



MULTI-COUNTRY REPORT

ENSURING FINANCIAL STABILITY IN COUNTRIES WITH ISLAMIC BANKING—CASE STUDIES—PRESS RELEASE; STAFF REPORT

June 2017

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- A **Press Release** summarizing the views of the Executive Board as expressed during its February 3, 2017 consideration of the staff report.
- The **Staff Report** prepared by IMF staff and completed on January 6, 2017 for the Executive Board's consideration on February 3, 2017.

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Price: \$18.00 per printed copy

International Monetary Fund
Washington, D.C.



January 6, 2017

**ENSURING FINANCIAL STABILITY IN COUNTRIES WITH
ISLAMIC BANKING—COUNTRY CASE STUDIES**

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Table 1. Key Instruments of Islamic Finance	
Term	Description
<i>Ijarah/Ijarah muntahia bittamleek</i> (Lease/ lease purchase)	A party leases a particular product for a specific sum and a specific time period. In the case of a lease purchase, each payment includes a portion that goes toward the final purchase and transfer of ownership of the product.
<i>Istisna</i> (Deferred payment, deferred delivery)	A manufacturer (contractor) agrees to produce (build) and to deliver a certain good (or premise) at a given price on a given date in the future. The price does not have to be paid in advance (in contrast to <i>Salam</i>). It may be paid in installments or part may be paid in advance with the balance to be paid later on, based on the preferences of the parties.
<i>Ju'alah</i>	<i>Ju'alah</i> is a contract of service whereby a party commissions another (a worker) with a task whose achievement is probabilistic rather than certain, and the task undertaker (the worker) is entitled to the agreed amount (ju'l) only if the task is achieved.
<i>Mudarabah</i> (Trustee finance contract)	An investment which represents the ownership of units of equal value in the equity of the <i>Mudarabah</i> . The provider of capital supplies the funds needed to finance a project while the entrepreneur offers labor and expertise. Profits are shared between them at a certain fixed ratio, whereas financial losses are exclusively borne by the capital's owner. The liability of the entrepreneur is limited only to his time and effort.
<i>Murabahah</i> (Mark-up financing)	A widely-used sale transaction between customers and banks. The buyer approaches the bank to acquire goods. In turn, the bank purchases them from a third party (a supplier) and then resells them to the borrower at an agreed mark-up for immediate or deferred payment. The seller informs the buyer of the cost of acquiring the specified product and the profit margin is negotiated between them. The total cost is usually paid in installments.
<i>Musharakah</i> (Equity participation)	An investment that represents ownership of partnership equity. The bank enters into an equity partnership agreement (joint venture) with one or more partners to jointly finance an investment project. Profits are distributed according to predetermined ratios, and losses are shared strictly in relation to the respective capital contributions.

Table 1. Key Instruments of Islamic Finance (concluded)	
Term	Description
<i>Qard</i> (Benevolent loan)	These are zero-return loans that the Qur'an encourages Muslims to make to the needy. Banks are allowed to charge borrowers a service fee to cover the administrative expenses of handling the loan. The fee should not be related to the loan amount or maturity.
<i>Salam</i> (Prepayment, deferred delivery)	The buyer pays the seller the full negotiated price of a product that the seller promises to deliver at a future date.
<i>Sukuk</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 <i>Shari'ah</i> -compliant.
<i>Tawarruq</i>	A multi-step transaction heavily used for interbank financing and liquidity management, often based on commodities traded on the London Metal Exchange (LME). The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) (2006, 525) defines <i>Tawarruq</i> as 'the process of purchasing a commodity for a deferred price determined through <i>Musawama</i> (bargaining) or <i>Murabahah</i> (mark-up sale), and selling it to a third party for a spot price so as to obtain cash. <i>Tawarruq</i> is often not accepted by <i>Shari'ah</i> scholars when the borrower sells the commodity back to the original seller. These practices have yet to gain AAOIFI's <i>Shari'ah</i> Board consensus.
<i>Wadi'ah</i> (Demand deposits)	Deposits held at the bank as a trustee for safekeeping purposes. They are guaranteed in capital value, and earn no return.
<i>Wakalah</i> (Agency)	One party (either the bank or client) acts as an agent to the other party to undertake transactions on his behalf. For example, the bank invests funds on behalf of a client or the bank appoints the client as an agent to buy the needed merchandise in a <i>Murabahah</i> transaction.

Glossary

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ADR	Alternative Dispute Resolution Forum
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
BMA	Bahrain Monetary Authority
BCBS	Basel Committee on Banking Supervision
BCD	Banque Central Djibouti
BI	Bank Indonesia
CAGR	Compound Annual Growth Rate
CAR	Capital Adequacy Ratio
CBB	Central Bank of Bahrain
CMA	Capital Markets Authority
DCR	Displaced Commercial Risk
DIS	Deposit Insurance Scheme
DSN-MUI	National <i>Shari'ah</i> Board of the Ulama Council of Indonesia
FATF	Financial Action Task Force
FPJPS	Fasilitas Pembiayaan Jangka Pendek bagi Bank Syariah
FSAP	Financial Sector Assessment Program
FSI	Financial Soundness Indicators
FX	Foreign Exchange
GCC	Gulf Cooperation Council
GFC	Global Financial Crisis
HQLA	High-Quality Liquid Assets
IAH	Investment Account Holders
IB	Islamic Banking
IBs	Islamic Banks
IF	Islamic Finance
IFIs	Islamic Financial Institutions
IFRS	International Financial Reporting Standards
IFSA	Islamic Financial Services Act
IFSB	Islamic Financial Services Board
IIFM	International Islamic Financial Market
IIFS	Institutions Offering Islamic Financial Services
IILM	International Islamic Liquidity Management Corporation
IMF	International Monetary Fund
IRR	Investment Risk Reserve
IRTI	Islamic Research and Training Institute
LAPS	Alternative Institute for Dispute Resolution
LCs	Letters of Credit
LCR	Liquidity Coverage Ratio
LME	London Metal Exchange
MENA	Middle East and North Africa
NPF	Nonperforming Financing
NSB	National Supervisory Board
NSC	National <i>Shari'ah</i> Committee

NSFR	Net Stable Funding Ratio
OFIs	Other Financial Institutions
OJK	Otoritas Jasa Keuangan
PER	Profit Equalization Reserve
PLS	Profit and Loss Sharing
PSIA	Profit-Sharing Investment Accounts
RWA	Risk-weighted Assets
SCDIS	<i>Shari'ah</i> Compliant Deposit Insurance Scheme
SME	Small and Medium-sized Enterprises
SSB	<i>Shari'ah</i> Supervisory Board

INTRODUCTION

1. This background paper, which is a supplement to the board paper on “Ensuring Financial Stability in Countries with Islamic Banking (IB) Sectors”, presents country experiences with reforms to strengthen regulatory oversight of the IB sector. It reviews experiences with and the progress made in adapting prudential, safety nets and resolution frameworks to the specifics of IB. The selection of several countries from a range of regions with different levels of development and approaches to IB was designed to provide a representative sample of country experiences so as to enrich the policy conclusions. Such a multiplicity of experiences can help to identify common challenges that countries face in reforming their regulatory frameworks and to distill best practices. The countries, for which detailed case studies have been undertaken, are: Bahrain, Djibouti, Indonesia, Kenya, Kuwait, Malaysia, Nigeria, Pakistan, Sudan, Turkey and the United Kingdom.

2. The case studies broadly follow a similar structure and analyze:

- The scale, structure and growth of the Islamic finance (IF) industry, in order to give an indication of the significance of the IB sector in the financial industries of the various countries;
- The corporate and balance sheet structures of the Islamic banks (IBs), to help identify financial stability risks that the IBs are exposed to, including both standard banking risks and risks that are unique to the sector.
- The regulatory, governance and supervisory frameworks as well as the supporting financial infrastructure for liquidity management, effective resolution and deposit insurance, in order to provide insights on the extent to which countries have adapted their frameworks to the specifics of IF, in order to address the identified stability risks;
- Policy options and lessons for reform.

3. The case studies highlight important, but uneven, progress in adapting the legal, regulatory and supervisory frameworks to the specificities of IB. Significant advances have been made in putting in place legislation that allow the establishment of IBs and the use of specific Islamic financial contracts. *Shari’ah* governance frameworks have been established in most countries and there has been an increase in the number of countries adopting centralized *Shari’ah* boards, albeit from a low base. The industry has been growing rapidly and, in most countries, the balance sheets of IBs exhibit substantial differences from those of conventional banks, as a result of which IBs entail some unique risks. Meanwhile, progress in adapting the prudential, consumer protection, liquidity management, safety nets and resolution frameworks remains uneven across countries. Bahrain and Malaysia have made the most advances in systematically adapting their policy frameworks to IF, in line with standards issued by the Islamic Financial Services Board (IFSB) and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

4. Based on the selected country experiences, a number of important lessons and policy options can be drawn that have implications for the stable and sound development of IB.

These include:

- An enabling regulatory and institutional framework and a level playing field for conventional and IBs is critical for the sound and stable growth of the IB industry. The country experiences underscore the importance of providing an enabling framework while letting market forces determine the size of the industry. For example, in Indonesia, Kuwait and Djibouti, IBs, which had been in existence for many years, grew rapidly after legal and regulatory frameworks were put in place and disincentives to IB reduced. The UK's experience also points to the importance of a "no favor, no obstacle" policy with respect to taxation and central banking operations.
- Flexibility in approaches to IB has also fostered greater acceptance of IB principles and their benefits. Selected countries (Turkey, Nigeria) have branded the IB industry with neutral terms and this has facilitated industry growth. In Turkey IB is branded as "participation banking", and in Nigeria it has been branded as "interest-free banking".
- Licensing requirements have not been effectively used as a tool for ensuring that licensed IBs have in place key structures that support supervision. In four of the countries (Djibouti, Kenya, Nigeria and UK), IBs are licensed based on a standard banking license that applies the criteria for conventional banks. In addition, at least four countries (Djibouti, Kenya, Turkey and the UK) do not require conventional banks to maintain Islamic deposit accounts (demand deposit, Unrestricted Investment Accounts (URIAs) etc.) separately from other funds under the control of the conventional bank. While many of the licensing criteria for conventional banks have the key elements to ensure financial stability, it is important that the approval process for IBs is also conditioned upon proof of ex-ante and ex-post robust *Shari'ah* governance framework and internal controls tailored to address risks specific to IB operations. Conventional banks that offer Islamic products through windows should also be required to provide proof of systems and procedures that separate IB activities from conventional ones. Fit and proper requirements for *Shari'ah* board members or advisors within IBs should include an appropriate level of knowledge of IF. For countries that allow IBs to invest in properties, the licensing tool should be applied to ensure that corporate structures are transparent and facilitate effective supervision.
- Jurisdictions continue to take different approaches to the application of capital adequacy requirements which undermines comparability of solvency risks. Some countries (Bahrain, Malaysia and Sudan) have adopted relevant IFSB standards, others still apply the capital regime for conventional banks and some (Pakistan) are in the process of changing. Greater consistency is needed in the approaches to the application of capital adequacy requirements with respect to the loss-absorbency (alpha factor) of profit-sharing investment accounts (PSIA), the eligibility of Profit Equalization Reserves (PER) and Investment Risk Reserve (IRR) in the regulatory capital, and the risk-weights for assets. This could be achieved through greater adoption of IFSB applicable prudential standards.

- Other prudential regulations, including those related to classification and provisioning, large exposures, investment in properties and liquidity, are mostly identical for conventional and IBs. For instance, the regulations do not fully take into account the differential credit risk and provisioning requirements between debt-based products (*Mudarabah*, *Ijarah*) and risk-sharing products (*Musharakah* and *Mudarabah*). There is, therefore, a need to better take into account the differential characteristics of IB products while ensuring a level playing field for Islamic and conventional banks.
- Centralized *Shari'ah* boards that help standardize industry practices and improve consumer perceptions have been established in only a limited number of countries. Further strengthening *Shari'ah* governance frameworks towards centralized *Shari'ah* boards could help ensure consistency in *Shari'ah* rulings within jurisdictions. There is also a need for better integration of the *Shari'ah* audit function in the enforcement process.
- Consumer protection frameworks have focused more on improving disclosure but, in many cases, they are not anchored in laws or regulations and do not have cost-effective enforcement mechanisms. In addition to improved disclosure on payouts and reserves to Investment Account Holders (IAHs), there is a need for greater protection of IAHs interests, for example through board representation of the IAHs, consumer education programs and the provision of dispute resolution frameworks that are speedy and cost-effective.
- Supervisory reporting and processes should be enhanced to allow adequate monitoring of IB risks. Manuals should include guidelines for supervisors on how to effectively undertake on-site and off-site supervision, and rating systems should include parameters that capture IB-specific risks, including *Shari'ah* compliance risk. Adequate capacity building should accompany the upgrade of the regulatory and supervisory process.
- Liquidity management frameworks need further strengthening. In order to provide IBs with instruments and markets comparable to the ones existing for conventional banks, more work is needed to develop *Shari'ah*-compliant capital and interbank markets, and to adapt central bank monetary operations, including the Lender of Last Resort (LoLR) framework. Regular sovereign issuance of tradable *Sukuk* with different maturities would also help to provide a benchmark pricing curve and to increase the provision of High Quality Liquid Assets (HQLAs).
- Commensurate efforts to develop resolution frameworks and *Shari'ah* compliant deposit insurance schemes (SCDIS) are also needed to facilitate orderly resolution of IBs, if and when stresses emerge. Special resolution frameworks for IBs are needed that also provide legal clarity on the treatment of investment accounts in resolution. Resolvability of large and complex Islamic financial institutions (IFIs) should also be enhanced through recovery and resolution planning. Strengthening SCDIS and other safety nets should help promote financial stability in the jurisdictions where IBs operate.

BAHRAIN¹

A. Overview of the Islamic Finance Industry

- 1. Bahrain’s Islamic finance (IF) industry has been in existence for more than 30 years, and the industry gained momentum in the last 5-10 years.** Bahrain operates a dual system where Islamic financial institutions (IFIs) operate in parallel with conventional banks. The first Islamic bank was established in 1979 and several Islamic banks (IBs) have been licensed over the following decades. The IB industry registered rapid growth in assets and market share (Figure 1). The other segments of the IF industry, including the *Takaful* industry and the Islamic asset management, also date back several years—the latter began as a way for IBs to make use of their excess funds.
- 2. The last 10 years have seen Bahrain increasingly play a premier role in the overall development of the IF industry.** Bahrain, with 22 Islamic banks, has the largest concentration of IB operations among the countries that operate dual banking systems. The country also pioneered the issuance of *Sukuk* in 2001, was the first country to launch a dedicated Islamic index and has been in the forefront in the development of the *Takaful* industry. In addition, Bahrain hosts a number of organizations that are central to the development of IF. These include: the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI); the International Islamic Financial Market (IIFM), and the Islamic International Rating Agency (IIRA).
- 3. The IB segment dominates the IF industry in Bahrain.** At end June 2015, the IB industry accounted for 94 percent of IF industry assets. The *Sukuk* segment follows a distant second with 5 percent. The seven Islamic insurance companies (*Takaful*) and two *Re-Takaful* companies that operate in the Kingdom account for less than 1 percent. Other Financial Institutions (OFIs), which comprise mostly investment funds with close to a 100 Islamic funds, account for a miniscule 0.6 percent (Figure 1).
- 4. The IB sector has registered rapid asset growth, but it remains a small player in the global IB industry.** Total assets of IBs (excluding the windows) grew strongly from USD 1.9 billion in 2000 to USD 24.7 billion in 2008 representing a Compound Annual Growth Rate (CAGR) of 44 percent. Thereafter, Islamic bank assets have grown slowly, equivalent to a CAGR of 0.4 percent between December 2008 and November 2015. The market share of IBs (wholesale and retail banks) increased to 13.2 percent of the banking industry assets and their assets amounted to about 83 percent of Bahrain’s 2015 GDP. In the retail segment, the share of IBs is higher and amounts to 21.6 percent of total assets. Despite this rapid growth, Bahrain accounts for less than 2 percent of the global IB assets (Figure 1).

¹ Prepared by Padamja Khandelwal, Maxym Kryshko and Inutu Lukonga.

B. Islamic Banks' Operations and Soundness

Corporate and Balance Sheet Structure

5. Bahrain's IF industry is complex and diverse. The IB industry consists of two broad segments—6 retail IBs that focus on the domestic and regional markets for business and 19 wholesale IBs with a broader geographical footprint. There is cross-shareholding between wholesale IBs and retail IBs, conventional wholesale banks and Islamic wholesale subsidiaries, and between Islamic retail banks and conventional retail banks. Most IBs are privately-owned with participation from foreign private shareholders from the Gulf Cooperation Council (GCC), primarily of Saudi, Omani, Kuwaiti and UAE origin, but one retail bank is indirectly majority owned by the Bahraini government via a state-owned conventional retail bank and social security institutions. The industry also includes large and systemically important IB groups as well as numerous small scale banks that focus on niche markets.

6. On the asset side, investments represent a large proportion and financing consists primarily of debt-based instruments, that transfer rather than share risks (Figure 1). At end June 2015, domestic assets accounted for 58 percent of the total assets of IBs, and the foreign assets included investments in the GCC, other Arab countries, Europe and the Americas. Financing items account for about 40 percent of total assets and most of the financing items are debt-based. *Murabahah* and *Ijarah* respectively account for over 70 percent and 19 percent of total facilities by retail IBs whereas financing facilities of wholesale banks are concentrated in *Murabahah*, which alone accounts for 90 percent of the total facilities. Risk sharing products such as *Musharakah* and *Mudharabah* are, on the other hand, very small.² A significant share of the financing is utilized in real estate (construction, commercial real estate and retail mortgages) which, respectively, accounts 28 percent and 22 percent of retail and wholesale IB financing. Other sectors accounting for a significant share of the financing are manufacturing, trade and consumer finance. The off-balance sheet component, which is equivalent to 7 percent of assets, mainly consists of assets funded with restricted investment accounts (RIA) while letters of credit (LCs) and bank acceptances account for about 2 percent of assets. Overall, while the aggregate balance sheet structure of the IBs is relatively diversified, many of the smaller IBs are reported to have concentrated portfolios.

7. Bahrain IBs finance their operations using both domestic and foreign sources of funding (Figure 2). Domestic sources of funding account for about 64 percent, of which private non-bank enterprises and households account for about 36 percent. Interbank deposits are a significant source of funding, accounting for 18 percent of total funding sources. Government deposits are small, accounting for about 4 percent. Other funding comes from head offices and bank affiliates as well as *Sukuk* issuance. Equity capital and other capital-like liabilities account for about 30 percent. Foreign funding comes mostly from the GCC and other Arab countries. Overall, while the bulk of the assets are funded by the banks' "own funds" and current accounts, PSIAs

² Central Bank of Bahrain Financial Stability Report 2016, pages 54 and 59. For the sectoral distribution of credit see pages 53 and 58.

represent a substantial share of funding, with URIAs estimated at 24 percent of total funding and RIA accounting for 7 percent.

Performance and Soundness of the Islamic Banking System

8. The financial fundamentals of IBs have been strengthening. The industry has for some years now been consolidating. At end September 2015, aggregate Capital Adequacy Ratios (CAR) were 20 percent for wholesale IBs and about 15 percent for retail IBs compared with a statutory minimum of 12.5 percent. Non-performing financing (NPFs) is, on the other hand, elevated particularly for retail IBs. The IB sector remains profitable on aggregate, but wholesale IBs have registered a compression in profit margins to reach negative territory in September 2015. Liquidity positions are tighter compared to conventional banks, with retail IBs registering lower levels relative to the wholesale IB sector (Figure 2).

9. The operating environment is, however, becoming challenging due to headwinds from lower oil prices. With the slump in oil prices persisting, domestic and regional Gross Domestic Product (GDP) growth is projected to slow down and system wide liquidity has tightened, thus IBs, like their conventional counterparts, could face asset quality and liquidity pressures. The concentration of assets in cyclically sensitive sectors (construction, real estate, trade and manufacturing) increase risks for the IB sector.

C. The Regulatory and Supervisory Framework

10. Bahrain has enacted legislation that is explicit on permissible IB practices, products and institutions. The Central Bank and Financial Institutions Law, Legislative Decree 64, confers on the Central Bank of Bahrain (CBB) regulatory and supervisory powers for all financial institutions, including Islamic ones. The regulatory and supervisory responsibility was transferred to the CBB, from the Bahrain Monetary Authority (BMA), in September 2006. The CBB Law is supplemented by CBB rule books, which includes separate independent self-standing regulatory frameworks for conventional and IBs. The framework allows for the provision of IB products and services through various modes, including stand-alone banks, unit/business lines, branches, and subsidiaries.

11. The CBB has been adapting its prudential framework to cater for risks that are specific to IB. Standalone IBs are issued with IB licenses and licensing requirements for conventional banks with Islamic windows have been customized. The regulatory capital adequacy requirements for IBs are based on the IFSB-15 prudential standard, apply an alpha factor of 0.3 and do not consider PER and IRR as part of the eligible capital. Segregation regulations designed to limit the risk of commingling conventional and Islamic funds are in place.³ On the other hand, the regulations governing loan classification and provisioning, large and related exposure limits, anti-money

³ IBs are required to maintain the funds raised by way of Islamic deposits (demand deposits, URIAs, etc.) separately from other funds under the control of the bank. The self-financed pool (which includes funds in current accounts) is maintained separately from the URIA pool. However, funds from both pools may be comingled to finance the same asset. Islamic windows must maintain separate books for *Shari'ah* compliant banking activities to ensure no comingling of conventional and Islamic funds.

laundering and combating the financing of terrorism (AML/CFT), and investments in real estate, and securities apply equally to conventional and IBs.

12. The CBB has also taken several steps to strengthen *Shari'ah* compliance by IBs and to reduce reputational risk. A Centralized *Shari'ah* Board was recently established and its mandate includes: overseeing product development IFIs and Islamic windows, strengthening *Shari'ah* compliance, providing guidance to the CBB in issuing rules and regulations for the sector, providing guidance to the courts in legal cases involving IFIs and acting as the *Shari'ah* Board for the CBB. Bahrain has adopted the AAOIFI standards for *Shari'ah* compliance and requires IFIs to establish a *Shari'ah* Supervisory Board (SSB), and conduct a *Shari'ah* review or *Shari'ah* audit. External auditors are also required to ensure *Shari'ah* compliance as part of ensuring internal controls.

13. The consumer protection framework incorporates the key elements, including a legal basis, disclosure requirements, consumer education and cost-effective dispute resolution processes. The Central Bank of Bahrain and Financial Institutions Law 2006 ('CBB Law') confers on the CBB duties to protect the legitimate interests of customers of financial institutions. The rulebook for IBs covers, among others, disclosure and reporting requirements. More specifically:

- All IBs are required to publish audited annual and reviewed quarterly financial statements. The financial statements have to be prepared in accordance with the Financial Accounting Standards (FAS) issued by AAOIFI. When there are no specific accounting standards under AAOIFI, IBs must use International Financial Reporting Standards (IFRS). Banks must disclose the main features of all capital and equity related instruments and URIAs.
- The SSB of IBs are required to publish a statement regarding the bank's state of *Shari'ah* compliance.
- IBs are permitted to use mechanisms (such as the PER) to smooth the low profits on URIAs accounts in low return periods, but bank customers have to be informed of their use. IBs are also required to appoint independent board of directors representing (explicitly or implicitly) the interests of IAAs, and to ensure that independent directors represent all stakeholders. In addition, banks are urged to have one of their SSB members to be in the Corporate Governance Committee of the Bank, representing RIAs and URIAs holders.
- Bahrain has in place an Alternative Dispute Resolution (ADR) forum that customers may go to for the resolution of disputes involving IBs.

14. The reporting framework and supervisory process take account of the specifics of Islamic modes of banking. The regulatory framework mandates that AAOIFI standards must be used by IBs for financial reporting purposes. There is a dedicated unit for supervision of IBs and specific off-site and on-site examination manuals. Bahrain has also made advancements in building capacity for assessing financial stability risks in IBs. The CBB established the Bahrain Institute of Banking and Finance (BIBF) to facilitate training and education in IF. IBs are supervised on a consolidated basis but cross-border supervision is currently not fully in place. There is, however, no

difference between conventional banks and IBs regarding the corrective and enforcement actions and the processes formulated in the regulatory framework.

D. Liquidity Management, Resolution and Deposit Insurance

15. The CBB has been at the forefront of developing financial markets and instruments to facilitate liquidity management by IBs. This includes developing *Sukuk* markets as well as the launch of *Shari'ah*-compliant CBB liquidity management instruments.

- In 2001, the Bahrain government introduced the long-term *Ijarah Sukuk* and short-term Al-Salam *Sukuk* to provide IBs with investment opportunities and to facilitate systemic liquidity management by the central bank. There is no overnight standing credit facility for IBs in Bahrain, but the *Ijarah Sukuk* securities can be used as collateral for banks to obtain funding from the CBB for tenors of 1-week. The Monetary Policy Committee of the CBB sets the applicable rates.
- In 2015, the CBB launched a new *Shari'ah* compliant *Wakalah* liquidity management instrument to absorb excess liquidity of the local retail IBs and place it with the central bank. The instrument has been developed based on a standard contract of the IIFM. The duration of the *Wakalah* is one week, which facilitates short term liquidity management

16. There is no special resolution framework for banks, nor does the framework distinguish between conventional banks and IBs. Banks are subject to the same insolvency framework as non-financial corporates. Nevertheless, in liquidation, the regulations give priority to demand deposits followed by RIAs, since the latter is an off-balance sheet item with restrictions in the manner as to where, how and for what purpose the funds are to be invested. Thereafter, the order of ranking is URIAs, and shareholders and creditors are last. *Shari'ah* boards do not play a role in resolution decisions and there are currently no cross border resolution arrangements.

17. IBs are covered by the same deposit insurance regulatory framework as conventional banks, but there are separate schemes within the framework. Bahrain's pre-funded deposit insurance structure is based on the *Shari'ah* compliant contract of *Takaful* whereby the deposit insurer is only an agent operating and managing the pool of funds that are collected as contributions from participating IBs. When one of the members fails, the reimbursements for insured deposits are paid from respective *Takaful* funds. The coverage limit is 20,000 Bahraini dinars (about USD 53,000) and the deposits covered include Islamic deposits and URIAs but not RIAs.

E. Conclusions and Policy Issues

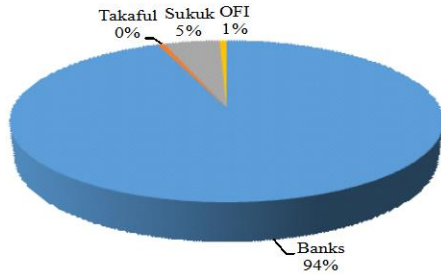
18. Bahrain has, over the past decade, emerged as an important player in the global IF industry. Bahrain's IF industry is well-established with a broad range of institutions, while the regulatory framework and financial infrastructures have been largely adapted to the specifics of IB. The recent establishment of a centralized *Shari'ah* board will help ensure consistency, strengthen supervision of *Shari'ah*-compliance, including fit-and-proper review of bank-level *Shari'ah* advisors, and facilitate the development of *Shari'ah*-compliant money and capital markets.

19. IBs in Bahrain have, nevertheless, experienced lower profitability and higher non-performing facilities than conventional banks, and low oil prices could present further challenges. This, in part, is due to higher real estate exposures, which affected IBs in a bigger way in 2009 and 2011. The concentration in loan portfolios, to some degree, reflects the lack of economic diversification and underscores the important role of diversifying the economy to ensure the sustained stability of the IB industry and the banking sector in general. Moreover, IB, which requires that all financing activities are underpinned by real economic activity, may be more exposed to macroeconomic shocks. Going forward, with oil prices projected to remain low, government spending is expected to decline and could negatively affect growth prospects, which coupled with concentrations in loan portfolios, could put further pressure on bank asset quality, profitability and internal capital generation. Strengthening the macroprudential framework and maintaining strong supervision will remain essential to mitigate risks and ensure the adequacy of the capital and liquidity buffers. In addition, the resolution framework should be further developed while taking into consideration the specificities of banking, and IB in particular.

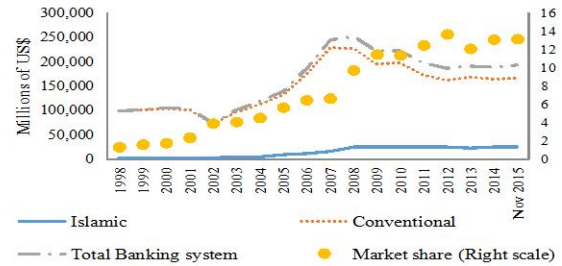
Figure 1. Bahrain: Structure of the Islamic Finance Industry and Bank Balance Sheets

Bahrain's Islamic Finance industry is bank dominated. The industry registered rapid growth in the last 10 years.

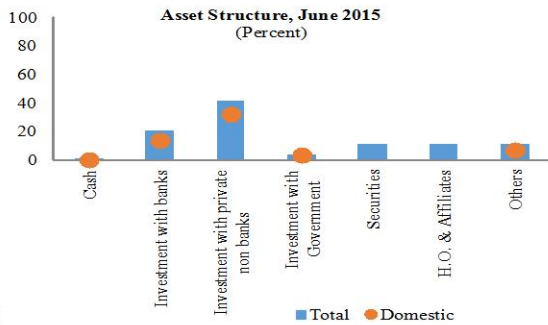
Bahrain: Structure of the Islamic Finance Industry



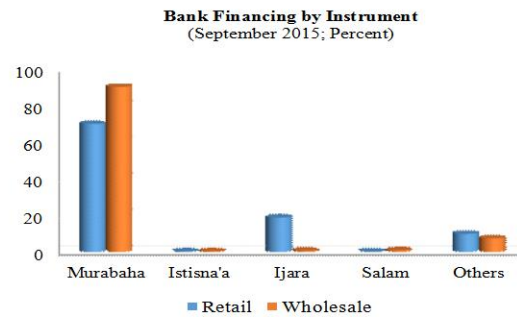
Growth of Islamic Banking Sector
(Market Share in Percent)



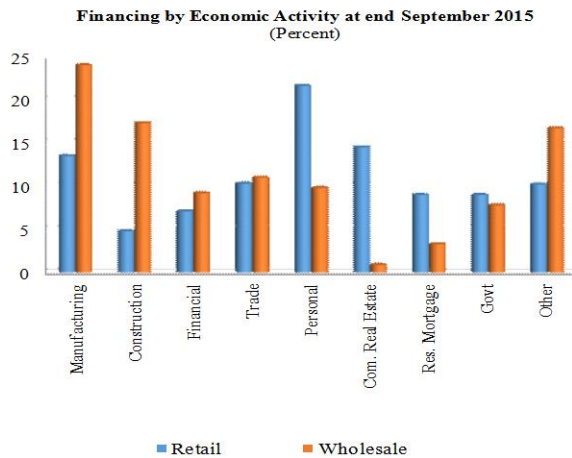
On the asset side, investments account for a large share.



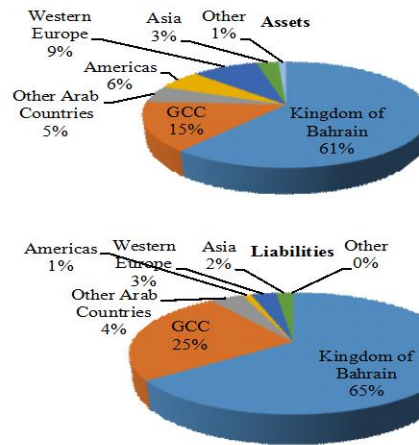
Financing is largely debt based.



The bulk of the financing is to real estates, comprising construction, commercial and residential real estates.



Though domestic market activities dominate cross border operations are significant

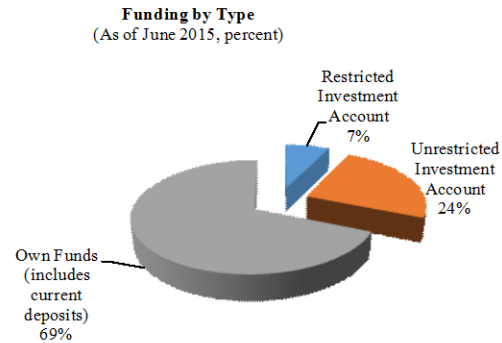
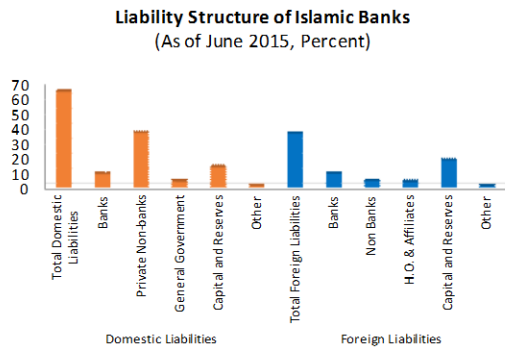


Source: Central Bank of Bahrain

Figure 2. Bahrain: Sources of Funding and Islamic Banks' Performance

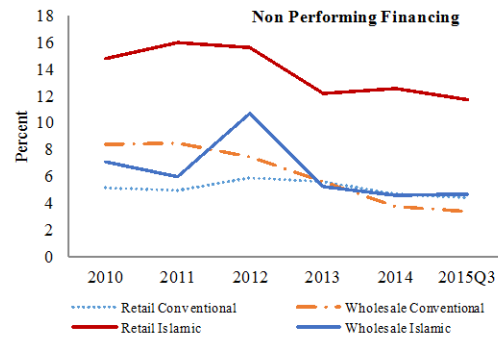
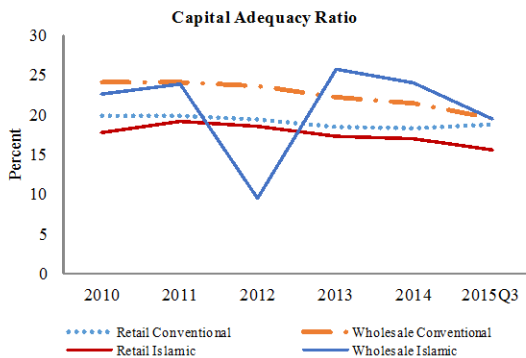
Funding is from domestic and foreign sources

PSIA account for a significant share.



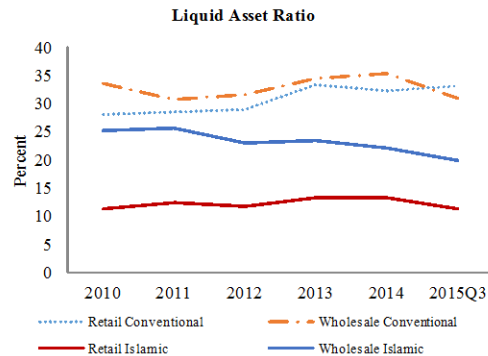
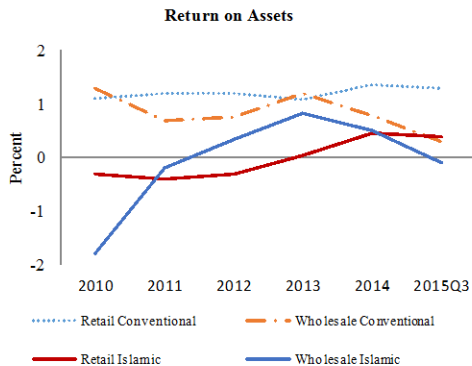
Capital Adequacy Ratios for wholesale and retail Islamic banks are high but trending down

Non performing assets are elevated for Islamic banks, particularly for retail Islamic banks



Profitability of Islamic banks is lower and has trended down for wholesale Islamic banks

Liquidity ratios are also lower for the Islamic banks, particularly the retail group.



Source: Central Bank of Bahrain.

DJIBOUTI⁴

A. Overview of the Islamic Finance Industry

20. The IF industry in Djibouti has limited breadth. The industry comprises mainly of the IB sector and a small Islamic micro-finance sector, which accounts for less than 1 percent of the total industry assets (Figure 3). The Islamic insurance companies (*Takafu*) have not yet started operating, there are no Islamic equity or *Sukuk* markets and no Islamic private pension operators.

21. IB has registered steady growth since the licensing of the first Islamic bank in 2006, though it has slowed in 2015. As of end 2015, four of the 10 banks operating in the country were full-fledged IBs. The market share of IBs reached 16.4 percent of the total banking system assets. Conventional banks have not yet started to offer IB products, although the law permits Islamic windows.

22. The industry is poised for further growth, though the cash culture is a lingering constraint. Latent demand for Islamic financial services, low levels of financial inclusion, facilitative regulatory support and cross border flows particularly from war torn countries such as Yemen and Somalia have been driving the growth of the industry. Although Djibouti's population is less than a million, about 96 percent of the population are Muslim, less than 20 percent of Djibouti adults hold a deposit account with a bank, and less than 8 percent had access to a loan account in 2014.⁵ However, the cash culture, which has limited the growth of conventional banking, also presents challenges for the growth of IB.

B. Islamic Banks' Operations and Soundness

Corporate and Balance Sheet Structure

23. Djibouti's IB sector consists of full-fledged IBs that are predominantly owned by foreign shareholders. The foreign shareholders are mainly from Yemen, United Arab Emirates, and Somalia.

24. The asset structure of the IBs balance sheets consists mainly of money market placements and financing. Financing instruments are almost equally divided between debt-like products based on *Murabahah* contracts and risk-sharing products based on *Mudarabah* contracts (Figure 3). Other Islamic products like *Salam*, *Istisna*, *Ijarah* and *Musharakah* are recognized in the banking law and the regulations, but they are not yet developed. The investment portfolio is not yet developed, in part reflecting the absence of capital market products.

⁴ Prepared by Malik Garad, Alexei Kireyev, Mohamed Afzal Norat and Inutu Lukonga.

⁵ IMF Country report number 16/249.

25. The main sources of funding are domestic deposits which are mostly placed in current accounts. Deposits account for about 60 percent of total liabilities, and current accounts are estimated at about 40 percent of total deposits. Investment accounts are estimated to be about 15 percent for URIAs and 7 percent for RIA. IBs in Djibouti have not issued *Sukuk* to raise funding but funding from the parent banks is reported to be very significant.

Performance and Soundness of the Islamic Banking system

26. IBs in Djibouti remain stable, but fundamentals are weakening. At end 2015, the aggregate CAR had fallen below the statutory minimum level of 12 percent; the NPF levels are lower than those of conventional banks, but they have been trending up and the divergence in accounting practices results in classification differences for NPFs. The IBs are still profitable, but margins have been tightening (Figure 4).

27. Most IBs prefer to finance and invest outside of Djibouti and the financing portfolio is concentrated in cyclically sensitive sectors, such as real estate. The investments are in a number of countries, including Yemen, Saudi Arabia, Sudan, Turkey, UAE and China. This cross-border activity has exposed Djibouti IBs to foreign exchange (FX) risks as well as geopolitical and banking spillover risks, since the operating environment is made challenging by conflicts (Yemen and Somalia). Data on the sectoral distribution of Islamic financing was not available but reports indicate significant domestic and foreign exposure of IBs to real estate and to land. Therefore, group risks, cross border risks and concentration risks are material and their mitigation should be a focus of supervision.

C. The Regulatory and Supervisory Framework

28. Djibouti licensed the first Islamic bank in 2006, but Islamic financial contracts were not explicitly recognized in Djibouti Banking Law until 2011. The legal framework did provide recognition of IBs as another type of credit establishment but that law did not specify the detail, definition, operations, and types of permissible IF contracts. IBs were, therefore, regulated and supervised by the Banque Central Djibouti (BCD) under legal and regulatory requirements established for conventional banks.

29. In January 2011, a law came into force that defined and established the operations of IBs and permitted use of certain Islamic financial contracts. The law enabled the establishment of IBs under existing banking Law. The law also allowed the use of eight Islamic financing contracts⁶; permitted conventional banks to undertake activities with IBs and to open Islamic windows; it defined Islamic deposits and PSIA; and required a *Shari'ah* board at the bank level. Moreover, the law included provisions for the possibility of a National Supervisory Board (NSB) that would advise

⁶ The eight Islamic contracts authorized under Law were *Mudarabah*, *Musharakah*, *Murabahah*, *Istisna*, *Ijara*, *Salam*, *parallel Salam*, and *parallel Istisna*.

the BCD; requires IBs to provide disclosures for PSIA holders and to make clear the priority of claims when IBs are liquidated.

30. Some gaps in the legal and regulatory framework, nevertheless, remain. The law does not specify the types of PSIA (restricted and unrestricted) nor their role in determining capital adequacy for IBs. While an *Ijarah* contract is defined in the Law, the opportunity to fully exploit this contract is limited because of the lack of legal framework authorizing leasing in Djibouti and lack of infrastructure to support it. The law, also, does not clarify the relationship that the NSB would have with the SSB of the IBs or the obligations and responsibilities it would have with the BCD.

31. The BCD has issued prudential regulations and directives to effect the provisions of the law, but the regulations do not fully take into account the characteristics of IB. The regulations governing minimum capital, liquidity requirements, loan classification, provisioning, investment in property, large and related party exposure limits are all identical with those for conventional banks. Djibouti has not fully adopted the IFSB-15 formula for calculating the CAR. PER, but not IRR are eligible for computing the CAR requirements. Macro-prudential policies have also not been developed to address potential systemic risks that IBs could be exposed to. The directives, nevertheless, require segregation of funds to avoid comingling of *Shari'ah* compliant and conventional funds.

32. The *Shari'ah* governance structure was developed recently. A Presidential Decree for the establishment of a National *Shari'ah* Committee (NSC) was adopted in November 2015. The NSC is established at the BCD but is independent from it in the execution of its functions and is financed from the state budget. The NSC prepares periodic confidential reports for the Governor of the BCD with its assessment of the governing structure of IFIs, conformity of their financial products and procedures with *Shari'ah*, and the audit of IFIs. The NSC is led by a President and consists of several members, three of whom are experts in Islamic law, one lawyer and one economist. IBs are required to establish their own *Shari'ah* committees but their members do not undergo fit and proper tests. These committees report to the Board of directors and are responsible for ensuring compliance with Islamic law of the bank's financial products and procedures.

33. A consumer protection framework for financial products has not yet been developed. Consumers of financial products are protected under the general civil law, which does not include any specific provision related to IBs. The IBs are subject to the same disclosure requirements as conventional banks. There are no independent board members designated to represent the interests of IAHS. Djibouti's *Shari'ah* court does not have jurisdiction over IB activities and there is no arbitral forum or ADR forums that customers may go to for the resolution of disputes involving transactions in IB. Nevertheless, there are a few provisions that provide a degree of protection for the consumers of IB products. The law requires the *Shari'ah* board to publish a statement regarding the bank's state of *Shari'ah* compliance. While banks have full discretion in setting profit-sharing ratios for investment accounts, the maximum profit share that IBs are permitted by law is 6 percent for URIAs and 5 percent for RIA. IBs are also required to inform their account holders of the profit smoothing practices.

34. The supervisory framework has not yet been tailored to cater to risks specific to Islamic modes of banking and capacity to supervise IBs needs strengthening. There are no on-site or off-site manuals designed for supervising IBs and there is no dedicated supervision unit for IBs. There is no fit-and-proper approval process for appointment of *Shari'ah* board members. While some of the IBs have cross-border operations, the BCD does not undertake consolidated supervision nor does it have cross-border supervisory arrangements. Techniques for risk assessment of IB operations are yet to be developed. The BCD does not enforce any updated accounting standards issued by IASB, IFRS or AAOIFI and IBs have the option of electing either AAOIFI or IFRS.⁷ Some gaps also remain in monitoring and surveillance of IBs from their balance sheet information.

D. Liquidity Management, Resolution, and Deposit Insurance

35. Liquidity management remains a challenge. Although IBs use a number of liquidity management instruments—interbank *Musharakah*, interbank *Mudarabah* and commodity *Murabahah*—they rely on international financing, rather than the domestic interbank market to meet liquidity needs. There is a domestic interbank market between conventional and IBs but not among the IBs. The BCD has not yet developed *Shari'ah*-compliant liquidity management instruments nor has it developed a *Shari'ah*-compliant LoLR framework. Instead, IBs are permitted to utilize the conventional facilities (such as discount window, open market operations) provided by the monetary authority for liquidity management purposes. There is no *Sukuk* market either for the sovereigns or corporates and there are yet no plans to develop one, which reduces the availability of income-generating high quality liquid assets.

36. A special resolution framework has not yet been developed for IBs nor is there an SCDIS. While one of the IBs is currently under resolution proceedings by BCD, there is no special resolution regime for IBs. The regulatory agencies have powers to take over the management of problematic IBs but the resolution process has not been adapted to take account of the unique contractual nature of IB. The law, nevertheless stipulates the priority of claims in liquidation, with depositors ranking ahead of PSIA holders who rank ahead of shareholders. There are also no cross-border resolution arrangements in place that involve IBs. There is a deposit insurance system in the country but it is only for conventional banks and does not cover IBs.

E. Conclusions and Policy Options

37. Djibouti's legal, regulatory and supervisory frameworks have not yet been adequately tailored to mitigate financial stability risks inherent in Islamic modes of banking. Prudential regulations currently do not distinguish between conventional and IBs, IFSB rules for computation of capital adequacy requirements have not been adopted, and the consumer protection framework has not been adapted to financial products in general. The *Shari'ah* governance framework is in place,

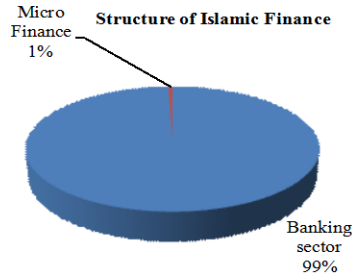
⁷ Two IBs in Djibouti are publishing their financial statements according to AAOIFI, while one is publishing according to IFRS.

but there are no fit and proper requirements for *Shari'ah* advisors. The supervisory framework and capacity are not yet aligned to cater to the specifics of Islamic modes of banking. Therefore, besides the standard banking risks, such as credit, liquidity, cross border and contagion risks, the IBs are exposed to equity investment and displaced commercial risks (DCR). The absence of developed capital markets also suggests that assessment of equity risk could be challenging.

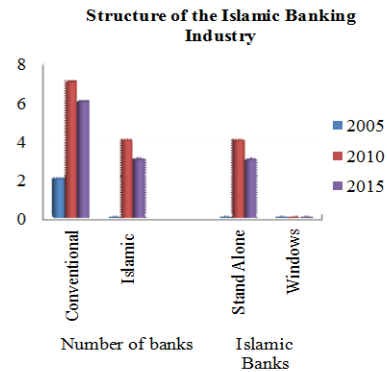
38. Given the rapid growth of Djibouti's IB industry, prudential and supervisory frameworks that are adapted to the specificities of Islamic modes of banking will be critical in ensuring financial stability. This requires adopting IFSB and AAOIFI standards, enhancing supervisory capacity in risk assessment, monitoring and management in domestic IBs and their cross-border operations, developing a consumer protection framework that includes disclosure requirements, and further strengthening the *Shari'ah* governance framework. Development of a *Sukuk* market, notably through regular issuance of tradable sovereign *Sukuk*, and the adaptation of monetary operations could also facilitate liquidity management by IBs. A legal framework authorizing leasing in Djibouti and infrastructure to support it could facilitate use of *Ijarah* by IBs. An SCDIS and a special resolution framework for banks that take into account the specific needs of Islamic banks are needed to ensure sustained financial stability.

Figure 3. Djibouti: Structure of the Islamic Finance Industry and Bank Balance Sheets

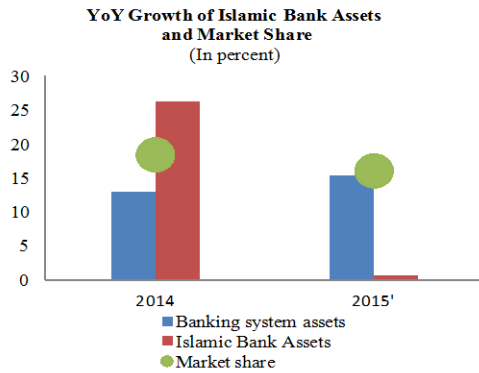
Djibouti's Islamic finance industry is bank dominated.



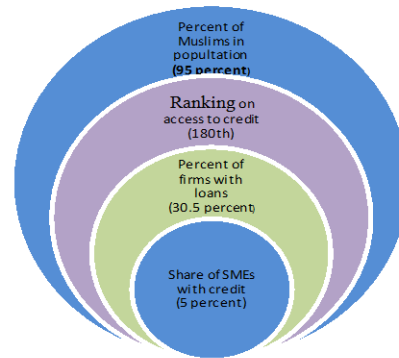
The number of Islamic banks increased after 2005.



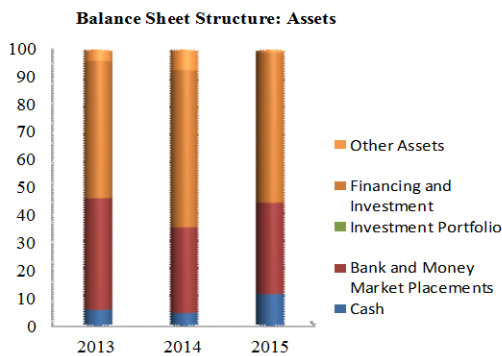
After rapidly gaining market share, the growth of Islamic bank assets tapered down in 2015.



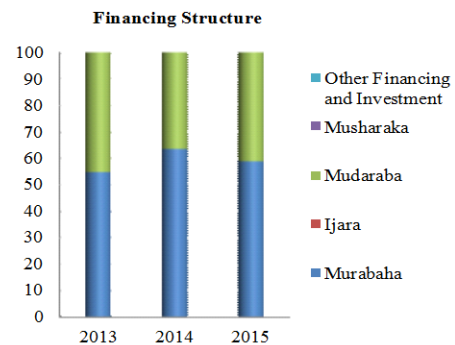
Potential for Islamic banking to grow is high.



Financing and investment account for the bulk of assets, but interbank financing is significant.



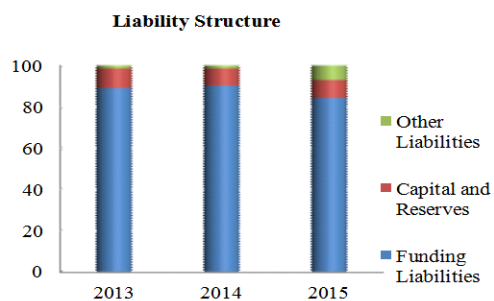
Debt based instruments accounts for the bulk of the financing but risk sharing products based on Mudaraba are significant.



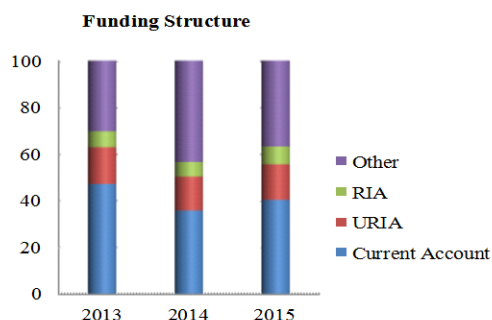
Source: Central Bank of Djibouti.

Figure 4. Djibouti: Sources of Funding and Islamic Banks' Performance

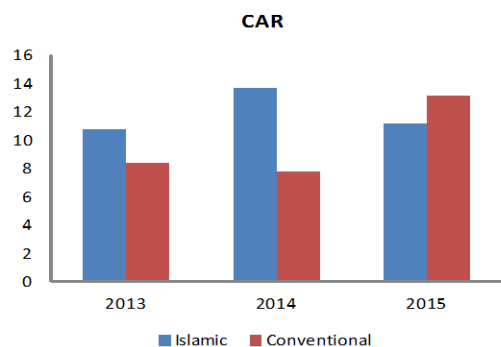
Deposits account for the bulk of the liabilities.



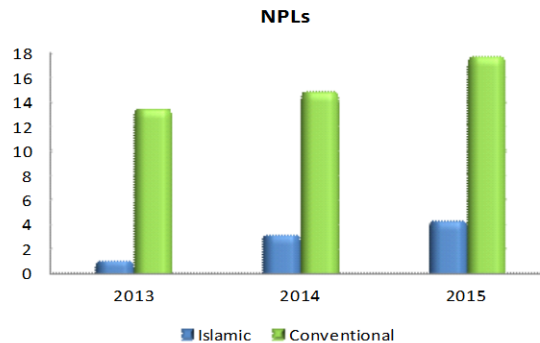
PSIA account for a small share of funding.



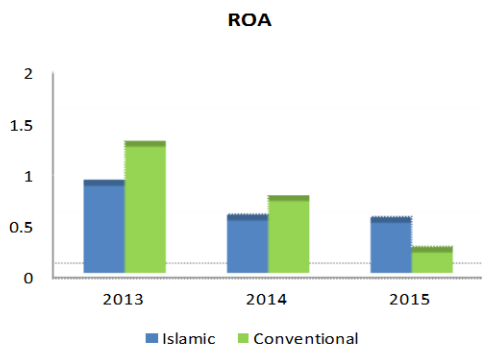
CAR have fallen below the statutory minimum level of 12 percent



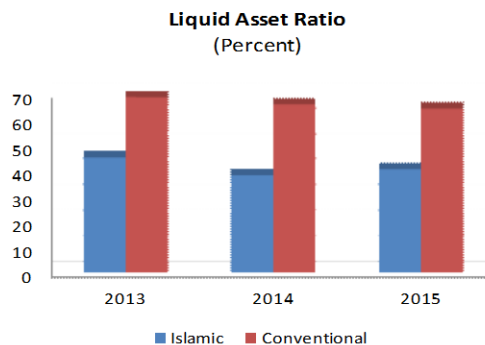
NPL ratios are below those of conventional banks but they are trending up



Islamic banks remain profitable, but margins are tightening



Liquidity, measured by the LAR, is tighter than those for conventional banks



Source: Central Bank of Djibouti.

INDONESIA⁸

A. Overview of the Islamic Finance Industry

39. Indonesia has a diversified IF industry, but market penetration of the IB sector remains low. The IF industry is dominated by capital market products, including *Shari'ah* stocks, *Sukuk* and mutual funds which collectively accounts for 83 percent. The IB sector, comprising 12 standalone banks and 22 Islamic windows of conventional banks, accounts for 7 percent of the domestic IF industry, 5 percent of the total banking system assets and 2.5 percent of the global IB industry. Other sectors include finance companies, the *Takaful* and *Zakat* and *Waqf* (Figure 5).

40. IB in Indonesia has a long history but its growth only accelerated after the issuance of the 2008 IB law. Indonesia's first Islamic bank was established in November 1991, and a legal framework for IB was enacted in 1992, which facilitated some growth in the industry. The issuance of the 2008 IB law had a major catalytic effect, with the number of full-fledged IBs doubling from six in 2009 to 12 by end 2015, while the number of conventional banks with Islamic windows declined somewhat from 25 to 22. The assets grew at a CAGR of 38 percent between 2009 and 2013 compared with 18 percent for conventional banks. However, as the macroeconomic conditions became more challenging in mid-2013, the asset growth of IBs decelerated rapidly to 8 percent in 2015, lower than the conventional banking sector (Figure 5).

41. Potential for further growth is high if the constraints are addressed. Indonesia is home to the world's largest Muslim population, with approximately 87 percent of the population of 207 million. Low market penetration for banking services in general⁹ and *Shari'ah*-compliant ones in particular, means Indonesia harbors tremendous upside potential for IF. Moreover, in 2015, the Indonesia Financial Services Authority (OJK) issued a five-year roadmap for Indonesia's IF Industry. The roadmap aims to increase the market share through various strategies, including through greater public education, easing restrictions on foreign ownership of IBs, increasing *Shari'ah* compliance and the provision of an enabling legal and regulatory environment.

B. Islamic Banks' Operations and Soundness

Corporate and Balance Sheet Structure

42. The IB sector is highly concentrated and some of the banks have complex conglomerate structures. Two of the 12 fully fledged IBs account for about half the industry's assets. A number of banks are part of banking groups that have complex conglomerate structures.

43. The asset structure of IBs balance sheets remains concentrated in debt-based financing items, although profit-sharing financing is significant and rising. Financing accounts for over

⁸ Prepared by Rani Setyodewanti and Inutu Lukonga.

⁹ According to the World Bank Findex database, only 36 percent of adults had a bank account in 2014.

75 percent of the total balance sheet assets while investments in *Sukuk* is about 5 percent. The financing is largely provided through debt-based *Murabahah* contracts, although the proportion of risk-sharing financing has been increasing. The latter comprises mostly of *Musharakah* contracts which have risen from 21 percent in 2013 to 26 percent by end-June 2015 while *Mudarabah* based investments are relatively small at around 7.3 percent. IBs finance a broad range of sectors, although business services and trade and hotels dominate (Figure 5).

44. The funding sources for IBs largely comprise of PSIA. The share of PSIA in total liabilities has remained around 70 percent, and about 85 percent of deposits.¹⁰ The PSIA structure of Indonesia's IBs is still heavily centered on *Mudarabah* time deposits (61 percent), where the profit is shared based on pre-agreed profit sharing rate, while the use of commodity *Murahabah* to collect deposits is very limited. Other funding sources such as *Sukuk* and interbank instruments are small (Figure 6). This structure implies that DCR is of material importance.

Performance and Soundness

45. Indonesia's IBs remain sound, but their performance has been persistently weaker than their conventional counterparts. The CAR is above the statutory levels, liquidity indicators are high and the banks are on aggregate profitable. However, NPFs have since 2007 been higher than those of conventional banks and the gap has widened considerably after 2013 (Figure 6). The weakening of asset quality reflects the greater focus of IBs on retail, micro enterprises and small and medium-sized banks (SMEs) that tend to carry higher risks and some financing in foreign currency against the backdrop of an increasingly challenging environment characterized by the depreciation of the Rupiah and economic slowdown.

C. The Regulatory and Supervisory Framework

46. The legal framework explicitly recognizes IB practices, products and institutions. The prevalent banking laws have been amended several times in order to make the *Shari'ah* principles operative in practice. The laws initially conferred on Bank Indonesia (BI) licensing and supervisory power over IBs, but in 2011 the Financial Services Authority (OJK) was established as an integrated financial sector agency and assumed regulatory and supervisory powers for banks at the beginning of 2014. The law allows for the establishment of IBs and the offering of IB products by conventional banks through windows and branches. The law requires the separation of the Islamic business unit from a conventional bank if the assets reach 50 percent of its parent conventional bank, and all business units must be separated from conventional banks by July 2023. The law currently restricts the participation of foreign investors to no more than 40 percent of local IBs, but there are already proposals to remove this restriction.

47. The regulatory framework applies equally to Islamic and conventional banks, with few exceptions. There are no differences in the regulations governing liquidity, large exposure limits,

¹⁰ These estimates are based on data provided by the authorities to the IFSB and differ from the estimates reported by the Financial Supervisory Authority of Indonesia (OJK).

related party exposures, loan classification, provisioning, rules on holding fixed property, fit-and-proper, or internal controls. IBs are not required to use the IFSB formula for the calculation of the CAR. IBs also have to hold capital against assets financed by RIAs or URIAs, suggesting that PSIA are not loss absorbing. The main differences in the regulatory framework for Islamic and conventional banks relate to the minimum capital and risk-weights for profit-sharing models.

- The paid up capital requirement for IBs is set at Rp 1 trillion compared to the requirement of Rp three trillion for conventional banks.
- The risk-weight for the profit-sharing financing that consists of *Musharakah* and *Mudarabah* is determined based on the prevailing rating of end user/ultimate customers or 100 percent if unrated, which is lower than the levels set by the IFSB standards. In November 2014, OJK introduced new rules on capital that require IBs (not Islamic business units of conventional banks) to hold increasing levels of capital depending on risk assessment (those banks with the highest risk profile need to comply with a minimum capital adequacy requirement of 14 percent).

48. Considerable progress has been made to strengthen *Shari'ah* governance under the oversight of a centralized *Shari'ah* board. IBs are required to publish statements on *Shari'ah* compliance. The National *Shari'ah* Board of the Ulama Council of Indonesia ('DSN-MUI'), a state-endorsed and state-funded NGO, has legal authority to issue *fatwa* of the *Shari'ah* suitability of bank products. IBs are required to have an SSB which determines the *Shari'ah* compliance of the products, in consultation with the DSN-MUI. With the transfer of supervisory authority in 2011, DSN-MUI is expected to cooperate and deal with the OJK rather than BI. In November 2014, the OJK signed an agreement with the country's DSN-MUI to strengthen oversight of the IF industry, supporting a centralized approach. External auditors, on the other hand, do not have duties or responsibilities regarding the *Shari'ah* compliance of the banks.

49. Consumer protection laws and regulations for financial services have been put in place but they do not distinguish between Islamic and conventional banking. The principles of consumer protection in Indonesia are generally set out in the Law No. 8 of 1999 on Consumer Protection. Regulation 1 elaborates on those principles specifically for the financial sector, whether they conduct their business under conventional or Islamic models.

- The regulation introduces a dispute settlement mechanism for small claims through the OJK. IBs and their customers can choose to resolve the disputes through BASYARNAS, an independent body that was established by DSN-MUI in October 1993 as the specific-purpose arbitration body for IF, or through the Alternative Institute for Dispute Resolution (LAPS) defined by the OJK. There is also a *Shari'ah* court.
- In November 2014, the OJK introduced new rules that require IBs to include ratios in contracts for profit-sharing financing (including *Mudarabah* and *Musharakah*), calculated based on a feasibility analysis of a customer's business and cash flows.
- IBs do not have unfettered discretion to set profit-sharing ratios on RIAs or URIAs accounts and banks are permitted to give indication of future rates of return.
- IBs are permitted to smooth low profits on URIAs but there is no obligation to inform the customers of the practices. The banks are, however, permitted to appoint independent board directors representing, explicitly or implicitly, the interest of IAHs.

50. The supervisory framework, on the other hand, is tailored to IB. BI had supervisory authority over IBs until December 2013 when the new integrated supervisor OJK assumed the supervisory responsibilities. BI had a set of dedicated offsite and onsite manuals/guidelines designed for IBs and no changes have been made with the changes in supervisory bodies. However, despite the prevalence of banking groups, IBs are not supervised on a consolidated basis nor does BI or OJK undertake cross-border supervision of banks.

D. Liquidity Management, Resolution and Deposit Insurance

51. Indonesia has made considerable progress in developing liquidity and FX management instruments, but some gaps remain. Specifically, progress has been made in developing *Shari'ah* compliant capital markets, hedging instruments, and *Shari'ah* compliant money markets. In case of liquidity surplus or shortage, banks can use Reverse *Murabahah*, Interbank *Musharakah* and *Mudarabah* and Islamic placements. However, less progress has been made in adapting the resolution framework to IB specifics and to developing an SCDIS.

52. The development of *Shari'ah*-compliant money and capital markets provides investment opportunities and liquidity management capabilities. Though small compared to the overall bond market, the *Sukuk* market has grown, driven mostly by sovereign issues which account for 85 percent of the market. There are also *Shari'ah*-compliant mutual funds, and a *Shari'ah* stock index. A standard contract template for *Shari'ah*-compliant repurchase agreement was launched by IBs in Indonesia, which allows the use of government-issued *Sukuk* as collateral. IBs (or Islamic windows) can issue financial instruments in the Islamic money market, although the market is small and banks rely more on BI for liquidity. BI initially developed *Wadi'ah* Certificates but due to concerns about its *Shari'ah* compliance, BI switched in 2008 to using the Islamic Certificate of Bank Indonesia (SBIS), which is based on a *Ju'alah* contract. BI also offers an overnight facility.

53. BI has developed instruments and facilities for managing liquidity in the IB segment.

IBs, particularly the full-fledged banks, can obtain financing from BI through a short-term *Shari'ah* financing facility called Fasilitas Pembiayaan Jangka Pendek bagi Bank syariah (FPJPS). The FPJPS is based on a *Mudarabah* contract and is typically a last resort facility, where IBs may obtain short-term financing against collateral. The return on this financing is tied to the *Mudarabah* deposit rate of the receiving bank, so that the bank has a better expectation of the cost of the facility. Depending on the level of liquidity distress, the type of collateral eligible for this facility may include BI certificates, sovereign bonds or sovereign *Sukuk*, high-quality corporate bonds or corporate *Sukuk*, and financing by a high-quality bank. The term of the facility can also be extended from 14 days up to 90 days in situations where there is the risk of a broader financial crisis, to avoid a rollover risk that could affect a bank's effort to maintain liquidity without endangering its capital.

54. More recently, a framework for crisis management and mitigation was put in place, though it is not tailor-made to the specificities of Islamic modes of banking. Law no 9, 2016 on prevention and resolution of financial system crises was ratified in April 2016 and covers both conventional and IBs. The Act provides a strong legal framework for the Ministry of Finance, BI, OJK and the Deposit Insurance Corporation (LPS) to prevent and manage financial system crises. The Act mandates the formation of the Financial System Stability Committee (KSSK) and provides criteria for systemically important banks, collateral policy and resolution options.

55. Some progress has also been made to develop *Shari'ah*-compliant instruments to manage FX risk. In April 2015, Indonesia's national *Shari'ah* board approved *Shari'ah*-compliant currency hedging tools. Following the fatwa issued by DSN-MUI, BI has issued on March 2016 regulations on hedging transactions based on *Shari'ah* principles that aimed to mitigate exchange rate volatility risk.

Box 1. Indonesia: Structure of the Shari’ah-compliant Foreign Exchange Hedging Instrument

BI has issued regulation on hedging transactions based on *Shari’ah* principles that aimed to mitigate exchange rate volatility risk. The *Shari’ah* hedging principles must be preceded with forward agreement (*Muwa’adah*) to do spot transaction in specific amount in the future with agreed exchange rates. *Shari’ah* hedging should not be based on speculation, but on real demand. Therefore, each transaction must be accompanied by specific underlying documents.

Underlying transactions include trade in goods and services domestically or abroad and/or investment, such as direct investment, portfolio investment, financing, capital, and other investment in domestic or abroad. Here the underlying transactions exclude:

- Funding placement to *Shari’ah* bank or *Shari’ah* business unit as saving, demand deposit, time deposit, and negotiable certificate of deposit;
- Remittance by money Transfer Company;
- Financing facilities that is not yet withdrawn, i.e. standby financing and undisbursed financing.

The nominal transaction of *Shari’ah* hedging must not exceed the nominal value stated in the underlying documents, and the maximum term allowed is the period stated in the underlying documents. Exchange rate and the exchange rate calculation are set during forward agreement.

The *Shari’ah* hedging transaction can be done between: i) customers as applicant to *Shari’ah* bank or *Shari’ah* business unit as provider; ii) *Shari’ah* bank or *Shari’ah* business unit as applicant to other *Shari’ah* banks or business unit as provider; and iii) *Shari’ah* bank or *Shari’ah* business unit as applicant to conventional bank as provider.

More recently, the IIFM and the ISDA have developed two new FX hedging standards, based on *Wa’ad* structure.

56. The resolution framework is fundamentally the same for Islamic and conventional banks, but there are a few provisions that are specific to IBs. In the case of liquidation, demand deposits receive priority followed by URIAs, RIAs, shareholders and other creditors. The new capital rules allow regulators to convert debt into equity if IBs faces insolvency. Besides these provisions, URIAs and RIAs are treated as deposits and therefore are not loss absorbing. *Shari’ah* boards do not have a role in determining or approving resolution actions in respect of failed IBs. There are also no cross-border resolution arrangements in place. IBs are covered by the same deposit insurance regulatory framework as conventional banks. Deposit insurance premiums collected are managed in a single indivisible pool.

E. Conclusions and Policy Options

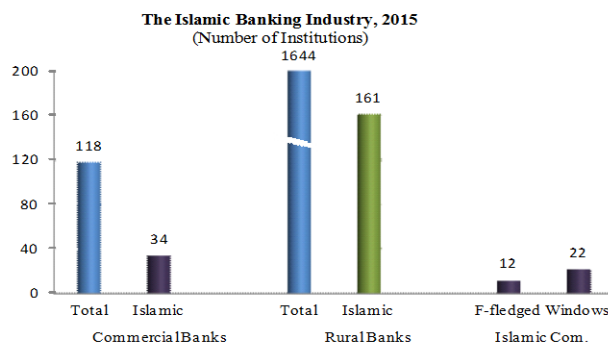
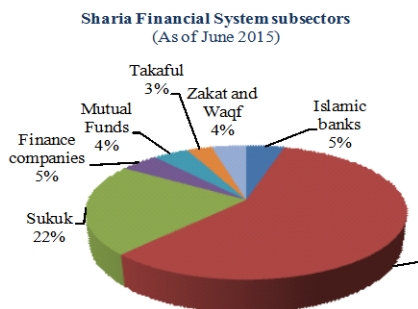
57. Indonesia has made considerable progress in putting in place an enabling environment for IB, but penetration remains low and there is scope to further strengthen the regulatory framework. Whereas profit-sharing financing, based on *Mudarabah* and *Musharakah* contracts, represents a significant share on the assets-side, the prudential framework has not been adapted to address the investment risks associated with these instruments. Capital requirements and deposit insurance also do not fully cater to the specificities of the IB industry or fully account for its unique risks.

58. Greater efforts are, therefore, needed to ensure the stability of Indonesia’s IB industry and to increase penetration rates. There is a need to further expedite reforms to adopt the IFSB and AAOFI standards with respect to capital and other prudential regulations, most notably the treatment of IAH and strengthening corporate governance. Further reforms are also required to strengthen liquidity management infrastructure, and to adapt the deposit insurance scheme (DIS) as well as the resolution framework to the specifics of the IB industry. Promoting financial literacy, increasing the reach of IBs to rural areas with large populations, and easing restrictions on foreign participation could help increase the penetration rates. External shocks, including the weak commodity prices, also increase macro-financial risks that call for enhanced oversight.

Figure 5. Indonesia: Structure of the Islamic Finance Industry and Bank Balance Sheets

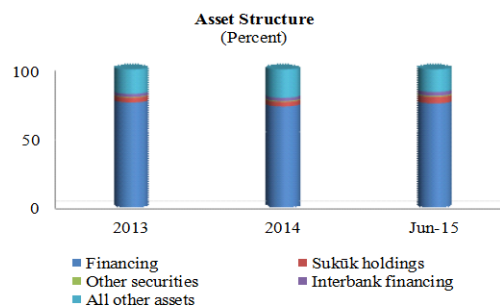
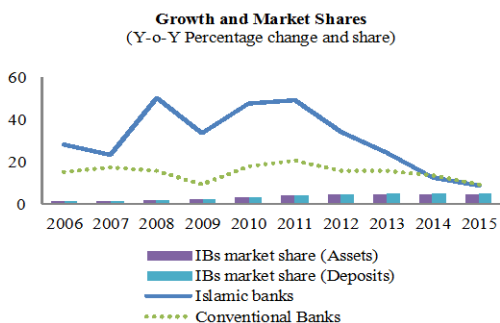
Indonesia has a diversified Islamic finance industry with a small banking segment.

The Islamic banking segment includes both full-fledged banks and windows



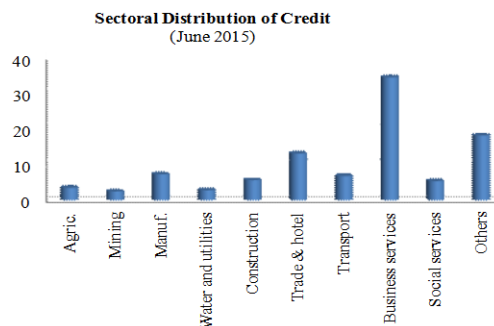
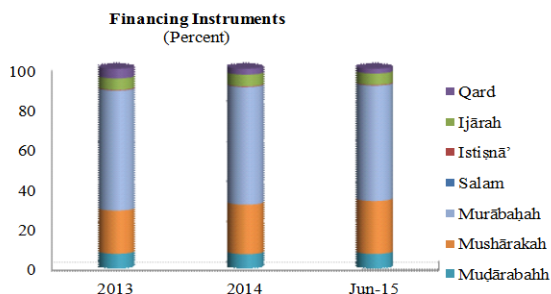
Market penetration of Islamic banking is low and growth has recently decelerated.

Islamic bank assets largely consist of financing items.



Most financing is based on Murabahah contracts, but risk sharing products (Musharaka and Mudaraba) are significant

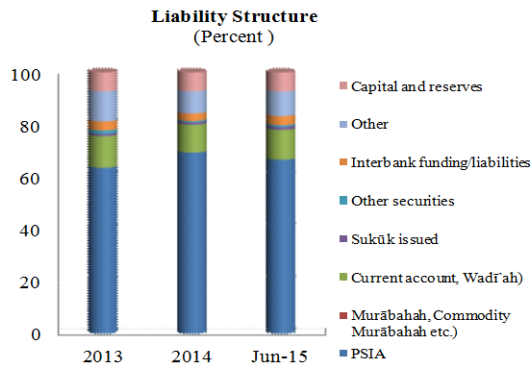
The financing is concentrated in business services and trade.



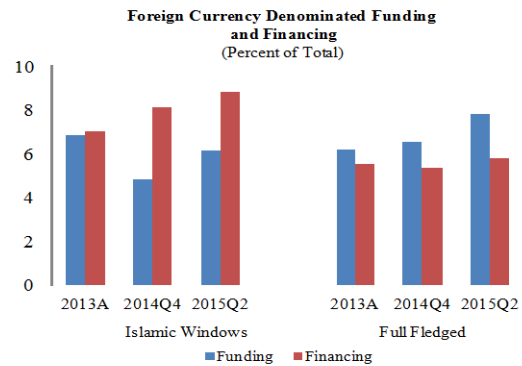
Source: Bank Indonesia and IFSB

Figure 6. Indonesia: Sources of Funding and Islamic Banks' Performance

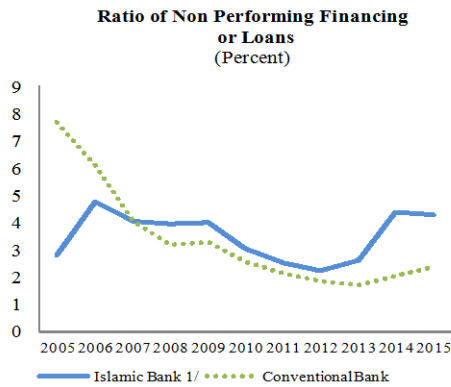
The funding consist largely of PSIA.



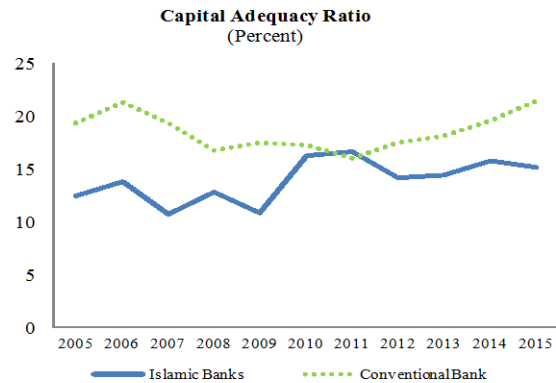
And is predominantly in domestic currency.



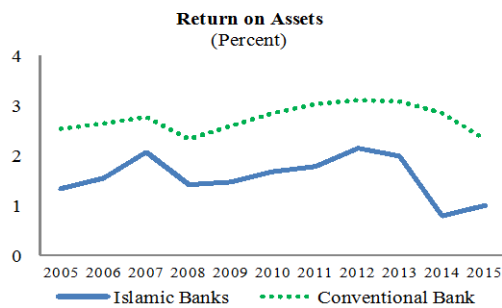
Islamic banks asset quality has persistently been weaker.



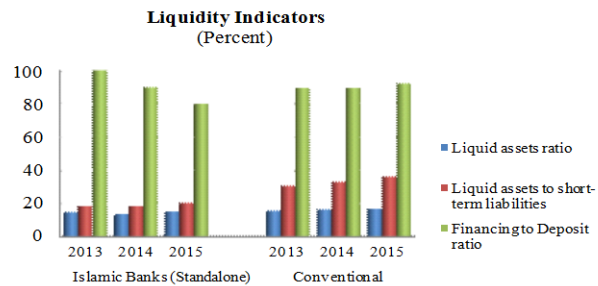
And capital is trending down.



Islamic banks have been less profitable.



And liquidity has been lower.



Source: Bank Indonesia and IFSB.

KENYA¹¹

A. Overview of the Islamic Finance Industry

59. Kenya's IF industry has been in existence for over a decade, but it remains in an embryonic stage. The IFIs currently operate in parallel with conventional financial institutions. The banking sector, which comprises two full-fledged IBs and 11 conventional banks offering IB products and services, is the dominant segment. The industry also includes two licensed investment funds, one Islamic investment company, one *Takaful* company and a *Takaful* reinsurance company.

60. The number of operators offering IB products has increased, but the market share of industry assets remain very small. Since the emergence of the first Islamic bank in 2005 by an international bank, the number of banks offering IB products increased to a total of 13 by end 2015 (see also Enrique Gelbard and others, 2014). However, while the assets of IBs grew at a CAGR of 14 percent between 2013 and 2015, the market share has remained below two percent of banking industry assets (Figure 7).

61. The current industry size is modest, thus there is scope for expansion of IF in Kenya. Considering the still low access to formal savings and borrowing, including among its population, and the country's positioning as a hub, demand for these services is expected to remain strong. The industry could also receive a boost since the government has actively encouraged expansion of IF to support the real economy.

B. Islamic Banks' Operations and Soundness

Corporate and Balance Sheet Structure

62. The ownership structure of IBs in Kenya is very diverse. The two full-fledged IBs are local banks with simple corporate structures. The conventional banks offering IB products through windows, on the other hand, include internationally active banks that operate in numerous countries.

63. IB assets mainly consist of financing, comprising both debt-based and risk-sharing instruments. Risk-sharing instruments account for close to 60 percent of the assets and are based on *Musharakah* contracts. Debt-based instruments comprise largely of *Murabahah* contracts whereas leasing type instruments are miniscule. The banks also place a significant share of the assets with the central bank and in interbank markets (Figure 7).

64. The IBs mainly depend on domestic deposits for funding, comprising both current accounts and URIAs. Current accounts are estimated at over 50 percent of total funding including

¹¹ This note was prepared by Rodolfo Maino and Inutu Lukonga.

equity at end 2015 while URIAs are around 45 percent. There are no restricted accounts so far and the banks have not issued *Sukuk* to fund their operations (Figure 8).

Performance and Soundness

65. The performance of IBs in Kenya has been mixed. The CAR is above the prescribed minimum levels of 10.5 percent, but the levels are below industry averages. The NPF ratio is on the high side although slightly better than industry averages (Figure 8).

C. The Regulatory and Supervisory Framework

66. Kenya has in place laws and regulations that explicitly recognize IB practices, products and institutions but some gaps remain. The Banking Act was amended in 2008 to include provisions for banks to provide non interest financial products and to allow banks to offer IB products, either through full-fledged IBs or windows. The amendment entailed the inclusion of a clause to recognize 'returns' as consideration for money lent/borrowed, as opposed to 'interest'. The Central Bank of Kenya (CBK) has also accommodated IBs by exempting them from provisions of the Act that prohibit trading or investment in consideration of the nature of their business. The law or regulations, however, do not provide adequate guidance on the Islamic contracts acceptable in Kenya. The Capital Markets Authority (CMA) also has powers to supervise and regulate IB investment activities.

67. Licensing procedures are the same as for conventional banks. A bank, irrespective of whether it is an Islamic bank or a conventional bank, will be issued a standard bank license. There is also no difference between IBs and conventional banks in terms of the fit and proper framework that applies to management and shareholders.

68. IBs are subject to the same prudential framework as conventional banks. The regulations relating to minimum capital requirements, fit and proper, internal controls, CAR, liquidity, asset classification, provisioning, and related party apply equally to conventional and IBs. Kenya has not adopted IFSB guidelines on capital calculation. IBs have to hold capital on all risk weighted assets (RWA), irrespective of whether they are financed by investment accounts. The PER or IRR are not considered eligible capital for regulatory capital adequacy requirements. IBs and conventional banks with Islamic windows are also not required to segregate funds raised by way of Islamic deposits (demand deposits, URIAs, etc.) separately from other funds under the control of the bank.

69. Corporate governance structures for *Shari'ah* compliance are in place, but important gaps remain. The legal and regulatory framework does not require the setting up of an NSB (with specified tasks pertaining to IF activities and institutions nor is the Central bank required to do so). IBs are however required to set up SSBs as a subsidiary organ of the board of directors of the IBs. The SSB reports to shareholders through the main Board of Directors, they have powers to rule on the compliance of products and contracts with *Shari'ah* and are by law required to evaluate and determine the *Shari'ah* compliance of the IBs. *Shari'ah* Scholars are full-time employees of banks

offering IB services. There is no governing body that oversees *Shari'ah* Scholars discharge of their professional obligations. There are no provisions specific to IBs relating to audit requirements.

70. The consumer protection framework is yet to be adapted to cater to consumers of IB products. There is currently no difference between IBs and conventional banks in the disclosure requirements, with the exception of the fact that IBs are required to publish a statement by their *Shari'ah* board regarding the bank's state of *Shari'ah* compliance. IBs are not required to appoint independent board directors, explicitly or implicitly, to represent the interests of IAHs. There is neither a *Shari'ah* Court nor an Islamic Affairs Ministry. Nevertheless, the consumer protection framework covers misrepresentation to the general public by someone or an entity holding itself out as conducting its banking business on a *Shari'ah* compliant basis. Consequences range from cautionary warnings, fines and other administrative penalties. Customers may also seek arbitration under the ADR initiative run by the Kenya Bankers Association although the decisions issued by the Forum are not binding in a court of law.

71. There is also no separate supervisory framework. All banks are also required to comply with IFRS whereas AAOIFI standards are not mandatory for IBs and have not been adopted. The onsite examination manual and guidelines do not distinguish between Islamic and conventional banks as does the supervisory process. The CBK does not supervise the banks on a consolidated basis nor does it have cross border supervisory arrangements in place. There are no macro-prudential policies tailored to IBs. The IBs, as with their conventional counterparts, are required to apply a risk management approach to the management of risks. Examination of *Shari'ah* compliance is not among the supervisory responsibilities. There is no difference between Islamic and conventional banks in the corrective and enforcement actions or in the processes.

D. Liquidity Management, Resolution, and Deposit Insurance

72. The development of *Shari'ah* compliant money markets and liquidity management instruments has been slow. Kenya does not yet have a *Sukuk* market, the central bank does not have liquidity provision or absorption operations for IBs, there is no LoLR facility. IBs, however, have access to the overnight standing credit facility for which acceptable collateral includes government securities. IBs also have access to interbank markets for conventional banks, though this might raise *Shari'ah*-compliance issues.

73. The law confers on the regulator powers to take over control of failing banks, but the resolution framework has not been adapted to cater to the specifics of Islamic modes of banking. In the case of liquidation, the order of priority is as follows: demand deposits, URIAs, RIAs, Shareholders and then other creditors. SSBs play a role in determining or approving resolution actions in respect of failed banks. The triggers for putting IBs under official control are the same as those for conventional banks. No Islamic bank has yet failed. A conventional bank with an IB window failed in 2016 and was placed under receivership with the Kenyan Deposit Insurance Corporation.

74. A *Shari'ah* compliant deposit insurance scheme has not yet been established. IBs are covered by the same deposit insurance regulatory framework as conventional banks. Deposit insurance premiums collected are managed in a single indivisible pool.

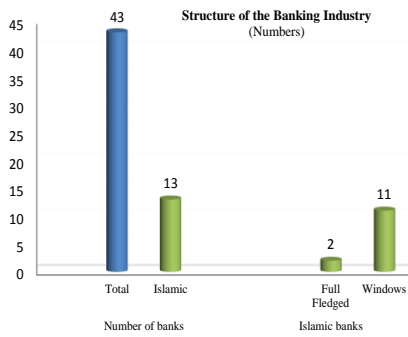
E. Conclusions and Policy Issues

75. The development of IB in Kenya has not been underpinned by commensurate efforts to ensure an appropriate regulatory framework. The legal framework exhibits some gaps, prudential frameworks have not been adapted to the specificities of IB, there are also remaining gaps in the *Shari'ah* governance framework, consumer protection framework, liquidity management, resolution and safety nets.

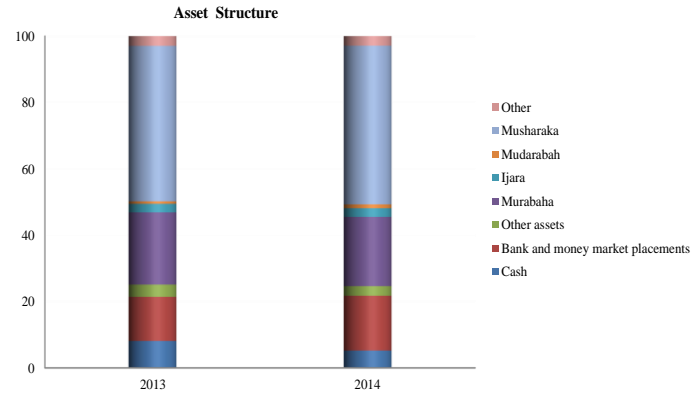
76. The reform agenda, therefore, remains broad. The legal framework could benefit from further amendments to clarify permissible contracts and segregation laws to minimize risks of comingling funds that can weaken *Shari'ah* compliance and public confidence. Licensing requirements should include provisions to address IB specifics, including adapting fit and proper requirements to include knowledge of IF principles and operations, and to require ex-ante evidence of corporate governance structures for *Shari'ah* compliance. Adoption of IFSB standards for capital and AAOIFI accounting standards could also ensure consistency and facilitate risk assessment of IBs. Consumer protection frameworks should cover laws, disclosures and cost effective dispute resolution frameworks. Greater efforts are also needed to develop *Shari'ah* compliant liquidity management instruments, interbank markets, LoLR and SCDIS.

Figure 7. Kenya: Structure of the Islamic Finance Industry and Bank Balance Sheets

Most banks offering Islamic banking products do so through windows.



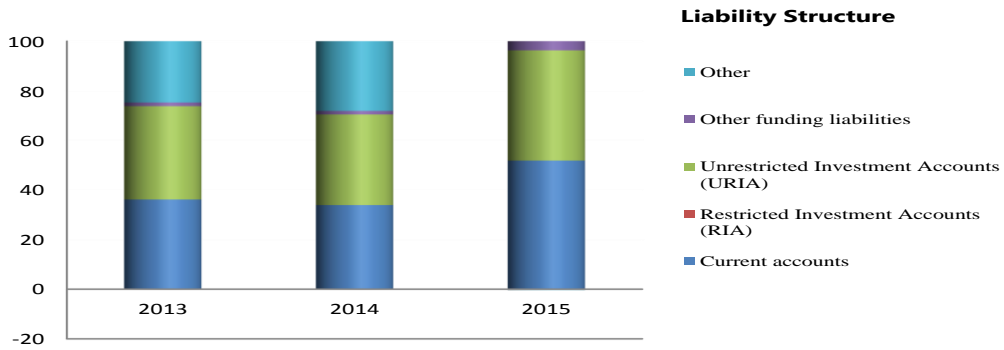
The assets of Islamic banks comprises mostly of financing items, which in turn, largely consist of risk sharing instruments based on Musharaka contract.



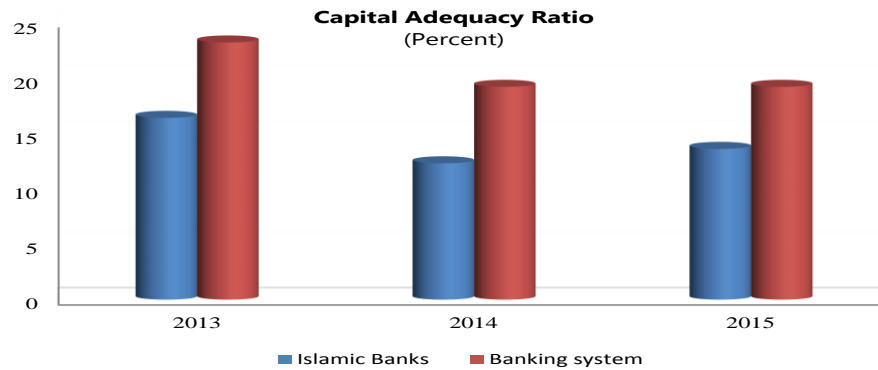
Source: Central Bank of Kenya.

Figure 8. Kenya: Sources of Funding and Islamic Banks' Performance

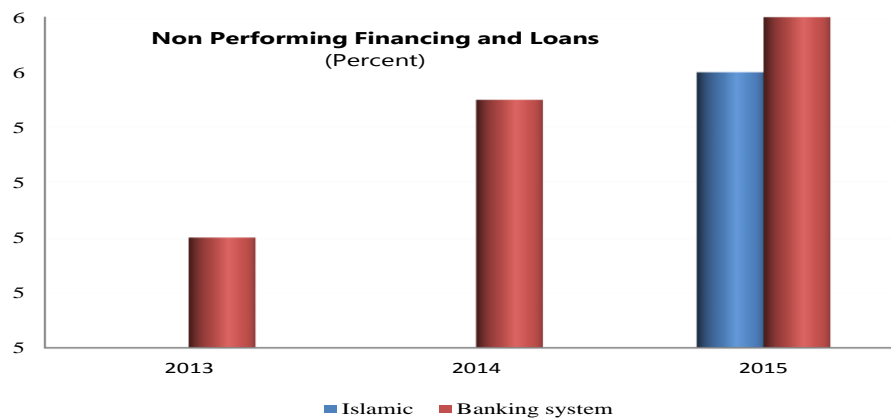
The main funding sources are current accounts and unrestricted investment accounts.



Islamic banks maintain high capital levels but are below the industry averages.



Non performing financing is also high.



Source: Authorities and IMF.

KUWAIT¹²

A. Overview of the Islamic Finance Industry

Scale and Structure

77. Kuwait operates a dual system where Islamic and conventional financial institutions co-exist. The banking sector is the most developed part of the IF industry and consists of full-fledged IBs only, whereas Islamic windows are not permitted. Other segments of the IF industry include investment companies (ICs), investment funds, insurance (*Takaful*), and reinsurance (Re-*Takaful*) companies. The *Sukuk* market has remained small and has been dominated by corporates issuing outside Kuwait as substantial fiscal surpluses in the past decade and the absence of a legal framework limited issuance by the government (Figure 9).

78. Kuwait's IB industry has grown rapidly to become an important part of the domestic and global Islamic financial system. The first Islamic bank began operations in 1978. At end-2015, five of the 11 locally registered commercial banks and one out of the 12 branches of foreign banks were conducting business in accordance with *Shari'ah*.¹³ Market share increased rapidly between 2005 and 2010 and has since then stabilized at around 38 percent. As of December 2015, Kuwait had the fifth largest share of IB assets and the sixth largest share of Islamic funds globally. Looking ahead, and notwithstanding challenges posed by the lower oil prices, the economic diversification effort could help drive further growth in Kuwait's IB industry (Figure 9).

B. Islamic Banks' Operations and Performance

79. Kuwait's IB sector includes systemically important banks and /or banks with complex conglomerate structures. The largest Islamic bank in Kuwait accounts for 23 percent of the total banking system assets, over 70 percent of the IB assets and it has substantial cross-sector and cross-border operations.¹⁴ The other IBs also have subsidiaries or associate companies with significant equity in financial and nonfinancial corporate subsidiaries and some of the subsidiaries or associate companies are incorporated abroad.

80. Banking operations are the main source of income, even though investment activities are integral to IBs business. Banking activities contribute over 60 percent of income, and the

¹² Prepared by Inutu Lukonga and Stephane Roudet. It is based on an earlier study by Inutu Lukonga which was published in the Country Report 14/334. The current report has been updated with information from the 2016 survey and therefore reflects data at end December 2015, unless otherwise indicated.

¹³ The five banks operating on Islamic principles are Kuwait Finance House (KFH), Boubyan Bank, Kuwait International Bank (KIB), Al Ahli United Bank (ABK) and Warba Bank. Two of these (KFH and Warba Bank) are largely controlled by the government through shareholding by various government enterprises.

¹⁴ It has 16 subsidiaries that span banking, ICs, real estate development, infrastructure and industrial developments, computers, aircraft leasing and management consultancy. It also has substantial cross border banking operations in Turkey, Malaysia, and Bahrain as well as real estate and other ICs in Cayman Islands and Saudi Arabia.

balance is largely accounted for by treasury and investment activities. Other *Shari'ah*-compliant financial services offered by banks include purchase and sale of properties, leasing, own-account and agency project construction, and other trading activities. Income from the domestic and regional markets represents about 60 percent of total IBs income (Figure 9).¹⁵

81. The assets of Kuwait's IBs are mainly debt-based instruments, thus their risk profile has broad similarities with those of conventional banks (Figure 9). Financing items, which are concentrated in real estate, personal loans and inter-bank lending, account for about 60 percent of the total assets of IBs. Most transactions are in the form of *Murabahah*, followed by *Ijarah* transactions. On the other hand, the share of equity and other partnership-based instruments like *Musharakah* and *Mudarabah* are negligible in the balance sheets. Investment activities are relatively moderate in magnitude, and they include management of direct equity and real estate investments as well as international leasing. Off-balance-sheet commitments, which range between 10 and 20 percent of the total assets, include LCs, acceptances and guarantees. Therefore, similar to conventional banks, the IBs' core risks are credit, market, concentration and operational risks.

82. IBs, nevertheless, face some unique risks inherent in IB models, and some of the standard banking risks are more pronounced. First, besides exposures to the real estate sectors, through lending and collateral, IBs are allowed to establish subsidiaries or joint ventures in non-financial real estate corporations, thus the IBs exposure to real estate is higher and more difficult to measure. Second, even with strong supervision, the scale and complexity of corporate structures of the larger IBs could present challenges for risk management, supervision and resolution, because of the presence of nonfinancial corporations and cross border operations in countries with diverse legal and regulatory frameworks. Such corporate structures, though central to the business model of IBs, also create potential for related-party lending as well as contagion from other parts of the group, particularly from the unregulated non-financial corporations. Third, the underdevelopment of *Shari'ah*-compliant financial markets and *Sukuk* instruments render liquidity management for IBs relatively more challenging.

83. IBs, like their conventional counterparts, have a healthy funding base with a strong deposit franchise and healthy liquidity profile. Over 60 percent of the assets are funded by customer deposits, which include PSIA. The contracts on the liability side include *Mudarabah* contracts as well as debt contracts, comprising (*Murabahah* and *Tawarruq*). Funds due to OFIs are significant, averaging around 20 percent (Figure 10).

84. Cost-to-income ratios have improved but remain higher than those for conventional banks. In large part, this is due to: (i) a more challenging operating environment given *Shari'ah* restrictions on certain products/services that are otherwise available for conventional banks; (ii) higher costs of *Shari'ah*-compliance; (iii) higher operating expenditures of non-banking subsidiaries, and (iv) industry concentrations that bias the overall aggregates (Figure 10).

¹⁵ For most banks, over 90 percent of income is generated within Kuwait and other Middle East and North Africa (MENA) countries.

85. Kuwait’s IB sector is in a strong position to weather the challenges from low oil prices, but there are some downside risks. The CAR and Tier 1 capital remain above 15 percent. NPF ratios are low and trending down, in part reflecting the loan write-offs by banks. Banks are also still highly liquid and provisioning ratios are high. However, with low oil prices persisting, deposit and asset growth for IBs have, respectively, slowed down to 3.5 and 1.7 percent in 2015 compared with the average of 9.5 and 10.4 percent between 2010 and 2014. The real estate sector, to which IBs have significant exposures through direct lending and indirectly through collateral, is also slowing down. Pressures in equity markets have also persisted and could contribute to NPFs, since some IBs lend for investment in stocks and also accept stocks as collateral (Figure 10).

C. The Regulatory and Supervisory Framework

86. The Central Bank of Kuwait (CBK) regulates and supervises Islamic and conventional banks.¹⁶ In light of the special nature of IBs, a Law was issued in 2003 that explicitly recognizes IB practices, products, and institutions and gives the CBK powers to regulate the licensing and activity of IBs. The law is silent on the provision of IB products and services through windows and currently only full-fledged IBs operate in Kuwait. The law is also silent on fit and proper approvals and auditing requirements.

87. IBs are subject to the same prudential regulations as conventional banks, with some modifications to reflect the unique aspects of IF. Rules that are equally applicable to Islamic and conventional banks include fit-and-proper requirements, large exposures, related-party lending, corporate governance, and asset classifications and provisions. For the other prudential regulations, there are some modifications to reflect the differences in the instruments employed, without prejudice to the Islamic *Shari’ah* principles. In particular, the CBK applies Basel III capital rules to both conventional and IBs but uses the IFSB formula in the calculation of capital, with an Alpha value of 50 percent. IBs are allowed to invest in fixed property while conventional banks are not. IBs are also subject to a maximum lending limit (MLL) that includes many sources of funds such as deposits (private, government and Financial Institutions), *Sukuk*, Certificate of Deposits (CDs) and interbank transactions.

88. Other ongoing regulatory reforms are aimed at strengthening all banks’ resilience to shocks. For example, regulations requiring the restructuring of complex conglomerate structures in existing banks, placing limits on the type of non-financial activities to be permitted for new banks, further strengthening capitalization under Basel III, and implementing macro-prudential policies to minimize systemic risks, augur well for financial stability. IBs have been strengthening their risk management systems—for example implementing group-wide capital and liquidity planning and integrating stress testing in the risk management framework. Banking regulations and supervisory processes are being aligned with the latest Basel III and IFSB regulatory reforms, including those related to capital, liquidity, and the Domestic Systemically Important Banks (D-SIB) framework.

¹⁶ ICs and investment funds are subject to the oversight of the CMA. Insurance companies are under the supervision of the Ministry of Industry and Commerce.

89. Supervisory arrangements are similar for conventional and IBs, but they take account of the specificities of IB. There is no dedicated unit for the supervision of IB, but the CBK has developed special on-site and off-site examination manuals for IBs and have dedicated personnel that are specialized in IB. Both conventional and IBs are subject to consolidated and cross-border supervision. Examination of *Shari'ah* compliance per se is not among the objectives, tasks and functions of the bank supervision authority. On the other hand, AAOIFI accounting standards are neither mandatory nor an option for banks.

90. The law provides for an independent SSB for each Islamic bank, but not a centralized board. The SSB is comprised of not less than three members appointed by the bank's General Assembly. In case of a conflict of opinions among members of the SSB concerning a *Shari'ah* rule, the board of directors of the designated bank may transfer the matter to the *Fatwa* Board in the Ministry of Awqaf and Islamic Affairs, that shall be the final authority on the matter. The opinion of the SSB has to be provided in the banks' annual reports. External auditors are required to assess the extent to which all the procedures followed by the bank in launching its new financial products or in modifying its existing products, include the proper steps for ensuring complete compliance with *Shari'ah* rules and principles, including the review of such procedures by the bank management and the SSB. In its report, the external auditor must indicate the extent of the bank management's compliance with the *Fatwa* (*Shari'ah* legal opinion), resolutions and directives of the SSB in the transactions executed.

91. Consumer protection framework has focused more on addressing information asymmetries and *Shari'ah* compliance, and less on resolution and other rights. In line with the IFSB Standard 4, IBs are required to disclose qualitative and quantitative information regarding investment accounts and to publish a statement by the bank's *Shari'ah* board regarding the bank's state of *Shari'ah* compliance. The framework does not cover misrepresentation to the general public by someone or an entity holding itself out as conducting its banking business on a *Shari'ah* compliant basis. IBs are not required to appoint independent board directors representing (explicitly or implicitly) the interests of IAHs. There is also no *Shari'ah* court nor are there any arbitral forums or ADR that customers may go to for the resolution of disputes arising from IB transactions.

D. Liquidity Management, Resolution, and Deposit Insurance

92. Liquidity management instruments continue to be strengthened. Banks use a range of instruments to manage liquidity surpluses, including Reverse Commodity *Murabahah* (*Tawarruq*), Islamic Placement Accounts and other instruments. Commodity *Murabahah* is largely used for managing liquidity deficits. The CBK offers a *Shari'ah*-compliant a LoLR facility to IBs through the use of *Tawarruq*.

93. A special resolution regime for banks is not yet in place but initiatives are underway to develop a special resolution regime for banks which will include IBs. The current legal framework does not provide explicit powers for taking official control of a failing bank. All banks, including IBs and conventional banks are, therefore, subject to bankruptcy law that applies to all

legal entities. Thus far, no IBs have had to be liquidated or otherwise resolved. The CBK, with the assistance of the World Bank, is in the process of developing a special resolution regime for banks which will also cover IBs.

94. Kuwait does not have an explicit deposit insurance scheme. The blanket guarantee that was introduced in 2008 remains in place and covers deposits of IBs, including unrestricted PSIA.

E. Conclusions and Policy Issues

95. Kuwait's experience underscores the important role of an enabling regulatory framework in facilitating the growth and stability of the IF industry. Although the history of IF dates back to the 1970s, the industry only grew more rapidly since 2005 as the regulatory environment became more favorable. The *Sukuk* industry remains small as the regulatory framework for issuance of Sovereign *Sukuk* is still in the process of being established. At the same time, Kuwait has made great advances in strengthening the regulatory framework in general, and to adapt the framework to the specifics of Islamic modes of banking. IBs, as with their conventional counterparts, will face headwinds from lower oil prices, but from a position of strength and the CBK's enhanced monitoring facilitates early identification of risks.

96. Low oil prices have, nevertheless, the potential to set in motion adverse macro financial dynamics, thus continued supervisory vigilance and further strengthening of the prudential and liquidity management frameworks will be important.

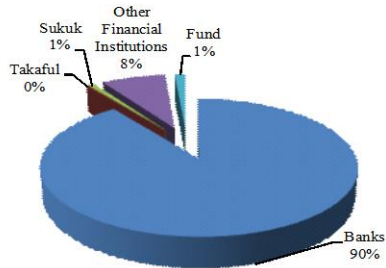
- The combination of sectoral concentration, which exposes banks to the risk of a sharp downturn in the real estate and stock markets, combined with complex corporate structures, calls for continuous efforts to develop indicators that can capture the true exposure of banks to these cyclical sensitive sectors and to monitor those risks.
- CBK currently supervises banking groups on a solo as well as consolidated basis, and monitors related party lending and intra-group exposures. Nevertheless, the presence of non-financial companies and cross-border operations in some of the bigger IBs against the backdrop of cross-country differences in the pace with which regulations for IBs are being adopted, can complicate risk identification, monitoring and supervision. Thus, current efforts by banks to divest out of non-core activities should be sustained and collaborative efforts to increase adherence to standards by countries will be important.
- An explicit DIS and a special resolution framework for banks that take into account the specifics of IB are needed to ensure sustained financial stability. In the event of bankruptcy, cross-country differences in legal frameworks and enforcement of legal rights could complicate the resolution process further. Strengthening the crisis management framework would promote orderly resolution of banks in the event of stress and safeguard fiscal resources. Also, formalizing arrangements between key regulatory institutions would help improve crisis preparedness.

- While the CBK is well positioned to manage liquidity risks, the limited *Shari'ah*-compliant investment-grade financial instruments remains a constraint which could become binding as banks try to comply with Basel III. Adopting a legal framework for the government to regularly issue tradable *Sukuk* and developing a secondary market for these instruments would help in this regard, though concerns about pledging government assets to underpin sovereign *Sukuk* issuance could remain a lingering constraint. Developing a liquidity forecasting framework would also facilitate systemic liquidity management and continued enhanced monitoring of deposit trends will remain important for early identification of liquidity and funding risks

Figure 9. Kuwait: Structure of the Islamic Finance Industry and Bank Balance Sheets

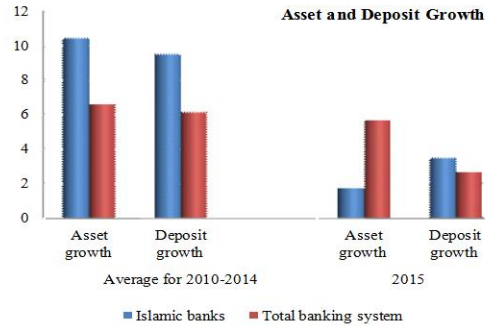
Kuwait's Islamic finance industry is bank dominated

Kuwait's Islamic Finance Industry Structure



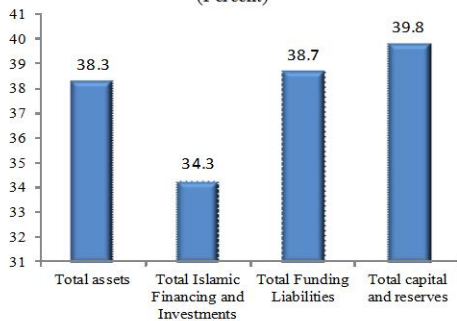
Islamic banks' deposit and asset growth has been higher than industry average.

Asset and Deposit Growth



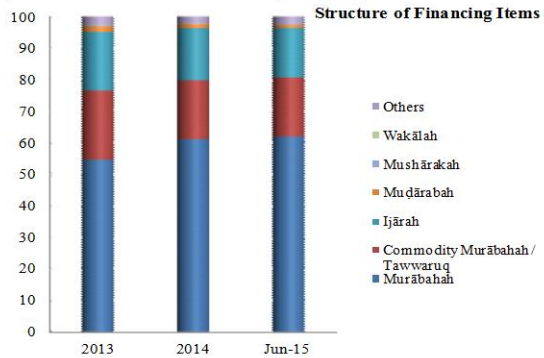
Islamic banking is now systemically important.

Market Share of Islamic Banks (Percent)



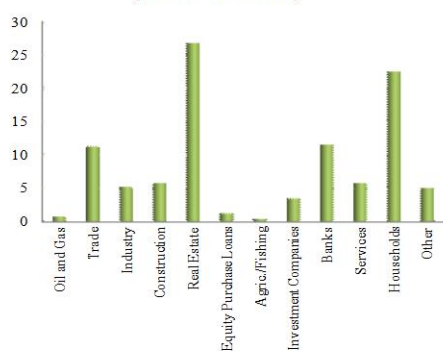
Financing items consist mostly of debt based products such as Murabaha and Ijara.

Structure of Financing Items



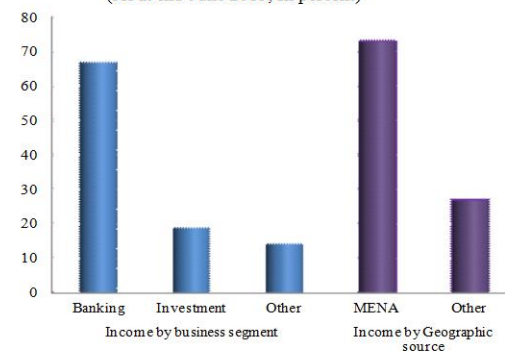
Financing items are concentrated in real estates and personal loans.

Sectoral Distribution of Credit (As at end June 2015)



Income is predominantly from banking activities and from domestic and regional markets.

Sources of Income (As at end June 2015, In percent)

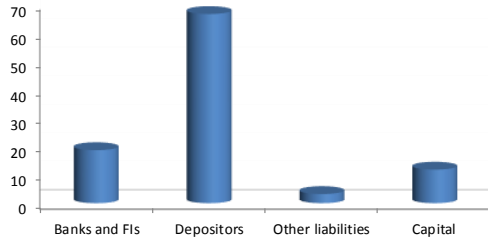


Source: Central Bank of Kuwait and Audited Financial Accounts

Figure 10. Kuwait: Sources of Funding and Islamic Banks' Performance

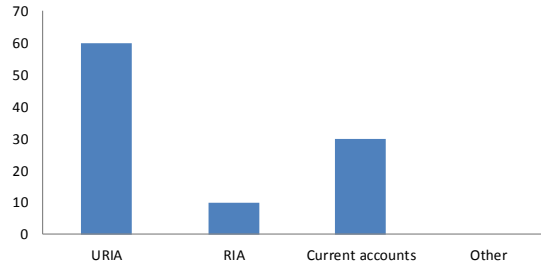
Islamic banks rely on deposits for funding but interbank funding is significant

Kuwait: Islamic Banks' Liability Structure
(end 2015, Percent)



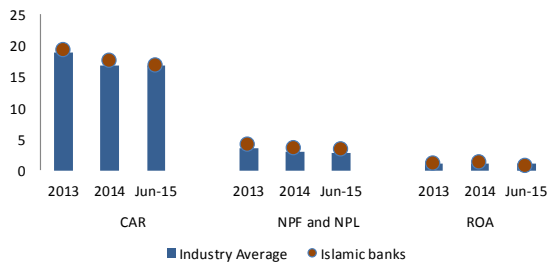
And deposits comprise mostly of PSIA is significant

Kuwait: Funding Instruments
(As of end 2015, Percent)



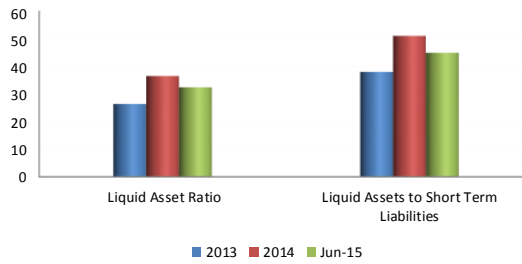
Islamic banks are highly capitalised, profitable with low NPLs

Financial Soundness Indicators
(Percent)



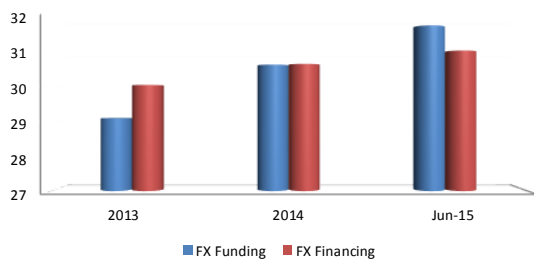
The Islamic banks have maintained high liquidity

Liquidity Indicators
(Percent)



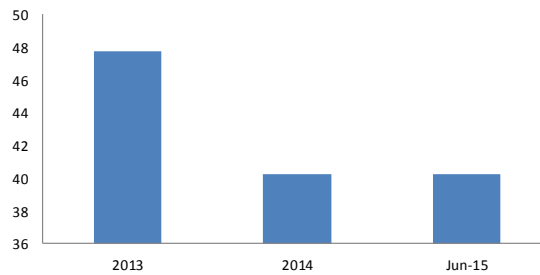
FX exposure is quite high

FX Funding and Financing
(Percent)



Efficiency indicators show significant improvement

Cost to Income Ratio
(Percent)



Source: IFSB and Banks' Annual Reports and Audited Accounts

MALAYSIA¹⁷

A. Overview of the Islamic Finance Industry

Scale and Structure

97. Malaysia has one of the most developed IF industries though, like in other countries, the IB sector dominates. IFIs operate in parallel with conventional financial institutions, both offering a full range of financial products and services and often using the same infrastructure. The industry is dominated by the IB sector, which accounts for 45 percent of industry assets, and is followed closely by the *Sukuk* market, which accounts for 40 percent. The balance is accounted for by a broad range of financial segments, including Islamic funds, *Takaful* industry, and other IFIs, such as mortgage companies, micro-finance institutions. In addition, there are well developed Islamic money markets and nearly 74 percent of listed securities on the Malaysia stock exchange are *Shari'ah* compliant. Malaysia is also an important player in the global industry for IF, including in banking, *Sukuk*, *Takaful* and Funds industry (Figure 11).

98. The IB sector has registered rapid growth, particularly in the aftermath of the GFC. Since the establishment of the first Islamic bank in 1983, the IF industry in Malaysia has morphed from a niche segment into the financial mainstream, and from a largely domestic focused industry to one of global relevance. By end 2015, Malaysia had 16 full-fledged IBs, of which six are foreign owned. In addition, 11 commercial banks were offering Islamic financial products through windows. Investment banks also participate in IF activities. Although conventional banks continue to dominate the banking sector, the IB sector has grown more rapidly, particularly after 2008. As a consequence, the market share of IBs has almost doubled since 2007 from 12 percent to 23 percent by end 2015. (Figure 11).

99. Prospects for further growth are also high. The facilitative business environment, which includes a comprehensive financial infrastructure and global regulatory and legal best practices, provides important incentives for growth. The government has successively implemented a number of initiatives to promote Malaysia as a regional hub for IF in South East Asia. The Financial Sector Blue print, released in 2011 to cover the period 2011-2020, aims to internationalize IF and the development of Malaysia as an international Islamic financial center. The plan also targets to increase the share for Islamic financing in the country's banking sector to 40 percent by 2020. Latent demand for IB products is also high given the high share of Muslims in the total population, estimated at 61.3 percent, who remain underserved by financial services.

¹⁷ This note was prepared by Umang Rawat and Inutu Lukonga.

B. Islamic Banks' Operations and Soundness

Corporate and Balance Sheet Structure

100. Malaysia's IBs have complex corporate structures, thus consolidated and cross-border supervision are essential in maintaining financial stability of the industry. Nine of the 16 IBs are part of banking groups that also operate as commercial banks in Malaysia. Malaysian IFIs have also been gaining a foothold in Southeast Asia through investments in a number of banks across the region.

101. Although IB assets comprise mainly non-profit and loss sharing (PLS) financing instruments, risk sharing instruments are increasing (Figure 11). *Shari'ah* compliant financing accounts for more than 70 percent of total assets, and the balance is almost equally divided between investment and interbank financing. Debt-based instruments (*Murabahah* and *Istisna*) and leasing type products (*Ijarah* and *Ijarah thumma Al-bai*) respectively account for 30 and 20 percent of the financing. The share of *Bai bithaman ajil* (deferred payment sale contract), which is generally not accepted outside Malaysia was estimated around 18 percent at end April 2016. The proportion of risk sharing instruments, such as *Mudarabah* and *Musharakah*, although still small, increased from 2.7 percent in 2010 to 8 percent in April 2016. Reflecting the large share of financing in the balance sheet, income from financing accounts for over 70 percent of total income and fee based income is small at around 8 percent.

102. Financing is heavily concentrated to the household sector, thus macro prudential policies that limit household leverage are important for ensuring financial stability (Figure 11). Financing to households accounts for about 60 percent of total assets. The large share of household borrowing, in large part, reflects the strong economic growth which raised household incomes and bolstered consumer confidence, lower interest rates that provided incentives to borrow and the government's efforts to support home ownership. Financing to other sectors is well diversified and the overall composition has remained relatively stable since 2010.

103. Customer deposits are the predominant source of funding for IBs, but the structure has undergone a dramatic transformation with the share of PSIA declining sharply over the last two years (Figure 12). The Islamic Financial Services Act 2013 required banks to fully align all existing customer deposits with their underlying *Shari'ah* contracts, notably for PSIAs to be loss-absorbing with no smoothing of return. The deposit insurance will also not be compensating the PSIA holders in resolution. Under the exercise that was carried out over two years, customers, depending on their risk appetite, were given a choice to choose to convert their deposits into investment accounts that offer different rates of return but are not principal-guaranteed. Consequently, the share of PSIA declined from 41 percent at end 2013 to 13 percent by end 2015 while other remunerative deposits, most notably commodity *Murabahah*, increased sharply from 40 percent to 68 percent.

Performance and Soundness

104. Malaysia's IBs are well capitalized with good and improving asset quality, but profitability and liquidity ratios are low and macro financial risks from low oil prices are increasing. The aggregate CAR is above the statutory requirements and the NPF ratio is low and declining. However, profitability and liquidity ratios of IBs are weaker than the conventional banks (Figure 12). The IBs' lower profitability could be attributed to the higher overhead cost-to-revenue ratios due to start-up costs of foreign full-fledged IBs. The cost structure of some standalone IBs is slightly higher relative to IBs within groups, as the latter reap the benefits of shared platforms. With low oil prices persisting and given prospects of the US normalizing its monetary policy and potential for capital outflows, macro-financial risks for both Islamic and conventional banks are increasing.

105. The rate of return risk in the IB sector continues to be reasonably well-managed, underpinned by active risk reduction strategies pursued by IBs. On the asset side, banks hold variable rate assets in the financing book, mainly in the form of *Musharakah*, *Ijarah* and variable *Murabahah* contracts. On the liability side, IBs issued more fixed rate funding instruments such as *Tawarruq* with longer contractual maturities to narrow the re-pricing gap against IBs' fixed rate assets. The shift towards *Tawarruq* was also partly in response to the regulatory requirement to clearly differentiate between deposit and investment account products in accordance with the Islamic Financial Services Act (IFSA) 2013. This increased demand for deposit products that are principal-guaranteed. In contrast, *Mudarabah* based general and specific investment deposits declined by 84 percent to account for 3.1 percent of the funding base compared with 19.7 percent in 2014.

C. The Regulatory and Supervisory Framework

106. Malaysia's legal framework gives clear legislative mandate for the provision of Shari'ah compliant financial products and the supervision of IBs. The enactment of the Islamic Banking Act 1983 (IBA) was a primer in providing the legal framework for carrying on IB business and in conferring powers to Bank Negara Malaysia (BNM) to regulate and supervise IBs. The Banking and Financial Institutions Act 1989 (BAFIA) subsequently gave powers to conventional banks to establish windows. Merchant banks and finance companies are also allowed to offer IB products. The Development Financial Institutions Act 2002 (DFIA) gives powers to development financial institutions to conduct IB business. More recently, the Financial Services Act 2013 (FSA) and Islamic Financial Services Act 2013 (IFSA) combined six pre-existing statutes,¹⁸ to provide a more cohesive and integrated legal framework that delivers a consistent and comprehensive treatment of similar risks, thus minimizing the prospect for regulatory arbitrage and gaps.

107. The regulatory framework for IBs leverages on the framework for conventional banks, with some modifications to address salient characteristics of IBs. The regulatory framework governing corporate governance, risk management, prudential limits for related party transactions,

¹⁸ These include the Banking and Financial Institutions Act 1989, Insurance Act 1996, PSA and Exchange Control Act 1953 (ECA), and the Islamic Banking Act 1983 and *Takaful* Act 1984.

NPF classification and provisioning and liquidity management are similar for both conventional and IBs. The regulations issued specifically to address the specifics of Islamic modes of banking include:

- IBs are required to comply with a tailored Capital Adequacy Framework (capital component and RWAs) which is in line with the Basel Committee on Banking Supervision (BCBS) and the IFSB. Malaysia has discontinued the use of Alpha in the capital adequacy calculation, but investment accounts are prohibited from any form of principal and profit guarantees by the IBs.
- IBs are allowed to undertake investment or acquisition of completed properties or land for the purpose of IB business activities, which includes for the purpose of onward sale or lease. However, in the case of conventional banks, the acquisition of immovable properties is allowed primarily for the purpose of providing housing or other amenities for the staff, satisfaction of debts (i.e., foreclosed properties) or premises for conducting its business operations.

Box 2. Malaysia: Treatment of Profit Sharing Investment Accounts

- The Islamic Financial Services Act 2013 (IFSA 2013) introduced *Shari'ah* contract-based regulatory framework that provides greater clarity on *Shari'ah* rulings with regard to each *Shari'ah* contract while also outlining operational requirements for the diversified product range of IFIs. Banks were given a two-year period, until June 2015, to provide customers with information on alternative IFSA-compliant deposit products that they can continue to maintain their funds in, or an option to participate in investment accounts. The regulatory implication of the exercise is that investment accounts are risk-absorbing and hence the IBs are not required to hold regulatory capital against assets funded by them.
- The IB sector completed the industry-wide exercise to migrate customers' Islamic deposit accounts into Islamic deposits or investment accounts. The exercise entailed the segregation of investment accounts (structured on *Shari'ah* contracts of *Musharakah*, *Mudarabah* and *Wakalah*) from deposit accounts, with the former being prohibited from any form of principal and profit guarantees by the IBs. At the expiry of the two-year deadline in June 2015, eight percent or RM 32 billion of total deposits in the IB system had been converted into investment accounts. Eight IBs have opted to offer the choice of Islamic deposits or investment accounts to their customers. The remaining IBs, meanwhile, have migrated all their existing customers to IFSA-compliant deposit products which will continue to be principal-guaranteed and insured by Perbadanan Insurans Deposit Malaysia (PIDM).
- The exercise was followed with the launch of the Investment Account Platform (IAP) by the industry in February 2016 to complement the operationalization of investment accounts. The IAP is an integrated multi-bank investment platform, allowing retail and corporate customers to view, invest in and efficiently monitor a wide range of *Shari'ah*-compliant ventures evaluated by different IBs. It also expands financing opportunities for entrepreneurs with viable projects to reach a wider investor base, while improving cost and operational efficiencies for participating banks by enabling them to leverage on a shared platform and services.

108. Corporate and *Shari'ah* governance are well developed. The National *Shari'ah* Advisory Council on Islamic Banking and Takaful (NSAC), established in 1997 by the BNM, is the highest *Shari'ah* authority on IB. All licensed IFIs are required to have a *Shari'ah* committee, appointments to which are subject to regulatory approval. Although the decisions of the *Shari'ah* Advisory Council (SAC) are binding on IFIs, the financial regulator does not get involved in dictating what operational

Shari'ah preferences must be adopted by the market. The IFSA makes it an offense for IFIs to carry on *Shari'ah* non-compliant activities and imposes heavy penalties for breaches. It also gives BNM wide powers to assess, intervene, direct and penalize IFIs in relation to offenses and breach of IFSA provisions. IBs banks are also required to establish three internal control functions within the institutions to ensure proper functioning of *Shari'ah* compliance, including *Shari'ah* review, *Shari'ah* audit and *Shari'ah* risk management functions. Final IB product approval lies with the supervisor.

109. The consumer protection framework has also been adapted to cater to consumers of IB products. Regulations on consumer protection and fair dealing regulations cover financial disclosure, exposures to related parties, single customer limit, and investment limits. Customers can also go to the Kuala Lumpur Resolution Center for Arbitration (KLRC) for the resolution of disputes related to IB transactions. IBs do not have unfettered discretion in the setting of profit sharing ratios on URIsAs and RIAs. On 14 September 2015, the Islamic Financial Services (Financial Ombudsman Scheme) Regulations 2015 were brought into force, paving the way for the establishment of a financial ombudsman scheme (FOS) to enhance financial dispute resolution arrangements in Malaysia. Preparations to transform the existing Financial Mediation Bureau (FMB) into an approved FOS are at an advanced stage with the FOS expected to commence its operations in the second quarter of 2016.

110. Supervision of both Islamic and conventional banks is guided by the Risk Based Supervisory (RBS) framework for risk management. There are no dedicated on-site examination manual/guidelines for IBs but there are specific sections or references in the generic on-site examination manual which refer to and apply only to IB. Supervisors of IFIs also need to understand and appreciate the unique risks, most notably equity risk, *Shari'ah* non-compliance risk, inventory risk and rate of return/DCR. They are also required to understand additional control function elements of IFIs such as the *Shari'ah* Committee oversight function, *Shari'ah* Review and *Shari'ah* Audit functions. The BNM supervises IBs on a consolidated basis and there are cross-border supervision arrangements.

D. Liquidity Management, Resolution, and Deposit Insurance

111. Malaysia's IB sector is supported by highly developed financial markets and infrastructure that enable the banks to manage various risks. These include a well-developed *Sukuk* market and interbank markets between the IBs and conventional banks. The safety nets are also well developed including the LoLR and deposit insurance.

112. The *Sukuk* market has gained breadth and depth, although banks are players as subscribers and not issuers. The market comprises both government and corporate issues with a broad range of tenors, including short term *Sukuk*. The growth of the *Sukuk* market has helped build liquidity management tools for IBs, but banks are significant players in the *Sukuk* market as subscribers and not issuers, thus growth of market has played a smaller role in minimizing liquidity mismatches. The decision in 2015 to discontinue the short term liquidity management program has been rescinded. It is understood that BNM has switched to other instruments for liquidity

management that cater specifically to the IBs it regulates. The previous *Sukuk* program was being subscribed to by a broad array of investors, preventing the *Sukuk* from reaching their intended end-users (primarily Malaysian IBs for liquidity management purposes).

113. Markets, instruments and facilities for managing liquidity are well developed. The Government Funding Act 1983 (GFA) conferred on the Government of Malaysia powers to issue government bonds based on Islamic principles which enable IBs to manage liquidity requirements and surplus funds. The Islamic Interbank Money Market (IIMM), introduced in 1994, provides the IFIs with the facility for funding and adjusting portfolios over the short-term. Since then, BNM has developed a variety of instruments to facilitate liquidity management, including the *Bai Al-Inah* Funding facility which serves as a last resort funding facility by BNM to cover an IBs deficit position.

114. The resolution of distressed IBs is governed by the provisions of the IFSA 2013, the Companies Act, and Malaysia Deposit Insurance Corporation Act. BNM has the discretion to recommend to the Minister of Finance to approve the commencement of resolution measures, including court based winding up, in respect of IBs. This would be based on specified circumstances, including breach or contravention of the central bank of Malaysia Act 2009 or any written law, inadequate capital or outright insolvency. IBs cannot voluntarily be wound up and no application for winding up can be presented to the Malaysian High Court without prior approval of BNM. SSB play a role in determining or approving resolution actions in respect of failed banks. In liquidation, demand deposits are paid out first followed in hierarchical order by other creditors, shareholders, URIsAs and RIAs. The law has, however, not yet been tested as no IBs have ever been liquidated, although a few have been mandatorily merged in the past as part of resolution efforts.

115. The Malaysia Deposit Insurance Corporation Act 2005 established the deposit insurance system in Malaysia to protect deposits placed with licensed commercial and IBs. The scheme is based on the *Kafalah bi al-Ajr* contract. Under this arrangement, the IFIs pay a fee to the deposit insurer in exchange for protection of deposits; this fee is owned by the deposit insurer. In the event of failure of an IFIs, the deposit insurer is responsible for making reimbursements from its own funds to cover eligible deposits. The scheme covers full-fledged IBs and Islamic windows and the following accounts: Savings account (*Wadi'ah, Qard*) Current account (*Wadi'ah, Qard*) and Commodity *Murabahah*. Coverage limit is MYR 250,000. However, under the IFSA 2013, PSIA are no longer covered by deposit insurance.

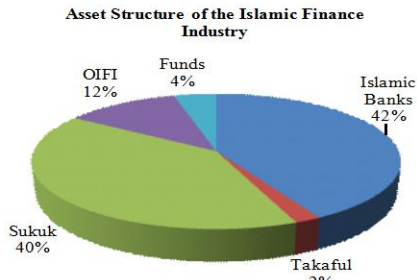
E. Conclusions and Policy Issues

116. Malaysia's experience underscores the critical role of an enabling regulatory environment in promoting growth and stability of the IB industry. The institutional and regulatory framework covers a broad range of areas, including legal, regulatory, *Shari'ah* governance, consumer protection and safety nets. Financial instruments and interbank investment allow surplus banks to channel funds to deficit banks, thereby maintaining the funding and liquidity mechanism necessary to promote stability in the system. Several reviews also point to the need to progressively adapt the regulatory framework in line with emerging risks and needs of the industry.

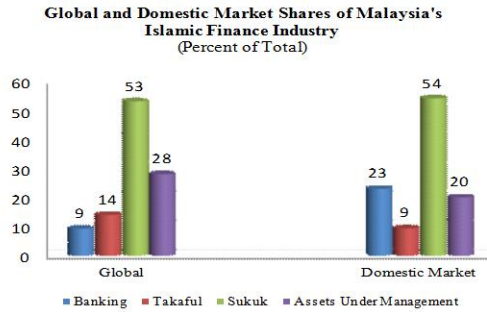
The absence of long term funding on the liability side could however increase maturity mismatches and increase liquidity risks for banks. Therefore, continued enhanced financial sector surveillance will be key to safeguarding financial stability and further adaptation of stress testing techniques to IB will be important for early identification of risks. In addition, the resolution regime for IBs should be continually reviewed to ensure that it fully complies with international best practices for resolution and relevant *Shari'ah* principles.

Figure 11. Malaysia: Structure of the Islamic Finance Industry and Bank Balance Sheets

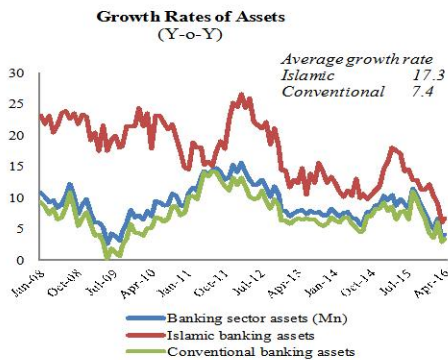
Malaysia has a highly developed Islamic finance industry.



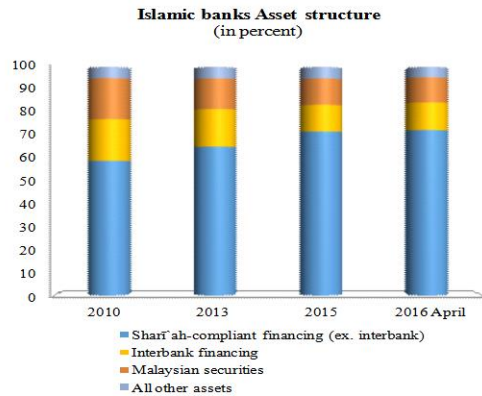
And is also an important player domestically and globally.



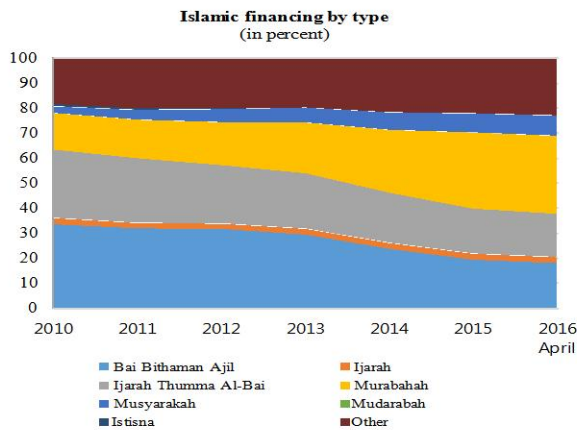
Growth of the Islamic bank assets outpaced conventional banks.



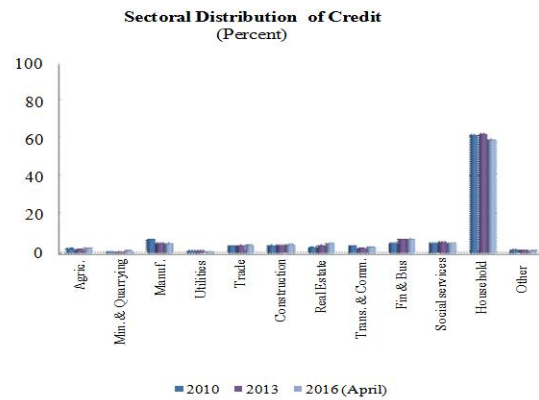
Islamic bank assets mainly comprise of financing.



The share of debt based financing and leasing has increased.



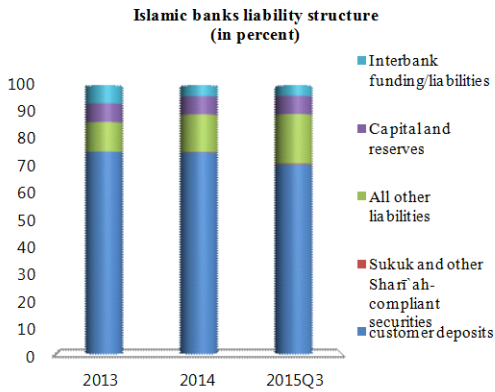
The financing is highly concentrated among households.



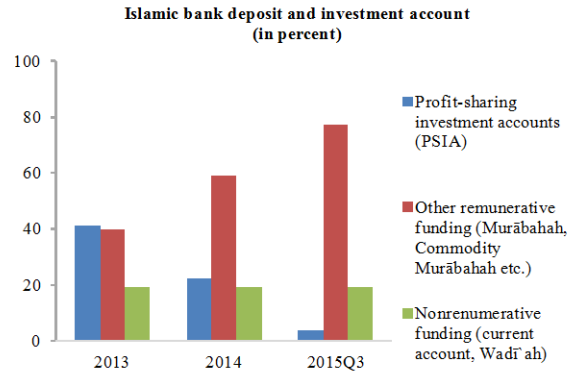
Sources: Bank Negara Malaysia and IFSB.

Figure 12. Malaysia: Sources of Funding and Islamic Banks' Performance

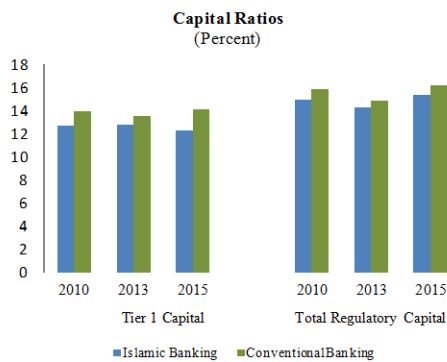
Customer deposits are the predominant source of funding.



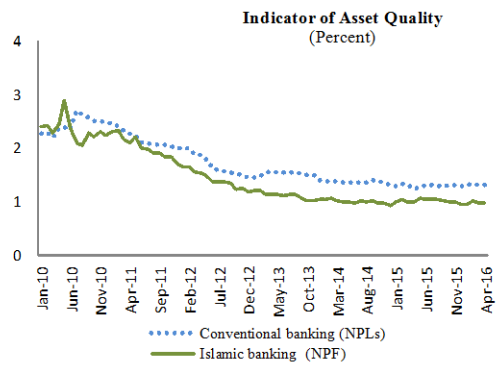
Funding structure has changed away from investment accounts that are not principal guaranteed.



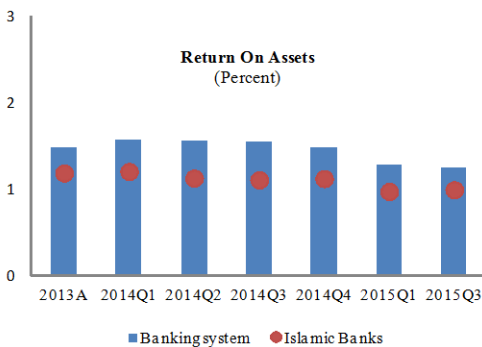
Islamic banks are well capitalised.



With good and improving asset quality.



But profitability is lower.



And liquidity indicators are significantly below the banking system average.

	Liquid Asset Ratio			Liquid Assets/Short Term Liabilities		
	2013	2014	2015 Q3	2013	2014	2015 Q3
Islamic Banks	3	3	14	6	8	80
Banking System	13	13	21	41	43	129

Source: Bank Negara Malaysia

Source: Bank Negara Malaysia and IFSB

NIGERIA¹⁹

A. Overview of the Islamic Finance Industry

117. “Interest free banking” in Nigeria, a term for the provision of *Shari’ah* compliant financial products, is still in its infancy, despite numerous attempts to establish the industry.

The first “interest free banks” became operational in 2012 after several failed attempts in the 1960s and the 1990s. In 2013, one of the Nigerian states issued the first Nigerian *Sukuk*, but no other *Sukuk* issuance has followed. The *Takaful* industry was established in 2003 and a full-fledged Islamic Microfinance bank in April 2010. Other segments of the industry have now emerged, including cooperatives that provide Islamic loans, Islamic investment funds, and Islamic pension funds. In 2012, Nigerian Stock Exchange (NSE) opened an Islamic window on its trading floor and Nigeria’s first *Shari’ah* compliant index—the NSE Lotus Islamic Index (LII)—was launched, to monitor performance of *Shari’ah* compliant assets.

118. While interest free banking has, since inception, recorded a steady increase, it is still very small relative to the conventional banking system. As of end 2015, only three of the 25 commercial banks in Nigeria were offering interest free finance products, including one full-fledged bank and two Islamic windows of conventional banks. The total assets and total deposits of the three banks operating on *Shari’ah* principles accounted for only 0.2 percent of the levels for total system assets and deposits.

119. Prospects for further growth are mixed. On the one hand, Nigeria’s demographics provides fertile soil for industry growth, as Muslims account for about over 46 percent of the country’s population of about 170 million and only 44 percent of the adult population have bank accounts. There is also political backing to establish the country as the African hub for IF. The enactment of the legal and regulatory framework for “interest free banks” could also provide an enabling regulatory environment for industry growth and, thus far, a number of market operators have applied for licenses for interest free banking. On the other hand, there is a strong ideological resistance to IB from the general public, due to suspicions that the government may be giving vent to official religiosity in the Nigerian Banking system.

¹⁹ This note was prepared by Mumtaz Hussain and Inutu Lukonga.

Box 3. Nigeria: The History of Interest-Free Banking

- The first Islamic bank was established in 1961 but the bank was later ordered to close down. Interest-free banking windows were later initiated by three commercial banks but they would face setbacks resulting from the banking crisis and Central Bank reform of 2005. Finally, the first full-fledged interest free Commercial Bank in Nigeria commenced operation in 2012.
- Although the initial efforts to establish IBs were underpinned by changes in the legal and regulatory framework, the banks failed to take off. This, in part, was due to challenges and opposition resulting from differences in culture and religion, and limited awareness about the system. Decree No. 46 of 1992 provided avenue for each community to establish community banking which can operate based on its own customs and tradition. Banks and other Financial Institutions Decrees of 1991 also recognized PLS banks. In 2005, the Financial System Strategy included plans to create IB in Nigeria. Towards this objective, in 2008 the Islamic Finance Working Group was founded and was highly supported by Enhancing Financial Innovation and Access organization, Nigeria Deposit Insurance Corporation (NDIC), National Insurance Commission, Pension Commission, Debt Management Office, Central Bank of Nigeria (CBN) among others.
- In addition to the domestic efforts, Nigeria was also active on the international front to advance IB. The CBN joined the IFSB as a full council member in 2009 and joined other countries to form the International Islamic Liquidity Management Corporation (IILM).
- Finally, in 2011 the CBN released the framework for the regulation and supervision of interest free banking in Nigeria, and licensed the current interest free banks (see CBN 2011). The NDIC also concurrently released a draft framework for interest free DIS. Banks offering non interest banking products and services shall not include the word “Islamic” as part of their registered name.

B. Interest Free Banks’ Operations and Soundness

120. Nigeria’s Interest free banks include an international bank and two domestic banks, but none have any cross border operations. The full-fledged interest free bank only has operations in Nigeria through several branches. The other two conventional banks that offer interest free banking, one is part of a multinational banking group and it offers interest free banking in Nigeria through a window while the other is a domestic bank.

121. The assets of the Interest free banks comprise mainly of non-PLS financing instruments and *Shari’ah* compliant investments in securities (Figure 13). Financing instruments mainly consist of *Murabahah* and *Ijarah*. Investments in *Shari’ah* compliant securities are very small, possibly reflecting the current dearth of the *Sukuk* markets. There is also no platform yet for the Interest free banks to make income from the treasury management activities due to the absence of *Shari’ah* compliant liquidity instruments in the market. On the other hand, while financing accounts for the bulk of the income, income from investments, including *Shari’ah* compliant securities has increased.

122. Customer deposits, comprising largely of PSiAs, are the predominant source of funding (Figure 14). At end September 2015, deposits accounted for more than 70 percent of total funding sources, of which about 45 percent were accounted for by PSiAs. Non remunerative deposits accounted for the balance of the deposits. None of the banks have issued *Sukuk* for funding or capital.

123. The banks have put in place measures to manage some of the unique risks. To manage DCR, the Interest free banks have set up PERs to smooth the return on the PSiAs as well as IRR exclusively to mitigate potential future losses.

Performance and Soundness

124. The Financial Soundness Indicators (FSIs) of the interest free banks currently reflect their nascent operations (Figure 14). The CARs were very high in 2013, the year of first operations, and have come down rapidly as the financing operations increased. Similarly, NPFs are very low and declining since financing is expanding and the vintage is still new. The very low profitability of the banks is consistent with new banking operations, because initial operating costs can be substantial, with many banks breaking even in the second or third year. However, low profitability is also indicative of the substantial non remunerated statutory deposits at the Central Bank. In addition, low oil prices have made the operating environment in Nigeria very challenging, and Interest free banks like the conventional counterparts, will face increasing financial stability risks.

C. The Regulatory and Supervisory Framework

125. The provisions of the Financial Institution Act (BOFIA) 1991 (as amended), the CBN Act 2007 and the Companies and Allied Matters Act (CAMA) 1990 provide a legal basis for establishment of interest free banking, also referred to as “non interest” banking. The law confers on “interest free” banks the status of specialized banks and prohibits the inclusion of the word “Islamic” except with the consent of the Governor of the CBN. The laws also give the CBN, in collaboration with the National Deposit Insurance Corporation (NDIC), powers to supervise the non interest banks.

126. A number of regulations and guidelines have been issued to operationalize the provisions of the legal frameworks for non interest banking. In January 2011, the CBN issued guidelines for the regulation and supervision of institutions offering Islamic financial services (IIFS) (see CBN 2011 and Enrique Gelbard and others, 2014). The guidelines provide minimum standards for the operation of non interest banking, including licensing requirements, corporate models, financial instruments, corporate governance, CBN *Shari’ah* council, Conduct of Business Standards and PSIA. The guidelines also recognize non-interest banking based on Islamic commercial jurisprudence and any established non interest banking principles.

- Licensed banks or promoters wishing to offer non interest banking products and services may operate using a full-fledged interest free bank, a subsidiary, a branch of a conventional bank or a window of a conventional bank.

- The minimum capital for interest free banks has been placed at 10 billion naira for those with national coverage and 5 billion naira for those with regional outlook, compared to 25 billion naira for commercial banks.
- For the purpose of calculating CAR, the RWA of an interest free bank shall consist of the sum of the RWA financed by the interest free bank's own capital and liabilities plus 50 percent of the RWA financed by the banks PSIAs, as in the IFSB discretionary formula. This applies to both unrestricted PSIAs that are accounted for on the non-interest banks' balance sheets and restricted PSIAs that are accounted for off-balance sheets.
- For liquidity management, the banks are prohibited from investing in interest bearing securities or activities.
- All non interest banks are required to develop appropriate risk management policies that take into account the unique risks faced by the bank, such as DCR, fiduciary risk, transparency risk, *Shari'ah* risk, reputational risk, mark up risk etc.
- All non interest banks with PSIAs may maintain a PER, which would serve as an income smoothing mechanism and risk mitigation tool to hedge against volatility of returns. The reserve shall be funded by setting aside a portion of gross income before deducting the banks own share. The basis for computing the amounts to be appropriated should be predefined and disclosed.
- Windows of conventional banks are required to maintain separate accounting books and records to avoid co-mingling their funds with those from the window of the interest free banking operations.

127. Interest free banks are required to comply with the Code of Corporate Governance issued for banks and the additional requirements for *Shari'ah* governance. In addition to CBN guidelines on Corporate Governance, Nigeria interest free banks shall have as part of their governance structure, a *Shari'ah* compliance review mechanism and an Advisory Committee of Experts (ACE). The CBN also created an Advisory Council of Experts whose function was to advise the CBN on matters relating to the effective regulation and supervision of the Institutions offering interest-free Financial Services in Nigeria. In matters of dispute, the CBN has the final say.

128. The CBN guidelines also stipulate Auditing and Accounting Requirements for the IFIs. Interest free banks must comply with the Generally Accepted Accounting Principles (GAAP) codified in local standards issued by the Nigerian Accounting standards board (NASB) and the IFRS/International Accounting Standards (IAS). For transactions, products and activities not covered by these standards, the relevant provisions of the Financial Accounting Standards (FAS) issued by AAOIFI shall apply.

129. The disclosure requirements take account the specificities of interest free banking products. All interest free banks must ensure that the disclosures required by the AAOIFI Financial

Accounting Standards (FAS) 18 are made to all clients. Banks are required to disclose to PSIA holders in writing that the risk of loss rests with the client unless there is negligence on the part of the bank. The agreement should also disclose to the client how his monies will be managed and invested, the basis for the allocation of profit between the bank and the client, and a confirmation of the investment objectives of the IAHs and details of restrictions requested by the client. A bank is required to provide periodic statements to a client indicating the performance of the client's investment and allocation of profit between the bank and client. In order to further engender public confidence in the banking system and ensure customer protection, the CBN established a consumer and financial protection division to provide platform through which consumers can seek redress.

D. Liquidity Management, Resolution and Deposit Insurance

130. The development of financial infrastructure to support interest free banking has been uneven. A *Shari'ah* compliant insurance scheme has been developed but less progress has been made to develop the *Sukuk* market. The 2011 guidelines on the operations of non interest banks is also silent on procedures for resolution procedures.

131. Some progress is being made to develop *Shari'ah* compliant liquidity management instruments, but important gaps remain. The CBN in 2012 introduced instruments to facilitate liquidity management and access to the CBN window. These include the CBN Non-Interest Note (CNIN), the CBN Safe Custody Account (CSCA), and the CBN Non-Interest Asset-Backed Securities (CNI-ABS).²⁰ However, the domestic *Sukuk* market has not yet developed. Interest free banks have been allowed to enter into interbank transactions with other conventional banks via conventional interbank products to help these banks manage liquidity, but this exposes the banks to *Shari'ah* non-compliance risks. The existing secondary financial market operates on interest rate basis and does not conform to the ethics of Islam (Dauda Momodu 2013). Government Treasury Bills, and securities as well as the open-buy transactions between the government and the commercial banks are interest bearing.

132. Nigeria established an SCDIS in 2011 before licensing the interest free banks. The SCDIS is based on the *Kafalah bi al-Ajr* contract and provides coverage to full-fledged interest free commercial banks, interest free windows and Islamic microfinance banks for the following accounts—Demand deposit (*Qard*), Savings (*Wadi'ah*) and Investment accounts (*Mudarabah*). It also covers individuals (local customers), corporate (businesses), foreign customers and others. The scheme is pre-funded and the coverage limit is 500,000 naira.

²⁰ The CNIN is a financial paper issued by the CBN evidencing an interest-free loan instrument between an authorized non-interest financial institution (lender) and the CBN (borrower), which entitles the authorized dealer to raise a corresponding interest-free loan from the CBN. The CSCA is an innovative instrument that is based on a contract of safe custody of funds (*Wadi'ah*) between a depositing non-interest financial institution and the Bank, with the CBN as the custodian, while the CNI-ABS involves the securitization of the CBN's holdings in ILM instruments, e.g., *Sukuk* and/or *Sukuk* issued by multilateral organizations in which Nigeria is a member.

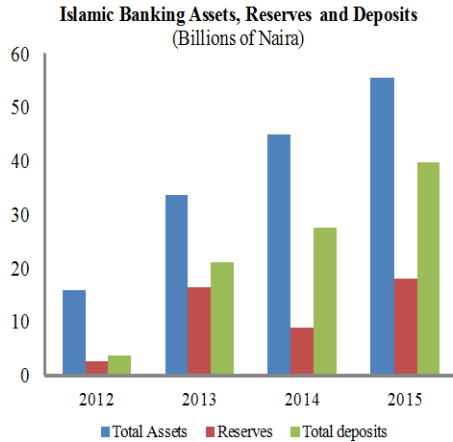
E. Conclusions and Policy Issues

133. The CBN has made concerted efforts to provide an enabling environment for interest free banking but the IB industry faces important challenges. There is still strong opposition from segments of the population to introduce religion in finance. Technical capacity to effectively supervise the banks in *Shari'ah* governance, accounting and auditing and resolution of disputes is still limited. Also, some of the institutional framework needed for the stable function of the industry, such as the judiciary and money and *Sukuk* markets are not yet in place. The absence of *Shari'ah* compliant interbank markets and the limited liquidity management instruments have stifled the investment of Interest free banks' surplus reserves in securities, leading to a total deposit of their whole reserve in cash with the Central Bank (Dauda Momodu 2013). Disputes that pertain to Interest free banks are only open to litigation before the regular conventional courts and tribunals which are not trained in Islamic commercial jurisprudence. Resolution procedures for the non interest banks are not stipulated.

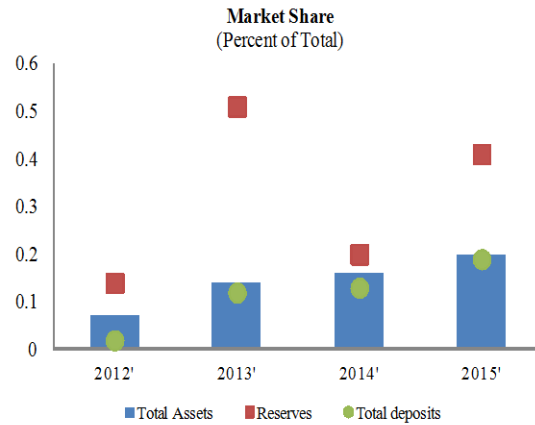
134. The sound and stable development of the industry will therefore require greater outreach and further reforms to strengthen supporting infrastructure. While the branding as interest-free can reduce the perception that the industry caters only for to the needs of specific segments of society, further growth of the industry will be contingent upon effective outreach and consumer education to ensure acceptance from a broader segment of society. It will also require further reforms to level the playing field, strengthen the regulatory framework and adapt liquidity management infrastructure. There is also a need to develop supervisory expertise and to train specialists in dispute resolution mechanisms as specifically applicable to interest free banks because of the complexities involved in IB and finance disputes. Clarity on the resolution framework for non interest banks is needed and strengthening the special resolution framework for banks in general could contribute to the orderly resolution of banks and financial stability.

Figure 13. Nigeria: Structure of the Islamic Finance Industry and Bank Balance Sheets

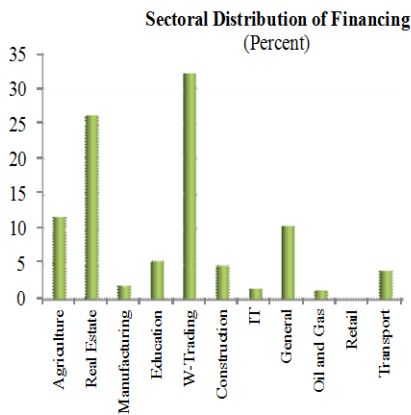
*Islamic banking **assets** have grown rapidly, albeit from a low **base**.*



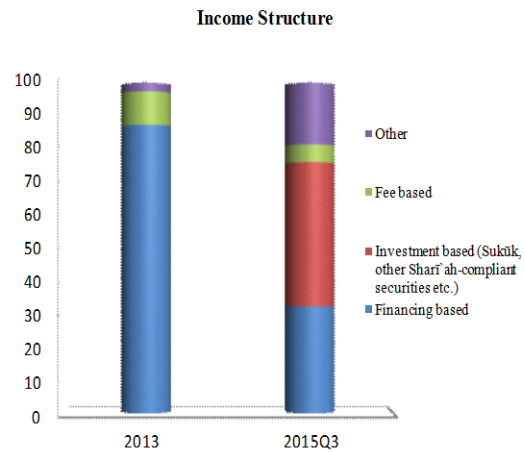
*The market share of **Islamic** banks, while increasing, remains **below 1 percent**.*



Financing structure is fairly diversified, although real estate and wholesale trading together account for close to 60 percent.



*Income is derived mostly **from financing** instruments and increasingly from **investments***

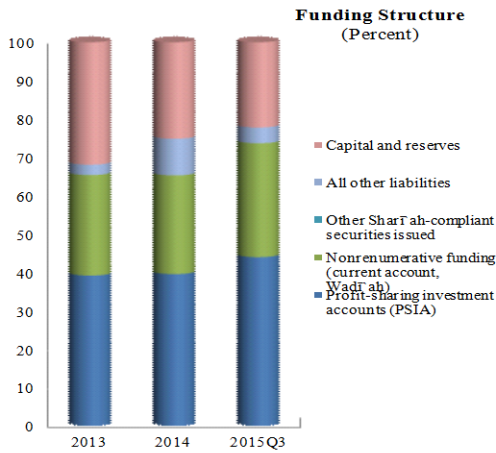


Source: Central Bank of Nigeria; and audited accounts of Jaiz Bank.

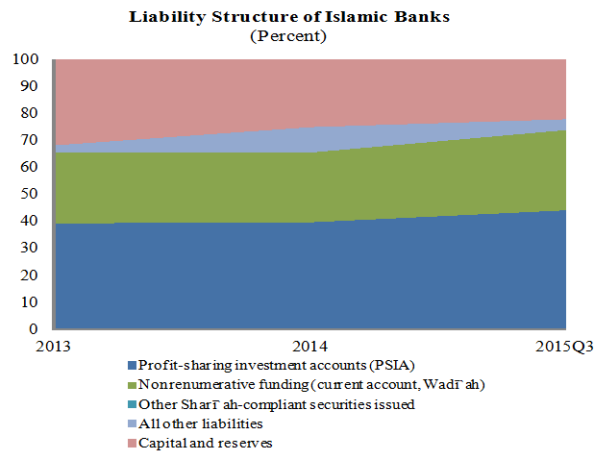
1/ The sectoral distribution of financing are for the one full fledged Islamic banks

Figure 14. Nigeria: Sources of Funding and Islamic Banks' Performance

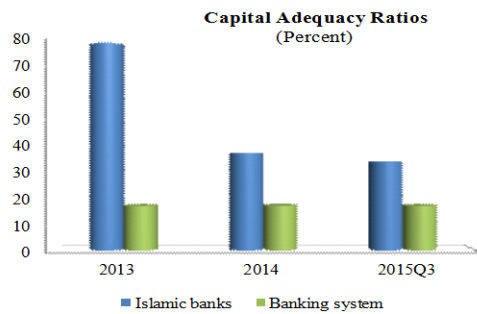
The main funding sources are deposits.



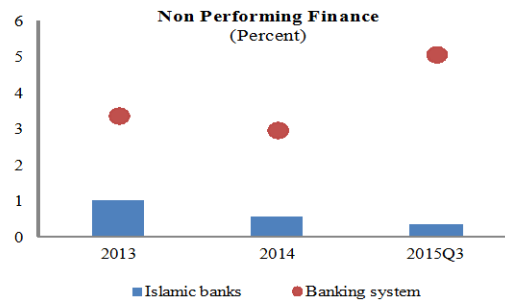
The deposits are comprised largely of PSIA.



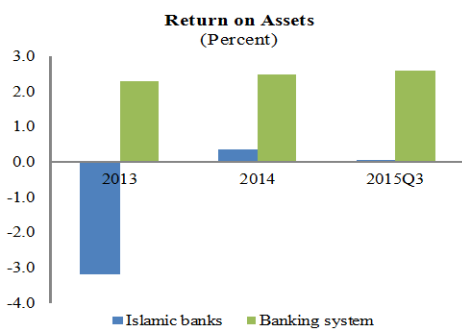
Islamic banks CAR, while higher than the average for the banking system, has been declining.



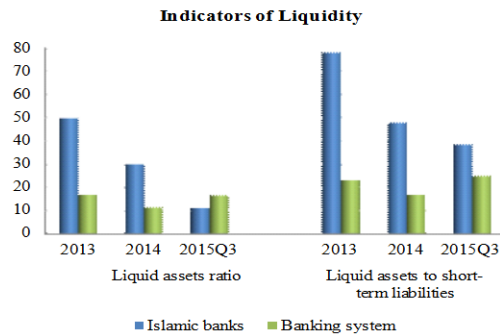
NPFs are lower than industry average.



But profitability of the Islamic banks is below industry average.



While liquidity indicators are higher.



Source: IFSB and Country Authorities

PAKISTAN²¹

A. Overview of the Islamic Finance Industry

135. Pakistan has a fairly developed IF industry that is bank dominated. At present, the IF industry of Pakistan consists of IBs, Islamic microfinance institutions, *Sukuk*, *Mudarabah* companies, and Islamic funds,²² *Takaful* companies, and Islamic Real Estate Investment Trusts (iREITs). The IB sector which dominates the financial industry assumes a variety of forms, including full-fledged IBs and conventional banks offering IB products through subsidiaries, branches and/or windows. The *Sukuk* market, which is the second largest segment, is driven mostly by sovereign issuances and is followed by Islamic funds, which include pension and other mutual funds. The *Takaful* (insurance and reinsurance) and Islamic micro-finance sector are still very small.

136. IB in Pakistan has been growing very fast since its relaunch in 2001. Though still in an evolutionary phase, Pakistan's IB industry expanded at a CAGR of nearly 50 percent between 2002 and 2015, and reached a market share of 11.4 percent by end 2015. Facilitative regulatory support, has been propelling the growth of Pakistan's IB sector. The large Muslim population and low market penetration also suggest that there is substantial upside potential for further growth. About 96 percent of Pakistan's population of 193 million is reported to be Muslim and the World Bank Findex data show that only 13 percent of the adult population has a bank account. The central bank has also devised a strategic plan for the IB Industry to reach 15 percent of banking system assets by end 2018.

B. Islamic Banks' Operations and Soundness

Corporate and Balance Sheet Structure

137. IBs in Pakistan derive their business mainly from the domestic market, thus domestic economic developments drive their performance. At end December 2015, the six full-fledged IBs comprised of four domestic IBs and two subsidiaries of foreign-owned banks from Gulf countries. Selected IBs have subsidiaries of investment banks and associate mutual funds, thereby making consolidated supervision materially important.

138. The industry offers a wide array of products, and risk-sharing financing has increased to a sizeable share. The asset base largely comprises of financing, investment and, to some degree, interbank placements. Financing instruments are almost equally divided between trade based products such as *Murabahah*, *Ijarah*, *Salam Istisna* and equity products based on *Musharakah* and diminishing *Musharakah* whereas *Mudarabah* has been miniscule (Figure 15, panel 4). The major share of financing is utilized for manufacturing activities whereas exposure to the real estate sector

²¹ This note is prepared by Khalid AlSaeed and Inutu Lukonga. It draws on the 2016 IMF survey.

²² *Mudarabah* companies are a two-tier fund structure, for undertaking *Shari'ah* compliant businesses.

is small (Figure 15, panel 5). This structure of assets suggests that credit, investment, liquidity and operational risks are material risks for the IB sector and for supervision.

139. The IBs have a healthy domestic funding base (Figure 16). Close to 85.3 percent of the assets are funded by customer deposits, and about 63 percent are PLS deposits accounts based on *Mudarabah* contracts while current accounts are mostly based on Qard. Funds due to OFIs account for a very small share. The funding is mostly in local currency, thus exchange rate risk is low. *Sukuk* issuance by banks and other long term funding appear limited, thereby potentially creating maturity mismatches with financing structure.

Performance and Soundness

140. IBs in Pakistan exhibit strong financial fundamentals (Figure 16). For full-fledged IBs, the CAR was 14 percent at end 2015, significantly above the prescribed minimum of 10 percent but below conventional banks. The NPF ratio of 2 percent is significantly below the average for conventional banks of 12 percent. IBs are also profitable and liquid but the profit margins and liquidity levels are, however, lower than their conventional counterparts.

C. The Regulatory and Supervisory Framework

141. Regulation of both Islamic and conventional banks is governed by the Banking Companies Ordinance (BCO) 1962 as amended. The BCO was amended in 2002 to authorize the “carrying on of banking business in conformity with the injunctions of Islam”. The amendments were supplemented with detailed guidelines for establishing full-fledged IBs, subsidiaries and branches. Conventional banks are also allowed to offer IB services through stand-alone branches/window operations, with nominal capital allocation from their existing capital based on RWA of these branches. IBs are allowed to offer PLS deposit accounts similar to URIAs.

142. The State Bank of Pakistan (SBP) has a single integrated regulatory framework that applies to all banks with provisions specific to IB. Full-fledged IBs are subject to the same prudential requirements as conventional banks, including the Minimum Capital Requirement (MCR) regime, the minimum CAR, large exposure, loan classification, provisioning and related party lending. The SBP has issued detailed licensing criteria, instructions for Profit & Loss Distribution and Pool Management to improve transparency and safeguard interests of IAHS. It has also adopted the IFSB-1 on risk management, partially adopted the IFSB-4 on transparency and 6 of AAOIFI *Shari’ah* standards while banks are required to use the remaining AAOIFI *Shari’ah* standards as guidelines with approval of their *Shari’ah* Boards. The SBP has tailored some of the macro prudential policies for IBs.

143. Reforms of the capital and liquidity frameworks are on-going. The SBP is developing instructions for adoption of implementation of Liquidity Coverage Ratio (LCR) under Basel III Liquidity guidelines, HQLAs and run-off rates in line with the BCBS. The SBP is reviewing the IFSB-15 on capital standards for IBs and plans to roll it out after conducting a Quantitative Impact Study (QIS) and soliciting feedback from stakeholders.

144. Considerable progress has also been made to strengthen corporate and *Shari'ah* governance. ²³ The SBP has adopted the IFSB 3 on corporate governance, and the IFSB 10 relating to *Shari'ah* Governance. The *Shari'ah* compliance system is well-structured with a central *Shari'ah* board established at the SBP level, and *Shari'ah boards* established at bank level, in line with the IFSB and AAIOFI standards, and customized according to the market environment in Pakistan. The SBP has developed detailed fit-and-proper criteria for the appointment of *Shari'ah* board members of IBs, which include *Shari'ah*-related academic qualification and experience, banking knowledge, and personal and professional track record. *Shari'ah* issues can be (and in practice have been) taken before the federal *Shari'ah* court.

145. The consumer protection framework has focused more on addressing potential information asymmetries, limiting scope for exploitation of consumers and providing a resolution framework. IBs are required to disclose details of Charity Account, pool management practices, and remuneration to the *Shari'ah* Board. A regulatory limit for *Mudarib* (the bank) share has been set at a maximum of 50 percent. The profit sharing ratio can be fixed by IBs in advance and the *Mudarib* share is calculated on the basis of profit distributable to depositors. IBs can and do give indications of anticipated rates of returns, though the indicative rate is not obligatory and actual rates may vary. Conventional banks that offer IB products and services are required to disclose details of their IB operations as an annexure to their annual accounts. Consumers have, available to them, arbitral forums and ADR frameworks for resolving disputes. However, there are no independent board members to represent IAHS.

146. The supervisory framework has also been adapted and there are procedures for standardization and *Shari'ah* harmonization and auditing. The SBP has developed an on-site inspection manual for IBs and a dedicated supervision department that provide regulatory oversight of IBs. The Banking Inspection Department of the SBP reviews compliance with *Shari'ah* related matters during the inspection of IBs. It has specified broader parameters for permissible Islamic modes of finance and banks have been allowed to develop products and services after getting approval of their *Shari'ah* Board for each product and service they offer. The scope of the external auditor's engagement has been broadened to include *Shari'ah* compliance and conduct of External *Shari'ah* Audit of IBs. Further, the Financial Stability Department (FSD) also performs the overall stability assessment of the IB industry. SBP performs stress testing of individual banks on a quarterly basis, including for IBs. It has also designed a separate stress testing framework for assessing the resilience of IBs against credit, market and liquidity shocks. The SBP, however, does not yet supervise IBs on a consolidated basis, but is in the process of amending the law. The presentation of audited accounts differs considerably across banks and the different classifications make consolidation and comparative analysis challenging.

²³ The *Shari'ah* Governance Framework to strengthen the overall *Shari'ah* compliance framework was published in April 2014 and updated/revised in 2015.

D. Liquidity Management, Resolution, and Deposit Insurance

147. The financial markets critical for liquidity management are being gradually developed.

The domestic *Sukuk* market has been growing since the first issuance in 2005. The SBP has also played a major role in the issuance of government of Pakistan *Ijarah Sukuk* which has paved the way for effective liquidity management of IBs. In addition, despite witnessing growth over the years, the domestic *Sukuk* market is still confronted with issues such as lack of short term and long term *Sukuk* of high quality, absence of a secondary market for trading, and identification of assets for sovereign *Sukuk*.

148. The liquidity management framework is still to be operationalized. A number of instruments have been developed for liquidity management by the SBP and banks, including *Bai Muajjal* of *Sukuk*, interbank *Mudarabah*, Islamic placements, *Wakala* and others. A liquidity management framework has also been developed that includes development of a *Shari'ah portfolio* at SBP, *Mudarabah*-based facility for IBs at the SBP, development of an Islamic inter-bank money market, and availability of *Shari'ah* compliant discount window for IBs. However, this framework has not yet been operationalized.

149. An institutional framework for resolving banks is in place. The Banking Ordinance 1962 provides a general framework for the resolution of banks and the legal framework relating to liquidation equally applies to both conventional and IBs. In case of liquidation, IAHS have priority over creditors and therefore bailing in options are limited. IAHS are legally liable to bear proportionate losses. Thus far, none of the IBs have been liquidated. To facilitate coordination, the SBP has put in place an institutional framework in the form of the Islamic Banking Department (IBD), *Shari'ah* Board of the Central Bank and the *Shari'ah* Boards of Banks. The IBD can escalate unresolved issues to the *Shari'ah* Board of the central bank to resolve conflicts between banks, the *Shari'ah* board and the regulator.

150. Pakistan is in the process of developing a deposit insurance framework. The Deposit Insurance Corporation Act, presently with the Parliament for enactment provides coverage for IB depositors.

E. Conclusions and Policy Issues

151. The experience of Pakistan offers important lessons for the sound development of the IB industry.

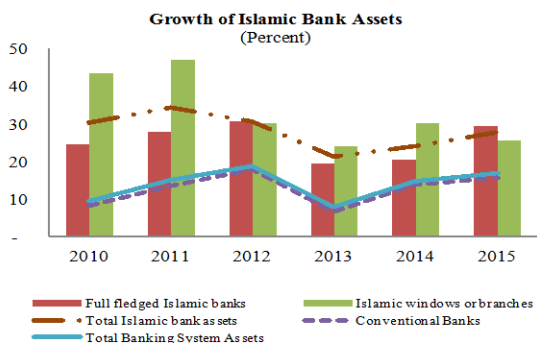
The experience shows that rather than forcing a transition toward a fully-fledged IB industry, policy makers should focus on putting in place an enabling environment that levels the playing field with the conventional industry, and let market forces play their role. Since opting for the latter, the IB industry has experienced rapid growth and the IBs in Pakistan have also increased the share of risk-sharing financing (*Musharakah* and *Mudarabah*).

152. Pakistan has made considerable progress in adapting the institutional, legal and regulatory framework to the specifics of IB, but scope remains for further strengthening.

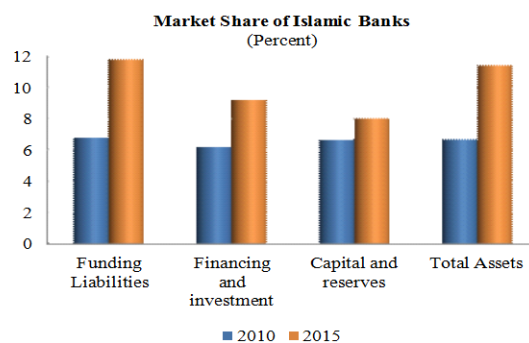
Additional reforms are needed to address gaps with respect to consolidated supervision, consumer protection, the resolution framework, and the absence of liquid secondary markets. Ongoing reforms with respect to CAR, liquidity framework and DIS need to be expedited. Concentrations in bank financing, maturity mismatches and development of interbank markets warrant attention and further efforts are needed to develop deep *Sukuk* markets. The SBP has an extensive database on IBs operations, but inconsistencies in the data methodologies in IBs audited accounts could affect data quality for policy formulation.

Figure 15. Pakistan: Structure of the Islamic Finance Industry and Bank Balance Sheets

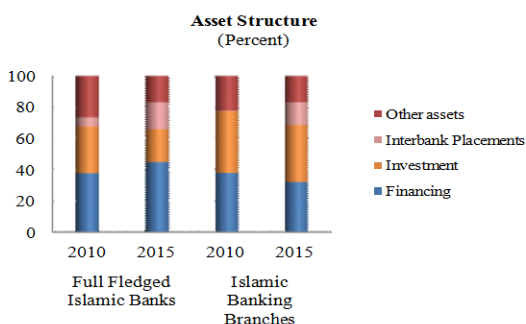
Islamic banks assets have grown faster than than conventional bank assets.



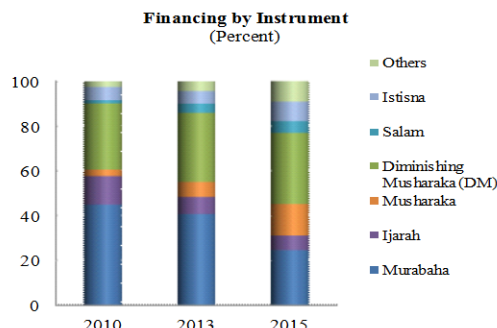
Thus, Islamic banks have been gaining market share.



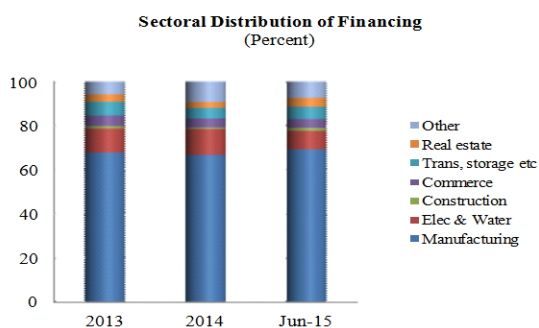
Financing and investment account for the bulk of assets, but interbank placements has increased.



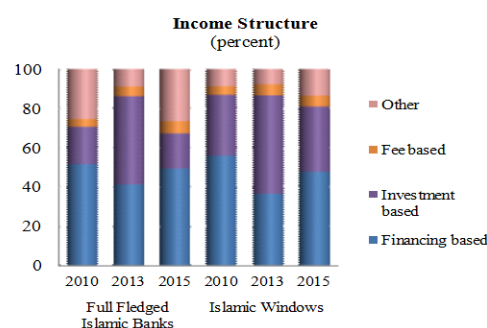
Financing is almost equally divided between risk sharing and trade based instruments.



Major share of financing is utilised for manufacturing activities



Income is largely derived from financing and investments.

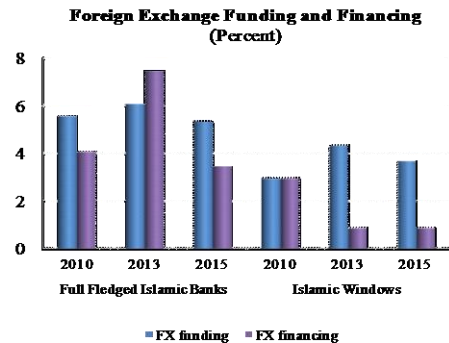
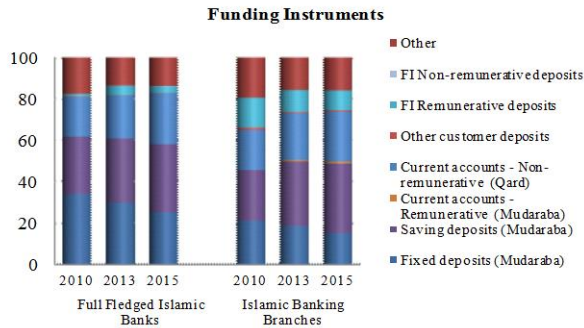


Source: Central Bank of Pakistan and World Bank.

Figure 16. Pakistan: Sources of Funding and Islamic Banks' Performance

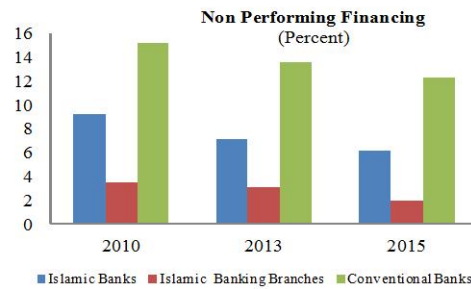
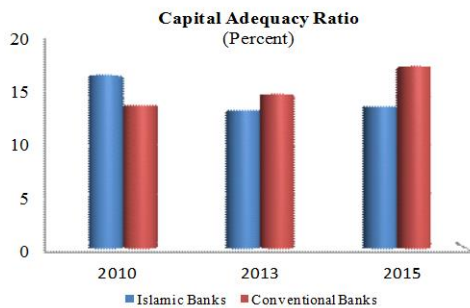
The assets are largely funded by PSIA based on Mudaraba contracts.

With most transactions in domestic currency, foreign exchange risk is limited.



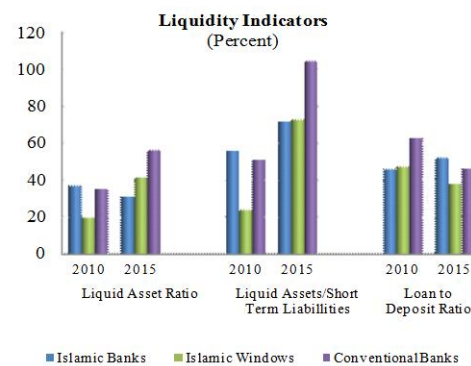
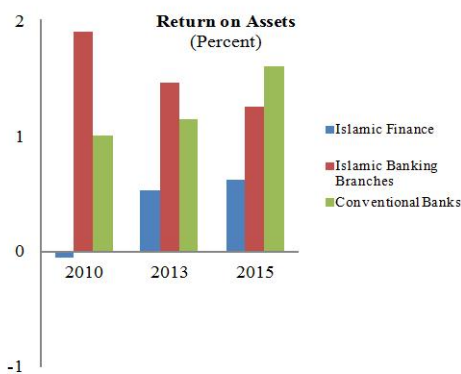
Capital adequacy ratios are high.

The asset quality is better than for conventional banks.



But Islamic banks' profits are lower.

And liquidity ratios are comparatively lower.



Sources: Authorities and IFSB and State Bank of Pakistan.

1/ Figures for conventional banks include CAR for Islamic branches of conventional banks.

SUDAN²⁴

A. Overview of the Islamic Finance Industry

153. Sudan—along with Iran— operate banking systems that are exclusively *Shari'ah*-compliant. IB in Sudan started in 1978 when the first and full-fledged Islamic bank (Faisal Islamic Bank) was established. The private sector (local and foreign) opened five more IBs between 1980 and 1983. The government in 1983 decided that all banks had to operate in accordance with *Shari'ah* rules. Accordingly, in 1984, the Central Bank of Sudan (CBOS) issued a circular that eliminated interest rate carrying financial instruments. The deepening of Islamization would eventually take effect with the 1991 Banking Business (Organization) Act, and the establishment of the High *Shari'ah* Supervisory Board (HSSB) in 1992. In 2005, following the signing of the Comprehensive Peace Agreement to address the long-standing civil conflict in southern Sudan, a dual banking system was adopted, with conventional banks in the South. After the secession of South Sudan in 2011, the full Islamic financial system was reinstated (see Central Bank of Sudan 2013).

154. The IF industry has registered considerable growth and breadth. The number of IBs increased from four banks in 1983 to 37 at end 2015. There are also 15 *Takaful* companies providing Islamic insurance services. Other financial segments include the pension fund industry, more than 30 microfinance institutions, and a capital market comprised of the *Sukuk* market and stock market. Banking is the dominant segment, accounting for more than 90 percent of total financial system assets (IRTI 2016). The *Sukuk* market is dominated by short-term domestic sovereign issuance and corporate issuance has been limited since the one issuance in 2007. However, despite the whole industry being Islamic, Sudan accounts for less than one percent of global IB assets and 2.1 percent of global *Sukuk* issuance [IIFM 2016].

155. The IB industry registered rapid growth in assets, but overall intermediation levels remain low (Figure 17). The bank assets of the industry grew at a CAGR of 20.4 percent over the 5-year period from 2010 to 2015, but in 2015, broad money represented only 19 percent of GDP, far below the average of 48 percent in LICs. Credit to the private sector of 9 percent of GDP compares unfavorably with the average of 18 percent for low income countries (LICs). In addition, while bank deposits steadily increased in nominal terms, they have lagged behind nominal GDP growth, as a result of which the ratio of deposits to GDP dropped from 17 percent in 2010 to 13 percent in 2015.

156. Prospects for further growth are mixed. Latent demand for Islamic financial products is high. Sudan is a Muslim country with a total population of 36 million, which is largely under banked. Access to finance is low, with only about seven percent of the adult population reported to have a bank account, and access is concentrated in urban centers. However, Sudan faces major challenges in developing its financial industry. The business environment is weak and access to global markets

²⁴ Prepared by Gabriel Presciuttini, Abdikarim Farah and Inutu Lukonga (All MCD).

is restricted, partly attributed to the sanctions imposed by the United States. Sudan also faces political challenges, economic uncertainty and infrastructure inadequacy.

B. Islamic Banks' Operations and Soundness

Ownership and Balance Sheet Structure

157. Sudan's banking system is highly concentrated despite a diverse ownership structure.

Of the 37 licensed commercial banks at end 2015, five are government-owned, 25 are joint ventures with the government or the CBOS, and seven are foreign-owned. The top three banks account for 38 percent of total assets.

158. Bank assets comprise largely of financing based on *Murabahah* contracts, but investment in Central bank and government paper is also significant (Figure 17).

At end December 2015, financing accounted for 49 percent of total bank assets, most of which is directed to construction, agriculture, industry and trade. Debt-based instruments account for the bulk of the financing with *Murabahah* contracts representing about 50 percent of total financing, followed by *Mugawala* contracts at around 18 percent. Risk sharing products based on *Musharakah* contracts have declined significantly from 30 percent in 2005 to 9 percent in 2015, while *Mudarabah* contracts have remained small at around 4 percent. The main risks facing the banks are credit, market, equity investment and operational risks.

159. Banks maintain considerable excess liquidity (Figure 17).

Reserves accounted for 30 percent of assets in 2015, of which only one-quarter were required reserves. The excess reserves have also remained high despite the fact that the CBOS, in 2014, established the Liquidity Management Fund that serves as a vehicle to provide liquidity to banks, to enable banks with excess liquidity to utilize their surpluses profitably and promote the interbank market. The persistent excess liquidity could therefore be attributed to the limited availability of alternative liquid instruments and an inactive secondary market for *Sukuk*.

160. Domestic deposits are the main source of funding for banks (Figure 18).

At end 2015, domestic deposits accounted for about 60 percent of total liabilities. An estimated 46 percent of the deposits are in the form of current accounts—these are safekeeping contracts with zero return, subject to bank service fees. PSIA accounted for 36 percent of total deposits. Savings accounts are small but they have increased from about 5 percent to 13 percent.²⁵ Since banks are not permitted to use any mechanisms to smooth the low profits on RIAs in low return periods, the large share of PSIAs reduces cost for banks but renders funding and liquidity risks material for banks.

²⁵ These are safekeeping loans with return in some banks and zero return in others, but not subject to bank service fees.

Performance and Soundness

161. The banking system is stable and FSIs have improved (Figure 18). The aggregate CAR has increased significantly since 2010, more than doubling to 20 percent in 2015 and far above the required 12 percent minimum requirement. The capital is also of high quality as Tier 1 capital is equally high. The asset quality of financing has improved as measured by the NPF ratio, declining from 14 percent of total financing in 2010 to 5 percent in 2015, owing to the establishment of the credit registry in 2010 which enhanced banks' assessment of clients' creditworthiness. The NPF ratio net of provision to capital also declined from 14.4 percent in 2010 to 3 percent in 2015, largely reflecting the tightening of provisioning regulations. On the other hand, due to the high levels of unremunerated liquidity, bank profitability has weakened significantly in 2015, thereby eroding internal capital generation capacity.

C. The Regulatory and Supervisory Framework

162. IB is governed by the 2002 Bank of Sudan Act and the 2003 Banking Business (Organization) Act. The law confers on the CBOS powers to regulate and supervise the banking system.

163. Pursuant to the provisions of the law, the CBOS has issued prudential guidelines tailored to the Islamic mode of banking. The prescribed minimum CAR was increased to 12 percent by the end of 2006 from 8 percent, in light of the inherent risks in the operating environment for banks. The regulatory framework requires the use of the IFSB discretionary formula in the calculation of the CAR and the Alpha for capital adequacy calculation is specified at 0.5. The risk weighting assigned to assets varies depending on the mode of financing. Funds allocated for PER are eligible for regulatory capital adequacy requirements whereas allocation for the IRR cannot be counted toward the capital adequacy requirements. Loan classification and provisioning also differ according to the modes of financing (*Murabahah* and other financing such as *Musharakah*).²⁶ IBs are not required to hold capital against assets financed by RIAs, but have to provide capital against assets financed by demand deposits and a share of URIAs.

164. Sudan has also adopted Islamic international regulatory standards. Banks are required to adhere to AAOIFI standards and to adopt a number of IFSB guidelines, including the definition for HQLA. The AML/CFT laws have been strengthened, as a result of which Sudan was removed from the Financial Action Task Force (FATF) "grey list" in October 2015.

165. However, some gaps remain in the prudential framework. These include:

- The banking law contains restrictions on lending to individual directors and shareholders of the bank, but there is no restriction on aggregate financing of such connected parties.

²⁶ Murabahah financing is considered non-performing if the installment is one month overdue while other financing is considered nonperforming if three months overdue.

- No macro prudential policies have been put in place.

166. Sudan’s *Shari’ah* governance framework has evolved from a bank specific framework to the current centralized *Shari’ah* board overseen by the central bank. Upon the introduction of IB in Sudan, *Shari’ah* governance was solely regulated by the internal *Shari’ah* committees of the IBs. However, in 1992 the Sudanese government created a HSSB—an independent body—as a regulatory body to supervise the development of the banking system. The HSSB interprets the *Shari’ah*, ensures that institutions are *Shari’ah*-compliant, and adjudicates disputes related to financial transactions. Each bank must also appoint a SSB and must have a *Shari’ah* auditor. Among the requirements, banks have to publish a statement on *Shari’ah* compliance and external auditors also have to report on compliance.

167. The Consumer protection framework has not been explicitly adapted for financial services, but there are several provisions that provide a degree of protection for consumers. Banks have unfettered discretion to set profit-sharing ratios subject to a maximum limit of 0.5. Banks are also required to give an indication of future rates of return on investment and have to inform the clients of the bank. Sudan also has a *Shari’ah* court and an Islamic Affairs Ministry. Bank customers can also avail themselves of the services of the Bank Special prosecution. The decisions issued by the Bank special prosecution are binding in the courts.

D. Liquidity Management, Resolution, and Deposit Insurance

168. The CBOS has been making efforts to develop liquidity management instruments, and has in this regard availed itself of IMF technical assistance. The CBOS mainly operates through changes in the unremunerated reserve requirement and to a lesser extent through open market operations—providing liquidity to ailing banks by purchasing government securities. It developed the first generation of *Sukuk*, Central Bank *Musharakah* Certificates (CMCs) and Government *Musharakah* Certificates (GMCs) to inject and withdraw liquidity from the system. The CBOS also developed Central Bank *Ijara* Certificates (CBICs) to manage liquidity in the banking system. The CBIS are lease contracts backed by the assets owned by the CBOS and are traded only by the banks operating in Sudan.

169. Commercial banks have also developed instruments for managing liquidity but domestic financial markets remain largely underdeveloped. The banks mainly use interbank *Musharakah* and *Mudarabah* and Islamic placement accounts to manage both liquidity surplus and shortages. However, among commercial banks, liquidity allocation has been less than efficient in the context of excess reserves, shallow interbank and secondary markets, and a cap on banks’ holdings of government securities.

170. To encourage interbank activity, a Liquidity Management Fund (LMF) was introduced in 2014. The LMF aims at encouraging the interbank market and limiting CBOS support as “lender

of first resort". All banks were required to subscribe.²⁷ The establishment of the Liquidity Management Fund (LMF) in 2014 widened the scope for banks to properly manage liquidity and helped reduce short term liquidity risk. However, despite the recent establishment of the LMF, the CBOS still occasionally acts as "lender of first resort" for banks facing persistent liquidity shortages.

171. The CBOS, in its capacity as LoLR, can provide liquidity support to banks. In the recent past, the CBOS has provided support to banks with long-term liquidity shortages in the form of deposits that were converted into equity. However, since the establishment of the LMF, banks can only recourse to the CBOS for any overdue repayments to the Fund. The remaining challenges are that the CBOS does not distinguish between a temporary liquidity shortage of a solvent bank and liquidity strain stemming from a solvency issue; and the CBOS resources are not protected by ensuring that the liquidity support is properly collateralized.

172. Sudan is ranked the second largest issuer of short term *Sukuk*, but some challenges remain that constrain further and efficient development of the market. Sudan has developed three types of government and central bank securities (*Sukuk*) and banks are the largest holders of government securities.²⁸ Development of the *Sukuk* market has been constrained both on the supply and the demand sides largely for policy reasons. On the supply side, issuance of government and central bank securities has been limited by the limited supply of eligible public assets to back the securities. On the demand side, the ceiling on bank holdings of *Sukuk* has clearly limited banks' capacity to absorb these securities and resulted in considerable excess liquidity. As a result, much of the government's financing needs have been covered by direct money creation by the central bank, while the CBOS has not been able to develop liquidity management instruments.

173. Since Sudan has an exclusive *Shari'ah* compliant banking system, the resolution framework for banks is aligned with *Shari'ah* principles, but some gaps remain. The legal framework provides explicit powers for taking over failing IBs and Sudan has already experienced bankruptcy of IBs. In liquidation, demand deposits are given priority followed by RIAs, URIAs other creditors and shareholders respectively. However, the law offers very limited alternative possible actions to resolve an ailing bank should the shareholders prove unwilling or unable to restore the

²⁷ The LMF invests 60 percent of its capital in government securities and the rest in cash; returns are distributed to banks based on their contributions. Banks facing liquidity shortages can, for a 0.5 percent fee, receive a short-term (5 days) loan from the LMF. In 2015, the LMF had 269 transactions with a value of SDG 3.6 billion (0.7 percent of GDP). This allowed the CBOS to start unwinding its stock of government securities by SDG 1.2 billion (or 0.24 percent of GDP) in 2015.

²⁸ *Sukuk* are mainly Government *Musharakah* Certificates (GMCs)—introduced in 1999—backed by government shares in public enterprises and representing 94 percent of total debt issuances in 2015. GMCs are issued to finance the budget, have a maturity of one year and an annual return of about 15-17 percent. Government Investment Certificates (GICs) are based on *Muḍarabah* contracts, backed by government investment projects; they have maturity of 2-6 years and a rate of return of about 18 percent. Central Bank *Ijarah* Certificates (CICs) or *Shijab* are lease contracts backed by central bank assets and held only by commercial banks; they have a 10-year maturity and a fixed annual return of 12 percent. CICs have been issued irregularly and consequently represent only 1.2 percent of the market.

soundness of the financial situation and management of the bank.²⁹ There are also no cross-border resolution arrangements and *Shari'ah* boards do not play a role in determining or approving resolution actions in respect of failed IBs.

174. An SCDIS has been in place since 1996. The scheme, termed the Bank Deposits Security Fund (BDSF), is based on the *Shari'ah*-compliant contract of *Takaful*. The Fund covers current accounts (*Qard*), and Investment accounts (*Mudarabah*) of full-fledged IBs and Islamic investment banks. The maximum coverage is SD 15,000 and all investment accounts are eligible for SCDIS protection. Banks pay an annual premium equal to 0.003 of current and savings deposits and owners of investment accounts pay the same (0.003). The Ministry of Finance and Economic Planning and the Central Bank of Sudan each pay 15 percent of the amount paid by banks.

E. Conclusions and Policy Issues

175. Sudan is one of the only two countries to have established a financial system that fully follows Islamic principles. While IF presents opportunities for Sudan's predominantly Muslim population, the financial system faces similar challenges as conventional systems in many low-income countries: underdeveloped markets, limited monetization and access to credit, and uneven banking supervision. Moreover, IF faces additional challenges, including a dearth of *Sukuk* and liquidity management instruments that constrain government financing and monetary policy. This requires reforms to address general structural constraints as well as those specific to IF.

Addressing general structural constraints

176. Monetization and access to financing. Greater macroeconomic stability, particularly an environment of low inflation and stable exchange rate would help increase demand for money. Increasing access to finance would require restructuring weak banks, bolstering bank competition, improving the collection and sharing of credit information, strengthening the judiciary, and improving financial education. Microfinance that caters to small enterprises and rural dwellers would improve financial inclusion.

177. Deposit insurance. Funding for the BDSF should be reviewed to ensure sufficient funds to cover deposits in case of bank failure, which should enhance depositors' confidence.

²⁹ The CBOS can take over the management and designate an administrator in the case of insolvency, contravention of regulations, or threat to depositor interests. However, the restriction framing the power of the provisional administration protects shareholders' prerogatives and prevents a forced sale of shares, merger, or transfer of assets. The power given by the law does not entitle the supervisor to use powers exceeding the normal powers of a Board of Directors, leaving key restructuring decisions under the continued control of the Extraordinary General Meeting of shareholders.

Addressing issues related to Islamic finance

178. Sukuk market and budget financing. Stepping up the volume of issuance of tradable *Sukuk* and lengthening their maturities would help deepen the market for government securities, create a benchmark for private issuance, and reduce the need for monetization of budget deficits (IMF 2015). Increasing the issuance of *Sukuk* may require a more active debt management strategy or innovative *Shari'ah*-compliant financial engineering to overcome limits on assets available to underpin the *Sukuk* issuance.

179. Monetary policy framework. Stepping up regular issuance of *Shari'ah*-compliant liquidity management instruments by the CBOS (including new CICs) is urgently needed to regain monetary control.

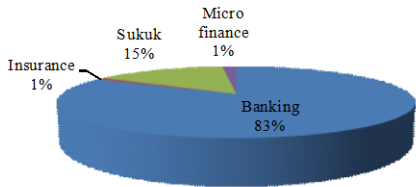
180. Liquidity management and LoLR. Limited *Shari'ah*-compliant interbank money market instruments restrict the options in managing liquidity effectively. Shallow secondary markets also contribute to the problem of access to liquidity. In 2015, LMF has contributed to improving the banks' liquidity management through collaborative redistribution of liquidity surpluses to finance banks with liquidity shortages as a result of which the CBOS interventions in the money markets has been reduced. Nevertheless, current bank regulations do not prevent banks from continued reliance on CBOS financing. This exposes the CBOS to credit risk in case of default. Bank regulations should clearly distinguish between banks' temporary liquidity shortfalls and solvency problems, to prevent banks from continued reliance on CBOS financing.

181. Resolution framework. Strengthening the legal framework, including broadening the instruments for resolving banks could minimize resolution costs and contribute to financial stability.

Figure 17. Sudan: Structure of the Islamic Finance Industry and Bank Balance Sheets

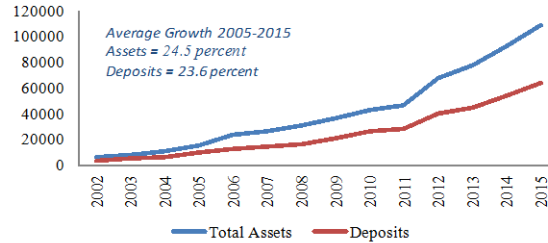
Sudan's **Islamic finance industry is bank dominated.**

Structure of the Islamic Finance Industry, 2015
(Percentage Share of Total Assets)



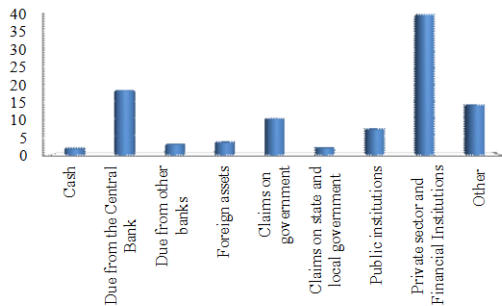
Banking **system** asset growth accelerated after 2011.

Trends in Banking Assets and Deposits
(In millions of Sudanese Pounds)



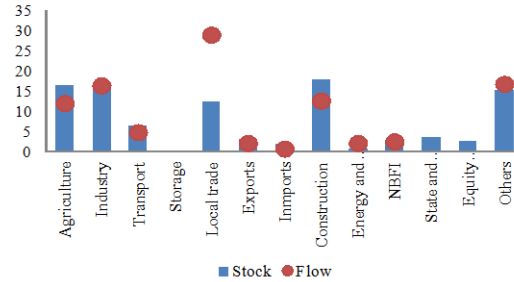
Bank **assets** comprise largely of financing, followed by claims on the central bank and the government.

Bank Assets at end December 2015
(Assets, Percent of Total)



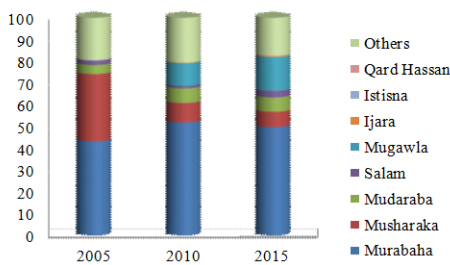
Financing is **diversified** although construction, agriculture, industry and trade are dominant.

Sectoral Distribution of Bank Credit at end December 2015
(In percent)



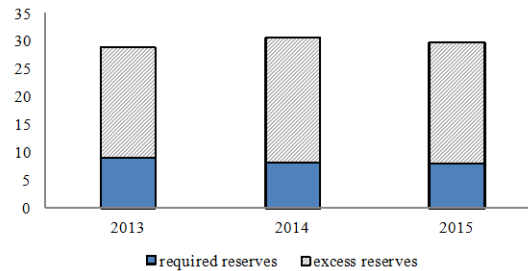
Financing **modes** largely consist of Murabaha while risk sharing **modes** based on Musharaka have declined significantly.

Financing by Instrument
(In Percent)



Banks **maintain** substantial excess reserves which may reflect **limited** investment opportunities.

Liquidity of the Banking Sector
(Reserves in Percent of Total Assets)

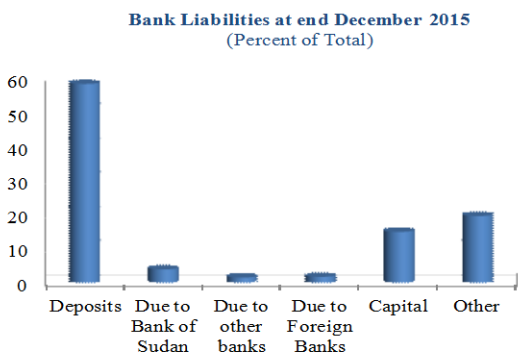


Source: Central Bank of Sudan.

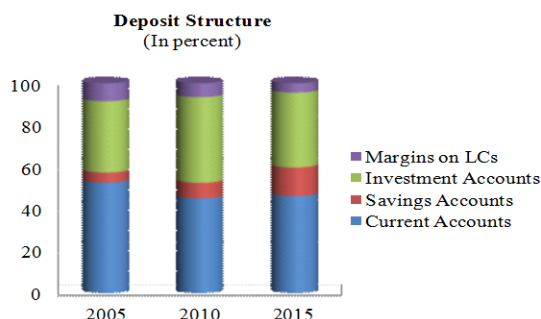
1/ Pie chart figure needs to be confirmed.

Figure 18. Sudan: Sources of Funding and Islamic Banks' Performance

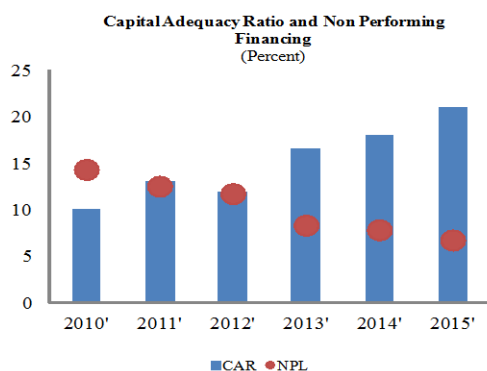
Domestic Deposits are the principal source of bank funding.



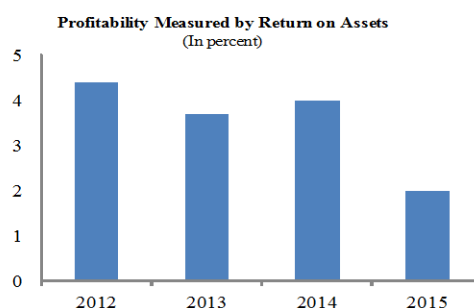
And the deposits largely comprise of current and investment accounts.



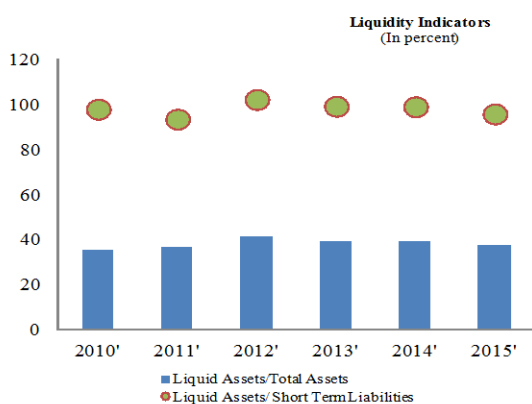
Solvency and asset quality indicators have improved.



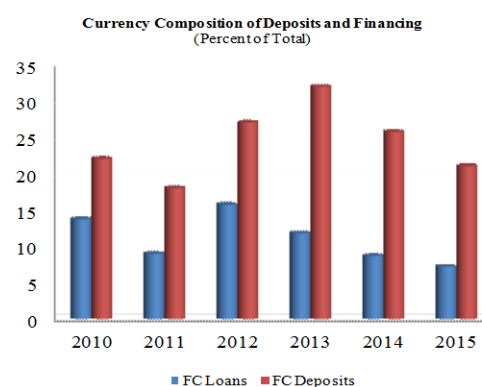
But bank profitability declined significantly in 2015.



The banking system is on aggregate highly liquid.



But deposit dollarisation remains high while loan dollarisation has declined.



Source: Central Bank of Sudan.

TURKEY³⁰

A. Overview of the Islamic Finance Industry

182. Participation finance, a term for financial practices structured in accordance with Islamic law, is not a new phenomenon in Turkey. Participation banking in Turkey dates back to the early 1980s. As part of a plan to attract more foreign direct investment from the Arab Gulf states, the government issued a decree in 1983 to legalize the operation of “special finance houses (SFHs)” to provide interest-free banking without any direct reference to Islam or religion, in line with the secular constitution. Following on the decree, the first SFH was established in 1985.

183. The participation finance industry in Turkey is still of limited breadth and depth, although it is rapidly gaining acceptance (Figure 19). Participation finance institutions, which operate alongside conventional financial institutions, are currently comprised of a banking segment, *Sukuk* market, and the *Takaful* industry whereas the Islamic Funds industry has not yet developed. The participation banking segment dominates with a market share of 83 percent of the total participation finance industry assets. Participation banking industry assets have grown from a very low base of US\$3.7 billion in 2004 to US\$41.2 billion in 2015, representing a compound average growth rate (CAGR) of approximately 24.5 percent per annum as compared to 20.1 percent of conventional banking. However, despite this growth, participation banking accounts for only 5.2 percent of Turkey’s banking industry and 3 percent of the global IB assets.

184. The slow start of the participation finance industry in Turkey and its subsequent rapid growth reflects the interaction of domestic and external factors. Turkey wanted to maintain a secular image and therefore did not encourage the label of IF. When the SFHs were established, they were highly regulated, they were not covered by the deposit insurance program and did not invest in government securities since the securities are debt based. SFHs later experienced more rapid growth when established IF houses from the Gulf began setting up SFHs in Turkey and smaller domestic companies followed in their wake. The poor performance of conventional banks during the GFC further boosted depositor interest in ethical finance. Shifts in government’s priorities also allowed IF to gradually acquire legitimacy in Turkey.

185. Growth prospects are mixed. There are several factors that could boost industry growth, but there are also important countervailing factors.

- **On the upside** there is a change in public policy and participation banking has gradually acquired legitimacy among the public. The growth of IF in other countries also had a positive demonstration effect. Latent demand is high as according to the Global Financial Inclusion (Global FINDEX) database, the percentage of adults claiming religion as the reason for excluding themselves from the financial system has increased from 6.9 percent in 2011 to 21.6 percent in

³⁰ This note was prepared by Recai Cecen, Alexander Tieman and Inutu Lukonga and benefitted from the Joint IMF/World Bank FSAP Technical Note prepared by Zamir Iqbal.

2014, leading to significantly lower access to formal accounts (World Bank 2016). There is also increased awareness, sensitivity and preference among households for Islamic financial products, aggressive marketing, and support from policy makers.

- **On the downside:** Growth of participation banking has slowed down significantly since 2013 and continued following regulatory intervention in 2015 of one of the largest participation banks (Asya Participation Bank) which was handed over to Savings Deposit Insurance Fund (SDIF) due to non-compliance. Despite its growing popularity, IB faces strong competition from the conventional banking system and a somewhat unlevelled playing field.

B. Participation Banks' Operations and Soundness

Corporate and Balance Sheet Structure

186. Turkey's IBs (termed participation banks) have diverse corporate and ownership structures with some cross border operations. At end June 2016, the participation banking sector comprised of six full-fledged participation banks, of which four are private banks and two are owned by the state. The private banks include subsidiaries of banking groups from the Gulf and some of Turkey's participation banks have established cross-border operations through subsidiaries or branches in Europe and the Middle East. The industry is concentrated with the largest participation bank accounting for 35 percent of the participation banks' total assets. Therefore, the IB sector is exposed to group and cross border risks.

187. The asset structure comprises mainly of financing, which in turn consist mostly of debt-based products structured on *Murabahah* contracts (Figure 19). Financing accounts for over 70 percent of total assets while investments have remained small. The financing is largely based on *Murabahah* contracts which at the end of September 2015 accounted for more than 95 percent [World Bank 2016]. The utilization of *Ijarah* has started to gain pace for the last five years and has reached 5.2 percent by the end of 2015, and this growth is attributed to the removal of a tax-disadvantage on *Ijarah* transactions. The sectoral distribution of the financing is very diverse, although the manufacturing sector, wholesale and retail trade businesses as well as individual credits, particularly for housing and automobile loans account for the bulk of the lending.

188. Customer deposits are the main source of funding for banks (Figure 20). The deposits are predominantly in the form of PSiAs, which at end of September 2015 accounted for 45 percent. The balance is almost equally divided between Commodity *Murabahah*, current, interbank, and capital. Participation banks have not attracted medium to long term funding. Deposits have predominantly been in domestic currency but the recent depreciation of the Lira has induced an increase in the share of foreign currency deposits.

Performance and Soundness of the Islamic Banking System

189. Participation banks remain sound but their financials deteriorated since 2013 and one of the banks had to be resolved. The CARs are above the statutory minimum level of 12 percent but below the banking system average. Asset quality has worsened somewhat since 2013 and remains weaker than the rest of the banking sector, with NPFs at 6.0 percent of total gross financing in 2015, up from 3.5 percent in 2013. Liquidity is generally tight and while all banks exhibit significant mismatches, the trend is more persistent for participation banks. Participation banks have also been less profitable and margins have declined further since 2013.

C. The Regulatory and Supervisory Framework

190. Participation banks are governed by the banking law which governs conventional banks, but there are some provisions that are specific to participation banks. In October 1983, the government issued a decree on Special Finance Houses that facilitated the establishment of the first SFH in 1985. In December 1999, SFHs were included in the banking law and in October 2005, the Banking law was amended to change the name of “Special Finance Houses” to “Participation Banks”. The Banking Law conferred on the Banking Regulation and Supervision Agency (BRSA) the regulatory and supervisory powers of the Turkish banking sector, including the participation banks. Participation banks also have to comply with the Capital Market Board’s regulations.

191. The prudential regulatory framework for participation banks is identical to that of conventional banks, with a few exceptions. Conventional and participation banks are subject to the same regulations for fit and proper, risk management, auditing requirements, AML/CFT, internal controls, liquidity requirements, CAR, provisioning, Large exposure limit, related party exposure and accounting standards. There are no differences in the corrective framework for conventional banks and IBs. Turkey is fully compliant with Basel III.³¹ The few exceptions are:

- **Computation of the CAR.** While both conventional and participation banks are subject to CAR requirements of 8 percent for Tier 1 and 12 percent total CAR, and although PER and IRR are not considered part of capital, credit and market risk, the RWA are discounted with a factor of 70 percent for on-balance sheet assets funded by URIAs funds based on *Mudarabah*, whereas, there is no discount for conventional banks.
- **Segregation of funds:** Participation banks have to maintain funds raised by way of Islamic deposits (demand deposits, URIAs, etc.) separately from other funds.

³¹ IBs have to hold capital against assets financed by current accounts, URIAs or RIAs. PER or IRR are not included in capital. Regulations do not require application of IFSB formula in calculation of CAR, no difference in accounting standards and IFSB rules are not mandatory for participation banks, IFSB standards are not incorporated into regulations. AAOIFI standards are not mandatory or an option.

- **Investment in fixed properties and movable properties.** Conventional banks are limited to invest in fixed properties up to half of their regulatory capital whereas participation banks are exempt from this limit.
- **Loan classification:** Financing sourced from URIA or RIA are classified separately in participation banks' chart of accounts whereas there is no separation in conventional banks since they are not allowed to operate as windows.
- **Provisioning requirements:** While the general and specific provisioning rates apply equally to conventional and participation banks, the way the provisions are accounted for differs.
- **Financial leasing:** Participation banks are allowed to intermediate through financial leasing operations whereas conventional banks can only undertake financial leasing through subsidiaries.

192. *Shari'ah* governance remains unregulated. There is currently no legal requirement for participation banking to comply with *Shari'ah* requirements and the BSRA, by law, cannot have a *Shari'ah* board. Participation Banks Association of Turkey (PBAT) has proposed the establishment of a centralized *Shari'ah* board to serve the banking industry and the proposal is with BRSA for further action but the establishment of a *Shari'ah* board would require legislative approval unless it is a self-regulatory body. There is no disclosure requirement regarding participation bank's state of *Shari'ah* compliance and external auditors of IBs do not have any duties and responsibilities regarding the *Shari'ah* compliance of participation banks. No limits have also been set on the number of *Shari'ah* board positions that scholars can hold. All participation banks have *Shari'ah* advisors and boards but their organizational set-up is not standard. In some cases, the *Shari'ah* board reports to the Board of Directors and in other cases it reports to the General Manager. Some participation banks have independent *Shari'ah* audit departments, in others it is part of the regular audit department and in many cases, the *Shari'ah* board is not part of the audit committee.

193. The supervisory framework does not distinguish between conventional and participation banks. The Risk Management Department treats participation banks as conventional counterparts and implements legislation and guidelines related to risk management without differentiation. The manuals for onsite and offsite supervision are the same for participation and conventional banks. The BRSA conducts supervision of banks on a consolidated basis but there are as yet no cross-border arrangements. BRSA does not have expertise in *Shari'ah*-related matters, including *Shari'ah* audit as well as in complex Islamic contracts such as Tier-I and Tier-II *Sukuk*, which are being issued by participation banks. Human resources trained in IB remain limited.

194. The consumer protection framework has, for the most part, not been adapted to cater for participation banks' business model. Participation banks are required by law or regulation to inform their RIA and URIA customers of their profit smoothing practices. Beyond this requirement, there is no difference between the disclosure requirements of conventional banks and participation banks. The institutions needed for resolution of disputes in Islamic financial transactions are not in place. There is no board representation to protect interests of IAHS. The consumer protection

framework does not cover misrepresentation to the general public by someone or an entity holding itself out as conducting its banking business on a *Shari'ah* compliant basis. Participation banks have unfettered discretion in the setting of profit-sharing ratios on URIA accounts and are not required to have full disclosure of the profits and the payout computation. There is also no *Shari'ah* court, no Islamic court, no arbitral forums or ADR forums that customers may go to for the resolution of participation banking disputes.

D. Liquidity Management, Resolution, and Deposit Insurance

195. Progress in developing the supporting financial infrastructures has been uneven.

Greater advances have been made in developing instruments for managing liquidity at the central bank and at the bank level. Beyond that, there is limited activity in the *Sukuk* market, though few sovereign *Sukuk* were issued recently, there are yet no interbank markets and no SCDIS.

196. The participation banks and the central bank have developed *Shari'ah* compliant liquidity management instruments. The central bank has a daily liquidity provision operation for IBs, using repo operations that have been modified to comply with *Shari'ah*—the repo ensures that Central Bank of the Republic of Turkey (CBRT) has an unbinding promise (*Waad*) to sell back the securities on maturity. The banks, on their part, have developed instruments for managing surplus and deficit liquidity positions, most notably reverse *Murabahah*, interbank *Musharakah*, *Murabahah*, Islamic placement accounts and commodity *Murabahah*. Acceptable collaterals include Domestic Government securities, FX Deposits and Banknotes, IILM *Sukuk*, domestic and Euro *Ijara Sukuk* issues by Turkish Treasury.

197. Interbank markets are not yet in place and participation banks are permitted to use facilities designed for conventional banks. There is no domestic currency interbank market between conventional and participation banks or between participation banks. The interbank commodity *Murabahah* transactions are mainly executed with domestic or foreign banks, mainly because all participation banks in Turkey have similar adverse liquidity positions. There are also no explicit or implicit provisions banning participation banks from utilizing the conventional facilities provided by the monetary authority for liquidity management purposes, such as the discount window or open market operations. Turkey does not yet have a *Shari'ah*-compliant mechanism of reserves remuneration so reserve requirements are remunerated in the same way as for conventional banks.³²

198. The existing bank resolution framework applies to both participation and conventional banks, though selected features apply specifically to participation banks. The order of payment takes account of the unique features of the liability structures of participation banks and accords the following priority for payment: Demand deposits, URIAs, and RIAs first followed by other creditors, and shareholders last. SSBs do not have a role in resolution and a cross border resolution framework is not yet in place and the absence of centralized *Shari'ah* board to

³² IBs see the remuneration as a “compensation” and uses the remuneration for their obligations to the government such as licensing fees and taxes.

support the resolution authority might hinder the *Shari'ah* compliance of resolution actions. Incidences of bankruptcy of participation banks have provided the Savings Deposit Insurance Fund (SDIF) operational experience in resolving participation banks under the Banking Law No. 5411.

199. Participation banks are covered by the same deposit insurance regulatory framework as conventional banks. Deposit insurance premiums collected are managed in a single indivisible pool. The insurance scheme covers all deposits, irrespective of whether they are investment or current accounts.

E. Conclusions and Policy Issues

200. Turkey's experience underscores the importance of an enabling regulatory framework and consumer education in facilitating growth and stability of IB. Participation banking is growing and gaining market share, albeit from a low base. The balance sheet structure of participation banks exposes the industry to standard banking risks such as credit, liquidity, exchange rate, group risk, cross border risks and to unique risks related to *Shari'ah* compliance and DCR. Meanwhile, progress has been slow in developing a regulatory and institutional framework as well as a consumer protection framework that caters to the specifics of IB.

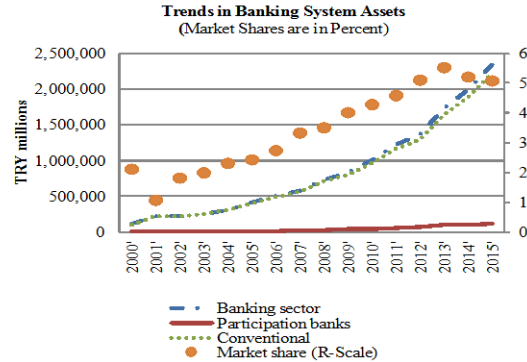
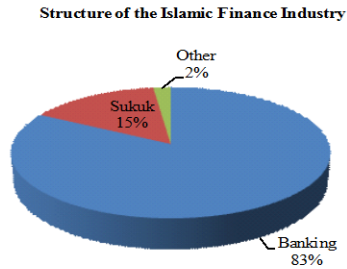
201. The growing presence of IB will need to be accompanied by the development of effective regulation and supervision and sound infrastructure, if the industry is to grow in a sound and stable manner. In particular, reforms are needed to:

- Enhance the regulatory framework for participation banks, including strengthening the consumer protection framework for less sophisticated IAHs, and the legal underpinnings for *Shari'ah* governance.
- Enhance the supervisory framework, including developing supervisory manuals, guidelines, and expertise to better supervise participation banks.
- Support consideration of international standards recommended by the IFSB and AAOIFI as additional sources of good practice.
- Strengthen the *Shari'ah* governance framework of banks, including ensuring consistency in rulings and integration of audit functions.
- Deepen the sovereign *Sukuk* market by regular issuance of tradable instruments at different maturities, including *Shari'ah*-compliant T-Bills, to provide liquid assets to participation banks and asset managers; and
- Increase financial awareness and literacy of Islamic products and services as part of the consumer protection framework.
- Strengthen the resolution framework for participation banks.

Figure 19. Turkey: Structure of the Islamic Finance Industry and Bank Balance Sheets

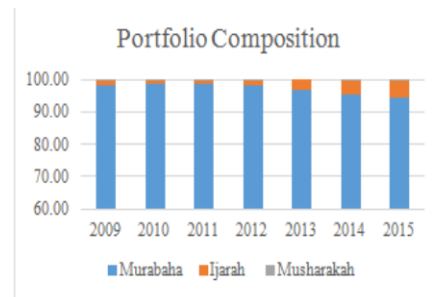
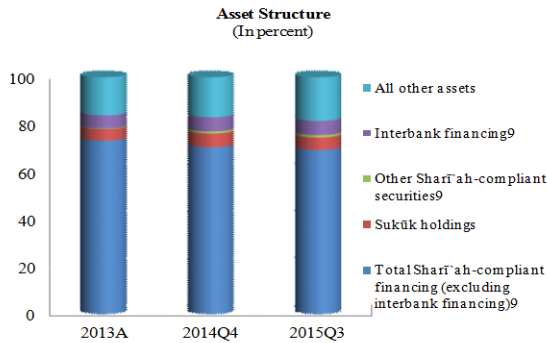
Turkey's **participation** finance industry is limited in breadth and dominated by the banking sector.

Participation banks have registered rapid growth, particularly after the GFC but the growth has tapered down after 2013.



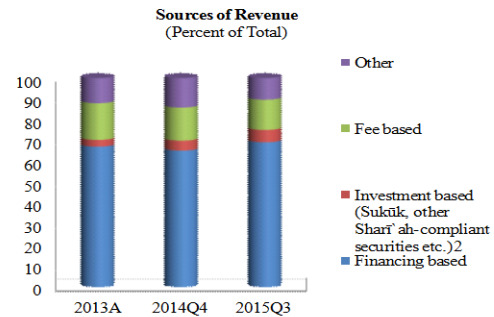
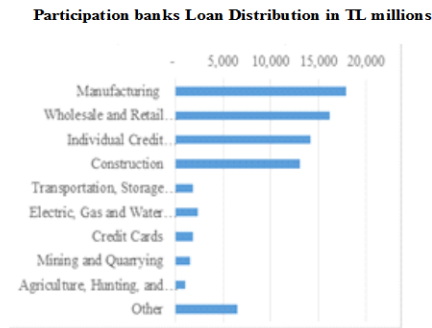
PB assets are concentrated in financing items, while investments currently account for a minute share.

PB financing mainly comprises of Murabaha while Ijarah has increased from a low base.



The financing is mostly to manufacturing, wholesale and retail, households and construction.

Financing is the major source of revenue, mirroring the balance sheet structure.

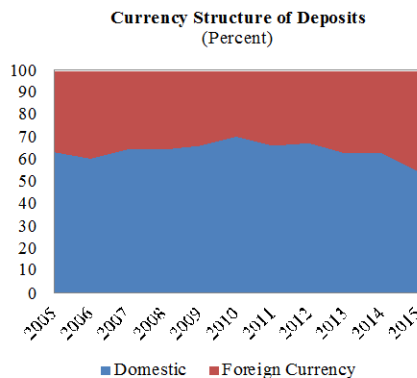
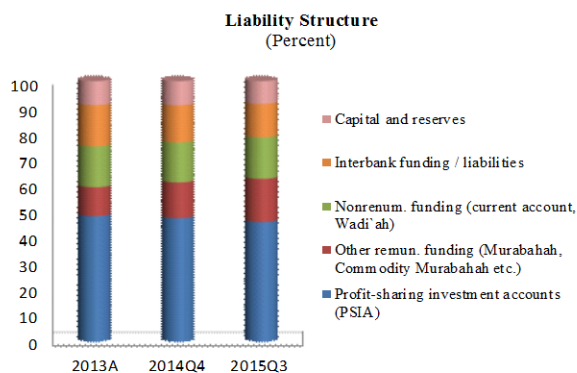


Sources: Banking Regulation and Supervision Agency; and BRSA and IFSB.

Figure 20. Turkey: Sources of Funding and Islamic Banks' Performance

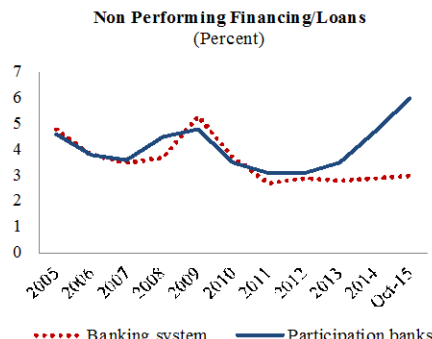
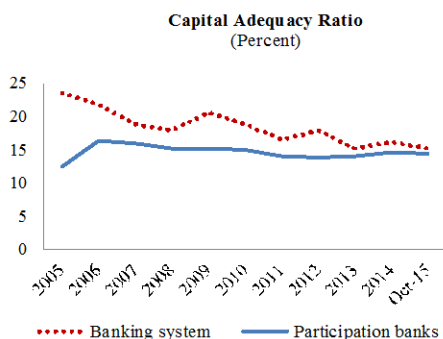
Participation banks largely rely on PSIA for funding.

And while most funding is in local currency, the exchange rate depreciation has induced a shift in favor of foreign currency.



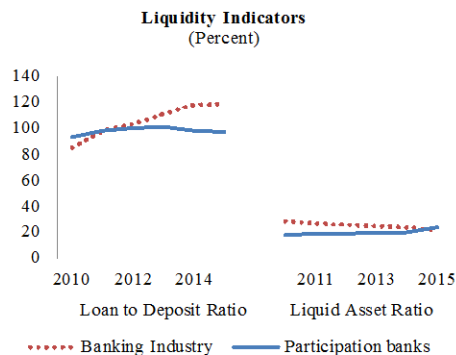
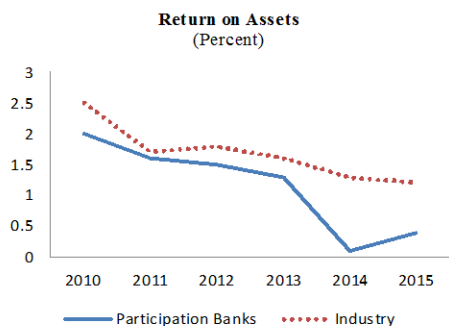
Participation banks capital is high but lower than industry average.

And asset quality is weaker and has deteriorated further.



Participation banks have been less profitable.

Liquidity is tight.



Sources: BRSA, IFSB and IMF Staff Calculations.

UNITED KINGDOM (UK)³³

A. Overview of the Islamic Finance Industry

202. Islamic financial transactions began in the UK as early as the 1980s. To provide *Shari'ah*-compliant financial institutions from the Middle East and high net worth investors with liquidity, significant commodity *Murabahah* transactions were conducted on the London Metal Exchange (LME) as early as the 1980s (Financial Services Authority (FSA), 2007). As the demand for IF increased, global market players in banking started developing *Shari'ah*-compliant retail products, a process that was aided by English law being the preferred legal jurisdiction for many Islamic contracts.

203. Supportive fiscal policies in the UK have broadened the market for IF products. Most of the growth in IF took place after the introduction of a series of Finance Acts as of 2003, in line with the FSA's view of "No obstacles, but no special favors" (FSA, 2007). Since Islamic mortgages attract double stamp duties (on the purchase of property by the bank and its transfer thereafter to the customer), government legislation removed the double tax anomaly. It also extended tax relief on Islamic products putting them on the same footing as conventional transactions, and reformed arrangements for *Sukuk* issues (FSA, 2007).

204. The development of the industry was also spurred by cross-cutting expertise in IF in different supporting areas. As common law provides a flexible framework for Islamic financial contracts and because it raises the likelihood of enforceability by the courts, a large number (25) of international legal advisory firms in the UK have established dedicated IF units (TheCityUK, 2015). The UK's largest accounting and professional service firms also provide expertise in all areas of IF. Further, the UK is the largest provider of education and training in IF in the world, offering a wide range of academic courses and professional qualifications.

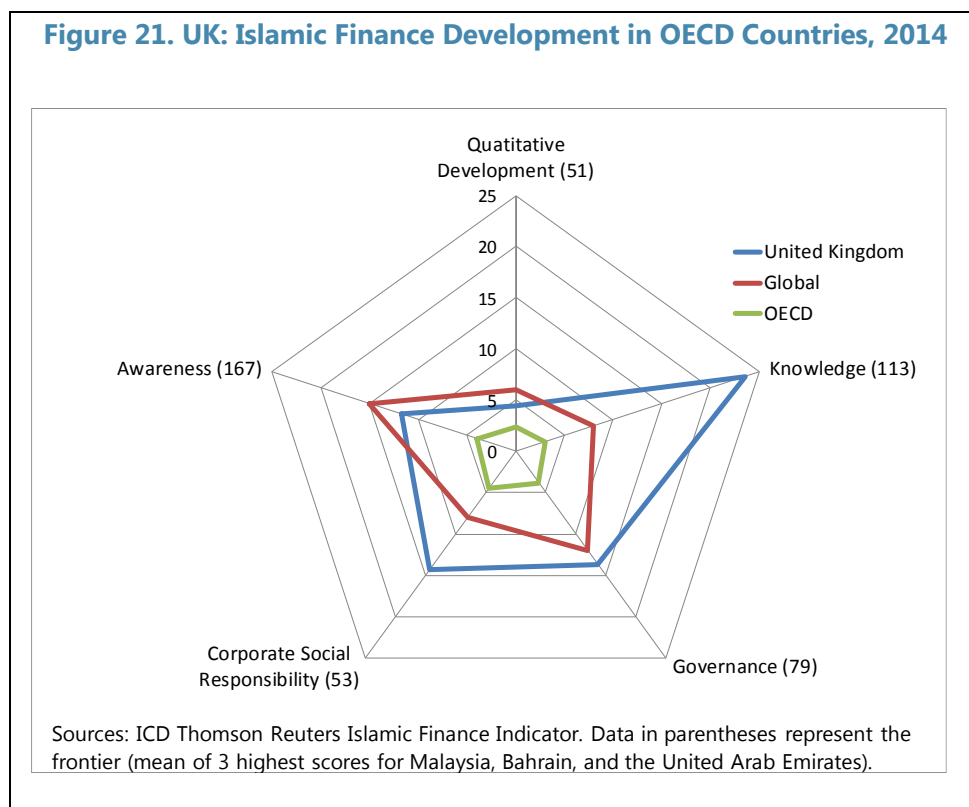
205. With its tradition for openness and flexibility, the government established an IF Task Force in March 2013 and the Bank of England (BoE) has recently joined the IFSB. The IF task force aims to consolidate London's status as the Western hub for IF by showcasing the UK as the preferred choice for the Muslim world to invest in and do business with (UK Trade and Investment, 2014). Its mandate includes supporting development of the UK's IF sector, increasing inward investment, and strengthening the economy. In December 2015, the BoE became the second regulator after Luxembourg from the Western Hemisphere to join the IFSB as member.

B. Recent Developments

206. The UK is the leading center for IF among OECD countries. The IF industry in the UK estimated at \$4.5 billion at end 2014 is small relative to the broader financial services sector and in comparison with global Islamic financial assets. Yet, the size of IF activity in the UK is largest among

³³ Prepared by Rima Turk.

all OECD countries (Bank of England (BoE), 2016). For nearly 40 years, the UK has been at the forefront of developing the IF industry among other developed economies, with major strengths residing in areas of knowledge, governance, corporate social responsibility, and awareness (Figure 21).



207. Assets of UK-based institutions offering IF services are concentrated in banking. IFIs in the UK offer a wide range of *Shari'ah*-compliant retail products, wholesale finance, and infrastructure development. With 5 fully-fledged IBs and 22 Islamic windows, total IB assets represent \$3.6 billion or 80 percent of assets of institutions offering Islamic financial services in the UK (TheCityUK, 2015). In 2015, asset growth of IBs exceeded 30 percent, compared with a decline of 0.7 percent for conventional banks (Table 2).

208. Headline financial ratios vary across Islamic and conventional banks, reflecting their different business models (Table 1). Higher lending spreads for Islamic than for conventional banks translate into higher net interest margin. These spreads may reflect higher credit risk, larger borrowing costs, or lower competition in the IF industry. Also, IBs have higher loan-to-deposit ratios but their overall profitability is lower than that of conventional, in part due to lower cost efficiency.

209. The London Stock Exchange (LSE) is also a global center for the issuance of *Sukuk* and for the listing of Islamic funds. The first *Sukuk* was listed on the LSE in July 2006 (FSA, 2007) and 10 years later the *Sukuk* market surpassed \$51 billion with 57 issues. The UK government also helped Airbus and Emirates with a world-first in aircraft *Sukuk* financing of \$913 million (UK Export

Finance, 2015). Other financial instruments also listed on the LSE include seven *Shari'ah*-compliant Exchange Traded Funds and two *Shari'ah*-compliant Exchange Traded Products (ICD Thomson Reuters, 2015). Further, with the establishment of the Islamic Insurance Association of London, the *Takaful* industry in the UK is likely to play a more prominent role within the global *Shari'ah*-compliant insurance market.

Table 2. UK: Key Financial Ratios for Islamic Banking

Key Financial Ratios for Islamic Banks, 2015			
	Ratio (in percent)	Islamic Banks	Conventional Banks
Growth	Growth of Total Assets	31.4	-0.7
	Growth of Gross Loans	48.9	-2.0
Credit Risk	Lending-Deposit Spread	3.7	2.9
Asset Quality	Reserves for Impaired Loans / Gross Loans	2.0	
	Loan Impairment Charges / Average Gross Loans	1.1	
Liquidity	Loans / Customer Deposits	195.7	85.8
	Interbank Assets / Interbank Liabilities	19.2	
	Customer Deposits / Total Funding excl Derivs.	54.8	
Capital Adequacy	Tangible Common Equity / Tangible Assets	14.3	
	Total Regulatory Capital Ratio	36.1	17.9
	Equity / Total Assets	14.9	6.3
Profitability	Net Interest Income / Average Earning Assets	4.2	1.0
	Non-Interest Expense / Gross Revenues	74.6	62.3
	Return on Average Equity	3.0	6.7
	Return on Average Assets	0.3	0.4

Sources: Bank of England, Fitch, and IMF Financial Soundness Indicators (FSI).

210. The UK is the first country outside the Islamic world to issue sovereign *Sukuk*. To cement its position as the leading western hub in IF, the government raised £200 million in 2014 through *Sukuk* (HM Treasury, 2014). The issue was heavily oversubscribed with orders totaling around £2.3 billion and participation from Asia, Middle East, and the UK. Investors included sovereign wealth funds, central banks and domestic and international financial institutions. The *Sukuk* is underpinned by three central government properties and has the most common structure of *Ijarah*, offering a profit rate of 2.036% in line with the yield on gilts of similar maturity.

C. The Regulatory and Supervisory Framework

211. There is a single integrated regulatory framework that applies to all banks, with provisions specific to IB. Consistent with principles to facilitate innovation and reduce barriers to entry or expansion, the 2000 Financial Services and Markets Act allows for the establishment of IBs (FSA, 2007). Both Islamic and conventional bank activities in the UK are regulated and supervised by the banking/financial regulatory and supervisory authority within a flexible but secular unitary framework.

212. The regulatory framework also aims at providing consumers using IB services the same protection as other consumers. All regulated firms in the UK are subject to the same set of conduct and product disclosure rules. Whereas the regulator does not provide guidance on *Shari'ah* principles and compliance, it requires disclosure of all material information, including explanation of the Islamic products and associated risks. In particular, the basis on which a financial institution is *Shari'ah*-compliant should be communicated appropriately to consumers (BoE, 2016). For scholars serving on SSBs, the supervisor examines factors such as the governance structure, reporting lines, fee structure, and terms and conditions of their contracts rather than their suitability (FSA, 2007).

213. The Basel capital framework (implemented in the EU under the Capital Requirements Directive) applies to all banks alike in the UK. There is no distinction between the capital requirements that apply to IBs and CBs. Also, the UK regulatory framework does not require the use of the IFSB formula in the calculation of the CAR of the IBs. Instead, IBs are required to hold capital against assets financed by demand deposit accounts. PER are considered eligible capital for regulatory capital adequacy requirements.

214. In its endeavor to level the playing field for all financial firms, the BoE is assessing the feasibility of establishing a *Shari'ah*-compliant central bank liquidity facility. Liquidity requirements for all banks, including IBs, are defined in the UK regulatory framework as part of the Delegated Act to the LCR (BoE, 2014). Recognizing the challenge for IBs to meet the liquid asset buffer requirement of Basel III rules, the BoE recently published a consultation paper on the feasibility of establishing a *Shari'ah*-compliant central bank liquidity facility (BoE, 2016). It is first focusing on setting a *Shari'ah*-compliant deposit facility with potential incorporation of liquidity insurance, thereby broadening liquidity insurance provision to a wider range of market participants.

215. The AML/CFT regulatory framework for IB activities is similar to the one prevailing for conventional banks. There is no difference between money laundering / terrorism financing risks of Islamic versus conventional banks in the UK.

D. Conclusions and Policy Issues

216. The UK is the leading western hub for IF. The UK has a long-standing tradition providing cross-cutting expertise in all areas of IF, from the provision of legal advisory and accounting services to academic and professional qualifications. The IF Development Report (ICD Thomson Reuters, 2015) gives the UK an index value of 14, well above the global (OECD) average of 10 (4) and the highest ranking of any non-Muslim-majority country. The UK is host to a number of IFIs (operating either as fully-fledged entities or Islamic windows)—with assets representing a tiny fraction of the financial services industry albeit larger than any other OECD country. It is also a leading international exchange center for the listing of *Sukuk* and was the first Western country to issue a sovereign *Sukuk*. The UK has also actively looked at earmarking new and existing infrastructure demands to be financed by IF.

217. Industry growth is facilitated by a flexible but secular unitary framework that promotes a level-playing field among all financial institutions. The authorities have developed a

fiscal and regulatory framework that fosters the development of IF following a “No obstacles, but no special favors” policy. The government has reformed tax legislation to put Islamic financial transactions on the same footing as conventional ones. Consumer protection laws also mandate disclosure of material information on financial products and associated risks, similar to practices in the conventional segment of the industry. As a result, the development of *Shari’ah* standards in the UK is mainly market led and application of *Shari’ah* compliance standards must be transparent to all customers.

218. The BoE is taking the lead to establish *Shari’ah*-compliant central bank liquidity facilities. The BoE is assessing how to cater for the special liquidity needs of IFIs, which are currently unable to use its existing facilities. It is considering two possible *Shariah*-compliant models for each of deposit facility and liquidity insurance, with the decision on which model for the central bank deposit facility to be made soon.

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Annex I. Risk Profile of Islamic Banks

Unique Risks

Rate of Return Risk	<p>Rate of return risk arises because of unexpected changes in the market rate of return, which adversely affect a firm's earnings. In a conventional financial institution, returns are fixed; both the firm and fund providers know in advance what their returns will be. In Islamic firms, returns are uncertain and investors share both profits and losses with the institution.</p> <p>Even though investors in Islamic products understand the risks of products that are based on PLS, they may react negatively — and possibly pull out their funds — if a firm's returns are lower than market benchmark rates. When market benchmarks increase, an Islamic institution feels pressure to provide more returns than its asset earnings alone may merit.</p> <p>If the firm fails to respond to the market rate increase, that failure may lead to liquidity risk (because customers may withdraw funds too rapidly). If it responds to the market pressure, it creates displaced commercial risk and must take the steps outlined in the preceding section</p>
Shari'ah non-compliance risk	<p>Shari'ah compliance is the reason Islamic financial institutions exist. If a firm isn't adhering to Shari'ah principles and guidelines, the impact can be severe. If one or more Islamic scholars indicate that an Islamic firm is veering away from compliance, its reputation will sink</p>
Displaced Commercial Risk	<p>Islamic financial institutions don't provide fixed returns in exchange for their customers' deposits or investments. Instead, people who provide funds expect to share profits and losses with the firm.</p> <p>The shared-risk-and-reward scenario is nice in theory, but in practice, investors expect returns! If they don't get them, they may move their money to OFIs. This becomes more likely as more IBs and other firms enter the marketplace and Shari'ah -compliant customers' options increase.</p> <p>As a result, Islamic firms face displaced commercial risk; they're forced to pay returns to fund providers even if the underlying assets don't earn profits. The financial</p>

	institution must smooth out what may otherwise be a bumpy road for depositors and investors.
Equity Investment Risks	Islamic financial firms offer instruments based on equity investments. The two contracts generally used for these instruments are <i>Mudarabah</i> (partnership) and <i>Musharakah</i> (joint venture partnership). Equity investment risk arises because of a potential decrease in the fair value of the equity position held by the Islamic firm
Generic Risks	
Credit Risk	Credit risk is the loss of income arising as a result of the counterparty's delay in payment on time or in full as contractually agreed. Such an eventuality can underlie all Islamic modes of finance. For example, credit risk in Murabaha contracts arises in the form of the counterparty defaulting in paying the debts in full and in time. In the case of profit-sharing modes of financing (like Mudaraba and Musharaka) the credit risk will be non-payment of the share of the bank by the entrepreneur when it is due.
Liquidity Risk	Liquidity risk arises from either difficulty in obtaining cash at reasonable cost from borrowings (funding liquidity risk) or sale of assets (asset liquidity risk). The liquidity risk arising from both sources is critical for Islamic banks. For a number of reasons, Islamic banks are prone to facing serious liquidity risks. First, there is a fiqh restriction on the securitization of the existing assets of Islamic banks, which are predominantly debt in nature. Second, because of slow development of financial instruments, Islamic banks are also unable to raise funds quickly from the markets. This problem becomes more serious because there is no inter-Islamic bank money market. Third, the lender of last resort (LoLR) provides emergency liquidity facility to banks whenever needed. Where the existing LLR facilities are based on interest, Islamic banks cannot benefit from these.
Market Risk	Market risk can take a variety of forms, including mark-up risk and commodity asset price risks. <i>Mark-up risk</i> Islamic financial institutions use a benchmark rate to price different financial instruments. For example, in a Murabaha contract the mark-up is determined by adding the risk premium to the benchmark rate (usually the LIBOR). The nature of a Murabaha is such that the mark-up is fixed for the duration of the contract. Consequently, if

	<p>the benchmark rate changes, the mark-up rates on these fixed income contracts cannot be adjusted. As a result, Islamic banks face risks arising from movements in market interest rate. Markup risk can also appear in profit-sharing modes of financing like <i>mudaraba</i> and <i>musharaka</i> as the profit-sharing ratio depends on, among other things, a benchmark rate like LIBOR.</p> <p>Commodity/asset price risk The <i>murabaha</i> price risk and commodity/asset price risk must be clearly distinguished. As pointed out, the basis of the mark-up price risk is changes in LIBOR. Furthermore, it arises as a result of the financing, not the trading process. In contrast to mark-up risk, commodity price risk arises as a result of the bank holding commodities or durable assets as in <i>Salam</i>, <i>Ijarah</i> and <i>Mudaraba/Musharaka</i>. Both the mark-up risk and commodity/asset price risk can exist in a single contract. For example, under leasing, the equipment itself is exposed to commodity price risk and the fixed or overdue rentals are exposed to mark-up risks.</p>
Operational Risk	<p>Operational risk is the 'risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and technology or from external events. Given the newness of Islamic banks, operational risk in terms of personal risk can be acute in these institutions. Operation risk in this respect particularly arises as the banks may not have enough qualified professionals (capacity and capability) to conduct the Islamic financial operations. Given the different nature of business, the computer software available in the market for conventional banks may not be appropriate for Islamic banks. This gives rise to system risks of developing and using informational technologies in Islamic banks.</p>
Other Issues	
Strategic	
Legal	<p>Legal risks for Islamic banks are also significant and arise for various reasons. First, as most countries have adopted either the common law or civil law framework, their legal systems do not have specific laws/statutes that support the unique features of Islamic financial products. For example, whereas Islamic banks' main activity is in trading (<i>Murabaha</i>) and investing in equities (<i>Musharaka</i> and <i>Mudaraba</i>), current banking law and regulations in most</p>

	<p>jurisdictions forbid commercial banks undertaking such activities. Second, non-standardization of contracts makes the whole process of negotiating different aspects of a transaction more difficult and costly. Financial institutions are not protected against risks that they cannot anticipate or that may not be enforceable. Use of standardized contracts can also make transactions easier to administer and monitor after the contract is signed. Finally, lack of Islamic courts that can enforce Islamic contracts increases the legal risks of using these contracts.</p>
Fiduciary	<p>Fiduciary risk can be caused by breach of contract by the Islamic bank. For example, the bank may not be able to comply fully with the Shari'ah requirements of various contracts. Inability to comply fully with Islamic Shari'ah either knowingly or unknowingly leads to a lack of confidence among the depositors and hence causes withdrawal of deposits. Similarly, a lower rate of return than the market can also introduce fiduciary risk, when depositors/investors interpret a low rate of return as breaching an investment contract or mismanagement of funds by the bank (AAOIFI, 1999).</p>