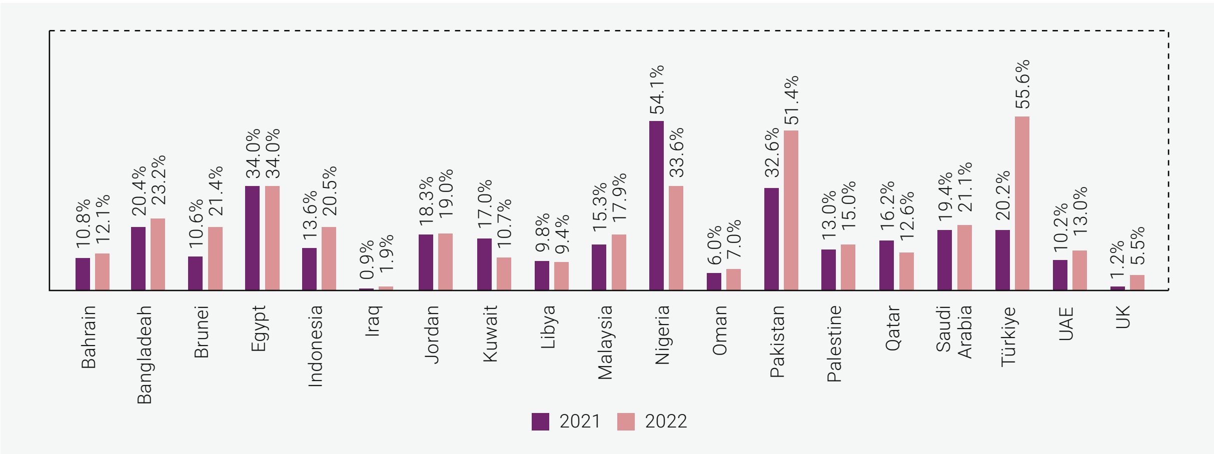
46 Both jurisdictions had fragile economies prior to the pandemic and have been faced with its effect along with political uncertainty, falling output, inflation and increasing poverty.

Chart 2.2.3.2 Islamic Banking Average ROA for Stand-Alone Islamic Banks by Country (2021–22)



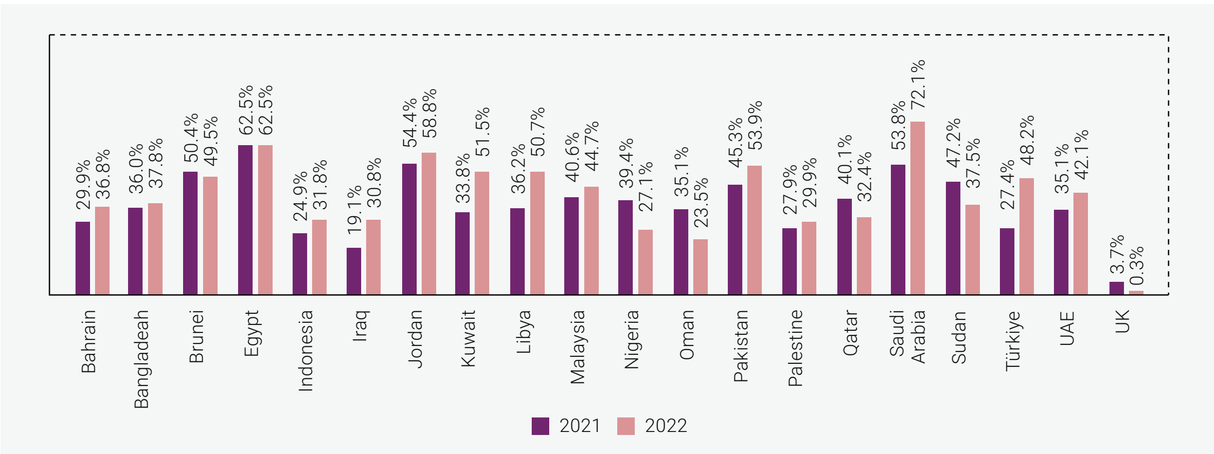
Source: PSIFIs

Chart 2.2.3.3 Islamic Banking Average ROE for Stand-Alone Islamic Banks by Country (2021–22)



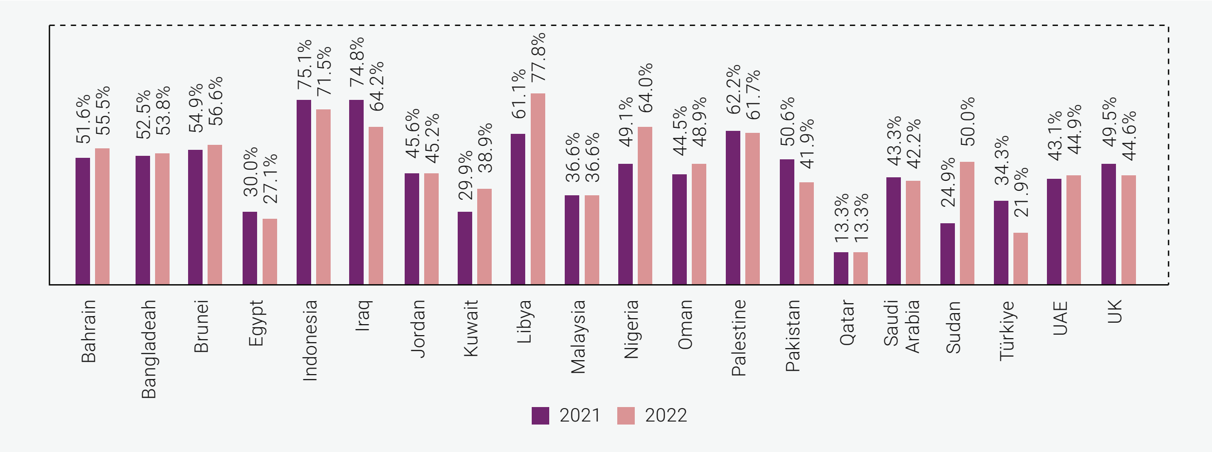
Source: PSIFIs

Chart 2.2.3.4 Islamic Banking Net Profit Margin by Country (2021–22)



Source: PSIFIs

Chart 2.2.3.5 Islamic Banking Cost-to-Income Ratio by Country (2021–22)



Source: PSIFIs

Despite the improved performance, increased tightening of financial conditions and high policy rates will affect weaker borrowers, especially low-income households and microenterprises, thus likely resulting in slow credit growth and constrained repayment capacity. This could also have implications for the profitability of Islamic banks, especially as businesses' capacity to pass on higher costs to consumers dwindles even if they have been able to navigate the cost pressures during the past year. Moreover, the benefits that should accrue from financing repricing would likely be subsumed by price competition for deposits which constitute a large proportion of the funding profile of Islamic banks. Nonetheless, the profitability outlook remains strong in many jurisdictions, especially those with sufficient front-loaded provisioning. The higher policy rates would also benefit Islamic banks. For instance, in GCC countries where GDP is expected to grow due to increased revenue from oil to support business growth. In some other jurisdictions, the discontinuation of some government fiscal policy measures to shore up budgets to mitigate the impact of COVID-19 would also help boost profitability. For instance, in Malaysia, the absence of the one-time prosperity tax (Cukai Makmur).[47]

2.2.4 Capital Adequacy and Leverage

The capital structure of the Islamic banking industry remains stable and strong, registering improvement throughout 2022. The average total and average Tier-1 capital adequacy ratios (CARs) of the global Islamic banking industry as of the end of 2022 were 18.2% and 17.7%, respectively (see Chart 2.2.4.1), well above regulatory thresholds in the IFSB-23 Revised Capital Adequacy Standard (RCAS), as well as those of their respective RSAs, thus indicating strength and stability to withstand balance sheet shocks and unexpected losses given the current global macroeconomic uncertainties.

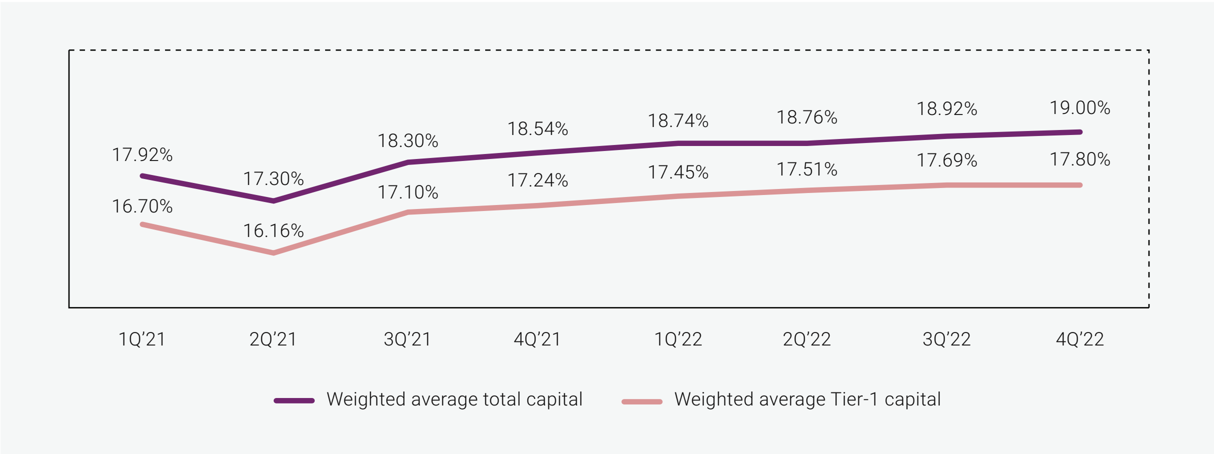
The strong CAR and Tier-1 capital ratio performance of the Islamic banking sector across jurisdictions could be linked to the increase in the internal generation of capital from retained earnings due to an increase in Islamic banks' income due to economic reopening and recovery and increased profitability.

[47] The Prosperity Tax is a one-off tax measure introduced by the federal government of Malaysia in Budget 2022 and levied on chargeable income (not net profit) above RM100 million at a higher rate of 33% compared to the hitherto blanket base rate of 24%.

These ratios have also attenuated the effect of the decline in values of fixed-income securities due to monetary policy rate hikes across jurisdictions. Moreover, there were also a number of mergers and acquisitions, as well as the establishment of new Islamic banks and the conversion of previously conventional banks to Islamic banking in a number of countries. The Islamic banking sector also registered an increase in CAR due to a decline in RWAs, as assets growth moderated. At the same time, there was an increase in total qualifying capital of banks due to dividend reinvestment and issuance of *ṣukūk* for Basel III regulatory capital purposes.

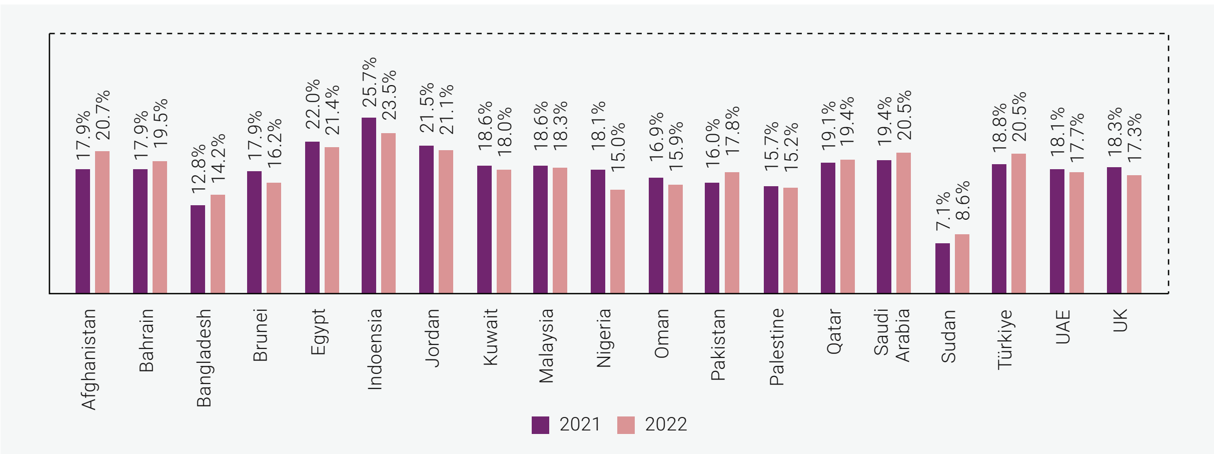
Notably, however, in Sudan, both regulatory capital ratios show worryingly low levels on average for the second consecutive year (see Chart 2.2.4.2). While no case of an Islamic bank failure in Sudan was announced in 2022, it is almost certain that some Islamic banks in the country may be hovering on the brink of failure, with possible knock-on effects on other banks. Although Sudanese banks are yet to begin compliance with Basel III, they are nonetheless undercapitalised. Their capital buffers are deemed to be fragile, given the upward pressure on RWAs due to the devaluation of the Sudanese Pound, as well as limited economic growth prospects amid political instability.

Chart 2.2.4.1 Global Islamic Banking Average Capital Adequacy Ratios (1Q 21–4Q 22)



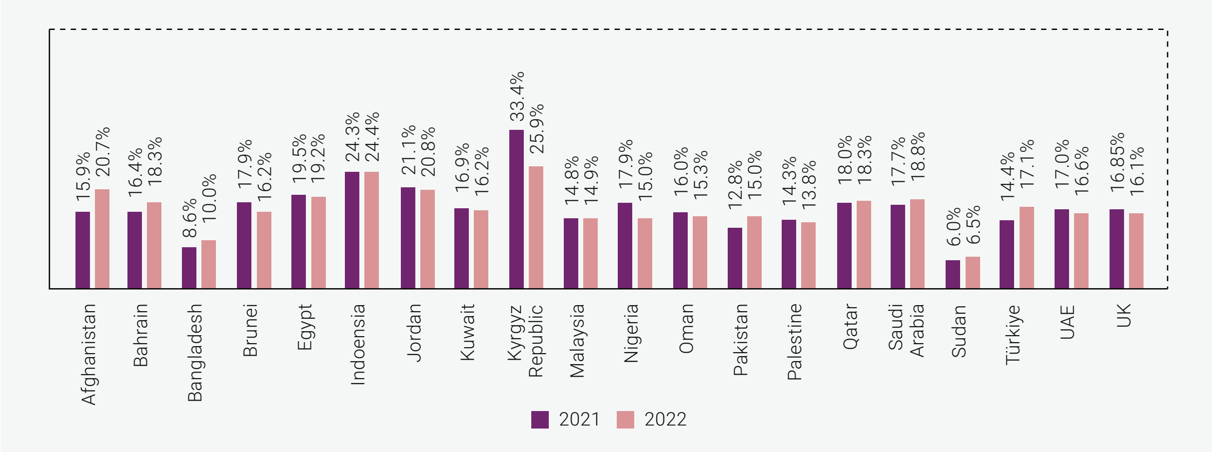
Source: PSIFIs

Chart 2.2.4.2 Islamic Banking Average Total Capital Adequacy Ratio for Stand-Alone Islamic Banks by Country (2021–4Q 22)



Source: PSIFIs

Chart 2.2.4.3 Islamic Banking Average Tier-1 Capital Adequacy Ratio for Stand-Alone Islamic Banks by Country (2021–4Q 22)



Source: PSIFIs

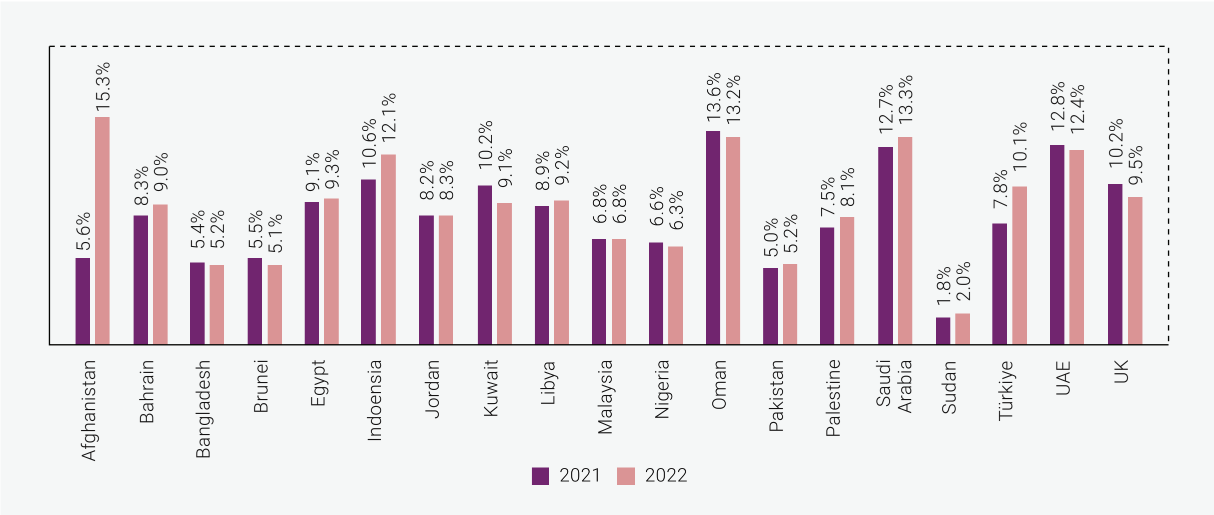
The regulatory leverage ratio[48] of Islamic banks across jurisdictions (apart from Sudan) has exceeded the 3% requirement (see Chart 2.2.4.4). This suggests that in most jurisdictions, there was no build-up of leverage and, as such, no susceptibility of their financial systems and the economy to the effect of any deleveraging process.

Generally speaking, Islamic banks are less prone to engaging in highly leveraged products because *Sharīʻah* requires, in principle, that all financing be linked to transactions in the real economy – that is, production and trade transactions and activities. Similarly, there are restrictions on debt trading and engaging in products involving undue and excessive speculation (gharar). At the same time, risk-sharing means of raising funds are encouraged. The combination of these measures seriously limits the leverage effects in Islamic finance, although it does not completely eradicate this phenomenon.

Only to a limited extent do Islamic banks use return-paying deposits to leverage their capital. Although they may use unremunerated current accounts for this purpose, with few exceptions, such as current accounts, they do not constitute the bulk of an Islamic bank's funding. Unrestricted PSIAs have historically been one of the major sources of funds for Islamic banks. Similarly, Islamic banks do not become involved in transactions involving gharar or other leveraged transactions, such as collateralised debt obligations or resecuritisations. Nonetheless, there are a few practices and transactions that may involve Islamic banks in leveraged transactions. Some offer a commodity *murābahah* transaction (CMT) for liquidity financing to their customers, as well as for raising deposits. Reverse CMT-based deposits are a form of leverage, which, together with CMT-based term financing, has the potential to create unlimited debt in the system. Based on the factors highlighted above, the IFSB considers it prudent that RSAs that are yet to implement the leverage ratio requirements in their jurisdictions are highly encouraged to do so.

[48] Leverage ratio = Tier-1 capital / total exposure Revised Compilation Guide on PSIFIs 2019, Page 73. *https://www.ifsb.org/download.php?id=5512&lang=English&pg=/psifi_08.php*

Chart 2.2.4.4 Islamic Banking Leverage Ratio by Country (2021–22)



Source: PSIFIs

BOX ARTICLE 3:

Credit Ratings of the Global Islamic Banking Industry in 2022 and Outlook for 2023

Contributed by:
Islamic International Rating Agency

Outlook for the Global Financial Sector

At the heels of a sudden spate of bank failures in early March 2023, the general outlook on the global financial sector today seems the gloomiest since the financial crisis of 2008. Despite having established itself as being resilient to a pandemic scale shock, the financial sector is on course to suffer from the twin effects of plummeting prices in fixed-income securities with rising benchmark rates and the prognosis of slow growth. Much of what we have seen in terms of ratings and their relative stability in the financial sector, during the past two years, is unlikely to continue.

The dim prospects are further exacerbated by distress at a European Bank, designated a G-SIB or a globally systemic important bank. While the quick-to-be-announced promise of rescue has so far largely localised the institution's troubles, it has raised new questions on the ability of carefully crafted regulations to safeguard depositors and investors and the treatment of investors in supplementary capital instruments. In turn, there may be some impact on the offtake of supplementary capital instruments, which has so far played a critical role in beefing up balance sheets when required.

Despite the scaled-up regulatory framework credited for the recent stability in bank risks, the potential of contagion of market losses through the banking sector is a real possibility. Moreover, there is a continued risk of panic withdrawals in the present situation. Retreating values of bank stocks have also seen equity markets take a knock. Already faced with an economic slowdown, banks will be increasingly cautious and build reserves to meet any future losses in the upcoming months.

Outlook for Islamic Banks

Closely tied to regional economics, Islamic banks deviate from the broader global banking scenarios in distinct ways. On some points, however, Islamic banks will remain in sync with their international counterparts. Most noteworthy of these is the Islamic banks' exposure to slowing economies, with implications for not just profitability but also credit quality. High inflation and high benchmark rates do not theoretically bode well for businesses. As such, we expect financing offtake conditions to not be particularly conducive, although the extent of the slowdown will vary across regional banks where Islamic banks are active. The potential for market losses is also there, although again, its scale in relation to their own balance sheets is unlikely to be comparable to global banks. Given the relative lack of depth in bond and *ṣukūk* markets, the propensity for shorter-term market exposures marks several regional banks in the OIC block, which also holds true for Islamic banks. With relatively weaker capital markets regionally, except in South-East Asia, banks are relatively less exposed to equity markets, often also given a restrictive regulatory environment.

The relatively higher sector and client concentrations in volatile sectors, such as real estate, seen in several Islamic banks, do cause some concern, especially in view of the likely dip in repayment ability as marginal players take the brunt of inflation and high benchmark rates. On the other hand, we have also seen significant volatility in the tourism sector, and its sustained avoidance in Islamic banks has protected the Islamic banks from losses in this sector. There is no G-SIB Islamic bank, and only a few D-SIB designations are held by Sharīʻah-compliant institutions; hence the severe risk of contagion in local Islamic financial markets may not be expected for Islamic banks due to any surprise losses in any major institution. In short, Islamic banks have their own idiosyncratic features that enhance or mitigate institution-level risks and vary across regional markets, reflecting regional particulars.

Rating Trends in the past few years since 2020 – the year of the pandemic

Except where affected by sovereign ratings, thus far, Islamic bank ratings have held out through not just the tumultuous COVID-19 pandemic but also the deteriorating economic conditions in many countries where Islamic finance has flourished over the last several decades. Given the fact that sovereign ratings cap the ratings of all obligors within the jurisdiction, there has been general downward pressure on ratings, although these pressures vary from region to region. For example, South-East Asia and the GCC region have mostly remained protected from significant pressures, as economies posted a strong recovery in 2021 and particularly in 2022. On the other hand, banks in economies that had either entered the recently stressed economic scenario in an already weak position or those which had suffered a significant setback in the last two years, experienced rating cuts, reflective of sovereign rating downgrades. Ratings have only sparingly moved above 2020 levels, mostly recovering from the earlier executed cuts during 2020[49], or again as a reflection of improvements to sovereign ratings.

Also worthy of mention in the context of ratings of Islamic banks, we have seen developing interest in ratings for Islamic institutions and instruments on the scale of Sharī'ah compliance and governance. Following the issuance of AAOIFI standards for ratings of Islamic institutions and exposure draft for ratings of Islamic financial instruments, we have seen some traction in ratings in the segment. We believe that this further helps bridge information gaps in the market.

Regional Outlook

While reiterating the pressures and their non-uniform severity in various regions, it is important to take a closer look at broader regions where Islamic banks have been active.

Gulf Cooperation Council

GCC countries feature strongly in the Islamic banking spectrum. The Gulf region has the highest proportionate share of Islamic banking assets in the world, led by Saudi Arabia, and is a growing market in general. Higher benchmark rates will also play a role in limiting growth forecasts in this region. However, in Saudi Arabia, government-led programmes envisaged under Vision 2030 and a bid for the privatisation of government assets may continue to fuel momentum, which Islamic banks are well positioned to benefit from.

Fast-paced recovery post-COVID-19, continuing into 2023 and ameliorating regional business sentiment, as well as buffered balance sheets, will continue to propel growth. Any upward pressure in credit risk seems immaterial at present, and even if some increase in non-performance cost does materialise, it will be protected by already well-provisioned asset books across the Islamic banking sector in the region. Islamic bank ratings that feature prominently amongst the few recently upgraded are almost entirely from this region, and largely reflective of easing economic constraints.

Capital adequacy is well above prudent requirements and also significantly above other regional blocks' averages. The prognosis is favourable, despite some structural factors which may be discriminating variables in the long term, such as economic segment concentrations and a higher dependence on public sector funds. With revenue mostly derived from margins, higher benchmark-

[49] Rating data collected for major rating agencies to allow for comparison

rates are likely to keep profitability buoyed. Consolidation has been a constant on the agenda in several of the markets within the GCC region and will strengthen the players within.

South-East Asia

Concentrated in Malaysia and Indonesia, Islamic banks in the region have ridden the wave of economic recovery. Especially in Malaysia, *Sharīʻah*-compliant banking comprises a significant 31.5% of domestic assets, which places it ahead of the curve vis-a-vis a number of other jurisdictions. Given a conducive ecosystem, Islamic banks have thrived and, in recent periods, have somewhat exceeded the growth of conventional banks. Some needed consolidation has also been seen in the region. Nevertheless, the same factors driving the expected global slowdown will play in the region, and a deceleration seems inevitable.

Overall, we see pressures on asset quality with the reduced buying power of retail consumers in the face of rising inflation and high benchmark rates. The consumer sector is a dominant part of the financing book and may post higher non-performance. Similar risks can be seen in the SME sector. However, adequate buffers built into balance sheets as a precaution, stringent financing guidelines, and a strong regulatory monitoring mechanism should limit any significant upward movement in non-performance indicators. While considerably higher margins will drive overall profitability, upward momentum will be broken somewhat by inflationary pressures. Nevertheless, profitability prospects are mostly positive.

Middle East and South Asia

The economies of both Pakistan and Bangladesh were vulnerable even before the COVID-19-led economic meltdown. The recent global inflationary trends have imposed further constraints, particularly for Pakistan, which has been pulled deeper into sub-investment grade rating territory. While largely not covered by international rating agencies, the general outlook for Islamic banks in the region mirrors the economic challenges ahead, with ratings of internationally rated banks having been successively cut over the last two years[50].

Pakistan has seen a record increase in benchmark rates, touching 20% in March 2023. Economy is likely to experience slowdown and financing books will experience deceleration. Re-payment capacity of the conventional and Islamic banks' borrowers may come under stress amid economic slowdown and tightened financial conditions. All players in the segment post adequately healthy balance sheets, unlike a few severely compromised banks on the conventional side. Over the last two years, Islamic banking has grown faster than conventional banks, and several developments on the macro level are driving this increase. We saw one successful "conversion to Islamic" in recent months of a relatively significant player in the domestic market and quite a few "conversions to Islamic" in the pipeline. The rating outlook, in our view, is generally "negative".

Non-performance is high for banks in Jordan, with a narrow base of economic activity. The largest Islamic bank in Jordan is designated a D-SIB and leads market indicators, which indicates conservative balance sheets with no material risks imminent. A narrow economic base has resulted in growth and funding-related constraints for smaller banks.

[50] Social Islami Bank, Bangladesh

Africa

A promising new market, there are several emergent economies on the continent in the context of Islamic finance. We saw a spurt of private sector *ṣukūk* issuances in Egypt, which bodes well for the growth of capital markets. We saw new banks in Nigeria and growth in East African Islamic finance segments. We see promising new growth in Tunisia, although clouded over by economic pressures building up rapidly and translating into high non-performance and weak balance sheets. Faced with higher commodity prices and supply chain disruptions, Egypt has experienced economic turmoil in recent periods. Sudan features prominently in the region as the only economy relying exclusively on Islamic banking and dominated by a few or even one large bank. Yet again, the economy is faced with deep-rooted structural challenges and, while not being covered by international ratings, is looking ahead toward continued difficulties and is in need of enhanced investment in banks.

Others Region

As the largest economy in the Levant region, Türkiye has its eyes set on the deeper penetration of the participation banking segment, embedding it in its economic vision. The sector has posted aggressive growth with the arms of well-established state-owned players having entered the domain, and more traction is expected in the area. However, the last few years have been marked by challenging macroeconomic conditions, a volatile currency, and soaring inflation. Highly dollarised balance sheets and a currency that has been under pressure for most of the three years in view have significantly increased the risk of the banking system as a whole, mirroring similar pressures on sovereign debt and hence its credit rating, which has seen successive cuts over the last few years.

The banking sector as a whole remains well-capitalised. Large foreign currency gains have boosted profitability in 2021 and 2022, allowing for record profits. Equity market exposures are limited, and shallow *ṣukūk* markets, in addition to significant volatility in benchmark rates, have kept the weighted average maturity of market portfolios on the lower side. Restricting the potential for marked-to-market losses in banks, including participation banks.

Where Türkiye deviates most significantly from other markets with direct repercussions for the banking sector outlook is the fact that the Central Bank of Türkiye has not just held benchmark rates steady but actually cut these aggressively, being now far below its 10-year historical average of over 12%, vis-à-vis 8.5% currently. Margins are still high for the banking sector, and growing volumes have resulted in strong income.

Conclusion

We expect growth to slow down in 2023 regionally as base effects kick in. Although inflation would also taper off, credit risk stands to rise on a market-wide basis. Well-provisioned balance sheets should render potential losses sustainable. While inflationary impacts are waning globally, inflation is likely to remain significantly above pre-pandemic levels on a global scale. Banks are mostly conservative in their balance sheet positioning, although credit risk, in general, is on the increase, exemplified by sovereign rating cuts. On the whole, we see a positive scenario for Islamic banks based in the GCC region, pressures largely neutralised in SEA, and challenging times ahead for Islamic banks based in both MESA and Africa.

2.3 Growth and Stability in the Islamic Capital Markets

Islamic capital markets saw moderated growth as global macro-financial conditions weakened…

The ICM stability conditions remained relatively resilient in 2022 amid weakening global economic conditions and an uncertain macroeconomic environment coupled with inflationary pressures and rising interest rates. Volatility in commodities and financial markets was intensified by broader political tensions, most notably the war in Ukraine, as well as the adjustment of monetary policies by major central banks to contain inflation –which in turn impacted the liquidity in capital markets and tightened global financial conditions.

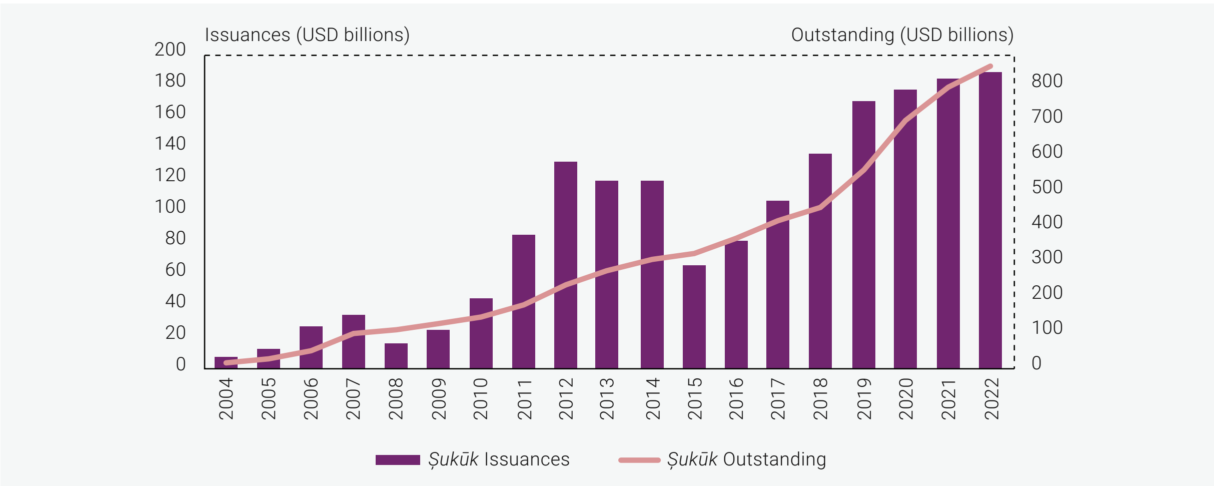
Large corrections were observed in the capital markets in 2022, affecting both equity and fixed-income markets. Islamic equity markets were impacted similarly to global equity markets, with significant market volatility and negative returns across most indices and sectors. However, Islamic equity indices performed better in the longer term, as they are inherently less prone to more severe impact due to the constituents of Islamic indices being generally less leveraged.

Activity in primary Islamic capital markets, particularly *ṣukūk* issuances saw continued but moderate growth, in contrast to bond markets which saw a decline. Islamic funds have also remained largely resilient, however, the pace of growth has slowed down.

2.3.1 Global Ṣukūk Markets: Growth, Trends, and Resilience

The *ṣukūk* market slowed down further in 2022, although still maintaining the consecutive upward growth trajectory observed since 2015 (see chart 2.3.1.1). Issuances in 2022 saw a y-o-y growth of just 2.3% (2021: 4%), with the slowdown driven by a number of factors, including higher oil prices, rise in rates, as well as geopolitical headwinds. The overall *ṣukūk* outstanding rose to USD 829.7 billion in 2022, demonstrating a y-o-y growth of 7% (2021: 12.5%). While *ṣukūk* markets experienced a lower y-o-y growth in 2022, it fared well compared to global bond issuances, which saw an overall 12% decline in issuances in 2022.

Chart 2.3.1.1 Global *Ṣukūk* Issuances and *Ṣukūk* Outstanding Trends (2004–22) USD billions



Source: IFSB estimates based on data from Refinitiv and regulators

Sovereign issuances increased in 2022 relative to the previous year, comprising 50% of overall issuances (2021: 44% of total issuances) (see Chart 2.3.1.2). Although better fiscal positions in some regions, due to the rise in energy prices reduced the overall funding needs, there was stronger than expected activity, with sovereign issuers from all core markets tapping into the *ṣukūk* market as a funding source, with some looking to add *ṣukūk* within their funding base, refinance maturing debt, or shore up foreign reserves.

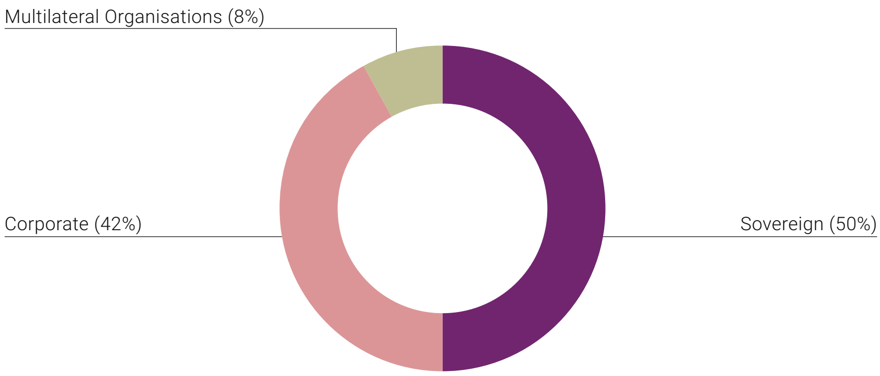
Although funding needs in the GCC region were generally lower in 2022 due to higher energy prices, Saudi Arabia remained the largest sovereign issuer, followed by Malaysia, which overtook Indonesia as the second largest sovereign issuer (2021: Indonesia – 19.6%; Malaysia – 17.8%) (see Chart 2.3.1.3a). Overall, primary market *ṣukūk* issuances by sovereigns remained strong in 2022, with a marked increase in the volume of *ṣukūk* issued across most major issuers, including Saudi Arabia, Malaysia, Indonesia and Kuwait. Moderate increases were also seen in sovereign issuances from Türkiye, Bahrain, and Brunei. Pakistan returned to the market with its first sovereign issuance since 2017, a five-year, international USD-denominated *ṣukūk* of USD 1 billion, intended to help bolster its foreign exchange reserves as its external debt servicing rose.

Corporate issuances also increased despite the pressure from rising interest rates and market liquidity strains. Corporate *ṣukūk* issuances rose by 34% in 2022, compared to the previous year, which reflects a divergence from the trend seen in the global bond market that saw a retraction of 30% in international corporate debt issuances in 2022, with emerging market corporate debt issuances seeing an even steeper drop of 42%.[51] The relatively better primary market activity in *ṣukūk* markets in 2022 may be an indication that the *ṣukūk* market is becoming a viable source of funding for corporates, which has previously proven to be challenging due to hurdles like higher issuance costs, time-to-market, and complexity compared with bonds and bank loans, as well as standardisation gaps. The improvement in corporate issuances is also reflective of efforts by regulators in Islamic finance jurisdictions to strengthen and implement a facilitative legal and regulatory environment for issuers and provide a level playing field.

Malaysia continues to dominate the corporate *ṣukūk* market, while Türkiye overtook Saudi Arabia as the second largest corporate issuer (see Chart 2.3.1.3b). In terms of individual jurisdictions, there was a general increase in corporate *ṣukūk* issuances across all jurisdictions, with the exception of the GCC region, which saw a lower volume of issuances from Saudi Arabia, Bahrain, Kuwait, and Qatar compared to 2021. Notably, corporate entrants from the African region increased, including issuers from Nigeria, Senegal, South Africa, and Tanzania.

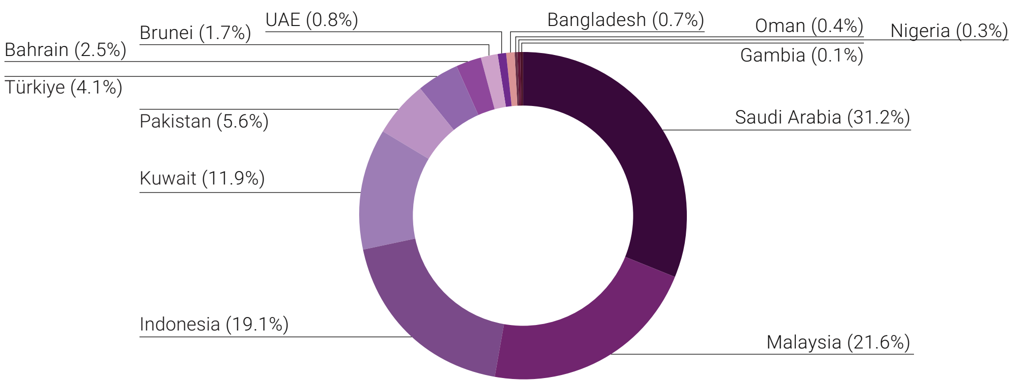
[51] Refinitiv

Chart 2.3.1.2 *Şukūk* Issuances by Issuer Type (2022)



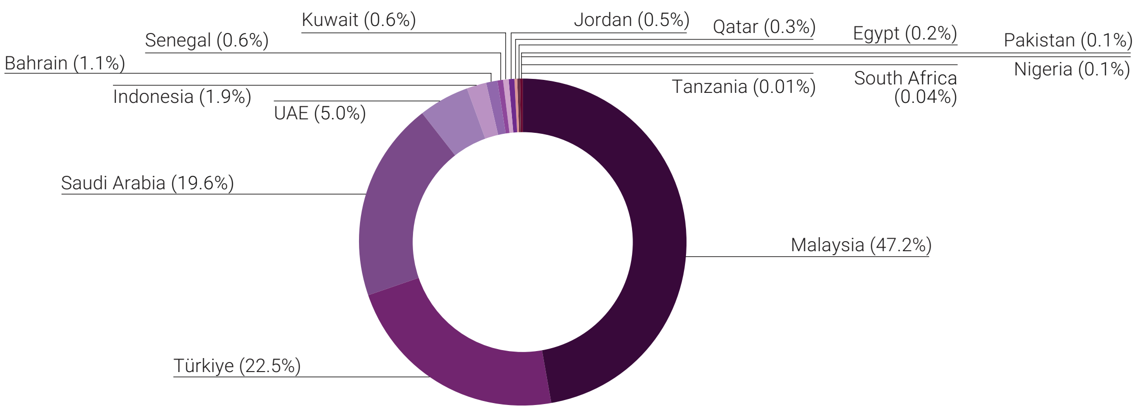
Source: IFSB Estimates based on data from Refinitiv

Chart 2.3.1.3 (a) Sovereign *Şukūk* Issuances by Jurisdiction of the Originator (2022)



Source: IFSB Estimates based on data from Refinitiv and Regulatory Authorities (excluding Iran due to data limitations)

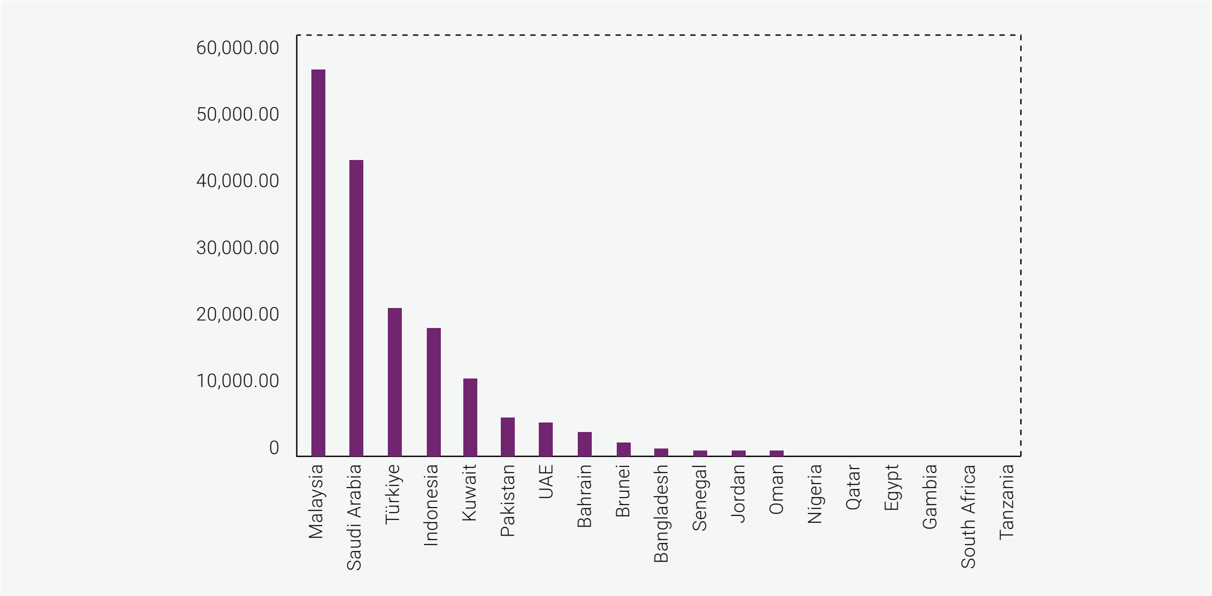
Chart 2.3.1.3 (b) Corporate *Şukūk* Issuances by Jurisdiction of the Originator (2022)



Source: IFSB Estimates based on data from Refinitiv and Regulatory Authorities (excluding Iran due to data limitations)

Overall, Malaysia overtook Saudi Arabia as the leading *ṣukūk* issuer in 2022. Saudi Arabia continued to be a major issuer and accounted for the second-largest share of overall issuances in 2022. Türkiye superseded Indonesia as the third largest issuer, with a significant increase in corporate issuances, as well as some increase in the volume of sovereign issuances (see chart 2.3.1.4).

Chart 2.3.1.4 Total *Ṣukūk* Issuances in USD Millions by Domicile (2022)



Source: IFSB Estimates based on data from Refinitiv and Regulatory Authorities (excluding Iran due to data limitations)

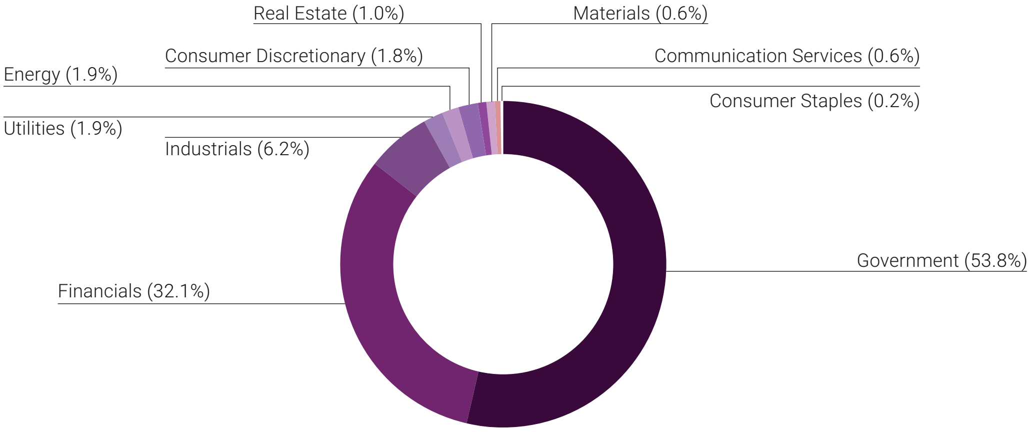
*Excludes issuances by multilaterals.

Regionally, South-East Asia was the largest regional issuer in 2022, accounting for 41% of total issuances, exceeding the GCC region, which was responsible for the largest volume of issuances in 2021. The GCC region remained the second largest, accounting for about 33% of issuances in 2022 (down from 48% in 2021) (2020: South-East Asia – 44%, GCC countries – 44%). Collectively, the two regions were responsible for 74% of global *ṣukūk* issuances – reflecting a decrease in the proportionate share from previous years due to an increase in issuances from other regions, signalling a gradual improvement in the regional and global diversity of *ṣukūk* issuers (2021: 91%; 2020: 83%; 2019: 84%).

Sector-wise, government and financials sector issuers continue to make up the largest share of *ṣukūk* issuers, which together accounted for 86% of issuances in 2022 (2021: 90%), a 4% drop from the previous year, pointing to a marginal increase in issuances from other sectors (see chart 2.3.1.5). In comparison, in the conventional markets, government and financial sectors accounted for 78% of the global debt issuances in 2022, which was a 5% increase from the previous year.[52] This points to a divergence from the general bond market trend of investors moving out of risk assets, as the corporate *ṣukūk* market did not experience a similar drop in demand, and there was sustained investor appetite for corporate *ṣukūk* issuances. It also signals a slow but promising move towards more corporate issuers other than the financial sector, entering the *ṣukūk* market, which has historically been dominated by government and financial issuers. In general, all sectors saw an increase in issuances except the real estate and consumer staples sectors, which saw a drop in 2022.

[52] Refinitiv

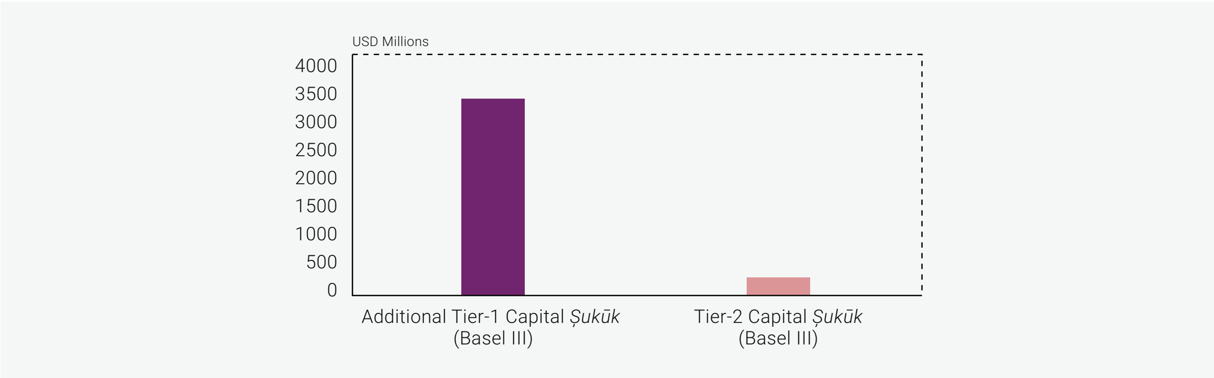
Chart 2.3.1.5 Sectoral Distribution of Global *Ṣukūk* Issuances (2022)



Source: Estimates based on data from Refinitiv and Regulatory Authorities

Basel III regulatory capital *ṣukūk* issuances by banks made up about 7% of financial sector issuances (2021: 14%). Although there was a drop in the volume of issuances, more regional diversity was observed in 2022 among issuers of regulatory capital *ṣukūk*, including issuances from Indonesia, Malaysia, Saudi Arabia, and Nigeria (compared to over 91% of issuances coming from the GCC region in 2021) (see chart 2.3.1.6).

Chart 2.3.1.6 Tier- 1 and Tier- 2 Capital *Ṣukūk* Issuances (2022)



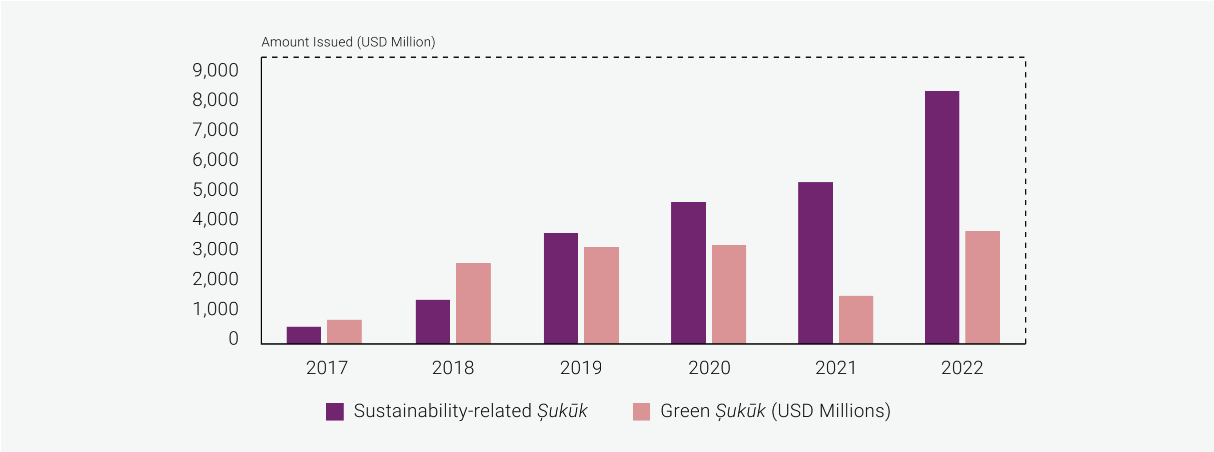
Source: IFSB Estimates based on data from Refinitiv

Sustainability-related[53] *ṣukūk* issuances increased in 2022, amounting to a total of USD 8.4 billion, of which USD 3.7 billion or 68% were green *ṣukūk* (see Chart 2.3.1.7). Again, bucking the trend, green *ṣukūk* issuances saw an increase in total volume compared to 2021, whereas green bond issuances saw a 19% decrease from 2021 levels, which is the first annual y-o-y decline in green bond issuances since 2015.[54] Green *ṣukūk* issued during the year included issuances from Bahrain, Türkiye and Indonesia. Two issuances (from Bahrain and Indonesia) were international USD-denominated issuances. The remaining were local currency issuances, including sovereign issuances from Indonesia, as well as a corporate green issuance from Türkiye. The Turkish issuance was a 6-month,

[53] Sustainability-related *ṣukūk*, as referred to in this report, include any type of *ṣukūk* instrument which are issued to achieve predefined Sustainability, Environmental, Social, or Governance (ESG) objectives, also including green *ṣukūk* issuances.
[54] Refinitiv

green lease certificate of TRY 50 million (USD 2.67 million), issued in line with the Capital Market Board of Türkiye's: "*Guidelines on Green Debt Instruments, Sustainable Debt Instruments Green Lease Certificates, and Sustainable Lease Certificates*". The proceeds of the issuance are intended to be used in purchasing, supplying, and collecting waste products and recycling them. The returns from the sale of the recycled assets to the market will constitute the income for *ṣukūk* investors.

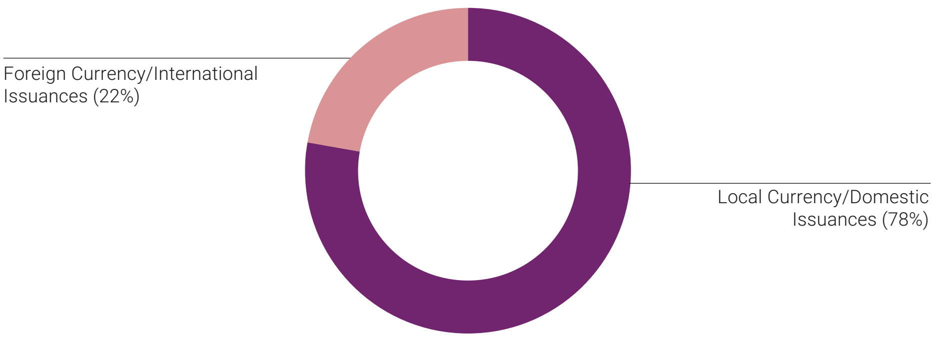
Chart 2.3.1.7 Sustainability-related and Green *Ṣukūk* Issuances (2017–22)



Source: IFSB Estimates based on data from Refinitiv

Local currency *ṣukūk* issuances increased to 78%, while foreign currency-denominated ṣukūk issuances declined slightly to 22% (2021: 73% local currency, 27% foreign currency; 2020: 70% local currency, 30% foreign currency) (see chart 2.3.1.8a). The retraction in international *ṣukūk* was marginal compared to the 30% decline in international bond offerings in 2022.[55] International *ṣukūk* issuances were offered by a number of jurisdictions in 2022, including Saudi Arabia, Indonesia, United Arab Emirates, Qatar, Bahrain, Kuwait, and Pakistan (see chart 2.3.1.8b). Corporate issuers accounted for 41% of total foreign currency denominated *ṣukūk* (2021: 64%), of which 86% were from financial sector issuers (2021:95%). Among the foreign-currency issuances, 65% were investment-grade issuances, while high-yield *ṣukūk* accounted for 21% of international issuances, the latter including corporates from the UAE, Türkiye, Saudi Arabia, and a sovereign issuance from Pakistan.

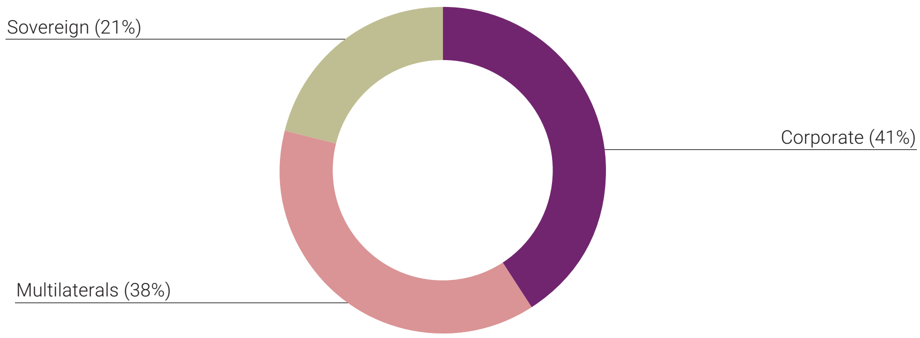
Chart 2.3.1.8a *Ṣukūk* Issuance by Market (2022)



Source: IFSB Estimates based on data from Refinitiv

[55] Refinitiv

Chart 2.3.1.8b Distribution of International USD-1 Denominated *Ṣukūk* Issuances (2022)



Source: IFSB Estimates based on data from Refinitiv

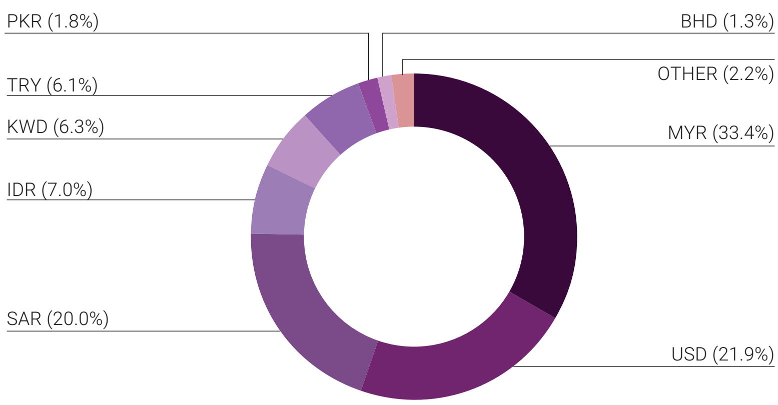
The Malaysian Ringgit emerged as the largest currency of issuance in 2022, overtaking US Dollar-denominated issuances (see chart 2.3.1.9), in a reversal from 2021, owing to an increase in the volume of both sovereign and corporate issuances from Malaysia, which has a well-established and strong domestic *ṣukūk* market. The US dollar was the second largest currency of issuance, owing to the large size of foreign-currency issuances. The main reasons for raising funds through international issuances include:

- meeting foreign currency funding needs;
- managing funding costs and structure;
- diversifying funding channels and investor base; and
- raising the profile in the international markets.

However, foreign currency issuances generally declined in 2022, which may be owing to worsening global macroeconomic conditions that may present the risk of adverse currency fluctuations for foreign-currency issuers. The observed drop in international issuances was not uniform across all jurisdictions, as countries whose currencies are pegged to the US dollar will not be affected by currency depreciation. The decline in international issuances may also be reflective of the availability of other sources of funding and strengthening domestic *ṣukūk* markets. The Saudi Riyal remained the third largest currency of issuance as it continues to issue a significant volume of local-currency-denominated *ṣukūk* aimed at the domestic market.

The deepening of domestic local currency markets is essential for strengthening financial stability. However, in most jurisdictions, *ṣukūk* markets continue to face liquidity challenges, as well as narrow domestic investor bases, while institutional investors tend to adopt buy-and-hold strategies that create challenges for secondary market liquidity as well as effective price discovery. These challenges may be further exacerbated, and vulnerabilities may emerge if global economic conditions deteriorate and the liquidity flow to emerging markets contract further.

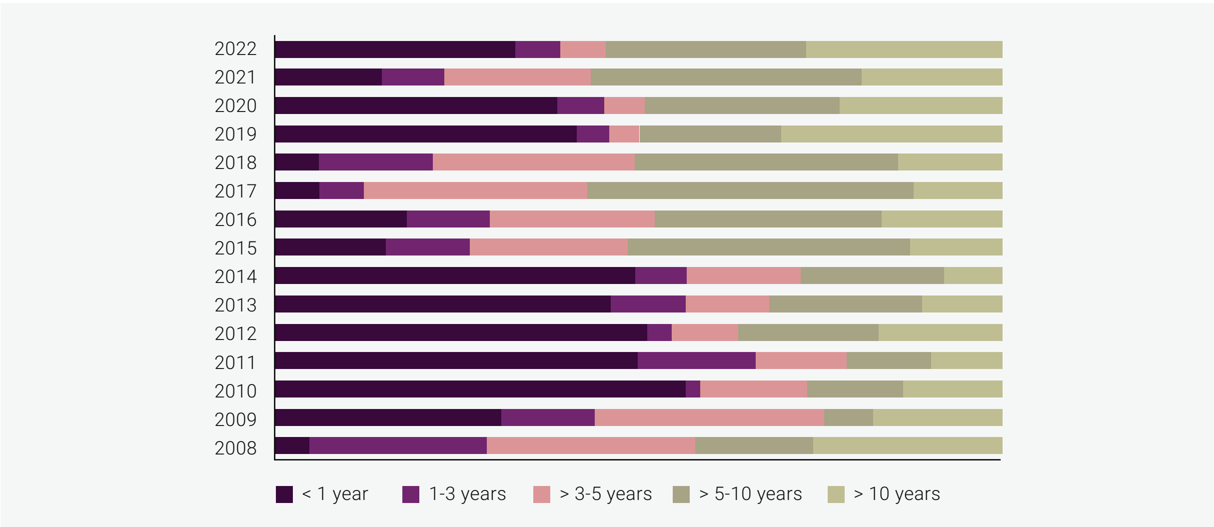
Chart 2.3.1.9 *Ṣukūk* Issuance by Currency (2022)



Source: IFSB Estimates based on data from Refinitiv

In a reversal from the trend seen in 2021, the maturity of *ṣukūk* issuances was skewed towards an increase in the proportion of both short-term *ṣukūk* issuances (tenor of less than a year) and longer-term issuances (>10 years), whereas a contraction was observed in medium-term *ṣukūk* (3–5- and 5–10-year tenors) (see Chart 2.3.1.10). This perhaps indicates an increased need for short-term *ṣukūk* issuance for liquidity purposes due to greater liquidity constraints in the market, as well as more issuers tapping the market for long-term financing for key sectors such as infrastructure and other development needs.

Chart 2.3.1.10 Maturity Trend of All New Issuances (2011–22)



Source: IFSB Estimates based on data from Refinitiv

The investor demand for *ṣukūk* remained relatively robust in 2022, although the level of oversubscriptions seen in 2022 was more moderate than observed in recent years (see Table 2.3.1.1). However, issuers with sound fundamentals were able to retain investor confidence and appetite for *ṣukūk*, including corporate issuers, despite the general global market downturn and a move away from risk assets. Oversubscriptions of both sovereign and corporate issuances, as well as a mix of both financial and other corporate issuers, indicated that a healthy demand for *ṣukūk* was sustained in 2022.

While there were some *ṣukūk* defaults in 2022 related to the impact of COVID-19 on the cashflows of corporates, defaults remained low at 0.21%[56] of total issuances. Malaysian energy firm Serba Dinamik defaulted on a USD 7 million coupon payment triggered on its USD 300 million *ṣukūk* due in May 2022 (with an outstanding amount of USD 222.22 million). The firm cited the impact of COVID-19 on operating conditions and cash flow constraints. The firm also has a USD-denominated *ṣukūk* that matures in March 2025 with an outstanding amount of USD 180 million. PT Garuda Indonesia, which defaulted on its *ṣukūk* in 2021 – resulting from negative cashflow throughout the COVID-19 pandemic attributed to the slowdown in air travel – is undergoing restructuring and has made proposals that holders of its USD 500 million *ṣukūk* switch portions of the debt to equity, take a haircut, and extend the tenure to 10 years.

Table 2.3.1.1 Demand Comparison for Selected Ṣukūk Issued in 2022

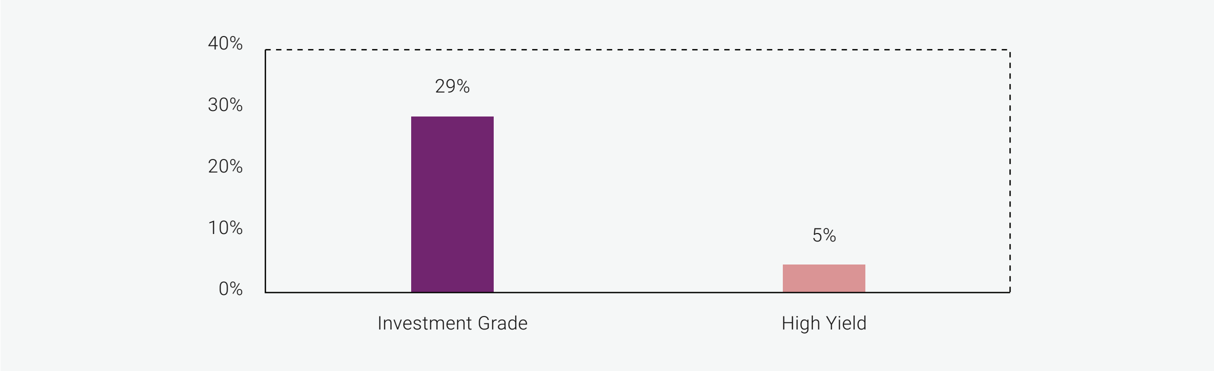
Ṣukūk Name	Issue Size (USD million)	Issuer Type	Tenure (Years)	Rating	Oversubscription (Times)
MBSB Bank Bhd 4/27; 4/299	70	Corporate	5 and 7	A2 (Moody's)	**10**
KSA *Ṣukūk* Ltd 10/28	2500	Sovereign	6	A1 (Moody's)	**5**
DIB *Ṣukūk* Ltd 11/27	750	Corporate	5	A3 (Moody's)	**2.3**
Edotco 9/32; 9/29; 9/27; 9/25	326	Corporate	3 to 10	AA+ (MARC)	**5**
Sustainability MGII 3/38	1051	Sovereign	6	A- (S&P)	**2.38**
FAB *Ṣukūk* 3/27	500	Corporate	5	Aa3 (Moody's)	**2.8**

Source: Various Sources

While investor appetite for *ṣukūk* remained healthy, markets generally saw a flight to quality towards investment-grade[57] *ṣukūk* issuances, which increased by 26% from 2021 to USD 49.7 billion (29% of total issuances) in 2022. Similar trends were seen in the bond market, with steep declines in high-yield issuances (80% decline), while investment-grade corporate issuances saw only a marginal retraction of 13%, reflecting a general flight to quality as investor concerns about global macroeconomic conditions heightened. Investment-grade *ṣukūk* issuances included sovereign issuances from Saudi Arabia, Indonesia, and the UAE, multilateral issuers such as IsDB and IILM, and corporate issuers from the GCC region, including Saudi Arabia, Kuwait, Qatar, and the UAE. About 49% of investment-grade *ṣukūk* were USD-denominated international issuances, up from 17% in 2021. Similar to the bond market, high-yield international *ṣukūk* issuances declined, however, much more marginally, amounting to around 5% of total issuances in 2022, compared to 7% in 2021 (see Chart 2.3.1.11). However, despite diminishing risk appetite, there was also consistent demand for high-yield *ṣukūk* in 2022, as they offered attractive yields to *ṣukūk* investors.

[56] Source: Fitch Ratings
[57] The common definition for investment-grade issuances is a BBB or higher rating on S&P and the equivalent from other agencies. The volume of investment-grade issuances was determined as per the classification on the Refinitiv database.

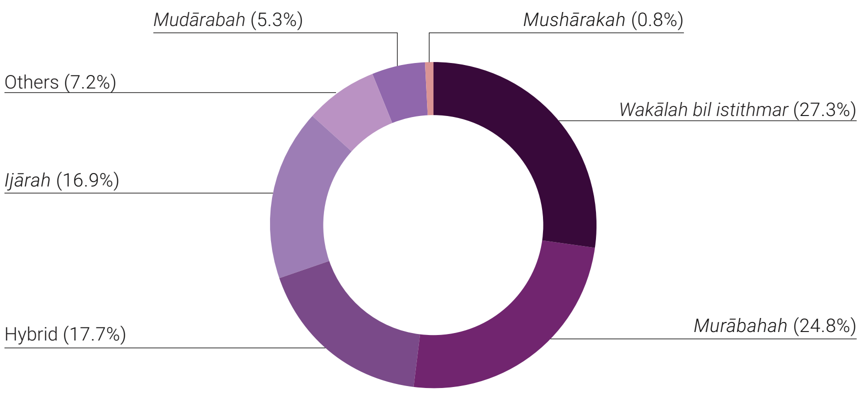
Chart 2.3.1.11 Investment Grade and High Yield *Ṣukūk* (2022)



Source: Various Sources

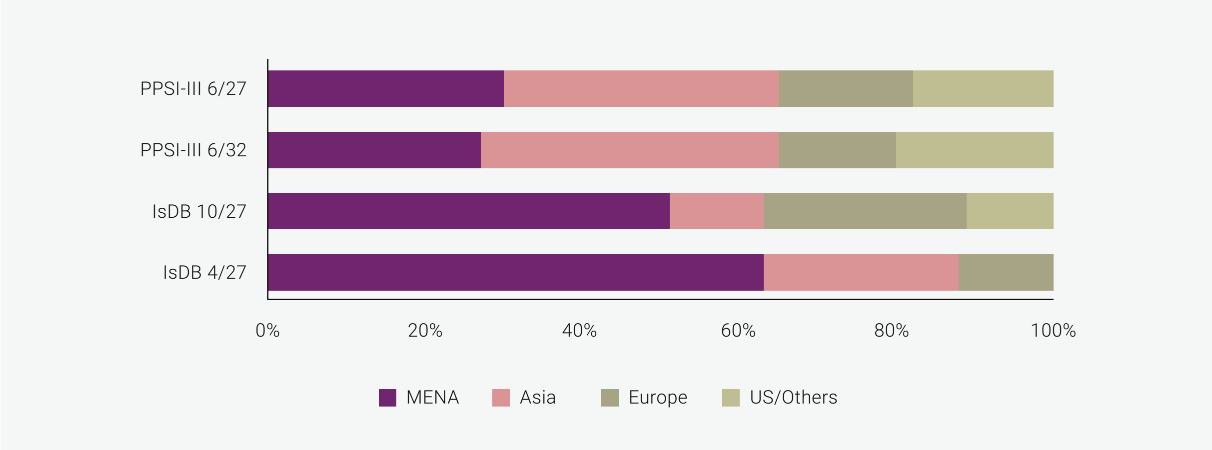
The types of *Sharī'ah*-compliant contracts remain largely dominated by debt-based contract types rather than equity-based contracts, the latter comprising about 6% of total issuances (see Chart 2.3.1.12). The use of profit-sharing contracts such as *Mudārabah* and *Mushārakah*, in general, remains low compared to fixed-return contracts, which are more desirable to the market, especially during times of turbulence and increased uncertainty. *Wakālah*-based contracts continued to be the most prominently used type of contract for *ṣukūk* issuance, which included issuances from IILM, Indonesia, Saudi Arabia, Qatar, the UAE and Malaysia. The second largest category was *murābahah*-based contracts, which were largely from Malaysian issuers but included some issuances from Jordan, Saudi Arabia, and the UAE. The third and fourth largest categories were Hybrid and *ijārah*-based issuances, respectively. Hybrid issuances were primarily from Malaysian corporate issuers, while ijārah-based structures were utilised by a number of jurisdictions, including Bahrain, Brunei, Indonesia, Nigeria, Pakistan, Senegal and Türkiye.

Chart 2.3.1.12 *Ṣukūk* Issuance by Structure (2022)



Source: IFSB Estimates based on data from Refinitiv

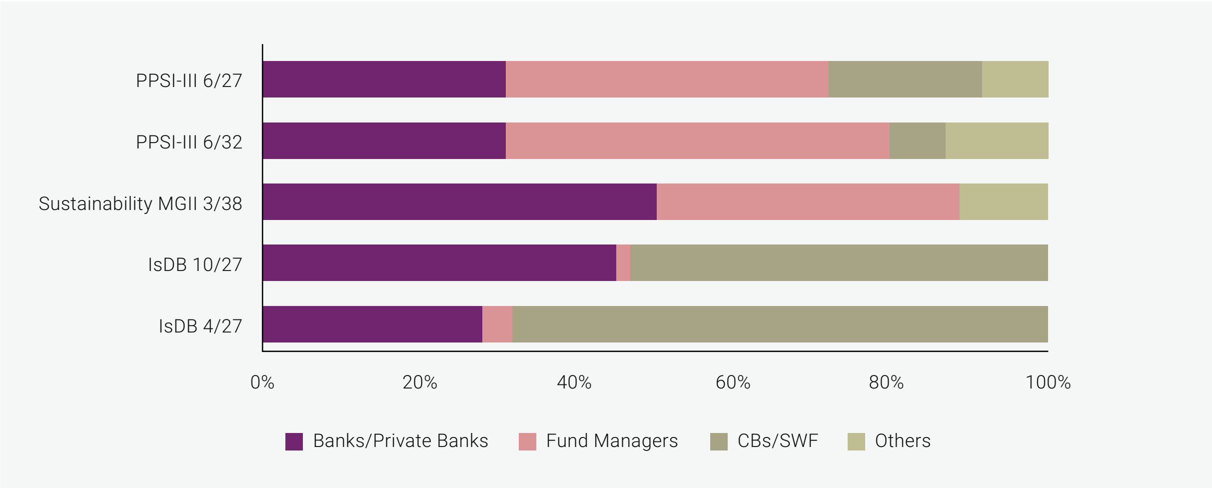
Chart 2.3.1.13 Geographical Distribution of Selected *Ṣukūk* Papers Issued in 2022



Source: Various Sources

In terms of investor distribution, the trends remain largely consistent with previous years based on available data on selected issuances. The majority of *ṣukūk* investors are institutional investors, with much of the demand coming from banks and fund managers, while international investment-grade issuances were taken up by central banks and sovereign wealth funds (see Chart 2.3.1.14).

Chart 2.3.1.14 Investors' Breakdown of Selected *Ṣukūk* Papers Issued in 2022



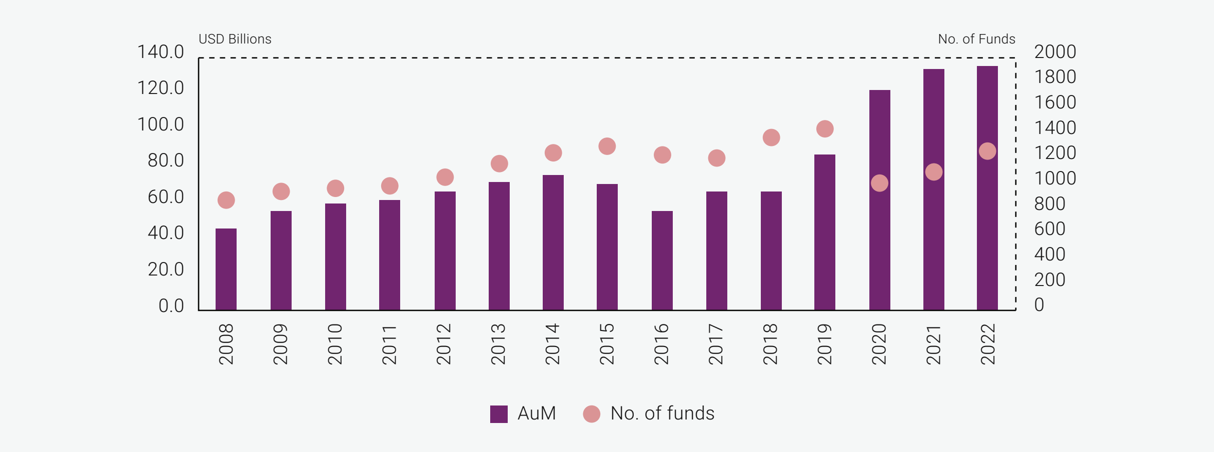
Source: Various Sources

The *ṣukūk* markets have shown consistent growth, a persisting high supply-demand gap, and low rates of penetration in some Muslim-majority jurisdictions. This indicates there is still high growth potential for the *ṣukūk* market. Highly subscribed issuances from non-OIC jurisdictions in past years also indicate the potential for *ṣukūk* to grow beyond the traditional Islamic finance markets. However, to foster the confidence of investors in the *ṣukūk* market, it is also important to enhance and strengthen the resilience of the market, as emerging conditions in the global economy bring about increasing financial stability risks.

2.3.2 Islamic Funds: Assets under Management and Performance

Growth of assets under management slowed down even further, with only 1% y-o-y growth in total assets under management in 2022 (2021: 6%) (see Chart 2.3.2.1). In terms of the scale of funds, some contraction in the size of funds was observed. Islamic funds holding total net assets of over USD 1 billion comprised 1% of funds, which accounted for 18% of total AUM in 2022 (2021: 0.1% of funds accounted for 38% of AUM).

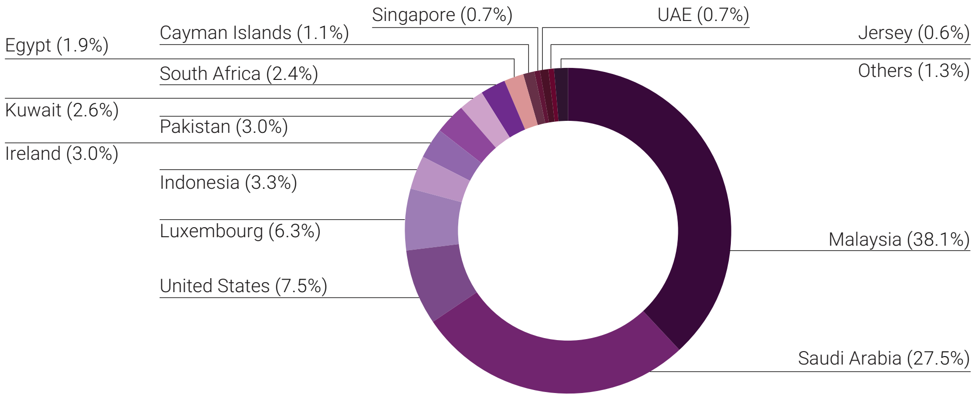
Chart 2.3.2.1 Growth in Assets Under Management and Number of Islamic Funds (2008–22)



Source: IFSB Estimates based on data from Refinitiv for 2019 -2022.[58] Data for the years 2008-18 from Bloomberg database as per previous Reports (excluding Iran due to data limitations).

While Malaysia and Saudi Arabia remain the largest Islamic fund domiciles globally, Malaysia overtook Saudi Arabia in 2022 as the domicile with the largest market share of Islamic assets under management (2021: Saudi Arabia - 35.2%; Malaysia - 27.7%) (see Chart 2.3.2.2). The share of Islamic funds across other smaller markets has also seen minor changes, with increases in the relative size of assets under management in Ireland, Pakistan, Kuwait, and Egypt, while contractions were seen in others.

Chart 2.3.2.2 Islamic Fund Assets by Domicile (2022)

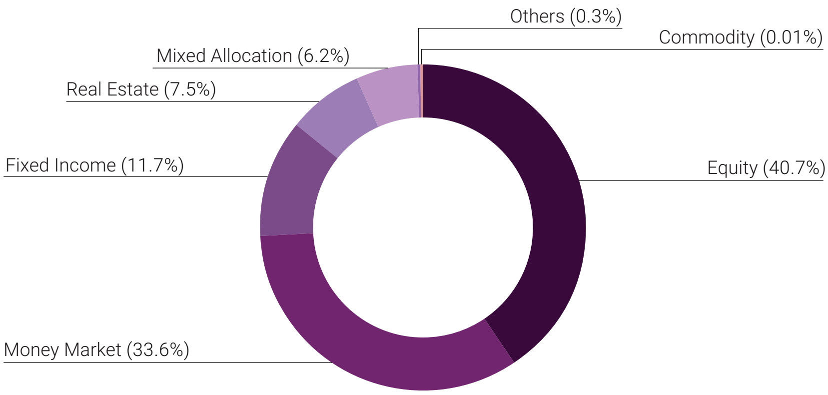


Source: IFSB Estimates based on data from Refinitiv and Regulatory Authorities. Data for Iran is not included due to limitations in data availability.

[58] Islamic funds data excludes pension funds and insurance funds.

Equity and Money Market funds made up the largest proportion of Islamic fund types (see Chart 2.3.2.3), with equity funds being the largest and the most prevalent, domiciled across 26 out of the 29 domiciles that have Islamic AUM. Money market funds (MMFs) were the second largest Islamic fund type but were domiciled in only five jurisdictions - Saudi Arabia, Malaysia, Pakistan, Indonesia, and Egypt. Islamic fixed-income funds, the majority of which are domiciled in Malaysia, were the third largest category, although comprising a relatively smaller percentage compared to equity funds and MMFs, which is reflective of limitations in *ṣukūk* supply and liquidity compared to conventional fixed-income markets. In comparison, the asset class distribution in the conventional market differed in that equity and fixed-income funds are the two largest categories, accounting for over two-thirds of global AUM.[59]

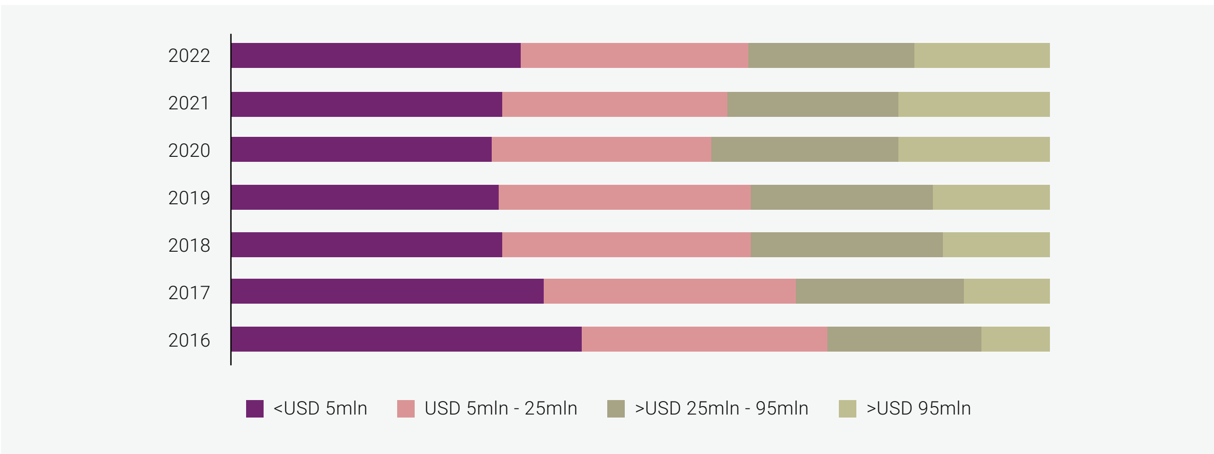
Chart 2.3.2.3 Islamic Fund Assets by Asset Class (2022)



Source: IFSB Estimates based on data from Refinitiv

The overall scale of Islamic funds contracted in 2022, with an increase in smaller funds. The asset size composition of Islamic funds shifted towards an increase in funds of less than USD 5 million total net assets (TNA) and a contraction in funds with over USD 95 million TNA, compared to 2021 (see Chart 2.3.2.4). The scale of funds has been a prevailing challenge for Islamic assets under management.

Chart 2.3.2.4 Number of Islamic Funds by Asset Size (2022; USD million)

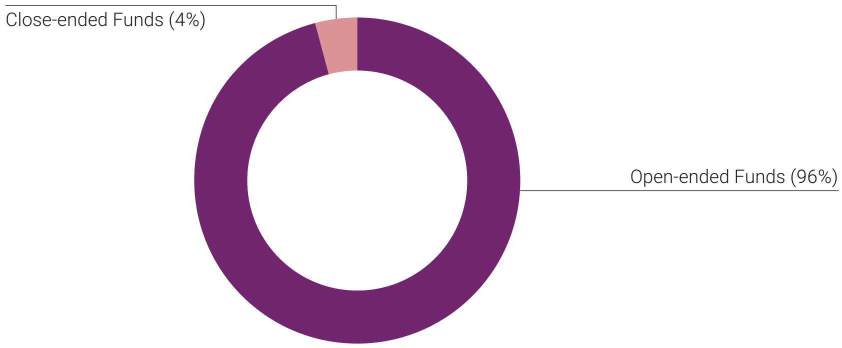


Source: IFSB Estimates based on data from Refinitiv

[59] IOSCO, 2022.

Overall, the Islamic funds market remained resilient despite a slowdown in growth and contraction in overall fund size. The functioning and resilience of Islamic AUM predicate upon the availability of liquidity and its effective intermediation under stressed market conditions. Unlike the preceding years, 2022 was characterised by liquidity strains in the market, and it may be expected to continue in 2023 if downside risks materialise. The Islamic funds market, particularly open-end funds, can be affected by liquidity imbalances and, if they are sufficiently large and pervasive, give rise to issues of financial stability. Nevertheless, Islamic funds, which are smaller in size and less leveraged, along with the absence of riskier fund types such as hedge funds and stable NAV money market funds, limit the potential of systemic risks. However, it remains important to assess and address any potential vulnerabilities in the Islamic funds market and enhance liquidity risk management, particularly given that open-end funds make up a large proportion (96%) of Islamic funds (Chart 2.3.2.5).

Chart 2.3.2.5 Closed-End and Open- End Islamic Funds (2022)



Source: IFSB Estimates based on data from Refinitiv

Open-end Islamic funds, while important to the overall growth and development of the Islamic funds market, can present financial stability risks. Funds holding illiquid assets, including fixed-income Islamic funds due to the relative illiquidity of secondary *ṣukūk* markets, can face liquidity mismatches, particularly during times of market stress. The higher proportion of open-end funds in the Islamic asset management segment may exacerbate the impact of an adverse event, such as disorderly tightening of financial conditions or abrupt risk repricing. Core Islamic finance jurisdictions are primarily emerging markets and developing economies. They may also be significantly impacted generally by any adverse shocks to the open-end funds' sector globally, due to the propensity to trigger large capital outflows from the equity and *ṣukūk* markets in such events, which can in turn, worsen financial conditions.

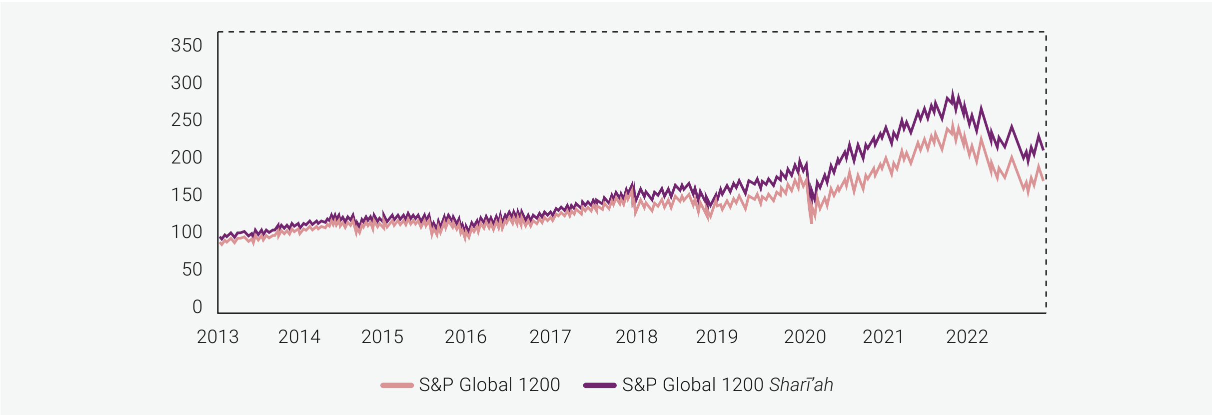
The increasing interconnectedness between the funds sector and the banking sector is also an important consideration. Due to these linkages, open-end funds facing liquidity challenges can amplify or spread financial stress to other sectors as well. The current high-inflation environment, the rise in interest rates, and tightening financial conditions can interact with any vulnerabilities in the funds sector, including liquidity challenges for open-end funds, and potentially trigger investor runs and asset fire sales. Thus, ongoing monitoring and timely identification of vulnerabilities among open-end Islamic funds are particularly important in the current environment to ameliorate potential liquidity risks, market stress, and financial stability challenges.

2.3.3 Islamic Equity Markets: Trends, Performance, and Resilience

The global equity markets experienced the biggest annual drop since the 2008 financial crisis, in sharp contrast to the overall growth and record year-end highs seen in the preceding two years. This market was affected by surging inflation, interest rate hikes, geopolitical risks, and persisting supply chain challenges. While 2021 also experienced rising inflation and supply chain crises, the equity markets climbed a "wall of worry", with investors driving up asset prices despite persisting uncertainties. In contrast, investors became more risk-averse in 2022, resulting in a sharp drop in equity prices, alongside widening credit spreads as concerns grew about a possible recession along with lower expectations of earnings growth.

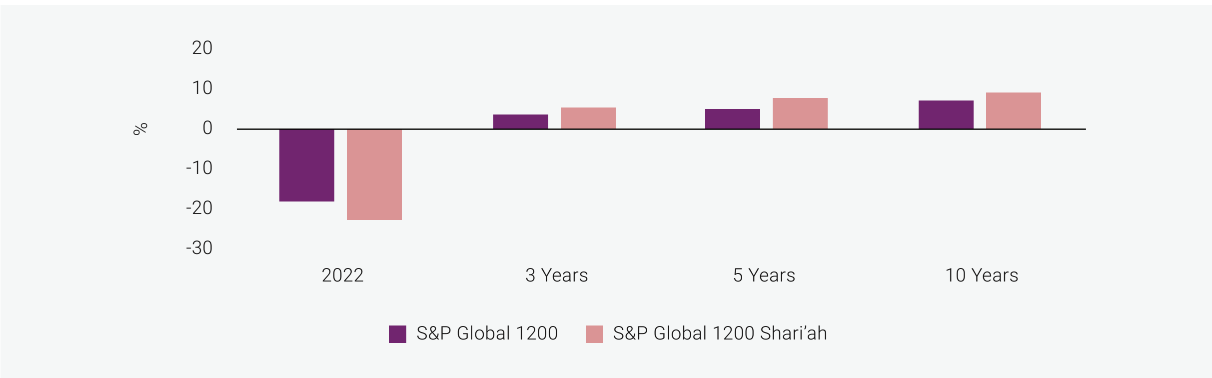
Islamic indices, in relative terms, performed better than the comparative conventional indices over a 10-year period (see Chart 2.3.3.1). However, the drop in YTD returns for *Sharīʽah* indices in 2022 was higher than conventional indices, contributed by the proportionate sectoral exposures of its constituents. *Sharīʽah* indices have a larger proportionate exposure to technology stocks, which underperformed in 2022. However, *Sharīʽah* indices continue to demonstrate better relative returns over the longer term than the comparative global indices, including across the 3-year, 5-year and 10-year periods (see Chart 2.3.3.2).

Chart 2.3.3.1 Historical Performance (2013-22)



Source: S&P | Data has been rebased at 100

Chart 2.3.3.2 Performance of Islamic Indices vs Global (2022)

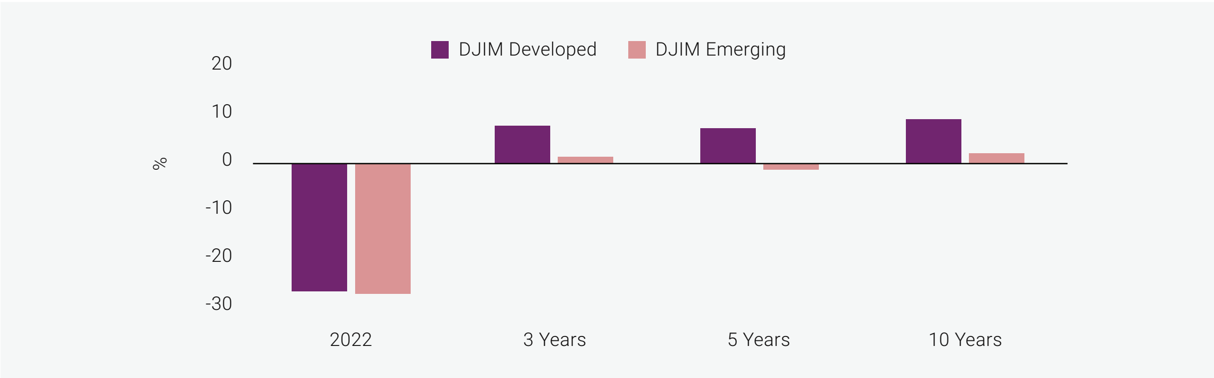


Source: S&P

Although both emerging markets and developed markets ended 2022 with negative returns, emerging market Islamic indices did not perform significantly worse than developed market Islamic indices (Chart 2.3.3.3). While emerging market equities have underperformed in the last 12 years compared to developed market equities amid a confluence of macroeconomic and market factors, they appear to be favourably positioned in 2023.

However, lingering risks to a possible emerging market rally include the impact of global inflation on overall equities valuations, as well as geopolitical factors, such as the China-Taiwan- US relations and the effects of the ongoing Ukraine-Russia conflict on energy prices.

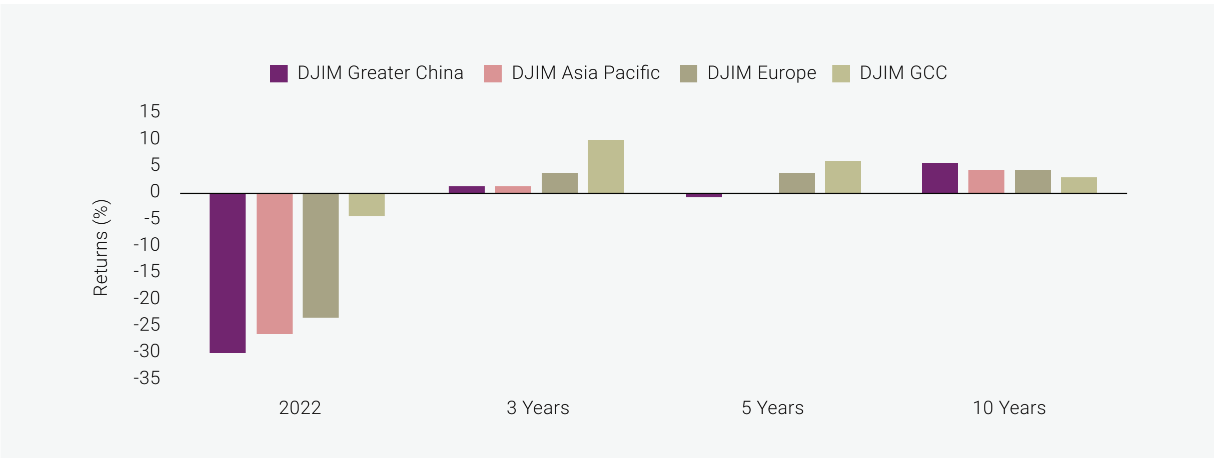
Chart 2.3.3.3 Emerging vs. Developed Markets (2013-22)



Source: S&P

In terms of the regional performance of Islamic indices, most regional indices registered relatively poor performance and negative YTD price returns, with the exception of the GCC region, which recorded a positive performance buoyed by higher energy prices. On the other hand, the Greater China Islamic Market index significantly underperformed in 2022, affected by COVID-19 lockdowns and the property market challenges in China (see Chart 2.3.3.4).

Chart 2.3.3.4 Regional Performance of Indices (2013-22)



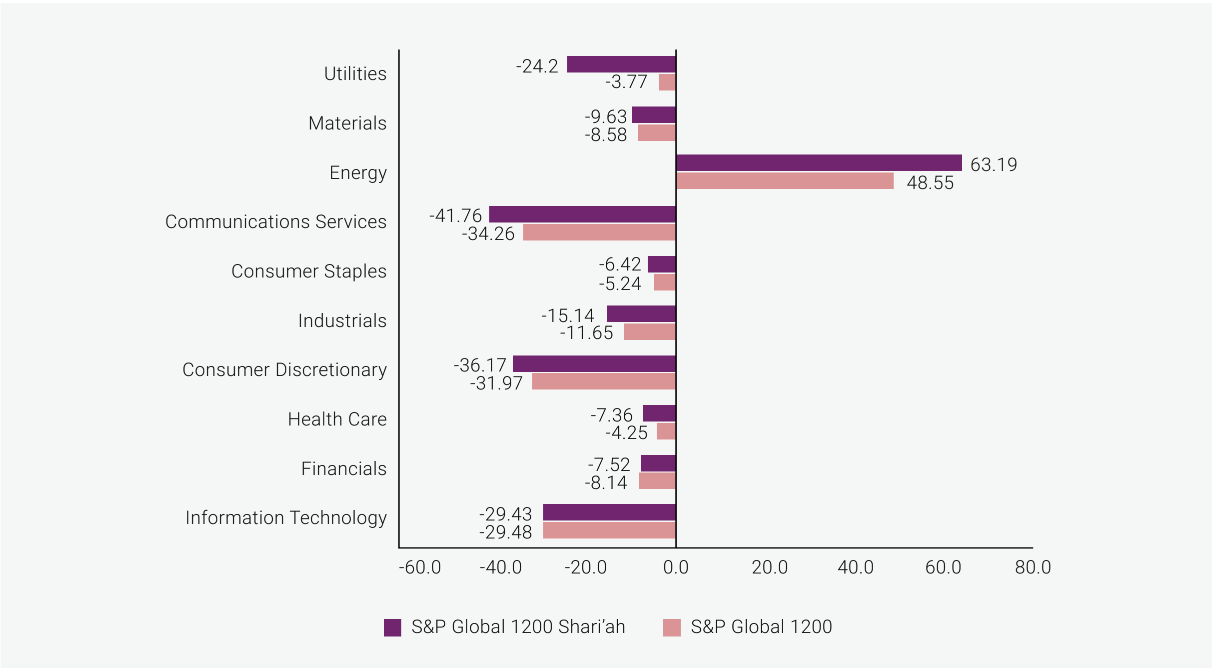
Source: S&P

The move towards value stocks overgrowth stocks continued in 2022, with value stocks outpacing growth stocks for the first time in 15 years. Growth stocks which are dominated by the technology sector, had a relatively worse performance. Value stocks outperformed the broader market by about 10% YTD and outperformed growth stocks by about 20% YTD. Several factors drove the relatively better performance of value stocks in 2022. Geopolitical factors drove commodity prices higher, with commodity-related equities falling predominantly within the value category. Cyclical factors also contributed to the better performance of value stocks as the business cycle entered a period of recession where defensive sectors tend to do better, such as consumer staples and utilities which benefit from resilient demand.

Furthermore, value stocks have historically outperformed during periods of rising interest rates, making value stocks more attractive to investors than growth stocks. However, while the decline in growth stocks has been broad-based, value stocks' performance was much more uneven. The main driver of its outperformance was the jump in energy stocks, while defensive sectors like utilities and consumer staples also aided relative returns. By contrast, the cyclical value sectors, such as financials and industrials, suffered more than the value average due to investors' concerns about the risks of a recession.

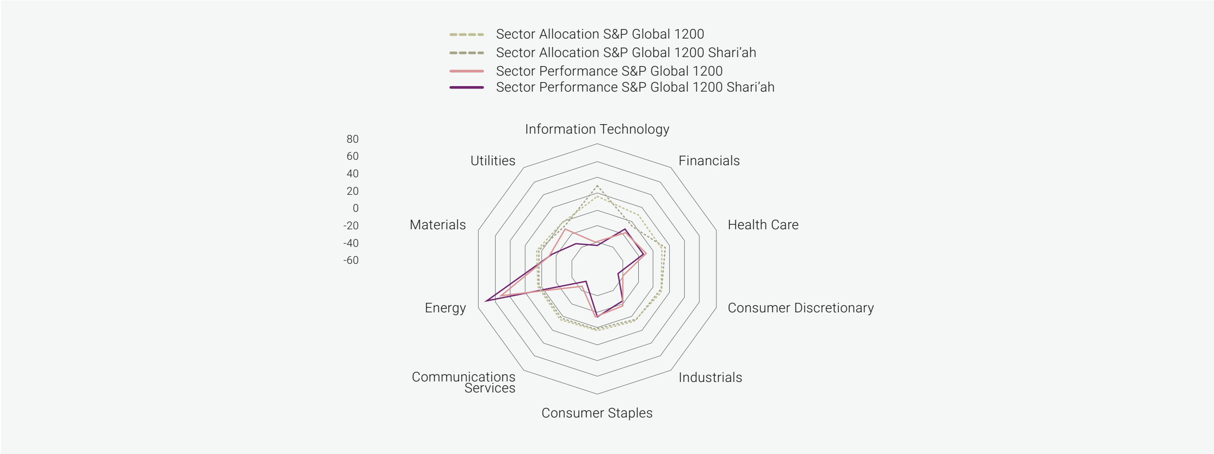
In terms of sectoral performance, energy was the only sector that registered a positive performance (see Chart 2.3.3.5a). The communications sector was the worst-performing sector, followed by consumer discretionary. Unlike recent years, the technology sector struggled in 2022, with technology stocks seeing steep declines across the board. *Sharīʻah* indices, which typically have a higher proportionate exposure to the technology sector, were affected by the drop in returns (see Chart 2.3.3.5b). The performance of the healthcare sector was mixed but observed a smaller decline compared to other sectors. While *Sharīʻah* indices have a slightly higher proportionate exposure to healthcare than conventional indices, *Sharīʻah* indices did slightly worse in the healthcare sector, most likely due to differences in the constituents of the Islamic indices vis-à-vis the conventional.

Chart 2.3.3.5a: Sectoral Performance (2022)



Source: S&P

Chart 2.3.3.5b: Sector Allocation and Sector Performance (2021)

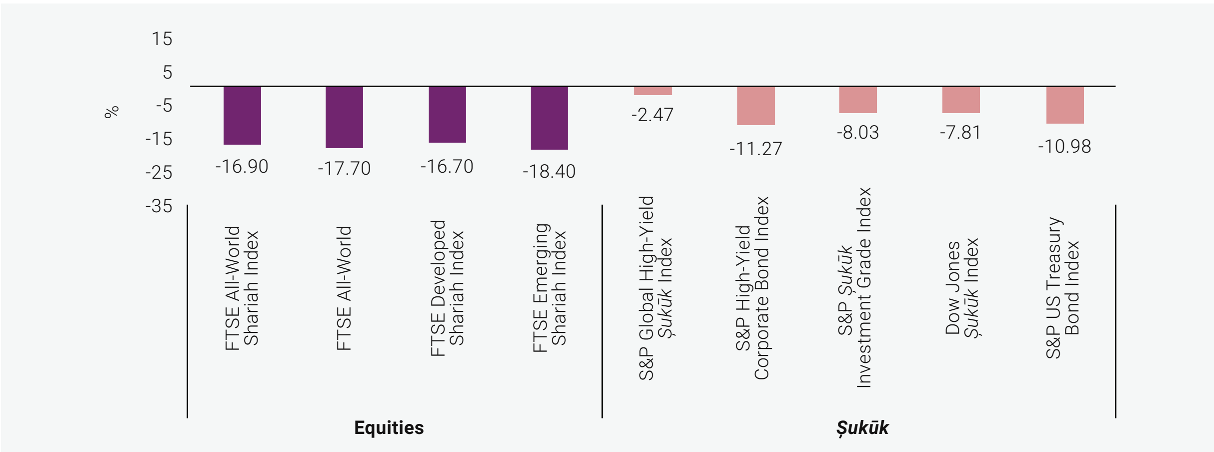


Source: IFSB workings based on data gathered from S&P

Overall, returns for both equities as well as the bond-*ṣukūk* markets, were negative in 2022 (see Chart 2.3.3.6). In 2022, due to high uncertainty about inflation, global growth outlook, and rising recession fears, there was a general sell-off pertaining to risk assets in financial markets, as well as increased volatility in prices in the equity markets, corporate bonds-*ṣukūk*, and commodities markets. Rising interest rates tend to reduce the appeal for investors to hold equities and other riskier assets such as corporate bond-*ṣukūk* and commodities because investors can earn better returns in cash or safe assets such as government bonds. Market liquidity, therefore, declined, including both equity markets as well as sovereign bond-*ṣukūk* markets.

Islamic equity markets may also see further repricing in 2023 if macroeconomic conditions worsen and risk premia increase for risk assets. Growing investors' risk aversion due to uncertainties in the economic and policy outlook and the resulting repricing of risk and volatility in markets – if coupled with a sudden tightening of financial conditions – could potentially exacerbate existing vulnerabilities that the pandemic had worsened. Therefore, addressing existing vulnerabilities and strengthening regulatory oversight in areas of higher financial stability risks is important going into 2023.

Chart 2.3.3.6: Returns for Equities and *Ṣukūk* (2022)



Source: S&P; FTSE; Total Return (percent) and YTD on 31 December 2022

2.3.4 Islamic Capital Market Growth and Stability Outlook 2023

While the ICM has seen sustained growth, the pace of growth has slowed, and a worsening or uncertain economic outlook could result in a further slowdown, as well as pose potential national and global financial stability risks in 2023. Looking ahead, the outlook for the ICM will be shaped by monetary policy actions as well as the materialisation of downside risks.

The capital markets have gone through a sequence of global shocks over the past three years, including the COVID-19 pandemic, severe supply chain disruptions, geopolitical tensions, an energy crisis and, most recently, the challenges in the banking markets. The latter also highlights the complex interplay between the financial markets, the banking system, and the global economy, with policies that are aimed at solving one problem having unintended consequences – sometimes with potentially systemic effects. For instance, at the crux of the banking crisis were interest rate hikes by the federal reserve to curb inflationary pressures, which in turn led to a drop in the prices of fixed-income securities such as government bonds. Financial institutions that were holding a large amount of such bonds, such as the Silicon Valley Bank, then saw a significant portion of their assets drop, which, in turn, limited their ability to raise funds and satisfy the demands for liquidity. The resulting threat of a potential systemic banking crisis, in turn, impacts investor sentiment in the financial markets. Significant volatility was observed in both equity as well as bond and *ṣukūk* markets in the aftermath of the collapse of Silicon Valley Bank and the fears over Credit Suisse. Although markets have now recovered some stability, the outlook and direction of financial markets (including the Islamic capital markets) may depend on how the challenges in the banking system unfold, as well as the impact of any further policy actions and related financial market and policy spill overs.

Notwithstanding global uncertainties, the growth potential for segments of the ICM remains substantial, backed by robust investor appetite and demand, upcoming refinancing needs for regular issuers, and funding diversification strategies, as well as Islamic finance development agendas. There are also several jurisdictions that are still largely untapped with respect to Islamic capital market penetration.

The Islamic capital markets also remained fairly resilient amid the global shocks experienced over the last three years. The growth outlook is, however, subject to how macroeconomic conditions, geopolitical factors, and other downside risks unfold, as well as climate change-related risks.

Although global risks present potential downside scenarios, the ICM, in principle, is better placed to weather adverse conditions than conventional counterparts, given that the inherent *Sharīʻah* rules and principles on which it is based diminish its exposure to speculative, highly leveraged, and riskier segments of the financial market. However, areas of potential vulnerabilities in the Islamic capital markets that should be closely monitored include liquidity risk management.

Although the global capital markets, including the Islamic capital markets, enjoyed a relatively high liquidity environment over the past decade after the GFC, the market turmoil in 2022 resulted in a worsening of market liquidity across most asset classes in the capital markets, particularly risk assets. Market liquidity is an indicator of the health of capital markets, and lower levels of liquidity increase the risk of disorderly asset price adjustments. Stressed market liquidity may, therefore, pose stability risks that can also affect Islamic capital markets in a number of ways. For example, sudden repricing, along with sell-offs, can lead to disorderly market conditions that can have broader implications for the resilience and functioning of all asset markets. Spillovers from disorderly asset markets could also increase funding costs for governments and corporates and worsen overall financial conditions.

In the case of the Islamic asset management sector, one of the main considerations moving forward is a need to strengthen and broaden the range of liquidity management tools available to Islamic fund managers. A large proportion of the Islamic fund's segment constitutes open-end funds and money market funds (MMFs). The resilience of open-ended funds and MMFs remains an area of global concern, as liquidity imbalances, if sufficiently large and prevalent, can lead to financial instability.[60] MMFs are also susceptible to sudden and disruptive redemptions and can face challenges in selling assets in stressed conditions. In addition to effective liquidity risk management in open-end funds, regulators should also look at reinforcing financial safety nets and crisis management, as well as stress testing tools for Islamic funds, to ensure that the Islamic fund's segment is well-positioned to weather a potential deterioration in global financial conditions.

New challenges, innovation, and developments in the Islamic capital market also present new areas for further action. Accordingly, regulatory priorities also need to broaden in step with the rapidly evolving financial system. For example, emerging issues such as cyber-resilience, FinTech, and climate change are becoming ever more prominent accompanied by structural changes in the financial system with respect to how firms operate as well as the structure of financial markets. Therefore, it is important to ensure that the regulatory perimeter covers all relevant Islamic capital market entities, activities, and instruments in a rapidly changing environment.

[60] This is particularly true if there are large and unexpected shifts in liquidity demand and an insufficient supply of liquidity in stressed conditions, which can, in turn, result in sell-offs and transition of stress to other parts of the financial system.

BOX ARTICLE 4:

Ṣukūk Issuance Expected to Slow Down in 2023

Contributed by:
S&P Global Ratings

S&P Global Ratings believes that *ṣukūk* issuance volumes will continue to decline in 2023, albeit at a slower pace than in 2022. We expect lower and more expensive global liquidity, increased complexity, and reduced financing needs for issuers in some core Islamic finance countries to deter the market.

Notably, future standards development and certain *Sharī'ah* scholars' preference for a higher proportion of profit-and-loss sharing in *ṣukūk* could pose additional legal challenges, in our view. We continue to believe that if *ṣukūk* becomes an equity-like instrument, investor and issuer appetite will likely diminish significantly, in particular amid already expensive liquidity. We do, however, see supportive factors in other areas.

Corporates are likely to contribute to issuance volumes, particularly in countries with government transformation visions or plans, such as Saudi Arabia. We also see continued momentum via the energy transition and increased awareness of environmental, social, and governance considerations among issuers in key Islamic finance countries. Finally, the *ṣukūk* market seems to be lagging behind the conventional one when it comes to automation and issuance of digital instruments, which could accelerate growth and make the process more appealing. Digital *ṣukūk* could provide a quicker and cheaper way to tap Islamic finance markets due to the limited number of intermediaries involved.

The forecast *ṣukūk* issuance in 2023 is expected to decline to USD 150 billion, with further risks building. Three factors explain our view: The first is that the world is getting used to more expensive global liquidity. High inflation prompted major central banks to accelerate interest rate increases. This has reduced global liquidity and made it more expensive. Investors' risk aversion has also increased, with major segments of capital markets (for example, speculative-grade issuers) experiencing significantly lower activity in 2022 compared to 2021. The *ṣukūk* market, as a component of the global capital market, is not immune to these trends. We may see some upside in activity if inflation trends down sustainably and central banks slow the pace of their interest rate increases.

Secondly, issuers have reduced financing needs. High oil prices have boosted the balance sheets of several issuers in core Islamic finance countries. Moreover, in some, particularly Qatar and the UAE, an investment cycle has just ended. In others, where government transformation visions are being implemented – such as Saudi Arabia – we expect some corporates to hit the *ṣukūk* market to complement the banking system's financing of the investments.

Finally, regulatory uncertainty is still high. *Ṣukūk* are more complex and time-consuming than conventional bonds. Therefore, new issuers are mainly taking the Islamic route because they expect to increase their investor base compared to purely conventional transactions. Regulatory uncertainty remains high and resides in the fragile equilibrium between making *ṣukūk* a fixed-income instrument and *Sharī'ah* scholars' pushing for more profit-and-loss sharing. In our view, if *ṣukūk* lose their fixed-income characteristics, while adding significant risks compared to bonds, they will become a less attractive option, reducing the market's prospects.

Despite the natural alignment of Islamic finance and sustainable finance, sustainability *ṣukūk* issuance remains limited, albeit expanding. From green to social, we expect to see higher volumes as issuers meet investor demands and core Islamic finance countries seek to reduce their carbon footprints.

Many of these countries are developing and implementing strategies to transition to greener economies, and some have ambitions in the electric vehicle space, which could imply future growth potential for green *ṣukūk* issuance. We expect to see much more activity in this space as issuers tap global investor interest. Furthermore, but less visible, Islamic finance's social aspect holds appeal as the economic impacts of various political and geopolitical shocks continue to hit populations in some countries. Over the past couple of years, the Islamic Development Bank, Indonesia, Malaysia and a few other GCC or Malaysia-based players were among the main issuers of sustainability *ṣukūk*.

In the digital space, we are seeing more conventional than Islamic activity. One could argue that this is a necessary step because the conventional market has traditionally led the Islamic one. However, even when companies have tried to develop the necessary infrastructure, issuer and investor take-up appears limited. In any case, we believe that digital *ṣukūk* could provide a quicker and cheaper way for issuers to tap Islamic finance markets due to the limited number of intermediaries involved. The benefits may also include enhanced transaction security, traceability, and integrity, which could further strengthen compliance with *Sharī'ah*. However, this assumes the availability of reliable technology, the readiness of legal frameworks to accommodate these instruments, and the presence of standard legal documents that can be used as a template.

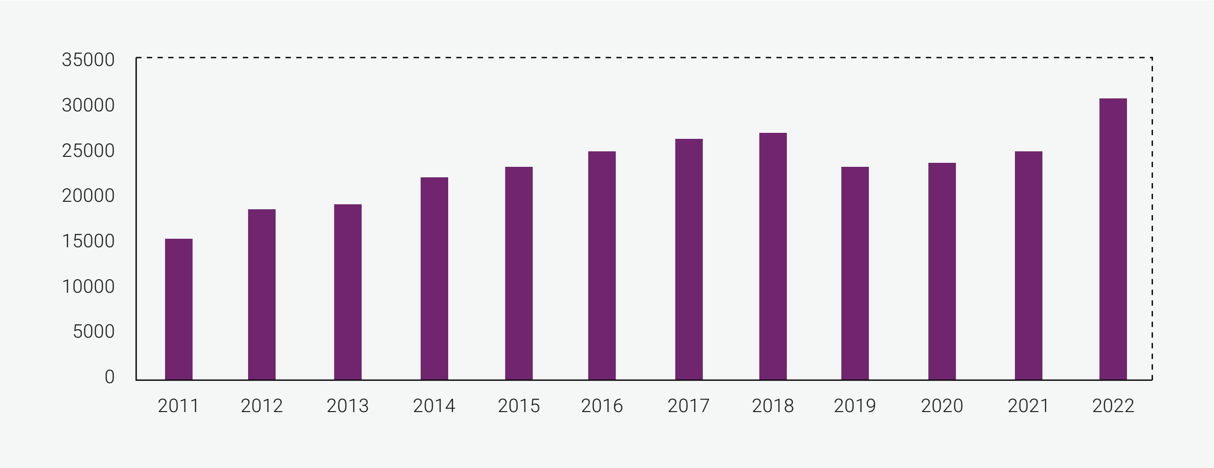
Reducing the time, cost, and minimum issuance volume requirement in this way could open the *ṣukūk* market to more issuers. However, investors in digital *ṣukūk* will continue to bear traditional risks, including credit, market and liquidity risks. They will also be exposed to higher operational risks from technology stability and cyber risks and need a means to transact digitally. For example, a stable Islamic coin or a central bank digital currency. Despite this, we expect to see more digital transactions in 2023.

2.4 *Takāful* Market Growth Trends[61]

The global *takāful* industry recorded a year-on-year contributions growth of 16.1% in 2022 to reach USD 30 billion, far exceeding the annual growth of 5.4% attained in 2021. Over the past 12-year period (2011–22), the industry has grown at a compound average growth rate of 6.4% (Chart 2.4.1). The remarkable growth in contributions achieved in 2022 was largely driven by a strong sectoral performance achieved by the industry in a number of jurisdictions, including Saudi Arabia, which make up roughly 44% of the global share of *takāful* contributions during the period under review (Chart 2.4.2).[62] The industry growth prospect remains healthy across many countries, and the uptake of *takāful* products is expected to increase, given the rising risk awareness in the post-COVID-19 era, and the implementation of mandatory covers for health business lines in many jurisdictions, which constitutes the core *takāful* markets.

Nonetheless, challenges remain across countries as the industry's growth outlook in the year ahead may be impacted by the effect of the headwinds mentioned in Chapter One, including but not limited to the ongoing Russia-Ukraine conflict, macroeconomic imbalances such as inflationary pressure, financial market volatility, and currency depreciation. This section outlines *takāful* industry's growth trend and growth drivers by region in 2021, with 2022 updates taking together countries where data are available.[63] In addition, individual country's resilience factors are highlighted based on available country-level data using two key performance metrics – profitability and underwriting performance. In the concluding part, a highlight of higher inflation as a key challenge to the business environment and its likely impact on *takāful* business in 2023 and beyond is provided.

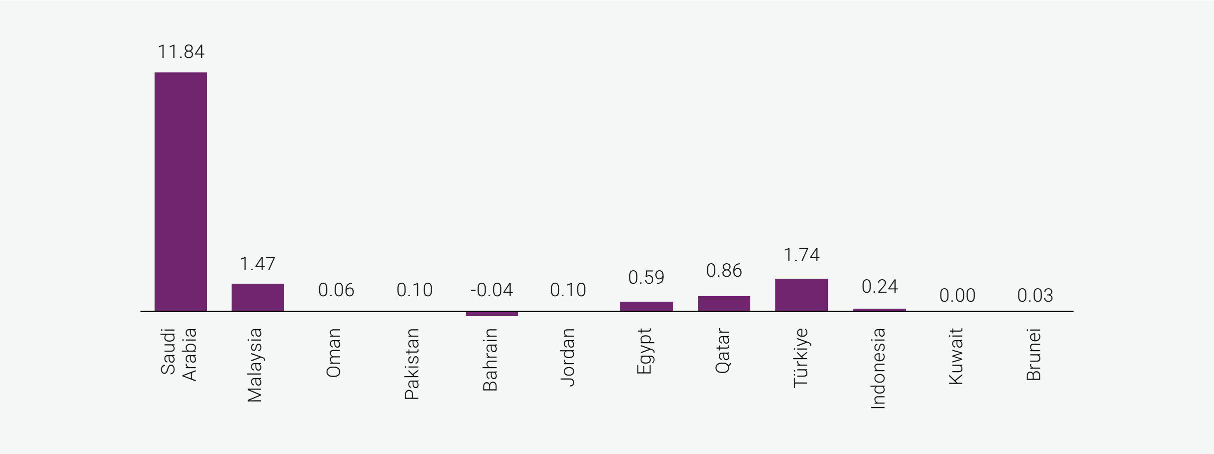
Chart 2.4.1: Trend of Global *Takāful* Contributions (USD million) (2011–22)



Source: IFSB Secretariat workings based on data culled from PSIFIs, various RSAs' websites, annual financial reports of *takāful* firms and other publicly available sources.

[61] The *takāful* market includes Saudi Arabia (cooperative model) and Sudan (mutual model), Iran, and Türkiye, whose country authorities have declared the model adopted to be *Sharī'ah*-compliant.
[62] Chart 2.4.2 shows the cumulative values of a series of countries' growth rates that constitute the global growth rate.
[63] *Takāful* industry contributions growth was estimated for 12 jurisdictions, with a global market share of 73.01% in 2021.

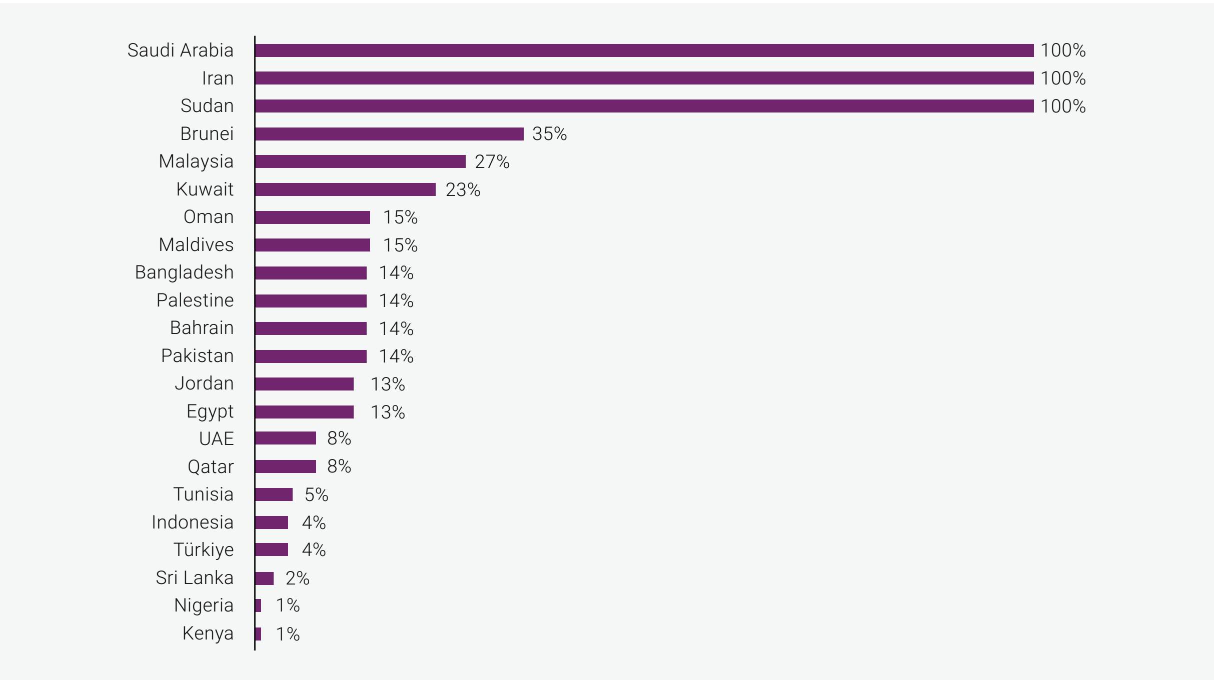
Chart 2.4.2: *Takāful* Contributions Growth Rate by Country in 2022 (%)



Source: IFSB Secretariat workings based on data culled from PSIFIs, various RSAs' websites, annual financial reports of takaful firms, and other publicly available sources

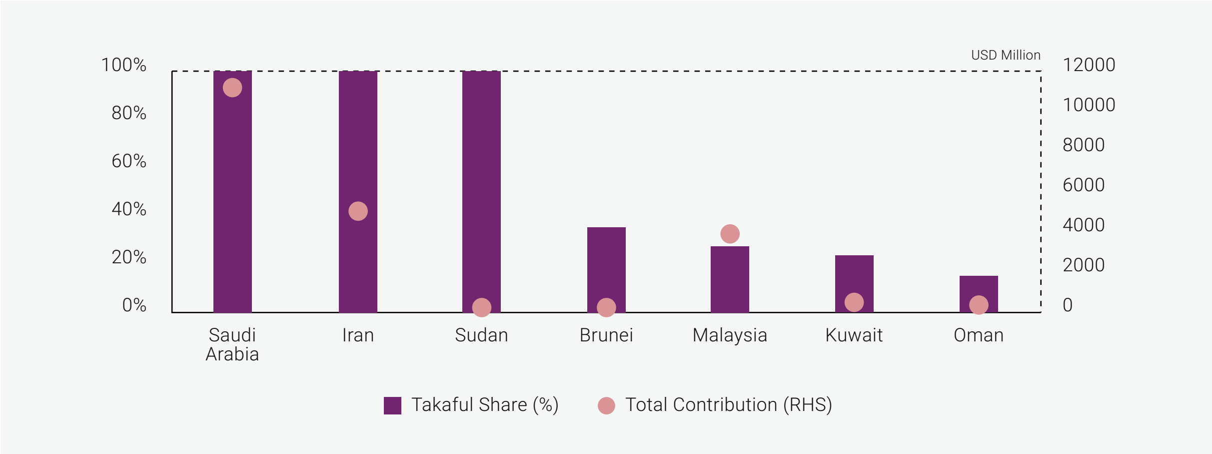
Chart 2.4.3 illustrates countries where *takāful* contributions as a percentage of the insurance sector's total premium were at least 1% in 2022. The chart also indicates that three countries – namely, Iran, Saudi Arabia, and Sudan – operate a wholly Islamic insurance market, even though each market has its distinct model. **Whereas other countries operate Islamic insurance alongside conventional insurers. The top seven markets, which generated roughly 95% of global contributions, are Saudi Arabia, Iran, Sudan, Brunei, Malaysia, and Indonesia (see Chart 2.4.4)**. General *takāful* business constitutes the lion's share (82.6%) of total contributions in 2022, estimated at USD 22.4 billion.

Chart 2.4.3: Share of *Takāful* Sector's Business Relative to Insurance Sector (%) (2022)



Source: IFSB Secretariat workings based on data culled from PSIFIs, various RSAs' websites, annual financial reports of takaful firms, and other publicly available sources.

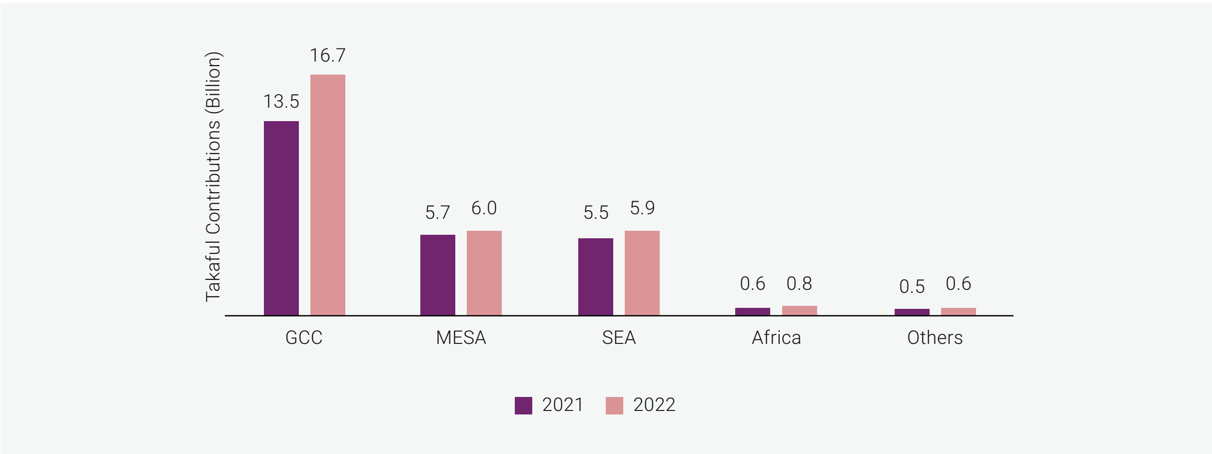
Chart 2.4.4: Contribution of Top Seven *Takāful* Markets (2022)



Source: IFSB Secretariat workings based on data culled from PSIFIs, various RSAs' websites, annual financial reports of takaful firms, and other publicly available sources.

In terms of the geographical distribution, Chart 2.4.5 illustrates that global *takāful* contributions at year-end 2022 were mainly from four regions – namely, the GCC (55.7%, USD 16.7 billion), the Middle East and South Asia (20.0%, USD 6.0 billion), South-East Asia (19.6%, USD 5.9 billion), Africa (2.6%, USD 0.8 billion) and others (2.0%, USD 0.6 billion).

Chart 2.4.5: *Takāful* Contributions by Key Region (USD million) (2021- 22)



Source: IFSB Secretariat workings based on data culled from PSIFIs, various RSAs' websites, annual financial reports of takaful firms, and other publicly available sources.

The Gulf Cooperation Council (GCC) Region

The *takāful* sector in the GCC region maintained its prominence as the largest *takāful* market in 2022, with a share of 55.7% of the global contributions. The sector posted a strong growth of 24.4% y-o-y to reach USD 16.7 billion in 2022. This marked a remarkable post-pandemic recovery in the majority of the countries in the region, fuelled mainly by higher oil prices and government investment in economic diversification and increased demand for health coverage, due to the introduction of additional mandatory coverage in these countries. Increased product pricing was another factor that further supported the growth, particularly in retail lines, where there was steep discounting during the pandemic.

The sector in Saudi Arabia registered a yearly contributions growth of 26.9% in 2022 to reach USD 14.2 billion (SAR 53.4 billion), which represents about 87% of the region's total contributions. The *takāful* sector in Qatar registered a milestone y-o-y growth of 72.5% with a contributions amount of USD 527 million in 2022, far above the 7.7% y-o-y growth reported in Oman. In Bahrain, *takāful* contributions stood at BD 61.6 million (USD 23.1 million), declining slightly by 4.9% compared to BD 61.1 million (USD 23 million) reported in 2021. This can be attributed to the 6.7% decline in the health and medical lines, which is also the highest contributor, accounting for 37.5% of total gross contributions.

The Motor and health lines of business represent the largest portion of *takāful* operators' portfolios in the region. For example, in Saudi Arabia, the two business lines together represent 79.1% of the total contributions in 2022. The contributions generated by both lines also increased by 26.7% and 26.8%, respectively. This increase is attributed to the introduction and extension of mandatory medical and health lines in the region.

As regards family the *takāful* business in the GCC region, the market share is relatively small compared to the general *takāful* business. Consistent with previous years' trends, the family *takāful* business accounted for about 20% of total *takāful* contributions in 2022. Over the past two years, the pandemic has played a role in expanding the family *takāful* business line, especially for corporations which faced fatalities in the period and is expected to push the demand upwards. Group protection has become a benefit that attracts staff, especially the young and well-educated ones. As a result, the family *takāful* line in Saudi Arabia saw a notable development in 2022, with a significant growth rate of 9.7% compared to 2021. In Oman, a double-digit growth rate of 28.7% was reported for the family *takāful* business, reflecting consumers' confidence, product innovation, and capability to attract the public.[64] A similar trend was reported in Kuwait and Bahrain. On average, the penetration rate for the family takāful line stood at 1.48% in 2020 for the whole market.[65]

The family *takāful* segment is projected to continue growing in the region, led by the rise in population and increasing awareness for coverage against risks of death and disability. Market players are introducing innovative products and integrating digital technologies across the value chain that are targeted towards citizens. Such measures are likely to drive the growth of the segment in the region. *Takāful* operators in the UAE have benefitted from the overall improving economy, growing resident population, and new mandatory coverage. Considering these favourable factors, the UAE is bound to remain the largest market for family takaful products in the GCC region.

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[64] Oman Market Performance Report 2022 Capital Market Authority.
[65] Saudi Central Bank Stability Report 2022.

The GCC region's *takāful* sector growth prospects are expected to be supported by improving economic fundamentals arising from higher oil prices in the near to medium term. As economic activity increases, the demand for protection (particularly in core classes like motor and health) will likely increase. Medical and health lines of business, have over the past five years, constituted the highest proportion of total contributions in the region, largely due to the implementation of mandatory health schemes. The *takāful* sector in the region is well-positioned to benefit from compulsory medical and motor lines implemented across the countries, given that the sector is more favourable to personal and retail lines. Looking ahead, further growth is expected from these business lines as digitalisation and customer-centricity become the focus of *takāful* operators, and more member countries implement mandatory health schemes, namely Oman, Qatar and Bahrain.

Over the past few years, the regulatory environment for the *takāful* sector has been strengthened across the countries in the region. Notably, the Central Bank of the UAE recently issued a *Sharī'ah*-governance framework for *takāful*, a first of its kind (see box article 5). Similarly, the supervisory authority in the UAE, Oman, and Kuwait are currently implementing new risk-based solvency frameworks and pushing for higher standards and regulations. The purpose is to strengthen the regulatory environment in order to create a stronger, more reliable, and compliant market capable of attracting further investments to the sector. As such, operators will be able to serve individuals and business communities better, improving the penetration rate, and reducing the protection gap.

Increasing minimum capital requirements in the region will result in further capital raising and likely trigger consolidation, including mergers and acquisitions (M&A) activity among small and mid-sized operators going forward. Consolidation is expected to produce some synergies and benefits like improvement in capitalisation and additional diversification. For example, in terms of products and geographies. Additionally, strategic acquisitions could produce a bigger scale which could help dilute operators' fixed costs, while reducing top- and bottom-line volatility.[66]

In response to the tightening of the capital regime, particularly around capitalisation and solvency,[67] the *takāful* sector in the region has recorded an increase in the number of M&A activity in 2022 and the momentum is expected to continue. For example, in the UAE, the merger between Dar Al *Takāful* and National *Takāful* Company (Watania) was completed in July 2022, forming one of the leading national *takāful* providers in the UAE with a share capital of AED 260 million. In October 2022, SALAMA announced that it had obtained initial regulatory approval for a merger with *Takāful* Emarat and had also initiated negotiations with Dubai Islamic Insurance and Reinsurance to acquire part of its general, medical, and family *takāful* portfolios.

At about the same time, Sukoon (formerly known as Oman Insurance Company) signed a share purchase agreement to acquire a majority stake (in excess of 93%) in the Arabian Scandinavian Insurance Company - *Takāful* (Ascana Insurance). Similarly, in Saudi Arabia, two separate non-binding Memorandums of Understanding were signed to evaluate potential mergers between Saudi Enaya Cooperative Insurance and United Cooperative Assurance, and between Alinma Tokio Marine and Arabian Shield Cooperative Insurance in December 2022. Earlier in October, Walaa Insurance and SABB *Takāful* announced that their merger transaction became effective. In Bahrain, T'azur *Takāful* merged with Solidarity Bahrain in January 2022.

66 S&P Global Ratings in a report on *takāful* in the GCC, 2022.
67 The introduction of risk-based capital regimes has prompted a greater emphasis on technical profitability, as volatile equity and property investments could require higher solvency capital charges.

The Middle East & South Asia (MESA) Regions

The Middle East & South Asia regions generated a total contribution of USD 6.0 billion in 2022, with a y-o-y growth rate of 5.1%, making up 20% of global *takāful* contributions during the period. Iran is the largest market in this region, accounting for roughly 89% of the region's total contributions in 2022. Over the years, Iran's economy has been hurt by significant foreign exchange depreciation and inflation due to economic sanctions imposed on the country, and the trend continued until the year-end of 2022. Invariably, significant foreign exchange depreciation has affected the value of contributions and growth reported after being denominated in USD to allow for cross-country comparisons.

According to the Central Insurance Company of Iran (CII) data, the market generated a contribution of 1,249 trillion Rials, up by 58.4% in 2022 compared to the previous year.[68] However, when denominated in USD, the estimation slipped to USD 5.4 billion.[69] This figure is higher by 6% compared to the 2021 figure. This is attributed to a number of factors. These include soaring demand for family and protection products, supported by heightened awareness of protection and savings, as well as greater awareness of financial risks associated with mortality amid the ongoing pandemic. In Iran, the third-party motor line registered 29.6% of total contributions, whereas health and medical business lines accounted for 30.81% of the total portfolio and achieved a significant growth milestone of 165.3% (USD 941.6 million) compared to the previous period.

The contributions generated by the *takāful* sector in Pakistan grew by 9.4% in 2022 to PKR 59.1 billion compared to the earlier period. However, in USD, the overall contributions growth plunged downward by 15.1% to USD 260 million (USD 306.1 million: 2021). When the overall contributions growth is disaggregated into segments, the contributions from the general takaful segment jumped by 27.1% (PKR 20.6 billion; USD 0.1 billion) over the same period in 2022, driven by a surge in contributions from fire and property damage business lines.[70] The *takāful* sector in Pakistan seemed to benefit from the acceptability and support of the faith-sensitive segments of society.

In Jordan, the markets posted a modest growth rate of 15% (USD116.1 million), 85% of the total contributions are mainly from compulsory motor third-party liability and health lines. The MTPL is expected to see a stronger annual uptick (growth) considering the support from the electronic insurance platform that was launched in 2021. The *takāful* contributions from Palestine and the Maldives showed a strong y-o-y growth of 45% and 29.4% respectively, estimated at USD 60 million and USD 11.8 million in that order.

The overall insurance market penetration for countries in the MESA region was only 0.9% in 2021, a decline of 1% from the previous year. The family *takāful* business lines in Iran achieved a moderate growth of 8% in 2022, after 44.5% growth in 2021 compared to the earlier year, accounting for 15.5% of the sector's portfolio. The family *takāful* business segment constituted a large proportion of total contributions generated in Bangladesh (79%) and Pakistan (65.1%) during the period under review. In Pakistan, the family *takāful* business has benefitted from an expanded national health insurance program and posted healthy gains of 22.8% as more health policies were underwritten. In contrast, the family *takāful* business in Jordan is undeveloped in terms of insurance density and penetration due to multiple factors, such as a widespread lack of financial literacy, low product awareness, limited disposable income, and cultural and religious factors that hamper insurance-buying decisions.

[68] Financial year 21 March 2021- 20 March 2022
[69] 233777 IRR = USD based on the exchange rate quoted by SEO (Securities Organisation of Iran)
[70] State Bank of Pakistan Financial Stability Review – 2021

The South-East Asia (SEA) Region

The *takāful* sector in the South-East Asia (SEA) region generated a total of USD 5.9 billion in 2022, which represents 7.5% growth compared to the estimate of the prior year. Malaysia, Indonesia and Brunei Darussalam are the constituent countries in the region.

The contributions from the Malaysia *takāful* sector, which have grown steadily over the past years, recorded 9.1% and stood at MYR 9.8 billion (USD 4.13 billion) in 2022,[71] representing 70.2% of the total SEA region's contributions in 2022. The contributions from the family *takāful* business slowed down to 15.5% in 2022, after y-o-y growth of 25.3% in 2021 and representing 76% of the total *takāful* contributions during the period. Annual contributions from new businesses increased by 18.3% in 2022, although slower than the 28.9% recorded in 2021, after COVID-19 restrictions were eased. The contributions' growth in new business was primarily supported by the growth of Mortgage Reducing Term *Takāful* (MRTT) business lines and in medical and health classes.[72]

Similarly, the general *takāful* business posted strong growth of 21.1% in 2022, with motor and fire lines contributing 66.1% and 18.3%, respectively. The tax incentives provided helped to boost car sales in 2022 and the uptake of motor takaful product lines. Going forward, the growth momentum is expected to be maintained in 2023, albeit at a moderate rate, given several factors, including the growing popularity of *takāful* products among consumers, the introduction of new innovative products, and the adoption of digital technologies to enhance service delivery. In addition, the liberalisation of the motor and fire tariffs is currently being implemented to enhance more competitive risk-based pricing and preserve access to coverage.

The contributions from the *takāful* sector in Indonesia slowed down to 3.74% in 2022 (2021: 35.56%). The slower growth in overall contributions in 2022 is attributed to a marginal growth of 0.37% posted by the family *takāful* segment, which represented 88% of the takāful sector's underwriting portfolio in Indonesia. With regard to the general *takāful*, the recovery in automotive sales backed by the tax-free policy has helped to push up the contributions in this segment to a yearly growth of 38% in 2022, above the 23.8% reported in 2021.

The long-term growth potential of the Indonesian *takāful* sector is positive, reflecting government support and growing awareness of *takāful* products among the Muslim population. Over the past two years, the *takāful* products penetration rate has risen to roughly 9% in 2022 from about 5% in 2020,[73] mainly attributed to digitalisation through InsurTechs and traditional insurers' digital platforms. However, long-term structural challenges persist, such as the small capital base of the sector and the limited range of takāful products. Only six *takāful* operators have become fully-fledged since 2014 due to high capital requirements and operating expenses, although over 70% of all operators are required to spin off their *Sharī'ah* business units (SBUs) by the October 2024 deadline.

In Brunei, the *takāful* sector registered a y-o-y growth of 6.9% in 2022 to reach USD 114.5 million (2021: USD 107.08 million). In contrast to other markets in the region, general *takāful* business dominates the sector, representing 82% of total contributions and posted 6.0% y-o-y growth (USD 88.12 million),

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71 Source Bank Negara Malaysia Monthly Highlights & Statistics (takāful sector).
72 BNM Financial Stability Review 2H21 and The Insurance and Takāful Sector, *https://www.bnm.gov.my/documents/20124/6459002/fsr21h2_en_ch2.pdf*
73 Indonesia Takaful Dashboard: 2023", Fitch says.

attributed mainly to motor lines of business, which made up 46% of the total *takāful* portfolio. Over the past years, Brunei has increased the *takāful* market share to 35% of the overall insurance sector premium in 2022. This development is attributable to two strong takāful operators dominating the market. Meanwhile, the contributions from the family *takāful* business in Brunei Darussalam dropped by 9.0%, estimated at (USD 18.96 million) in 2022.

In January 2022, the Insurance Commission (IC) of the Philippines released baseline guidelines for all existing and authorised insurers and mutual benefit associations that will set up *takāful* windows and fledged *takāful* undertakings. Hitherto, there had been no regulatory framework for Islamic insurance in the Philippines. Included in the guidelines, a complete governance policy framework, which outlines the strategic duties and tasks of each organ of governance, as well as procedures for balancing stakeholder accountability, must also be established by an operator.

The Africa Region

The *takāful* sector in Africa presently constitutes a fringe market and exists alongside conventional insurance, aside from Sudan, which operates a fully *takāful* sector and has existed for more than four decades. The sector is still a nascent market in the region and gradually evolving in countries such as Egypt, Morocco, Algeria, Tunisia, Libya, Kenya, Nigeria, Senegal, South Africa, Gambia, Mauritania, Ethiopia and Zambia.[74] Many countries in this region suffered a significant currency depreciation which impacted the value of the respective countries' *takāful* market contributions in USD terms.

The total *takāful* contributions from Sudan are estimated at SDG 60 billion representing a leap of 78% compared to SDG 22.3 billion (USD 48.85 million) in 2020,[75] General *takāful* still dominates the market accounting for 98% of market contributions. The family *takāful* business was within a range of 1.4% to 2.4% of the market's contributions. Given that three out of seven newly licenced operators are purely life and medical, it is expected that the new companies will drive the family *takāful* business lines.[76] The *takāful* market in Sudan is presently having a setback due to ongoing factional war in the country. However, the sector is still promising, given the potential to develop and grow, especially in the areas of agricultural insurance, livestock insurance, micro-insurance, and medical insurance.

The total *takāful* contributions reported in Egypt reached USD 278.1 million (EGP 8.2 billion) in 2022, representing a strong increase of 118.1% compared to the previous period (2021: EGP 3.76 billion).[77] This increased the share of *takāful* contributions to 18.7% of the market gross written premium against 12% in 2021. The Family *takāful* business dominates the market, accounting for 58% of the overall contributions. Family and health lines saw significant growth in the post-COVID-19 era, due to the increased awareness of the need for protection and reliability demonstrated by *takāful* companies. The supervisor is supporting the collaboration between *takāful* operators and microfinance institutions to provide protection and coverage along different policy lines.

In Tunisia, the contributions from the three *takāful* operators slowed down to 12% in 2022 compared to 22% reported in 2021, reaching USD 60 million (TND 175 million). The growth outstripped that of the insurance sector's gross written premium, which posted 6.5% within the same period. Currently, the-

[74] Quantitative information was not available for many of these countries and, therefore, could not be included in this report.
[75] National Insurance Regulatory Authority, Khartoum Sudan, Annual Report 2021.
[76] National Insurance Regulatory Authority, Khartoum Sudan, Annual Report 2021.
[77] Financial Regulatory Authority's (FRA) Egypt, Annual Report 2022; Monthly performance report of non-banking financial activities

contributions from *takāful* operators accounted for roughly 6% of the total insurance sector's premiums for the year under review.[78] Given the majority Muslim population, *takāful* holds promises of a better future but needs to respond to current challenges, such as the modernisation of the regulatory framework, digital transformation, thriving in niche markets, product innovation and inflation.

In Morocco, *takāful* companies licensed in 2021 generated contributions totalling USD 2.18 million (MAD11.8 million) in 2022, marking the first year of their operations.[79] This was mainly from family *takāful* business (84%), fire insurance (10%) and individual *takāful* investment lines (5%). *Takāful* regulations came into force in October 2021 when licences were granted to seven participatory banks to carry out *takāful* operations related to coverage for accidents, fire and natural elements, glass breakage, water damage, family protections, and investment. The authority believes that *takāful* operations will develop and promote several products together with the participatory banks that meet the needs of different segments of the population, thus contributing to the promotion of the financial inclusion of a large category of citizens who await an alternative to conventional insurance plans.

The *takāful* market in Algeria is forecast to get a big boost this year following the issuance of an executive decree to drive *takāful* business in the country by the Algeria National Council of Insurance (CNA). In January 2021, the regulator issued general terms and conditions for practising *takāful* in the country, and at the beginning of 2022, the CNA announced the granting of *takāful* licences. Prior to this, Salama Assurances Algérie was the only company out of the 23 insurers in Algeria that provided *takāful* products and services.

The Tanzania Insurance Regulatory Authority (TIRA) has launched *takāful* guidelines that have taken effect since May 2022. The guidelines cover the insurance sales force and digital insurance platforms, including web aggregators. The two sets of guidelines are expected to improve access to insurance, increase insurance penetration, and create more jobs.

The African Insurance and Reinsurance Company (SAAR Assurances) in Côte d'Ivoire has established a *takāful* window to offer Islamic-compliant insurance products. SAAR TAKAFUL offers its participants *takāful* policies certified by an independent *Sharī'ah* committee, which ensures that operations comply with Islamic requirements. The window, dubbed 'SAAR TAKAFUL', represents a step taken towards improving customer satisfaction and improving the insurance penetration rate in Côte d'Ivoire. Muslims form 42% of the total population of the country.

In South Africa, few companies are currently offering *takāful* products, and this creates an opportunity for businesses to think of expanding into a niche market.[80] In more recent times, large South African medical aid insurers are seen to be offering *Sharī'ah*-compliant medical aid products. This is certainly an indication that the market recognises the opportunity and value of offering *Sharī'ah*-compliant products. Presently, there are no *takāful* regulations, Islamic insurers in South Africa are still governed by the Insurance Act, as well as the supporting regulations set out by the Prudential Authority. Although, there was a move in 2010 when specific changes were made to the income tax legislation, the effect of which was to put Islamic finance, and conventional finance, on a similar footing. Since then, there has been little to no change from a legislative perspective on the tax treatment of Islamic finance.

[78] Comité Général des Assurances (CGA), Tunisia Insurance Regulatory Authority, Annual report 2022.
[79] According to its report, "Insurance and reinsurance sectors in 2022", released by the Morocco Insurance and Social Welfare Control Authority (ACAPS) in April 2023.
[80] The South African Insurance Industry Survey 2022. Published by KPMG, 2022.

Other Markets – Türkiye

The total contributions, which stood at USD 647.35 million in 2022, were largely contributed by the "Participation Insurance" sector in Türkiye, which increased by 57.1% compared to the earlier year.[81] The Participation Insurance sector's contributions accounted for around 5.5% of the market gross written premium in 2022, up by 1.3%. The general *takāful* segment, which comprises motor and property, and accident lines provided a significant proportion of the contributions, representing 44% and 29%, respectively, while the medical and health lines added only 18% to total contributions. During this period, the family *takāful* business increased as a proportion of the overall contributions by 22.8%[82] and stood at TRY 17.7 billion (USD 0.95 billion) driven by bancassurance and credit-linked policies subscribed through banks and digital channels. The family *takāful* business in Türkiye is rapidly developing, given the relatively young population, and has the potential to increase the insurance penetration rate from its low level of 1.3% in 2022. Meanwhile, the sector is confronted with numerous challenges, including natural catastrophe losses and the recent earthquake in 2023, which put significant pressure on the contributions' growth, especially those in personal lines.

2.4.1 Takāful: Assessment of Resilience

This section assesses the resilience of the *takāful* sector based on country-level data covering 2022 using two key performance metrics – profitability and underwriting performance. The trend analysis is performed for each performance metric by comparing country-level data for the year-end 2022 with the average of the previous three years (2019–21).[83] The countries considered are mostly where the *takāful* sector has achieved a notable presence and where data is available.[84] Additionally, the analysis and discussion for each performance metric follow business segments (i.e., general and family business) to reflect the developments and peculiarity of each business segment. However, this approach could not be applied to profitability performance indicators due to different operating structures across markets (i.e., composite, general and family) and the difficulties encountered in data segmentation of some items in the financial statements, such as expenses and assets in *Takāful* Undertakings (TUs) with composite business.

Over the past two years, the world economy has recovered from the economic crisis caused by the pandemic. However, during this period, the sector underwriting performance came under pressure to absorb the COVID-19-related claims, above-average catastrophe losses, and the impact of high inflation, as well as rising policy rates to curb higher than expected inflationary pressure. Different risk mitigation measures taken by *takāful* operators and supervisors alike were mainly guided by the country's circumstances and, to some extent, by global market developments. Some of these measures include *retakāful* (reinsurance) and dynamic hedging strategies for capital management, investments and underwriting activities.

Generally, the growth in *takāful* contributions (top-line revenue) over the past two years has continued to lend support to underwriting performance and has helped bolster bottom-line profitability despite moderation in some business lines like the motor class of business. Although some of the underwriting performance dynamics are within the scope of the operators (i.e., pricing of risk, underwriting-

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[81] Statistics from the Insurance Association of Türkiye.
[82] 22.8% in nominal terms, however, taking inflation into account shrank by 9.7% in real terms.
[83] The assessment is limited to profitability and underwriting metrics because they are the limited requisite data available to compute other metrics e.g., liquidity and solvency.
[84] The countries include Saudi Arabia, UAE, Kuwait, Bahrain, Qatar, Oman, Jordan, Malaysia, Brunei, Indonesia, Türkiye, Pakistan and Bangladesh.

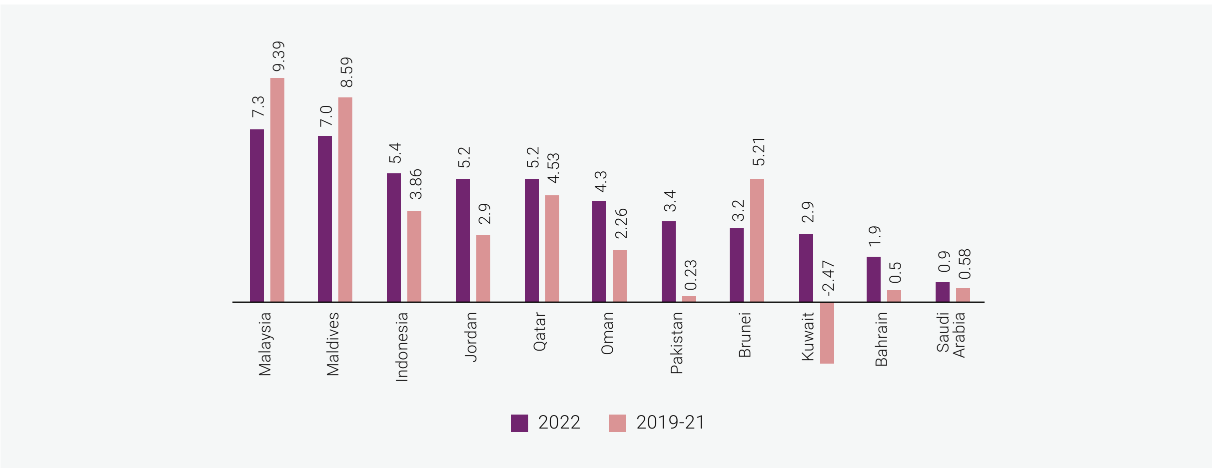
discipline, and risk management framework), the outcomes are largely influenced by the macroeconomic environment and other extraneous factors (e.g., a low investment return environment, catastrophe-related losses, and political instability) which are outside the industry's control. The capacity of the *takāful* operators to manage these challenges and build the resilience needed will determine its performance. Therefore, the sector needs to emphasise technical pricing and adhere to the stipulated pricing approach to continue to achieve profitability along the *takāful* operations value chain.

2.4.2. Profitability & Earnings Performance[85]

The *takāful* sector showed improvement in profitability across the market in 2022 compared to the average of the three-year (2019-21) period under review. The sector has thus reversed the weaker profitability (shown by ROA and ROE) posted in these markets in 2021 due to rising claims and costs. In 2022, claims from motor and medical lines reached near pre-pandemic levels as mobility increased. Losses were partly offset by higher rates and income from investment activities.

Return on assets (ROA) and return on equity (ROE) in all the *takāful* markets reviewed showed a remarkable improvement in 2022 relative to the average of the previous three-year period, supported by stronger investment and higher underwriting profits, as well as owing to lower claims recorded during the period. The Malaysia *takāful* market topped both charts (ROA and ROE); however, it showed a declining trend compared to the previous period. Over the past two years, profitability has remained an issue for the sector, reflecting weaker investment performance and valuation losses from *ṣukūk* and equity investments due to weaker investment performance and volatile financial market conditions.[86] While technical losses persist in many markets in 2022, due to a rise in claims from motor and medical to pre-pandemic levels, the improvements in profitability were mainly attributed to earnings from investment income from higher yield financial instruments (Chart 2.4.2.1 & 2.4.2.2).

Chart 2.4.2.1 Return on Assets (%) (2019-21 and 2022)

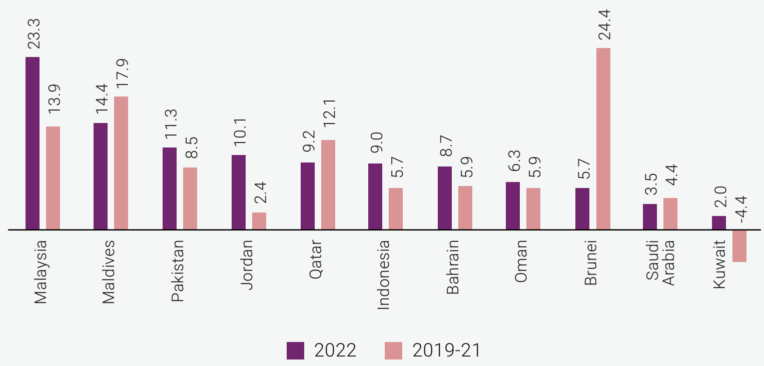


Source: IFSB Secretariat Workings 2023

[85] Profitability and earning metrics such as Return on Assets (ROA) and Return on Equity (ROE) are indicators of profitability, as well as the income-generating capacity of TU. It shows how much income TUs have generated with the capital that shareholders have invested. For a given TU when policyholder and shareholder funds are prepared separately, it may be necessary to aggregate the two income statements so as to avoid double-counting.

[86] (Net unrealised losses)

Chart 2.4.2.2 Return on Equity (%) (2019-21 and 2022)



Source: IFSB Secretariat Workings 2023

2.4.3 Underwriting Performance and Risk

Underwriting performance is one of the key metrics to determine the resilience and stability of the *takāful* risk fund (participants' risk fund) and, ultimately, a TU's profitability. A typical TU with a relatively stable *takāful* risk fund is most likely to benefit from a number of factors, including better risk selection, product pricing decisions and claims management, and operational efficiency. Hence, the assessment of underwriting performance and risks is commonly performed in *takāful* risk funds using indicators such as loss ratio, expense ratio, and combined ratio having regard to the different natures of *takāful* funds in both general and family *takāful* segments across markets.

2.4.3.1 Loss Ratio[87]

General Takāful business

The average loss ratio in the general *takāful* business surged across markets in 2022 when compared with the average of the earlier period (2019-21). The weaker underwriting performance recorded in many markets, despite appreciable growth in top- line revenue (gross *takāful* contributions), was mainly due to higher claims frequency and costs, particularly in motor and health business lines, which constituted the largest components of the business (Chart 2.4.3.1). The highest loss ratio was reported in Türkiye, where the loss ratio rose to 99% in 2022, compared to the 70% average for the prior period.[88] During the same period, the overall loss ratio for both general and health insurance increased by 22.8% in Saudi Arabia to 83.4%.[89] Other countries which showed an increase in loss ratio during 2022 include Bahrain (68.9%), Malaysia (60.7%) and Indonesia (32.7%).[90]

[87] The loss ratio measures the net incurred losses relative to the net earned contributions. It is an indication of underwriting performance and represents the actual impact of incurred losses on participants' risk funds (PRF). An operator's goal is to achieve a loss ratio below 100% to prevent the need for Qard (although any gap could be partly bridged by investment earnings on PRF assets). In this regard, the loss rati measured the sufficiency of the PRF to cover the actual losses incurred. Mostly, variabilities in this metric are caused by both externalities, such as economic factors (i.e., market competition, price and underwriting cycles), and catastrophic losses (e.g., natural disasters), including emerging risks such as cyber risk and climate-related risk, among others. Depending on the rates and underwriting pricing, the ratio may increase (decrease) without any significant changes in the actual loss experience.

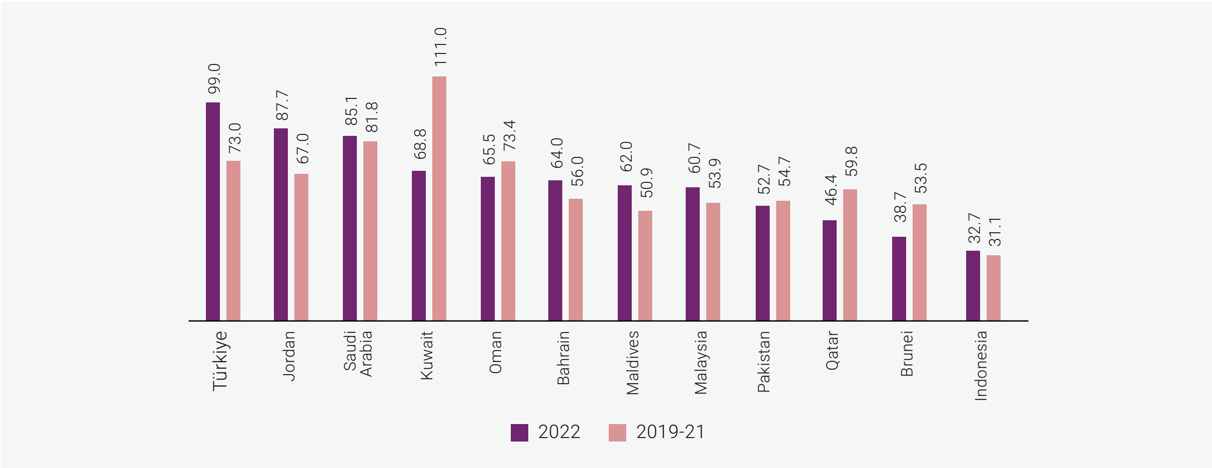
[88] The Insurance Association of Türkiye (TSB) Report 2023.

[89] Saudi Central Bank, Insurance market report 2022.

[90] The loss ratio in Malaysia (55.7%: 2020; 51.3%: 2021, Indonesia 30.4%: 2021).

On the other hand, relatively stable net claims together with appreciable growth in contributions (i.e., motor, health, fire, and property casualty lines) have resulted in a declining loss ratio in 2022, compared to the earlier period in countries such as Kuwait, Brunei, Qatar, Oman and Pakistan.[91]

Chart 2.4.3.1 Loss Ratio: General *Takāful* (%) (2019–21 and 2022)



Source: IFSB Secretariat Workings 2023

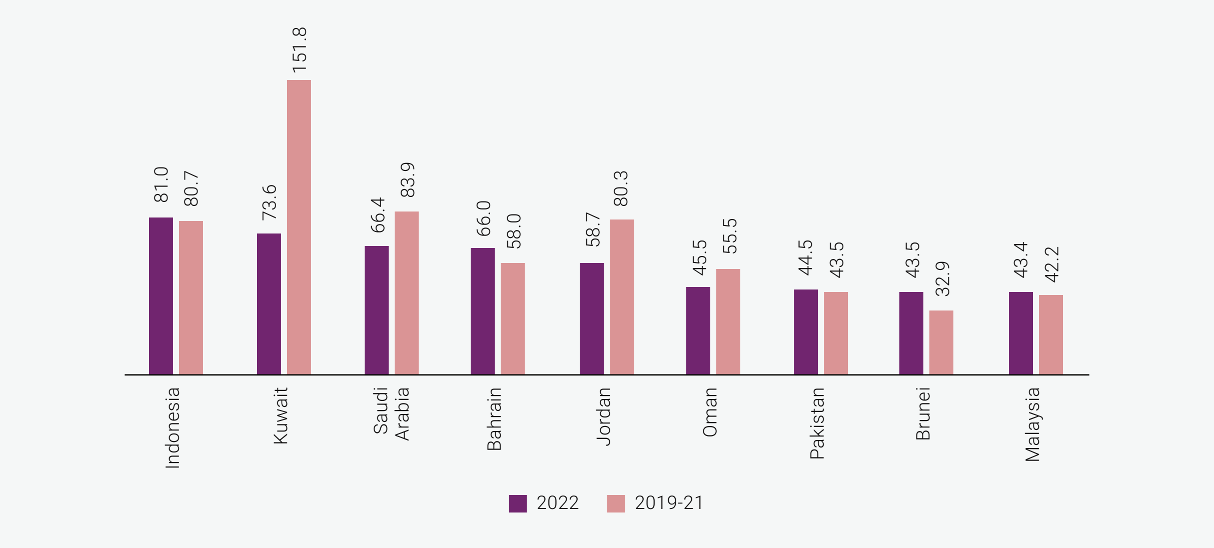
Family Takāful business

Although there were appreciable increases in benefit payouts in the family *takāful* business over the previous period, perhaps due to the pandemic, in 2022, it remained stable or declined in most markets, leading to a boost in underwriting performance and further supported by growth in gross contributions in 2022 (Chart 2.4.3.2).[92] Indonesia topped the entire market with a benefit ratio of 80.97% in 2022, although declining slightly from 92% shown in the previous period.[93] Also in Malaysia, the family *takāful* funds posted a slight increase in benefit ratio to 43%.[94] The surge in the loss ratio over the last two years in Kuwait reached 151% in 2021, before plunging downward to 73.6% was attributed to the expansion in the underwriting of group health in the aftermath of the pandemic outbreak, as well as an increase in surrender and maturity claims.[95]

In contrast, the improvement in underwriting performance in Oman in 2022 was due to a decrease in the benefits payout ratio to 45.5% compared to 74.5% in 2021. Oman, by its geographical location, is prone to the incidence of tropical cyclone Shaheen, which contributed to the increase in compensations paid in property and casualty lines in October 2021.

[91] Capital Market Authority of Oman, Insurance Market Index 2020-21.
[92] Long-term family takāful products include products such as unit-linked life and family takāful products through the illustrative example of a long-term endowment family takāful plan, term product family takāful, and investment-linked family takāful products. For these products, ethical business conduct requires a clear explanation at both points of establishing the contractual relationship - at this point and after the point of contract - that is when the operators are performing the contract (charging premiums, paying claims, and, in the case of family takāful products, managing the policyholder's accumulated funds for the benefit of the beneficiaries over what may be a term of many years).
[93] OJK Annual Report 2022 *https://www.ojk.go.id/id/kanal/iknb/data-dan-statistik/asuransi/default.aspx*
[94] Excess of income over outgo is indicated by underwriting results in the family takāful segment in Malaysia. (See *https://www.bnm.gov.my/-/monthly-highlights-statistics-in-february-2023*)
[95] Financial Stability Review 2021, State Bank of Pakistan.

Chart 2.4.3.2 Benefits to Claims Ratio: Family *Takāful* (%) (2019–21 and 2022)



Source: IFSB Secretariat Workings 2023

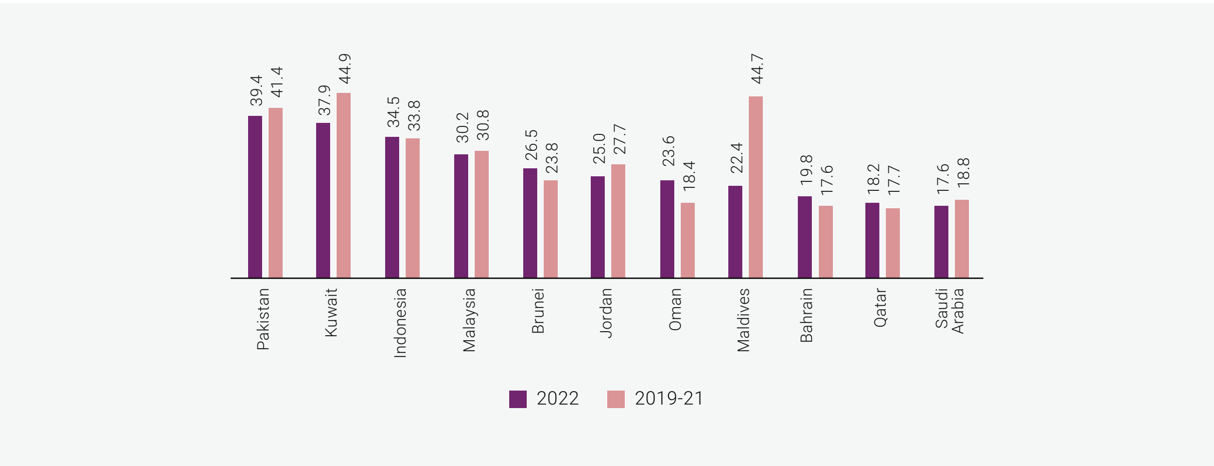
2.4.3.2 Expense Ratio[96]

The expense ratio attributable to a *takāful* operator is determined by the extent of market competition (e.g., high commissions and brokerage fees) and inflation, thereby negatively impacting its operating income.

General Takāful business

While the expense ratio increased in 2022 across all the *takāful* markets reviewed, the top-line revenue grew as well, which assisted in dampening the impact of competitive market conditions and pricing pressures reflected in the amount of commissions charged, administrative costs and management expenses. Saudi Arabia, Qatar, Oman, Brunei, and Jordan recorded the lowest percentage, whereas other markets showed a slightly higher expense ratio above 30%. To a large extent, the ratio posted in the respective markets reflects pricing pressures on motor and medical lines, which account for a larger proportion of retained risk (Chart 2.4.3.2a).

Chart 2.4.3.2a Expense Ratio: General *Takāful* (%) (2019–21 and 2022)

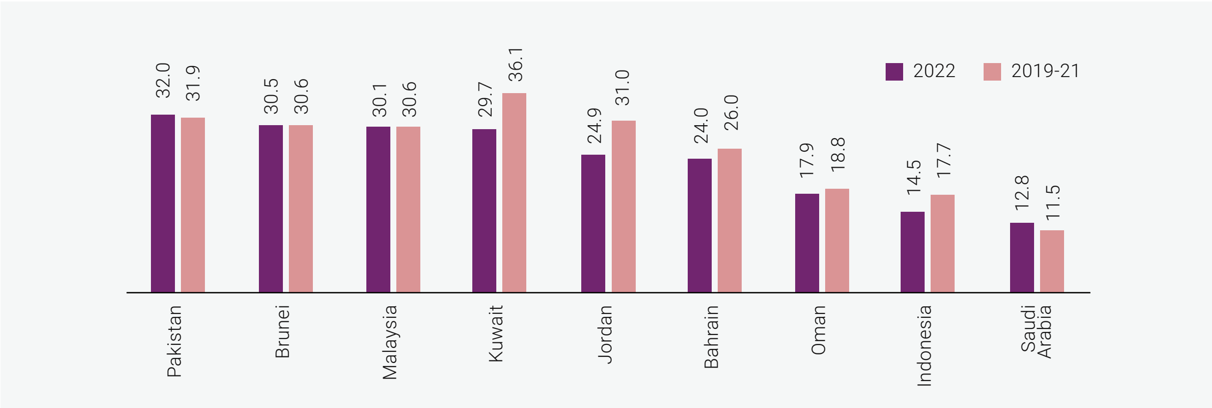


Source: IFSB Secretariat Workings 2023

Family Takāful business

Similar to the general *takāful* segment, the expense ratio reported in this segment is reflective of competitive market conditions and pricing pressures in 2022. While the expense ratio is stable in some of the markets reported, a number of them also showed a declining trend in the ratio. Those markets which saw improvement in the expense ratio for this segment include Kuwait, Jordan, Bahrain, Indonesia and Oman (Chart 2.4.3.2b). The implementation of a broad range of cost-saving measures, such as the adoption of digital technology to reduce overhead expenses in marketing and consulting services, may have been the option adopted during this period. Since agents' commissions are one of the biggest contributors to the increase in overhead costs, the adoption of digital technology will ensure significant improvements in the cost structure of various business lines, and offset an increase in loss ratios.

2.4.3.2b Expense Ratio: Family *Takāful* (%) (2018–21 and 2022)



Source: IFSB Secretariat Workings 2023

2.4.3.3 Combined Ratio

A combined ratio measures the underwriting performance of a typical *takāful* operator and markets. It aggregates both the loss ratio and expense ratio, reflecting *takāful* operators' choices and decisions along different phases of its operations, including marketing, risk selection, product pricing, and claims administration.[97] An increase in the combined ratio can be offset by other sources of earnings, such as *retakāful* (reinsurers) commission and investment income, higher top-line revenue (contributions), as well as better cost control and risk management measures.

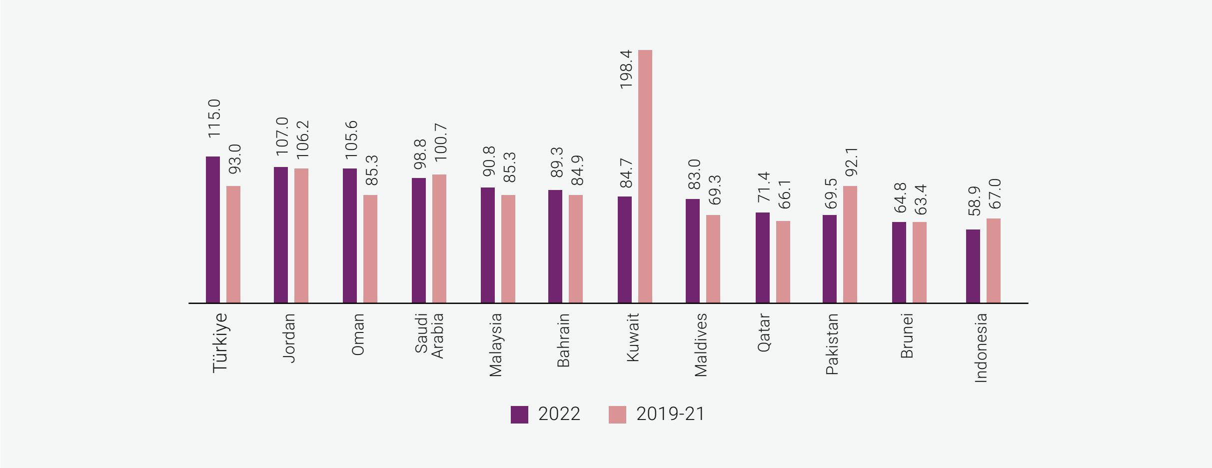
General Takāful business

The overall combined ratio in the general *takāful* segment increased in 2022, well surpassing the pre-pandemic period in the majority of the markets reviewed. This is largely attributed to higher operating expenses and claims payments in the health and motor lines, which constituted the major business lines.[98] However, the combined ratio narrowed down in some markets during the period, marking an improvement in underwriting performance. This is attributed largely to the offsetting effect of strong growth in contributions and lower claim payments in 2022 (Chart 2.4.3.3a).

[97] The combined ratio measures the sufficiency of contributions revenue to cover the underwriting operations of a *takāful* fund. A ratio less (greater) than 100% means profits (losses) in the fund during the period. It is most often used in general business, although a similar measure may be adapted to monitor the sufficiency of contribution revenue in the family business. Generally, a combined ratio exceeding 100% over two or more years can probably provoke a long-term stability concern.

[98] Health and motor third-party liability accounted for approximately two-thirds of the *takāful* undertakings' portfolio liabilities.

Chart 2.4.3.3a Combined Ratio: General *Takāful* (%) (2019–21 and 2022)

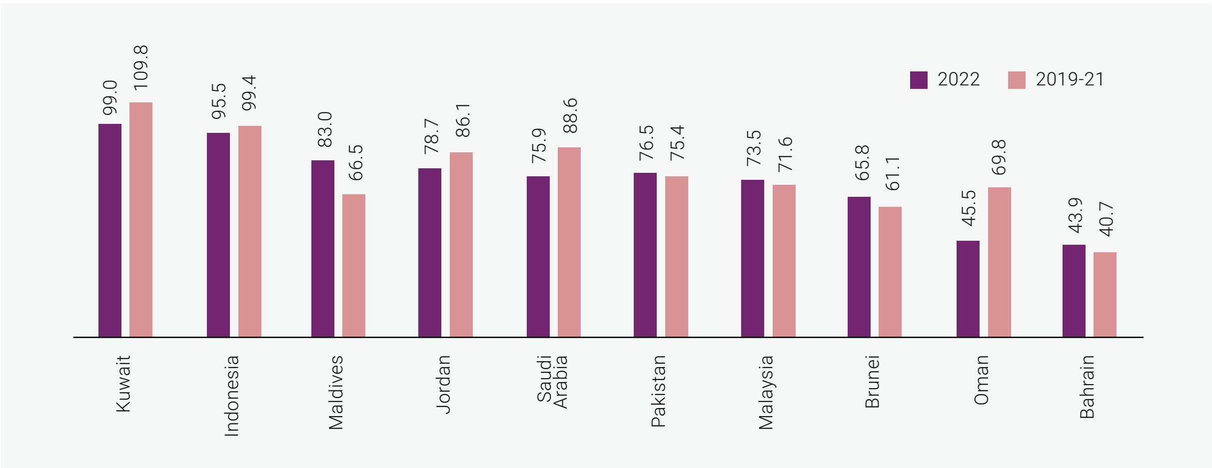


Source: IFSB Secretariat Workings 2023

Family Takāful business

The drop in the combined ratio in 2022 shown in the family *takāful* segment in some of the markets reviewed was mainly due to low payout together with the offsetting effect of top-line revenue growth (Chart 2.4.3.3b).

Chart 2.4.3.3b Combined Ratio: Family *Takāful* (%) (2019–21 and 2022)



Source: IFSB Secretariat Workings 2023

A challenging outlook: Managing inflation impact and other evolving risks in takāful markets

More generally, *takāful* operators have improved their competitive position and their ability to offer sustainable higher-quality products to customers. Evident from the steadily rising global contributions in the post-pandemic years, particularly in the core markets across regions. These markets have grown off the back of factors such as developing regulatory environments, increasing awareness of *takāful* products, and enhanced digitalisation.

Currently, many drivers affect the outlook and generate uncertainty. Most prominently, ongoing geopolitical conflicts, inflation, tightening monetary policy, and the deteriorating economic outlook. These drivers increase market, credit, and liquidity risks going forward. This scenario creates a very complex and challenging environment for consumers and businesses to navigate.

With macroeconomic imbalance and uncertainty set to prevail into the foreseeable future, as professional managers of risk, macroeconomic shocks such as unexpected inflation challenge *takāful* operators' role in society, however, they also offer opportunities. Nevertheless, *takāful* operators need to react to inflationary pressure in order to maintain the overall risk and cost-bearing capacity. With that in mind, this theme takes a timely look at the impact of inflation and rising policy rates on the *takāful* business and considers potential responses to the challenges they pose. This is expected to provide useful insight for takāful operators on how they can adapt to continue to meet customer needs.

The immediate impact of inflation on general *takāful* (property and casualty, and health) operators' earnings is negative, primarily through rising future claims costs on current contracts and policies, the need to bolster loss reserves, and probably, reduced demand. Loss reserves are typically set based on the assumption that recent years' inflation rates will continue. For some casualty lines of business, however, loss settlement periods may take decades. Therefore, if inflation starts to rise, the loss reserves established to settle these claims will prove insufficient.[99] Any reserve increase will diminish the insurer's earnings and shareholders' equity.[100]

Administrative expense inflation presents another challenge and impacts family *takāful* operators' earnings. This is particularly relevant to the administration of long-term policies with fixed contributions where the administrative expenditure contributions load could soon prove insufficient to cover actual expenses. The effect on family *takāful* operators' earnings is limited. As opposed to general *takāful*, most family *takāful* products, e.g., mortality, wealth accumulation, and longevity protection, offer benefits that are nominally fixed. As a result, inflation tends to erode the value proposition of family *takāful* with fixed benefit payouts, weighing on new business and leading to higher lapses.

Lower equity markets, rising interest rates, and widening credit spreads adversely affect *takāful* operators' balance sheets through mark-to-market valuation losses. On the other hand, higher policy rates, i.e., discount rates, have a favourable effect on the net present value of future liabilities. There is a wide range of management actions operators can take to respond to the new macroeconomic environment. In terms of product design, with customers typically suffering a reduction in real income, *takāful* operators could offer more affordable, low-cost products with an increased focus on risk and loss prevention.

Cost discipline and operational excellence achieved by a high degree of automation and digitalisation enable *takāful* operators to minimise the cost burden borne by customers. This will assist them in maintaining the drive to improve operational cost efficiency and overall productivity (i.e., output per employee). Obviously, digitalisation is a key route to achieve this objective in areas such as distribution (the biggest non-claims cost block), marketing and customer service. In addition, digitisation and automation constitute crucial levers to counter the increase in operating costs. Substantial efficiency gains resulting from such endeavours can drive down cost ratios and will ultimately strengthen the resilience of our industry.

The main underwriting response is to reprice *takāful* (policy) risks that exhibit elevated claims costs. The need and scope for doing so depend on the competitive environment in the relevant markets, takāful operators' assumptions concerning central banks' ability to tame inflation within a reasonable period and the degree of public policy and regulatory constraints and interventions.

[99] Dorofti and Jakubik 2015
[100] The Geneva Association 2019. Author: Kai-Uwe Schanz; Baumol 1993; Masterson 1968

In investment management, there is some scope for inflation protection on the back of tactical asset allocation, for example, by tilting the investment portfolio away from fixed-income securities towards commodities, equities and real estate. For *takāful* operators, however, such benefits remain elusive in light of very high solvency capital requirements for those asset classes. Inflationary episodes typically cause lower economic growth or even recessions, hurting demand for protection, especially in areas where customers consider protection covers a discretionary or non-essential expense. However, it argues that for customers, and society at large, the value of protection coverage increases in times of inflation.[101]

Going forward, demand for *takāful* products could benefit from the shock experience of resurging inflation, typically affecting risk perception and sharpening risk awareness. Demand for general *takāful* products could also benefit from portfolio shifts from financial to real assets. Furthermore, increasing prices of real assets such as cars and property translate into higher demand for *takāful* policies as asset owners seek to expand policy limits. For family *takāful*, inflation presents particular challenges, as it erodes the value of future fixed payouts, making in-force family *takāful* products less attractive, adversely impacting sales, and increasing lapses and surrenders. However, the effects of inflation on policy rates are widely considered more relevant. Customers might have more appetite for savings-oriented family *takāful* products that come with higher yields and inflation-protection features.

Pricing review - How are Takāful operators responding to inflation?

In the current uncertain global financial condition, *takāful* operators should closely monitor price developments, focusing on the drivers relevant to the respective coverages, such as repair costs, construction prices or medical inflation. Naturally, operators have to react to sustained cost increases by reviewing their pricing of risks.

However, the balance of an increase in pricing of risks (contributions) on the one hand, and potential adverse selection effects on the other, must always be kept in mind. The same logic applies to reserving, especially in long-tail business. In this context, rising policy rates can mitigate selection issues. It is critical to ensure that pricing is aligned with portfolio risks, and that contributions are adequate to cover the increasing compensation costs. Product design should also be reviewed. Lump-sum benefits, maximum sums covered, caps, and deductibles help limit maximum loss exposure while also reducing the extent of required premium adjustments. *Takāful* operators should endeavour to review and rationalise all major expense items, underwriting expenses, and other operating expenses in order to ensure a reasonable profit margin that would enable them to sustain operations and growth under extremely difficult economic conditions.

Losses resulting from catastrophes and extreme weather conditions have increased by 250% during the past three decades, with perils such as wildfires and storms seen as particularly impacted by climate change, causing a high rise in insured losses.[102] The increasing magnitude, frequency, and severity of natural disasters have caused many insurers of property and casualty lines to change their approach and policies in providing insurance coverage and reshaping their business models. Globally, *takāful* markets have had their fair share of natural disasters, such as flooding and earthquakes, during 2021 and 2022 in Indonesia, Malaysia, Oman, Pakistan, Sudan, and Yemen, which have resulted in economic damages.

[101] The Geneva Association 2022
[102] Swiss Re Sigma July 2022

If *takāful* operators properly manage the challenges ahead and limit negative effects on profitability, the impact will be limited on market capacity, which is needed to close protection coverage gaps. Furthermore, repricing or hardening will help to keep the business attractive. Some strategies that can restore profitability in the coming period are product innovation and underwriting techniques, better pricing allowing for scientific methods, increased reliance on digitalisation, and concentration on niche segments. This, combined with the improved and more transparent framework to inform capital allocation decisions and working capital management, would lead to improved financial performance and drive sustainable profitability from 2023 onwards.

BOX ARTICLE 5:

Takāful Insurance Sector In the UAE: Regulatory Development and Market's Updates

Contributed by:
Central Bank of the United Arab Emirates

Introduction

Takāful insurance (Islamic insurance) is an important constituent of the insurance sector in the UAE. The UAE is a pioneer in this area, hosting *takāful* insurance since 1979 after the establishment of the first *takāful* Company operating in a dual system. This box article gives an overview of the *takāful* market in the UAE and provides insights into its regulatory development.

The Dawn of *Takāful* Insurance in the UAE

Takāful insurance has been offered in the UAE insurance market since the establishment of the Islamic Arab Insurance Company (SALAMA) in 1979. Since then, many *takāful* insurance companies have penetrated the market to meet the increased demand for this business. The year 2015 marked the first instance globally for an insurance company to convert to a fully-fledged *takāful* Insurance company: Arabian Scandinavian Insurance (Ascana – *Takāful*). Recently, an increased level of merger and acquisition activities has been observed among *takāful* insurance providers with the aim of building bigger and more efficient *takāful* insurance companies.

The *Takāful* Insurance Regulatory Landscape in the UAE

The UAE witnessed supervisory and regulatory evolution with the issuance of Decretal Federal Law No. (25) of 2020, which mandated the merger of the Insurance Authority into the Central Bank of the UAE (CBUAE). This serves as part of the UAE's strategic objective to transform its regulatory landscape, promote financial system stability, and protect public and policyholder interests.

Evolution of Insurance Regulatory Authorities in the UAE

Source: *Takāful* Insurance Report 2022, Central Bank of the UAE

In 2010, the UAE became the first country in the MENA region to issue regulations pertaining to *takāful* insurance. These regulations were updated by the newly issued *takāful* Insurance Regulations in 2022. These regulations aim to set the minimum requirements for *takāful* insurance companies, ensuring their soundness and compliance with *Sharīʻah* rules and principles.

Another milestone in the *takāful* insurance regulatory framework is the issuance of Standard Re. *Sharīʻah* governance for *takāful* insurance companies. It aims to set the minimum requirements for companies to ensure their compliance with Islamic *Sharīʻah* provisions in all their objectives, activities and operations. This standard enhances current *Sharīʻah* governance practices, in particular internal *Sharīʻah* controls, by moving from a single line of *Sharīʻah* control to adopting the three lines of defence approach.

The Three Lines of Defence Approach

i.

The first line of defence is represented by the business line, which shall set clear policies, procedures, and controls, approved by the Internal *Sharīʼah* Supervision Committee (ISSC), for executing the business activities in a manner compliant with Islamic *Sharīʼah* provisions at all times.

ii.

The second line of defence is represented by the Internal *Sharīʼah* Control Division, which undertakes various functions related to the ISSC Secretariat, *Sharīʼah* consultations, *Sharīʼah* research & development, *Sharīʼah* compliance and *Sharīʼah* training. This division shall not be organisationally part of any business division or reporting to it.

iii.

The third line of defence is represented by the Internal *Sharīʼah* Audit Division, which undertakes *Sharīʼah* audits and monitors compliance. This is conducted through an annual plan to collect and assess evidence of company activity and transactions to ensure their compliance with Islamic *Sharīʼah* provisions and the adequacy of internal procedures and *Sharīʼah* governance framework. This division shall not be organisationally part of any business division or reporting to it.

The Higher *Sharīʼah* Authority

The Higher *Sharīʼah* Authority (HSA) was established, and its members were appointed in accordance with resolutions enacted by the UAE Cabinet. Decretal Federal Law No. (14) of 2018, regarding the Central Bank of the UAE and the organisation of financial institutions and amendments, reaffirmed the HSA's establishment and provided further details of its mandate. Due to the Insurance Authority's merger with the CBUAE, the HSA's Charter was amended to include *takāful* insurance as part of its mandate.

The HSA aims to harmonise and standardise the practices of Islamic Financial Institutions (IFIs), aligning them with internationally recognised *Sharīʼah* standards. This is to support the creation of a robust infrastructure that enables further development of the country's Islamic finance industry and advances the UAE's vision of becoming a hub for Islamic finance.

The HSA's Main Functions and Responsibilities

i. Provide fatwas and *Sharīʿah* opinions on matters submitted to it by CBUAE or IFIs, including takāful insurance companies, and issue necessary resolutions and recommendations.

ii. Develop a framework for *Sharīʿah* governance and the issuance of fatwas, and the general rules and principles for conducting *Sharīʿah* compliant activities.

iii. Develop fit and proper criteria for the appointment, replacement, and termination of members and chairmen of Internal *Sharīʿah* Supervision Committees of IFIs.

iv. Introduce new international *Sharīʿah* standards, or adapt existing ones, and develop standard documentation on best practices for the IFI and establish parameters or criteria for conducting IFI activities.

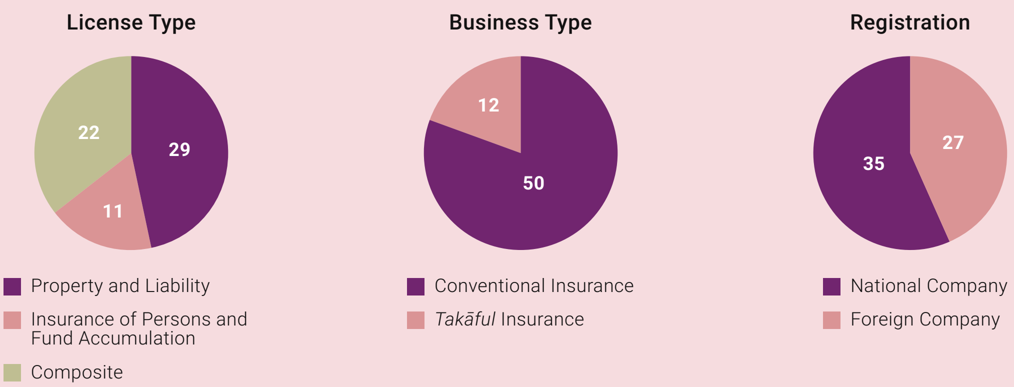
v. Review and approve the annual *Sharīʿah* reports of the Internal *Sharīʿah* Supervision Committees of IFIs before presenting them to their respective General Assemblies.

vi. Decide on disputes arising between the Internal *Sharīʿah* Supervision Committee and the management of an IFI.

Market Structure

The UAE insurance market includes 12 national *takāful* insurance companies; the remainder operate as conventional insurance firms. These *takāful* insurance companies are fully-fledged *takāful* firms; Islamic windows are not permitted for *takāful* insurance operations. It is worth noting that the number of *takāful* insurance companies declined in 2022, due to ongoing merger and acquisition activities.

Licensed Entities in the UAE insurance Sector

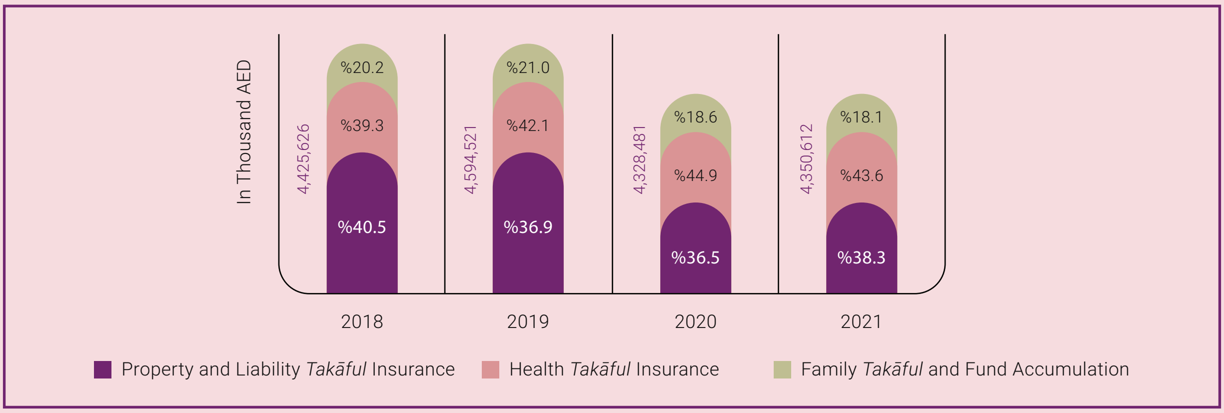


Source: *Takāful* Insurance Report 2022, Central Bank of the UAE

Performance of the *Takāful* Insurance Sector in the UAE

In 2021, the total Gross Written Contributions (GWC) grew by 0.51%, reaching AED 4.35 billion, compared to AED 4.32 billion in 2020. The amount of GWC represented 9.82% of the overall gross written premiums in the UAE insurance industry. Health *takāful* insurance represents the largest business type at 43.6% of the *takāful* insurance market, while family *takāful* and fund accumulation remained the smallest business type, recording 18.1%.

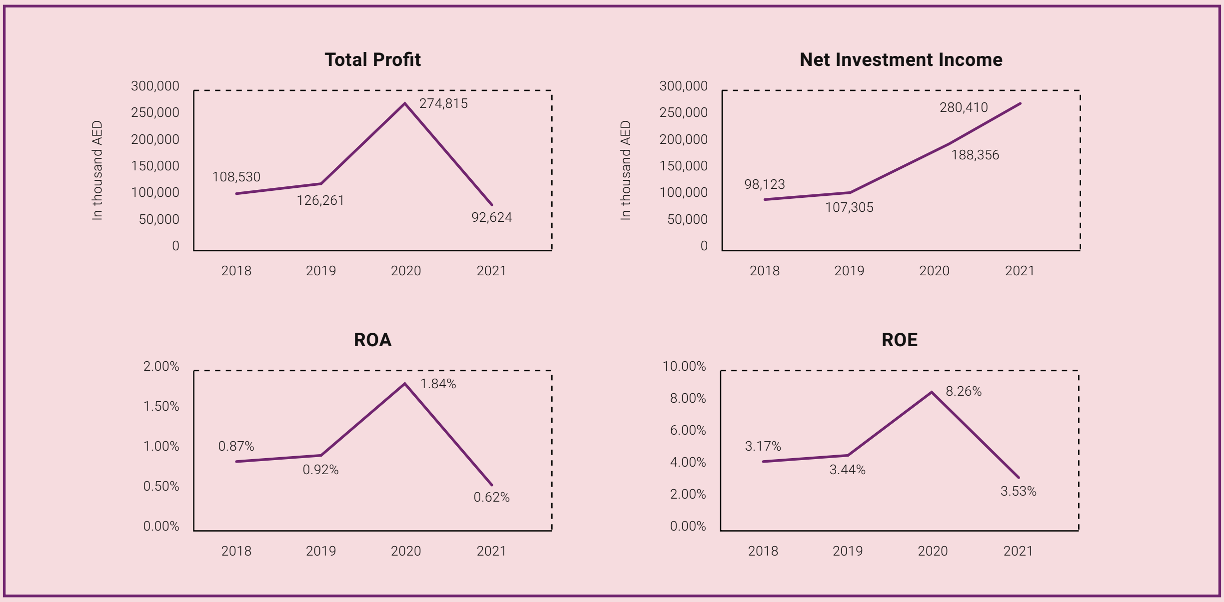
Gross Written Contributions Per Types of Business



Source: *Takāful* Insurance Report 2022, Central Bank of the UAE

In terms of profitability, *takāful* insurance companies recorded overall net profits of AED 92.6 million (USD 25.2 million) in 2021, compared to AED 274.8 million (USD 74.8 million) in 2020. The net underwriting income (also known as net underwriting surplus) decreased from AED 150 million in 2020 (USD 40.8 million) to AED 3 million (USD 0.817 million) in 2021. However, the net investment income witnessed notable growth of 48.9%, reaching AED 280 million (USD 76.2 million) in 2021, compared to AED 188 million (USD 51.2 million) in 2020. In 2021, the *takāful* insurance market's Return on Assets (ROA) declined to 0.62%, and the takāful insurance market's Return on Equity (ROE) declined to 3.53%.

Financial Performance of the *Takāful* Insurance Market



Source: *Takāful* Insurance Report 2022, Central Bank of the UAE

Conclusion

Takāful insurance is an important component of the UAE's Islamic finance landscape, as *takāful* insurance companies and other related stakeholders integrate and update their practices to lead the global *takāful* industry. The CBUAE will continue to promote the development of the sector and ensure the effectiveness and efficiency of its prudential practices, *Sharī'ah* governance, and conduct of business, in addition to undertaking various other initiatives related to sustainability, innovation and talent development.

3.0 CRITICAL ISSUES IN THE ISLAMIC FINANCIAL SERVICES INDUSTRY

This chapter addresses concerns related to the tightening global financial conditions and pre-existing vulnerabilities in the financial system mentioned in earlier chapters. It features three articles from members of the IFSB Secretariat that explore different aspects of the issue. The first article identifies liquidity management instruments in Islamic banking and associated operational, regulatory, and supervisory considerations. The second article discusses the regulatory challenges faced by Islamic Non-Banking Financial institutions and suggests a way forward. The third article summarises the recent failure of the Silicon Valley Bank and draws lessons for Islamic banks.

3.1 Liquidity Management Tools in Islamic Banking

Introduction

Effective liquidity risk management is crucial for the smooth functioning of financial institutions, including those that offer Islamic financial services. To manage liquidity risk well, financial institutions require high-quality liquid assets, stable funding sources, an appropriate balance between asset and liability maturity mismatches, and good management of over-the-counter (OTC) exposures. Liquidity pressure in one institution can impact other institutions, and disruptions in liquidity markets may affect the entire financial intermediation process and the real economy if not resolved promptly, given the strong interconnections between local, regional, and international financial systems.

Islamic financial institutions (IIFS) in many countries face numerous constraints in liquidity management, making it a challenging aspect of their operations. These challenges can be observed across different levels of the liquidity risk management framework, including institutional, interbank, and central bank levels. The limitations include various factors, inter alia:

- Lack of *Sharīʿah*-compliant money market activities or lack of an active *Sharīʿah*-compliant trading or repo market.
- Insufficient *Sharīʿah*-compliant mechanisms and tools that can be used to mitigate liquidity risks, and insufficient tools available to supervisory authorities to provide liquidity support to IIFS in normal and stressed market conditions.
- Insufficient consideration in open market operations of the needs of IIFS to meet monetary policy objectives.
- The absence of any form of *Sharīʿah*-compliant lender of last resort in most countries to protect the soundness and stability of IIFS in cases of severe liquidity pressure.
- The Islamic banking sector requires the management of *Sharīʿah*-compliant instruments to anticipate and meet a number of pressing liquidity needs, such as:
- Short-term placement of funds for liquidity management.
- Management of asset-liability mismatches.
- Financial risk management and hedging.
- Mobilise resources at a competitive cost.
- Balance-sheet management through securitisation.

The next sections of this article will go through types of liquidity risk, the importance of the Islamic money market, existing IFSB publications on managing liquidity risk, and then issues and challenges related to the availability of *Sharīʻah*-compliant liquidity risk management tools and finally, different models of *Sharīʻah*-compliant liquidity risk management tools.

Types of Liquidity Risk

Islamic financial institutions (IIFS) face two types of liquidity risk: market-related liquidity risk and fund-related liquidity risk. Market-related liquidity risk arises due to the inability of the bank to monetise assets in a timely manner and at reasonable market prices or due to adverse market conditions. Fund-related liquidity risk is the possibility that the IIFS will be unable to refinance its activities or fail to meet its financial obligations when due, and the consequent mismatch in liquidity positions when liabilities mature significantly shorter than asset maturities. Central bank liquidity is also relevant, as IIFS hold these balances to meet mandatory reserve requirements and complete the final settlement of financial transactions in the payment system. Therefore, there are three types of liquidity shortages:

- a shortage of *Sharīʻah*-compliant central bank liquidity;
- a critical shortage of funding liquidity at specific institutions; and
- a systemic shortage of funding and market liquidity.

In managing liquidity risk, it is important to consider its interaction with other types of risks. IIFS face various risks, and credit risk can transform into liquidity risk if an IIFS faces major defaults in its financing and investment asset portfolio. Uncertain asset quality can also make it difficult for IIFS to obtain funding from the market or re-sell an eligible asset portfolio to another IIFS. Additionally, failures in counterparty information and operating systems, or problems with the payment and settlement systems, can lead to increased liquidity risks for IIFS.

Furthermore, IIFS that invest in long-term assets have a problem with short-term deposits, liabilities, and obligations which aggravates the liquidity mismatch issue. The development of appropriate Islamic liquidity risk-management tools is necessary to bridge this gap. As IIFS make up a small proportion of the financial system in some areas, *Sharīʻah*-compatible money-market instruments that are acceptable to both Islamic and conventional institutions need to be created to develop Islamic finance.

The Importance of the Islamic Money Market

The Islamic money market is essential for managing liquidity risk in IIFS. However, in many countries, it is not developed enough to meet the needs of IIFS. There is a lack of *Sharīʻah*-compliant financial instruments, which can affect the flow of liquidity between IIFS. The development of new products and innovations is necessary to enable IIFS to manage its liquidity gaps and to remove the disadvantages they face compared to conventional banks.

The lack of suitable financial instruments in the Islamic finance market leads to oversubscription and limited access to the market. A deep secondary market is necessary for liquidity; however, it may be shallow due to insufficient participants, regulations, or available instruments. This can lead to difficulties for IIFS seeking liquidity through asset sales and increasing market-related liquidity risks.

The lack of a mature market for *Sharīʿah*-compliant instruments like *ṣukūk* in many countries has increased market risks for Islamic financial institutions holding these instruments, as the deterioration of liquidity in the market may affect a wide range of assets. Additionally, over-the-counter markets for *ṣukūk* suffer from a lack of supply, resulting in a hold-to-maturity policy by *ṣukūk* holders. This may force IIFS to hold other less liquid assets.

Existing IFSB Publications on Managing Liquidity Risk

In the past, the IFSB has published a number of guidance documents in an effort to provide direction regarding liquidity risk management in IIFS. The relevant publications include:

- **TN-1**: Technical Note on Issues in Strengthening Liquidity Management of Institutions Offering Islamic Financial Services: The Development of Islamic Money Markets (March 2008); The objective of the technical note (TN) was, inter alia, to support the development of efficient trading arrangements and the associated market microstructure for Islamic money and Government finance instruments, and the development in parallel of the foreign exchange markets; and to provide supervisory guidance and incentives for effective liquidity risk and asset liability management by IIFS, and in parallel to foster privately issued Islamic money market securities.

- **GN-2**: Guidance Note in Connection with the Risk Management and Capital Adequacy Standards: Commodity *Murābahah* Transactions (December 2010); the GN has highlighted the risks associated with Commodity *Murābahah* Transactions (CMT) and products of similar design and structure, and to assess their implications in relation to the regulatory capital requirements in institutions offering only Islamic financial services (IIFS).

- **IFSB-12**: Guiding Principles on Liquidity Risk Management for Institutions Offering Islamic Financial Services (March 2012); The standard provided guiding principles for the robust management of liquidity risk by IIFS and its vigorous supervision and monitoring by the supervisory authorities, taking into consideration the specificities of the IIFS and complementing relevant existing and emerging international best practices.

- **GN-6**: Guidance Note on Quantitative Measures for Liquidity Risk Management in Institutions Offering Islamic Financial Services (April 2015); The main objective of the GN is to provide guidance to supervisory authorities on the application of the LCR and NSFR in their jurisdictions and on their role in assessing the discretionary items specified in this GN, including the application of the alternative liquidity approaches (ALA).

- **GN-7**: Guidance Note on *Sharīʿah*-Compliant Lender-Of-Last-Resort Facilities (December 2019); The GN covered, among others, the preconditions for developing and implementing a SLOLR mechanism, including considerations of moral hazard and achieving a level-playing field between the conventional and Islamic systems; and *Sharīʿah* perspectives on instruments, and operating modalities for developing SLOLR facilities for IIFS.

- **IFSB-23**: Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services (Banking Segment) (December 2021); the standard has provided some insights on the use of CMT, *wakālah* and *mudārabah* in placement with the central bank and interbank market.

- **WP-01**: Strengthening the Financial Safety Net: The Role of *Sharīʿah*-Compliant Lender-of-Last Resort Facilities as an Emergency Financing Mechanism (April 2014). This latter is not an IFSB Standard but was an important step towards the development of GN-7.

Issues and Challenges Related to the Availability of *Sharī`ah*-Compliant Liquidity Risk Management Tools

IIFS face the risk of liquidity pressures which can lead to bankruptcy. Their ability to meet cash flow obligations, such as mandatory cash reserves and payment to creditors, depends on cash inflows from investment accounts, new deposits, the sale of assets, and the mobilisation of new funds. However, since IIFS cannot obtain interest-based loans from interbank markets or other sources, the lack of available *Sharī'ah*-compliant securities in many jurisdictions exacerbates the problem. As a result, IIFS must maintain a higher level of cash and non-profit liquid assets compared to conventional institutions, which affects their competitiveness.

Liquidity risk management is particularly challenging for IIFS because, unlike their conventional counterparts, these banks cannot hold interest-based deposits with other financial institutions or high-quality interest-based liquid assets, nor can they borrow through the traditional interbank market, while at the same time maintaining excess cash balances that cost the bank as non-yielding. In most jurisdictions, this challenge puts IIFS at a disadvantage compared with their conventional counterparts that can access central banks' standard interest-based lending and deposit facilities. This uneven playing field compounds the liquidity risk-management challenge for IIFS.

In the past, IIFS have held more liquid assets than conventional banks, which has impacted their efficiency and profitability negatively. However, as the industry has progressed, liquidity risk management tools and infrastructures have evolved. Despite this, the use of currently available liquid instruments for IIFS is limited due to challenges related to tradability, inactivity or maturity of the secondary market, and cross-border transactions.

The issues and challenges related to the availability of *Sharī'ah*-compliant liquidity risk management tools (SLRMT) can be summarised into the following points:

1. **Limited supply of short-term *ṣukūk***: The supply of short-term *ṣukūk* is limited because they are usually held until maturity, making it difficult to have enough available for trading in the market. Additionally, most *ṣukūk* issued by governments or the IsDB have long maturities because the projects they finance have medium or long-term maturities.

2. **Insufficient tools that meet high-quality liquid assets (HQLA) criteria**: IIFS could meet the minimum liquidity coverage ratio (LCR) requirements, but they face challenges in finding enough *Sharī'ah*-compliant high-quality liquid assets (HQLA) to include in their liquidity buffer. Most of their HQLA are in the form of non-interest-bearing assets such as coins, banknotes, and central bank reserves, which do not provide returns for IIFS. Additionally, HQLA must have low risk, be stable, easy to value, and eligible for liquidity facilities, which is not always possible for *Sharī'ah*-compliant assets in some jurisdictions.

3. **Possible excessive dependence on commodity *murābahah* transactions**: When a commodity is sold or bought on a deferred-payment basis, the asset becomes a debt, which cannot be traded unless at par value. This lack of tradability significantly limits how useful the contract is in managing liquidity risk. Ideally, it should be possible to easily buy and sell the instrument on the secondary market to balance the bank's liquidity position.

4. **Issues with interbank placements**: The interbank deposit placement is, however, not a preferred way for IIFS – or indeed conventional banks – to manage their liquidity for two reasons:

    - Deposits placed in other banks do not meet HQLA criteria (if the placement is for more than 30 days maturity). To meet the LCR set by Basel III, it is crucial to place excess liquidity in HQLA. Since Islamic banks that hold funds also face liquidity problems, interbank deposits are also subject to counterparty risk – the risk that the other Islamic banks cannot meet the obligation when it is due.

    - Banks' liquidity positions tend to move in a similar manner, especially during a significant macroeconomic event. For example, during a recession, most banks will be short of liquidity, and interbank deposits will automatically cease to exist as banks do not have excess funds to deposit.

5. **Shortage of *Sharī'ah*-compliant foreign-currency instruments**: IIFS use limited *Sharī'ah*-compliant tools such as Islamic foreign currency swaps and forward transactions to hedge their foreign currency exposure. However, authorities and IIFS need to develop additional *Sharī'ah*-compliant alternatives for foreign exchange hedging and risk management arrangements. Although IIFS cannot enter into forward sale and purchase agreements, they can use promise-to-sell and purchase agreements to sell or purchase foreign currencies in the future.

6. **No form of *Sharī`ah*-compliant lender-of-last-resort (SLOLR) scheme, in most jurisdictions**.

7. **Lack of *Sharī`ah*-compliant collateral**: The availability of *Sharī'ah*-compliant collateral is essential for IIFS to obtain support from liquidity facilities, particularly in emergencies or normal times. However, in many jurisdictions where IIFS operate, there is a shortage or unavailability of *Sharī'ah*-compliant instruments such as *ṣukūk* issued by governments or supervisory authorities.

8. **Differing interpretations of *Sharī`ah* rulings**: Different interpretations of *Sharī'ah* rulings or fatwas on financial matters have resulted in various methods of structuring or packaging financial instruments, or in some cases, non-recognition of certain types of contracts. This has affected the development of Islamic money markets, particularly across borders.

During the development of TN-5, the IFSB conducted surveys to gather information from regulatory and supervisory authorities as well as market players and also sought feedback from key stakeholders. The survey results show the main challenges with SLRMT are that interbank, money, and capital markets are absent or too limited because:

- the Islamic banking sector is still developing;
- local instruments are not accepted in other markets due to different *Sharī`ah* opinions;
- there is no robust SLRMT that Islamic banks can use to manage liquidity risk; and
- the available Islamic instruments that meet the requirements of being HQLA, tradable, low-risk, and predictable in providing a return are limited

According to the same survey, when asked about the main challenges they face with regard to the SLRMT, IIFS have mentioned:

- limited, or no, *Sharī`ah*-compliant instruments and mechanisms;
- an underdeveloped interbank market for Islamic instruments;
- a shortage of tradable instruments;
- *Sharī`ah* restrictions on certain tools and mechanisms; and
- different *Sharī`ah* interpretations, which limits the number of counterparties they can deal with (this applies to countries with no central *Sharī`ah* board).

Different Models of *Sharī`ah*-Compliant Liquidity Risk Management Tools

The development of Islamic money market infrastructure can provide a level playing field for IIFS, reduce costs, enhance liquidity and profitability, and macroprudential stability. It can also reduce the likelihood of liquidity shortages and the spread of systemic contagion across financial markets. Therefore, the central bank should encourage the issuance of tradable Islamic instruments that are suitable for both its monetary and liquidity management businesses in IIFS.

The IFSB is working on publishing a technical note (TN-5) for liquidity risk management instruments. The specific objectives of this TN-5 are to:

- Enumerate liquidity risk management tools and examine their *Sharī`ah* compliance and assess their regulatory and supervisory implications.
- Assess the needs of the IIFS and provide recommendations in dealing with liquidity risk management issues.
- Propose illustrative versions of *Sharī`ah*-compliant tools to be used for liquidity risk management purposes.
- Provide technical guidance on the modus operandi of the *Sharī`ah*-compliant liquidity risk management tools.

Central banks use open market operations to manage liquidity by offering repurchase agreements, reserve requirements and bank deposits. Banks use these to manage liquidity and earn a return. It is crucial for central banks to include *Sharī`ah*-compliant instruments in open market operations. However, only a few have modified these to accommodate transactions with Islamic financial institutions.

IIFS can obtain liquidity from the central bank through overnight liquidity support, standing liquidity facilities, or as a *Sharī`ah*-compliant lender of last resort (*Sharī`ah*-compliant lender of last resort as detailed in the IFSB GN-7). However, the provision of funds in this manner must be at a "punitive" rate and requires the use of a specific mechanism.

TN-5's fifth section outlines *Sharī`ah*-compliant liquidity risk management tools that central banks can use. It also provides models for Islamic interbank markets, short-term *ṣukūk*, and certificates, which are summarised in the following table:

Table: 3.1.1 Different Models for *Sharī`ah*-Compliant Liquidity-Risk-Management Tools

Models for Deposits with Central Banks	Models for Obtaining Funds from a Central Bank	Islamic Interbank Instruments	Short Term *Ṣukūk* and Certificates	*Sharī`ah*-Compliant FX Risk Management Models
Qard	Commodity *Murābahah* Central Bank Funding Model	*Mudārabah* Model for Interbank Investment	Salam *Ṣukūk*	Wa'd Forward Foreign Currency Exchange
Wakālah Central Bank Deposit Model	Collateralised Commodity *Murābahah* Central Bank Funding Model	*Wakālah* Model for Interbank Investment	*Murābahah Ṣukūk*	
Wakālah Certificates of Deposit	Qard Central Bank Overnight and Intraday Funding Model	Commodity *Murābahah* Interbank Deposit Model	*Ijārah Ṣukūk*	
Commodity *Murābahah* Central Bank Deposit Model	Sell & Buy-Back (Islamic REPO) Model	*Mudārabah* Interbank Investment Certificates	*Mushārakah Ṣukūk*	
	Wakālah Model for use of collateral for Central Bank Funding	Sell and Buy-Back Islamic Interbank Model	*Wakālah Ṣukūk*	
		Collateralised Commodity *Murābahah* Islamic Interbank Model	*Mudārabah Ṣukūk*	
		Islamic Interbank Qard Model		

3.2 Islamic Non-Banking Financial Institutions: Regulatory Challenges

Introduction

Financial institutions are categorised into banking and non-banking entities (NBFI) (IsDB, 2016; BIS, 2022a). Banking institutions comprise commercial banks, financial companies, and merchant banks, whereas NBFIs[103] are considered a sub-sector for banking institutions (IsDB, 2016; World Bank, 2016; BIS, 2022a). NBFIs are vital components of the financial system's development as they play significant roles in society as well as contribute to the country's economy (FSB, 2015; FSB, 2018; FSB, 2020a; FSB, 2020b; FSB, 2021). Admitting that banks are the dominant form of financial intermediaries in most economies, NBFIs complement the activities of banks by providing various services (World Bank, 2016). NBFIs provide diversity in the financial sector and perform various essential functions towards the growth of the economy (World Bank, 2002; World Bank, 2004).

The rapid surge of the NBFI sector, however, tends to trigger several regulatory and supervisory issues as banks' exposures are getting larger, whereas it varies amongst jurisdictions (BIS, 2022b). In fact, banks engage with NBFIs across a wide range of transactions, where common NBFI counterparties for banks are investment and pension funds as well as insurance and *takāful* companies. Banks are also exposed to NBFI counterparties through more complex instruments in the areas of derivatives and securities financing, which might eventually trigger systemic risk and liquidity imbalance in distressed situations (BIS, 2022a; World Bank, 2002; FSB, 2020a; FSB, 2020b; FSB, 2021).

Based on the aforementioned insights, an extensive literature review is conducted in order to identify the main challenges related to Islamic NBFIs. Recommendations are also provided to regulators and policy makers to ensure the stability of the Islamic finance sector. The remainder of this article is divided as follows: Section Two illustrates the development of the Islamic NBFI sector. Section Three discusses the main challenges faced by the Islamic NBFIs towards a sustainable and resilient Islamic finance sector. Section Four concludes and provides policy recommendations for regulators and policy makers.

The Development of the Islamic NBFI Sector

As part of the global financial sector, the Islamic finance industry has experienced significant growth during the last decade due to the development of the Islamic banking industry, which constitutes the dominant sector (IFSI, IFSB Stability Report, 2022). Moreover, the Islamic NBFI sector has remarkably contributed to the rapid surge of the Islamic finance industry, mainly via *takāful*, ICM, pension funds, and Islamic collective investment schemes (IFSI, IFSB Stability Report, 2022; World Bank, 2016). The Islamic NBFI sector can be classified into five categories, as illustrated in Figure 1:

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[103] Previously, the FSB defined shadow banking as "credit intermediation involving entities and activities (fully or partly) outside the regular banking system, or non-bank credit intermediation in short." (FSB, 2015). At the 2018 Plenary meeting in Ottawa, the Financial Stability Board (FSB) decided to replace the term "shadow banking" with the term "non-bank financial intermediation" (FSB, 2018). Overall, NBFIs encompass the insurance and takāful sector, cooperatives, micro-financing, fund management, and pawnbroking (IsDB, 2016; BIS, 2022a).

Figure 1: Classification of Islamic NBFS Sector

Islamic asset management, venture capital and private equity companies that provide investment-related services for their institutional and corporate clients

***Takāful* and micro *Takāful* operators** that are *Sharī'ah* compliant cooperative systems of reimbursement or repayment in care of loss

Islamic Microfinance and Micro-savings that provide small amounts of fundings, typically to the underbanked (those not served by financial institutions)

Corporate foundations providing philanthropic services such as awqaf (Islamic foundations, endowments and trusts)

Hajj Funds allowing Muslims from different income groups to finance travels and accommodations for pilgrimages at various stages of their lives

Source: World Bank (2016)

The composition of the Islamic NBFI sector differs from country to country, depending on the legal environment and the organisations that exist (FSB, 2021; BIS, 2022a; World Bank, 2016). With the exception of a few countries, the non-bank financial sector is relatively underdeveloped in most emerging economies in general and in member countries of the Islamic Development Bank (IDB) in particular (BIS, 2022; World Bank, 2016). Although the Islamic banking systems in the Middle East and North Africa (MENA) are generally large relative to other regions (IFSB, IFSI Stability Report, 2022), the NBFIs are mostly undeveloped (World Bank, 2011). South-East Asia, however, has a vibrant Islamic NBFI sector, with a wide range of financial institutions providing a diversity of financial products (World Bank, 2016). The growing role of Islamic NBFIs in South-East Asia over the past decade has been driven by various factors. Such as:

(i) regulatory reforms;
(ii) demographic changes;
(iii) greater importance of Islamic capital markets;
(iv) technological changes; and
(v) the pursuit of operational efficiencies (BIS, 2022a).

Nevertheless, additional effort is needed when addressing peculiar issues[104] mainly related to:

(i) regulations;
(ii) systemic risk and liquidity Imbalance; and
(iii) *Sharī'ah* governance with the aim to ensure the stability of the Islamic NBFI sector in jurisdictions offering IIFS.

In fact, the most remarkable difference between Islamic and non-Islamic NBFIs is the Sharī'ah non-compliance risk, which is mostly linked to their financial operations and governance structure. Another significant difference can also be attributed to the fact that Islamic NBFIs business models have to take into account the social and environmental aspects, besides the financial perspectives, with the aim to fulfil *Sharī'ah* objectives (preserving wellbeing and capital).

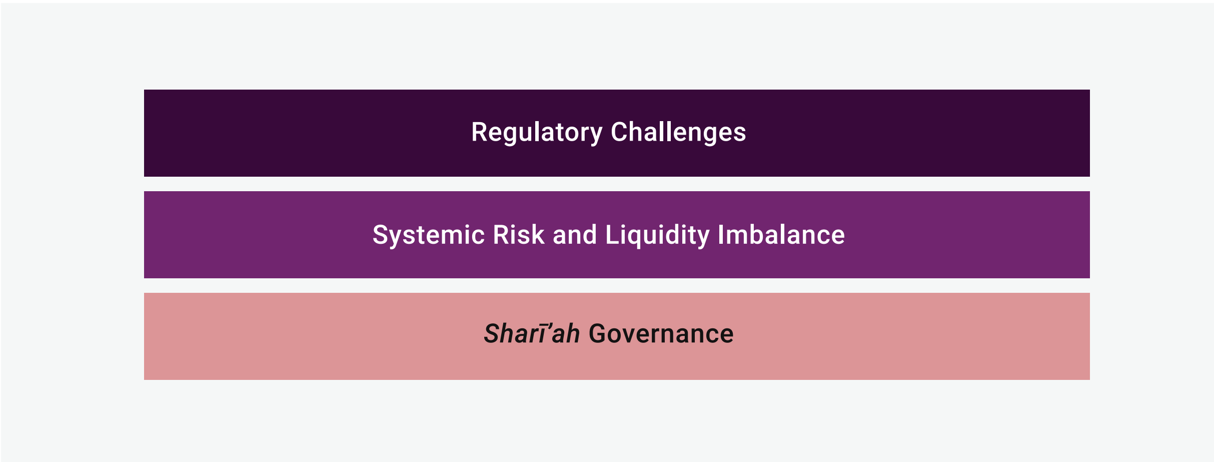
[104] The issues related to legal Infrastructure, incentives for the Growth of NBFIs, and Tax incentives are not addressed in this article as they are not within the scope of the IFSB. Only regulatory and supervisory issues are considered, along with governance and risk managemen challenges as per the IFSB mandate.

From a risk management point of view, Islamic and non-Islamic NBFIs are basically facing the same risks especially when it comes to liquidity imbalance. The intensity of liquidity imbalance issues tend to be severe for Islamic NBFIs (subject to their size and the complexity of their operations) compared to conventional counterparts, as the access to Sharī'ah-compliant liquidity management tools is limited, besides the lack of an in-depth Islamic capital market in most jurisdictions offering IIFS. Thus, regulators have to make sure that required processes are in place to ensure a continuous assessment of Islamic NBFIs' growth. The dynamic assessment shall enable RSAs to identify vulnerabilities and consider necessary actions if needed with the aim to ensure the stability of the Islamic finance sector.

Challenges Related to Islamic NBFIs

Based on an extensive desktop review of the relevant studies in the field issued by BIS, FSB, World Bank, and IsDB, among others, several issues have been identified. Addressing these issues, therefore, is crucial to ensure the stability of the Islamic finance sector due to the strong interconnectedness between banks and NBFIs (World Bank, 2016; FSB, 2020a; FSB, 2020b; FSB, 2021; BIS, 2022b).

Figure 2: Challenges Related to Islamic NBFIs



Source: World Bank (2002, FSB, BIS)

Regulatory challenges: The rapid surge of Islamic NBFIs increased Islamic banks' exposures due to the significant interconnectedness between banks and NBFIs (BIS, 2022b). To this extent, RSAs advised IIFS to take rigorous measures to ensure:

- (i) sufficient governance and risk management frameworks, including risk monitoring and stress testing in relation to the business strategy;
- (ii) adequate collection of information on clients' positions and exposures as part of due diligence;
- (iii) the existence of comprehensive financing limit frameworks;
- (iv) the presence of margining practices, including the use of adequately calibrated margining by some banks; and
- (v) the absence of regulatory arbitrage behaviour regarding the leverage ratio requirement (BIS, 2022b).

Overall, Islamic NBFIs can be negatively influenced when adopting repressive and inappropriate regulations. Repressive regulation can have a negative influence on the development of NBFIs, especially where it taxes the earnings of the regulated institution more heavily than those of its competitors or where it imposes balance sheet restrictions that constrain risk management. Repressive regulation in this context includes not only excessive licensing, capitalisation, and investment regimes but also situations where related regulations discriminate against NBFIs (World Bank, 2002). Inappropriate regulation or poorly designed regulatory structures can also stimulate Islamic NBFI growth for the wrong reasons, which creates incentives for regulatory arbitrage and the emergence of unanticipated systemic problems (World Bank, 2002, FSB, 2022).

Systemic risk and Liquidity imbalance: The types of Islamic NBFIs and the size of Islamic banks' exposures to NBFIs vary across jurisdictions offering IIFS (IFSB IFSI, Stability Report 2022; BIS, 2022). These exposures are growing in size and tend to cause financial stability concerns (BIS, 2022). In fact, the common NBFI counterparties for banks are investment (Islamic collective investment schemes) and pension funds, insurance and *takāful* operators and broker-dealers. Banks are also exposed to NBFI counterparties through more complex instruments in the areas of derivatives and securities financing, leveraged lending, and prime brokerage, which may give rise to counterparty credit and liquidity risks (BIS, 2022). These types of exposures raise concerns about risk concentration and potential sudden market stress that might be caused by fire asset sales or margin calls (BIS, 2022a; BIS, 2022b; World Bank, 2016). In fact, the NBFI sector itself has become a key source of spikes in liquidity demand, particularly from investment funds exposed to liquidity mismatches, such as money-market and bond/ or *ṣukūk* funds. To this extent, RSAs need to take into account any emerging vulnerabilities related to liquidity in *ṣukūk* markets, especially when dealing with open-end Islamic funds.[105] A massive redemption of invested units might lead to liquidity tension, which may trigger stability issues, subject to the size and complexity of Islamic open-end funds. To this extent, the availability of appropriate regulations, as well as necessary *Sharī'ah* requirements and liquidity management tools, is a must to mitigate liquidity issues.

The supply of liquidity is no longer the exclusive domain of bank dealers alone, as it increasingly involves NBFIs as well. Cases in point are the activity of principal trading firms (PTFs) in electronic markets and the trading strategies of certain hedge funds (BIS, 2022a; World Bank, 2016). *Takāful* undertakings might also trigger systemic risks due to liquidity imbalances in distressed situations, especially when dealing with emerging issues such as climate-related financial risks. In fact, *takāful* undertakings usually invest contributors' funds for the long term and are less likely to be adversely affected by an increase in the OPR, as they have no fiduciary obligations like Islamic banks. In contrast, liquidity risk might be triggered when for instance, a major climate change event strongly affects a specific sector such as agriculture.

In these situations, *takāful* undertakings might initiate the compensation process for their affected contributors. The liquidity of certain investments, therefore, might be challenging, as the increase in the OPR or policy rate usually leads to a decrease in long-term investments profitability, such as bonds and *ṣukūk*. Intuitively, the value of *takāful* undertakings' investments is most likely to be significantly deteriorated. Admitting that most jurisdictions offering IIFS do not have deposit insurance schemes for the *takāful* sector, a liquidity mismatch might be triggered, leading to systemic risk.

105 Islamic open-end funds refer to funds where investors have a right to have their units redeemed or repurchased at a value calculated based on the net asset value of the Fund Property.

As several recent episodes have shown, liquidity provisions by non-banks tend to be more opportunistic and more prone to evaporate at times of stress, with entities that generally provide liquidity suddenly turning into liquidity consumers (BIS, 2022a; World Bank, 2016). As broker-dealers have reassessed their business models and scaled back market-making activities, the supply of liquidity has become less responsive when the demand for it spikes. These structural shifts mean that liquidity imbalances have the potential to greatly affect prices and, in extreme cases, endanger financial instability. The "dash for cash"[106] turmoil at the height of the COVID-19 crisis painfully exposed such structural NBFI vulnerabilities and spillovers that affected other participants in the financial system. Ultimately, it was only central banks' flexible use of their balance sheets that arrested the adverse feedback loops and helped to restore market functioning.

***Sharīʻah* governance**: Islamic NBFIs and Islamic banks are part of the Islamic financial services, where their business activities and operations must necessarily comply with *Sharīʻah* principles. In fact, *Sharīʻah* governance is a vital organ in the Islamic NBFIs, that promotes transparency, fairness, and justice to all the contracted parties, which would ultimately enhance the confidence of the public, investors, and all the stakeholders (Ahmad and Ishak, 2021). The composition of *Sharīʻah* committee members in an Islamic NBFI necessarily depends on the size and complexity of the entity, meaning that proportionality should be respected (Ahmad and Ishak, 2021). As such, Islamic NBFIs do not require a large composition of *Sharīʻah* committees as compared to Islamic banks. Intuitively, Islamic NBFIs may have more flexibility in terms of establishing comprehensive governance depending on their needs, size and complexity of products and services. In addition, the *Sharīʻah* governance framework shall be consistent with the latest practices of the Islamic banking industry. Due to the rapid development of the Islamic NBFI sector, consistency is important. Otherwise, the Islamic NBFIs would be left behind.

Conclusion and Recommendations

The NBFI sector continues to grow and has the potential to cause financial stability concerns, whereas its size and the associated risks vary amongst jurisdictions offering IIFS (BIS, 2022b). To this extent, vulnerabilities and deficiencies may appear in some banks' management practices related to NBFIs, due to exposures to highly leveraged counterparties via derivatives, securities financing and commodities, as well as crypto assets (BIS, 2022b).

In this regard, IIFS are encouraged to improve their practices by reviewing and enforcing existing guidelines and standards.[107] Precisely, more focus is needed with regard to Islamic banks' risk management practices, governance and monitoring, risk-sensitive margining, and disclosures from investment fund counterparties (BIS, 2022b). Furthermore, special consideration should be given to *Sharīʻah* governance to make sure that all Islamic NBFIs business activities and operations are in line with *Sharīʻah* principles. This enables Islamic NBFI operators to mitigate the rise of potential *Sharīʻah* misconduct, harming their reputation.

Finally, it is advised to continue the exchange of regulatory and supervisory views on Islamic banks' exposures to NBFIs, including liquidity concerns in the non-bank sector and related practices. As per its mandate, the IFSB shall continue to provide assistance and guidance on assessing and addressing the risks emanating from the rapid surge of the Islamic NBFI sector to ensure the resilience of the Islamic finance sector.

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IFSB-8: Guiding Principles on Governance for *Takâful* (Islamic Insurance) Undertakings

IFSB-9: Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services

IFSB-10: Guiding Principles on *Sharî`ah* Governance Systems for Institutions offering Islamic Financial Services

IFSB-11: Standard on Solvency Requirements for *Takâful* (Islamic Insurance) Undertakings

IFSB-12: Guiding Principles on Liquidity Risk Management for Institutions offering Islamic Financial Services

IFSB-14: Standards on Risk Management for *Takāful* (Islamic Insurance) Undertakings

IFSB-18: Guiding Principles for *retakāful* (Islamic Reinsurance)

IFSB-19: Guiding Principles on Disclosure Requirements for Islamic Capital Market Products (*Ṣukūk*and Islamic Collective Investment Schemes)

IFSB-20: Key Elements in the Supervisory Review Process of *Takâful/Retakâful* Undertakings

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

IFSB-24: Guiding Principles on Investor Protection

IFSB-25: Disclosures to Promote Transparency and Market Discipline for *Takāful/Retakāful* Undertaking and; IADI-IFSB Core Principles for Effective Islamic Deposit Insurance Systems

IFSB_TN 3: Technical Note on Financial Inclusion and Islamic Finance

[107] **General (Banking and non-banking)**: IFSB-12: Guiding Principles on Liquidity Risk Management for Institutions offering Islamic Financial Services; IFSB-10: Guiding Principles on *Sharī'ah* Governance Systems for Institutions offering Islamic Financial Services; IFSB-9: Guiding Principles on Conduct of Business for Institutions offering Islamic Financial Services.
Microfinance: (TN 3) Technical Note on Financial Inclusion and Islamic Finance.
ICM: IFSB-19: Guiding Principles on Disclosure Requirements for Islamic Capital Market Products (Sukûk and Islamic Collective **Investment Schemes); IFSB-21**: Core Principles for Islamic Finance Regulation (Islamic Capital Market Segment); IFSB-24: Guiding Principles on Investor Protection; IFSB-7: Capital Adequacy Requirements for Sukûk, Securitisations and Real Estate Investment; IFSB-6: Guiding Principles on Governance for Islamic Collective Investment Schemes.
Takaful: IFSB-8: Guiding Principles on Governance for *Takâful* (Islamic Insurance) Undertakings; IFSB-11: Standard on Solvency Requirements for *Takâful* (Islamic Insurance) Undertakings; IFSB-14: Standard On Risk Management for takāful (Islamic Insurance) Undertakings; IFSB-18: Guiding Principles for *retakāful* (Islamic Reinsurance); IFSB-20: Key Elements in the Supervisory Review Process of *Takâful/Retakâful* Undertakings; IFSB-25: Disclosures to Promote Transparency and Market Discipline for ***Takāful/Retakāful* Undertakings and; IADI-IFSB**: Core Principles For Effective Islamic Deposit Insurance Systems.

3.3 Recent Bank Failures and Lessons Learned for Islamic Banks

Following the Global Financial Crisis of 2008, the financial market experienced low-interest rates.[108] This reality would eventually come to an end, and following the COVID-19 pandemic, it finally did in many jurisdictions. With increasing inflation rates after the pandemic, several governments had to mop up that excess liquidity by increasing interest rates.

On 10 March 2023, the financial world awoke to one of the consequences of the policy rates hike - the collapse of the Silicon Valley Bank (SVB), followed by that of Signature Bank due to poor management, and in a classic case of the test of the banking reforms was the buy-out of Credit Suisse by UBS. Later, JP Morgan bought First Republic Bank, which failed due to having a larger share of its deposits in excess of the limit that the Federal Insurance Corporation in the US can cover. The occurrence of these events has opened up several discourses relating to the trickle effect, potential damage to the global financial market, prospective mitigation strategies, and, most importantly, possible implications for banks in general.

With particular reference to SVB, its failure can be primarily attributed to mismanagement and supervisory failures, as highlighted in a report by the Federal Reserve.[109] The report indicates that SVB failed to effectively hedge against risk, did not meet its liquidity stress test and prioritised short-term profitability over long-term stability and had supervisory deficiencies.

Based on those mentioned above and other notable factors that explain the recent incidence of bank failures, it is pertinent to consider the relative susceptibility of Islamic banks to such factors and what lessons can be learned therefrom. Specifically, this would be in the context of the peculiarity of Islamic banks' balance sheet profiles vis-à-vis diversification and concentration, sensitive to policy rate fluctuations, having limitations to accessing various liquidity management tools, resolution proceedings, etc.

Interest Rate Risk and Islamic Banks

Interest rate risk is considered very significant for financial institutions. However, the indirect impact of interest rate risk on Islamic banks, particularly those operating in a dual system, may also be profound. This is due to the various implications that the movement of interest rates, which is used as a benchmark pricing reference, can have on the rate of return for Islamic banks,[110] as well as on their deposits and funding instruments.

Islamic financial institutions commonly mobilise funds on a short-term basis yet engage in financing for relatively longer periods, leading to a mismatch between the repricing of their assets and liabilities or a maturity mismatch. In practice, Islamic banks' financing is mostly on debt-based models. They tend to use debt-like instruments in creating assets, whereas they collect investment account deposits mainly through the PLS model. This can pose a significant challenge to Islamic banks in a high-interest rate environment.

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108 *https://data.worldbank.org/indicator/FR.INR.RINR?locations=US*
109 Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank, 28 April 2023.
110 As stated in para 6.2 of IFSB-1, IIFS are exposed to the rate of return risk in the context of their overall balance sheet exposures. An increase in benchmark rates may result in IAHs having expectations of a higher rate of return. Rate of return risk differs from interest rate risk in that IIFS are concerned with the result of their investment activities at the end of the investment-holding period. Such results cannot be pre-determined exactly.

Liquidity Risk

The question of liquidity risk and its management arises when considering the liquidity crunch faced by these banks, which contributed to their eventual resolution. Due to the limited availability of *Sharīʼah*-compliant liquidity management tools, Islamic banks could be more exposed to liquidity risk than conventional banks. Additionally, Islamic banks in many jurisdictions face challenges caused by the absence of a robust *Sharīʼah*-compliant money market, an overreliance on short-term current accounts, and *Sharīʼah*-compliant options from the interbank market. This challenge might make it more difficult for Islamic banks to mitigate liquidity risk as compared to conventional banks that have access to a variety of liquidity management tools.[111] On the flip side, such exposure may also be marginal given that Islamic banks, by nature, might also hold more liquidity due to limited *Sharīʼah*-compliant investment opportunities and limited liquidity management options.

Nevertheless, Islamic banks are exposed to liquidity risk when the reputation of banks is at stake. In fact, the *Sharīʼah* compliance specificities of Islamic banks make them prone to additional reputational risk compared to their conventional counterparts. Damage to the trust of depositors in Islamic banks, due to reputational issues, might lead to a loss of their faith-inclined clientele and may result in deposit withdrawals. To mitigate this risk, Islamic banks should prioritise reputational risk management[112] and good governance practices.[113]

Regulatory frameworks must take into account the unique characteristics of Islamic banks to ensure stability. Maintaining a strong reputation and adhering to *Sharīʼah* principles are also crucial for resilience. Moreso, because of the significant influence of social media in communication, information sharing, and the rapid spread of rumours and concerns, it is essential for Islamic banks to proactively monitor and address social media reputational risks.

Bank Size

With the exception of Credit Suisse, other banks that failed are categorised as mid-to-small banks. The debate on whether bigger or smaller banks are better remains unsettled, as different studies have presented valid arguments for both sides. Critics of big banks argue that their excessive risk-taking behaviour has led to major financial crises, while proponents of big banks argue that they benefit from economies of scale that small banks do not have. This argument also applies to Islamic banks, where some studies suggest that small Islamic banks are more stable than larger ones[114], while others indicate the opposite.[115]

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111 Mohammad, S., Asutay, M., Dixon, R., & Platonova, E. (2020). "Liquidity risk exposure and its determinants in the banking sector: A comparative analysis between Islamic, conventional and hybrid banks". Journal of International Financial Markets, Institutions and Money, 66, 101196.
112 IFSB-12: Guiding Principles on Liquidity Risk Management for Institutions offering Islamic Financial Services
113 IFSB-10: Guiding Principles on Sharî`ah Governance Systems for Institutions Offering Islamic Financial Services. ED on Revised Guiding Principles on Corporate Governance for Institutions Offering Islamic Financial Services.
114 Čihák, M., Hesse, H., (2010), "Islamic Banks and financial stability: An empirical analysis". Journal of Financial Services Research 38, 95-113
115 Ibrahim, M. H., & Rizvi, S. A. R. (2017), "Do we need bigger Islamic banks? An assessment of bank stability". Journal of Multinational Financial Management, 40, 77-91.

However, due to the relative infancy of the Islamic banking sector, the question might not be whether banks are too big to fail but rather whether they might be too small to succeed. In some cases, Islamic banks may need to be bigger to withstand operational costs, competition, and regulation.[116] Considering this narrative in the context of the discussion about risk, more specifically, the risk of a bank run. While bigger banks may gain more confidence from depositors and be less likely to experience a bank run during a crisis, Islamic banks' niche clientele may provide more sticky deposits due to religious branding and the financial inclusion of faith-inclined individuals and groups.[117]

While on the subject of bank runs, the one that occurred in SVB was primarily caused by the fact that over 95% of its deposits were uninsured. This emphasises the significance of having adequate insurance coverage for deposits to provide a level of security for customers. Therefore, it might be necessary for RSAs to carefully monitor the level of uninsured deposits that Islamic banks hold, as well as the level of insurance coverage provided to customers. This can help to ensure that the bank can meet its obligations in the event of a liquidity crisis, while also providing customers with the necessary level of security for their deposits.

Liquidity Coverage Ratio, HQLA's Maturity, and Unrealised Losses

SVB was able to maintain a liquidity coverage ratio (LCR) of less than 100% because of relaxed regulations in the US for banks with assets less than USD 250 billion. The 2019 update played a role in SVB's failure, as its LCR didn't exceed 75% by the end of 2022. If SVB had been subject to LCR restrictions, it would have been required to disclose more information about its liquidity risks, potentially leading to greater market awareness of these risks. In contrast, Islamic banks, especially those operating in jurisdictions that are already on Basel III, are less vulnerable to such situations. This is because they are subject to full LCR disclosure and threshold requirements in their jurisdictions, regardless of their size.

Besides, one of the issues with SVB's HQLAs portfolio is that it was made of long-term mortgage securities with more than 10 years to maturity. However, the LCR does not differentiate between short-term and HQLAs or between HQLAs with unrealised losses and those trading at par. One potential area for improvement, to be looked at by relevant stakeholders, would be to develop a new LCR approach for held-to-maturity HQLAs or a penalty for HQLAs that Islamic banks cannot sell without a significant loss. Alternatively, regulators might want to ensure that banks with concentrated uninsured deposits hold a portion of their HQLAs in reserve balances and short-term treasury bills.

Moreover, SVB classified nearly 80% of its securities as held to maturity, indicating that unrealised losses had not yet been reflected in its equity. While this loss was real, SVB did not recognise it because the accounting rules allow securities held to maturity to be recognised effectively at their cost. This raises questions with regard to the acceptable threshold of HQLAs classified as held to maturity by banks in general and Islamic banks in particular with due regard to the peculiarity of the latter's balance sheet profile.

[116] ibid
[117] Farooq, M., & Zaheer, S. (2015), "Are Islamic banks more resilient during financial panics?". Pacific Economic Review, 20(1), 101-124.

The failure that occurred in SVB could have been anticipated if appropriate stress test scenarios had been implemented. For instance, conducting a stress test to assess the impact of a potential future interest rate hike by the Federal Reserve would have alerted regulators and SVB management to the potentially severe consequences. This would have provided them with sufficient time to enhance their preparations and strengthen their ability to withstand such an increase. Hence, meticulous scenario preparation is crucial for conducting effective stress testing. Therefore, it is recommended that Islamic banks embrace challenging and comprehensive scenarios in their testing.

Finally, from a governance perspective, the board of directors bears the ultimate responsibility for the business strategy and financial stability of IIFIs. In fulfilling this role, the board should consider the legitimate interests of depositors, investment account holders (IAHs), shareholders, and other relevant stakeholders. It is crucial for the board to comprise individuals who possess a suitable level of knowledge and exhibit personal attributes aligned with Islamic ethical values. This qualification is essential to minimise instances of non-compliance with *Sharī'ah* principles, including ethics, and mitigate reputational risks. Adherence to these principles, along with those outlined by the IFSB governance standards, is expected to mitigate governance-related issues and thereby reduce the risk of internal failures.[118]

Concentration and Diversification in Islamic Banking

A factor that was specific to the collapse of SVB was its high concentration in the tech sector. Taking the traditional banking theory into consideration, a bank needs diversification in order to operate efficiently. As such, diversification is also seen as a buffer against liquidity risk from unexpected withdrawals.[119] On the other hand, studies have also shown that with regard to assets, concentration does not necessarily make a bank more susceptible to risk or collapse and in some cases, diversification does not promise safety for banks.[120] In fact, it can lead to better performance as concentrated banks get to lean on the advantage of their expertise and profit from it.[121] Concentration could also lead to reduced complexities, overhead costs, agency costs and inefficiencies.[122]

Islamic banks, due to restrictions on permissible activities, tend to have less diversification compared to conventional banks.[123] However, studies on the impact of diversification on Islamic banks yield varied conclusions. Some studies highlight the potential risk associated with heavy reliance on debt-based products,[124] while others suggest that focusing on Islamic instruments reduces risk but negatively affects profitability.[125]

118 Exposure Draft (ED-30): Revised Guiding Principles on Corporate Governance for Institutions Offering Islamic Financial Services (Banking Segment), March 2023
119 Rose, P. S., & Hudgins, S. C. (2008), Bank management and financial services. McGraw-Hill companies.
120 Acharya, V. V., Hasan, I., & Saunders, A. (2006), "Should banks be diversified? Evidence from individual bank loan portfolios". The Journal of Business, 79(3), 1355-1412.
121 Tabak, B. M., Fazio, D. M., & Cajueiro, D. O. (2011). "The effects of loan portfolio concentration on Brazilian banks' return and risk". Journal of Banking & Finance, 35(11), 3065-3076.
122 Klein, P. G., & Saidenberg, M. R. (2010), "Organisational structure and the diversification discount: Evidence from commercial banking". The Journal of Industrial Economics, 58(1), 127-155.
123 Šeho, M., Shaiban, M. S. M., & Ghafoor, A. (2023), "Loan and financing diversification and bank stability in dual-banking systems". Finance Research Letters, 51, 103395.
124 ibid
125 Al-kayed, L. T., & Aliani, K. C. (2020), "Effects of focus versus diversification on bank risk and return: evidence from Islamic banks' loan portfolios". Journal of Islamic Accounting and Business Research, 11(9), 2155-2168.

Geographical diversification is another aspect that elicits differing views. Evidence suggests that diversifying geographically can enhance profitability and stability for Islamic banks, but it also exposes them to credit risk.[126] This exposure is understandable as monitoring becomes more challenging the farther away branches are from the head office. Another study indicates that a general focus on a specific geography increases the likelihood of default risk.[127]

Furthermore, sectoral diversification presents its own considerations. One study recommends that Islamic banks focus on sectors where they possess expertise rather than diversifying into multiple sectors.[128] However, another study indicates that while sectoral focus reduces risk, it may harm profitability. Consequently, adopting a well-defined diversification policy could be the optimal approach.[129] Thus, the presiding evidence shows that the impact of diversification on risk is not consistent. Although a lack of diversification contributed to the fall of SVB, it could also be contingent on other present factors. Islamic banks that are concentrated are not necessarily susceptible to the same reality by that mere fact.

Resolution proceedings

As evident with Credit Suisse, where indenture in the bonds issued as Additional Tier- 1 capital resulted in an unprecedented event where bond holders were affected more than equity holders in a resolution event. This could have an impact on investors' confidence in the asset class.[130] As critical as this is, Islamic banks are less likely to have a similar issue because *mudārabah ṣukūk* are used as Additional Tier-1. By virtue of a *mudārabah* contract, participants are expected to bear losses. Thus, proceeds are invested in the IIFS's general asset pool after being combined with Common Equity (CET1) capital. This allows *ṣukūk* holders to participate in the entire business of the IIFS, including all financial entitlements and liabilities as outlined in the *mudārabah ṣukūk* agreement. Regardless, this incident further stresses the importance of having effective recovery and resolution planning for Islamic banks.

The standardisation sphere of the industry saw, in June 2022, a significant enrichment with the release of the IFSB Technical Note (TN-4) on Recovery and Resolution (RR) for IIFIs.[131] This TNRR takes into account the IIFIs unique characteristics, such as *Sharī'ah* compliance, while ensuring the fulfilment of their balance sheet requirements. The primary objective of the TNRR is to facilitate the relevant RSAs and other related authorities to establish an effective RR framework and appropriate tools for its effective implementation for IIFS in a manner that is fully compliant with *Sharī'ah* principles.

[126] Zoghlami, F. (2020), "Geographical Diversification Effects on Banks' Performance: Evidence from Islamic Banks of Some Selected Countries". Journal of Accounting, Business and Management (JABM), 27(2), 15-29.
[127] Al-kayed, L. T., & Aliani, K. C. (2020), "Effects of focus versus diversification on bank risk and return: evidence from Islamic banks' loan portfolios". Journal of Islamic Accounting and Business Research, 11(9), 2155-2168
[128] Šeho, M., Ibrahim, M. H., & Mirakhor, A. (2021), "Does sectoral diversification of loans and financing improve bank returns and risk in dual-banking systems?". Pacific-Basin Finance Journal, 68, 101619.
[129] Al-kayed, L. T., & Aliani, K. C. (2020), "Effects of focus versus diversification on bank risk and return: evidence from Islamic banks' loan portfolios". Journal of Islamic Accounting and Business Research, 11(9), 2155-2168.
[130] Credit Suisse bondholders prepare lawsuit after contentious USD17 billion writedown. See; *https://www.cnbc.com/2023/03/21/credit-suisse-bondholders-prepare-lawsuit-after-at1-bond-writedown-in-ubs-deal.html*
[131] Technical Note on Recovery and Resolution for Institutions Offering Islamic Financial Services, June 2022

Conclusion

Bank failures usually occur due to the miscalculation of risks. In the case of SVB, this was due to the substantial exposure to government bonds and loss in value of their assets due to a rapid increase in interest rates. Proper deployment of mitigating strategies could have prevented such bank failures. While it is noteworthy that no Islamic bank failures have been recorded thus far due to global financial tightening, it remains crucial to duly consider the implications and lessons learned from recent failures in the conventional banking system for the operational and regulatory aspects of Islamic banks. By doing so, Islamic banks can proactively address potential risks and strengthen their overall resilience to meet safety and soundness objectives across a wide range of potential risks.

Although no cross-border contagion spillover of bank failure is recorded, it is nonetheless important to strengthen cross-border cooperation and foster information sharing among supervisors, as emphasised in the IFSB CPIFR 13.[132] This collaborative approach is crucial to prevent or minimize the risk of contagion in the event of a failure of a systemically important bank.[133] By enhancing communication and coordination across jurisdictions, supervisors can effectively address and mitigate the potential spillover effects that could arise from such a failure.

[132] IFSB, (April 2015): Core Principles for Islamic Finance Regulation (Banking Segment) (CPIFR)
[133] Fortunately, the recent banks' failures have had a marginal impact on Islamic Banks around the world (NBK has reported a minimal exposure represented in off-balance sheet items in the form of letters of guarantee worth USD 4.9 million. Additionally, KFH reported a minimal exposure of USD 1.2 million)

ANNEXURE

ASSUMPTIONS AND CONVENTION

In this IFSI Stability Report 2023, the following conventions are used:

- IFSI Stability Report "2023" implies that the report covers activities for the year 2022 and is published in the year 2023.
- "1H22" means the first half of the year 2022.
- "4Q22" means quarter 4 of the year 2022.
- "Billion" means a thousand million.
- "Trillion" means a thousand billion.
- "IFSB Secretariat workings" means figures indicated in the corresponding table or chart are based on IFSB staff estimates or calculations.
- "PSIFIs" implies that the data used in a corresponding table or chart are obtained from the IFSB's Prudential and Structural Islamic Financial Indicators database.
- "SR2022" refers to the IFSI Stability Report 2022.
- The data and analysis in the IFSI Stability Report are compiled by IFSB staff from various sources and are assumed to be correct at the time of publication. The data analysed correspond to the latest data available to the IFSB.
- Data for *ṣukūk* outstanding and Islamic funds are for full-year 2022. Data for Islamic banking are mainly as at the end of December 2022 (4Q 22) except where indicated otherwise. Data for *takāful* are mainly for full-year 2021 and as per the available indicated data period in 2022.
- In all cases, where data for the periods indicated above are not available to the IFSB Secretariat, the latest data available to the IFSB Secretariat have been used.
- Data used are mainly from primary sources (regulatory authorities' statistical databases, annual reports and financial stability reports, official press releases and speeches, etc.), as well as from the IFSB's Prudential and Structural Islamic Financial Indicators (PSIFIs) database and IFSB surveys.
- Where primary data are unavailable, third-party data providers have been used.

As much as possible, the data used, and the charts and figures provided in the IFSI Stability Report 2023 have been checked for accuracy, completeness and timeliness. Discrepancies in the sums of component figures and totals shown are likely due to the rounding-off effect. Where errors are observed, corrections and revisions will be incorporated into the online version of the report. The IFSB appreciates feedback on the report, which is available for free download at *www.ifsb.org*.

DATASET USED IN THE REPORT

	ROA		ROE		NPM		CTI	
	2021	2022	2021	2022	2021	2022	2021	2022
Afghanistan	-2.5%	-4.2%	-40.7%	-24.9%	-171.1%	-109.9%	317.5%	409.2%
Bahrain	0.9%	1.1%	10.8%	12.1%	29.9%	36.8%	51.6%	55.5%
Bangladesh	0.9%	1.1%	20.4%	23.2%	36.0%	37.8%	52.5%	53.3%
Brunei	1.4%	2.5%	10.6%	21.4%	50.4%	49.5%	54.9%	56.6%
Egypt	2.7%	2.7%	34.0%	34.0%	62.5%	62.5%	30.0%	27.1%
Indonesia	1.7%	2.6%	13.6%	20.5%	24.9%	31.8%	75.1%	71.5%
Iran	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Iraq	0.5%	1%	0.9%	1.9%	19.1%	30.8%	74.8%	61.0%
Jordan	1.7%	1.7%	18.3%	19.0%	54.4%	54.8%	45.6%	45.2%
Kazakhstan	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Kuwait	1.6%	1.4%	17.0%	10.7%	33.8%	51.5%	29.9%	38.9%
Kyrgyz Republic	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Lebanon	0.1%	N/A	0.9%	N/A	N/A	N/A	N/A	N/A
Libya	0.8%	0.9%	9.8%	9.4%	36.2%	50.7%	61.1%	77.8%
Malaysia	1.1%	1.2%	15.3%	17.9%	40.6%	44.7%	36.6%	36.1%
Morocco	0.0%	N/A	N/A	N/A	N/A	N/A	140.0%	N/A
Nigeria	3.4%	1.9%	54.1%	33.6%	39.4%	27.1%	49.1%	64.0%
Oman	0.9%	1.0%	6.0%	7.0%	35.1%	23.5%	44.5%	48.9%
Pakistan	2.0%	2.9%	32.6%	51.4%	45.3%	53.9%	63.5%	61.7%
Palestine	1.0%	1.2%	13.0%	15.0%	27.9%	29.9%	50.6%	41.9%
Qatar	1.5%	1.4%	16.2%	12.6%	40.1%	32.4%	13.3%	13.3%
Saudi Arabia	1.9%	2.6%	19.4%	21.1%	53.8%	72.1%	43.3%	42.2%
Sudan	4.9%	3.0%	80.7%	34.1%	47.2%	37.5%	24.9%	50.0%
Türkiye	1.4%	4.2%	20.2%	55.6%	27.4%	48.2%	34.3%	21.9%
UAE	1.4%	1.8%	10.2%	13.3%	35.1%	42.1%	43.1%	44.9%
UK	0.1%	0.5%	1.2%	5.5%	3.7%	0.3%	49.5%	44.6%

	FDR		LASTR		LCR		NSFR	
	2021	2022	2021	2022	2021	2022	2021	2022
Afghanistan	22.5%	49.7%	189.4%	192.4%	N/A	N/A	N/A	N/A
Bahrain	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Bangladesh	104.6%	106.5%	25.7%	29.4%	178.9%	26.0%	111.8%	112.0%
Brunei	N/A	N/A	0.0%	N/A	N/A	N/A	N/A	N/A
Egypt	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Indonesia	76.3%	81.1%	17.3%	12.8%	N/A	N/A	N/A	N/A
Iran	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Iraq	65.7%	93.7%	164.2%	133.1%	N/A	N/A	N/A	N/A
Jordan	80.2%	82.0%	N/A	N/A	N/A	N/A	N/A	N/A
Kazakhstan	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Kuwait	N/A	N/A	24.5%	21.7%	185.4%	151.8%	109.1%	116.2%
Kyrgyz Republic	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Lebanon	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Libya	N/A	N/A	93.3%	88.7%	N/A	N/A	N/A	N/A
Malaysia	96.9%	102.4%	138.3%	131.8%	N/A	N/A	N/A	N/A
Morocco	170.9%	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Nigeria	31.6%	26.7%	39.3%	40.4%	N/A	N/A	N/A	N/A
Oman	105.7%	106.6%	35.4%	26.7%	187.9%	154.0%	119.1%	118.2%
Pakistan	61.7%	60.2%	74.9%	88.6%	210.5%	239.4%	163.9%	164.4%
Palestine	73.8%	77.3%	48.5%	39.3%	219.7%	171.8%	173.6%	165.1%
Qatar	77.5%	82.2%	127.7%	88.4%	N/A	0.0%	N/A	0.0%
Saudi Arabia	97.0%	105.5%	25.4%	27.1%	131.1%	135.6%	115.1%	110.3%
Sudan	42.9%	53.4%	115.7%	109.2%	N/A	N/A	N/A	N/A
Türkiye	60.1%	66.1%	70.6%	76.2%	285.2%	252.0%	N/A	N/A
UAE	87.7%	80.7%	19.4%	18.2%	N/A	N/A	N/A	N/A
UK	N/A	N/A	0.0%	9.3%	437.9%	554.5%	N/A	149.3%

	NPF	
	2021	2022
Afghanistan	N/A	N/A
Bahrain	6.5%	5.5%
Bangladesh	3.9%	1.0%
Brunei	4.1%	3.5%
Egypt	3.7%	2.9%
Indonesia	2.6%	2.3%
Iran	N/A	N/A
Iraq	32.2%	20.1%
Jordan	1.9%	2.0%
Kazakhstan	N/A	N/A
Kuwait	1.5%	1.4%
Kyrgyz Republic	9.1%	6.9%
Lebanon	41.3%	N/A
Libya	N/A	N/A
Malaysia	1.3%	1.6%
Morocco	0.3%	N/A
Nigeria	5.2%	5.0%
Oman	1.8%	2.1%
Pakistan	2.7%	2.6%
Palestine	3.3%	3.0%
Qatar	1.8%	4.2%
Saudi Arabia	1.5%	1.5%
Sudan	3.4%	4.7%
Türkiye	2.9%	1.3%
UAE	7.9%	7.3%
UK	1.5%	1.6%

	CAR		Tier-1		Leverage Ratio	
	2021	2022	2021	2022	2021	2022
Afghanistan	17.9%	20.7%	15.9%	20.7%	5.6%	15.3%
Bahrain	17.9%	19.5%	16.4%	18.3%	8.3%	9.0%
Bangladesh	12.8%	14.2%	8.6%	10.0%	5.4%	5.2%
Brunei	17.9%	16.2%	17.9%	16.2%	5.5%	5.1%
Egypt	22.0%	21.4%	19.5%	19.2%	9.1%	9.3%
Indonesia	25.7%	23.5%	24.3%	24.4%	10.6%	12.1%
Iran	N/A	N/A	N/A	N/A	N/A	N/A
Iraq	N/A	N/A	138.2%	116.7%	53.3%	49.8%
Jordan	21.5%	21.1%	21.1%	20.8%	8.2%	8.3%
Kazakhstan	N/A	N/A	N/A	N/A	N/A	N/A
Kuwait	18.6%	18.0%	16.9%	16.2%	10.2%	9.1%
Kyrgyz Republic	N/A	N/A	33.4%	25.9%	17.8%	20.5%
Lebanon	35.4%	27.0%	N/A	N/A	N/A	N/A
Libya	N/A	N/A	N/A	N/A	8.9%	9.2%
Malaysia	18.6%	18.3%	14.8%	14.9%	6.8%	6.8%
Morocco	20.0%	N/A	N/A	N/A	7.9%	N/A
Nigeria	18.1%	15.0%	17.9%	15.0%	6.6%	6.3%
Oman	16.9%	15.9%	16.0%	15.3%	13.6%	13.2%
Pakistan	16.0%	17.8%	12.8%	15.0%	5.0%	5.2%
Palestine	15.7%	15.2%	14.3%	13.8%	7.5%	8.1%
Qatar	19.1%	19.4%	18.0%	18.3%	12.8%	12.5%
Saudi Arabia	19.4%	20.5%	17.7%	18.8%	12.7%	13.3%
Sudan	7.1%	8.6%	6.0%	6.5%	1.8%	2.0%
Türkiye	18.8%	20.5%	14.4%	17.1%	7.8%	10.1%
UAE	18.1%	17.7%	17.0%	16.6%	12.8%	12.4%
UK	18.3%	17.3%	16.8%	16.1%	10.2%	9.5%

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LIST OF ABBREVIATIONS

ACAPS	Morocco *Takāful* Sector Supervisory Authority
ASEAN	Association of South-East Asian Nations
AuM	Assets under management
BCBS	Basel Committee on Banking Supervision
BNM	Bank Negara Malaysia
CAGR	Compound annual growth rate
CAR	Capital adequacy ratio
CBDC	Central bank digital currency
CBN	Central Bank of Nigeria
CGA	Tunisian Insurance Authority
CIS	Commonwealth of Independent States
ECL	Expected credit losses
ESG	Environmental, social and governance
FDR	Financing-to-deposits ratio
FSB	Financial Stability Board
GCC	Gulf Cooperation Council
GDP	Gross domestic product
GFC	Global Financial Crisis
HQLA	High-quality liquid assets
ICM	Islamic capital market
IsDB	Islamic Development Bank
IFRS	International Financial Reporting Standards
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
IOSCO	International Organisation of Securities Commissions
LASLR	Liquid assets to short-term liabilities ratio
LCR	Liquidity coverage ratio
M&A	Mergers and acquisitions

MENA	Middle East and North Africa
MESA	Middle East and South Asia
MTPL	Mandatory third-party auto policy
NIB	Non-interest banking
NPF	Non-performing financing
NPM	Net profit margin
NSFR	Net stable funding ratio
OJK	Otoritas Jasa Keuangan
OPEC	Organisation of the Petroleum Exporting Countries
PSIA	Profit-sharing investment accounts
PSIFIs	Prudential and Structural Islamic Financial Indicators
ROA	Return on assets
ROE	Return on equity
RPSIA	Restricted profit-sharing investment account
RSA	Regulatory and supervisory authority
RWA	Risk-weighted assets
SBU	Sharīʾah business unit
SDG	Sustainable Development Goal
SEA	South-East Asia
TO	*Takāful* operator
TU	*Takāful* undertaking
UAE	United Arab Emirates
VBI	Value-based intermediation

GLOSSARY

Commodity *Murābahah* or *Tawarruq*	A *murābaḥah* 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 *murābaḥah*, 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.
Diminishing *Mushārakah*	A form of partnership in which one of the partners promises to buy the equity share of the other partner over a period of time until the title to the equity is completely transferred to the buying partner. The transaction starts with the formation of a partnership, after which buying and selling of the other partner's equity takes place at market value or 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.
Fiqh	Knowledge of the legal rulings pertaining to conduct, which has been derived from specific evidence.
Ijārah	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. The *ijārah* contract 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), financing and investment that are Sharī'ah-compliant, with separate funds. It could also provide *Takāful* or *retakāful* services.
Istisnā`	The sale of a specified asset, with an obligation on the part of the seller to manufacture or 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.
Mudārabah	A partnership contract between the capital provider (*rabb al-māl*) and an entrepreneur (*muḍārib*) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms.
Murābahah	A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin.
Mushārakah (Sharikat al-'Aqd)	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

Retakāful	An arrangement whereby a *takāful* undertaking cedes a portion of its risks on the basis of treaty or facultative *retakāful* as a representative of participants under a *takāful* contract, whereby it would contribute a portion of the contribution as *tabarru‘* into a common fund to cover against specified loss or damage.
Sharīʿah	The practical divine law deduced from its legitimate sources: the Qur'ān, Sunnah, consensus (*ijmā*'), analogy (*qiyās*) and other approved sources of the Sharī'ah.
Sharīʿah 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.
Ṣukūk	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.
Tabarru‘	The amount of contribution that the *takāful* or *retakāful* participant commits to donate in order to fulfil the obligation of mutual help in bearing the risks and paying the claims of eligible claimants.
Takāful	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.
Sadaqah	*Sadaqah* also describes a voluntary charitable act towards others, whether through generosity, love, compassion or faith.
Urf	*Urf* is an Arabic Islamic term referring to the custom, or 'knowledge', of a given society.
Wadīʿah	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.
Wakālah	An agency contract where the customer (principal) appoints an institution as agent (*wakīl*) to carry out the business on his behalf. The contract can be for a fee or without a fee.
Waqf	A *waqf* (also known as hubous [αϭΑ̤Σor mortmain property) is an inalienable charitable endowment under Islamic law.
Zakāh	An obligatory financial contribution disbursed to specified recipients that is prescribed by the Sharī'ah on those who possess wealth reaching a minimum amount that is maintained in their possession for one lunar year.

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