ISLAMIC FINANCIAL SERVICES BOARD

ISLAMIC FINANCIAL STABILITY REPORT 2026

Emergence of Hybrid Risks in Islamic Banking

Enhancing Prudential Frameworks and Addressing Vulnerabilities in an Evolving Landscape

Published by:

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Recommended citation: Islamic Financial Services Board, Islamic Financial Stability Report 2026 (Kuala Lumpur: Islamic Financial Services Board, May 2026).

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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. The IFSB also conducts research and coordinates initiatives on industry-related issues, as well as organises roundtables, seminars and conferences for regulators and industry stakeholders. Towards this end, the IFSB works closely with relevant international, regional and national organisations, research/ educational institutions and market players.

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

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FOREWORD

The growth momentum of the Islamic financial services industry (IFSI) strengthened further in 2025. Robust, broad-based growth was recorded across all sectors, with non-banking segments sustaining rates that exceeded those of the banking sector, underscoring their increasing contribution to overall industry momentum. This growth reflects favorable financing conditions, regulatory and market developments, and sustained increase in demand for Islamic financial products, particularly in Africa and central Asia.

The IFSI has become systemically important, or even the dominant part, of the financial systems in a rising number of jurisdictions, a trend that is expected to continue in the foreseeable future. This transition was most pronounced in jurisdictions where national strategies formally embedded Islamic finance within broader economic transformation programmes.

As reported in Chapter 1, financial stability indicators for the IFSI have remained broadly steady in 2025. Capital adequacy and asset quality of Islamic banks were generally stable, while funding and liquidity conditions remained broadly resilient. Solvency ratios in the Islamic insurance sector also remained broadly within regulatory requirements. Sovereign domestic ṣukūk were generally priced at yields similar to, or slightly below, comparable bonds, although bid-ask spreads for ṣukūk remained higher in many markets. However, key vulnerabilities are increasingly evident across all IFSI's segments, with variations across jurisdictions. These vulnerabilities, if not addressed could potentially intensify the risk environment facing the industry and undermine its long-term development.

Resilience in Islamic banks' asset quality and capital adequacy is uneven across jurisdictions, and signs of asset quality deterioration have emerged that could lead to the build-up of credit risk in some markets. Governance gaps and concentrated sovereign exposures in Islamic banks, particularly in frontier markets, highlights the need for stronger supervisory oversight. The Islamic insurance sector is facing elevated risks with declining capital buffers and weakened underwriting performance in many jurisdictions. Opacity in the underlying business model, and governance and regulatory gaps, are further exposing the industry to stability and solvency risks. Structural impediments, as discussed in the 2025 IFSI Stability Report, continue to undermine orderly ṣukūk market evolution, particularly in corporate ṣukūk, and results in trading frictions in secondary markets.

Chapter 2 highlights an important evolution in the Islamic finance risk landscape, the emergence of "hybrid risks" in Islamic banking. These risks arise when the risks and balance-sheet characteristics of Islamic banks' products, structures, and balance-sheet configurations mimic attributes of conventional banks in ways that materially reshape their risk-return profiles and prudential features. In 2017, an IMF Policy Paper raised concerns about these emerging practices as they may give rise to complex stability risks and heighten consumer protection and reputational risks.

Over the past decade, divergent views have emerged on these practices. In many jurisdictions, including in some major Islamic banking markets, these products have proliferated, while some other jurisdictions have restricted these practices. Nonetheless, hybrid risks have become an important part of the Islamic banking risk landscape, which should be carefully considered in addition to the familiar risks that are common with conventional banks or uniquely relevant to Islamic banks.

This report documents market trends for Islamic banking's hybrid instruments and key drivers behind their proliferation. The report also discusses in detail the idiosyncratic and systemic financial stability implications of hybrid risks, which are material and yet not fully captured in existing prudential frameworks creating regulatory gaps and arbitrage opportunities, including in cross-border transactions. Accordingly, the report calls for action by financial sector standard-setters, regulators, and supervisors, as well as relevant international financial institutions, to address these risks effectively and limit their potential adverse impact on financial stability, particularly during times of financial stress.

Dr. Ghiath Shabsigh

Secretary-General

Islamic Financial Services Board

EXECUTIVE SUMMARY

The Islamic Financial Services Industry (IFSI) continued to expand in 2025, reaching approximately USD 4.4 trillion in total assets, supported by favourable financing conditions and ongoing market development across all three sectors. Growth was particularly strong in non-bank segments – including ṣukūk, Islamic funds, and Islamic insurance sectors. Islamic banking remains the dominant sector, accounting for nearly 70% of total IFSI assets.

In the Islamic banking sector, prudential indicators remained broadly stable, although some vulnerabilities are becoming more visible. Asset quality has generally been resilient, but early signs of deterioration have emerged in some markets, particularly in commercial real estate and wholesale and retail sectors, pointing to a potential build-up of latent credit risk in more vulnerable segments. Capital adequacy remained broadly resilient across most jurisdictions, but this resilience was not uniform with stresses emerging in some jurisdictions. Balance sheet composition of Islamic banks varied across regions, with significant sovereign ṣukūk exposures in a few jurisdictions that reinforces the sovereign-bank nexus. Funding and liquidity conditions remain broadly contained, but structural limitations present constraints in effective liquidity management and may potentially reduce flexibility in stress scenarios.

Strengthening governance practices, risk management, and supervisory effectiveness in the Islamic banking system remains important, particularly through more forward-looking supervisory approaches that can identify and address vulnerabilities in a timely manner. Enhancing crisis management and resolution frameworks is also important, as financial safety nets that cater to Islamic finance specificities remain underdeveloped in many jurisdictions, with recent stress episodes highlighting limitations in early intervention and resolution preparedness. Addressing the existing structural liquidity vulnerabilities through further development of Islamic money markets, liquidity instruments, and central bank facilities tailored to Islamic banks is essential to strengthen both institution-level resilience and system-wide shock absorption capacity.

Islamic insurance remained broadly stable, with solvency ratios generally within regulatory requirements across jurisdictions. However, pressures are emerging in some markets. Rising claims, particularly in motor and medical lines, have weakened underwriting performance in several jurisdictions, increasing reliance on investment income. In a number of cases, persistent policyholder fund deficits continue to require qarḍ support, which may weigh on capital over time. These pressures are further compounded, in some markets, by challenges in wakālah fee calibration and limited availability of Islamic reinsurance, keeping risk retention elevated.

Strengthening resilience of the Islamic insurance sector will require improvements in business models, pricing discipline, and capital frameworks, alongside enhanced risk-based supervision. This includes incorporating fund-level indicators, and continued efforts to develop Islamic reinsurance capacity.

Islamic capital markets recorded strong momentum in 2025, with ṣukūk issuances reaching USD 234.5 billion, supported by favourable global financing conditions and continued investor demand. However, this has not been consistently accompanied by broad-based market deepening. Structural constraints discussed in the 2025 IFSI Stability Report remain in some markets. Domestic issuance is declining

while reliance on international funding has increased, reflecting accommodative external financing conditions as well as limited local absorption capacity in some markets. Increase in foreign currency issuances may expose markets to external vulnerabilities, particularly under conditions of tighter global liquidity and shifts in investor risk sentiment. Market development is further constrained by limited depth across maturities and increasing structural complexity in ṣukūk issuances, which reduces comparability and fungibility.

Strengthening resilience in the Islamic capital markets sector requires enhancing the depth, structure, and functioning of Islamic capital markets through the development of foundational infrastructure, alongside improvements in disclosure, transparency, and legal certainty in ṣukūk structures. Expanding and diversifying the domestic institutional investor base remains critical to improving absorption capacity, reducing concentration risks, and supporting more stable market functioning.

A central development shaping the current risk landscape is the growing prevalence of hybrid risks in Islamic banking. Hybrid instruments or models that replicate conventional credit-like exposures, have supported rapid growth and scalability but have also altered the risk profile of Islamic banks. In some jurisdictions, these structures now dominate both financing and funding activities, resulting in balance sheets that increasingly resemble conventional banking models in their economic characteristics. This evolution raises important prudential questions, particularly where regulatory frameworks may not fully capture the risks embedded in these structures.

Hybrid risks present both microprudential and macroprudential implications that are increasingly relevant for financial stability. At the institutional level, hybrid structures can increase balance sheet elasticity and rapid expansion of credit, and support leverage build-up, as well as introduce greater sensitivity to benchmark rates. Some hybrid instruments introduce additional external operational dependencies, where disruptions can affect financing and liquidity management activities of Islamic banks and amplify liquidity stress. At the system-wide level, their widespread adoption may contribute to more synchronised credit expansion, stronger feedback loops between credit growth and asset prices, and increased potential for liquidity stress to propagate through interbank markets. These dynamics are further amplified by structural constraints in Islamic financial systems.

Addressing these challenges requires a coordinated policy response that strengthens both prudential frameworks and market infrastructure. Capital frameworks should remain risk-sensitive and ensure that the treatment of hybrid instruments adequately reflects their underlying risk characteristics. Macroprudential frameworks should also be enhanced to monitor the aggregate scale and concentration of hybrid risks, incorporate relevant stress scenarios, and support the calibration of buffers that reflect system-wide risks. In addition, greater supervisory attention to operational dependencies is critical, particularly where multiple institutions rely on a narrow set of commodities, brokers, or trading platforms.

Looking ahead, global financial stability risks are elevated in a rapidly evolving environment. Escalating geopolitical tensions, particularly in the Middle East, have triggered heightened volatility across energy, commodity, and financial markets. Elevated uncertainty around the trajectory of these developments has made it more difficult for markets to price fundamentals, increasing the likelihood of abrupt and

potentially disorderly asset price adjustments. This risk is amplified by compressed risk premia, which provide limited buffers against further shocks. These developments are particularly consequential for the Islamic financial services industry, given its geographic concentration in affected regions.

In this context, the key concern is the interaction between external shocks and existing vulnerabilities highlighted in this report. Sovereign risk remains a central channel, as repricing of sovereign ṣukūk can directly affect balance sheets, liquidity conditions, and financing capacity. Structural features of Islamic capital markets, including limited market depth and exposure to non-resident investors, may further contribute to sharper valuation adjustments and increased exposure to external funding conditions. At the same time, the impact of the ongoing geopolitical events may place further pressure on asset quality and funding in the banking sector, particularly where latent credit risks are already present. Corporate sector stress, arising from higher costs, disrupted activity, and weaker earnings, could further translate into increased impairments, especially in sectors such as real estate, infrastructure, and energy-sensitive industries.

Overall, while the IFSI remains resilient, the balance of risks has shifted to the downside. This underscores the importance of heightened vigilance, forward-looking supervision, and proactive risk management, including stress testing and strengthening liquidity preparedness, supported by robust regulatory frameworks and continued international cooperation.

1.0 Growth and Resilience of the Islamic Financial Services Industry

1.1 Global Macrofinancial Environment

Accommodative Conditions Mask Rising Strains

Global financial conditions in 2025 remained accommodative despite a weakening growth outlook and elevated macroeconomic and geopolitical risks, indicating a growing divergence from underlying economic fundamentals. Equity valuations reached record highs, funding conditions remained accommodative, and credit spreads compressed to near-historical lows. At the same time, global growth was estimated to decelerate from 3.3% in 2024 to 3.2% in 2025 and 3.1% in 2026,[1] with some estimates pointing to the slowest expansion since 2008.[2] Persistent trade tensions, elevated fiscal burdens, and ongoing economic fragmentation continued to weigh on economic activity,[3] while diverging inflation dynamics contributed to increasing desynchronisation of monetary policy across major economies.[4] These developments suggest financial conditions remained comparatively loose relative to the evolving macroeconomic backdrop, leaving asset valuations and risk pricing increasingly sensitive to changes in the outlook.

Compressed risk premia left limited buffer against shocks, and the conditions for abrupt repricing remain. The market recovery since mid-2025 has been swift but narrow, driven heavily by technology stocks.[5] Credit spreads are similarly tight, while rising geopolitical tensions and macroeconomic uncertainties increase the risk of abrupt repricing. In this setting, even modest shifts in inflation or sentiment could trigger higher yields, leading to valuation losses, tighter financial conditions, and amplified market volatility – especially in systems with concentrated fixed-income portfolios and limited market depth, which remain prevalent in many jurisdictions with significant Islamic finance activity.

Elevated public debt levels are testing the traditional role of government securities as portfolio stabilisers. Debt in many economies remains near peacetime highs, contributing to upward pressure on term premiums.[6] Financial institutions have long relied on government securities to provide a counterbalance during periods of market stress, but this relationship may be shifting as fiscal sustainability concerns grow. In emerging markets, the move toward domestic-currency financing has successfully reduced foreign exchange exposure. However, it has also strengthened the sovereign-bank nexus and increased the financial system's sensitivity to changes in sovereign credit conditions.[7] These dynamics carry particular weight for financial systems where sovereign and government-related securities constitute the dominant share of available fixed-income instruments, creating common exposures across financial sectors and strengthening the transmission of fiscal conditions into broader financial system performance.

Within this broader global context, countries were unevenly positioned, reflecting different domestic conditions. The Gulf Cooperation Council (GCC) and key East Asia and Pacific (EAP) economies remained positioned relatively well in 2025, supported by stronger fiscal buffers, external

1 International Monetary Fund, *World Economic Outlook: Global Economy in Flux, Prospects Remain Dim* (IMF, 2025). Available at: https://www.imf.org/en/Publications/WEO/Issues/2025/10/14/world-economic-outlook-october-2025#:~:text=Global%20Economy%20in%20Flux%2C%20Prospects%20Remain%20Dim,-October%202025&text=Some%20extremes%20of%20higher%20tariffs,front%2Dloading%E2%80%94are%20fading

2 World Bank Global Economic Prospects-June (WB, 2025). Available at: https://thedocs.worldbank.org/en/doc/8bf0b62ec6bcb886d97295ad930059e9-0050012025/original/GEP-June-2025.pdf

3 Bank for International Settlements, Annual Economic Report (BIS, 2025). Available at: https://www.bis.org/publ/arpdf/ar2025e.htm

4 Bank for International Settlements, BIS Quarterly Review-September (BIS, 2025). Available at: https://www.bis.org/publ/qtrpdf/r_qt2509.htm

5 International Association of Insurance Supervisors. Global Insurance Market Report (GIMAR) 2025 Mid-Year Update (IAIS, 2025). Available at: https://www.iais.org/uploads/2025/06/Global-Insurance-Market-Report-2025-mid-year-update.pdf

6 See footnote 1 and 3

7 See footnote 1, 2 and 3

surpluses, and more stable growth dynamics.[8] Other emerging markets, particularly in parts of South Asia (SA) and the broader Middle East and North Africa (MENA excluding GCC) region, faced tighter macrofinancial conditions, characterised by elevated public debt levels, the highest real financing costs in a decade, and increased dependence on domestic financial institutions to absorb sovereign financing needs.[9] Sub-Saharan Africa (SSA) continues along a path of gradual, reform-driven stabilisation, though macroeconomic vulnerabilities persist, particularly in relation to debt sustainability, external balances, and limited fiscal space.[10]

Islamic financial institutions operate predominantly within emerging market jurisdictions where these macrofinancial conditions are most relevant. These global dynamics constitute the operating environment that prudential outcomes across Islamic banking, capital markets, and insurance have taken shape in during the review period. The sections that follow examine how these conditions have shaped resilience, growth, and vulnerability across the three Islamic financial sectors: banking, capital markets, and insurance.

1.2 Growth and Market Development Trends

Sustained Growth but Sectoral Imbalances Remain

The global Islamic financial services industry reached USD 4.4 trillion in total assets in 2025 (Figure 1.1). In several major markets, Islamic finance has increasingly transitioned from a parallel offering to a mainstream component of the domestic financial system, reflecting its deeper integration. This transition was most pronounced in jurisdictions where national strategies formally embedded Islamic finance within broader economic transformation programmes. Broad-based growth was recorded across all sectors, with non-banking segments sustaining double-digit growth rates that considerably exceeded the pace of Islamic banking growth, underscoring their increasing contribution to the overall industry momentum. This was supported by improved financing conditions that strengthened ṣukūk issuance, mandatory insurance requirements that expanded insurance coverage, and continuing demand for Islamic finance products. New and frontier markets continued to expand rapidly, driven by regulatory and market developments across all three sectors.[11] Notwithstanding broader growth, the industry remains highly concentrated, with the GCC and EAP regions accounting for 75% of global assets, making aggregate industry performance highly dependent on conditions in these markets (Figure 1.2 and Table 1.1).

8 EY (2025): GCC banking sector outlook: H1 2025. Available at: ey-gcc-banking-outlook-h1-2025.pdf

9 See footnote 1

10 International Monetary Fund, Regional Economic Outlook for Sub-Saharan Africa (IMF 2025). Available at: https://www.imf.org/en/Publications/REO/SSA/Issues/2025/10/16/regional-economic-outlook-for-sub-saharan-africa-october-2025

11 Specific milestones include: first Islamic insurance licences in the Philippines; return of Islamic insurance products in Singapore; enactment of the National Islamic Insurance Law in Somalia; launch of the first dedicated operator in Ethiopia; preparation of comprehensive regulations in Ghana; and drafting of legislative frameworks in Uganda. In banking, new institutions were established in Nigeria and Uganda.

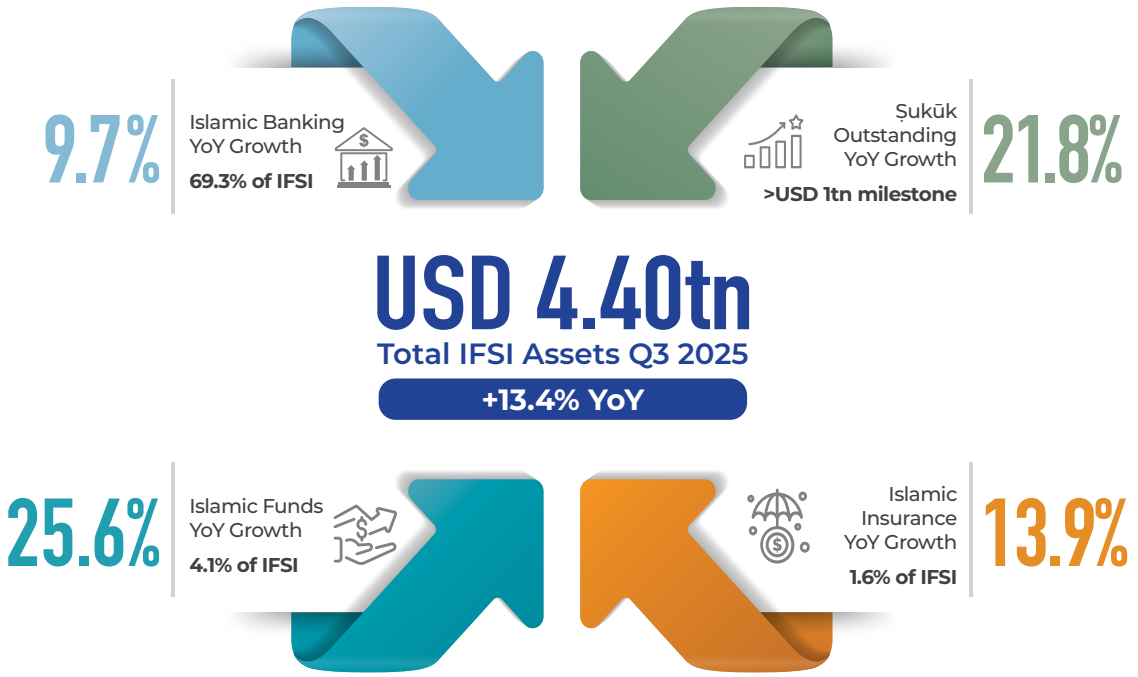


Table 1.1: Islamic Financial Services Industry Size by Sector and Region (2025)

Region	Islamic Banking Assets	Ṣukūk Outstanding	Islamic Funds Assets	Islamic Insurance Assets	Total (USD Billions)
East Asia and the Pacific (EAP)	375.85	491.40	46.54	22.49	936.28
Europe and Central Asia (ECA)	104.35	37.71	71.62	3.32	217.00
Gulf Cooperation Council (GCC)	1,759.65	543.29	34.21	30.22	2,367.37
Middle East and North Africa (MENA exc.GCC)	702.00	6.80	0.11	13.64	722.54
South Asia (SA)	94.74	3.44	6.19	1.44	105.82
Sub-Saharan Africa (SSA)	14.36	1.19	15.20	0.04	30.79
Others	-	16.99	6.60	-	23.60
	3,050.94	1,100.83	180.47	71.14	4,403.39

Source: IFSB PSIFIs, data provided by regulators and other public data, Refinitiv and Bloomberg

Figure 1.1: Global IFSI Growth Trends

Global IFSI Total Asset Size (USD in Trillion) (2012-2025) and Growth

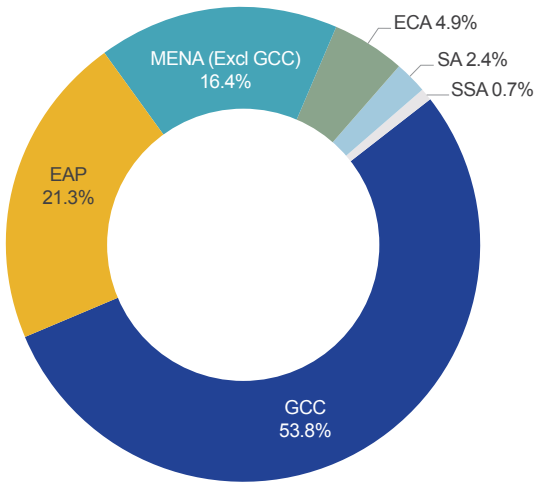
Source: IFSB Islamic Financial Services Industry Stability Report, various editions

Figure 1.2: Regional and Sectoral Distribution of Global IFSI Assets

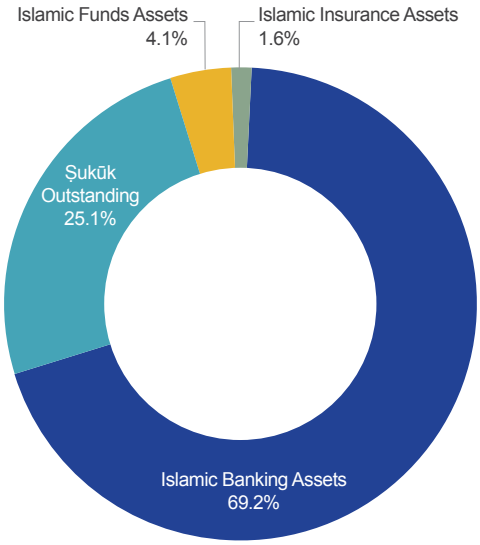
Mature Islamic finance markets in GCC and EAP account for 75% of the global IFSI asset base

Islamic banking continues to dominate, representing nearly 70% of global Islamic financial assets.

1. Regional Distribution of Global IFSI Assets
(Percent)



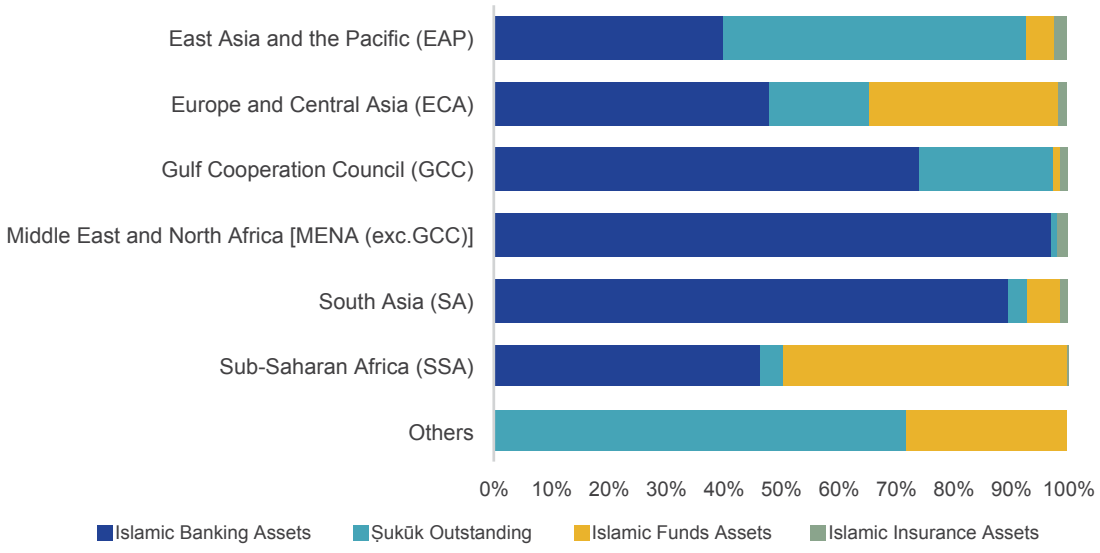
2. Sectoral Distribution of Global IFSI Assets
(Percent)



Sectoral composition varies and most continue to be banking dominant. While capital markets have developed to varying extents in different regions, Islamic insurance represent a consistently marginal share across all markets.

3. Regional Sectoral Assets

(Percent)



Source: IFSB PSIFIs

Notes: a) The Secretariat has adopted a regional classification made up of the following regions: Gulf Cooperation Council (GCC), Middle East and North Africa (MENA excl. GCC), East Asia and Pacific (EAP), South Asia (SA), Europe and Central Asia (ECA) and Sub-Saharan Africa (SSA); b) The breakdown of Islamic funds' assets is by domicile of the funds, while for şukūk outstanding, it is by domicile of the obligor.

Islamic banking growth moderated relative to 2024 and accounts for around 69% of total IFSI assets. The sector remained systemically significant in 16[12] jurisdictions where Islamic banking accounts for more than 15% of total domestic banking assets (Figure 1.3). Assets remain concentrated in a limited number of core markets, with faster expansion observed in emerging and frontier markets, against a backdrop of varying market maturities and infrastructure and supervisory capacity. In markets where Islamic banking already commands a dominant share of total banking assets, growth rates broadly aligned with overall growth of the financial system. Balance sheets remained structurally concentrated, with a predominant reliance on debt-based instruments and exposures skewed toward household and real estate segments, reinforcing linkages to domestic credit and property cycles.

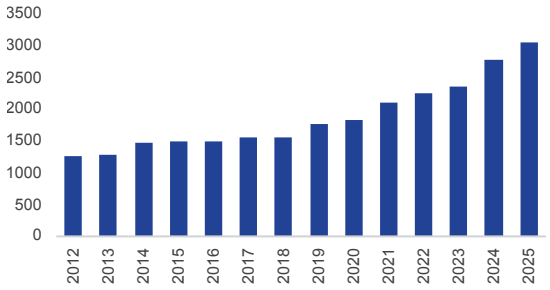
12 Declines from 17 to 16 due to a very slight drop in the market share of Palestine due to ongoing geopolitical challenges.

Figure 1.3: Islamic Banking Developments

Islamic banking assets have grown steadily across all regions, with a global CAGR(5yr) of 10.6%

1. Islamic Banking Assets (2012-2025)

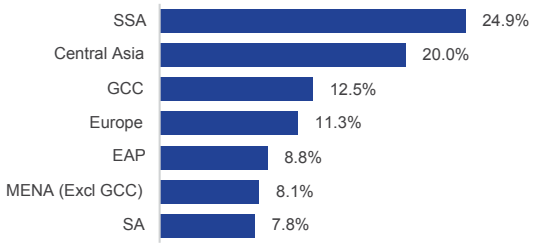
(Billions USD)



Frontier and emerging markets continue to record high growth rates outpacing established markets

2. CAGR of Regional Islamic Banking Assets (2020-2025)

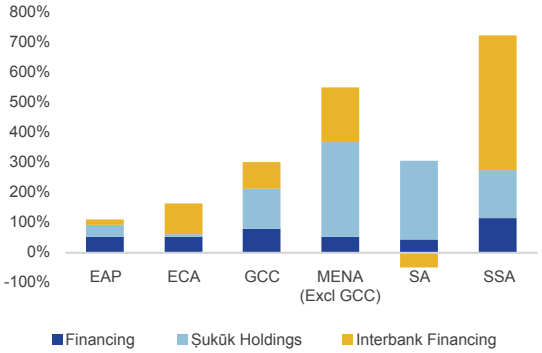
(Percent)



On the asset side, ṣukūk holdings and interbank financing expanded faster than financing portfolios in some regions

3. Regional Asset Composition Changes

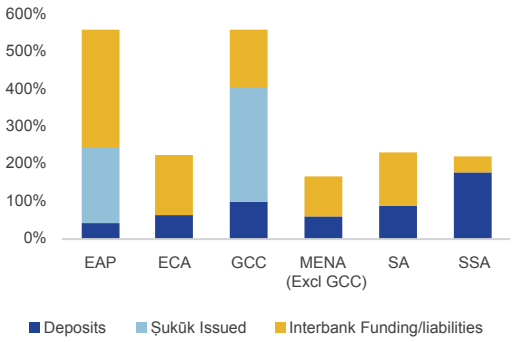
Change in percent (from 2020 to 2025)



On the liabilities side, interbank funding and ṣukūk issuances are increasing in many jurisdictions

4. Regional Funding Composition Changes

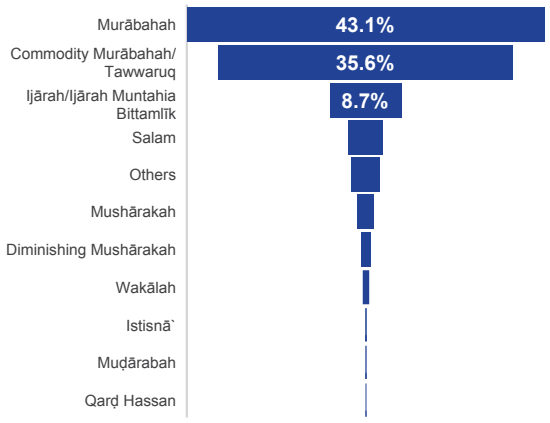
Change in percent (from 2020 to 2025)



Murābaḥah and commodity murābaḥah account for significant portion of financing contracts globally

5. Global Financing by Contract (2025Q3)

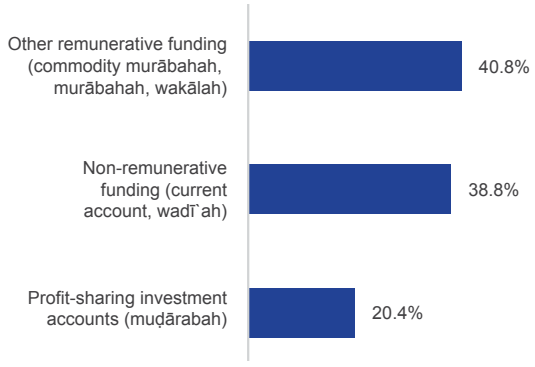
(Percent)



Debt-based remunerative deposits constitute the dominant share of Islamic banks' funding composition

6. Global Composition of Deposits (2025Q3)

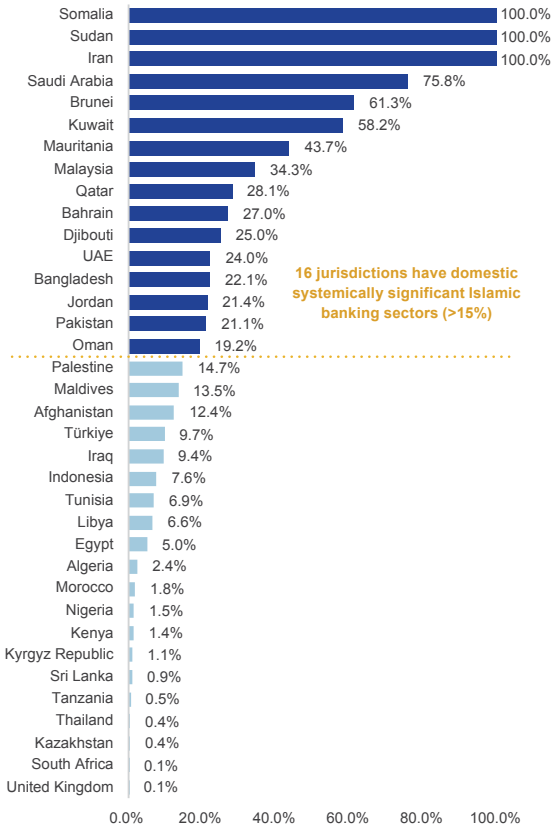
(Percent)



16 Domestic Systemic Important (DSI) markets retained 93% of global Islamic banking assets

7. Islamic Banking Share in Total Banking Assets by Jurisdiction (2025Q3)

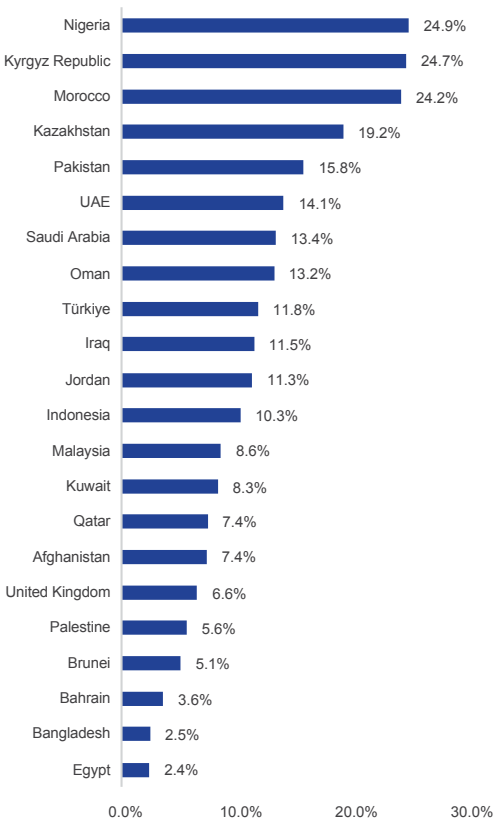
(Percent)



Double-digit growth rates across many jurisdictions, including frontier and established markets

8. Islamic Banking Growth Rates (5-yr CAGR) Across Jurisdictions

(Percent)



Source: IFSB PSIFIs

The global Islamic insurance sector has continued to expand at double digit growth rates, with its footprint continuing to widen across new and emerging jurisdictions. Growth is shifting structurally from established markets toward emerging and frontier jurisdictions. Expansion has moderated in more mature markets in the GCC and EAP, while momentum has increased significantly in the ECA, SSA, and SA, supported by substantive market development, regulatory progress,[13] and strong demand for insurance coverage (Figure 1.4). Growth drivers differ meaningfully by region. In the GCC, large-scale infrastructure pipelines are generating sustained insurance demand. Across parts of MENA (excl GCC), Islamic insurance is displacing conventional alternatives on the strength of consumer preference.[14] In SSA and the GCC, compulsory health and group life schemes are broadening participation. However, mandatory lines also often compress pricing power and shift competitive advantage toward operational efficiency and scale, reinforcing market structures that favour larger operators and accelerating consolidation. As the sector extends into frontier markets, supporting infrastructure – such as investment options, reinsurance capacity and supervisory frameworks – often lag behind market growth.

13 The Philippines issued its first licences in late 2024, Singapore saw Islamic insurance return in early 2025, Somalia enacted its National Islamic Insurance Law in May 2025 and commenced licensing, Ethiopia launched its first dedicated operator, and Ghana and Uganda advanced their respective regulatory frameworks.

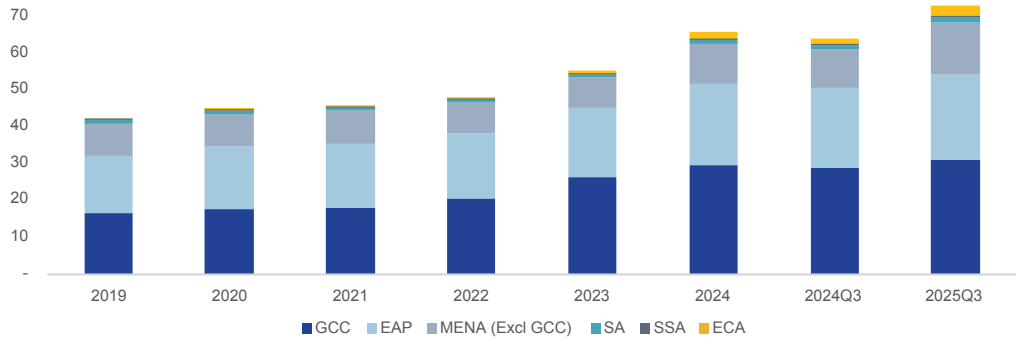
14 Middle East Insurance Review, *Building tomorrow's solutions - Market Profile – Jordan* (2025). Available at: https://www.meinsurancereview.com/Magazine/ReadMagazineArticle/aid/49338/Building-tomorrow-s-solutions

Figure 1.4: Islamic Insurance Growth Trends

Global Islamic insurance assets have grown steadily, surpassing USD 70 billion in 2025Q3

1. Islamic Insurance Total Assets

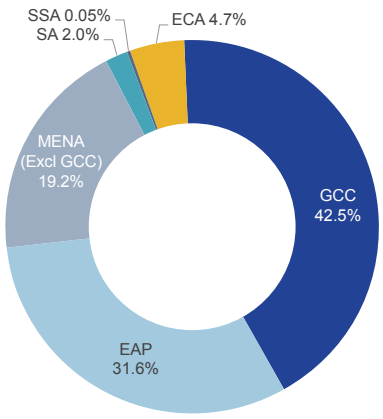
(USD Billions)



Established markets account for three-quarters of global Islamic insurance assets

2. Regional Share of Islamic Insurance Assets (2025Q3)

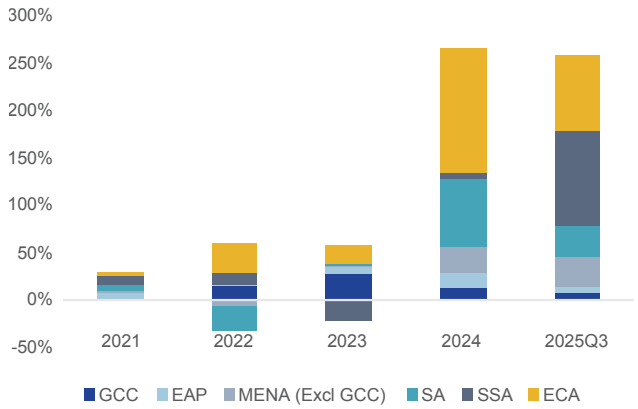
(Percent)



Frontier markets are growing at a faster pace than mature markets

3. Total Assets Change in Percent (2021 – 2025Q3)

(Percent)



Source: IFSB PSIFIs, data provided by regulators and public institutional data

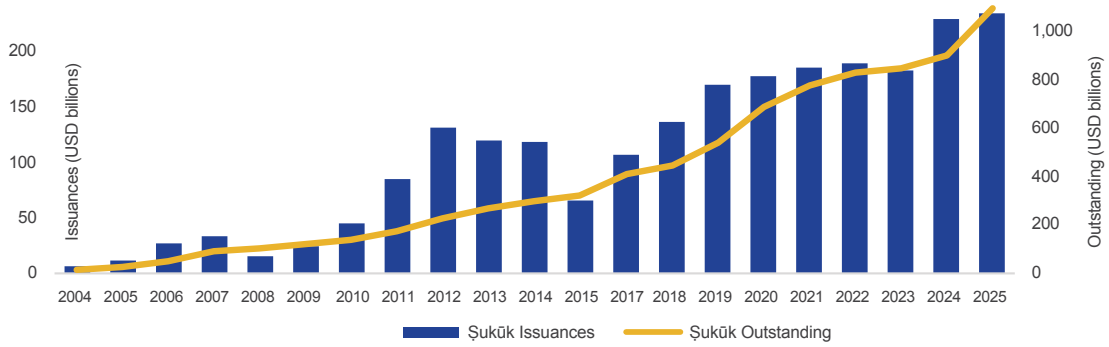
In the Islamic capital markets, the ṣukūk market expanded to USD 1.10 trillion in outstanding ṣukūk, recording strong double-digit growth driven by continued deepening in established markets and increased activity in newer jurisdictions. Ṣukūk issuance reached a new high, at USD 234.5 billion, with several jurisdictions, including Tanzania and Egypt, issuing debut ṣukūk. Issuances in 2025 were driven by an increase in quasi-sovereign issuances (66% of which were international issuances) and by an increase in corporate issuers taking advantage of favourable financing conditions. Overall, international issuances increased by 12% while domestic local currency issuances fell by 6%, pointing to continued constraints in the depth of local ṣukūk markets and, in some cases, a narrow domestic investor base. Regulatory capital ṣukūk issuances by Islamic banks increased markedly, indicating a growing use of ṣukūk for capital management purposes. Sustainability and climate-related issuances saw significant growth (33% and 94% YoY growth of sustainability-related ṣukūk and green ṣukūk, respectively) (Figure 1.5). As the ṣukūk market continues to deepen and become a systemically important funding channel, the opacity and complexity of ṣukūk structures becomes an increasingly material concern, reinforcing the need for greater transparency and the development of taxonomies that standardise definitions and disclosures to improve comparability, enhance fungibility, and strengthen market confidence.

Figure 1.5: Islamic Capital Market Size and Issuances

Outstanding ṣukūk crossed the USD 1 trillion threshold in 2025: a structural milestone for the global Islamic capital market

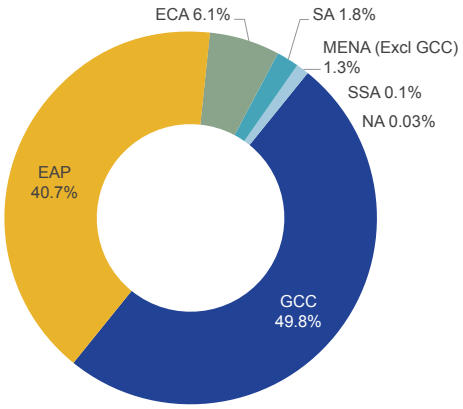
1. Global Ṣukūk Issuances and Outstanding (2004–2025)

(USD Billions)



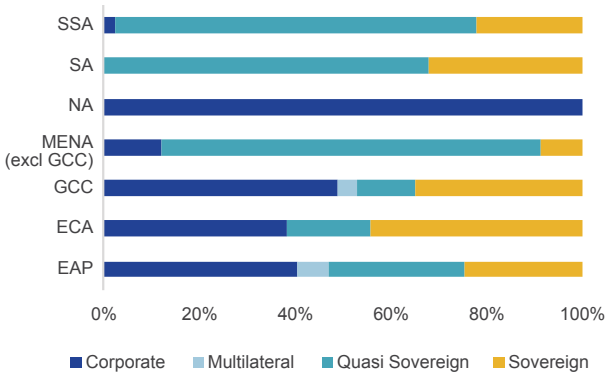
Activity remains highly concentrated in core markets (GCC and EAP) which accounted for 91% of issuances

2. Ṣukūk Issuances by Region (2025)



Composition varied by region, with sovereign and other government related issuances being dominant in many jurisdictions

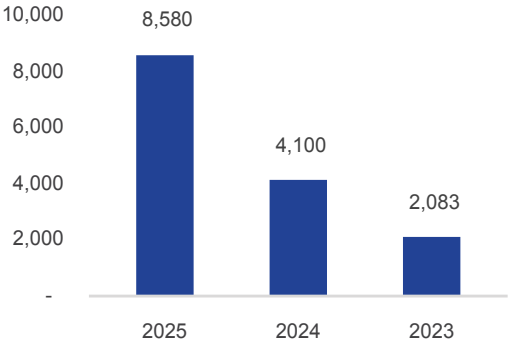
3. Ṣukūk issuances in 2025 per region and issuer type



AT1 capital ṣukūk issuance more than doubled in 2025, driven predominantly by GCC-based Islamic banks

4. Additional Tier 1 Capital Ṣukūk (Basel III)

(USD Millions)



Sustainability-related issuances increased significantly, though it remains a modest share of the broader market

5. Sustainability-related and Green Ṣukūk Issuances (2017–2025)

(USD Millions)

Source: Refinitiv
Notes: NA = North America

1.3 Banking

Headline Prudential Indicators Remain Broadly Stable but Mask Potential Underlying Fragilities

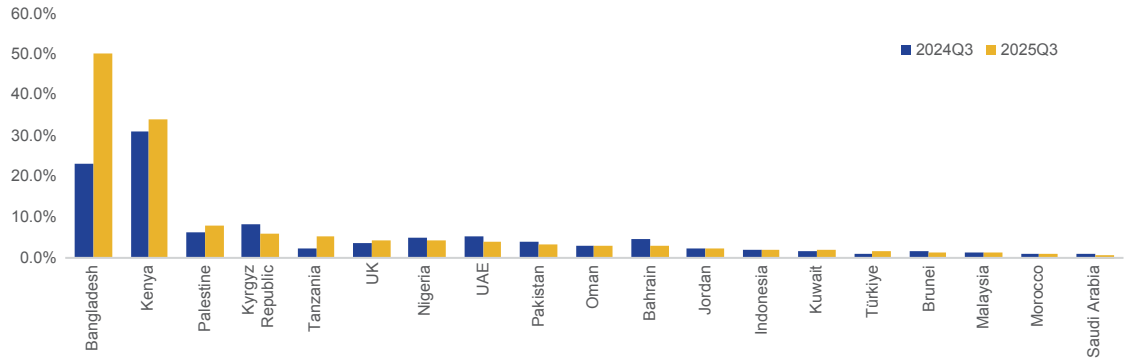
While headline prudential indicators suggest that Islamic banks have remained broadly stable in aggregate, emerging pockets of vulnerability are becoming more evident across jurisdictions. Asset quality has remained broadly resilient in most markets, but signs of deterioration have emerged in a subset of jurisdictions. In some cases, improvements in reported non-performing financing (NPF) ratios were driven by write-offs and restructurings rather than a sustained strengthening in underlying credit quality. Asset quality pressures have emerged in a small group of jurisdictions, while most others have maintained ratios that are within sound thresholds. Gross NPF ratios were exceptionally high in a few jurisdictions, most notably Bangladesh and Kenya, while in a few others, they exceeded 5% (Figure 1.6 Chart 1).

Credit risk developments during the period pointed to pressure in specific portfolio segments. Indicators of credit impairment were more evident in portfolios with material exposure to commercial real estate (CRE) and industrials sectors as well as retail-oriented financing, including consumer financing where performance remained sensitive to tighter financing conditions, valuation pressures, and weaker commercial activity (Figure 1.6 Chart 2). This is aligned with broader global assessments of elevated credit risk conditions affecting these segments within the conventional banking system in 2025. In several markets, domestically systemically important Islamic banks (D-SIBs) had concentrated exposures to these higher risk sectors, where rising delinquencies have translated into increased transition to Stage 3 classifications[15] indicating a growing share of credit-impaired assets (Figure 1.6 Chart 3). This deterioration in asset quality increases expected credit losses and the sensitivity of earnings and capital to further stress. Higher sectoral concentration alongside rising impairment suggests a potential build-up of latent credit risk that could materialise if financing conditions tighten, particularly in the event that macroeconomic conditions deteriorate.

Figure 1.6: Islamic Banking Asset Quality

Asset quality pressures have emerged in a small group of jurisdictions.

1. Islamic Banks' Average Gross Non-Performing Financing to Total Financing (2024Q3, 2025Q3)
(Percent)

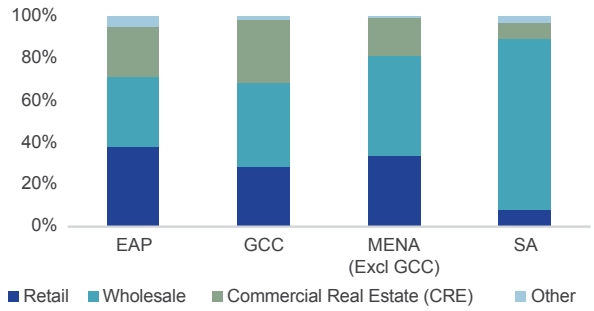


15 Stage 3 classification indicate credit-impaired exposures where borrowers are in default or close to default.

Real estate and household financing accounted for the largest share of NPF across most regions

2. Economic Sector-Wise Share of Non-Performing Financing by Region (%) (2025Q3)

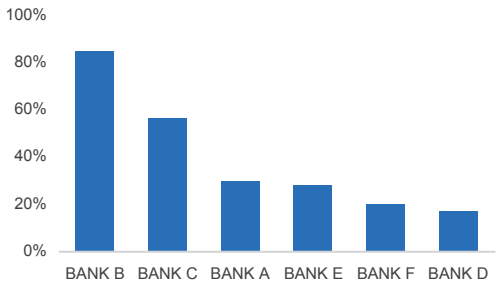
(Percent)



Stage 3 NPF in Islamic D-SIBs rose across multiple regions, signalling building credit impairment

3. Change in Stage 3 Non-Performing Financing of Islamic D-SIBs (2024Q3-2025Q3)

(Percent)



Source: IFSB PSIFIs

Notes: In chart 3, bank names are anonymised. Data are derived from the financial statements of six domestic systemically important ((D-SIBs) Islamic banks across four regions (ECA, EAP, GCC, and SA).

Capital adequacy remained broadly resilient across most jurisdictions, with ratios comfortably above regulatory minima with one exception. Capital buffers were supported by retained earnings and, in some cases, by the issuance of ṣukūk qualifying as Additional Tier 1 or Tier 2 capital (Figure 1.7). However, the extent of this resilience was not uniform. In South Asia, profit margin compression weighed on retained earnings, constraining the capacity to build capital buffers through internal generation and potentially weakening forward-looking loss-absorption capacity. Bangladesh represents a clear outlier, with capital ratios declining sharply from already weak levels to negative territory following the recognition of previously unreported impairments, reflecting underlying governance and supervisory weaknesses as well as delayed loss recognition that had masked the true capital position (Box 1.1).

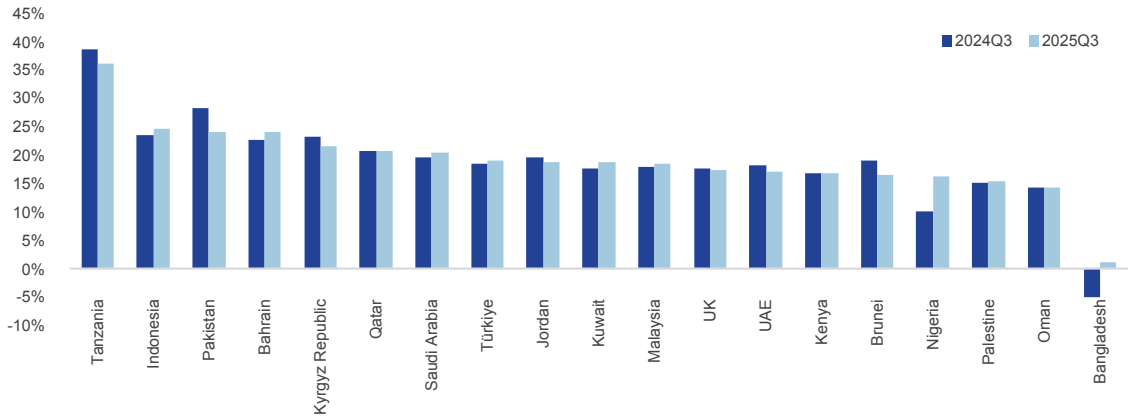
The emergence of hybrid risks bears on the quality of capital adequacy assessments across the industry. The expanding adoption of hybrid financing models introduces risk profiles that are not always fully captured by existing standardised risk-weights (see Chapter 2). Where risk calibration does not keep pace with the complexity of underlying exposures, reported capital ratios may present an incomplete picture of effective loss-absorption capacity. This concern is particularly relevant in markets where credit growth expanded rapidly during the recent period of favourable macroeconomic conditions.

Figure 1.7: Islamic Banking Capital Adequacy

Capital adequacy ratios for most countries remained comfortably above regulatory minimums with one exception

1. Country-level Capital Adequacy Ratio (CAR) (2024Q3, 2025Q3)

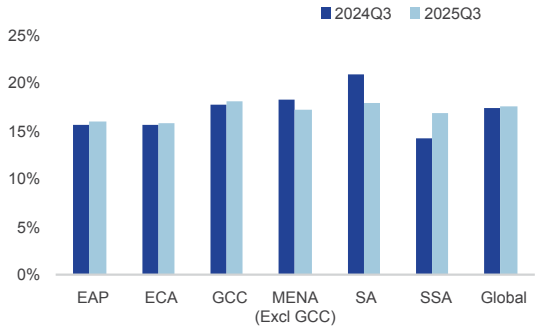
(Percent)



Tier 1 capital ratios held broadly stable globally, though contracting in some markets

2. Global and Regional IB's Tier 1 Capital Ratio (2024Q3, 2025Q3)

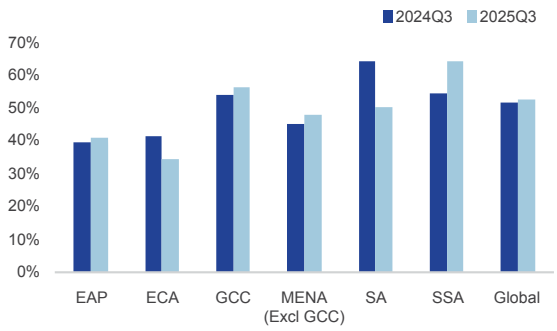
(Percent)



Net profit margins compressed in some markets, particularly in South Asia

3. Global and Regional Net Profit Margin (2024Q3, 2025Q3)

(Percent)



Source: IFSB PSIFIs

Notes: Bangladesh is excluded from the SA figures in Charts 2 and 3, given that it is a significant outlier that affects the regional assessment.

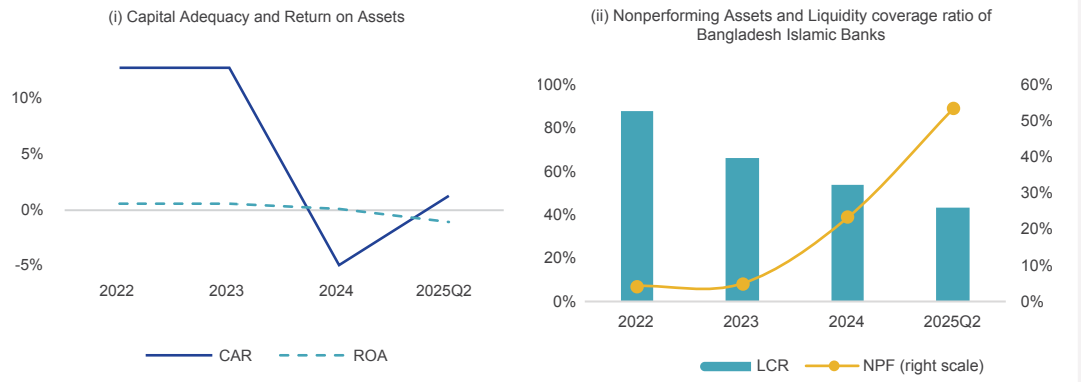
Box 1.1 Governance Failures and Islamic Banking Sector Stress in Bangladesh

Recent stress in Bangladesh's Islamic banking sector illustrates how weaknesses in governance, risk controls, and supervisory oversight can translate into severe prudential deterioration. At the root of the crisis was the systematic concentration of ownership: a single business group acquired controlling stakes in five of ten full-fledged Islamic banks through multiple entities under common control. At the largest institution, 81–83% of shares were held through 24 related entities, giving the group effective control of Boards. This weakened governance structure shifted incentives away from prudent risk management and depositor protection, facilitating large-scale misallocation of credit.

At the affected institutions, related-party financing accounted for almost 50% of total financing, rendering single obligor limits ineffective where common beneficial ownership existed. Weak internal controls, risk management, and audit functions failed to identify or escalate these exposures.

Prudential indicators deteriorated sharply over the period (Figure A). NPF ratios rose steeply while liquidity buffers declined materially, indicating concurrent asset quality and funding stress. As impairments were recognised, capital adequacy fell from above regulatory minima in 2023 to negative levels by 2024, reflecting the delayed crystallisation of previously unrecognised losses.

Figure A: Selected soundness indicators of the Islamic Banking Industry of Bangladesh



Source: IFSB PSIFIs, Bangladesh Bank Financial Stability Report

Notes: a) 2022–2024 data are extracted from the Bangladesh Bank Financial Stability Report;
b) 2025Q2 data are extracted from the PSIFIs, representing the full-fledged Islamic banks of Bangladesh

Supervisory responses did not capture the deterioration in a timely manner. Provisioning deferrals allowed institutions to report stronger positions than underlying conditions warranted, while dividend distributions continued despite reliance on liquidity support. Central bank observers appointed to these banks were withdrawn in 2020, which further reduced oversight. The episode also exposed significant gaps in the financial safety net and crisis management frameworks. Crisis management relied on ad hoc measures until a formal framework was developed and introduced under the Bank Resolution Ordinance 2025.

The composition of Islamic bank balance sheets varies materially across regions, with significant implications for income structure, intermediation capacity, and the nature of underlying risks. Financing activity ranges from approximately 78% of total assets in EAP to 28% in SSA, with GCC and MENA (excl GCC) sitting closer to the higher end of this range. In SA and SSA, ṣukūk and interbank placements account for a substantially larger share of total assets than financing (Figure 1.8). This compositional difference has direct income consequences: banks in SA and SSA rely more heavily on securities yields and short-term placement returns, making earnings more sensitive to benchmark rate movements and reinvestment conditions, with less capacity to expand net financing margins as a buffer against funding cost pressure. The elevated cash and interbank balances in ECA and SSA reflect limited availability of suitable short-term liquidity instruments, shallow interbank and secondary markets, and in some markets weaker private sector credit demand. The growth in interbank placements, particularly in SSA, raises the proportion of short-term confidence-sensitive exposures

on balance sheets that are already lightly deployed into productive assets; a structural feature that warrants continued supervisory attention as these systems expand.

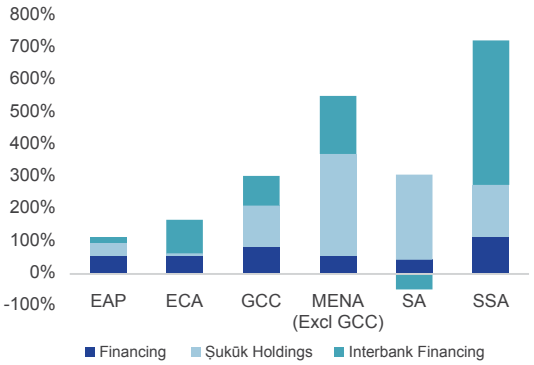
Ṣukūk holdings represent a significant component of Islamic bank balance sheets across regions, with important implications for valuation sensitivity and sovereign-bank linkages. Ṣukūk holdings accounted for around 45% of total assets in SA and 36% in SSA, while remaining a meaningful share in ECA and MENA, and more balanced in other markets. The concentration of sovereign in SA and SSA is particularly prominent, reflecting structural factors such as shallow corporate ṣukūk markets and limited investment alternatives, regulatory requirements, and the role of Islamic banks as captive absorbers of domestic sovereign issuance. In these jurisdictions, the sovereign-bank nexus is structurally reinforced, as Islamic banks rely heavily on sovereign ṣukūk for both liquidity management and balance sheet deployment. This creates a direct transmission channel through which sovereign stress can affect the valuation of ṣukūk holdings and, where exposures are large, materially weaken capital positions and financing capacity. The impact may be non-linear, as relatively modest declines in sovereign valuations can have disproportionate effects on bank solvency.[16]

Figure 1.8: Islamic Banking Asset Composition

Balance sheet compositions are showing increases in ṣukūk and interbank financing in some regions

1. Regional Asset Composition Changes (2024/25)

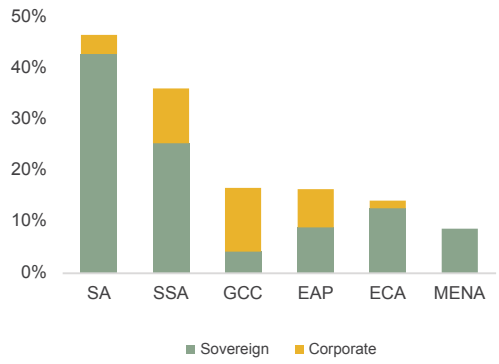
(Percent)



Significant exposures to sovereign ṣukūk in some Islamic bank securities portfolios

2. Ṣukūk Holdings Composition by Type as a Share of Total Islamic Banking Assets (2025Q3)

(Percent)



Source: IFSB PSIFIs

Notes: Chart 1.A is generated from PSIFIs data. Chart 2 presents the regional average share of ṣukūk holdings by issuer type as a proportion of total assets. The Chart is based on institutional-level data covering 20 DSI Islamic banks in 13 jurisdictions, representing six regions.

Funding and liquidity risks for Islamic banks remain broadly contained at the aggregate level, with liquidity indicators above regulatory minima across most jurisdictions (Figure 1.9). The exception was Bangladesh, where liquidity coverage ratios at several Islamic banks declined below the 100% regulatory threshold, reflecting the transmission of governance-related asset quality stress into liquidity positions of affected Islamic banks, as referred to in Box 1.1. Several structural features of Islamic banks' funding and liquidity frameworks introduce vulnerabilities that are not fully captured by aggregate ratios. These include limited availability of suitable high-quality liquid assets, concentration of short-term funding in commodity murābaḥah transactions, and underdeveloped Islamic money markets that may constrain effective liquidity management under stress.

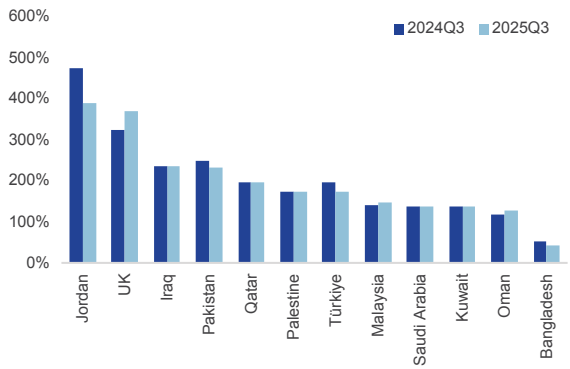
16 World Bank *Finance and Prosperity 2024*, Chapter 2: Sovereign-Bank Nexus Risks Need to Be Addressed. Washington, DC: World Bank Group (2024).

Figure 1.9: Islamic Banking Liquidity

Liquidity buffers remained ample, with the exception of one jurisdiction experiencing Islamic banking sector stress

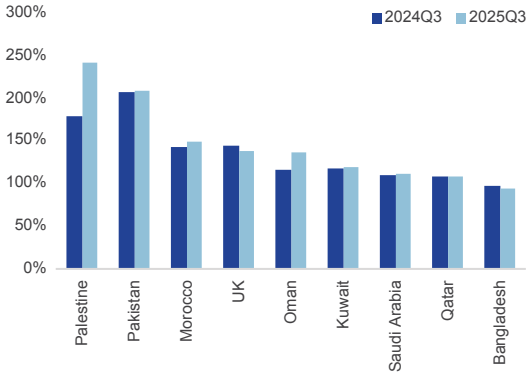
1. Country-level Liquidity Coverage Ratio (LCR) (2025Q3)

(Percent)



2. Country-level Net Stable Funding Ratio (NSFR) (2025Q3)

(Percent)



Source: IFSB PSIFIs

Islamic banks' funding profiles remain predominantly retail-deposit based, which historically has provided relative stability compared to wholesale funding. The retail orientation is reinforced by the limited development of Islamic wholesale funding markets in most jurisdictions, making deposit retention structurally important (Figure 1.10). Profit-sharing investment accounts (PSIAs) constitute a significant component of the funding base in some jurisdictions. While PSIAs are contractually structured as loss-bearing, in practice Islamic banks in most jurisdictions manage depositor returns through profit equalisation reserves (PER) and investment risk reserves (IRR), and absorb displaced commercial risk (DCR) by forgoing part of their own share to maintain returns competitive with conventional deposit rates. The practical effect is that PSIA holders in most markets experience returns closely approximating conventional deposit-equivalent income, with loss exposure largely insulated. This practice, however, transfers risk to the bank rather than the PSIA depositor as contractually intended. Under sustained periods of weak investment returns, the capacity to maintain competitive PSIA payouts while continuing to absorb DCR may come under pressure, compressing retained earnings and creating a contingent liability on the equity base that is not always transparently reflected in reported funding metrics. In jurisdictions where PSIAs are practiced without a return smoothing mechanism, depositors bear investment return risks more directly. In these jurisdictions, a sustained deterioration in investment performance may increase the likelihood of deposit withdrawals, as depositors respond to realised or anticipated reductions in returns, which presents a funding risk dimension that requires explicit treatment within liquidity risk management frameworks.

A significant and growing source of structural vulnerability in interbank markets lies in the concentration of interbank funding in commodity murābaḥah transactions. It represents nearly three-quarters[17] of total interbank funding. This heavy reliance could over time amplify systemic vulnerabilities (see Chapter 2), particularly in the absence of a broader range of alternative liquidity management tools.

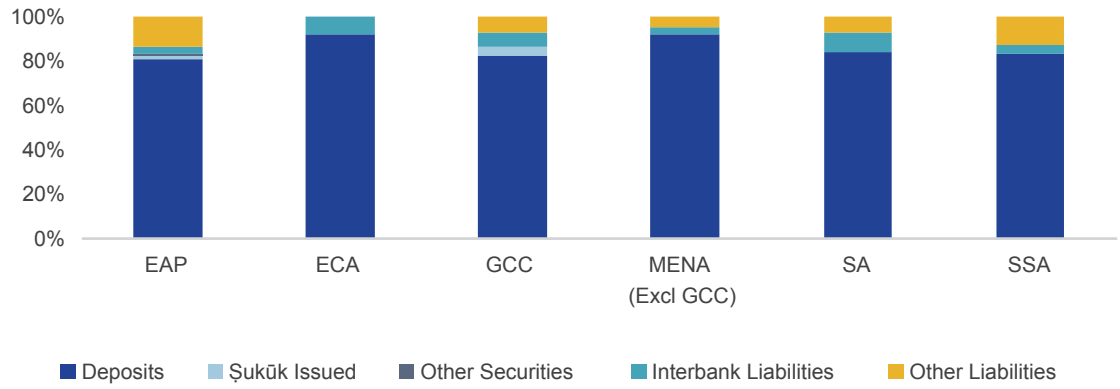
17 Data are derived from the financial statements of 8 domestic systemically important ((D-SIBs) Islamic banks across three regions (ECA, EAP and GCC).

Figure 1.10: Islamic Banking Funding and Liabilities Composition

Deposits remain the primary funding source for Islamic banks globally, while interbank liabilities constitute a prominent component of the funding base in ECA and South Asia.

Regional Islamic Banking Funding and Liabilities Composition (2025Q3)

(USD Billions)



Source: IFSB PSIFIs

1.4 Insurance

Solvency Positions Remain Adequate, though Pressures on Capital Accumulation are Building

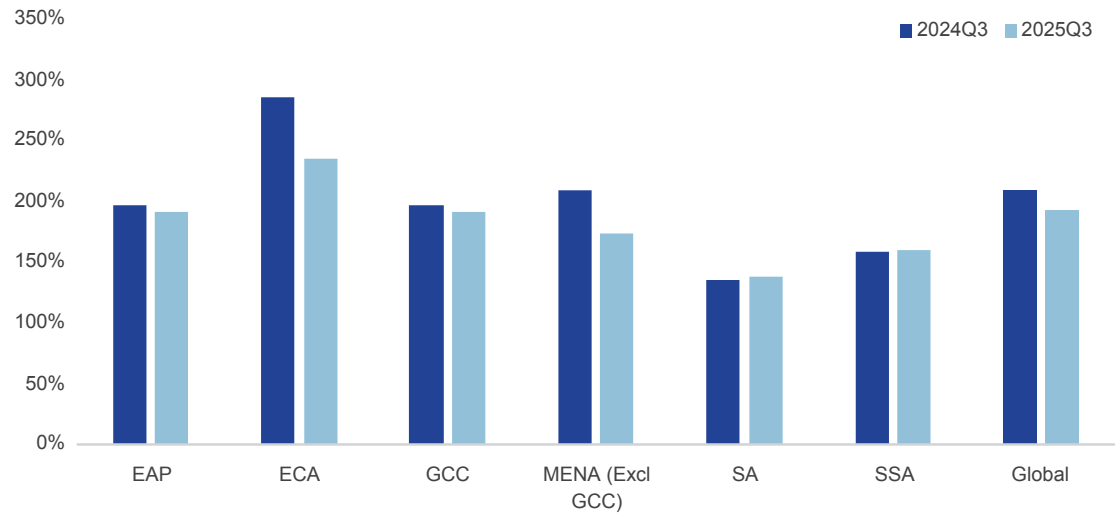
Headline solvency ratios remained comfortably above minimum requirements, but buffers have narrowed in several markets (Figure 1.11). In several jurisdictions, elevated claims growth, driven by both higher frequency of claims and inflation-induced increases in claims severity, outpaced internal capital generation and eroded excess capital. In others, particularly in high-inflation environments, rapid balance sheet expansion and rising risk exposures increased capital requirements, which absorbed previously accumulated surplus capital and compressed solvency ratios despite continued growth in nominal capital levels.

Several markets have adopted, or are transitioning, toward risk-based capital frameworks. This prompted Islamic insurance operators to reassess capital allocation and risk retention strategies. Mature markets have increased the diversity and complexity of regulatory capital instruments, reflecting more advanced capital management and greater integration with capital markets. Islamic insurance operators in the GCC and EAP expanded the range of Islamic capital instruments, with the region's first perpetual Tier 1 preference shares issued in the GCC and Tier 2 subordinated ṣukūk issued in the EAP region.

Figure 1.11: Solvency Ratios Across Islamic Insurance Markets

Headline solvency ratios remained above regulatory minima across most markets

Solvency Ratio (2024Q3, 2025Q3)
(Percent)



Source: IFSB calculations based on data provided by regulators and publicly reported data

Increased dependency on qarḍ in several markets reflect structural pressures on underwriting performance and raises risks of capital impairment.[18] Across most jurisdictions, policyholder[19] risk funds were unable to cover deficits from their own surpluses increasing reliance on qarḍ from shareholders. Increases in claims cost, particularly in medical and motor lines, drove deterioration in underwriting performance in regions where contribution adjustments lagged. Persistent deficits suggest that pricing, cost management, or risk selection decisions taken on behalf of policyholders have not preserved the fund's capacity to meet obligations from its own resources and raise concerns about the adequacy of fund management. Standard solvency ratios, which aggregate shareholder and policyholder positions at the entity level, may obscure these vulnerabilities until deficits in the policyholder fund materialise.

Profitability Weakens amid Margin Compression

Underwriting margins have tightened as claims costs outpaced contribution growth, with the net combined ratio increasing across most regions (Figure 1.12). Motor and medical segments faced the highest margin compression. Premium inadequacy was most acute in GCC motor lines, where sustained below-cost pricing, driven by market-share competition, eroded technical margins and contributed to the deterioration in combined ratios observed across the segment. Medical inflation substantially outpaced contribution adjustments in EAP, SA, and the GCC. Macroeconomic conditions added further pressure in several markets: currency devaluation raised replacement costs for imported vehicles, spare parts, and medical equipment in parts of SSA, and elevated living costs across SSA and EAP weighed on demand, reducing uptake from households and small enterprises.

Against the backdrop of tightening underwriting margins, increasing reliance on investment income and weaknesses in calibration of management (wakālah) fees are leading to emerging risks to profitability across markets. In highly competitive markets, management fees were compressed to levels that may be insufficient to cover operating expenses, placing pressure on operators' expense ratios and increasing dependence on investment income to maintain overall profitability. This has introduced earnings volatility and increased vulnerability to changes in market conditions affecting investment returns. On the other hand, in some markets, elevated wakālah fees may distort the allocation between shareholders and policyholders by reducing the share of contributions available to the risk (policyholder) fund. This can weaken the financial position of the risk fund, potentially leading to higher deficits and increasing reliance on qarḍ from shareholders to meet claims obligations which, while supporting short-term solvency, places an additional burden on future profitability through delayed recovery and capital strain (Box 1.2).

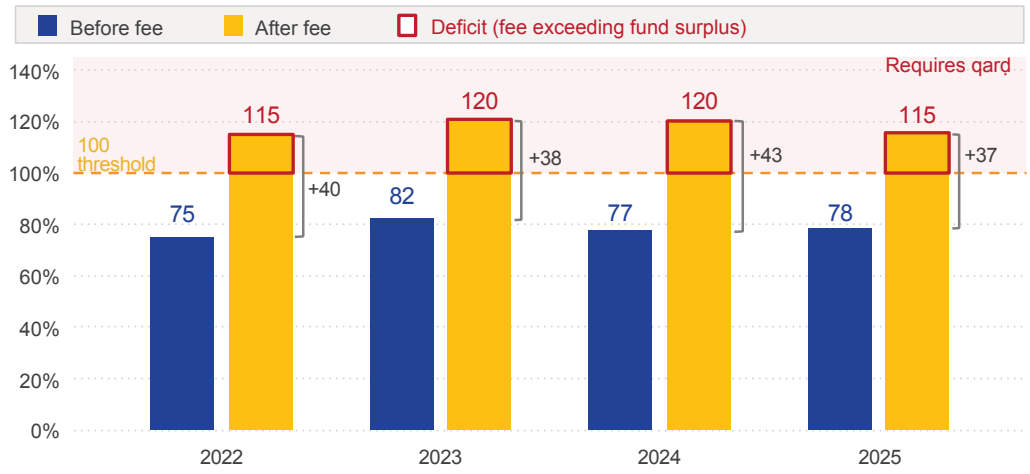
18 Where policyholder funds are in deficit or unable to meet claims, the shareholders provide interest-free loans (qarḍ) to the policy holder fund to meet claims, which are recovered from the future surpluses of the fund.

19 In Islamic insurance, customers are formally referred to as 'participants' rather than 'policyholders,' reflecting the cooperative nature of the arrangement: policyholders contribute to a common risk pool through voluntary donations (tabarru') and share in the underwriting outcome, rather than purchasing a commercial indemnity contract from an insurer. For consistency with widely used global insurance terminology, this chapter uses the term 'policyholder'.

Box 1.2 Sustainability Challenges in the Wakālah Model: Misalignment Between Management Fees and Pricing of Underwriting Risk

In many jurisdictions, Islamic insurance operators compete on price with conventional insurers, which constrains the level of contributions (premium) that can be charged to policyholders. In the wakālah model, this is compounded by a structural feature where the operator's fee is deducted upfront from gross contributions, rather than emerging as a residual outcome of underwriting performance as in conventional insurance. As a result, the portion of contributions allocated to the risk fund is reduced ex ante. Given pricing pressures, the net amount available to the fund after wakālah fee extraction may not adequately reflect the underlying risk, and can be insufficient to support a sustainable underwriting position. This creates a structural misalignment: pricing may appear technically adequate at the gross level but becomes insufficient at the fund level once the fee layer is imposed, effectively embedding an underwriting deficit within the operating model (Figure A).

Figure A: Fund cost ratio before and after fee extraction (% of insurance revenue)

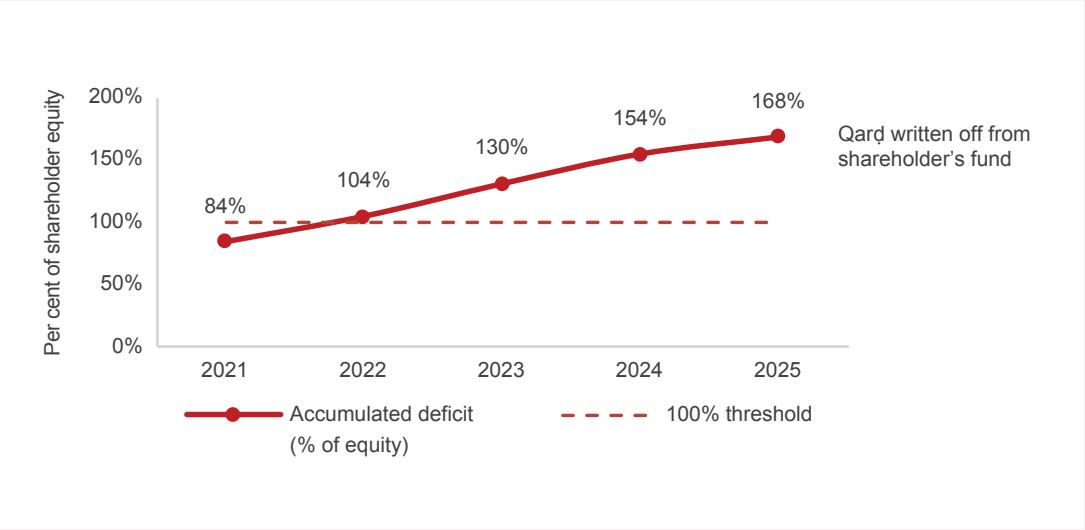


Source: Published Institutional data

The immediate consequence is an underwriting shortfall within the risk fund that may become persistent, as claims and related outflows exceed the net contributions retained after fee extraction (Figure B). This issue was first flagged by the IFSB in 2018,[20] where survey findings indicated that the magnitude of wakālah fees deducted from participants' contributions can materially weaken the solvency position and underwriting capacity of the fund, contributing to persistent deficits. In such cases, the qarḍ mechanism, intended as a temporary liquidity facility to smooth short-term volatility, begins to operate as a recurrent tool to meet routine claims obligations, effectively financing an underlying underwriting deficit. This leads to an accumulation of unpaid qarḍ on the fund's balance sheet. Over time, this dynamic can become self-reinforcing: the fee structure reduces the net contributions retained by the fund below the level required to cover claims and related outflows, constraining its ability to meet obligations and rebuild reserves, while the absence of surplus prevents repayment of outstanding qarḍ. In effect, the risk fund enters a structurally impaired position, where underwriting deficits are continuously rolled forward and operational viability depends on ongoing shareholder support.

20 IFSB (July 2018). *Issues Arising from Changes in Takāful Capital Requirements*, IFSB Working Paper WP-08

Figure B: Accumulated fund deficit as a percentage of shareholder equity



Source: Published Institutional data

Note: The accumulated deficit surpassed equity in 2022 and widened for three further years, reaching 168% before write-off

The implications are most acute under stress conditions. When claims experience deteriorates, whether due to adverse underwriting outcomes, catastrophe events, or broader macroeconomic pressures, or when shareholders face constraints in extending further qarḍ (e.g. due to capital limitations or group-level stress), the model's fragility becomes evident. Without the ability to generate internal surplus or access external liquidity, the risk fund may become non-viable, with deficits crystallising into solvency concerns. At this point, accumulated qarḍ effectively represents an unrecoverable claim on the fund, and losses may transmit to the shareholder balance sheet, potentially eroding capital. Where a supervisor does not impose fund level solvency requirements, entity-level solvency metrics may mask underlying fund-level deterioration, delaying corrective action until the point at which liquidity support can no longer be sustained and insolvency risks materialise.

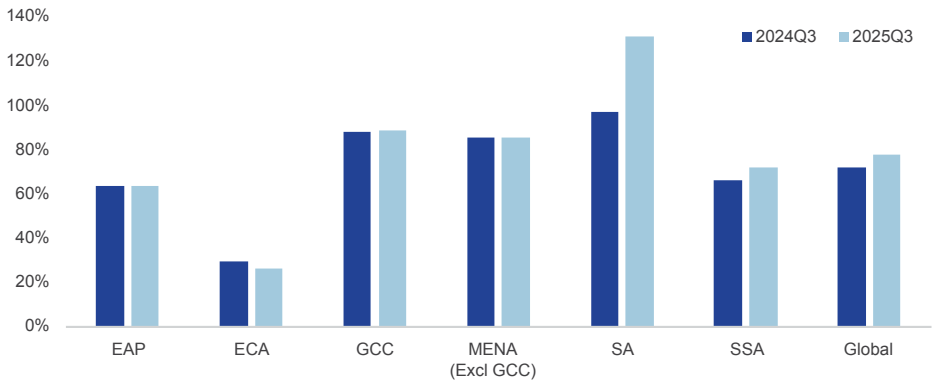
Furthermore, profitability is becoming increasingly concentrated among larger operators, highlighting structural challenges for smaller firms. In the GCC, larger operators were able to absorb cost pressures and maintained positive, albeit reduced, profitability, while smaller peers collectively shifted into significant losses. This divergence reflects the advantages of scale in managing claims inflation, pricing pressures, and rising regulatory compliance costs. Smaller operators, with limited capacity to spread these costs, face persistent profitability constraints that cannot be addressed through pricing adjustments alone. These dynamics point to increasing consolidation pressures, with a higher likelihood of mergers or market exits in the near term.

Figure 1.12: Islamic Insurance Profitability

Net combined ratios worsened globally as claims costs outpaced contribution growth, with motor and medical lines facing the sharpest increase.

1. Net Combined Ratio (2024Q3, 2025Q3)

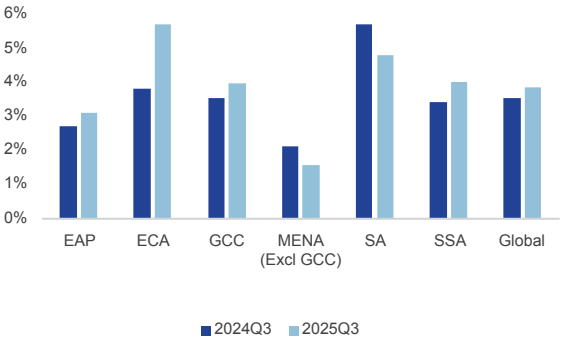
(Percent)



Investment income became the primary profitability buffer in 2025, partially offsetting deteriorating underwriting margins across most regions.

2. Investment Income Ratio (2024Q3, 2025Q3)

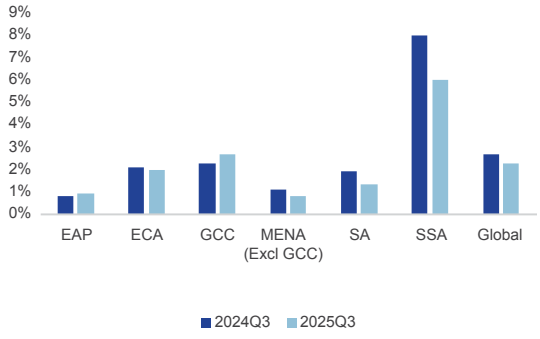
(Percent)



Return on assets declined across most markets, with the sharpest contractions where profitability had previously been highest.

3. Return on Asset (ROA) (2024Q3, 2025Q3)

(Percent)



Source: IFSB PSIFIs, publicly reported data and data provided by regulators

Portfolio Allocation Reflects Market Structure, but Reshapes Risk Sensitivity

Portfolio allocation has increased the allocation toward ṣukūk, though regional patterns differ. Globally, ṣukūk increased to around one-third of total investments, accompanied by a reduction in bank deposits (Figure 1.13). The adjustment was most pronounced in the family segment, where Islamic insurance operators increased ṣukūk allocations to align asset duration with long-tail liabilities. In EAP, ṣukūk accounted for more than three-fifths of portfolios, with one jurisdiction increasing its allocation to corporate ṣukūk. The GCC similarly increased ṣukūk investment while modestly raising equity exposure. This supported investment income in the near term but leaves balance sheets more exposed to repricing as market conditions shift. At the same time, higher allocations to sovereign ṣukūk, particularly in ECA and parts of EAP, improved credit quality and liquidity, while increasing the sensitivity of operator performance to fiscal conditions.

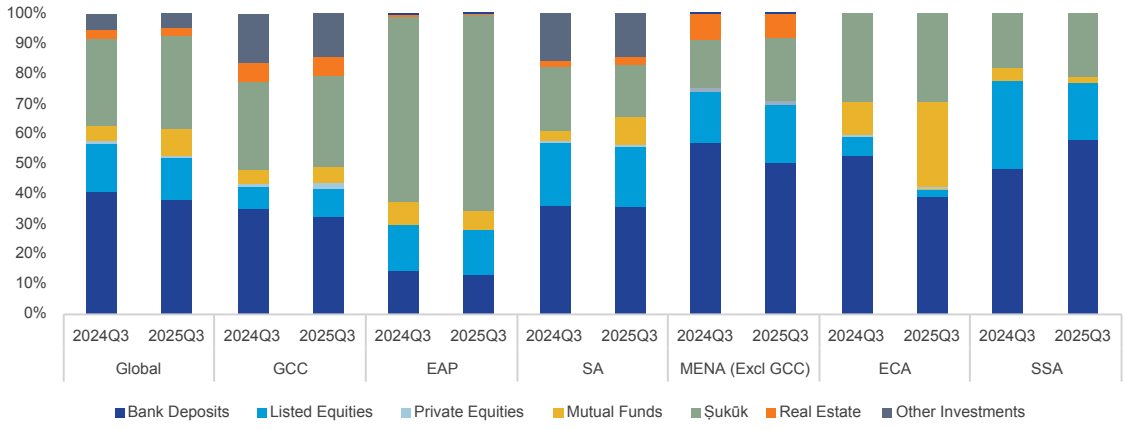
Long-term ṣukūk scarcity continued to constrain family segment development across most regions. Family businesses command a majority share of contributions only in specific EAP and SA markets. The scarcity of long-term ṣukūk prevents the sustainable development of savings products in frontier markets. Operators cannot effectively match the extended liability profiles these products create. This structural constraint forces many markets to remain concentrated in the general segment, limiting the sector's ability to address long-term protection needs. The constraint is particularly acute in parts of SA and SSA, where demographic demand for savings products exists but the investment infrastructure to support them does not.

Figure 1.13: Islamic Insurance Investment and Asset Composition

Increasing allocation of investments to ṣukūk

1. Investment Composition (2025Q3)

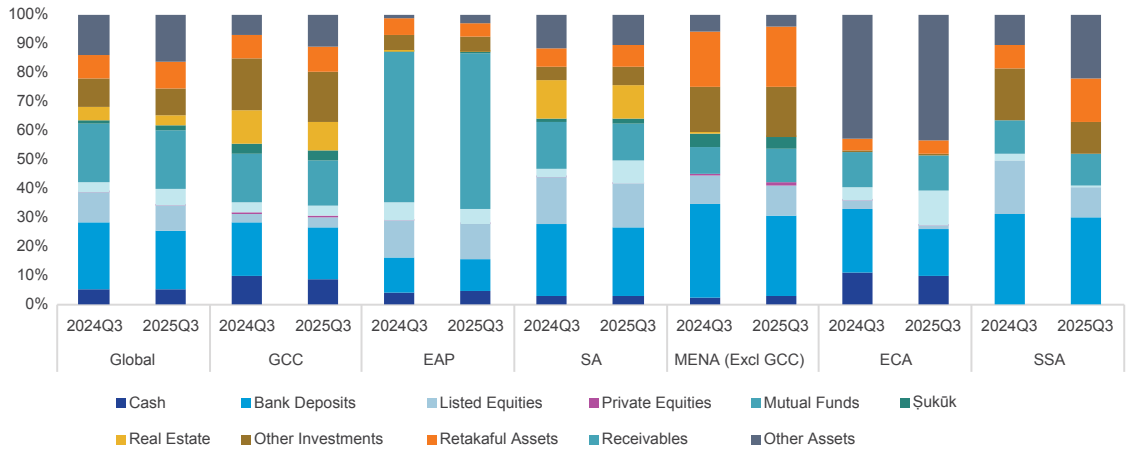
(Percent)



Bank deposits remain the single largest asset class on Islamic insurance balance sheets

2. Islamic Insurance Assets Composition (2025Q3)

(Percent)



Source: IFSB PSIFIs, publicly reported data and data provided by regulators

Increasing Interconnectedness between the Islamic Insurance and Banking Sectors

The growing adoption of bancassurance distribution strengthened the linkage between contribution volumes and banking credit cycles. Long-term exclusive partnerships and distribution through bank branch networks have redirected business away from traditional agents toward credit-linked protection products in parts of EAP and SA. This evolution created a correlation between financing activity and contribution volumes. Operators with strong banking relationships or bank ownership enjoyed structural advantages, while product designs adapted toward standardised offerings amenable to point-of-sale distribution. A contraction in Islamic banking credit would therefore simultaneously reduce new business volumes for affiliated operators. The combined effect of deposit concentration and distribution dependency means that banking sector stress would affect operators on both the asset and revenue sides simultaneously.

Structural Constraints Limit the Sector's Capacity to Absorb Large-Scale Losses

Climate-related losses have exceeded USD 100 billion in insured claims globally for five consecutive years, making natural catastrophe risk a pertinent financial stability consideration of growing relevance.[21] The geographic distribution of these losses have evolved, with regions historically characterised by lower risk profiles now experiencing severe weather events that test local financial capacity (Box 1.3). However, the majority of economic losses remain uninsured: protection gaps reached 85% in some emerging markets with losses falling predominantly on households, businesses, and governments rather than being transferred through insurance mechanisms.[22] These uncompensated losses can impair balance sheets throughout the economy and contribute to loan impairments as well as create contingent fiscal exposures.

The shallow Islamic reinsurance market increasingly forced operators to retain catastrophe risk, concentrating large-scale loss exposure on balance sheets not structured to absorb it. Domestic retention rose most notably in SSA, where operators retained the substantial majority of underwritten risk locally. This shift was partly driven by upcoming regulations prohibiting co-insurance with conventional peers. SA's general segment reduced dependency to minimal levels, leaving operators to manage the entirety of gross claim cash flows on their own balance sheets. The GCC similarly maintained modest dependency, partly influenced by regulatory mandates to strengthen domestic retention. This approach reduced contribution outflows and counterparty exposure but concentrated catastrophic loss risk on local balance sheets (Box 1.3).

Reinsurance terms hardened following catastrophic events, shifting greater first-loss retention onto primary operators when their balance sheets were most depleted. Following severe weather events, reinsurers introduced sub-limits on secondary perils such as floods. This affected the GCC markets, where tightening terms following severe weather meant operators absorbed more losses domestically, contributing to technical margin deterioration. In contrast, in the ECA, favourable ceding arrangements helped local operators to cover catastrophe risk claims.

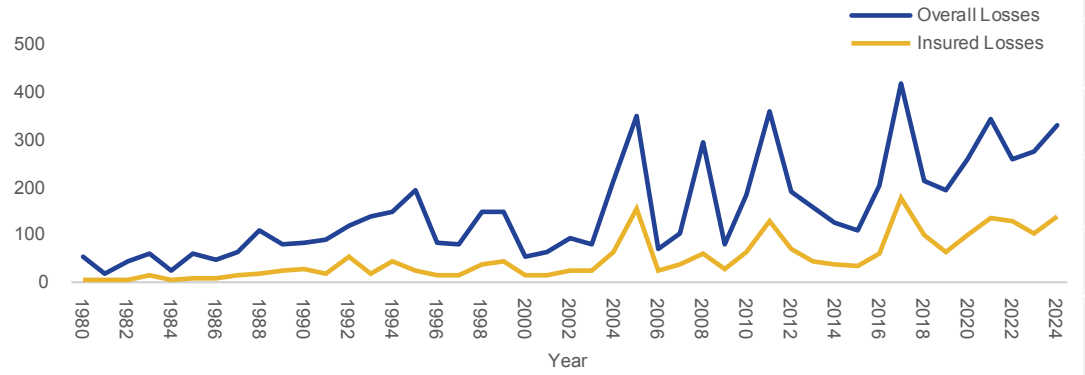
21 Swiss Re, Sigma 1/2025: *Natural Catastrophes Report* (2025). Available at: https://www.swissre.com/institute/research/sigma-research/sigma-2025-01-natural-catastrophes-trend.html

22 See footnote 21

Box 1.3 Successive Catastrophes Test the Limits of Local Balance Sheets

Successive catastrophic events between 2021 and 2024 tested Islamic insurance operators' capacity to absorb large-scale losses, bringing structural constraints into sharper focus. Severe flooding struck the UAE and Oman in April 2024, Malaysia experienced significant flood damage in late 2021, Pakistan's 2022 monsoon caused widespread devastation, and Türkiye faced the February 2023 earthquake sequence that generated the largest insured loss in the country's history.

Figure A: Natural Disaster Losses Over Time (1980-2024) USD Billions



Source: Swiss Re-sigma 1/2025

Islamic reinsurance capacity remained the most binding constraint on catastrophe risk management, though it operated differently across regions. In the GCC, operators with limited reinsurance coverage absorbed flood losses directly, depleting reserves built over multiple years. Malaysia formally acknowledged this constraint during the review period, issuing guidance permitting conventional reinsurance where Islamic reinsurance capacity is unavailable. In Pakistan, the regulator identified limited Islamic reinsurance capacity as a binding constraint on sustainable sector growth.

Data deficiencies contributed to the pricing and provisioning challenges across all affected regions. Lack of granular geospatial data has been identified as a critical impediment to accurate flood risk pricing at the micro level. Catastrophe models historically calibrated for earthquake risk underestimated flood exposure in regions now experiencing more frequent severe weather.

The 2024 GCC flooding illustrated how quickly capital buffers could be overwhelmed. Several operators breached regulatory solvency thresholds, where one required substantial capital restructuring, and another exited the sector after accumulated losses reached critical levels. Liquidity stress intensified as claims required immediate settlement while reinsurance recoveries took months to materialise. Regulatory directives accelerating claims disbursement, while appropriate for policyholder protection, placed additional cash flow pressure on operators already managing strained positions.

Türkiye offers a model where sovereign infrastructure supports private market resilience. The national catastrophe insurance pool absorbed the substantial majority of residential earthquake claims, preventing concentrated losses from overwhelming private operators. This allowed Islamic insurance participants to manage commercial and excess-of-loss exposures within their capacity while the sovereign mechanism addressed mass-market residential risk.

1.5 Capital Markets

Strong Issuance Growth, but Persistent Structural Constraints

Primary ṣukūk markets saw strong growth in 2025 supported by favourable global financing conditions. Issuances reached USD 234.5 billion, driven largely by issuances concentrated in core markets such as Malaysia and Saudi Arabia. The growth in primary market issuances has not been accompanied by broad-based deepening in most markets. Issuance activity in most jurisdictions continues to be driven by sovereign and quasi-sovereign issuers, while corporate participation, although improving, remains more episodic, limiting broader market development (Figure 1.14). A large share of issuances continues to take the form of stand-alone transactions, with limited reopenings, especially outside the sovereign segment (Table 1.2). As a result, even with strong issuance volumes, fragmentation across the market persists, which has implications for fungibility, market liquidity, and efficiency of price discovery.

Table 1.2: Analysis of Ṣukūk Issuances in 2025

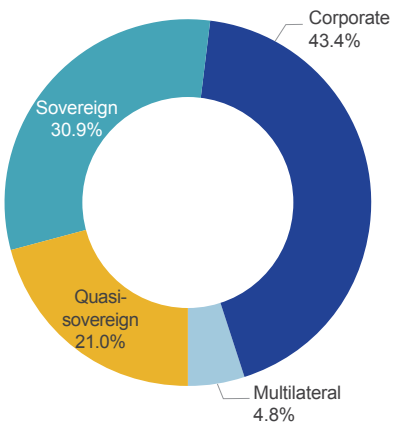
Reason for issuance	Size (USD Billions)	% of total issuances in 2025	Distribution per issuer types
Initial Issuance	174.2	74.3%	60% corporate, 22% semi-sovereign, 14% sovereign, 7% multilateral
Re-opening	60.2	25.7%	80% sovereign, 20% semi-sovereign

Source: Refinitiv

Figure 1.14: Ṣukūk Trends

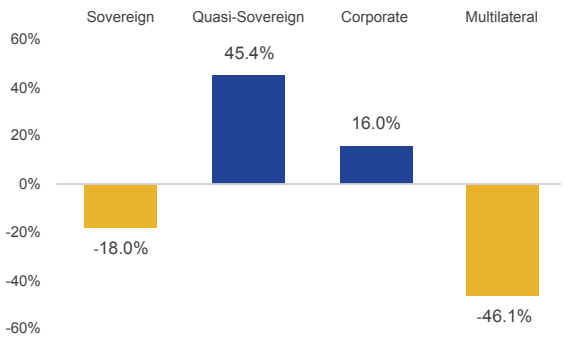
Global ṣukūk issuance surpassed USD 234 billion

1. Ṣukūk Issued in 2025 (issuer type)
(Percent)



Quasi-sovereign and corporate issuances increase

2. Change in ṣukūk issuances by Issuer Type (2024 to 2025)
(Percent)



Source: Refinitiv

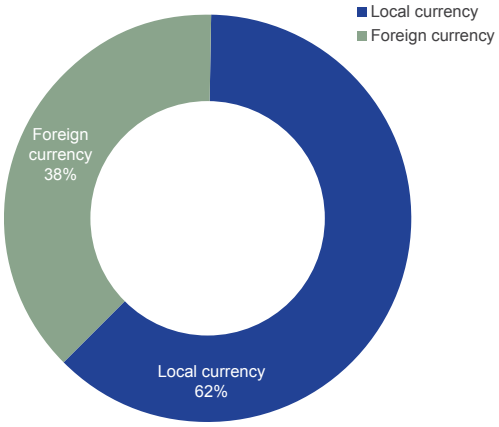
Domestic issuance contracted for the second consecutive year while international issuance expanded, reflecting structural constraints in domestic local currency markets alongside more accommodative external financing conditions. Local currency ṣukūk issuance remains a significant share of issuances (Figure 1.15). However, on aggregate, issuance patterns have shifted, with local currency issuance declining and foreign currency issuance expanding over the 2023-2025 period. The increasing foreign currency funding reflects a number of factors, including issuers taking advantage of improved global liquidity conditions and strong investor appetites for ṣukūk, as well underlying constraints in domestic market depth in some jurisdictions, with limited capacity of domestic investors to absorb larger issuances. While access to international markets broadens funding sources, it also introduces currency mismatch risks and vulnerability to non-resident outflows, both of which may amplify the transmission of external shocks into domestic financial systems.

Ṣukūk market expansion in some jurisdictions has been accompanied by a growing reliance on domestic banking sectors to absorb sovereign issuances, which may present downside financial stability risks. In select developing Islamic finance markets, a narrow investor base and overreliance on captive investors, particularly banks, to absorb sovereign domestic issuances raise potential financial stability concerns as well as a risk of crowding out of private sector financing. In the event of domestic debt distress or restructuring, these exposures could impose disproportionate losses on domestic Islamic banks and pose potential systemic stability risks in both the Islamic banking sector and the broader economy.[23] Thus, the sovereign-bank nexus discussed earlier remains a concern, particularly in jurisdictions where exposure is large (e.g., over 40% of Islamic banking assets in Pakistan) and where ṣukūk market expansion has not been accompanied by a well-diversified local investor base. Where ṣukūk market development remains incomplete, strong issuance activity may coexist alongside underlying structural fragilities.

Figure 1.15: Currency Composition of Ṣukūk

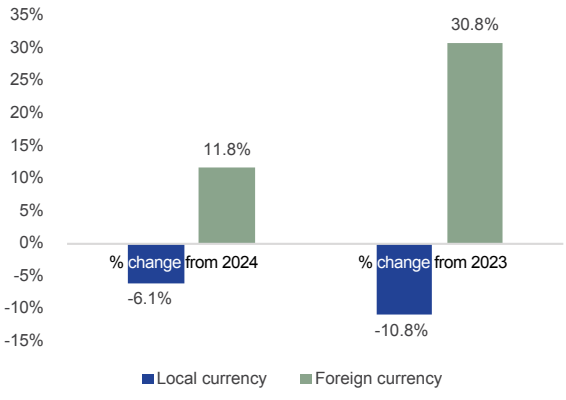
Local currency ṣukūk remain dominant, though foreign currency issuance accounts for a sizeable share

1. Ṣukūk, by currency, issued in 2025
(Percent)



Foreign currency ṣukūk issuance expanded over the past two years, while local currency issuance declined

2. Changes in ṣukūk issuances based on currency
(Percent)

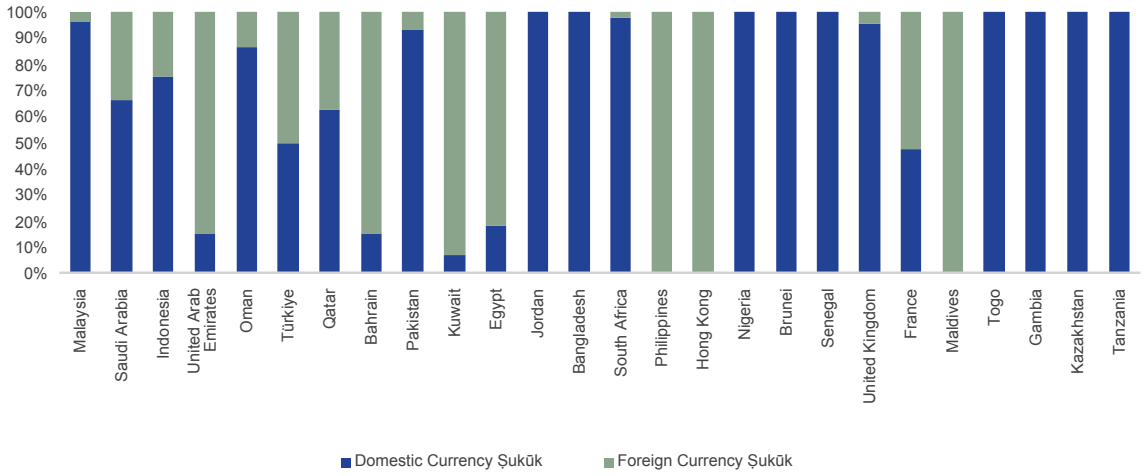


23 International Monetary Fund, *Global Financial Stability Report* (IMF, October 2025).

Composition of ṣukūk issuance between local currency domestic markets and reliance on foreign currency funding differed between jurisdictions

3. Local and Foreign Currency Ṣukūk Issuance

(Percent of Total Issuance)



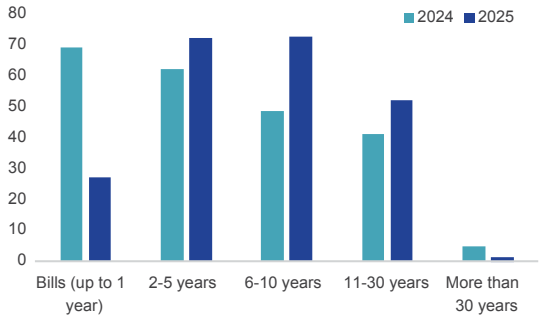
Source: Refinitiv

The maturity profile of ṣukūk issuance points to a shift towards medium- and long-term tenors, though without a corresponding development of the longer end of the curve. Issuance of short-term bills declined sharply, reflecting reduced reliance on short-term sovereign issuance in several key jurisdictions, alongside evolving funding strategies and market conditions (Figure 1.16). While this reduces the frequency of refinancing and rollover pressures, it may also constrain the availability of highly liquid, low-duration instruments. Increased issuance across mid- to long-term tenors suggests stronger issuer demand for longer-term funding and a preference to lock in financing over extended horizons, which can support duration matching and reduce refinancing pressures over time, thereby enhancing funding stability, provided market conditions remain supportive. However, issuance beyond 30 years contracted materially (−67%) indicating that the ultra-long end of the ṣukūk market remains thin and lacks consistent issuance. The absence of consistent issuance at the long end limits the development of a complete and reliable benchmark curve. As a result, price discovery may remain constrained, and the market continues to rely on a narrow set of maturities, reinforcing the structural issues related to depth and secondary market liquidity.

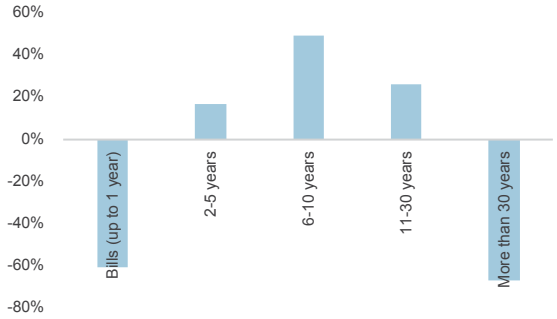
Figure 1.16: Ṣukūk by Maturity Profile

Mid-range to long maturities increased, while short and ultra-long tenors contracting at both ends of the curve

1. Ṣukūk Maturity Profiles (2025 vs 2024)
(USD Billions)



2. Change in Ṣukūk Issuance (2024 – 2025)
(Percent)



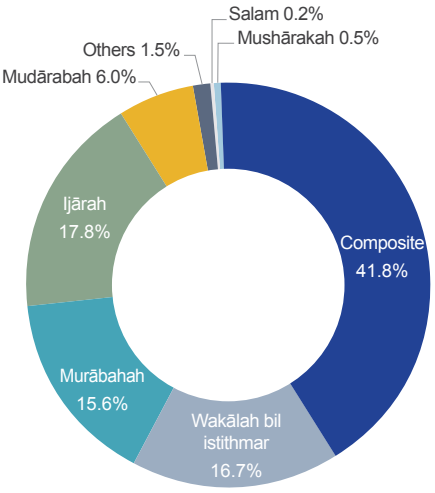
Source: Refinitiv

The structural composition of ṣukūk issuance indicates a growing shift toward composite structures. Composite structures increased by 70% y-o-y and accounted for 42% of total global issuances (2024: 25%) (Figure 1.17). The growing use of these structures, which typically combine tangible and intangible assets alongside receivables components, suggest attempts to meet tradability thresholds[24] while accommodating constraints in the availability of eligible asset pools and structuring of cash flows. The increase in 2025 was driven primarily by quasi-sovereign and multilateral issuers. The increased structural complexity introduces greater heterogeneity in asset composition, cash flow mechanisms, and risk characteristics, reducing comparability and fungibility across instruments and reinforcing the need for a clearer and standardised classification framework to support transparency.

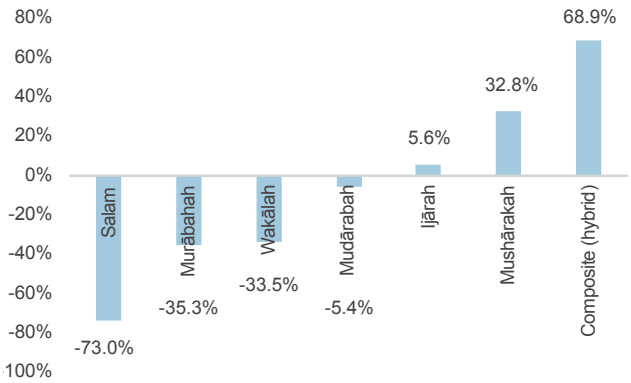
Figure 1.17: Ṣukūk by Contracts

Composite (hybrid) structures dominate ṣukūk issuance and recorded the strongest growth

1. Ṣukūk Composition by Contract (2025)
(Percent)



2. Change in ṣukūk structure (from 2024 to 2025)
(Percent)



Source: Refinitiv

24 For ṣukūk to be considered tradable in secondary markets, the underlying asset pool is required to comprise a majority of tangible assets or usufructs, commonly understood as at least 51%, although specific thresholds may vary across jurisdictions.

Sovereign ṣukūk pricing relative to comparable bonds indicates lower yields in domestic markets. In domestic-currency markets, sovereign ṣukūk price similar to, or slightly below, comparable bonds, with discounts ranging from near-parity (5–10 bps) to around 50 bps depending on tenor, the latter most likely reflecting strong demand from Islamic financial institutions. Corporate ṣukūk, where ṣukūk issuances are generally lower in most jurisdictions, yields varied more widely than sovereigns, with roughly two-thirds pricing above comparable bonds.

In hard-currency markets, ṣukūk yields were generally observed to be higher than comparable bonds, pointing to a modest liquidity premium, typically in the range of 5–25 bps. Compared with domestic markets, relatively lower demand pressure allowed differences in trading conditions and the structural characteristics of ṣukūk markets to be more fully reflected in yields.

Ṣukūk were typically more costly to trade than bonds, with the differential most pronounced in less developed domestic-currency markets. In less developed domestic markets, ṣukūk spreads were wider than bonds, reaching a differential of around 40 bps for maturities beyond 1 year. In relatively deeper domestic Islamic markets, ṣukūk and bonds traded at similar bid-ask spreads. Hard-currency markets sat between these extremes, with differentials of 0–10 bps tenor-matched in larger sovereign programs and reaching around 20 bps in smaller programs at longer maturities. These higher trading costs reflect structural features of the ṣukūk market rather than differences in credit risk. Market-making in ṣukūk tend to be more costly for dealers, because positions are harder to finance and hedge. Efficient intermediation requires deep repo markets and liquid hedging instruments. These are well developed for bonds but remain smaller, less standardised, and more expensive in ṣukūk markets. Higher funding and hedging costs tend to pass through to wider quoted bid-ask on the underlying ṣukūk. Lower secondary market turnover in the ṣukūk market due to buy-and-hold strategies further reinforces this effect. Lower turnover means dealers earn less spread revenue per unit of inventory risk and quote wider to compensate. These issues are most pronounced where Islamic capital market trading infrastructure is least developed.

Robust Growth in Islamic Funds but Scale is Still Limited

Islamic funds recovered in 2025, supported by improved performance in commodity and equity markets, but the segment remains structurally constrained (Figure 1.18). Despite the rebound, the industry is still relatively small and geographically concentrated, with limited penetration in regions such as SA and SSA. This uneven distribution suggests that Islamic asset management continues to play a limited role in intermediating savings beyond the Islamic banking system, particularly in jurisdictions where financial intermediation remains predominantly bank based.

Performance across Islamic fund segments reflected varying risk-return profiles. Commodity-focused funds recorded the strongest performance, supported by higher metal prices and persistent inflation concerns. Equity funds also benefited from improved market sentiment and relatively firm earnings. Ṣukūk funds delivered more modest but relatively stable returns compared to higher-risk asset classes, while real estate funds experienced a short-term rebound (Figure 1.18).

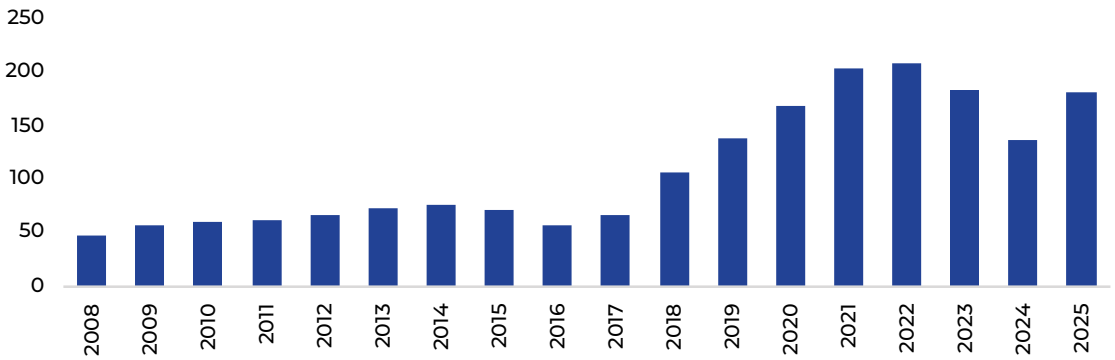
The limited scale of the Islamic funds sector constrains its contribution to capital market development and financial stability. A small asset management base reduces the presence of long-term institutional investors needed to absorb ṣukūk issuances and support market stability, particularly during periods of stress. It can weaken demand-side depth, contributing to lower secondary market liquidity and less reliable price discovery. In turn, limited fund participation reinforces reliance on bank-based financing and sustains concentration of exposures within the financial system. Expanding the Islamic funds sector is therefore important to support market development as well as financial stability, as a deeper and more diversified investor base enhances the system's capacity to absorb shocks.

Figure 1.18: Islamic Funds Growth and Performance

Islamic funds' assets under management recovered in 2025 but remain small and geographically concentrated relative to total IFSI assets

1. Global Islamic Funds Assets under Management (AuM) (2008–2025)

(USD Billions)



2. Performance of Islamic Funds (2025)

	Average 1Y return	Average 3Y return	Average 5Y return
Ṣukūk funds	4.2	4.2	2.8
Equity funds	9.6	9.3	5.7
Commodity funds	49.2	19.3	10.7
Real estate funds	15.0	4.1	1.8
Mixed funds	7.5	6.8	3.7
Average	**17.1**	**8.7**	**5.0**

Source: Bloomberg and Refinitiv

1.6 Financial Stability Outlook

Global Financial Stability Risks are Elevated in a Rapidly Evolving International Environment

Escalation of geopolitical conflict in the Middle East has triggered a sharp increase in volatility across global financial markets, particularly in energy and commodity markets. The conflict has also interrupted the rally in global equity markets, while emerging market assets and currencies have come under pressure, particularly in commodity-importing economies. The disruption to energy supply has introduced a significant negative supply shock to the global economy, contributing to higher and more volatile energy prices, rising inflationary pressures, and tighter financial conditions. It has also resulted in spillovers to sovereign bond yields, credit spreads, and other asset classes. These developments are expected to weigh on global growth while increasing the sensitivity of financial markets to changes in the macroeconomic and geopolitical outlook.

The global risk environment has therefore become more uncertain and more prone to abrupt and potentially disorderly market adjustments. Heightened uncertainty around the scale, duration, and broader implications of the conflict has made it more difficult for markets to price underlying economic fundamentals, increasing the likelihood of sharp movements in asset prices in response to new information. Despite recent volatility, as of the writing of this report, risk premia remain relatively compressed by historical standards, leaving limited buffers against further adverse developments and increasing the potential for sudden repricing across equity, credit, and sovereign debt markets. The concurrent sell-off in equities and longer-term bonds also points to an ongoing erosion of the safe-haven properties of core sovereign bonds, raising the likelihood that stock and bond markets decline at the same time and limiting the scope for traditional diversification strategies.[25]

Elevated sovereign debt levels and rising rollover risks in bond and ṣukūk markets may place upward pressure on yields, particularly in an environment of heightened uncertainty and inflationary pressures. Increased volatility in bond markets could also spill over into funding conditions, tightening market liquidity and reinforcing linkages between sovereign balance sheets and the banking sector. Emerging markets may face additional pressures through external channels, with currency and capital flow volatility potentially intensifying where shifts in global interest rate differentials, carry-trade positioning, and terms-of-trade developments lead to reversals in previously supportive flows.These dynamics could contribute to tighter external financing conditions and more abrupt adjustments in exchange rates and asset prices, particularly in economies with limited foreign exchange reserve buffers.

These global developments are particularly consequential for the Islamic financial services industry given the concentration of its assets in regions directly exposed to these shocks. A substantial share of Islamic finance assets is located in the Gulf and other affected jurisdictions, increasing both direct exposure to geopolitical developments and indirect exposure through energy markets, fiscal conditions, and investor sentiment.

Potential Transmission Channels to the IFSI and a Need for Heightened Vigilance

In this context, the key concern is the interaction between external shocks and existing structural and prudential vulnerabilities within Islamic financial systems that are highlighted in this report. The current environment increases the likelihood that multiple risk channels could

25 International Monetary Fund (IMF), Global Financial Stability Report: Global Financial Markets Confront the War in the Middle East and Amplification Risks, April 2026.

crystallise simultaneously, amplifying their combined impact on financial stability. Tighter financial conditions, weaker growth, and increased volatility may interact with shallow market structures, concentrated exposures, and underdeveloped financial market infrastructure, thereby intensifying stress transmission and pressures across sectors in a number of ways:

- **Sovereign risk represents a central transmission channel for both Islamic financial systems and globally.** Sovereign ṣukūk markets have continued to see high issuance volumes. Globally, the current environment of higher financing costs and weaker growth has worsened the outlook for sovereign debt. In many Islamic finance jurisdictions, sovereign ṣukūk constitute a significant share of the investable universe and are widely held by Islamic banks for liquidity and balance sheet management purposes. This is particularly significant in lower-rated emerging markets where banks are increasing absorbing sovereign issuances, due to limited access to external financing and the need to rely on domestic banks to absorb fiscal issuance.[26] Repricing of sovereign risk can transmit directly to bank balance sheets through valuation losses, tighter liquidity conditions, and a reduced capacity to extend financing to households and corporations, with the risk of sizable recapitalisation needs in the event of sovereign debt distress.

- **Structural features of Islamic capital markets may further amplify these dynamics under stress.** Limited depth and breadth of domestic ṣukūk markets and limited secondary market liquidity may result in more abrupt valuation adjustments and reduced market functioning. At the same time, increased reliance on international ṣukūk issuance in some jurisdictions exposes issuers to shifts in global investor sentiment, exchange rate pressures and external financing conditions. More broadly, the current global environment raises the risk of disorderly adjustments in global financial markets spilling over into Islamic financial systems. A sustained increase in global risk aversion could lead to non-resident capital outflows, tighter funding conditions and valuation losses across Islamic financial institutions, with potential implications for credit availability and real economic activity.

- **The banking sector remains well-capitalised to absorb potential shocks, but the outlook suggests the potential for increasing pressure on asset quality and funding conditions.** In most jurisdictions, Islamic banks have built up significantly high capital and liquidity buffers to absorb shocks, as highlighted in this report. However, pockets of vulnerability persist, and rising financing costs and weaker economic conditions may affect borrower repayment capacity, particularly in the sectors facing elevated risk as discussed in this report. Latent credit risks, already evident in some jurisdictions, may become more pronounced if macrofinancial conditions deteriorate further. Structural constraints, including limited availability of a diverse range of liquidity management instruments and underdeveloped money markets, may also reduce the flexibility of banks' responses under stress.

- **Corporate sector stress represents an important transmission channel to Islamic banking systems, particularly in jurisdictions directly affected by the conflict.** In the Middle East and Gulf region, disruptions to economic activity, higher input costs, and increased uncertainty may weaken corporate earnings and repayment capacity, particularly in sectors sensitive to energy price volatility, trade flows, and investment conditions. At the same time, in energy-importing jurisdictions, higher energy prices may compress margins for corporates, particularly in energy-intensive sectors such as manufacturing, transport, and construction. These developments could translate into increased credit risk for Islamic banks, given their exposure to corporate and

26 International Monetary Fund (IMF), Global Financial Stability Report: Global Financial Markets Confront the War in the Middle East and Amplification Risks, April 2026.

project-based financing, including real estate and infrastructure-related sectors. A deterioration in corporate performance may lead to rising impairments, particularly where exposures are concentrated.

Overall, while the Islamic financial services industry remains resilient, the balance of risks has shifted to the downside. In this environment, supervisors should continue to monitor risks closely and manage exposures to the vulnerabilities highlighted in the report, taking account of the materially more unpredictable global landscape.

1.7 Policy Recommendations

Addressing the vulnerabilities and structural constraints identified in this chapter requires a coordinated policy response that balances market development with prudential safeguards. While the IFSI has demonstrated resilience, underlying structural features – including concentrated exposures, underdeveloped markets, and evolving risk profiles – alongside emerging macrofinancial pressures, necessitate targeted policy interventions. These should aim not only to mitigate vulnerabilities but also to strengthen institutional robustness and support market deepening across all three sectors.

Aligning market development with regulatory and supervisory capacity is essential, particularly in fast-growing frontier jurisdictions. Rapid expansion of Islamic finance across many developing and emerging markets underscores a need to sequence reforms appropriately, ensuring that regulatory, legal, and supervisory frameworks evolve in tandem with market growth, with particular attention to the specificities of Islamic finance. Capacity building, both at the institutional and supervisory levels, remains critical to ensuring that growth does not come at the expense of stability.

Strengthening governance practices, risk management, and supervisory effectiveness remains fundamental to financial stability. Stress episodes in certain jurisdictions underscore the importance of robust governance frameworks, effective risk controls, and timely supervisory intervention, particularly in the context of challenging macroeconomic conditions that may test existing vulnerabilities. Supervisory frameworks should be forward-looking, capable of identifying the build-up of vulnerabilities early and enforcing corrective measures where necessary before risks crystallise.

Strengthening crisis management and resolution frameworks for Islamic banks is essential to ensure preparedness for potential adverse scenarios. Financial safety nets and crisis management frameworks in Islamic finance jurisdictions remain underdeveloped, with recent experiences indicating limitations in early intervention, resolution preparedness, and the operational readiness of crisis management frameworks. The development of frameworks tailored to the specificities of Islamic finance should therefore be prioritised to enhance systemic resilience.

Addressing structural liquidity management vulnerabilities requires further development of broader liquidity management options for Islamic banks. While more mature markets have made some progress, underdeveloped interbank markets, high reliance on commodity murābaḥah instruments, and limited availability of high-quality liquid assets remain binding constraints in many jurisdictions. The development of appropriate instruments and central bank facilities tailored to Islamic banks should therefore be prioritised to strengthen both institution-level resilience and system-wide liquidity shock absorption capacity.

Addressing structural pressures in Islamic insurance requires improvements in business models, pricing discipline, and capital frameworks. Regulators should ensure that underwriting practices remain sustainable, particularly in mandatory or highly competitive lines where pricing pressures are most acute. Strengthening actuarial standards, enhancing data availability (including for catastrophe risks), and improving risk-based capital frameworks would support more accurate pricing and capital allocation. Reducing persistent reliance on qarḍ financing requires closer scrutiny of fund-level sustainability and business model viability, as well as clearer separation of policyholder and shareholder risk positions within supervisory frameworks.

Supervisory assessments of Islamic insurance should include fund-level prudential monitoring, which would provide earlier and more granular supervisory signals than current entity-level frameworks permit. Incorporating metrics related to qarḍ and wakālah fees would enable supervisors to identify deteriorating fund sustainability before it translates into entity-level concerns. Recognising elevated qarḍ or prolonged dependency as early warning indicators may allow intervention before fund-level stress translates into entity-level solvency concerns.[27] Supervisory frameworks that establish appropriate disclosures and require Boards to demonstrate that fee levels reflect fair value for services rendered would introduce greater discipline and help address the incentive distortions identified as contributing to aggressive pricing and qarḍ dependency.

Developing Islamic reinsurance capacity remains a structural priority. Targeted measures should be considered to expand Islamic reinsurance supply, including market development initiatives and regulatory incentives that facilitate market entry and scalability. To address limited local capacity, some regulators have allowed cross-border reinsurance arrangements. Such arrangements require careful consideration of all relevant risks, including foreign currency risks. Where commercial Islamic reinsurance capacity remains insufficient, regional pooling arrangements may merit exploration as a mechanism to distribute risk across a broader base of participants. In parallel, solvency treatment should be reviewed to ensure that capital requirements and risk assessments adequately capture this structural limitation, which can result in elevated risk retention on balance sheets in the absence of sufficient Islamic reinsurance cover.

Enhancing the depth, structure, and resilience of Islamic capital markets should remain a key area of focus as discussed in the IFSB's IFSI Stability Report 2025. The composition of ṣukūk issuance, investor absorption capacity, and underlying market structure play a critical role in shaping resilience to both domestic and external shocks. Policymakers should prioritise the development of foundational market infrastructure specific to Islamic capital markets, alongside development of Islamic money markets, primary issuance frameworks, and liquid secondary markets. In addition, strengthening legal certainty and reducing opacity in ṣukūk structures as well as enhancing disclosure practices are essential to improve market confidence and comparability.

Strengthening local currency ṣukūk markets through a more diversified investor base is essential in strengthening resilience of the Islamic financial system. This requires deepening the domestic institutional investor base for ṣukūk, by promoting the broader development of non-bank financial institutions, particularly long-term savings institutions such as pension funds, Islamic insurance, and Islamic funds. This can improve market absorption capacity as ṣukūk issuances expand, while reducing the concentration of exposures in the banking sector in markets where banks hold significant shares of sovereign ṣukūk. Concentrated investor bases, as observed in earlier analysis, can amplify spillovers from external shocks, making diversification of the investor base a macroprudential imperative as much as a market development objective.

27 See Guidance Note on Recovery and Resolution for Takaful Undertakings

Broadening the Islamic capital markets, particularly the development of the Islamic funds sector, is essential to strengthen the overall Islamic financial ecosystem. A deeper and more diversified Islamic funds industry can provide a stable institutional investor base for ṣukūk and enhance market liquidity. Islamic funds can play a critical role in reinforcing financial stability and supporting long-term growth by broadening intermediation channels and mobilising long-term savings within the Islamic financial system.

The global outlook heightens the importance of timely and active risk management, including stress testing, that incorporates scenarios of sudden and significant market price adjustments. Adequate preparedness for market stress events and proactive actions to enhance liquidity risk management options would help mitigate the risk that structural vulnerabilities are amplified when shocks materialise. The implementation of robust regulatory standards including IFSB and Basel III frameworks and continued international cooperation remain important supporting elements in preventing and responding to such shocks.

2.0 Hybrid Risks and Financial Stability Implications

2.1 Introduction

The growing prominence of hybrid models in Islamic banking is reshaping Islamic banks' risk profiles in ways that have important implications for financial stability. Hybrid instruments or models, as referred to in this chapter, are Islamic banking structures whose risk and balance sheet characteristics mimic attributes of conventional banks. This includes Islamic banking products, structures, and balance sheet configurations that combine elements of conventional finance with Islamic finance in ways that materially shape their risk-return profiles and prudential features (Box 2.1).

Box 2.1 Hybrid Structures and Models in Islamic Banking

Hybrid characteristics arise in Islamic banking systems where the contractual form of a transaction is structured as an Islamic financial instrument, but the resulting economic exposure and risk allocation resemble those of conventional financial instruments. Such outcomes may emerge through the structure of individual contracts or through the way financing and funding arrangements are combined across the balance sheet. Where they do, they give rise to a distinctive category of hybrid risks: exposures that are not fully captured by conventional risk frameworks or adequately addressed by those developed specifically for Islamic finance.

At the contract level, hybrid outcomes are most evident in various murābaḥah transactions configurations. In commodity murābaḥah structures, for example, commodities are used as an intermediary to structure financing. Because the commodities involved are typically held only briefly and are not central to the economic purpose of the transaction, the arrangement effectively produces cash financing with predetermined repayment obligations. Similar outcomes may also arise in many trade-based financing structures, even where there is an asset involved. Risk is largely transferred to the counterparty at the point of transaction, such that the bank's exposure becomes primarily a credit claim on the counterparty with fixed repayment obligations linked to a benchmark interest rate reference. In such cases, the economic substance and financial exposure closely resemble that of conventional lending.

Hybrid dynamics may also emerge at the balance-sheet level, where such instruments dominate either side of the balance sheet (referred to in this chapter as hybrid models). For example, this may include business models built predominantly on fixed-income structures, with financing provided largely through murābaḥah on the asset side and funding mobilised primarily through reverse murābaḥah on the liabilities side. This produces a balance sheet configuration that is economically similar to that of a conventional bank. A less common variant involves Islamic financing on the asset side funded through conventional deposits, which raises additional concerns.

Even in the case of distinctively Islamic finance instruments such as profit-sharing investment accounts (PSIA) or wakālah products, if they are structured or managed in a way that effectively insulates account holders from asset performance variability, their economic behaviour converges toward that of conventional deposits, regardless of its contractual form, reinforcing hybrid balance sheet dynamics.

Concerns about hybrid instruments were first highlighted by the IMF in its 2017 report on *Ensuring Financial Stability in Countries with Islamic Banking*.[28] The report noted that the growing replication of conventional financial structures within Islamic banking could alter underlying risk characteristics and give rise to complex risks, as well as lead to consumer protection and reputational risks. The 2025 edition of the IFSB Stability Report similarly observed that hybrid financial instruments have become a dominant mode of transactions in some jurisdictions, and that their widespread use may contribute to greater credit risk concentration, the build-up of leverage, and heightened interconnectedness and spill-over risks, including between Islamic and conventional banking systems. In environments where credit expansion through such structures is sustained over time, these features may also support the build-up of leverage and, under certain macrofinancial conditions, reinforce feedback loops between credit expansion and asset prices, amplifying financial cycles. Over time, these dynamics may shape how shocks are transmitted across Islamic banking systems, with potential implications for resilience under stress.

28 IMF, *Ensuring Financial Stability in Countries with Islamic Banking* (IMF, 2017).

The widespread adoption of hybrid structures raises important prudential questions about the nature of the risks they introduce. While the use of hybrid structures has enabled rapid growth and market penetration, it also raises prudential questions regarding whether the resulting exposures behave more like traditional Islamic finance or conventional credit intermediation. Balance sheet configurations that converge more toward conventional banking risk profiles may introduce vulnerabilities that Islamic banks were once thought to avoid and raise issues relevant for regulation, supervision, and financial-stability assessment.

Understanding the financial-stability implications of hybrid models requires examining both their microprudential and macroprudential effects. Accordingly, this chapter examines current market trends and their prudential implications and potential consequences for financial stability. The analysis does not address related Sharī'ah issues and focuses on the economic, prudential, and supervisory dimensions relevant to regulatory and financial-stability oversight.

2.2 Market Trends and Drivers

Hybrid instruments have become an important feature shaping financing and funding patterns across many Islamic banking systems. On the asset side, hybrid instruments account for a dominant share of financing in several major markets, with recent data indicating a continued increase in their proportion of total financing. This trend is not observed uniformly across jurisdictions. However, in many jurisdictions, a more diversified financing mix is observed, with fewer or no hybrid features.

On the funding side, hybrid-based structures account for a significant and, in several jurisdictions, growing share of Islamic banks' funding. In a number of markets, retail deposits structured through commodity murābaḥah represent a large and increasing portion of the funding base. There are also cases where the use of commodity murābaḥah has been adopted only more recently or has declined over time, reflecting evolving institutional practices and regulatory preferences rather than a uniform industry trajectory. In some jurisdictions, funding relies primarily on unrestricted profit-sharing investment accounts (PSIAs) and wakālah-based arrangements. Whether these instruments give rise to hybrid risks, depends not on contractual form alone but also on how they are structured and operationalised, particularly the economic outcomes they produce (as highlighted in Box 2.1).

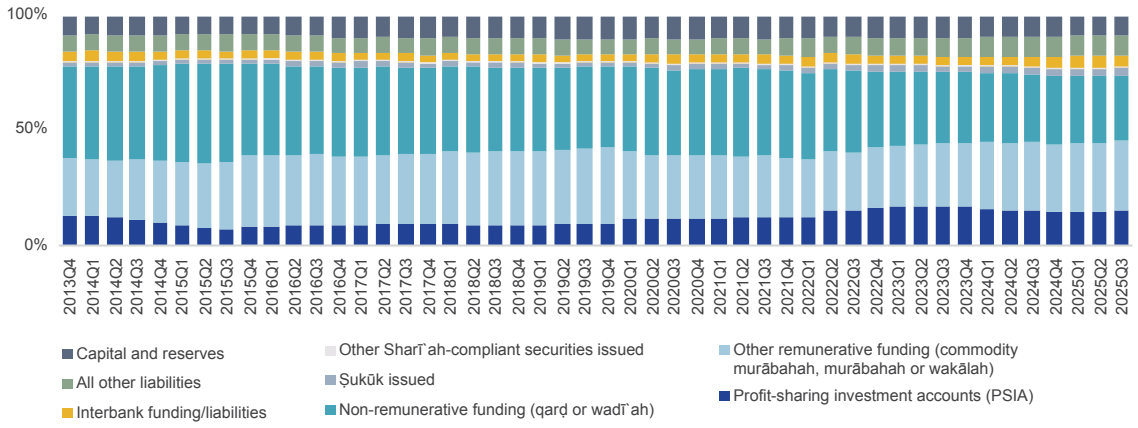
The extent to which hybrid instruments shape Islamic banking balance sheets varies considerably across jurisdictions. In some jurisdictions, hybrid models are structurally significant, with both financing and funding predominantly executed through murābaḥah and commodity murābaḥah. In others, hybrid elements appear only in some parts of the balance sheet, resulting in more mixed configurations that retain features of traditional Islamic banking models. As a result, the relevance and implications of hybrid models differ across markets, depending on the extent to which these structures are embedded within financing portfolios and funding bases (Figure 2.1).

Figure 2.1: Composition of Funding and Financing

Hybrid-based structures account for a significant component of the funding base in several jurisdictions

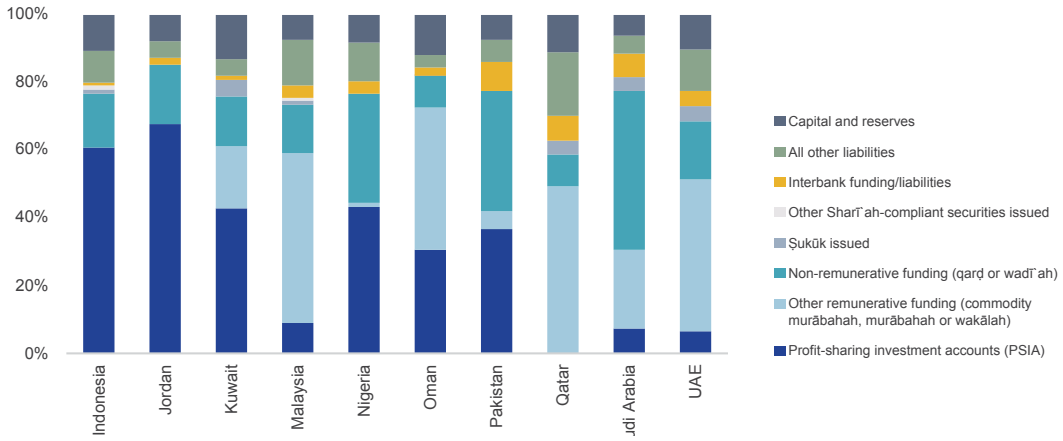
1. Global Composition of Funding and Liabilities (2013-2025)

(Percent)



2. Country-level Composition of Funding and Liabilities (2025Q3)

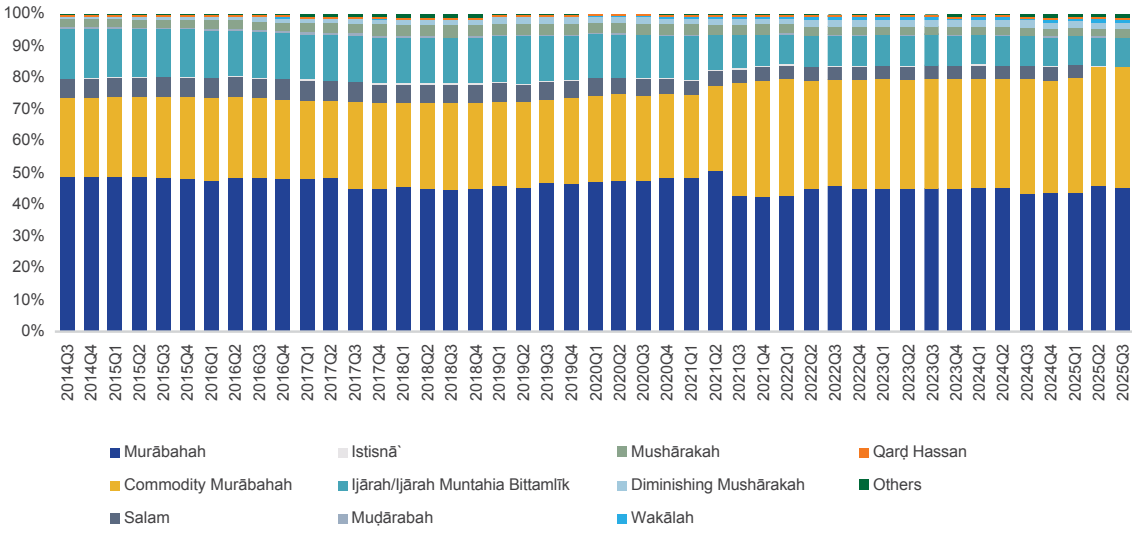
(Percent)



Hybrid instruments account for a dominant share of financing in several major markets, with a continued increase in their proportion of total financing, although this trend is not uniform across jurisdictions

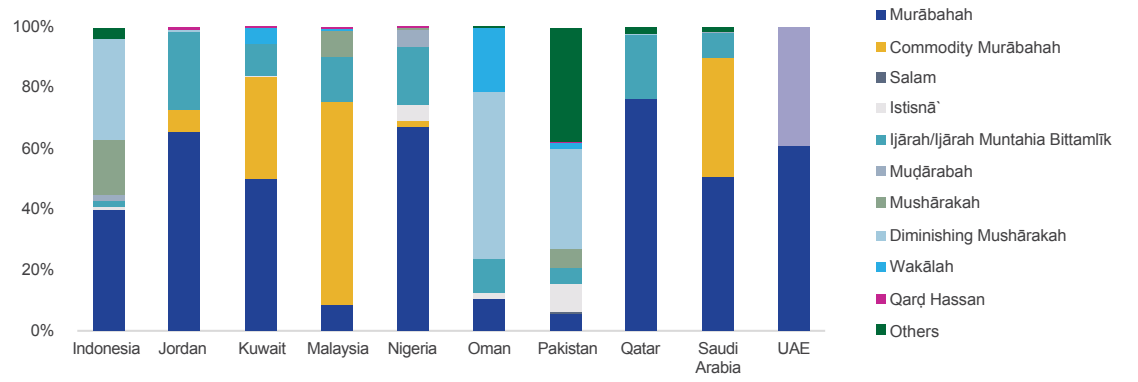
3. Global Composition of Financing (2014-2025)

(Percent)



4. Country-level Composition of Financing (2025Q3)

(Percent)



Source: IFSB PSIFIs

Interbank funding and liquidity management in many major Islamic banking jurisdictions is predominantly conducted through placements structured using commodity murābaḥah and wakālah arrangements. They serve as the principal channels for short-tenor interbank funding. Muḍārabah-based interbank placements, although recognised as a relevant tool, are typically used more selectively for short-term liquidity management. The prominence of interbank placements is particularly evident in jurisdictions with limited central bank facilities for Islamic banking and shallow domestic ṣukūk markets. Otherwise, banks commonly maintain more precautionary liquidity positions.

The predominance of hybrid instruments reflects structural constraints in Islamic financial markets, reinforced by commercial, operational, and regulatory factors. In many jurisdictions, the limited availability of high-quality liquid assets and shallow Islamic money markets leave banks with few practical alternatives for managing short-term liquidity and balance sheet volatility, which has resulted in a greater reliance on hybrid structures in some markets. Commercial pressures further reinforce this reliance: in the absence of infrastructure supportive of traditional Islamic banking, strong demand

for predictable cash flows and competitive dynamics in dual-banking systems favour instruments that closely replicate the economic outcomes of conventional interest-based products. At the same time, balance sheet growth objectives increase the appeal of structures that can be originated rapidly and at scale through established commodity markets. Regulatory, accounting, and risk-management considerations have also shaped product choices, as hybrid instruments often fit more readily within existing conventional prudential, accounting, and supervisory frameworks than more asset-intensive or equity-based alternatives. Operational enablers, including organised commodity platforms, facilitate routine use at scale. In parallel, institutional capacity constraints have encouraged reliance on well-understood contractual forms, while the slower evolution of regulation and Islamic money-market and capital-market infrastructure has sustained the predominant reliance on hybrid structures.

2.3 Financial Stability Implications

The growing reliance on hybrid instruments in some jurisdictions has important implications for financial stability at both the institutional and system-wide levels. Hybrid models may give rise to new risks arising from their specific structural and operational characteristics. At the institutional level, these may include greater balance sheet elasticity and leverage build-up, as well as operational complexities in hybrid transaction structures that may create liquidity pressures under stress. At the system-wide level, these dynamics may contribute to more synchronised credit expansion across institutions, stronger feedback loops between credit growth and asset prices, and greater potential for liquidity stress to propagate through interbank markets. In many jurisdictions, these vulnerabilities may be further compounded by structural constraints within the Islamic finance ecosystem, including the limited availability of appropriate high-quality liquid assets, shallow Islamic money and capital markets, and a narrow range of instruments available for liquidity risk management. These constraints may amplify pressures on Islamic banks under stress and limit the balance sheet adjustment options available to them. Sections 2.4 and 2.5 explore these financial stability implications at the institutional and system-wide levels, respectively.

2.4 Microprudential Implications

Hybrid banking models can give rise to microprudential vulnerabilities that differ materially from those associated with traditional Islamic banking. These vulnerabilities may arise through four channels: the amplification of credit and leverage dynamics; reduced loss-absorption capacity; funding vulnerabilities affecting balance sheet resilience; and non-financial risks, including reputational, legal, and Sharī'ah-compliance risks, that can translate into financial stress.

Credit and Leverage Dynamics

Hybrid banking models can give rise to credit growth dynamics that resemble those observed in conventional banking systems, particularly during favourable phases of the economic cycle. As economic conditions improve, rising collateral valuations and easier refinancing conditions tend to relax effective constraints on credit expansion, especially in property and consumer financing segments that often play a prominent role in credit cycles. Where hybrid models are widely adopted across institutions, and exposures are directed toward similar sectors, credit expansion may become increasingly broad-based across institutions and concentrated in the same asset classes. Such patterns are commonly observed during periods of strong credit growth, where lending expansion is reinforced by rising asset prices and favourable financing conditions.[29] In such settings, hybrid banking models, lacking the discipline of asset-based financing, may reinforce procyclical credit dynamics during economic upswings and increase the likelihood of credit booms (Box 2.2).

Box 2.2 Procyclicality in the Islamic Banking System

Procyclicality refers to the amplification of financial activity in response to the business cycle, characterised by expansion during periods of economic growth and contraction during downturns, thereby reinforcing rather than moderating cyclical fluctuations in the real economy. In the banking system, this dynamic often arises when rising asset prices, improved borrower balance sheets, and favourable financing conditions reinforce one another, allowing credit expansion to accelerate during growth phases. When conditions reverse, these same mechanisms may operate in the opposite direction, tightening financing conditions and reinforcing economic downturns.[30]

In the context of Islamic finance, the literature does not reach a definitive consensus regarding whether the Islamic financial services industry exhibits procyclical or countercyclical behaviour. In the aftermath of the Global Financial Crisis (GFC), Islamic finance was widely viewed as having potentially countercyclical characteristics, reflecting the relative resilience of Islamic financial institutions during that episode.[31] This resilience was often attributed to structural features of Islamic finance, including the prohibition of interest and the requirement that financing be linked to underlying real economic activity.

Subsequent empirical research has produced more nuanced findings, with evidence of both procyclical and countercyclical behaviour across different jurisdictions and institutional settings.[32] These studies suggest that the cyclical behaviour of Islamic financial institutions may be influenced by a range of institutional and structural factors, including differences in regulatory environments, financial market structures, and the composition of financing contracts within banks' portfolios. Islamic financing contracts were found to exhibit varying cyclical sensitivities, reflecting differences in their underlying economic characteristics and risk profiles. Mushārakah, and muḍārabah financing were associated with countercyclical behaviour, particularly in smaller institutions, while ijārah exhibited more procyclical patterns. Bank size also appears to be a significant determinant of cyclical behaviour more broadly, with smaller Islamic banks tending toward procyclicality.[33]

29 Borio, Claudio, *The Financial Cycle and Macroeconomics: What have we learnt?* (BIS: Working Paper No. 395, 2012); Drehmann, Borio & Tsatsaronis, *Characterising the Financial Cycle: Don't Lose Sight of the Medium Term* (BIS: Working Paper No. 380, 2012).

30 Borio, C., 'The Financial Cycle and Macroeconomics: What Have We Learnt?' (2014) *Journal of Banking and Finance*.

31 Hasan, M. and Dridi, J. *The Effects of the Global Crisis on Islamic and Conventional Banks: A Comparative Study* (2010) IMF Working Paper 10/201.

32 Bitar, M., Hassan, M.K., and Walker, T. 'Cyclicality of Bank Credit Growth: Conventional vs Islamic Banks in the GCC' (2018) *Journal of International Financial Markets, Institutions, and Money*.

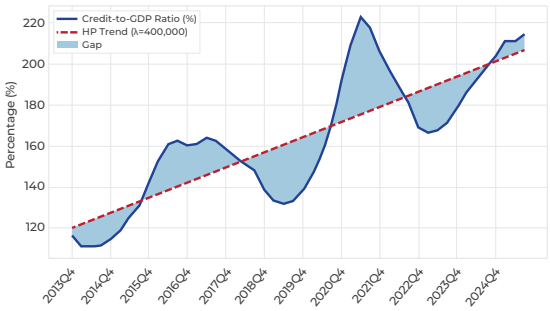
33 Ascarya, 'Testing the Procyclicality of Islamic and Conventional Banks in Indonesia' (2016) from Ismail and Hidayat, Macroprudential Regulation and Policy for the Islamic Financial Industry (Springer, pp. 133-152; 2016); Soedarmono, W. and Yusgiantoro, I., 'Islamic Bank Procyclicality in an Emerging Market Economy' (2023). *Quarterly Review of Economics and Finance*.

Country-level analysis of the credit-to-GDP gap offers support for these dynamics across different models of Islamic banking (Figure 2.2). In jurisdictions A and B (where hybrid instruments account for a substantial share of financing), the credit-to-GDP ratio rises materially above its long-term trend for sustained periods, producing sizeable positive gaps indicating that credit is expanding faster than its estimated long-term trend. In jurisdictions C and D (where hybrid instruments account for a small share of financing), deviations from trend remain comparatively limited.[34] In these jurisdictions, the Islamic banking model differs structurally from that in jurisdictions A and B, with more diversified financing mixes and funding structures that rely more heavily on profit-sharing investment accounts. Although cross-country differences also reflect broader structural and macroeconomic conditions, the observed patterns are consistent with the view that hybrid financing systems may exhibit comparatively stronger credit cycle dynamics. Large positive gaps signal credit is expanding faster than economic activity, increasing the stock of credit relative to the size of the economy and increased vulnerability to future credit cycle reversals.

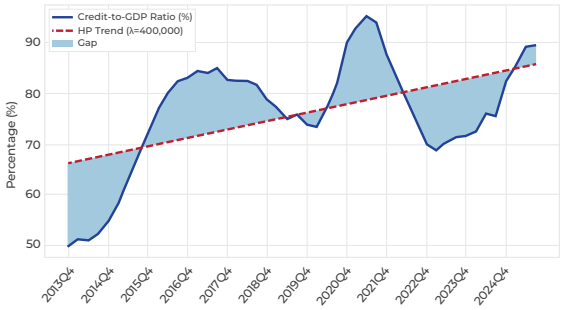
Figure 2.2: Credit to GDP Gap of Islamic Banking Systems Across Jurisdictions

More pronounced positive credit gaps indicating periods where credit expansion materially exceeds its long-term trend observed in jurisdictions with higher shares of hybrid financing structures (A and B)

1. **Jurisdiction A** (High Hybrid Risk Model)

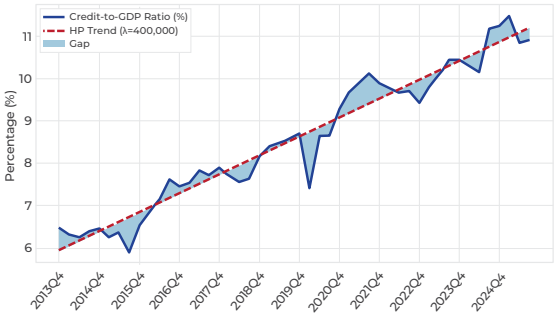


2. **Jurisdiction B** (High Hybrid Risk Model)

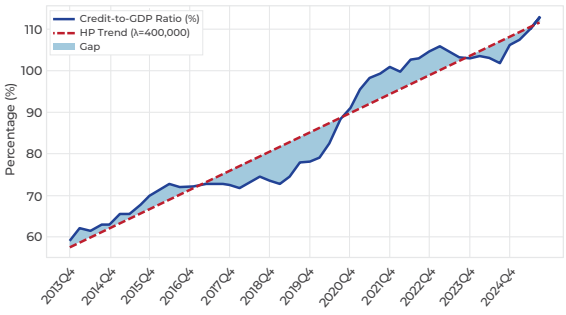


Jurisdictions with fewer hybrid features and greater reliance on profit-sharing structures (C and D) exhibit credit-to-GDP ratios that remain broadly aligned with their long-term trends, with smaller and more temporary deviations.

3. **Jurisdiction C** (Low Hybrid Risk Model)



4. **Jurisdiction D** (Low Hybrid Risk Model)



Source: IFSB PSIFIs, IMF

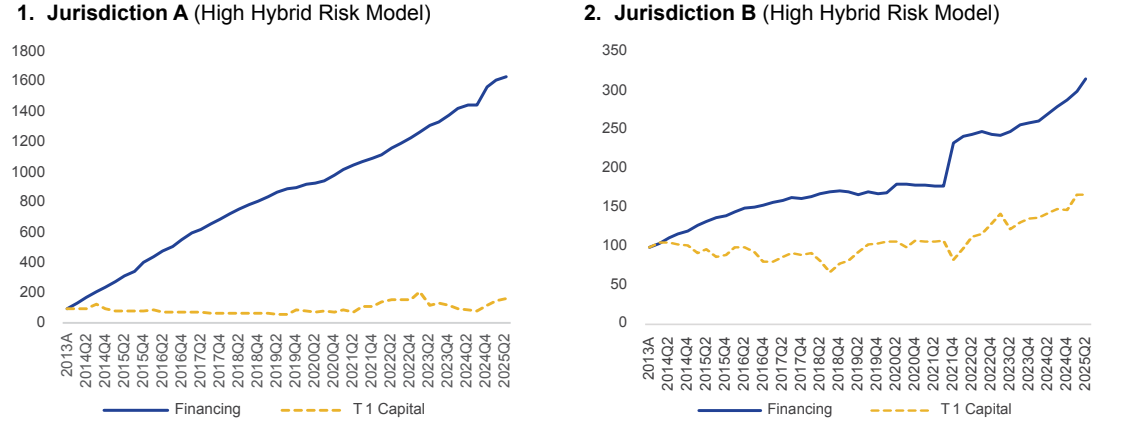
34 Jurisdictions are anonymised and classified based on the prevalence of hybrid risks. For the purpose of this analysis, "high hybrid risk models" were defined as those where contracts such as commodity murābaḥah, or a combination of commodity murābaḥah and murābaḥah, account for more than 40-50% on aggregate, on both or either side of the balance sheets of Islamic banks in that jurisdiction, while 'low hybrid risk models' were those where the use of such contracts is limited or represents a smaller share of the funding and/or financing base.

Hybrid banking models can increase balance sheet elasticity and facilitate faster leverage build-up, in ways similar to conventional banking systems. Hybrid instruments allow the scalable creation of debt-like exposures that can be replicated and rolled over across counterparties with relatively limited structural or operational frictions. Unlike traditional Islamic instruments that rely more directly on risk-sharing or closer linkage to real economic activity and assets, hybrid structures enable financing volumes to expand more rapidly during favourable financing conditions, while capital typically adjusts more gradually through retained earnings or capital issuance. As a result, as noted by the IMF, 'commodity murābaḥah provides Islamic banks with an opportunity to significantly increase leverage that might not have been possible under more traditional Islamic banking instruments'.[35]

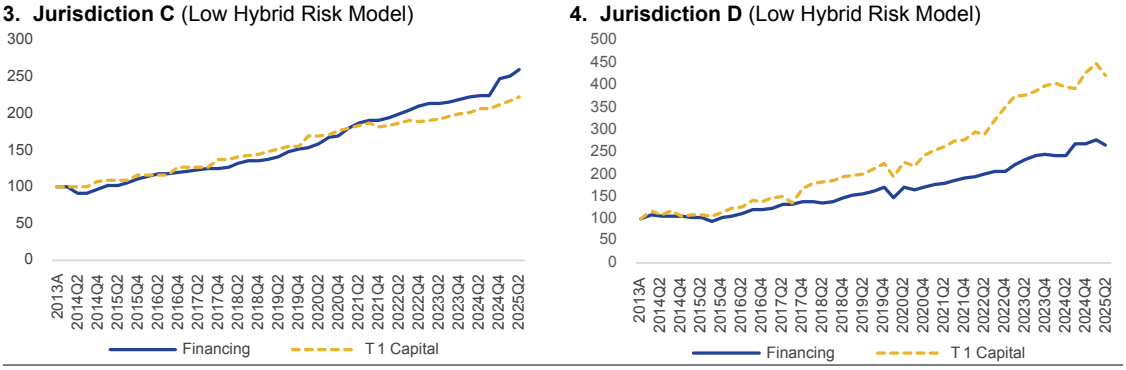
Country-level data on financing growth and capital accumulation are consistent with this pattern. In jurisdictions where hybrid instruments account for a larger share (A and B), credit expansion has tended to outpace Tier 1 capital growth over sustained periods, suggesting a degree of balance sheet elasticity that may, if persistent, create conditions in which exposures grow faster than the capital base. In jurisdictions with a balance sheet composition that has fewer hybrid instruments (C and D), financing growth appears more closely aligned with capital accumulation. Where such divergence between financing and capital growth is sustained, vulnerabilities may accumulate gradually without triggering visible deterioration in reported capital ratios, with adjustment pressures tending to emerge only when economic or financing conditions deteriorate (Figure 2.3).

Figure 2.3: Indexed Financing and Tier 1 Capital Growth (2013–2025Q2, 2013 = 100)

Financing growth substantially outpaces Tier 1 capital reflecting sustained balance sheet expansion relative to capital accumulation in jurisdictions with higher shares of hybrid financing structures (A and B).



Financing growth remains broadly aligned with, or slower than, Tier 1 capital growth, suggesting more balanced balance sheet expansion relative to capital.



Source: IFSB PSIFIs
Note: Financing and Tier 1 capital are indexed to 100

35 IMF, *Ensuring Financial Stability in Countries with Islamic Banking* (IMF, 2017)

Loss Absorption Capacity

Hybrid instruments can alter the loss-absorption characteristics of Islamic banks relative to more traditional Islamic banking models. In traditional Islamic banking arrangements, investment account holders share in asset performance, which can provide an additional layer of loss absorption beyond the bank's own capital. Where fixed-return, receivable-based[36] contracts account for a large share of financing and funding, losses arising from credit deterioration are borne primarily by the bank. In such cases, the cushioning effect associated with profit-sharing structures is more limited, and earnings and regulatory capital become more directly exposed to asset quality shocks. This places greater emphasis on the role of capital quality, provisioning, and retained earnings in absorbing losses, bringing the effective loss-absorption profile closer to that observed in conventional banking.

Repricing Risk and Earnings Sensitivity

Where funding is predominantly fixed-return or benchmark-linked, repricing mismatches between assets and liabilities become a material source of earnings volatility and, in economic substance, constitute interest rate risk in the banking book. When benchmark rates rise, funding costs may increase before asset returns adjust, compressing margins; when rates fall, higher-cost funding contracted at earlier rates may remain outstanding until maturity, again weighing on profitability. Where such margin compression persists, it erodes retained earnings and constrains the gradual accumulation of capital buffers over time. This is a distinctively hybrid risk: under traditional Islamic banking instruments such as profit-sharing investment accounts, payouts adjust in line with underlying asset performance, providing a natural partial absorption mechanism for rate fluctuations.[37] On the financing side, returns under profit-sharing instruments such as muḍārabah and mushārakah arrangements reflect the business performance of the financed activity rather than a fixed rate of return, reducing exposure to repricing dynamics.

Non-Financial Risks

Operational dependencies embedded in some hybrid instruments can act as a channel through which external shocks propagate into Islamic banking systems. For example, commodity murābaḥah structures rely on the continuous functioning of commodity markets, brokers, exchanges, and associated pricing and settlement infrastructures that lie outside the banking system itself. Disruptions in these external markets can impair execution, delay settlement, and constrain banks' ability to undertake financing, deposit placement, and liquidity management operations (Box 2.3). While such risks are exogenous to banks, their transmission into core banking activities means they can influence balance sheet dynamics and funding conditions during periods of stress.

36 Financing receivables arising from a sale- or lease-based contracts (e.g., murābaḥah, ijārah, salam, istiṣnāʿ)

37 While Islamic banks may sometimes use mechanisms, such as profit equalisation reserves (PER), to smooth return volatility, this does not fundamentally alter the return payout dynamics in traditional Islamic banking.

Box 2.3 Exogenous Operational Dependencies arising from Commodity Murābaḥah

Commodity murābaḥah transactions embed a structural dependency on market infrastructure that lies outside the banking perimeter. The execution of transactions is operationally dependent on the continuous availability of underlying commodities, observable market prices, and functioning commodity broker and exchange infrastructure, all of which lie outside the banking and supervisory perimeter. Any disruptions to commodity supply, price formation, or trading arrangements can impair execution by limiting price discovery or restricting access to eligible commodities, delaying or preventing settlement across multiple institutions simultaneously.

This dependency was illustrated during the commodity market disruptions of 2022.[38] Geopolitical tensions contributed to extreme volatility in global metals markets, including sharp price movements in nickel that led a major exchange to suspend trading and temporarily withdraw the benchmark price required for commodity murābaḥah transactions. Nickel-based transactions were halted as a result, demonstrating how external market events can propagate directly into Islamic banking operations.

Nickel Price Chart (2018-2026)

Source: LME

The capacity to substitute alternative commodities or exchanges offers only a partial buffer against these dependencies. While Islamic banks can switch to alternative commodities or exchanges, effective substitution depends on supply availability, exchange capacity, and other factors. Reliance on a narrow set of commodities or commodity broker and exchange infrastructure can also amplify interruption risks, particularly where commodity murābaḥah underpins multiple business lines. Where substitution is constrained, execution failures and settlement delays can affect financing, deposit placement, and liquidity management operations simultaneously.

Factors other than geopolitical and market events may also increase the frequency and severity of such disruptions over time. For example, climate-related physical risks and transition-related demand shifts can affect the supply and market liquidity of agricultural and mining commodities commonly used in these transactions, increasing sensitivity to external shocks.

Extensive use of commodity murābaḥah across a banking system could also give rise to systemic risk through reliance on shared market infrastructure. A disruption affecting common commodity exchanges, broker networks, or settlement infrastructure would affect multiple banks at the same time. This is particularly relevant where such infrastructure supports short-term liquidity management, as a common disruption could impair liquidity operations across institutions simultaneously, compounding pressures when funding conditions are already tight. In this context, the operational risk associated with commodity murābaḥah extends beyond institution-specific vulnerabilities to represent a potential source of system-wide stress.

Non-financial risks associated with hybrid instruments can amplify financial stress by undermining confidence in Islamic banking products and institutions. Where Islamic finance products are perceived to closely replicate conventional instruments, questions may arise regarding product authenticity or alignment with Islamic finance principles, potentially giving rise to reputational and Sharīʿah governance concerns. It can affect depositor and investor behaviour, particularly in systems where confidence plays a central role in funding stability. These non-financial risks may translate into financial pressure through several channels, including changes in deposit retention, funding costs, and supervisory responses. During periods of stress, shifts in confidence can lead to funding pressures, reinforce liquidity strains, and place additional demands on capital buffers. Reputational and governance-related risks can interact with financial vulnerabilities, amplifying stress beyond what would be implied by balance sheet indicators alone.

38 BNM Financial Stability Review 2H2022 https://www.bnm.gov.my/documents/20124/10150236/fsr22h2_en_box2.pdf

Extensive reliance on hybrid structures may also expose Islamic banks to Sharī'ah non-compliance risk arising from changes in Sharī'ah interpretations or supervisory and regulatory expectations. Sharī'ah interpretations and market practices are not static and may evolve over time in response to scholarly reassessment, changes in regulatory guidance, or developments in international standards. A material shift in rulings or supervisory expectations affecting widely used hybrid structures could give rise to reputational pressures, operational adjustments, and compliance challenges for banks with concentrated exposures to such instruments. Such changes could necessitate the modification, restructuring, or unwinding of affected contracts, increasing the scope for legal disputes, delaying recoveries, and weakening depositor and investor confidence. These effects could, in turn, affect asset valuations, slow balance sheet adjustment, and increase volatility in funding conditions.

Dual Banking Systems and Regulatory Arbitrage

The coexistence of Islamic and conventional banking within dual banking systems may create incentives for regulatory arbitrage, particularly where hybrid structures replicate the economic substance of conventional financing but are subject to different regulatory treatment. Differences in the classification and prudential treatment of hybrid contracts can encourage institutions to structure exposures in ways that optimise regulatory outcomes, rather than reflecting underlying risk. This may allow exposures similar to conventional banking to be originated under Islamic frameworks where capital or liquidity requirements may differ. This blurring of boundaries can obscure the true risk profile of exposures and weaken the effectiveness of prudential measures. Over time, the cumulative effect of such arbitrage may contribute to the expansion of hybrid exposures that are not fully aligned with their economic risks, complicating supervisory oversight and increasing the potential for the build-up of system-wide vulnerabilities.

2.5 Macroprudential Implications

At the system level, the widespread use of hybrid banking models can shape how risks accumulate and propagate across Islamic banking systems. Where hybrid instruments are a dominant feature of balance sheet structures, common exposures and funding practices may give rise to correlated behaviour and shared vulnerabilities, particularly in jurisdictions where Islamic banking has reached systemic scale. Two areas are particularly relevant for the assessment of potential system-level vulnerabilities: credit and leverage developments at the system level, and vulnerabilities related to liquidity management and interbank transmission.

System-Level Credit and Leverage Cycles

Hybrid models have the potential to amplify credit and leverage cycles at the system level beyond the institutional dynamics already described. As financing expands rapidly across institutions during favourable conditions, the aggregate build-up of debt in the economy accelerates, with system-wide leverage rising as multiple institutions expand simultaneously on similar assumptions. During downturns, fixed contractual obligations remain due in full regardless of borrower or economic conditions, placing pressure on balance sheets, increasing defaults, and driving credit deterioration across institutions simultaneously. Traditional Islamic banking models, in principle, distribute losses more broadly and tie balance sheet growth more closely to real-sector performance through profit-and-loss sharing and asset-backed financing. These features can moderate the intensity of credit cycles and introduce a degree of resilience that is structurally absent from conventional credit intermediation. To the extent that hybrid models become the predominant form of Islamic banking, this moderating capacity may be reduced.

Liquidity Fragility and Interbank Stress Transmission

The systemic implications of hybrid instrument use are reinforced by interconnectedness within Islamic banking systems. Where hybrid instruments dominate Islamic interbank markets, participating institutions are exposed to common funding conditions and share operational dependencies on the same instruments and trading infrastructure. This may create two reinforcing vulnerabilities. First, stress at one institution can propagate through bilateral interbank exposures to counterparties reliant on the same funding channels, in a manner analogous to wholesale funding contagion in conventional banking. Second, where multiple institutions rely on shared market infrastructure for the execution of interbank transactions, an operational disruption can constrain funding access across institutions simultaneously, regardless of direct bilateral exposure. Further, the close co-movement of Islamic interbank rates with conventional benchmarks further suggests that Islamic banking systems are not insulated from broader market stress, and that hybrid-driven interconnectedness may transmit external shocks as well as amplify those originating within the Islamic banking system itself (Box 2.4).

Box 2.4 Interconnectedness in Islamic Banking Systems

Interconnectedness refers to the network of financial relationships through which shocks can propagate across banks and financial markets. In banking systems, such linkages commonly arise through interbank funding markets, shared exposures to borrowers and asset classes, and common responses to macrofinancial conditions.

Interbank markets represent an important transmission channel through which liquidity conditions affecting one part of the banking system can influence others. Empirical research on Islamic money markets show that profit rates of Islamic interbank placements move closely with conventional interbank interest rate benchmarks.[39] This co-movement is reflective of the predominant use of debt-based contracts to structure Islamic interbank transactions that reference conventional benchmark interest rates.

Research examining risk transmission across Islamic banks also points to systemic linkages. Studies using tail-risk connectedness measures find statistically significant spillovers of downside risk between Islamic and conventional banks. It also suggests close interconnectedness among smaller banks, including Islamic banks, which may increase their exposure to systemic risk during periods of financial stress. Studies examining volatility transmission across financial institutions similarly find significant volatility spillovers between Islamic and conventional financial sectors.[40]

2.6 Policy Recommendations

Hybrid banking models raise distinct supervisory and regulatory challenges given that they do not fit neatly within the assumptions underlying either traditional Islamic or conventional prudential frameworks. Where such models have become structurally significant, prudential frameworks need to evolve to reflect how the associated balance sheet structures shape the behaviour and interaction of capital, liquidity, leverage, interconnectedness, and operational dependencies over the financial cycle. The central objective is to ensure that the resulting balance sheet dynamics and risk-transmission mechanisms support resilience and avoid amplifying vulnerabilities during periods of stress.

Capital frameworks should remain risk-sensitive by ensuring capital treatment adequately captures the risk profile of hybrid instruments. In cases where hybrid instruments increasingly account for a large share of assets, supervisory attention may need to extend to whether existing classifications and calibration of risk weights continue to reflect the underlying risk profile of these exposures, so that capital treatment remains aligned with observed default and loss behaviour over the cycle. This would help ensure that capital requirements evolve in line with the risk characteristics of hybrid models.

Capital adequacy dynamics may warrant particular attention in systems where hybrid Islamic banking models support rapid balance sheet expansion. In hybrid models, leverage may build up without immediate visible deterioration in risk-weighted capital ratios. Supervisory responses may therefore need to incorporate forward-looking visibility on balance sheet growth, including the pace of asset origination relative to earnings retention and provisioning. Strengthening the supervisory review process to identify accelerating expansion trends and ensuring the adequacy of buffers would support timely supervisory intervention in periods of rapid credit growth. In addition, capital adequacy

39 Bacha, O. I. 'The Islamic Inter-Bank Money Market and a Dual Banking System: The Malaysian Experience', (2008) *International Journal of Islamic and Middle Eastern Finance and Management.*

40 Maghyereh, A., Awartani, B., & Abdoh, H. '*Volatility Spillovers between Islamic and Conventional Financial Systems'*, (2024). *Journal of International Financial Markets, Institutions, and Money.*

assessments may benefit from closer attention to the interaction of credit and liquidity conditions, as rising funding costs or tightening liquidity during downturns can affect the loss-absorption capacity of institutions exactly when credit risk materialises.

Addressing the liquidity vulnerabilities associated with hybrid banking models requires attention to both supervisory practices and further development of liquidity management infrastructure for Islamic banks. At the supervisory level, liquidity risk assessments should take into consideration dependence on a limited set of liquidity instruments as well as operational dependencies on shared infrastructure that can leave multiple institutions exposed to simultaneous stress. At the structural level, strengthening liquidity resilience will depend on expanding the range of liquidity instruments and markets available to Islamic banks, including continued development of sovereign ṣukūk issuance programmes, a broader supply of high-quality liquid assets, and the expansion of central bank eligible instruments and active Islamic money markets.

Strengthening macroprudential monitoring tools should reflect how stress may propagate across institutions when hybrid instruments feature prominently in financing, funding structures, and liquidity management practices. Strengthening macroprudential oversight in this context involves tracking the aggregate scale and concentration of hybrid exposures across the system and conducting stress-testing exercises that incorporate scenarios relevant to hybrid risks, including commodity price shocks and operational disruptions to shared infrastructure, as well as monitoring the pace of credit and balance sheet expansion associated with these instruments. Integrating these dimensions into the calibration of countercyclical and systemic risk buffers would support timelier and more targeted macroprudential responses during periods of rapid hybrid-driven credit growth.

Greater supervisory attention to the operational and market-infrastructure dependencies associated with hybrid instruments would be warranted, particularly in jurisdictions where these instruments are structurally important. Supervisory frameworks may benefit from monitoring infrastructure concentration, substitution capacity, and operational resilience, especially where multiple institutions rely on a narrow set of commodities, brokers, trading platforms, or settlement arrangements. Incorporating these dimensions into supervisory monitoring and resilience assessments, and encouraging effective contingency planning, could help ensure that banks are able to maintain core functions, including transaction execution and liquidity management, during periods of market or infrastructure disruption.

Overall, in jurisdictions where hybrid banking models are an important feature of the Islamic banking landscape, sustained resilience depends on appropriate alignment between business models and prudential frameworks. This involves ensuring that capital, liquidity, and supervisory approaches are calibrated to the way risks arise and propagate under prevailing banking practices. At the same time, the continued development of Islamic finance requires market infrastructure that supports a broader range of Islamic finance instruments aligned with its inherent principles.

ANNEXURES

Assumptions and Conventions

In this Islamic Financial Stability Report (IFSR) 2026, the following conventions are used:

- IFSR "2026" implies that the report covers activities for the year 2025 and is published in the year 2026.
- "2025Q3" means Quarter 3 of the year 2025.
- "Billion" means one thousand million.
- "Trillion" means one 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.
- 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 corresponds to the latest data available to the IFSB.
- Data for ṣukūk outstanding and Islamic funds are for the full year 2025.
- Data for Islamic banking are mainly as of 2025Q3 except where indicated otherwise.
- Data for Islamic insurance are mainly for 2025Q3.
- 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 IFSR 2026 have been checked for accuracy, completeness, and timeliness. Discrepancies in the sums of component figures and totals shown are likely due to rounding effects. 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*.

Regional Classification

The regional classification is based on UN classifications, for the purpose of standardisation and comparability of the data.

East Asia and Pacific (EAP)

Australia; Brunei Darussalam; China; Indonesia; Japan; Malaysia; Philippines; Republic of Korea; Singapore; Thailand

Europe and Central Asia (ECA)

France; Germany; Ireland; Kazakhstan; Kyrgyzstan; Luxembourg; Russian Federation; Serbia; Tajikistan; Türkiye; Uzbekistan; United Kingdom

Gulf Cooperation Council (GCC)

Bahrain; Kuwait; Oman; Qatar; Saudi Arabia; United Arab Emirates

Middle East and North Africa (MENA excluding GCC)

Algeria; Egypt; Iran (Islamic Republic of); Iraq; Jordan; Lebanon; Libya; Morocco; State of Palestine; Syrian Arab Republic; Tunisia; Yemen

North America (NA)

Canada; Caymen Islands; United States

South Asia (SA)

Afghanistan; Bangladesh; India; Maldives; Pakistan; Sri Lanka

Sub-Saharan Africa (SSA)

Benin; Burkina Faso; Côte d'Ivoire; Djibouti; Ethiopia; Gambia; Guinea-Bissau; Kenya; Mali; Mauritania; Mauritius; Mozambique; Niger; Nigeria; Senegal; Somalia; South Africa; Sudan; Tanzania; Togo; United Republic of Zambia

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List of Abbreviations

AuM	Assets under management
CAGR	Compound annual growth rate
CAR	Capital Adequacy Ratio
CMT	Commodity murābahah transactions
CRE	Commercial real estate
DCR	Displaced commercial risk
DSI	Domestic Systemic Important
ECA	Europe and Central Asia
EAP	East Asia and Pacific
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GFC	Global Financial Crisis
IB	Islamic Bank
ICM	Islamic capital market
IFSB	Islamic Financial Services Board
IFSI	Islamic financial services industry
IFSR	Islamic Financial Stability Report
IIFS	Institutions offering Islamic financial services
IMF	International Monetary Fund
LCR	Liquidity coverage ratio
LME	London Metal Exchange
MENA	Middle East and North Africa
NA	North America
NPF	Non-performing financing
NPM	Net profit margin
NSFR	Net stable funding ratio
PSIA	Profit-sharing investment accounts
PSIFIs	Prudential and Structural Islamic Financial Indicators
ROA	Return on assets
RSA	Regulatory and supervisory authority
RWA	Risk-weighted assets
SA	South Asia
SSA	Sub-Saharan Africa

Acknowledgements

The contents and analysis of this report were prepared, under the guidance of the Secretary-General, Dr. Ghiath Shabsigh, by the IFSB Secretariat team led by Aminath Amany Ahmed, and comprising Erfanul Alam Siddiquee, Hechem Ajmi, Mir Iftekhar Hossain, and Mohamed Osama Alchaar, with contributions from Muhammad Arif, Fazeela Riaz and Fahd Almassi Ndanghwa. Data compilation was supported by Kazi Md Masum, Mohamed Hamza Ghaouri, Mohamed Omer M. Elamin Abbasher, Dauda Adeyinka Asafa, Musa Abdullahi Bayero and Ridwan Sobirin.

The report benefited from valuable feedback provided by members of the Technical Committee, whose contributions are gratefully acknowledged.

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