



**ISLAMIC FINANCIAL
SERVICES BOARD**

**ISLAMIC FINANCIAL
SERVICES INDUSTRY
STABILITY REPORT
2020**



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STABILITY REPORT
2020

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ABOUT THE ISLAMIC FINANCIAL SERVICES BOARD (IFSB)

The IFSB is an international standard-setting organisation which was officially inaugurated on 3 November 2002 and started operations on 10 March 2003. The organisation promotes and enhances the soundness and stability of the Islamic financial services industry by issuing global prudential standards and guiding principles for the industry, broadly defined to include the banking, capital markets and insurance sectors. The standards prepared by the IFSB follow a comprehensive due process as outlined in its Guidelines and Procedures for the Preparation of Standards/Guidelines, which involves, but is not limited to, the issuance of exposure drafts, the holding of workshops and, where necessary, public hearings. The IFSB also conducts research and coordinates initiatives on industry-related issues, and 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.

ASSUMPTIONS AND CONVENTIONS

In this *Islamic Financial Services Industry (IFSI) Stability Report 2020*, the following conventions are used:

- “*IFSI Stability Report 2020*” implies that the report covers activities mainly up to the year 2019 and is published in the year 2020.
- “1H19” means the first half of the year 2019.
- “3Q19” means Quarter 3 of the year 2019.
- “Billion” means one thousand million.
- “Trillion” means one thousand billion.
- “IFSB Staff Workings” means that figures indicated in the corresponding table or chart are based on estimates or calculations by IFSB staff.
- “PSIFIs” implies that the data used in a corresponding table or chart are obtained from the IFSB’s Prudential and Structural Islamic Finance Indicators (PSIFIs) database.
- “SR2019” refers to the IFSB’s *IFSI Stability Report 2019*.
- The regional classification used for both the Gulf Cooperation Council (GCC) Countries and Southeast Asia regions remain the same as in previous issues of the *IFSI Stability Report*. Two new regions introduced in this edition are the Middle East and South Asia (MESA) region, and the Africa region which now comprise North African and Sub Sahara African countries. Countries located in Europe and the Commonwealth of Independent States (CIS) are categorised as ‘Others’.
- The data and analyses in the *IFSI Stability Report* are compiled by IFSB staff from various sources, correspond to the latest data available to the IFSB, and are assumed to be correct as at the time of publication.
- The data for *shukūk* outstanding and Islamic funds are for full-year 2019. The data for Islamic banking are as at the end of September 2019 (3Q19). The data for *takāful* (excluding *retakāful*) are mainly for the full-year 2018 and in some instances up to June 2019 (2Q19) where available.
- 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.), 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.
- The third-party statistical database used for Islamic capital market data has changed for this publication in order to further strengthen the coverage of global data. The change in the database affects the time series data for previous years; therefore, the trend analysis in this report is based on the time series presented in the current report.

As much as possible, the data used and figures provided in the *IFSI Stability Report 2020* have been checked for accuracy, completeness and timeliness. Discrepancies in the sums of component figures and totals shown are likely due to the rounding-off effect. Where errors are observed, corrections and revisions will be incorporated in the online version of the *IFSI Stability Report*. The IFSB appreciates feedback on the Report, which is available for free download at www.ifsb.org.



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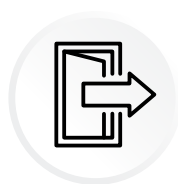
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PREFACE

The Islamic Financial Services Board's (IFSB's) *Islamic Financial Services Industry (IFSI) Stability Report 2020* presents an assessment of the key vulnerabilities, resilience and future outlook of the global IFSI in general, and in IFSB member jurisdictions in particular, across three key segments: Islamic banking, the Islamic capital market (ICM), and *takāful*. Since its first edition was published in 2013, the report has attracted interest beyond the IFSB's member jurisdictions. The report's broad coverage, in-depth analysis of pertinent issues based mainly on data extracted from the IFSB's Prudential and Structural Islamic Financial Indicators (PSIFIs) database, and indicative outlook for the IFSI make it a prime reference for key information on the stability and resilience of Islamic finance globally and across jurisdictions.

Similar to its previous editions, the *IFSI Stability Report 2020* is divided into four chapters. It is worth mentioning that, in addition to a rearrangement of the chapters, the period of coverage for Islamic banking data is extended to the third quarter of 2019 (3Q19), while ICM data are for the full-year 2019. *Takāful* data are mainly for 2018, but in some instances reflect second-quarter 2019 (2Q19) data where available.¹ Islamic banking data are obtained from the IFSB's PSIFIs database; ICM data are obtained from both the Bloomberg and Thomson Reuters Eikon financial databases; and *takāful* data have been obtained from jurisdictions' regulatory and supervisory authorities (RSAs), SwissRe and various company annual reports.

Chapter 1 of the report, as in previous editions, provides updates on the key trends in growth and developments, and analytical and structural outlooks across the Islamic banking, ICM and *takāful* sectors since *IFSI Stability Report 2019*. The new **Chapter 2** provides a detailed assessment of the resilience of the three segments of the IFSI based on technical analyses and interpretation of the likely implications of selected stability indicators. These indicators are analysed, interpreted, and compared with the previous year's report, conventional financial institutions in the respective jurisdictions and international benchmarks. The implication of the COVID-19 pandemic for the outlook of each segment is also provided in the report.

Chapter 3 covers emerging issues in the IFSI, with a particular focus on regulatory and supervisory concerns for the industry. Specifically, issues covered include those relating to trends and the way forward for Islamic digital banking and its implications for the stability of the IFSI. Other emerging issues relate to financial market infrastructure and regulatory considerations for Islamic finance.

Chapter 4 tracks initiatives and developments in the other international financial standard-setting bodies with an emphasis on aspects that relate directly to the complementary role played by the IFSB. In addition, the various initiatives of the IFSB since the publication of the *IFSI Stability Report 2019* are highlighted, including standards development, research and working papers, IFSB standards implementation, and various industry collaborations.

The report also contains contributions on Islamic finance developments from IFSB members: Bangladesh Bank, Otoritas Jasa Keuangan; Indonesia, Autoriti Monetari Brunei Darussalam, and National Insurance Regulatory Authority, Sudan, respectively.

The analyses and information in the *IFSI Stability Report 2020* have been provided by a core team from the Technical and Research Department of the IFSB Secretariat comprising Dr. Abideen Adeyemi Adewale (Project Manager), Mr. Mohamed Sani Tazara, Mr. Jhordy Kashoogie Nazar, Ms. Aminath Amany Ahmed, Mr. Mohamad Farook bin Naveer Mohideen, Dr. Dauda Adeyinka Asafa, Dr. Ahmad Al-Shammari, Ms. Mardhiah Muhsin, Dr. Md Salim Al Mamun. Other members include Mr. Tarig Mohamed Taha Abdelgadir, Mr. Esam Osama Al-Aghbari, Ms. Ainaz Faizrahkman, Mr. Ahmed Barakat, and Mr. Madaa Munjid. Professor Volker Nienhaus provided extensive review of the report. Mrs. Noorliza Abdul Latiff and Ms. Nur Khairun Nissa Md. Zawawi assisted in managing correspondences with the IFSB members. Mrs. Nirvana Jalil Ghani and Ms. Rosmawatie Abdul Halim, also from the IFSB, provided assistance in the editing, formatting and publication of the final document. Finally, the report has benefited immensely from comments and suggestions from the IFSB Technical Committee members, Mr. Peter Casey and the IFSB's member RSAs.

¹ Previous editions were based on second-quarter data for Islamic banking and a year lag for the *takāful* sector.



FOREWORD

The eighth edition of the Islamic Financial Services Board's (IFSB's) *Islamic Financial Services Industry (IFSI) Stability Report* takes place at a time when numerous developments that may impact the stability of the global financial system are prevalent: notably, the COVID-19 pandemic and global crude oil price volatility.

Although the duration and full extent of the damage brought about by the pandemic, as well as the span and form of future economic recovery, remain unclear, the consequential macroeconomic shock to the global financial system is indisputably the greatest since the 2007–8 Global Financial Crisis (GFC). The current global economic shock is also exacerbated by the oil price volatility that has been evident since the first quarter of 2020 due to a delay by the OPEC+ coalition (Organization of the Petroleum Exporting Countries and 10 other oil exporting countries led by Russia) to agree to a deal on possible oil production cuts. Both shocks will obviously have a devastating effect on global economic activities, as well as on various growth forecasts for 2020 and, perhaps, beyond. The International Monetary Fund (IMF), in its June 2020 World Economic Outlook, projects that global growth will be -4.9% in 2020, contrary to its -3% growth projection made three months earlier.

These developments will no doubt have a strong effect on key jurisdictions with an Islamic finance presence, and especially on those that are oil-exporting nations. The measures taken by various countries – cutting monetary policy rates, providing liquidity, increasing fiscal stimulus, and intervening in foreign currency markets and balance of payments – seem to be yielding favourable outcomes in terms of keeping the financial market functional. However, these monetary and fiscal policy responses may have a limited effect if the pandemic persists and there is a prolonged cessation of or delay in production activities and capital projects completion. This may result in a contraction in the real economy to which the IFSI is highly exposed.

The financial reforms arising from the GFC are now being operationalised, albeit with delayed implementation in a number of jurisdictions with an Islamic financial market. This delay may be prolonged due to easing compliance with prudential regulations as RSAs find a balance between ensuring financial stability and supporting economic activity in response to the dual shocks to the financial system. In addition, known challenges arising from evolving market structures, advancements in financial technology, increasing activities of the non-bank financial institutions, as well as increasing cyber risks, among other operational issues, are still very prevalent and growing. In 2019, trade wars escalated, regional and national political impasses continued, economic sanctions remained, civil unrest increased, and a myriad of natural disasters occurred, all resulting in uncertain business environments and sentiments.

Notwithstanding, the total worth of the IFSI increased to an estimated USD 2.44 trillion in 2019 (from USD 2.19 trillion in 2018). The IFSI sustained its growth momentum in 2019, recording a growth rate of 11.4% year-on-year (y-o-y) based on significant improvement across the three segments of the IFSI, especially Islamic banking and the ICM. There was also an improvement in the resilience of the IFSI based on satisfactory financial stability indicators and compliance with most international regulatory requirements, especially when compared with previous years' performance, conventional peers, and assessment criteria used by international standard-setting bodies.

This performance of the IFSI in 2019 projected a sense of optimism for 2020 based on, among other factors, the expected depressed but relatively stable prices of oil and other export commodities, improved regulatory and investment environment in most jurisdictions with a significant Islamic finance presence. However, the combined effects of the shock from the COVID-19 pandemic and oil price volatility, as well as the financial services industry's vulnerability to factors such as global trade wars, economic sanctions and political blockades, will test the strength and resilience of the IFSI in 2020.

The IFSB closely monitors developments in the global financial system generally, and specifically in its member jurisdictions. In line with its core mandate, the IFSB in addition to issuing statements on measures to mitigate the impact of COVID-19 in the IFSI, publishing a compendium of policy responses across its member jurisdictions, is also preparing a paper on the impact of COVID-19 on the IFSI. The IFSB has issued several standards, guidance/technical notes and research papers that generally complement the work of other international standard setters but, most importantly, cater for the specificities of the IFSI. In this regard, since the publication of the 2019 report, the IFSB has issued three new standards across the three segments of the IFSI, along with five working papers, and has conducted numerous workshops on the implementation of its standards. Presently, the IFSB is working on nine standards and guidance/technical notes across its three main segments, as well as on five research working papers on various aspects relating to emerging issues in the IFSI. At least three standards and the five research papers are expected to be published this year.

FOREWORD

The analysis conducted on the Islamic banking segment in this report is based on the IFSB's PSIFIs database. The IFSB has issued a new compilation guide for the database and would extend its scope to both the Islamic capital market and *takāful* segments from 2020 onwards.

The *IFSI Stability Report 2020*, as a flagship publication of the IFSB, examines the implications for the global IFSI of recent economic developments and changes in the global regulatory and supervisory frameworks. It also includes a dedicated chapter on pertinent emerging issues, with a focus on digital Islamic banking and Islamic financial market infrastructure. These areas are considered pertinent post-COVID-19 due to the envisaged consequential quickening of the digital transformation process among Islamic banks, as well as the need for central counterparties to manage counterparty risks. There are also contributions from Bangladesh Bank, Otoritas Jasa Keuangan, Indonesia, Autoriti Monetari Brunei Darussalam, and National Insurance Regulatory Authority, Sudan on the developments and prospects of the IFSI in their respective jurisdictions.

As always, it is my fervent hope that the *IFSI Stability Report 2020* will provide a better understanding of trends and developments in the IFSI across jurisdictions and sectors, of the workings of the IFSB, and of both the extant and emerging issues that affect the stability and resilience of the IFSI.

Dr. Bello Lawal Danbatta

Secretary-General

Islamic Financial Services Board

August 2020.



KEY IFSI HIGHLIGHTS

Islamic Financial Services Industry (IFSI) Development Review

Downside Risks of the Global Economy in 2020:

- Magnitude and duration of COVID-19 pandemic
- Health crisis leading to an economic crisis
- OPEC+ Coalition deal on oil output cut and impact on oil price volatility
- Foreign exchange rate volatility
- Long-term funding disruption
- Weakened real sector productive capacity
- Trade war, geopolitical impasse, social unrest



Global IFSI Maintains Positive Growth in 2019:

The global IFSI maintained its positive growth by **11.4% growth (y-o-y)** with the IFSI's total worth estimated at USD 2.44 trillion (2Q19).

The downside risks are expected to effect the projected sense of optimism for 2020.



SEGMENTAL ANALYSIS

Islamic Banking



Growth (y-o-y):
12.7%
Share of IFSI[^]:
72.4%

Islamic Capital



Growth (y-o-y):
23.5%
Share of IFSI*:
26.5%

Takāful



Growth (y-o-y)**:
3.2%
Share of IFSI:
1.1%

[^] Islamic banking data as at end 3Q19.

* Islamic capital market share comprise *shukūk* and Islamic funds assets as at end 2019.

** Takāful as at end 2018



SECTORAL FACTS

Islamic finance assets are still concentrated in the GCC region (45.4%) Middle East and South Asia (25.9%), and South-East Asia (23.5%).

Islamic banking is considered as systemically important in 13 IFSB jurisdictions.

91.4% of Islamic banking assets are concentrated in jurisdictions where Islamic banking is of systemic importance.

83.6% of *shukūk* outstanding and 77.6% of *shukūk* issuances in 2019 were in jurisdictions where Islamic banking is of systemic importance.



EXECUTIVE SUMMARY

IFSB IFSI Stability Report 2020 at a Glance

01

The IFSI, as part of the global financial ecosystem, is faced with the dual shock of a COVID-19 pandemic and volatility in the price of crude oil.

02

Notwithstanding the trade war, economic sanctions, regional political blockades, civil unrest, etc., in 2019, the IFSI recorded a y-o-y global growth rate of 11.4% and is now estimated to worth USD 2.44 trillion.

03

The financial analyses conducted in this report indicate that in 2019, the IFSI recorded improved resilience against financial vulnerabilities.

04

The projected sense of optimism for the IFSI in 2020, based on the financial analyses conducted in this report, is attenuated by the abrupt shock of the COVID-19 pandemic and crude oil price volatility.

05

The digital transformation process is taking root in the IFSI especially in the Islamic banking segment.

06

The IFSB is monitoring global developments and responding with new initiatives.

The global financial system is faced with an abrupt and pervasive COVID-19 pandemic, the duration and ultimate impact of which remain unclear. The effect of the pandemic on the global economy is already devastating and arguably presents the most significant shock to the financial system since the GFC, which occurred just over a decade ago. In addition, weakened production and economic activity due to movement restriction orders aimed at curbing the spread of the pandemic have resulted in weakening global demand for oil. The consequential price volatility has been aggravated by the failure of the OPEC+ coalition to immediately agree on a deal to cut output. These developments have led governments and the central banks to respond via stimulus packages and fiscal and monetary policy easing measures. Multilateral organisations have also made available substantial financial and non-financial resources to support their respective member countries.²

The combined effect of the COVID-19 and oil price volatility shocks, as well as the pre-existing conditions of financial vulnerability in jurisdictions where Islamic finance is practised, will put the resilience of the IFSI to test in 2020 and perhaps beyond. It is arguable that the optimistic assessment of a favourable outlook for the IFSI in 2020 on the back of financial ratio analyses contained in this report based on data up to 2019 may have to be reconsidered depending on how the IFSI responds to various international and national policy initiatives to reduce the impact of the dual shocks.

Size and Resilience of the IFSI

In 2019, the IFSI recorded continuous improvement for a third straight year in terms of its total worth and y-o-y growth. The combined total worth of the three broad segments of the IFSI is estimated at USD 2.44 trillion, compared to the USD 2.19 trillion recorded in 2018. In addition, the IFSI recorded a y-o-y growth rate of 11.4% compared to the 9.6% growth rate recorded between 2017 and 2018. The growth rate is commendable given that the IFSI in 2019 was faced with, among other issues, geopolitical and economic factors, as well as prolonged depreciation of the local currency in US dollar terms in some jurisdictions.

In specific terms, in 2019, the Islamic banking segment experienced a higher growth rate of 12.7% compared to the 0.9% growth recorded in 2018. The segment's asset worth increased from USD 1,571.3 trillion as at 2Q18 to USD 1,765.8 trillion as at 3Q19. However, due to an even stronger growth of the ICM, the share of Islamic banking assets declined by -3.6 percentage points from (76%: 2Q18) to (72.4%: 3Q19). The ICM segment's share of the total worth of the IFSI increased by 3.6 percentage points from USD 501.6 billion (22.9%: 2018) to USD 645.7 billion (26.5%: 2019). This is as a result of a double-digit y-o-y growth of 22.2% recorded in terms of *shukūk* outstanding of USD 543.4 billion, and of 29.8% y-o-y growth in Islamic funds' assets worth USD 102.3 billion, respectively, in 2019. The *takāful* segment slowed by -1.1 percentage points as at the end of 2018 to 3.2% (4.3%: 2017) as measured by y-o-y gross *takāful* contributions. The segment's share of the total worth of the IFSI also declined marginally, by -0.2 percentage points, to USD 27.07 billion at the end of 2018.

² The global fiscal stimulus only reached about USD 9 trillion as at May 2020. <https://blogs.imf.org/2020/05/20/tracking-the-9-trillion-global-fiscal-support-to-fight-covid-19/>.

Islamic Banking

Size and Structural Trends: The number of jurisdictions with a systemically important Islamic banking sector increased marginally, from 12 in 2018 to 13 in 2019. Nonetheless, with the exception of one jurisdiction that experienced a marginal decline, all others recorded an increased share of Islamic banking assets relative to their total banking sector assets. In aggregate, these jurisdictions marginally account for a larger share of the global Islamic banking assets, at 91.4% in 2019, compared to 91.0% in 2018.

The Gulf Cooperation Council (GCC) region still accounts for the largest share of the global Islamic banking assets, at 45.4%. It is followed by the Middle East and South Asia (MESA)³ region and the South-East Asian region, with shares of global IFSI assets of 25.9% and 23.5%, respectively. Despite merging the shares of North African and Sub-Saharan African countries, the share of the African region in the global worth of Islamic banking remains marginal at 1.6%. Nonetheless, the prospects for entrenching Islamic banking in the region seem bright given the various efforts and initiatives being made to that end.

On a country-by-country basis, 11 of the 23 jurisdictions covered in the IFSB PSIFs database recorded a double-digit growth in Islamic banking assets, while at least nine jurisdictions recorded a similar feat in financing growth. In terms of growth in deposits, one jurisdiction recorded a double-digit growth rate, while at least eight other jurisdictions recorded improvements of at least 2 percentage points compared to 2018.

Resilience: Spurred by a rebound in oil prices and improved asset quality due to credit growth, among other reasons, the improving resilience of the global Islamic banking sector recorded in the previous two years is sustained in 2019. Except in a few instances, most of the stability indicators are in satisfactory conformance with minimum international regulatory requirements, and compared favourably with those of conventional banking in both the United States and the European Union, as well as with those of the conventional banks in their respective jurisdictions.

Both the return on assets (ROA) of 1.6%, and return on equity (ROE) of 15.2%, of the global Islamic banks are greater than their respective moving averages for the past five years at 1.56% and 14.3%, respectively. The ROE for the global Islamic banking sector is also greater than those recorded by conventional banks over the same period in both the US and the EU, at 11.67% and 6.6%, as well as in both Malaysia and the GCC, at 13% and 11.8%, respectively. Both the net profit margin and income-to-expense ratios remain around their global historical averages on account of divergent performance across jurisdictions. Similar to 2018, the improved performance recorded in most jurisdictions in 2019 regarding both indicators is attenuated by the poor

performance in a few jurisdictions on account of increasing operating expenses due to operational inefficiency, cash maintenance costs and expensive technological initiatives. Nonetheless, in 2019 and in a number of jurisdictions, the Islamic banks recorded better profitability performance than their conventional peers.

The archetypal excess liquidity predicament of Islamic banks is still persistent and prevalent in a number of jurisdictions. The main reason for this is the lack of Shari'ah-compliant avenues for liquidity management. Conversely, in some other jurisdictions, there is an issue of liquidity shortages due to macroeconomic pressures, runaway inflation rates and negative economic outlooks triggering increased deposit withdrawals. More countries have commenced implementation of the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) as regulatory standards on liquidity. Specifically, seven jurisdictions reported the LCR compared to only one in 2018.⁴ Nonetheless, based on the financing-to-deposits ratio (FDR) and liquid assets ratio, the liquidity situation in most jurisdictions is satisfactory. All but three jurisdictions recorded a declining FDR of above 90%, with many others following with ratios of less than 50% on account of sustained long-term funding and a high volume of corporate deposits.

The financing exposure of global Islamic banking reflects jurisdictional peculiarities but generally follows a similar trend from 2018 mostly concentrated in wholesale and retail trade financing. This is closely followed by the household sector, driven mainly by continued favourable labour market conditions and income growth, which support households' repayment capacity, especially in some emerging markets. While financing for agriculture, real estate and construction has regional concentrations and is still relatively low compared to other sectors, about one-fifth of the global Islamic banks' financing exposure is in the manufacturing sector.

Despite subdued economic activity and financial sector turbulence, the global Islamic banking industry's asset quality has continued to improve during the analysis period. The global Islamic banking average non-performing financing (NPF) ratio of 4.96% as at 3Q19 compares favourably to a higher ratio of 5.1% registered at the same period in 2018. Nonetheless, the Islamic banking sector's NPF is still higher than those of conventional banks in both the EU and the US, with an average NPF of 2.5% and 1.5%, respectively, during the same period. Reasons include, but are not limited to, economic sanctions and the consequential slowdown in growth recorded in some jurisdictions. On a sector-by-sector basis, the NPF also mirrors the global financing exposure of Islamic banks, with the highest NPF recorded in the wholesale and retail trade, manufacturing and household sectors.

³ The MESA region comprises: Afghanistan, Bangladesh, Iran, Iraq, Jordan, Lebanon, Maldives, Palestine, Pakistan, and Sri Lanka.

⁴ The analysis of NSFR is not included in this report due to short time series and the low number of reporting countries. Nonetheless, the data from the IFSB PSIFs indicated that, with the exception of one of the reporting countries, all recorded figures above the regulatory minimum set by the IFSB in its GN-6: Guidance Note on Quantitative Measures for Liquidity Risk Management in Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (*Takaful*) Institutions and Islamic Collective Investment Schemes].

In general, the total capital and Tier-1 capital adequacy ratios in most jurisdictions are both stable and above the regulatory requirements. On average, however, these ratios declined on account of economic sanctions and economic turbulence, respectively, witnessed especially in some jurisdictions. Some few jurisdictions' Islamic banking sectors also face heightened foreign exchange exposure resulting in economic slowdown, fluctuations in foreign currency exchange, and inflation. This is in contrast to the Islamic banking sector in most other jurisdictions, which record foreign currency exposure that is generally around their historical average. In terms of both leverage and regulatory capital, all jurisdictions covered for this purpose have ratios above the regulatory requirements as per the Basel Committee on Banking Supervision (BCBS) and the IFSB standards.

Islamic Capital Market

The ICM sector continues to record improved developments in 2019. The sector accounts for 26.5% of global IFSI assets and is worth about USD 645.7 billion. *Shukūk* recorded a double-digit growth of 22.2% in 2019, similar to 2018, and still clearly dominates the ICM sector in terms of share of assets. The strong performance was due largely to the strong sovereign and multilateral issuances in key Islamic finance markets to support respective budgetary expenditures, as well as to an increase in corporate issuances in some jurisdictions in 2019. In contrast to the trend observed in the global equity markets in 2018, Islamic funds bounced back strongly in 2019, recording a double-digit growth of 29.8% in terms of assets under management (AuM) and a 3.8% growth in number of Islamic funds compared to 2018.

Shukūk: The growth trend in *shukūk* issuance observed in 2018 continued in 2019, with sovereign issuances at 55% still accounting for the majority of issuances in the reporting period. A resurgence in sovereign issuances reflects the increasing use of *shukūk* for fiscal deficit financing as well as liquidity management purposes. This trend is dissimilar to that observed in 2018 in which a moderation in sovereign issuances was recorded, especially from the GCC on account of a positive rebound in the price of oil.

Another continuing trend observed in 2019 is an increase in corporate *shukūk* issuances. Malaysia maintained its position as the jurisdiction with the largest volume of *shukūk* issuance, at 36.8%. The top six jurisdictions – namely, Malaysia, Indonesia, Saudi Arabia, Turkey, Kuwait and the United Arab Emirates (UAE) – accounted for a 86.1% share of total *shukūk* outstanding in 2019⁵. The share of *shukūk* issuance by multilateral development banks and international organisations declined, as only the Islamic Development Bank (IsDB), the International Islamic Liquidity Management Corporation (IILM) and the International Finance Facility for Immunisation (IFFIm) issued *shukūk*

in 2019⁶. Moreover, on a sector-by-sector basis, the government and financial services sectors maintained their relative prominence in 2019.

Overall, the demand for new *shukūk* issued in the primary market, as measured by times oversubscription, has continued to be positive. Unlike the trend observed in the preceding three years, based on available information, tranche allocations, especially in the GCC region, no longer reflect regional bias as the issuances from the region have been taken up by a more diverse group of international investors.

Generally, the *shukūk* market started 2020 on a bright note on the back of an improved performance in 2019 and with a relatively higher *shukūk* issuance recorded in the first two months of 2020 compared to 2019. It was also expected that in 2020 *shukūk* would play a huge role in bridging the climate financing gap, due to the trend in recent years that indicates interest in green *shukūk* issuance. However, the optimism has been significantly moderated by the abrupt shock due to the pervasive COVID-19 pandemic and volatility in global oil price and production. Except for a few issuances in Iran⁷ and the USD 400 million Dar Al Arkan seven-year *shukūk* issued in Saudi Arabia, most of those planned for the first quarter of 2020 have been delayed or cancelled outright, resulting in a dip of 32% in expected issuance during the period⁸. It is expected that even an early containment of the pandemic will not deter a relatively lower *shukūk* issuance and higher risk of default in 2020. In response to market volatility, investors are already exhibiting flight to safety and quality, causing prices of gold, for instance, to rise sharply at the expense of yields on fixed-income investments, which have plummeted.

Equity Indices: Similar to the trend observed in 2018, most Islamic equity indices performed better than conventional benchmarks in 2019. This could be attributed to a higher proportionate exposure of the Islamic indices to the technology and health-care sectors, both of which recorded positive returns in 2019. This contrasts with the proportionately high exposure of the conventional indices to sectors that performed poorly in 2019, such as financials, energy, industrials and materials. The outperformance of the Islamic indices compared to their conventional benchmarks in 2019 also reflects regional distribution, given that the former performed better in emerging markets and the pan-Arab region compared to the developed markets. While a cautious optimism on the back of the performance recorded in 2019 projects a positive outlook in 2020, the negative impacts of COVID-19 and the volatility of global oil prices have already started to manifest across markets. The consequential and implied volatility effect on global equity markets manifested by high spikes across various asset classes led to a significant drop in various indices at a level close to half of the magnitude recorded during the GFC of 2007–8.⁹

⁵ These jurisdictions also jointly account for 91% of global total *shukūk* outstanding in 2019.

⁶ The IFFIm *shukūk* was private placement *shukūk* transaction with the Islamic Development Bank Group (IsDB).

⁷ Data from the Securities and Exchange Organisation (SEO) Iran indicate both sovereign and corporate *shukūk* issuances in the first quarter of 2020 amount to USD 1.25 billion (IRR 153,912 billion).

⁸ <https://gulfnnews.com/business/banking/covid-19-to-hold-back-global-shukuk-issuances-in-2020-1.71057306>.

⁹ IMF, Global Stability Report, April 2020, p. 2.

Islamic Funds:¹⁰ In 2019, the performance of the Islamic funds subsector was remarkable, recording notable improvement in both value of AuM and number of funds. The value of active AuM increased from USD 67.1 billion in 2018 to USD 102.3 billion in 2019, while the number of funds increased from 1,489 to 1,545. In addition, returns across most assets remain positive in 2019 except for the real estate sector.

Of the 34 jurisdictions where Islamic funds are domiciled, Saudi Arabia, Malaysia and Iran are the most prominent, collectively accounting for about 81.5% of total AuM in 2019. Structure-wise, equity, money market and commodities remain the main asset classes of global Islamic funds in 2019. Like the other subsectors in the ICM, the Islamic funds market is also susceptible to the implications of the dual shock of COVID-19 and volatile oil market conditions as detailed in this report. This subsector is already facing large portfolio losses, raising concerns about actual and anticipated redemptions. Asset prices are expected to decline further, especially if asset managers are forced to sell assets in order to de-risk their portfolio.¹¹

Takāful

In 2018, the *takāful* industry maintained its expansionary trend of the past eight years, recording a compound annual growth rate of 8.5% (2011–18). Nonetheless, compared to the preceding year, in 2018 the segment recorded a relatively slower growth as well as a decline in the segment's share of the global IFSI asset. The total *takāful* contributions growth declined by -1.1 percentage points, from 4.3% reported in 2017 to 3.2% in 2018, to reach USD 27.07 billion. Although reflecting regional peculiarities, the general business still retains its dominance over the family business, with shares of USD 22.4 billion of total *takāful* contributions (82.6%) and USD 4.7 billion (17.4%), respectively. There are an estimated 353 *takāful* institutions, including *retakāful* and *takāful* windows, offering *takāful* products in at least 33 countries globally, mostly in the GCC, MESA and South-East Asian regions. Most of these jurisdictions have developed specific *takāful* sector regulations. The GCC region remains the largest global *takāful* market in 2018 with a contribution worth USD 11.7 billion, accounting for 43% of the total global *takāful* contributions.

Generally, most jurisdictions recorded a high retention ratio of above 80% in the personal line business, in contrast to the low ratio of between 30% and 36% recorded in the marine, engineering, fire and transport lines. With the exception of a few countries where the expense ratio recorded a decline due to the deployment of technology, the expense ratio increased during 2018 compared to the three-year average (2015–17) in more than half of the jurisdictions in the sample. Plausible reasons for the upsurge in the expense ratio include strong competitive environments, higher administrative and management expenditures, and higher commissions for their operations.

Notable improvement in the combined ratios was observed in many jurisdictions. In the few exceptions, variations stem from increases in loss ratios due to line-specific cycles and catastrophic events experienced in some jurisdictions. Notwithstanding, the markets remain profitable due to earnings from other sources, such as commission income from *retakāful*/reinsurers and investment income, which offset the losses. In general business, the compulsory lines of business such as medical and motor are expected to continue to drive growth. As in the other two segments, it is expected that the *takāful* segment would also be significantly affected by the dual shock of the COVID-19 pandemic and oil market volatility, as well as by pre-existing vulnerability conditions as detailed in this report.

Changes in Global Financial Architecture

With due cognisance of the IFSI being an important part of the global financial ecosystem, the *IFSB IFSI Stability Report* also tracks developments in the global regulatory systems, especially those that have had, or will have, an impact on the IFSI and the work of the IFSB.

The *IFSI Stability Report 2020* takes cognisance of the implementation of the G20 financial regulatory reforms and will continue to keep tabs on the effects of these reforms on the IFSI in the three IFSB jurisdictions that are G20 members. In fact, as per the current report, two of the three countries are categorised as having a systemically important Islamic banking sector. In addition, through its standards and working papers, the IFSB is tracking the works and publications of the International Organization of Securities Commissions (IOSCO) regarding the financial market infrastructure, retail investor protection and financial literacy for investors.

The BCBS has, since the issuance of the *IFSI Stability Report 2019*, issued a number of supervisory documents that relate to the IFSI and the future work of the IFSB. These BCBS documents may help to enhance the stability of the IIFS. The IFSB is tracking the BCBS's revisions to the leverage ratio disclosure requirements and similar developments. The IFSB is also currently reviewing its *Standard on Capital Adequacy* (IFSB-15) and, in this process, also takes cognisance of the changes made by the BCBS, especially those relating to the Standardised Approach (SA) and the Internal Ratings Base (IRB) Approach to the calculation of market risk capital charges. Importantly, the IFSB also takes note of the revised implementation dates for Basel III standards due to COVID-19 outbreak for consideration in the implementation of its ongoing Revised Capital Adequacy Standard.

The *IFSI Stability Report 2020* also takes note, and provides excerpts, of the various issues and application papers by the International Association of Insurance Supervisors (IAIS). Highlights are also provided on the Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame), the Insurance Core Principles, as well as the public consultation document on a holistic framework for systemic risk in the insurance sector by the IAIS.

¹⁰ The data for funds represent only funds that are invested in tradeable securities and are publicly available

¹¹ Ibid, p. 18.

Recent Initiatives of the IFSB

Standards Development: The IFSB is further strengthening its standards development process to ensure that published standards, guidance notes, and technical notes adhere to stringent and thorough review processes before their issuance and meet the highest quality expectations of IFSB stakeholders. Since the publication of the IFSI Stability Report 2019, the IFSB has issued GN-7 Guidance Note on Shari'ah-compliant Lender-Of-Last-Resort Facilities, and TN-3 Technical Note on Financial Inclusion and Islamic Finance. The Secretariat is presently developing three standards within its Islamic banking workstream, two standards within its Islamic capital markets workstream, three standards within its *takāful* workstream, and one standard within its cross-sectoral workstream. Synopses on these ongoing standards are provided in Chapter 4 of this report.

Research Papers: Since the *IFSI Stability Report 2019*, the IFSB has issued five working papers – three relating to the Islamic banking sector with a focus on the risk-sharing practices in Islamic banks, intersectoral linkages in the IFSI, and money laundering and financing terrorism risks in Islamic banking respectively. The other two papers focus on activities in the ICM sector relating to the conduct of intermediaries, and regulatory and supervisory issues arising from Shari'ah-compliant hedging instruments. In 2020, the IFSB intends to issue five working papers focusing on emerging issues such as financial stability implication of operational and regulatory digital transformation in Islamic banking, risk-based supervision in Islamic banking, and the effectiveness of macroprudential tools in Islamic banking. The pertinence of these papers derives from the likely speed of digital transformation post COVID-19 and the associated cyber risks. The various monetary policy easing measures and delayed implementation of various Basel III and related IFSB standards due to the abrupt onset of COVID-19 relate very much to the intended outcomes of both the risk-based supervision and effectiveness of macroprudential tools papers. Another paper focuses on the prudential and supervisory issues in *takāful* windows operation.

Other IFSB Initiatives: In addition to activities aimed at facilitating the implementation of the IFSB standards, the IFSB PSIFIs database (which forms the basis of the analysis of the Islamic banking sector in this report) is being extended to both the ICM and *takāful* sectors. In addition to its revised detailed financial statement template, the IFSB therefore also issued its revised PSIFIs compilation guide and is currently exploring the possibility of developing a web-based system to enhance the database's usability and accessibility.

Emerging Issues in Islamic Finance and Developments in IFSB Member Jurisdictions: A chapter of this report is dedicated to contributions from some members of the Secretariat on emerging issues in the IFSI. Specifically, the contributions focus on issues relating to digital Islamic banking and Islamic financial market infrastructure. There are also contributions from selected IFSB member jurisdictions cutting across the three main segments of Islamic banking, the Islamic capital market and *takāful*. In this regard, the Bangladesh Bank provides insights into the developments in Islamic banking in Bangladesh, while the Otoritas Jasa Keuangan, Indonesia, provides a synopsis of the ICM in Indonesia with an emphasis on recent initiatives, especially on *shukūk*. The third contribution provided by the Autoriti Monetari Brunei Darussalam, addresses *takāful* developments in Brunei; while the fourth is a contribution by the National Insurance Regulatory Authority, (NAIRA) Sudan on the market developments, existing *takāful* models and prospects for the industry in Sudan.



1.0 DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

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1.1 IFSI: SUSTAINED GROWTH MOMENTUM AMID GLOBAL ECONOMIC SLOWDOWN

The global economy in 2019 recorded its weakest pace of growth since the Global Financial Crisis of a decade ago. Although each region's or country's actual percentage points contribution to growth reflected its particular peculiarities or idiosyncrasies, the slowdown in economic growth was pervasive in 2019.

Most of the factors responsible for the economic downturn experienced in the last few years remain unabated. These include, but are not limited to, escalating trade wars (especially between the United States and China), social and civil unrest, geopolitical impasses and economic blockades, trade and economic sanctions, etc. The slow growth in 2019 can also be linked to a number of headwinds, including natural disasters and climate-related occurrences (such as drought, flood, wild-fires, volcanic eruptions, etc.), in various parts of the world.

These factors inhibited global economic activity and heightened uncertainty. They also impacted negatively on the global financial ecosystem, especially in the emerging and developing economies.¹² In the sphere of financial markets, monetary easing policies were prioritised in a number of advanced and emerging economies to spur growth and prevent further deterioration of financial conditions. Macroprudential policy was enhanced in several advanced and emerging economies to protect the financial sector from any vulnerabilities arising from the deceleration of growth of the real economy.

In an abrupt turn of events, the IMF reversed its earlier projection made in January 2020 of a 3.3% global growth rate, to a decline of -3% in the global economy in 2020 due to the COVID-19 pandemic and volatile global oil output and prices.¹³ The earlier projection

was based on the expected positive impacts of monetary policy and fiscal easing in several developed economies, expected gradual recovery and temporary stability of the global economy, a decisive and clear direction on Brexit, and a likely improved trade relation between the United States and China. In addition, it was expected that the appreciation of currencies in the emerging markets recorded from 2Q19 to 3Q19 would continue. However, the situation that emerged globally in the first quarter of 2020 presented a different story and manifested in a near total collapse of global production, restricted travelling, a significant drop in the equities market, heightened unemployment, budget cuts, government bail-outs, stimulus packages, monetary and fiscal policy cuts, foreign exchange interventions, etc. The IMF again, in its June 2020 World Economic Outlook, projects that global growth will be -4.9% in 2020, contrary to its -3% growth projection made three months earlier. According to the Asian Development Bank (ADB) the global economy is estimated to lose up to USD 8.8 trillion in the wake of the shock¹⁴. Obviously, these conditions, amplified by pre-existing vulnerabilities, will strongly test the resilience and stability of the IFSI.

Global IFSI improves on its growth momentum in 2019 and is now estimated to worth USD 2.44 trillion

The total worth of the IFSI across its three main segments (banking, capital markets and *takāful*) is estimated at USD 2.44 trillion in 2019¹⁵ (see Table 1.1.1), marking a y-o-y 11.4% growth in assets in US dollar terms [2018: USD 2.19 trillion]. All segments contributed to the increased total worth of the global IFSI; however, the key rebound in performance was experienced by the Islamic capital markets and the Islamic banking segments, with steady growth in the prominent Islamic banking jurisdictions as well as emerging countries. The overall growth was achieved despite the heightened uncertainties within the global economic landscape and negative sentiments in the financial market space.

¹² These economies are not only rapidly indebted, but also are faced with increasing vulnerabilities and weak growth prospects. See: *World Bank Year in Review: 2019 in 14 Charts*. <https://www.worldbank.org/en/news/feature/2019/12/20/year-in-review-2019-in-charts>.

¹³ IMF, *World Economic Outlook*, April 2020.

¹⁴ <https://www.adb.org/news/videos/covid-19-s-global-economic-impact-could-reach-8-8-trillion-ADB>

¹⁵ The figure quoted here is in fact a composite made up by adding assets in the banking sector and Islamic funds to the value of *shukūk* outstanding and *takāful* contributions. The latter is a measure of income, rather than assets, and elsewhere there may be elements of double counting – for example, if a bank holds *shukūk*. The figure is nevertheless the best measure we can offer in the current state of data availability.

DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

Table 1.1.1 Breakdown of the Global IFSI by Segment and Region¹⁶ (USD billion, 2019*)

Region	Banking Assets	Shukūk Outstanding	Islamic Funds' Assets	Takāful Contributions	Total	Share
GCC	854.0	204.5	36.4	11.70	1,106.6	45.4%
South-East Asia	240.5	303.3	26.7	3.02	573.5	23.5%
Middle East and South Asia	584.3	19.1	16.5	11.36	631.3	25.9%
Africa	33.9	1.8	1.6	0.55	37.9	1.6%
Others	53.1	14.7	21.1	0.44	89.3	3.7%
Total	1,765.8	543.4	102.3	27.07	2,438.6	100%
Share	72.4%	22.3%	4.2%	1.1%	100.0%	

* Data for shukūk outstanding and Islamic funds are for full-year 2019; for Islamic banking, they are as at 3Q19; and for takāful, they are as at end-2018.

Notes: (a) Data are mostly taken from primary sources (regulatory authorities' statistical databases, annual reports and financial stability reports, official press releases and speeches, etc., and the IFSB's PSIFI database).

(b) Where primary data are unavailable, third-party data providers have been used, including Bloomberg.

(c) Takāful contributions are used as a basis to reflect the growth in the takāful segment.

(d) The breakdown of Islamic funds' assets is by domicile of the funds, while that for shukūk outstanding is by domicile of the obligor.

(e) The regional classification is different from that used in the previous IFSI stability reports. Other than the GCC and South-East Asian region, a new classification – Middle East and South Asia (MESA) – is used to capture other jurisdictions in Asia. The African region now includes both North Africa and Sub-Saharan Africa. Jurisdictions not belonging to any of the four regions are classified as 'Others', specifically countries located in Europe, North America, South America, and Central Asia regions.

Source: IFSB Secretariat Workings

The shukūk sector ended 2019 with a total shukūk outstanding worth of USD 543.4 billion [2018: USD 444.8 billion], thus recording a y-o-y growth of 22.2%. In isolation, the shukūk sector accounts for 22.3% of global IFSI worth and recorded significant expansion in 2019, bringing its compound annual growth rate (CAGR) over the last 15 years (from 2004 to 2019) to 26%. The expansion recorded in 2019 was due mainly to the strong sovereign and multilateral issuances in key Islamic finance markets aimed at supporting government spending and environmental preservation initiatives, among other reasons. In addition, corporate shukūk issuances also recorded significant expansion in 2019 in prominent Islamic banking jurisdictions. Section 1.3 of this report provides a detailed country analysis of shukūk issuances by sector, domicile, type, issuer and volume, as well as discussion of matters relating to green shukūk.

The Islamic equity markets also bounced back from the effects of a steep sell-off in December 2018 to a remarkable double-digit growth performance across numerous sectors in 2019, thus recording its strongest performance since the GFC. One likely explanation for such a significant rebound in performance could be the relatively higher exposure of

the Islamic indices to the technology sector, which recorded an outstanding performance in 2019. Islamic funds, on the other hand, are still faced with the issues of being largely concentrated and having lack of scale. Notwithstanding, the sector also recorded noteworthy performance in 2019 in terms of both value of AuM of Islamic funds,¹⁷ which grew by 29.8% y-o-y to close at USD 102.3 billion as at end-2019 [2018: USD 67.1 billion], as well as the number of Islamic funds, which increased to 1,545 [2018: 1,489] and grew by 3.8% y-o-y in 2019.

On the back of the performance of the shukūk, Islamic equities and Islamic fund sectors in 2019, the ICM segment of the IFSI now accounts for a 26.5% share of global IFSI assets. Over the past three years – from 2016 to 2019 – the sector had recorded an increasing share of global IFSI assets at the expense of the Islamic banking segment, which also regained momentum in 2019. The ICM remains a key and viable component of the global IFSI (see Chart 1.1.1). Section 1.3 provides a detailed analysis of the Islamic equities market, Islamic funds and the growth of financial technology (FinTech) in the ICM.¹⁸

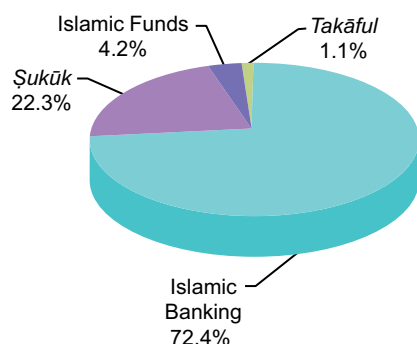
¹⁶ For the purposes of regional classification, Iran is included in "MESA", North African countries are included in "Africa", and Turkey is included in "Others".

¹⁷ Funds that are marketed and offered generally with their data publicly available, and excluding private equity funds.

¹⁸ Ibid

DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

Chart 1.1.1 Segmental Composition of the Global IFSI (2019)



Source: IFSB Secretariat Workings

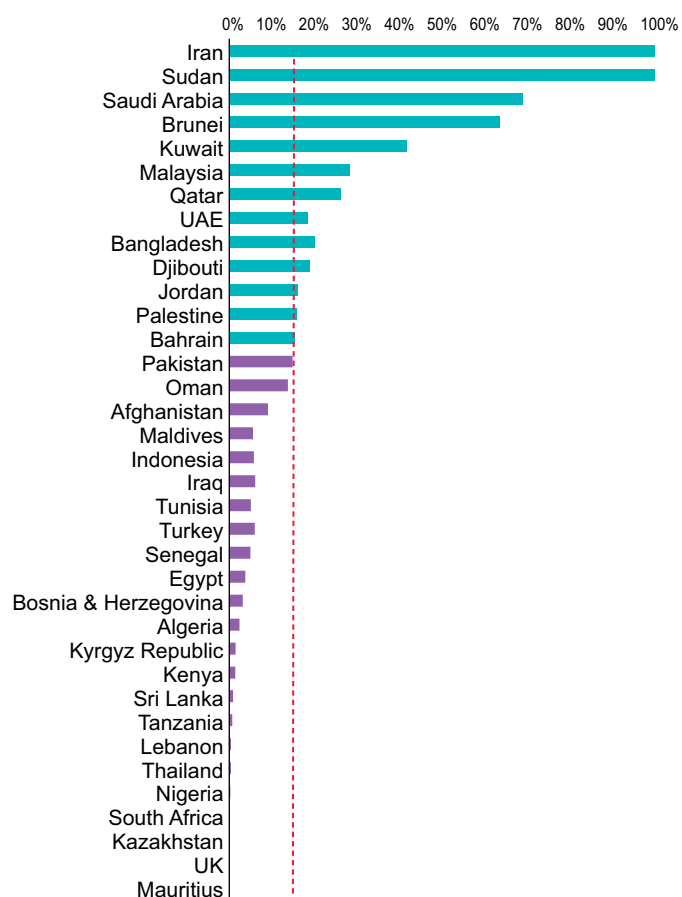
In contrast, the growth rate of gross contributions of the global *takāful* industry contracted by -1.1% from 4.3% in 2017 to 3.2% as at end-2018 to close at USD 27.07 billion [2017: USD 26.23 billion]. This resulted in a decrease in the segment's market share in the global IFSI to 1.1% at end-2018 [2017: 1.3%]. Nonetheless, the *takāful* segment recorded a CAGR of 8.5% over the period 2011–18. Despite its huge potential, the segment is still faced with a high concentration in key markets and in the general line of business.

... notwithstanding an improved double-digit growth, the share of Islamic banking in the global IFSI worth declined for the third consecutive year.

The global Islamic banking segment in 2019 experienced an improvement of y-o-y assets growth by 12.7% [2018: 0.9%], with total assets as at 3Q19 amounting to USD 1.77 trillion [2Q18: USD 1.57 trillion]. The growth recorded is due to an improvement in the Islamic banking assets in some jurisdictions, especially the GCC region which witnessed significant mergers of Islamic banks to strengthen competitiveness, attract stable deposits and enhance efficiency. The impact of the exchange rate on the nominal assets of the Islamic banking segment in the particular period of reporting has been minimal, compared to the situation reported as at 2Q18. Nonetheless, the Islamic banking segment recorded a three-year continuous decline in its share of global IFSI worth, to 72.4% [2Q18: 76.0%] especially as the ICM sector sustained momentum.

As at 3Q19, tracking a list of 36 jurisdictions (see Chart 1.1.2), Islamic banking experienced an increase in domestic y-o-y market share in 27 countries [2Q18: 19 countries] while remaining unchanged in seven others¹⁹ (including Iran and Sudan, which both have 100% domestic market shares). Meanwhile, the number of jurisdictions with declining market shares decreased from 10 in 2018 to two as at 3Q19 (being United Arab Emirates and Maldives).

Chart 1.1.2 Islamic Banking Share in Total Banking Assets by Jurisdiction (3Q19)



Source: IFSB Secretariat Workings (See note in Table 1.1.1.)

Notes:

- The countries whose coloured bars extend beyond the red dotted line satisfy the criterion of having a more than 15% share of Islamic banking assets in their total domestic banking sector assets and, hence, are categorised as systemically important.
- A recognition of systemic importance is considered for a jurisdiction that is within one percentage point off the 15% benchmark, provided it has active involvement (is among the top 10 jurisdictions) in the other two sectors of the IFSI – Islamic capital markets and *takāful*, for instance, Bahrain.
- Yemen, which has previously been classified as having achieved domestic systemic importance, is not included in this IFSI Stability Report 2020, due to a lack of availability of data.

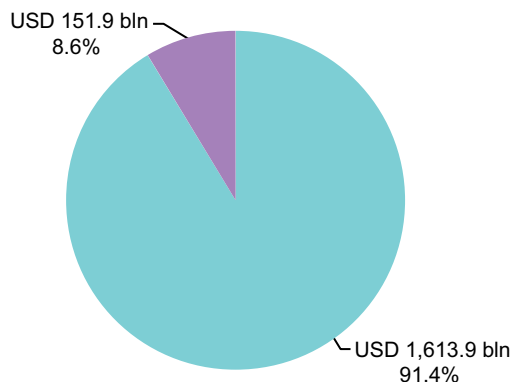
¹⁹ The market share of Islamic banks in Brunei Darussalam declined marginally from 63.5% as at 2Q18 to 62.8% as at 3Q19 but increased back to 65.1% as at 4Q19

DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

Based on the above, the number of jurisdictions where Islamic banking has achieved domestic systemic importance²⁰ is 13 as at 3Q19 [2Q18: 12 jurisdictions]. Palestine is the latest addition to the list of systemically important jurisdictions, with Islamic banking's share in the total value of the domestic banking market amounting to 15.5%. Furthermore, aside from Iran and Sudan with 100% domestic share, there are two jurisdictions with an Islamic banking share of more than 50% in their domestic banking asset worth. Saudi Arabia's Islamic banking share increased to 69.0% as at 3Q19 [2Q18: 52%]; while Brunei's share declined marginally to 62.8% as at 3Q19 [2Q18: 63.5%]. Kuwait and Malaysia²¹ have recorded market shares, as at 3Q19, of 48% [2018: 41%] and 28.4% [2Q18: 27%], respectively.

Improvements in market share were also made across other systemically important jurisdictions, including Bangladesh (25.3%; 2Q18: 20.1%) and Jordan (16.2%; 2Q18: 15.7%). In contrast to last year, when it recorded a decline, Qatar has improved its market share to 26.1% (2Q18: 25.2%). Collectively, the 13 systemically important Islamic banking jurisdictions are now host to a slightly increased 91.4% share of the global Islamic banking assets (2Q18: 91.3%) and whilst for the *shukūk* outstanding, a slightly increase to 83.6% of the global *shukūk* outstanding (2018: 80%) (see Charts 1.1.3 and 1.1.4).

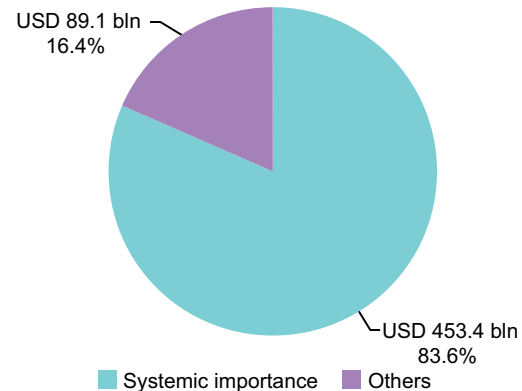
Chart 1.1.3: Islamic Banking Assets in Jurisdictions* with an Islamic Finance Sector of Systemic Importance (2019)



*Based on the domicile of obligors.

Source: IFSB Secretariat Workings

Chart 1.1.4: *Shukūk* Outstanding in Jurisdictions* with an Islamic Finance Sector of Systemic Importance (2019)

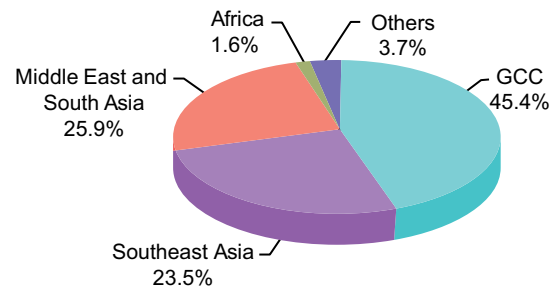


*Based on the domicile of obligors.

Source: IFSB Secretariat Workings

Regionally, the GCC retained its position as the largest domicile for Islamic finance assets (see Chart 1.1.5); in 2019, the region experienced a modest increase in its share in global Islamic banking assets to 45.4%. This is followed by the share of the MESA region with 25.9% of global IFSI assets. The South-East Asian region ranks next with 23.5%, while Africa ranks least with a share of 1.6% of global IFSI assets.

Chart 1.1.5 Breakdown of IFSI by Region (%) (2019)



Source: IFSB Secretariat Workings

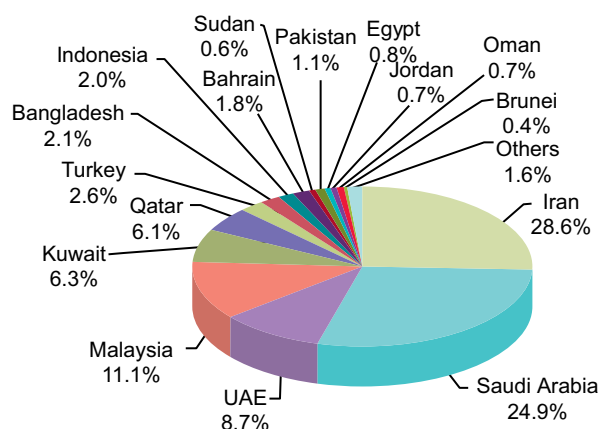
²⁰ This report considers the Islamic financial sector as being systemically important when the total Islamic banking assets in a country comprise more than 15% of its total domestic banking sector assets. The report uses the Islamic banking segment as the criterion for systemic importance of Islamic finance, since over 70% of Islamic financial assets are held within the banking sector. A recognition of systemic importance is also considered for jurisdictions that are within one percentage point of the 15% benchmark, provided they have active involvement (among the top 10) in the other two sectors of the IFSI – Islamic capital markets and *takāful*.

²¹ Based on Islamic banks regulated by the Bank Negara Malaysia and excluding development financial institutions (DFIs) regulated by the Ministry of Finance, Malaysia. The share for Islamic banking in Malaysia is approximately 30% if DFIs are also included in the banking sector pool of assets.

DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

In terms of the top jurisdictions for Islamic banking assets, Iran at 28.6% (2Q18:32.1%), Saudi Arabia 24.9% (2Q18: 25.1%), Malaysia 11.1% (2Q18: 10.8%), UAE 8.7% (2Q18: 9.8%) and Kuwait, which remains at 6.3%, are the top five. The other countries in the top 10 Islamic banking jurisdictions, in order of size, are Qatar, Turkey, Bangladesh, Indonesia and Bahrain (see Chart 1.1.6).

Chart 1.1.6 Share of Global Islamic Banking Assets* (%) (3Q19)



*The share is apportioned in US dollar terms.

Source: IFSB Secretariat Workings

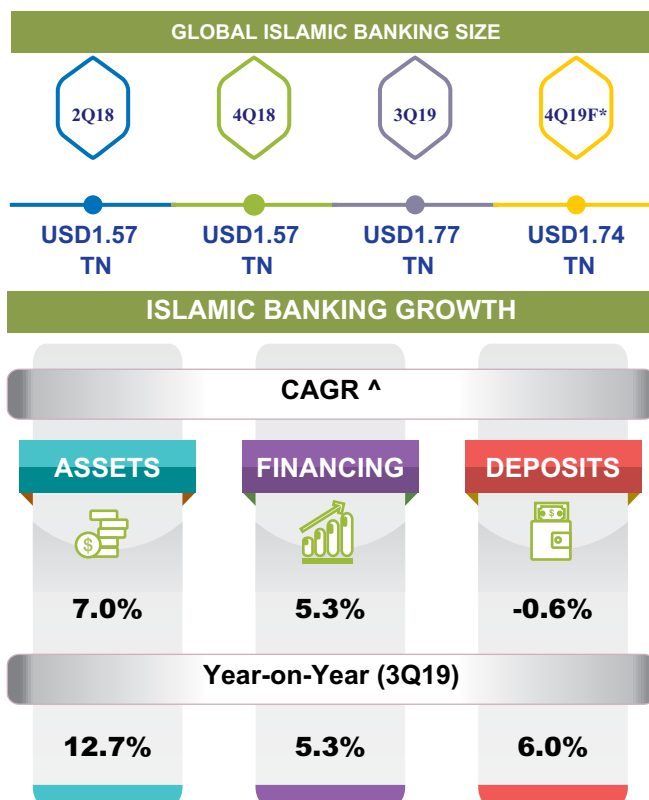
Given the continued prevalence of possible downside risks, as well as emerging developments such as the COVID-19 issue, global growth projections for 2020 will have to be revised downwards. The pervasiveness of and speed with which COVID-19 is spreading has affected the global economy through disruptions to both domestic and international trade, travel, supply chains and production linkages.

The remainder of Chapter 1 provides a detailed analysis of the growth, and developments across, the three key sectors of the global IFSI, while Chapter 2 provides further analyses from a stability and resilience perspective.

1.2 ISLAMIC BANKING SEGMENT: MILD GROWTH, WANING DOMINANCE

The aggregate US dollar value of global Islamic banking assets increased by 12.7% in the year to 3Q19 (y-o-y) in the midst of uncertainty in the global economy.²² Although the impact of the depreciation in exchange rate is minimal compared to 2018, it continues to affect the growth of the Islamic banking industry in 2019 through reduced share of global Islamic banking assets of countries with depreciating currencies. Currency exchange rates that are not pegged to the US dollar in key Islamic banking markets, coupled with difficult economic conditions in a few Islamic banking jurisdictions, will continue to have a significant influence on the value of global Islamic banking assets and other aggregate indicators of the industry.

Figure 1.1.1 Key Highlights on Global Islamic Banking



* Forecast.

^ Compound Annual Growth Rate (December 2013 – September 2019). Data used in calculating CAGR, as well as growth rates for assets, financing and deposits, were obtained from the Prudential and Structural Islamic Financial Indicators of the IFSB, and include data from both Islamic banks and windows in Bangladesh, Indonesia, Malaysia, Oman, Pakistan and Saudi Arabia, and from Islamic banks in Brunei, Iran, Jordan, Kuwait, Lebanon, Nigeria, Palestine, Qatar, Sudan, Turkey and the UAE. Aggregate growth rates for deposits, including CAGR, exclude Kuwait and Qatar due to data limitations. The UK data were not used for growth calculations due to their short time series, but were used to calculate aggregate asset, financing and deposit values.

The abrupt shock to the global financial system created by the COVID-19 pandemic, fueled by the volatility of oil prices and rising uncertainties due to many other vulnerability factors will put the resilience of the Islamic banking sector across jurisdictions to test in 2020.²³ Islamic banks, due to their high exposure to the real economy are expected to record declined revenue, high pressure on earnings and lower y-o-y growth in 2020 especially as focus will be on preserving asset quality at the expense of business growth. Increased pressure on liquidity position is also expected due to the mandatory postponement of repayment of existing financing extended to especially the

²² Growth rates (other than CAGR) for assets, financing and deposits are calculated on a y-o-y basis.

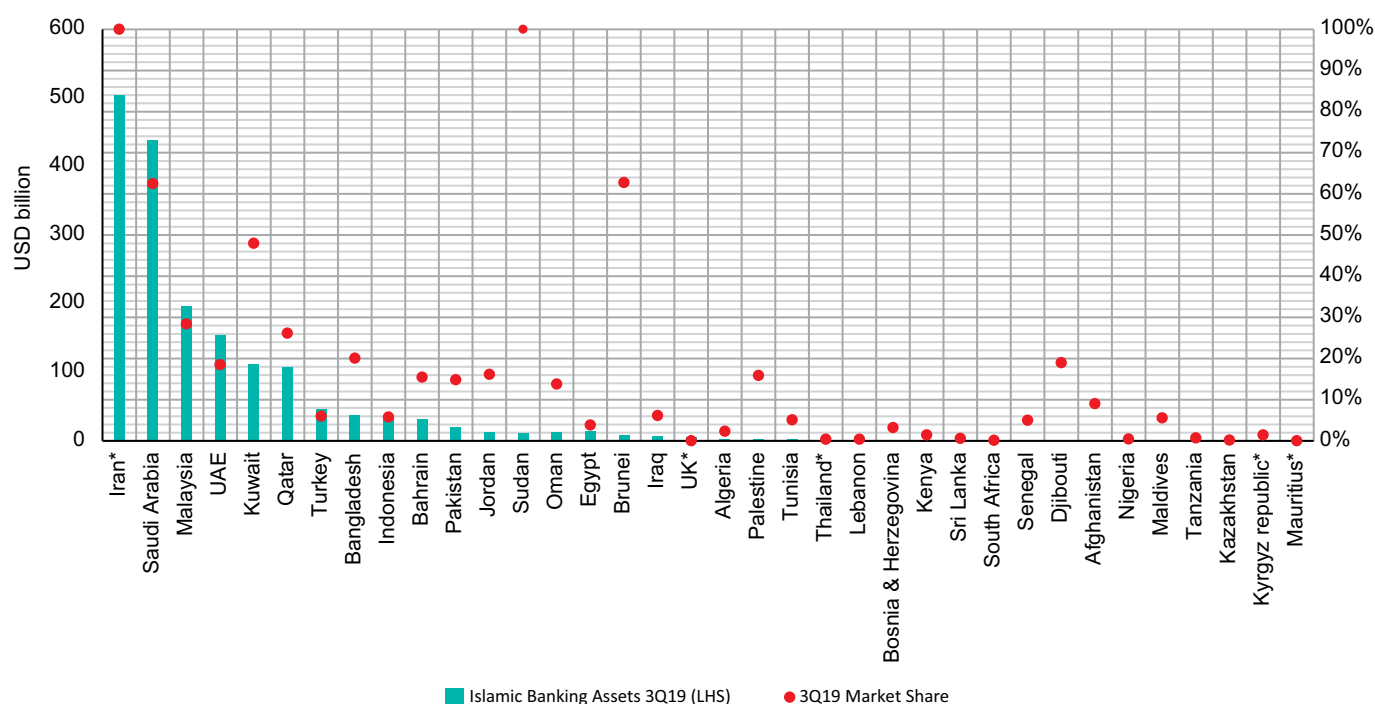
²³ The IFSB plans to conduct a specific impact analysis study of the effect of the COVID-19 pandemic on the resilience and stability of the global Islamic banking industry.

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small and medium enterprises (SMEs) and households in many jurisdictions where Islamic banking is practiced. Many Central Banks have introduced various measures via the open market operations (OMO) to inject liquidity to cushion the effect of the consequential reduced funds inflow to banks. Monetary policy easing measures and policy rate cuts have been implemented across jurisdictions and these are expected to place further pressure on profitability of banks. Notwithstanding the foregoing effects of the shocks to the financial system, the fundamentals of the global Islamic banking industry on the back of the performance recorded over the past few years indicate it is both resilient and stable.

The foregoing expectation of resilience is based on the y-o-y growth of Islamic banking assets in 2019 especially in the emerging economies: Saudi Arabia (8.7%), Turkey (21.0%), Malaysia (10.4%) and Indonesia (7.3%). Consistent with 2018, the majority of countries made significant Islamic banking market-share gains relative to conventional banking in 3Q19 (see Chart 1.2.1). A notable example in this regard is Saudi Arabia, which attained a 69.0% (2Q18: 52%) Islamic banking market share due to (among other reasons) higher penetration of the Islamic banking windows and a supportive regulatory environment that aligns with the economy diversification vision of the Saudi Arabia government.

Chart 1.2.1 Islamic Banking Assets and Market Share (3Q19)



* Where 3Q19 data were not available, the latest available figures were used.

Source: PSIFIs IFSB Secretariat Workings

The Islamic banking industry in Malaysia, on the back of a supportive regulatory environment that offers a level playing field with conventional banking, sustained its growth momentum, albeit modestly, in the year to 3Q19. The industry now captures 28.4% (2Q18: 26.5%) of the Malaysian commercial banking system. The growth outlook for the Malaysian Islamic banking sector is strong even as the Islamic banks adjust to the initial effects of the value-based intermediation business model. In this regard, Malaysia's well-established Islamic banking infrastructure and deep customer penetration are key.

Bangladesh and Indonesia have also slightly improved their shares of Islamic banking assets, to 21.5% (2Q18: 20.1%) and 5.9% (2Q18: 5.7%), respectively, as at 3Q19. In Bangladesh, the eight Islamic banks and 16 windows have sustained the gradual but steady growth recorded in recent years. Prudential policy support and increasing demand for Islamic banking have fueled the growth of the sector, which has seen further penetration into the domestic market especially through rural banking operations and the provision of remittance services.

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With the unveiling of Indonesia's Masterplan of Shari'ah Economy 2019–2024 and the pivotal role Islamic banking is expected to play, it is envisaged that the growth rate of the country's domestic Islamic banking would surge in the years ahead from the 5–6% market share recorded in previous years. This expectation is hinged on the increasing adoption of a halal lifestyle by the huge Muslim population, to whom Islamic banks may channel their market penetration drive.

Brunei still maintains a high market share of Islamic banking assets at 62.8%, although it is down slightly from the previous year (2Q18: 63.6%). Notwithstanding, Brunei remains fourth position in the ranking of jurisdictions based on the highest domestic share of Islamic banking assets after Iran, Sudan, and Saudi Arabia.

Within the Central Asian region, the Islamic banking sector in Kazakhstan constitutes 70% of the total Islamic finance assets; however, domestically, Islamic banking assets still account for less than 1% of the total Kazakhstan banking industry, which is worth USD 1 billion. Digitalisation and strong government support are providing a major boost to Islamic banking. Attention to the development of a regulatory framework for Islamic banking has also been a key focus in the Kyrgyz Republic. Improvement of the legal and regulatory framework has been initiated to support the growth of Islamic banking assets, among other risk management and corporate governance measures. Such developments contribute to a positive outlook for stable growth of the Islamic banking sector there to improve on its existing 1.5% market share.

In Pakistan, the Islamic banking sector recorded growth across various indicators. Specifically, the sector recorded 21% growth in assets and 19% growth in deposits of both Islamic banks and windows. In Pakistan, these include Islamic counters at conventional branches and stand-alone Islamic banking branches of conventional banks. Both Islamic banks and windows have also grown their market share, to 13.8% in 3Q19 (2Q18: 12.9%), and their share of total banking deposits is now about 16.1%. Although the number of Islamic banking institutions increased only marginally, from 21 in 2018 to 22 in 2019, the number of Islamic banking branches grew significantly, from 2,685 in 2018 to 2,979 in 2019 (8.5% y-o-y), as a manifestation of the enhanced market penetration.

While the number of full-fledged Islamic banks and Islamic banking windows remains unchanged at one and six, respectively, in Afghanistan, the country's Islamic banking sector continued its growth momentum. Islamic banking in Afghanistan now accounts for 11% (2Q18: 9.1%) of the domestic banking market share.

In the GCC, offsetting the decline of Qatari Islamic banks' market share in 2018 by -0.5%, the shares as at Q319 have increased by 1 percentage point to 26.1% (2Q19: 25.1%) due to the operational consolidation of two merged Islamic banks. The merging banks are expected to create improved efficiency amid regional geopolitical tensions, and to achieve about a 6% share of the Qatari banking system.

Bahrain's Islamic banks remain consistent in improving their market share by sustaining their recovery momentum following the 2Q16 marginal decline. The Kingdom's Islamic banking system now accounts for 15.5% of its total banking assets as at 3Q19 (2Q18: 14.3%). On the other hand, the UAE Islamic banks' share of domestic banking assets decreased after crossing the 20% mark that was reported in 2018. This decline was due to the slower growth (2.3% in 3Q19) brought about by heightened economic challenges faced by the entire domestic banking market, especially the slow recovery of oil prices in 2019 as the core sector in the economy. Oman's Islamic banking industry, meanwhile, was poised to gain further systemic importance, gaining 1.4 percentage points to capture 13.8% of the domestic banking system in the Sultanate as at 3Q19.

Elsewhere in the Middle East, Jordan maintained its position in the list of jurisdictions in which the Islamic financial sector is regarded as systemically important, with the Kingdom's Islamic banking share increasing marginally to 16.2% of its total banking sector assets (2Q18: 15.6%). This follows a moderate increase in Jordan's Islamic banking asset base (4.1%) which is lower than the growth in the overall Jordanian banking sector, which registered 9.4% growth between 3Q18 and 3Q19. Palestine's Islamic banks are close to Jordan's in terms of their Islamic banking share, now standing at 15.9% (2Q18: 14.6%).

In Turkey, the share of the participation banks continued to grow and now represents 6.3% of the total domestic banking assets. Moreover, with the recent change in the Banking Law (Article No. 77), the development and investment banks are now permitted to provide interest-free finance, which will see the share of Islamic finance in Turkey continue to grow in future.

The African continent has witnessed several developments highlighting its significant potential for the Islamic banking industry. While new full-fledged Islamic banks are being licensed to commence operation, a few notable conventional banks have also established Islamic banking windows. At the moment, there are over 80 institutions offering Islamic financial services in Africa.²⁴

Several participation banks have opened their doors in Morocco since May 2017, and Tunisia is in the process of enhancing its regulatory framework to support further expansion of the Islamic banking industry's 5.1% market share. Algeria is following in its neighbours' footsteps, preparing to allow a few banks to launch Shari'ah-compliant banking products and putting in place relevant regulatory guidelines.

A few countries, including Nigeria, Senegal and Kenya, have recently commenced implementation of their Islamic banking legal and regulatory framework.²⁵ Nigeria's non-interest banking has maintained its share of total domestic banking assets, at 0.5% in 3Q19 (2Q18: 0.3%). Uganda is yet to operationalise its Islamic banking regulation, which was gazetted in early 2018, while Kenya is considering a proposed Islamic banking regulatory framework that aims to encourage growth of the sector and attract foreign cash inflows to a country that is already home to three Islamic

²⁴ Moody's Investors Service (2020). "Cross-Sector – Islamic Finance: GCC and Malaysia will drive growth across Shari'ah-compliant products in 2020", pp. 1–19, March.

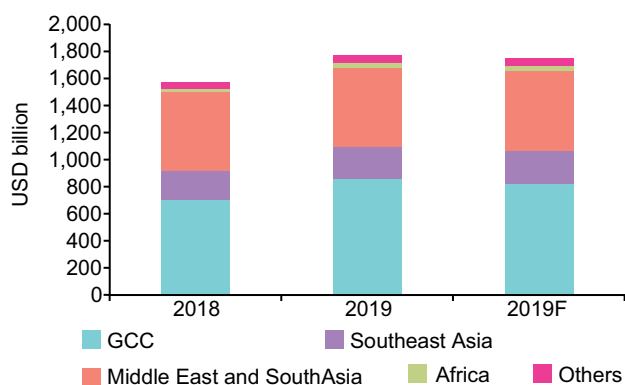
²⁵ Ibid.

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banks and a few Islamic banking windows. In addition, with the support of multilateral organisations, Islamic banks have been established in several African countries, including Ethiopia, Benin, Ivory Coast, Mali and Senegal.

Within the positive trajectory of Islamic banking assets growth, global Islamic banking assets are forecasted to decline slightly, to USD 1.74 trillion, by end-4Q19²⁶ (see Chart 1.2.2). Geographical concentration of Islamic banking assets remains substantial and similar to what was reported as at 2Q18, with 91.5% of these assets in countries in which the Islamic financial sector is considered systemically important. The top 10 Islamic banking jurisdictions by asset size²⁷ account for 94.1% of the global Islamic banking industry, slightly higher than its 93.7% level reported in 2Q19, while the top five countries – namely Iran, Saudi Arabia, Malaysia, the UAE and Kuwait – account for more than 79% of the industry's assets globally.

Chart 1.2.2 Islamic Banking Assets (2018–2019F)

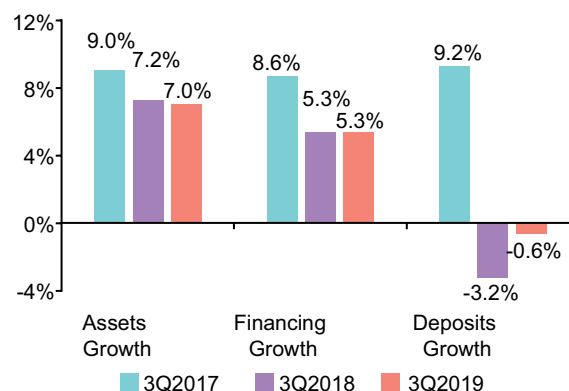


Source: PSIFIs, IFSB Secretariat Working.

1.2.1 Overview of Islamic Banking in Key Markets²⁸

Compound annual growth rates for Islamic banking continue to be moderate in light of lower asset growth rates in recent years. In US dollar terms, and across 17 jurisdictions, Islamic banking assets expanded at a CAGR of 7.0% between 4Q13 and 3Q19, decreasing from 7.2% as at 3Q18 (see Chart 1.2.1.1). Analysis of country-level growth shows that 10 jurisdictions achieved double-digit asset growth rates in the year to 3Q19 (see Chart 1.2.1.2). This can be attributed, in at least nine of these countries, to financing growth that was also in the double digits (see Chart 1.2.1.3). Deposits on the other hand, grew by at least two digits in eight countries, out of 14 for which data were available (see Chart 1.2.1.4).

Chart 1.2.1.1 Compound Average Growth of Key Islamic Banking Statistics (3Q17– 3Q19)²⁹



Source: PSIFIs, IFSB Secretariat Workings

²⁶ This forecast was derived by projecting forward jurisdiction-specific average year-end asset growth rates (2018 and 2017) and adjusting for applicable end-2019 exchange rates. Data were obtained from jurisdictions covering approximately 96.5% of the global Islamic banking industry by asset size (3Q19).

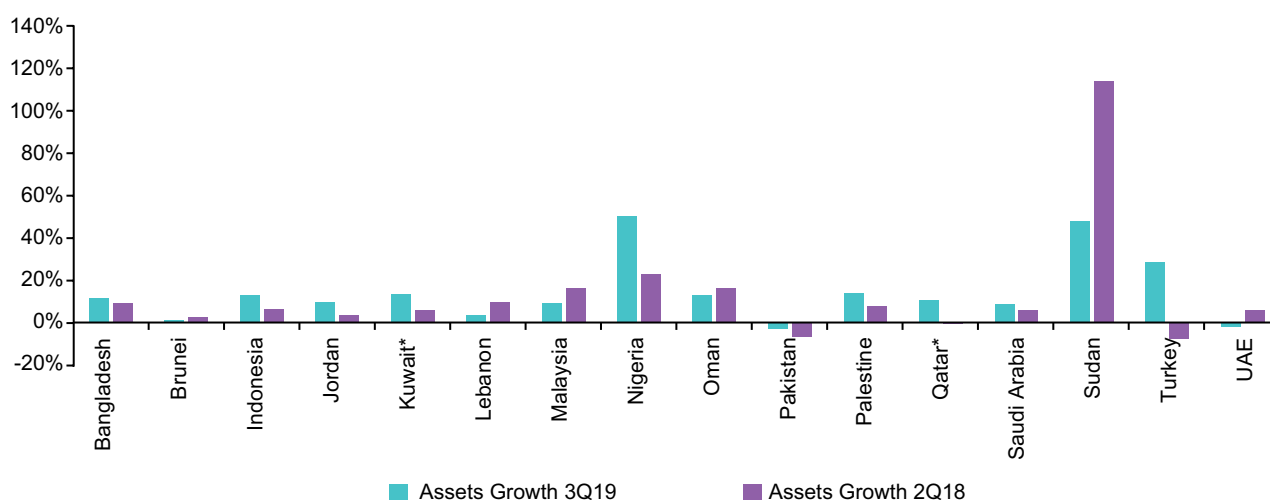
²⁷ These jurisdictions are (in order of size) Iran, Saudi Arabia, Malaysia, the UAE, Kuwait, Qatar, Turkey, Bangladesh, Indonesia and Bahrain.

²⁸ Data used in calculating CAGR, as well as growth rates for assets, financing and deposits, were received from local banking regulatory authorities in the relevant jurisdictions and include data from both Islamic banks and windows in Bangladesh, Indonesia, Malaysia, Oman, Pakistan and Saudi Arabia, and from Islamic banks in Brunei, Iran, Jordan, Kuwait, Lebanon, Nigeria, Palestine, Qatar, Sudan, Turkey and the UAE. Aggregate growth rates for deposits, including CAGR, exclude Brunei, Kuwait and Qatar due to data limitations. The UK data were not used for growth calculations due to their short time series, but were used to calculate aggregate asset, financing and deposit values for 4Q17 and the first two quarters of 2018. Where reporting is based on local currencies, conversion to USD was done prior to CAGR calculation.

²⁹ The term "deposits" in this section includes remunerative funding (*murābahah*, commodity *murābahah*, etc.), non-remunerative (current accounts, *Wad'iah*), and unrestricted profit-sharing investment accounts, which are treated as equity in the financial statements of Islamic banks in some jurisdictions and as liabilities in others.

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Chart 1.2.1.2 Aggregate Islamic Banking Average Annual Assets Growth by Country (y-o-y) (2Q18 and 3Q19)



Source: PSIFIs, IFSB Secretariat Workings. The figures indicated for each country are denominated in the respective local currency.

Regulatory improvements and enhanced maturity of the industry have led to a moderation in growth rates in the Sultanate of Oman, with assets, financing and deposits as at 3Q19 growing at 12.7%, 13.2% and 10.3%, respectively – albeit lower than the previous year as at 2Q18. Other GCC Islamic banks are experiencing a similar pace of growth in the past couple of years, with their growth rates in 3Q19 still among the lowest in the sample. As reported as at 3Q19, Saudi Arabia's banking industry shows an improved performance, with Islamic banking assets having grown in 3Q19 by 8.7% supported by financing growth of 7.7% in the midst of declining oil prices. However, the deposit base, which seems still to be in the recovery phase, grew by 1.8% in 3Q19.

Islamic banks in Kuwait increased their assets by 14.0%, up from 5.2% reported as at 2Q18, driven mainly by domestic credit off-take to the private sector buoyed by the infrastructure programme as part of the New Kuwait Vision 2035. It is expected that this growth trend will continue based on the opportunities to be provided by the huge amount earmarked by the government for the privatisation and SMEs development initiatives. However, the UAE's growth of Islamic banking assets at 3Q19 declined by -2.3% due to severe impacts on the core market in the economy, which also explains the financing growth decline by about -0.6% as at 3Q19. Qatar, on the other hand, appears to have experienced a positive growth of 10.4% as at 3Q19 after a negative growth recorded in 2018. This may be linked to the merger deal between two Islamic banks that led to an increased asset growth there.³⁰ The positive asset growth is supported by the financing growth of 13.1% in 3Q19.

Consistent with the previous year, Turkish participation banks registered positive growth of assets by 21.0% coupled with the deposit growth of 26.0% reported in 3Q19. However, the financing growth was sluggish, registering a

meagre positive growth of 0.7% in 3Q19. Sudanese banks' growth trend slowed in 3Q19, with asset growth dropping by as much as -48.2%, financing growth by -54.2%, and deposit growth by -45.2%. Notwithstanding an end to the political impasse that engulfed the country for most of 2019, the consequential economic pressures on Sudan appear to be continuing into 2020 with the persistent high inflation rate. While market shares of Islamic banking in Sudan would not be affected, and local currency asset values and growth rates are generally quick to adjust to volatile currencies, these economic challenges would continue to have implications for the global value of Islamic banking assets and resilience indicators.

With its highly mature and broad-reaching Islamic banking industry, Malaysia's Islamic banks and windows reported a healthy expansion in their aggregate assets by 10.4% supported by the financing growth of 8.3%. These performances could be linked to the country's "Islamic First" strategy – where banks offer new customers Islamic products over conventional ones – and a supportive regulatory environment. The Islamic banking sector in Malaysia is supporting responsible financing growth by providing guiding documents for value-based intermediation to Islamic banking's market players. The IFSB PSIFIs data show that deposits in Malaysia have grown by 16.5% in 3Q19, which growth is reflected in the healthy liquidity of the Islamic banking industry.

The Indonesian Islamic banking sector grew by 7.3% in 3Q19, while financing and deposits registered 10.7% and 9.7% growth rates, respectively. The Islamic banking development in Indonesia is aimed at inclusive growth, whereby Islamic finance development would be part of the government's national package to boost economic growth by establishing a National Islamic Economics and Finance Committee (Komite Nasional Ekonomi dan Keuangan Syariah, or KNKS) to drive this initiative.

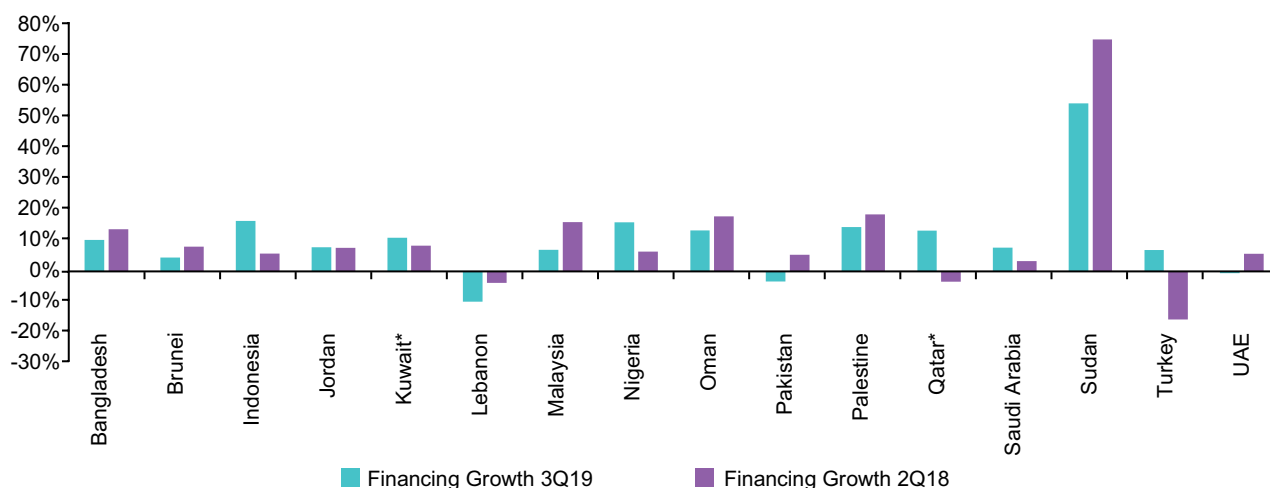
³⁰ The successful merger between Barwa Bank and International Bank of Qatar in April 2019 led to the creation of the third-largest Islamic bank with a combined asset worth over QAR 80 billion (see <https://www.barwabank.com/media-center/press-release/barwa-bank-and-ibq-complete-legal-merger>).

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The Pakistani Islamic banking sector has issued five Shari'ah Compliant Refinance Schemes together with an Islamic Export Refinance Scheme and an Islamic Long-Term Financing Facility³¹ that are expected to provide a level playing field to the Islamic banking industry to spur its growth. Besides the Shari'ah-compliant export refinance facility and Islamic long-term financing, facilities for exporters are also available to the Islamic banking

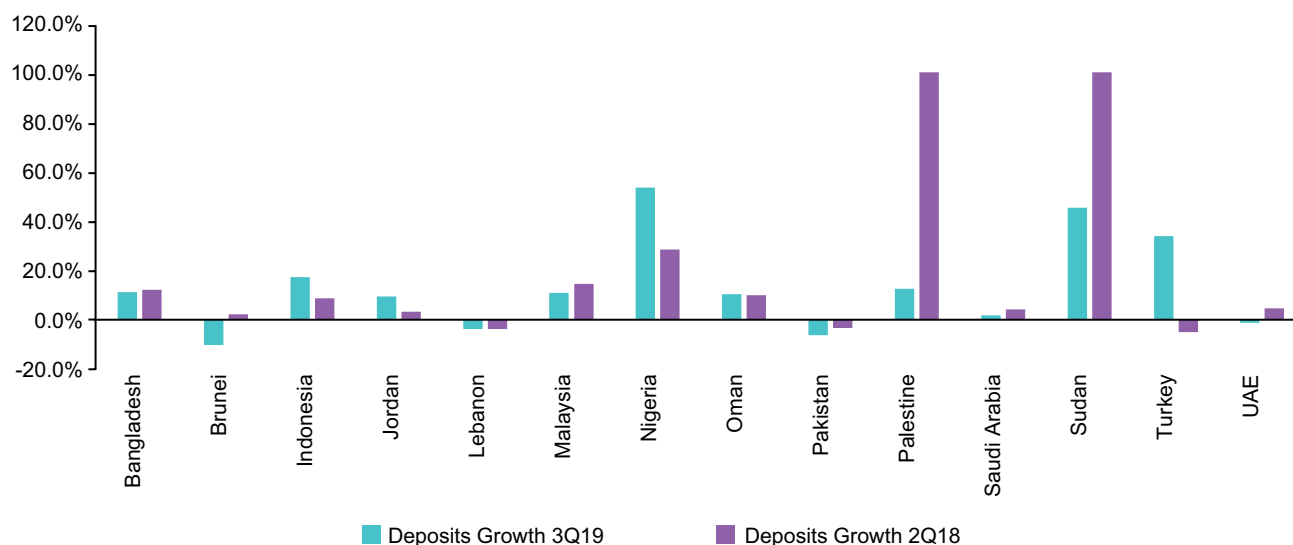
industry. Financing in Pakistan grew by 13.5% in 3Q19, albeit a slower growth compared to the previous period (3Q18: 25.2%), and contributed to an asset growth rate of 21.8% in this particular period. In Bangladesh, the Islamic banking sector has maintained a positive growth trajectory, with assets, financing and deposits increasing by 17.28%, 11.4% and 12.3%, respectively, at par with expansion rates shown in previous years.

Chart 1.2.1.3 Aggregate Islamic Banking Average Annual Financing Growth by Country (y-o-y) (2Q18 and 3Q19)



Source: PSIFIs, IFSB Secretariat Workings. The figures indicated for each country are denominated in the respective local currency.

Chart 1.2.1.4 Aggregate Islamic Banking Average Annual Deposit Growth by Country (y-o-y) (2Q18 and 3Q19)



Source: PSIFIs, IFSB Secretariat Workings. The figures indicated for each country are denominated in the respective local currency.

*Deposit data for Islamic banks in both Palestine and Sudan for 2Q18 were 288.3% and 172.5% respectively but were rescaled to 100% to make chart legible.

³¹ (i) Islamic Financing Facility for Renewable Energy (IFRE), (ii) Islamic Financing Facility for the Storage of Agriculture Produce (IFFSAP), (iii) Islamic Financing Facility for Low-Cost Housing for Special Segments, (iv) Islamic Refinance Scheme for Working Capital Financing of Small Enterprises, and Low-End Medium Enterprises (Details can be found at <http://www.sbp.org.pk/smefd/circulars/2019/index.htm>).

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The majority of the analysed countries displayed reasonable growth levels in the key Islamic banking indicators. Assets, in local currencies, showed healthy growth rates in many jurisdictions. Exchange rates continue to affect the global value of the industry, and trends from previous years continue to prevail as challenging economic conditions and reliance on the oil sector in certain jurisdictions impact on the development of the banking sector in general, both conventional and Islamic. Countries in North and Sub-Saharan Africa are continuing to make efforts to set up

appropriate regulatory frameworks and to forge economic ties aimed at introducing Islamic banking services and attracting foreign cash inflows. These initiatives are to be seen as contributing to the industry's long-term prospects. The concentration of assets in a few jurisdictions is an area of concern for the development of Islamic banking, as industry numbers tend to be easily swayed by any large jurisdiction's conditions. Further assessments of the fundamentals and resilience of the Islamic financial services industry are provided in Chapter 2 of this report.

Box 1 Islamic Banking in Bangladesh: Development, Regulation and Supervision

Contributed by Bangladesh Bank (BB)

Introduction and Overview of Islamic Banking in Bangladesh

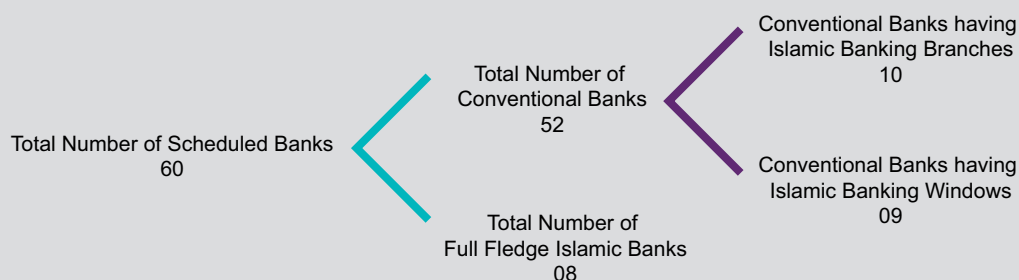
Bangladesh is one of the largest Muslim countries in the world with its population closely following the Islamic way of life in accordance with the Holy Qur'an and the Sunnah. In 1974, Bangladesh signed the charter of the Islamic Development Bank (IsDB) and committed to developing its economy and financial system according to the Shari'ah. Furthermore, in accordance with the charter of the Organisation of Islamic Conference (OIC), Bangladesh Bank inaugurated its Islamic Banking activities in 1983, with the establishment of Islamic Bank Bangladesh Limited, assisted by the IsDB. This was followed by the establishment of nine more Islamic banks in the country. From the first establishment to date, the Islamic banks in Bangladesh have demonstrated their soundness in fulfilling requirements of the Shari'ah and all other concerned laws of the land. In view of their success and popularity, many conventional banks have commenced Islamic banking services by opening Islamic banking branches or windows. Due to the exponential growth of customer demand for Islamic banking, a good number of conventional banks have shown their willingness to convert their conventional banking business to Islamic banking.

Bangladesh Bank, the central bank of Bangladesh, has initiated several policies to expand the Islamic banking industry in the country. Islamic banks are expected to provide contemporary financial services in accordance with the laws set forth in the Shari'ah governance system of each bank. As the regulator, Bangladesh Bank has issued Guidelines for Islamic Banking through BRPD Circular No. 15, dated 9th November 2009.

Islamic banking has experienced phenomenal growth and expansion in the country against the backdrop of strong public demand and support for the system along with its gradually increasing popularity across the world. As a result, a good number of full-fledged Islamic banks has been established, while a good number of conventional banks have come forward to offer services compliant with Islamic Shari'ah through opening of Islamic branches/windows. As at end of December 2019, eight full-fledged Islamic banks and 17 conventional banks with Islamic banking branches/windows (with two of the conventional banks having both Islamic banking branches and windows) are providing Islamic financial services in Bangladesh. Three conventional banks (presently providing Islamic financial services through Islamic banking branches/windows) have licenses for operating full-fledged Islamic banking. In terms of deposits and investments at the end of December 2019, the Islamic banking industry in Bangladesh has accounted for one-fourth share of the entire banking industry.

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Figure:1



Bangladesh Bank became a full member of the IFSB in 2004 and Bangladesh Bank has played a very vital role at IFSB since its inception. H.E. Mr. Fazle Kabir, the Governor of Bangladesh Bank was the Chairman of IFSB during the year 2019 and successfully organized the 35th Council Meeting of the IFSB. Further, Bangladesh Bank has nominated its delegates to IFSBs various committees such as the Executive Committee, Technical Committee and various Task Forces etc.

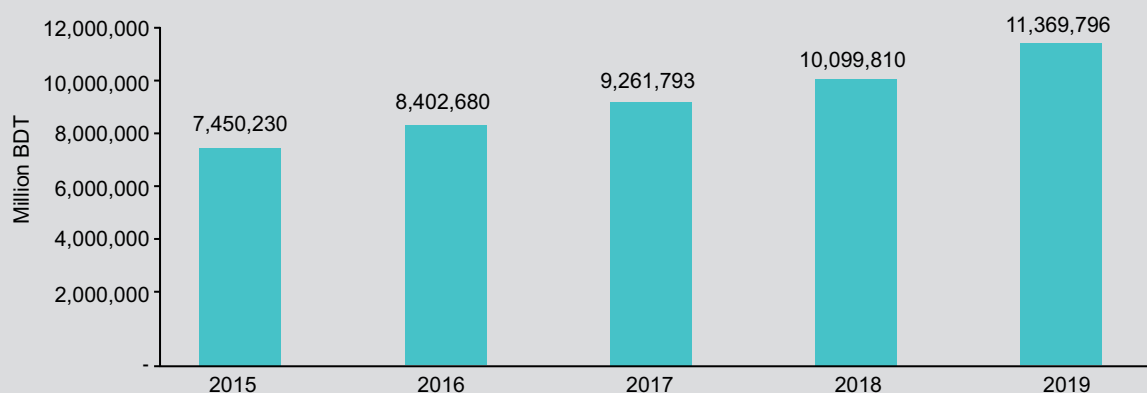
Banking Performances and Contribution of Islamic Banking

Banking Industry in Bangladesh

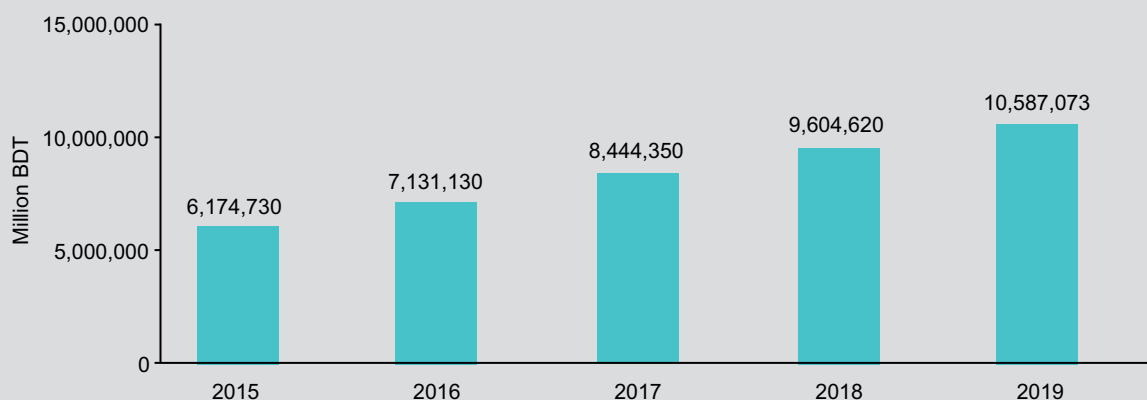
The total banking system deposit of Bangladesh grew at 12.57% while the total loans grew at 10.23% from 2018 to 2019 [figure:2]. Non-performing loans (NPLs) decreased significantly in 2019. The strenuous effort of Bangladesh Bank has made it possible to reduce the NPL level and ensure deposit and loans and advances (investment) growth of the Islamic banking industry.

Figure:2

Banking Deposit (2015-2019)



Banking Loan (Investment) (2015-2019)



Source: Bangladesh Bank

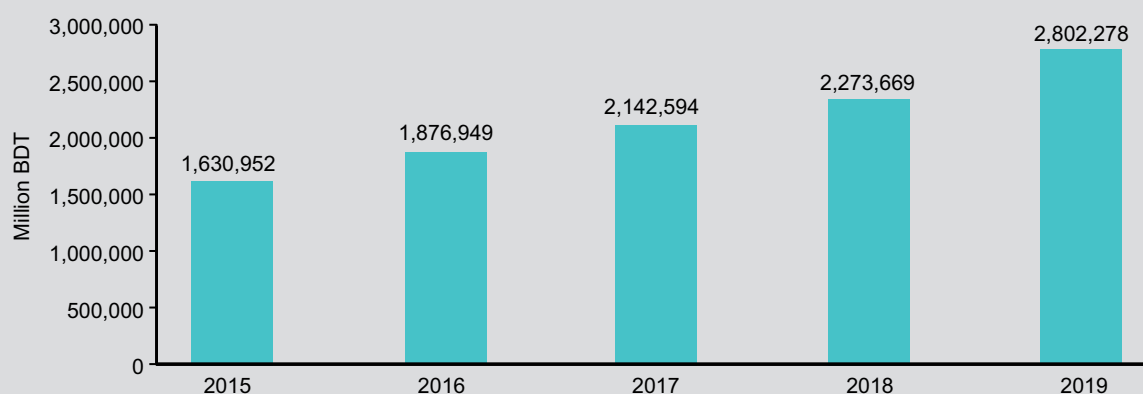
DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

Share of Deposit of Islamic Banking Industry

Deposits of the Islamic banking industry in Bangladesh has been growing progressively since the establishment of the first Islamic bank in 1983. Total deposits of the Islamic banking industry reached BDT 2,802,278.03 million at the end of December 2019, while it was BDT 2,373,669 million in December 2018 and BDT 1,630,952 million in December 2015. The Islamic banking industry in Bangladesh has experienced an 18.06% deposits growth in 2019 compared to that of 2018 [figure:3]. The share of total deposits of Islamic banks accounted for 24.65% among all banks at the end of December 2019.

Figure:3

Islamic Banking Deposit (2015-2019)



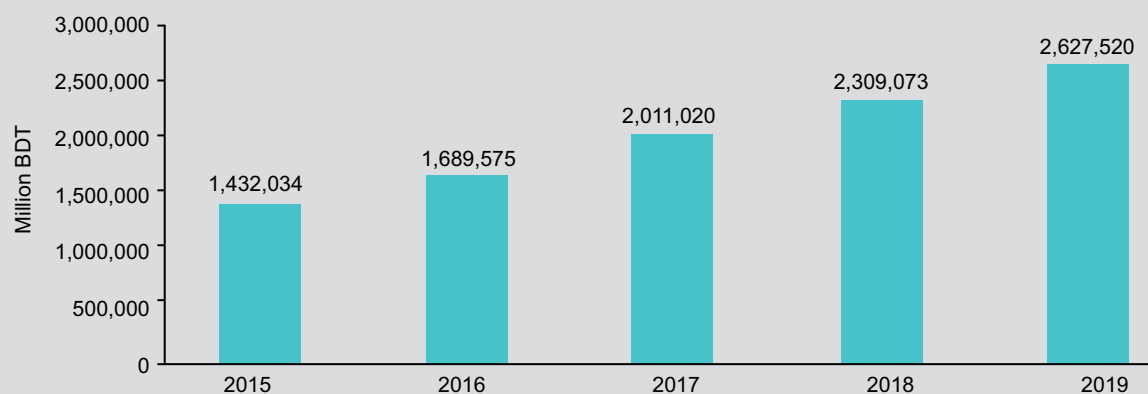
Source: Bangladesh Bank

Share of Investment of Islamic Banking Industry

Similar to deposits, investments of the Islamic banking industry in Bangladesh has also been growing progressively since the establishment of the first Islamic bank in 1983. Total investments of the Islamic banking industry reached BDT 2,627,520 million at the end of December 2019, while it was BDT 2,309,073 million at the December 2018 and BDT 1,432,034 million in December 2015. Investment growth of Islamic banking industry in Bangladesh was 8.41% in 2019 compared to that of 2018 [figure:4]. The share of total investments of Islamic banks accounted for 24.82% among all banks.

Figure:4

Islamic Banking Loan (Investment) (2015-2019)

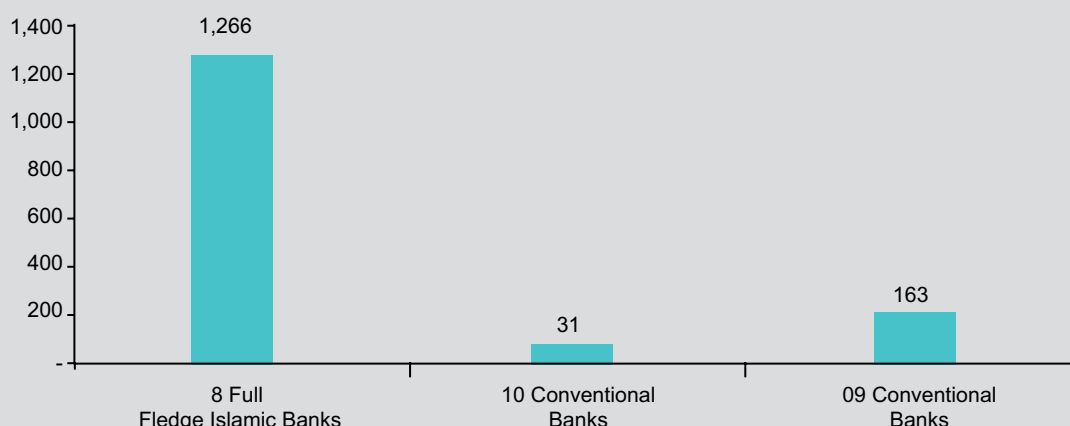


Source: Bangladesh Bank

DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

The Islamic Banking Players

Presently, there are eight full fledged Islamic banks which are providing Islamic banking services through 1,266 branches. Three more conventional banks recently obtained Islamic banking licenses to convert to full fledged Islamic banks. There are currently 19 conventional banks which are providing Islamic banking services through 31 Islamic banking branches and 163 Islamic banking windows [figure:5]. Among them Islamic Bank Bangladesh Limited (IBBL) is the pioneer Islamic bank in Bangladesh. IBBL commenced operations in 1983 and plays a vital role in the Islamic banking industry in Bangladesh. In terms of assets, deposits and investment, IBBL remains the largest among all Islamic banks in Bangladesh.

Figure:5**Islamic Banking Service Providing Branches/Windows****Regulation and Supervision:**

In Bangladesh, all banks are required to follow the Bank Company Act-1991 (amended up to 2018), Bangladesh Bank circulars, BFRS (Bangladesh Financial Reporting Standard) and other related laws of the land. Notably, Bangladesh Bank is also a stakeholder of AAOIFI. In order to ensure Islamic best practices in the banking industry, Bangladesh Bank tries to follow IFSB and AAOIFI Shari'ah standards.

In order to ensure smooth Islamic banking practices in Bangladesh, Bangladesh Bank has issued "Guidelines for conducting Islamic Banking" in 2009. Further, as a regular update process Bangladesh Bank is working to prepare a more comprehensive guideline on Islamic banking.

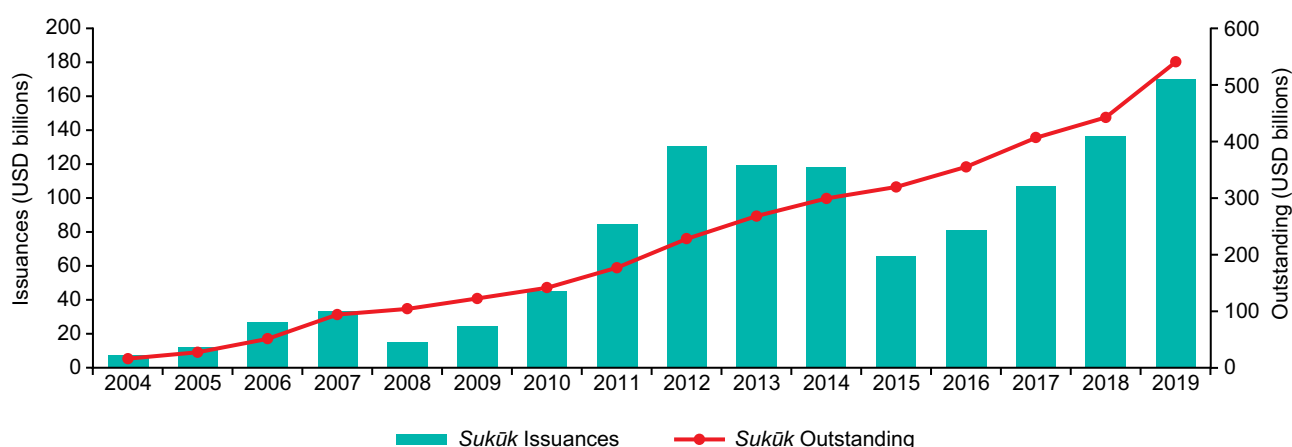
Bangladesh Bank has a dedicated department for on-site supervision of Islamic service providing banks. This department is entrusted with the responsibility of supervising and monitoring the performance of Islamic banks in Bangladesh. There is a dedicated division under the off-site supervision department, which is responsible for off-site supervision of Islamic banks.

DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

1.3 ISLAMIC CAPITAL MARKETS: A NEW GROWTH PHASE

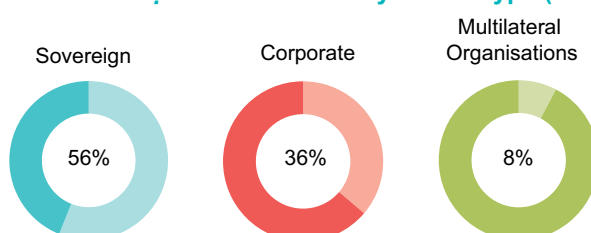
1.3.1 *Ṣukūk*

The *ṣukūk* market experienced double-digit growth in 2019. Total *ṣukūk* issuances expanded by more than 24% under attractive global financing conditions for issuers (see Chart 1.3.1.1). The strong growth in the *ṣukūk* market was supported primarily by increases in issuance from Malaysia, Saudi Arabia, Qatar and Turkey. The robust issuance in 2019 marks the fourth consecutive year of expansion of the *ṣukūk* market. It also represents an overall growth in *ṣukūk* outstanding in the last 15 years (from 2004 to 2019) by a CAGR of 26%, making it the fastest-growing segment in the IFSI.

Chart 1.3.1.1 Global *Ṣukūk* Issuances and *Ṣukūk* Outstanding Trends (2004–19)

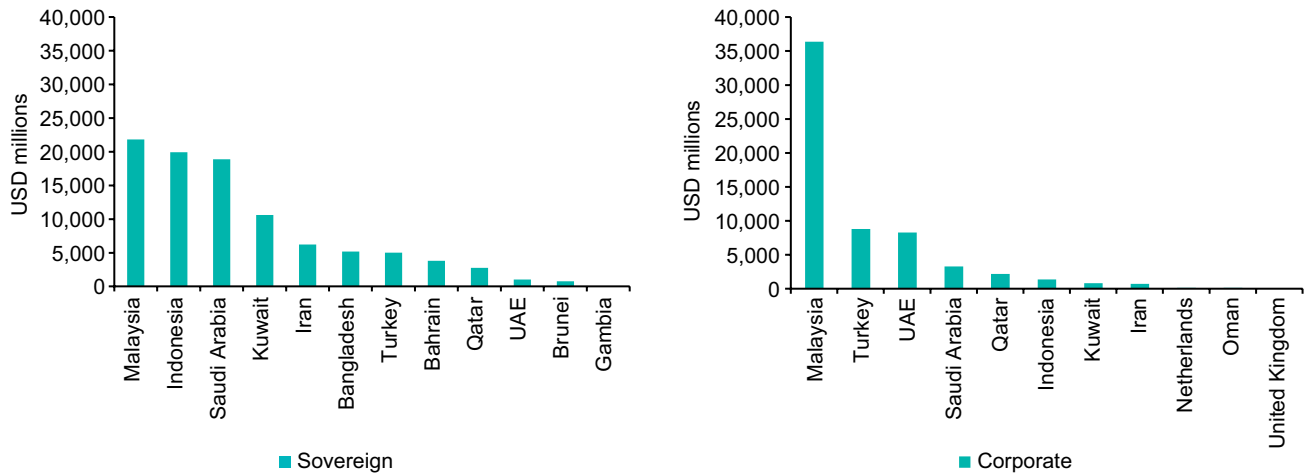
Source: Thomson Reuters Eikon, Bloomberg and data received directly from regulators

Sovereign issuers continue to lead the *ṣukūk* market. Consistent with past trends, sovereign and government-related issuers remain the largest issuers by value, making up over half of the annual global issuances in 2019 (see Chart 1.3.1.2). Following a slight contraction in overall sovereign issuances in 2018, the growth in issuances reflects, in part, the generally better financing conditions coupled with the increasing share of *ṣukūk* in fiscal deficit financing in many jurisdictions, particularly GCC countries and Turkey; *ṣukūk* refinancing needs in jurisdictions such as Malaysia; and increasing *ṣukūk* issuances for liquidity management purposes, including by Indonesia, Kuwait, Bahrain and others. While all of the major sovereign issuers returned to the market, no new sovereigns made issuances in 2019.

Chart 1.3.1.2 *Ṣukūk* Issuances by Issuer Type (2019)

Source: Thomson Reuters Eikon, Bloomberg and data received directly from regulators

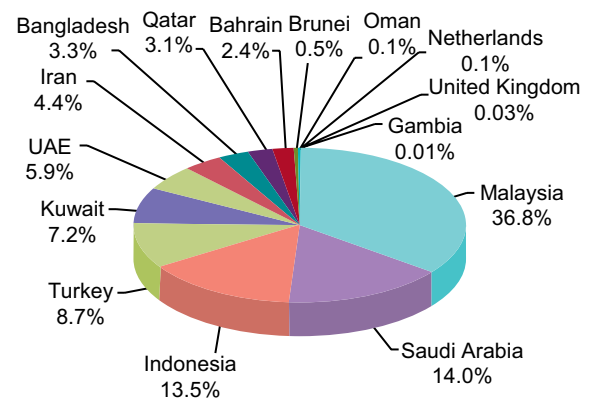
DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

Chart 1.3.1.3 *Shukūk* Issuances by Type and Jurisdiction of the Originator (2019)

Source: Thomson Reuters Eikon, Bloomberg and data received directly from regulators

Corporate *shukūk* issuances have demonstrated an upward growth trajectory in recent years, a reversal from the generally lower issuance rates observed historically. The turnaround of the downward trend observed for corporate *shukūk* issuances from 2012 to 2015, and the steady growth of the market since 2016, has been supported by structural reforms across regulatory and legal frameworks in many countries. These are in addition to more expansionary monetary policies globally, as well as a gradual acceptance of *shukūk* as a viable long-term funding source for non-financial companies in some jurisdictions. Stronger corporate issuances were observed in particular in jurisdictions that have more established regulatory frameworks or a market infrastructure that supports Islamic finance and *shukūk* issuance, which enabled corporates in those jurisdictions to take advantage of the lower costs of funding in 2019 by issuing *shukūk*. Moreover, the issuance of regulatory capital *shukūk* by Islamic banks has also been one of the key drivers of corporate *shukūk* issuances, most notably from Islamic banks in the UAE and Qatar. However, corporate issuances are also largely influenced by economic conditions, and while the increase in issuances has been generally supported by favourable economic conditions, an economic downturn will likely affect the corporate *shukūk* issuance trend.

While the overall growth across the global *shukūk* market comprises a sizeable number of high-quality investment-grade issuances, more accommodative financing conditions may also encourage issuances with lower credit quality due to the search for yield, as well as longer maturities from non-financial sector corporates. The latter will require closer monitoring since they are more vulnerable to the impact of a global economic downturn. While the overall increase in corporate *shukūk* issuances has contributed to greater diversity of issuers and provides a positive development in supporting the prevailing need for greater liquidity and deepening of the *shukūk* market, the overall characteristics of global *shukūk* issuances, including the quality of issuers and any potential vulnerabilities and risks of default, should be closely monitored in the context of the current downside risks and the fragile global economic outlook (assessed further in section 2.3 of Chapter 2).

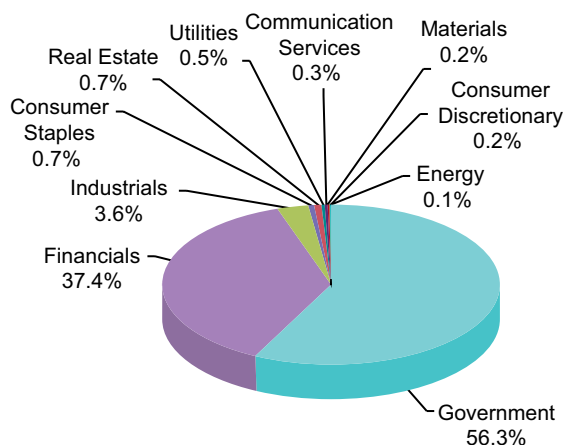
Chart 1.3.1.4 Total *Shukūk* Issuances by Domicile (2019)

Source: Thomson Reuters Eikon, Bloomberg and data received directly from regulators

*Excludes issuances by multilateral organisations and development banks.

In terms of sectoral distribution of *shukūk* issuances, both the government and financial sectors were the dominant issuers. Issuances in 2019 were driven largely by issuers from sovereign/government-related entities and corporates in the financial sector, with all other sectors accounting for about 6% of total issuances. Across sectors, a number of new issuance trends and innovative financing strategies are also emerging. This included a blockchain-based microfinance *shukūk* issuance from Indonesia, as well as several green *shukūk* issuances from sovereign, multilateral and corporate issuers.

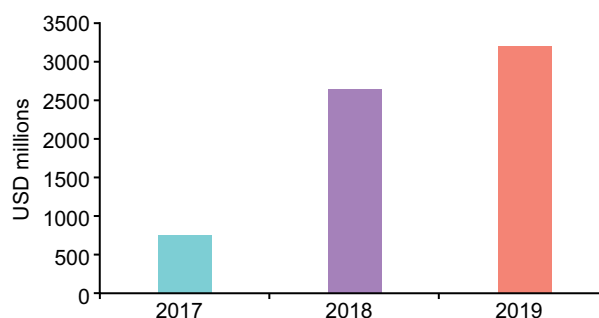
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Chart 1.3.1.5 Global *Shukūk* Issuances by Sector (2019)

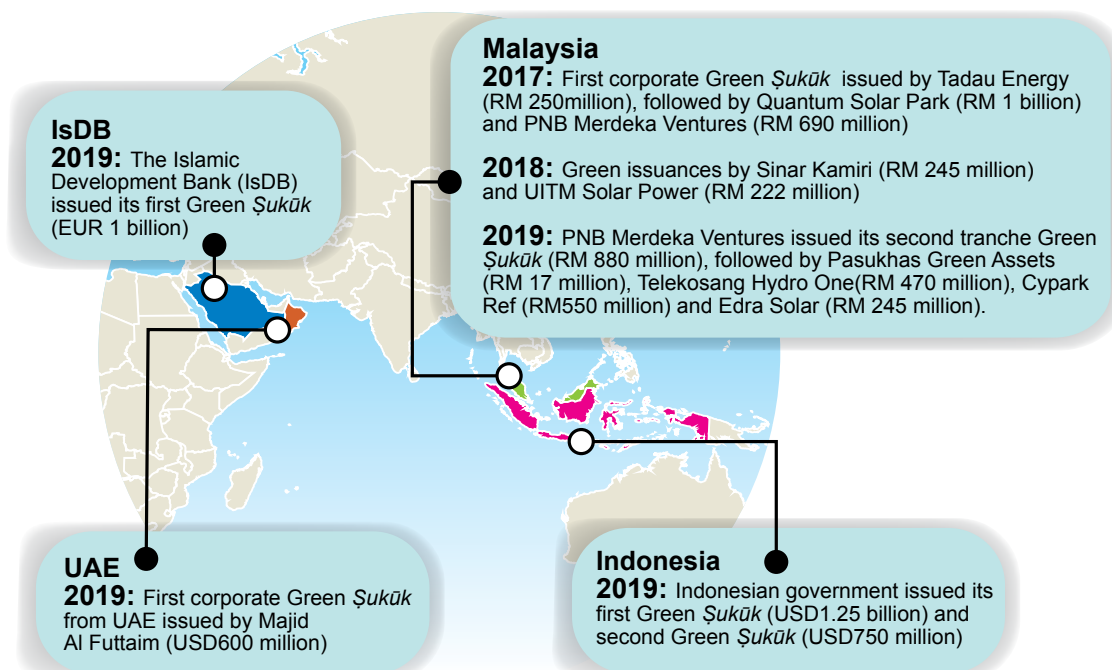
Source: Thomson Reuters Eikon, Bloomberg

Green *shukūk* as a growth driver...

The issuance of green *shukūk* is expected to accelerate in the coming years as part of efforts to combat climate change and to meet sustainable development goals in the national and international agenda. Thus far, Malaysia and Indonesia have been the main pioneers of green *shukūk* issuances, with Malaysia issuing the first corporate green *shukūk* in 2017, while Indonesia issued the first sovereign green *shukūk* in 2018. Since then, green *shukūk* have been issued from the UAE in addition to further issuances by Malaysia and Indonesia, as well as an issuance by a multilateral body, the Islamic Development Bank, with the total green *shukūk* issuances in 2019 exceeding USD 3 billion.³²

Chart 1.3.1.6 Green *Shukūk* Issuances (2017–19)

Source: Bloomberg, IFSB Estimates

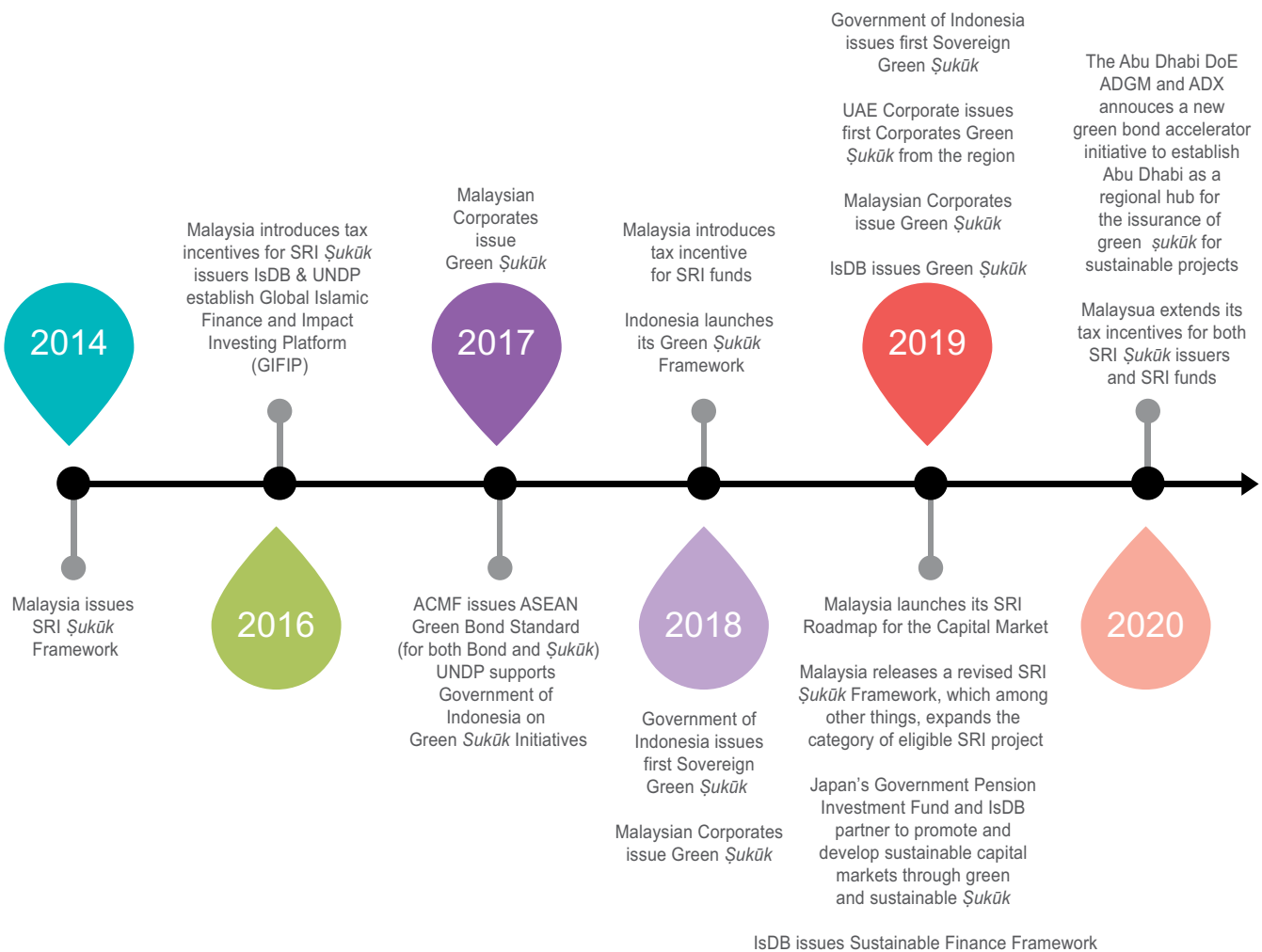
Figure 1.3.1.1 Green *Shukūk* Issuances

³² According to Climate Bond Initiative, total issuances of green bonds and green loan amounted to USD254.9 billion in 2019.

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Şukūk are likely to become an increasingly viable source of funding to bridge the climate financing gap. Significant financial investments are needed for the global economy to transition to low-carbon emissions, reduce greenhouse gas concentrations to safe levels, and build the resilience of vulnerable countries to climate change. Since signing the Paris Agreement in 2016, many countries have incorporated initiatives for greater reliance on renewable energy into their reform agenda. The Association of South-East Asian Nations (ASEAN) and the Gulf Cooperation Council (GCC) have both set targets to invest in renewable energy. To meet these investment targets, many countries have established or are in the process of developing frameworks that will facilitate the issuance of green bonds and *şukūk* to finance renewable energy projects or other climate financing objectives. While the green *şukūk* market currently makes up only a very small proportion of issuances compared to the overall *şukūk* market, the growing global need to finance climate-mitigation projects and socially responsible investments (SRIs) is likely to provide more opportunities and incentives for the growth of green *şukūk* in the future.

Figure 1.3.1.2 Timeline of Developments, Initiatives and Green Şukūk Issuance

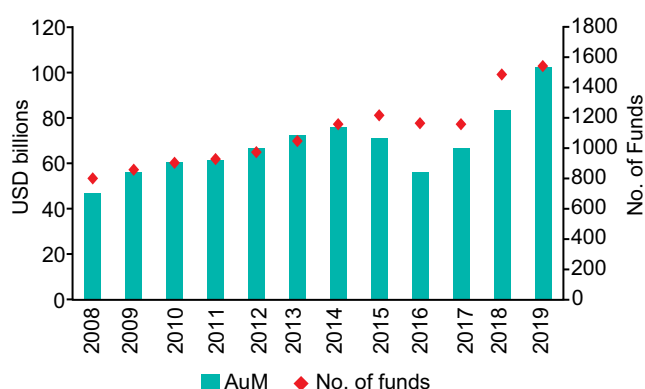


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1.3.2 Islamic Funds

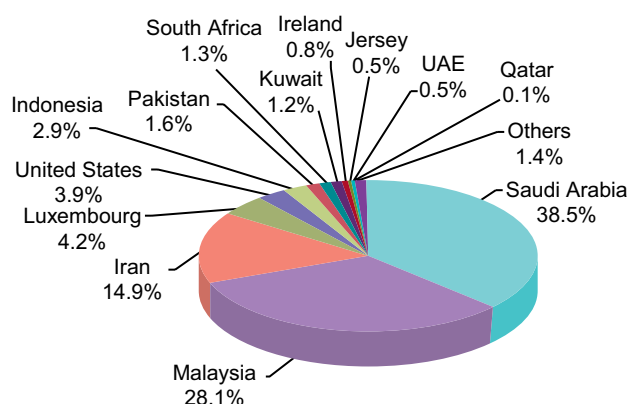
Islamic funds demonstrated positive growth in terms of the total value of assets under management, recovering from the slower growth observed in recent years. The growth in total value of AuM may have been supported by the strong growth in equity markets, as well as by an increase in average size of funds, while the total number of Islamic funds increased from 1,489 in 2018 to 1,545 in 2019.

Chart 1.3.2.1 Growth in Assets under Management and Number of Islamic Funds (2008–19)³³



Source: Bloomberg, Thomson Reuters, EIKON and data received directly from regulators

Chart 1.3.2.2 Islamic Fund Assets by Domicile (2019)



Source: IFSB Estimates; Source: Bloomberg, Thomson Reuters, EIKON and data received directly from regulators

Islamic funds have remained largely concentrated in core markets, and lack of scale remains a challenge. Saudi Arabia, Malaysia and Iran account for 81.5% of the total AuM and there has been no significant deviation from the historical trend in terms of Islamic fund domiciles. Islamic funds are domiciled in a total of 28 jurisdictions, with five jurisdictions accounting for over 90% of total AuM.

However, the observed growth in the overall size of Islamic funds is a positive indication, since Islamic funds have remained smaller in size in relation to the conventional funds sector, although demand for Shari'ah-compliant investments in Muslim-majority jurisdictions can provide opportunities to increase scale. Currently, only 2% of funds hold AuM of USD 1 billion or more each, while 46% of funds hold AuM of less than USD 10 million.

The Islamic fund management segment represents a very small proportion of the overall global fund management industry, and thus presents opportunities for further growth. The Islamic funds segment is still underdeveloped or small in size in a number of Muslim-majority jurisdictions that have well-established Islamic banking sectors and where there is a strong demand for Shari'ah-compliant investments. In a number of these jurisdictions, the regulatory frameworks for Islamic finance have already been established or are in the process of being developed, providing a conducive environment for growth. Outside of the core markets, the Islamic funds segment still faces challenges in terms of lack of facilitative regulatory and legal frameworks, lack of government support in some countries, and a limited range of Shari'ah-compliant investment avenues. The latter implies that further growth of Islamic funds also requires the concurrent development of other segments of the Islamic capital markets in order to provide a more diverse range of Shari'ah-compliant instruments for asset managers.

1.3.3 Islamic Equities

Islamic equity markets rebounded in 2019, posting the strongest performance since the GFC in 2009. Following weak returns in 2018 due to a steep sell-off in December, equity markets recovered in 2019, with the S&P Global 1200 Shari'ah Index gaining 32.6%, while its conventional comparator, the S&P Global 1200 Index, gained 28.2%. Despite transient market volatility during the year due to fears of a global economic slowdown, a disruptive trade war or a hard Brexit, and the volatility of oil prices, global equity markets ended 2019 at a record high, helped by rate cuts by central banks which alleviated recession fears along with easing of trade tensions towards the end of the year.

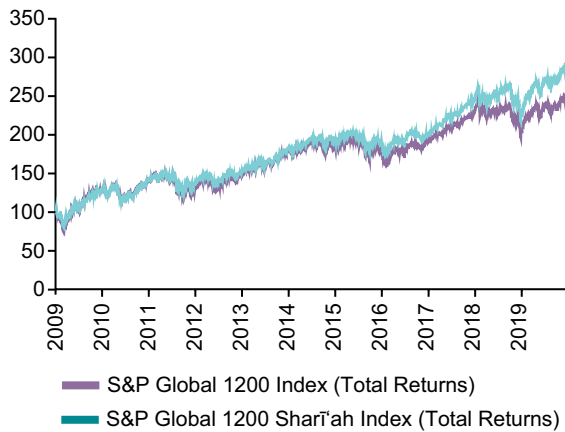
Table 1.3.3.1 Total Returns of S&P Global 1200 Index vs. S&P Global 1200 Shari'ah Index (2019)

	S&P Global 1200	S&P Global 1200 Shari'ah
2019	28.2%	32.6%
3 Yrs	12.1%	15.4%
5 Yrs	9.7%	11.6%
10 Yrs	10.4%	11.8%

Source: Bloomberg, IFSB

³³ The data represent only funds that are invested in tradeable securities and are publicly available. The data for 2019 includes data for Iran.

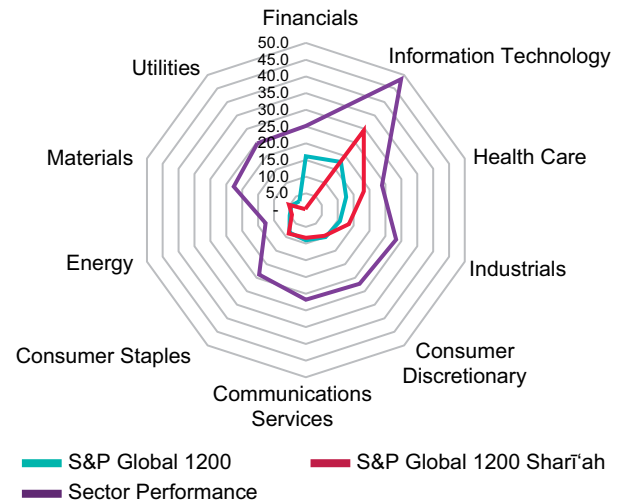
DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

Chart 1.3.3.1 Ten-Year Historical Performance (2009–19)

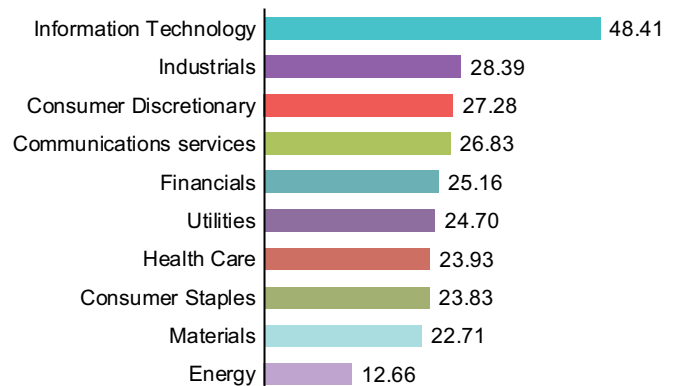
'Data has been rebased at 100

Source: Bloomberg, IFSB

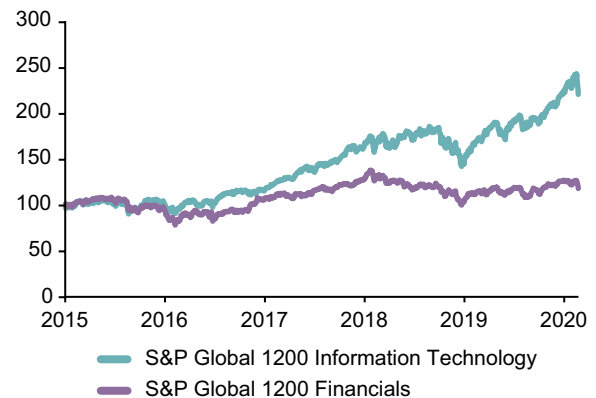
Islamic indices, which have a higher overall exposure to the technology sector, benefited from the substantial surge in the performance of the technology sector in 2019. One of the main differences in the sectoral composition of Islamic indices and comparable conventional indices (such as the S&P Global 1200 Shari'ah Index and the S&P Global 1200 Index), is the higher exposure of the former to the technology sector, as well as a considerably lower exposure to the financial sector (see Charts 1.3.3.2 and 1.3.3.4). While Islamic indices also had a higher proportional exposure to the industrials and health-care sectors, the differential exposures across these and other sectors were much smaller than in the technology and financial sector allocations and thus did not have any significant impact on performance. In general, two factors may be responsible for driving the performance of Islamic indices higher than conventional counterparts: (a) the overall performance of the Shari'ah-compliant constituents within an Islamic index in comparison to the larger set of constituents represented in the conventional index, due to the exclusion of highly leveraged or indebted firms in Islamic indices; and (b) the differential exposure to certain sectors as a result of the screening and performance of those specific sectors. Sector-wise, while the technology sector to which Islamic indices had higher exposure had significantly better performance in 2019, the performance across all sectors was positive, with double-digit gains in 2019 (see Chart 1.3.3.3), in comparison to largely poor performances at the end of 2018 across almost all sectors.

Chart 1.3.3.2 Sector Allocation and Sector Performance (2019)

Source: Standard and Poor

Chart 1.3.3.3 S&P 1200 Sector Performance (2019)

Source: Standard and Poor

Chart 1.3.3.4 S&P 1200 Performance Trend for Information Technology and Financial Sectors (2015–19)

Source: Bloomberg

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*Growth of FinTech in Islamic Capital Markets*

A steady evolution and growth in FinTech is also taking place within the ICM, driven by global trends and supported by government and regulatory initiatives. While this segment is still nascent, there has been a series of developments in the FinTech space and the opportunities for FinTech in the ICM are growing.

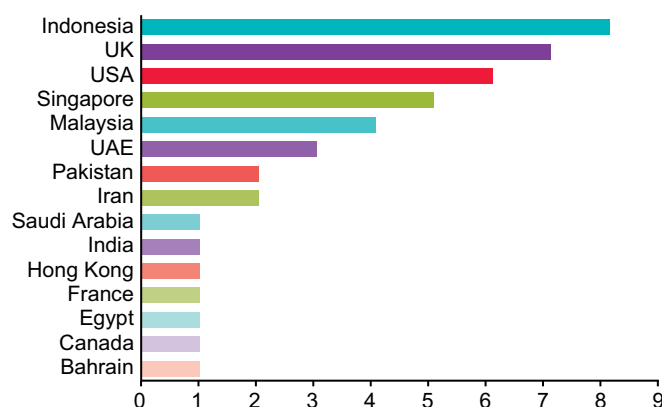
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FinTech Firms in
the ICM

15

Countries

Chart 1.3.4.1 FinTech Firms Operating in the ICM



Source: IFN Fintech

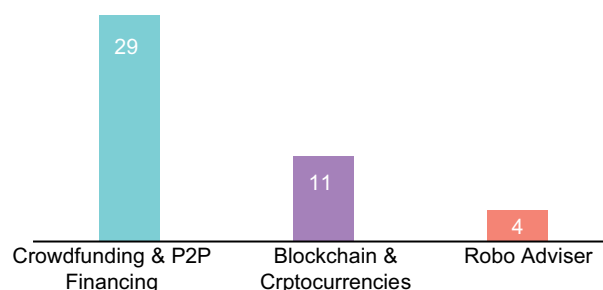
The types of FinTech that are emerging within the ICM include online alternative investment platforms, retail trading and investment platforms, and distributed ledger technologies, such as blockchain-based *shukūk* and crypto-assets. While some of these technologies are slowly gaining ground in a number of jurisdictions, others have so far had little impact in the ICM. The most established of these are alternative financing platforms such as Sharī'ah-compliant peer-to-peer (P2P) financing and equity crowdfunding platforms. A number of Islamic finance jurisdictions have developed guidelines to regulate such platforms, recognising their growth and the need to ensure investor protection.

The second category, online investment and trading platforms, is also evolving to include a number of FinTech models that enable brokers and asset management firms to provide products and services to customers through multiple distribution channels, including models such as Sharī'ah-compliant robo-advisers, platforms for trading and investment or research and networking, as well as other innovative business models. The third category, distributed ledger technologies (DLT), is gaining prominence with their emergence as a potential new model for *shukūk* issuance and trading.

Two issuers thus far, Dubai-based Al Ghurair and Indonesia-based BMT Bina Ummah, have issued blockchain-based primary *shukūk* in 2019, while Abu Dhabi's Al Hilal bank undertook the first blockchain-based *shukūk* transaction in 2018. Also emerging is the issuance of security tokens (crypto-assets) based on DLT, which are digital tokens

similar in nature to traditional securities. Security tokens typically provide an economic stake in a legal entity, conferring a right to future profits, dividends or a residual interest in a business, sometimes the ability to vote in company decisions and/or a residual interest in the entity. While the aforementioned technologies and business models are relatively new and still evolving within the ICM, they have the potential to disrupt as well as transform the sector. The introduction of new technologies and business models in the ICM, alongside new opportunities for growth, are also likely to produce associated new risks that require careful consideration by regulators with respect to ensuring financial stability and investor protection.

Chart 1.3.4.2 FinTech Firms in the ICM by Type*



Source: IFN Fintech.

*The current data only capture those firms that identify themselves as FinTech firms and do not capture the use of the above technologies by existing ICM entities (e.g. fund managers, brokers, other market intermediaries) in the provision of their services.

DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

Growth Drivers in the ICM

The major trends and key growth drivers that are expected to shape the growth outlook for the ICM segment in 2020 include:

- » Regulatory capital issuances that will continue to be a significant driver of *ṣukūk* issuances.
- » Utilisation of financial technologies for issuance of *ṣukūk*, as well as growth in other FinTech-based models to provide ICM products and services.
- » *Ṣukūk* market growth propelled by sovereign issuers for fiscal deficit financing needs and the issuance of short-term *ṣukūk* for liquidity management.
- » Downside risks to the positive growth outlook include the unknown magnitude and duration of the COVID-19 outbreak, a global economic downturn, re-escalation of trade tensions, or materialisation of other lingering global risks.

Box 2 The Indonesian Islamic Capital Market: Big Challenges Leading to Optimistic Development



Contributed by the Indonesia Financial Services Authority (OJK), Indonesia

Introduction

The Indonesian Islamic capital market is unique. While other countries encourage their ICM development by providing tax exemptions for both demand and supply sides, the Government of Indonesia applies tax neutrality. This policy aims to put ICM on the same playing field with the conventional capital market. The government charges Islamic financial products the same tax rate as conventional financial products. Nevertheless, the Indonesian ICM grows well with its uniqueness.

The relevant authorities and stakeholders face various challenges in developing the ICM. The first challenge is related to the general doubtful perception of and low literacy level about ICM. Some people think that investing in shares is prohibited *ḥarām* because it contains speculation or gambling. Lack of knowledge of the capital market, and in particular of the ICM, is also shaping a view where investing in the capital market is seen as risky and as requiring a lot of money. To address this challenge, relevant authorities have carried out socialisation programmes to promote the capital market industry to schools, universities and other groups in the community. The Indonesian Financial Services Authority (OJK) and stakeholders deliver training for trainers, lecturers, public figures, *dā'ī*, and so forth. OJK also creates ICM modules as reference material for ICM courses at university. These activities are aimed to introduce ICM products and to advise on how to manage safe investments according to investors' risk profiles and needs. Furthermore, the programme aims to encourage potential investors to start investing in ICM products and to increase the level of ICM inclusion.

The second challenge is the limited variant and quantity of ICM products. When ICM was just developed, its products were very rare. In response to this, much research has been carried out, policies to stimulate ICM development have been formulated, and coordination with relevant stakeholders has been started. As a result, currently the Indonesian ICM has an array of instruments.

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The third challenge is that ICM instrument issuance entails extra effort and cost. The issuance of ICM products such as *ṣukūk* requires the existence of underlying assets and opinion from Sharī'ah experts, while bond issuance does not. To address this challenge, OJK provided a levy discount for *ṣukūk* issuance. When bond issuers have to pay 0.5% of the emission amount, or a maximum of IDR 750 million, *ṣukūk* issuers pay only a maximum of IDR 150 million. OJK has also released a policy on ICM product management that relaxes the minimum amount and period for pooling funds of Sharī'ah mutual funds, the limitations of offshore portfolios for Sharī'ah mutual funds, and the length of period of shelf registered *ṣukūk* public offering, etc.

All of the above strategic steps have paid off. Currently, the Indonesian ICM has a significant amount of assets, a comprehensive regulatory framework, various types of investment products, and an increasing number of investors and market participants. Besides, Indonesia has become a top 10 country in terms of *ṣukūk* issuance, it is the first country to issue a sovereign green *ṣukūk* to the global market, and it has successfully issued retail-based sovereign *ṣukūk*. Such achievements can be credited to the close collaboration between OJK, other related regulators and all stakeholders since the emergence of ICM in Indonesia.

The emergence of ICM was marked by the issuance of the first Islamic mutual fund – that is, Danareksa Syariah Berimbang – in 1997. Although, at the time, there had not been specific regulations regarding ICM, the ICM continued to grow, driven by the market. The Islamic stock index, known as the Jakarta Islamic Index (JII), was launched in 2000. Subsequently, the first *ṣukūk* – *muḍārabah* Indosat – was issued in 2002. In response to this development, in 2006 the capital market authority at the time, BAPEPAM (Capital Market Supervisory Agency), issued specific regulations related to ICM covering guidance for issuing Islamic products and regulations concerning Islamic contracts (*aqad*). Currently, the supervision of the capital market, including ICM, is under OJK.

Market Development

In general, the development of ICM products in Indonesia has seen a positive trend. The products experiencing significant growth are Sharī'ah mutual funds and *ṣukūk*; meanwhile, Sharī'ah stock fluctuates with the global market. The following provides a more detailed picture of ICM product development in the past seven years, or since OJK's establishment.

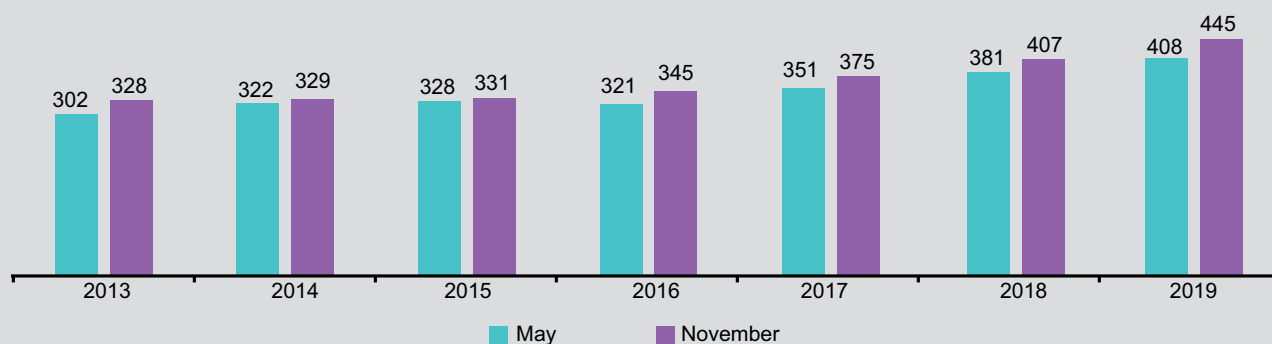
Sharī'ah Stocks

The Indonesian ICM first launched its Sharī'ah stock, the Jakarta Islamic Index (JII), on 3 July 2000. The JII consists of 30 stocks that are Sharī'ah-compliant and mostly liquid. At the time, the criteria for a Sharī'ah stock focused on business screening. In 2007, the regulator issued a regulation concerning the screening criteria for Islamic securities. The current criteria for a Sharī'ah stock require that: (i) there are no impermissible business activities; (ii) there are no impermissible transactions; and (iii) the ratio of interest-bearing debts to total assets does not exceed 45% and non-ḥalāl income does not exceed 5%.

To facilitate the market and investors who have a preference for Sharī'ah securities, OJK issues the Sharī'ah Securities List (SSL) twice a year specifically at the end of May and November. In addition, when a corporation gets an effective statement for its initial public offering (IPO), OJK issues what is known as an "incidental SSL", which is a decree stating the level of Sharī'ah compliance of the issued stock. The incidental SSL is aimed at providing an equal opportunity for both Sharī'ah and conventional investors to buy IPO stocks.

The number of Sharī'ah stocks continues to increase over time. This growth is in line with the increase in number of companies issuing IPOs. At the end of 2019, the number of Sharī'ah stocks reached 445 out of around 700 issuers, with market capitalisation of IDR2.23 trillion.

The Number of Sharī'ah Stocks



Source: OJK

DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

Besides JII, the Indonesian ICM also has the JII70 Index and the Indonesia Shari'ah Stock Index (ISSI). The JII70 comprises the most liquid 70 Shari'ah stocks, while the ISSI is the universe index of Shari'ah stocks. In order for Shari'ah investors to be able to easily choose Shari'ah stock portfolios, some Indonesian Stock Exchange (IDX) members have developed the Shari'ah online trading system (SOTS). SOTS is compliant with Shari'ah principles in the capital market. This system is certified by DSN-MUI based on fatwa No. 80 of 2011 regarding the implementation of Shari'ah principles in the trading mechanism of equity on the regular stock exchange. This system only covers Shari'ah stocks; thus, when a user chooses a non-Shari'ah-compliant stock the system will notify that the stock is not Shari'ah-compliant. As at the end of 2019, based on IDX data, there are 15 securities companies providing SOTS and 68,599 Shari'ah investors, which makes 6.2% of the total number of investors in the capital market. In 2019 the number of Shari'ah investors using SOTS saw a year-on-year increase of 54.03%. It is believed that such a rate will increase in the future.

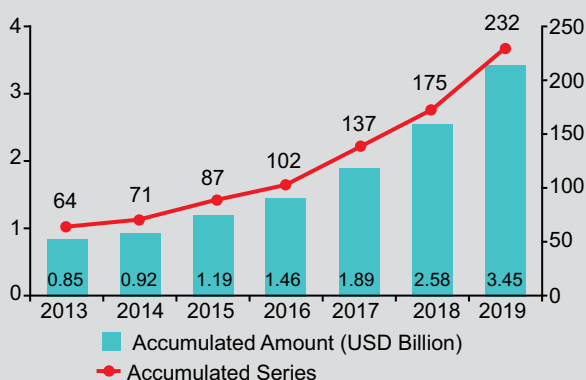
Corporate *Shukūk*

Indonesia's first corporate *shukūk* was issued in 2002. The development of corporate *shukūk* shows stable growth. In the last seven years, corporate *shukūk* issuance has continued to increase. On average, *shukūk* issuances made up 24% of total issuances of the previous year. At the end of 2019, there were 143 series of outstanding *shukūk* amounting to IDR 29.83 trillion (USD 2.13 billion).

Since the first issuance of corporate *shukūk*, the contracts commonly used in *shukūk* issuance are the *ijārah* (lease), *muḍārabah* (profit-loss sharing) and *wakālah* (agency) contracts. *wakālah shukūk* was first introduced in Indonesia in 2018. The majority of outstanding *shukūk* use the *ijārah* contract, which represents 67.13% of outstanding series. *Shukūk* under the *muḍārabah* contract make up 28.67%, while the remaining percentage is under the *wakālah* contract.

Although corporate *shukūk* is demonstrating stable growth, the liquidity of the *shukūk* market remains a challenge. The illiquidity of the market causes investors to ask for higher rates of return, which, ultimately, is reflected in a higher cost of capital.

Indonesia Corporate *Shukūk* Issues



Source: OJK

Sovereign *Shukūk*

The Indonesian government first issued *shukūk* in 2008. The issuance was based on Act No. 19 of 2008 regarding Shari'ah sovereign securities (SBSN), *Fatwā* No. 69/DSN- MUI/VI/2008 regarding Shari'ah sovereign securities (SBSN), *Fatwā* No. 70/DSN- MUI/VI/2008 regarding the methodology of SBSN issuance, and other relevant regulations and fatwas.

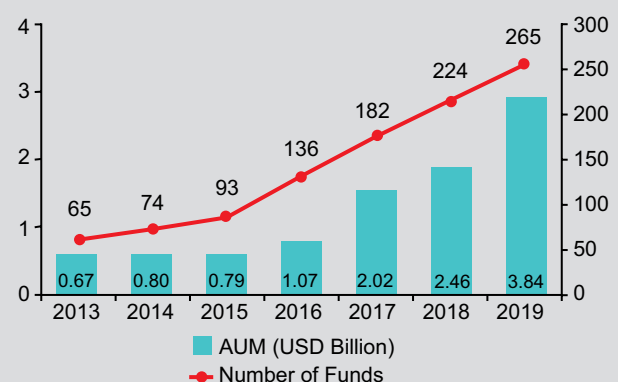
In order to capture a wider investor base and to attract more investors, the Government of Indonesia has issued many types of *shukūk*, including global *shukūk* for foreign investors, Rupiah *shukūk* for domestic institutional investors, and retail and savings *shukūk* for individual and retail investors. In addition, Indonesia issued green *shukūk* to the global and domestic market to support green projects in Indonesia.

In 2019, the outstanding *shukūk* issued by the Indonesian government comprised 67 series amounting to IDR 740.62 trillion (USD 52.90 billion). Further information related to sovereign *shukūk* can be accessed from the website of the General Directorate of Financing and Risk Management, Ministry of Finance (<https://www.djppr.kemenkeu.go.id>).

Shari'ah Mutual Funds

In general, the Shari'ah mutual fund industry has shown stunning growth. The most significant growth during the past seven years was experienced in 2017, when it reached almost 90%. The growth was driven by issuance of some new types of Shari'ah funds, such as *shukūk*-based mutual funds and Shari'ah offshore mutual funds. These types of funds were introduced by OJK Regulation No. 19/POJK.04/2015 regarding the issuance and requirements of Shari'ah mutual funds. For Shari'ah offshore funds, the regulation allows a Shari'ah offshore portfolio at a minimum of 51%, when others are limited at 15%. In addition, the minimum subscription of Shari'ah offshore funds is USD 10,000. Besides introducing new products, OJK issued a regulation related to the establishment of a Shari'ah full-fledged investment manager and Shari'ah investment management unit for investment managers of Shari'ah products. The formation of a Shari'ah unit encourages investment managers to focus on their Shari'ah products and, as such, contribute to the development of ICM.

Shari'ah Funds Development



Source: OJK

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The growth of Sharī'ah funds in Indonesia saw an increasing number of investors turning to these funds. According to the Indonesian Central Securities Depository, at the end of 2019 the number of investors holding Sharī'ah funds increased by 174.41% over 2018 – from 94,097 to 258,207. The outstanding increase represented growing awareness of the importance of investments among the millennial generation. Such an increase can also be attributed to the selling strategy of mutual funds, both Sharī'ah and conventional, which increasingly used financial technology and online marketplaces at affordable rates.

Such a development is positive feedback for OJK and stakeholders to continue to support the growth of investor numbers and Sharī'ah products. This is done through a national campaign of Sharī'ah investment for students, introducing and promoting Sharī'ah investment via social media and other strategies.

Activities and Sharī'ah Supervisory Function in ICM in Indonesia

Activity	Sharī'ah Supervision	
	SSB	Other Functions
1. Sharī'ah entity declaring that business activities are based on Sharī'ah principles	Mandatory	
2. Non-Sharī'ah entity, but it:		
• has Sharī'ah windows/unit	Mandatory	
• is an investment manager doing Sharī'ah funds management	Mandatory	
• is a custodian bank of Sharī'ah investment	Optional	A director or person in charge who has adequate understanding and/or has experience in Islamic finance
• bases part of its activity on Sharī'ah principles		
• provides Sharī'ah services	Optional	Sharī'ah expert team to endorse whether the issued securities scheme is in compliance with Sharī'ah principles
• issues Sharī'ah securities and/or is involved in Sharī'ah securities issuance		

Source: OJK

Sharī'ah Supervision

The Sharī'ah supervision of the Indonesian ICM operates by two mechanisms – self-supervision and supervision by authority. Self-supervision is conducted by the Sharī'ah supervision board (SSB), which is attached to an entity's structure or other form of Sharī'ah supervision function. Under OJK Regulation No. 15/POJK.04/2015, the Sharī'ah supervision functions are classified based on an entity's activity. A Sharī'ah entity, a corporation declaring that the business is managed based on Sharī'ah principles, is required to have an SSB to supervise Sharī'ah compliance of all its business aspects on a daily basis. For a company not declaring so, the Sharī'ah supervision can be done by an SSB or other function as described in the table. Either the SSB or the Sharī'ah supervision function is required to ensure that the activities, products and services comply with Sharī'ah principles as set out in regulations issued by OJK and *fatwās* issued by the National Sharī'ah Board – Indonesian Ulama Council (DSN-MUI).

A Sharī'ah expert team ensures the Sharī'ah compliance of securities issued. The team only conducts Sharī'ah supervision during the Sharī'ah securities issuance process. In order to strengthen Sharī'ah supervision functions, a person who becomes a member of an SSB or Sharī'ah expert team has to have certification of their Sharī'ah expertise in the capital market (known as ASPM) and be registered at OJK. The certification covers both capital market and Sharī'ah expertise. To date, there have been over 100 registered ASPMs at OJK. Following registration, the ASPMs are required to further their professional education by attending relevant short courses, workshops or other classes.

Furthermore, other than supervision by attached function, OJK as a regulator also supervises the ICM activities by monitoring the implementation of OJK regulations, reviewing periodic reports and conducting on-site supervision. The

requirements related to Sharī'ah issues are adopted from fatwas. Currently, Indonesia has 12 OJK regulations and 20 fatwas related to ICM. The synergy between OJK and DSN-MUI in the process of setting up regulations and fatwas is an effort to guarantee that the ICM in Indonesia is in line with Sharī'ah principles.

Impacting the Strategic Development Plan

To ensure structured and integrated development, OJK and stakeholders refer to the Roadmap for the Islamic Capital Market. In the period from 2015 to 2019, the Roadmap covered five main development directions, as follows: (i) strengthening the regulatory framework for products, institutions and supporting professions; (ii) improving supply of and demand for ICM products; (iii) developing human resources and information technology; (iv) promotion and education; and (v) coordinating with relevant governments and institutions to synergise ICM development policies. The Roadmap has been fully implemented except for some issues that need further high-level coordination.

To guide development of the ICM in the future, in 2019 OJK prepared its Roadmap for the Islamic Capital Market for the period 2020–24. This Roadmap will focus on the following major strategies: (i) ICM product development; (ii) ICM infrastructure empowerment and development; (iii) literacy and inclusion of ICM; and (iv) synergy among stakeholders.

The strategies for further developing the ICM will continue to evolve, as Indonesia's ICM makes a significant contribution to the country's financial industry and the economy as a whole. Besides, Indonesia has significant potential supported by its demography and resources. With such potential, it is believed that the Indonesian ICM will be able to develop well and compete in the global market.

DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

1.4 TAKĀFUL: A SHRUB AMONG THE POPLARS

1.4.1 Overview of the Global Insurance Sector

This section provides a general overview of the growth pattern in the global insurance sector, and of specific developments in the *takāful* (Islamic Insurance) market³⁴ across countries and regions. Based mainly on data for 2018 and in a few instances up to 2Q19, this section also provides market outlook for 2020. A more detailed discussion is provided on the GCC and South-East Asian regions due to their relative size and the development of their *takāful* market compared to other regions.

In 2018, the global insurance sector recorded expansion in total direct premiums, albeit at a slower growth rate. The low financial markets' returns lingering over the past few years remain a challenge to the life insurance sector.³⁵ The sector grew both in nominal and real terms³⁶ – at 4.8% and 1.5%, respectively – reaching USD 5.2 trillion, equivalent to roughly 6% of global GDP. Non-life insurance premium growth was steady at 3% in real terms from the previous year to reach USD 2.4 trillion. However, overall growth was slower compared to 2017 due to the contraction in life insurance premiums, which increased by only 0.2% in real terms to reach USD 2.8 trillion in 2018, and which is below the 0.6% annual average of the previous 10 years. The slowdown was due mainly to the contraction in China's life insurance segment. China remains the key driver of global growth and in 2018 accounted for about half of life insurance premiums and for a third of property and liability, a trend that has continued over the past few years.

The effect of the COVID-19 outbreak, which is fundamentally a health crisis have also significantly affected economic activities. The measures imposed by country authorities to contain the virus have led to a sharp decline in economic activity. The consequential effects on the financial markets represent a significant downside risk to the global economic outlook, which will inevitably impact the global insurance sector's growth and performance in 2020.

At this point, there is great uncertainty about the severity and length of the slowdown. Lloyd's projected the global non-life insurance sector to suffer a total loss estimated at USD 203 billion in 2020, with underwriting losses, and impairment losses from their investment portfolios estimated at USD 107 billion and USD 96 billion respectively in 2020 alone.³⁷ The study estimated the pay-out to be a largest single market loss in history, covering a wide range of policies to support businesses and people affected by COVID-19. The figure could rise considerably, once projected losses from life insurance and losses from the tail associated with COVID-19 are determined.

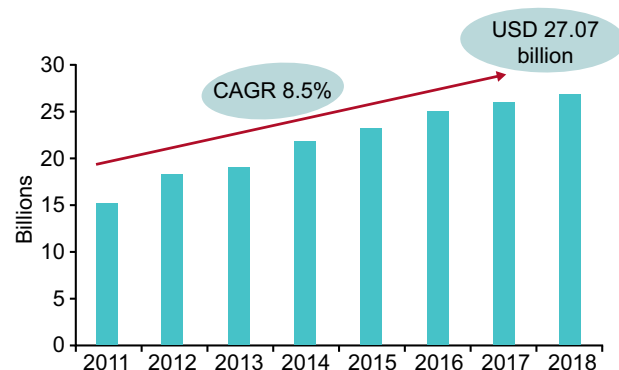
Reports from re/insurers' Q1 2020 results have shown that the impact of COVID-19 pandemic is hitting both the underwriting and investment side of balance sheets. The financial impact may vary significantly between individual companies, depending on product mix between various re/insurers, as well as the composition of investment portfolios. Those business lines that appear to be worst hit include contingency coverage for large scale event cancellation, medical/health, employer's liability coverage, trade credit, surety and policies that cover payment risk on trade receivables.

1.4.2 Global Takāful Segment: Slowing Growth and Declining Share of the Global IFSI Worth³⁸

The total *takāful* contributions grew by 3.2% in 2018 to reach USD 27.07 billion; a slower growth rate than the 4.3% reported in 2017.³⁹ Over the eight-year period from 2011 to 2018, the industry's global contributions grew at a compound average growth rate of 8.5% (Chart 1.4.2.1). Chart 1.4.2.2 illustrates countries where *takāful* contributions as a percentage of the insurance sector's total premium were at least 2% in 2018. Three countries – Iran, Saudi Arabia and Sudan – operate a wholly Islamic insurance market. About 91% of the global total contributions in 2018 were generated from five countries, namely Iran, Saudi Arabia, Malaysia, the UAE and Indonesia (Chart 1.4.2.3). General *takāful* constitutes the lion's share (82.6%) of total contributions in 2018 estimated at USD 22.4 billion.

By region,⁴⁰ the GCC region led with contributions estimated at USD 11.70 billion, accounting for 43.2% of the total global contributions. The MESA region is next with a 42.0% contribution (USD 11.36 billion), followed by South-East Asia (USD 3.02 billion) and Africa (USD 0.55 billion), representing 11.2% and 2.03%, respectively.

Chart 1.4.2.1 Trend of Global Takāful Contributions (2011–18)



Source: IFSB Secretariat Workings

³⁴ In this report, "*takāful*" refers to various Islamic insurance models across different jurisdictions that are adjudged to be "Shari'ah-compliant". These include the Cooperative Insurance model in Saudi Arabia; the Mutual Insurance model (*ta'awun*) in Sudan; the Insurance model in Iran; and the Participating Insurance model in Turkey.

³⁵ See Swiss Re Sigma, World Insurance: "the great pivot east continues", No. 3/2019.

³⁶ "Real terms" refers to premium growth rates adjusted for inflation (i.e. measured using local consumer price indices).

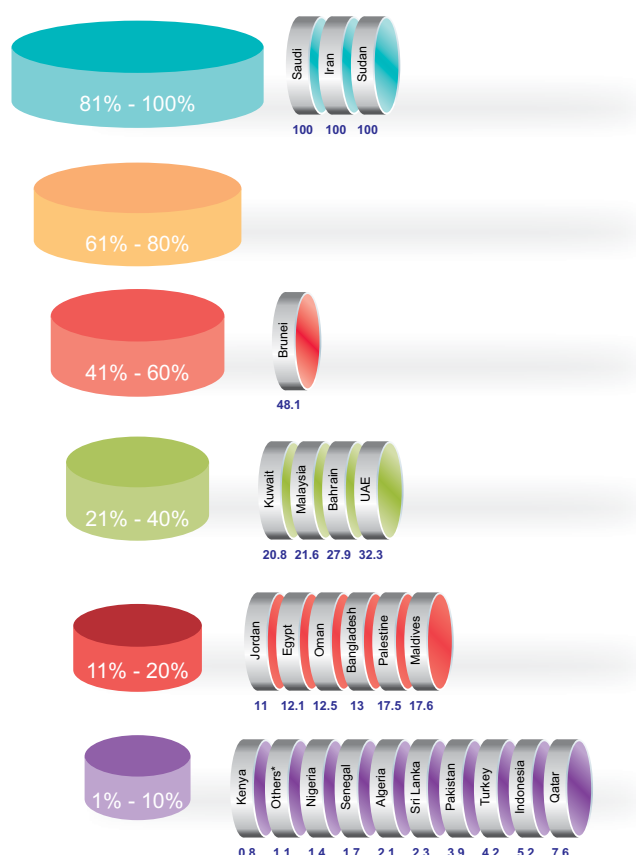
³⁷ Reinsurance News: Lloyd's forecasts USD107bn Covid-19 industry loss for 2020, 14th May 2020

³⁸ All *takāful* contributions estimate bases are gross.

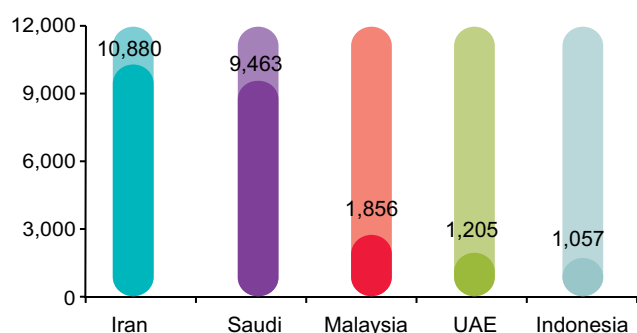
³⁹ The estimate is derived from country-level data provided by the insurance/*takāful* supervisory authorities in many of these countries, and to some extent, from other publicly available information.

⁴⁰ Globally, *takāful* markets have been delineated into four key regions – namely, the Gulf Cooperative Countries; Middle East (ex. GCC) & South Asia; South-East Asia; and Africa. Each region has its own peculiarities.

DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

Chart 1.4.2.2 *Takāful* Gross Premiums/Total Sector Gross Premiums (%) (2018)

Source: IFSB Secretariat Workings

Chart 1.4.2.3 Contribution of Top Five *Takāful* Markets (USD million) (2018)

Source: IFSB Secretariat Workings

Chart 1.4.2.4 Share of *Takāful* Contribution by Business Segment (2018)

Source: IFSB Secretariat Workings

Gulf Cooperation Council Countries: Declining Growth and Market Share

The year 2018 was actually a challenging year for the *takāful* sector in the six GCC countries. Total contributions in the region declined by -0.5% y-o-y to USD 11.65⁴¹ billion in 2018, although this was an improvement compared to a declining growth of -6.9% (USD11.7 billion) reported in the preceding year. Within the six-year period from 2013 to 2018, the overall market contributions had a CAGR of 7.3%. As a result of the growth contraction, the region's global market share fell to 43.2% in 2018 from 45% in the preceding period.

A decline in growth rate is reported in the GCC region for the two consecutive years between 2016 and 2018. This trend can be mainly attributed to declining contributions experienced in the Saudi Arabian market for the two straight periods. The contributions from Saudi Arabia, the largest market in the region with a market share of 86%, declined by -2.8% y-o-y to USD9.4 billion, more than a -1.1% drop recorded in 2017. Medical and motor insurance segments together account for over 80% of total gross contributions in the Saudi market. The decline in contributions growth reported in Saudi Arabia for the past two years (i.e. 2017–18) was due mainly to the inability of the operators to take corrective measures in pricing risks due to competition. Appropriate actuarial pricing of products, especially medical, which has been an area of severe competition, will increase the market contributions growth and performance. Other factors include regulatory reforms, such as application of higher no-claims discounts for motor policies – leading to contraction of average contributions by 25%. Other reasons include the departure of more than one million expatriates in 2018 due to higher taxes on foreigners, nationalist employment policies and a competitive business environment.⁴²

Notwithstanding the declining contributions recorded in Saudi Arabia, the short-term outlook for the *takāful* sector is favourable. It is expected that contributions from the motor business line would recover in the medium term as higher discounts on no-claims motor policies may be somewhat offset by new business from female drivers and the authorities' plans to gradually clamp down on uninsured drivers. (An estimated 50% of drivers currently do not have adequate insurance cover.) According to Am Best's estimates, the policy is expected to cover about 17 million people, and to account for over USD 800 million (SAR 3 billion) of contributions (about 8% of total contributions) annually.⁴³

At the end of 1Q20, the COVID-19 pandemic and curtailment measures adopted such as lockdown and the resulting businesses disruptions have significantly impacted on the new policies subscriptions and renewal of the existing policies, even as operators offer 60% to 70% discounts on motor policies. To a large extent, this is likely to affect their earnings performance for year 2020.

⁴¹ This figure is so reported here to show the implication of the -0.5% dip in total contributions in the GCC but rounded-off and reported as USD 11.7 in other parts of this report.

⁴² "GCC insurers' biggest challenges are geopolitical tensions and intense competition", *Moody's Investor Services Research* (26 February 2020).

⁴³ "AM Best Maintains Gulf Cooperation Council Outlook at Stable", *Best's Market Segment Report* (18 February 2020).

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Health/medical business lines remains the largest business line in Saudi Arabia, and was prior to COVID-19 outbreak expected to record continuing growth beyond 2020 following the preparedness for the implementation of temporary health/medical coverage for pilgrims from foreign countries. However, the cancellation of 2020 Umrah and a restricted Hajj pilgrimage being part of the containment measures to limit the spread COVID-19 would impact on the industry's anticipated earnings from this protection scheme launched at the beginning of the year 2020.

The *takāful* market in the UAE sustained its growth momentum, albeit at a slower growth rate. With a contribution of USD 1.2 billion in 2018, the UAE market grew by 5.8% y-o-y, slower than the double-digit growth of 13.2% reported in the preceding year. The UAE market is the second-biggest market in the region, with a 10.3% share of the GCC *takāful* market in 2018 (Chart 1.4.2.5). General *takāful* made up 95% of the gross contributions (USD 11 billion) in the year under review. Medical and motor were the largest lines, accounting for over 40% and 30% of gross contributions, respectively. The growth in *takāful* business offset a decline in sales of conventional insurance players. The combined gross written premiums of the 30 publicly listed conventional and Islamic insurance firms edged up marginally by 0.5% to AED 21.9 billion in 2018, up from AED 21.8 billion in 2017. The key factors that drove the growth of the *takāful* market in the UAE in 2018 are the continued infrastructure projects, and the rise in demand for *takāful* consequent upon the introduction of compulsory cover in medical and liability business in all the emirates. These factors are envisaged to likely continue to drive the *takāful* market in the UAE, returning its growth momentum to the double-digit rate recorded in the preceding year.

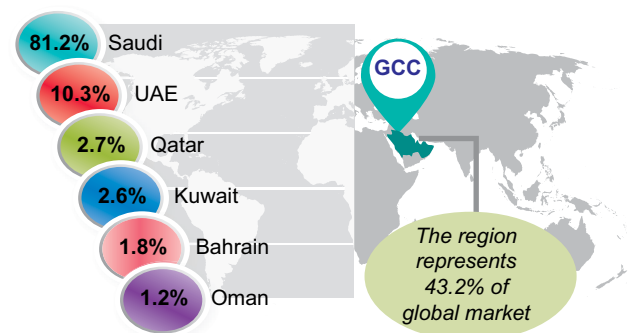
Family *takāful* is relatively small compared to the general *takāful* business in the GCC, with contributions of USD 636.41 million accounting for 6% of the total *takāful* contributions in 2018. Penetration for family *takāful* is much lower than the 0.3% reported for life insurance in the region. The family *takāful* segment in the UAE is still the highest in the region, with 6% growth in 2018, slower than the double-digit growth rate of 13% in 2017.

A combination of factors, such as a sustained and diversified expatriate population base, favourable demographics, business-friendly environment and progressive regulatory regime, and the drive towards operational digitization have positioned the UAE as the region's leading market. The low insurance penetration rate is expected to support long-term future growth as the demographic structure and economic outlook changes. However, much will depend on how far individuals are encouraged to save and how much of those savings go into family *takāful*.

The UAE Insurance Authority (IA) has recently rolled out new regulations relating to family *takāful* and life insurance, following a roughly three-year consultation period. The regulations cover 22 articles, dealing with, inter alia, commission caps for intermediaries related to the sale of life products, including investment-linked products, wider disclosure obligations on operators, intermediaries and other distribution channels, such as banks. Other aspects of the new regulation include product filing obligations with the authority and cooling-off period, as well as policyholders' protection schemes. This is to bring more transparency and credibility to the market and offer better protection to customers.

The push for the advancement of digital technology in the UAE is yielding results, with five leading operators adopting an integrated blockchain platform developed by the DIFC-based Addenda – an InsurTech start-up firm that uses distributed ledger technology to streamline processes between insurers. The insurers are: Aman Insurance, Al Wathba Insurance, National *Takāful* Company (Watania), Noor *Takāful* and Oriental Insurance. This would probably encourage these institutions to developing cutting-edge technologies and innovative entrepreneurship.

Chart 1.4.2.5 *Takāful* Market Share of Countries in the GCC (2018)



Source: IFSB Secretariat Workings

The other four GCC markets – Qatar, Kuwait, Bahrain and Oman – shared only 8.5% of the GCC market contributions. Specifically, while Qatar and Kuwait recorded 2.8% and 2.7% gross contribution, respectively, Bahrain and Oman also recorded 1.8% and 1.2%, respectively. *Takāful* contributions growth was positive in these markets except in Kuwait where it fell by –2.4%. Bahrain showed the highest growth with 22% (USD 173 million), followed by Oman with 13% (USD 139.3 million) and Qatar with 2.3% (USD 324.3 million).

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Government investments in infrastructure projects being part of “Qatar National Vision 2030”, along with preparations for the 2022 FIFA World Cup, have provided favourable underwriting opportunities for the *takāful* sector in Qatar. The Qatar Central Bank is planning to establish a centralised Sharī'ah supervisory body and central supervision of the Islamic finance sector to ensure consistent standards in Islamic finance products and transactions.⁴⁴ This would harmonise standards and financial product structures and transactions, as practised in countries like Malaysia, Indonesia and Sudan. Qatar has four *takāful* operators as at the end of 2019,⁴⁵ although the largest drivers of *takāful* growth in the country could be linked to the performance of the Islamic subsidiaries of conventional insurance operators, which collectively provide a domestic market share of 45%.

Although Bahrain's insurance penetration compares favourably to larger GCC markets such as UAE and Saudi Arabia,⁴⁶ Bahrain's *takāful* market contribution in 2018 was relatively smaller at USD 173 million. Given the number of operators and the limited size of the overall market, price competition is intense, particularly in retail lines. Approximately 45% of gross premium is generated by the five largest insurance operators – namely, gig Bahrain, Bahrain National, Takāful International, Solidarity Bahrain and AXA Gulf. The Central Bank of Bahrain (CBB) has issued rules relating to insurance aggregators⁴⁷ to further enhance the position of Bahrain as a leading FinTech hub in the region.

Mergers and Acquisitions (M&As) – a New Trend in Takāful in the GCC Region.

A range of regulatory measures has been introduced in the region in recent times to address prudential issues, with greater emphasis on enforcement in line with global standards and best practices. This may inevitably compel smaller operators to merge with stronger ones in order to strengthen their capital base and enhance product offerings in a highly competitive industry. This is considered to be a positive development, and an appropriate response to the current high operating costs, with many operators experiencing continuing decline in gross written contributions and capital erosion due to operating losses.

A number of operators have seen a sizable part of their capital eroded in the recent years due to operation losses. For instance, In 2018, 14 operators in Saudi Arabia reported a roughly 52% plunge in gross written contributions,⁴⁸ and three operators namely, Sanad Cooperative Insurance Co.,

Weqaya Cooperative Insurance Co. and Wafa Cooperative Insurance Co. have ceased operations in the last few years due to similar circumstances thereby reducing the number of active operators from 34 to 31. In view of this, SAMA has raised the minimum capital requirements to enhance the capacity of the operators, and as well, encourage consolidation among the operators.

Recent moves in this direction are merger arrangements involving six cooperative insurance operators in Saudi Arabia. Walaa Cooperative Insurance seeks to take over MetLife AIG ANB via a share swap. As at its financial year-end 31 July 2019, MetLife AIG ANB's accumulated losses stood at USD 48 million (SAR 180 million), representing 20.2% of its capital. Solidarity Saudi Takāful Co. and Al-jazira Takāful have entered discussions with Ta'awuni Cooperatives Insurance Co. regarding the terms and conditions for a merger arrangement. Another discussion is ongoing between Gulf Union Cooperative Insurance Co. and Al Ahlia Cooperative Insurance Co. Similarly, in the UAE, the deal for 100% shares acquisition of both General and family of Noor Takāful by Dar Al Takāful has been approved by the shareholders of the two groups and the supervisory authorities. Likewise, in Bahrain M&A arrangements involving four *takāful* operators (i.e. gig Bahrain's acquisition of Takāful International and Solidarity's acquisition of Al Ahleia) was concluded in 2019.

Given the current difficult operating situation caused by the COVID-19 pandemic and measures so far taken to curtail its spread, there is no doubt that consolidation arrangement remains an option and solution for operators to realise meaningful cost synergies needed to support their drive towards building significant market share in their respective markets, and offer better terms to consumers.⁴⁹

The GCC Takāful Sector's Earnings are Under Threat from COVID-19

The extreme volatility in capital markets in the region due to the COVID-19 pandemic, and the sharp decline in oil price to near its lowest level in 17 years, have weakened the optimism expressed at the beginning of 2020 about the sector's outlook. The significant fall in equity markets, widening *shukūk* spreads and ongoing decline in real estate prices will likely damage earnings and capital buffers of *takāful* operators with material exposure to these asset classes.⁵⁰ However, it is too early to assess the full financial impact that COVID-19 will have on the sector given that the situation is still evolving.

⁴⁴ Qatar Central Bank, *Financial Stability Review*, 2018.

⁴⁵ Qatar Financial Centre – an offshore financial centre – has three *takāful* operators and 11 conventional insurers.

⁴⁶ Central Bank of Bahrain, *Insurance Market Review*, 2018.

⁴⁷ Insurance aggregators are intermediaries with an insurance broker's license to operate an online platform, offering price comparisons between insurers and facilitating the purchase of insurance from several insurers.

⁴⁸ Eikon Thomson Reuters Saudi Arabia Cooperative Insurance Companies, *Annual Income Statement*, 2018.

⁴⁹ This view was expressed by both the Saudi Arabia Monetary Authority (SAMA) and Insurance Authority of UAE published by the MEIR May 2020 edition.

⁵⁰ S&P Global Ratings credit analysis, March 2020.

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Takāful operators are exposed directly to systemic risk impact of COVID-19 through a potential surge in claims and indirectly through the impact on economic growth and the resultant financial market volatility. Although, the scale and dimensional impact of COVID-19 on *takāful* operators is yet to be determined, medical/health business lines are likely to experience a significant number of COVID-19 related claims. The impact will vary across countries depending on whether or not there are extensive government provided health services. In jurisdictions where medical/health business lines constitute a large proportion of business mix, the medical bills may be challenging if the numbers are high and the pandemic persists.

A minimal impact is expected on auto business line taking into account a slow down in new car sales. Claims from auto business such as third-party liability cover, usually constitute a significant proportion of general *takāful*'s pay-outs, and are likely to decline substantially for a few months, with few numbers of people driving. However, operators would have to deal with calls for rebates in lines of business that see a significant drop in claims, such as motor, as well as an increasing number of defaulting customers.

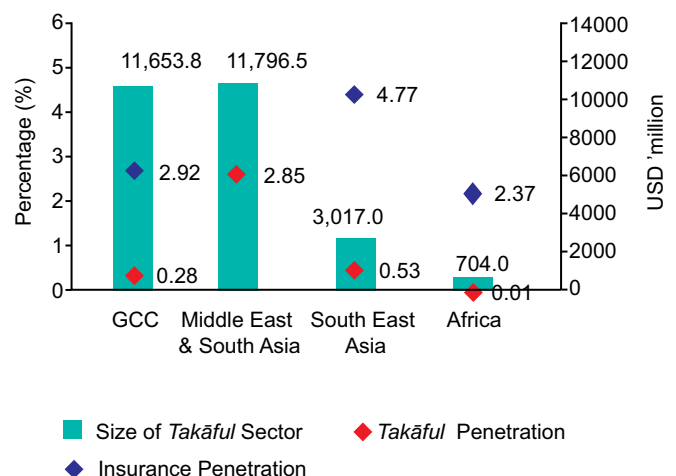
Family segment could face larger claims if the COVID-19 pandemic persists beyond 2Q20. A rise in mortality rates as a result of COVID-19 related death could spike claims and benefits incurred. Liability classes such as workers' compensation (i.e. unemployment) could as well be affected. Moreover, the disruption of business activities due to measures to curtail the spread of the pandemic might depress new policy sales especially if agents are unable to meet customers in person. This will affect their productivity and income and consequently severely impact on new business growth in 2Q20 and perhaps 3Q20.

COVID-19 related losses combined with volatile capital markets and lower investment returns have weakened the optimism expressed about the industry's outlook at the beginning of 2020. The significant fall in equity markets, widen *shukūk* spreads and decline in real estate prices will likely weigh heavily on operators' earnings performance.

In general, technical profit's resilience would be weakened, potentially impact on capital and invariably on the economic solvency of *takāful* entities in the medium term.⁵¹ The impact on economic solvency will have two major implications: mismatches in the duration of assets and liabilities (i.e. asset-liability mismatched), and variance in the basis of valuations. Given that choice on assets-liability maturity duration have already been made during product design and investment management decisions, the implication would be revealing especially in the jurisdictions that have implemented the risk-based capital framework for the *takāful* industry.

Despite the challenges, supervisors in the respective countries in the region have expressed optimism of ability of the *takāful* industry to withstanding impact of COVID-19 crisis. The balance sheets of most *takāful* operators in the region are generally well capitalised and capable of absorbing COVID-19-related claims and capital market volatility. With Oman and Bahrain already commencing implementation, the wider adoption and implementation of mandatory health coverage and unified motor policy across the GCC is expected to boost contributions. Moreover, a steady rise in population, coupled with an increasing population of senior citizens, is expected to boost contributions of the health segment.

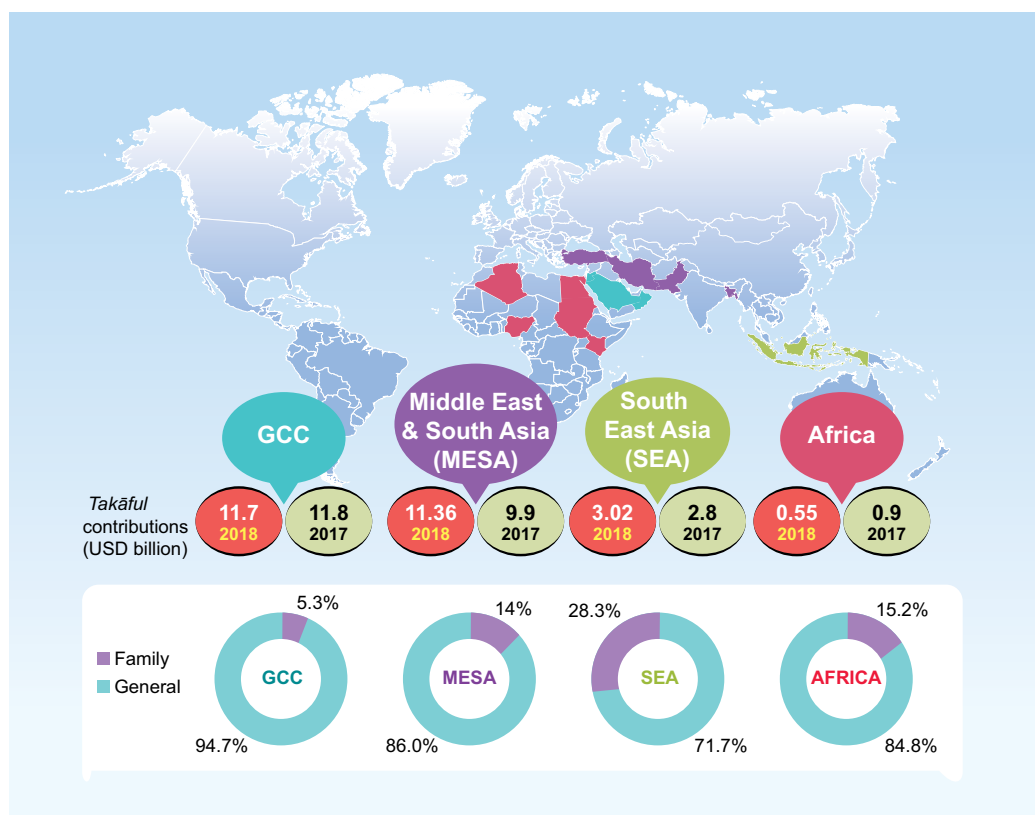
Chart 1.4.2.6 *Takāful*/Insurance Size and Penetration by Key Region (2018)



Source: IFSB Secretariat Workings

⁵¹ ibid

DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

Chart 1.4.2.7 *Takāful* Contributions and Share of General and Family *Takāful* by Key Region (2017–18)

Source: IFSB Secretariat Workings

The Middle East and South Asia (MESA): New Classification Dominated by Iran

The MESA region comprises Iran, Jordan, Palestine, Pakistan, Bangladesh, Sri Lanka and Maldives. Collectively, these countries accounted for USD 11.36 billion (Chart 1.4.2.7) and grew their *takāful* market by 14.1% y-o-y in 2018. Iran is the largest market in the region, with contributions estimated at USD 10.8 billion⁵² and representing 95% of the region's total contributions. Other countries in the new regional classification collectively share only 5% of the total contributions. The Iranian market has experienced significant growth over the past two years, with the general business segment accounting for 86% of the contribution and family *takāful* generating the remaining 14%. The third-party auto and medical/health classes had the largest shares of the market, with contributions of 32.3% and 26.2%, respectively. According to the view expressed by the Central Insurance of Iran (CII),⁵³ there has been a shift of focus towards the family segment due to its prospects for growth and expansion.

Takāful contributions in Jordan are estimated at USD 94.1 million in 2018, up 7% y-o-y higher than 3.4% in the foregoing period. The two *takāful* operators in Jordan – Islamic Insurance Co. and Solidarity First Insurance account for about 11% of the market premiums in 2018. General lines of business accounted for about 86% of the market in 2018, with medical/health accounting for roughly one-third of the market contributions. Jordan's market has been witnessing slower economic growth over the past few years. Instability in neighbouring countries is putting great pressure on growth, as almost all sectors of the economy are affected. Notwithstanding, the market has been showing reasonable growth rates.

According to IMF forecasts, Jordan's economy is expected to record a 2.2% growth rate in 2020, slightly below that of the preceding year. The country's continued poor economic outlook has impacted on the growth of the insurance business. In response, the Jordan Insurance Authority has taken some important initiatives, such as increasing the rates on business lines that operate at a loss and introducing electronic linkage (e-linkage) with the Ministry of Health to exchange medical reports pertaining to motor accident injuries. This latter initiative is intended to address the problem of exaggeration of disabilities in medical reports, which is one of the main reasons for losses in motor third-party liability (MTPL) cover.

⁵² Central Insurance of Iran Report, 2018–19.

⁵³ Central Insurance of Iran (CII) is the Insurance supervisory authority in Iran

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There are notable developments in both the Palestinian and Iraqi markets. Takāful Palestine Insurance Co. (affiliated to Trust International Insurance), and Tamkeen Insurance Co., both with a combined market share of 17.5% and registered contributions estimated at USD 49 million in 2018, up 29% y-o-y compared to 2017. In another development, a *takāful* company has been licensed in Iraq with initial shareholders' capital of USD 12.5 million (IQD 15 billion).

In general, on a positive note, life premium growth in 2019–20 is expected to improve slightly from 2018 on the back of changing regulations and a developing life and savings culture in the Middle East region. However, according to Swiss Re, given the region's weak economic environment, the outlook for insurance markets looks unclear, particularly in the oil-exporting markets.

South Asia Corridor: A Mild but Sustained Growth Momentum

The overall *takāful* contribution from the South Asia corridor (comprising Pakistan, Bangladesh, Sri Lanka and Maldives) grew by 2% to USD 204.1 million in 2018 (up from USD 199.9 million in 2017), accounting for approximately 2% of the MESA region's contributions in the period under review. More than two-thirds of contributions in Pakistan and Bangladesh are derived from family *takāful*, which recorded a negative growth of 0.1% in 2018, whereas general *takāful* showed a positive growth of 3.0% in the same period.

In Pakistan, the aggregate contributions from both family and general business grew by 20.7% to USD 252 million in 2018, accounting for only 2.0% of the region's total contributions and representing 12.8% of the insurance sector's premium in that country. Family *takāful* showed a double-digit growth of 13.6% in 2018, slower than the 18% reported in the preceding period and representing more than 70% of the total contributions. There are five full-fledged *takāful* operators (i.e. two family and three general) and 29 *takāful* windows currently operating in Pakistan. Contributions written by the window operations in 2018 amounted to USD 172.8 million, which is 68% of the total contributions, while full-fledged *takāful* operators accounted for more than USD 79.2 million in contributions.

The *takāful* sector in Pakistan has increased its market share in recent years due to greater consumer acceptability and the entrance of conventional insurers into the sector as windows *takāful* operators. The strong growth recorded in the family segments is a reflection of market developments and structural reforms that have taken place in the industry. In addition to the improving political and economic environment, the introduction of new distribution channels such as bancassurance and online platforms has seen Pakistan's insurance penetration ratio increase to 0.89% in 2018 from 0.84% in 2017. This presents a vast potential for growth in the industry for which a deliberate effort is needed. The Securities and Exchange Commission of Pakistan (SECP) is contemplating a comprehensive road map and is engaging with all stakeholders in order to expand the insurance market's contribution to the Pakistani economy.

South-East Asia: Continued Growth, Expanded Market Share

Takāful contributions in South-East Asia – mainly Malaysia, Indonesia and Brunei Darussalam – grew by 8% in 2018 to reach USD 3.02 billion, up from USD 2.8 billion in 2017, representing 11.2% of the gross global *takāful* contributions.⁵⁴ In the period under review, *takāful* contributions witnessed strong growth of 8.8% and 8.6% in Malaysia and Indonesia, respectively, while Brunei experienced a notable decline of 9.2%. Unlike in the GCC and the MESA regions, family *takāful* dominates the business in South-East Asia, accounting for more than three-quarters of the total *takāful* contributions in 2018.

The *takāful* industry in Malaysia maintained its steady growth both in the general and family segments, collectively representing 22% of gross premiums of the overall insurance market in the country in 2018, an increase of 2 percentage points compared to 2017.⁵⁵ General *takāful* expanded by 8.9% to MYR 2.79 billion (USD 0.67 billion), outperforming the 1.8% growth of the conventional insurance industry. Consequently, general *takāful* continued to increase its market share in the domestic insurance market, accounting for 17% of total combined direct premiums and contributions in 2018.

The motor business remained the largest class, with a market share of 62.3% and y-o-y growth of 14.6%, in 2018. Fire coverage maintained its position as the second-largest business, with a share of 20.1% and a y-o-y growth of 1.9%, in 2018. Medical/health, with a share of 1.8%, recorded the highest y-o-y growth rate of 655.41% in 2018. In contrast, marine aviation and transport coverage, with a share of 1.4%, plummeted by 7% y-o-y in 2018, and personal accident insurance also dipped 7.1% in 2018 to MYR 190 million (USD 45.72). The miscellaneous class also recorded a drop of -13% in 2018, with gross direct premiums at MYR 80 million (USD 19.25 million).⁵⁶ Given the awareness for greater healthcare created by COVID-19 pandemic, medical/health business is expected to becoming a critical business class, therefore, price transparency is a critical issue to be address so that consumers can make informed choices on the cost of treatment.⁵⁷ In this regard, in December 2019, the Ministry of Health mandated the disclosure of consultation fees by private hospitals, similar to what is currently practised in Singapore, for instance.

Takāful represents 22% of total combined premiums in Malaysia, but to make the next leap in growth, it has to be made more inclusive and affordable. An obvious challenge among operators is the need to embrace new competitive parameters such as market liberalisation and de-tariffication of key property classes, motor and fire. *Takāful* is well suited for promoting insurance penetration among the lower-income segment of Malaysia's population.⁵⁸

⁵⁴ The figure is estimated based on data compiled from the Monthly Highlights and Statistics of the respective supervisory authorities BNM OJK and AMBD.

⁵⁵ Bank Negara Malaysia data, *Financial Stability and Payment Systems Report*, 2019.

⁵⁶ Ibid.

⁵⁷ This was the view expressed by RAM Rating Services, published in Asia Insurance Review October 2019 edition.

⁵⁸ Bank Negara Malaysia, *Annual Report 2018*.

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Nonetheless, Malaysia's general *takāful* segment could be compared favourably to other markets in the region. This feat is largely attributable to the robust regulatory framework, with the country being the first market in the world to implement a risk-based capital (RBC) framework for *takāful* and the requirement for operators to disclose their *wakāla* (agency) fees in their sales documents. In addition to the robust regulation, the government is favourably disposed to *takāful* in terms of awareness building and providing suitable assets for investment. Finally, technology and digitisation will reshape Malaysia's insurance market, making products more affordable, accessible and appealing.

Total new business contributions for the family *takāful* grew by 13.1% to MYR 4.91 billion (USD 1.07 billion) in 2018,⁵⁹ supported by increased demand for mortgage-related term policies as a result of growth in Islamic financing and leveraging on technology. Relative to the overall life market, family *takāful* business increased its share of the domestic insurance market and accounted for 30% of the new business premiums in the overall life market in 2018. Notably, the agency and bancassurance channels have been the main drivers of new business, accounting for over 82.1% of the total new premiums in the life insurance business. The online distribution channel is still fairly new, but is increasingly being utilised as an alternative distribution channel. *Takāful* operators are thus expected to fully leverage on the outreach potential of multiple distribution channels and to innovate their products.

Some notable *takāful*-related developments occurred during 2018. A significant instance is the successful acquisition of a 49% stake in HSBC Amanah Takāful (Malaysia) by FWD Group, headquartered in Hong Kong, making the group the largest shareholder in the Islamic insurer entity.⁶⁰ This operation in Malaysia marks FWD's ninth market entry across the region. Another notable development is the process of splitting of *takāful* operators with composite licences into separate ones for family and general *takāful*, as required under the Financial Services Act 2013 and the Islamic Financial Services Act 2013. This requirement will encourage operators to be more focused in their requests for compliance with higher capital requirements, as well as to optimise returns on the increased capital deployed.

Malaysia's *takāful* industry outlook for 2020 is expected to remain stable despite the considerable economic impact of the COVID-19 pandemic. The strong capitalisation of *takāful* operators is anticipated to sufficiently cushion claims incurred from the pandemic-related coverage, the impact of heightened financial markets volatility and mounting credit stress. According to RAM Ratings Services, the preliminary capital adequacy ratio (CAR) for both the family and general *takāful* industry stood at a strong 207% and 283%, respectively, equivalent to 1.6 times the minimum requirement as at end-December 2019.⁶¹

The impact of the current COVID-19 crisis will significantly attenuate the growth rate projections for 2020. Bank Negara Malaysia (BNM) has recently announced, as part of the industry's COVID-19 relief measures, the option of deferring regular payments by life insurance policyholders and family *takāful* participants for three months without affecting their coverage. Currently, there is significant uncertainty surrounding the growth outlook, with downside risks arising from more volatile financial markets and heightened credit stress as a result of the economic downturn. This may call for revision of the industry outlook if the extent of the economic impact exceeds our current expectations.

In Indonesia, *takāful* (Shari'ah) grew by 8.6% y-o-y to USD 1.1 billion in 2018. Similar to Malaysia, the family *takāful* segment dominates the market, accounting for more than three-quarters of *takāful* contributions. Along with China, the Indonesian market is considered one of the best-performing life insurance markets in the world.⁶² Family *takāful* is identified as a significant growth driver; therefore, a consistent growth of Islamic insurance among (predominantly Muslim) consumers will boost protection penetration, which currently stands at 1.98%.

On the downside, general *takāful* contributions dipped by -1.08% to IDR 1.84 trillion (USD 126.53) in 2018, due mainly to a decrease in demand for motorcycles - a major contributor to the share of motor business class. Notwithstanding, the Indonesian *takāful* sector still possesses huge growth prospects. The industry is expected to benefit from developments in the broader Shari'ah ecosystem set in Indonesia's Financial Services Master Plan. Moreover, following the cancellation of trips to Saudi Arabia by thousands of Ummrah pilgrims from Indonesia due to a suspension of Ummrah visa issuance by the Saudi Arabia Authority, as it seeks to curb the spread of COVID-19, the Indonesian Shari'ah Insurance Association (AASI) and operators are discussing moves to improve the insurance system for Ummrah pilgrims, thus creating further business opportunities given the high number of pilgrims from the country.

Insurers with Shari'ah windows are required by the new law to spin off their Shari'ah business units into fully capitalised subsidiaries by 2024. Also, *takāful* operators in Indonesia rely much less on agents as the main distribution network compared to their conventional counterparts. The rise in online distribution channels is expected to enhance the appeal, access and affordability of products. Product differentiation remains the key to stepping up *takāful* operators' genuine new value propositions through product differentiation, pricing, innovation and distribution. Currently, there are 13 full-fledged or stand-alone *takāful* operators, including four recent spin-off windows.⁶³ Another 10 insurers have declared their intention to spin off their *takāful* windows in the second quarter of 2020. However, 49 insurance operators are yet to make any move to carry out a spin-off.⁶⁴

⁵⁹ Thomson Reuters publication, August 2018. <https://www.reuters.com/article/us-hsbc-insurance>

⁶⁰ Ibid.

⁶¹ RAM Rating Services Bhd (RAM Ratings) *Insurance Insight*, April 2020.

⁶² SwissRe 2019 edition. See also *Indonesia Shari'ah Insurance Association (AASI) Report*, March 2020.

⁶³ These are Jasindo Syariah, Askrida Syariah, Asuransi Jiwa Bumiputera and Reindo Syariah.

⁶⁴ Otoritas Jasa Keuangan.

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In Brunei Darussalam, *takāful* contributions showed a growth of -9.2% in 2018, with estimated contributions of USD 103.6 million. This is a significant decline compared to 0.3% in the preceding period. The decline in *takāful* contributions was noticeable in both business segments. While contributions from general *takāful* declined by 2.7%, the family segment plummeted by -23.9%. The proportion of *takāful* contributions relative to total insurance sector premiums stood at 48%.

Africa: Gradual Progress at the Margin

Africa is still in its nascent stage regarding *takāful*, but is growing steadily. Apart from Sudan and Egypt, *takāful* is still relatively insignificant in Africa, accounting for less than 2% of the global contributions. *Takāful* contributions from a number of African countries (Sudan, Egypt, Algeria, Tunisia, Senegal, Kenya and Nigeria) stood at USD 433 million in 2018.

In Sudan, the *takāful* industry registered a y-o-y growth rate of 61.2% in 2018, estimated at SDG 8,051 million from SDG 4,996 million in 2017 (in local currency). General *takāful* accounted for at least 90% of the total contribution. In recent years, the country has suffered significant foreign exchange depreciation due to political upheaval. Consequently, upon conversion to USD, the worth of the Sudanese *takāful* has reduced significantly, to USD 169.50 million in 2018 from USD 689.10 million in 2017. Economic sanctions on the country which among other factors prevented the National Insurance Regulatory Authority (NAIRA) from interacting with international organisations like the International Association of Insurance Supervisors (IAIS) have constrained the growth of the market there. Further details on the insurance industry in Sudan is provided in a box article in chapter 2.

Takāful is making progress in Egypt. The industry started with a single operator in 2002, but currently comprises nine operators with contributions worth 12% of the country's insurance business. Contributions collected by Egyptian *takāful* operators surged by 141% y-o-y during the first half of 2018. The 2Q18 contributions reached USD 281.7 million (EGP 4.6 billion), up from EGP 1.9 billion in the preceding period.⁶⁵ The *takāful* sector was among the fastest growing in the country, mirroring the improvement in economic development over the past two years. The impact of currency devaluation has been phased out and the Egyptian pound exchange rate has now stabilised.⁶⁶

The family business share of total contributions has continued to grow, and stood at 45% in 2018. The accelerated growth in life and personal lines reflects citizens' improved purchasing power and the decreased inflation rate. (The inflation rate has dropped to below 8%, and therefore had no impact on the size of premiums in 2018.) Bancassurance played a key role in supporting family business. Also, technology is helping to spread microinsurance products, particularly by reaching out to rural areas. The Egyptian Financial Regulatory Authority's (FRA) microinsurance initiative has created a demand for affordable products.

In terms of outlook, the prospects for the *takāful* market remain positive, especially with the economic indicators continuing to improve. This supportive economic development is expected to continue to open windows of opportunity for the industry. Personal lines are also envisaged to be the engine for growth in the coming years. In this regard, the FRA has issued comprehensive regulations for *takāful*, covering all areas from licensing, mergers and acquisitions, capitalisation, governance and disclosure, to run-off. It is expected that the introduction of the new law will create a healthy business environment that will nurture the growth and development of players.

The Egyptian FRA has set an agency fee of 25% for family operators and 30% for general *takāful* operators.⁶⁷ However, the executives of *takāful* companies are yet to agree to these percentages because of the significant negative effect on profits. (Currently, administrative expenses exceed 40%, and may be as high as 80% for family *takāful*, especially in the first year.) The FRA has asked *takāful* operators to submit their plans for implementing the agency fee ratio.

Takāful operators in Egypt include Egyptian Saudi House, Egyptian *Takāful*, Wethaq, Tokyo Marine General *Takāful*, Orient *Takāful* and Misr *Takāful* Insurance. State-run Misr Insurance Holding plans to establish a new unit for life *takāful* activities by mid-2020. The establishment of the family *takāful* operator will follow that of Misr *Takāful* Insurance, which was launched in 2017. The general *takāful* operator is 40% owned by Misr Insurance Holding and 40% owned by other units in the group.

In Morocco, prospective *takāful* operators are expected to commence operations within the first quarter of 2020.⁶⁸ The new *takāful* framework, which is expected to bring diversification to the Moroccan insurance market, will also enable the roll-outs of a variety of products, including family *takāful*, mortgage *takāful*, and general, property, accident and casualty *takāful*. It will also open up the Islamic savings market through *takāful* investments, including *bancatakāful*.⁶⁹

⁶⁵ Financial Regulatory Authority, *Egypt, Annual Report 2018/19*.

⁶⁶ Ibid.

⁶⁷ Hitherto, the percentage was not previously defined for *takāful* companies.

⁶⁸ Insurance and Social Insurance Supervisory Authority (ACAPS).

⁶⁹ *Bancatakāful* is an arrangement in which *takāful* policies are sold through banks. Under this arrangement bank acts as an agent of the *takāful* operators, so that the *takāful* operators can sell its policies to the bank's client base using the bank's network.

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According to market projections, the Moroccan insurance market will reach USD 7.6 billion by 2023, while the premium ratio should reach up to 10% of GDP. Based on the current market share, this will translate into approximately USD 3.2 billion of life premiums, highlighting the vast potential of the life business in Morocco. Morocco's life market is among the most developed in the North Africa region and this status should be further cemented with the approval of the *takāful* law.

Meanwhile, the Inter-African Conference on Insurance Markets (CIMA)⁷⁰ has introduced *takāful* in its insurance law. The law stipulates specifically that a *takāful* operator or *takāful* window requires approval, and that the minimum capital requirement for a *takāful* operator is USD 5.1 million (CFAF 3 billion). CIMA has left it to each member country to introduce *takāful* regulations under the legislative framework. The new *takāful* rules introduced in these countries are expected to provide the requisite framework for the take-off of *takāful* and *takāful* window operators. However, *takāful* operators in these markets will have to compete with well-established conventional players. How well the *takāful* operators are able to deploy their marketing strategies in line with the value propositions offered by *takāful* will determine their success.

Islamic insurance in Kenya is offered by Takāful Insurance of Africa, which is currently the only Sharī'ah-compliant underwriter. Islamic insurance recorded the fastest growth in 2018 within the microinsurance class of business.⁷¹ *Takāful* contributions collected from low-income earners exceeded the KES 254.52 million (USD 2.53 million) recorded in 2017. Furthermore, Kenya Re (a state-controlled reinsurer company) is planning to establish a Sharī'ah-compliant *retakāful* subsidiary in Egypt. Egypt is given priority following feasibility studies carried out for both Sudan and Nigeria, which are Muslim-majority nations. This would raise the new capital base to USD 64 million in compliance with the minimum capital required for reinsurers in the new Egyptian insurance law. The Nairobi-based reinsurer started its *retakāful* window in 2013, and has a presence in Uganda, Ivory Coast and Zambia.

With a Muslim population of more than 30%, the Africa region thus has great growth potential. Countries such as Algeria, Morocco and Tunisia have finalised their *takāful* regulations. There is evidence that *takāful* has also gained a presence in other African countries such as Tanzania, Somalia, Gambia, Mauritania, Senegal and South Africa. For instance, an Islamic insurance operation has been established in Hargeisa, capital of Somaliland, backed by some of Africa's largest players in the insurance sector.

Other Takāful Markets

There are few other markets, for instance Turkey which is not classified into any of the regions above. Participation insurance in Turkey posted contributions of TRY 23.11 billion (USD 437.6 million) in 2018, representing a growth of 46.5% y-on-y⁷² and contributing around 5% of the total insurance sector premiums (a 19.8% increase compared to 2017).⁷³ Participation insurance received a boost following the implementation of the participatory insurance regulatory framework. The framework was launched as a separate class of business in the country following the issuance of a regulation published in the Official Gazette in September 2017 by the General Directorate of Insurance. As with conventional insurance, the largest business line in participation insurance in Turkey is motor insurance, which generated contributions of TRY 1.61 billion (USD 200.91 million) in 2018, an increase of 49% over the preceding period.

Global Number of Takāful Operators and Windows

In reference to a 2019 survey conducted by the IFSB, and the Global *Takāful* Directory 2019 published by the Middle East Insurance Review, the total number of *takāful* institutions⁷⁴ is estimated at 353 in 33 countries. Although there are exceptions in which case a country may have *takāful* institutions operating without specific *takāful* regulation in place, countries covered in this report are those that have developed specific regulations designed for the development of the *takāful* market.

By region, MESA has the largest number of *takāful* institutions (114), followed by South-East Asia (SEA) and the GCC, with 106 and 79, respectively (see Chart 1.4.2.8). A breakdown by type of operation is shown in Chart 1.2.4.9. Accordingly, existing full-fledged *takāful* and *retakāful* operators number 222 and 15, respectively, while the corresponding *takāful* and *retakāful* windows number 88 and 28, respectively.

Takāful has significant opportunities to provide sound financial protection and an alternative platform for driving financial inclusion. However, the success of *takāful* operators depends on establishing strong business profiles. More established conventional insurers with licensed windows are already benefiting from greater brand awareness and established distribution networks.

⁷⁰ CIMA is a governmental organisation responsible for enhanced and satisfactorily balanced *market* from a technical, economic and financial point of view. The members are representatives of the governments of Cameroon, Central African Republic, Congo, Côte d'Ivoire, Dahomey (currently Benin), France, Gabon, Malagasy Republic (currently Madagascar), Mauritania, Niger, Senegal and Upper Volta (currently Burkina Faso).

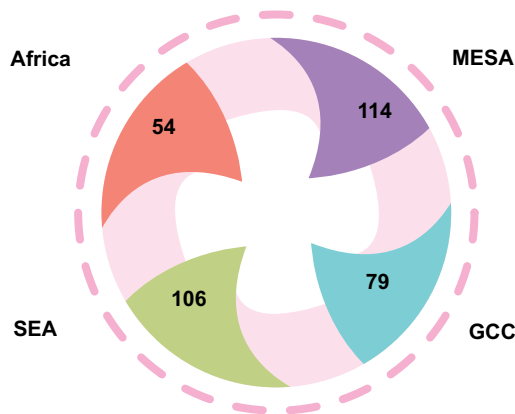
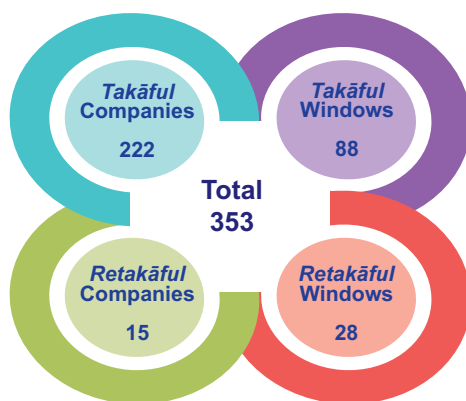
⁷¹ Association of Kenya Insurers (AKI), *Annual Report 2018*.

⁷² According to data supplied by Insurance Directorate, Ministry of Treasury and Finance, Turkey.

⁷³ According to *Turkey Insurance Association* (TSB) Report, 2019.

⁷⁴ *Takāful* institution" refers to both *takāful* and *retakāful* institutions, including windows.

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Chart 1.4.2.8 Number of *Takāful* Operators by Key Region (2019)Chart 1.4.2.9 Number of Full-Fledged *Takāful* and Windows Operators (2019)*Takāful Industry Outlook and Response to COVID-19 Challenges*

The outbreak of COVID-19 and the measures taken to limit contagion are having a significant impact on the global economy and, consequently, on the financial system.⁷⁵ *Takāful* operators are being hard hit with multiple challenges that expose both sides of their balance sheets to increasing pressure on solvency ratios and liquidity. On the liability side, *takāful* operators are required to maintain sufficient funds in order to be able to face the repercussions of this crisis and mitigate its effects. This is in particular regard to expected consequential spike in COVID-19 related claims, and further deterioration of financial markets leading to material investment losses or write-downs of assets. Moreover, there is likely to be a drop in volume of new business written, as well as delays in the payment of existing contributions in the face of a potential increase in claims. This could put a strain on cash flow. On the asset side, extreme stock market volatility could significantly impact on operators' investment portfolios, thereby undermining growth and profitability.

Nonetheless, *takāful* operators have an essential role to play during a pandemic event such as COVID-19 in providing protection to individuals, households and businesses. Financially, they will need to adjust their budgets and implementation plans, cash-flow expectations and investment portfolios in the light of recent developments. Generally, *takāful* operators are well capitalised, with sophisticated risk management capabilities that will enable them to withstand the shocks associated with COVID-19. *Retakāful*/reinsurance entities are also helped by spreading risk over a large part of their books.

Due to concerns about the financial impact of the COVID-19 pandemic, various IFSB RSA members are pursuing a range of regulatory and supervisory measures that are aimed to provide operational relief to operators and help them to navigate successfully through the present challenges. For instance, some IFSB RSA members have provided appropriate flexibility and have relaxed certain regulatory requirements, such as licensing renewal requirements for operators, brokers, and other ancillary services providers including loss adjusters and surveyors to ensure ease of doing business. Where necessary, specific grace period have been granted to those whose licences expire during the lockdown period, to be able to continue to carry on their business.

To support consumers and businesses in this pandemic period, supervisors have asked operators to consider extending the grace period for payment of renewal contributions, and ensure fairness to all customers, regarding clear disclosure in delivery of their services and efficient claims processing. Moreover, operators are encouraged to utilise digital or online payment modes for the collection of contributions and disbursement of claim payments, utilise electronic media such as SMS, emails, mobile applications, online portals, etc, for claims handling, delivery of policy documents and issuance of pre-authorisation for treatment in hospitals.

Furthermore, taking into consideration the anticipated low claim ratio in auto related policies due to a lockdown, supervisors have recommended that operators pass on the benefits of a low claim ratio to consumers by granting a free one-month extension of coverage to participants.

No doubt, the COVID-19 pandemic has posed unprecedented challenges to businesses across the IFSI, including *takāful* industry. Evidence from 1Q20 results of *takāful* operators have shown that the pandemic has hit both their underwriting and investment portfolios. This is likely to significantly impact on earnings in 2020, however, it is still unclear how impactful the episode would be for operators' balance sheets.

⁷⁵ The Insurance Information Institute, 1Q20 report: "Global Macro Outlook – Covid-19 impact on global growth and the insurance industry".

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Nonetheless, several supervisors have indicated that majority of their operators are well capitalized to withstand potential shocks to their balance sheets as a result of the ongoing COVID-19 pandemic. They also strongly expressed their belief that the various measures taken so far, would assist operators and consumers to cope with the disruption caused by the COVID-19 pandemic and strengthen the consumers' confidence in the industry.

The IFSB believes that its work over the past years on enhanced international standards for the *takāful* industry will provide the framework for supervision across countries and has assisted in strengthening risk management and enabling greater resilience of the industry. The IFSB supports the implementation of various measures by its members and, as the situation evolves, will continue to facilitate the sharing of information on supervisory measures being taken or planned in this regard, in support of the protection of consumers and the maintenance of financial stability.

Box 3 *Takāful* in Brunei Darussalam: Development, Regulation and Supervision

Contributed by Autoriti Monetari Brunei Darussalam (AMBD)

Introduction

Brunei Darussalam has a dual financial system where both conventional and Islamic financial institutions co-exist. The *takāful* and insurance sector in Brunei Darussalam is serviced by a total of 11 licensed companies, in which five companies carry out life business and six companies carry out general business.

Insurance and *Takāful*: Number of Insurance Companies/*Takāful* Operators

Insurance Companies/ <i>Takāful</i> Operators	2018	2019
General conventional insurers	4	4
General <i>Takāful</i>	2	2
Life conventional insurers	3	3
Family <i>Takāful</i>	2	2
Total	11	11

Source: AMBD

The Early Days of *Takāful* in Brunei Darussalam

Takāful has been offered in Brunei Darussalam since the establishment of Takāful TAIB Sdn Bhd in 1993 by Perbadanan Tabung Amanah Islam Brunei (TAIB). During the same year, Takāful IBB was also established as a subsidiary of Islamic Bank of Brunei (IBB). In 2001, the Islamic Development Bank of Brunei Darussalam (IDBB) established their subsidiary *takāful* operator, Takāful Islamic Development Bank of Brunei Sendirian Berhad (TIDBB).

In its early years, these *takāful* operators only depended on their respective Shari'ah Advisory Body for Shari'ah-related advice on their operations and products. They carried out composite businesses but were primarily focused on gaining market share in Brunei Darussalam's compulsory motor business. All the *takāful* operators initially applied the *wakālah* concept for their general business and *muḍārabah* concept for their family business.

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In 2006, Brunei Darussalam's Islamic banks, IBB and IDBB, announced a merger of their companies as Bank Islam Brunei Darussalam (BIBD). Additionally, their *takāful* subsidiaries merged under the holding company, Syarikat Takāful Brunei Darussalam.

To support the development of Islamic finance in Brunei Darussalam, the Sharī'ah Financial Supervisory Board (SFSB) Order and Takāful Order were enacted in 2006 and 2008 respectively. Key requirements of the legislation included:

1. For all Islamic financial products to be approved by the SFSB, as the national Sharī'ah Committee;
2. For *takāful* operators to separate their general and family *takāful* businesses, as composite businesses were no longer allowed in Brunei Darussalam; and
3. The increase of minimum paid-up capital requirement from BND 1 million to BND 8 million.

As a result of the reforms, the *takāful* operators formed a holding company and established 2 subsidiaries to carry out general business and family *takāful* business registered by Autoriti Monetari Brunei Darussalam (AMBD). The holding company would provide shared services to their subsidiaries such as Human Resources, Finance, Internal Audit, etc

Registered Takāful Operators

Syarikat Takāful Brunei Darussalam	Insurans Islam TAIB Holdings
<ul style="list-style-type: none"> • Takāful Brunei Am Sendirian Berhad • Takāful Brunei Keluarga Sendirian Berhad 	<ul style="list-style-type: none"> • Insurans Islam TAIB General Takāful Sendirian Berhad • Insurans Islam TAIB Family Takāful Sendirian Berhad

Description of Takāful product offerings and focus

Since the introduction of *takāful* in Brunei Darussalam, products offered were mostly traditional. However, since 2017, new products have emerged in the market, in particular agriculture, aquaculture, latent defect and extended warranty. The focus has been shifted to providing coverage to more specialised areas as the underwriting capacity increases.

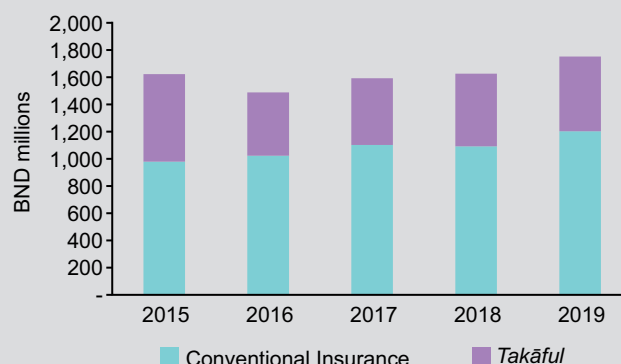
The industry is also looking into expanding their family *takāful* product offerings towards savings and protection. Nonetheless, family *takāful* is also experiencing investment challenges due to limitation of longer-term Sharī'ah-compliant assets in the country.

Market Development

While total assets for *takāful* only makes up about 31% of the total insurance and *takāful* industry assets (Figure 1), *takāful* assets have shown improvements over the past 5 years. The ICD-Refinitiv Islamic Finance Development Indicators Report 2019 placed Brunei Darussalam in the top 10 position in *takāful* assets. Additionally, in its 2018 report, Brunei Darussalam was reported as one of the top 3 countries with fastest growing markets in *takāful* assets.

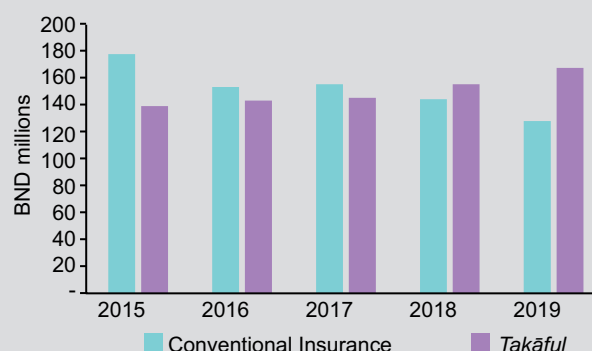
More than 50% of the total *takāful* assets are in cash and cash equivalent, followed by investments which make up 28% of the total assets, comprising of common shares, short-term investment and bonds and debentures

Insurance and Takāful: Total Industry Assets (Audited figures)



Source: AMBD

The total industry insurance and *takāful* gross premiums/contributions declined by -1.2% from BND 294.7 million in 2018 to BND 291.2 million in 2019. In terms of share of premiums/contributions, general *takāful* held the largest share of 34.0%, followed by conventional life insurance at 28.7), conventional general insurance at 28.0%, and family *takāful* at 9.3%. This leaves room for improvement for family *takāful* to grow in Brunei Darussalam.



Source: AMBD

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Regulatory and Supervisory Framework

Takāful operators are governed by the *Takāful* Order, 2008 and *Takāful* Regulations, 2008. In terms of capital requirement, both conventional insurance and *takāful* undertaking apply rules-based capital regime which consists of maintaining the following:

1. A minimum paid-up capital of BND 8 million;
2. A surplus of assets over liabilities of 20% as the capital equivalent test; and
3. A fund margin of solvency of not less than 20% of net premium income in the last accounting period.

However, the industry will be expecting a new capital regime in the coming years which is foreseen to be more risk sensitive.

With the full implementation of risk-based insurance supervision in 2017, AMBD has embarked on enhancing the framework with a profiling tool for insurers and *takāful* operators. This tool determines the category of supervisory stance for each insurer and *takāful* operator based on the results of the overall risk ratings calculated within the tool. An enhanced Early Warning System (EWS) has also been introduced which will help to determine the appropriate supervisory intervention, according to the level of risk.

Since 2016, AMBD has issued a number of requirements to ensure level playing field between conventional insurance and *takāful*, with specificities of *takāful* dealt with separately. Some of the common areas include corporate governance, risk management and internal control. To improve corporate governance in the Islamic financial sector, AMBD has drawn up the Shari'ah Governance Framework (SGF), the Internal Shari'ah Audit Framework (ISAF) and the Product Approval Process Guidelines (PAPG) in its capacity as the Secretariat to the Shari'ah Financial Supervisory Board (SFSB). These frameworks and guidelines aim to ensure that Islamic financial activities and products are in accordance with international best practices in Islamic finance.

In 2017, public disclosure requirements were introduced in the market, based on the International Association of Insurance Supervisors (IAIS) Insurance Core Principle 20 (ICP 20) with additional requirements for *takāful* operators following the Accounting and Auditing Organisation of Islamic Financial Institutions (AAOIFI). This includes:

- AAOIFI FAS 12: General presentation and disclosure in the financial statements of Islamic insurance companies;
- AAOIFI FAS 13: Disclosure of bases for determining and allocating surplus or deficit in Islamic insurance companies that are not prescribed by the IFRS 7; and
- AAOIFI FAS 19: Contributions in Islamic insurance companies.

To ensure fair treatment and transparency to *takāful* participants in Brunei Darussalam, *takāful* operators are required to specify the basis of determining the surplus or deficit and method of transferring it to *takāful* participants. The new requirement specifies that surplus can only be distributed to participants who have not received indemnity during the financial period with variation (wholly or partially) of the distribution method shall be approved by the respective Shari'ah Advisory Body and the Board of the *takāful* operator.

Conclusion

As Brunei Darussalam aspires to develop its financial sector towards becoming an international Islamic finance hub, as outlined in its Financial Sector Blueprint 2016-2025, AMBD will continuously welcome the introduction of innovative Shari'ah-compliant financial products and services to assist in paving a way towards the development of the *takāful* industry in the country. AMBD will continue to monitor and assess the needs of the *takāful* industry by introducing the necessary regulations to meet the demands for Shari'ah-compliant financial solutions that are value-adding to both the economy and society..

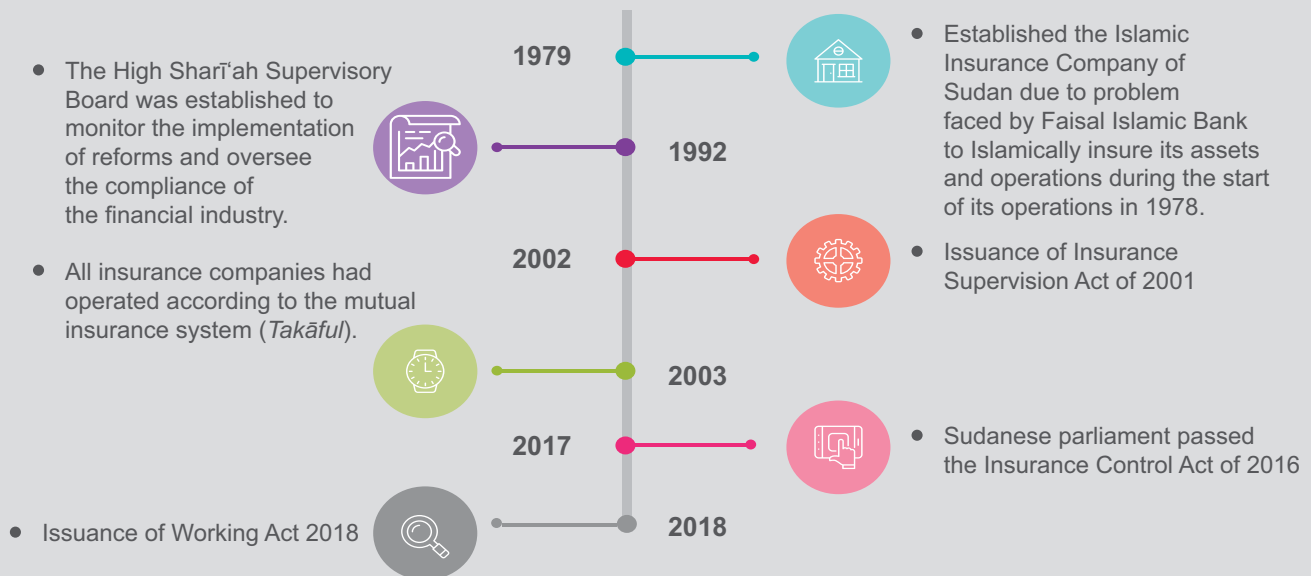
DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

Box 4 Developments in the Sudanese Islamic Insurance Industry

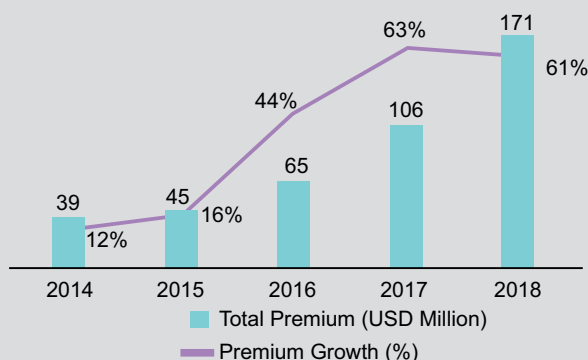
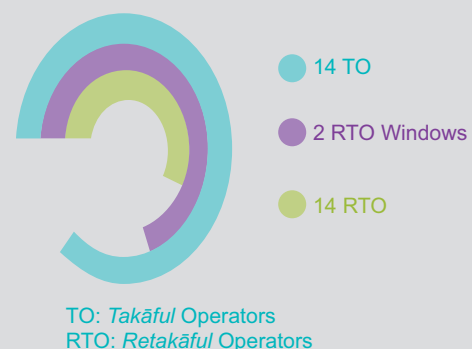
Contributed by National Insurance Regulatory Authority (NAIRA), Sudan

Introduction

The insurance sector in Sudan has since the establishment of the first insurance company in 1979 witnessed a number of changes both in structure and size. As the industry matures, various laws and regulations have also been introduced to among other objectives enhance operational efficiency, resilience, and stability of the industry. Figure 1 below depicts the historical developments of the Sudanese Islamic Insurance market as well as various laws enacted since 1979.

Figure 1: Laws and Regulations issued in the Sudanese Islamic Insurance Industry**Performance of the Sudanese Islamic Insurance Industry**

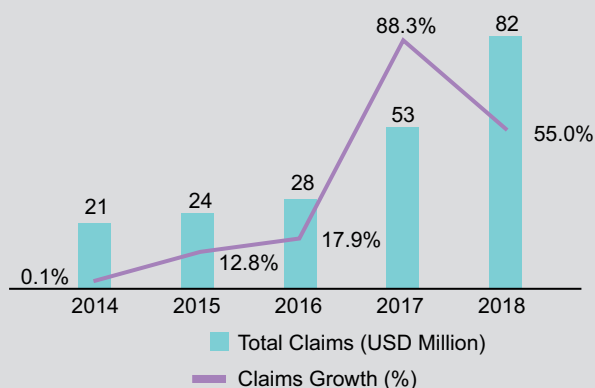
Notwithstanding economic sanctions and internal political impasse the Islamic insurance sector in Sudan has recorded consistent performance for the past five years with total premium growth (in USD) averaging 39% per year (see Figure 2). The incremental growth in total premium recorded over the period 2014 to 2018 from USD 39 million to USD 171 witnessed the highest y-o-y growth between 2016 and 2017 at approximately 63%. The growth in total premium dipped by 2 percentage point to 61% in 2018. The Islamic insurance market remained a profitable business given a loss ratio⁷⁶ average of 66% per year for the past five years. In 2018, the sector recorded that claims grew by 55% to USD 82 million, while the loss ratio recorded a marginal increase by 4%. There are presently 17 operators in the market.

Figure 2: Key Highlights of the Islamic Insurance Industry in Sudan (2014- 2018)**Positive Growth of Total Premium in USD****No of Operators**

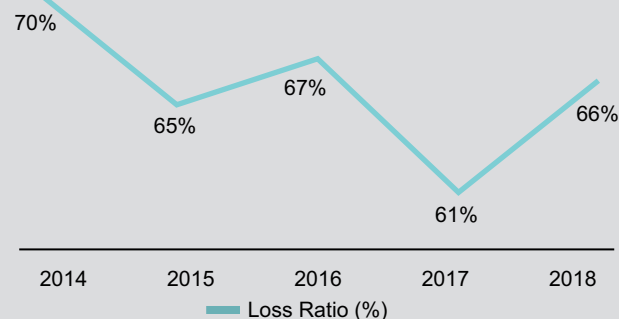
⁷⁶ An Islamic insurance company or *takāful* operator is unprofitable and may likely be in poor financial health if the loss ratio is above 100% because it is paying out more in claims than it is receiving in premiums.

DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

...Lower Claims Growth in 2018



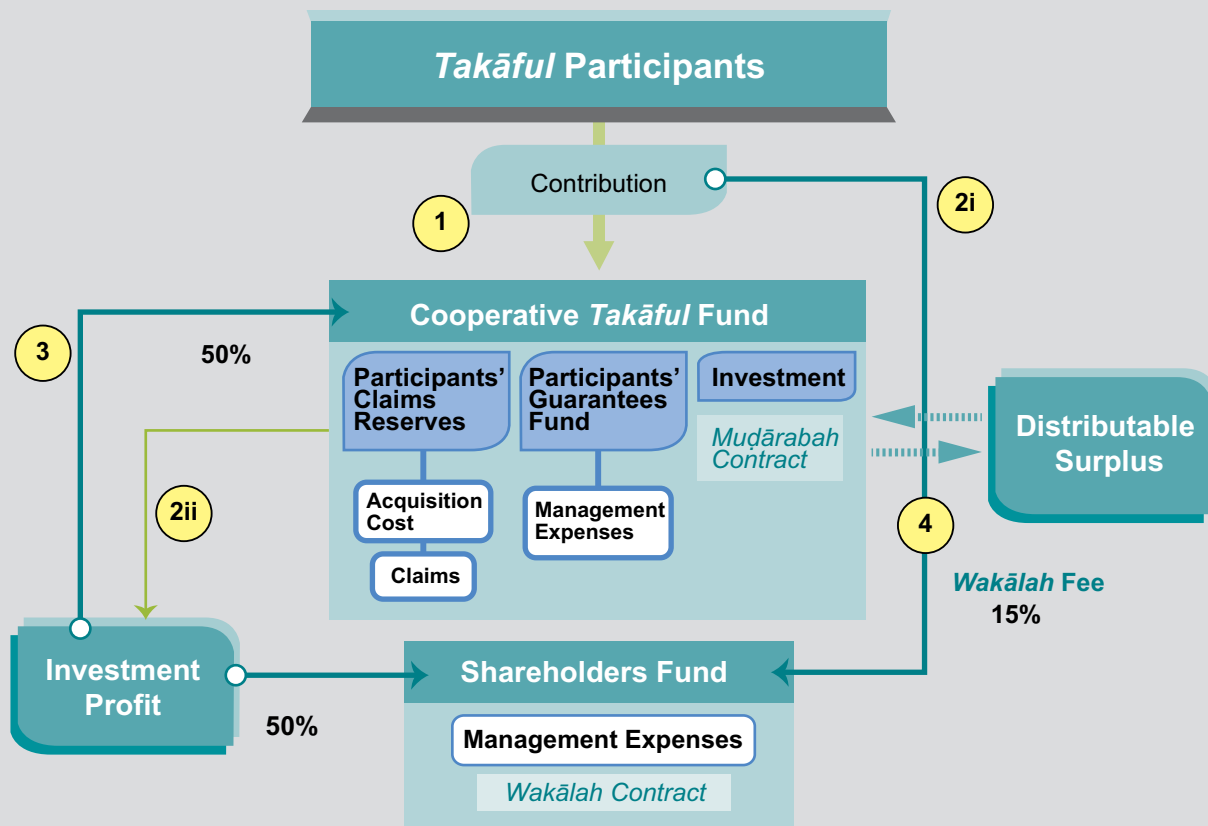
...With an Adequate Loss Ratio Below 70%



Regulation Requires Segregation of Funds between Participants and Shareholders

Taking cognisance that segregation of funds is fundamental in a *takāful* model, the latest regulatory requirement emphasised on the segregation of funds in both operation as well as reporting to the regulator'. The rule requires establishment, maintenance and management by the *takāful* operator, separate funds in accounts of (i) policyholders (i.e. income, expenses, surplus and deficit); and (ii) shareholders (i.e. profits and losses). The requirements shall promote the Islamic insurance operator as acting on behalf of and in the best interests of the policyholders. The operationalisation of the Sudanese mutual insurance model is depicted in the Figure 3 below.

Figure 3: The Sudanese Mutual Insurance Model



DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

The distribution of the surplus in the regulatory requirement based on its mutual insurance model requires the *takāful* operator to:

- distribute a minimum of 65% of the total surplus to the participants;
- allocate a legal reserve of 15% out of the surplus for the current year; and
- allocate a reserve with the ratio of 50:50% to the Policyholder Reserves and Policyholders Guarantees Fund⁷⁷ for the remaining surplus that has accumulated for more than two years.

Important features of the Working Act issued in 2018

Sudan's regulatory landscape has been evolving since the Islamisation of the country's insurance market in 1992. The first law was introduced in 1960 to regulate the insurance business, and the first Act – known as the Insurance Control Act – was passed in 1960 to achieve, among other objectives, a strong national insurance market and to serve the economy by employing insurance funds in development. From 1960 until 1992, the law went through a few phases of amendment, from maintaining a general reserve and protecting national insurance companies from foreign competition, to increasing the capital requirement.

In 1992, the Law of Supervision of the Insured of 1960 was abolished and the Insurance Supervision and Control Act was enacted to oblige all insurance companies to operate in the form of Islamic cooperative insurance. In 2018, the Insurance Control Law of 2018 was issued, while two previous laws – the Insurance Supervision and Control Act of 1992 and the Insurance Supervision Act of 2001 – were repealed in 2001 and 2018, respectively.

The newly enacted Working Act issued in 2018 placed important provisions on opening branches, subsidiary operations and corporate governance as fundamental prudential requirements to foster the confidence of stakeholders and to promote the safety and soundness of the insurance sector in Sudan.

Figure 4: Some Highlights of the Working Act 2018 in Sudan

OPENING BRANCHES

Allowing opening branches for foreign companies on conditions that 30% of the shares are owned by the Sudanese

SUBSIDIARY OPERATION

Separating life products e.g. medical insurance, life & transport insurance

CORPORATE GOVERNANCE

Establishing governance committee as part of the Board of Directors



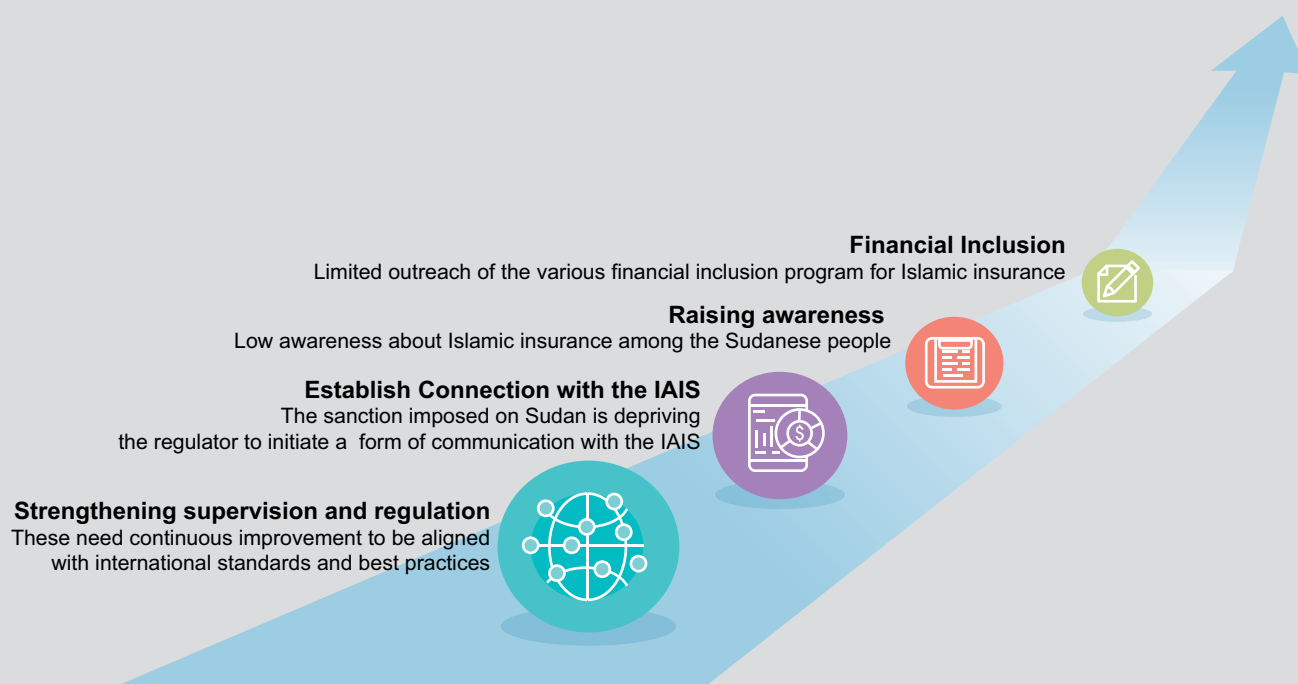
⁷⁷ Fund supporting the operation of the *takāful* company.

DEVELOPMENT REVIEW: ISLAMIC FINANCIAL SERVICES INDUSTRY (IFSI)

Challenges ahead require strengthening of regulation and supervision

Numerous challenges face stakeholders in the Sudanese insurance industry as it attempts to integrate the insurance market with society generally. Strong regulatory and supervisory authorities are required to address these challenges. Four key challenges that will keep the regulator abreast of and able to position the latest regulatory reforms as leverage are shown in the following figure 5.

Figure 5: Challenges Facing the Insurance Industry in Sudan



The newly enacted Act may underpin a robust regulatory reform and strengthening of supervisory practices in the Sudanese Islamic insurance industry. Establishment of a feasible communication platform with international organisations will enable a more dynamic ecosystem between the regulators, market players and customers. Deepening the key regulations such as capital, risk management, policyholder protection and control functions will elevate the role of the Islamic insurance operator in fulfilling its obligation to perform its fiduciary duty in relation to the policyholder. Fostering the reformed regulations and strengthened supervision shall drive the Islamic insurance industry towards a more effective Islamic insurance market operating within a stable environment.



Prudential and Structural Islamic Financial Indicators (PSIFIs)

The Prudential and Structural Islamic Financial Indicators (PSIFIs) are developed by the IFSB with the objective of establishing a global database on Islamic finance in order to facilitate assessment of the strengths and vulnerabilities of Islamic financial systems and support macroprudential oversight of the industry. The PSIFIs database is part of an international effort involving the IFSB, other international organisations and the IFSB member regulatory and supervisory authorities to construct a comprehensive picture of the development of the Islamic financial services industry.

The indicators provide a set of jurisdiction-level, aggregate indicators on the financial soundness, growth, and structure of the Islamic banking system, covering capital adequacy, earnings, liquidity, asset quality, exposures to various types of risks and structural elements such as asset and liability composition, revenues and earnings. Many indicators are parallel to the IMF's Financial Soundness Indicators (FSIs), but are customised to capture information unique to Islamic banks.

Key features of the PSIFIs database

- Publishes aggregated country-level Islamic banking data compiled by banking regulatory and supervisory authorities
- Reports the data separately for stand-alone Islamic banks and Islamic windows of conventional banks
- Provides the data on a quarterly basis, subject to availability
- Comprehensive metadata, providing information / description of the reported data
- Currently comprises data reported by banking regulatory and supervisory authorities from 20 countries: Afghanistan, Bahrain, Bangladesh, Brunei, Egypt, Indonesia, Iran, Jordan, Kuwait, Lebanon, Malaysia, Nigeria, Oman, Pakistan, Palestine, Qatar, Saudi Arabia, Sudan, Turkey and United Arab Emirates
- Comprehensive coverage of the Islamic banking sector (the database reflects more than 90% of global Islamic banking assets)
- Indicators are available starting from December 2013

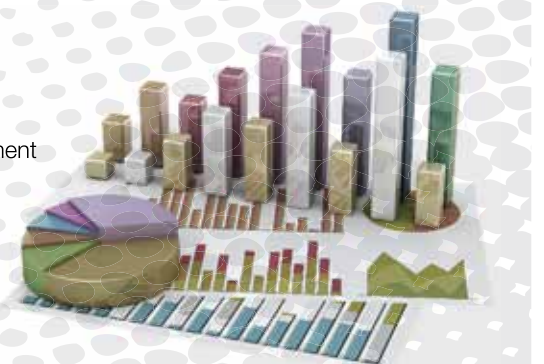


The PSIFIs Database is useful for:

- Financial sector supervisors and policy-makers
- Fund providers and investors
- Academics and researchers
- International agencies and standard-setters in the financial sector
- International financial press and media
- Shari'ah-related stakeholders

Key Benefits:

- Provides a set of reliable and consistent, internationally comparable measures of the soundness, growth and structure of Islamic banking systems
- Strengthens transparency and supports macroprudential analysis and assessment of the structure, state of development and performance of the industry at any given time
- Helps track the progress of the Islamic banking industry in adopting new regulatory standards
- Provides a clear picture of the role and contribution of Islamic banking within national economies and enhances comparability of Islamic finance within and across jurisdictions



Access to the Database:

The full set of PSIFIs data and metadata is available on the PSIFIs portal at the IFSB website: <http://psifi.ifsb.org>

For more information on the PSIFIs database, please see the Frequently Asked Questions (FAQ) page at the above link.



2.0 ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM



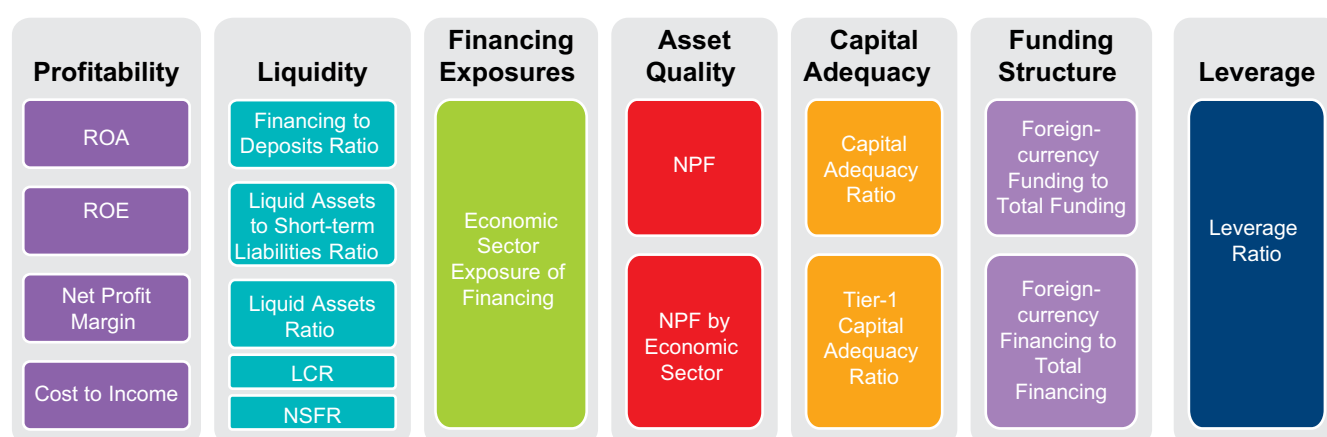
2.0 ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

This chapter focuses on the resilience of the IFSI, with specific attention paid to each of the three sectors: Islamic banking, the Islamic capital market and *takaful*. A number of prudential and structural indicators are used in the analysis of the stability and resilience of the various sectors, and plausible reasons for the outcomes and their likely implications are explained.

2.1 ISLAMIC BANKING: ASSESSMENT OF RESILIENCE⁷⁸

This section examines the resilience of Islamic banking for the period 2Q18 to 3Q19, and for the period 4Q17 to 4Q18 in certain cases where comparisons are made to the conventional banking sector in each jurisdiction. Resilience in this report is assessed by utilising key profitability, liquidity, asset quality, capital adequacy and leverage indicators. Other assessment indicators include Islamic banking exposures to foreign currency (in both funding and financing) and certain economic sectors, such as real estate and households. Figure 2.1.1 highlights the key ratios and indicators used throughout this section.

Figure 2.1.1 Key Indicators for the Assessment of Islamic Banking Resilience



2.1.1 Profitability

The profitability level of the global Islamic banking industry has remained strong and stable over the past seven years (3Q13–3Q19), averaging a rate of 1.56% return on assets (ROA) and 14.30% return on equity (ROE) for stand-alone Islamic banks.⁷⁹ This performance compares favourably with that of conventional banks⁸⁰ in the United States and the European Union, whose ROEs in the same period, for instance, were 11.67% and 6.6%, respectively. The ROAs for Islamic banks were also higher compared to those of conventional banks in both Malaysia and the GCC in the same period, which were 1.40% and

1.48%, respectively. The ROEs for global Islamic banks also showed better performance than those of conventional banks in Malaysia and the GCC in the same period, which were 13% and 11.8%, respectively. Notwithstanding, it is noteworthy that the average ROA and ROE of global Islamic banks in the review period declined slightly when compared to the end of the financial year 2018 (ROA: 1.66%; ROE: 15.21%), attributable to low profit as a result of increased non-performing financing and operating costs in some jurisdictions in 2019.

⁷⁸ Differences may be observed in the figures contained in this section and those reported in IFSI stability reports of previous years. Such differences arise from backdated inclusion of data from new jurisdictions in this year's report, as well as from revisions of previously reported data in PSIFIs by some jurisdictions.

⁷⁹ "Stand-alone Islamic banks" refers to full-fledged Islamic banks and Islamic subsidiaries of conventional banks, but excludes Islamic windows of conventional banks.

⁸⁰ This comparison does not control for the likely effects of whether profit-sharing investment accounts (PSIAs) are treated as on balance sheet or off-balance sheet, as well as for the effects of applying the IFSB alpha on the equity of Islamic banks on the required equity capital as the denominator in the computation of the ROE.

ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

Chart 2.1.1.1 Global Islamic Banking Weighted Average ROA and ROE (4Q13–3Q19)



Source: PSIFIs, IFSB Secretariat Workings.

In the review period, the performance of the Islamic banks in the GCC was mixed. While Islamic banks in some GCC countries recorded a notable improvement in their ROA and ROE,⁸¹ there was an obvious contraction in the performance of Islamic banks in the others. For instance, Islamic banks in both the Kingdom of Saudi Arabia and Kuwait witnessed notable improvements in contrast to Islamic banks in both Bahrain and the Sultanate of Oman, which showed a modest contraction in profitability performance indicators. Although no notable change was observed in the profitability indicators for Islamic banks in Qatar over the review period, it may still be considered commendable given that a geopolitical blockade imposed by some GCC countries, which has affected the profitability performance of Qatari banks, is still in effect.

As at 3Q19, the banks in Saudi Arabia recorded ROA and ROE of 2.81% and 20.04%, respectively, as against ROA and ROE of 2.48% and 16.45%, respectively, in the first half of 2018. The deliberate policy of the Saudi Arabian Monetary Authority (SAMA) in raising the threshold on the financing-to-deposit and financing-to-value ratios which took effect in April 2018 have stimulated credit extension and the improved profitability indicators recorded by the Islamic banks. Another plausible reason could be the impact of the rapidly expanding mortgage financing as a key aspect of the Kingdom's newly launched "Vision 2030" project, which also promotes Saudis' home ownership. However, the improvement in the profitability indicators of the Islamic banks in the Kingdom was attenuated by SAMA's introduction of International Financial Reporting Standard (IFRS) 9 at the beginning of 2018. As such, stricter rules have been introduced about how banks must make provision for problem exposure, as well as tighter corporate financing rules designed to limit a bank's exposure to a single customer that take effect in the review period.

The profitability figures for Kuwait Islamic banks indicated a slightly declining performance, with 3Q19 ROA at 1.38% (3Q18: 1.48%) and ROE at 12.31% (3Q18: 13.47%). Notwithstanding, an increase in profitability of Islamic banks in Kuwait is envisaged due to the improved regulatory and operating environments in the country. The amendment made by the Central Bank of Kuwait (CBK) in November 2018 to the regulations on granting personal financing is expected to boost financing activities and increase in assets of Islamic banks. This should also positively impact on their profitability considering the fact that the Islamic banks' non-performing financing has dropped significantly. The envisaged increased profitability of the Kuwaiti Islamic banks is expected to remain so despite a further likely downward trend in real estate prices and volumes to which they are exposed. Moreover, given that the Central Bank of Kuwait (CBK) rules resulted in more provisions, the implementation of IFRS 9 in 2018 have had no effect on the Islamic banks in Kuwait. The banks are sufficiently equipped with the necessary buffers to limit the effect of the implementation of the standard.⁸²

Islamic banks in the Sultanate of Oman recorded lower profitability figures as at Q319 compared to Q318. The profitability figures for the weighted average ROA and ROE for Islamic banks in Oman as per Charts 2.1.1.2 and 2.1.1.3 declined as at 3Q19 to 0.28% (3Q18: 0.75%) and 2.11% (3Q18: 5.16%), respectively. The impact of an increase in total assets (from USD 3.81 billion as at 3Q18 to USD 4.37 billion as at 3Q19) on the profitability figures was attenuated by the increase in delinquent and defaulted or non-performing financing. The NPF ratio for the Islamic banks in Oman increased slightly, from 0.67% as at 3Q18 to 0.89% as at 3Q19. This increase negatively affected the overall profitability of the Islamic banks, and may persist due to likely declining property prices and high household debts.

⁸¹ Only the full-fledged Islamic banking data are used in the computation of both ROA and ROE.

⁸² Central Bank of Kuwait, Financial Stability Report 2018.

ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

Lower profitability, increasing cost-to-income ratio in the UAE. Notwithstanding the economic recovery and property price stability recorded in the UAE, the profitability figures of Islamic banks have dropped just as the cost-to-income ratio has significantly increased. The increase in the operational cost from 64% as at 3Q18 to 78.6% as at 3Q19 has impacted negatively on the Islamic banks' net profit and, ultimately, on the ROA and ROE, both of which showed a downward move. As at 3Q19, the ROA stood at 1.14% (3Q18: 1.69%) and ROE stood at 8.4% (3Q18: 12.77%). The increase in the operating cost of the Islamic banks may be accounted for by a possible increase in write-offs of financings, which may have caused the NPF ratio to worsen. The assets of the Islamic banks remain relatively unchanged, which may be a result of the slow growth recorded in the UAE in the period under review, which in turn is also due to a decline in oil prices, production and export as per the agreement among the OPEC member countries. The World Expo in Dubai 2020 was expected to result in investment opportunities in the non-oil and gas sector which could help growth rebound in 2020 fiscal year. However, the postponement of the World Expo to 2021 and the sharp decline in global oil prices in the first quarter of 2020 due to disagreement to reach a deal on output cut among the OPEC+ coalition, may exert high pressure on the earnings of Islamic banks in the UAE.

The Islamic banks in Sudan have been consistently reporting their highest ROA and ROE numbers since 4Q13. Inflation in Sudan may have contributed to the unusually high profit numbers, as the Central Bank of Sudan continue to depreciate the Sudanese Pound by double digits for a number of years, the latest being by 74.2% in early 2018⁸³. Although the profitability indicators for the review period have declined when compared with 3Q18, they remain the highest among the reported jurisdictions. In 3Q19, the average ROA stood at 3.2% (3Q18: 4.5%) and ROE stood at 40% (3Q18: 74.8%). The decline in the ROE could also be linked to the significant increase in equity capital of Sudanese banks in 2019. The cost-to-income ratio has increased to 41.3% in 3Q19 from 31.6% in 3Q18, but remains one of the lowest among the reporting jurisdictions. Sudan was engulfed in several months of political imbroglio compounded by public protests that infringed on economic activities and resulted in a significant contraction in key economic sectors. The regime change ushered in by a new coalition government that has promised to make some structural reforms is envisaged to positively impact on the performance of Sudanese banks.

The continued implementation of structural reforms has attracted more foreign direct investment into Indonesia.⁸⁴ The revitalisation of economic activity has impacted positively on the performance of Islamic banks in Indonesia. The Indonesian Islamic banking sector's profitability has appreciated when compared to the previous review period as evidenced by the increase in ROA of 1.84% (3Q18: 1.59%) and ROE, which stood at 15.34% as against 13.74% reported in 3Q18. Both operating costs and non-performing financing have decreased considerably. The cost-to-income ratio stood at 78.7%, as against 83.6% reported in 3Q18, while the NPF ratio declined from 3.8% as at 3Q18 to 3.3% as at 3Q19. It is expected that Islamic banks in Indonesia will perform better in 2020, based on the country's positive economic outlook⁸⁵ and coupled with the government's deliberate policy towards developing the socio-commercial integration of "Shari'ah Finance".

Despite domestic and external headwinds,⁸⁶ the financial stability of the Malaysian banking system remains resilient. This is based on the support enjoyed from relatively resilient economic growth in the first half of 2019. Banks' intermediation activities continued to be supported by growth in deposits and long-term funds.⁸⁷ Malaysia's Islamic banks have shown consistent stability in ROA figures over the years, although appearing to generate slightly less profits out of their assets than their conventional counterparts, recording an average ROA of 1.1% in each of the past 20 quarters between 2Q14 and 2Q19. However, in 2Q19, the ROE of 16.0% for Islamic banks indicated a better performance than the conventional banks' ROE of 13%. The overall Malaysian banking system reported an average ROA of 1.5% and ROE of 13% over the same period.

The Islamic banks in Brunei maintain a positive average ROA, increasing almost 100% from 1.1% as at 3Q18 to 2.1% in 3Q19. The ROE for 3Q19 also almost doubled that of 3Q18, which stood at 16.5% (3Q18: 9.9%). The Islamic banks in Brunei have outperformed their conventional counterparts, with the Brunei banking sector recording an ROA and ROE of 1.8% and 12.5%, respectively, as of end-2019. Generally, the outlook for Brunei Islamic banks' profitability is positive. The Bruneian economy has since adjusted and continued on its recovery sequel to the recessionary period of the 2017 fiscal year. Gross domestic product (GDP) grew by 1.0% y-o-y in 2Q19, driven by an expansion of 7.1% y-o-y in the non-oil and gas industrial sectors, mainly in the financial sector.

⁸³ The Africa Development Bank projects an inflation rate of 61.5% and 65.7% in 2020 and 2021, respectively, for Sudan.

⁸⁴ Bank of Indonesia, Financial Stability Report 2018.

⁸⁵ According to the Asian Development Outlook (2020), the impact of COVID-19, lower commodity prices and volatile financial markets are expected to have significant impact on the Indonesian economy in 2020. This obviously will moderate the expected improved performance of Islamic banks in Indonesia in 2020 based on the analysis conducted in this report.

⁸⁶ Slower global growth and volatility in both commodity and financial asset prices due to trade wars and geopolitical tension, as well as concerns arising from the review provided by two global benchmark indices on Malaysian government securities. See: Press Release on Bank Negara Malaysia Financial Stability Review – First Half 2019. https://www.bnm.gov.my/index.php?ch=en_press&pg=en_press&ac=4916

⁸⁷ Ibid.

ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

Despite a challenging macroeconomic environment, the Pakistan banking sector maintained its growth trajectory during the first half of 2019. Similarly, the share of Islamic banking institutions in the banking sector's assets increased to 13.8% at 3Q19. It has been noted that the Islamic banks' contribution to total assets flows in the period under review was the highest in the last three years, indicating the growing significance of Islamic banking in Pakistan. In 3Q19, the Islamic banking institutions recorded impressive profitability figures, with an increased ROA before tax of 2.1% (3Q18: 1.3%), ROE before tax of 33.2% (3Q18: 20.2%) and improvement in cost efficiency as evidenced by the decline in the operating expenses of the Islamic banks from 65.1% as at 3Q18 to 52.5% as at 3Q19.

Participation banks in Turkey recorded a decline in their profitability figures. This decline is despite a significant increase in their asset portfolio. While the assets of the participation banks increased by 28.4% (from USD 35.5 billion in 3Q18 to USD 45.6 billion in 3Q19), the annualized net income declined by -4.5% (from USD 524.9 million in 3Q18 to USD 501.2 million in 3Q19). The decline in the net income may be accounted for by the significant increase in non-performing financing (which will require banks to make more provisions) as evidenced by the increase in the NPF ratio from 3.3% as at 3Q18 to 4.9% as at 3Q19. As a result of the decline in net income, both the ROA and ROE have also declined – from 1.7% as at 3Q18 to 1.2% as at 3Q19, and from 21.7% as at 3Q18 to 14.5% as at 3Q19, respectively.

Chart 2.1.1.2 Islamic Banking Average ROA by Country (4Q13–3Q19)



* Data available from 4Q16.

** Data available from 2Q18.

*** Data available from 3Q18.

Source: PSIFIs, IFSB Secretariat Workings

ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

Chart 2.1.1.3 Islamic Banking Average ROE by Country (4Q13–3Q19)

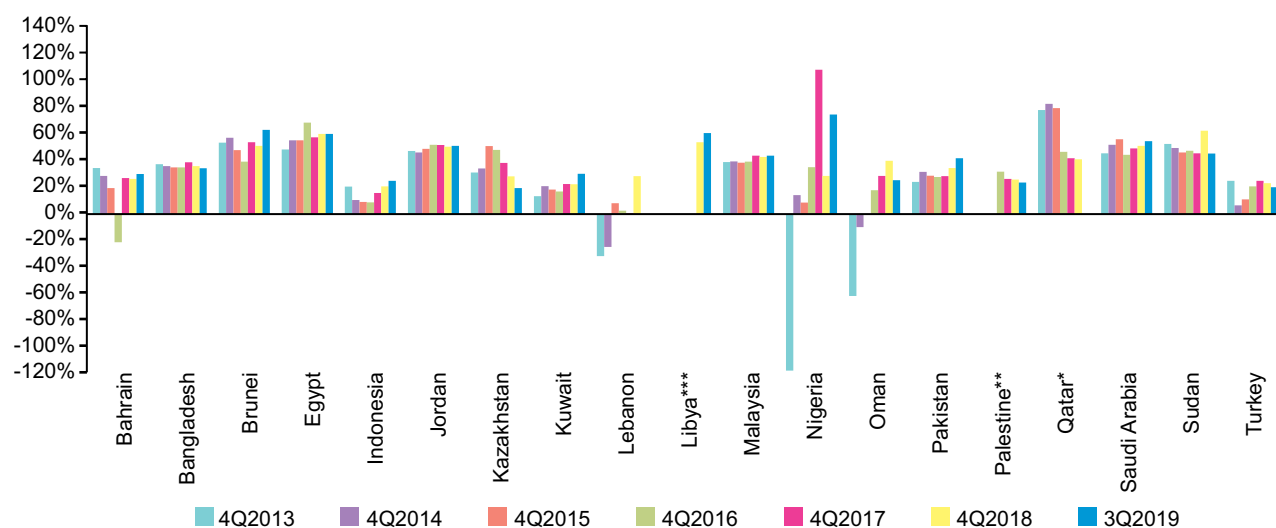


* Data available from 4Q16.

** Data available from 2Q18.

*** Data available from 4Q18.

Source: PSIFIs, IFSB Secretariat Workings

Chart 2.1.1.4 Islamic Banking Net Profit Margin by Country (4Q13–3Q19)⁸⁸

* Includes IFSB Secretariat's Workings until 4Q15.

** Data available from 4Q16.

*** Data available from 4Q17.

Source: PSIFIs, IFSB Secretariat Workings

⁸⁸ Net profit margin = net income (before extraordinary items, taxes and zakāh) / gross income.

ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

Chart 2.1.1.5 Islamic Banking Cost-to-Income Ratio by Country (4Q13–3Q19)⁸⁹

* Data available from 4Q16. ** Data available from 3Q18.

Source: PSIFIs, IFSB Secretariat Workings

2.1.2 Liquidity

Liquidity continues to be a concern among several jurisdictions with Islamic banking assets. While some jurisdictions maintain large amounts of liquidity due to the lack of Shari'ah-compliant avenues for liquidity management, others face liquidity shortages due to macroeconomic pressures, runaway inflation rates and negative economic outlooks that lead to increased deposit withdrawals. Liquidity risk is highlighted as a risk priority for Islamic banks, particularly in South-East Asia and North Africa where Islamic banks cited liquidity risk as their most important risk for the coming years.⁹⁰ The impact of COVID-19 on liquidity position will be particularly challenging and more serious for Islamic banks. This is because they have more exposure to retail and small businesses, most of which have had to shut down and with the possibility that some may not return to business.

Delayed implementation of Basel liquidity standards.

The PSIFIs data revealed that many member jurisdictions are yet to implement the latest liquidity standards – liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). As such, this stability report continues to perform country-specific analysis on the liquidity performance of their Islamic banks using parameters such as the financing-to-deposits ratio (FDR)⁹¹ and liquid assets to short-term liability ratio, alongside LCR where available.

Only seven jurisdictions reported the LCRs of their Islamic banks, among which are four GCC countries – namely, Oman, Qatar, Saudi Arabia and Kuwait. Their reported LCRs are well above the required minimum of 100% as per both the Basel and IFSB liquidity standards. This indicates the Islamic banks' high level of short-term resilience in their jurisdictions.

In the GCC countries, Oman has the highest LCR, which stood at 267.6% as at 3Q19 as against the LCR of 148.8% reported in 3Q18 (see Chart 2.1.2.3). The high LCR ratio will ensure the short-term resilience of their liquidity risk profile. The FDR as a measure of banks' liquidity has also weakened marginally, as it increased to 111% in 3Q19 as against 108% reported in 3Q18. It was observed that while financing increased by 46%, deposits increased by only 13% in the period under review. Although the LCR is an indicator of the banks' strong liquidity resilience in the short term, the participation of Islamic banks in the interbank market suggests otherwise, as they have consistently been net takers in the interbank market. Omani banks' funding and liquidity is expected to remain tight over the next 12 to 18 months if the price of oil, which recorded significant volatility in 1Q20, stays below breakeven, restraining deposits from the government⁹² whose current account deficit is already quite high.⁹³ In view of this development, the Islamic banks in Oman need to ensure that their long-term funding is robust in order to sustain the growth in their financing activities.

⁸⁹ Cost to income = operating costs / gross income.

⁹⁰ Council for Islamic Banks and Financial Institutions (CIBAFI), Global Islamic Bankers' Survey 2019.

⁹¹ FDR is a widely used ratio that assesses the ability of financial institutions to support unforeseen needs. Deposits for the purposes of FDR calculation include unrestricted profit-sharing investment accounts, remunerative funding (*murābahah*, commodity *murābahah*) and non-remunerative funding (current accounts and *wadi'ah* accounts), and exclude interbank funding.

⁹² Moody's Investors Service's Outlook, September 2019.

⁹³ S&P Global Banking Country-By-Country Outlook, 2020

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Saudi Arabian Islamic banks recorded impressive liquidity indicators. The average LCR for the Islamic banks stood at 159.6% in 3Q19, as against 154% in 3Q18. Despite the increase, the LCR is well above the required minimum and this reflects the resilience of the banks to withstand short-term liquidity stress. The average FDR of Saudi Islamic banks registered a minor increase, moving from 87.8% in 3Q18 to 92.9% in 3Q19, which is slightly above the regulatory threshold of 90% stipulated by SAMA.⁹⁴ The liquidity situation in the Saudi Arabian banking system will likely improve based on the raising of USD 29.4 billion by Saudi Aramco with the sale of 1.5% of its stock. However, the banking liquidity situation may deteriorate if the drop in oil prices experienced since the first quarter of 2020 persists as well as the impact of COVID-19, which has significantly reduced global energy demand.

Qatar's banking system remains stable as infrastructure spending drives economic growth. The spending is expected to continue in preparation for the 2022 FIFA World Cup.⁹⁵ Consequently, Islamic banks in Qatar have recorded stable and impressive liquidity indicators except for the LCR, which dropped slightly to 192% in Q219 from 196% in Q218 (see Chart 2.1.2.3). Notwithstanding the decline, the reported LCR is well above the regulatory minimum of 100%. FDR remains the same as reported in the previous review period, at 69% (see Chart 2.1.2.1), apparently due to the likely proportionate increase in both financing and deposit liabilities.

The UAE's banking system has been reported to have a stable funding and liquidity outlook.⁹⁶ Islamic banks showed a modest deterioration in their FDR (see Chart 2.1.2.1), which could be accounted for by the greater decline in deposit liabilities than in financing activities. The decline in financing and funding activities of Islamic banks could also be attributed to the subdued economic activity in the UAE. Furthermore, with the unstable production and prices of crude oil, and the postponement of the staging of the Dubai Expo 2020 to October 2021 due to the effect of COVID-19, economic activity will decrease significantly and have a negative multiplier effect on the banking system.

High liquidity resilience recorded in Pakistan's Islamic banking sector. Since the implementation of the liquidity standards by the State Bank of Pakistan (SBP)⁹⁷, the country's Islamic banks have been reporting LCR above the regulatory minimum, which indicates their short-term liquidity resilience. The short-term liquidity indicator has

increased, with LCR standing at 162.4% in 3Q19 compared to 159.8% in 3Q18 (see Chart 2.1.2.3). The Islamic banking industry recorded FDR of 65.4% in 3Q19 as against 69.1% recorded as at 3Q18. The Islamic banks FDR is higher than the loan-to-deposit ratio (LDR) of 53.6% recorded by the conventional banking industry in Pakistan during the same period under review⁹⁸. This indicates better utilisation of the deposits by the Islamic banking industry as compared to the conventional banking industry. It is important to note that investment constituted nearly 20 percent of overall assets of Islamic banking industry. Pakistan's Islamic banks showed a significant increase in their holdings of *shukūk*, interbank financing and other assets. The investment in these pools of assets is based on the efforts and other initiatives by the SBP to assist Islamic banks to manage their liquidity effectively.

Bangladeshi Islamic banking records a high FDR. Despite a minor decline in FDR from 98.8% in 3Q18 to 97.9% in 3Q19, Bangladeshi Islamic banks and windows continue to maintain high FDR due to the robust economic conditions in the country, which encourage expansionary financing activities. All the liquidity ratios in 3Q19, including LCR of 99.9% (3Q18: 109.5%), and the ratio of liquid assets to short-term liabilities of 98.83% (3Q18: 95.77%), indicate a robust and resilient liquidity situation (see Charts 2.1.2.1–2.1.2.4).

Malaysia's Islamic banking sector experiences a slight decline in FDR. Malaysia's Islamic banking sector witnessed a decline in FDR from 97.2% in 3Q18 to 93.8% in 3Q19, due to deposit liabilities increasing at a faster rate than financing activities, signifying an improvement in the liquidity position of Malaysian Islamic banks. Even the liquid asset to short-term liabilities ratio has appreciated significantly, to 139% in 3Q19 from 128% in 3Q18.

Turkish Islamic banks recorded their highest LCR during the review period, with a remarkable improvement from 197% in 3Q18 to 308% in 3Q19. The liquid assets to short-term liabilities ratio has also increased significantly, from 63% to 85%. These liquidity ratios indicate high-liquidity short-term resilience.

Afghanistan, Nigeria, and Palestine all reported FDR below 50%, as Islamic banks, particularly in Nigeria and Afghanistan, are yet to effectively mobilise deposits and expand their financing network.

⁹⁴ Financing-to-deposit ratio is set at 90% in Saudi Arabia since 2016. However, in order to encourage banks to offer more investment products, a new method of calculation has been introduced (effective April 1st, 2018). The methodology assigns different weights to deposits based on their maturity.

⁹⁵ *Moody's Investors Service's Outlook*, September 2019.

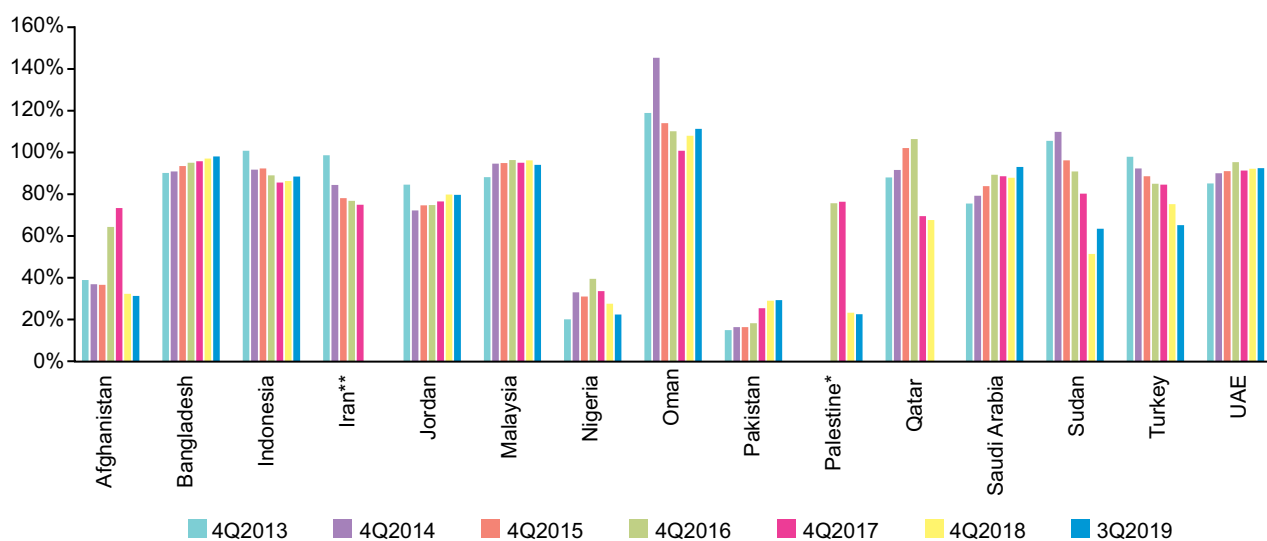
⁹⁶ Ibid.

⁹⁷ The SBP via BPRD circular no. 8 issued 23 June 2016 required banks to report BASEL III Liquidity Standards and to disclose same in their financial statements.

⁹⁸ State Bank of Pakistan – Islamic Banking Bulletin: September 2019.

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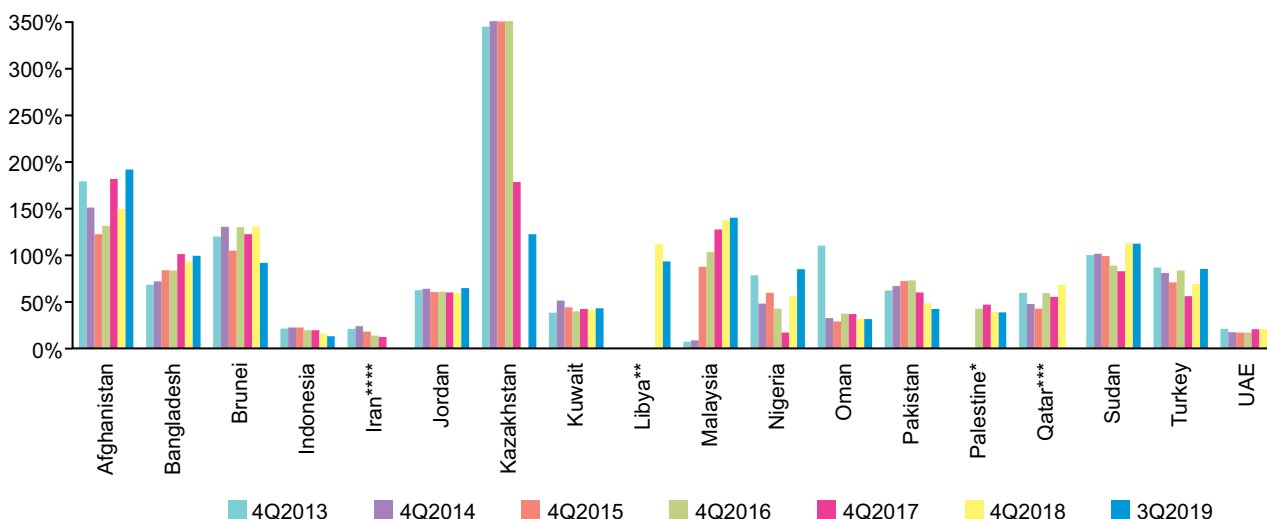
Chart 2.1.2.1 Islamic Banking Financing-to-Deposit Ratio (4Q13–3Q19)



* Data available from 4Q16.

**No data available from 2Q18.

Chart 2.1.2.2 Islamic Banking Liquid Assets to Short-term Liabilities by Country (4Q13–3Q19)



* Data available from 4Q16.

** Data available from 3Q18.

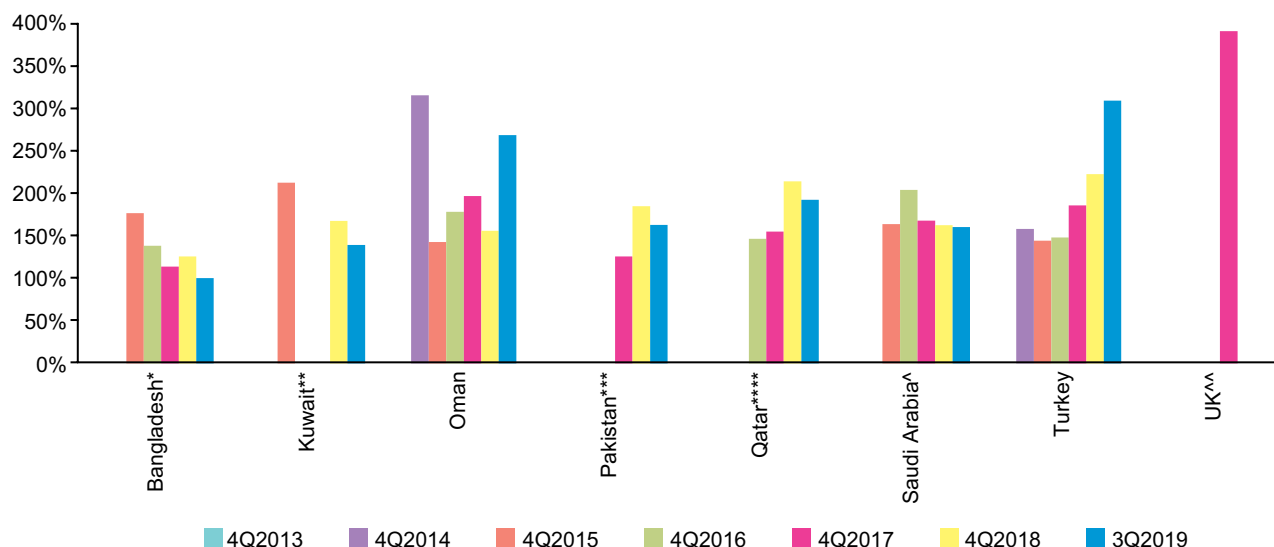
*** No data available from 2Q19 onward.

**** No data available from 2Q18 onward.

Source: PSIFIs IFSB Secretariat Workings

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Chart 2.1.2.3 Liquidity Coverage Ratio for Stand-alone Islamic Banks by Country (4Q13–3Q19)



* Data available from 2Q15.

** Data available from 1Q15 to 2Q16, and for 2Q18.

*** Data available from 1Q17.

**** Data available from 4Q16.

^ Data available from 1Q15.

^^ Data available from 4Q17.

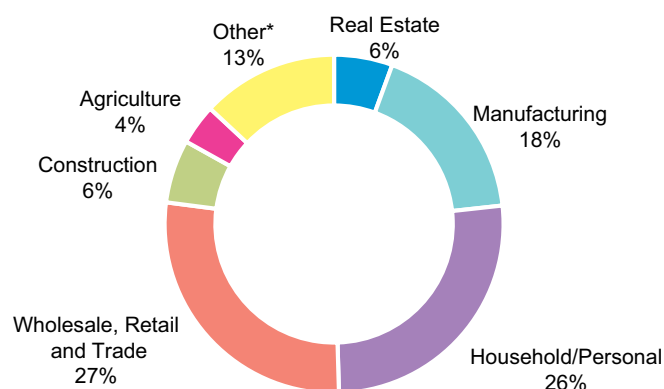
Source: PSIFIs

2.1.3 Financing Exposures

Globally, Islamic banks' and Islamic banking windows' financing activities remain largely concentrated in the wholesale and retail trade, and household sectors, followed by the manufacturing sector. This pattern was witnessed in the 2Q18 review period and continued into 3Q19.

Overall, wholesale and retail trade and household sectors received 27% and 26%, respectively, of the total financing from the Islamic banks and windows in the jurisdictions for which data were available as at 3Q19 (see Chart 2.1.3.1). This was followed by manufacturing at 18%, real estate at 6%, construction at 6% and agriculture at 4%.

The sectoral composition of financing varies greatly between countries and regions, and the weighted average may not reflect a balanced view of global economic sector exposures for Islamic banking. For instance, Malaysian Islamic banks' and windows' highest financing exposures were to the household sector, which received 60.9% of their total financing, up from 58% in 2Q18. Other countries where the household sector was the highest recipient of financing from Islamic banks and windows were Saudi Arabia (43.2%) with an upward move; and Oman (42.2%) and Brunei (32.8%), both of which saw a decrease (see Chart 2.1.3.2).

Chart 2.1.3.1 Weighted Average Concentration of Financing in Selected Economic Sectors (3Q19)⁹⁹

Source: PSIFIs, IFSB Secretariat Workings

* 'Other' represents other sectors such as education, healthcare, transportation and storage, public administration, etc. that Islamic banks advance financing to as per PSIFIs.

⁹⁹ Weighted average concentration of financing is based on data from Bangladesh, Brunei, Indonesia, Iran, Jordan, Malaysia, Oman, Saudi Arabia and the UK.

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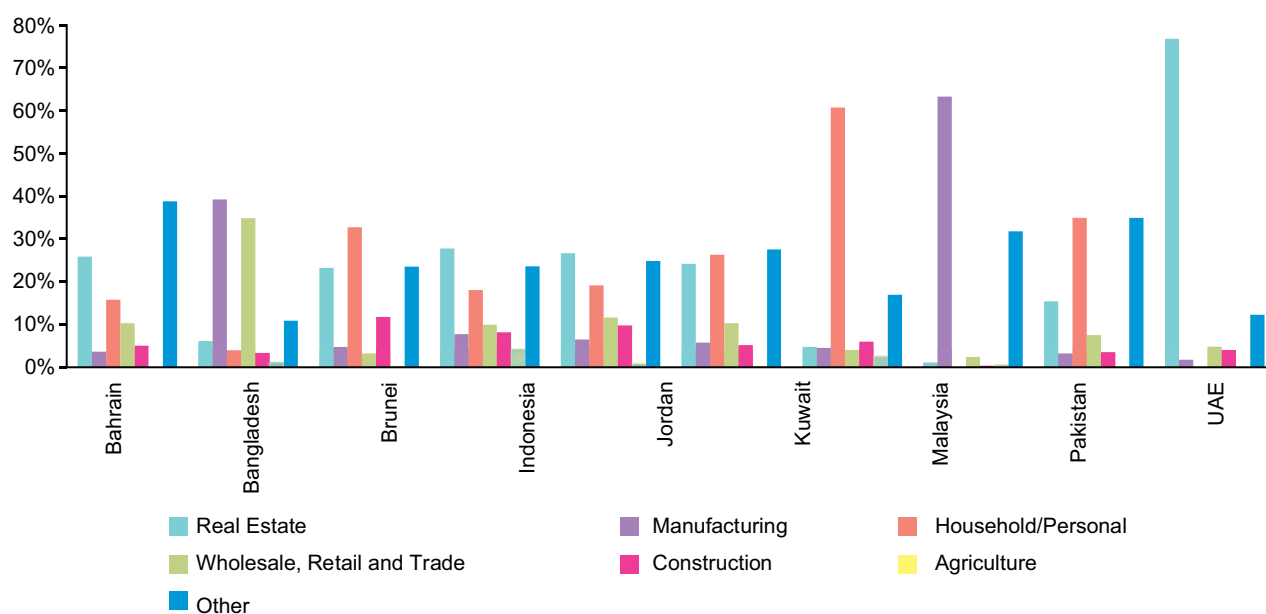
Real estate financing continues to receive the highest (26%) financing from the Islamic banks in Bahrain, although with a downward trajectory, followed by the household sector, which received total financing of 15.9% in 3Q19 as against 17.2% in 3Q18. A similar focus on real estate and construction was observed in Indonesia (27.8%), Jordan (26.8%) and Brunei (23.3%). The UAE banking sector's (Islamic and conventional) exposure to real estate has remained relatively stable and shown a similar trend since the financial year 2017 on account of the emirates' subdued economic activity. However, financing to the household sector continues to play a major role in the activities of the Islamic banks in the emirates, with shares of financing at 35.1% and 35.0%, respectively.

The banking sector in Kuwait has a key responsibility to support the country's ambitious infrastructure development plan and its "Vision 2035". With that in mind, banks should be seen as becoming a major player in financing mega-transactions across various economic sectors as part of the overall capital spending programme.

The report captures the increasing trend of financing to the manufacturing sector in a number of jurisdictions that made their Islamic bank data available. In Bangladesh, the manufacturing sector received 39.4% of the total financing, which is the highest in the jurisdiction, a modest increase from the 36.2% recorded in 2Q18, and the highest concentration to manufacturing among the sample countries. Similarly, financing to the manufacturing sector increased relatively in the Sultanate of Oman (9.3%), Jordan (6.6%) and Brunei (4.9%), compared to the previous review period (2Q18).

The construction sector has also received a significant boost in some jurisdictions. In Brunei, for instance, the construction sector's share of Islamic financing increased from 4.0% in 3Q18 to 11.8% in 3Q19. A number of other jurisdictions, such as Indonesia, Malaysia and Oman, all reported a higher allocation of financing to the construction sector.

Chart 2.1.3.2 Islamic Banking Sectoral Composition of Financing by Country (3Q19)¹⁰⁰



Source: PSIFIs.

¹⁰⁰ Data are reported in the IFSB's PSIFIs database as submitted by the regulatory and supervisory authority of each respective jurisdiction.

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2.1.4 Asset Quality

Despite subdued economic activity and financial sector turbulence, the global Islamic banking industry's asset quality has continued to improve during the analysis period. The available data between 4Q13 and 3Q19 showed consistent improvement in measures of asset quality of Islamic banks and windows, registering an average NPF ratio of 4.96% as at 3Q19, down from 5.1% a year earlier (see Chart 2.1.4.1). While the global Islamic banking NPF ratio is below the global average of the banking sector NPL ratio of 6.6% in 2018,¹⁰¹ it is much higher than the average recorded by conventional banks in the EU (2.5%)¹⁰² and the US (1.5%).¹⁰³ The persistent higher-than-normal NPF ratio recorded by the global Islamic banks could be attributable to the elevated currency, and to economic and geopolitical risks in some emerging markets that are home to a large proportion of Islamic banking activities worldwide. The highest NPF figure in the sample was reported by Islamic banks in Lebanon, which in the Q319 analysis period stood at 22.0% as against 12.5% in 2Q18. Kazakhstan, Kuwait, Indonesia, Pakistan and the UAE registered overall improvements in asset quality during the year to 3Q19 (see Chart 2.1.4.2).

Sudanese Islamic banks record a declining NPF ratio. Sudan Islamic banks continue to demonstrate their resilience, recording an NPF ratio of 3.9% in 3Q19, down from 4.7% in the previous review period. Islamic banks in Sudan continue to grapple with political and economic challenges in carrying out their intermediation roles. It was reported that the real GDP contracted in 2019 by an estimated 2.4% driven by a contraction in the services sector and investment in real estate and business services. In 2019, all macroeconomic variables have deteriorated due to political uncertainty, which discouraged private investment and dampened confidence and productivity in the manufacturing, construction and agricultural sectors.¹⁰⁴ It is expected that the Sudanese banking industry may perform better as a result of the relative stability in the political arena that is expected to accompany the new administration.

Islamic banks in Bahrain continued to record a high NPF ratio over the review period from 4Q13 to 3Q19. This current analysis period's NPF of 11.3%, though slightly lower, is not fundamentally different from the 11.7% that was recorded as at 2Q18. It was observed that the source of the NPF was relatively evenly distributed among many economic sectors, such as the wholesale and retail trade (2.45%), construction (1.9%), real estate (1.89%) and "other" sectors, accounting for 2.59%. Hinged on a likely drop in the prices of real estate due to an excess of supply over demand, the Islamic banks may be faced with a possible increase in NPF. However, the impact may be attenuated by the continued likelihood of stable funding from deposits from the public sector.

The NPF rates of Islamic banks in Oman remain low (see Chart 2.1.4.2). However, a consistent upward move has been observed in the NPF rates over the years from 4Q13 to 3Q19. This analysis period witnessed an increase from 0.67% in 3Q18 to 0.89% in 3Q19. For the Omani Islamic banks to remain strong and resilient, they will have to be mindful of the gradual build-up of non-performing financing especially due to declining real estate prices and the country's high household debt profile. Otherwise, it is likely that their capital and liquidity positions will be negatively affected by the deteriorating asset quality.

Low but increasing Islamic banking NPF rates in Saudi Arabia. A gradual and unabated increase can be observed over the review period, from 0.84% in 2Q17 and 0.95% in 2Q18 to 1.24% in 2Q19. This increase is primarily attributed to three sectors – namely, wholesale and retail trade, manufacturing, and construction – due to the continuous outflow of expats from the Kingdom exerting pressure on the property and automobile markets.¹⁰⁵ Although the Kingdom's Islamic banking institutions have strong capital and liquidity positions, there is a need to ensure that the increasing trend in the NPF is nipped in the bud.

UAE Islamic banks' NPF: declining, but higher than in other GCC countries. In consultation with the IMF, the Central Bank of the UAE enhanced its reporting of non-performing financing for the UAE banking system in order to align its methodology with international best practices. Under its previous reporting methodology, the UAE banking sector's NPF ratio was comparatively overstated. Its numbers, although on a declining trend, are higher than those of Saudi Arabia and Oman, settling at 4.8% in 3Q19, down from 5.1% a year earlier. Due to subdued economic activity and the slump in real estate prices, it was forecasted that the Emirati banks may suffer rising impairment in their assets in the coming year.¹⁰⁶

Asset quality numbers for Qatar's Islamic banks continue to be among the lowest in the sample. The numbers are similar to Saudi Arabia's and second only to Oman's, with an average NPF rate of 1.36% in 2Q19 as against the 1.23% recorded in 2Q18. This is an increase in the NPF assets of the Qatari Islamic banks.

The assets quality of the Kuwait Islamic banking sector has been impressive, with a steady decline in the NPF ratio from 4.01% in 3Q13 to a record-low level of 0% in 3Q19. This low level of the NPF ratio has been reported to be the result of the low financing exposure to the oil sector and a high concentration in housing financing, which has typically had one of the lowest NPF ratios among the major economic sectors.¹⁰⁷

¹⁰¹ *The Global Economy* – data as of 4Q18.

¹⁰² European Banking Authority, *Risk Dashboard* – data as of 3Q19.

¹⁰³ Federal Reserve Bank of St. Louis, *Federal Reserve Economic Data*.

¹⁰⁴ African Development Bank, *Sudan Economic Outlook*.

¹⁰⁵ S&P Global Banking Country-By-Country Outlook, 2020.

¹⁰⁶ Fitch rating of UAE banks, 2019.

¹⁰⁷ Central Bank of Kuwait, *Kuwait Banking Report*, 2019.

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Stable NPF figures in the Middle East region. Some countries in the Middle East region registered relatively stable NPF figures, including Jordan (3.28%) and Palestine (2.67%). In the case of the former, the NPF figures are comforting viewed against the fact that household income is low, and the country's economy is relatively small and highly vulnerable to regional political developments.¹⁰⁸ It is nonetheless expected that the economic situation would improve if there is de-escalation in the regional political situation, thus allowing Jordanian Islamic banks to leverage on the improved economic situation to improve assets quality.

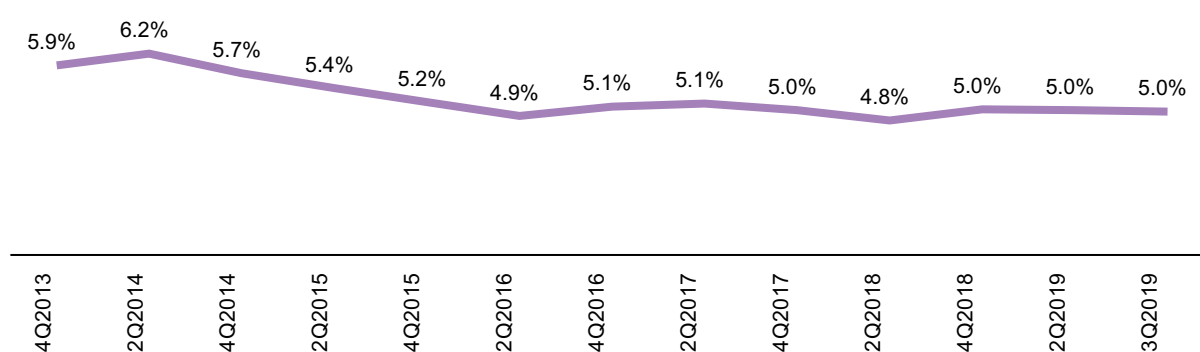
Declining financing exposures among Turkish participation banks. Significant improvement was recorded by the Turkish Islamic banks in 3Q19. Financing exposures have been eroded, as the NPF ratio has significantly increased – from 3.28% in 3Q18 to 4.9% in 3Q19. The deterioration in the quality of assets of the Islamic banks may be related to the financial difficulties faced by many corporate debtors and to the problems in the construction and energy sectors. The plummeting of the Lira could be due to the elections and other underlying economic challenges, while other geopolitical challenges may also have affected the quality of assets of the Islamic banks. These are issues that the Islamic banks will be grappling with in the coming year and the banks may have to take strong measures to deal with the situation to avoid escalation of the NPF ratio.

The Islamic banking sector in Pakistan witnessed a deterioration in the quality of financing exposures. Pakistan's NPF ratio increased to 3.1% in 3Q19 from 2.7% in 2Q18, the highest NPF ratio recorded throughout the

analysis period for the country's Islamic banking sector. Although the NPF has increased, but this is much lower than the NPL ratio for the conventional banking industry which was recorded at 8.8% during the same review period.¹⁰⁹ This asset quality indicator showed that the Islamic banks have financing exposure that performs better than the conventional banking exposures.

The NPF conditions in Bangladesh have worsened. The Bangladeshi Islamic banks' NPF ratio increased to 5.23% in 3Q19 from 5.04% in 3Q18. The primary source of the increase in non-performing financing came from the manufacturing and wholesale and retail trade sectors, which contributed more than 77% of the NPF ratio. It is forecasted that asset quality will further deteriorate due to poor corporate governance and weak laws and regulations, which hamper the recovery of non-performing financing. However, the negative outlook for the Islamic banking system is in stark contrast to the country's robust growth prospects, with real GDP set to grow 7.8% in the fiscal year ending June 2020. It was initially envisaged in the early period of the COVID-19 outbreak that there will be significant improvement in the NPFs of Bangladeshi Islamic banks as the country leverages on its growth prospects, which analysts expect to soar as the country grabs some fraction of the trade ceded by China. However, this expectation did not materialise as the COVID-19 pandemic spreads to Bangladesh. The consequential lockdown restrictions by the government, closure of factories especially those dealing in garments manufacturing¹¹⁰, and other prudential policy measures as directed by the Bangladesh Bank will have implication for the asset quality of banks in the country including those offering Islamic financial services.

Chart 2.1.4.1 Global Islamic Banking Average Gross Non-Performing Financing to Total Financing (4Q13–3Q19)¹¹¹



Source: PSIFIs, IFSB Secretariat Workings

¹⁰⁸ S&P Global Banking Country-By-Country Outlook, 2020.

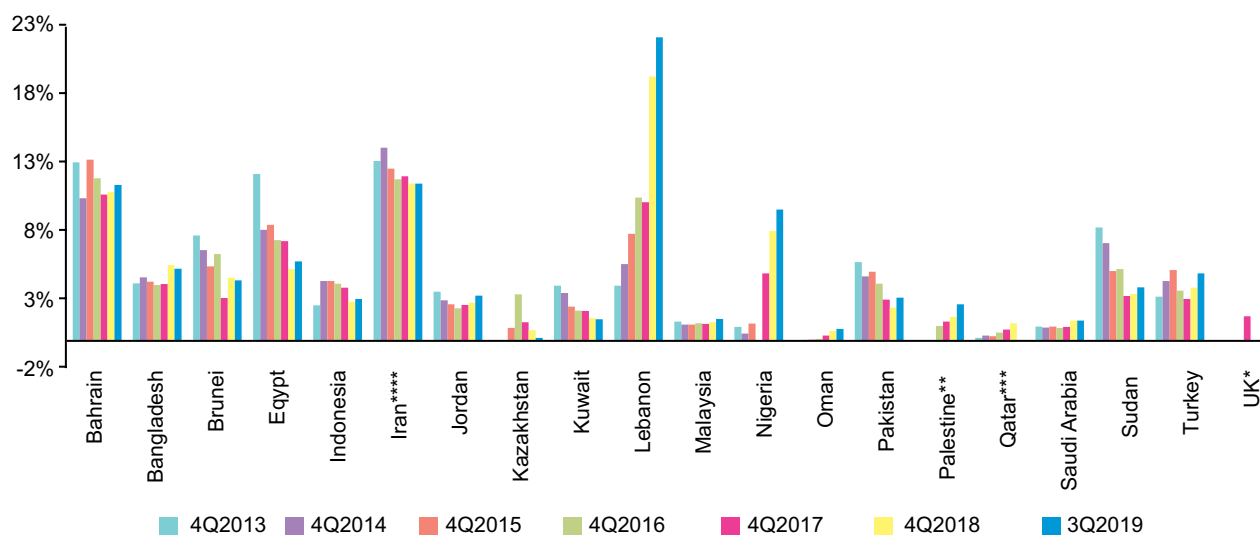
¹⁰⁹ State Bank of Pakistan – Islamic Banking Bulletin: September 2019.

¹¹⁰ This sector accounts for 80% of the country's exports. Due to the lockdown, the Forbes magazine quotes the President of the Bangladesh Garment Manufacturers Export Association (BGMEA) stating that 1,025 factories have had their export deals of 864.17 million pieces worth USD 2.81 billion cancelled. <https://www.forbes.com/sites/rebeccasuhrawardi/2020/03/30/collapse-of-bangladeshs-garment-industry-leaves-its-workers-more-vulnerable-than-ever-during-coronavirus/#1c246dabf27e>

¹¹¹ Average non-performing financing to total financing calculation is based on data from 21 jurisdictions contributing to the IFSB's PSIFIs database (excluding Afghanistan and Egypt, due to data limitations), with Palestine data included from 4Q16 and UK data from 4Q17.

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Chart 2.1.4.2 Islamic Banking Average Gross Non-Performing Financing to Total Financing by Country (4Q13–3Q19)



*Data available from 4Q17.

** Data available from 4Q16.

*** Includes the IFSB Secretariat's Workings until 4Q15.

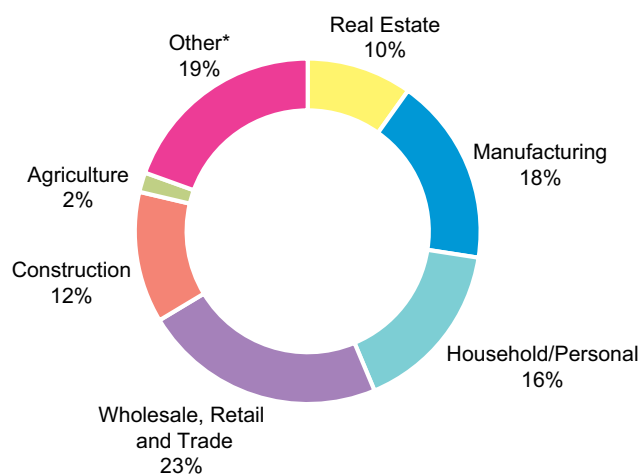
****Data not available since 3Q18

Source: PSIFIs, IFSB Secretariat Workings

Wholesale and retail trade, and manufacturing are the sectors with the highest NPF, accounting for 41% of total NPF as at 3Q19.¹¹² These sectors contributed to a combined 41% of total NPF as at 3Q19. They are followed by the household (16%), construction (12%) and real estate (12%) sectors respectively (see Chart 2.1.4.3). Individual country comparisons between financing figures and NPF further corroborates this picture. Household sector in all jurisdictions and in the sample period under review appears to have a lower share of NPF in comparison to their share of financing. On the other hand, the 'wholesale, retail and trade', and manufacturing sectors account for a larger proportion of NPF than financing in almost all jurisdictions in the sample, with particularly high NPF rates in Bahrain, Brunei, Jordan and Oman.

Data also show variations among jurisdictions in the quality of real estate and construction financing. For example, in Bangladesh, all sectoral NPF percentages appear to be relatively similar to their financing proportions. Jordan's Islamic banks have real estate and construction sectors' NPF contained within their share of financing, with both contributing lower NPF percentages than their respective financing proportions. Meanwhile, Bahrain's real estate and household sectors showed impressive performance as they received 42% of total financing, but contributed only 26% of total NPF in the country's Islamic banking sector. On the other hand, the wholesale and retail trade, and manufacturing sectors received 14% of total financing but contributed the highest NPF figure – 34% of the total NPF in the Kingdom's Islamic banking sector. Chart 2.1.4.4 highlights the NPF proportions for selected jurisdictions.

Chart 2.1.4.3 Global Islamic Banking Weighted Average Concentration of NPF in Selected Economic Sectors (3Q19)¹¹³



Source: PSIFIs, IFSB Secretariat Workings

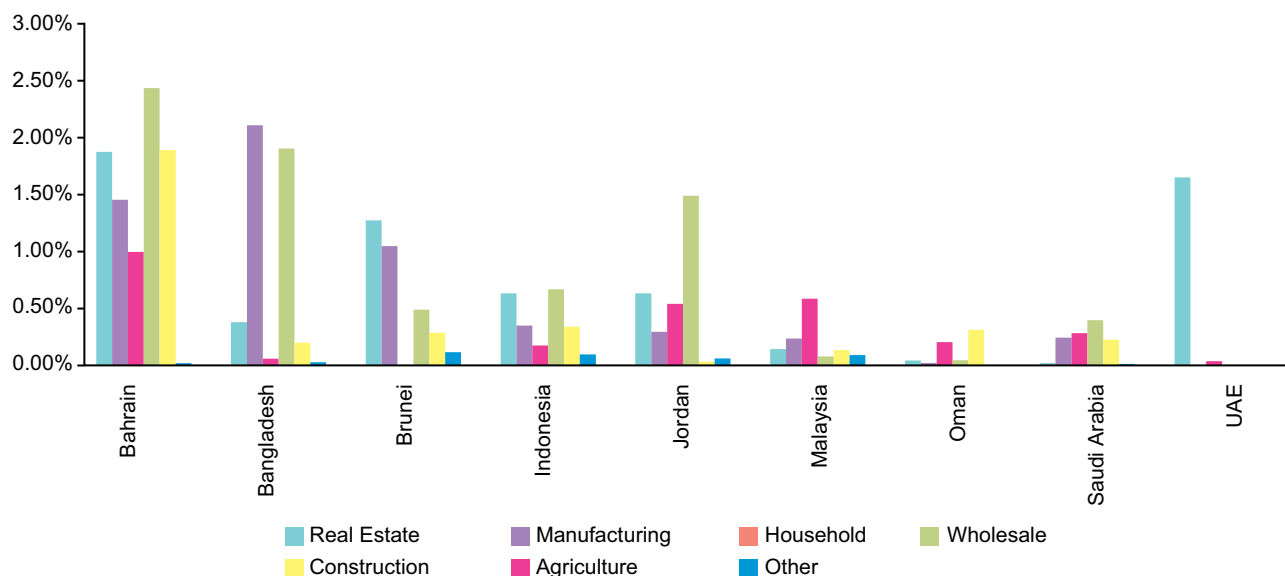
* 'Other' represents other sectors such as education, healthcare, transportation and storage, public administration, etc. that Islamic banks advance financing to as per PSIFIs.

¹¹² NPF ratio by sector = NPF amount in the sector / total NPF in the jurisdiction as at the end of the respective period.

¹¹³ Weighted average concentration of financing is based on data from Bangladesh, Brunei, Indonesia, Jordan, Malaysia, Oman, Saudi Arabia and the UK.

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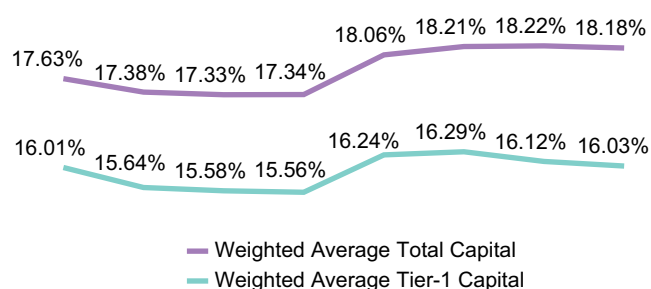
Chart 2.1.4.4 Islamic Banking Sectoral Composition of NPF by Country (3Q19)



Source: PSIFIs

2.1.5 Regulatory Capital

The capital adequacy ratios remain stable and relatively unchanged from the previous analysis period when Iranian banking data are excluded. The average total capital and Tier-1 capital adequacy ratios¹¹⁴ across the Islamic banking industry were in a strong position, at 18.2% and 16.0%¹¹⁵ respectively, as of 3Q19 (see Chart 2.1.5.1). The average capital adequacy ratio indicates that the global Islamic banks are well capitalized and are in good position. With the outbreak of the COVID-19 pandemic, it is likely that the CAR may decline below minimum thresholds in some jurisdictions. While in the short term, reduction in credit risk weights for financing to SMEs for instance as part of measures to ease the effect of the pandemic would allow Islamic banks to provide more financing without much infringement on CAR, the implication may be severe where there is no credible restoration plan especially if the pandemic prolongs causing NPFs to build and value of collateralized assets deteriorates.

Chart 2.1.5.1 Global Islamic Banking Average Capital Adequacy Ratios (4Q13–3Q19)¹¹⁶

Source: PSIFIs, IFSB Secretariat Workings

A country-by-country analysis of the capital adequacy ratio of the Islamic banks revealed jurisdictions could be categorised as follows: (i) countries that have recorded an increase in CAR of the banking sector; (ii) countries whose CAR remains relatively the same; and (iii) countries with declining CAR positions.

For the first category of countries, it was observed that the CAR increased due to the growth in regulatory capital. For instance, CAR increased due to higher profitability, which impacted on the Islamic banks' regulatory capital growing at a faster rate than the risk-weighted assets – as was the case in Pakistan and Sudan. In some rare instances, the y-o-y CAR increased due to the decline in the risk-weighted assets of the Islamic banks in the relevant jurisdictions – as was the case in Brunei and UAE.

In most jurisdictions where the CAR remained flat, it was observed that both the regulatory capital and risk-weighted assets either increased proportionally or remained relatively the same as in the previous review period. The third category includes countries with a declining CAR position. It was observed that, in some cases, the decline could be attributable to the efficient utilisation of capital as a result of which more risk assets were created. On the other hand, capital declined while the risk-weighted assets remained on the upward move. This is the case with Bahrain and Indonesia.

¹¹⁴ These ratios are calculated using the definitions prevailing for regulatory purposes in each jurisdiction. To the extent that these definitions change – for example, as a result of implementing new prudential regimes – this may lead to a change in the ratios and affect the year-on-year comparisons.

¹¹⁵ Excluding 3Q19 data for Iranian banks due to non-availability.

¹¹⁶ Average CARs calculation excludes Iran and is based on data from 20 jurisdictions contributing to the IFSB's PSIFIs database (excluding Afghanistan, Egypt, Kuwait, Lebanon and Pakistan, due to data limitations). Qatar and Palestine's data are available from 4Q16, and UK data are available for 4Q16 and 4Q17 onwards.

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Kazakhstan and Nigerian Islamic banks recorded the highest CARs of 33.26% and 24.0%, respectively, as at 3Q19. However, these high CARs do not show optimal fund utilisation. A plausible reason for this could be the nascent stage of Islamic banking in both countries. In addition, two other countries reported CARs of above 20% in their Islamic banking sectors – namely, Jordan (22.57%) and Indonesia (20.39%).

Omani Islamic banks were highly capitalised at inception, with an average CAR of 81.0% in 2013. They were able to utilise that capital to the point of reaching the 14.34% reported in 3Q19. The declining CAR may not be a cause for concern, considering the stable growth in both the financing and funding activities, coupled with a low NPF ratio. However, making the necessary arrangements for a credible capital plan to support the growing assets will be a very good business strategy.

...Despite the mergers and acquisitions that took place in the GCC, the overall regulatory capital of the Islamic banks remains at sufficient levels and, in some instances, there is an increase in their CAR except for Bahraini Islamic banks, which recorded a slight decline in their CAR position.

Saudi Arabian Islamic banks witnessed a slight decline in their CAR position from an average of 21.7% in Q318 to 20.2% in Q319 (see Chart 2.1.5.2). This is also slightly below the CAR position of 20.5% for the overall Saudi banking sector. The slight decline in the CAR could be attributed to financing activities having increased at a faster rate than regulatory capital as well as a slight increase in the NPF with a negative impact on the capital position. Notwithstanding, the Kingdom's Islamic banks are in a comfortable and sufficient capital position.

UAE Islamic banks remained well capitalised, and the average CAR has been on an upward trajectory since 4Q13. Kuwait and Qatar Islamic banks continue to maintain sufficient CAR in support of their ever-growing financing activities. Kuwait Islamic banks need to maintain robust capital to enable them to support the Kuwaiti government's "New Kuwait Vision 2035". Although Bahrain's Islamic banks maintained sufficient CAR, there is a decline in the capital position, with the CAR averaging 17.23% in 3Q19 as against a ratio of 19.35% reported in 3Q18. The analysis revealed a decline in the regulatory capital due to a decline in profitability because of rising non-performing financing, while risk-weighted assets continue an increasing trend.

The Sudanese banking sector witnessed an increase in their CAR after a long period of continuous decline, reaching its lowest ratio of 9.86% in 4Q18 before bouncing back to 15.39% in 3Q19. This increase ends a perennial decrease in the Islamic banks' CAR. So many macroeconomic factors must have badly affected the capital position of the banks, although a CAR above the regulatory requirements was maintained. It is expected that

the Sudanese banking system will build on the momentum because of Sudan's current relative political stability and the government's effort towards reconnecting with the global economy after long years of economic sanctions, especially by the United States.

...Islamic banking sectors in the South-East Asian region continue to record CARs above the regulatory minimum requirement.

The Malaysian Islamic banking sector has continued to report stable and consistent capital above the regulatory minimum. Recording an increase in financing activities, the regulatory capital of the Islamic banks is on an upward trajectory on the back of healthy and stable earnings, due to improvements in cost efficiency and lower financing loss provisions as banks continue to refine their credit risk estimations under MFRS 9 (the equivalent of IFRS 9).¹¹⁷ The resilience of Islamic banks' capital and profits continued to be underpinned by sound asset quality and supported by the sustained debt-servicing capacity of the household sector for which, at 60.9% of total financing, the Islamic banks have the highest exposures. The total capital adequacy and Tier-1 capital adequacy ratios for Malaysian Islamic banks stood at 16.71% and 13.27%, respectively, as at 3Q19. There was no difference reported in the total capital adequacy; however, the Tier-1 capital ratio of 13.27% in 3Q19 is an improvement on the 12.8% reported in 3Q18 (see Charts 2.1.5.2 and 2.1.5.3), respectively. Although the CAR and the Tier-1 capital ratio for Islamic banks are well above regulatory requirements, they are nonetheless lower than those for the country's overall banking system, which registered a total CAR of 17.4% and a Tier-1 capital ratio of 14.1%.

The Islamic banking sectors in Indonesia and Brunei continue to report CARs well above the regulatory minimum. In Indonesia, the Islamic banks' CAR stood at 20.39% in 3Q19, as against 21.25% in 3Q18. This indicates a slight decline in the CAR position as a result of the improvement in fund utilisation. Brunei, on the other hand, saw an appreciation of its CAR, moving from 17.26% in 3Q18 to 19.30% in 3Q19, based on the improvement in its earnings and decline in its NPF ratio.

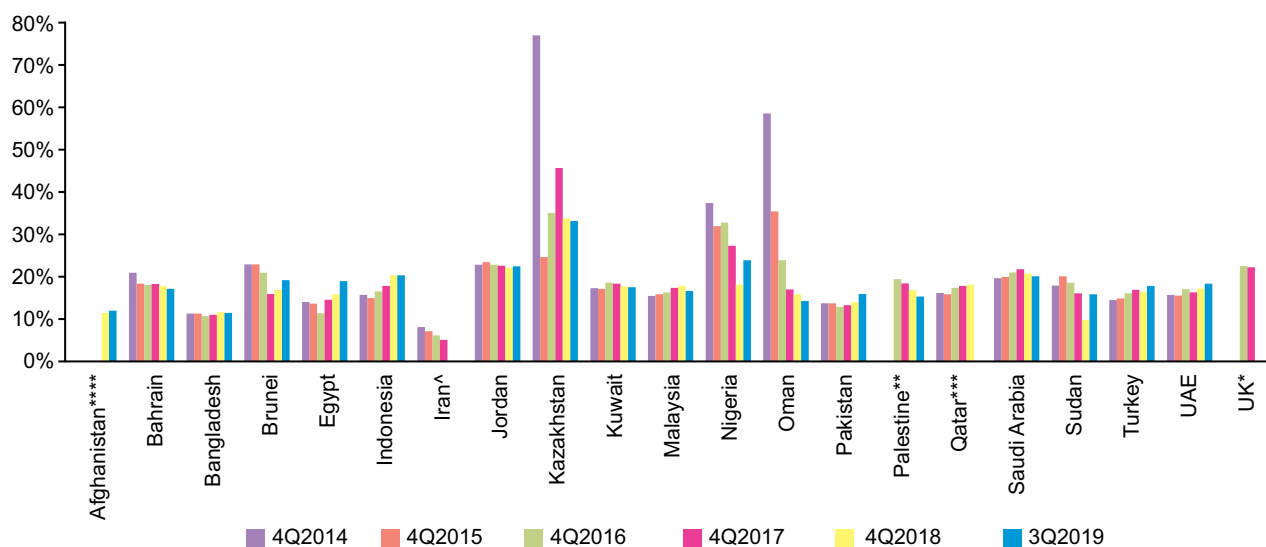
Bangladesh Islamic banks have stable total CAR ratios, but have been on a declining trend as regards Tier 1 capital. Given that Bangladesh Islamic banks are not famous for issuing *shukūk* for regulatory capital purposes, the increase in the total CAR could be attributed to general credit risk adjustments (see chart 2.1.5.2 and chart 2.1.5.3).

Turkish participation banks remain well capitalised and had their CARs on a general upward trend from 4Q13 to 3Q19, with only some slight fluctuation around the 2018 financial year. The CAR averaged 17.94% in 3Q19, as against 17.89% in Q318. The decline may be attributable to the deterioration in the Turkish Lira.

¹¹⁷ Bank Negara Malaysia, *Financial Stability Review – First Half 2019*.

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Chart 2.1.5.2 Islamic Banking Average Total Capital Adequacy Ratio by Country (4Q14–3Q19)



*Data available for 4Q16 and 4Q17 onwards.

** Data available from 4Q16.

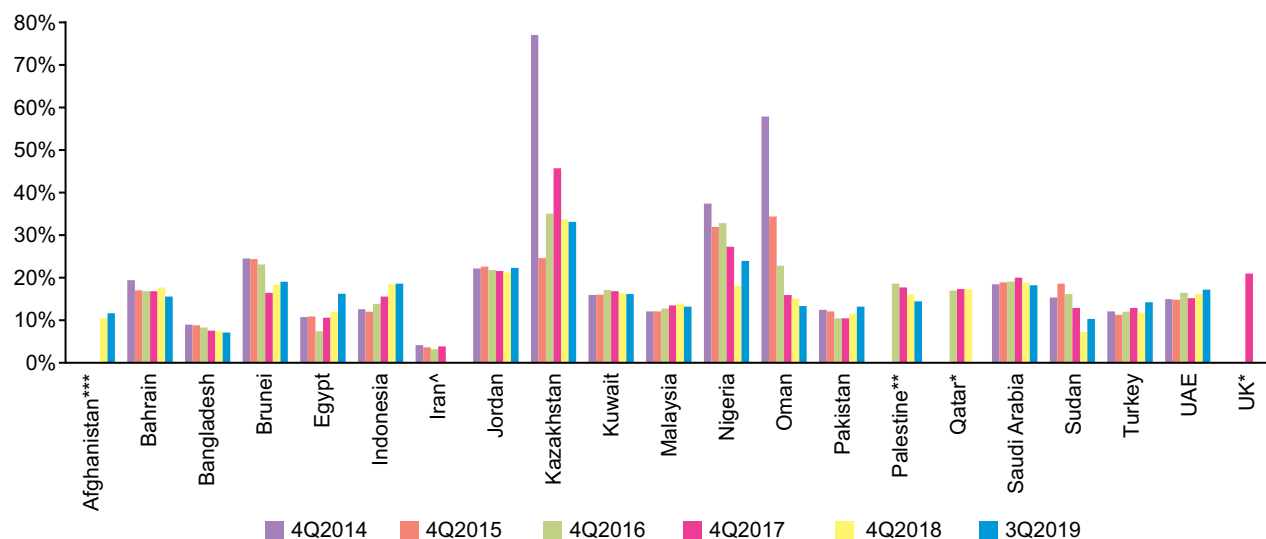
*** Includes IFSB Secretariat's workings until 4Q15.

**** Data available from 2Q18.

^Data not available from 3Q18

Source: PSIFIs, IFSB Secretariat Workings

Chart 2.1.5.3 Islamic Banking Average Tier-1 Capital Adequacy Ratio by Country (4Q14–3Q19)



*Data available for 3Q17 - 3Q18

** Data available from 4Q16.

*** Data available from 2Q18.

^Data not available from 3Q18

Source: PSIFIs, IFSB Secretariat Workings

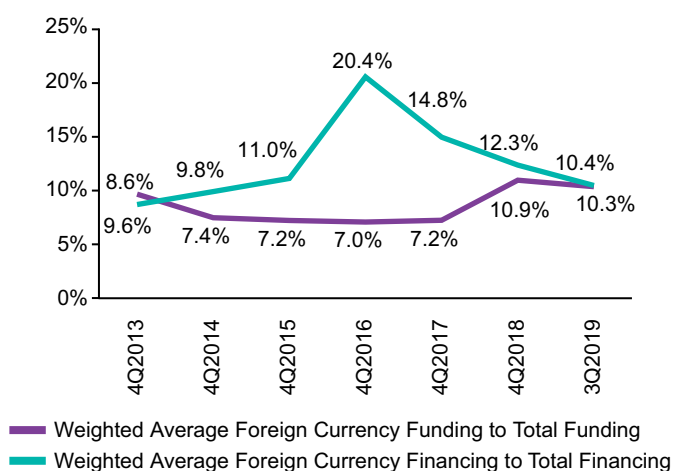
ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

2.1.6 Foreign Currency Funding Exposure

The proportion of foreign currency funding vis-à-vis the total funding of the global Islamic banks remained relatively unchanged between 4Q14 and 4Q17. Although the proportion subsequently increased to 10.9% as at 4Q18, the ratio showed a downward move in 3Q19 to reach 10.3%. The various jurisdictions that provided data on this particular liquidity indicator were evenly split between those that recorded an increase in foreign currency funding and those that recorded a contraction and reduced reliance on foreign currency funds. Lebanon, Kazakhstan and Afghanistan's Islamic banking sectors continue to lead with the highest foreign currency funding levels, at 83.87%, 82.55% and 63.23%, respectively.

Although Sudan continues to face political and economic challenges, which have badly affected the inflow of foreign currency, its banking sector witnessed an increase in foreign currency funding from 24.26% in 3Q18 to 29.39% in 3Q19. On the other hand, the banking sector's foreign currency financing declined significantly, from 12.98% to 7.63%. The increase in funding and a decline in financing has created a mismatch in the banking sector's portfolio, which can hurt the viability of the banks and expose them to severe vulnerabilities from unfavourable movements in exchange rates in the event of a major currency devaluation (see Chart 2.1.6.1).

Chart 2.1.6.1 Global Islamic Banking Average Foreign Currency Funding and Financing to Total Funding and Financing (4Q13–3Q19)



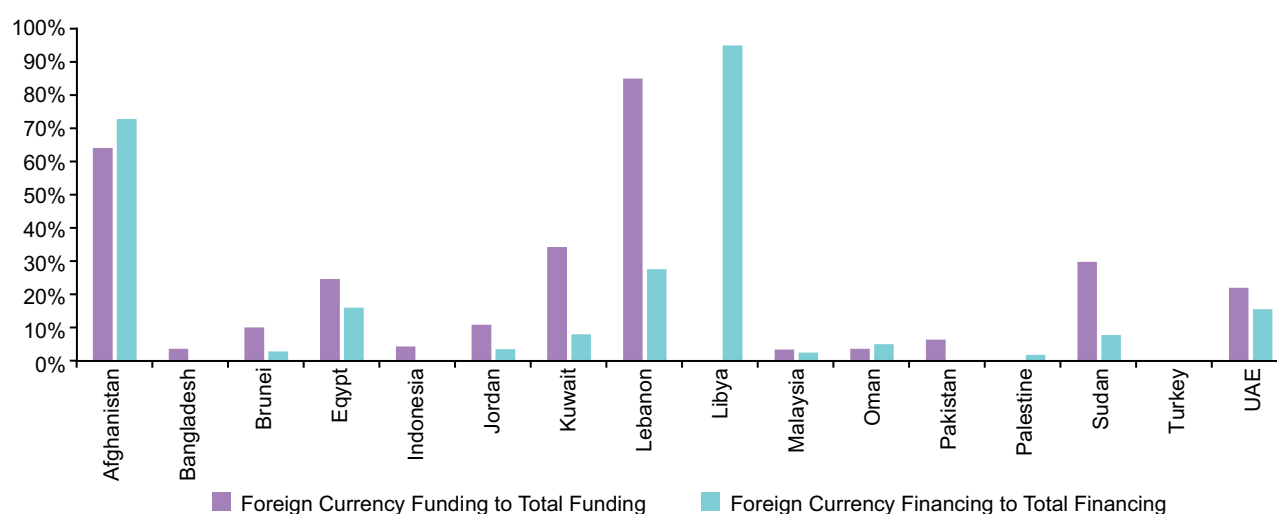
Source: PSIFIs, IFSB Secretariat Workings

The Islamic banking sector in Lebanon appears to continue to rely heavily on foreign currency funding, as the ratio increased from 80.8% to 83.9%. Similarly, foreign currency financing has also increased slightly, from 92.3% to 93.7%. In 2019, Lebanon witnessed escalation of its economic and financial challenges. US dollar liquidity was of serious concern, as the banking system had to ration the amount a customer could withdraw. These challenges do not appear likely to disappear anytime soon, and the Islamic banking sector needs to have robust risk management practices around the liquidity challenges experiences in the economy.

The monetary policy of the Central Bank of Egypt (CBE) is effectively controlling inflation rates and ensuring a free market policy in the country's exchange market. This policy intervention by the CBE has yielded positive results, as witnessed in the strengthening of the Egyptian Pound. In fiscal year 2019, the Pound appreciated to its highest value in over two and a half years and it is expected to continue its strong performance during 2020. However, the Islamic banking sector witnessed a decline in foreign currency funding, from 31.7% in 3Q18 to 24.3% as of 3Q19. In the same vein, the ratio of foreign currency financing to total financing declined to 20.1% as of 3Q19 as against the reported ratio of 24.8% in the previous year.

Other countries in the sample had their foreign currency exposures generally within their historical trends, with minor decreases in foreign currency funding and financing reported in, for instance, Indonesia and Oman, and minor increases in foreign currency funding and financing in the UAE and Pakistan. Malaysian Islamic banks' foreign currency funding increased marginally from 3.2% in 3Q18 to 3.3% in 3Q19, while the ratio of foreign currency financing to total financing dropped from 3.7% in 3Q18 to 2.4% in 3Q19. This could be attributed to the higher risk assets exposures denominated in the local currency. Fiscal year 2019 witnessed marginal appreciation of the MYR against the USD by 0.7% as a result of strong economic fundamentals coupled with the successful intervention of the Central Bank of Malaysia in the foreign exchange markets in order to avoid excessive volatility. Chart 2.1.6.2 highlights the proportions of foreign currency funding and financing against the total funding and financing reported by Islamic banks and windows in several jurisdictions.

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Chart 2.1.6.2 Islamic Banking Average Foreign Currency Funding to Total Funding and Average Foreign Currency Financing to Total Financing by Country (3Q19)

Source: PSIFIs

2.1.7 Leverage

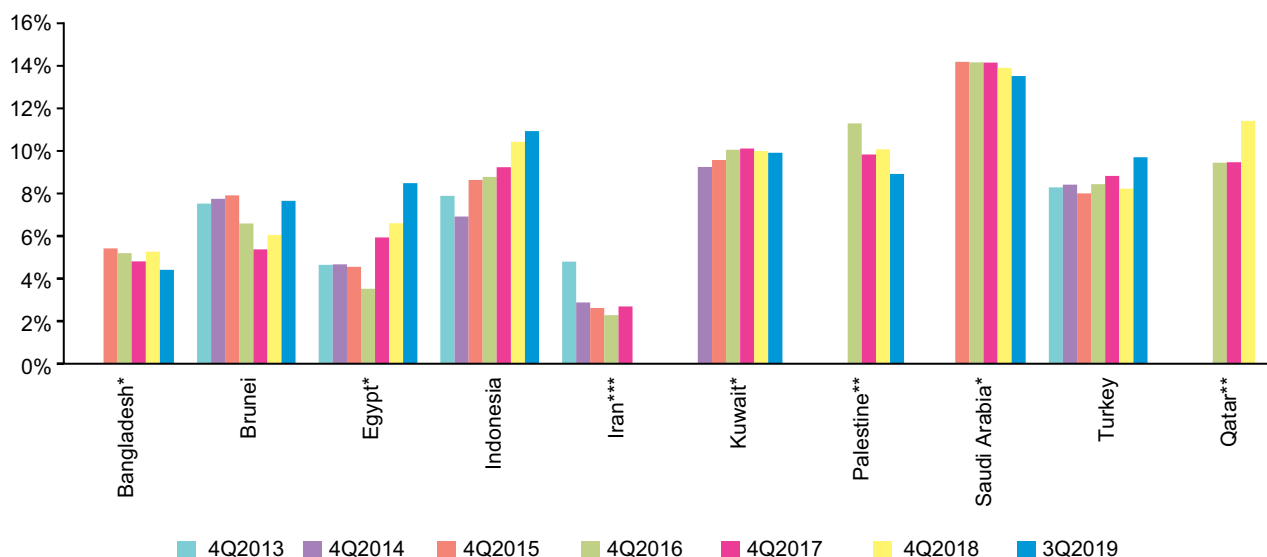
The leverage ratio¹¹⁸ is a measure that acts as a supplement to risk-based capital requirements in order to help restrict the build-up of leverage and prevent damage to the financial system, and economy, resulting from any occurring deleveraging process. As per the BCBS and IFSB standards, the leverage ratio is applicable at the level of 3%. The regulatory leverage ratio was reported by eight PSIFIs-contributing jurisdictions, all of which have exceeded the 3% requirement (see Chart 2.1.7.1). Generally speaking, Islamic banks are less prone to engaging in highly leveraged products, because Sharī'ah requires in principle that all financing be linked to transactions in the real economy – that is, production and trade transactions and activities. Similarly, there are restrictions on debt trading and engaging in products involving undue and excessive speculation (gharar). At the same time, risk-sharing means of raising funds are encouraged. The combination of these measures seriously limits the leverage effects in Islamic finance, although it does not completely eradicate this phenomenon.

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

¹¹⁸ Leverage ratio = Tier-1 capital / total exposure.

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Chart 2.1.7.1 Islamic Banking Leverage Ratio by Country (4Q13–3Q19)



* Bangladesh started reporting leverage ratio data from 2Q15, whereas Kuwait and Saudi Arabia began in 4Q14 and 1Q15, respectively.

** Data available from 4Q16.

*** Data not available from 3Q18.

Box 5 COVID-19 and Implication for Stability in the Islamic Banking Industry

If the various analyses based on prudential and structural Islamic finance data for years up to 2019 as contained in this IFSB IFSI Stability Report 2020 is considered in isolation, the IFSI seem very resilient and stable. This is based on satisfactory compliance of its financial indicators with most international regulatory requirements, especially when compared with its previous years' performance, conventional peers, and assessment criteria used by international standard-setting bodies.

The projected sense of optimism and outlook for the IFSI in 2020 and perhaps beyond may, however, need to be reconsidered due to the abrupt yet pervasive COVID-19 pandemic. While the impact and duration of the pandemic remains unclear, its implication for the IFSI depends on how the institutions offering Islamic financial services (IIFS) respond to various international and national policy initiatives to support economic activities and maintain financial stability. The combined effects of the pandemic as well as the other peculiar conditions of financial vulnerability in jurisdictions where Islamic banking is practiced are envisaged to put the resilience of the industry to test in 2020 and perhaps beyond.

Although varying in intensity across jurisdictions, Islamic banks' and Islamic banking windows' financing activities remain largely concentrated in the wholesale and retail trade and household sectors, followed by the manufacturing sector. This pattern continued from previous periods into 3Q19. Overall, the wholesale and retail trade and household sectors received 27% and 26%, respectively, of the total financing from the Islamic banks and windows in the jurisdictions for which data were available as at 3Q19. This was followed by manufacturing at 18%, real estate at 6%, construction at 6% and agriculture at 4%. This suggests that 87% of the financing exposure of the Islamic banks is to the real sector of the economy.

Analyses in this stability report indicate that based on previous year's data, the profitability of the global Islamic banking industry maintained its stable trend observed over the five years 3Q15–3Q19. The global Islamic banking also outperforms the conventional banks in the United States (US), European Union (EU), Malaysia and the GCC in terms of both return on assets (ROA) and return on equity (ROE). However, COVID-19 is expected to exert increased pressure on earnings of the Islamic banks due to sudden stop or restriction in economic activities in the real sector.

Furthermore, due to increased credit risk, there would be a decline in profitability of Islamic banks, which would be further aggravated in due course due to provisions and write-downs. In the short term, Islamic banks are likely to be susceptible to recognition lag on their level of vulnerability to credit losses due to accounting and legal processes, and immediate impact of other stimulus policy measures put in place by governments especially to SMEs and households to keep the economy running. Market losses will also likely increase due to mark-to-market losses on the Islamic banks' financial instruments suffering a price dip.

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The 2019 Global Islamic Survey 2019 by CIBAFI stated that liquidity risk remains a risk priority for Islamic banks in the coming years, particularly in South-East Asia and North Africa. The COVID-19 pandemic is expected to have significant effects on the liquidity position of Islamic banks. While some jurisdictions maintain large amounts of liquidity due to the lack of Shari'ah-compliant avenues for liquidity management, others face liquidity shortages due to macroeconomic pressures, runaway inflation rates and negative economic outlooks that lead to increased deposit withdrawals.

Following measures put in place to minimise the effect of the pandemic, delayed cash inflows due to moratorium as well as liquidity mismatches that may arise will put Islamic banks in a difficult liquidity position. As Islamic banks draw down on their liquidity buffers, and as corporate clients scramble to drawdown on their credit lines, the resilience of the Islamic banks' funding liquidity will be put to test in which case a persistent pandemic may lead to a liquidity crunch in some jurisdictions that are already facing liquidity shortages pre-COVID-19. Generally, a lack of Shari'ah-compliant avenues for liquidity management, tightened domestic and international liquidity conditions may exacerbate liquidity issues in the short run with possibility of morphing into a solvency risk subsequently.

Data from the IFSB PSIFIs indicate that Islamic banks' asset quality improved with an average NPF ratio of 4.96% as at 3Q19, which compares favourably with a global average NPF ratio of 6.6% but lower than those of their conventional peers in both the US and the EU at 2.5% and 1.5% respectively. The slight improvement recorded based on the NPF ratio is expected to be attenuated by the outbreak of COVID-19. This is sequel to the financing exposure of the Islamic banks to the real sector especially wholesale and trade, and household sectors.

SMEs whose economic activities were either stopped or restricted will struggle with maintaining operational resilience. Some may not make it back. Households that have either had to proceed on compulsory leave, pay cuts, job losses or constrained employment opportunities may also default. The implication would only crystallise when the moratorium period is over and governments gradually withdraws stimulus packages.

Furthermore, there will be issues arising from accounting treatment of the likely significant increase in credit risk (SICR) and amount of Expected Credit Loss (ECL) to be recognised especially given the peculiarities of Islamic banks (varying stages of contract, treatment of profit and loss sharing contracts) which the IFRS discountenances. The IFSB-15 also does not specify issues bothering on relaxation of transitional measures when it comes to aligning both prudential and accounting consideration on measures of capital adequacy. In this case, in jurisdictions that have commenced implementation of IFRS 9, taking full capital impact of ECL in the early years of such implementation will stress Islamic banks further in the present circumstance.

With an average total capital and Tier-1 capital adequacy ratios of 18.18% and 16.03% respectively, the capital adequacy ratio (CAR) of the global Islamic banking seems stable. Noting that one of the drawbacks of the CAR is that it fails to account for expected losses in a crisis situation like it is presently, the true impact of COVID-19 on the regulatory capital of the Islamic banking industry may not be captured. Nonetheless, it is expected that CAR will decline below minimum thresholds in some jurisdictions especially if the pandemic prolongs and regulatory buffers are exhausted.

While in the short term, reduction in credit risk weights would allow Islamic banks to provide more financing without much infringement on CAR, the implication may be severe where there is no credible restoration plan especially if the pandemic prolongs and NPFs build and value of collateralized assets deteriorates. Moreover, introduction of regulatory forbearance for instance, adopting a blanket suspension of provisioning requirements or a temporary breach of capital, solvency or liquidity requirements may further expose Islamic banks with very low buffer margins to significant risks. This will also affect Islamic banks' capacity to provide financing to the real economy as they are bugged down with poor quality assets and depleted buffers.

Islamic banks' exposure to foreign exchange risk remains minimal as the proportion of foreign currency funding in total funding remains unchanged. In this case, a very low impact of the pandemic on this exposure is expected.

At the moment, there has been a suite of swift policy responses from the various regulatory authorities, governments and international organisations. These include a combination of monetary, fiscal, and other policy measures aimed at promoting financial stability and supporting economic activities. Examples include allowing use of various capital and liquidity buffers, debt moratoria, restructuring or rescheduling financing facilities, tax holidays, credit guarantees especially to households, and SMEs, etc. to boost aggregate demand, preserve businesses, and create job opportunities. However, there may be concerns relating to such stimulus packages especially in terms of targeting if impossible to avoid leakages to unintended targets, timing in terms of duration so that while trying to avoid fiscal pressures arising from massive public spending growth rate of output is also not stymied by abrupt stopping of a stimulus.

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The IFSB takes note of the various regulatory and supervisory measures implemented in its various member jurisdictions to find a balance between ensuring financial stability and supporting economic activity especially due to the COVID-19 pandemic. While these policies are generally applied to both the Islamic banks and their conventional counterparts, there may be peculiar implications for the former. This may be in relation to specificities for example, the size and portfolio components of their balance sheet. These policy measures may have a limited effect if the pandemic persists and there is a prolonged cessation of or delay in production activities and capital projects completion, which may result in a contraction in the real economy¹¹⁹ to which the Islamic banks are highly exposed especially in those jurisdictions where Islamic banking sector has attained systemic significance.¹²⁰

The sudden outbreak and high speed of the spread of COVID-19 as well as the pressure on governments and regulators to respond could have necessitated in some instances that measures taken may be inconsistent with prudential recommendations, which may also generate new risks.¹²¹ Moreover, there may be hidden vulnerabilities due to the likely recognition and impact lags of the pandemic on the balance sheets of financial institutions. The consequence may be a further effect on the real economy in which case there would be either a constrained credit availability or a higher cost of capital to the real sector to avoid further losses.

Numerous standard-setting organisations including the IFSB have released policy papers and guidance notes on various issues including but not limited to treatment of prudential and accounting matters arising from the pandemic. The COVID-19 policy compendium developed and issued by the IFSB takes note that a range of regulatory and supervisory measures are being pursued in its various member jurisdictions to find a balance between ensuring financial stability and supporting economic activity. The IFSB also highlights the implication of the pandemic for its key segments of Islamic banking, Islamic capital markets, and *takāful* in its *IFSI Stability Report 2020* excerpts from which this box is mainly based.

Numerous publications and commentaries have focused on what Islamic banks are expected to do regarding issues arising from the outbreak of COVID-19. Mainly, these publications have focused on the need for the regulatory and supervisory authorities to provide clear directions on how the Islamic banks should address matters arising from COVID-19 related to the timing, transparency, targeting, and treatment of prudential regulatory interventions. In most instances, recommendations have been offered on the use of regulatory buffers, the need to preserve compliance with international standards, and promote international and inter-organisational coordination. A few have also looked at these issues with focus on the specificities of Islamic banking such as its balance sheet components, relatively smaller size in many jurisdictions, and the state of the economy of countries where Islamic banking is practiced.

A review of some of the published standards by the IFSB indicate that though they largely address the prudential matters arising from the GFC, they nonetheless contain detailed provisions to guide the regulators on the treatment of prudential matters peculiar to the IFSI due to COVID-19.¹²² For instance, IFSB-15: Revised Capital Adequacy Standard for Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (*Takāful*) and Islamic Collective Investment Schemes) in Section II already provides rich details on prudential matters relating to treatment of regulatory capital as well as treatment of liquidity facilities using sovereign *shukūk* for liquidity management purpose in the event of a financial situation as presented by the outbreak of COVID-19.¹²³ The Standard clearly spells out the utilisation and requisite treatment of prudential matters relating to components of capital, countercyclical buffer, capital conservation buffer, leverage ratio, operation of Islamic banking windows, and Domestic Systemically Important Banks (D-SIBs) in situations similar to the present.

Moreover, GN-6: Guidance Note on Quantitative Measure for Liquidity Risk Management in Institutions Offering Islamic Financial Services (Excluding Islamic Insurance (*Takāful*) and Islamic Collective Investment Schemes) provides guidance on how regulators may address liquidity concerns on implementation of the Net Stable Fund Ratio (NSFR) and Liquidity Coverage Ratio (LCR), inadequacy of Shari'ah compliant High Quality Liquid Assets (HQLA), and easing the features of eligible collaterals. GN-7: Guidance Note on Shari'ah-Compliant Lender of Last Resort Facilities also provides guidance on eligibility criteria access to such facilities as well as lowering collateral haircuts as IIFS assets deteriorates. It is expected that regulators would utilise the flexibility offered in these standards to address peculiarities of the specificities of Islamic banking in their respective jurisdictions.

The IFSB PSIFIs data for both 1Q20 and 2Q20 will be disseminated by the 3Q20 and by then the impact of the pandemic can be further assessed and the effectiveness of the various policy measures vis-à-vis their objectives can be gauged.

¹¹⁹ There has been significant disruption to production and sales activities as well as supply chains due to movement and travel restrictions, job losses, declined demand for goods and services, reduced commodity prices etc.

¹²⁰ Early emerging data indicate significant drop and volatility in equity and commodity prices, delayed issuance of *shukūk*. There is also increased risk of credit deterioration and tightening market liquidity due to uncertainties which may affect investors' confidence and sentiments.

¹²¹ IMF-World Bank Staff Position Note (2020).

¹²² Issues considered pertinent but not covered in the existing standards will be highlighted in the prudential matters for discussion in this note.

¹²³ The GN-4 Guidance Note on the Determination of Alpha in the Capital Adequacy Ratio for Institutions Offering Islamic Financial Services [Excluding Islamic Insurance (*Takāful*) and Islamic Collective Investment Schemes] also provides additional guidance in this regard.

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Summary

The global Islamic banking industry has sustained its resilience moving into 2019, with most of its financial indicators, as of 3Q19, observed to be in comfortable compliance with minimum international regulatory requirements. Generally, risks facing the Islamic banking industry are highly dependent on the underlying economic and regional dynamics across jurisdictions. While most sample jurisdictions appear to be in a stable economic and financial condition, a few others are faced with structural economic weaknesses that could affect the resilience and viability of their Islamic banks.

The majority of Islamic banking domiciles reported largely stable profitability, asset quality and liquidity indicators, and outperformed, in a few instances, their historical trends and the indicators for the conventional banking segment.

Volatilities observed were well-within historical norms, and the short-term outlook for the IFSI appears very promising. It is imperative to mention that the global economy is currently grappling with the deadly COVID-19 pandemic, which (according to forecasts) may pose the risk of a significant global economic setback especially because it was not effectively contained within 1Q20.

In addition, cyber-security threats continue to occupy important regulatory attention, especially the attendant increased systemic risks due to financial interlinkages and the high propensity towards digital banking and financing. While these issues are not peculiar to Islamic banking, they either in isolation or in composite affect a number of jurisdictions where Islamic finance is prominent.

2.2 ISLAMIC CAPITAL MARKET: ASSESSMENT OF RESILIENCE**The macro-financial environment presents financial stability challenges...**

Global economic growth slowed in 2019 to its lowest rate since the GFC. Economic expansion was projected to be subdued in the near term, but was expected to stabilise in the medium term. However, given the emergence of COVID-19 in 2020 and the uncertainty around its severity and the time required for its containment, it is expected that there will be a significant disruption to global economic activity and a further weakened growth outlook for 2020.

The downside risks for 2020 are prominent, including the risk of a prolonged and severe COVID-19 pandemic, higher-risk aversion affecting financing, oil price volatility, a reescalation in trade disputes, renewed geopolitical tensions in the Middle East, cyberattacks, and climate change risk, among others, the materialisation of which can affect the stability outlook for the ICM.

Good external financing conditions, including low global interest rates, supported flows to Islamic capital markets in 2019. However, the favourable financing conditions could also encourage a risky build-up of debt, increasing vulnerability in some markets. This may create concerns about rollover risks, debt sustainability and financial stability in the event of a sharp downturn in the global economy or episodes of financial stress.

The materialisation of downside risks could prompt financial market volatility and abrupt asset repricing, which can amplify existing vulnerabilities and affect financial stability in some economies. Islamic finance economies need to be cognisant of building vulnerabilities in their own markets, as well as of the impact that events in other vulnerable markets may have on their own financial markets.

Vulnerabilities in emerging market economies remain a concern. Emerging markets experienced substantial capital outflows as a result of the COVID-19 outbreak. Significantly, emerging markets have less room for policies to cushion the economic impact of the outbreak. The materialisation of any financial and real shocks associated with China's economic rebalancing process and/or its trade dispute with the US or severe instability in other vulnerable emerging markets, could also result in a broad-based risk aversion to all emerging markets, which may have significant implications for core ICM jurisdictions located in emerging market jurisdictions.

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2.2.1 *Shukūk*

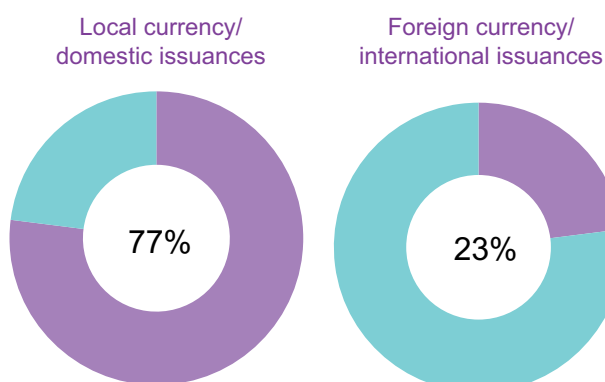
Financial stability in the ICM amid a surge in global liquidity...

Financing conditions were accommodative for *shukūk* issuance in most jurisdictions in 2019. The accommodative monetary policy stance in most countries during 2019 favoured growth of the *shukūk* market. In 2020, further monetary easing by central banks and lowering of short-term interest rates across both advanced and emerging economies to mitigate the economic impact of COVID-19 are likely to further boost global liquidity conditions. While good global liquidity conditions are important in supporting further expansion of the *shukūk* market, a surge in global liquidity and loose financing conditions can also have adverse consequences for financial stability if they induce elevated credit growth, excessive risk taking and misalignment of asset prices.

Global liquidity conditions have increased the capital flows to emerging markets with ICM activity. In particular, the accommodative monetary policy regimes in advanced economies have driven more capital into emerging market ICM assets, which is partially responsible for the robust growth and significant rise in positive returns in the ICM globally at the end of 2019. Elevated capital inflows, while supporting growth, may also have a number of negative consequences for financial stability in core ICM jurisdictions if strong inflows place further upward pressure on assets, particularly in countries where valuations are already high, leading to deviations of prices from fundamental values.

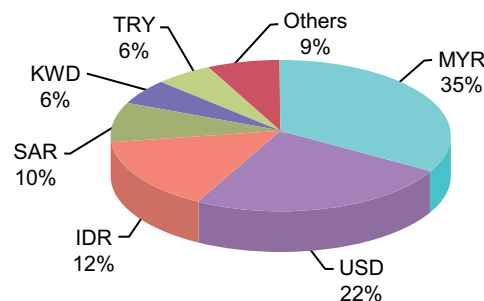
While local currency issuances have been a growing feature in certain markets, some jurisdictions have also found it favourable to issue foreign currency *shukūk* in international markets. Some countries have begun to increasingly diversify their funding base beyond domestic or regional markets. Qatar Islamic Bank, for example, issued the first Formosa *shukūk* from the GCC region in January 2020, which was listed in Taipei and Dublin, raising USD 800 million. Around 23% of global *shukūk* issuances in 2019 were foreign currency issuances. Given an environment of high appetite for emerging market securities, in combination with the low interest rates in advanced economies, the increased incentive for emerging market jurisdictions to issue *shukūk* in foreign currencies should also be balanced against the potential exposure of the jurisdiction to excessive foreign exchange risk.

Chart 2.2.1.1 *Shukūk* Issuance by Market (2019)



Source: Bloomberg, Thomson Reuters Eikon

Chart 2.2.1.2 *Shukūk* Issuance by Currency (2019)

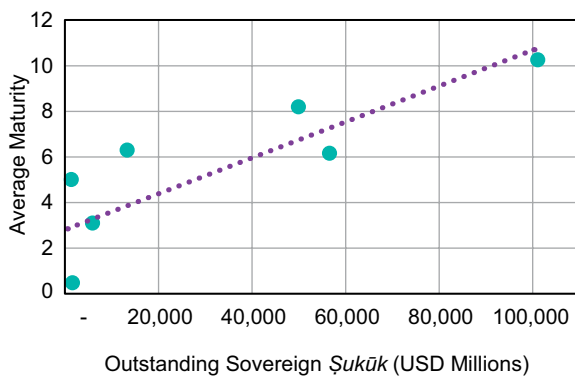


Source: Bloomberg, Thomson Reuters Eikon

Short-term *shukūk* issuances for liquidity management have increased, which can help close the gap in the availability of Shari'ah-compliant short-term instruments in many jurisdictions. The limited availability of Shari'ah-compliant short-term financial instruments for IIFS has been a key challenge in many jurisdictions in terms of enabling an efficient and robust liquidity management. The demand for Shari'ah-compliant short-term liquidity management instruments has continued to be high, both at the national and global levels. However, short-term *shukūk* issuances had been on a declining trend since 2015, which showed a notable reversal in 2019, with several countries issuing short-term *shukūk* of less than one year for liquidity management, in addition to USD-denominated short-term issuances by the International Islamic Liquidity Management Corporation. This is a positive trend towards enhancing the capacity of IIFS to manage liquidity shocks over time to promote financial stability.

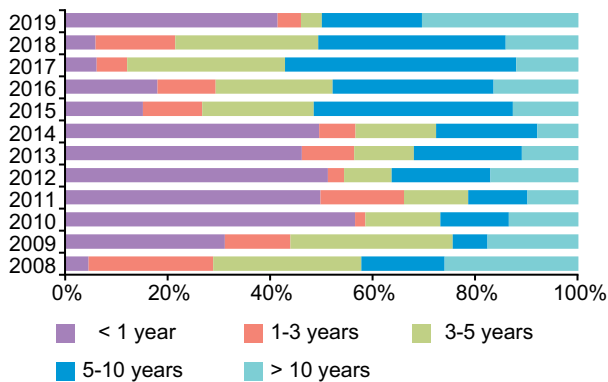
The shift towards *shukūk* with longer maturities may create pockets of vulnerability in countries with high debt levels. While there is considerable cross-country heterogeneity, in general, countries with higher outstanding sovereign *shukūk* have also, on average, issued *shukūk* with longer maturities than those with lower levels (see Chart 2.2.1.3). Given a gradual shift in net issuance activity towards the long end of the spectrum over time (see Chart 2.2.1.4), vulnerabilities may arise in countries that have higher debt levels and high refinancing needs if potential downside risks materialise that can trigger rollover risks. The lengthening maturities of sovereign *shukūk* outstanding means that over 60% will mature in the next five years and 80% in the next 10 years, increasing the refinancing needs over the medium term. The current favourable financing conditions continue to mitigate sovereign risks, but a further weakening of macroeconomic conditions could result in fiscal vulnerabilities resurfacing in some countries. The materialisation of such risks can also, in turn, create challenges for financial stability.

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Chart 2.2.1.3 Outstanding *Shukūk* vs. Average Maturities across Sovereign Issuers

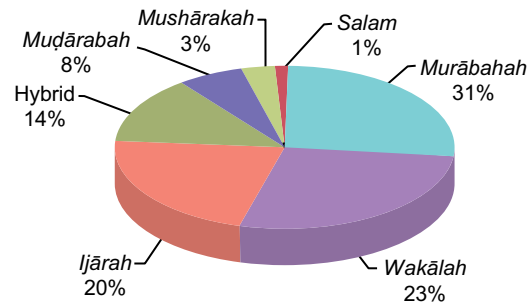
Source: Thomson Reuters Eikon, Bloomberg

Chart 2.2.1.4 Maturity Trend of All New Issuances (2008–19)



Source: Thomson Reuters Eikon, Bloomberg

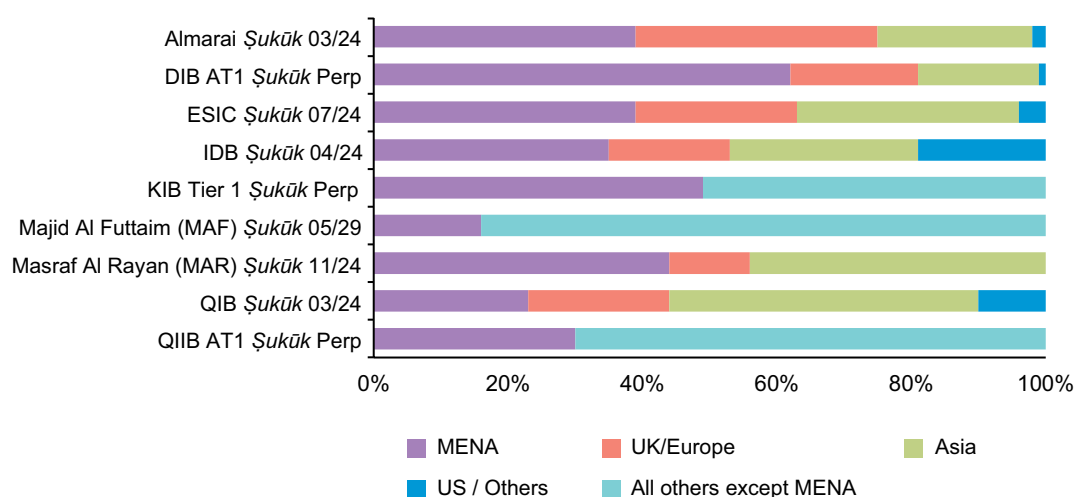
The diversity in the types of Sharī'ah-compliant contracts used for *shukūk* issuance has also increased. Historically, *shukūk* issuances have been largely concentrated on *murābahah*-based contracts followed by *ijārah*-based contracts. However, in addition to these two contract types, there has been a gradual shift towards increasing utilisation of *wakālah*-based contracts as well as hybrid contracts. Nonetheless, the majority of *shukūk* issuances continue to be based on debt or lease-type contracts, suggesting that the market still favours contract types that are considered to have stable return profiles. Profit-sharing contracts, whose returns are anchored to real sector returns, still remain a relatively small proportion of the total volume of issuances. However, a positive shift towards increasing utilisation of profit-sharing contracts was observed among new issuances in 2019 compared to preceding years, with a conspicuous jump in *shukūk* that are based on *muḍārabah* contracts.

Chart 2.2.1.5 *Shukūk* Issuance by Structure (2019)

Source: Thomson Reuters Eikon, Bloomberg

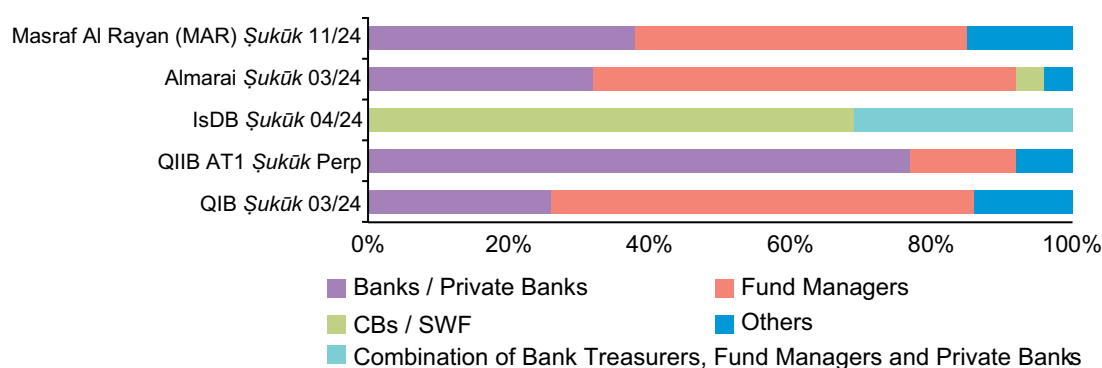
The geographical distribution of *shukūk* investors suggests that there is less of a regional bias in *shukūk* uptake, with new *shukūk* issuances receiving broad-based international interest. *Shukūk* issuances from the GCC, for example, do not have a majority base of regional investors and have been generally taken up by a wider group of investors internationally (see Chart 2.2.1.6). This represents a shift from historical trends, where tranche allocations typically have a regional bias in terms of the proportion of investor take-up of *shukūk*. The increased uptake of *shukūk* by international investors reflects not only the prevailing supply/demand imbalance of *shukūk*, but also the low interest rate environment, which has resulted in a renewed risk appetite and more capital flows to GCC and South-East Asian financial assets. However, while the GCC and the overall MENA region have seen increasing capital flows in response to more favourable global risk sentiment and accommodative financing conditions, the region may also be more vulnerable to a shift in global risk sentiment, particularly for jurisdictions that have high fiscal deficits or high debt burdens. The region is more sensitive to changes in global risk sentiment and to the possibility of capital flight during high-risk periods due to the perceived overall risk of the region in terms of geopolitical uncertainties and reliance on volatile oil prices. To address the heightened risk of volatile flows of capital, it is important for jurisdictions in the region to strengthen financial supervision and regulation and to build resilience to large capital flow volatility.

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Chart 2.2.1.6 Geographical Distribution of Selected *Shukūk* Papers Issued in 2019

Source: Various Sources

Investor breakdown for new *shukūk* issuances reveals a high demand for *shukūk* by fund managers and a strong appetite by Islamic banks for Tier-1 *shukūk*. The investor demand for *shukūk* has been driven by investment, as well as by Basel III-compliant capital adequacy and liquidity management requirements and the growing demand from fund managers due to an increasing number of dedicated *shukūk* funds and sub-funds. Additionally, the inclusion of rated *shukūk* from five GCC countries in the JP Morgan Emerging Markets Bond Index from 2019 onwards is likely to result in increased subscriptions to *shukūk*. There was a high demand by Islamic banks for Tier-1 *shukūk* issued by a number of GCC Islamic banks that took advantage of the low interest rate environment in 2019, which could be a potential channel for contagion in a financial crisis. There was also a high demand by central banks for the AAA-rated *shukūk* issued by the multilateral IsDB.

Chart 2.2.1.7 Investors' Breakdown of Selected *Shukūk* Papers Issued in 2019

Source: Various Sources

***Shukūk* oversubscription rates indicate exceptionally high demand for *shukūk* and a strong risk appetite.** Rates of oversubscription in 2019 were substantial, reflecting a strong appetite for a diverse range of *shukūk*, including Tier-1 *shukūk* and green *shukūk*, as well as generally for both corporate and sovereign issuances of varying maturities and credit quality (see Table 2.2.1.1). The high subscription rates for *shukūk* across a range of credit ratings reflect the generally higher investor risk appetite in 2019 as a result of central bank policy shifts, as well as easing of some of the fears regarding geopolitical risks towards the end of the year.

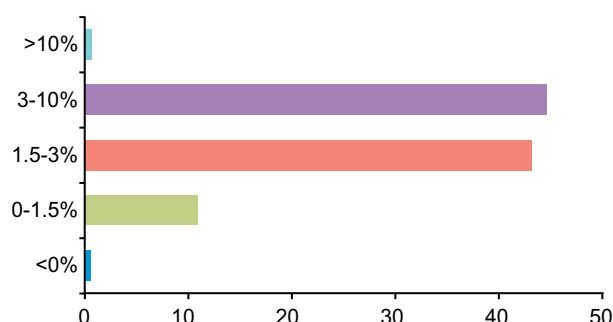
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Table 2.2.1.1 Demand Comparison for Selected *Shukūk* Issued in 2019

<i>Shukūk</i> Name	Issue Size (USD million)	Issuer Type	Tenure (Years)	Rating	Oversubscription (Times)
KIB Tier 1 <i>Shukūk</i> Perp	300	Corporate	Perp	A+ (Fitch)	15
Almarai <i>Shukūk</i> 03/24	500	Corporate	5	Baa3 (Moody's)	11
Edra Solar	59.5	Corporate	18	AA2 (RAM)	11
Sharjah Islamic Bank Tier 1 <i>Shukūk</i> Perp	500	Corporate	Perp	BBB+ (Fitch)	10
QIIB Tier 1 <i>Shukūk</i> Perp	300	Corporate	Perp	A (Fitch)	9
Warba Bank 09/24	500	Corporate	5	Baa2 (Moody's)	6.32
ESIC <i>Shukūk</i> 07/24	600	Corporate	5	Baa3 (Moody's)	6.2
Aldar <i>Shukūk</i> 10/29	500	Corporate	10	Baa1 (Moody's)	6
Majid Al Futtaim (MAF) <i>Shukūk</i> 05/29	600	Corporate	10	BBB (Fitch)	6
Saudi Government <i>Shukūk</i> 10/29	2500	Sovereign	10	A+ (Fitch)	5
DIB Tier 1 <i>Shukūk</i> Perp	750	Corporate	Perp	A3 (Moody's)	4.9
QIB <i>Shukūk</i> 03/24	750	Corporate	5	A1 (Moody's)	4.1
Prasarana Malaysia <i>Shukūk</i> 08/34	202.7	Corporate	10	AAA (RAM)	4
Arabian Centres Company (ACC) <i>Shukūk</i> 11/24	500	Corporate	5	BB+ (Fitch)	4
Indonesia Green Sovereign <i>Shukūk</i> 08/24	750	Sovereign	5.5	Baa2 (Moody's)	3.8
Saudi Telecom Co (STC) <i>Shukūk</i> 05/29	1250	Corporate	10	A1 (Moody's)	3.5
CBB <i>Shukūk</i> 12/19	69	Sovereign	0.5	BB- (Fitch)	3
Masraf Al Rayan (MAR) <i>Shukūk</i> 11/24	500	Corporate	5	A1 (Moody's)	3

Source: Various Sources

An increase in high-yield, non-investment-grade *shukūk* issuances by non-financial sector corporates as a result of favourable financing conditions can present the likelihood of increased credit risk. While the increasing participation of corporates in the *shukūk* market is a positive development for the sector, if there is a tendency among non-financial corporates to increase leverage and secure low financing costs, this may lead to an increase in the likelihood of *shukūk* defaults, particularly in the event of a downturn in the economic cycle or an increase in rates. While demand for high-yield *shukūk* increased in the short term due to a search for yield in a low-rate environment, the emergence of a greater number of speculative-grade issuers can lead to elevated financial stability risks. Among the outstanding *shukūk* globally, a sizeable volume of *shukūk* are within higher-yield buckets (see Chart 2.2.1.8).

Chart 2.2.1.8 Outstanding Volume of *Shukūk* by Yield Bucket (2009–19, percentages)

Source: IFSB Estimates, Thompson Reuters Eikon

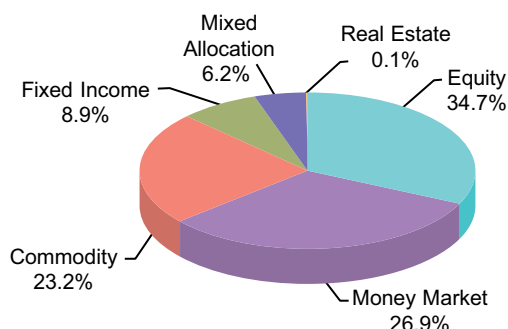
2.2.2 Islamic Funds

The relative importance of Islamic funds has grown as their number and the value of assets under management have continued to increase. Islamic funds typically have fewer vulnerabilities due to the requirement to comply with Shari'ah principles. This means that riskier types of funds such as hedge funds or stable net asset value money market funds are not a feature of the ICM owing to the Shari'ah restrictions related to them. However, financial stability risks can still arise in the Islamic funds segment, even in the absence of leverage or guaranteed returns.

Islamic funds are currently primarily concentrated across equity, money market and commodity asset classes.¹²⁴ At the individual country level, however, particularly in core markets, there has been a shift towards greater diversification across the different asset classes. The overall share of total AuM in commodity and money market-focused Islamic funds saw an increase in 2019, while the share of funds with an equity focus contracted slightly. This shift may be due to the higher volatility in equity markets as a result of continuing global uncertainty, which also led to an increase in flows to the relative safety of money market-focused funds by risk-averse retail investors, particularly after the sharp sell-off in the stock market at the end of 2018.

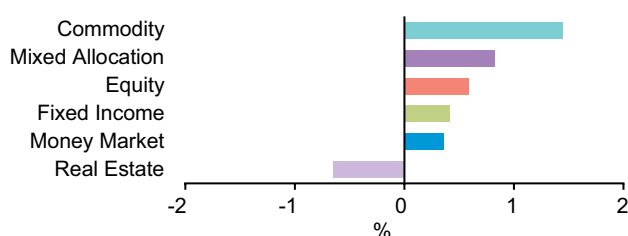
¹²⁴ Noting the limitation in data availability, as the databases used may not capture all funds.

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Chart 2.2.2.1 Islamic Fund Assets by Asset Class (2019)

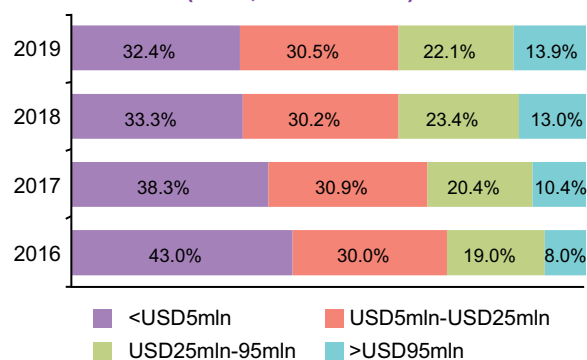
Source: Bloomberg

Returns of Islamic funds were positive across most asset classes in 2019. Commodities-focused funds, which currently account for around 23% of global Islamic funds, were the top performers in 2019. The performance of commodity-focused funds was supported by a recovery in petroleum prices and a rally in gold and palladium. Mixed allocation funds, which provide diversification across asset classes, provided the second-highest average returns in 2019. Real estate-focused funds had the worst performance in 2019 based on the sample of funds studied. From a stability perspective, the investment focus of funds carries some significance in gauging risks to financial stability. In particular, fixed-income funds are considered to create larger contagion risks than, for example, equity investments. Specifically, funds that are subject to liquidity mismatches, including high-yield and emerging markets fixed-income funds that provide daily redemptions but are invested in less liquid assets, experience greater volatility in flows than other fund styles and should be monitored carefully. Nonetheless, fixed-income funds currently make up only a small proportion of total Islamic funds' AuM. Given that a larger share of Islamic funds are equity funds, it is important to consider that liquidity mismatches can also arise when equity funds take positions in relatively illiquid equities. Any withdrawals can trigger a liquidity squeeze in which the most liquid investments are sold first, leaving the fund even more illiquid. Monitoring and managing liquidity risk of Islamic funds becomes particularly important during periods of stress, when there is a large amount of redemptions. High-yield and emerging market funds, for example, experienced large outflows during the GFC as well as during the taper tantrum in mid-2013.

Chart 2.2.2.2 Returns on Islamic Funds by Asset Type (2019) (LCL basis)

Source: Bloomberg

There has been a steady and gradual increase in the size of Islamic funds over time (see Chart 2.2.2.3). This can improve some of the current challenges faced by Islamic funds due to limited scale. However, Islamic funds remain considerably smaller in scale compared to conventional funds and are unlikely to pose any systemic risks. While Islamic funds do not raise major financial stability concerns in the current environment, one concern is that a prolonged period of low interest rates can result in a search for yield that lead fund managers to invest in assets that are less liquid. Effective liquidity risk management by funds is increasingly important in the presence of several downside risks, in order to avoid financial stress on Islamic funds in the event of a sudden liquidity shortage and volatility spike.

Chart 2.2.2.3 Number of Islamic Funds by Asset Size (2019; USD million)

Source: Bloomberg

2.2.3 Islamic Equities

The global equity markets rebounded in 2019, as market sentiment improved significantly towards the end of the year. Synchronised monetary policy easing by central banks across both advanced and emerging economies helped to contain the downside risks to global outlook and contributed to an easing of financial conditions globally.

Supported by favourable global conditions, Islamic equity markets in general had strong gains in 2019, although there were regional differences in performance and market volatility. Emerging market and Asia-Pacific Islamic indices had positive double-digit gains at the end of 2019. However, both experienced volatile performance in recent years (see Charts 2.2.3.2 and 2.2.3.3). Factors that have contributed to volatility in these two markets include changes in monetary policy, increased policy uncertainty and deteriorating conditions for international trade. However, in 2019, equity flows mostly suffered transient volatility, primarily due to trade tensions, which improved towards the close of the year. Nonetheless, further escalation of trade tensions still remains a major risk factor for emerging markets and the Asia-Pacific region in 2020. The performance of GCC indices was more subdued at the end of 2019 and experienced volatility due to investor sentiment being affected by escalation of geopolitical tensions. It may also be reflective of the sluggish performance of the energy sector, which was the worst-performing sector in the S&P 1200 in 2019 (see section 1.3 of this report).

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Returns of Equity Indices across Countries and Regions

Chart 2.2.3.1

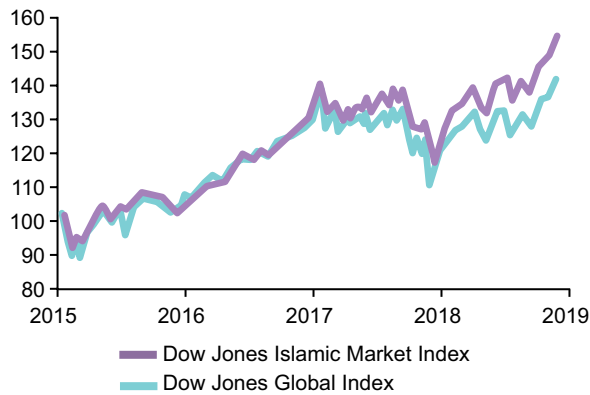


Chart 2.2.3.2

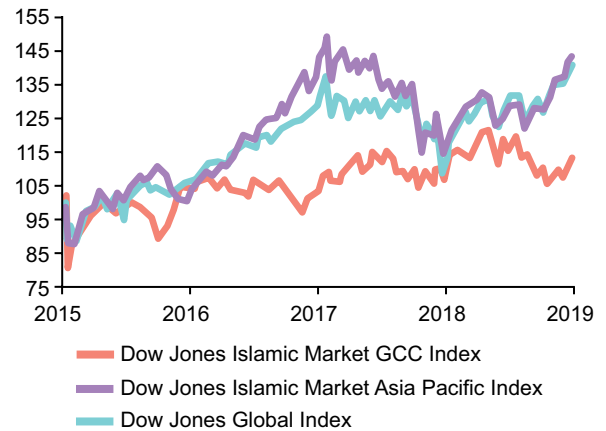


Chart 2.2.3.3

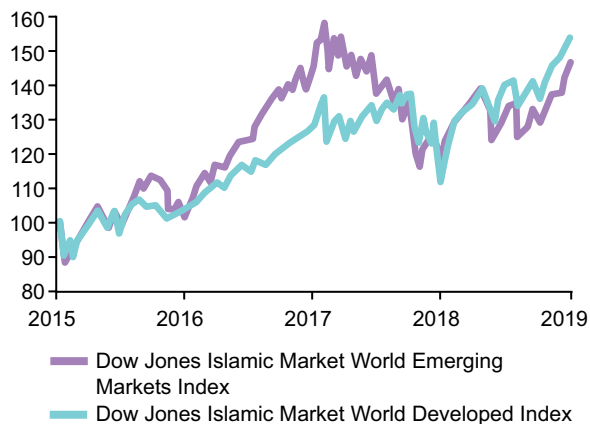


Chart 2.2.3.4

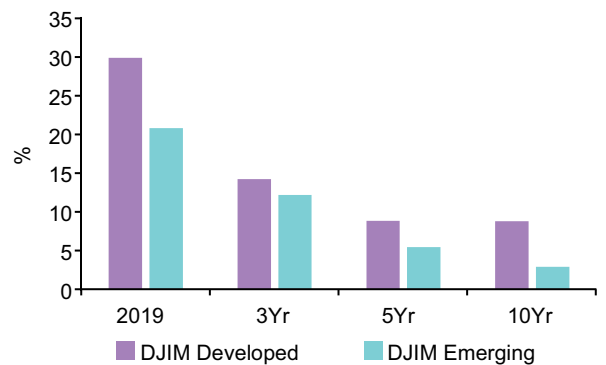
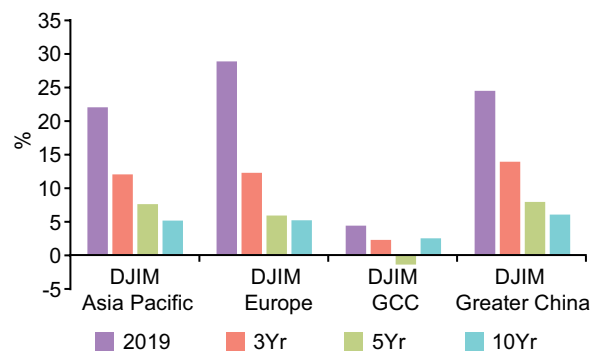


Chart 2.2.3.5



Source: Bloomberg

The performance of Islamic equities in core Islamic finance markets is likely to be weaker as a result of the COVID-19 outbreak and further weakening of the global growth outlook. The impact of the COVID-19 outbreak on global financial markets is likely to also be reflected in the Islamic equity markets through increased market volatility in 2020. The oil price war and fears of recession resulted in a turbulent first quarter for global equity markets in 2020, with the likelihood of recovery of markets depending on the length and severity of the outbreak and the resulting impact on global economies.

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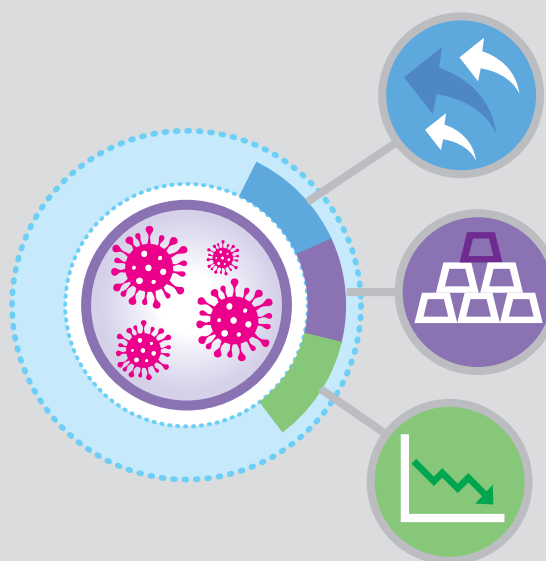
Financial stability risks emanating from the Islamic equity markets are considered to be moderate given the low interest rate environment. However, according to the IMF, the easing of global financial conditions late in the cycle and continued build-up of vulnerabilities, including asset overvaluations in some countries, could

have possible risks for stability in the medium term. It is therefore important for policymakers to monitor the build-up of financial vulnerabilities, particularly in the context of possible external shocks due to the ongoing global risks and to take steps to reduce the impact of such vulnerabilities in amplifying the adverse impact on the ICM.

Box 6 COVID-19 and Financial Stability in the Islamic Capital Markets

There is significant uncertainty about how the COVID-19 outbreak will evolve. A realistic picture of the impact of COVID-19 on economies and the financial markets will emerge as the severity and potential duration of the outbreak becomes clearer. However, significant market corrections and repricing of risk are expected in financial markets as the outbreak continues and the market reacts to developments such as recession fears, announcements of central bank policy actions, the oil price war, etc. However, while market movements or possible market corrections may be expected as a result of COVID-19, market volatility is not necessarily the same as financial stability. Transient market turbulence will certainly be experienced in the ICM as a result of global events. However, the financial stability of the ICM is predicated on the strength of the measures that have been put in place to ensure resilience of countries and Islamic financial institutions to financial market stress and exogenous shocks.

Short-term Impact of COVID-19



Turbulence in Islamic equity markets

Significant volatility is expected in Islamic equity markets as the outbreak continues. Market dislocations are similar to other major events in the last 30 years. An effective containment of the outbreak or a more optimistic outlook could spur a recovery.

Safe-haven flows to gold and investment-grade sovereign *ṣukūk*

Global flight-to-quality is expected to continue, with gold prices rising and government treasury yields falling even further as investors seek safe havens.

Lower investor risk appetite

Outflows of capital from risky instruments, including speculative-grade *ṣukūk* and from perceived riskier markets/countries. This might also impact flows to emerging market ICM instruments.

The primary bond market was not observed to be significantly affected during the first quarter of 2020 amid the COVID-19 outbreak and market turmoil, although primary *ṣukūk* issuances were overall much lower during the same period compared to the previous year, with some issuers delaying planned *ṣukūk* issuances due to the outbreak.

If the decline in oil demand due to the outbreak and a decline in oil prices is sustained, it is likely to widen budget deficits, particularly in oil-producing countries in the GCC. However, the associated increase in investors' risk aversion could also potentially make it more difficult for sovereigns with lower credit ratings to issue *ṣukūk* to finance their budget deficits. Some of the significant issuers of sovereign *ṣukūk* have ratings below investment grade. The degree of risk aversion observed may vary depending on the spread and impact of the outbreak. On the other hand, sovereign issuers with good credit quality may have favourable access to the *ṣukūk* market due to higher demand for safer government assets, in addition to lower borrowing costs as a result of further rate cuts by central banks to spur economic activity and counteract the impact of COVID-19 on global productivity.

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Corporate *shukūk* issuances, particularly those from issuers with lower credit profiles, could see a significant drop due to the change in investor risk sentiment. Policy measures by governments, including rate cuts and government stimulus to ensure that credit remains accessible to firms, could help to support liquidity. However, a recession or sharp global economic slowdown raises concerns of increased credit risk and defaults, particularly among non-financial corporates. Prolonged shock to investor sentiment could also result in higher near-term refinancing risk for low-rated issuers. Firms that are highly rated should, however, be able to withstand a temporary shutdown of the *shukūk* markets and have alternative sources of funding. The actual impact on the annual primary market issuances of *shukūk* for 2020 remains to be seen, depending on how the outbreak develops and on the policy actions that are taken to mitigate its impact. In general, the magnitude of the impact on the *shukūk* markets could also vary depending on sector, geography and rating level, with some markets showing greater resilience than others.

The potential implications for Islamic funds are primarily hinged on funds' investment focus and sector focus. Performance may be impacted, particularly for funds that have a concentrated focus on sectors that have been significantly affected by the COVID-19 outbreak, including energy, technology, agriculture and mining sectors, among others, due to supply chain disruption and a drop in productivity. Funds having an equity focus, which currently make up the largest proportion of Islamic funds, may also be significantly impacted due to market volatility and a decline in equity valuations. Furthermore, for Islamic funds, policymakers should keep an eye on potential areas of vulnerability that may be more greatly affected during periods of market stress. This includes open-ended Islamic funds that may have a mismatch between redemption terms and the liquidity of fund assets (e.g. some fixed-income funds/real estate funds), which can potentially give rise to systemic or contagion risks. For example, in the event of large-scale redemptions from funds during a period of severe market stress, the ability of markets to absorb asset sales could be tested, amplifying the movement of prices as well as transferring stress to other parts of the financial system and limiting the availability of financing to the real economy.

Thus far, the most substantial sign of market stress due to COVID-19 has been major volatility in equity markets and massive sell-offs, with a sharp drop across all Islamic equity indices in parallel with other representative global indices. Given that the scale of COVID-19 is growing globally, the threat of market dislocation remains serious and equivalent to other major events that resulted in market dislocations historically.

Overall, while market volatility does not necessarily indicate financial stability issues, it significantly raises the risk of market shocks that could have an impact on more vulnerable markets, which needs close monitoring by policymakers and regulators. While it is challenging to predict the outcome of the ongoing outbreak, it can be expected to have significant implications in terms of a potential contraction in the real economy as a result of exogenous supply and demand shocks, the effects of which may extend longer than the duration of the outbreak. Moreover, it is likely that monetary policy actions taken by central banks may not alone be able to revive economic activity, given that the main impact of COVID-19 is in terms of supply chain disruption or physical limitations due to lockdown of sectors such as production halts, and the shutting down of businesses, transport, hotels and restaurants in quarantined zones. The expected slowdown in the global economic growth in turn presents a downside risk for the ICM, particularly for equities and riskier instruments such as speculative-grade *shukūk* issuances. While a slowdown in growth will have a resulting slowdown in issuances and growth of the ICM, a more severe scenario of the global economic impact of COVID-19 and a global recession may include increased corporate-sector defaults or liquidity stress for Islamic funds in the ICM.

2.2.4 Islamic Capital Market Outlook

While the outlook for the Islamic capital market based on analyses of 2019 data is positive, there are some areas of potential vulnerability and persistent downside risk that need to be carefully monitored. Global risks are currently significantly weighing towards the downside. Some of the more prominent downside risks include the prolonged and severe COVID-19 pandemic, volatility in oil prices, an escalation in geopolitical conflicts, renewed trade tensions, climate change-related risks, increasing protectionism, and cyber-attacks, all of which can pose risks to financial stability. The materialisation of lingering downside risks is also further amplified in some economies due to growing vulnerability, caused by the build-up of debt and declining productivity in the last decade.¹²⁵

In the GCC region, which has significant ICM markets, specific downside risks that affect stability include a sustained decline in the price of oil or other commodities, or a rise in oil price volatility. On average, oil prices in 2019 were 10% lower than in 2018 and are forecasted to decline further in 2020 and 2021. The COVID-19 outbreak generated a drop in global oil demand and a resulting sharp drop in oil prices in the first quarter of 2020. In particular, the delay in reaching a deal on oil output cuts among the OPEC+ coalition led to the largest crash in oil prices since 1991. A steep decline in oil prices, especially a sustained one, or a rise in oil price volatility, could lead to fiscal tightening in the region for oil-producing countries, similar to that experienced in 2014–16. In addition, a shift

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in public risk sentiment or volatility in external financing conditions can affect capital flows to financial markets in the GCC region, impacting the ability to raise financing through *shukūk* issuances. In general, geopolitical conflicts also remain an important variable for the region in 2020. Any new or potential escalation of existing geopolitical conflicts can lead to an increase in funding costs, an outflow of foreign funds and lower appetites for instruments issued from the region.

The oil price war in the first quarter of 2020 presents new downside risks for an already vulnerable global economy. Its impact, alongside the decline in demand due to the COVID-19 outbreak, is likely to affect sovereigns that are dependent on oil revenue, as well as impacting high-risk credit markets. While further exacerbating the volatility in equity markets, a sustained decline in oil prices due to the price war will also place significant risk on high-yield *shukūk* markets – in particular, energy firms.

In the South-East Asian region, where some of the core Islamic finance markets are located, regional risks are linked to the deep global integration of the region which increases their vulnerability to financial shocks and supply-side shocks in the real economy. A slowdown in the Chinese economy, in particular, is likely to have regional repercussions. While the COVID-19 outbreak presents a major risk, a quick containment may allow a possible recovery in markets. Other downside risks, such as outcomes of the China–US trade dispute, also have significant implications for the region given that emerging East Asian economies depend heavily on trade with both China and the US. Any further intensification of the dispute could have spillover effects on the capital markets in the region. Episodes of financial market stress in response to the materialisation of any of the aforementioned downside risks are also more likely to have a greater impact on ICM of countries that have elevated debt levels or a higher reliance on volatile capital flows. Another major threat to regional financial stability is the emergence of any significant financial turmoil in vulnerable emerging markets with weaker fundamentals. This can spill over to other markets and may result in a generalised risk aversion of investors towards emerging markets, affecting capital flows to the region.

Climate change is another factor that presents an increasing risk to the ICM, as a result of the need to incorporate climate risks into asset valuations and the risk of mispricing. Abrupt mispricing of ICM assets is possible when prices adjust rapidly to reflect unexpected realisations of transition risks or physical risks of climate change, especially as more information becomes available about assets that are at risk from climate change. Physical risks such as severe climate shocks can result in erosion of collateral and asset values, while transition risks can impact the ICM when climate mitigation policies, technological advances, or changes in investor or market sentiment lead to value reassessments by market participants. Climate and environmental risks can also affect credit ratings of *shukūk* issuers, particularly greater sovereign risk for issuers that have carbon-intensive industries.

The global health pandemic resulting from COVID-19 poses significant downside risks for the ICM especially if the outbreak is prolonged and the impact on the economy is severe. Investor concerns about the impact of the pandemic on the global supply chain resulted in a steep drop in the equity markets in the first quarter of 2020, with a marked impact on the technology sector, to which Islamic equity indices have significant proportional exposure. Supply chain disruption is likely to affect several sectors, and the uncertainty about contagion is expected to have a significant negative impact on the consumer discretionary services sector. Recession triggered by lockdowns in many jurisdictions also means that safe-haven flows are likely to continue.

The oil price war in the first quarter of 2020 presents new downside risks for an already vulnerable global economy. Its impact, alongside the decline in demand due to the COVID-19 outbreak, is likely to affect sovereigns that are dependent on oil revenue, as well as impacting high-risk credit markets. While further exacerbating the volatility in equity markets, a sustained decline in oil prices due to the price war will also place significant risk on high-yield *shukūk* markets – in particular, energy firms.

The elevated risk factors as a result of the COVID-19 outbreak also bring to the fore the potential stability risks and vulnerabilities that may have formed in the global economy following the financial crisis in 2008. Following the GFC, central banks stimulated the economy with unconventional monetary policies such as quantitative easing and low interest rates, which have led to the generation of asset bubbles, decreased productivity growth and high debt levels. The disruption of global economic activity as a result of the COVID-19 outbreak is likely to exacerbate any existing vulnerability. There are, however, significant uncertainties as to how the capital market will be impacted, depending on how the situation develops and whether other downside risks materialise during the year. The overall financial stability and resilience across ICM jurisdictions will also depend on individual country circumstances, the strength of regulatory and governance systems, and the policies in place to weather potential financial shocks.

Islamic Capital Market Outlook and Policy Responses to Ensure Resilience

- » There are material global downside risks that might affect the growth and stability of Islamic finance markets in the short term.
- » The search for yield in a low-rate environment may exacerbate the build-up of vulnerabilities in the ICM by lowering financing costs for riskier issuers.
- » Islamic finance regulators and policymakers should look to strengthen regulations and supervision to ensure resilience to adverse global developments and market shocks that might affect financial stability.
- » Carefully calibrated policy responses are important to help foster investor confidence as well as resilience in the ICM.

ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

2.3 TAKĀFUL: ASSESSMENT OF RESILIENCE

This section of the report focuses on the performance and risks, as well as resilience, of the *takāful* sector in 2018 in 15 countries where the *takāful* market has a notable presence. They include the GCC countries (Saudi Arabia, UAE, Kuwait, Bahrain, Qatar and Oman), Middle East and South Asian countries (Iran, Jordan, Pakistan and Bangladesh) and South-East Asian countries (Malaysia, Brunei and Indonesia). Sudan and Turkey complete the list of countries whose *takāful* markets are assessed in this chapter. The assessment is based on commonly used analytical indicators of the depth and competitiveness of the insurance sector.

Generally, the global *takāful* sector operates within the larger macroeconomic environment, which invariably influences its performance and risks. *Takāful* RSAs have established metrics to measure the performance of individual insurance companies and the market more broadly.¹²⁶ In the light of this, the performance of the *takāful* industry in the selected countries is reviewed using two major performance metrics – profitability and underwriting performance. The estimates and analysis are presented in country-level aggregates for each of these metrics based mainly on 2018 financial-year data,¹²⁷ and in comparison, with average data of the previous three years (2015–17).¹²⁸

Due to different operating structures across countries (i.e. composite, general and family), and the difficulties encountered in data aggregation, especially for the earnings performance indicators, the separate discussion by business segment (general and family) is limited to underwriting risk indicators to reflect their peculiarity.

2.3.1 Profitability/Earnings Performance

Generally, *takāful* operators are mainly focused on two overarching goals – namely, growing top-line revenue (contributions), while bolstering bottom-line profitability, mostly influenced by the prevailing economic environment. In pursuance of these goals, *takāful* operators are confronted with many challenges, some of which are within the scope of the operators (i.e. pricing of risk, underwriting discipline and risk management framework),¹²⁹ while others such as a low investment return environment, catastrophe-related losses and political instability are not within the industry's control. The capacity of the *takāful* sector to build the resilience needed to overcome these challenges will determine its viability over the long term.

Both ROA and ROE are used to evaluate the overall profitability of the *takāful* market to determine its well-being and sustainability over a given period. Overall, Islamic insurance generated positive ROA in 2018 in all the markets with the exception of Pakistan and Turkey. The negative return recorded in both markets can be attributed to high operating costs and high pay-outs in the motor line of business. The Indonesian and Bangladeshi markets achieved ROAs above 5%, attributed to their low pay-out ratios (Chart 2.3.1.1). Qatar, UAE, Oman, Jordan and Kuwait showed a moderate return of above 3% ROA in 2018.

Generally, the net income of *takāful* companies in the GCC – the key *takāful* region – fell by 27% (y-o-y) to USD 281 million in 2018, compared with USD 383 million in 2017. To further illustrate the extent of the decline, the aggregate earnings of 31 cooperative insurers operating in Saudi Arabia¹³⁰ produced a net profit before zakat of USD 153.9 million in 2018, down by 45.8% y-o-y. The financial results for 21 operators in 2018 posted net losses before zakat of between 29.2% and 2,784.9%, dragging down overall profitability.

Among the top five Saudi insurers, the hardest hit was Amana Cooperative Insurance, which recorded a net loss before zakat of USD 5.4 million in 2018, representing a -2,784.9% decline. Saudi Indian Company for Cooperative Insurance (Wafa) suffered the largest dip in terms of both profits and gross contributions. The Company for Cooperative Insurance (Tawuniya) and MedGulf reported a pre-tax loss of USD 56.9 million (-45.6% y-o-y) and USD 54.5 million (-47.3% y-o-y), respectively. However, Bupa Arabia, the biggest Saudi insurer by contributions in 2018, saw its net profit before zakat grow by almost 5% to USD140.1 million.

The accumulated losses recorded in the Saudi Arabian market are attributed to high operating costs as a result of market concentration in few business lines and limited distribution capabilities. Regulatory reforms have been undertaken in the last few years which, although could have contributed to the decline in total contribution in the short-term, are expected to offer opportunities for market growth and development in the long term.

¹²⁶ The IAIS's application paper on information gathering and analysis (2010) outlines the statistical and financial information, and the basic ratios, that RSAs should monitor in their supervisory work.

¹²⁷ The data are inclusive of *takāful* windows where they are available, but exclude data on *retakāful* companies.

¹²⁸ Data are sourced differently – the national supervisory authorities, *takāful* associations, the Thomson Reuters EIKON database, and directly from publicly available sources, including published annual reports and financial statements of *takāful* operators.

¹²⁹ Swiss Re Institute, *Re/insurance in the Middle East and Pakistan* (2017); S&P Global Rating, *GCC Insurance Sector Report*, 2017.

¹³⁰ Saudi Arabia contributes almost 85% of total contributions written by all Islamic insurers in the region.

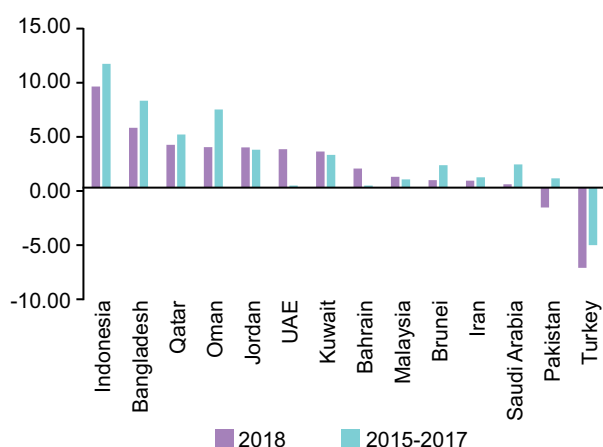
ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

In contrast, the UAE *takāful* sector continued its trend of growing net income in absolute terms in 2018, albeit at a slower pace. Over the last two years, market growth has primarily been bolstered by regulatory changes such as setting minimum pricing for motor insurance and the introduction of mandatory health insurance for workers in the Emirate. In aggregate, *takāful* operators' net profit in 2018 remained positive with 8.3% y-o-y growth rate estimated at USD 35.7 million. Two *takāful* companies, Methaq Takāful and Arabian Scandinavian Insurance Company-Takāful (Ascana-Takāful), generated the highest increase in net income with y-o-y increases of 1,809.1% and 266.4% respectively in 2018. The biggest drop in net profit came from SALAMA, a leading *takāful* operator in the UAE by contributions, with a decrease of -98.7% from USD 10.2 million in 2017 to USD 0.13 million in 2018.

Three *takāful* markets achieved a significant growth in profits in 2018, including: Bahrain (1,405.3% to USD 8.6 million), Qatar (34% to USD 17.1 million) and Oman (18.9% to USD 7.5 million). In contrast, Kuwait's *takāful* market witnessed a -30.4% decline in net profit to USD 3 million. In terms of company performance, Qatar's Al Khaleej Takāful posted the highest profit growth in the region with a net income growth of 11,040% to USD 5.6 million in 2018.

As illustrated in Chart 2.3.1.1, compared with the three-year average (2015–17), a drop in ROA was observed in almost all the markets except Malaysia and Bahrain. Malaysia's *takāful* sector maintained steady growth in technical profitability, helped by adequate pricing and improved operating efficiencies to achieve a stable positive return over the years, and it is likely to remain so in the foreseeable future. Similarly, Bahraini *takāful* companies also delivered an impressive performance. For instance, Takāful International saw its profit jump by 1135.8% to USD 1.7 million; and Solidarity Bahrain, a subsidiary of Solidarity Group Holding, recorded the third-strongest net profit growth rate, up 1,493% y-o-y to USD 6.9 million. These impressive performances are mainly due to the significant improvement in technical and investment income in 2018 compared to the corresponding previous period.

Chart 2.3.1.1 Return on Assets (2015–17 and 2018)



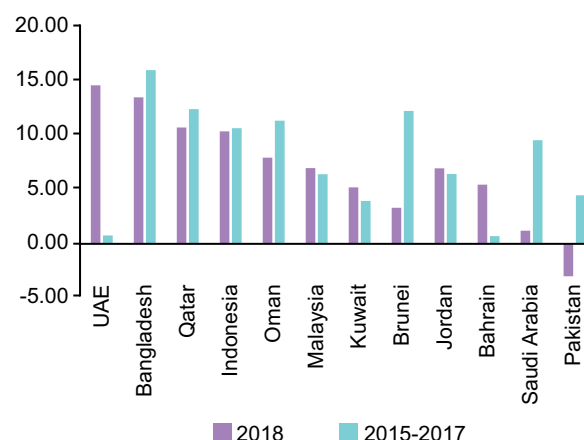
Source: IFSB Secretariat Workings

ROE shows a wider margin across the market in 2018, ranging from a low of -3% to a high of 14.65% (Chart 2.3.1.2). The UAE market showed the highest ROE at 14% in 2018, up from an average of 0.8% recorded in the past three years.¹³¹ The overall net income of listed *takāful* companies in the same period increased to USD 381 million (AED 1.4 billion), attributed to improved underwriting operating results and expense management, especially from motor and medical lines. UAE *takāful* has also benefited from a favourable regulatory environment and strong reputation. Comparatively, Malaysia, Bahrain and Jordan showed a moderate improvement in the ROE, while Brunei, Oman and Saudi Arabia maintained a positive ROE but with a slight decline. However, Pakistan's *takāful* market showed a negative return in aggregate.

Accumulated losses and market concentration have continued to depress underwriting profitability in recent years, eroded capital buffers, and resulted in solvency issues and temporary, or even permanent, licence suspensions for a number of insurers. The *takāful* sector in many markets is becoming more dynamic than before, due to diminishing profit margins as a result of competition. A notable development is the decline in both ROA and ROE across multiple lines in 2018, driving concerns surrounding technical margin erosion. Further possible deterioration of rates is not unexpected in the coming year, given the economic and financial impact of COVID-19 on the operating environment, and the persistent highly competitive operating environment.¹³² Additionally, continued fluctuations in oil prices and reduced government spending will continue to affect *takāful* coverage.

As *takāful* firms strive to adequately respond to these challenges, regulatory regimes are also expected to strengthen across all *takāful* markets, with improvements in risk management, underwriting and reserving. Also, demand is expected to be bolstered by the widening of compulsory cover in products such as motor, travel and health. Market consolidations among the operators are inevitable in order to combat this weak profitability.

Chart 2.3.1.2 Return on Equity (2015–17 and 2018)



Source: IFSB Secretariat Workings

¹³¹ The low average ROE for the UAE over the period 2015–2017 was due to the -9.01% ROE recorded in 2016. The UAE *takāful* sector nonetheless recorded a positive ROE of 7.06% in 2017.

¹³² *Takāful* companies continue to struggle to differentiate themselves from – and therefore remain subject to the same pricing pressures as – conventional insurers.

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2.3.2 Underwriting Performance and Risk

Sound underwriting performance is a key element in determining a *takāful* undertaking's profitability and income generation, especially in the current low investment yield environment. Underwriting performance is a critical area for supervision and market surveillance and is determined by a *takāful* operator's product pricing decisions, risk selection and claims management. Indicators used for evaluating underwriting performance and risks of a typical *takāful*¹³³ undertaking or market are the loss ratio, the expense ratio and the combined ratio.

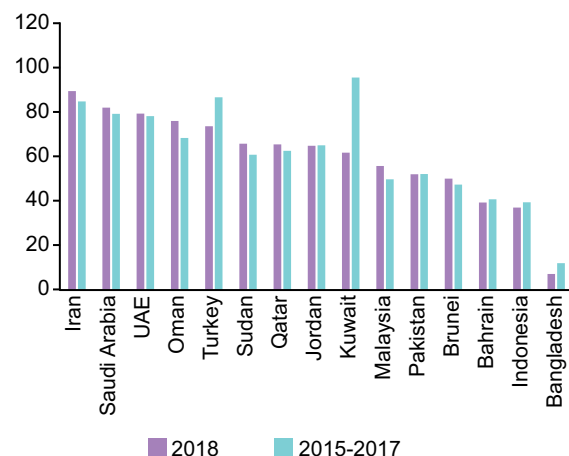
Loss Ratio

The loss ratio¹³⁴ measures the actual impact of incurred losses on participants risk funds (PRF)¹³⁵ under *takāful* models with participants risk fund segregated from operator's fund (i.e. *wakālah* model and *muḍārabah* model).¹³⁶ The sufficiency of the PRF to cover the actual losses incurred is the measure of underwriting performance.¹³⁷ An operator aims to achieve a loss ratio below 100% to prevent the need for *qard*.¹³⁸ Loss ratio variabilities are caused by externalities such as economic factors (i.e. market competition, price/underwriting cycles) and catastrophic losses (e.g. natural disasters), among others. Depending on the rates and underwriting pricing, the ratio may increase (decrease) without any significant changes in the actual loss experience.

Chart 2.3.2.1 shows the loss ratio for general *takāful* while Chart 2.3.2.2 shows the benefits/claims ratio for family *takāful* in selected countries for 2018, and the average for three years (2015–17). In the general *takāful* business, Iran tops the chart with estimated economic losses of roughly USD 3.6 billion in 2018 caused by flooding that swept through the province of Sistan and Baluchistan and damaged infrastructure and agricultural lands. Additionally, a series of floods and earthquakes pushed the losses paid to a high level in Iran. An upward-trending loss ratio is observed in almost all markets, with the highest (above 80%) in Saudi Arabia, UAE, Oman and Turkey indicating a decline in the efficiency of the *takāful* operators' underwriting activities (Chart 2.3.2.1). This decline is due to (among other reasons) an increase in the required level of provisioning in view of the increase in expected claims on the one hand, and inadequate pricing on the other hand, with the motor and health product lines experiencing the highest loss payouts.

Furthermore, the rise in losses incurred by *takāful* companies in Sudan was due to the political turmoil experienced in the country in 2018, and is estimated to run into billions of Sudanese pounds (SDG) with the average loss for small and medium-sized businesses estimated to be between SDG 10 million (USD 221,000) and SDG 40 million. Meanwhile, the narrowed spread between the net earned premium and the net claims incurred by *takāful* operators in countries like Kuwait, Indonesia and Bangladesh is due to the reduction in their loss ratio. Chart 2.3.2.2 illustrates markets with a significant presence of family *takāful* business. Markets that experienced a benefits/claims ratio of above 70% in 2018 are Bangladesh, Jordan, Kuwait and UAE. Compared to the average of the previous three-year period, Kuwait and Brunei experienced a significant drop in their benefits/claims ratio in 2018. The lowest benefits/claims ratio was experienced by Pakistan. In the coming years, we expect an increase in payouts in the family *takāful* segment as participants become more aware of their cover and the claim-making process becomes more efficient. This is also expected to facilitate greater participation and an increase in the penetration rate.

Chart 2.3.2.1 Loss Ratio: General *Takāful* (2015–17 and 2018)



Source: IFSB Secretariat Workings

¹³³ "Takāful undertaking" combines operator plus participants' risk and investment funds. Furthermore, the participants' risk pool receives the risk coverage and the takāful operator manages the risk coverage for a fee.

¹³⁴ Loss ratio is the ratio of claims/benefits incurred to earned contributions. Claims/benefits incurred include loss adjustment expenses (LAE) incurred. This ratio provides a measure of the actual risk coverage per unit of contributions that an operator has already earned.

¹³⁵ Participants' Risk Fund (PRF) A fund to which a portion of contributions paid by *takāful* participants is allocated for the purpose of meeting claims by *takāful* participants on the basis of mutual assistance or protection.

¹³⁶ A contract between the capital provider and a skilled entrepreneur whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur as the *muḍārib* (or labour provider)

¹³⁷ The ratio may also increase (decrease) without any significant changes in the actual loss experience should an operator increase (decrease) its contribution rates. All of the surveyed countries monitor the claims/loss ratio.

¹³⁸ A non-interest-bearing loan intended to allow the borrower to use the funds for a period with the understanding that this would be repaid at the end of the period.

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Chart 2.3.2.2 Benefits/Claims Ratio: Family *Takāful* (2015–17 and 2018)

Source: IFSB Secretariat Workings

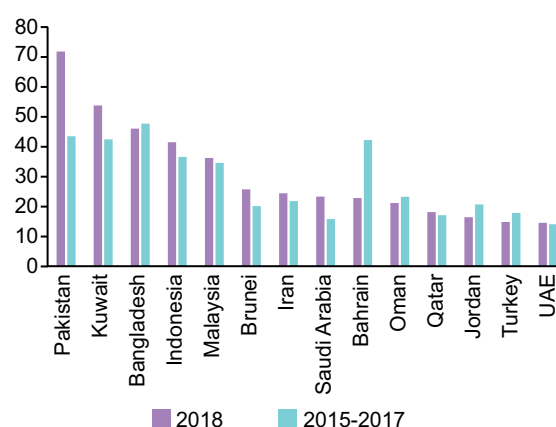
Expense Ratio

The expense ratio measures the marketing and administrative expenses incurred relative to contributions written.¹³⁹ Gross contributions may be more appropriate as the denominator (rather than as earned contributions), as the expenses are incurred prior to and throughout the coverage period. However, different supervisors use different approaches (including both gross and net premiums written or earned). A high expense ratio may be due to a rise in market competition (e.g. high commissions and brokerage fees) or to inflation in the territory of operation.¹⁴⁰

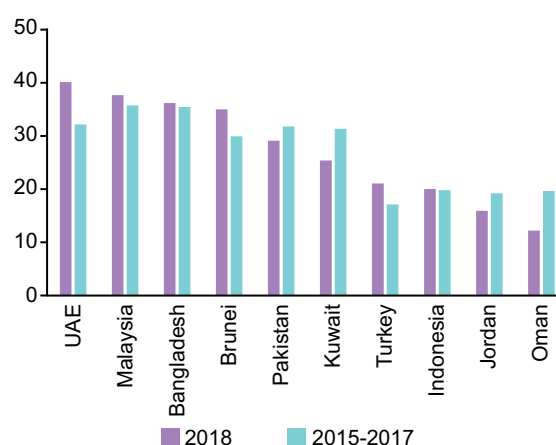
Similar to the case of loss ratio, rates or underwriting pricing is a key determinant. In interpreting this ratio, it is therefore noteworthy that there is a possibility of the expense ratio rising (falling) while holding the denominator (numerator) constant. For example, the ratio may fall even when actual expenses remain unchanged, or rise if premium rates rise (at a faster rate than expenses).

More than half of the markets assessed recorded an upsurge in the expense ratio compared to the average of the previous three-year period, indicating a competitive operating environment. As illustrated in Charts 2.3.2.3 and 2.3.2.4 for general and family *takāful* businesses, respectively, the expense ratio shown for general business is unusually high at above 45% of gross contributions in Pakistan. Other markets with a high expense ratio of above 30% are Bangladesh, Kuwait, Indonesia and Malaysia.¹⁴¹ The high expense ratio across these jurisdictions indicates that the operators are incurring higher administrative and management expenditures, as well as paying higher commissions for their operations. A high expense ratio is an indication of a competitive operating environment and weighs heavily on the margin.

All other markets have a modest ratio, ranging from slightly above 20% to below 10%, which indicates operational efficiency at the industry level in these markets. Comparatively, Bahrain and Oman showed an improvement in their expense ratios in 2018. Bahrain showed a marked reduction in the ratio from an average of 41% in the previous period to 22% in 2018. Greater deployment of technology, and other country-specific factors such as business mix and more cost-effective distribution channels for personal lines (car, home and travel insurance products) such as online, mobile or digital platforms, have further contributed to cost reduction and improvement in operational efficiencies.

Chart 2.3.2.3 Expense Ratio: General *Takāful* (2015–17 and 2018)

Source: IFSB Secretariat Workings

Chart 2.3.2.4 Expense Ratio: Family *Takāful* (2015–17 and 2018)

Source: IFSB Secretariat Workings

¹³⁹ Marketing expenses include the sum of policy acquisition expenses (e.g. agency commissions, advertisements, property inspection costs and other administrative expenses).

¹⁴⁰ For instance, when a new operator enters the market, they offer distributors [agents, brokers, banks] higher commissions/fees to gain access and market share for products with very limited price transparency and (hence) price sensitivity of the consumers. A particular instance is the case of *takāful* operators in Malaysia, which historically are paying more net commissions than their conventional counterparts. However, having built a critical market share over the years, they have managed to reduce this difference in recent years.

¹⁴¹ Historically, *takāful* operators in Malaysia are paying more net commissions than their conventional counterparts. However, by building market share, they have managed to reduce this difference in recent years.

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Combined Ratio

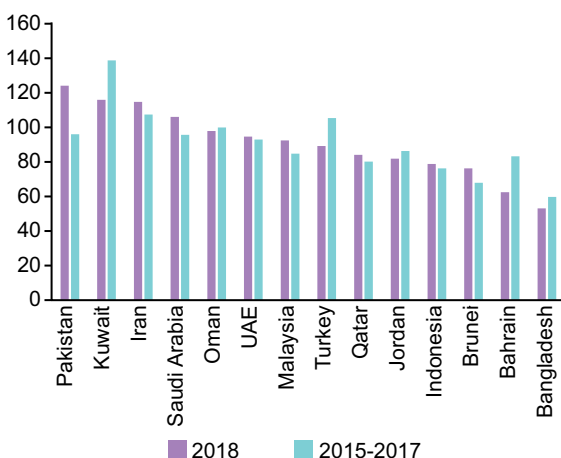
The combined ratio measures the sufficiency of contributions revenue to cover the underwriting operations of a *takāful* fund. A ratio less (greater) than 100% means profits (losses) in the fund during the period. It is most often used in general business, although a similar measure may be adapted to monitor the sufficiency of contribution revenue in the family business. Charts 2.3.2.5 and 2.3.2.6 illustrate the combined ratio in 2018 and an average of the past three years (2015–17) for both general and family business in the selected markets. Four markets – Pakistan, Kuwait, Iran and Saudi Arabia – recorded a combined ratio above 100% in the general business. A combined ratio of below 80% was recorded in Jordan, Indonesia, Brunei, Bahrain and Bangladesh.

Relative to the average of the past three years, improvement in the combined ratios is observed in Kuwait, Turkey, Bahrain and Bangladesh. Much of the variation in the combined ratio stems from changes in the loss ratio, which are influenced, to a great extent, by line-specific cycles, economic factors and catastrophe-related losses. This is true for Iran, as deterioration in its combined ratio in 2018, compared to the three-year average, was due to rising losses and declining rates.

The overall combined ratio mirrors choices regarding marketing, client segmentation, risk selection, pricing and claims administration. As observed in some of these markets, earnings from other sources, such as commission income from *retakāful* reinsurers and investment income, may offset a rise in the combined ratio in 2018.

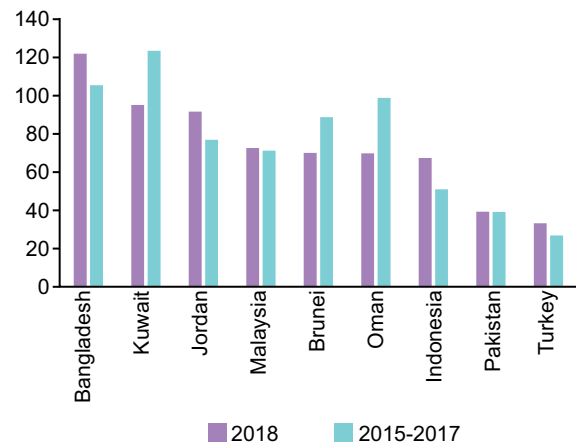
In the family segment, Bahrain, Kuwait and Oman showed marked improvement in the combined ratio for 2018, compared to the preceding period. This improvement is an indication of effective underwriting controls and experienced management teams, and is expected to translate to sustained momentum in improved underwriting margin especially as the *takāful* sector in these countries becomes mature and able to compete efficiently.

Chart 2.3.2.5 Combined Ratio: General *Takāful* (2015–17 and 2018)



Source: IFSB Secretariat Workings

Chart 2.3.2.6 Combined Ratio: Family *Takāful* (2015–17 and 2018)



Source: IFSB Secretariat Workings

Investment Composition

Investment composition is mostly related to changes in asset mix. It can be used to examine changes in the distribution of invested assets during a single period or over time, and can be an important indicator for monitoring any move towards riskier assets (e.g. search-for-yield in a low interest rate environment). Investment composition is measured as a percentage of asset mix to measure trends in various asset classes annually. Given the limited data available, this section captures the aggregate investment allocations of *takāful* companies in 10 markets based on data provided by the insurance supervisors in these countries. Data collected for 2018 show a variance in the investments mix in both family *takāful* and general *takāful* businesses. This illustrates that investment allocations and choice of *takāful* operators reflect the needs of different *takāful* funds.

Equally important is the fact that market conditions and instruments available in the respective markets also determine the asset mix. According to the available data for 2018, a noticeable variation is observed in the investment compositions between the general and family segments of *takāful* funds across the listed countries. More established Islamic finance markets such as Malaysia and Saudi Arabia have a larger percentage of *shukūk* in their investments mix than do other countries, although the percentage is greater for family *takāful* than for general *takāful*.

The operators in Saudi Arabia held more cash and bank deposits compared to other instruments, whereas the UAE, Qatar and Pakistan held a high proportion of equities in the general *takāful* fund's portfolio in 2018. Although the preference for equities is supported by fairly active and liquid stock markets in the region, profits from equity trading could be vulnerable to market volatilities, and especially of oil prices. Recently, regulations in these countries have changed the investment regime to allow *takāful* operators to invest in a wider range of assets. This may lead to future changes in asset allocation, with operators holding a higher proportion of equities in their funds' portfolios.

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Investments allocation in Malaysia was directed mainly towards *shukūk* issued by public institutions and the private sector. Investment in real estate is virtually absent in the general *takāful* investment portfolio. This is understandable considering the short-term nature of the fund, which dictates that the assets are in correspondingly short-term investments. Even in the family *takāful* segment, where it exists, it constitutes a small percentage. The Risk-based Capital Requirements accords risk charge of 8% (for self-occupied properties) and 16% (for other property investment), comparable to KLCI equity of 16%. In addition, there is only restriction in the form of an investment limit of 20% for general *takāful* fund.

Unit trust funds and other collective investments are grouped together as “others” and are significant in the general *takāful* fund compared to family *takāful*, probably due to its near marketable nature.

Business Mix in General Takāful

Both general and family *takāful* segments consist of so many business lines whose groupings vary across jurisdictions. The general *takāful* segment in many jurisdictions includes business lines such as accidents and liability, motor, property/fire insurance, marine, aviation, energy and engineering. The family segment basically includes protection and saving products.¹⁴² Chart 2.3.2.7 illustrates the dominance of few business line among *takāful* operators in various markets, and this often influences the retention ratio.¹⁴³ Business lines (motor, medical and health, and personal accident) accounted for more than 80% of gross contributions in 2018. *Takāful* operators in these markets showed a high retention ratio above 80% in these line of business in 2018. For instance, medical/health and motor classes registered retention ratios ranging from 88% to 97%. However, the retention level for commercial lines (marine, engineering, fire and transit risks) is low, ranging between 30% and 36%, and is much lower for energy and aviation lines (at 2.8% and 6.5%, respectively). A low retention level indicates a limited capacity to retain larger and complex risks; therefore, it highlights the importance of *retakāful* in reinforcing underwriting capacity by spreading the risks and enhancing capacity to underwrite complex risks.

Chart 2.3.2.7 Percentage of *Takāful* Contributions by Business Line

Source: IFSB Secretariat Workings

¹⁴² The medical/health class is classified under the general business segment because of its short-term nature. However, some markets group it under long-term family business.

¹⁴³ Generally, a high retention ratio indicates that a proportion of the underwriting risk is being assumed by the *takāful* companies, whereas a low retention ratio shows high reliance on *retakāful*/reinsurance

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Conclusion

The *takāful* market has ample room for growth, notwithstanding the industry accounts for a tiny share of the global insurance market which generated premiums exceeding USD 5 trillion in 2018. This share is indeed small when we consider the fact that Muslims comprise about a quarter of the world's population. The penetration ratios of *takāful*, even in personal lines, remain lower than those of conventional insurance in the countries that permit both types of operations.

The COVID-19 pandemic and its financial impacts on the global financial system combined with the fall in crude oil prices experienced from the first quarter of 2020 adds to the pre-existing vulnerabilities confronting the *takāful* industry. Consequently, *takāful* operators are under pressure to find an appropriate balance between the goal of safeguarding the interests of consumers and beneficiaries, and safeguarding the soundness and health of their entities.

The financial impacts of COVID-19 on *takāful* operators are mainly in two forms: first, with regards to pay-out on a very wide range of policies to support businesses and people affected by COVID-19. Health/medical line are likely to experience a significant number of claims related to COVID-19. Similarly, a rise mortality rates caused by COVID-19 related death could spike claims and benefits incurred in family *takāful* business segment. Secondly, with equities falling and widening of *shukūk* spreads experienced in the financial market across countries, *takāful* operators would have to deal with losses in their investment portfolios. Invariably, it may likely lead to a significant loss in the market value of high-quality assets, which may impact on the economic solvency of *takāful* entities in the medium term.

Supervisors in several jurisdictions have expressed satisfaction on the strength of majority of operators' capital levels to provide adequate buffer against a potential shock to their balance sheets. However, lower revenues from business disruptions in face of continued payment of usual expenses such as rental costs, utilities and salaries would weigh heavily on operators' 1H2020 earnings, and further add to the bleak economic outlook.

Box 7 COVID-19 Pandemic: Implications for the *Takāful* Industry

The devastating human and social impact of COVID-19 pandemic, and social-distancing measures put in place to curtail the spread of the disease is currently affecting the financial services sector including *takāful* industry.

Given the important role of *takāful* as a tool to ease the stress and financial safety net during crises, *takāful* operators have been focusing on supporting customers and businesses and continuing to pay claims on a number of policies. The direct impact of the pandemic is likely to be felt across core business lines – namely, motor, medical/health, property and liability coverages considering their sensitivity economic conditions. The sensitivity to the pandemic is greater for both medical/health business and family segment, in particular, if the pandemic persists and results in a second wave of mortality losses.

Exclusions are expected to limit COVID-19 pandemic related losses for *takāful* operators, but inconsistency in the treatment of exclusions could lead to consumer detriment and potential risk of litigation as experienced in some countries. This also has reputational implications if not properly managed.

It is crucial at this time that *takāful* operators should make clear in their communications, including on their websites and apps, the different solutions available to customers, and the scope of their cover, including the exemptions that apply and the impact of COVID-19 on their policies. *Takāful* operators must adopt a more responsible and business-sensitive position on the COVID-19 pandemic or risk long-term damage to trust and reputation of the industry.

Many supervisors have taken regulatory actions to support business continuity and fair treatment of consumers, as well as prioritising their monitoring efforts on timely handling of payment of claims and ensuring operators have sufficient liquidity. Ultimately, *takāful* operators are expected to handle claims with utmost good faith and to deal with complaints genuinely, promptly, fairly and consistently. Many operators are taking actions to support customers, for instance, with regards to a grace period on payment of contributions to assist consumers affected by the COVID-19, discounts, fees waiver fees, and payment deferrals.

Taking into account the anticipated low claim ratio in motor cover due to a lockdown and closure of businesses, supervisors have recommended that operators pass on the benefits of a low claim ratio to customers by granting a free one-month extension of coverage to customers. These various measures will help operators and consumers to cope with the disruption caused by the COVID-19 pandemic and strengthen the latter's confidence in the industry.

Furthermore, the pandemic is currently presenting considerable operational challenges to the *takāful* operating model in many ways, similar to the challenges faced in all industries across the globe. Indeed, it is affecting every facet of *takāful* operations – from frontline sales, to underwriting, to back-end policy administration, to claims management. The behavioural and economic impact of the pandemic will hinder *takāful* operators' mid- and longer-term growth and profitability.

ASSESSMENT OF THE RESILIENCE OF THE ISLAMIC FINANCIAL SYSTEM

The most immediate impact on the business model is that some functions, such as claims adjusting, typically require employee presence in the field. Even those who technically can work fully from remote locations may initially have to struggle to adjust to this new way of working. Remote working tends to inhibit cross-functional collaboration – which is particularly crucial for the claims, underwriting and actuarial functions. It can also make decision making more inconsistent on multiple levels – from executives steering the portfolio to frontline workers making claims and underwriting choices, resulting in higher leakage and potentially poor results.

During the pandemic, the use of technology - ‘contactless’ online purchase and information acquisition has become a way of doing business. When in-person communication and the traditional agent mechanism is not possible. *Takāful* operators are generally starting to embrace new tools for sales and marketing, streamlining their processes (such as claims handling) and offering a smoother customer experience.

Some supervisors for example, Saudi Arabia Monetary Authority (SAMA) have activated the electronic payments system to facilitate payment of claims and benefits to customers and to enable online collection of premiums by working with online payments companies, using credit and debit cards, as well as adopting mobile wallets. Similar mode has been used in settling payments due to service providers, especially in the medical/health business lines.

The issues of data privacy and cyber risk are also on the front burner. *Takāful* operators, by the nature of their business, compile and aggregate large volumes of data that may require subscribing to an external third-party cloud service provider. This presents myriad risks, including, but not limited to, cloud concentration risks due to operational centrality of computing services. This can result in an operational halt in the event of a cyber-attack, data breach, connectivity breakdown, etc. The effects of such failures on perceptions of data integrity may also have implications for public confidence in the technology. In addition, there are concerns relating to mitigating operational risks that may crystallise from using legacy technology infrastructure to cope with the rate and speed of technological transformation today.

It is projected that the cost of global cybercrime will reach USD 6 trillion by 2021.¹⁴⁴ While this presents opportunities for *takāful* operators to underwrite cyber-*takāful* as *takāful* participants increase their demand for mitigation of cyber risks, it may also create the issue of “silent cyber”.¹⁴⁵

¹⁴⁴ <https://www.insurancebusinessmag.com/ca/news/cyber/the-key-cyber-trends-keeping-insurance-professionals-up-at-night-171709.aspx>

¹⁴⁵ A case whereby the cyber-exposure is exogenous to the actual cyber-*takāful* policy. For instance, a non-affirmative coverage may crystallise in the event of a loss suffered by a *takāful* participant due to a cyber-attack on a property under a policy.

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3.0 EMERGING ISSUES IN THE IFSI



3.0 EMERGING ISSUES IN THE IFSI

3.1 DIGITAL ISLAMIC BANKING: TRENDS, IMPLICATIONS AND THE WAY FORWARD

Contributed by Abideen Adeyemi Adewale

Introduction

Even though the global Muslim population is projected to reach 2.2 billion by 2030,¹⁴⁶ the leverage that religious appeal and sentiments offer to Islamic banks among their traditional customer base may be waning. Customers, especially young people, now place a high premium on the efficiency, speed, transparency, convenience, etc. that digital financial services offer. Islamic banks today face challenges arising from both market structure dynamics and transformation to digital banking. The adoption of innovative technologies and business models is a prominent emerging trend that is fast changing the ecosystem of the IFSI, and Islamic banks are not immune to these developments.

Digital financial services (DFS)¹⁴⁷ involves:

“financial operations using digital technology, including electronic money, mobile financial services, online financial services, i-teller and branchless banking, whether through bank or non-bank institutions. DFS encompass various monetary transactions such as depositing, withdrawing, sending and receiving money, as well as other financial services, including payment, credit, pensions and insurance. DFS can also include non-transactional services such as viewing personal financial information through digital devices.”

The COVID-19 outbreak and the consequential movement restrictions and social distancing which encourages minimal use of cash and physical contacts in financial transactions as measures to flatten the curve of its spread has added to the need to quicken transforming to DFS. Banking services are considered essential thus requiring that banks continue to operate during the lockdown order. While their customers adjust to the changing circumstances of having to conduct their financial transactions online, banks have also had to get used to the new normal of some staff working from

home by enhancing their teleworking and remote access capabilities without compromising on the integrity of their technology network.

The scenario is not essentially different for the Islamic banks. Rather, it provides a further basis for the argument that to sustain the growth momentum of the Islamic banking industry requires Islamic banks to reinvigorate and radically explore new horizons, identify untapped potential, and unlock opportunities.¹⁴⁸ The Islamic banking industry also requires a radical departure from its traditional sales and product inclination and move to a collaborative, or competition-induced innovative ways of service delivery that align with the high expectations of today's tech-savvy and convenience-driven customers.¹⁴⁹ This should be done in a way that promotes financial inclusion while neither compromising on the fundamental premise of Shari'ah¹⁵⁰ upon which Islamic banking is built nor infringing on its value-based intermediation essentials as they are being championed today.¹⁵¹

Islamic banks will need to further adapt to the latest technological innovations, enhance their preparedness and boost resilience against the consequential and peculiar operational risks as these will be crucial especially for post-COVID-19 pandemic economic recovery process. This is possible through Islamic digital banking¹⁵² given that it allows disruptive players to reproduce in most instances, superior customer value and experience while being able to do so without being subjected to, for instance, stringent regulatory requirements and huge capital investments.¹⁵³ Bank Negara Malaysia (BNM) for instance, announced it will be issuing up to five licences to applicants to establish either digital conventional or Islamic banking business. Although a business limitation of RM 2 billion total assets size will be imposed, licensed digital banks will also only be expected to comply with some simplified regulatory requirements during a foundational phase of between a minimum of three and maximum of five years.¹⁵⁴ This implies that both competition and competitors are changing in the Islamic banking segment and are envisaged to further increase as new players come on board and regulators respond to finding a balance between encouraging innovation, promoting financial inclusion, protecting consumers¹⁵⁵ and ensuring financial stability.¹⁵⁶

¹⁴⁶ <https://www.pewforum.org/2011/01/27/the-future-of-the-global-muslim-population/>

¹⁴⁷ OECD (2018) pg. 13, G20/OECD Policy Guidance on Financial Consumer Protection Approaches in the Digital Age.

¹⁴⁸ As stated in the Dinar Standard's Islamic Fintech Report, 2018, the median age of Muslims worldwide is 24 years compared to 32 years globally, and 15 among the top 59 countries with smartphone penetration are Organisation of Islamic Cooperation (OIC) member countries. Compared to 49% worldwide, 72% of the unbanked population reside in the OIC countries.

¹⁴⁹ pwc (2019) Virtual Banking: Malaysian customers take charge. <https://www.pwc.com/my/en/assets/workshops/2019/virtual-banking-malaysian-customers-take-charge-report.pdf>.

¹⁵⁰ Forty per cent of Islamic FinTechs are already Shari'ah certified, while another 4% and 32% are either in the process of obtaining Shari'ah certification or intend to seek certification in the future, respectively. <https://ceif.iba.edu.pk/pdf/IslamicFinTechReport19.pdf>

¹⁵¹ Bank Negara Malaysia, for instance, is at the forefront of this proposition. https://www.bnm.gov.my/index.php?ch=en_speech&pg=en_speech&ac=810&lang=en

¹⁵² Digital banks provide and deliver all banking services and transactions through the internet or other forms of electronic channels instead of physical branches.

¹⁵³ A.E. Omarini (2018). "Banks and Fintechs: How to Develop a Digital Open Banking Approach for the Bank's Future", International Business Research, Vol. 11, No. 9, pp. 23–36.

¹⁵⁴ <https://www.bnm.gov.my/index.php?ch=57&pg=137&ac=924&bb=file>

¹⁵⁵ The OECD has stated that, due to the risks of digital financial services, vulnerability of consumers to unfair and deceptive practices may increase. See: OECD (2018), p. 14.

¹⁵⁶ X. Vives (2019), "Digital Disruption in Banking", Annual Review of Financial Economics, Vol. 11, p. 243. Hereafter "Vives (2019)"

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The response to transforming to digital Islamic banking seems heterogenous across jurisdictions, with incumbent Islamic banks (henceforth “incumbents”) exploring options to either collaborate or compete with new-entrant Islamic financial service disruptors (henceforth “new entrants”). Incumbents that favour the competition option are either outrightly launching their own digital Islamic banks or branches, or take a gradual approach of first digitalising products and operations in existing branches. Incumbents that favour cooperating or collaborating with the new entrants are exploring the possibility of ownership via a partial or total buy-out, sponsorship or partnership with the new entrants. Perhaps this is an attempt to avoid switching costs, and to tap into the huge opportunities to earn income from interchange fees to be paid by the latter.¹⁵⁷

The remainder of this article focuses on trends in digital Islamic banking, with examples given of prevalent practices among Islamic banks, the financial stability implications for the Islamic banking industry, and the roles of regulators as well as prudential standard-setting organisations such as the IFSB.

Projections and Application of Technology in Banking

Based on a projected CAGR of 15.3%, the global worth of the digital banking market's AuM of USD 5.2 billion as of end-2018 will reach USD16.2 billion by 2025.¹⁵⁸ In 2019, the financial technology (FinTech) industry¹⁵⁹ attracted about USD 136 billion worth of global investments with 2,693 deals, including mergers and acquisitions, private equity and venture capital.¹⁶⁰ More than 3.5 billion people around the world are connected to the mobile internet, with about 300 million people newly connected in 2018 alone.¹⁶¹ The adoption of blockchain technology as a connectivity backbone in the digital transformation process of financial institutions is expected to have a potential impact exceeding USD 3.9 trillion by 2025. Similarly, artificial intelligence is forecasted to drive 800 million jobs by 2030; and the big data and analytics industry, which is crucial for personal financial management and “Know Your Customer” requirements to prevent fraud and money laundering in the financial services industry, will be worth USD 123 billion by 2025.¹⁶² The foregoing statistics indicate that a lot is happening globally in terms of leveraging on the synergy between finance and technology.

The use of software applications, especially for payments and transaction services, is becoming fundamental to banks' operations due to increasing contestability and competition. Robotics process automation, machine learning and AI technology are now pervasive. Financial institutions including Islamic banks are expected to use these technologies more for repeatable transactional tasks, as well as predictive analytics based on big data, cloud computing and the Internet of Things (IoT) to better anticipate customer needs. Application Programming Interfaces (APIs), which connect software programmes and allow them to communicate based on programming code,¹⁶³ and cloud computing have been deployed especially for unbundling of services as well as for data sharing in open banking applications.¹⁶⁴

Trends in Digital Islamic Banking

In the Islamic financial services industry in general and the Islamic banking industry in particular, the key trends and important developments regarding disruptive technology are not essentially different from those found in conventional banking. Exceptions in a few instances may be due to the additional layer of Sharī'ah compliance required of the former. This is considered a significant hurdle that needs to be scaled in the digital transformation process of Islamic banks, which though is relatively slower compared to the conventional banking segment seems nonetheless to be gathering momentum.¹⁶⁵

Trends in the Islamic banking industry indicate that related digital banking activities are already taking place. Some developments in the digital transformation of Islamic banking can be observed in various countries, especially those where the industry has attained systemic significance. In 2019, the GCC region witnessed the launch of its first Sharī'ah-compliant digital bank.¹⁶⁶ Similarly, an Islamic bank in Turkey in partnership with a German bank launched a fully-digital Islamic banking service in 2018 targeted at the Muslim community in Europe.¹⁶⁷

A global-leading Islamic bank only recently entered into a strategic technology partnership with a leading innovative banking software provider to leverage on the entity's Islamic Banking Suite solution, while the latter benefits from the former's size and banking experience. The partnership is intended to enhance operational efficiency and provide cutting-edge experiences to customers based on modern financial technology without discounting the intrinsic values of Islam.¹⁶⁸

¹⁵⁷ Vives (2019).

¹⁵⁸ <https://www.gulf-times.com/story/654386/Malaysia-builds-framework-for-digital-Islamic-bank>

¹⁵⁹ FinTech is viewed as technologically enabled innovation in financial services that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services, <https://www.fsb.org/work-of-the-fsb/policy-development/additional-policy-areas/monitoring-of-fintech/> accessed 16 April 2020.

¹⁶⁰ KPMG, Pulse of Fintech Report, H22019. <https://assets.kpmg/content/dam/kpmg/xx/pdf/2020/02/pulse-of-fintech-h2-2019.pdf>

¹⁶¹ GSMA, The State of Mobile Internet Connectivity, 2019. <https://www.gsma.com/mobilefordevelopment/wp-content/uploads/2019/07/GSMA-State-of-Mobile-Internet-Connectivity-Report-2019.pdf>

¹⁶² State of the Global Islamic Economy Report, 2018/2019, p. 18. <https://haladinar.io/hdn/doc/report2018.pdf>

¹⁶³ Ibid.

¹⁶⁴ According to the Financial Stability Board (FSB) (2019), “open banking operations” refers to a system in which financial institutions' data can be shared for users and third-party developers through APIs.

¹⁶⁵ N. Alam, L. Gupta and A. Zameni (2019). Fintech and Islamic Finance. Switzerland: Palgrave Macmillan. Hereafter Alam et al (2019)

¹⁶⁶ <https://www.gib.com/en/meem-region%E2%80%99s-first-digital-bank-launches-kingdom-bahrain>

¹⁶⁷ <https://salaamgateway.com/story/albaraka-turk-expanding-fintech-footprint-with-own-accelerator-launching-digital-only-islamic-bank-i>

¹⁶⁸ <https://www.temenos.com/news/2019/02/27/al-rajhi-bank-selects-temenos-to-power-digital-transformation/>

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There is a notable shift in the channel of distribution with an emphasis on distribution dominance over branch dominance¹⁶⁹ as a manifestation of a continuing digital transformation process in the global banking industry. Islamic banks are making efforts to keeping pace and are generally committing huge investments to digital transformation initiatives through which full-fledged digital branches are being opened¹⁷⁰ and, in some cases, staff are being retrained to leverage on the new technology. Some Islamic banks, in addition to previously rolling out digital-only banks, have established online banks that cater for small and medium-size enterprises and start-ups by supporting their cash-flow and financing needs.¹⁷¹

An Islamic bank is extending its digital banking experience to include interactive teller transactions via videoconferencing.¹⁷² The deployment of this technology has gained traction in the delivery of retail banking even in the last few months due to among other reasons the development of increasingly capable mobile apps and the movement restrictions associated with the COVID-19 pandemic, which have minimised physical visits to banks except in unavoidable situations.¹⁷³

Numerous Islamic banks have also introduced various mobile banking apps and digital wallets,¹⁷⁴ which are among the most popularly deployed technologies – especially for deliveries and e-hailing services. Their usefulness especially for financial inclusion through payment services and financing is well noted in jurisdictions with a low penetration of bank accounts ownership but a high rate of access to mobile smartphones, especially among millennials.¹⁷⁵ In addition, “Cardless Cash Withdrawal” was recently introduced by an Islamic bank as part of its mobile banking app. With this, customers can use their mobile smartphone number to transfer funds to an intended recipient who may not necessarily have a bank account. The recipient receives an SMS with a one-time PIN that can be used to withdraw cash from the closest ATM of the bank without a debit or credit card.

Another Islamic bank also introduced Chat Banking via the WhatsApp platform. This is to further enhance the experience and engagement of the patrons of its digital banking channels who will be able to perform myriad financial transactions in a secure and confidential manner over the platform.¹⁷⁶ An Islamic bank, as part of its innovation and digital transformation process to enhance customer experience and convenience, unveiled its digital virtual employee called “Dana”, which will digitally provide FinTech tips and insights as well as information on the Islamic bank’s products and services.¹⁷⁷

Based on the alignment of its operational principles with Shari’ah principles such as trust, transparency, traceability, fairness and equality, Islamic banks have also applied blockchain technology in their various operations, albeit still at a very early stage and mainly in cryptocurrency¹⁷⁸ which although has attracted variety of rulings among Shari’ah scholars seems to be gaining momentum.¹⁷⁹ Some FinTech firms have obtained certification for the Shari’ah compliance of their digital currencies in their respective jurisdictions.¹⁸⁰ Blockchain technology is also increasingly being used for the operation of smart contracts in Islamic banking. In this case, programmable applications have been employed to self-verify and self-execute Shari’ah-compliant financial transactions. For instance, while appearing virtually to all network users, automatic change of ownership or adjustment to financial flow in a contractual transaction can be triggered due to the occurrence of specified events in the contractual clause.¹⁸¹ Some Islamic banks have also used blockchain in their cheque-based payment process as well as for *shukūk* issuance to authenticate transactions and mitigate potential for fraud.

¹⁶⁹ While a notable trend in global banking is the gradual increase in opening of digital banking accounts at the expense of branch banking, the COVID-19 pandemic, especially its consequential social distancing and restricted movements, will further make digital banking inevitable.

¹⁷⁰ For instance, in Malaysia, Bank Islam has earmarked RM 300 million for its digitisation project between 2019 to 2021, while the MBSB Bank plans to spend RM 250 million on digitising its operations that will also see five of its 46 branches converted into digital branches. Though spending is earmarked for its entire banking group including CIMB Islamic, the bank plans to spend RM 2 billion between 2019 and 2023 to enhance its operational efficiency via digitisation.

¹⁷¹ <https://fintechnews.ae/4797/abudhabi/uaes-first-digital-business-bank-unveiled/>

¹⁷² <https://www.thenational.ae/business/banking/adib-goes-digital-at-uae-branches-as-it-courts-savvy-customers-1.969330>

¹⁷³ <https://thefinancialbrand.com/94345/coronavirus-covid-mobile-video-banking-branch/>

¹⁷⁴ The digital wallet is a device in which money is stored or pre-funded to make payments to connected payment terminals regardless of whether or not the holder has a bank account.

¹⁷⁵ Conversely, a new form of exclusion could also be created, especially among the elderly or extremely poor people.

¹⁷⁶ https://www.zawya.com/mena/en/press-releases/story/Emirates_Islamic_becomes_worlds_first_Islamic_bank_to_launch_banking_via_WhatsApp-ZAWYA20190407092519/

¹⁷⁷ <https://wanbabablog.com/2019/05/28/bahrain-islamic-bank-unveils-its-first-virtual-employee/>

¹⁷⁸ See N. Alam et al. (2019) for examples of the deployment of blockchain and smart contracts in Islamic finance.

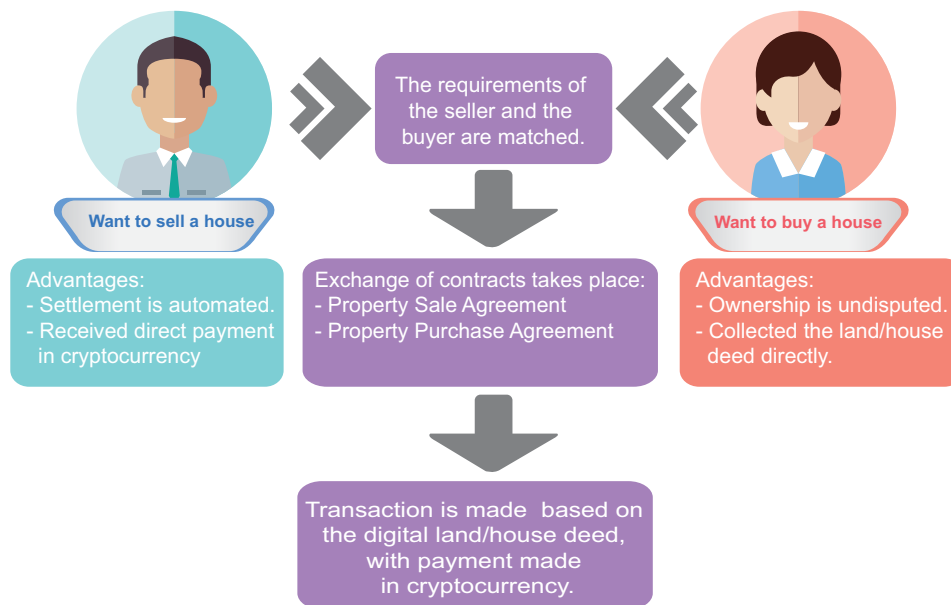
¹⁷⁹ See Mufti Muhammad Abu-Bakar (2019). Shari’ah Analysis of Bitcoin, Cryptocurrency, and Blockchain. <https://blossomfinance.com/bitcoin-working-paper>

¹⁸⁰ Some examples include HelloGold in Malaysia that received certification from Amanie Advisors, and Blossom Finance in Indonesia. There is also Qintar, a Switzerland based firm which launched its first Shari’ah-compliant coin. Similarly, Switzerland based X8 AG and Bahrain based Rain have also obtained certification from Shari’ah Review Bureau in Bahrain. Adab Solutions based in the UAE also launched its First Islamic Crypto Exchange (FICE) which has since passed legal registration in Bahrain.

¹⁸¹ Mohd. Zain, N.R., Engku Ali, E.R., Adewale, A. and Abdul Rahman, H. (2019). Smart Contracts in Blockchain: An Exploration of the Legal Framework in Malaysia, *Intellectual Discourse*, Vol. 27, No. 2.

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Figure 3.1.1 Operation of a Smart Contract



Source: N.R. Mohd. Zain, E.R. Engku Ali, A. Adewale and H. Abdul Rahman (2019). "Smart Contracts in Blockchain: An Exploration of the Legal Framework in Malaysia", *Intellectual Discourse*, Vol. 27, No. 2.

With the support of multilateral organisations like the Islamic Corporation for the Development of the Private Sector (ICD), further options are still being explored by start-ups to deploy blockchain technology for Shari'ah-compliant liquidity management, interbank relations and commodity transactions. Other areas being explored include using smart contracts based on blockchain technology to automate the entire contractual process of institutions offering Islamic financial services.¹⁸²

No doubt, there are enormous benefits to be obtained from digital Islamic banking. Customer experience in terms of speed, convenience, inclusion, etc., and the enhanced operational efficiency of Islamic banks, would be significantly impacted. However, the consequential increase in competition and contestability in the banking industry, as well as other factors explained in the next section, have financial stability implications.

Financial Stability Implications of Digital Islamic Banking

The future outlook of the IFSI in general and Islamic banking in particular revolves around the repository, availability and access to accurate yet comprehensive digitalised data about a customer, which can be processed in real time based on algorithms to arrive at creditworthiness, products and services preferences, etc. This would have implications for the financial stability of the Islamic banking industry arising from how the incumbents respond to the digital transformation process and its consequential increased possibility for new disruptors to enter the market, thus heightening competition.¹⁸³

At the moment, both large and small incumbents consider competition from the novel and technology-enabled business model of the new entrants as being moderate at most.¹⁸⁴ However, competitive differentiation and contestability of the incumbents will largely depend on to what extent they can digitalise their workplaces to enhance operational efficiency through optimal combination of both front-office and back-office technology, and to attract the right talents with the specific requisite human capital.

Perhaps new entrants, in a bid to avoid regulation and compliance costs, would not opt to become licensed digital banks, so would not be able to venture into activities such as accepting deposits.¹⁸⁵ This presents a competitive advantage to incumbent Islamic banks due to the opportunity it provides for them to get stable and cost-efficient funding, to access the existing network infrastructure, and to understand the regulatory terrain, compared to new entrants. Nonetheless, the new entrants are envisaged to continue to have an increasing influence on customers' experience and expectations especially as they expand the scope of their services beyond digital payments and e-wallets to now include Shari'ah compliant P2P financing and equity crowd funding which are considered top growth sectors for the Islamic FinTechs in 2020.¹⁸⁶ This may exert pressure on the incumbent Islamic banks' profitability and ability to weather future business cycles.¹⁸⁷ There will even be more pressure where the incumbent Islamic banks still rely on obsolete legacy infrastructure, overextended branch network, disparate data sources and rigid internal

¹⁸² <https://ifkr.isra.my/news/post/blockchain-is-making-its-way-into-islamic-finance>

¹⁸³ FSB (2019). "FinTech and market structure in financial services: Market developments and potential financial stability implications", p. 1. www.fsb.org

¹⁸⁴ General Council for Islamic Banks and Financial Institutions (CIBAFI), Global Islamic Bankers' Survey, 2019: Sustainability, Growth Drivers, and the Regulatory Challenge. <http://cibafi.urbansoft.co.uk/Files/L1/Content/CI1809-CI1809-GlobalIslamicBankersSurvey2019Report.pdf>

¹⁸⁵ As stated in the Islamic Fintech Report, 2018, out of the 93 Islamic FinTech start-ups, only eight focused on deposits and transfers.

¹⁸⁶ <https://ceif.iba.edu.pk/pdf/IslamicFinTechReport19.pdf>

¹⁸⁷ FSB (2019).

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operations and culture. This is because post-COVID-19, awareness created about social distancing and avoiding cash¹⁸⁸ as a measure to prevent contracting diseases, and increased experience with online banking due to the restrictions on movement, will not favour the physical service delivery that branches are meant to provide.

There has been a gradual shift among financial institutions from an on-premises data service to a public cloud-based data service. The possibility of technology externalisation due to the proliferation of technology vendors and platforms that offer cloud services would reduce incumbents' infrastructure and human resource requirement costs significantly. However, incumbents may have to contend with providing financial services on platforms they neither own nor have control over. The FSB already notes the financial stability implications of such, especially in the event of a cyber-attack on or an operational failure of such cloud services. In a case where quite a number of incumbents rely on a few dominant cloud service suppliers, this may pose a systemic risk triggered by "cloud concentration" risk.¹⁸⁹

The potential for the occurrence of a cyber-attack on any financial institution is more a matter of when than if. The swift changes in technological advancement make the legacy infrastructure of many incumbents highly susceptible to cyber risks. In fact, the CIBAFI Islamic Global Bankers' Survey 2019 ranked cyber risk as the number one risk facing Islamic banks. Given the implications of cyber-risk occurrence for financial stability, the focus of incumbents should therefore transcend cyber-risk prevention and also cover response, recovery and adaptation, as such risks are difficult to pre-empt yet evolve and transform swiftly with no trace of perpetrators. Huge sums of money are currently being spent, and more would be needed for an outright overhaul of legacy infrastructures for information sharing among stakeholders as well as to strengthen cyber-security units with the requisite human talents, especially domain specialists.

If properly executed, digital transformation holds opportunities for Islamic banks to boost their revenues.¹⁹⁰ Otherwise and in a bid to sail through, the incumbents may resort to increased risk taking to make up for the shortfall in margins.¹⁹¹ In order to curb excessive risk taking at the individual bank level and systemic risks at a macro level, prudential requirements have often been imposed on incumbents. For instance, to complement the Basel III accords, there are equivalent IFSB standards on capital adequacy and liquidity requirements for Islamic banks that have been implemented in numerous jurisdictions. However, by imposing prudential regulations, the impetus for shadow banking activities may increase, as has been observed in conventional banking. Shadow banks¹⁹² as financial service disruptors have been said to prosper in areas and activities where compliance with regulatory requirements has been considered a burden by traditional deposit-taking banks.¹⁹³

In addition, there are relatively limited investment opportunities for Islamic banks compared to their conventional counterparts, due to the Shari'ah-compliant requirements for the former. Islamic banks also face a high regulatory capital requirement of high risk weights on the assets (RWA) of risk-sharing financing modes, which impedes the placing of funds in such assets.¹⁹⁴ This is in sharp contrast to the relative focus of about 70% of the Islamic FinTech start-ups, which is on business and consumer financing mainly based on P2P technology solutions.¹⁹⁵ While this might be welcomed by proponents of more risk-sharing financing in Islamic banking, there may be other stability issues. For instance, the fact that these new entrants help to mobilise a substantial amount of funds, which they do not retain, may heighten their susceptibility to moral hazards and adverse selection due to information asymmetry.¹⁹⁶ There are also arguments that the new entrants in a bid to increase financing volume to boost revenue may result in a lower-quality financing assessment process.¹⁹⁷

¹⁸⁸ In the UK, it was reported that ATM transactions dipped by more than 50% compared to 2019 due to the COVID-19 outbreak. See H. Eroglu (2020). The NEW NORMAL in banking and payments has come to stay. <https://www.finextra.com/blogposting/18665/the-new-normal-in-banking-and-payments-has-come-to-stay>.

¹⁸⁹ R. Harmon (2018). "Cloud Concentration Risk: Will this be our next systemic risk event?", Cloudera White Paper. https://www.researchgate.net/publication/331099204_Cloud_Concentration_Risk_Will_this_be_our_next_Systemic_Risk_event

¹⁹⁰ For instance, in Malaysia, Bank Islam's multi-year digitisation programme resulted in 80% y-o-y growth in internet banking related fee income, 25% y-o-y growth to 1.2 million in number users, and a 133% growth in online transactions in 2018. See <https://themalaysianreserve.com/2019/07/08/digitising-to-drive-growth-of-islamic-banks/>

¹⁹¹ Profitability is a significant predictor of financial crises and the resilience of banking institutions. As an important determinant of retained earnings, it serves as the first line of defence in the event of financing losses or impairment.

¹⁹² These institutions provide partial or full financing intermediation outside the regular banking system.

¹⁹³ Buchak et al. (2018, cited in Vives, 2019) stated that approximately 55% of the growth in shadow banking could be attributed to the regulatory difficulty faced by traditional banks.

¹⁹⁴ A. Adewale, and S. Archer (2019). Risk Sharing in Islamic Banking. IFSB Working Paper 10. www.ifsb.org

¹⁹⁵ These start-ups comprise only customer-financing solutions. Software and payment system providers are excluded.

¹⁹⁶ For instance, based on the *muḍārabah* financing mode adopted in Islamic equity crowdfunding, only the investors bear the loss of capital to the extent the crowdfunding service provider is not negligent.

¹⁹⁷ Bayluk and Davydenko (2018, cited in Vives, 2019) stated that P2P loans recorded higher default rates relative to other types of credit among consumers of comparable scores.

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In the short term, it is likely that the influence of new entrant service disruptors on incumbent Islamic banks may not be severe due to a number of factors, such as inertia inhibiting switching among many old customers, and regulatory barriers to entry to disruptors and their lack of access to soft information.¹⁹⁸ Other factors include reputation and brand recognition, and the possibility of the incumbents using their financial capability either to replicate or to absorb the new entrants outright.¹⁹⁹ The COVID-19 pandemic has also resulted in significant pull-back of venture capital investments in FinTechs leading many of them to be faced with the challenge of coping with abrupt pressure to maintain operational resilience even as the economic uncertainty may stunt their growth trajectory.²⁰⁰

In the medium to long term, however, these new entrants,²⁰¹ and other non-bank players such as TechFins,²⁰² are expected to be the pivot around which the changing landscape of the Islamic financial industry ecosystem rotates. A widely held view is that the future of financial services will be shaped by how much control customers have over the data held about them by financial institutions and how much access third parties have to this data. In which case, Islamic FinTechs are also expected to accelerate their entry into prominence in the Islamic banking and financial ecosystems.

The Way Forward

Without prejudice to the numerous benefits that digital banking offers, it has resulted in increasing activities of the non-bank financial institutions,²⁰³ as well as increasing cyber-security risks²⁰⁴ among other operational issues. Technological adoption has brought about a new regulatory and supervisory challenge for the financial sector regulators as new risks are introduced – for instance, safeguarding data privacy,²⁰⁵ cyber security, consumer protection, consumer financial health, compliance with anti-money laundering/combating the financing of terrorism (AML/CFT) regulations, and so on.

Regulatory and supervisory authorities have been generally cautious about ensuring that a favourable disposition towards technological financial innovation does not infringe on financial market integrity and stability. Lack of, or unequal application of, regulation on, for instance, prudential requirements may encourage regulatory arbitrage and higher risk taking by new entrants. The inertia that inhibits provision of a clear policy guideline in this regard could also magnify the threat to financial stability.

RSAs need to be cognisant of the potential new risks that digital Islamic banking poses as they coordinate prudential regulation and competition policy.²⁰⁶ Thus, developing a “fit-for-purpose” regulatory and supervisory regime is imperative, notwithstanding the formidable challenge it presents in balancing the objectives of facilitating innovation while ensuring effective risk management, financial stability. Regulators are expected to increase the frequency of simulation exercises on emerging technology risks and to strengthen focus on internal cyber-security activities by requesting data on cyber threats.²⁰⁷

More importantly, technological innovation should not provide a premise upon which the principles of Shari’ah would be compromised. IFSB-10: Guiding Principles on Shari’ah Governance Framework for Institutions Offering Islamic Financial Services, allows for a variety of Shari’ah governance structure. In jurisdictions where it is possible, the synergy between Islamic finance and financial technology entails a very prominent role for the Shari’ah Supervisory Board at the Islamic financial institutional level and for the Shari’ah Council at the supervisory level. This role is specifically aimed at ensuring that their oversight function adequately addresses Shari’ah non-compliance issues that may arise from the proliferation of innovative financial products and processes due to the use of advanced technologies to render Islamic financial services. Importantly, such oversight should also address matters arising from product design – for instance, Islamic FinTech apps – in a manner that permits a discerning, end-to-end Shari’ah compliance, contractual relationship, rights and beneficial ownership, etc., based on Islamic jurisprudence.

¹⁹⁸ This advantage of the incumbents that is often created due to the long-term relationship they have with their customers can be attenuated if the service disruptors use machine-learning techniques – for instance, to process big data on the consumers: Vives (2019), p. 252.

¹⁹⁹ Ibid.

²⁰⁰ N. Uwaje (2020). A Presentation made at the Arab Monetary Fund (AMF) Online meeting on “FinTech Innovation, Regulations and Collaboration: FinTech Resilience during and post COVID-19”, held on 7 May 2020.

²⁰¹ According to the FSB (2019), these are “technology-enabled innovations in financial services that could result in new business models, applications, processes or products with an associated material effect on the provision of financial services”.

²⁰² These firms leverage on their advantage of possessing technological advantage and data about a large number of their pre-existing customer base while rendering their primary business. On the basis of these dual advantages, they add rendering financial service to their value chain.

²⁰³ Vives (2019), pp. 243–72.

²⁰⁴ Concerns about cyber-security risks featured prominently in the response to the CIBAFI’s Global Islamic Banking Survey 2019. <http://cibafi.urbansoft.co.uk/Files/L1/Content/CI1809-CI1809-GlobalIslamicBankersSurvey2019Report.pdf>

²⁰⁵ There is a need to ensure that digital footprints generated are not used to expose customers to the threat of security risks such as digital fraud and abuse, or “emotional manipulation” arising from unsolicited suggestions to purchase other products and services.

²⁰⁶ In some countries, RSAs for the financial service industry do not have concurrent powers of enforcement of competition policy due to ring-fencing and security concerns (Vives, 2019).

²⁰⁷ Examples from conventional banking – including efforts like the Cyber Security Fortification Initiative in Hong Kong, and the centre established in Singapore to monitor cyber threats to firms – are expected to continue in numerous other jurisdictions.

EMERGING ISSUES IN THE IFSI

A wave of new regulations is also being rolled out to the non-bank financial service providers, such as Islamic FinTechs and Islamic TechFins. While some countries have rolled out action plans for FinTech, others have included technology companies within the purview of their macroprudential assessments. In order to strengthen regulatory oversight on financial technology, some countries are also considering monitoring the implications of third-party relationships that exists among various Islamic banks and their FinTech partners, perhaps to mitigate against step-in risk that may arise outside of, but connected to, the Islamic banking industry.²⁰⁸

Essentially, RegTech and SupTech²⁰⁹ in Islamic finance are aimed at enhancing the transparency, consistency and standardisation of regulatory processes in a way that promotes proper interpretation of regulatory standards and at a lower cost and ensures risk-based supervision for Islamic banks' regulators. The role for regulators in this space would be to ensure that huge investments are made in technology to enhance the automated analysis of examination and enforcement of Islamic banking principles. It is envisaged that the consequential enhanced regulatory compliance, monitoring of activities and improved real-time surveillance would have positive implications for stability of the financial system.

Government support for the digital transformation process has been very encouraging in numerous jurisdictions where Islamic banking is present, especially through providing guiding policy documents, conducive environment and the infrastructure needed for regulatory sandbox experiments.²¹⁰ Building on experiences garnered specific to digital Islamic banking regulatory guidance on conduct requirements and operational matters relating to risk, data management, product and process compliance with Shari'ah, etc. may be necessary to create justification for the distinct identity from the general digital banks. It should also be possible to support Islamic FinTechs in developing partnerships with incumbents, or providing a conducive regulatory environment for incumbents to assist the growth of Islamic FinTechs.

Human capital development is a fundamentally important pillar for innovation to be successful. The digital transformation process requires highly specialised human capital and domain experts. Therefore, digital Islamic banks will need to retrain and reskill existing talent even as they make efforts to attract new ones that fit the imminent digital workforce transformation of the banking workforce.

Perhaps, if at all it is necessary, there may not be an urgent need for standards on financial technology. Standards or regulations are principles-based, whereas most of the activities around ML and AIs are based on algorithms built around big data. As such, the pace of disruptive technology may be too fast for a standard development process, which may take years thus exacerbating exposure of Islamic banks to the vagaries of the pervasive technological disruption. In this case, a role for international standard setters like the IFSB²¹¹ would be to observe and share best practices as a form of general principles across jurisdictions.

The IFSB has a dedicated segment on digital finance in its recently issued technical note on financial inclusion and Islamic finance. In this document, the IFSB has provided a detailed technical guide on the priorities and considerations that are pertinent for regulatory and supervisory oversight vis-à-vis the implications of technological innovation for financial inclusion through the Islamic financial services industry of member jurisdictions. The IFSB has also included as part of its strategic work plan for 2020 the issuance of a working paper that assesses the cybersecurity preparedness of Islamic banks as well as their resilience to cyber risks.

Conclusion

Emerging technology is expected to further revolutionise the financial sector, and to enhance financial accessibility, convenience and efficiency. The inevitability of the digital transformation process as a new normal in the banking industry has been strengthened by the movement restriction order and social distancing instructions as measures to curb the spread of COVID-19. Islamic banks that commenced their digital transformation process prior to the outbreak of COVID-19 may find it relatively easier than those that would have to react due to the inevitability of such transformation as a crucial post-COVID-19 economic recovery reality.

Regulators in jurisdictions where Islamic banking is practiced have, and are continuing to roll out requisite policy guidance and framework, promoted regulatory sandboxes, etc. Nonetheless, as events unfold further consideration needs to be explored on how technological innovation can be pursued without adversely impacting financial stability and consumer protection as well as achieving support for financial inclusion and real-economic growth.

Yet, it is essential to ensure that technology-led operations duly comply with Shari'ah governance requirements to ensure best practices while protecting consumer rights. An effective Shari'ah governance system for maintaining Shari'ah compliance is the core of the Islamic banking business that differentiates it from conventional banking regardless of the platform through which products and services are provided.

²⁰⁸ According to Vives (2019), this interconnection may arise through ownership, partnership or a sponsorship relationship between an incumbent and a financial service disruptor.

²⁰⁹ RegTech is the use of technology by financial institutions to enhance compliance with prudential regulations, while SupTech is the use of technology by regulatory and supervisory authorities to enforce prudential regulation.

²¹⁰ This requires providing support for critical infrastructure and ancillary services available to FinTechs, such as incubator centres, office spaces and other "hard" infrastructure. This may also require governmental support through tax incentives and other schemes that may attract Islamic FinTech start-ups. Examples of the regulatory sandboxes of the UAE, Bahrain, Malaysia, etc. are worth highlighting in this respect.

²¹¹ As per its mandate, the IFSB sets prudential standards for institutions offering Islamic financial services to complement other international standard setters such as the BCBS, IOSCO and IAIS.

EMERGING ISSUES IN THE IFSI

3.2 FINANCIAL MARKET INFRASTRUCTURES: SOME REGULATORY CONSIDERATIONS FOR ISLAMIC FINANCE

Contributed by Mohamad Farook bin Naveer Mohideen

Introduction

The Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO) define a financial market infrastructure (FMI) as a “multilateral system among participating institutions, including the operator of the system, used for the purposes of clearing, settling, or recording payments, securities, derivatives, or other financial transactions. FMIs typically establish a set of common rules and procedures for all participants, a technical infrastructure, and a specialized risk-management framework appropriate to the risks they incur”.²¹² In layman’s terms, it refers to an integrated system designed to facilitate securities and payment transactions in a financial market. An FMI has five components, namely: a payment system (PS) that is systematically important, central securities depository (CSD), central counterparty (CCP), securities settlement system (SSS) and trade repository (TR).

FMIs are a vital component in the financial market, serving as a backbone in any financial transaction. The failure of an FMI could result in disruption of or transmittal of shocks within the economy, the impact of which would be catastrophic to the domestic market and potentially extended to the cross-border or international level.

FMIs can be seen in various forms and ownership structures as they can be owned and operated by a central bank (CB) or other government agency, or by the private sector, such as by an association of financial institutions, non-bank clearing corporation or specialised banking organisation. FMIs may also be operated by for-profit or not-for-profit entities. It is also important to note that in most jurisdictions, FMIs may be regulated by various regulators, since they concern banking and non-banking entities and regulation may involve both prudential and conduct elements.

FMIs in the Context of Islamic Finance

Currently (except in those countries whose systems are entirely Islamic), the IFSI is leveraging on the common FMIs ecosystem, which is shared by both industries (i.e. conventional and Islamic finance) to operationalise their financial activities. However, little or no in-depth work/research has been carried out in relation to the specificities of Islamic finance in FMIs and there may well be potential Shari’ah issues that have so far been overlooked. Thus, it is an area of the IFSI that has not yet gained sufficient attention and exploration.

So far, Malaysia is the only country that has a dual FMIs system that caters for both conventional and Islamic securities.²¹³ In 2016, Bursa Malaysia launched its “world’s first end-to-end, fully integrated Islamic securities exchange platform”, known as Bursa Malaysia-i (BM-i). The establishment of BM-i was intended to create a conducive marketplace where investors can have access to the capital market to undertake both trade and post-trade activities (including trading, clearing depository and settlement) in a Shari’ah-compliant manner. As at March 2020, the registered participants (stockbrokers) numbered 16, comprising both Islamic windows and full-fledged Islamic financial institutions. Salient features of Shari’ah-compliant FMIs are depicted in Bursa Malaysia’s Explanatory Notes, namely: Shari’ah Principles in Clearing Guarantee Fund (September 2016) and Shari’ah Principles in Equities Margining (September 2016). The former document sets out the Shari’ah principles in relation to the settlement guarantee fund, which serves as a safety net for the FMIs should any of the participants default in a transaction. The Equities Margining document sets out the Shari’ah principles in relation to the margin system, where it functions as a risk mitigation tool that is usually operated by the CCP to minimise the impact of a default by its FMIs participant.

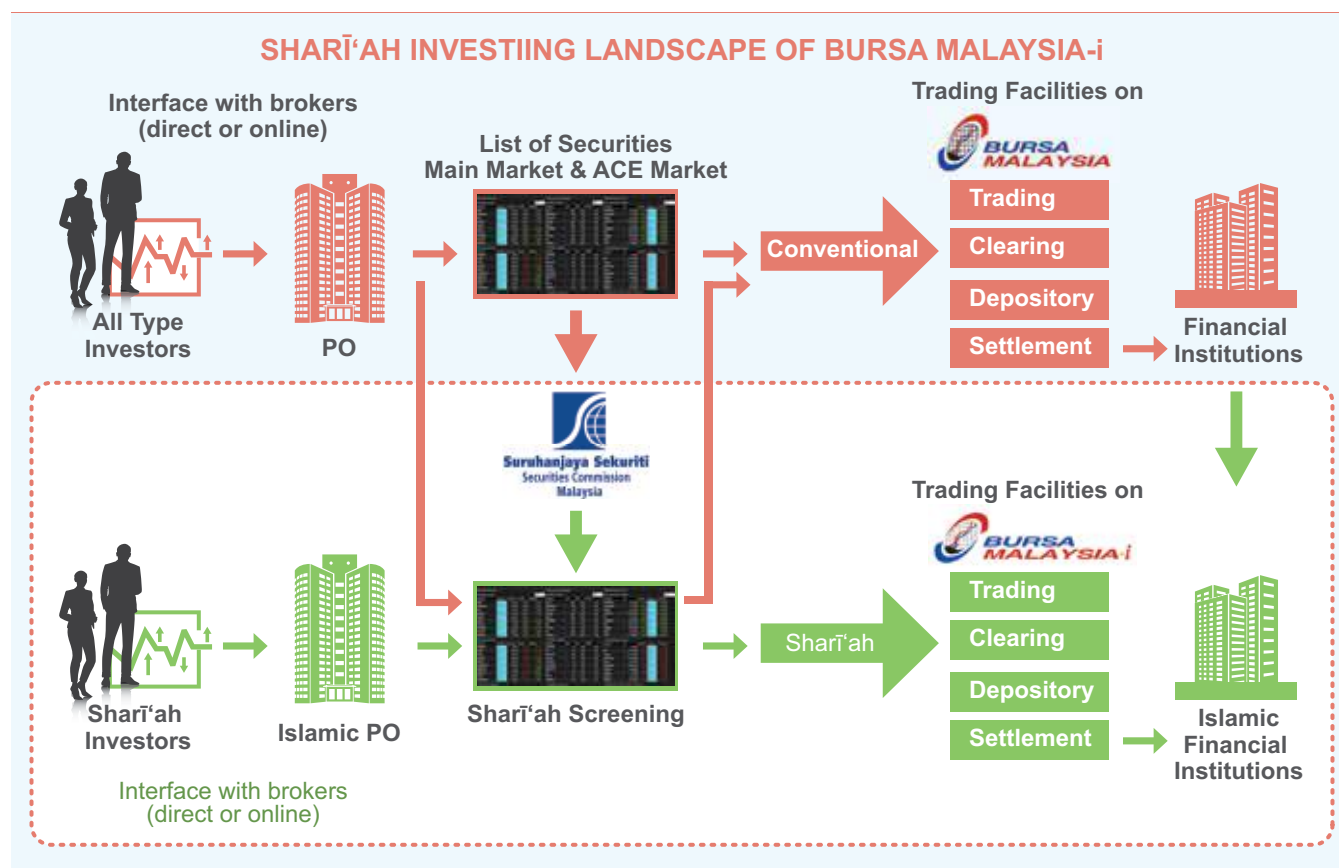
²¹² CPSS-IOSCO, Principles for Financial Market Infrastructures, April 2012, p. 7.

²¹³ The FMIs responsible for clearing, depository and settlement are the same for both conventional and Islamic securities.

EMERGING ISSUES IN THE IFSI

Figure 3.2 illustrates the differences between the conventional platform and BM-i:

Figure 3.2.1 Overview of BM-i



Source: Adapted from Bursa Malaysia's presentation on Shari'ah Investing on Bursa Malaysia-i (IFN Indonesia Forum 2017), 27 July 2017.

The second row in Figure 3.2.1 (in a red box) illustrates that for investors who are keen to invest in Shari'ah-compliant equities and that are transacting via BM-i through registered Islamic brokers, only equities that are tagged as Shari'ah-compliant²¹⁴ are made available. Furthermore, the process that follows after will be conducted via the BM-i system, where trading, clearing, depository, settlement (including the margin system and the guarantee settlement fund) will be conducted in a Shari'ah-compliant manner. Lastly, at the final stage of a transaction, the settlement leg will be concluded in an Islamic financial institution to avoid any comingling of funds. To complement the BM-i, Bursa Malaysia has issued several guiding documents known as Best Practices for Shari'ah Investing and Best Practices in the Islamic Stockbroking Services Undertaken by Participating Organisations in an effort to provide guidance for investors and FMIs entities on the specificities of Islamic finance within the ambit of FMIs.

Other than the two issues addressed by BM-i above (i.e. the settlement guarantee fund and the margin system), for an FMI to be considered as Shari'ah-compliant it should also address other aspects, such as collateral accepted in exchange for a liquidity facility provided by CBs or other FMIs entity as well as for the margin system. Other considerations are Shari'ah governance, and liquidity facility (which includes securities borrowing and lending²¹⁵), investment methodology by the CCP or other entity within FMIs, and appropriate disclosure requirements to guide the stakeholders on the specificities concerning Islamic finance.

²¹⁴ The list of Shari'ah-compliant equities is announced twice a year by the Securities Commission Malaysia using its own set of benchmarks.

²¹⁵ It is worth mentioning that, in the past, conventional standard setters encouraged the development of securities borrowing and lending arrangements. As part of the effort of Islamic finance to integrate with the international architecture, a proper balance is needed to achieve such an objective.

EMERGING ISSUES IN THE IFSI

IFSB Initiative

The IFSB has addressed some of the issues raised above in its publications, but in only a brief manner. For example, the IFSB standard on Core Principles for Islamic Finance Regulation [Islamic Capital Market Segment] (IFSB-21) dealt with the management of default risk and market disruption, and suggested that as part of the risk mitigation tools for principal, settlement guarantee, or performance risk, the Sharī'ah-compliant option would include the following scenarios:

- (i) Establish a *takāful* fund or a *takāful* scheme whereby all market participants become members of such a fund;
- (ii) Allow the exchange to assume such a risk only on a *tabarru'* basis without stipulating this as a condition; or
- (iii) Allow the exchange to act as a third-party guarantor or a *kafil*, assuming these risks without any counter-value.

However, in case of negligence or misconduct, the exchange will be held liable.

Other than that, the IFSB's guidance note on Sharī'ah-Compliant Lender-of-Last-Resort Facilities (GN-7) provides discussion and guidance on liquidity facilities provided by the CBs pertaining to Sharī'ah-compliant lender-of-last-resort (SLOLR) where it covers, among others, matters relating to collateral, structure and contracts of SLOLR, disclosure requirements by CBs, and supervisory actions. To some extent, the guidance in this publication may be applicable to liquidity facilities provided by other entities within the FMIs, such as the central counterparty.

It is also worth mentioning that IFSB Working Paper 1: Strengthening the Financial Safety Net: The Role of Sharī'ah-Compliant Lender-of-Last-Resort (SLOLR) Facilities as an Emergency Financing Mechanism provides several examples of collateral acceptable in Sharī'ah, including property, vehicles, *shukūk*, shares, ornaments or other valuables.

In order to give proper attention to such a long-overlooked segment of IFSI, the IFSB has allocated its resources to developing a new standard that is aimed to address the specificities of Islamic finance in the FMIs: Core Principles for Islamic Finance Regulation (Financial Market Infrastructures) (CPIFR FMI). This standard aims to complement the existing standard by the CPSS²¹⁶ and IOSCO's Principles for Financial Market Infrastructures (April 2012) and its associated Disclosure Framework and Assessment Methodology (December 2012), covering the 24 principles and five responsibilities of FMIs regulators. The CPIFR FMI, based on its initial study, has identified the following areas of focus.

- (i) **Settlement Guarantee Fund:** In addition to its underlying Sharī'ah basis, matters concerning acceptable contribution, the investment strategy for the guarantee fund, and the ownership and treatment of the income generated from the investment are among the areas where Islamic specificities are needed in order to provide guidance in this space. A guarantee fund is a common way for a CCP to manage defaults by its participants, and establishing one or more Sharī'ah-compliant approaches to this will assist CCPs in achieving compliance throughout their ICM operations.
- (ii) **Margin System:** Where an FMI operates in a Sharī'ah-compliant manner, the underlying contract used to provide the margin financing should be clearly stated and conducted in a way that is compliant with Sharī'ah law. Also, matters concerning the permissibility of the participant/investor to use the Islamic margin facility to buy non- Sharī'ah-compliant stocks from the exchange or to use a Sharī'ah non-compliant stock as collateral in the margin account in order to purchase a Sharī'ah-compliant stock (bearing in mind that some investors may be non-Muslim) should also be addressed accordingly. The margin system is widely used in securities trading activities, and currently there is no guidance provided by any Islamic standard setter in this matter.
- (iii) **Liquidity Facility:** There is a wide range of liquidity facility types provided by the entities in the FMI to ensure settlement finality. For example, some CBs provide a collateralised interest-free liquidity facility limited to financial institutions as opposed to a normal interest-based liquidity facility, and other jurisdictions provide liquidity facilities in the form of overnight repo, overdraft facility, securities borrowing and lending (SBL), etc. It is worth mentioning that there are reservations by some jurisdictions in relation to SBL's compliance with Sharī'ah. The main issue concerning SBL and short selling is the fact that a seller offers for sale an asset he does not own yet, which contradicts Sharī'ah rules and principles. This may raise broader issues of liquidity management for the market, since in the past conventional standard setters have encouraged the development of SBL arrangements for this, in some of which CCPs have been involved.
- (iv) **Investment Methodology by the FMIs' Entities:** To be in line with Islamic teachings, several aspects need to be addressed to avoid any prohibitions from Sharī'ah – for instance, assets in money market and fixed deposits should be kept in an Islamic bank account and be invested in Sharī'ah-compliant securities (where applicable). Where the FMI covers both Islamic and conventional markets, there may be issues about the maintenance of segregation between two or more sets of assets. Investment in Sharī'ah-compliant assets is a basic element of compliance, but its application in the case of FMIs has not previously been considered.

²¹⁶ The Committee on Payment and Settlement Systems (CPSS) changed its name to the Committee on Payments and Market Infrastructures (CPMI) on 1 September 2014. The CPMI promotes the safety and efficiency of payment, clearing, settlement and related arrangements, thereby supporting financial stability and the wider economy.

EMERGING ISSUES IN THE IFSI

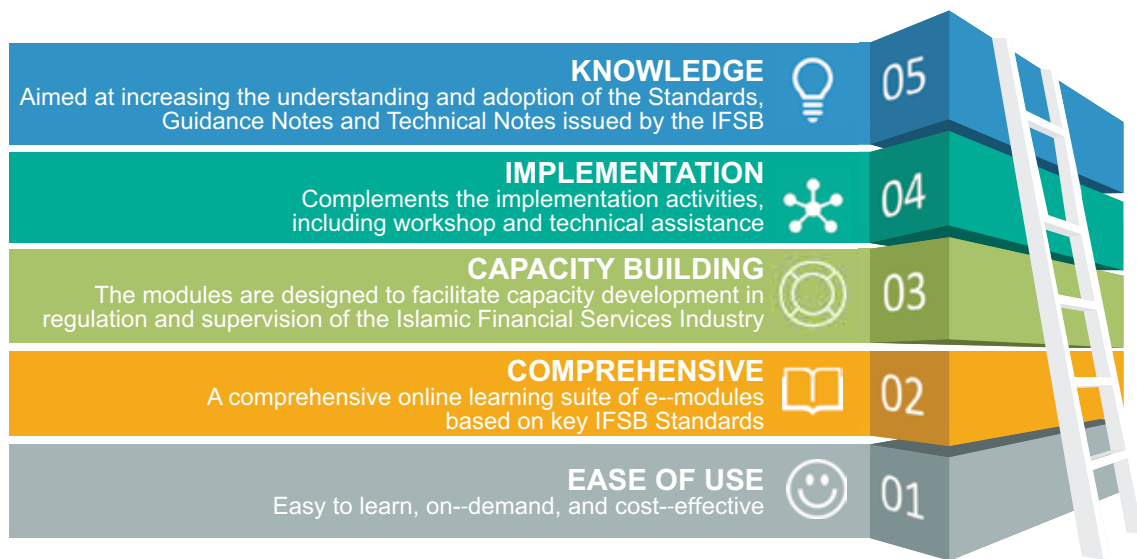
(v) **Disclosure Requirements:** There are several disclosures that the Sharī'ah-compliant FMI should arguably make known to the public/participants to ensure transparency and clarity in the marketplace. For instance, for an FMI that applies a settlement guarantee fund as part of its infrastructure, the disclosure of its investment (i.e. where the money is invested and which financial institution it is kept with) and the structure of the guarantee fund should be made clear to the participants, along with the recovery process upon default, etc. Also, where applicable, when the CCP invests the assets of its participants, it should be made clear to the participant where it is being invested.

(vi) **Sharī'ah Governance:** The FMIs should have a sound Sharī'ah governance framework in place to supervise all activities, services and/or institutions implicitly or explicitly claiming Sharī'ah compliance in the financial market infrastructure.

The development of the CPIFR FMI is intended to promote further integration of Islamic finance with the international architecture for financial stability and operational efficiency, especially in the areas of securities clearance and settlement, payment, and data recording in FMIs.

The standard on CPIFR FMI is expected to address the above-mentioned Islamic finance specificities and beyond, with greater emphasis on the CCP and CSD that they are the main areas of focus that require additional guidance for Islamic finance. Currently the standard drafting is ongoing and it is anticipated to be published in December 2021.

IFSB E-LEARNING PACKAGES



Core Principles

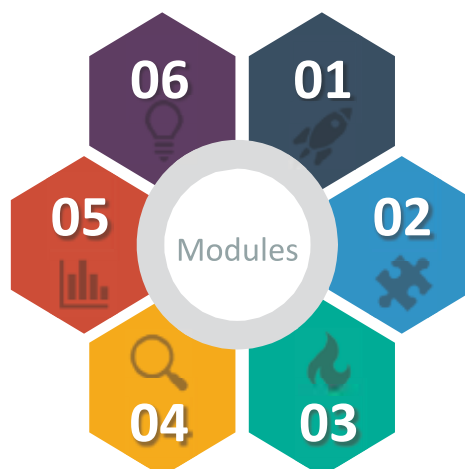
- IFSB-17: Core Principles for Islamic Finance Regulation (Banking Segment)

Supervisory Review Process

- IFSB-16: Revised Key Elements In The Supervisory Review Process

Conduct of Business

- IFSB-9: Conduct of Business for IIFS



Capital Adequacy

- IFSB-15: Revised Capital Adequacy

Risk Management

- IFSB-1: Guiding Principles of Risk Management
- IFSB-14: Risk Management for Takāful Undertakings

Governance

- IFSB-10: Shari'ah Governance Systems
- IFSB-6: Governance for Islamic Collective Investment Scheme
- IFSB-8: Governance for Takāful Undertakings

FULL MEMBER	ASSOCIATE MEMBER	OBSERVER MEMBER	NON MEMBER
<ul style="list-style-type: none"> • 3 Complimentary Access* • All Modules • Online Support • Certificate • Learning Progress Report to HR** 	<ul style="list-style-type: none"> • 2 Complimentary Access* • All Modules • Online Support • Certificate • Learning Progress Report to HR** 	<ul style="list-style-type: none"> • 1 Complimentary Access* • All Modules • Online Support • Certificate 	<ul style="list-style-type: none"> • All Modules • Online Support • Certificate
4 th user and above:	3 th user and above:	2 nd user and above:	Fee:
\$ 100	\$ 100	\$ 100	\$ 200
Valid for 12---month	Valid for 12---month	Valid for 12---month	Valid for 12---month

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- (*) Certificate and Learning Progress Report will not be provided for the Complimentary Access Users
- (**) Learning Progress Report to HR will be provided quarterly to Full Members and half---yearly to Associate Members

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4.0 GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

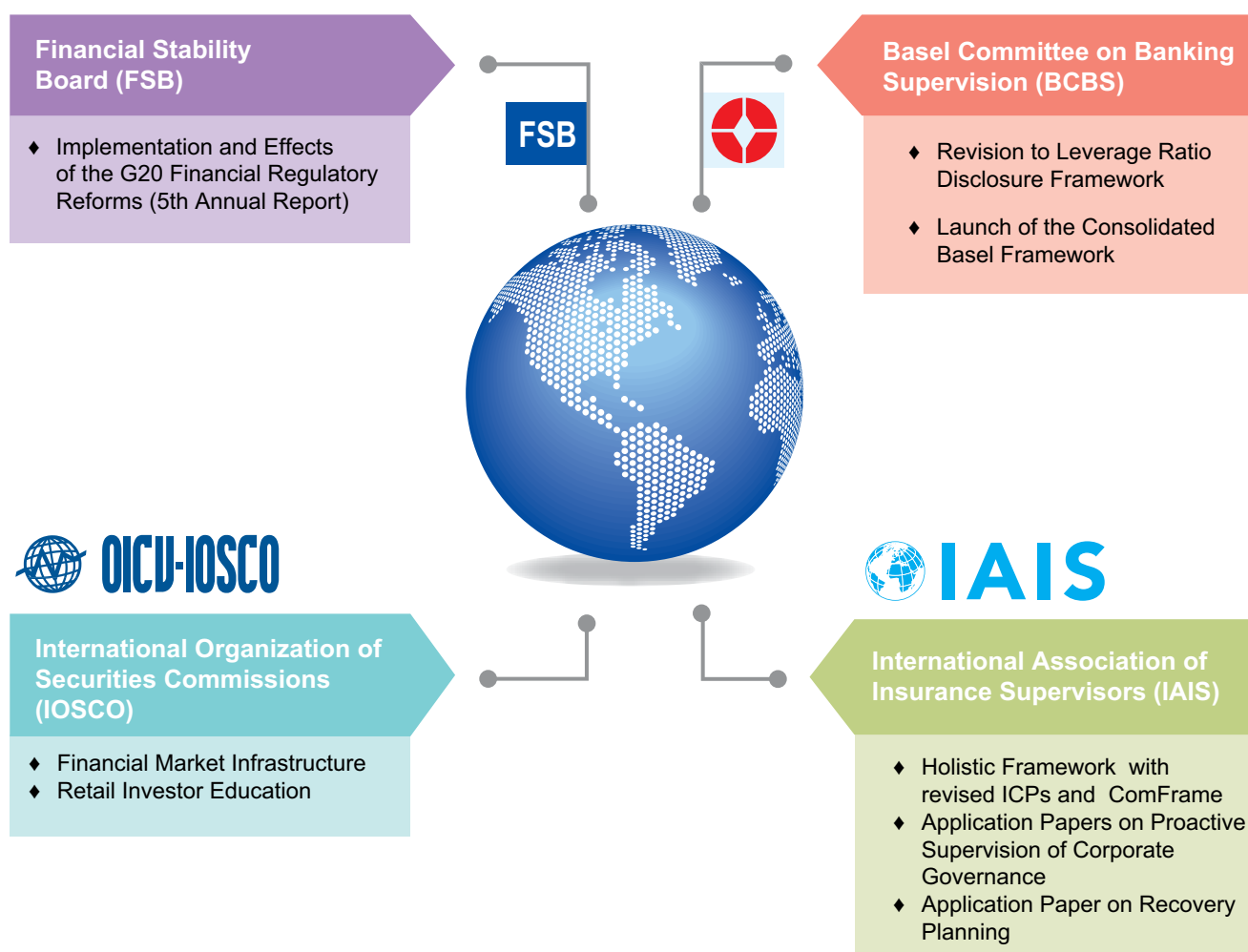


4.0 GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

4.1 GLOBAL DEVELOPMENTS AND IMPACTS ON THE IFSI

There have been some notable developments in the global regulatory landscape in the course of the year that are likely to impact on the Islamic financial services industry and on the work of the IFSB.

Global standard setters for the banking, securities and insurance sectors, such as the BCBS, IOSCO, IAIS and the FSB, have issued a number of documents in 2019, including standards, final reports, consultation reports and survey reports. The IFSB, being the complementary global standard setter for the Islamic banking, Islamic capital markets and *takāful* sectors, monitors closely the work streams of global standard setters, and this section of the report provides an update on those documents that have key relevance for the IFSB's standard-setting work.



GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

4.1.1 Financial Stability Board

Implementation and Effects of the G20 Financial Regulatory Reforms (5th Annual Report)

The FSB's fifth annual implementation report, published in October 2019, describes the implementation of the reforms called for by the G20 following the global financial crisis. The implementation, which is still in progress, is aimed at ensuring a stable and resilient financial system. The report describes that the positive progress of the financial reforms achieved in G20 jurisdictions led to improved capitalisation and liquidity positions, with less leveraged positions in the balance sheets of the large banks

Special attention was paid to regulations relating to FinTech and non-bank financial intermediation (NBFI), due to their growth expansion within the global financial system, such as the publication entitled BigTech in Finance, Third-Party Dependencies in Cloud Computing, and FinTech and Market Structure in Financial Services. Although these regulations may not be relevant yet for the IIFS due to their relatively small size and complexity, the IFSB remains vigilant regarding the development of FinTech regulations.

As members of the G20 countries, three IFSB jurisdictions – Saudi Arabia, Turkey and Indonesia – were included in the annual report. These jurisdictions made noticeable implementation progress, which is expected to support the rapid growth of Islamic finance in their jurisdictions.

4.1.2 Basel Committee on Banking Supervision

In 2019, the BCBS issued the following standard publications that may impact on the current or future work of the IFSB.

Revisions to Leverage Ratio Disclosure Requirements

The BCBS proposed revisions to address potential “window-dressing” of the leverage ratio, in the form of temporary reductions of transaction volumes in key financial markets around reference dates resulting in the reporting and public disclosure of elevated leverage ratios. This standard could be considered for the future work of the IFSB regarding Revised Standard on Disclosures to Promote Transparency and Market Discipline for Institutions Offering Islamic Financial Services.

Revisions to Leverage Ratio Treatment of Client-Cleared Derivatives

This revised version will allow leverage ratio treatment of client-cleared derivatives to generally align it with the measurement as determined per the Standardised Approach to measuring counterparty credit risk exposures (SA-CCR) as used for risk-based capital requirements. The revised treatment will permit both cash and non-cash forms of initial margin and variation margin received from a client to offset the replacement cost and potential future exposure for client-cleared derivatives only. To be eligible for offset, an initial margin that a bank has received from a

client should be subject to appropriate segregation by the bank as defined in the relevant jurisdiction. As the volume of the derivatives transactions in the Islamic finance space is limited, this standard does not have implications for the current and future work of the IFSB.

Launch of the Consolidated Basel Framework

In April 2019, the Basel Committee issued a draft version of the consolidated Basel Framework. The framework brings together all of the Basel Committee's global standards for the regulation and supervision of banks and presents them in a new section of its website. The framework comprises 14 “standards”, setting out requirements on specific topics, each of which is further divided into “chapters”. This modular format will make it easier to maintain the standards over time. The publication of the standards in the new format of the consolidated framework has focused on reorganising existing requirements, not introducing new requirements or otherwise amending the standards previously agreed and published by the Basel Committee. These changes will be considered as part of the current review of the IFSB's Revised Capital Adequacy Standard (IFSB-15). The working group on this project will study the document and determine which of the approaches suit the business activities of the IIFS.

4.1.3 International Organization of Securities Commissions

Financial Market Infrastructure (FMI)

The IOSCO and Committee on Payment and Market Infrastructures (CPMI)⁹⁶ publication entitled Principles for Financial Market Infrastructures (PFMI), published in 2012, provides 24 principles and five responsibilities for authorities to serve as minimum standards for RSAs in developing regulatory regimes and best practices in their respective jurisdictions. Amid the evolving financial ecosystem, the two standard setters are currently embarking on a joint work relating to FMIs, especially on central counterparty resilience, recovery and resolution, implementation monitoring of the PFMI, cyber resilience of FMIs and digital innovation in the context of FMIs.

In light of this, the IFSB is currently developing a new standard, Core Principles for Islamic Finance Regulation [Financial Market Infrastructures]. The standard is aimed to complement the existing PFMI standard, with the specificities of Islamic finance addressed in the 24 principles together with the five responsibilities for regulators where applicable.

Retail Investor Education

The IOSCO published its Core Competencies Framework on Financial Literacy for Investors in 2019. The aim of the framework is to provide an input for regulatory reform for RSAs in matters concerning investor education. The framework's main objective is to equip investors, especially retail investors, with an adequate level of financial literacy to make informed investment decisions.

GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

Similarly, the IOSCO published in 2019 a report entitled *The Application of Behavioral Insights to Retail Investor Protection*. The report ultimately aims to provide further insights to regulators on relevant issues and practices in various jurisdictions for the purpose of identifying areas for improvement in their regulatory reforms concerning retail investor protection.

Recently, the IOSCO released its work programme for 2020, in which the international standard setter reported that it is working on a policy to address and mitigate the risks posed by online cross-border marketing and distributions. This is in response to growing concerns relating to issues of online marketing and distribution of all investment products and services, including new high-risk products.

On that note, the IFSB is currently developing a new standard, *Guiding Principles for Investor Protection in the Islamic Capital Market*, which aims to provide a comprehensive minimum standard requirement for RSAs in developing regulatory regimes and best practices concerning the entire spectrum of investor protection, by taking into account the specificities of Islamic finance. This IFSB standard which is planned for issuance in 2020 is benchmarked against the relevant IOSCO publications.

Sustainable Finance

Ever since the Paris Climate Agreement in 2016, there has been increasing interest from the stakeholders concerning sustainable finance, and how everyone can play their role in providing better future for generations to come. In response to that, in late 2017, the IOSCO's Growth and Emerging Markets Committee (GEMC) had begun working on Sustainable Finance in Emerging Markets and the Role of Securities Regulators, with aim to help emerging market regulators better understand the issues and challenges that affect the development of sustainable finance in capital markets.

In June 2019, GEMC had published its report on Sustainable Finance in Emerging Markets and the Role of Securities Regulators, which provides 10 recommendations for emerging market member jurisdictions to consider when issuing regulations or guidance regarding sustainable financial instruments. Among other things, the recommendations include requirements for reporting and disclosure of material Environmental, Social and Governance (ESG) specific risks, aimed at enhancing transparency.

In relation to the above, the IFSB is monitoring these developments and implications for the stability of the IFSI, and also considering related issues for inclusion in its future research workstream.

4.1.4 International Association of Insurance Supervisors

Holistic Framework with Revised Insurance Core Principles and ComFrame

Following a consultation process, the IAIS adopted in November 2019 its holistic framework for the assessment and mitigation of systemic risk in the insurance sector, marking a significant stage in the development of its international standards for this sector. The holistic framework consists of three key elements: (i) an integrated set of supervisory policy measures; (ii) a global monitoring exercise; and (iii) implementation assessment activities aimed at assessing and mitigating the potential build-up of systemic risk in the global insurance sector.

The first of these three key elements, the supervisory material, takes the form of revised Insurance Core Principles (ICPs) and a new Common Framework for the Supervision of Internationally Active Insurance Groups (ComFrame). The supervisory material aims to protect policyholders and contribute to global financial stability through the maintenance of consistently high supervisory standards in IAIS member jurisdictions.

The 24 ICPs,²¹⁷ which have been established in their present form for a number of years, apply to supervision of all insurers. ComFrame applies to Internationally Active Insurance Groups (IAIGs) only, which are defined by their size and international activity. The issuance of ComFrame, integrated into the text of the revised ICPs, marks the fruition of several years' development work on both qualitative and quantitative standards for larger insurance groups. It includes an Insurance Capital Standard for IAIGs, now adopted for an initial five-year monitoring period during which IAIGs will report confidentially to their group-wide supervisors.

The IFSB has initiated a working group to develop a standard setting out *takāful* core principles (TCPs), closely aligned with the ICPs but modifying them or adding to them as necessary to reflect the specificities of *takāful* and, in particular, the need for observance of Shari'ah. The IFSB aims in this way to promote sound regulatory and supervisory systems for maintaining a fair, safe and stable *takāful* sector for the benefit and protection of the interests of *takāful* participants, beneficiaries and claimants, as well as contributing to the stability of the Islamic financial system and providing a benchmark for assessment and international comparison.

In addition, the IFSB has formed a working group to revise IFSB-11: Solvency Requirements for *Takāful* (Islamic Insurance) Undertakings. The specific objectives of the proposed standard include: to increase the likelihood that a *takāful* undertaking would be able to meet all its contractual obligations and commitments; acts as an early warning system for regulatory intervention and immediate corrective action, and foster confidence amongst the general public, in particular *takāful* participants to promote the financial stability of the *takāful* sector.

²¹⁷ The ICPs are numbered from 1 to 25, but there is no longer a separate ICP 11.

GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

Application Paper on Proactive Supervision of Corporate Governance, February 2019

This application paper provides additional material pertaining to supervisory proactiveness in corporate governance, to help with practical interpretation and application of aspects of ICPs 7 and 8. The Application Paper emphasises the importance of proactive rather than reactive supervision and/or supervisory forbearance, so as to identify corporate governance-related issues at an early stage, giving the supervisor the opportunity to take early corrective actions. To help with early identification of issues, the Application Paper emphasises the importance of the culture within the supervisor, and of timely provision of information for supervisors. It also provides a non-exhaustive list of potential early warning signals ("yellow and red flags") whose presence may indicate that supervisory investigation or action is required. Lastly, it discusses the value of effective communication with insurers and the public as an aid to proactive supervision. This paper applies to supervision of all forms of insurance, regardless of their organisational structure. It will be taken into consideration in any future revision of IFSB-8 on corporate governance in *takāful*.

Application Paper on Recovery Planning, November 2019

This Application Paper aims to provide further guidance to supervisors and insurers in relation to recovery planning, in support of the material on this topic in ICPs 16, 23 and 25, as well as ComFrame and materials of the Financial Stability Board. It discusses the objectives of recovery planning, as helping an insurer to understand its own risks from severe stress scenarios, and to develop an effective response in advance rather than having to plan when already under the pressure of such a scenario. The Application Paper discusses the proportionate application of requirements for recovery planning (solo and group). It provides detailed guidance on governance for recovery planning processes, the elements of a recovery plan, and supervisory considerations in relation to assessment of recovery plans and in relation to cooperation and coordination between supervisors. The IFSB has issued WP-07: Recovery, Resolution and Insolvency Issues for Institutions Offering Islamic Financial Services. Section 3.4.3, in particular, of WP-07 discusses key recovery issues in *takāful*.

4.2 IFSB STANDARDS, RESEARCH AND PSIFIS ACTIVITIES

4.2.1 Strengthening IFSB Standards Development Process

The IFSB Guidelines and Procedures for the Preparation of Standards and Guidance/Technical Notes "the Guidelines" are the anchor of the standard development process at the IFSB. They were designed to ensure IFSB standards and guidance notes adhere to stringent and thorough review processes before their issuance and meet the highest quality expectations of IFSB stakeholders.

The latest amendments to the Guidelines were approved by the IFSB Council in its 35th meeting in December 2019, and primarily enhanced two sections as follows:

- (i) Standard development approach
- (i) Appointment of consultant(s) and experts

The following paragraphs provide brief descriptions of enhancements to each section.

- (i) Standard development approach

Revisions to the standard development approach intend to improve its efficiency and timeliness, enhance the quality and usability of IFSB standards, and ensure appropriate allocation of the Secretariat's resources.

The Guidelines, through these revisions, introduced two distinct approaches for standard development:

1. A comprehensive approach, through which the IFSB standards provide complete regulatory and supervisory guidance for Islamic finance, including retention of certain principles from conventional standards which do not require any changes by the IFSB (as they are equally applicable to both Islamic and conventional finance and do not raise Sharī'ah issues).
2. A supplementary approach, which allows the IFSB to provide only regulatory and supervisory guidance that is specific for Islamic finance; principles equally applicable to both Islamic and conventional finance are not added to the IFSB standard and RSAs could be referred to the conventional standards for details. Where this is the case, the IFSB Secretariat will provide mapping of such guidance.

The IFSB Secretariat would undertake a background study and propose to the IFSB Technical Committee (TC) a suitable approach for each standard under development on a case-by-case basis. The working group appointed to oversee the development of a standard may also make its recommendations to the TC.

- (ii) Appointment of consultant(s) and experts

The IFSB Secretariat appoints external experts to guide the development of its standards. An improved structure for the criteria and roles for external consultants were introduced in the revised Guidelines. These revisions recognise several ways in which external experts could contribute to the IFSB standard development process. Specifically, the roles that external experts could play in the IFSB standard development process are now categorised as follows:

GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

External expert	Main Role
Consultant	Advise the Project Manager (PM) and Working Group, and help in the drafting of the standard/guidance.
Reviewer	Thoroughly review drafts at certain stages of the standard development and provide his/her expert comments on the subject matter.
Mentor	Work closely with the PM and guide him/her on specific issues or areas of regulations related to project, as well as coaching and empowering the PM on prudential regulation and supervision in general.
Supervisory consultant	Assume the role of a “consultant” but to specific area(s) of the project. He/she would be appointed from among IFSB member regulatory and supervisory authorities from a specialist department relevant to the project.

Revisions to the two sections recognise the distinctiveness of each technical project, and allow the IFSB to adapt its approach and required external support to the demands of individual standards.

The Guidelines contain further details on these revisions and are available on the IFSB website (www.ifsb.org).

4.2.2 Update on Standards under Development

The IFSB is currently developing three standards within its Islamic banking workstream

RESOLUTION AND RECOVERY PLAN (RRP) FOR IIFS

The IFSB's Technical Note on RRP for IIFS aims to develop guidance on regulatory and supervisory best practices for recovery and resolution issues of insolvent IIFS in an effort to fill the gap in the IIFS regulatory development. The TN is also expected to promote a sound and prudent regulatory framework for resolution and recovery issues on IIFS from both micro- and macroprudential framework perspectives.

REVISED CAPITAL ADEQUACY STANDARD (RCAS)

The IFSB's RCAS aims to provide an updated framework for regulatory capital components for IIFS that comply with Sharī'ah rules and principles as well as the latest BCBS criteria. The standard will revise and supersede IFSB-15 and provide standardised approaches for identifying and measuring risks in Sharī'ah-compliant products and services and in assigning risk weights thereto. The standard will also enhance the capital adequacy treatment for IIFS in the securitisation and *shukūk* issuance process in line with the current global regulatory standards and developments in the IFSI.

TECHNICAL NOTE ON SHARĪ'AH-COMPLIANT LIQUIDITY MANAGEMENT TOOLS

This new Technical Note on Sharī'ah-compliant liquidity management tools aims to provide harmonised and standardised liquidity management instruments that will meet Sharī'ah rules and principles to enable RSAs to transpose into national regulations for the purpose of managing liquidity issues of their IIFS. The TN is also intended to provide technical guidance on the modus operandi of the specific Sharī'ah-compliant liquidity management tools, highlight risks associated with these instruments and assess their implications in relation to liquidity risk management and regulatory capital requirements for IIFS.

The IFSB is currently developing two standards within its Islamic capital market workstream

INVESTOR PROTECTION IN ISLAMIC CAPITAL MARKETS (IPICM)

The IFSB's IPICM standard aims to identify Islamic finance-specific issues that need to be considered within capital market regulatory frameworks for investor protection. It intends to define best practices for investor protection in relation to the specific types of Sharī'ah-compliant capital market instruments and practices and to increase harmonisation of regulatory practice.

CORE PRINCIPLES FOR ISLAMIC FINANCE REGULATION (CPIFR): FINANCIAL MARKET INFRASTRUCTURES (FMIs)

The main objective of the CPIFR (FMIs) is to provide a set of core principles for financial market infrastructures and their regulation and supervision, taking into consideration the specificities of Islamic finance, while complementing the existing international standards, principally the CPSS-IOSCO's Principles for Financial Market Infrastructures (April 2012) and its associated disclosure framework and assessment methodology (December 2012).

GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

The IFSB is also currently developing one standard within its cross-sectoral workstream

REVISED GUIDING PRINCIPLES ON SHARĪ'AH GOVERNANCE FRAMEWORK FOR IIFS

The IFSB and the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) have partnered to jointly provide a revised set of guiding principles on the key components of a sound and effective Sharī'ah governance system for institutions offering Islamic financial services (IIFS). The joint standard intends to synergise efforts by both the IFSB and AAOIFI to provide consistent and harmonised Sharī'ah governance guidelines for IFSI stakeholders.

The IFSB is currently developing three standards within its *Takāful* workstream

DISCLOSURES TO PROMOTE TRANSPARENCY AND MARKET DISCIPLINE (TMD) FOR *TAKĀFUL/RETAKĀFUL* UNDERTAKINGS

The IFSB's TMD *takāful/retakāful* standard aims to facilitate access to relevant, reliable and timely information by *takāful* market actors generally, and by *takāful* participants in particular, thereby enhancing their capacity to monitor and assess the performance of *takāful* undertakings.

CORE PRINCIPLES FOR ISLAMIC FINANCE REGULATION: *TAKĀFUL*

The CPIFR *takāful* standard aims to provide an international benchmark to promote a sound regulatory and supervisory system for the *takāful* sector. A fair, safe and stable *takāful* sector will benefit and protect the interests of participants, beneficiaries and claimants, as well as contribute to the stability of the Islamic financial system. A hierarchical structure of principles, standards and guidance material, consistent with that of the IAIS Core Principles, is being proposed.

REVISED STANDARD ON SOLVENCY REQUIREMENTS FOR *TAKĀFUL* (ISLAMIC INSURANCE)

The revised solvency standard for *takāful* undertakings is intended to foster confidence among the general public – in particular, *takāful* participants – in the financial stability of the *takāful* sector. It aims to increase the likelihood that a *takāful* undertaking would be able to meet all its contractual obligations and commitments; to act as an early warning system for regulatory intervention and immediate corrective action; and to provide a buffer so that even if the *takāful* participants are to suffer a loss in the event of failure of a *takāful* undertaking, the impact can be limited or reduced, especially the systemic effects.

4.2.3 Synopsis of IFSB Research Projects

The IFSB, in line with its mandate to undertake research on pertinent issues in the IFSI, has, since the publication of the IFSI Stability Report 2019, issued three Working Papers. IFSB Working Papers are research-based publications intended to lay the groundwork for future standards development and implementation. The papers can be downloaded from the IFSB website.

The IFSB issued three working papers since the publication of the IFSB IFSI Stability Report 2019.

WP-12: WORKING PAPER ON MONEY LAUNDERING AND FINANCING OF TERRORISM RISKS IN ISLAMIC BANKING (DECEMBER 2018)

This joint working paper between the IFSB and the Arab Monetary Fund examines money laundering and financing of terrorism (ML/FT) methods, trends and typologies as specifically related to Islamic banking contracts, structure and regulation, and attempts to address whether there is any evidence that ML/FT risks in Islamic banking are indeed different from those that arise in conventional banking. Based on responses to a survey of RSAs, the paper found no evidence of relative high susceptibility of both Islamic banking and Islamic social finance platforms to ML/FT risks compared to conventional banks. The paper concludes that there is no need to introduce specific regulations or preventive measures to address the ML/FT risks in Islamic banking, and that Islamic banks should adhere to their own country regulations and the Financial Action Task Force standards to combat ML/FT.

WP-13: WORKING PAPER ON INTERMEDIARIES IN THE ISLAMIC CAPITAL MARKET (DECEMBER 2019)

This exploratory working paper derives from the pertinent role played by intermediaries in the Islamic capital market noting that the changing market landscape where ICM intermediaries operate today makes managing their fiduciary responsibility towards their clients very complicated. Based on a survey questionnaire administered to ICM intermediaries, the paper focused on four key core principles in IFSB-21: Core Principles for Islamic Finance Regulation (Islamic Capital Market Segment) relating to ICM intermediaries. The paper concludes that there are commendable licensing and entry requirements in place in various jurisdictions, as well as ongoing assessments of due compliance by ICM intermediaries with those requirements and procedures that promote the soundness and safety of the Islamic capital market.

GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

WP-14: WORKING PAPER ON REGULATORY AND SUPERVISORY ISSUES IN SHARĪ'AH-COMPLIANT HEDGING INSTRUMENTS (DECEMBER 2019)

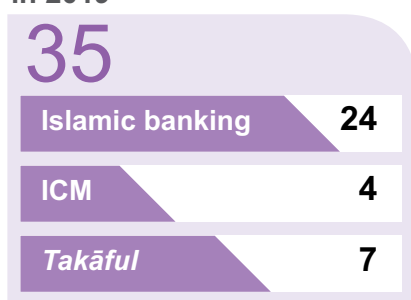
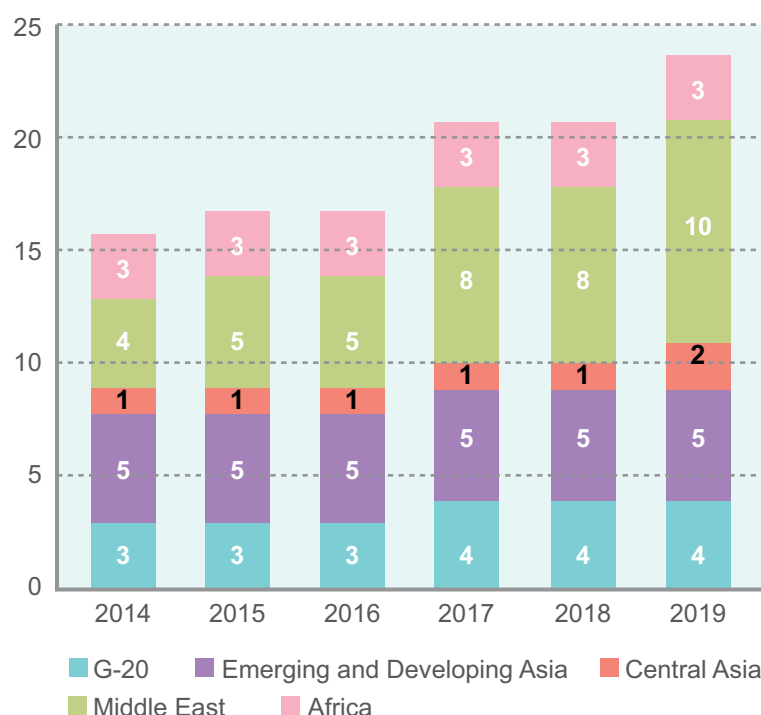
This working paper provides some initial exploratory findings on regulatory and supervisory issues, Sharī'ah compliance concerns, and the existing practices in relation to the use of Islamic hedging instruments across IFSB jurisdictions. Islamic hedging instruments are being used in a variety of ways in several jurisdictions, essentially as a Sharī'ah-compliant alternative to conventional derivative instruments. The paper found that the risk profile of IFIs is not much different from that of the conventional banks, and thus credit risk, liquidity risk and rate-of-return risk were the main risks for Islamic institutions. Asset–liability alignment and *wa'd* emerged as the main hedging tools; however, in general, IFIs were either not using hedging instruments or lacked the motivation to utilise them given that the regulations were not standardised across the globe.

4.2.4 PSIFIs Database: A Repository of Global Islamic Finance Data

The prudential and structural Islamic financial indicators database as a global platform of Islamic finance statistics which reflects Sharī'ah-compliant accounting practices and regulatory standards in its compilation has reached a sustainable stage in terms of regular reporting and extension of the Islamic banking database to new jurisdictions. The database completed the last phase (Phase IV: 2017–19), extending the number of reporting countries from 17 to 24 with a regular quarterly dissemination of Islamic banking database since 2015. This PSIFIs project currently compiles data from Afghanistan, Bahrain, Bangladesh, Brunei, Egypt, Indonesia, Iran, Jordan, Kazakhstan, Kuwait, Lebanon, Libya, Malaysia, Nigeria, Oman, Pakistan, Palestine, Qatar, Saudi Arabia, Sudan, Turkey, the United Arab Emirates and the United Kingdom. Overall, the PSIFIs member countries collectively held more than 95% of global Islamic banking assets at the end of the third quarter of 2019.

In 2020, the IFSB Secretariat will launch its new phase (Phase V) under a new Medium-Term Plan (2020–22), targeting to start collection and dissemination of data from the beginning of 2020 for the Islamic insurance (*takāful*) and Islamic capital market (ICM) sectors. Thus far, the Secretariat has started data collection and is closely working with the respective RSAs in these two sectors to finalise the indicators/data for dissemination.

The trend in participation of countries in the Islamic banking, ICM and *takāful* sectors of the PSIFIs project is shown in Chart 4.2.4.1. Out of the total of 35 PSIFI member RSAs, 24 are actively participating in regular data collection and compilation for the Islamic banking sector. The other 11 PSIFIs members that recently joined the database program have commenced activities relating to the collection and compilation of data for the *takāful* and ICM sectors. The IFSB Secretariat plans to disseminate the *takāful* and ICM data regularly from 2020.

Chart 4.2.4.1 Current Status of PSIFIs Members**Overall PSIFIs members in 2019****Sharp increase in number of IFSB members contributing to the PSIFIs database****PSIFIs Participants for Islamic Banking Sector by Year and Region**

GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

The IFSB Secretariat has also taken some initiatives in 2019 to increase awareness about the PSIFIs database among different stakeholders of the IFSB so that the database can be accessible to more users. The Secretariat encourages member RSAs to take some initiatives in order to increase the use of PSIFIs, which include creating web links to PSIFIs on the RSA's website and incorporating the PSIFIs database in the national summary data page, among other measures. The IFSB Secretariat has been using PSIFIs data for its IFSI Stability Report to calculate different performance indicators of the Islamic banking sector. In this regard, users can apply the database as an input to a broader surveillance framework, together with other relevant indicators of economic and financial positions of a jurisdiction. Along with the vulnerability tests to shocks as well as capacity tests to absorb resulting losses which can be done by using PSIFIs data, the progress of implementation of IFSB standards in IFSB member countries can also be tracked implicitly through using PSIFIs indicators, particularly those related to capital adequacy, earning capacity, asset quality, liquidity and leverage. The current status of dissemination and uses of PSIFIs is shown in Chart 4.2.4.2.

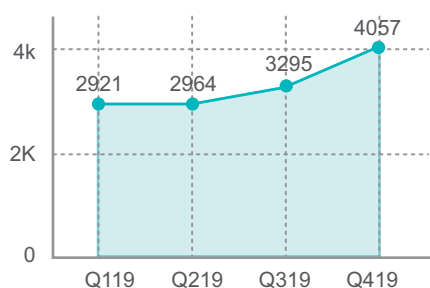
Chart 4.2.4.2 Current Status of Dissemination and Uses of Data

PROGRESS OF DISSEMINATION

IFSB disseminated one full year data from Q32018 to Q32019.



Total Download Hits for 2019



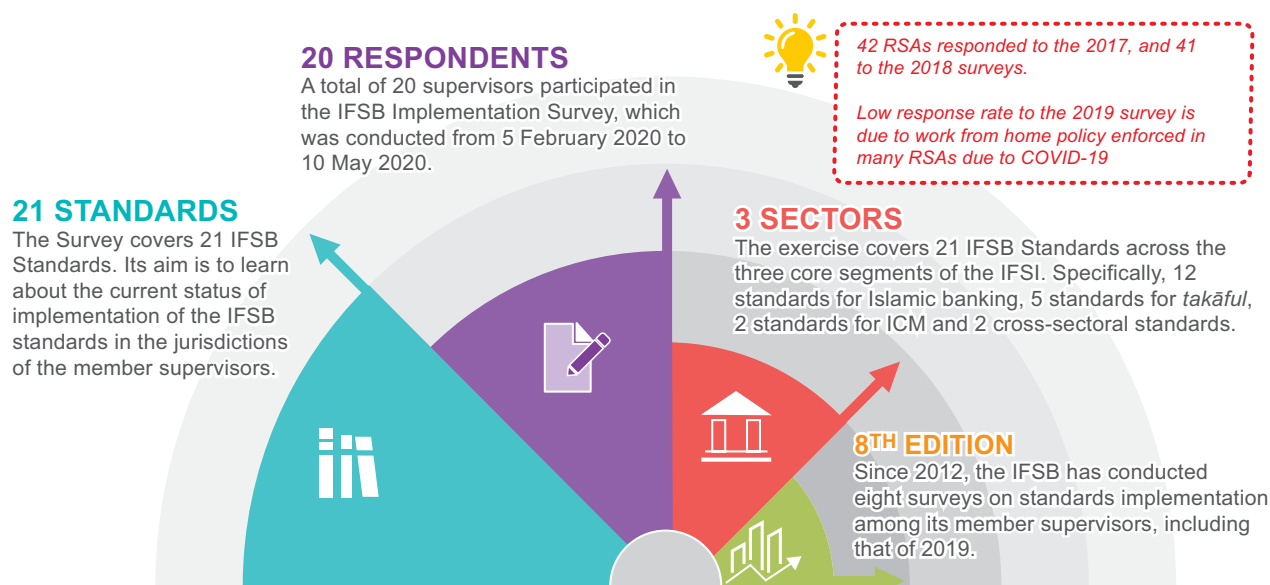
- The IFSB Secretariat conducted various awareness programmes to increase the downloads of PSIFIs data.
- In 2019, staffs from the Secretariat visited two universities in Malaysia to make presentations about the uses of PSIFIs data for research purposes.
- The IFSB Secretariat encourages its PSIFIs Task Force members to create web link of PSIFIs on the website of their respective RSA and incorporate the database on their national summary data page.

GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

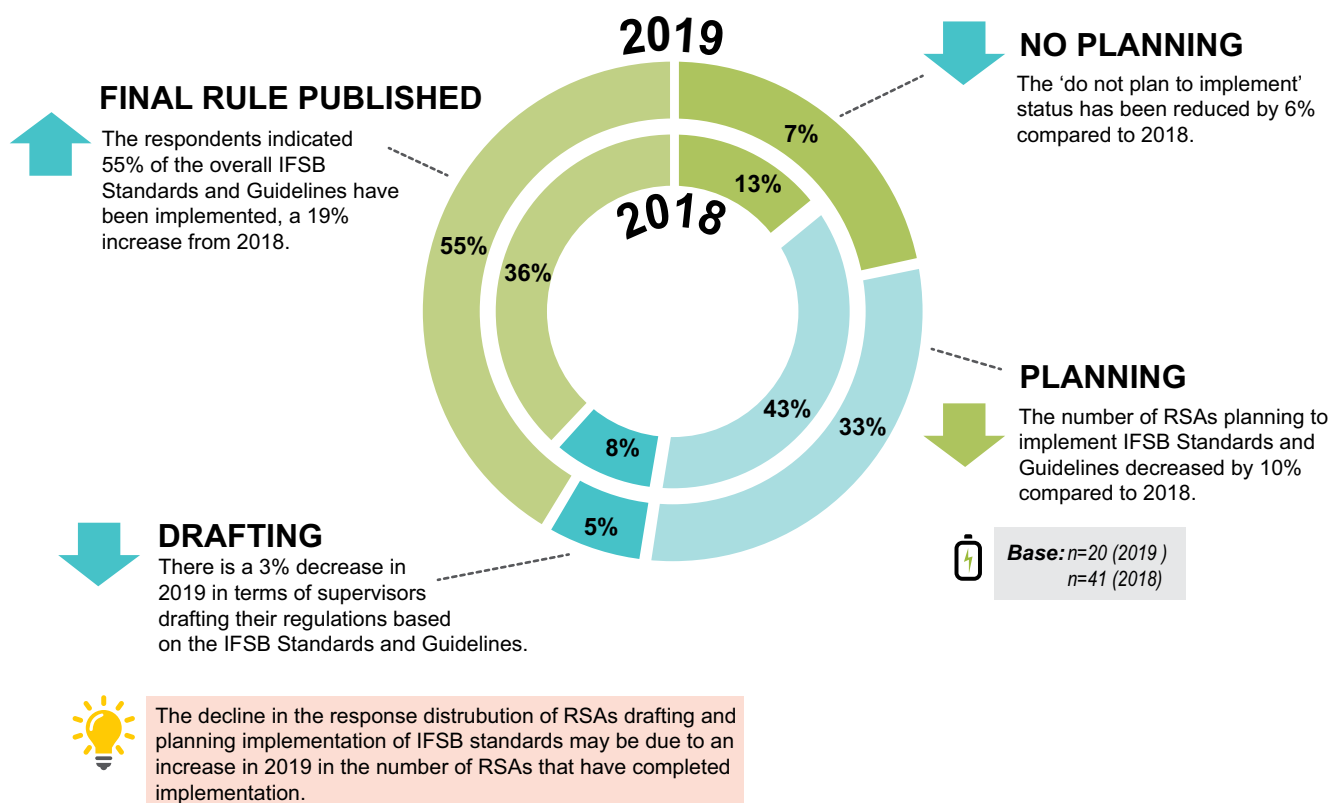
4.2.5 Highlights of IFSB Implementation Survey 2019

The IFSB Standards Implementation Survey is an annual survey exercise, undertaken by the IFSB, covering IFSB RSA members. Specifically, the survey helps to assess the progress made in implementing IFSB's published standards by member RSAs, and to understand the major challenges and constraints the RSAs face in the process. The implementation survey is thus an important component of the IFSB's efforts towards enhancing implementation of IFSB Standards by identifying the right strategies that can assist in accelerating and strengthening the process of implementing IFSB Standards in member jurisdictions.

Overview of IFSB Standards Implementation Survey 2019

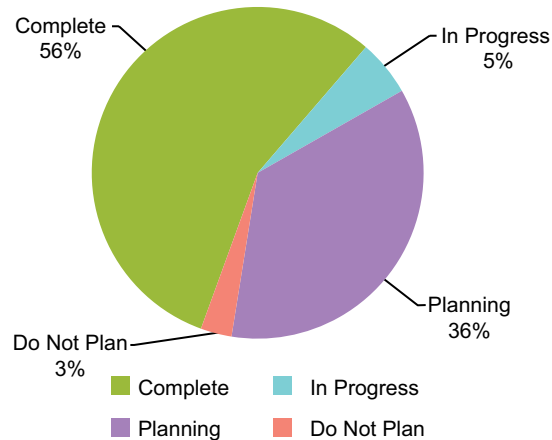


Implementation Status 2018 vs. 2019 – Overall Comparison



GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

IFSB Islamic Banking Standards

**MOST IMPLEMENTED STANDARDS**

IFSB-3 Guiding Principles on Corporate Governance recorded 67% implementation rate followed by IFSB-15 Revised Capital Adequacy Standard with 64%.

STANDARDS CONSIDERED 'IN PROGRESS'

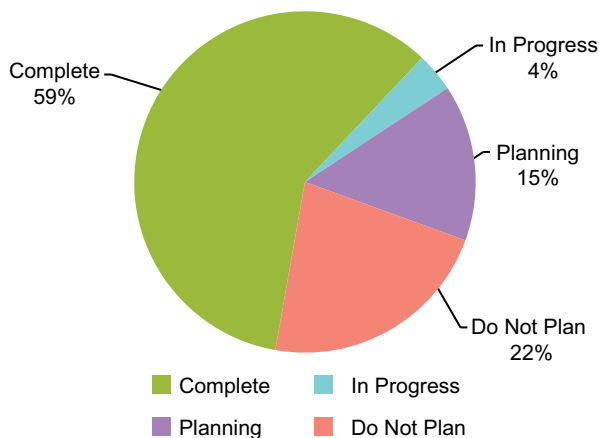
IFSB-3 Guiding Principles on Corporate Governance standard recorded the highest "In Progress" rate with 17% of respondents drafting regulations according to the standard.

STANDARDS CONSIDERED FOR IMPLEMENTATION

IFSB-13 Guiding Principles on Stress Testing standard is the highest standard being considered for implementation with 55% of respondents indicating their interest to implement it.

Source: IFSB Master Non-Technical Survey 2020

IFSB Islamic Capital Markets Standards

**IMPLEMENTATION STATUS**

59% of the RSAs indicated that they have completed the implementation of the ICM standards, while 15% of the RSAs are in the planning stage, 4% are in the drafting stage. The remaining 22% do not plan to implement the ICM standards for now.

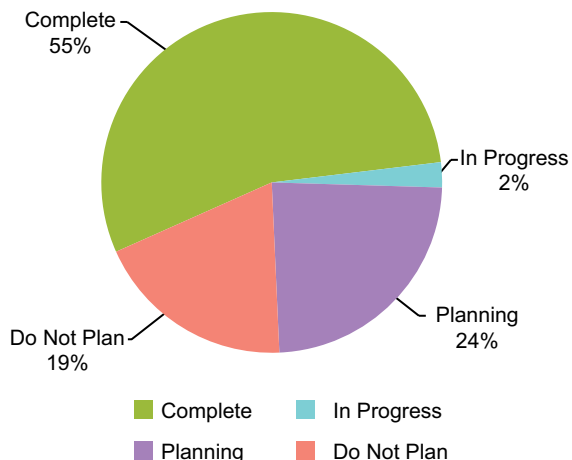
MOST IMPLEMENTED STANDARDS

For the Islamic Capital Market standards, IFSB-6 on Governance for Islamic Collective Investment Schemes has a higher implementation rate with 57% completion rate.

IFSB-19 on Disclosure Requirements for Islamic Capital Market Products has a completion rate of 43%. However, it has to be taking into consideration that IFSB-19 was only released in 2017.

Source: IFSB Master Non-Technical Survey 2020

IFSB Takāful Standards

**IMPLEMENTATION STATUS**

55% of the RSAs indicated that they have completed the implementation of the *takāful* standards, while 24% of the RSAs are in the planning stage, 4% are in the drafting stage. The remaining 19% do not plan to implement the *takāful* standards for now

MOST IMPLEMENTED STANDARDS

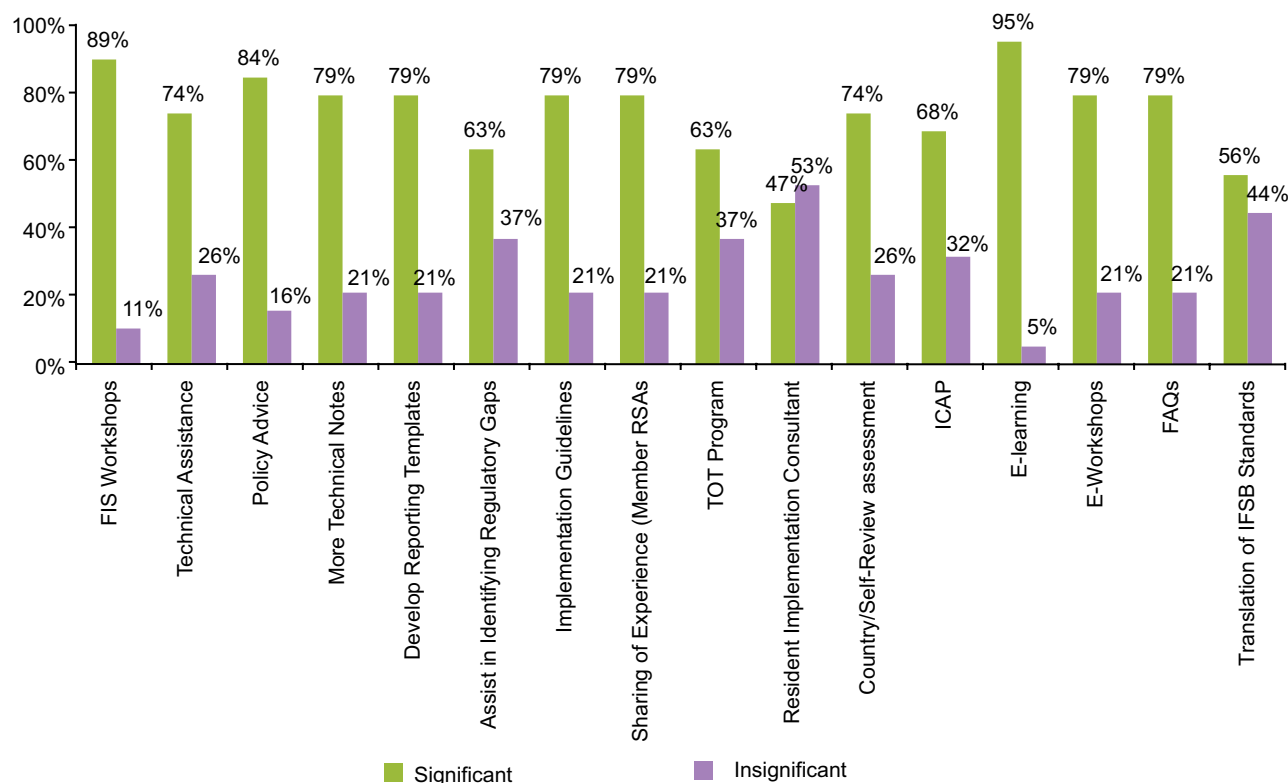
For the *takāful* standards, both IFSB-8 on Governance for *Takāful* Undertakings and IFSB-14 on Risk Management for *Takāful* Undertakings have an implementation rate of 67% and considered to record the highest completion rate among the five standards.

IFSB-11 on Solvency Requirements for *Takāful* Undertakings has the highest planning rate, with 50% of respondents considering the standard for implementation.

Source: IFSB Master Non-Technical Survey 2020

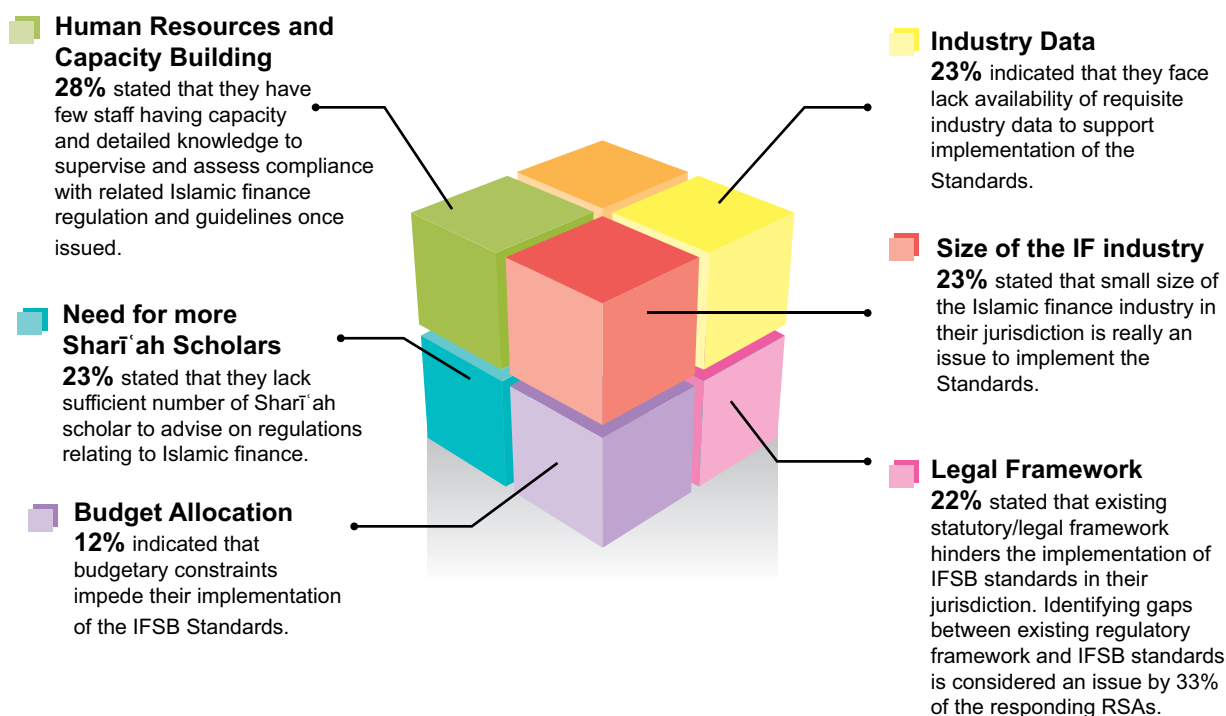
GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

Significance of Implementation Tools



Source: IFSB Master Non-Technical Survey 2020

Challenges in Implementing IFSB Standards



Source: IFSB Master Non-Technical Survey 2020

GLOBAL DEVELOPMENTS: IFSB INITIATIVES AND ACTIVITIES

CHALLENGES	IFSB INITIATIVES	SUGGESTIONS FOR RSAs
1. Lack of Sharī'ah scholars to advise RSA on regulations related to Islamic finance	<ul style="list-style-type: none">➤ Providing capacity building workshops and online consultations.➤ Re-vamping the E-learning platform for the convenience of IFSB members	<ul style="list-style-type: none">❑ Establishing a dedicated team to carry out Islamic finance regulatory and supervisory functions.❑ Building capacity for nurturing new generation of Sharī'ah scholars.❑ Developing strategic plans on IFSB standards implementation in the jurisdiction.
2. Supervisory staff lack of capacity to supervise and assess compliance with Islamic finance related regulations and guidelines	<ul style="list-style-type: none">➤ Providing direct Technical Assistance (TA) and Policy Advice (PA).	
3. Process of standards implementation is too time intensive		
4. Identification of gaps between the existing regulatory framework and IFSB standards	<ul style="list-style-type: none">➤ Implementing Train of Trainers (ToT) Programme.➤ Creating a database of experts to support the implementation.➤ Introducing the Impact and Consistency Assessment Program (ICAP) to assist RSAs in identifying regulatory gaps.	<ul style="list-style-type: none">❑ Improving and adapting the legal and regulatory framework to the context of Islamic law and regulatory environment of the jurisdictions.

Source: IFSB Master Non-Technical Survey 2020



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LIST OF ABBREVIATIONS

ABBREVIATIONS	
AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ADB	Asia Development Bank
AI	Artificial Intelligence
AML	Anti-Money Laundering
ASEAN	Association of Southeast Asian Nations
AuM	Assets under Management
BCBS	Basel Committee on Banking Supervision
CAGR	Compound Annual Growth Rate
CAR	Capital Adequacy Ratio
CCP	Central Counterparty (CCP)
CFT	Combating the Financing of Terrorism
CMT	Cash Management Trust
CPIFR	Core Principles for Islamic Finance Regulation
CPSS	Committee on Payment and Settlement Systems
CSD	Central Securities Depository
DFIs	Development Financial Institutions
DJIM	Dow Jones Islamic Market
DLT	Distributed Ledger Technology
EU	European Union
FDR	Financing-to-Deposits Ratio
FinTech	Financial Technology
FMI	Financial Market Infrastructure
FSB	Financial Stability Board
GCC	Gulf Cooperation Council
GFC	Global Financial Crisis
IAIS	International Association of Insurance Supervisors
ICD	Islamic Corporation for the Development of the Private Sector
ICM	Islamic Capital Market
ICPs	Insurance Core Principles
IOSCO	International Organization of Securities Commissions
IsDB	Islamic Development Bank
IFFIm	International Finance Facility for Immunisation
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IFSI	Islamic Financial Services Industry
IIFS	Institutions offering Islamic Financial Services
IILM	International Islamic Liquidity Management Corporation
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IRB	Internal Ratings-Based
LCR	Liquidity Coverage Ratio
M&A	Mergers and Acquisitions
MENA	Middle East and North Africa
MESA	Middle East and South Asia
ML/FT	Money Laundering and Financing of Terrorism
MTPL	Motor Third Party Liability
NAIRA	National Insurance Regulatory Authority, Sudan

LIST OF ABBREVIATIONS

ABBREVIATIONS	
NPF	Non-Performing Financing
NSFR	Net Stable Funding Ratio
OECD	Organization for Economic Cooperation and Development
OIC	Organisation of Islamic Cooperation
OJK	Otoritas Jasa Keuangan, Indonesia
OPEC	Organization of the Petroleum Exporting Countries
PS	Payment System
P2P	Peer to Peer
PSIA	Profit/Loss-Sharing Investment Accounts
PSIFIs	Prudential and Structural Islamic Financial Indicators
ROA	Return on Assets
ROE	Return on Equity
RSA	Regulatory and Supervisory Authority
RWA	Risk-Weighted Assets
SA	Standardised Approach
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SRI	Socially Responsible Investment
SSB	Sharī'ah Supervisory Board
SSS	Securities Settlement System
TR	Trade Repository
UAE	United Arab Emirates



GLOSSARY

Commodity <i>Murābahah</i> or <i>Tawarruq</i>	A <i>murābahah</i> transaction based on the purchase of a commodity from a seller or a broker and its resale to the customer on the basis of deferred <i>murābahah</i> , followed by the sale of the commodity by the customer for a spot price to a third party for the purpose of obtaining liquidity, provided that there are no links between the two contracts.
<i>dāʿī</i>	A person who generally engages in the act of inviting people to Islam.
<i>Ijārah</i>	A contract made to lease the usufruct of a specified asset for an agreed period against a specified rental. It could be preceded by a unilateral binding promise from one of the contracting parties. An <i>Ijārah</i> contract is binding on both contracting parties.
Islamic window	That part of a conventional financial institution (which may be a branch or a dedicated unit of that institution) that provides both fund management (investment accounts) and financing and investment that are Sharīʿah-compliant, with separate funds. It could also provide <i>takāful</i> or <i>retakāful</i> services.
<i>Maqāṣid al-Sharīʿah</i>	The fundamental principles of Sharīʿah, which aim to promote and protect the interests of all human beings and avert all harm that impairs their interests.
<i>Muḍārabah</i>	A partnership contract between the capital provider (<i>rabb al-māl</i>) and an entrepreneur (<i>muḍārib</i>) whereby the capital provider would contribute capital to an enterprise or activity that is to be managed by the entrepreneur. Profits generated by that enterprise or activity are shared in accordance with the percentage specified in the contract, while losses are to be borne solely by the capital provider unless the losses are due to misconduct, negligence or breach of contracted terms.
<i>Murābahah</i>	A sale contract whereby the institution offering Islamic financial services sells to a customer a specified kind of asset that is already in its possession, whereby the selling price is the sum of the original price and an agreed profit margin.
<i>Mushārahah</i> (<i>Sharikat al-ʿAqd</i>)	A partnership contract in which the partners agree to contribute capital to an enterprise, whether existing or new. Profits generated by that enterprise are shared in accordance with the percentage specified in the <i>mushārahah</i> contract, while losses are shared in proportion to each partner's share of capital.
<i>Qarḍ</i>	The payment of money to someone who will benefit from it provided that its equivalent is repaid. The repayment of the money is due at any point in time, even if it is deferred.
<i>Retakāful</i>	An arrangement whereby a <i>takāful</i> undertaking cedes a portion of its risks on the basis of treaty or facultative <i>retakāful</i> as a representative of participants under a <i>takāful</i> contract, whereby it would contribute a portion of the contribution as <i>tabarruʿ</i> into a common fund to cover against specified loss or damage.
Sharīʿah	The practical divine law deduced from its legitimate sources: the Qurʾān, Sunnah, consensus (<i>Ijmāʿ</i>), analogy (<i>Qiyās</i>) and other approved sources of the Sharīʿah.
Sharīʿah board	An independent body set up or engaged by the institution offering Islamic financial services to supervise its Sharīʿah compliance and governance system.
Sharīʿah non-compliance risk	An operational risk resulting from non-compliance of the institution with the rules and principles of Sharīʿah in its products and services.
<i>Ṣukūk</i>	Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of tangible assets and other types of assets. These assets could be in a specific project or specific investment activity that is Sharīʿah-compliant.
<i>Takāful</i>	A mutual guarantee in return for the commitment to donate an amount in the form of a specified contribution to the participants' risk fund, whereby a group of participants agree among themselves to support one another jointly for the losses arising from specified risks.
<i>Tawarruq</i>	A <i>murābahah</i> transaction based on the purchase of a commodity from a seller or a broker and its resale to the customer on the basis of deferred <i>murābahah</i> , followed by the sale of the commodity by the customer for a spot price to a third party for the purpose of obtaining liquidity, provided that there are no links between the two contracts.
<i>Waʿd</i>	An undertaking by someone to perform an act in the future related to someone else.
<i>Wadʿah</i>	A contract for the safekeeping of assets on a trust basis and their return upon the demand of their owners. The contract can be for a fee or without a fee. The assets are held on a trust basis by the safekeeper and are not guaranteed by the safekeeper, except in the case of misconduct, negligence or breach of the conditions.
<i>Wakālah</i>	An agency contract where the customer (principal) appoints an institution as agent (<i>wakīl</i>) to carry out the business on his behalf. The contract can be for a fee or without a fee.
<i>Zakāh</i>	An obligatory financial contribution disbursed to specified recipients that is prescribed by the Sharīʿah on those who possess wealth exceeding a minimum amount that is maintained in their possession for one lunar year.



ISLAMIC FINANCIAL SERVICES BOARD
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1	Be part of a prestigious international organisation with the broadest representation in the IFSI, from 57 countries	√	√	√
2	Attend the IFSB General Assembly	√	√	√
3	Vote at the IFSB General Assembly	√		
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20	Bank of Mauritius
21	Bank Al-Maghrib, Morocco
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43	Indonesia Deposit Insurance Corporation
44	Capital Markets Authority, Kenya
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59	Qatar Financial Centre Authority
60	Qatar Financial Markets Authority
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86	Al Baraka Bank Egypt
87	Faisal Islamic Bank of Egypt
88	FWU Group, Germany
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107	Kuwait Finance House K.S.C., Kuwait
108	Kuwait International Bank K.S.C., Kuwait
109	KFH Capital Investment Company K.S.C.C., Kuwait
110	National Bank of the Kyrgyz Republic
111	Al Baraka Bank Lebanon, Lebanon
112	Affin Islamic Bank Berhad, Malaysia
113	Al Rajhi Banking and Investment Corporation (Malaysia) Bhd., Malaysia
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115	Bank Islam Malaysia Berhad, Malaysia
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159	Al Salam Bank, Sudan
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186	Tiybr Payments, U.A.E.
187	United Nations Development Programme - UNDP



