DIVERSIFICATION OF ISLAMIC FINANCIAL INSTRUMENTS

PREPARED FOR THE

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Overall Structure of the Report

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a. Islamic banking

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Countries selected for Case studies:

1. **Nigeria**
2. **Indonesia**
3. **Pakistan**
4. **Sudan**
5. **Turkey**
6. **Bangladesh**
7. **Oman**
8. **Malaysia**
9. **Bahrain**
10. **The United Kingdom**

THE SELECTION OF 10 COUNTRIES FOR CASE STUDIES

Why chose these countries?

The main factors for our choice to include a particular country were:

- Geographical location
- At least one country that is not an OIC member state (UK) to be included
- New Entrant in the market-
- 100% Islamic Banking
- Product diversification in countries
- Availability of data.
- Presence of academic experts for the countries in our Research Team

Why chose these countries?

- The geographical diversity of the 10 countries selected:

Arab Group	Asian Group	African Group	Others
Bahrain	Malaysia, Turkey	Nigeria	United Kingdom
Oman, Sudan	Indonesia, Pakistan, Bangladesh		

- The following map depicts their different geographical locations

Our selected countries in the IFCI index 2016

ADJUSTED IFCI SCORES FOR 2016

Countries	2016	Countries	2016
Malaysia	77.77	Egypt	9.02
Iran	77.39	Turkey	8.95
Saudi Arabia	66.98	Jordan	7.98
United Arab Emirates	36.68	United Kingdom	5.96
Kuwait	35.51	Oman	5.91
Indonesia	24.21	Brunei Darussalam	5.85
Qatar	22.02	United States of America	3.28
Bahrain	21.90	Sri Lanka	2.96
Pakistan	18.89	Lebanon	2.67
Bangladesh	16.14	Nigeria	2.35
Sudan	14.04	Kenya	2.28

Different levels of Islamic finance presence in chosen countries

- Indonesia and Pakistan are OIC member countries home to the largest Muslim populations (respectively) in the world
- Malaysia and Bahrain are leaders in Islamic finance, and have shown some of the earliest developments in the three segments
- Pakistan, Turkey, Bangladesh, Sudan and UK were regarded as Potential Leaders in the Islamic finance world (IFCI indicator, 2015)
- The top ten Islamic banking jurisdictions by assets' in 2015 (IFSB) comprised of Iran, Saudi Arabia, Malaysia, UAE, Turkey, Bahrain, Bangladesh, Indonesia, Kuwait and Qatar, and we have selected five of these for our case studies.

COUNTRY SPECIFIC TAKEAWAYS,

CHALLENGES AND RECOMMENDATIONS

Nigeria

Suggestions	➢ Resolving the Inconsistency in the Regulatory Frameworks, Capacity Development, ➢ Develop more suitable products for the poor, ➢ Awareness programme to educate the public on Islamic Finance, ➢ Training the Shariah Board members on the fundamentals of Islamic Finance, ➢ Both Regulators and Practitioner should embrace Financial Engineering.

Nigeria

Challenges	➢ Lack of separate legal framework, ➢ Lack of viable liquidity management instruments for IFIs, Inconsistency in regulatory framework, ➢ General lack of adequate knowledge of Islamic finance on the part of both the Practitioners and the Regulators, ➢ Some Apathy or Skepticism by the general public ➢ Some shortage of Shariah Scholars who are also knowledgeable in conventional finance

Indonesia

Challenges	
Challenges	▪ Indonesia is a huge potential market for Islamic banking in particular. But, Indonesian Islamic banking asset market share is still very low (5.12% of Indonesian banking market share in 2016). Diversification of financial instruments might increase product innovation and hence hopefully more participants in Islamic banking industry. ▪ Poor connection between Fatwa produced by A) National Shariah Council of Indonesian Ulama Council (DSN – MUI), B) the regulator Bank Indonesia and Otoritas Jasa Keuangan (OJK) . To adopt fatwa by DSN MUI is optional since DSN MUI is not part of regulator. ▪ There appeared to be some complacency in the Islamic finance industry in Indonesia , in terms of lesser innovation for new products using various types of contracts

Indonesia

Recommendations	Indonesian Islamic capital market is dominated by Sovereign Sukuk, largely uses Ijarah in its structure. Innovation using various types of contracts based on *Murabahah*, *Salam*, *Istisna'*, *Musharakah*, *Wakalah bi al-Istihmar*, and others in Sukuk structuring as in other jurisdictions can attract investors to buy Indonesian Sukuk. Creation of Takaful products and build distribution channels, services and sales management to increase the size of the industry. Development of the **micro-Takaful** aspect by exploring various types of contract such as *kafalah*, *mudarabah* and *musharakah* to capture the lower segment in Indonesian society.

Pakistan

Challenges	Lower **profitability** and **profit rates to depositors** of Islamic banks A need for **more sovereign Shariah compliant securities for the IFIs** Re-financing Scheme was offered by GoP in 2016 for renewable energy projects (over 50 MW), in wind, solar, biofuel etc. However, there should be an option for **Shariah compliant refinancing** A greater adaptation of international standards. At present, in Pakistan, 6 AAOIFI Shariah Standards (#s 3, 8, 9, 12, 13, 17) and 4 IFSB standards (# 1. 3. 4. 10) are implemented.

Pakistan

Main Challenge	CPEC presents a major challenge and opportunity for Islamic finance in Pakistan. With its over USD 50 billion projects for the next 15 years (at least) in infrastructure, energy, power, Gawadar airport development, transport etc. there is a need to develop and promote Shariah compliant financing modes.
Recommendations	There is a dire need for Re-Takaful facilities, particularly for General Takaful. More educational, professional trainings and awareness programs are needed, particularly for Takaful

Pakistan

Steps taken and Recommendations	3 Centers for Islamic finance established in 2015 (in Karachi, Lahore and Peshawar), and several certificate/degree programs/courses are now also offered in many universities, relating to Islamic finance. There is need for **greater financial inclusion**, particularly towards the SMEs, agricultural and the large unbanked population of Pakistan. More products need to be developed to cater to these segments. In terms of product diversification in Islamic banking segment, more saving account products could be developed to attract the young age group (15 – 24 years) towards Islamic banking. There is also a need for greater and successful adaptation of Fintech in Islamic banking products, e.g. greater technical training and adaptation of smart phone technology, data analytics, mobile banking, Meezan Upaisa etc.

Turkey

- Recommendations

- Turkey should establish a **central Shariah Advisory Board**.
- Great potential for Takaful in Turkey, but there are no separate regulatory framework in place.
- PBs can develop other modes of financing, such as ‘Mudharabah’ and ‘Musharakah’. 90% financing of PBs is ‘Murabaha’ based and this has created some misperceptions about the similarity between the operations of conventional and PBs among customers
- At present, deposit insurance clause is also applicable to PBs. PBs financing is based on the notion risk-sharing, provisions of such insurance can be in conflict with the Shariah

Sudan

- Suggestions

- Establishing specialized educational institutions for the different fields of Islamic finance.
- A challenge is to start adopting Fintech concepts and models in the Sudanese financial sector. Fintech startups should be encouraged in Sudan as new vehicles for financial inclusion.
- Slightly weak corporate Sukuk issuance at present. Encourage private sector to issue Sukuk.
- Further research about developing Waqf sector in Sudan through different Islamic financial instruments including *Sukuk* and equities.
- Establish and maintain a comprehensive official database for: banking, takaful, microfinance, sukuk, waqf, zakat (very important for research and decision making).

Bangladesh

Take away: 1) Legal infrastructure and guidelines for IFIs	Bangladesh Bank is a founding member of IFSB, Malaysia. Yet, no standard is made compulsory for the Islamic banks. Islamic legal infrastructure for IBs and Takaful firms is not adequate (only a guideline issued in 2009 for the Islamic banks) Hence, **a need for enactment of some new regulations for IFIs** Greater adaptation of international standards developed by IFSB and AAOIFI Need for Islamic banking act, Islamic financial institutions Act Takaful act etc.
2) Need for Shariah compliant sovereign instruments	The CB of Bangladesh needs Shariah compliant monetary policy instruments tools to manage the excess liquidity of the Islamic banks, takaful operators and other IFIs. A 7-member Working group at the central bank is studying the nature and methodologies of Sukuk issuances – may come with their recommendations in December 2017.
3)Establish National Shariah Board at the Central Bank	National Shariah Supervisory Board needed at CB to formulate necessary policies to guide and supervise the authorities. Also, Securities & Exchange commission should also acquire necessary expertise to frame policies to facilitate Islamic capital market with products.

Oman

Challenges and Recommendations

- The most dire need is of trained Human capital
- Develop the product base and market for Islamic capital market and Takaful in Oman
- Implement policies to create a level playing field for equities like products to compete fairly with debt-based instruments
- Investing in massive public education campaign, to familiarize the population with the benefits of stock market participation

Malaysia

Suggestions

- Ensure consumer protection especially in the Takaful industry
- Encourage more innovative products for SMEs
- Encourage technological innovation in areas such as Financial services, Mobile Banking, Distributed Database (Block chain), Asset Management, Payments &Financing, Security, Big Data, Loyalty & Rewards, Document Management using block chain, P2P, Crowd funding, Digital Wallets etc.
- However, simplify the products and services offering through the Fintech applications in Islamic banking, Takaful and Islamic Capital Market

Bahrain

Main challenges and suggestions	Bahrain's Islamic retail and wholesale banks are characterized by high asset concentration. Real estate/ construction exposure remains the highest. High **operating expenses and low profitability** of Islamic retail banks. **High ratio of nonperforming facilities (NPF)** at Islamic retail banks is an issue. [Implement policies to mitigate credit risks of banks' financing portfolios. Adopt more sophisticated credit scoring and risk management models. Advances in financial technology allow for assessing risk where banks have not been able to do so, based on non-traditional data and analyses, such as social media, phone records, satellite data and psychometric analysis.] To address the **lower profitability of Islamic retail banks**, attention must be given to controlling operating costs, including documentation and legal costs, and unlocking new investment avenues. The potential of Blockchain is noteworthy: Blockchain-enabled solutions are expected to eliminate significant components of banks' cost base, resulting in meaningful savings of up to 30-50%

Bahrain

Main challenges and suggestions	Financial technology can also boost the **penetration of Takaful companies, and** provide access to traditionally underserved markets, such as blue-collar workers. It can also improve profitability and pricing of risks There is a need to **broaden the base of issuers and investors of Sukuk, to** deepen Islamic capital market and reduce hydrocarbons/oil prices dependency. (Oman's debut retail Sukuk sets an example).There is also a need for innovation in Islamic capital markets to mobilize capital beyond Sukuk. Facilitate the listing of SMEs supported by Tamkeen, in order to provide a larger universe of equities for investment and bring new products and services to the Bourse (it will improve Bourse's competitiveness and appeal as well). To mitigate the sectorial concentration risk, the regulator can implement sector limits (regularly review) with reference to market studies and industry's best practices. [e.g. Precautionary thresholds can be introduced below the maximum limit; to necessitate reporting to regulatory authorities before concentration becomes excessively risky.]

United Kingdom

Suggestions

- **A more aggressive marketing and awareness campaign.**

With the increasing 'Islamophobia', the value system prevalent in Islamic banking needs to be further highlighted. Diversify the product range they offer currently to consumer segment. Long term sustainability can be derived from a **strong retail banking base**.

Also UK Islamic banks can **further diversify towards zakat and Waqf based products** through financial engineering to tap into the entrepreneurial and start-up businesses.

- UK is a leader in the innovations in **Sukuk**, and this contributes towards the knowledge economy UK is moving towards. In this regard, various types of Sukuk contracts based on *Murabahah*, *Salam*, *Istisna'*, *Musharakah*, *Wakalah bi al-Istihmar*, and others can be used in structuring Sukuk to attract investors.
- The **Takaful sector development** is lacking in the UK - need to build more awareness and distribution channels which can be done (initially) via the 'Windows model' by the existing Insurance providers.

GENERAL CHALLENGES AND RECOMMENDATIONS

Some common challenges for Islamic finance product diversification

- Lack of necessary human capital,
- Need for Shariah harmonization across jurisdictions,
- Regulatory evolution for financial innovation and challenges,
- Customer awareness and public awareness,
- Need for grater promotion of risk sharing,
- Greater product innovation for better financial inclusion
- Adaptation of Fintech

Common Recommendation

- Creation of an enabling regulatory environment by supporting consistent regulations and development of standards to promote risk IF.
- Establishment of Shariah Board in CB or SEC, or development of Takaful regulatory framework, when none is present
- Development and introduction of risk-sharing products and services instead of focusing on replication of conventional risk- transfer products.
- Move towards harmonization of Shariah governance standards and policies across different jurisdiction.
- Greater adaptation of international standards, e.g. AAOIFI and IFSB
- Expanding Islamic finance's reach to the lower income group of society. Also, product innovation for SMEs, agriculture, microfinance, unbanked segment etc.
- Development and training of human capital and literacy in Islamic finance.

Additional requirements noted in some jurisdictions

- Development of financial architecture and infrastructure – key elements include liquidity management instruments, rating and external credit assessment, statistics and information gathering, research and development, market micro structures, Shariah screening technologies, separate legal framework for IFIs etc.

Global policy recommendation: Legal infrastructure required:

- ✓ Separate Islamic Banking, Islamic Capital Markets and Takaful Law to allow for registering and operations of the companies.
- ✓ Taxation law to allow for a level playing field, or preferential treatment to Islamic financial products to incentivize the market players to move towards Islamic finance.
- ✓ Legal framework for dispute resolution and arbitration. In almost all Islamic finance jurisdictions there is a need for dispute resolution centers which are governed by the Islamic law.
- ✓ Develop a general Islamic bankruptcy framework for the corporate sector.

Suggestion for a global Shariah Governance framework:

- Shariah governance standards and framework should be incorporated in the Islamic financial law, allowing for similar standards for all financial institutions.
- There is a need to further develop Shariah governance standards at a global scale for the Takaful industry as well as the Islamic capital markets. AAOIFI and IFSB have already issued standards which need further global acceptability.
- Existence of an independent national Shariah body (in some jurisdictions) can help harmonize the Shariah rulings and minimize diversity of Fatwas that introduces legal and reputational risks.
- Separate Shariah boards at national level for each sector of Islamic finance, to ensure effective and efficient Shariah parameters and standards are defined per the needs of the specific sector.

Additionally

- ✓ There is a requirement of developing detailed standards for greater Shariah compliance disclosure. This is primarily needed since Islamic finance deals with faith, which is a crucial matter for human beings.

- ✓ The policy makers need to focus on developing rating standards which would help investors with information.
- ✓ At the public level, governments and regulators can take initiatives to establish educational, training and research institutions.
- ✓ Also, private Institutions - research and training institutions, advisory firms and trade associations can take the lead in developing ideas and acting as think-tanks to government and policy makers.

Incentives for more risk sharing instruments

- The low appetite for risk sharing products has led to higher reliance on certain financial instruments like Murabahah, and very low dependence on *Mudarabah* and *Musharakah*..
- These modes, and other instruments used in agriculture sector, which can be used by agrarian economies in OIC, like *Muzaraa'* and *Musaqah*, could be addressed by government policies through encouragement of these modes through tax exemptions or subsidies.

POLICY OPTIONS

5 main policy options summarized

Policy 1	Policy 2	Policy 3	Policy 4	Policy 5
Improving the architecture and legal infrastructure for Islamic finance	Improving a global Shariah governance framework	Islamic finance rating standards	Knowledge transfer among IF destinations	Strengthen human capital through creating/supporting programs

Improving the architecture and legal infrastructure for Islamic finance

- Improving the legal infrastructure for IFIs to operate in, for creating a better enabling environment for Islamic finance. This could include **separate taxation laws for IFIs**, introducing/revising Islamic banking Act or Takaful Act, development of an **Islamic bankruptcy framework** for the corporate sector, and introducing a **legal framework for dispute resolution** and arbitration.
- Development and introduction of more risk-sharing products and services instead of focusing on replication of conventional risk- -transfer products
- Establishment of national Shariah Boards in the central banks or Securities and Exchange commissions, where one doesn't exist
- More sovereign Shariah compliant instruments by the governments of the OIC member countries, to enable better management of the excess liquidity of Islamic financial institutions

Improving a global Shariah Governance framework

- Improving a global Shariah governance framework, through greater implementation and more harmonization of the Shariah governance standards across the different countries

Strengthening Human capital for Islamic finance in OIC member countries

- Development and training of human capital and literacy in Islamic finance- This is both to create better awareness of the products and Islamic finance principles for the consumers, and also specialized training through creating or supporting educational programs and trainings for the human resource development for IFIs. It can also include technical trainings in data analysis and technology for better adaptation of fintech into Islamic finance products.

THANK YOU