

Taking Islamic Finance to the Next Level: Key Challenges and Opportunities

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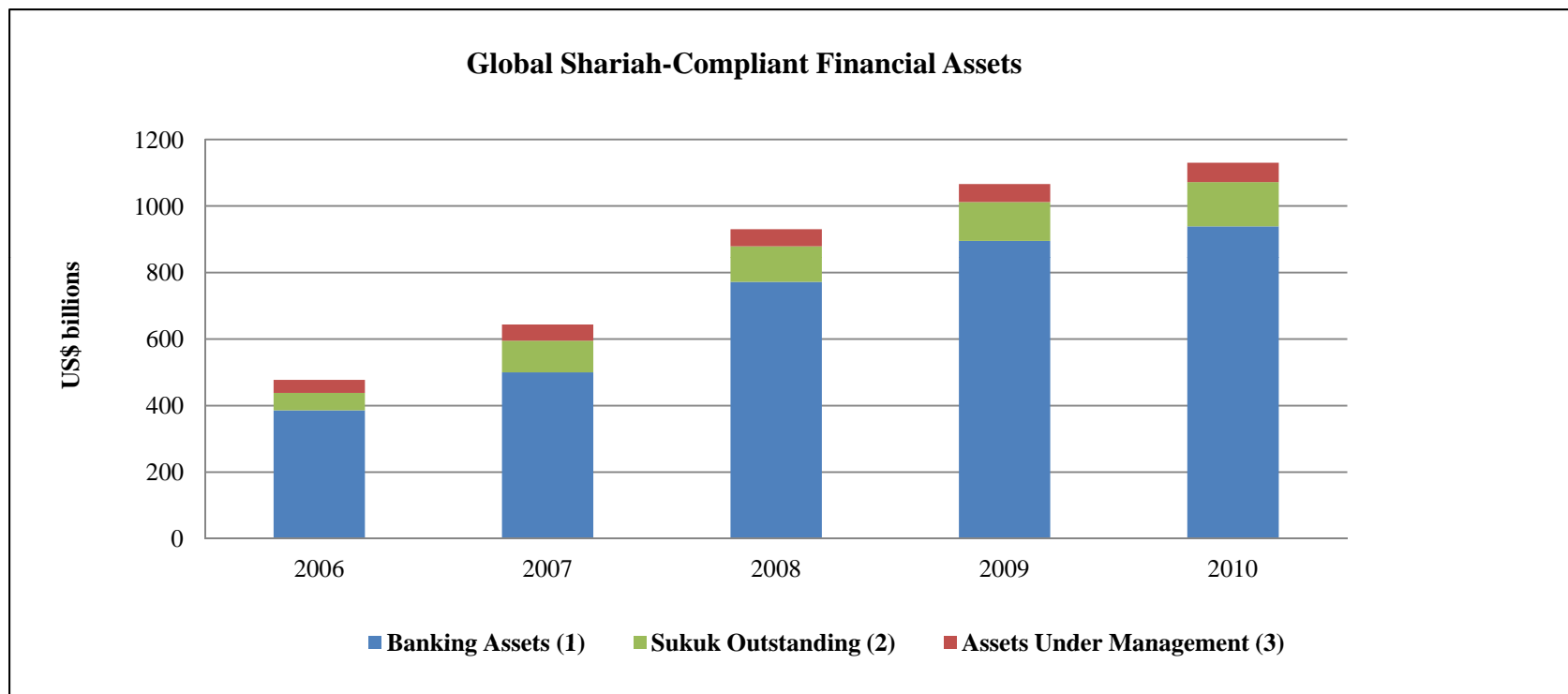
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Introduction

Key questions

- ❖ Where is Islamic finance today?
- ❖ What role can Islamic finance play in economic development?
- ❖ Where are the key opportunities?
- ❖ What are the main challenges?
- ❖ What is the contribution of the World Bank?

Islamic Finance Today

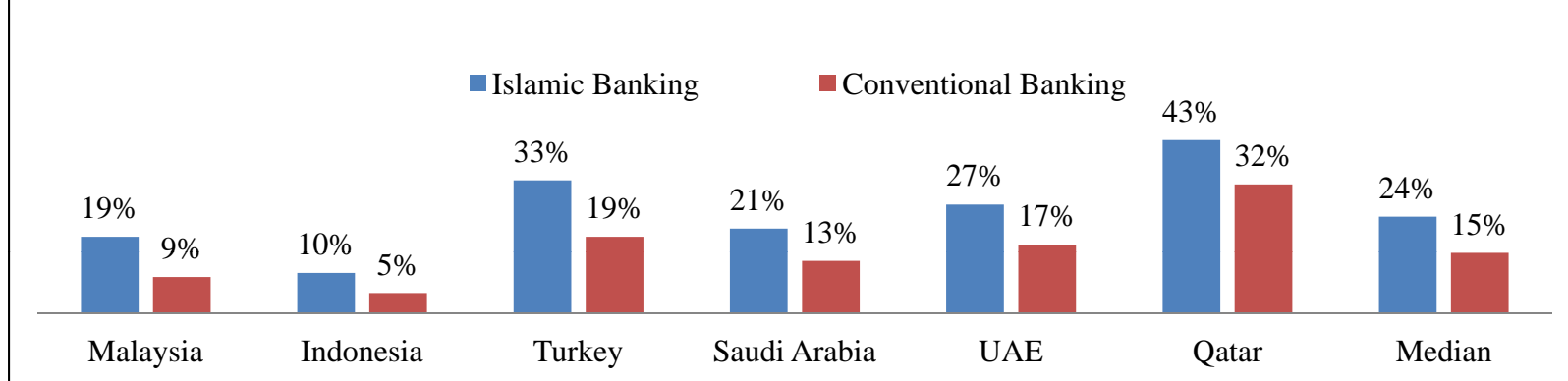


Sources: (1) Deutsche Bank 2010;(2) International Islamic Financial Markets database, March 2012; and (3) Ernst and Young 2011a.

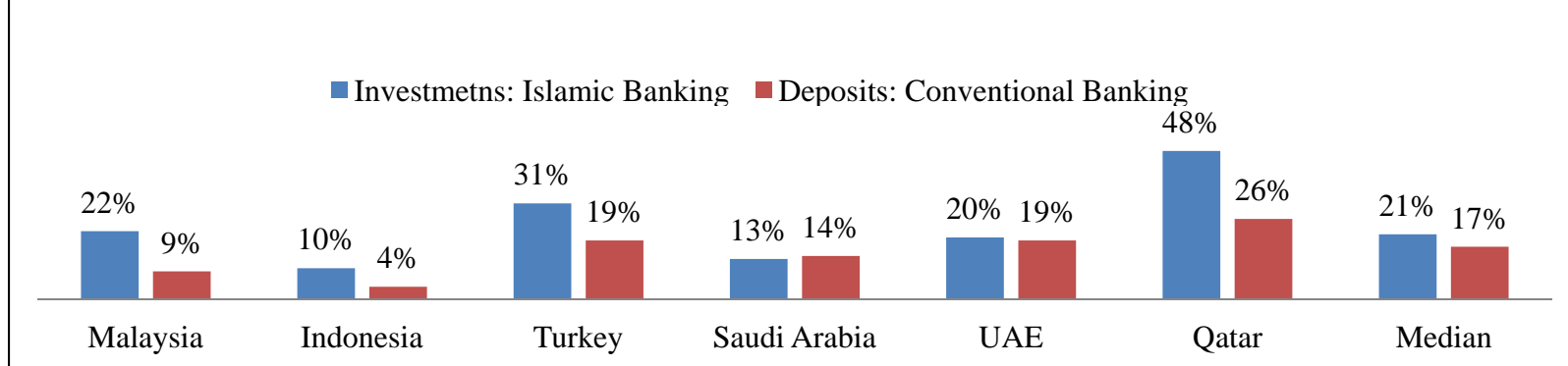


Islamic Finance Today

Growth of Islamic Banking and Conventional Banking Assets in Selected Countries (2006-2010)

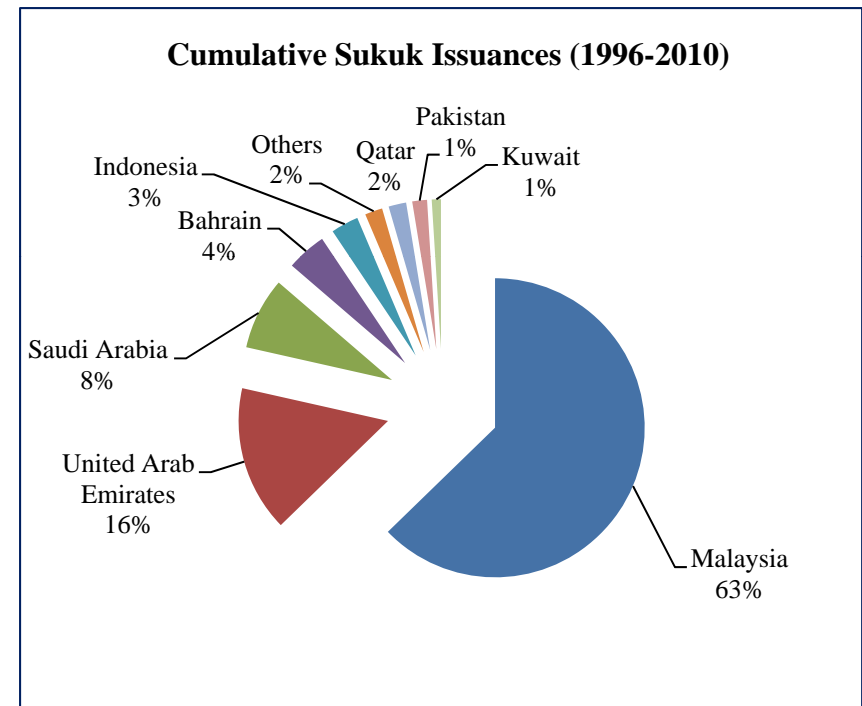
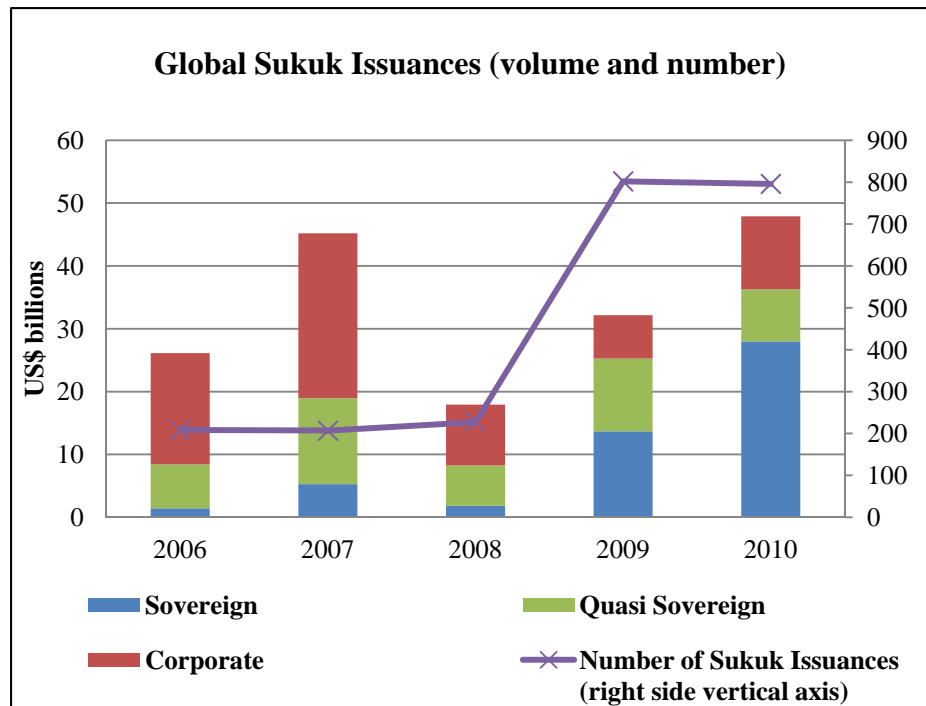


Growth of Islamic Banking and Conventional Banking Deposits in Selected Countries (2006-2010)




Source: Deutsche Bank 2011, 8.

Islamic Finance Today



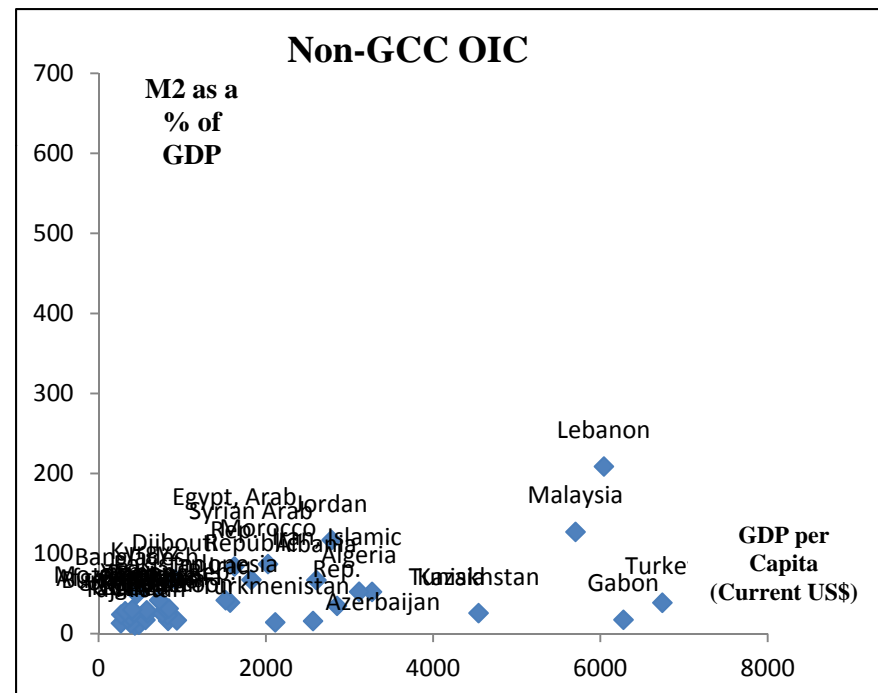
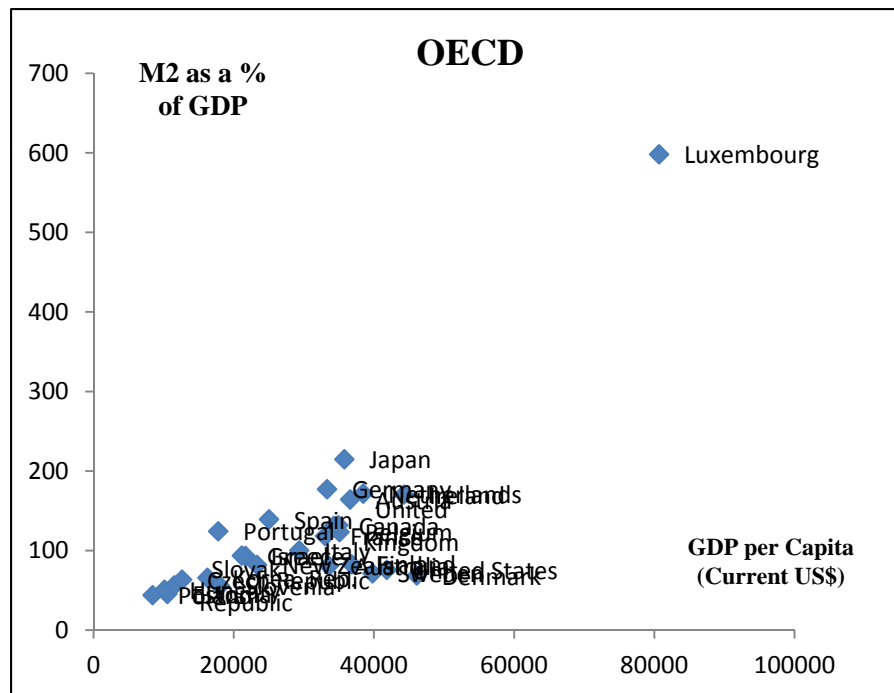
Source: Islamic Finance Information Services Database, October 2011.

The Role of Islamic Finance in Development

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- ❖ **Deepening financial intermediation**
 - ❖ **Enhancing financial inclusion**
 - ❖ **Strengthening financial stability**

The Role of Islamic Finance in Development

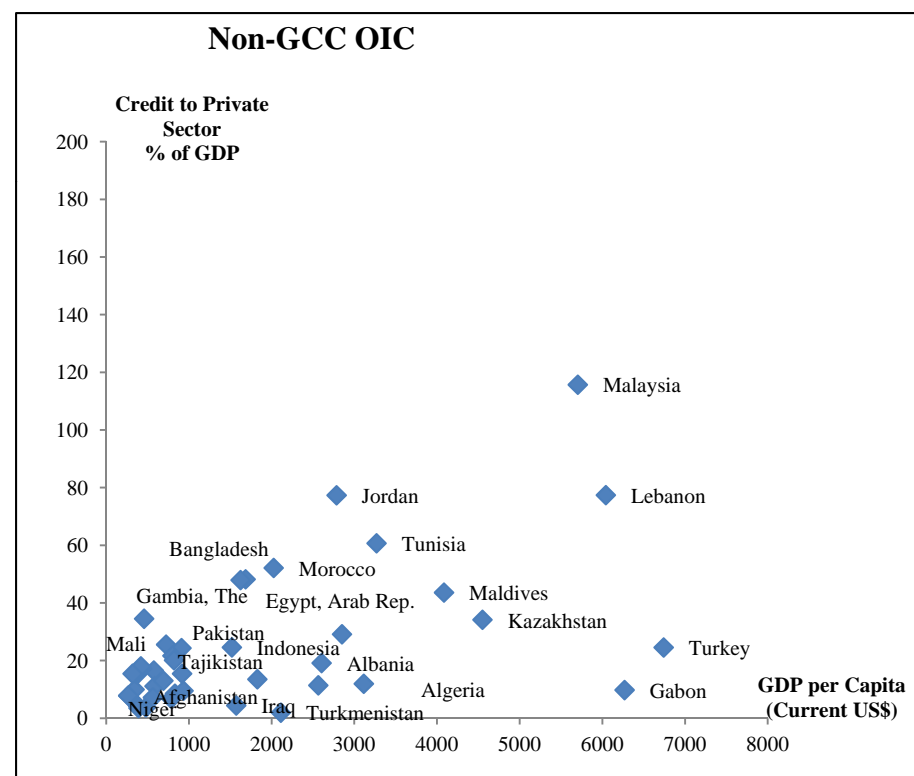
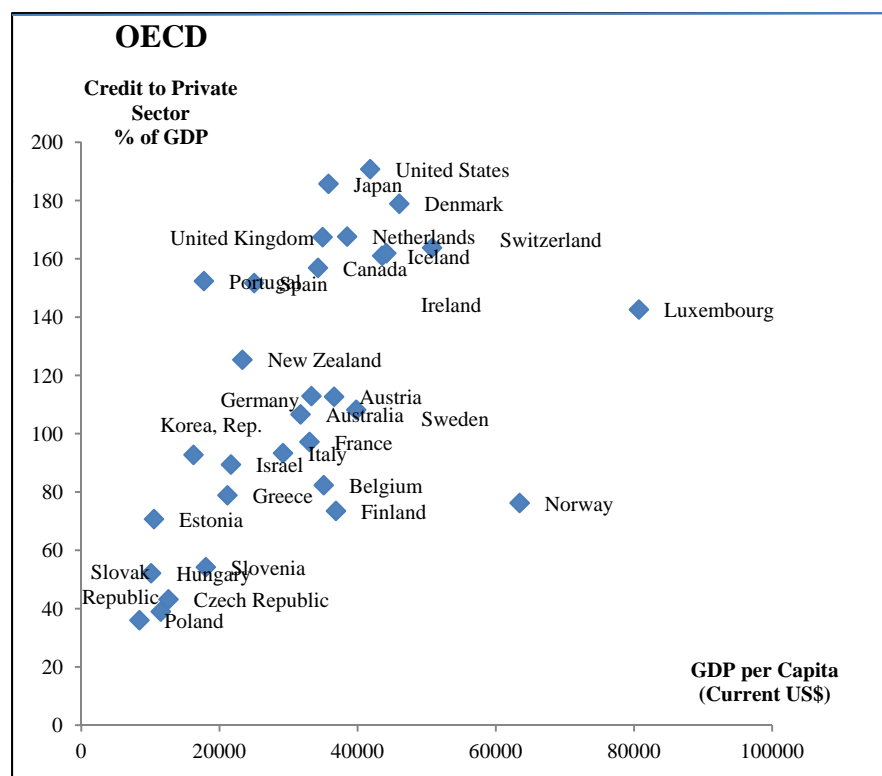
❖ Deepening financial intermediation (M2 as a share of GDP)



Source: World Development Indicators database, The World Bank, April 2012

The Role of Islamic Finance in Development

❖ Deepening financial intermediation (Credit to the Private Sector as a share of GDP)

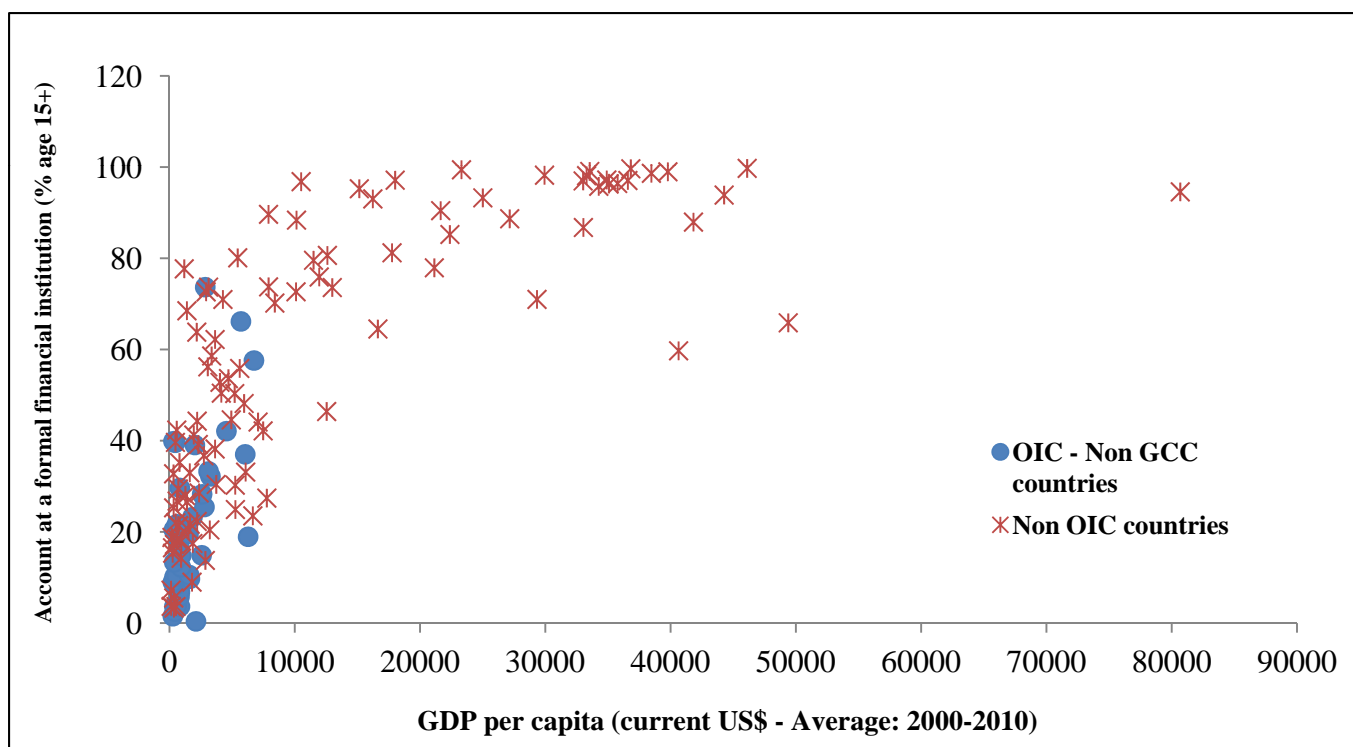


Source: World Development Indicators database, The World Bank, April 2012

The Role of Islamic Finance in Development



❖ Enhancing financial inclusion (Adults with an account at a formal institution)



Source: www.worldbank.org/globalindex, World Development Indicators database, The World Bank, April 2012

The Role of Islamic Finance in Development

❖ Enhancing financial inclusion

Economic development and growth, along with social justice, are the foundational elements of an Islamic economic system.

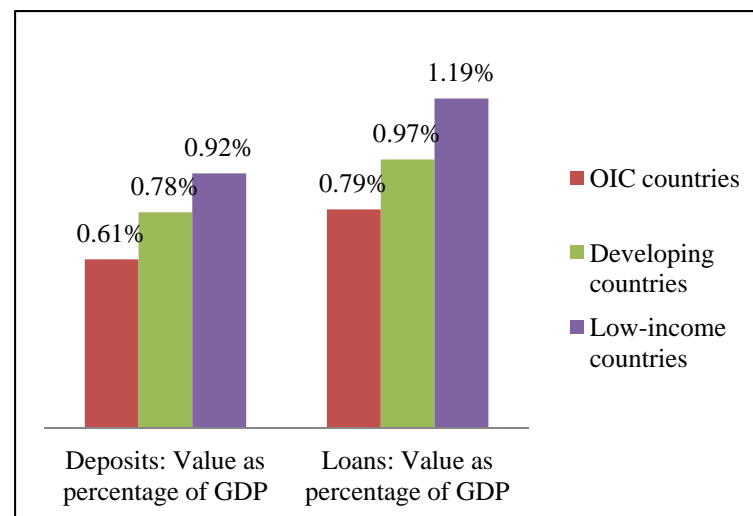
- *Zakat*
- *Sadaqat*
- *Qard-al-Hassan*
- *Waqf*

**Distributive
and Re-
Distribution
Institutions**

- Small-Medium Enterprises (SME)
- Micro-Finance (MF)
- Micro-Insurance (Micro-Takaful)

**Risk-Sharing
or Hybrid
Alternatives**

Limited scale of Microfinance deposits and loans



Source: Mohieldin et al., 2011.

The Role of Islamic Finance in Development

❖ Strengthening financial stability:

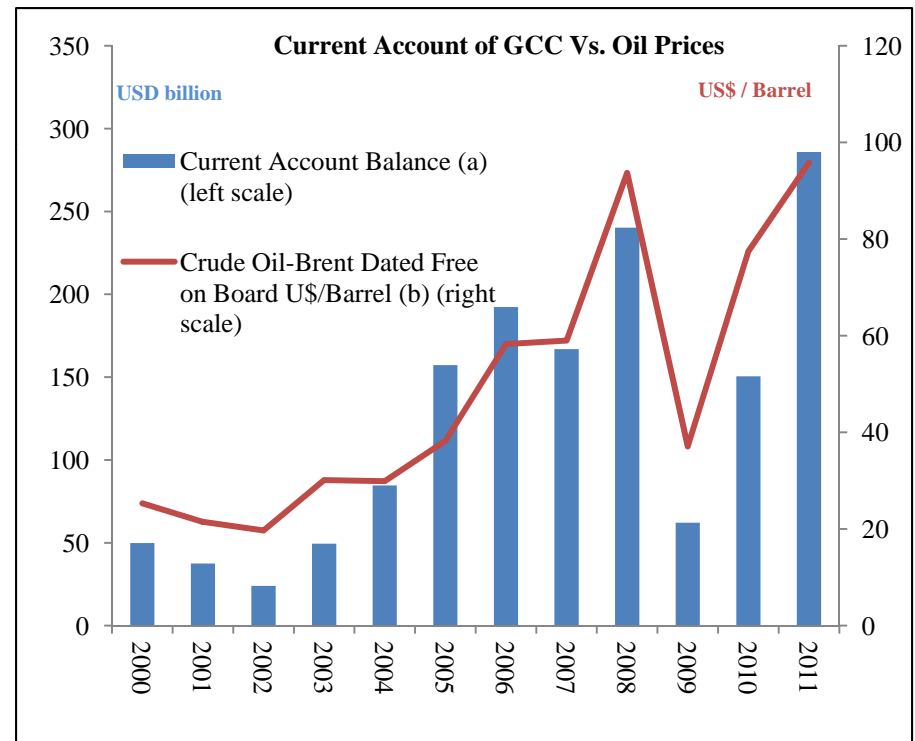
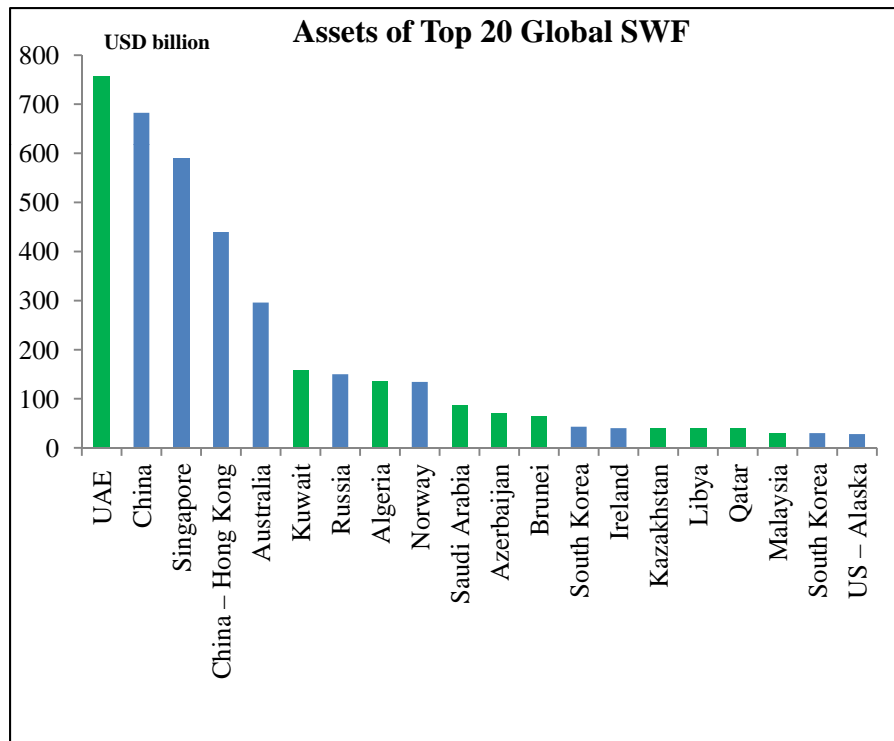
- Encourages its banks to have greater capitalization.
- Consistent evidence of higher capitalization of Islamic banks.
- Eliminates pure debt securities from the financial system.
- Calls for bank deposits to be collected on a profit/loss- (PLS) sharing basis rather than fixed predetermined liabilities.
- Ensures a close link between the real economy and financial sector.
- Affirms property rights and contract enforcement (honoring of debt obligations).
- Emphasizes principles of morality and ethics in business conduct.
- Advocates the sharing of risk and reward between the rich and poor.

Opportunities

- ❖ **Commodity boom**
- ❖ **Quality improvements**
- ❖ **Islamic finance windows at conventional financial institutions**
- ❖ **Shariah compliant indexes**

Opportunities

- ❖ The **commodity boom** has generated surpluses in some Muslim countries that need to be allocated through financial intermediaries and sovereign wealth funds.



Source: Sovereign Wealth Funds Institute, March 2012

Source: (a) Institute of International Finance database, April 2012, (b) Reuters.

Opportunities

❖ Quality improvements

- Quality has improved substantially over the years.
- New instruments have been developed.
- Islamic finance is increasingly being seen to offer practical alternatives to conventional instruments for savers and investors.

Opportunities

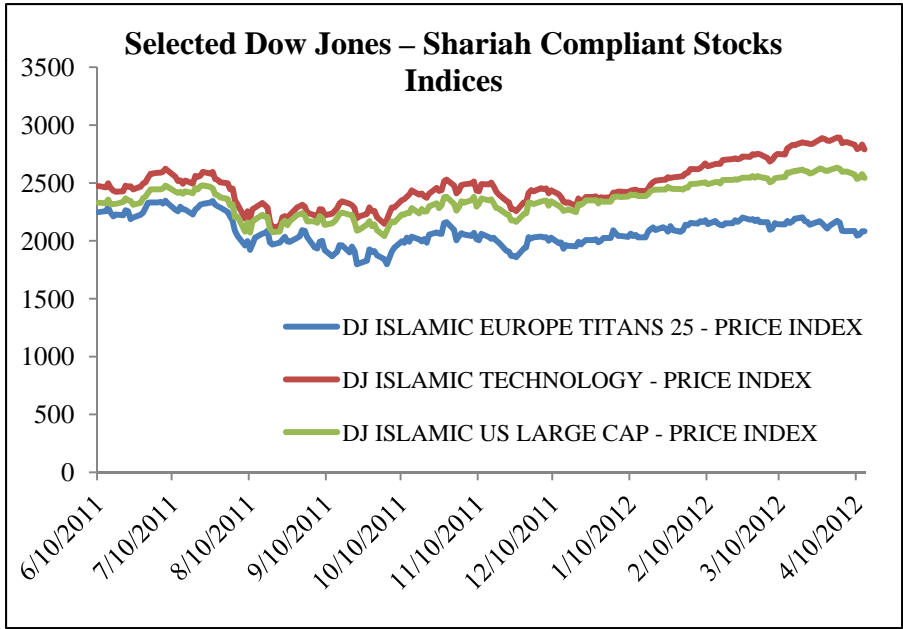
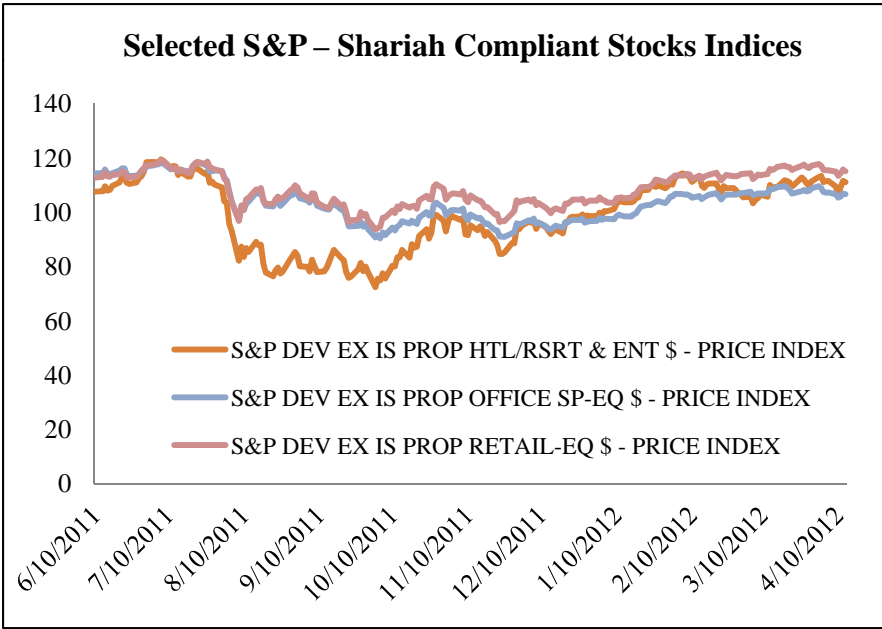
- ❖ **Conventional financial institutions are offering Islamic windows**
 - Over the past three years, ten major international conventional financial institutions have opened Islamic finance windows.
 - This translates into Islamic finance products potentially being available in an additional 44000 outlets/branches across more than 70 countries.

Opportunities

❖ Shariah compliant indexes



S&P INDICES → **33**

A NEWS CORPORATION COMPANY DOWJONES → **42**



Source: Reuters

Key Challenges

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- ❖ **Improving regulatory oversight**
 - ❖ **Rebalancing tax treatment**
 - ❖ **Strengthening insolvency frameworks**
 - ❖ **Promoting standardization**
 - ❖ **Ensuring adequate liquidity for long term financing**
 - ❖ **Establishing sound risk-management practices**
- 

Key Challenges

❖ Improving regulatory oversight:

- Progress needs to be made on improving the regulatory framework and strengthen regulations.
- International experience points to two approaches:
 - ✓ Minimal alterations: United Kingdom
 - ✓ Dual approach: Bahrain and Oman
- Consensus remains to be established on a widely accepted and comprehensive risk based supervisory approach , essential for mitigating the risk of systemic failures.

Key Challenges

❖ Rebalancing tax treatment:

- Conventional debt often receives advantageous tax treatment (encouraging leverage), while some Islamic finance products face double taxation.
- Malaysia and Thailand took fundamental steps to ensure that Islamic financial transactions operate on a level playing field:
 - ✓ In Malaysia, this principle has extended to ensuring that profits, asset transfers, and expatriation of profits by foreigners are treated equally, whether occurring under conventional or Islamic financial contracts.
 - ✓ In Thailand, a package of proposed tax changes for Sukuk issuances is making its way through the legislative process to address the main hurdles faced by Sukuk issuers.

Key Challenges

❖ **Strengthening insolvency frameworks:**

- More work is needed to ensure convergence between best insolvency practices on the conventional and Shariah-compliant sides.
- The need to establish reliable mechanisms for dealing with Sukuk defaults, and addressing adverse outcomes, with special adaptations for risk sharing.
- Setting up these mechanisms requires the specification of parties' rights under Shariah-compliant finance, especially in the case of cross-border transactions.

Key Challenges

❖ Promoting standardization:

- Lack of standardization and cohesion, especially in sukuk products, hinders the growth potential of Islamic finance
- The industry would benefit from more widely accepted benchmarks and indices.
- Innovation and knowledge sharing between various market players are essential to facilitate the standardization and unification of global markets for Islamic financial products.

Key Challenges

❖ Ensuring adequate liquidity for long term financing:

- The divergence between fully guaranteed Sukuk by sponsors, partially guaranteed Sukuk, and those that are not covered by any guarantee.
- Uncommon and poor understanding of various Sukuk structures limits diversification and hinders growth potentials of the industry.

Key Challenges

❖ **Establishing sound risk-management practices:**

- Basel III compliance and concerns about liquidity risk management need to be addressed.
- Relying on equity-based finance, Islamic banks incur a higher cost of capital, since by definition they hold more equity than conventional banks.
- More work is needed to find a greater convergence on the rules governing risk weighting and the treatment of investment accounts in Islamic banks.

Contribution of the World Bank



- ❖ **Joining other MDBs in tapping Islamic financial markets**
- ❖ **Insolvency and Corporate governance frameworks**
- ❖ **Knowledge sharing and capacity building**

Contribution of the World Bank



❖ Tapping Islamic financial markets

- Financial products include the Multilateral Investment Guarantee Agency's (MIGA) transaction in Indonesia in FY11, using a murabaha instrument involving exposure of some US\$450 million to improve the quality of the mobile network and increase population coverage.
- MIGA also had a US\$ 427 million in guarantees supporting the construction of the Doraleh Container Terminal in Djibouti in 2007.
- The International Bank for Reconstruction and Development (IBRD) launched a five-year RM760 million Islamic bond in 2005.
- International Finance Corporation (IFC) recently issued a US dollars-denominated 100 million - non-amortizing – Sukuk issue with a five-year maturity against a portfolio of leases which was well-received in the market.

Contribution of the World Bank



❖ **Insolvency and Corporate governance:**

- Collaborating with IFSB to establish widely accepted Principles for Effective Insolvency and Creditor Rights Systems – the essentials of an effective insolvency regime.
- The World Bank is in the process of finalizing the Supplemental Corporate Governance Guidelines for Islamic financial institutions .

Contribution of the World Bank



❖ Knowledge sharing and capacity building.

- Islamic Development Bank
- IFSB
- AAIOFI
- Collaboration with research centers and universities, including:
 - ✓ INCEIF
 - ✓ Oxford Center for Islamic Studies
 - ✓ Harvard – Islamic Finance Project – Islamic Legal Studies Program

Conclusion

- ❖ Within a relevant framework of regulations, standards and corporate governance, Islamic finance, based on its main principles and through continued investment in human capital can play an ever-more important role in ensuring broadened financial access to support sustainable development.

Thank You