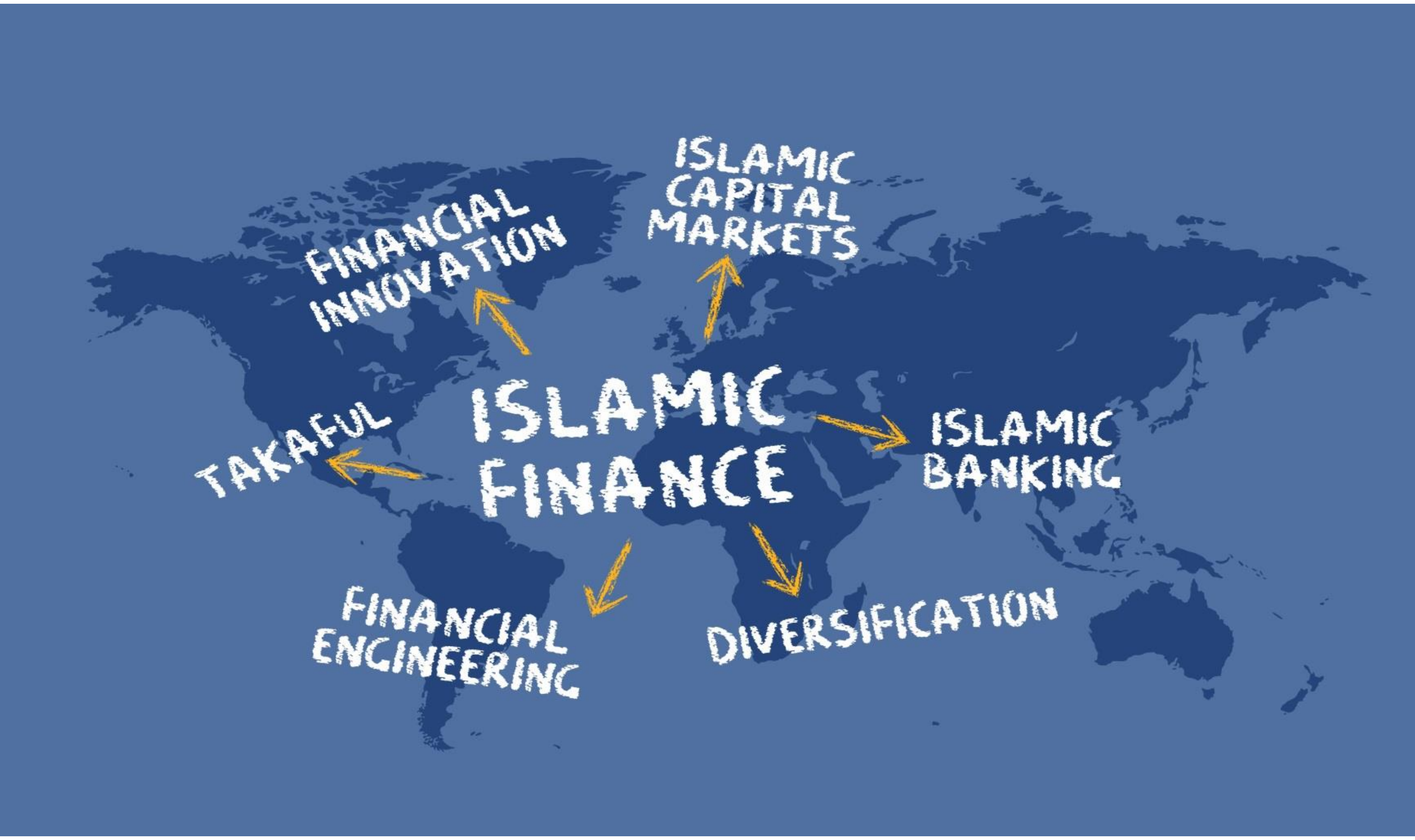
Standing Committee
for Economic and Commercial Cooperation
of the Organization of Islamic Cooperation (COMCEC)

Diversification of Islamic Financial Instruments



COMCEC COORDINATION OFFICE
October 2017

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ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
BNM	Bank Negara Malaysia
CBs	Central banks
CSR	Corporate Social Responsibility
Fintech	Financial technology
IBIs	Islamic banking institutions
ICM	Islamic Capital Markets
IDB	The Islamic Development Bank
IFIs	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
IIFM	International Islamic Financial Market
IMF	International Monetary Fund
MFIs	Micro finance institutions
MSME	Micro, small and medium enterprises
NBFIs	Non-banking financial institutions
OIC	Organization of Islamic Cooperation
P2P	Peer-to-peer lending
PBs	Participation banks
PLS	Profit and loss sharing
SBP	The State Bank of Pakistan
SEC	Securities and Exchange Commission
SMEs	Small and Medium Enterprises
SSB/SSC	Shariah Supervisory Board/ Shariah Supervisory Committee

EXECUTIVE SUMMARY

The growth of the global Islamic finance sector over the last decade has been steady and relatively fast, even with the economic challenges the world witnessed. These range from energy price crash, geopolitical conflicts, and exchange rate depreciations in many key Islamic finance markets, including Turkey, Malaysia and Indonesia, and an asset sell-off spree in emerging markets. This report takes the inquiry on Islamic finance a step further, as it deliberates on the different instruments and products that are prevalent in different countries.

The report structures the Islamic finance industry into three main components for the ease of analysis: Islamic banking segment, Islamic capital markets segment and the Islamic insurance or Takaful segment. Today, Islamic finance has an important presence in the OIC world as well as the non-OIC world. Different products based on the structures of Mudarabah, Musharakah, Ijarah, Wakala, Salam, Istisna, Qard-e-Hasan etc. and hybrid structures such as Diminishing Musharakah, Wakala-Waqf etc. are used across all three segments.

This study selects ten different countries covering the Arab, Asian and African Groups as Case Studies, and examines the different financial instruments, the best practices and the challenges in each of the three segments of Islamic finance.

As Chapter 2 highlights, despite the huge growth of the Islamic finance and banking industry over the past few years, the industry currently faces considerable challenges in product diversification. These include: lack of human capital, Shariah harmonization across jurisdictions, regulatory evolution for financial innovation and challenges, customer awareness and public awareness, promotion of risk sharing, greater product innovation for better financial inclusion and adaptation of Fintech, etc.

The Islamic financial sector in Nigeria (Chapter. 3.1) has high prospects of growth, though it needs a more developed architecture for development. Diversified products based on Qard-e-Hasan, Murabahah, Mudarabah and Ijarah dominate. Recommendations include specialized human capacity development programs for better product development and diversification, developing a separate legal framework for IFIs, an Islamic financial engineering training program from regulatory bodies (for better product development) and more attractive products targeting the low income groups.

In Indonesia (Chapter 3.2), Islamic banking has been commenced only in the 1990s. With the biggest Muslim population in the world, it has a promising Islamic banking market for global growth, but a greater adaptation of international financial standards as developed by IFSB and AAOIFI is recommended. The dominating structures in Indonesian Islamic banking are based on Murabahah financing, and it is recommended to encourage IFIs to offer equity-financing based on the principle of risk sharing to promote the development of the real economic sectors.

In Pakistan (Chapter 3.3), though Islamic banking commenced only in 2003, it dominates the Islamic finance industry and has shown a steady and impressive double digit growth compared to the conventional banking sector. However, even with and an impressive share in the consumer financing market, with Diminishing Musharakah and Murabahah-based financing products dominating, there is a need to encourage more equity-based products, and to increase Shariah compliant financing in infrastructure development, SMEs, agriculture and corporate project financing. There is also a need for more Shariah compliant securities for the liquidity management of IBIs, and more re-Takaful firms.

Chapter 3.4 focuses on Sudan, one of the only two main OIC member countries with a 100% Islamic banking industry. Murabahah, Musharakah and Muqawalah contracts dominate the Islamic banking products, and fixed income Sukuk products such as Government Musharakah Certificates, Government Investment Certificates, Central Bank Ijarah Certificates and Shariah compliant equities dominate the capital market.

Turkey (Chapter 3.5) witnessed the market share of Islamic banks (called Participation banking) and the volume of Sukuk issuances increasing significantly. However, Murabahah based banking products dominate, and there were only limited issuances of domestic corporate Sukuk. Also, even though there is a strong potential for Takaful products, Takaful only has a limited presence in the market.

In the Bangladesh (Chapter 3.6), it is recommended to initiate an extensive Islamic Financial Sector Reform Program to re-design the Islamic financial architecture, for the smooth development of Islamic banking and ICM instruments, in line with the international standards issued by AAOIFI and IFSB. Bangladesh's Takaful firms also face the challenge of a regulatory requirement to invest 30% of funds with government securities, when the CB's own Government Islamic Investment Bonds offer significantly less returns than the conventional market.

Oman (Chapter 3.7) had a relatively late entry to Islamic banking (2012), but the segment has already reached an impressive 10.2% market share. As a new entrant, it can potentially lay a strong foundation of risk sharing implemented through deliberate, slow and well-planned stage-wise products' design. The Takaful sector is minimal, and there is also a need for legal and regulatory bodies to become more informed about Islamic finance products.

The ICM, Islamic banking and Takaful industry in Malaysia (Chapter 3.8) has reached a comprehensive structure with great degree of product diversification, and a very impressive Islamic capital markets segment, though more products for SMEs and wealth management services can be offered. The Takaful industry can benefit from greater consumer protection, and all three segments can improve with greater Fintech solutions.

With specialized IFIs and strong government support, Bahrain (Chapter 3.9) has become a major hub in the global Islamic finance market, though it can also benefit from Fintech based platforms and Shariah compliant marketing strategies,

Chapter 4 explains policy recommendations for better Islamic finance product diversification in the OIC and non-OIC world. The Islamic financial architecture is not structured in the same way as conventional finance is: it's more focused towards being an intermediary offering banking and asset management services. The current model of Islamic finance which we are operating in is restricting the growth of the Islamic banking sector, as it is focused on replication of the conventional financing structure. Some of the challenges that Islamic banking faces which the policy makers need to address arise primarily of structural matters. These structural issues arise out of the prevalence of debt-based instruments and the aspirations of financing predominantly through equity and risk sharing, to the need for increased social capital, and the challenges of creating an enabling regulatory framework. This report dwells into the debate on that, from studying the case studies to have specific policy recommendations and strategies that the industry should follow. While the report gives specific policy recommendations for different countries, depending on the extent of Islamic finance sectors' growth in the country, some general policy recommendations that need to be followed globally for a shared prosperous and growth oriented financial society are:

a. Creation of an enabling regulatory environment by supporting consistent regulations and development of standards to promote risk sharing.
b. Development and introduction of risk-sharing products and services instead of focusing on replication of conventional risk- -transfer products
c. Move towards harmonization of Shariah governance standards and policies across different jurisdiction.
d. Expanding Islamic finance's reach to the lower income group of society.
e. Development and training of human capital and literacy in Islamic finance.

The report also emphasizes that as Shariah compliance is the unique differentiating factor of Islamic finance, there is an immediate need for having a global Shariah governance framework. It explains a need for greater transparency and disclosure in the financial reporting of IFIs, and also states that policy makers should focus on developing rating standards which would help investors with information on Islamic finance products. The need for adaptation of Fintech and product diversification to attract the different markets, from smart phone users to agricultural sector, SMEs, and low income groups is also emphasized.

INTRODUCTION

Globally, the Islamic finance industry has a total size of USD 1.893 trillion by June 2016 (IFSB report 2017) and is estimated to reach $3.2 trillion (or $6 trillion by some estimates) according to ICD Thomson Reuters Islamic Finance Development indicator. Though the whole industry is still only about 1% of the global finance industry and largely segregated in some jurisdictions, there is no doubt that it has witnessed consistent, profound growth in the past 30 years.

In terms of jurisdictions, Islamic finance is present in almost 90 countries across the globe, with about 50 Muslim countries. Iran and Sudan are two Muslim countries that operate wholly Shariah compliant banking systems. By the end of 2016, there were a total of 12 jurisdictions in which Islamic banking industry had a share of 15% or more in the whole banking industry. The major OIC jurisdictions also include Saudi Arabia, Bahrain, UAE and Malaysia (the leaders in the industry), Pakistan, Indonesia, Bangladesh, Jordan, Qatar, Bahrain, Kuwait, Turkey, Yemen, Brunei, Algeria, Azerbaijan, Kenya, Oman, Lebanon etc. Of these, Saudi Arabia, Malaysia, Yemen, Kuwait, Bangladesh and UAE have a substantial share (18 – 50%) of Islamic banking in their overall banking industry. More recently, countries such as Maldives, Palestine and Djibouti (in Africa) have also entered the landscape.

This study examines the different financial instruments and products used in the Islamic financial industry in different countries across the globe. The Islamic finance industry can be divided into (a) Islamic banking segment, (b) Islamic capital markets segment and (c) Islamic insurance or Takaful segment. Today, Islamic finance has an important presence in the largely Muslim OIC world as well as the non-OIC world. Different products based on the structures of Mudarabah, Musharakah, Ijarah, Wakala, Salam, Istisna, Qard-e-Hasan etc. and hybrid structures such as Diminishing Musharakah, Wakala-waqf etc. are used across all three segments.

The Islamic Finance Country Index (IFCI) splits the countries in four categories – a) Established Leaders in Islamic Finance (Malaysia, Iran and Saudi Arabia), b) the Emerging Leaders, c) the Potential Leaders and d) the Tail-enders. Geographically, the major countries in the Islamic finance world can be divided between those in the Arab Group, the Asian Group (including South and South East Asia), the African Group, and Others (such as Europe, North America etc.). This study selects ten different countries covering these groups and examines the different financial instruments, the best practices and the challenges in each of the three segments of Islamic finance.

Malaysia is selected from the Established Leaders, representing the Asian Group. Among the Emerging Leaders, Bahrain from the Arab Group and Indonesia from the Asian Group are selected. From the Potential Leaders, Sudan is selected from the Arab Group, Pakistan, Bangladesh and Turkey from the Asian Group, and the United Kingdom is selected representing the non-OIC member countries. Oman from the Arab group and Nigeria from the African Group make up the Tail-enders. Since Islamic finance is more dominant in terms of its size, development and history in the Asian countries, from Turkey in the west to Malaysia and Indonesia in the south-east, five of the selected ten countries fall in this region.

Table 1 Selected Countries in the Study

Established Leaders	Emerging Leaders	Potential Leaders	Tail Enders
Arab	**Asian**	**African**	**Non-OIC**
Bahrain	Malaysia	Nigeria	United Kingdom
Sudan	Indonesia		
Oman	Pakistan		
	Turkey		
	Bangladesh		

Source: GIFR 2016

United Kingdom in included in this Report as a representation of the Islamic finance industry in non-Muslim countries. As per the 2016 EY Islamic Finance report, the presence of Islamic banking, Islamic capital markets (particularly Sukuk) is very significant today in the international world in non-OIC member countries including UK, USA, China and Hong Kong, Singapore, Germany etc. The United Kingdom has a very significant Islamic banking and ICM market, and has had licensed Islamic banks since 2004. London is also recognized as one of the major financial hubs for the Islamic finance industry. Hence, it should be reflected on the overall Policy Recommendations and presentation of Islamic financial products' diversification used in the world today.

Other than this, the majority of the study focuses on the OIC world. More countries are selected from the Asian Group, as they have represented the global Islamic banking industry for a significantly longer time. **Nigeria** represents the African countries.

Pakistan, Malaysia, Indonesia, Turkey and **Bangladesh** are presented from the Asian group, as these countries show a fast growing Islamic banking industry, strong central bank support, and show significant presence of the capital markets and/or Takaful sectors The Islamic Finance Country Index (IFCI) marked Pakistan as one of the Potential Leaders in the Islamic finance industry – a list that also included Sudan, Bangladesh, Turkey and the United Kingdom.

Sudan, Oman and **Bahrain** represent the Arab Group. It was appropriate to include one case study from the two countries in the world (Iran and Sudan) that constitute a 100% Islamic banking market. Oman can be an example of an emerging Islamic banking and finance market with a fairly recent entry (2012) and a relatively strict approach to Islamic finance products. It also debuted issuance of Sukuk in 2015. Bahrain is one of the earliest entries into the Islamic banking, Takaful and capital markets industry with a well-developed framework, known for its Shariah compliance and product development. According to the IFSB Report 2016, the 'top ten Islamic banking jurisdictions by assets' 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.

Bahrain and **Indonesia** are also labelled as one of the Emerging Leaders in the Islamic financial industry (IFCI 2015). Indonesia, representing the Asian Group with Malaysia, Pakistan and Bangladesh, is also home to the largest Muslim population in the world (with Pakistan being second). Indonesia is also important in the Islamic capital markets industry (IIFM 2016 Sukuk Report), having had a total of 37 short-term Global Sukuk issues alone (till December 2015), compared to Pakistan's 8, Bahrain's 275 and Malaysia's 2231 issues.

According to the IFSB Sustainability Report 2017, Pakistan, Malaysia, Indonesia and **Bangladesh** were among the main contributors of Asia's share of total Islamic banking assets. Apart from Iran and Sudan, the IFSB 2016 report categorized Brunei, Qatar, Malaysia and Bangladesh as having a systemically important Islamic financial industry, having more than

15% share of Islamic banking asserts (as a percentage of total domestic banking assets). It also marks Pakistan and Bahrain as countries with over 10% share of Islamic banking assets.

In this Study, chapter 1 provides an overview of the global Islamic financial industry landscape, with Chapter 2 highlighting the Islamic banking, Islamic capital markets and Takaful segments separately. Chapter 3 then presents individual case studies of the above mentioned ten countries, examining the different products used in each of their Islamic banking, capital markets and Takaful segments, and highlighting the major takeaways and recommendations. Chapter 4 culminates with some policy recommendations for improving the Islamic financial industry product diversification in OIC member countries, non-OIC member countries and the major international Islamic financial institutions.

There are many different standard setters for these three main sectors of Islamic finance at the global level. Some of them are given below;

Table 2 Sectors of Islamic Finance at the Global level

Global Financial Industry	Standard Setter
Overall	Growth of Islamic Finance Assets (annual) as compared to conventional sector
Islamic banking	Share of Islamic Banking segment of an OIC member country as a percentage of the overall banking industry, measured in terms of a) Deposits and b) Assets
Islamic capital markets	Total Size of issued international and sovereign Sukuk issued (rated and non-rated).
Takaful	Size of total Takaful institutions' assets.

Source: Created by Author

Diversification of Islamic financial instruments refers to the different products (and their underlying contracts) that are available in a given economy, in the Islamic banking, Islamic capital markets and Takaful industries. For example, Islamic capital markets sector may include Shariah compliant funds, short term, medium term and long term Sukuk structures (based on Musharakah, or Ijarah etc.), Wakala-based asset management products etc. on The significance of this diversification can be understood in that a sector offering a multitude of diversified products, for example in Islamic banking, could mean that the sector is well developed, is competitive, and caters to the different needs of the savers, investors, SMEs, corporates, low income groups, regulators, bankers etc.

A general and brief glimpse of legal and regulatory environment that looks after the Islamic finance industry is:

Table 3. Legal and Regulatory Environment of Islamic Finance Industry

Islamic banking institutions	Islamic capital markets segment	Takaful institutions and Insurance companies with Window Takaful operations
Regulated by the Central Bank	Regulated by the Securities and Exchange commission	Regulated by the Securities and Exchange commission. In few countries by Central bank.
A Shariah Board at the Central Bank serves as the main national body for Shariah governance of Islamic banks	Many OIC member countries' Securities and Exchange Commissions have their own Shariah Boards.	

Source: Created by Author

1 GLOBAL OVERVIEW OF THE ISLAMIC FINANCIAL SYSTEM

Globally, the Islamic finance industry had a total size of USD 1.893 trillion by the end of 2016 (IFSB report 2017). However, the years 2016 and 2015 saw a relatively modest growth in the Islamic finance industry, noticeably lower than the double-digit growth rates of previous years. This was attributed[1] partially to low energy prices and economic growth rates, some geo-political conflicts, and in particular, to the exchange rate depreciations in many key Islamic finance markets, including Turkey, Malaysia and Indonesia.

The Islamic financial system can be divided into the Islamic banking, Islamic capital markets (including Sukuk) and the Takaful sectors. Islamic banking sector is by far the dominating segment in the international Islamic finance industry, representing about 78.9% of the overall Islamic financial services industry by June 2016 (IFSB May 2017). The global Takaful sector was estimated at USD 23.2 billion in size (2015). Though the whole industry is still only about 1% of the global finance industry and largely segregated in some jurisdictions, there is no doubt that it has witnessed consistent, profound growth in the past 30 years.

In terms of jurisdictions, Islamic finance is present in almost 90 countries across the globe, with about 50 Muslim countries. Iran and Sudan are two Muslim countries that operate wholly Shariah compliant banking systems. By the end of 2016, there were a total of 12 jurisdictions in which Islamic banking industry had a share of 15% or more in the whole banking industry. The major OIC jurisdictions also include Saudi Arabia, Bahrain, UAE and Malaysia (the leaders in the industry), Pakistan, Indonesia, Bangladesh, Jordan, Qatar, Bahrain, Kuwait, Turkey, Nigeria, Yemen, Brunei, Thailand, Algeria, Azerbaijan, Kenya, Oman, Lebanon etc. Of these, Saudi Arabia, Malaysia, Yemen, Kuwait, Bangladesh and UAE have a substantial share (18 – 50%) of Islamic banking in their overall banking industry. More recently, countries such as Maldives, Palestine and Djibouti (in Africa) have also entered the landscape.

Today, Islamic finance is no longer targeted at only Muslim populations, with its presence in major non-Muslim countries such as United Kingdom (one of the earliest leaders in the industry with London as one of the 4 major Islamic finance hubs), Singapore, South Africa, and Sri Lanka etc. Other states such as Germany, China in particular (with Hong Kong entering Islamic capital markets hub), the United States, Canada and Australia have also shown a growing interest in the Islamic banking or Islamic capital markets industry.

The Islamic finance industry is deemed inherently asset-based with risk-sharing instruments such as Mudarabah and Musharakah, and claims to be more financially stable than the recently fragile (albeit recovering) conventional system. Other common Islamic finance contracts used in the different banking, insurance and asset management products include Wakala (agency), Ijarah (rental lease), Murabahah (cost plus sale), Salam (deferred sale with full payment on spot), Istisna (order for manufacture), Tawarruq, and supporting contracts such as Qard-ul-Hasan, Wadiah, Hiba, Waqf, etc.

The industry has seen phenomenal growth at the global level in the last three decades, though this has not come without several challenges and emerging areas of concern. Today, there are over a thousand Islamic Financial Institutions operating in the world, in over 50 Muslim

1 IFSB Stability Report 2017

countries (including Bahrain, Malaysia and Iran as the leaders, and Saudi Arabia, UAE, Sudan, Indonesia, Pakistan, Bangladesh, Jordan, Qatar, Oman, Kuwait etc.) and over 40 non-Muslim countries including the UK (with London as one of the main Islamic finance centers), USA, South Africa, Canada, Australia, Switzerland and Sri Lanka), with recent initiatives to launch Islamic banking in countries like China and Germany. Though it started as an economic need for faith-based (Muslim) investors, consumers, corporations and governments, today, Islamic finance is no longer exclusive to Muslims. It is often seen as a form of ethical banking and investing (with the legal guidelines based on Islamic law) and a possibly stable/less risky alternative mode of financing by the non-Muslim world. The size and presence of the three different sectors of the Islamic financial industry is summarized in the table below, as at December 2015. Countries included in this report (excluding the United Kingdom, Nigeria and Oman) are highlighted.

Table 4. Size of Islamic Finance Assets

	Islamic Finance Assets (US$Mn)	No. of IFIs	Islamic Banking Assets (US$Mn)	No. of Islamic Banks Windows	Takaful Retakaful Assets (US$Mn)	No. of Takaful Retakaful Operators	Other Islamic Institutions' Assets (US$Mn)	No. of Other IFIs
Global	2,003,542	1,329	1,451,087	480	37745	322	106,351	527
Saudi Arabia	446,664	127	350,128	16	14206	40	7,991	71
Iran	434,420	131	379,664	42	10502	27	27,574	62
Malaysia	414,343	77	159,986	39	7324	20	39,494	18
UAE	187,051	87	148,187	24	2072	17	5,593	46
Qatar	100,538	37	84,062	8	535	19	734	10
Kuwait	100,361	99	86,153	8	186	15	11,712	76
Bahrain	81,069	64	75,083	36	372	9	795	19
Turkey	51,710	6	41,710	5				1
Indonesia	47,645	138	20,081	33	1269	57	747	48
Bangladesh	26,192	45	25,438	26	669	18	85	1
Pakistan	22,164	69	15,120	23	174	13	2,607	33
Egypt	14,280	31	13,793	13		9	291	9
Sudan	11,110	54	11,010	32	43	14	58	8
Jordan	9,447	13	9,025	4	125	2	168	7
Switzerland	6,937	3		1			6,879	2

Source: Thomson Reuters (2016)

The size of the global Islamic finance industry has traditionally been measured in terms of the value of assets held by institutions considered as a part of the Islamic finance industry. This size (June 2016) was estimated at between $1.88 trillion to $2.1 trillion, with the market size expected to reach more than $3.4 trillion by the end of year 2018[2]. The Islamic banking industry is typically measured both in terms of the size of its liabilities (deposits) and assets. However, such figures generally underestimate the size of the industry, as they do not consider Islamic equities as an asset class. According to the Islamic Financial Services Board (IFSB)'s annual stability report, the total value of the global Islamic financial market industry was USD 1.88 trillion by the year 2015. The table below shows the breakdown by segments. As the table

2 'The Size of the Islamic Finance Market', June 2016, Islamicfinance.com.

demonstrates, the Total value of the Banking assets, Outstanding Sukuk, Islamic funds' assets and Takaful Contributions for year 2015 are USD 1.881 trillion.

Table 5. Breakdown of Islamic Finance Segments by Region (USD billion, June 2016)

Region	Islamic Banking Assets	Sukuk Outstanding	Islamic Funds' Assets	Takaful Contributions
Asia	218.6	174.47	19.8	4.4
GCC	650.8	115.2	23.4	11.7
Mena (exc. GCC)	540.5	16.6	0.2	8.4
Africa (exc. North Africa)	26.6	1.9	1.5	0.6
Others	56.9	2.1	11.2	-
Total	1493.4	318.5	56.1	25.1

Source: IFSB Annual Stability Reports

Compared to the conventional industry, the global Islamic finance industry has witnessed a far more aggressive growth. According to the March 2016 Islamic Finance Bulletin[3], between 2011 and 2015, the Islamic finance industry grew at a compound annual growth rate of 3.6%, compared to only 1.5% of the conventional industry. However, the industry is only about 1% of the size of the global financial industry today.

Sukuk represent the major part of the global Islamic capital markets industry. The issuance of international Sukuk, as illustrated in the graph below, began in 2001, and witnessed a growth trajectory in the years 2012 and 2013, though the industry entered a somewhat consolidated phase in 2015, with some internal and external factors, such as Bank Negara Malaysia's decision to stop issuing its short term Sukuk, a sharp drop in oil prices etc.[4]

The diversity in Sukuk structures has increased in the past two decades, starting from mainly Ijarah-based Sukuk to now those including Diminishing Musharakah, Musharakah etc. Corporate and sovereign Sukuk have been issued in many countries, including Malaysia, Bahrain, Kuwait, Qatar, Jordan, Saudi Arabia, UAE, UK, USA and Pakistan. In countries with a developed Islamic financial industry, such as Bahrain, Malaysia, Iran, Sudan, Pakistan etc., different Sukuk instruments also provide an important avenue for liquidity management and/or developmental project financing. In other newer jurisdictions, such as Hong Kong, they can represent an introduction to the Islamic financial industry.

Takaful, or Islamic Insurance, is relatively a slighter newer sector in some jurisdictions, though the global Takaful industry reached a size of USD 37.7 billion by 2016[5]. Countries such as Sudan and Malaysia (included in this report) began their regulations for Takaful early: Sudan pioneered the global industry with the first Islamic insurance company established in 1979. In Malaysia, *Takaful Malaysia* commenced in 1981, after the Government of Malaysia had set up a task force for studying the feasibility of establishing an Islamic insurance company in Malaysia.[6] Countries which most recently included separate Takaful regulations by the end of

3 CEIF, King Fahad University of Petroleum and Minerals
4 IIFM Sukuk Report 2016.
5 Thomson Reuters 2016 Report
6 Takaful Malaysia Annual Report 2016.

2015 included Pakistan (2012), Indonesia and Nigeria (2013), UAE (2014) and even Kenya (2015).[7]

Over the past three decades, different Islamic finance contracts and principles have been developed to be used in the diversified products in the segments of Islamic banking, capital markets and Takaful. For example, the idea of **Islamic windows –** dedicated Shariah compliant units of a conventional financial institution (such as a bank, insurance firm, asset management industry etc.) have been developed across several jurisdictions, with their regulatory frameworks, partly to provide investors and customers with a greater diversity in Shariah compliant financial services, and partly to aid in the growth of the Islamic finance industry. Similarly, since 2012, there has been an added diversity in the different Sukuk structures used to meet clients' needs, and now include Ijarah, Mudarabah or Musharakah contracts, and also BBA (Bai Bithaman Ajil – sale based on deferred payments), Murabahah, Wakalah, Salam and Istisna. Tawarruq and commodity Murabahah instruments have been developed to meet the liquidity management or financing needs of IFIs and corporates, respectively (though the use of Tawarruq may be prohibited in some jurisdictions, e.g. in Indonesia, Middle East etc.). For savings and current account products (which form a significant part of the Islamic consumer banking markets), as Chapter 2 explains in more detail, products are usually based on Mudarabah, Qard and Wadiah contracts. For Takaful products (an industry which began in the 1980s, but is still regarded as developing), often hybrid structures that use Mudarabah, Wakala or Wakala-Waqf are used. Different Ijarah structures have been developed for both consumer and project financing, Salam and Istisna based products are also used by IFIs in corporate financing.

The origin of Islamic finance dates back to the dawn of Islam 1,400 years ago. Historical books written during the early years of Islam indicated that during the 1stcentury of Islam (AD 600), some forms of banking activities existed that were similar to modern banking transactions. Furthermore, these ancient books revealed that Al-Zubair bin Al-Awam, one of the most famous personalities in Islam, was accepting deposits from people as loans and investing that money. At the time of his death, his debt had reached 2,200,000 dinar, as counted by his son Abduallah.

Post that the revival of Islamic banking thought revived in the last century, which can be divided into a few phases.

Phase 1: This stage began in the early 1900s and was marked by the writings of Abul Aala Maudud, Hasan AlBanna, Hifz Al-Rahman etc on theory of Islamic economic state. The first work devoted to the subject of interest-free banks was Muhammad Uzair's research in 1955 where he introduced the concept of banking within the Islamic financial system.

Phase 2: This stage involved tremendous development at both the intellectual and implementation levels. The early banks became pillars for the continued development of the Islamic financial system. The following points summarize the events that took place during this period. 1. Local savings banks were established in Mit Ghamr, Egypt, in 1963. Many researchers consider these banks to be the first banks without interest in Islamic society. However, these banks merged with government banks in 1967 for political reasons

7 Takaful Primer, World Takaful Report 2016 by Middle East Global Advisors, pages 10-17.

In 1970s, institutional involvement also increased. Some examples include the Islamic Research Academy Al-Azhar conference, the Finance Ministers of the Islamic Countries conference held in Karachi in 1970, the First International Conference on Islamic Economics in Makkah in 1976, the International Economic Conference in London in 1977, and an Egyptian study in 1972. In the Karachi conference, delegates from Egypt proposed that an international Islamic bank be established, and delegates from Pakistan proposed that an international union for Islamic banks be established.

Nasser Social Bank was established in Egypt in1971 by Presidential Decree 66. The bank's charter clearly identified that it was an interest-free bank. Also, Act 13 of the decree stated that the bank would not be subject to the regulations applied to conventional banks. The purpose of the bank was to broaden the social solidarity among citizens and to create a competent and just society. The bank's capital was formed from funds allocated by the president of the republic from outside the state budget resources specified for this purpose. In addition, money was allocated from public bodies and economic units. However, the Nasser Bank Law did not mention that the bank had to adhere to shariah. Still, because the bank was a member of the International Union of Islamic banks, it was considered an Islamic bank.

In 1974, the finance ministers of all Islamic countries held a convention on the establishment of the Islamic Development Bank (IDB). The IDB was considered to be the first international Islamic bank that was established, albeit in part, by members of the OIC. The bank began operating in 1977, and since then it has played a pivotal role in the development of the Islamic banking and finance industries. The purpose of the bank is to foster the economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of shariah. As of June 1992, the bank's paid-up capital was 2billion Islamic dinars (an IDB accounting unit that is equivalent to one special drawing right of the International Monetary Fund). From July 1992 to December 2000, the bank increased its capital to 6billion Islamic dinars. In 2001 the bank increased its capital from6 billion to 15 billion Islamic dinars (USD 20.55 billion).

Phase 3: The Spread of Islamic Banks, 1977 to Present

The International Association of Islamic Banks was established in 1977. The CEOs of the Islamic banks agreed to establish the International Union of Islamic Banks in 1997, with the headquarters in Makkah. The aim of this union was to strengthen cooperation and increase coordination among Islamic banks. However, although the union still exists, it has not begun operations. This changed in July 1999 when the International Association of Islamic Banks was reorganized and renamed the General Council for Islamic Banks and Financial Institutions (CIBAFI), Bahrain was chosen as its headquarters.

With the development and awareness of Islamic finance globally, Islamic banks mushroomed over the last four decades, with Islamic banks present in nearly 50 countries globally. The following chapter further dwells on the state of Islamic banking, Islamic capital markets and Takaful currently.

2 EVALUATION OF THE ISLAMIC FINANCIAL INDUSTRY BY SEGMENTS

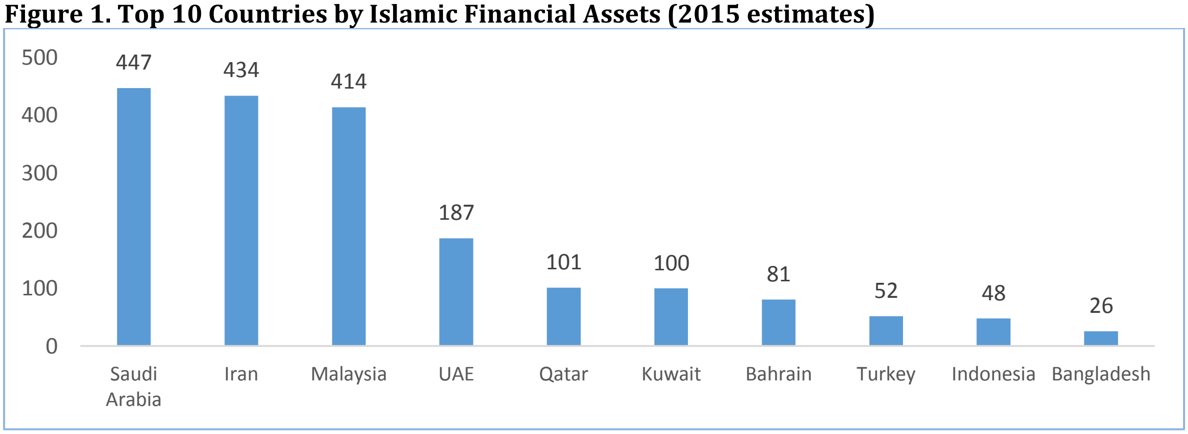
2.1 INTRODUCTION: THE STATE OF ISLAMIC FINANCE

As Chapter 1 earlier showed in the Table showing the breakdown of Islamic financial industry by segments, the size of the global Islamic banking industry (2016, IFSB 2017 report) was estimated at USD 1.49 trillion, with outstanding Sukuk amounting to USD 319 billion, Islamic fund assets USD 56 billion, and Takaful at USD 25.1 billion. The growth of the Islamic finance industry over the last decade has been steady and relatively fast even with the economic challenges the world witnessed, ranging from energy price crash, geo-political conflicts, exchange rate depreciations and an asset sell-off spree in emerging markets. After sustaining double digit growth for nearly half a decade, in 2016, the Islamic financial sector witnessed a slight slowdown, although IFSB 2017 reported a slight reversal of earlier decline in global outstanding Sukuk, increasing from USD 300.3 billion in 2015 to USD 318.5 billion by the end of 2016. The Takaful industry witnessed gross contributions increasing by 13.1% to reach USD 25.1 billion by the end of 2015 (refer to the Table on Breakdown of Islamic finance industry by Segments, in Chapter 1).

2.2 GEOGRAPHICAL DISTRIBUTION OF ISLAMIC FINANCE

Islamic finance has been dominating primarily in the Asian and GCC markets. The figures reported by Islamic Financial Services Board for 2016 highlighted the GCC markets as nearly being 40% of the global Islamic financial markets with another 20% coming out of Asian markets. Within the GCC markets, Saudi Arabia has historically been the leader in Islamic finance assets across all jurisdictions. With the decline in oil prices, Saudi Arabia has introduced a new long term vision which plans on reducing the dependency on oil revenue by 2030. The diversification of the economy will be fueled by the banking sector, which bodes a good omen for the Islamic banking sector. While in Asia, Iran has been the major contributor of the Islamic financial world, and with the lifting of the sanctions in 2016, the Islamic banking industry of Iran will re-enter the global financial market.

Figure 1. Top 10 Countries by Islamic Financial Assets (2015 estimates)



Source: ICD-Thomson Reuter Islamic Finance Development Indicator 2016

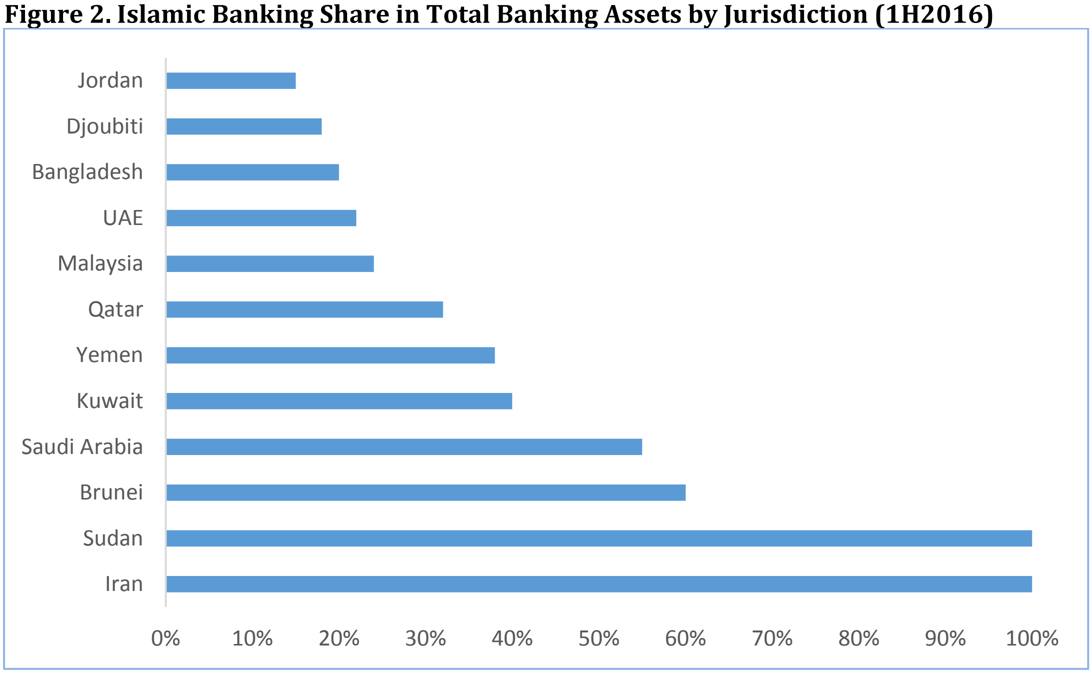
Another major destination for Islamic financial sector is Malaysia which has dominated the Sukuk markets with 46% of total assets based in the Sukuk markets. The ICD-Thomson Reuters Islamic Finance Development Indicator has judged its Sukuk market as the most developed in the world for last four years. The Islamic Financial Services Act (IFSA 2013), which replaces the old Islamic Banking Act 1983 and Takaful Act 1984, is designed to improve the observance of Shariah and operational compliance guidelines for Malaysia's Islamic financial institutions.

2.3 STATE OF ISLAMIC BANKING

While Islamic Banking has dominated the Islamic financial sector over the years, the relatively slow growth of the sector over the last couple of years has come at a critical time. Multiple factors have contributed towards the slowdown, with the exchange rate depreciations in key Islamic finance markets; Iran, Malaysia, Turkey, and Indonesia being an important contributor to the modest performance over the last two years.

Islamic Banking has developed to a level of systemic importance to 12 countries. The classification of systemic importance for this report has been kept at Islamic banking being 15% or more of the total banking industry of a country. The latest addition to this club is Jordan where Islamic banking assets surpassed 15% threshold in 2016.

Figure 2. Islamic Banking Share in Total Banking Assets by Jurisdiction (1H2016)



Source: IFSB 2017 Report.

Note: The countries that satisfy the criterion of having a more than 15% share of Islamic banking assets as a proportion of their total domestic banking sector assets

- Amongst all OIC member countries, Iran and Sudan are the only two jurisdictions which follow a 100% Islamic banking framework.

- Brunei has shown considerable betterment where nearly half of the banking sector is Shariah compliant. Brunei joins Saudi Arabia in this category which nearly has 50% of their banking Shariah compliant.

- Kuwait and Yemen follow in the relative Islamic Banking size with Islamic banking at 38% and 33% respectively of the total banking industry in the country.

- Qatar at 26.1% and Malaysia at 23.0%, Bangladesh at 19.4% and the United Arab Emirates at 18.4% all have shown improving Islamic banking sizes over the last couple of years.

Shariah compliance is at the core of the activities for Islamic products. The Sharia compliance is ensured or verified by bank's own Shariah boards with Sharia scholars. There are differing opinions of how to apply or interpret Shariah law amongst the different banking regions. Also, currently there are a number of regulatory frameworks within which Islamic banking is developing. These frameworks and rules can often be contradictory and lead to differences in the application compliance.

Over the recent years Islamic banking has been expanding across different jurisdictions, and the key indicators for each jurisdiction have been influenced by the local context and macroeconomic conditions. As per data collected by IFSB return on equity (ROE) for stand-alone Islamic banks in the first half of 2016 stood at 13.81% up from 13.4% in 2015. These numbers are impressive considering the global state of banking sector where banks in United States and European Union had ROE of 9.45% and 5.7%. Within the OIC member countries the recent persistent lower prices have dampened the profitability. GCC Islamic banks while on a year to year basis the ROE decreased in 2016 but it still remained above 10% for them. Amongst all the Islamic banking jurisdictions in OIC member countries, only Nigeria and Oman had negative ROEs in recent years. Oman's case is unique in the sense as it is a new comer with only two full-fledged Islamic banks which are in the buildup phase, and are expanding. The trend is generally expected to reverse in 2017 and onwards as Islamic banking penetration increases in the country.

While on the liquidity of Islamic banks, the latest General Council for Islamic Banks and Financial Institutions (CIBAFI) report highlights liquidity as a risk priority for Islamic banks, particularly larger banks. This appears to be a consequence of general macroeconomic conditions and negative sentiment resulting from lower oil prices, as well as of the need to comply with the new Basel III liquidity standards. However, data from Pakistan and Bangladesh indicate that many Islamic banks experience excess liquidity, and are unable to earn returns on liquid assets given the low supply of short-term Shariah compliant investment instruments.

A major concern of banking sector is the asset quality, where Islamic banks have been consistently improving over the last few years. Data for financial half year of 2016 shows that asset quality in more mature Islamic banking markets like Saudi Arabia, Malaysia and Bahrain is relatively lesser than the developing Islamic banking markets. The major share of poor quality is witnessed in real estate and household sector which is owing to the economic slowdown globally as these sectors have suffered the most. A brief snapshot of percentage of non-performing assets of total Islamic financing is presented below for first half of 2016.

Table 6. Islamic Banking Sectorial NPF by Country

	Real Estate	Manufacturing	Household	Construction
Bahrain	29%	10%	13%	13%
Bangladesh	6%	30%	1%	3%
Brunei	22%	11%	10%	20%
Indonesia	15%	10%	8%	6%
Jordan	12%	8%	52%	6%
Malaysia	11%	11%	35%	15%
Oman	10%	1%	64%	25%
Saudi Arabia	1%	11%	30%	15%

Source: Author's estimation through Bankscope and IFSB data

Islamic banks worldwide traditionally offer four categories of financial contracts: Deposits, Lending, Treasury and Trade Finance. The following Table provides a comparative evaluation of Islamic Banking products offerings across geographical regions. Briefly the comparative analysis of the main markets and the products used highlights that amongst deposits a general conformity of products exists between Malaysia and Indonesia and then within Middle East and North Africa. This is understandable owing to the geographical proximity and the religious school similarities between these pairs. While the variety of products on deposit side are, vast and cover almost all needs of the Islamic finance consumers North Africa and Indonesia still need to expand more as some categories haven't been offered yet.

Similar trend is prevalent on the financing side products of Islamic banking amongst these major jurisdictions. While Malaysia and Indonesia have a wider product offering, Middle Eastern Islamic banks are diversifying their product offerings which are prevalent in Malaysia and Indonesia but not there. This trend has picked up over the last decade fueled by internationalization of Islamic banks. While the Trade financing products are relatively similar across different regions, the product base is standardized amongst them. The treasury products, on offer by Islamic banks globally are similar in nature, but Malaysian banks have a more diversified portfolio on the back of a well-developed Islamic money market which allows them to offer more products to service customers than other regions. A huge opportunity exists for further expansion through cross-learning between regions.

Different Deposit Products Trade Finance and Treasury products in Middle East North Africa Malaysia and Indonesia

Table 7: Deposits

Product/Process	Middle East	North Africa	Malaysia	Indonesia
Savings Account Based on : Wadiah Mudarabah, Qard	Mudharabah and Qard are standard offerings	Mudharabah and Qard are standard offerings	Wadiah is more popular than Mudharabah	Mudharabah is most popular, followed by Wadiah
Current Account based on: Wadiah Mudharabah Qard	Qard and Mudharabah are standard offerings	Qard and Mudharabah are standard offerings	Only Wadiah is offered to customers	Only Wadiah is offered to customers
Fixed Deposit based on: Mudharabah, Commodity Murabahah Wakala	All three are popular products, especially within GCC countries	All three are popular products	Mudharabah is the standard offering. Commodity Murabahah and Wakala are gradually becoming more popular	Only Mudharabah is being offered to customers
Recurring Deposits/Saving Plan to increase deposits	Popular scheme offered to customers as a "forced saving plan"	Popular scheme	Slow take-up as Takaful unit-linked plan is more attractive to customers	Popular scheme to encourage saving for Hajj and Education
Structured Products	Products are offered to selected customers	Products are offered to selected customers	Products are offered to selected customers	Not offered to public yet
Profit Distribution	Adopt guideline issued by AAOIFI on Mudharabah-based products	Adopt guideline issued by AAOIFI on Mudharabah-based products	Adopt guideline issued by AAOIFI but more refined and complex	Revenue-based (instead of profit based) but less complex
Liquidity Management	Standard offering when banks promote their cash management services to commercial and corporate customers	Emerging requirements	Same as ME and Africa	Emerging requirements in Indonesian market
Fund Management (Allowing banks to create multiple funds or pools meant for	Very popular arrangement wherein customers can	Popular arrangement wherein customers can	Low demand from customers. However, non-bank financial	Emerging requirements but take up from

Product/Process	Middle East	North Africa	Malaysia	Indonesia
specific target customers)	place deposits into various funds based on their risk preferences and expected returns	place deposits into various funds based on their risk preferences and expected returns	institutions (NBFI) and developmental banks are using this capability to manage borrowings or "special allocation" received from banks and government agencies	customers is low

Source: Created by Author

Table 8: Financing

Product/ Process	Middle East	North Africa	Malaysia	Indonesia
Monetization Products (Cash finance based on Tawarruq and Salam	Salam structure is preferred as Tawarruq is discouraged by scholars	Salam structure is preferred	Very popular scheme based on Tawarruq concept	Both Tawarruq and Salam structures are not approved by scholars
Vehicle Financing (Murabahah and Ijarah)	Standard offering	Standard offering	Standard offering	Standard features, some are managed by multi-finance outfits
House Financing (Murabahah, Ijarah and Diminishing Musharakah)	Only Ijarah and Diminishing Musharakah are popular	Only Ijarah and Diminishing Musharakah are popular	Only Murabahah and Diminishing Musharakah are popular	Only Ijarah and Diminishing Musharakah are popular
Pawn Broking (Al-Rahnu)	Prohibited product	Prohibited product	Popular, as a form of personal financing with gold as collateral	Popular form of financing with gold as collateral
Equipment/Industrial leasing (Operating/Financial) based on Ijarah concept	Operating and financial leases are popular	Operating and financial leases are popular	Mostly financial lease	Mostly financial lease
Plant/Construction financing using Istisnaq and forward Ijarah	Both structures used but forward Ijarah is popular	Forward Ijarah is popular	Istisnaq and forward Ijarah are prevalent	Istisnaq structure is more popular
Project Financing based on Musharakah and Dim Musharakah and Mudharabah	Popular form of financing	Popular form of financing	Banks not keen to offer as deemed too risky	Popular form of financing

Product/ Process	Middle East	North Africa	Malaysia	Indonesia
Working capital financing based on Tawarruq , Mudharabah or Musharakah	Mudharabah and Musharakah offered but not Tawarruq as it is prohibited	Mudharabah and Musharakah offered but not Tawarruq as it is prohibited	Only Tawarruq is being offered by banks	Mudharabah and Musharakah offered but not Tawarruq as it is prohibited
Syndication origination, processing and support	Basic requirements. Subscription received under Musharakah and other structures	Basic requirements. Subscription received under Musharakah and other structures	Syndication mimics arrangement in conventional using Sharia compliant structures	Basic requirements. Subscription received under Musharakah
Rebate processing	Rebates are given at end of financing or at redemption	Rebates are given at end of financing or at redemption	Rebates are given during or at end of financing	Rebates are given at end of financing or at redemption
Penalty charging	Penalty charged is always given to charity	Penalty charged is always given to charity	Penalty charged is treated as income, and if above a threshold to be given to charity	Penalty charged is treated as income, and if above a threshold to be given to charity
Asset securitization (Selling of financing assets to other parties)	Practice is now emerging	Not Prevalent	This is common practice in Malaysia wherein a government body buys mortgages from banks to enhance liquidity	Requirement is being discussed but is yet to be approved by the Sharia scholars
Rescheduling and restructuring	Complete flexibility required, especially for corporates	Complete flexibility required, especially for corporates	Complete flexibility required, especially for corporates and VVIPs	Less complex requirements than ME, Africa and Malaysia
Collection	External collectors and lawyers are used extensively by banks and they form part of the eco-system and must be	External collectors and lawyers are used extensively by banks and they form part of the eco-system and must be	Same as ME and Africa	Less complex requirements. Collections are mostly handled by internal collectors

Product/ Process	Middle East	North Africa	Malaysia	Indonesia
	monitored closely	monitored closely		
Assets Takeover	Very popular scheme as this helps reduce complexity and to transfer assets to banks' books	Popular scheme as this helps reduce complexity and to transfer assets to banks' books	Same as ME and Africa	Same as ME and Africa
Origination – Retail (Ijarah, Istisna, Mudharabah, Musharakah, Murabahah and Tawarruq)	Advanced requirements to address competitive landscape including Doc Mgmt., Credit Scoring and Credit Control before disbursement	Advanced requirements to address competitive landscape including Doc Mgmt., Credit Scoring and Credit Control before disbursement	Same as ME and Africa	Requirements are still basic. However, future requirements may match that of ME and Africa
Origination – Corporate (Ijarah, Istisna, Mudharabah, Musharakah, Murabahah and Tawarruq)	Advanced origination features for various business requirements like Project finance, Working capital Financing, Term financing including Financial analysis, workflow definition, Doc Mgmt., Credit Scoring and Credit Control before disbursement	Advanced origination features for various business requirements like Project finance, Working capital Financing, Term financing including Financial analysis, workflow definition, Doc Mgmt., Credit Scoring and Credit Control before disbursement	Same as ME and Africa	Requirements are still basic. However, future requirements may match that of ME and Africa

Source: Created by Author

Table 9: Treasury Products

Product/Process	Middle East	North Africa	Malaysia	Indonesia
Forex	Standard requirements. Forward deals are not allowed	Standard requirements. Forward deals are not allowed	Standard requirements. Forward deals are not allowed	Standard requirements. Forward deals are not allowed
Money Market	Money market is active but products are less complex due to strict rules imposed by the Sharia scholars	Money market is active but products are less complex due to strict rules imposed by the Sharia scholars	Money market is very active and many unique products based on Mudharabah, Commodity Mudharabah and other structures are offered by central banks and government agencies	Standard requirements, very basic instruments based on Mudharabah are offered. Commodity Mudharabah is yet to be offered in the market
Securities	Government papers and Sukuk offered by government and large companies are the typical securities traded	Government papers and Sukuk offered by government and large companies are the typical securities traded	Active market Active repo market as well	Only government papers are traded. Very limited Sukuk and other instruments
Derivatives	Very limited derivatives products due to strict ruling by Sharia scholars	Not Yet Available	More advanced than Middle East and Africa. Profit and Currency swap derivatives have been seen in the market	No derivative-based product in the market
Front Office	Standard front-office functionalities to facilitate dealers in their trading daily, with good support for all instruments available in the market	Standard front-office functionalities to facilitate dealers in their trading daily, with good support for all instruments available in the market	Same as ME and Africa	Same as ME and Africa
Middle Office	Standard middle office functionalities to ensure dealing risks are minimized and	Standard middle office functionalities to ensure dealing risks are minimized and	Same as ME and Africa	Same as ME and Africa

Product/Process	Middle East	North Africa	Malaysia	Indonesia
	all limits are properly assigned and controlled	all limits are properly assigned and controlled		
Back Office	Standard back-office functionalities to facilitate completion of deals, sending of notices and swift messages to transacting parties and to handle all accounting entries and reporting	Standard back-office functionalities to facilitate completion of deals, sending of notices and swift messages to transacting parties and to handle all accounting entries and reporting	Same as ME and Africa	Same as ME and Africa

Source: Created by Author

Table 10: Trade Finance

PRODUCT/PROCESS	MIDDLE EAST	NORTH AFRICA	MALAYSIA	INDONESIA
Complete LC Processing based on Murabahah, Wakalah and Musharakah Concepts	Standard requirements due to UCP practices	Standard requirements due to UCP practices	Same as ME and Africa	Same as ME and Africa
Bills	Standard requirements due to UCP practices	Standard requirements due to UCP practices	Same as ME and Africa	Same as ME and Africa
Guarantees	Standard requirements due to UCP practices	Standard requirements due to UCP practices	Same as ME and Africa	Same as ME and Africa
Complete LC Processing based on Murabahah, Wakalah and Musharakah Concepts	Standard requirements due to UCP practices	Standard requirements due to UCP practices	Same as ME and Africa	Same as ME and Africa

Source: Created by Author

Trend wise, 2016 saw a decline in Islamic banking slightly, which is largely attributable to an adjustment to the value of Islamic banking assets in Iran, in addition to exchange rate depreciations in some key Islamic banking markets. In currency rate impact on Islamic banking, Malaysia and Turkey contributed the most, as Malaysia's Islamic banking assets grew by 9.5% in the year to 2Q2016, and the Turkish participation banking sector's assets expanded by 9% in the same period; the comparative growth figures in US Dollar terms for both countries are just 1.4% and 0.01%, respectively.

Between 4Q2013 and 2Q2016, Islamic banking assets showed moderate growth in US Dollar terms, expanding at a CAGR of 9.9% across 14 jurisdictions which together represent about 94% of the global Islamic banking industry.

According to IFSB reported data of May 2017, amongst the GCC markets the, Kuwaiti Islamic banks recorded the lowest level of asset growth, in 2015 up to 2016Q2, posting 6.9% growth in 2Q2015 and a moderate 2.2% in 2015 (though in terms of Financing, they had 6.2% growth between the second quarters of 2015 and 2016).

On the other hand, Turkish participation banks have consistently maintained strong growth in assets and financing over the last few years. Another major Asian destination Iran has also shown high growth rates over the last two years, particularly with deposits, which have increased by 19.5%, 24% and 30.5% in quarters two and four of 2015, and in quarter two of 2016.

Malaysian Islamic banks and windows over 2016 continued to grow their aggregate deposit base, which increased by 8.2% between 2Q2015 and 2Q2016; the comparative figure for conventional Malaysian banks was 1.6%. Growth in Malaysian Islamic deposits can be attributed to the recovery in value, and deposits share, of its profit-sharing investment accounts (PSIAs).

Bangladesh and Pakistan maintained robust levels of growth in their assets, financing and deposit portfolios. Pakistan, in particular, sustained a high level of financing growth in 2015 and 2016 with the second quarter of 2016 witnessing 31.8% increase in Shariah compliant financing as compared to 12.7% in conventional financing.

2.3.1 ISLAMIC BANKING DRIVERS IN KEY MARKETS

The Islamic banking in general has grown at a compound annual growth rate (CAGR) of 15%[8] in the last seven years (2009–2016). The growth has tapered off in the recent years and has slowed down to 10% CAGR over the last three years globally (2013-2016). This slowing down of growth in Islamic Banking has been caused by multiple factors across different jurisdictions. Some key factors which have influenced this are as follows:

- Exchange rate depreciation in emerging markets
- Economic slowdown globally and a depressed outlook for the future.
- Prolonged low energy prices in world markets,
- Weaker investor and consumer confidence in the global economy. There have been recent signs of a global recovery, which are expected to rejuvenate growth of Islamic banking globally.

According to IFSB, the Islamic financing and deposit growth have fared reasonably well with a compound annual growth rate (CAGR) of 9.9% between the last quarter of 2013 to June 2016.

8 Authors' calculation through data from Bankscope

The more promising part of their findings lie in the post financial crisis years where Islamic financing continued to grow in double digits of over 10%, and Islamic deposits fared much better with a CAGR of 15%. The factors which have contributed to this growth arises out of number of factors.

a) Revival of financing by Islamic banks during the post-financial crisis years;
b) New Islamic banks have been established across the globe and more Islamic banking friendly policies are in place. The expansion of Islamic banks has allowed to tap into previously unexplored markets and this has resulted in higher levels of deposit mobilization.

The major growth over the last few years has come from Muslim dominated markets within the OIC like the UAE, Bangladesh and Pakistan. Pakistani Islamic banking industry seen tremendous growth with Islamic financing growing at a phenomenal around 20% CAGR over the last 3 years[9].

- This drive has been led by expansion of Islamic banking activities as well as conventional banks actively pursuing Islamic banking opportunities through establishment of Islamic banking subsidiaries. A few conventional banks are even in the process of complete transformation to Islamic banks.

The Malaysian Islamic banking industry, which has been at the cutting edge of innovation and human capital, has the benefit of a strong government motivation, where the target is a 40% share for Islamic financing in the country's banking sector by 2020.

- In the Malaysian context, a major factor has been the growing awareness of the benefit proposition of the Shariah compliant instruments. The government and policy makers have invested heavily in developing awareness amongst the masses as well as through academia.

Similar factors have helped the Islamic banking asset side to grow in UAE and Bangladesh. Several conventional banks in these two countries have opened Islamic banking windows and subsidiaries.

- There are still concerns being raised whether allowing so many Islamic banks providing financing activities may result in becoming overly competitive.

Jordan is one of the only member countries within the OIC which has experienced negative rate of financing growth within Islamic banking industry in the last few years. This is mainly owing to biases by one major Islamic bank in the sample.

Generally, Islamic banks are facing strong fundamentals in terms of their assets and liabilities. They are expected to experience some challenges in the coming years, while facing numerous risks. Most of the banking industry is concerned about the future as the outlook of the global banking industry is riddled with challenges of the global economic uncertainty and civil and

9 SBP Bulletin December 2016.

political unrest in multiple jurisdictions. These challenges are expected to impact the asset side of the Islamic banking industry globally at risk of deterioration of asset quality.

2.3.2 FUTURE CHALLENGES TO ISLAMIC BANKING

- Islamic banking industry has grown leaps and bounds, and has now started venturing out of Muslim dominated countries to the mainstream banking hubs. This gives rise to an essential need for Islamic banking to be fully integrated into the global financial markets while maintaining at the same time its distinctive nature and the uniqueness of its services. The Islamic banking institutions need to be subjected to the full ambit of the banking regulations and supervised as intensely as other financial institutions.

- The conventional banking industry provides a level of support and assurance to the depositors and investors. The Islamic banking needs to meet similar levels of comfort as they enjoy under conventional banking that their interests are being constantly watched and safeguarded by a vigilant regulator. Any laxity in the standards, practices or enforcement on the part of the regulators would be counterproductive but also act as an impediment towards the acceptance of these assets by international financial markets.

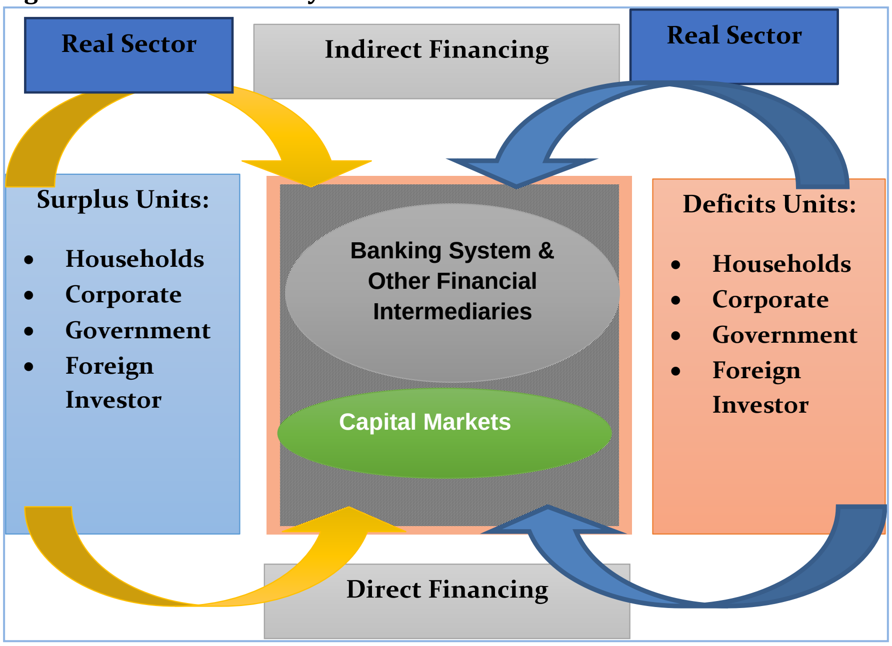
- Lack of adequately trained and skilled human resource base for Islamic banks. While many Islamic finance and banking educational institutions have emerged over the years, there is still a huge gap in trained professionals to complement the growth of Islamic banking globally. More trained professionals who are well versed in Shariah and finance is the need of the hour to sustain the growth of Islamic banking industry.

- Some of the key elements of financial architecture and infrastructure such as liquidity management instruments, rating and external credit assessment, statistics and information gathering, research and development, market micro structures and Shariah screening technologies have to be fully embedded and integrated in the global perspectives. Attention is being paid to fill these gaps by the Islamic Financial Services Board, the AAOFI and others.

2.4 ISLAMIC CAPITAL MARKETS OVERVIEW

The capital market plays a very important role in the development of a nation. In many ways, capital markets are at the heart of a nation's financial system. Economists often divide the overall economy into two sectors, the real sector and the financial sector. While the real sector of the economy produces the nation's output of goods and services, the financial sector plays the vital role of providing the financing needed to fund this productive capacity. It does this by mobilizing the savings of surplus chapters and channeling them to productive chapters that need the funds. The following figure highlights the role of capital markets in the economic system.

Figure 3. Overall Economy



Source: Created by Author

The Islamic Capital Market (ICM), which broadly refers to the market in Islamic securities, is one of the fastest growing segments of the capital market. In the case of Malaysia and Bahrain, it permeates all segments of the capital market, equities, bonds, foreign, exchange and derivatives. Islamic securities are simply capital market instruments that are Shariah compliant. While such compliance has been fairly easy where equity instruments are concerned, the bond market has had to completely redesign the instruments in order to be Shariah compliant. Since equity financing is in congruence with the Shariah, listed equities and derivatives merely had to be screened in order to determine their acceptability as a 'halal' stock.

The Islamic capital markets can be divided into three sub components which are prevalent in most Islamic financial instruments namely the Sukuk Market, Equity Markets and Islamic Funds Markets. The last few years have witnessed some volatility in these markets and setbacks recently, including contractions in returns and asset values. This is not unique to Islamic capital markets as the global trend has been of volatility and reducing returns in conventional emerging markets as well. Most OIC member countries and Islamic finance destinations fall under the category of emerging and developed economies which have suffered in the recent years owing to moderation in the global economic growth with risks shifting to the emerging markets and its associated macroeconomic rebalancing pressures. Along with these factors political and geopolitical conflicts have impacted the Islamic capital market growth as well. These facts don't lead to serious shrinking of the sector, as Islamic capital markets are still garnering interest and new entrants. Since 2015, Sultanate of Oman, Cote D'Ivoire in the sovereign sector, and World Bank in multilateral agency category have tapped into the Islamic Capital markets by issuing Sukuk. Like this the number of Islamic funds has been on steady increase by increasing above 1000 publicly available Islamic funds across different asset classes of investments by the end of 2015.

The Islamic finance industry has evolved regulatory perspective wise over the last couple of decades. With introduction of addendums to financial laws in Muslim countries to initiate Islamic banking as the origin of Islamic regulatory framework the industry is moving to global standards. Major Islamic finance destinations, like Malaysia, Pakistan, Turkey, UAE, Indonesia etc. have now separate regulatory laws which govern Islamic finance in their jurisdictions. Newer entrants to Islamic finance are working towards developing standalone Islamic financial laws to govern the growing industry. These efforts have gained pace with the efforts of global Islamic finance regulatory bodies like IFSB, AAOIFI, IIFM etc. The international regulatory bodies have been able to harmonize regulations and reporting of Islamic finance globally while maintaining the diversity of Islamic financial products. The evolution of regulatory frameworks has strengthened the Islamic financial industry by introducing risk management and financial reporting standards to assist the rapid growth of the industry. The regulatory evolution has been discussed in detail in the following sections.

2.4.1 SUKUK MARKET

Sukuk which is plural for sakk, refers to an investment certificate. It could also mean a trustee certificate. Sukuk, it appears, have been used extensively by Muslims in the Middle-Ages as papers denoting financial obligations from commercial activities. Being a fund-raising product, Sukuk have often been referred to as "Islamic bonds" and subjected to comparison with conventional bonds. While the objective of a Sukuk issuance may be the same as that of a bond, i.e. to raise financing, there are many differences between the two instruments. To begin with, one has to keep in-mind that there is no such a thing as "debt" financing in Islamic finance. The only debt there is in Islam, is Qard-ul-hassan, which is a benevolent loan. That is, one which does not have a compulsion on repayment. Given this, while Sukuk are intended to raise external financing just like bonds, their operational, legal, and regulatory frameworks are vastly different. We will address some of these differences later.

Sukuk are perhaps the most successful and most visible Islamic finance product today. Given the range and international diversity of Sukuk issuers, it is obvious that Sukuk have become an internationally accepted Islamic finance product.

Sukuk instruments can be structured in multiple manners by adopting from more than one Islamic contract. Sukuk are often structured on multiple contracts in order to have a needed risk profile and/or a desired cash flow stream. Table 11 briefly discusses different types of Sukuk according to contract nature.

The global Sukuk markets had been thriving for nearly a decade but have faced a slowdown in the recent years, with main reduction in global sovereign Sukuk after the Malaysian central bank ceased issuing short-term Sukuk and the GCC economic downturn.

The history of Sukuk starts of from a demand from financial institutions and governments as Shariah compliant financial institutions required Shariah compliant investment instruments to absorb their surplus liquidity. Although the Sukuk issuances have grown rapidly, the issue of excess liquidity requiring to be absorbed still stands given the limited supply of Sukuk relative to demand.

The general appeal of the Sukuk has attracted issuers from all aspects, sovereigns, corporates, and financial institutions. The demand side of Sukuk is a captive market as all Islamic financial institutions are bound by the Shariah law to invest in them. Recently, high-profile issuances by non-Muslim sovereigns have catapulted Sukuk into the big leagues of finance, earning global visibility despite their very modest size in absolute terms.

Table 11. Underlying Contracts in Sukuk Contracts

Underlying contract	Originator (Mudarib)	Investor (Sukuk holder)	Interim cash-flows(to Sukuk holders)	Cash-flow at maturity
Ijarah (lease)	Lessee of asset. Pays lease payments	Lessor	Periodic Lease Payments	At maturity from sale of asset
Wakalah (Principal-agent relationship)	Agent undertaking investment in underlying asset.	Principal Owner of invested asset	Cash Flows generated by investment	Dependent on type of invested asset and/or economic life of project. No fixed return.
Bay Bithaman Ajil (sale based on deferred payments)	Purchaser of underlying asset	Owner/seller of underlying asset	Payment of purchase price in instalments	May and may not have a final balloon payment
Mudarabah	Mudarib (entrepreneur in need of financing)	Rab-ul-Mal (provide capital)	Periodic cash flows from asset as determined by PSR	Unlikely. Final payment could simply be the last periodic payment given tenor of Mudarabah contract.
Salam (Contract for goods to be delivered later–forward)	Seller of commodity/goods which will be delivered later	Purchaser of commodity/goods which will be delivered later	Proceeds from sale of goods received – if there will be delivering in the interim	Usually the largest cash flows occur at maturity when delivery occurs. Cash flow is from sale proceeds
Istisna	Purchaser of asset under construction	Financier for asset under construction	Payments from Mudarib if any	Profit from sale of completed asset
Murabahah	Purchaser of asset	Financier of asset	Periodic payments received from Mudarib representing price of asset plus mark up	Unlikely. Final payment could simply be the last periodic payment of contract

Source: Created by Author

The appeal of the Sukuk and the structure of the Sukuk to be followed are variable and highly customizable according to multiple factors, as the availability of the underlying asset, the preference of payment plans, and the ownership risk of the parties, pricing etc.

In cases where the underlying asset exists, the Sukuk can be structured using an Ijarah, Murabahah, BBA or even a Mudarabah/Musharakah contract, while Istisna and Salam can't be used as those are to build or to crop contracts in nature. While the preference of payment plan of the parties matters a lot, as structures using Mudarabah/Musharakah offer more flexibility in deciding how the repayments can be made. At the same time, which party is willing to take on the ownership risk of the underlying asset can change the choice and preference as well. While the Murabahah Sukuk transfers the ownership to the Purchaser of the asset immediately, Ijarah Sukuk holds the ownership risk with the financier of the asset. While there is risk associated with the ownership preference, it also provides ownership claims which may allow the financiers of the asset more security. Pricing of the Sukuk contributes towards the use of underlying contract. Murabahah, Salam, Istisna, provide a predetermined pricing to a Sukuk, as legally their pricing cannot be modified once the contract has been signed. Mudarabah and Musharakah contracts are variable pricing in nature as they are profit sharing contracts, while Ijarah Sukuk can fall under both categories.

Some of the current trends in Sukuks are:

- The growth of Sukuk issuances catapulted to mainstream attraction post 2005 as the oil prices increased globally and demand for Sukuk increased since most Islamic financial jurisdictions were flush with cash.

- The Sukuk issuances nearly doubled in 2006 from the preceding year's total of $11.3 billion to $20.4 billion and the trend continued in 2007 when the Sukuk issuances stood at $37.6 billion globally.

- The financial crises of 2007-08 took its toll on the Sukuk market as well as the Sukuk issuances declined to $20.9 billion in 2008 and slowly recovered to $34.3 billion

- The recovery of the Sukuk markets was dramatic post that and it surpassed $50 billion mark in 2010 for the first time. This was on the back of booming Islamic banking business and a huge demand from investors for placing their investments Shariah compliant way.

- The quantitative easing of 2012 globally catapulted Sukuk markets to a global level and it became a financing vehicle for Islamic and conventional issuers from all over the world, reaching the $137.1 billion in new Sukuk issuances breaching the $100 billion-mark first time.

- Sukuk issuance decreased slightly to $116.93 billion in 2013 and to $101.7 billion in 2014. Although the $ value of Sukuk issuances declined slightly in these years the number of issuances had increased to 834 in 2013 as compared to 763 in 2012. One of the reasons was the diversification to non-traditional markets
- 2014 is probably one of the more prominent years for global acceptance as several non-Muslim countries issued their debut Sukuk, including Hong Kong, Luxembourg, South Africa, Senegal, and the United Kingdom. Not only did non-Muslim Sovereigns

entered the Sukuk market, several corporate entities from non-traditional jurisdictions raised capital through Sukuk issuances. The number of different jurisdictions in Sukuk issuance reached 19 in 2014 increasing from 16 in 2013.

- The entrance of United Kingdom in 2014 to the Sukuk markets has acted as a catalyst for other non-Muslim sovereigns and corporates to enter the market. Hong Kong, South Africa, Luxembourg, Japan's Bank of Tokyo-Mitsubishi UFJ, and Goldman Sachs all followed United Kingdom's Sukuk issuance with their own.

- The Sukuk market dropped in 2015 was a drastic 35.2% to $65.9 billion from $101.8 billion in the year before. 2015 and 2016 have been challenging economic years for the Islamic finance jurisdictions. The reasons for the challenges are summarized below:

  - Exchange rate depreciation in emerging markets
  - Economic slowdown globally and a depressed outlook for the future.
  - Prolonged low energy prices in world markets,
  - Weaker investor and consumer confidence in the global economy. There have been recent signs of a global recovery, which are expected to rejuvenate growth of Islamic banking globally.
  - Increasing global interest rates.

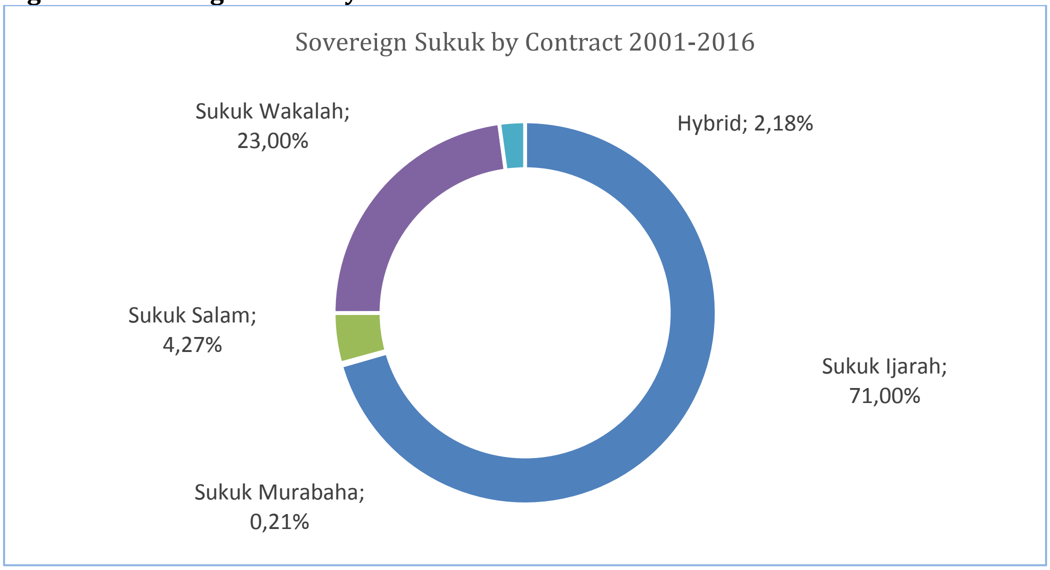
Although the general reasons as highlighted above contributed to the drop in 2015 and 2016, another major reason is the high dependency of the Sukuk industry on government issuances. The drop was contributed mainly by the Malaysian governments' decision of terminating any new issuance of short-term paper, and to a lesser extent, a drop in Saudi Arabian issuance.

Sovereign Sukuk Issuances

Sovereign Sukuk issuances have contributed the major chunk to the total Sukuk markets over the last decade. Rough estimates show that in 2012-2015, nearly 50% of the Sukuk issuances originated from governments and were the drivers of the growth in the industry. Malaysia has historically been the leader in sovereign Sukuk issuances, with nearly half of sovereign Sukuk globally coming from the country. Over the last year a new entrant to the market has been Indonesia which contributed 20% of the sovereign Sukuk. The issuances coming out of Indonesia are expected to grow in the coming years as it embarks on an aggressive development of its infrastructure. Although sovereign Sukuk issuances volume has been relatively declining over the past few years, the gap has been fulfilled by quasi-sovereign Sukuk. Malaysia has been leading the effort as government agencies have started tapping the Sukuk market to raise capital. In 2016, nearly 80% of Sukuk issuances were quassi-sovereign.

In terms of structure of Sovereign Sukuk issuances, Ijarah Sukuk has been popular over the last decade with almost 70% of all issuances based on ijarah contract. The Figure below gives a snapshot of the Sovereign Sukuks by their contracts.

Figure 4: Sovereign Sukuk by Their Contracts



Source: IIFM 2017

2014 and 2015 were strong years for Sovereign Sukuk issuances in terms of newer jurisdictions as countries outside the OIC and previously untapped OIC membe countries' governments entered the sovereign Sukuk markets.

- International organizations and governments in 13 jurisdictions tapped the global sovereign Sukuk market in 2015 alone. The markets witnessed the entry of the Sultanate of Oman in the GCC with the jurisdiction issuing an OMR250 million (USD650 million) five-year Sukuk Ijarah in October 2015. It was originally planned as an OMR 200 million issuance but was oversubscribed by 1.7 times which led the government to upsize the issuance. This Sukuk issuance not only raised capital for the Sultanate but also acted as a catalyst for the Islamic banks, Islamic funds and Takaful companies to invest their excess liquidity. They are expected to follow up with another issuance this year.

- African continent witnessed Ivory Coast (Cote D'Ivoire) becoming the latest African state to enter the Sovereign Sukuk markets in the end of 2015 by launching its five-year sovereign Sukuk programme worth XOF150 billion19 (USD250 million). The Sukuk issuance has been arranged and supported by the Islamic Corporation for the Development of the Private Sector, an IDB affiliate, and the proceeds will be raised to finance development projects in Ivory Coast.

- Another notable issuance was the repeat offering of Hong Kong 5 year Sukuk worth USD 1.1 billion.

- Turkey has been fast catching up on the sovereign Sukuk market, and 2015 witnessed the government treasury tapping the sovereign Sukuk market twice in 2015

Corporate Sukuk Issuances

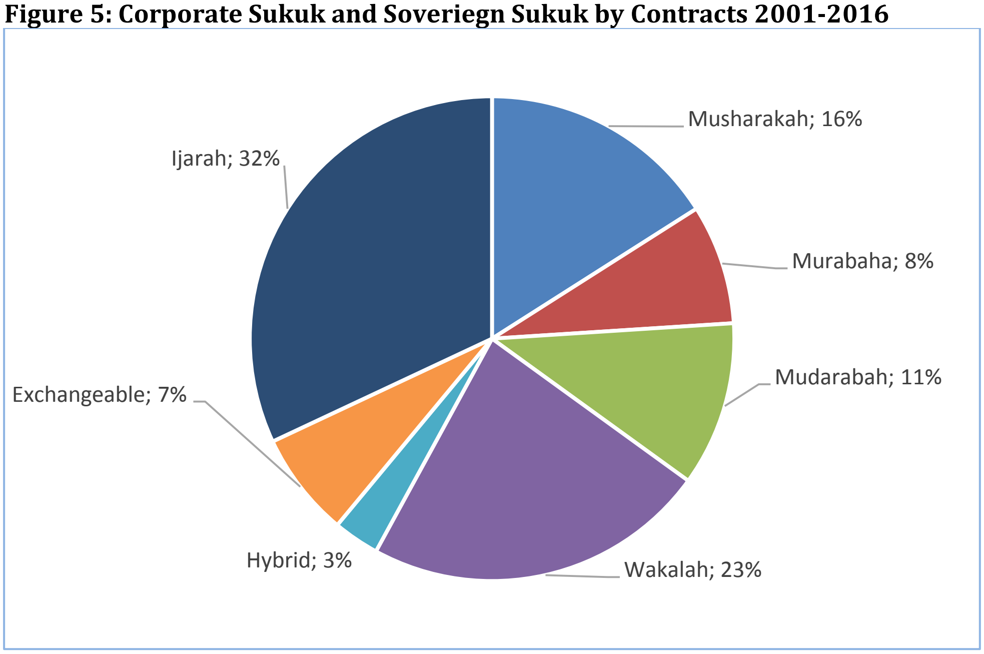
Post the financial crisis, the corporate issuers have relatively been shy of issuing large Sukuk, with 2016 Sukuk issuances amounting to estimated USD 15.4 billion, a 25.7% decline from the previous year USD 20.7 billion as reported by IFSB (May 2017).

The downward trend commenced in 2013, starting with the US Federal Reserve's first indications in mid-2013, and eventual decision in early 2014, to gradually begin scaling back its quantitative easing programme, leading to concerns of rising global interest rates; this has been followed in 2015–2016 with socio-political and macroeconomic challenges in various regions of the global economy, leading to subdued economic growth performances.

The year 2016 witnessed notable issuances by GCC based banks, who issued tier 1 Sukuk to comply with Basel III requirements, such as Dubai Islamic Bank (US$500 million), Abu Dhabi Islamic Bank (US$1,000 million), Noor Bank (US$500 million), and Bank Al Jazira (US$533 million).

In terms of structure of Corporate Sukuk issuances, Ijarah and Murabaha Sukuk has been popular over the last decade with almost 55% of all issuances based on these two contracts. The following table gives a snapshot of the Corporate Sukuks by contract

Figure 5: Corporate Sukuk and Soveriegn Sukuk by Contracts 2001-2016



Source: IIFM 2017

Challenges to Sukuk Markets

The Sukuk markets though developing at a fast pace historically have slowed down, and the trend seems to have persisted for the last two years. Surveys and inquiries into the apparent challenges the Sukuk markets face in both primary and secondary markets. Summary of those challenges and issues is highlighted below.

- Limited Sukuk supply main driver for lack of liquidity and tradability. The reason for this arises out of the shortage in the supply of Sukuk in the market. Mainly because of the general hold till maturity strategy of investors. Generally, Islamic financial institutions invest more heavily in Sukuk compared to other non-Shariah-compliant investors, as the former are limited to Shariah-compliant investments.
  From the sell side perspective, the issue of liquidity arises out of insufficient depth of bids in the Sukuk market. This can be attributed to the significant drop in Sukuk issuances since 2014. It has risen out of the suspension of short-term issuances in Malaysia and the drop in sovereign issuances from GCC countries that have recently shown a preference for conventional bonds.
  The shortage of supply also emanates from the asset based nature of Sukuk. Sukuk issuers need to have underlying Shariah-compliant assets to structure Sukuk and, therefore, the size of issuance is somewhat limited, whereas conventional issuers can access the market more easily.

- Market preference of long-term Sukuk: As a recent survey by Thomson Reuters suggested that investors and issuers have a stronger preference for long term Sukuk. The survey suggested that preference is for 3-5 years' tenor followed by longer 5-10 years' tenor Sukuk in the market players. The shift to longer tenors for investors indicates that they are willing to accept the risks associated with longer tenors.

- Legal regimes: Different legal regimes put Sukuk at a disadvantage as compared with conventional bonds. The issuance of Sukuk often requires the issuing entity to create a Special Purpose Vehicle (SPV) and transfer the assets underlying the Sukuk to such SPV. Additional taxes and stamp duties may be incurred as a result. Muslim majority countries have generally introduced laws to bring Sukuk and bonds at same level, but more global laws need to be brought in.

Investment exposure to Sukuk offers diversification benefits, as well as generally being an instrument used for long term holding strategy. This grants an additional layer of insulation against volatility relative to conventional fixed incomes.

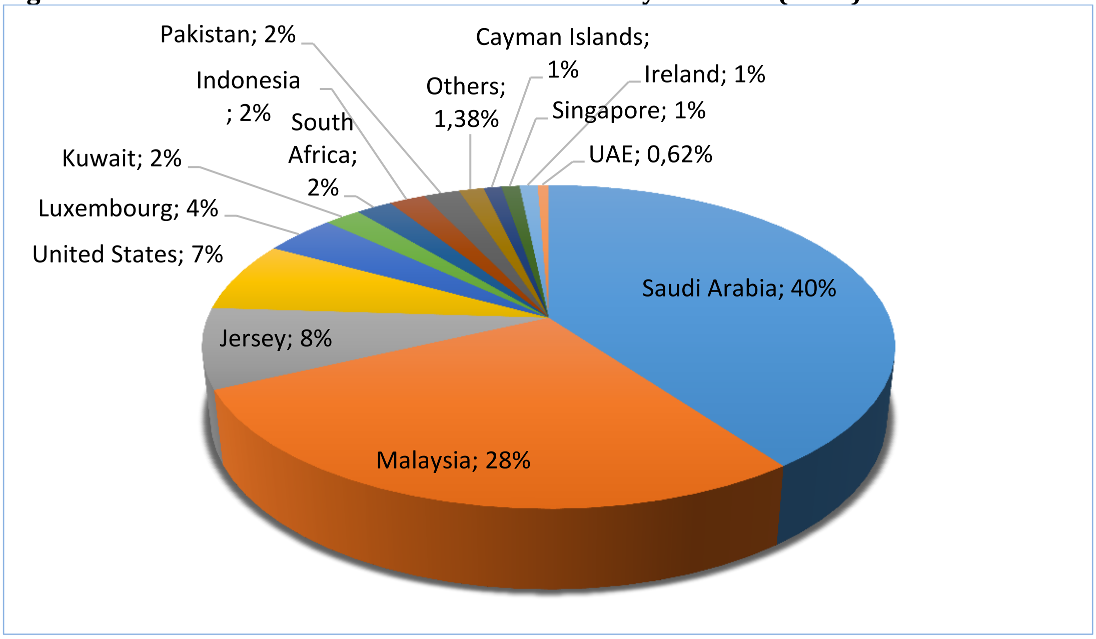
With additional information and enhanced knowledge, investors are becoming more comfortable with Sukuk investing. There are clear signs that the Sukuk market is maturing and spurring a growing interest in gaining investment exposure to the asset class. Sukuk investments and the reversal in the global Sukuk issuances presents diversification benefits for investors who have until now only invested in the traditional fixed income space. It has the ability to enlarge the total fixed income investment universe to offering international diversification with credit quality and Shariah-compliant financial sector exposure.

2.4.2 ISLAMIC EQUITIES AND FUNDS

While Sukuk hold their uniqueness, and considered as alternative instruments in the global markets, the Shariah compliant equities operate as a subset of the broader global stock markets. Securities listed on stock markets which comply with Shariah principles and pre-defined Shariah screening criteria are considered as Islamic Equities and forms the composition of all Shariah compliant mutual funds. Being a subset of the global equity markets results in Islamic equities and funds being affected by the volatilities and pricing movements in global stock markets.

The Shariah screening criteria tends to reduce the number of available stocks to Shariah compliant investors, as compared to their conventional counterparts. Nevertheless, in recent years it appears that Shariah-compliant equity indices have outperformed their larger conventional peers, largely due to their different sectorial composition.

Figure 6. Global Breakdown of Islamic Fund Assets by Domicile (2016)



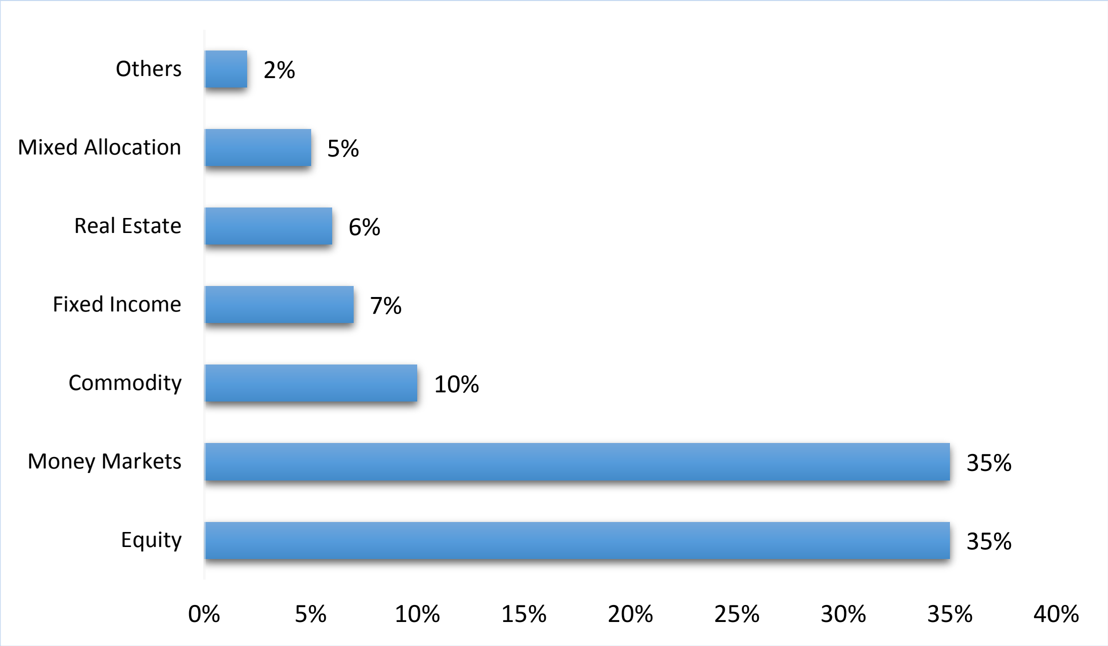
Source: IFSB, Bloomberg and Zawya

The availability of a universe of Islamic equity listings/indices has led to enabling the development of Islamic funds industry to offering innovative funds to Shariah conscious investors. The number of funds over the years has grown steadily from around 800 in 2008 to over 1200 funds this year globally. The global markets downturn coupled with emerging market currency depreciations (particularly impacting domestically invested funds in Malaysia and Indonesia) in 2015, has had an adverse impact on the net asset values of the Islamic funds in US Dollar terms. At the end of 2016, the Assets under Management industry's Shariah compliant funds was estimated to be $ 74 billion[10] as compared $76 billion in 2014. The steady increase in the number of funds while a slight drop in the asset size has led to a decrease in

10 Author's calculations using data from multiple sources. (Zawya, Bloomberg, IFSB)

average fund sizes of Shariah compliant funds. This may not be a time to worry as global equity markets have been volatile and depressed due to global economic cycle. But lower average size can lead to an implication that a considerable number of funds may not reach a critical mass in volume which would lead to mergers of funds or in a worst-case closure, as the Islamic fund management companies struggle for achieving economies of scale.

Figure 7. Global Islamic Fund Assets by Asset Class (2016)



Source: IFSB

In terms of domicile of Islamic funds, the global diversity and appeal of Islamic finance is witnessed. While Saudi Arabia leads the global Islamic fund industry with lion's share of 40% of the total Asset under management followed by Malaysia at 28%, the next three domiciles in the top five are non-OIC jurisdictions – namely, Jersey 8%, the United States 7% and Luxembourg at 4%.

In terms of asset-class breakdown of the global Islamic funds' assets under management the share of equity funds has dropped from 38% in 2014 to 35% by the end of 2016 while money market funds have increased to 35% by 2016. This change has been propelled by contracting equity markets over 2015 and 2016 and an increasing shift towards fixed-income instruments by investors.

2.4.3 TAKAFUL (ISLAMIC INSURANCE)

Takaful is the Shariah compliant counterpart of conventional insurance. Linguistically, in Arabic the word 'Takaful' is derived from 'Kafalah', meaning guarantee. Though some jurisdictions like Sudan and Malaysia have a well-developed Takaful sector dating back to the 1980s, at the global level, Takaful can still be thought of as an infant industry. The Takaful industry includes Family Takaful (sometimes referred to as 'Life takaful'), General Takaful, Micro-Takaful and Re-Takaful.

The concept of Takaful in its essence is very similar to that of mutual insurance, with the exception that it complies with Islamic law. Essentially, an operational Takaful model has to be free of not just Riba, but the elements of Gharar (excessive or avoidable uncertainty) and Maysir (gambling). The basis of Takaful is mutual solidarity with risk sharing – specific funds are established with a selected group of Takaful participants agreeing to jointly support each other from any losses arising from specified risks. The schemes or funds are then managed on their behalf by a Takaful operator, who usually earns income on the basis of Mudarabah (profit and loss sharing) or Wakala (agency). Hence in one word, the two key characteristics of any Takaful operation are Shariah compliance and Risk sharing.[11] A diversified Islamic financial industry with a well-developed Takaful sector also contributes to increasing the overall stability of the financial system.

The 'optimal structure' of a Takaful model is still a disputed matter. In the international landscape, multiple models are used, mostly based on Tabarru (donation), Wakala, Mudarabah and Waqf. As the table below demonstrates, though sometimes the Takaful operation is on a pure Mudarabah or a pure Wakala basis, in many jurisdictions today including Sudan, Bahrain, Malaysia and Pakistan, hybrid models are used, such as Wakala – Waqf, Mudarabah – Wakala and Wakala-Mudarabah-Waqf. The choice of the operational model depends on factors such as

- Regulations in a given jurisdiction
- Whether its Family Takaful or General Takaful
- Requirement from Shariah advisor
- Compliant securities.

Table 12. Differences in Takaful Models Used

Properties	Mudarabah	Pure Wakala	Mixed	Wakala-Waqf
Creation of fund:	The participants (Takaful clients)' contributions	participants' contributions	participants' contributions	There is an initial donation to create Waqf
Fees:	None	Up-front fees as agreed	Up-front as agreed	Up-front as agreed
Underwriting losses:	Qard-a-hasan from Takaful operator	Qard-a-hasan from Takaful operator	Qard-a-hasan from Takaful operator	Waqf to solicit funds
Investment profits:	None	None	As per the agreed profit-sharing ratio	As per agreed profit-sharing ratio
Investment losses:	Borne by participants	By participants	Borne by Takaful operator	by Takaful operator
Operational expenses:	Borne by Takaful operator (with some exceptions)	by Takaful operator	by Takaful operator	by Takaful operator
Liquidation	Proceeds accrue to participants only	Proceeds accrue to participants only	Proceeds accrue to participants only	Proceeds accrue to participants only
Present in Jurisdictions:	Malaysia, Saudi Arabia and some GCC members	United Kingdom	Bahrain, Malaysia and Sudan	Pakistan & South Africa

Source: IRTI Global Report on Islamic Finance, 2016

11 IRTI The Global Report on Islamic Finance 2016, Chapter 5 Takaful

The pioneering Sudan, Malaysia and Bahrain practice a mixture of Wakala and Mudarabah models. The United Kingdom uses pure Wakala-based model for Takaful, whereas Saudi Arabia and Malaysia also use pure Mudarabah. In Pakistan, it is a Shariah requirement that the Participants' Takaful fund be operated as a Waqf (i.e. not in the direct ownership of either the Takaful operator or the participants), and hence a Wakala-Waqf model (which also includes the Takaful operator acting as a Mudarib for the Participants' investment fund) is used.

In all these models, a separate fund is set up, managed by the Takaful operator, on behalf of the Takaful participants. When multiple products are offered, e.g. Motor insurance, marine insurance and fire insurance, usually separate funds are set up to cover losses arising from each risk. For any given period, the Takaful operator can either have an underwriting surplus (contributions exceeding payments, usually paid for either by past retained surplus or by Qard-e-Hasan from shareholders or investment fund) or an underwriting loss. Quite separate from this, the investment fund also bears investment profits or losses. In some hybrid models, such as the Wakala-Waqf-Mudarabah model for Family Takaful practiced in Pakistan, there is a separate Participants' Investment Fund, while payments made to the participants to cover their risks are made from a separate Takaful fund.

In a pure Mudarabah Takaful model, the Takaful operator acts as a Mudarib, entitled to a pre-agreed profit ratio (such as 35%, 40%, 50%) of any underwriting surplus and/or investment profits. The participants are then similar to depositors or investors in a typical Mudarabah based product. Hence, the Takaful firm bears the operational expenses, shares in favorable performance returns of the assets under management, but their income cannot be guaranteed. Any losses from investment are born by the Rabb ul Maal as per Shariah rules (i.e. the Takaful participants), while underwriting losses are paid for by Qard – Hasan from the operator.

The mixed Wakala-Mudarabah model is the dominant Takaful model in the Middle East, with the Central Bank of Bahrain taking an initiative to make it compulsory for its Takaful and Re-takaful firms. Compared to pure Mudarabah, here the Takaful operator manages two funds – one with shareholders, and the other of the Takaful participants. A Wakala fee (a percentage of participants' contribution) is paid to the Takaful operator for the takaful fund (from which the underwriting claims are paid). The operator earns a fee for any surplus in the participants' fund (serving as incentive for effective management), and invests the surplus as a Mudarib in Shariah However, there were issues arising from the fact that the participants' takaful fund was at least partially owned by either the Takaful operator or the participants. The distribution of surplus raised similar concerns – with a conflict of interest on whether to hold them for future sustainability or distribute them among the participants. As Takaful (to make the process Shariah compliant and free from Maysir-gambling contract where several members contribute and only a few win) is conceptually based on Tabarru (donation), there was also a Shariah issue that profit sharing contract should not be applied to donations, and over the legal status (and ownership) of the Takaful fund. Hence, a hybrid Waqf model was developed, in which the participants' contribution goes directly to a Waqf fund (from which payments cannot be made except for claims payout – the purpose of the Waqf). This is because the Waqf has no owner (except Allah Almighty). Waqf-like trusts are legal institutions in their own right, and the operator can only manage the fund and administer its rules. The operator ears a Wakala fee on the Waqf fund, and the Waqf pays underwriting costs, claims and re-Takaful expenses. The participants have a Mudarabah relationship with the operator in the separate investment fund.

After Sudan in 1979, Malaysia was the first country to establish a Takaful company. The Malaysian government had set up a task force for studying feasibility of Takaful companies' establishment in the country, and the first company, Takaful Malaysia, was established in 1981, commencing its operations in July 1985[12]. By 2013, Takaful operators were active in other South east Asian and GCC countries including Saudi Arabia, Bahrain, UK (in 2008), Kuwait, UAE, Qatar, Indonesia, Nigeria (2013) and Pakistan, and the total gross Takaful contributions exceeded USD 12 billion[13], with EY estimates suggesting a size of USD 20 billion by the end of 2017. The different Takaful products available (individual and group) include:

- Motor Takaful (Also referred to as 'Auto', car insurance is compulsory in many jurisdictions)
- Marine Takaful
- Commodity Takaful
- Fire
- Property
- Health
- Family Takaful
- Savings plans and Banca Takaful products
- Micro-takaful[14], in some jurisdictions only such as Sudan
- Agricultural takaful
- Miscellaneous

The Takaful industry in any given country may include both full-fledged companies, and local insurance companies operating Takaful windows. Takaful firms sometimes operate solely as either Family or General Takaful operators, and sometimes offer both products. Only a selected few jurisdictions, located mainly in GCC states (excluding Malaysia and recently Singapore) such as Bahrain, Dubai and Sudan have Re-takaful companies. Family Takaful differs inherently from General Takaful. The participants' funds in a Family Takaful can roll over to subsequent years, with Life insurance plans being typically long term in nature. These products include contracts of indemnity but also contracts of benefit. In the latter, the participants (mostly the family breadwinners) contribute to a plan to compensate their family members in the event of their passing[15], choosing the maximum coverage they wish to be entitled to (with the premiums varying accordingly). However, family takaful products (including Banca life takaful ones) are also saving plans, where the participants can withdraw the accumulated fund with a significant gain after the contract expires, while their beneficiaries are paid in the event of the participant's death during the contract period. In general Takaful, however, including health, fire and motor, the plans by their very structure are often not able to accumulate enough funds to cover all the claims. There is also the element that the maximum claim (the cost of indemnity, such as in the event of a fire) can often not be known beforehand, and the Takaful participants can have multiple claims over the duration of the contract. In essence, the contribution balances are typically not rolled over with each policy period. Unlike family takaful, if a participant pays $200 for a general takaful product,

[12] Takaful Malaysia Annual Report 2016
[13] Ernst and Young, 2014
[14] Micro Takaful refers to products designed for the financial needs of low-income groups, to enable them to get partial relief from unexpected events, major expenses or financial difficulties.
[15] Often different benefits are paid in event of natural death and accidental death. Benefit is also paid to the participant in many Life takaful products in the event of permanent disability

such as Car theft policy, and their car is not stolen in the period, the sum is not repaid to the participant. If the event does occur, the Takaful operator inherently relies on the funds of other participants to finance the payout. The main countries in which Takaful companies exist (at the start of 2016) are given below. Of these, the countries included in this report are underlined.

- ➔ Malaysia-
- ➔ Saudi Arabia
- ➔ Iran
- ➔ Sudan-
- ➔ UAE
- ➔ Qatar
- ➔ Kuwait
- ➔ Bahrain
- ➔ Turkey
- ➔ Pakistan
- ➔ Indonesia
- ➔ United Kingdom
- ➔ Bangladesh
- ➔ Egypt
- ➔ Nigeria
- ➔ Singapore
- -> Jordan
- -> Oman (entered in 2016)
- -> South Africa

Finally, the Takaful industry across the globe faces some major challenges that contribute to preventing the growth of this sector in the major Islamic finance jurisdictions. First and foremost is that even in many of the Muslim countries which have presence of Islamic banking and/or Islamic capital markets, there is a general lack of awareness of Takaful, of its needs, its Shariah fundamentals, how it operates and differs from conventional insurance. By comparison, Islamic banking and Islamic capital markets segments often see a demand-driven growth in Muslim countries. Second, as mentioned above, operating Takaful operators (full-fledged and windows) in both Life and General Takaful face a shortage of available Re-Takaful companies. In Pakistan for example, prior to 2010, the Securities and Exchange Commission of Pakistan (SECP), due to dire need, even allowed the Takaful operators to obtain Re-takaful services from conventional re-issuers. Third is a general lack of well-developed legal framework for Takaful, Takaful windows or Re-Takaful in several jurisdictions.

Summarizing, some of the key issues and challenges facing the Takaful industry are:

- Lack of consumer awareness: Despite Takaful industry being around for a few years the increase in the level of penetration anticipated has yet to be realized. Many consumers are still unaware of Takaful as an alternative, and some view Takaful as commercialization of conventional insurance into the Islamic world and reject the notion that it is a Shariah-compliant instrument. Moreover, in developing countries the understanding by individuals of the importance of security and retirement planning is low and thus lower interest in the Takaful industry. Most of the current education on Takaful is among interested or related practitioners and investors, and very few awareness campaigns are aimed at or designed for the target population.

- Scarcity of human resources with both insurance and Shariah expertise: Growth has been hindered because of a very small pool of professionals with sufficient Takaful knowledge in areas such as law, sales, and actuarial services. Most operators would typically employ human resources, such as legal advisors and actuaries, with conventional insurance experience who tend to undertake short courses on Shariah. Hence the mindset of most operators tends to be driven by conventional thoughts and solutions and, as a result, there has been limited original thinking in the industry.

- The shortage of Shariah scholars with appropriate experience: Since Takaful companies by laws in most places require a Shariah Supervisory Board, the lack of Shariah scholars with an understanding of insurance and takaful market are a handful only. Also these handful of scholars inevitably, are sitting on multiple boards, which may create conflicts of interest.

- Lack of standardization in the industry that is due to Shariah interpretations: Since the Takaful industry is in its nascent stage, a wide range of issues are still under debate amongst different scholars and practitioners. The main issue is the model used for Takaful structure. There is a wide variation in practices and model preferences in various countries, which is due to the varying interpretation by scholars. For example, in Saudi Arabia, the regulators—Saudi Arabian Monetary Agency (SAMA)— approve a cooperative model in which only 10% of the surplus is mandatory for distribution to policyholders. Similarly, in Iran (where the entire legal system is Islamic-based), Takaful remains an unknown concept as the as they do not view conventional insurance to be non-Shariah-compliant.

  However, despite these regional variations, there is a global trend elsewhere towards a Wakala-based model without any sharing of the underwriting profits. This approach has also been formally approved by the AAOIFI, which is a step towards standardization. However, a global standard for Takaful models remains to be seen, which is due to the varying opinions and interpretations of Shariah scholars around the world.

- Diverging regulatory approaches and the lack of centralized regulations: In the absence of standardization of a global Takaful regulatory regime, the industry is relying heavily on the opinion of the Shariah boards of the Takaful companies, subject to any local regulatory constraints.

- Corporate governance: The current relationship between the Shariah Supervisory Board and the board of directors of the Takaful operator is typically one of deep trust and integrity. However, it is still necessary to set clear, written guidelines on the scope and the responsibilities of the Shariah board. Compliancy should cover all aspects of the operation, including the Takaful model adopted, product offerings, surplus sharing and fee structures, Islamic investments, contract

3 CASE STUDIES IN DIVERSIFICATION OF ISLAMIC FINANCIAL INSTRUMENTS

The following chapters, from 3.1 to 3.10, examine ten (10) different countries, as mentioned in the Introduction, as case studies in the diversification of Islamic financial instruments at present, in Islamic banking, Islamic capital markets and Takaful segments in these countries.

3.1 CASE STUDY: NIGERIA

3.1.1 SUMMARY

The Islamic finance sector of Nigeria comprised of active players in the Islamic banking, *Takaful* and Islamic capital market segments. Even though it is a relatively new concept compared to the conventional finance, it has high prospects for growth and development as evidenced by the increasing number of institutions as well as the impressive growth rate. An analysis of the sector revealed that most of the basic Islamic financial contracts are offered by the Islamic financial institutions however the following contracts dominate*: Qard Hasan, Mudharabah, Murabahah* and *Ijarah*. The sector is also being challenged by lack of adequate Islamic finance architecture which poses threat to its growth and development. The legal and regulatory environments are still not fully developed to effectively support its workings. Additionally, the Islamic financial institutions are constrained largely by lack of knowledge and expertise to come up with sophisticated Islamic financial instruments beyond the traditional instruments. These factors have adversely affected the ability of the institutions to innovate thereby limiting the diversification of Islamic financial instruments in Nigeria. There is however great expectations that over time we will begin to see innovations in the development of the Islamic financial instruments as there are some educational institutions offering courses in financial engineering in Islamic finance in the country. This will expectedly bridge the knowledge gap of the operators and facilitate innovations in product developments. For proper development of diversified Islamic financial instruments, some key recommendations in the areas of regulations, capacity development and legal requirements are made in the paper.

Nigeria is located in West Africa and has a total area of 923,768 square kilometers. It shares land borders with four (4) Countries: Chad, Niger, Benin, Cameroon and a water border with the Atlantic Ocean. It is a political federation consisting of 36 autonomous States with Abuja as its Capital. It runs a presidential system of government and has multi- ethnic, religion and cultural identities. According to the World Bank, Nigeria's population is currently estimated at about 184 million inhabitants accounting for 47% of West Africa's population, and a 50% Muslim population (2015)[16] – with the Muslims population in Nigeria being quite large. It is this huge Muslim population and the fastest growth of Islamic financial institutions that make Nigeria a great potential for Islamic Finance.

[16]According to the CIA's World Fact book 2016, the religion distribution of Nigeria was: Muslim 50%, Christian 40% and indigenous beliefs 10%

3.1.2 INTRODUCTION

The Islamic finance sector, which comprises of Islamic Banks, *Takaful* institutions and Islamic capital markets is relatively new in Nigeria when compared to the conventional finance sector. Habib Bank was the first conventional bank in Nigeria to be granted license to operate an Islamic Banking Window in 1992 following the amendment of Banks and Other Financial Institutions Act (BOFIA) in 1991 to recognize profit and loss sharing banking model. The Window commenced operations in 1999; however, it did not survive as Habib Bank, which metamorphosed into Bank PHB after merger with Platinum Bank in 2005, was liquidated in 2011.

Islamic finance was again boosted in 2011 when the Central Bank of Nigeria (CBN) released the guidelines for the regulations and supervision of institutions offering non-interest financial services in Nigeria. Following the release of the guidelines, a full-fledge Islamic Bank (Jaiz Bank), Stanbic IBTC and Sterling bank Islamic Banking Windows as well as Tijara microfinance Islamic bank were licensed and commenced operations between 2011 and 2014. A new Microfinance Islamic Bank, I-Care Microfinance was recently licensed (in the last quarter of 2016) and commenced operations in April 2017. These five (5) institutions constitute the Islamic banking sub-sector.

A significant milestone in *Takaful* was also recorded in 2013 when the National Insurance Commission (NAICOM) issued the Guidelines for *Takaful*-Insurance. Following the release of the guidelines, two full-fledged *Takaful* companies, namely *Jaiz Takaful* and *Noor Takaful* as well two (2) *Takaful* windows (African Alliance Insurance and Niger Insurance) and a division of *Takaful* (Cornerstone Insurance) of conventional insurance companies were incorporated and thus by December 2016, there were two full-fledged *Takaful* companies and three conventional insurance companies offering *Takaful* as a product.

Similarly, the Nigerian Islamic Capital market comprises of two (2) Islamic funds, namely: Lotus Capital Halal Fund and Stanbic IBTC- Iman Fund as well as Osun State Government *Sukuk*.

In Nigeria there are no dedicated laws for Islamic Finance. The legal framework for Islamic finance was derived from the existing conventional finance laws by leveraging on some provisions in the laws to establish Islamic financial institutions. These laws include: Banks and Other Financial Institutions Act (BOFIA) 1991, Central Bank of Nigeria (CBN) Act 2007[17], Nigerian Deposit Insurance Corporation (NDIC) Act 2006[18], National Insurance Commission (NAICOM) Act 1997[19] as well as Company and Allied Matters Act (CAMA) 1990[20] and Investment and Securities Act (ISA) 2007[21]. This lack of separate laws for Islamic finance has contributed in retarding the growth and development of Islamic finance in Nigeria.

[17]For details see sections 23(1) 52; 55(2); 59(1)(a); 61 of Banks and Other Financial Institutions Act (BOFIA) 1991 (as amended). Available at: https://www.cbn.gov.ng/OUT/PUBLICATIONS/BSD/1991/BOFIA.PDF

[18] For details see part 1 section 2. Available at: www.ndic.gov.ng/files/ndicact.pdf

[19] For details see section 7 of the NAICOM Act 1997. Available at: https://www.proshareng.com/report/Regulators/NAICOM-Act-1997/3394

[20] For details see Part II Chapter 1: Available at: www.placng.org/new/laws/C20.pdf

[21] For details see parts 8, 13 and 17: Available: www.sec.gov.ng/wp.../THE-INVESTMENTS-AND-SECURITIES-ACT-2007_NIGERIA.pdf

The key regulatory bodies in the Nigerian financial sector are the Central Bank of Nigeria, the Nigerian Deposit Insurance Corporation, the National Insurance Commission, the Securities and Exchange Commission and the Corporate Affairs Commission (CAC). The regulatory bodies' main objective is to promote and develop a sound financial system in Nigeria. It is in the realization of this objective that the regulators made some significant achievements in the promotion and development of Islamic Finance in the Country. These achievements include the following:

- Issuance of regulatory and supervisory frameworks for financial institutions offering non-interest financial services between 2011 and 2016;
- Issuance of guidelines for determining the liquidity status of *Sukuk*
- Setting up of Advisory Council of Experts (ACE)[22] – which is the Supervisory Shariah Board – by the regulatory bodies;
- Reduction in the liquidity ratio requirement from 30% to 10% for Islamic banks in view of their peculiar liquidity management challenges;
- Reduced minimum capital requirement for setting up Islamic banks; and
- Development of liquidity management instruments for Islamic banks to ameliorate their precarious liquidity challenge
- Development of guidelines for the implementation of IFSB 15 & 16 for Islamic banks in Nigeria

3.1.3 ISLAMIC BANKING IN NIGERIA

The performance of the segment as can be seen in the following table, remains dismal when compared to the entire banking industry as the total assets, deposits and financing (credit) of the segment according to the CBN's FinA[23] (Financial Analysis) which stood at $230 million, $164 million and $116 million as at December 2016, accounted for only 0.23%, 0.27% and 0.22%, respectively of the industry. Even though the performance was dismal, the growth rate of the three indicators outperformed those of the conventional financial institutions as total assets, deposits and financing grew by 29.4%, 26.6% and 39.2% as against 11.8%, 6.2% and 22% recorded by the conventional financial institutions in 2016, respectively.

[22] This is the Shari'ah Supervisory Board (SSB). In Nigeria, in the regulatory agencies it is known as the Financial Regulation Advisory Council of Experts (FRACE) while in the individual Islamic financial institutions it is known as Advisory Committee of Experts (ACE)

[23] Regulatory software for rendition of returns by Commercial Banks to the Central Bank of Nigeria on a daily basis

Table 13: Financial Performance Indicators as at December 2015 and 2016

Banking Sector Data in $ (1$ = 306 NAIRA)						
2016:	**Conventional Banks (Million $)**	**Non-interest Banks (Million $)**	**Total for Industry (USD million)**	**% Non-interest Banks/ Industry**	**Conven-tional Banks growth rate (%)**	**Non Interest Banks growth rate (%)**
Total Assets	98,473.88	229.66	98,703.54	0.023	11.76	29.4
Total Deposits	60,575.76	164.33	60,740	0.27	6.15	26.58
Total Credits	53,131.13	115.55	53,247	0.22	21.98	39.21
2015:						
Total Assets	88,111.92	177.48	88,289	0.2		
Total Deposits	57,066.86	129.82	57,197	0.23		
Total Credits	43,558.08	83	43,641	0.19		

Source: CBN's FinA (Financial Analysis)

The Islamic Banking Products[24]

Islamic banks structured products to satisfy the demand for service from their customers. These products are classified into two categories; namely: Funding (Deposit mobilization) and Financing products. A snapshot of the deposit mobilization products is depicted in table given below:

Table 14: Deposit (liabilities) Mobilization Products

Customer requirements	Islamic Banking Product
Individual & Corporate Savings Accounts **Tier one & two Savings Accounts**	Mudarabah, Qard Hasan
Special Investment Accounts	Mudarabah Term Deposit
Investment account, Zakat and Sabil Management accounts	Wakala Investments
Liquidity Management Purposes	Wadiah based Accounts
Current and Domiciliary Accounts for both individual and corporate customers as well as Salary Account for individuals.	Qard Hasan

Source: Compiled from the websites of Jaiz Bank, Sterling and Stanbic IBTC Non-interest banking windows and Tijara Islamic Microfinance Bank.

[24] Details of these products can be obtained from the websites of Jaiz bank, the two Islamic banking windows and Tijara Microfinance at: http://jaizbankplc.com/?s=jaiz+annual+report, http://www.stanbicibtcbank.com/Nigeria/noninterestbanking, http://www.saf.ng/about.php, http://aifreport.afrief.com/tijara-microfinance-bank-limited/

The shares and sizes of these products in the entire Islamic banking segment are presented in table given below:

Table 15: Sizes and Shares of Deposit Mobilization Products

Funding Mode	Local Currency (Million Naira)	Dollar Equivalent (Million $)	% of Total Financing
Qard Hasan	22,038.01	72.37	46.39
Mudarabah Investment Accounts	25,465.21	83.62	53.61
Mudarabah Term Deposit	0.72	.0024	0.00
TOTAL FUNDING	**47,503.94**	**156.00**	**100**

Source: Computed from Jaiz Bank Annual and Islamic banking windows' Management Accounts

From above table, *Qard Hasan* and *Mudarabah* constitute the common funding sources in the Islamic banks in Nigeria with *Mudarabah* accounting for 53.6% and *Qard Hasan* constituting 46.4% of the funding sources. These two products are favored by the Islamic banks as they provide sources of free funds and loss bearing deposits.

On the Financing side, the snap shots of the products used for corporate and retail customers are presented in the next two tables, respectively:

Table 16: Financing Products – Corporate Customers

Customer Requirements	Islamic banking product
Working Capital	Murabahah
Local Purchase Order (LPO)	
Project/Venture Financing	Musharakah
Financing of shareholding companies, small personal enterprises and Public Private Partnership	Diminishing Musharakah
Contingent Liabilities (Performance bond, Advance Payment Guarantee, etc.)	Kafalah contract
Financing Construction/Manufacturing	Istisna/Parallel Istisna
Follow-ups, Inspection and taking delivery	Wakalah
LC Financing	Murabahah/Ijarah wa Iqtina
Agro Financing	Salam/Murabahah/Ijarah wa Iqtina

Source: Compiled from the websites of Jaiz Bank, Sterling and Stanbic IBTC Non-interest banking windows and Tijara Islamic Microfinance Bank.

Table 17: Financing Products – Retail Customers

Customer Requirements	Islamic Banking Product
Interest free loan (mainly for internal customers)	Qard Hasan
Household Appliances, Auto Finance	Murabahah
Medical Treatment, School Fees, Hajj and Umrah, Logistic Rent-a-Month and Airtime	Ijarah Service
Home Finance	Ijarah wa Iqtina

Source: Compiled from the websites of Jaiz Bank, Sterling and Stanbic IBTC Non-interest banking windows and Tijara Islamic Microfinance Bank.

The shares and sizes of these products in the entire Islamic banking segment are displayed in table given below:

Table 18: Sizes and Shares of Financing Products (Corporate and Retail)

Financing by Islamic Banks as at December 31, 2015			
FINANCING MODE	**Local Currency (Million Naira)**	**Dollar Equivalent (Million $)**	**% OF TOTAL FINANCING**
***Murabahah* Receivables**	12,290.25	40.30	47.45
***Musharakah* Financing**	653.18	2.13	2.52
***Qard Hasan* Receivables**	147.24	0.48	0.57
***Istisna* Investments**	781.90	2.57	3.02
***Ijarah* Assets Investments**	12,028.84	39.50	46.44
TOTAL FINANCING	**25,901.42**	**84.98**	**100**

Source: Computed from Annual and Management Accounts

From above table it is obvious that the retail financing products dominate the market with *Murabahah* and *Ijarah* accounting for 47.45% and 46.44%, respectively, while the corporate financing which mainly consists of *Musharakah* and *Istisna* accounts for only 2.52% and 3.02, respectively. The following are some of the issues and benefits that account for this financing trend in Nigeria:

(a) The use of *Hamish Jiddiyya* (Down Payment) in *Murabahah* to secure the promise to purchase
(b) Mark up is defined considering historic market trend and tenured as much as possible for shorter period thus encouraging fixed income instrument like Murabahah
(c) Accurate forecast of income in view of the fixed income nature of the preferred financing products
(d) In an *Ijarah* contract the customer maintains the asset in protection of the interest of the Lessor at his expense except in cases of any accident due to natural calamity/disaster (Acts of Allah) which has to be ascertained by the banks.
(e) Use of *Takaful* cover as a mitigant to natural disasters.
(f) Longer gestation period of project normally financed through either *Istisna* or *Musharakah* discourages Islamic banks from using such products.
(g) The Islamic banks lack the expertise to appraise and monitor projects and this discourages them from financing such projects through either *Mudarabah* or *Musharakah*

Thus in Nigeria, the Islamic banking industry is dominated by retail financing (*Murabahah, Ijarah* and *Qard Hasan*) accounting for about 94.46% while the corporate financing (*Musharakah* and *Istisna*) accounted for only 5.54%.

3.1.4 ISLAMIC CAPITAL MARKETS IN NIGERIA

Islamic Funds

As at 31st December 2016, according to data obtained from the Securities and Exchange Commission (SEC), the total Net Asset Value (NAV)[25] of the two Islamic funds was $7.3 million, representing only 1.01% of $722 million for the entire mutual funds market as indicated in table 19 below.

Table 19: Net Asset Value (NAV) of Islamic Funds

Islamic Funds	NAV as at 31st Dec 2016 (Million $)	NAV for All Mutual Funds (Million $) – 31st Dec 2016	% Islamic Fund/All Mutual Funds
Lotus Halal Inv. Fund	6.85		
Stanbic IBTC Imaan Fund	0.48		
Total	**7.33**	**722.45**	1.01

Source: Extracted from Securities and Exchange Commission website

According to information available on the website of Lotus Capital[26] which is the key player in the Islamic Capital market there are five key products offered by the fund manager as follows: Halal Fund, Halal Fixed Income Fund, Hajj Plan, Equity Exchange Traded Fund (Equity ETF) and Nigerian Stock Exchange (NSE) Lotus Islamic Index, NSE LII which was created in 2009 and launched in 2012 as the first index to track the performance of 15 *Shariah* compliant equities listed on the NSE.

Sukuk

IFBS defines *Sukuk* as the holder's proportionate ownership in an undivided part of an underlying asset where the holder assumes all rights and obligations to such asset. It is issued and traded in the Capital market. The first *Sukuk* issued in Nigeria was the Osun State Government *Ijarah Sukuk* issued in 2013. It was a $90 million *Ijarah Sukuk*[27] (14.75 percent) fixed return tranche 2 which had 42 investors with Lotus Capital Limited as the leading issuing house and Augusto and co, one of Nigeria's leading rating agencies, as the rating agent. It was meant to finance roads and school constructions across the state and is due in 2020.

There is also a plan to issue a hundred billion naira (about $327 million) Sovereign *Sukuk* in Nigeria. According to Security and Exchange Commission (SEC), the sovereign *Sukuk* which was initially scheduled for third quarter of 2016, later shifted to the first quarter of 2017 and was further postponed to the end of the second quarter of 2017 is again shifted to a later date. The main reasons that delayed the issuance of the Sukuk are: (i) capacity building in Debt Management Office (DMO), an agency of Government responsible for the issuance of the

[25] The net asset value of all the mutual fund (Islamic fund and conventional fund) is available at the website of SEC: www.sec.gov.ng
[26] Details of the products can be obtained from the Lotus Capital website: http://www.lotuscapitallimited.com/index.php/products/halal-funds
[27] Details of the Sukuk issued by Osun State Government available at: http://osun.gov.ng/2013/10/11/osun-successfully-completes-n11-4-billion-sukuk-bond-aregbesola-commended-for-exploring-new-development-options/

Sovereign *Sukuk*, (ii) public awareness and (iii) delayed issuance by the Central Bank of Nigeria of the *Sukuk* liquidity status guidelines. Diversification through Sovereign *Sukuk* issuance has the potential of engendering financial inclusion as well as attracting significant amounts of affordable capital from the Gulf countries and other established Islamic markets around the world into Nigeria and these are part of cardinal objectives of Government which will further result into more Sovereign *Sukuk* issuance.

3.1.5 TAKAFUL (ISLAMIC INSURANCE) IN NIGERIA

The *Takaful* institutions in Nigeria comprised of two full-fledged *Takaful* companies (*Jaiz* and *Noor Takaful* Insurance) and two *Takaful* windows of conventional insurance companies (Niger and African Alliance Insurance) and a *Takaful* division of Corner Stone Insurance. The *Takaful* segment of Islamic finance in Nigeria is not as vibrant as the Islamic Banking segment as the two full-fledged *Takaful* companies were expected to have commenced operations during the first quarter of 2017.

The contract of *Takaful* as a business venture in Nigeria is mainly based on the hybrid principles of Islamic profit sharing of *Mudarabah* and Agency (*Wakala*) contracts.
The *Takaful* institutions provide both general and family *takaful* insurance services. According to the Managing Director of Jaiz *Takafu*l insurance, the General *Takaful* insurance products offered includes; Motor *Takaful*: (Comprehensive, Third party, Fire & Theft and Third Party only); Fire and Miscellaneous accident *Takaful*: (Fire & Allied Peril, Burglary , All risks, Fidelity Guaranty, Public liability, Group personal accident, Goods in transit, Money *Takaful*, Professional indemnity); others are Engineering *Takaful*: (Contractor's plant and machinery Contractor's all risk, Machinery breakdown, Electronic equipment); Marine *Takaful*: (Marine Cargo & Hull), while the Family *Takaful* as listed by Noor *Takaful*[28] includes: Education Plus Family *Takaful*, Provest Family *Takaful*, Flexip Family *Takaful*, Group Mortgage Family Takaful, Group Family Takaful, Hajj and Jerusalem Family *Takaful*, Enchart Family Takaful, Mortgage Takaful, Prosave Family *Takaful* and Mortsave Family *Takaful*. These products provide benefits to participants ranging from protection, investment to savings and they operate mainly on the basis of *Mudharaba* and *Wakala*. The three (3) conventional insurance companies that have *Takaful* windows and division also offered similar products to the ones offered by the full-fledged *Takaful* companies, however, the African Alliance Insurance has a very robust *Takaful*[29] arrangement when compared to the other two (2) Windows[30].

The performance of *Takaful* insurance in Nigeria can only be analyzed by comparing the performance of the *Takaful* products offered by the conventional insurance companies vis-à-vis the performance of the conventional insurance products since the two full-fledged *Takaful* insurance companies became operational only in the first quarter of 2017 and as such there are no operating results for analysis and comparison.

[28] Family Takaful products listed by Noor Takaful available the website: www.noortakaful.ng/family-takaful/
[29] African Alliance Insurance website: Takaful products offered as at March 2017. Available at http://www.africanallianceplc.com/product.php?mode=62&page=true
[30] Cornerstone Insurance website: Takaful products offered. Available at: https://cornerstone.com.ng/products/detail/Nw==, Niger Insurance website: Takaful Products offered. Available at: http://www.nigerinsurance.com/index/general/productdetails.php?id=3&subid=4&pid=4

According to the 2016 financial statements[31] of Cornerstone Insurance Plc., the performance of the *Takaful* products vis-à-vis the conventional insurance products is shown in the table (Takaful Products Performance) below. It should be noted that the other two conventional insurance companies did not report the performance of their *Takaful* products perhaps due to its insignificant.

Table 20: Takaful Products Performance as at end December 2016

	***Takaful* Insurance Products**	**Conventional Insurance Products**	**% *Takaful*/Conventional**
Gross Premium ($' 000)	672.73	18,242.83	3.69
Gross Claim ($' 000)	247.58	8,025.20	3.09
Underwriting Expenses ($' 000)	139.32	3,634.15	3.83
Underwriting Results ($' 000)	298.30	2,081.03	14.33

Sources: Computed from Cornerstone Insurance Financial Statements for 2016

From the table above, the gross premium, gross claims and underwriting expenses generated by the *Takaful* products is less than 4% of those generated by the conventional insurance products. Compared to the entire insurance industry, the performance of the *Takaful* in terms of premium, claims and underwriting expenses will be much more less than 4% signifying insignificance of the *Takaful* business in Nigeria.

Challenges Facing the Islamic Financial Sector

There are a number of issues that are militating against the development and growth of Islamic finance sector Nigeria. These include:

- **Lack of separate legal framework:** The operations of Islamic financial institutions are subjected to the interpretation of the laws guiding the operations of the conventional financial institutions. There are no explicit statements of laws for the Islamic financial institutions; they depend on the interpretation of some provisions of the laws for conventional financial institutions.

- **Lack of viable liquidity management instruments for Islamic financial institutions:** To date the Central of Bank of Nigeria has been able to come up with only three (3) liquidity management instruments and only one of the three instruments is viable as it enables an Islamic bank to manage it liquidity and obtain some return. This instrument involves securitization of the Central Bank's holding of multilateral financial institutions' *Sukuk* for the Islamic banks to invest. Unfortunately, this instrument is still not available as the Central Bank is still having some challenges

[31] Cornerstone Insurance Annual Report and Financial Statements 2016 available at: www.nse.com.ng/.../13741_CORNERSTONE_-_2015_AUDITED_ACCTS_FINANCI...

in making investment in *Sukuk* because of the constraint imposed by the legal and regulatory environments.

- **Inconsistency in regulatory framework:** As an example, while the Guidelines for the licensing and regulation of Islamic banks in Nigeria issued by the Central Bank in 2011 allows a conventional bank to own an Islamic bank subsidiary, the Regulation 3 issued in 2010 permitted a conventional bank to own a subsidiary only in a foreign Country. This inconsistency is currently affecting the ability of one of Islamic banking windows to convert to a subsidiary.

- **General lack of adequate knowledge of Islamic finance on the part of both the Practitioners and the Regulators:** The case of knowledge gap in the area of Islamic finance is glaring on both the Operators and Regulators side. The issue of liquidity management instruments is an indicator of this challenge. The Central Bank is unable to come up with a viable instrument and the Operators on the other hand are unable to propose a structure to the Central Bank for consideration.

- **Apathy and Skepticism by the general public:** Islamic finance products are sometimes regarded by the general public as a'Muslim affair, although there are some segments from the Muslem population as well who are skeptical about Islamic finance and believe that it may not succeed.

- **Shariah Scholars knowledgeable in conventional finance:** The Shariah scholars have limited knowledge of conventional finance and this has led to frequent reversal of decisions by the Shari'ah board of the financial institutions.

Best Practices in IFIs

According to the IMF, Islamic finance has some strength in at least three key areas: it fosters greater financial inclusion, especially of large underserved Muslim populations, its emphasis on asset-backed financing and risk-sharing feature means that it could provide support for small and medium–sized enterprises (SME), as well as investment in public infrastructure.

These areas of strength highlighted by the IMF are also relevant to the Nigerian case and are briefly discussed as follows:

- **Greater Financial Inclusion:** In a country like Nigeria with an approximate population of 184 million out of which at least 50% are Muslims, Islamic finance presents great potential for financial inclusion. According to EFInA (Enhanced Financial Innovation and Access) Access to Financial Services 2016 Survey[32], the financially excluded dropped from 68% in 2014 to 62% in 2016 in the North East of Nigeria signifying an increase in financial inclusion by 6%. This development is partly explained by the introduction of Islamic banking system in Nigeria which started with a regional Islamic bank in 2012 that covered North East and North West geopolitical zones of Nigeria. The North West has however witnessed an increased in financial

[32] The EFInA 2016 Survey is available at: EFInA: http://efina.org.ng/assets/A2F/2016/Key-Findings-A2F-2016.pdf

exclusion as the rate increased from 56% in 2014 to 70% in 2016 due mainly to the effect of economic recessions (job losses, lower disposal income and inflation).

- **Support for Small and Medium Enterprises (SMEs):** In Nigeria the business model of SMEs makes it difficult for them to obtain financing from the normal conventional banks because of high collateral requirement as such they rely more on Microfinance banks for financing which is dismal in spite of the contribution to the GDP. According to the Port Harcourt Chamber of Commerce[33] SMEs account for 80% of the total number of enterprises in Nigeria, 75% of the total workforce amounting to about 31 million employees and contributed 46.5% of the GDP in 2014. Despite this impressive statistics, the Chamber of Commerce reported that only 5% of development loans got to SMEs and the ratio of loans to SMEs to Commercial banks' total credit was a meager of 0.13%. This scenario presents an abundant opportunity for Islamic banks in Nigeria as their asset backed financing and risk sharing business model makes it compatible with the SMEs.

- **Deficit/Public Infrastructural Financing:** According to the approved 2017 budget of government, fiscal deficit is estimated at 2,321[34] billion naira (about 64.47 billion dollar) which will be financed through a combination of foreign and domestic borrowings. This is an ample opportunity for Islamic finance in Nigeria and that is why the decision of government to issue a sovereign *Sukuk* in 2017 is apt.
- **Employment generation:** Employment generation is also one of the strengths of Islamic finance in Nigeria. According to the National Bureau of Statistics, the Nigeria's unemployment rate rose to 14.2 per cent in the fourth quarter of 2016. The rate is somewhat high and the growing Islamic finance sector has the potential to reduce the rate by generating employment in the Country.

- **Islamic Financial Engineering:** Financial engineering is being innovative in products development through applying complex mathematical models to develop financial products. In contemporary times derivatives such as Options, Futures, Forwards and Swaps are financially engineered products. These derivatives according to Al-Suwilem (1996) are not *Shariah* compliant as they are mainly based on promises that end up in a zero sum game. Financial engineering promotes product diversification as such Islamic finance will immensely benefit from financial engineering. According to Iqbal (1999) two different approaches could be taken to apply financial engineering in Islamic finance. The first approach is to take an existing instrument in conventional system and make an evaluation of each component to find the closest substitute from the set of basic Islamic instruments while the second approach which is synonymous with reverse engineering is to design and invent new instruments using Islamic instruments by applying principles of financial engineering. He further said that the result would be new array of instruments with each having unique risk-return profile and that this approach requires deep understanding of the Islamic economic and financial system as well as the risk-return characteristics of each basic building block as such it is a long-term solution which requires extensive research and commitment. For Islamic finance to effectively benefit from financial engineering, Islamic finance

[33] 2014 International Chamber of Commerce Competition: Port Harcourt Chamber of Commerce Credit Support Scheme for SMEs. Available online at: http://www.phccimang.com/portal/home.php?page=article&id=5
[34] Approved 2017 budget: Available at www.budgetoffice.gov.ng

experts have to understand the structure of the engineered products. This understanding can only come through extensive training. In Nigeria, Nigerian Trainings and Seminars[35] in conjunction with HRODC Postgraduate Training Institute, Doha offers training programme in Advanced Islamic banking and Finance for Islamic bankers and financiers. The programme has a module on Islamic Capital Markets incorporating Islamic Financial Engineering and Islamic Microfinance.

Additionally, the Islamic Institute of Accounting and Finance[36] in Nigeria offers some programmes leading to a certification such as Certified Islamic Finance Professional (CIFP). Part of the programme involves extensive training on Islamic Financial Market, Instruments and Products. Similarly, the International Institute of Islamic Banking and Finance Bayero University[37], Kano offers certification programmes leading to the award of professional certificates in Islamic banking and finance, Islamic capital market as well as *Takaful*.

The level of Islamic financial engineering is very low in Nigeria. However, there are some institutions providing the platform for capacity development in the area thus signaling a promising future for financial engineering in Islamic finance in Nigeria.

3.1.6 POLICY RECOMMENDATIONS

The Islamic finance sector is a recent development on the Nigerian financial landscape which has high prospects for growth as reflected in the growth potentials of some key indicators. An analysis of the segment revealed that most of the basic Islamic financial contracts are offered by the Islamic financial institutions, however the following contracts dominate*: Qard Hasan, Mudharabah, Murabahah* and *Ijarah*. The sector is also being challenged by lack of adequate Islamic finance architecture which poses threat to its growth and development. The legal and regulatory environments are still not fully developed to effectively support the workings of Islamic finance. The legal system limits the ability of the regulatory bodies such as the CBN to come up with robust liquidity management instruments for Islamic financial institutions. It also poses some difficulty to operators in documenting legal requirements during products development. Additionally, the Islamic financial institutions are constrained largely by lack of knowledge and expertise to come up with sophisticated Islamic financial instruments beyond the traditional instruments. This has adversely affected the ability of the institutions to innovate thereby limiting the diversification of Islamic financial instruments in Nigeria. There are however great expectations that over time we will begin to see innovations in the development of the Islamic financial instruments as there are some educational institutions offering courses in financial engineering in Islamic finance in the Country. This will expectedly bridge the knowledge gap of the operators and facilitate innovations in product developments. For proper development of diversified Islamic financial instruments, the following key recommendations are critical:

[35] Details of courses offered available at this website: https://www.nigerianseminarsandtrainings.com/events/26728/Advanced-Islamic-and-Banking-Finance---Postgraduate-Diploma--Doha-
[36] Details of courses by the institute are available at the website: www.islamicfinance.com.ng/courses.php
[37] Details of courses are available at the website: http://iiibf.buk.edu.ng/

- A separate legal framework for Islamic financial institutions needs to be developed. This will facilitate the regulatory bodies develop some instruments to deepen the Islamic financial sector. It will make it easy for the Islamic financial institutions to document legal requirements during product development

- The inconsistency in regulatory frameworks should be resolved to allow for orderly growth and development of Islamic finance in Nigeria.

- The regulatory bodies should include in their training plan a programme on Islamic financial engineering. This is to better position the Examiners understand and examine any financially engineered product that the institutions might come up with

- The Islamic financial institutions should have a human capacity development programme in place to address the inherent knowledge gap that exists in sophisticated product development/differentiation

- The Islamic financial institutions should develop suitable and attractive products for the poor segment of the society in order to promote financial inclusion with its attendant economic growth potential as well as promotion of social economic justice.

- The Islamic financial institutions should have an awareness programme to educate the general public on the viability of Islamic finance.

- Both the Regulators and the Islamic financial institutions should have training programme for the members of their Shariah boards on the fundamentals of Islamic finance

3.2. CASE STUDY: INDONESIA

3.2.1 SUMMARY

Being the world's most populous Muslim country, the emergence of Islamic finance industry has come somewhat late. Only in the 1990's, Indonesia established its first Islamic bank, namely Bank Muamalat Indonesia. The demand largely came from the public, which wanted to eliminate interest from their financial practices. The Islamic finance industry in Indonesia consists of Islamic banking, Islamic insurance (Takaful) and Islamic capital market segments. The growth of Islamic finance industry is quite impressive, although the market share captured is relatively small. Looking at the potentials and increasing demand from the public, Indonesian authorities' attempts to strategically increase the size of industry and bring the industry to higher level in the country's financial system. It is observed that in general the development of Islamic finance industry in Indonesia is very bright. Many players have looked up Indonesian potentials in Islamic finance sector and Indonesia has successfully attracted foreign investment in domestic Islamic finance industry which the policy reforms by Indonesian Islamic finance authority is recognized. Nevertheless, to improve further the industry and to bring it to higher level, financial engineering and innovations to answer the demand and need of the industry, consolidation and further enhancement in term of legal and regulatory framework, and market education and awareness appears inevitable.

Indonesia is the fourth most populous country in the world after China, India and the US. It is home to the world's largest Muslim population of approximately 210 million people (about 87.18% of the total population).

Being the world's most populous Muslim countries, the emergence of Islamic financial institutions arrived somewhat later than they did in other Muslim-majority countries. Islamic finance in Indonesia officially emerged in 1992 with the establishment of its first Islamic commercial bank, Bank Muamalat Indonesia.

Nevertheless, the development of Islamic finance industry in Indonesia is very bright, with strong potential. The large number of Muslim population (+85% of total population) is considered as one of the reasons for investors to invest in Islamic financial services in Indonesia. Besides, internationally, Indonesia is also considered as one of top 10 countries which are a potential big market in Islamic finance industry. Indonesia, together with UAE, Saudi Arabia, Malaysia and Bahrain, is considered in a position 'to offer lessons' to other countries in developing Islamic finance industry. Additionally, Indonesia, together with Qatar, UAE, Saud Arabia, Malaysia and Turkey (QISMUT) are considered as pushing factor countries in the future Islamic finance industry (ICD 2014). In addition, Indonesia is also ranked as number Six (6) out of the 48 ten countries in Islamic Finance Country Index 2016 (GIFR, 2016).

In Indonesia, the Islamic finance industry consists of Islamic banking (regulated by Islamic Banking Act 2008), takaful (Islamic insurance) (regulated by Insurance Act 2014) and Islamic capital market (regulated by National Shariah Securities Law 2008).

The central authorities in Islamic finance industry in Indonesia are **Otoritas Jasa Keuangan** (Indonesian Authority of Financial Services) concerning financial institutions supervision and regulations, and **Bank Indonesia** (concerning the macroeconomic aspects of financial stability). In addition, the Islamic finance industry in Indonesia also has various stakeholders that regulate the industry, namely the Lembaga Penjamin Simpanan (Deposit Insurance Institution) for deposit insurance scheme, Dewan Syariah Nasional – Majelis Ulama Indonesia (National Shariah Council - Indonesian Ulama Council) for Fatwa and Shariah-based decisions, Ministry of Finance to regulate sovereign Sukuk, Ministry of Cooperative and Medium and Small Scale Enterprises to supervise the Shariah cooperative business, Badan Arbitrase Syariah Nasional (Arbritrage and Dispute Resolution in Islamic finance), and Ikatan Akuntan Indonesia (Indonesian Accountant Association) Shariah for Accounting standard.

Indonesia is among the countries that have specific acts regulating Islamic banking, insurance and Sukuk. The first act regulating Islamic banking practices was the Banking Act 1992. This Act facilitated the establishment of the first Islamic bank in Indonesia, namely Bank Muamalat Indonesia. Since then various acts have been passed to accommodate the practice of finance in Shariah perspective and guide its development. The Indonesian acts related to Islamic banking and financial practices are as follows:

- Banking Act No. 7 of 1992 (amended by Act No. 10 of 1998).
- Central Bank Act No. 23 of 1999 (amended by Act No. 3 of 2004).
- Deposit Insurance Act No. 24 of 2004.
- Islamic Banking Act No. 21 of 2008.
- Islamic Sovereign Bond (Sukuk) Act No. 19 of 2008.
- Government Law No. 25 of 2009 (income tax for sharia transactions).
- Tax Neutrality in Government Law no. 42 of 2009.

Internationally, Indonesia is already a member of the Islamic Development Bank (IDB), the Islamic Financial Services Board (IFSB), the International Islamic Financial Market (IIFM) and the International Islamic Liquidity Management Corporation (IILM) and has adopted the regulations of the IFSB and the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) beside adhering to various fatwa issued by the OIC Fiqh Academy (based in Jeddah).

3.2.2. INTRODUCTION

The early development of Islamic finance industry in Indonesia is very promising. Since the first establishment of Islamic bank in1992 through the establishment of Bank Muamalat Indonesia, the Islamic banking industry currently is having 34 Islamic banks (full-fledged and windows), 53 Takaful operators, and more than 5000 Islamic micro-financing institutions (called as Bank Perkreditan Rakyat Syariah) across the country (OJK, *Islamic Bank Monthly Statistic January 2017*).

With the growing public interest in the industry and its significant contribution to the national economy, the Government of Indonesia has shown concern on how to develop and elevate the industry further.

However, the contribution of Islamic finance industry to the national financial system, and to the national economic growth at large has not yet been significant, compared to the existing conventional financial market. Islamic banking industry, for example, contributed only 5 % of country's banking assets in 2015. Another ASEAN country, Brunei Darussalam, has achieved nearly 49% of the country's banking assets being Shariah-compliant, and Malaysia has reached over 20%. While for Indonesia, the growth is getting stronger every year, the impact of Islamic finance industry on the national economy is still relatively small as compared to the contribution of conventional finance industry. Likewise, Indonesian contribution to global Islamic finance is also quite marginal, with a share of 1.6% of the global Islamic banking assets (June 2016, IFSB 2017 report). In 2015, Indonesia contributed only 1.39% of global Islamic finance asset (as compared to Malaysia 9.56%) (IFSB, *IFSI Financial Stability 2015*). This rose to 1.6% by June 2016 (IFSB May 2017).

3.2.3. ISLAMIC BANKING IN INDONESIA

Industry Development

Islamic bank in Indonesia was established in 1992 through the establishment of Bank Muamalat Indonesia (BMI). BMI was the single full-fledged Islamic bank until 2002, when the second full-fledged Islamic bank was established - namely Bank Syariah Mandiri. In 2008, the new law on Islamic Banking was tabulated. The Islamic Banking Act 2008 set a new direction of the industry with a solid legal foundation and best approach in regulating and developing Islamic banking industry in Indonesia.

Since then, the growth of Islamic finance industry in Indonesia has been impressive. The total assets of Islamic banking industry in Indonesia reached IDR 356 trillion in 2015 (IDR 145 trillion in 2011) with CAGR 19.5%, as can be seen in the following table.

Table 21: Growth of Assets of Indonesian Islamic Banking Industry (IDR Billion)

	2011	2012	2013	2014	2015	2016
Total Asset on Islamic Banking Industry	145.466	195.018	242.276	272.343	296.262	356.504
Growth of Assets	49.17%	34.06%	24.23%	12.41%	8.78%	20.33%
Market Share of Indonesian Banking Industry	3.98%	4.58%	4.89%	4.85%	4.83%	5.12%

Source: OJK Statistic of Indonesian Islamic Banking Industry (December 2016)

The growth of the industry is also reflected in the increasing number of institutions that provides Islamic banking services. The Islamic banking institutions in Indonesia are classified into three types, namely: full-fledged Islamic bank, Islamic business unit, and Islamic rural bank. At the end 2016, there were 34 Islamic banks with total branches more than 2.301 (previously 1.737 offices in 2011) representing 7% of the total banking branches in Indonesia, as the following table demonstrates.

Table 22: Growth of Islamic Banking Institutions in Indonesia (IDR Billion)

Full-fledged Islamic Bank						
	2011	2012	2013	2014	2015	2016
Number of Banks	11	11	11	12	12	13
Number of Offices	1401	1745	2132	2163	1990	1869
Number of Employees	21820	24111	26717	41393	51413	51110
Total Assets	-	-	-	204.961	213.423	254.184
Islamic Business Unit						
	2011	2012	2013	2014	2015	2016
Number of Banks	24	24	23	22	22	21
Number of Offices	336	517	422	320	311	332
Number of Employees	2.067	3.108	11511	4425	4403	4487
Total Assets	-	-	-	67.383	82.839	356.504
Islamic Rural Bank						
	2011	2012	2013	2014	2015	2016
Number of Banks	155	158	163	163	163	166
Number of Offices	364	401	420	439	446	453
Number of Employees	3.773	4.359	4.826	4.704	4.704	4.478

Source: OJK Statistic of Indonesian Islamic Banking Industry (December 2016)

Even though the growth of Indonesian Islamic banking industry is very impressive, the market share only reached 5.12% of total banking industry in 2016. This is still considered very low compared to other OIC member countries such as Malaysia and Saudi Arabia. However, high demand in funding, financing and growth of the industry, Islamic banking sector in Indonesia is still considered as huge market with a lot of potentials to be explored (E&Y World Islamic Banking Competitiveness Report 2016).

Financial Instruments Commonly Used

In general, the Indonesian Islamic bank portfolio of financing is not yet reflected the spirit of profit sharing. Debt financing products based on the contract of *Murabahah*, *Istishna*, *Ijarah* and *Salam* are dominating the equity-financing in Islamic bank instruments (based on *Mudarabah* and *Musharakah)*. *Murabahah* based financing is dominating the whole financing of Indonesian Islamic banking industry, with about IDR 112 trillion, which is much larger compared to other types of financing in December 2016.

Table 23: Financing Based on Type of Shariah Contract (IDR Billion)

Type of Financing Contracts	2011	2012	2013	2014	2015	2016
Mudarabah	10.229	12.023	13.625	14.354	14.820	15.292
Musharakah	18.960	27.667	39.874	49.336	60.713	78.421
Murabahah	56.365	88.004	110.565	17.371	122.111	139.536
Qard	12.937	12.090	8.995	5.965	3,951	4,731
Istisna'	326	376	582	633	770	878
Ijarah	3.839	7.345	10.481	11.620	10.631	9.150

Source: OJK Statistic of Indonesian Islamic Banking Industry (December 2016)

Perhaps this is because, the dominant financing in Islamic banking services is consumptive (consumer) financing. In 2016, the consumptive financing in Indonesian Islamic banks was higher (41%) than that of conventional banks (which was about 28%). Most of those financing prodicts were using *Murabahah* contract. On the other hand, working capital financing is lower in Indonesian Islamic banking - 40% compared to conventional banks' 47%. Probably this is because Islamic banking does not prefer to use *Mudharabah* and *Musharakah* due to higher risk. Investment financing in Islamic banking industry (19%) was also lower than conventional banking industry (25%) in 2015 (OJK Islamic Banking Statistic, January 2017).

In general, it is observed that the instruments used and products offered in Indonesian Islamic banking are very limited or much less diversified, as compared to the conventional banking products and instruments. With limited products range and features to offer, Islamic banks can be relatively unable to meet the needs of the costumers or industry at large. This implicates the room for Islamic banks to develop is very limited, and hence the profitability remains low as compared to conventional banks. Some common contracts used in other Islamic finance jurisdictions such as in Malaysia and Middle East Countries are not used in Indonesian Islamic banking products. *Bay' 'inah* and *Bay' Tawarruq,* for example are used in Malaysia and Middle East Countries to structure various financial products, but those contract are not allowed in Indonesian Islamic banking practices by the National Religious Council – **Indonesian Ulama Council** (DSN – MUI).

Moving forward, the Islamic bank players in Indonesia have to think strategically to find a workable solution to diversify their products and instruments in order to attract customers and fulfil their various needs. Various contracts as found in Islamic commercial law (*Fiqh al-Muamalat*) can be used to cater various needs of industry. Product innovation and development to meet the people needs and productive sector in society is very important.

3.2.4. ISLAMIC CAPITAL MARKET IN INDONESIA

Industry Development

The capital market is a very important segment in Indonesian Islamic financial market to stimulate economic growth. The capital market can assist in providing capital to assist government budget in developing infrastructure as well as corporate structure in expanding their businesses.

The Islamic capital market in Indonesia is developing gradually in the last decade, to become a greater part of domestic financial system. The market is currently dominated by Sukuk that provide alternative financing and investment for Indonesian government, companies and public at large. Besides Sukuk, Islamic stocks and unit trust are among the products that have been developed intensively in Indonesian Islamic capital market.

Indonesia started Sukuk issuance when Indosat (telecommunication firm) issued one amounting to IDR175 billion - the first corporate Sukuk - based on *Mudharabah* contract in 2002. This was followed by an Indonesian retail company, Matahari Putra Prima, through an IDR150 billion 5-years based on Ijarah in 2004.

Despite the headway made in issuing Sukuk, the size of Indonesia's corporate Sukuk market is relatively small compared with the sovereign Sukuk. Outstanding corporate Sukuk reached IDR11.748 billion at end-2016. The following table presents corporate Sukuk outstanding at end-2016.

Table 24: Total Corporate Sukuk Issuance and Corporate Sukuk Outstanding 2002 -2016

Year	Sukuk Issuance		Sukuk Outstanding	
	Total Value (in IDR Billion)	Number of Sukuk Issuance	Total Value (in IDR Billion)	Number of Sukuk Outstanding
2002	175	1	175	1
2003	740	6	740	6
2004	1,424.00	13	1,394.00	13
2005	2,009.00	16	1,979.40	16
2006	2,282.00	17	2,179.40	17
2007	3,174.00	21	3,029.40	20
2008	5,498.00	29	4,958.40	24
2009	7,015.00	43	5,621.40	30
2010	7,815.00	47	6,121.00	32
2011	7,915.40	48	5,876.00	31
2012	9,790.40	54	6,883.00	32
2013	11,994.40	64	7,553	36
2014	12,956.40	71	7,105	35
2015	16,114.00	87	9,902	47
2016	20,425.40	100	11,748	52

Source: OJK Islamic Capital Market Statistic January 2017

Sovereign Sukuk, however, only commenced in 2008, after the enactment of Indonesian Act No 19 (year 2008) on National Shariah Securities Law (Undang-Undang Surat Berharga Syariah Negara/SBSN). This allowed the government to issue Islamic securities (Sukuk) as a new source of funding for financing the government's budget deficit. The sovereign Sukuk is not only for financing the government budget deficit (*general financing*), but also for *project financing* of infrastructure building. In addition, the sovereign Sukuk in Indonesia is also used as liquidity management instrument for Islamic finance industry and investors in Islamic finance.

Currently, Indonesian Sukuk market is dominated by sovereign Sukuk. Total sovereign Sukuk issuance in 2016 has reached 48 issuances with value IDR 565.74 billion, and Sukuk *outstanding* about IDR 413.84 billlion with CAGR about 32.20% in the last five years. The following table summarizes the issuance of Indonesian sovereign Sukuk in all its forms since 2009 – 2014.

Table 25: Sovereign Sukuk Issuance (IDR Billion)[38]

Sukuk	Shariah Contract	2009	2010	2011	2012	2013	2014
Islamic Fixed Rate Sukuk (IFR)	*Ijarah Sale and Lease Back*	5,976	12,126	16,736	17,136	16,586	16,586
Ritel Sukuk (SR)	*Ijarah Sale and Lease Back*	5,556	13,590	20,931	28,989	35,924	47,906
Indonesian Sovereign Sukuk (SNI)	*Ijarah Sale and Lease Back*	6,110	5,844	14,962	25,466	50,584	40,470
Hajj Fund Sukuk (SDHI)	*Ijarah al-khadamat*	2,686	12.783	23,783	35,783	31,533	35,533
Islamic Treasury Bill (SPN-S)	*Ijarah Sale and Lease Back*			1,320	195	8,633	5,165
Project Based Sukuk (PBS)	*Ijarah Asset to be Leased*				16.714	26,030	30,181
Total		20,328	44.344	77.733	124.28	169,29	175,842

Source: Indonesian Ministry of Finance (2016)

Financial Instruments Commonly Used

The National Shariah Board of Indonesian Ulama Council (DSN-MUI) has issued fatwa No. 32/DSN-MUI/IX/2002 on the permissible Sukuk contracts in Indonesia namely *Mudarabah*, *Murabahah*, *Musharakah*, *Salam*, *Istisna'* and Ijarah. However, the most common structures used in Indonesian Sukuk structure are *Ijarah* and *Mudarabah.*

The Corporate Sukuk in Indonesia are mainly structured following the principles of *Ijarah* and *Mudarabah*. At end-2015, corporate Sukuk based on an *ijarah* contract accounted for 65.9% of total corporate Sukuk outstanding.

Table 26: Corporate Sukuk Instruments in Indonesia

Sukuk Structure	Outstanding Amount (IDR billion)
Sukuk Ijarah	4,974
Sukuk Mudarabah	1,079
Sukuk Mudarabah Subordinated	1,500

Source: Indonesia Stock Exchange 2016

Likewise, sovereign Sukuk in Indonesia are mainly structured using *Ijarah* contract. In sovereign Sukuk, at least three types of *Ijarah* are used in the structure, namely *Ijarah* sale and lease back,[39] *Ijarah al-Khadamat*[40] and *Ijarah* asset to be leased[41]. The preference to use *ijarah* in

[38] Availabe at http://dmo.aqilpapa.com/stats/statistik-sukuk/
[39] *Ijarah sale and lease back* is defined as a contract whereby the buyer of an asset lease back of the asset that has been bought to the seller. The underlying asset is usually land or building. This type of Sukuk is categorized as certificate of ownweship of leased asset as can be referred to AAOIFI Shariah Standards Nomor 17 (3/1).

Sukuk structure due to some reasons such as the requirement for underlying assets is relatively varied which can be real assets, project based asset or services. In addition, the Sukuk that is structured using *ijarah* or *mudarabah* contract can be traded in secondary market and hence preferred by investors.

Table 27: Structure of Indonesian Sovereign Sukuk (SBSN/Surat Berharga Syariah Nasional)

	Ijarah Sale and Lease Back	Ijarah al-Khadamat	Ijarah Asset to be Leased
Classification on AAOIFI Shariah Standards 17	Certificates of ownership in leased assets (3/1)	Certificates of ownership of described future services (3/2/4)	Certificates of ownership of assets to be leased (3/1)
Underlying Asset	State-Owned Assets	Hajj Services	Infrastructure Projects
Coupon	Fixed rate	Fixed rate	Fixed rate
Tradability	Tradable	Non- Tradable	Tradable
Series of Sovereign Sukuk	IFR, SNI, SR, SPN-S	SDHI	PBS, SR

Source: Indonesia Stock Exchange 2016

The Sukuk market in Indonesia is dominated by sovereign Sukuk. The corporate sector seems to have little interest in the issue of Sukuk, perhaps due to the complexities in Sukuk issuance and their risk preferences. There are two main factors that are possibly contributing to this phenomenon, namely the limitation in liquidity as secondary market is not that developed in Indonesian capital market, and the behaviour of investors that prefer to hold the Sukuk to maturity (especially the long-term investor such as Takaful companies, pension funds, and others).

This phenomenon should be noted by the Indonesian authority in Islamic capital market, to solve the problem of liquidity and secondary market trading to attract the corporate sectors to issue Sukuk and hence the supply of the Sukuk in the market can be increasing.

It seems that in doing diversification of Shariah contracts (‘*aqd*), the Sukuk issuers are very concerned with the preference of the investors. So far, Sukuk based on *Ijarah* and *Mudarabah* are preferred by Indonesian investors. Nevertheless, moving forward various types of contracts based on *Murabahah*, *Salam, Istisna’, Musharakah, Wakalah bi al-Istihmar*, and others can be used in structuring Sukuk as in other jurisdictions to attract investors (including international investors) without relying too much on *Ijarah* or *Mudarabah* as in the present scenario*.* In addition, the *Sukuk* structure such as in the form of perpetual Sukuk, exchangeable and convertible Sukuk which can be found in other jurisdictions, are also not common in Indonesian Islamic capital market. Those structures could be considered to diversify Indonesian Sukuk market.

[40] *Ijarah Al-Khadamat* is a contract used in Sukuk using services as underlying asset. In this case, the underlying asset is Hajj services. In this regard, Sukuk is categorized as certificates of ownership of describe future services as can be referred to AAOIFI Sharia Standards Nomor 17 (3/2/4).

[41] *Ijarah Asset to be Leased* (*ijarah Milkiyyah al-Maujudat Al-Mau’ud Bisti’jariha)* is defined as a contract whereby the ijarah object has been specified and some of its objects are already in existence when the contract is signed, but the delivery of total ijarah object will be done in the future as agreed as can be referred to AAOIFI Scxhariah Standards Nomor 17 (3/1).

3.2.5. TAKAFUL (ISLAMIC INSURANCE) IN INDONESIA

Industry Development

The establishment of takaful company in Indonesia started in 1994, with the establishment of PT. Syarikat Takaful Indonesia as the *Holding Company* and 2 Takaful companies namely PT. Asuransi Takaful Keluarga (life insurance) in 25 Agustus 1994 dan PT. Asuransi Takaful Umum (general insurance) in 2nd June 1995.

In 2008, the government of Indonesia issued the first regulation on Takaful practices (Peraturan Pemerintah No. 39 Tahun 2008). The regulation provides opportunities for conventional insurance and re-insurance companies to open Islamic windows in Takaful businesses with a detail requirement on capital, structure of organisation, and Shariah supervision of Islamic Takaful unit.

At the end of 2015, in aggregate there were 8 (eight) full-fledged Takaful operators in Indonesia, and 42 conventional insurance firms that offered Islamic Takaful units for life and general Takaful. There is no re-Takaful company in Indonesia, and all re-Takaful businesses are in the re-Takaful unit of conventional re-insurance companies. With three such re-Takaful units, the total number of Takaful companies in Indonesia is now 53 (in 2011: 43 units).

Table 28: Takaful Operator in Indonesia

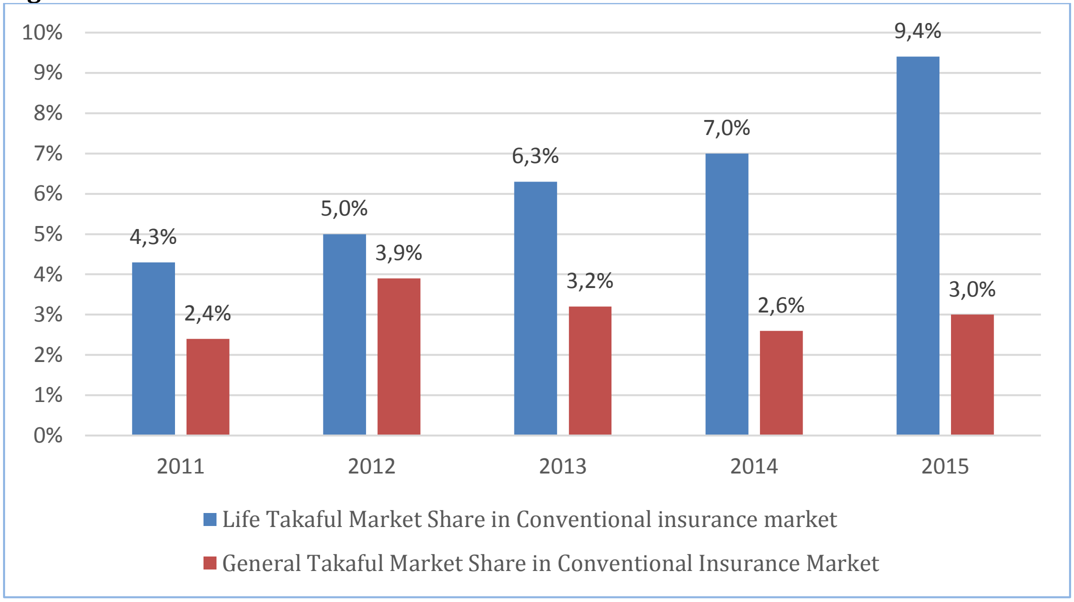
Takaful Operator	2011	2012	2013	2014	2015
Life Takaful (full fledged)	3	3	3	3	5
Life Takaful Windows	17	17	17	18	19
General Takaful (full fledged)	2	2	2	2	3
General Takaful (Windows Unit)	18	20	24	23	23
Re-Takaful windows unit	3	3	3	3	3
TOTAL	**43**	**45**	**49**	**49**	**53**

Source: OJK Monthly Statistic of Takaful Industry (2016)

The growth of Takaful industry in Indonesia is very promising. At the end of 2015, the total gross contribution of Takaful industry was about IDR 10.489 billion. Even though the growth of Takaful industry is impressive, the market share of the industry was relatively low - about 7.01% of the total Indonesian insurance industry in 2015.

The Takaful market in Indonesia is dominated by life insurance, which was about 80% of total Takaful contribution in 2015. It is expected that the market share of Takaful industry will be increasing in the future in line with the growth. As illustrated in the following graph, the growth in Life Takaful was increasing from 4.3% in 2011 to 9.4% in 2015 while the growth in General Takaful market share increased slowly from 2.4% in 2011 to 2.6% in 2014, and 3% in 2015.

Figure 8: Market Share of Life Takaful and General Takaful



Source: OJK Monthly Statistic of Takaful Industry (2016)

Financial Instruments Commonly Used

In general, there are two types of Takaful products offered in Indonesian Takaful market, namely Life Takaful and General Takaful. Life Takaful products are offered to provide services and protection for life and family such as for education, family care, Hajj fund, travelling, accident and others. The general Takaful provides services and protection of assets in general purposes such as from fire, transportation, business, cars, and others. The Islamic insurance products in Indonesian Takaful market are mainly using the following contacts: namely contract of *Tabarru'*, *Wakalah bil Ujrah* and the contracts of *Mudarabah* and *Mudarabah Mushtarakah.* The application of those contracts is based on the fatwa issued by National Shariah Countil – Indonesian Council of Ulama (DSN – MUI) as the following:

- **Aqd al-Tabarru**[42]*:* This contract is used in Takaful product as a basic relationship among the Takaful participants whereby they agreed to mutually help each other through the pool of funds generated in the Takaful. In the contract of *Tabarru'* the participants donate funds (*Hibah*) to be used to help other participants who are in need. The Takaful companies will act as Fund Managers based on the contract of *Wakalah* (agency).

- **Aqd Wakalah bil Ujrah**[43]: This contract is made between the Takaful participants and the Takaful operator whereby the participants authorize Takaful operator as the agent (*Wakil*) to manage the *Tabarru'* funds (or investment funds) with a specified fee (*Ujrah*).

[42] Fatwa DSN No.53/DSN-MUI/III/2006
[43] The *'Aqd Wakala bil Ujrah* contract is based on DSN-MUI fatwa No.52/DSN-MUI/III/2006.

- **Aqd Mudarabah**[44]: In this contract, the Takaful operator will act as the operator (*Mudarib*) that manages the funds and the Takaful participants act as the owner of funds (*Sahibul Mal*). The participants authorize Takaful operator to manage the funds and the profit gained in the investment will be shared with an agreed ratio of profit sharing.

- **Aqd Mudarabah Mushtarakah**[45]: The contract is a combination of Mudarabah contract and Musharakah whereby the Takaful operator as Mudarib also provides capital in their investment with Takaful participants. Both capital (funds) are invested and the profit shared accordingly with an agreed ratio or share in accordance with capital contribution.

The system provides for the Takaful funds in both cases of an Underwriting Surplus or an Underwriting Deficit.

- **Underwriting Surplus:** If there is underwriting surplus on the Tabarru' fund, some of the following can be chosen provided promise (*Wa'ad)* is signed between Takaful participants and Takaful operator, namely:[46]

  - ✓ The underwriting surplus are kept as reserve in *Tabarru'* fund account.
  - ✓ Some of the surpluses are kept as reserve but some are distributed to the Takaful participants in accordance with actuarial or risk management requirement.
  - ✓ Some of the surpluses are kept as reserve but some are distributed between Takaful participants and Takaful operator.

- **Underwriting Deficit**: If there is underwriting deficit on the *Tabarru'* fund, the Takaful operator are required to take care the deficit using loan (*Qard*). The loan will be settled to the Takaful operator using Tabarru' fund.[47]

3.2.6. BEST PRACTICE AND CHALLENGES

Islamic Banking

One of the practices of Islamic banking practices in Indonesia is financial inclusion through Islamic micro financing that attempts to reach the medium and small segment of society through Islamic Rural Banks, known as Bank Perkreditan Rakyat Syariah (BPRS). In 2011 and 2015, the number of BPRS operating becomes 163 in 2015 while in 2011 is about 155 institutions. Their total assets are growing from IDR 3.52 trillion in 2011 to IDR 7.74 trillion in 2015 (OJK Islamic Banking Statistic, December 2016). BPRS offers various financing products for their costumers based on various principles approved by Shariah such as *Murabahah*, *Musyarakah*, *Mudharabah*, *Salam*, *Istisna'*, and others.

[44] The *'Aqd Mudarabah* practice is based on Fatwa of DSN-MUI Number 21/DSN-MUI/X/2001.
[45] *Mudarabah Mustarakah* is based on Fatwa DSN No.51/DSN-MUI/III/2006.
[46] This is based on Fatwa DSN No.53/DSN-MUI/III/2006 on Underwriting Surplus.
[47] This is based on Fatwa DSN No.53/DSN-MUI/III/2006 on Underwriting Deficit.

Another characteristic in Indonesian Islamic banking industry is that is has more retail orientation. Consumer retail financing in Islamic banks in 2015 is about 38.2% while conventional banks is about 27.25% which shows Islamic banking commitment to reach the lower segment of Indonesian society.

Nevertheless, Indonesian Islamic banking industry still have to address the challenges of relatively small market share compared to conventional banking industry, relatively lack of diversification of products with various contracts (*'aqd*) to be used to attract customers and to fulfill various needs of Islamic banking users.

Islamic Capital Market

Indonesian Sukuk market is recognized as having best practice in retail investors and sovereign Sukuk for infrastructure development. The retail Sukuk issued by the Indonesian Ministry of Finance (IIFM report 2014: 4) has invited the entry of retail investors particularly in Indonesia which has opened another stable investor base for Sukuk market.

Recently, there is a recent innovation by the government of Indonesia to launch new retail Sukuk (Sukuk Retail Negara) called as *Sukri*, for infrastructure project financing, education, and agriculture. This retail Sukuk being marketed through Islamic banks including the local Micro Finance Institutions such as Bank Pembiayaan Rakyat Syariah (BPRS) and Baitul Mal wa Tamwil (BMT) that are allowed to develop new deposit scheme related to Sukuk so that the people can directly invest by open an account (ADB, 2012: 10).

Furthermore, another best practice in Indonesian Sukuk industry is that the sovereign Sukuk based on project financing (called as Project Based Sukuk/PBS). This type of sovereign Sukuk are developed in line with a specific infrastructure project done by the government. In the PBS, project underlying Sukuk that utilizes infrastructure project that has been approved in the government budget is used as underlying asset for Sukuk issuance. The proceeds will be used to replace the revolving fund whereby the project is usually initially funded by the government from the sources of taxes or others, but once the Sukuk issued the proceeds will be utilized to replace the funds.

Nevertheless, Indonesian Sukuk market still has to overcome the challenges of small market share as compared to conventional bonds, limited investors and lack of attraction of global investors. In addition, initiatives to issue Sukuk by corporate sectors also need to be enhanced with various incentives.

Takaful

Takaful products in Indonesia are developed based on what conventional products have been made, not based on specific Muslim needs. In other word, the Takaful operator attempts to 'Islamize' the conventional insurance product using Islamic contracts (*'aqd*) and to follow the rules and contract requirements of Shariah. Moving forward, it is expected that the Takaful products can be designed creatively based on the needs of the Muslim and other fellow human being.

Furthermore, in Indonesia, many segment market levels are only low income level to affluent level. Many Takaful products are aimed at the middle to affluent market (the same is happened with conventional insurance). Generally, the product of Takaful in Indonesia is unit-linked investment that uses an Islamic investment vehicle such as equity funds, unit trust and Sukuk. This product is suitably to be sold to people who have knowledge of investment - which is the middle to affluent segment. However, large population numbers in Indonesia are Muslim in the low to middle market levels which are less aware and hence lack having Takaful. There is a gap between the affluent market and the low to middle market which are not touched by Takaful (IFN Roundtable, November 2014).

Furthermore, takaful industry in Indonesia have also to address some challenges such as to create takaful products that are really needed and suitable with the characteristics of Indonesian society, to develop Microtakaful and build distribution channels, services and sales management that are addressed towards entering the markets of the low to middle income society.

3.2.7. POLICY RECOMMENDATIONS

3.2.7.1. Islamic Banking

Indonesia is a promising market for global growth in Islamic banking but the sector is still in its infancy and its national market share is growing at a snail's pace. Without a strong initiative from the regulatory authorities to nurture and grow Islamic banking, this sector could remain stuck in its infancy for years. A more aggressive and strategic move to develop the industry is very much needed. The Islamic banking industry should be a credible alternative to conventional banks and open to all Indonesians. In this perspective, some recommendations could be considered as follows:

- A regulatory environment that attracts new entrants from the more established Islamic banking markets that could potentially create a spark to help Islamic banking grow in Indonesia should be established. Opportunities for global business for Islamic banks and units in the global market should be tapped by Indonesian authority to hopefully increase the Indonesian Islamic banking market share.

- Indonesia is also known as country that has complex regulation in Islamic finance practices. Various stakeholders are involved to regulate and supervise the practice of Islamic finance industry, hence it is recommended that the regulations should be made with coordination among the regulators and could be streamlined to create rooms for the players to innovate and expand their business.

- To increase the market share of the industry, Indonesian Islamic banking industry for funding and financing should be improved with various products based on variety of contracts approved by Shariah. Indonesian Islamic banks should attract for example the potential sources that they have such as remittance business from Indonesian workers in Muslim countries and others, idle fund placement, foreign exchange transaction, and L/C and trade finance for export-import should also be tapped by Islamic bank in Indonesia.

- As can be seen in the above statistics, the dominant structure in Indonesian Islamic banking financing is Murabahah Financing, the OJK in this regards should encourage Islamic banks in Indonesia to also offer equity-financing based on the principle of risk sharing to promote the development of real economic sectors.

- To increase the intermediary role in Islamic finance towards real sector economy and expanding the reach of Islamic banks to the lower segment in society. The current branding of Islamic banking industry "beyond banking' promote by the OJK and Bank Indonesia should be promoted by Indonesian Islamic banking industry to increase their competitive advantage.

- To be able to compete globally in international Islamic banking industry, it is important for Islamic banking industry in Indonesia to adopt best practices and international financial standards as developed by IFSB and AAOIFI. Indonesian Islamic banks also need to comply with these standards to enhance their capability to conduct business globally.

- Innovation in this regard is important focusing on product development, service quality, efficiency in economics of scale to create an equal level of playing field with conventional banking industry. In this regards, Islamic banking industry should support larger-scale strategic planning and development.

- Since the market share of Indonesian Islamic bank industry is very small (below 5%) of total market share of national banking industry, some consolidation in Islamic banking sector to create a bigger player that is financially strong to move the industry further is considered important.

- Another potential strategy is collaboration of Islamic banking industry with zakat and Waqf institution for poor empowerment through financing scheme for startup business and others entrepreneurship program.

3.2.7.2. Islamic Capital Market

Indonesian Sukuk market has reached a CAGR 63.56% from 2002 till 2015. However, the size of the industry is relatively small as compared to conventional bond market. There are some challenges to increase the market share of Sukuk in Indonesia and to release its full potentials to facilitate the development of the country and to accelerate the growth of Islamic finance industry in Indonesia. To improve further the development of Islamic capital industry, some recommendations could be considered as follows:

- To integrate with international capital market and to enhance the infrastructure of Islamic capital market that would streamline the processes and procedures in Sukuk issuance is important in order to reduce the cost of Sukuk issuance such as in legal documentation, agreement. This would attract investors to invest in Sukuk both locally and globally.

- To offer incentives especially to the new instruments that are designed to fund the national economic agenda in developing infrastructure, education, agriculture and others.

- Innovations in Sukuk instruments are needed in Indonesian Islamic capital market to diversify the products and meet the needs of the Sukuk issuer and also investors.

- Research and development to further develop Sukuk industries is important. Perhaps cooperation between regulator, industry players, academia and investors is very significant. Likewise, incentives or rewards could also be given to the innovative Sukuk structure.

3.2.7.3. Takaful

The development of Takaful industry in Indonesia is quite promising. There is a growth trend in the industry every year although the market share is still lower compared to conventional insurance. To increase the potentials and to enlarge the industry the following are some of the recommendations that can be considered in this report, namely:

- A strong capital structure is significantly needed to expand the Takaful industry in Indonesia. The market is open but it needs strategy on how to focus on products, distribution channels which are suitable for product type and target market, education programs, marketing plans and selling processes and research and development. With a strong capital, the Takaful companies can do many things such as sustainably product development, educating the society on Takaful products and increase public confidence to the Takaful companies. To realize this, each Takaful companies has to attempt to generate more capital from investors who would like to invest in the industry beside doing merger among the Takaful companies is also one of the possibilities.

- Lack of awareness of Takaful by the public at large is still one of the factors that prevent the industry to expand. Public need to get more information about Takaful practices, for example what products are really suitable for the purpose, how much they can pay and how to collect contributions and payments. More efforts need to be done to socialize and educate the public on Takaful industry to increase their awareness and willingness to buy Takaful products.

- Finally, the support from the government to Takaful industry is needed at this initial phase of development. Government-linked business, for example, should give priority to Takaful and Islamic methods as in the case of Malaysia to expand the market share of the industry. Likewise, a supportive regulatory framework that would facilitate the industry development (and not to restrict it) is also needed.

3.3. CASE STUDY: PAKISTAN

3.3.1 SUMMARY

Pakistan presents an interesting case study for Islamic finance, as the country with the second largest Muslim population, a growing Islamic banking segment, and significant recent efforts on the part of the central bank, the industry as well as the academia in improving product awareness and diversification in Islamic finance. Significant recent developments include Pakistan's entry into the international Sukuk market in 2014, the development of Sukuk Rules in 2015, the central bank's establishment of three Centers of Excellence for Islamic Finance in Lahore, Karachi and Peshawar in late 2015, the framework for Takaful Window Operations being passed in 2015, as well as the Islamic banking segment reaching a size of 13.3% by December 2016. However, the country's Islamic banking, capital markets and Takaful industry is also facing significant challenges, in increasing awareness of Islamic finance processes and products, developing its trained human resource, providing a greater variety of both sovereign and private Shariah compliant products for investment and liquidity management of its IFIs, developing Re-takaful products, etc.

3.3.2 INTRODUCTION

Islamic Republic of Pakistan is a major Muslim majority state in South Asia, which shares borders with Iran and Afghanistan in the east, disputed Kashmir and China in the North, India in the west, and the Arabian Sea in the south. It gained its independence along with neighbor India in August 1947.

Pakistan is a major developing economy with a GDP of USD 283.66 billion (the 40th largest economy by GDP in 2016) and boasts a population of 193.2 million, with 95-98% being Muslim (2016)[48].

3.3.3 ISLAMIC BANKING IN PAKISTAN

An initiative to re-launch Islamic banking in Pakistan started in the early 2000, as a long term plan to shift the financial system to an interest-free economy, but through a gradual, market-driven and flexible approach, without major disruptions. The government of Pakistan decided to promote Islamic banking as a parallel and compatible system.

Islamic Banking was re-introduced in Pakistan in 2002, with Meezan as its first licensed Islamic bank. In the year 2002, Al Meezan Investment Management Ltd, which had been established earlier in 1995 as the country's first wholly Shariah compliant Asset Management and Investment Advisory firm, was granted the license by the State Bank of Pakistan to operate the first Islamic bank. Hence, Meezan Bank Ltd. was formed, which is still the country's first and largest full-fledged Islamic bank

The Islamic Banking Policy had been introduced in 2001, and Modaraba Companies and Modaraba Rules had existed in Pakistan since 1981. Today, there are a total of twenty-two Islamic banks operating in Pakistan. These consist of (a) four full-fledged Islamic banks

[48] World Bank data Pakistan, year 2016..See http://data.worldbank.org/country/pakistan

(Meezan, Dubai Islamic Bank Pakistan, Bank Islami and Bank AlBaraka), (b) one subsidiary (MCB Islamic bank, established in 2015) and (c) seventeen Islamic banking windows. The market share of Islamic Banking assets stood at 11.7% in December 2016, with the market shares in terms of deposits at 13.3%[49].

Pakistan has an active Islamic Banking department at the State Bank of Pakistan (SBP), the Securities and Exchange Commission of Pakistan (SECP) and a Shariah Advisory Board at the SBP serving as the highest authority for IFIs in the country. There is a legal framework in place that is a combination of the Bahraini and Malaysian model, for any FI operating as (a) an Islamic commercial bank, (b) an Islamic subsidiary of a conventional bank or (c) financially separate Islamic branches of a conventional bank (Islamic windows). Of the 17 conventional banks operating Islamic windows, two (Faysal Bank and Summit Bank) have announced their intent to convert to full-fledged Islamic banks. Other conventional banks with Islamic branches include Habib Bank, Bank of Khyber, Bank Al Habib, National Bank of Pakistan, United Bank Limited, Askari Bank, Standard Chartered, BOP, Sindh Bank, Habib Metro etc. There are also five Takaful companies operating in Pakistan (2015), though with no local IFI offering re-Takaful products as yet. Though the Bahrain-based international AAOIFI standards for Accounting, Auditing and Shariah are widely accepted by SBP and IFIs in Pakistan, their implementation is still in its initial stages.

In terms of size, there are about 2075 Islamic banking branches operating in Pakistan[50], with Islamic banking assets totaling to PKR 1,853 billion by December 2016 (approx.. 17.7 billion USD) with a 11.7% market share of the industry. Total deposits of Islamic banks stood at PKR 1,573 billion (13.3% of the industry). The share of Islamic Banking assets in Pakistan, which was 12.8% (Dec 2015) of the total banking industry rose to 13.3% December 2016, and the figure is targeted to reach 20% by 2020. In fact, between 2010 and 2015, the Islamic banking industry experienced a compound annual growth of over 30% both in terms of assets and deposits.[51]

In terms of the popularity of Islamic financial instruments used by Islamic banks in Pakistan, **Diminishing Musharakah** is the most popular mode of financing, followed by **Murabahah** and **Musharakah.** In the calendar year 2016, the size, in terms of financing assets, of debt based Murabahah decreased and that of Musharakah increased.

Table 29. Percentage Share of Instruments Used for Financing by Islamic Banks in Pakistan

Instrument	Dec-16	Dec-15	Change
Diminishing Musharakah	34.7	31.7	+3.0
Murabahah	15.8	24.5	-8.7
Musharakah	15.6	14.0	+1.6
Ijarah	6.8	6.6	+0.2
Salam	4.4	5.5	-1.1
Istisna	8.6	8.4	+0.2
Others	14.3	9.3	+5.0
Total	100	100	

Source: SBP Islamic Banking Bulletin, December 2016

[49] 'State Bank of Pakistan Islamic Banking Bulletin', December 2016
[50] As of December 2016, SBP Islamic Banking Bulletin
[51] Pakistan Islamic Finance Country Report 2016

An important challenge for the Islamic banking industry in Pakistan is that it is commonly perceived as less profitable (for depositors) than the conventional banks. This is partially because of the limitation of Shariah-compliant investment avenues open to Islamic banks. In December 2016, the liquid assets of Islamic banking institutions rose to PKR 610 billion (approx. USD 5.8 billion), compared to PKR 566 billion in December 2015[52] It is said that Islamic banks are not treated at a level playing field with the competing conventional banks. The table below (Profit Rates for Islamic banks) describes the comparative profit rates offered by the main (full-fledged) Islamic banks in Pakistan, on their Mudarabah-based deposit savings accounts. As it is illustrated, the rates are comparatively lower than those offered by conventional banks. The difference is often attributed to the less Shariah compliant investment avenues available to Islamic banks, and the fact that Islamic banks in Pakistan often do not have a level playing field given the regulations, available Shariah compliant government securities and liquidity management options.

Islamic banks, like their conventional counterparts are faced with the challenge of having short-term liabilities (in terms of deposit accounts that can be called at any time) with medium to long term assets on their balance sheets. Typically, Islamic banks offer several Mudarabah-based deposit instruments to their customers, with their profit rates varying by as much as two or three times[53]. Though the profit-sharing ratio is kept constant, varying rates are offered by the difference in weightages, and gives depositors financial incentive to deposit larger amounts of money, keep them fixed for longer periods of time, or receive profit payments at lesser frequency (e.g. quarterly, yearly or at maturity, instead of monthly).

Table 30. Profit Rates of Islamic vs. Conventional Bank in Pakistan

Mudarabah-based deposits and their comparative profit rates, in PKR, offered by Islamic banks in Pakistan – as at March 2017			
Islamic Bank	**Basic savings account profit rate (annualized)**	**Range of rates on different saving account instruments**	**Mudarabah profit-loss sharing ratio used (PSR) Rab-ul-Maal/depositor: Mudarib (bank)**
Meezan Bank Ltd	2.40%[54]	2.40 – 5.98%[55]	50% – 50%[56]
Bank Islami	2.60%	2.60 – 5.90%	50% - 50%
Dubai Islamic Bank Pakistan (DIBPAK)	1.78%	1.73 – 5.18%	50% - 50%
Bank AlBaraka Pakistan	2.45%	2.45 – 6.40%	60% - 40% (Depositor: 60%)
MCB Islamic Bank	2.31%	2.25 – 6.03%	50% - 50%

[52] State Bank of Pakistan Islamic Banking Bulletin, December 2016.
[53] This is a State Bank of Pakistan regulation for Islamic banks: the maximum deposit rate offered cannot exceed more than three times the minimum rate offered.
54 The Mudarabah-based saving account is inherently a one month Mudarabah between the depositor and Islamic bank. The profit rates are declared at the end of every month, and weightages and PSR at the start of each month. The profit rate for the simplest saving account is quoted here.
[55] These ranges exist because different weightages are assigned to different types of saving account instruments, based on amount, payment frequency (monthly, quarterly, yearly), term deposits and tenure. The highest profit rate is typically for a five or seven year fixed term deposit instrument
[56] Profit sharing ratios (PSR) have been taken as at 31st March 2017 from the respective websites of the five full-fledged Islamic banks in Pakistan. The PSR is found in 'Weightages' section, which are updated at the start of every month.

Comparative savings accounts interest rates offered by the largest conventional banks in Pakistan – March 2017			
National Bank of Pakistan	3.75%	3.75% - 5.55%	-
Habib Bank Limited	4.04%	5.00% - 7.23%	-

Source: Banks' websites - declared profit rates and weightages

To illustrate the different saving account instruments used, extracts from the 'Pool Distribution sheet' for Pakistan's two largest full-fledged Islamic banks, Meezan Bank and Bank Islami, for March 2017 is shown below. As the Table earlier illustrates, the simplest kind of saving account (with no restrictions on amount, tenure etc. and with monthly frequency) is quoted. However, the actual profit rates varied from 2.4% to almost 6.0%. Depositors with, for example, more than PKR 1 million are offered a higher profit rate (as their weightage is higher). Instruments such as Mudarabah-Certificates are also found, where the saver fixes the deposit for one, three or six months, or one to three years, receiving a higher return. Depositors willing to take profit payment only annually or at maturity of the instruments are awarded an even higher rate. The highest profit rate product is hence the Mudarabah certificate (called Term Deposit) of over 0.1 million PKR that is fixed for seven years.

Figure 9: Different Saving Account Instruments

Meezan Bank

Income Distribution - Month ended August 31, 2017 (Extract)
(Profit Rates are "Per Annum" basis and Declared on Monthly basis) - Updated on 5th September 2017)

Basic Saving Accounts rates:

Profit: Frequency & Rate	**Rupee Savings Account:**	**Labbaik Savings Account:**	**Meezan Kids & Teens Accounts: (Special Savings A/c)**	**Meezan Kafalah Account:**
	Monthly 2.40%	Monthly 3.01%	Monthly 2.40%	Monthly 4.69%

Basic quoted Saving A/c rate

Other Savings accounts: [Monthly profit payments]

Meezan Bachat Account:
For individuals

Amount in PKR	Profit Rate
Re. 1 - 49.99K	2.40%
Rs. 50K - Rs. 199.99K	2.65%
Rs. 200K - Rs. 499.99K	2.90%
Rs. 500K - Rs. 25M	3.15%

Meezan Islamic Institutions Deposit Account
Minimum Invesment; PKR 10 million

Amount in PKR	Profit Rate
Re. 1 - Rs. 199.9 Million	2.40%
Rs. 200M - Rs. 499.9 Million	2.40%
Re. 500 Million & above	2.40%

Karobari Munafa Account: (for businesses)
Minimum Investment: PKR 1 million

Amount in PKR	Profit Rate
Re. 1 - 9.99 Million	2.40%
Rs. 10M - 49.99M	3.01%
Rs. 50M - 99.99M	4.19%
Rs. 100M - 249.99M	4.41%

Mudarabah - based Term Deposits (savings fixed but with higher profit rates)

Tenure	1 month	3 months	6 months	1 Year		2 Years		3 Years		5 Years	
Profit Rates	Maturity	Maturity	Maturity	Monthly	Maturity	Monthly	Maturity	Monthly	Maturity	Monthly	Maturity
	3.58%	3.90%	4.16%	4.33%	4.80%	4.69%	5.16%	5.09%	5.41%	5.52%	5.59%

Long Term Fixed Deposit Certificates
Meezan Amdan Certificate
Monthly profit, Min. investment of PKR 100,000/-

Tenure	5 - 1/2 Years	7 Years
Profit Rate	5.66%	5.98%

Highest Mudarabah based Savings profit rate

Foreign Currency Savings Accounts
Mudarabah based, monthly profit payments

Currency	Profit Rates
USD	0.51%
GBP	0.07%
EURO	0.03%

Source: Extract from Meezan bank's profit rates for August 2017

However, one interesting aspect to note in Table earlier depicting Islamic banks' offered profit rates was that the profit rates offered by Islamic banks on Mudarabah-based deposit instruments are slightly lower than those offered by their conventional counterparts. The table uses the interest rates prevailing in fiscal year 2017 of the two largest banks in Pakistan: National Bank of Pakistan and Habib Bank (though both conventional banks operate Islamic windows as well), and they exceed the Islamic rates by over 120 basis points. In the market, this is attributed to the lack of Shariah-compliant investment opportunities available for Islamic banks, which adversely impact their profitability. It should be noted that the year by year growth in deposits of Islamic banks in Pakistan has been despite these comparatively low profit rates, and therefore may be partially attributed to the perceived demand of faith-based depositors for Shariah-compliant banking instruments.

Islamic banks in Pakistan also offer **foreign currency accounts** to their depositors. These products are usually **Qard-e-Hasan** (loan) - based and most banks offer the products for US dollars, GBP and Euro. Very low profit rates are offered to Pakistani investors in these foreign currency deposit accounts. However, they tend to be higher than those offered by conventional banks, such as 0.12% - 0.70% annualized.

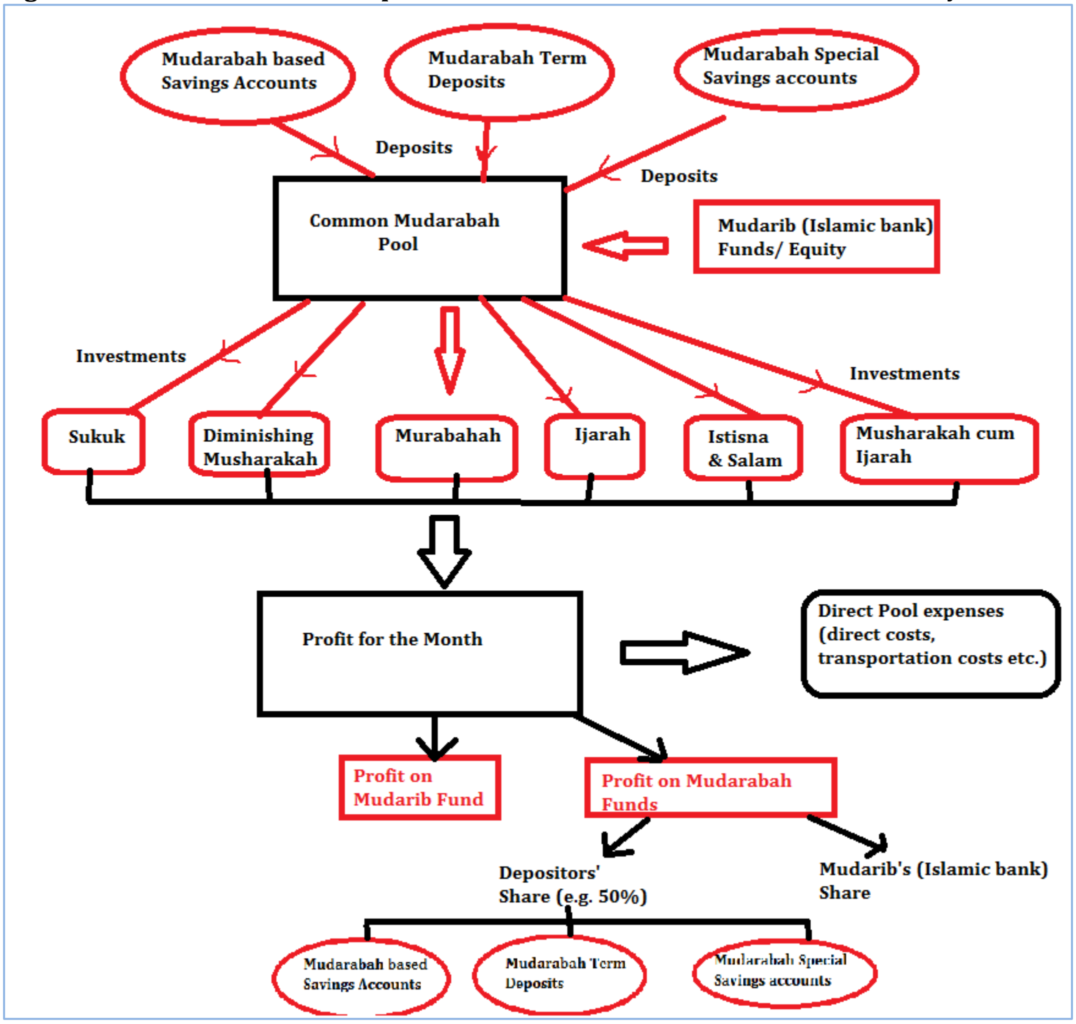
The Islamic banks in Pakistan operate deposit instruments on month-long Mudarabah bases, and the Mudarabah is automatically renewed every month. They announce the weightages (and Profit-sharing ratio) at the start of each month, and the profit rates at the end of the month (typically in the first week of the next month). An extract from Meezan Bank's declared profit rates for the month of April 2017 is shown above, demonstrating the different local and foreign currency deposit instruments used by Islamic banks in Pakistan.

As the extracts show, the Mudarabah deposit instruments differ in their profit rates based on the amounts, profit payment frequency and tenure. Islamic banks also offer Mudarabah based Certificates of Islamic Investments (CCI), or Term Deposits, in which depositors are given marginally higher profit rates for fixing their deposit for one month to seven years.

As the Extract from Bank Dubai Islami Pakistan (DIBPAK)'s profit distribution pool shows, Islamic banks use the Mudarabah structure with their depositors for profit distribution in their following products: Saving accounts (current accounts are operated on Qard ul Hasan structure with no profits), Term deposits (ranging from 1 month to 3 years), special savings accounts (with higher rates, e.g. for financial institutions, teenage savers etc.) and Mudarabah Certificates (ranging from 6 months to 7 years). Funds are combined in a 'Common Mudarabah Pool') which is then added to funds from Mudarib (Islamic bank's) equity pool, using Musharakah. The funds are then utilized in different structures in consumer financing, project financing and corporate ventures, via the structures of Diminishing Musharakah and Murabahah (most popular in Pakistan), Ijarah, Salam and Istisna, and limited Sukuk.

In Pakistan, almost 60% of the consumer financing, including House financing and car financing, is now done by Islamic banks. This is remarkable given that Islamic banking only commenced in 2003, and is still only 13.3% of the overall banking industry. Islamic banks' house financing products are mainly based on Diminishing Musharakah and Ijarah bi Tamleek[57].

Figure 10: Mudarabah-Based Deposits Profit Distribution Procedures Followed By Islamic Banks



Source: Extract from DIBPAK

3.3.4 ISLAMIC CAPITAL MARKET IN PAKISTAN

The Islamic capital markets segment of Pakistan consists of the Islamic asset management industry (including the different Shariah compliant funds), Islamic equity indices, Sukuk and Modaraba companies.

[57] Ijarah bi Tamleek in Pakistan is when the Islamic bank agrees to gift the asset (car, bike, house etc.) to the customer once all the rental payments are completed.

Islamic Asset Management Industry

The first Islamic asset management firm was established in Karachi, Pakistan in 1995 as Al Meezan Investment Management. Apart from investment advisory, it offered open ended mutual funds and voluntary pension schemes, with the stated objective of making Shariah compliant products the investment of first choice for individuals and firms in Pakistan. By the end of February 2017, it was the only wholly Shariah-compliant Asset Management firm, and the largest private sector asset management and investment Advisory company operating in Pakistan, with a total of PKR 111.3 billion assets under management (approx. USD 1060 million). Its mutual fund products include equity funds, balanced funds, asset allocation funds, fixed income and sovereign funds (investing primarily in corporate and sovereign or government-backed Ijarah Sukuk), money market funds (such as Cash Fund), fund of funds and lastly, voluntary pension schemes.

At present, though Al Meezan is the only fully Shariah compliant asset management firm in Pakistan, several other conventional asset management firms have started Islamic windows which offer Shariah compliant mutual funds and pension schemes.

The Securities and Exchange Commission of Pakistan (SECP), which regulates the non-banking financial institutions including insurance and asset management firms, has offered significant tax benefits to Pakistani investors to encourage investment in mutual funds. Recently, these Tax credits or exemptions have been extended to Shariah compliant funds as well. As per the Income Tax Ordinance 2001, resident investors in Pakistan may avail tax credit for up to 20% of their annual incomes by investing in mutual funds or voluntary pension funds.[58] The incentives offered are slightly higher (up to 30%) for individuals over the age of 40, for saving in pension funds.[59]

The sum of Shariah-compliant funds under management was PKR 1053 billion (approx. USD 10.0 billion) in June 2015[60], with Al Meezan Investment Management alone holding a market share of 57% of Islamic assets under management. The Non-Banking Financial Institutions (NBFI) and Modaraba Association was formed in 2010, and by 2014, there were twenty-two Modaraba companies operating in Pakistan.

Shariah Compliant Equity Index

The Pakistan Islamic capital markets segment has two Shariah compliant indices. The first was the **KMI-30**, launched in 2008, comprising of thirty listed firms passing the Shariah screening criteria for stocks. As can be seen in the different real industry sectors shown in Table (KMI-30 composition), the KMI-30 includes listen companies from the Oil and Gas industry, fertilizers and cement industries, pharmaceuticals, oil refineries, automobiles, electrical appliances etc. The second is the **All Share Islamic Index** developed by the Pakistan Stock Exchange (PSX) and Meezan Bank, comprising of about 232 listed companies. The PSX– Meezan also gives a list of compliant equities with their 'dividend purification rate' (based on their annual accounting ratios, the percentage of dividend that has to be disbursed to charity).

[58] Section 62 of Pakistan Income Tax Ordinance, 2001. Actually, the amount of investment eligible for tax credit is the lower of a) PKR 1.5 million, b) 20% of investor's annual taxable income or c) total cost of investment

[59] In the Pakistan market, generally only public corporations offer non-voluntary pension benefits to employees.

[60] Pakistan Islamic Finance Country Report 2016

Table 31. KSE Meezan Index (KMI - 30) Composition

No.	Company Name	Industry
1	Oil and Gas Development Company Limited	Oil and Gas
2	Pakistan Petroleum Limited	Oil and Gas
3	Pakistan Oilfields Limited	Oil and Gas
4	Mari Petroleum Company Limited	Oil and Gas
5	Pakistan Telecommunication Company Limited	Technology & Communication
6	K-Electric Limited	Power Generation and Distribution
7	Hub Power Company Limited	Power Generation and Distribution
8	Fatima Fertilizer Company Limited	Fertilizers
9	Engro Fertilizers Limited	Fertilizers
10	Engro Corporation Limited	Fertilizers
11	Dawood Hercules Corporation Limited	Fertilizers
12	Fauji Cement Company Limited	Cement
13	Maple Leaf Cement Factory Limited	Cement
14	Lucky Cement Limited	Cement
15	Pioneer Cement Limited	Cement
16	Cherat Cement Company Limited	Cement
17	Sui Southern Gas Company Limited	Oil and Gas Marketing Companies
18	Sui Northern Gas Pipelines Limited	Oil and Gas Marketing Companies
19	Hascol Petroleum Limited	Oil and Gas Marketing Companies
20	Engro Foods Limited	Foods industry
21	Pak Elektron Limited	Electrical Appliances Manufacturing
22	GlaxoSmithKline (Pakistan) Limited	Pharmaceuticals
23	The Searle Company Limited	Pharmaceuticals
24	Packages Limited	Paper and Board
25	Honda Atlas Cars (Pakistan) Limited	Automobile Assembler
26	Pak Suzuki Motor Company Limited	Automobile Assembler
27	Ghandara Nissan Limited	Automobile Assembler
28	Ghandhara Industries Limited	Automobile Assembler
29	Attock Refinery Limited	Refinery
30	National Refinery Limited	Refinery

Source: KSE Stocks website, May 2017

Mudarabah Companies

In addition to the different Shariah compliant funds, equity indices and Sukuk, the SECP also regulates a total of 28 Mudarabah companies in Pakistan (titled 'Modarabas'), as shown in the table below.

In the early 1980s attempt of 'Islamization' of the Pakistan economy, the Modaraba Companies and Modaraba Ordinance 1980 and Modaraba Rules 1981 were formed. [61] These, along with the Companies Ordinance of 1984 provide the rules relating to registration of Modaraba companies, and the flotation, management and regulation of the twenty-eight active Modarabas.

[61] Securities and Exchange Commission of Pakistan website

Modaraba companies provide investors with Shariah compliant Mudarabah-based savings instruments, similar to the savings accounts offered by Islamic banking institutions. However, unlike saving account products, these certificates of investments offered by Modaraba companies typically have tenures ranging from three months to five years, are for larger investment amounts (e.g. PKR 50,000 to over 100 million), and offer slightly more attractive profit rates than Islamic banks (e.g. 5.0 – 6.35% annual).[62] The Modaraba companies' products range from 'Certificates of Investments' (Musharakah or Mudarabah based) or selected financial services (based mainly on Diminshing Musharakah and Ijarah, and sometimes using Murabahah, Salam or istisna as well), e.g. financing for computers, motor vehicles, machinery, plant equipment etc. Like other IFIs, Modaraba companies in Pakistan are also required to have Shariah advisors. Modarabas are listed at the Pakistan Stock Exchange and typically offer attractive annual dividend yields.

Table 32. List of Active Registered Modaraba Companies Operating in Pakistan

Sr. No.	Name of Modaraba Company
1.	First Habib Modaraba
2.	BRR Guardian Modaraba
3.	Standard Chartered Modaraba
4.	Modaraba Al-Mali
5.	B.F. Modaraba
6.	First IBL Modaraba
7.	First Prudential Modaraba
8.	KASB Modaraba
9.	First Pak Modaraba
10.	First UDL Modaraba
11.	Trust Modaraba
12.	First Fidelity Leasing Modaraba
13.	First Elite Capital Modaraba
14.	First Equity Modaraba
15.	Popular Islamic Modaraba
16.	First AL-Noor Modaraba
17.	First Punjab Modaraba
18.	Crescent Standard Modaraba
19.	First Imrooz Modaraba
20.	First Paramount Modaraba
21.	First National BanK Modaraba
22.	First Treet Manufacturing Modaraba
23.	Allied Rental Modaraba
24.	Sindh Modaraba
25.	Unicap Modaraba
26.	Awwal Modaraba
27.	First Constellation Modaraba
28.	First Tri-Star Modaraba

Source: SECP Website, April 2017

[62] First Habib Modarabah website. Retreived September 2017. See: http://www.habibmodaraba.com/projection-of-profit-rates

Sukuk

The Sukuk segment in the Pakistan Islamic capital markets industry consist of sovereign (Government of Pakistan –issued) Sukuk, government backed Sukuk and corporate Sukuk. Both listed and unlisted Sukuk are issued in Pakistan, mostly based on the structures Ijarah, Diminishing Musharakah and Mudarabah. The common practice is to list the profit rates using the Karachi Interbank Operating rate (KIBOR) with a premium, e.g. 6 month KIBOR + 0.70%

The SECP issued Sukuk rules in the year 2015. The Government of Pakistan entered the Sukuk market in June 2014, with the issue of a PKR 49.5 billion Ijarah Sukuk. Later in November 2014, it entered the international Islamic Sukuk market with its first foreign currency Sukuk issue: a 5 year Ijarah Sukuk of USD 1 billion. This was at a profit rate of 6.75% (50 basis points less than the rate offered on Eurobond in April 2014), and was pledged against the Islamabad-Lahore Motorway. This attracted a wide international investor base, with 35% subscriptions from Europe, 32% from the Middle East and 20% from North America. In December 2015, the GoP (government of Pakistan) issued a local currency Ijarah Sukuk, this time on the Jinnah Airport Terminal in Karachi, to raise PKR 300 billion (USD 2.86 billion, about 14 times greater than the Britian Sukuk). This provided the local Islamic FIs with much needed investment opportunities in government securities, as they had about PKR 225-220 billion in excess liquidity at the time, unable to invest in the conventional Treasury bills and government securities and hence being at a significant disadvantage with the local conventional finance industry

WAPDA (Pakistan's Water and Power Development Authority) then issued a ten year PKR 100 billion Sukuk on the Neelum Jhelum Hydropower plant (NJHP) in April 2016, to raise finance for the hydel project. This was rated at 0.113 basis points over the 6-month KIBOR, and was backed by a sovereign guarantee from the GoP (government of Pakistan). Private corporations in Pakistan can also issued Sukuk, with the legal framework developed by the Islamic Banking Department of the SBP. K-Electric issued a PKR 22 billion 7-year Musharakah-Sukuk in May 2015 to help repay its long term debt via the Karachi Stock Exchange, with HBL and Meezan Bank as its lead arrangers, and this was reportedly the largest listed corporate Sukuk in the country at the time. In October 2016, the GoP issued another foreign currency 5-year sovereign Ijarah-Sukuk of USD 1 billion[63]. By the end of 2015, Pakistan had outstanding Sukuk worth USD 2.92 billion, and outstanding Islamic mutual funds assets worth USD 1.32 billion.[64] The Table below lists the different corporate and sovereign Sukuk issued in 2016.

[63] Source: Sukuk.com website.

[64] Pakistan Islamic Finance Country Report 2016, pages 56-57

Table 33. Structures of 2016 Corporate and Sovereign Sukuk Issued in Pakistan

Name of Issuer	Date of Issue	Issue Size (Billion Rs.)	Tenure	Type		Structure	Profit Rates
				Soverign/ Corporate	Listed/ Unlisted		
Neelum Jehlum Hydro Power Company Limited	29/Jun/16	100	10 yrs	Sovereign	Unlisted	Diminishing Musharaka	6M KIBOR + 113 bps
Pak Elektron Limited	25/Aug/16	1.072	15 mon	Corporate	Unlisted	Diminishing Musharaka	3M KIBOR + 250 bps
Meezan Bank Limited	22/Sep/16	7.0	10 yrs	Corporate	Unlisted	Tier II Sukuk based on Mudaraba	6M KIBOR + 70 bps
Fatima Fertilizer Company Limited	29/Dec/16	10.5	5 yrs	Corporate	Listed	ijarah	6M KIBOR + 1.10%

Source: Securities and Exchange Commission of Pakistan, 29th April 2017

3.3.5 TAKAFUL (ISLAMIC INSURANCE) IN PAKISTAN

The Takaful industry took its first step in Pakistan in the year 2005, with the introduction of the Securities and Exchange Commission of Pakistan (SECP) Takaful Rules. In 2006, the first General Takaful operator, Pak-Kuwait Takaful was established, and in the same year,

The SECP passed a regulatory framework for Takaful Window operations in 2015, and by the end of 2016, there were as my as sixteen window Takaful operators in Pakistan, both for Family and General Takaful. The table below lists the different full-fledged and window Takaful operators and their products.

Table 34. Family and General Takaful Operators in Pakistan as at December 2016

Full Fledged Takaful Operators		
Sr. No.	**Name of Takaful Operator**	**Nature**
1	Pak-Qatar Family Takaful Limited	Family/Life
2	Dawood Family Takaful	Family
3	Pak-Qatar General Takaful Limited	General/ Non-Life
4	Takaful Pakistan Limited	General
5	Pak-Kuwait Takaful Limited	General
Windows Takaful Operators (Post 2015)		
Sr. No.	Name of Takaful Operator	Nature
1	EFU Life Assurance Limited	Family
2	Jubilee Life Insurance Company Limited	Family
3	IGI Life Insurance Limited	Family
4	Adamjee Life Assurance Limited	Family
5	State Life Insurance Company Limited	Family

6	The United Insurance Company of Pakistan Limited	General
7	TPL Direct Insurance Limited	General
8	SPI Insurance Company Limited	General
9	Jubilee General Insurance Company Limited	General
10	EFU General Insurance Limited	General
11	Askari General Insurance Company Limited	General
12	Asia Insurance Company Limited	General
13	Alfalah Insurance Company Limited	General
14	Premier Insurance Limited	General
15	Adamjee Insurance Company Limited	General
16	UBL Insurers Limited	General
17	Atlas Insurance Limited	General
18	Reliance Insurance Limited	General
19	Sindh Insurance Limited	General
20	Allianz EFU Life & Health Insurance	General

Source: Created by Author

There is no Re-Takaful operators at present in Pakistan, and this presents a significant challenge for the Takaful industry. Re-Takaful is essential for the insurance industry, both Life and non-Life Takaful as it combines several different Takaful pools to create a 'pool of pools', mitigating risks. The coverage amount exceeding the legal 'retention limit' has to be covered by a Re-takaful arrangement. Family Takaful operators in Pakistan are able to avail the large global capacity of the Re-Takaful industry, using international operators such as Takaful-Re, Munich-Re, Hannover-Re and Swiss Re-Takaful. This is partially because Family Takaful products have been in existence for a comparatively longer time period. However, the lack of local Re-Takaful operators poses a challenge for General Takaful. In view of this, the Shariah advisors of General Takaful companies in Pakistan have allowed a relaxation in the sharing of risks, by allowing a 'co-Takaful' instrument (5-6 Takaful operators sharing risks).

Wakala-Mudarabah-Waqf Model

In Pakistan, the Shariah advisors and the SECP regulators advise a hybrid model for both Family and General Takaful operators, based on Wakala, Mudarabah and Waqf. It is commonly denoted as 'Wakala-Waqf' model and is the only model commonly used by Takaful operators.

Table 35. Financial Instruments Used in Takaful Industry in Pakistan

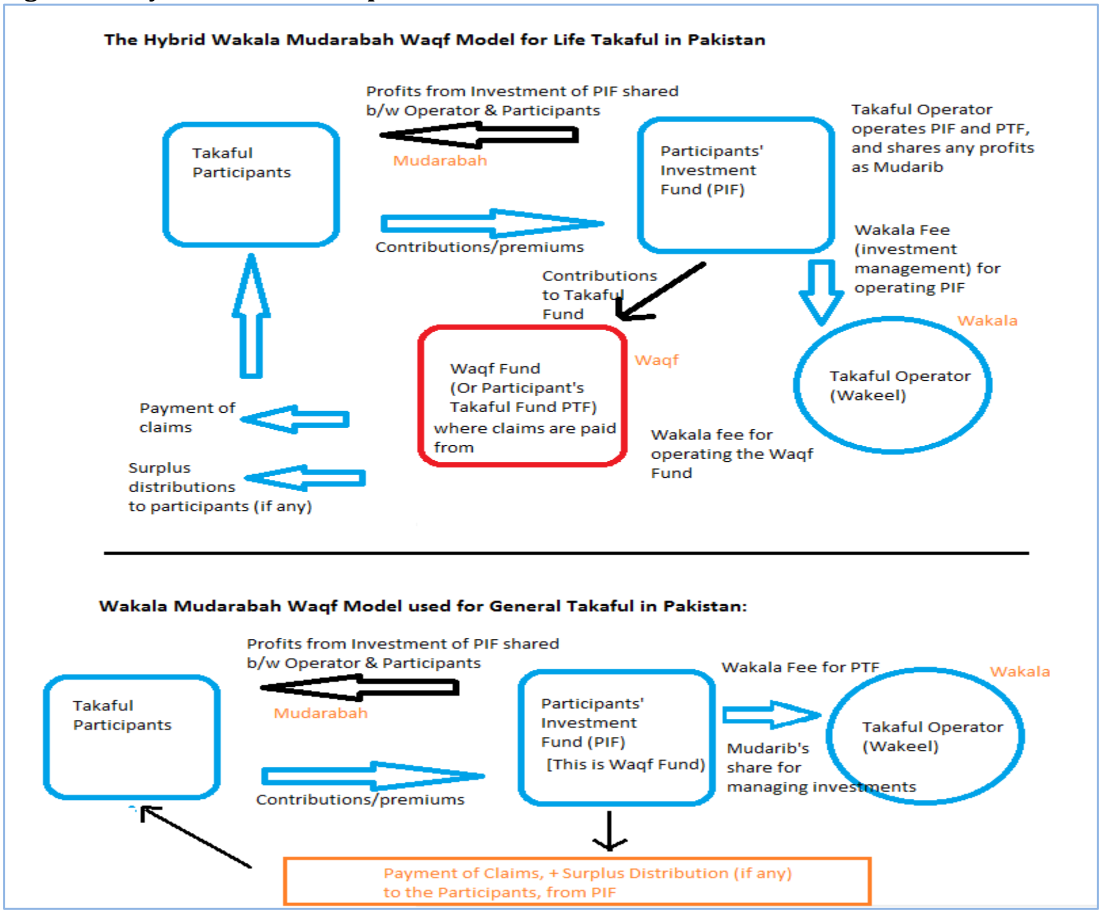
	Description
Minimum Capital Requirements	For Life Takaful: PKR 700 million For General Takaful: PKR 500 million Paid up capital requirements make it easy for Insurance companies to commence Window Takaful operations in Pakistan, since 2015
Shariah Governance requirements	Minimum one qualified resident Shariah Advisor for both Life and General Takaful, full-fledged and Windows. Advised but not necessary to have a Shariah Supervisory Board. Pak Qatar and Dawood Takaful have Shariah Supervisory Boards.
Model used for Life/Family Takaful	Hybrid Wakala-Waqf-Mudarabah model used. Takaful operator acts as Wakeel for Waqf fund (or Participants Takaful Fund PTF, from which claims are paid), and Mudarib for Participants Investment Fund.
Model used for General Takaful	Hybrid Wakala-Waqf-Mudarabah model used. Unlike Life Takaful, there is no separate Participants Investment Fund (PIF) and PTF in general Takaful.
Products offered in Life Takaful	Individual life insurance Group Life insurance Banca Takaful group Life insurance
Products offered in General Takaful	Health insurance Group health insurance Motor takaful Fire takaful Marine Takaful Engineering Takaful

Source: Annual Reports, Pak Qatar Family Takaful 2015, Pak Qatar General Takaful 2015.

In Pakistan, following the development of Takaful Rules in Pakistan in 2005, the Wakala-Mudarabah-Waqf model was developed. This was partially in response to criticisms of earlier models such as the Wakala-Mudarabah model (e.g. regarding the ownership of the Takaful fund being with the operator), and Mufti Muhammad Taqi Usmani suggested declaring the Takaful Fund a Waqf. The full hybrid model, called Wakala-Mudarabah-Waqf model, is now used for both Life and General Takaful in Pakistan, and has been approved along with Waqf deed by the SECP. A depiction is given in the Figure (Hybrid Wakala Waqf Mudarabah model) below.

As the figure below explains, the main difference between the model used in Life Takaful and General Takaful in Pakistan is the existence of a separate Participants' Takaful Fund (PTF) in Life/Family Takaful. This is the Waqf fund from which all participants' claims are paid. Note that when the participants or beneficiaries pay their risk coverage Takaful premiums, they are first transferred to the Participants' Investment Fund (PIF), and then only a fraction is transferred to the PTF. The Waqf deed stipulates that, once funds are transferred to the Waqf fund (as the ownership of this fund is neither with the Operator nor the Participants, but with Allah alone), they cannot be withdrawn for any purpose other than that of the establishment of the fund. All claims of participants for their risk coverage are paid from this Waqf fund. If a client withdraws or the policy matures, he/she gets the remaining balance from PIF as well as PTF.

Figure 11. Hybrid Wakala Waqf Mudarabah Model Used in Pakistan



Source: Created by Author

In contrast, in General Takaful, there is no separate PTF, and the Participants' Investment Fund itself acts as the Waqf fund.

In both business models, the income of the Takaful operator is both in the form of a Mudarib (for managing the investments of the PIF) and as a Wakeel (fixed percentage fee charged for operating the Waqf fund). In cases where there is a surplus in the Waqf fund (contributions exceeding claims in a financial period), with the approval of the Shariah Board of the Takaful Operator, the surplus is either

- Used to pay back any Qard-Hasan from shareholders, taken previously in case of deficit
- A portion of the surplus is kept as a reserve, to mitigate for future losses.
- The remaining portion is distributed among the participants of the fund

Note that, as per SECP regulations, it is not incumbent for Takaful operators to have a Shariah Board. The minimum requirement is that of one qualified approved Shariah Advisor. However, a few full-fledged operators such as Pak Qatar Takaful and Dawood Family Takaful have their own Shariah Boards.

Some of the main challenges facing the Takaful industry in Pakistan are:

- Both Life and General Takaful inherently seek to provide risk coverage. However, the current market mainly views the profit rates/returns from investments of these instruments. Hence, the Operators are faced with the challenges of providing competitive returns to their participants, as opposed to providing better risk coverage

- The general awareness about Takaful and its products among the population is very limited. This has improved in certain segments of the population since 2015 with repeated educational trainings on Takaful. However, there are many segments of the population who may understand Islamic banking but not insurance in general, or may comprehend insurance but may not be able to differentiate between conventional insurance and Takaful.

- There is a long-term need for local Re-Takaful firms, particularly in General Takaful.

3.3.6 POLICY RECOMMENDATIONS

Islamic banking in Pakistan is gradually increasing in awareness since 2015, with the State Bank of Pakistan and Finance Minister helping in the establishment of three active Centers of Excellence in Islamic Finance (at IBA Karachi, LUMS Lahore, and IM Sciences Peshawar) by the end of 2015. The Islamic asset management industry in Pakistan was the first segment to commence, back in 2003. The number of Takaful operators significantly increased in 2015 and 2016 with the introduction of Takaful windows. However, there are still significant challenges facing the three sectors, in terms of product diversification and innovation as well as Shariah compliance:

- Islamic banking has a dominant share in the Consumer financing market, capturing close to 60% of the market, via its popular Ijarah, Diminishing Musharakah and Murabaha based financing products. However, its share in the corporate financing needs to be increased

- One of the most important issues facing Islamic banks is the lack of Shariah compliant avenues for Liquidity Management. There are very few sovereign Shariah compliant products available, such as Bai Muajjal (credit sale) and GoP (government of Pakistan) Ijarah Sukuk. However, the profitability of Islamic banks, as well as the rates they subsequently offer to their depositors, has been significantly lower than that of conventional banks due to an acute shortage of well performing Shariah compliant investment products. In December 2016, Islamic banks had a total of Rs. 610 billion liquid assets, with an average ROE of only 10.6%, compared to the main industry average ROE of 14.4%.[65]

- There is a gradually increasing awareness in Pakistan that Islamic banks, in essence, should be more of financial intermediaries and trading houses rather than a replication of conventional banking. However, the current Islamic banking operating mode is mainly geared towards 'Islamizing' the existing conventional products. This is restricting the growth of product diversification and innovation in Islamic banking.,

[65] State Bank of Pakistan's Islamic Banking Bulletin, December 2016, pages 8-9.

- The industry needs to develop newer products catering to needs of the specific population segments, e.g. agricultural farmers, SMEs, young university students, small scale entrepreneurs etc. The Islamic banking segment also needs a Shariah compliant profit rate benchmark.

- Incentives need to be given to large corporations to finance their projects and long term debts via Shariah compliant products, such as Diminishing Musharakah, Ijarah and Musharakah – based Sukuk. The recent examples, such as K-Electric, Fatima Fertilizers etc. doing so have been far and few.

- More saving account products could be developed to attract the young age group (15 – 24 years) towards Islamic banking. E.g. UBL Ameen (Islamic window of United Bank) offers a Minor Savings Account (age under 18) with significantly higher profit rates.

- In 2016, the State Bank of Pakistan announced a 2% tax rebate for listed companies that achieve Shariah compliance. Such major incentives, such as tax rebates/holidays need to be introduced in policies to encourage more firms in non-financial industries, including Fertilizers, Software Engineering, Cement, Power and Gas, Telecommunications, Motor industry etc. to achieve Shariah compliance. This will aid the Islamic asset management industry as well, giving them a greater diversified portfolio of stocks to invest in.

- Fintech is causing a significant disruption in the Islamic banking industry. There is a need for greater technical training and adaptation of smart phone technology, data analytics, mobile banking etc. by Islamic banks.

- There is a need for developing Re-Takaful providers, particularly for General Takaful.

- A major opportunity for both Islamic banking and Islamic capital markets industry for the next 15 years is the upcoming China Pakistan Economic Corridor. It should be an important part of the policy to use Shariah compliant financing structures for many of the USD 46 billion worth projects in infrastructure financing, Gwadar airport development, energy and power etc.

3.4 CASE STUDY: SUDAN

3.4.1 SUMMARY[66]

Sudan is a prominent centre for applying Islamic finance in all its aspects especially in the African continent. It is also an interesting case study, as one of the two main OIC member countries to have a 100% Islamic banking size. It has a long journey in transferring its banking and financial sector into Shariah-compliant on regulatory and operational levels and that motivated the authors for more exploration and analysis about this rich experience. Moreover, governmental Sukuk in Sudan is probably a very good example that could be an inspiration for other countries; therefore, more focus will be concentrated on various types of this Sukuk and the features of each. The experience of Takaful and micro-Takaful in different sectors in Sudan could also be beneficial for other countries, besides being an evidence of how non-banking Islamic finance could be helpful in economic and social development. In the following case study, we will present briefly the profile of Sudan, then we analyse the diversity in its Islamic finance sectors, and finally we provide Islamic finance policy recommendations for both Sudan and OIC member countries that could assist decision makers in developing Islamic finance sectors in their countries.

3.4.2 INTRODUCTION

Sudan is an African country which is situated in North Africa bordered by Egypt, Eretria, Ethiopia, Chad, Central African Republic and South Sudan. According to UNDP, over 97% of the population in the north Sudan are Muslims at the year of 2011 (the year of division from the south). Other religions in Sudan include Christianity (1.5%) and African traditional religion (1.5%) (World Fact book)

The motivation behind choosing Sudan as a case study for this report was mainly because its importance as an Islamic financial hub in the World and particularly on the African level. According to IFSB Report Islamic financial services industry stability report for the year 2017, the share of Islamic banking from the total banking system is 100%.

Brief Review for the Financial System in Sudan

During the period of English colonialism in Sudan, the banking system was restricted to foreign banks only such as the Barclays Bank, Ottoman Egypt Bank and the National Bank of Egypt, and Credit Lyonnais. However, following independence in 1956, the currency committee was developed to issue a unified Sudanese currency that reflected the culture and the diversity in Sudan and This was then followed by a law of the Central Bank of Sudan which was passed in 1959 and the bank started officially in 1960 as an organisation with its own legal and contractual status, having litigation on its behalf (Babiker 2011).

In May 1970, a fundamental change took place in the banking system in Sudan. The government decided to nationalise the entire commercial banking sector and severely

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restricted three areas, the direct influence for foreign capital over Sudan's banking, the insurance sectors and the export-import business. Moreover, the government tried to develop and improve the banking facilities available to various sectors, especially the traditional sector in the rural areas which desperately needed banking facilities, and by mid-seventies, private foreign banks were allowed to operate in Sudan again, side by side with the nationalised banks. However, these banks were prohibited from dealing with Sudanese citizens, but were allowed to open accounts for import-export and for Sudanese working abroad. During that time, the idea of 'Islamisation' of the modern banking system emerged in Egypt (Abdel Mohsin, 2005).

Emergence of Islamic Banking in Sudan

The introduction of Islamic banking system in Sudan came as an idea in 1966 when the Islamic University of Omdurman, Department of Economics, called for the establishment of Islamic banking in Sudan. However, this idea faced several obstacles and political changed which delayed it until 1977 with the establishment of Faisal Islamic Bank with eighty-six founders from Sudan, Saudi, and from some other Muslim countries who agreed to give six million Sudanese pounds as the required capital for establishing this bank. The success of Faisal Islamic Bank in 1977 in this short period encouraged the government to open five new Islamic banks, which succeeded in attracting more depositors, and hence more branches were opened all over the states in Sudan. (Abdel Mohsin, 2005).

With the introduction of the elements of Islamic banking since 1970s and their adoption by the country's entire financial system in 1991, Sudan become one of very few countries in the world with its financial system built completely on Islamic principles (IMF, 2001). However, after the peace agreement in 2005 which stipulated the division of wealth and authority between the north and the south of Sudan, banks in the south of Sudan officially separated from the authority of the central bank in the north and continued it's operating as conventional banks (Babiker 2011).

Current Financial System in Sudan

Sudan's financial system consists of six types on institutions; the Central bank of Sudan, commercial and investment Islamic banks (private, pubic and joint), *Takaful* and *Retakaful* companies and Khartoum Stock Exchange.
Since early 90's, various reforms have been done within the financial sector by the Sudanese government with the assistance of the international organizations. These reforms include the following (IMF, 2001).

- Banking supervision and prudential regulations for more financial stability.
- Liberalization of the financial sector for more flexibility in sectoral and regional credit allocations.
- Monetary policy instrument that fulfils classical objectives of inflation and exchange rate stability by affecting Islamic finance instruments rates (*Murabahah* and *Musharakah*) used by banks, beside introducing new instruments for indirect monetary management.
- Financial deepening through enhancing interbank credit and offering different financial instruments for investment (government *Sukuk*).
- Institutional reforms.

According to the IMF, the reforms have had a widely positive impact on the Sudanese financial system. The main monetary aggregates and the deposits stared rising in real terms, and real rates of return became positive which stimulated growth in private deposits with commercial banks. Nevertheless, regardless of the progress achieved, the overall level of financial intermediation remains low, and the banking system is still weak and largely undercapitalized (IMF, 2001). This is consistent with recent indicators where Sudan got the 11th place in the Islamic Financial Development Indicator (IFDI)[67], despite the relatively long experience of Sudan in Islamic banking and finance. The Table below shows the main regulatory authorities in the financial sector in Sudan and the IFIs and sectors they cover, while the next Table (Financial inclusion indicators) exhibits the position of Sudan in the IFDI comparing to other countries.

Table 36: Main Authorities of Financial Sector in Sudan

	Central Bank of Sudan	Khartoum Financial Market	Insurance Supervisory Authority	National Agency for exports credit
Legal framework	The Act of 2002 and its latest amendment in 2012	Act of organizing Capital markets of 2016 Act of Khartoum Financial Market of 2016	Act of supervision on Insurance companies of 2001	Act of the National Agency for export credit of 2004
Main roles	Regulatory and supervisory	Regulatory and supervisory	Regulatory and supervisory and developing the insurance sector in line with Shariah	Developing exports sector through Islamic financial and insurance instruments
Institutions and companies under coverage	Commercial, specialized and investment banks - SME's financing institutions - Electronic services company - Forex exchange companies - Sudan financial services company - Banks deposits guarantee funds - Liquidity management fund	Financial brokers and intermediaries	Takaful and retakaful companies	Sudanese exporters

Source: Official Sudanese websites

Despite the relatively long history of banking system Islamization, the above table shows that Sudan is still behind many Arab and Muslim countries in terms of the development and the

[67] The ICD Thomson Reuters Islamic Finance Development Indicator (IFDI) represents the overall health and development of the Islamic finance industry worldwide, using one composite and weighted numerical measure. For 2016, IFDI tracks the performance of 124 nations assessed against 5 indicators: Quantitative Development (QD), Knowledge, Governance, Corporate Social Responsibility (CSR) and Awareness. These indicators are broken down into a total of 15 sub-indicators, which take into account 55 different metrics-related and 3 rationalizing coefficients (total banking assets, GDP and population) that adjust indicator values to each country's size. Hence, more than 6,300 country-level metrics and data are entered to calculate IFDI average global indicator values. The methodology chapter of this report explains the IFDI methodology in full.

efficiency of its sectors and even in the number of Islamic financial institutions. The same applies on *Takaful* sector where *Takaful* and *Retakaful* assets are significantly lower than many other smaller jurisdictions. The following Table shows some key financial inclusion indicators in Sudan for the year 2012.

Table 37: Basic Financial Inclusion Indicators in Sudan (2012)

	Low income countries	Sub-Saharan	Sudan
Loan from a financial institution	11%	5%	2%
Loan from a family or friends	30%	40%	47%
Credit cards	2%	3%	1%
Saved at financial institution	11%	14%	9%
Saved using a saving club	8%	19%	7%
Account at formal financial institution (Male)	20%	24%	4%
Female	24%	21%	3%

Source: World Bank Findex database. The indicators represent percentage of population above 15

From above table, it is realized that the Sudanese depends more on other modes of finance such as family, friends and clubs comparing to other Sub Saharan and low income countries. Moreover, their savings at banks are less than others. This could be due to the significantly lower percentage of bank accounts per person which is only 4% for male and 3% for female. Hence, the weak financial inclusion in Sudan emphasise the importance of a comprehensive financial development that include banking and non-banking institutions.

3.4.3 ISLAMIC BANKING IN SUDAN

Banking system in Sudan works under the supervision and regulations of Central Bank of Sudan within the banking business organization act for the year 2004 which clearly states that "banking business operating in Sudan should not contradicts with Islamic Shariah, and defines finance as "investing funds according to Islamic contracts".

The banking sector forms the backbone of Sudan's financial system and is the primary source of financing for the domestic economy. Sudan and Iran continue as the two jurisdictions that operate fully *Shariah*-compliant banking systems; hence, a 100% Islamic banking market share for each (IFSB, 2017). According to the Islamic finance development indicator for 2016: "Sudan came at the 11th place out of 124, although it has followed a "fully" Islamic financial system for quite a long time. This indicates many challenges that face the financial sector in Sudan, and large area for improving it".

Overview of the Sudanese Banking System:

As shown in the following Table, the number of Islamic banks increased form five Islamic banks in 1980s to reach 37 Islamic banks in 2015. All these banks are operating according to *Shariah* principles and under the supervision of Central Bank of Sudan. These Islamic banks vary in their activities and the type of entities that established them.

Table 38. Structure of Sudanese Banking System (2015)

(a) Specialized banks		**6**
	Joint	3
	Governmetal	3
(b) Commercial banks		**31**
	Joint	22
	Governmental	1
	Foreign	8
Total (a) + (b)		**37**

Source: Central Bank of Sudan – Banks Affairs Department

Moreover, it is also realized that the majority of the Islamic banks in Sudan are joint ventures between the private and the governmental entities, while the foreign banks come at the second place with 8 Islamic banks and only one Islamic bank that is fully government known as Al-Nilein Bank. From another perspective, 31 of the Islamic banks in Sudan are commercial, 6 are specialized Islamic banks that have social and economic goals besides, providing finance to agriculture and to industrial projects and family savings.

All banks in Sudan are under the supervision and monitoring of a higher *Shariah* commission. According to chapter [3] of the Banking Business Act for the year 2003: *There shall be established an independent part time commission, to be known as the, "Higher Sharia Commission of Control on Banks and Financial Institutions", and to be appointed by the President of the Republic, in consultation with the Minister. The objectives of the Higher Shariah Commission are to: to pass the sharia edicts, recommendations and consultancy, for a unifying Shariah bases and ordinances, upon which the banking and financial activity is based; to follow-up the policies and performance of the banks activities and the financial institutions, for the purpose of exposing the same to the regulations and the values of the Islamic Sharia; to purify the laws and the regulations and to provide guidelines for the banks and financial institutions, usury transactions, to strive to lay down for execution, to provide Islamic forms of transactions and devise such forms, as may be appropriate to all the needs and instruments of financing, and to promote the same as may be suitable for the primary and secondary stock exchanges.*

Deposits

Official data shows that banking deposits in Sudan exceeded 8.3 billion USD in 2015, 51% of them are saving and investment deposits and the remaining are demand deposits. Analysing this 51% of saving and investments deposits, it is found that 94% of these deposits come from private sector which consists of individuals and private businesses, and this shows the confidence on the Sudanese banking system as saving and investing channel. The Table (Total Deposits) below presents the structure of deposits according to the type of depositors and deposits.

Table 39. Total Deposits in Local Currency 2015 (in million USD)

Depositors	Demand deposits	Savings and investments deposits
Federal and state gov.	158.7	108.1
Public enterprises	149.1	142.3
Private sector	3728.8	4014.1
Total	4110.6	4264.5
Grand Total	8375	
Deposit/GDP	9%	

Source: Central Bank of Sudan

Finances

In Sudan finance is provided by Islamic banks according to the economic activity and according to the Islamic mode of financing. The following Table (Stocks of Banking Finance) presents the stock of finance in local and foreign currencies provided to different economic sectors in Sudan. The banking finance includes finance extended by the operating banks to the private sector, public enterprises and to the state and local governments.

Table 40. Stock of Banking Finance by Economic Activities in Local and Foreign Currency 2015

Sector	Stock of finance (in millions USD)	%
Agriculture	1428.8	16.0
Manufacturing	1276.2	14.3
Exports	230.5	2.6
Transportation and storage	669.2	7.5
Local trade	988.3	11.1
Imports	240.4	2.7
Construction	1610.1	18.1
Mining	51.9	0.6
Services	2414.2	27.1
Total (stock)	8909.33	100

Source: Central Bank of Sudan.

In 2015 the stock exceeded 8.9 billion USD where services sectors (telecommunication, medical services etc.) received 27.1% of the total finance in local currency. This is followed by the construction sector 18.1% and the agriculture sector (16 %). Regarding the mode of finance, the Table below shows the Flow of Islamic banking finance during 2015.

The flow exceeded 9 billion USD. As realized it is dominated by Murabahah mode as the case in all jurisdictions that practice Islamic finance (almost 50% compared to 30% in Malaysia), however, according to Central Bank of Sudan, it's decreasing through years because of the Bank's policy in encouraging banks using other modes.

Muqawalah mode (contracting for construction)[68], which works mainly in construction projects, is not found in other jurisdictions and it consists significant portion of finance provided by Sudanese banks. Partnership modes (*Musharakah* and *Mudarabah*) consist about 14% of finance (compared to 0.8% only in Malaysia).

Table 41. Flow of Banking Finance by Mode of Islamic Finance in Local Currency

Mode	Finance	%
Murabahah	4497.8	49.8
Musharakah	637.1	7.0
Mudarabah	597.0	6.6
Salam	270.4	3.0
***Muqawalah* (Constructing)**	1400.4	15.5
Ijarah	33.3	0.4
Istisna	7.9	0.1
Qard Hasan	20.0	0.2
Others	1571.05	17
Total (flow)	9035.0	100

Source: Central Bank of Sudan

Salam mode, which is basically used for agricultural finance, is not as effective as it supposed to be in a country like Sudan where almost 30% of GDP come from agriculture activities. Salam finance works well for the agriculture sector and will give the delivery of goods which will happen in the future following the harvest season while cash is paid in advance (CIBAFI & IRTI, 2016).

"*Tackling the agriculture sector is a key priority as its growth is directly linked to improving Sudan's infrastructure environment. Today, agricultural lands are not well utilized in Sudan mainly due to inadequate roads, insufficient water supply, and a lack of electric power in these isolated areas. The agriculture sector employs 80% of the country's workforce and accounts for nearly one-third of GDP. In general, the agriculture sector represents a business line that banks should focus on especially with regard to financing trade, working capital, and capital expenditures. Nowadays, Sudan is looking to the agriculture sector as an important source of growth and diversification for the economy*" (CIBAFI & IRTI, 2016). Therefore, finance modes like *Salam* should be more encouraged and practiced next to the other tools for agricultural financing like *Muzaraa'a*[69], *Musaqah*[70] and *Mugharasah*[71] which was not mentioned in this table.

[68] *Muqawalah* is a contract of hire of labour, where Islamic bank provide materials and hire clients to process them. In other words, it's a contract where one party undertakes performing certain job or manufacturing certain good for a certain consideration from the second party, and both of the work and materials should be provided by the first party. *Muqawalah* contract is very close to *Istisna* contract especially in construction sector. However, in Sudan there is a separation between the two contracts.

[69] Muzaraa'a, (crop-sharing) is a partnership agricultural contract close to *Musharakah* where the Islamic bank provides the land and machinery to the farmer who cultivates the land, and they share the output in pre-agreed proportions.

[70] *Musaqah*: (irrigation purpose) is a partnership agricultural contract close to *Musharakah* which potentially can be used to finance irrigated multiyear crops, dates, oranges etc.

[71] *Mugharasah* (orchid financing) is a partnership agricultural contract close to *Musharakah* where the Islamic bank provides land for growing new fruitful trees by the farmer, it is used for planting trees and undertaking the work and expenses required by such plantation and then sharing profits.

To examine the extent to which Islamic banks are committed to *Shariah* compliance, it is important to identify the nature of the financial transactions in Islamic banks (Babiker 2011). According to El-Hawary et al. (2004) the financial products in Islamic banks are guided by four concepts:

- Risk-sharing which should be applied between all parties of a financial transaction.
- Materiality which should exist to link transaction to the real economy.
- No exploitation should be practiced by any of the transaction's parties.
- No finance to be given to any unlawful activities or any prohibited products.

It is clear that Murabahah is the main financing mode in Sudan although it's practised to a less extent than other countries. According to (Babiker 2011), he argues that Islamic banks have to be restructured in a "bank-based" architecture to implement the classical *Murabahah* (similar to that of Germany and Japan) in the spirit of the *Shariah*. Here, the Islamic bank would own either voting shares (*Musharakah*) or non-voting shares (*Mudharabah*) of a merchant/trader. It's worthy to mention here that due to the intensive use of this mode, the Central Bank of Sudan issued a decree in 2000 ordering all banks to decrease their dealings based on *Murabahah* to 30% and to increase their transactions based on other modes (decree no. 29 A, 2000, 4) (Abdel Mohsin, 2005). However, what's seen from table (Flow of Banking Finance) is that still, *Murabahah* was intensively used (almost 50%) in the year 2015.

According to Ibrahim, 2001 as cited in Abdel Mohsin (2005), the mechanism used to decease the use of Murabahah mode by all Islamic banks in Sudan are quoted below as provided by Central Bank of Sudan: "*Decreasing the share of Murabahah in Sudan is carried out in various mechanisms: first by decreasing the Murabahah margin in the annual financing policy of the central bank, second by imposing certain procedure conditions on the Murabahah application so as it make it difficult for the bank and unappealing to the client, and third by the periodical review of the local bank's statistical reports and the share or the Murabahah and thus imposing sanctions on the bank*".

It is believed that some of the reasons of preference and tendency of using *Murabahah*[72] in Sudan can be related to lower associated risks, easy to apply with clear modus operandi, and easy to explain to clients, pre-known profits comparing to *Mudarabah* and *Musharakah*. Hence, this helps the bank to plan its cash flows, short-term financing compared to other modes, fast rate of working capital turnover and high demand by customers. On the other hand, it's notable that the usage of *Muqawalah*, which is very close to *Istisna* and has important role in developing real estate sector, is widely practiced in Sudan and which is a distinguish feature in the Sudanese banking system that should not be underestimated.

[72] Note that in Sudan *Murabahah* is used only for short-term financing (mainly for consumer durable goods and vehicles)

3.4.4 ISLAMIC CAPITAL MARKETS IN SUDAN

Islamic capital markets include Sukuk and Shariah-compliant equities markets where both government and corporates seek capital to finance their activities. This section will present the Islamic capital markets in Sudan with main focus on the government Sukuk sector which, from our point of view, has good experience to learn from.

"Africa has been a regular player in the *Sukuk* market since Sudan and Gambia start meeting their domestic financing needs through *Sukuk* financing. Even though Sudan is the pioneer in this regard accounting for almost 95% of the dollar value of *Sukuk* issuance so far yet, Gambia has been a regular issuer of *Sukuk"* (IIFM, 2016).

"After the implementation of Islamic banking system in Sudan in 1983 the monetary authorities found themselves restricted only to the direct tools for liquidity management. This encouraged them to search for more Islamic financial tools instead of the traditional ones. Hence, with the great effort of the Higher Shariah Supervisory Board and the expert from the IMF they managed to find the first generation of Sukuk, such as Central Bank Musharakah Certificates (CMCs) and Government Musharakah Certificates (GMCs)" (IIFM, 2016).

To manage the issuance of these Sukuk the Central Bank of Sudan established Sudan Financial Services Company in 1998.

Sudan Financial Services Company (SFSC)

SFSC was established in 1998 by the Central Bank of Sudan (CBS) with a percentage ownership of (99%) and the Ministry of Finance and National Economy (MFNE) with (1%). This service company was then registered at the registrar of company's chamber in accordance with the Companies Act 1925 on 16 May 1998. The company's vision is to work towards achieving sustainable economic and social development. Moreover, through establishing this services company, Islamic financial services will be provided to finance projects that can help create a stable and prosperous economy that fulfills the needs of the society. Since then, the company exercises all it business transactions in accordance with *Shariah* rules and all its financial products are subject to supervision by the *Shariah* Supervisory Board. According to the company's official website, the main functions of the company are:

- Provision of financial services related to management; dealing in the shares and the allocation owned by government, corporations and institutions; issuing *Sukuk* in accordance with *Shariah* rules.
- The company may provide financial services which is related to the management and the dealings in issuing of any *Sukuk*; representing financial assets owned by any other holders as requested by them.
- Coordination with specialized departments in the MFNE, CBS, Khartoum Stock Exchange (KSE) and any other regional and international markets in order to promote Islamic financial instruments and their issue.

Sudanese Sukuk Market

- **Sudan Governmental Certificates (Sukuk)**

Sudan's fixed income security market is based on Islamic Shariah Principles. The Government Musharakah Certificates and the Government Investment Certificates (which are similar to the conventional treasury bills and the government bonds), as well as the Central Bank Ijarah Certificates are regularly issued by the Ministry of Finance and the National Economy. Both the Central Bank of Sudan and the Government of Sudan have raised funds through the domestic issuance of *Shariah*-compliant securities via the Sudan Financial Services Company which was created in 1998. Since the first issuance in 1999, the Government Musharakah Certificates has been growing rapidly depending on the high profitability, free risk, and the short- term maturity (one year) and too high liquidity, which is match with the objectives of the investors. On the other hand, the growth of Government Investment Certificates is not as favourable as Government Musharakah Certificates as it showed sluggish development due to long-term duration (2-6 years) and stability of profit. In 2013, the Government Musharakah Certificates outstanding increased by 8.5 % from previous year, reaching SDG 14,131 million, while the Government Investment Certificates outstanding decreased due to zero issuance while some of the Sukuk has reached its maturity (CIBAFI & IRTI, 2016).

The government investment certificates (GIC) are medium-term financial instruments to attract financial resources from investors based on **Mudarabah** or **Ijarah_**for financing projects allocated by ministry of finance and national economy. The maturity date for such certificate varies from 2 to 5 years. Beside their roles in providing funds, these certificates aim to achieve liquidity management on the macro level, develop domestic capital markets and reduce the inflationary impact of conventional debt by providing stable funding to the government in the form of goods and services. The Sudanese government only issues Shariah-contract Sukuk, and there is no existence for conventional bonds.

- **Central Bank Musharakah Certificates (CMCs)**

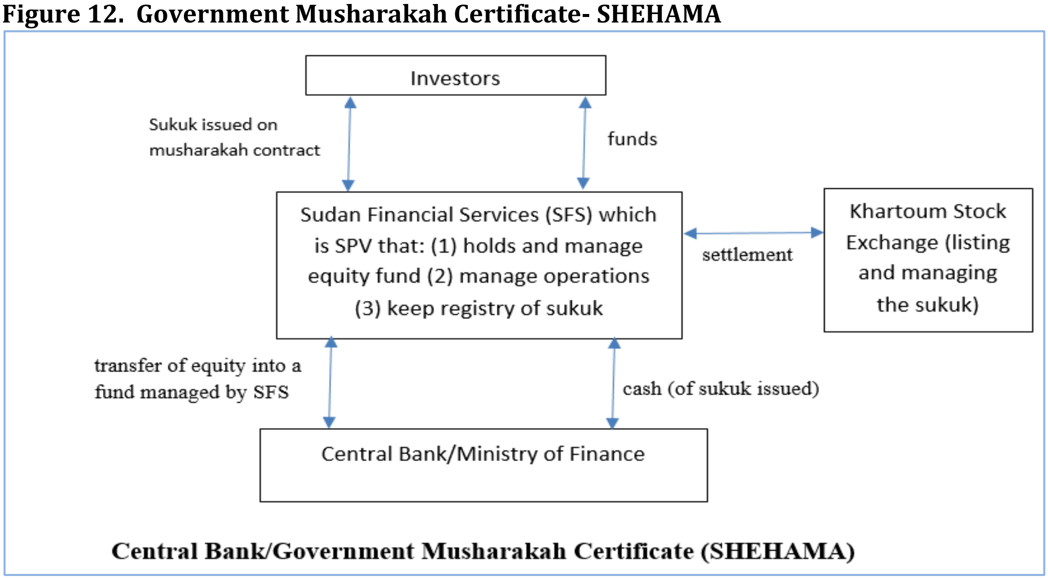
Sarker (2015) argues that "even though the CMCs were issued for the implementation of monetary policy yet, it has been proven to be too costly. The CMCs were similar to trust certificates in a closed-end fund managed by the SFSC, which assigned investors as stake in commercial banks in which the central bank was a shareholder. Despite the strong investor demand, the security design of CMCs was severely flawed and the issuance of CMCs was soon discontinued because of its high cost, limited volume, and lack of its tradability".

According to Sarker (2015), "CMC is designed as an instrument based on a profit- and loss-sharing contract. It is an asset based security issued against central bank and Ministry of Finance equity participation in a commercial bank's assets. The CMC is sold through auction and the return on investment is determined by the expected return on the underlying asset where a pro-rata share of the income stream is distributed between the partners. Among its features, CMC can be used by a central bank to conduct monetary operations, or offers bank an investment opportunity for their excess reserves, besides, it has medium-term maturity, is transferable and is tradable in the stock exchange. However, access to CMCs is limited only to commercial banks, Government-owned companies' funds and insurance companies".

- **Government Musharakah Certificate (GMCs) – SHEHAMA**

"From 2001 to early 2007 the government used short-term GMCs (SHEHAMA) to finance the government budget deficit. Investment in GMCs was restricted to Sudanese only. Investors received ownership interest in a portfolio of specific state-owned enterprises, whose profits were distributed as pro-rated bullet payments at maturity. GMCs were tradable in the secondary market immediately after issuance. In early 2007 the government discontinued GMCs following reduced short-term financing needs. GMC is designed as an instrument based on a profit- and loss-sharing contract. It is an asset based security issued against a certain percentage of Government ownership in more profitable and joint venture enterprises. The returns form GMC are determined by the expected return on the underlying asset where a pro-rata share of the income stream is distributed between the partners. Among its features GMC is fixed short-term maturity (one year), listed on and traded in the stock exchange (transferable and fully negotiable), accessible to all, provides financing for Government's budget deficit through a non-inflationary instrument and can be used as a tool for open market operations" (Sarker 2015).

Figure 12. Government Musharakah Certificate- SHEHAMA

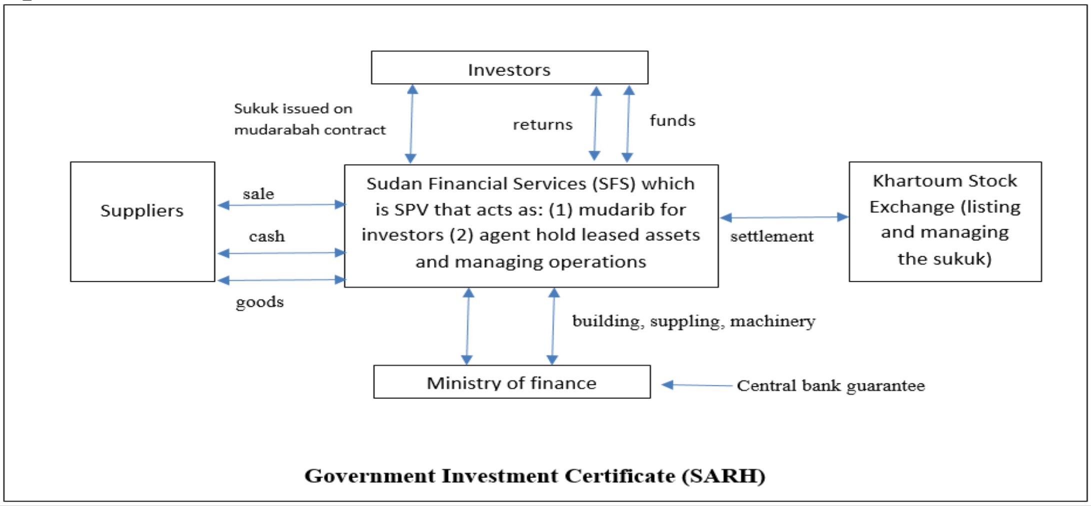


Source: IIFM (2016)

- **Government Investment Certificate (GICs) – SARH**

"In 2003, the government also introduced GICs to fund its trade, procurement, and development projects. Unlike GMCs, investors are shareholders of an investment company managed by SFSC and do not hold a title to government assets. GICs can also be traded in the secondary market. GIC is designed as an asset-based security issued against a number of contracts, including *Ijarah*, *Salam*, *and Mudarabah*. The relationship between the holder of a GIC and the issuer is based on a restricted Mudarabah contract. The instrument's maturity profile ranges from two to six years. The expected return is determined by the fixed rental income on *Ijarah* plus the income from the sale of *Murabahah*, *Salam* and *Istisn*a contracts. Profit is distributed every three or six months. Sales of primary issues are made through an auction system. The GIC is listed on the stock exchange. Among its features GIC appears promising in terms of market acceptance, cost to the Government, and prospects for secondary markets. Besides, it is an instrument that can be readily tradable so long as the proportion of the underlying *Ijarah* assets exceeds the percentage specified by the relevant Shariah Board. It also requires close coordination between the Government's expenditure execution and debt issuance programs" (Sarker 2015).

Figure 13. Government Investment Certificate - SARH



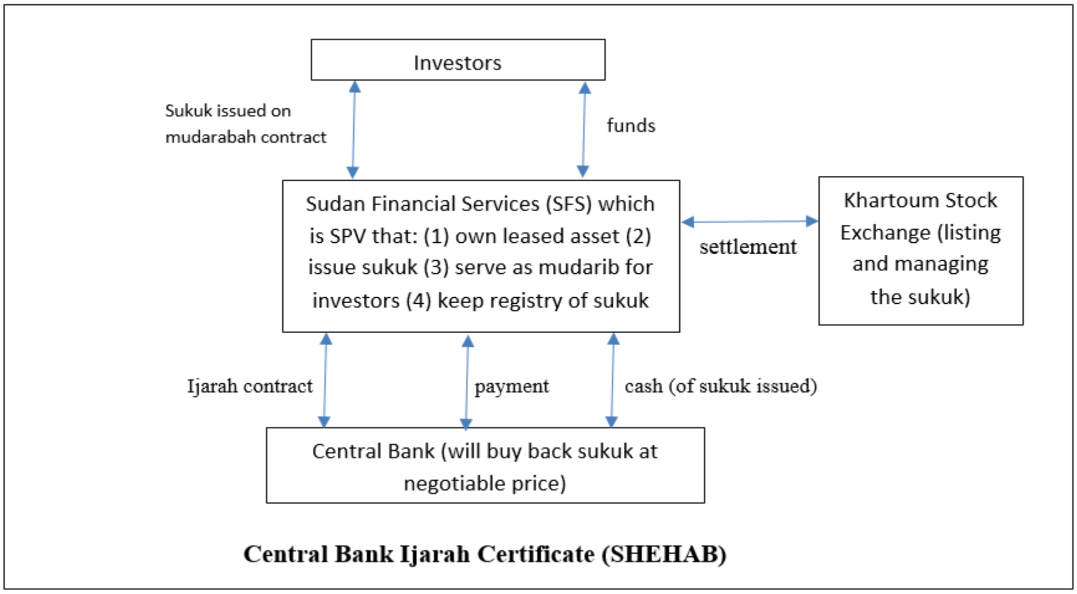
Source: IIFM (2016)

The GICs have contributed to financing development projects in the Sudan by more than one billion Sudanese pounds in the following sectors (SFS 2017). For example, financing the domestic medical care projects through imports of advanced medical equipment for heart surgery, Magnetic Resonance Imaging (MRI), kidney transplant and Computerized Axial Tomography (CT). Finance the import of these equipment had contributed in reducing the cost of treatment inside the country as an alternative to high cost medical treatment outside the country. Moreover, financing the construction of hostels in all States of Sudan, project for the rehabilitation of projects and promote the infrastructures and development of the country. In addition, financing the import of laboratories, chemicals and lab- bottles for all Sudanese Universities besides, besides, computers and accessories which were distributed to all the schools of Sudan.

- **Central Bank Ijarah Certificate (SHEHAB)**

"The certificate represents part of the ownership of the assets that have been leased to the central bank or to the government buildings or other assets that might acquire and sell to a special purpose vehicle (SPV) that issues the securities. The contract between the SPV and the investor is based on restricted *Mudarabah* in Sudan. In the case of Bahrain, the Central Bank arranges the issuance of *Sukuk* (without an SPV) on behalf of the government, which guarantees the rental payment to Sukuk holders and the repurchase of assets at maturity.

Figure 14. Central Bank Ijarah Certificate - SHEHAB



Source: IIFM (2016)

The expected return is then determined by the fixed rental income from the *Ijarah*. In the case of Sudan, the sale of primary issue is made through auction, and the maturity of the CIC may vary from three to ten years. Short term Sukuk *al-Ijarah* is also issued by Brunei and Bahrain (Sarker 2015). SHEHAB is used by the central banks; for open market operations; to list on the exchange. Its supply is limited to the availability of assets for sales and lease-back.

Table (Positions of Sudanese Government Sukuk) presents the key numbers of government *Sukuk*/certificate in Sudan at the end of 2015 including those related to Khartoum Refinery Ijarah Certificates (SHAMA), and Sudan's Company for Electricity Transmission Ijara Certificates (Noor).

Table 42. Positions of Sudanese Government Sukuk 2015

Type of Sukuk/Certificate	Value of certificates at the end of 2015 (million USD)	Reasons for the usage of these instruments
Government Partnership Certificates (SHEHAMA)	3074	To finance the government deficit as a non-inflationary instrument (fiscal tool)
Government Investment certificates (SARH)	150.7	To fund the government's trade, procurement, and development projects
Khartoum Refinery Ijarah Certificates (SHAMA)	315.3	Providing investment tools that offer profits for investors
Central Bank of Sudan Ijarah Certificates (SHEHAB)	0	Used by central bank for open market operations to manage liquidity (monetary tool)
Sudan's Company for Electricity Transmission Ijara Certificates (NOOR)	0.758	Providing investment tools that offer profits for investors

Source: Sudan Financial Services Company

The above table illustrates a comparison between the issuance of Government Musharakah Certificate (SHEHAMA) and Government Investment Certificate (SARH) which shows the dominance of SHEHAMA significantly.

3.4.4.3 Incentives of Sudanese Governmental Sukuk: (SFS 2017)

- The higher Shariah Supervisory Board for the banking system and financial institutions in Sudan gave a fatwa underlining the legality of these certificates.
- Low investment risks.
- Higher profitability compared with other investment opportunities.
- Can be presented as first class collateral for banking finance.
- Can be feasibly liquidated and traded at any time easily in Khartoum Stock Exchange.

According to Sudan Islamic Finance Report 2016 (IRTI & CIBAFI), the Sudanese government, through the Khartoum Stock Exchange (KSE) and CBoS, is quite active in the capital markets with yearly Sukuk issuance since 1998. The majority of investors are local, however, and there is a clear lack of a foreign investor base.

There are three types of certificates that are regularly being issued by the government to inject liquidity into the market. The most active type is the government Musharakah certificates (GMCs), also known as Shahama, which is issued every three months and structured as Musharakah. The GMCs are issued for the purpose of government lending to cover the budget deficit as well as for liquidity management. The two other types of certificates are Government Investment Certificates (GICs) which base on Mudarabah and Ijrarah, and Central Bank Ijarah Certificates (CICs).

In 2014, 29% of the country's budget deficit was financed through GMC and GIC issuances, and another 4% was financed by CIC issuances. There is a significant concentration of banks investing in the sukuk issued by the government. By 2014 also, almost half of the investors in GIC were commercial banks, with the Central Bank making up 22.3% of the investor base. Although both GMC and GIC are issued every three months, there is a clear lack of retail activity in the GIC market, as opposed to the GMC market where retail engagement stood at 13.3% in 2014. Retail Sukuk investors have a few key merits, mainly 1) tapping into a new investor base which is usually overlooked, 2) creating a new investment opportunity for the people, and 3) utilizing people's money to more effectively develop the country instead of placing their funds in fixed deposit accounts.

The Sudanese Sukuk market remains significantly untapped on the corporate side. As of the end of 2015, there has only been one corporate Sukuk issuance in Sudan despite regular issuances by the government. The assortment of Sukuk structures can play a key role in developing the Sukuk corporate market. As per available data in Zawya, the only corporate Sukuk issuer was Berber Cement Co. who made an issuance in 2007 before the separation from South Sudan. The company raised US$ 130 million using a Musharakah structure with a tenor of seven years. The Sukuk was fully subscribed by regional banks mainly from the GCC indicating strong investor appetite to invest in Sudan corporate issuances.

3.4.4.4 Objectives of Government Sukuk in Sudan (SFS 2017)

- Allocate real savings for government financing to meet spending on development and infrastructural projects.
- Contributing in filling part of fiscal deficit in the public budget which was usually financed by borrowing from the Central bank.
- Managing liquidity at the macroeconomic level by using contractionary or expansionary open market operations to control liquidity within the ambit of *Shariah*.
- Mitigating inflationary effects by providing stable and real financing for the government in the form of commodities and services.

3.4.4.5 Corporate Sukuk in Sudan

A corporate *Sukuk* market is also present in Sudan. The primary market, largely composed of the Sudan Financial Services Company (Ltd) (which markets and trades all government securities). Security instruments are also traded on the Khartoum Stock Exchange, and around 40 brokerage firms operate on the market. Secondary market activity is limited to over-the-counter trades, and is largely dominated by government securities. Access to securities markets in open to local and foreign investors, including banks, corporate entities, financial institutions, and individuals, with the exception of Ijarah Certificates which are restricted to bank.

A special joint report between (CIBAFI and IRTI 2015) states that "*The Sudanese Sukuk market remains significantly untapped on the corporate side. As of today, there has only been one corporate Sukuk issuance in Sudan despite regular issuances by the government. The assortment of Sukuk structures can play a key role in developing the Sukuk corporate market...*" (CIBAFI and IRTI 2015). Therefore, although Sudan has developed a government *Sukuk* market, the corporate *Sukuk* market is still very limited and that explains why Sudan's issuance of *Sukuk* is only 2.12% (December 2015) from the global *Sukuk* issuance in spite of its 100% Islamic financial system.

To conclude, Sudan used Islamic bonds since 1998 as one of the monetary policy's mechanisms in the context of Open Market Operations (OMO). Therefore, investment certificates have been used for liquidity management purposes in the economy, where such certificates are bought when there is liquidity deficit in the economy and they are sold in the case of liquidity surplus. Moreover, these investment certificates assist in spreading savings awareness, they contribute in financing the budget deficit rather than borrowing from Banking sector (inflationary finance), as well as they encourage the development of the regional capital market. Furthermore, investment certificates are listed in the capital market (KSE); hence they could be traded in the secondary market and that deepen the financial market in general by offering different financial instruments for investors. With that it is believed that Sudanese experience in issuing sovereign *Sukuk* is pioneer and could be applied in other OIC member countries besides developing it in Sudan.

3.4.5 TAKAFUL (ISLAMIC INSURANCE) IN SUDAN

Overview of Takaful sector in Sudan

With reference to Takaful sector Sudan is the pioneer of both Takaful regulations and developments since 1979. Sudan started Islamic Insurance in 1979 when Faisal Islamic bank established the first Islamic Insurance Company in the world (Mohamed Abass 2012). In 1992 a new supervision law was introduced under which all companies were required to operate according to *Shariah* principles (Abu Elbasher, n.d). Since Then Takaful spread to Malaysia in 1984 which has been also a pioneer in the developments of Takaful by the enactment of the Takaful act of 1985- the first such regulatory act. The present insurance law in Sudan was introduced in 2001 and is probably the only law which stresses on the authenticity of the *Takaful* principles. In addition, the law has placed strict measures on the investment returns, surplus distribution and commission paid for the operator.

Table 43. Key Statistics of Takaful Sector in Sudan (2013)

	No. of companies	Premiums* %	Investments** %
General & Life Takaful	4	62	68
Non-life Takaful	9	29	28
Retakaful	2	9	4
Total	15	100	100

*Premiums are the instalments (contributions) paid by clients of Takaful companies for getting Takaful coverage.
**Investments are Takaful company's investment portfolios in different sectors (real estate- bank deposits- shares – sukuk) for a return.

Source: Bank of Khartoum

Takaful is consolidating its foundations in Sudan and has accomplished much over the past few years, especially in the size of contributions. (Noor, 2015). As seen in the above table, there are 15 *Takaful* and Retakaful companies in Sudan: 9 Non-life T*akaful*, 4 general and life *Takaful* and only 2 *Retakfaul* companies as of 2013.[73]

Main Takaful Products in Sudan

According to (Abu Elbasher, n.d), takaful companies in Sudan operate under mixed modes namely: *Wakalah* and *Mudarabah*. The *Wakalah* model is used for insurance operations where the company looks after the technical and administrative activities of technical and administrative activities of the policy holders fund for a fee which is portion of the contributions (actual management expenses). On the other hand, the *Mudarabah* mode is used to invest the *Takaful* funds where the company invests the shareholders. The company invests the shareholders fund according to *Mudarabah* agreement in which the company becomes the *Mudarib* and the shareholders are the owners of money (*rab-almal*). Profits are distributed between shareholders and policyholders according to a certain policyholder's agreement.

[73] Note that in Sudan the whole insurance sector is based on Shariah-compliant principles, however, the terms "insurance" and "Takaful" are used interchangeably and each insurance/Takaful company should have a Shariah committee. http://elibrary.mediu.edu.my/books/RPS0008.pdf

Personal and Family Takaful Products

Personal Takaful coverage can be acquired for death, injury, permanent and temporary disability, and dread diseases, such as cancer, kidney failure, stroke, and coronary thrombosis. Benefits paid in event of death are subject to the distribution in accordance with Shariah inheritance law. However, personal insurance is sold only on a group basis, with the members of the cooperative sharing in the disbursed portion of the annual surplus. A group may be constituted from duly organized individuals in a neighbourhood, but usually professional associations and employees constitute cooperative insurance purchasing groups. Family insurance is offered for travel, accidents and medical risks coverage. The insurance law also provides for business interruption insurance and public liability insurance, the latter useful to contractors and others involved in operations posing coincidental risks to the public at large (Glomedia web). Although only four operators provide family *Takaful*, which accounts for just around 4% of the market volume, are noteworthy initiatives to take this line to the next level. For example, Ta'awuniya Insurance tied up with universities to provide their professors with pensions covering against 25 risks, including death, personal accident and disability. Interestingly, it also provides a "widowhood income benefit" tailored to working ladies. This is the first such policy in the Muslim world and it has been highly commended by the Sudanese community (Mena Insurance Club web).

Agriculture Takaful

Abu Elbasher, (n.d) argues that Insurance is of crucial importance to all people, most of all for agricultural insurance activities, for the following reasons:

- Offer security to farmers by indemnifying losses resulting from insured perils over which they have no control, such as floods, shortage, shortage of rain, fires, pests and diseases, etc.
- Constitutes an acceptable guarantee to the banks to offer all required financing and facilities.
- Encourage the farmer to increase his investments and acquire new technology.
- Creates good conditions for settlement in the Country -side, thereby reducing emigration to urban centers.
- Enhances national savings and encourages mutual cooperation.
- Mitigates the burden on the national budget with respect to natural hazards.

Shiekan was the first operator to launch agricultural insurance in Sudan in 2002 by covering the country's largest irrigated agricultural scheme spreading over 2.2 million feddans*. The first phase insured a cotton crop in an area of 22,000 feddans for 6,300 farmers. By 2011, the total insured area reached around 2.4 million feddans for irrigated and rain-fed areas for a total of 800,402 farmers of various crops (Mena Insurance Club web).

Microtakaful

A Microtakaful product is a Takaful product that is designed to respond to the financial protection needs of low-income households. In this respect: (a) "financial protection" means being able to access timely and adequate financial resources to: (i) cope with major expenses; or (ii) provide temporary or partial relief from financial difficulties arising from unexpected adverse events; and (b) "low-income households" refers to poor, vulnerable or lower middle-income households, particularly groups that have been previously excluded from access to takaful. (Bank Negara Malaysia, 2016).

Table 44: Differences Between Takaful and Microtakaful in Sudan

	Takaful	Microtakaful
Market	Policyholders are from middle and high-income households	Policyholders are the poor and low-income households, often working in the informal economy and outside of the social insurance coverage with irregular income streams.
Market awareness	Market is largely familiar with insurance	Market is largely unfamiliar with insurance
Contributions (premiums)	Based on age or other specific risk characteristics.	Low contributions and affordable
Affordability considerations	Contributions are paid by policyholders	Contributions may be paid in full or partly by a subsidy from zakah funds, waqf funds or th government
Sums insured	Large sums insured	Small sums insured
Policy document	Complex policy document with many exclusions	Simple and easy to understand policy document with a few or no exclusions
Claims handling	Claims process for large sums insured may be quite complicated	Simple and fast procedures to small sums, yet still controls fraud

Source: Hasim (2014)

However, in Sudan the Microtakaful models are the same as the Takaful models as seen in table below.

Table 45. Microtakaful Models

Aspects	Wakalah	Mudarabah with surplus sharing	Mudarabah without surplus sharing	Hybrid	Waqf
Takaful operator share in investment profits	Fees as percentage of total investments	Profit share	Profit share	Profit share	fees as percentage of total investments
Takaful operator share in underlying surplus	Not available	Profit share	Not available	Profit share	Not available
Operating expenses	Borne by shareholders which are compensated by upfront charge of wakala fees	Borne by shareholders and no fees	Borne by policyholders and charged at year end	Borne by shareholders which are compensated by upfront charge of Wakala fees	Borne by shareholders which are compensated by upfront charge of Wakala fees

Source: Haydari (2007), Erlbeck et al (2011), Khan (2011), Barawi (2012)[74]

[74] See: http://slideplayer.com/slide/10448792/

According to (Noor, 2015), medical, agriculture and *Microtakaful* are increasingly attracting operators and leading the growth in the market. This is a promising sign because companies are addressing untapped areas and new segments. Besides, by targeting these lines, operators are serving genuine needs which are relevant to people's day-to-day lives and activities. *Microtakaful* is one of fastest-growing lines of business and the government is paying a lot of attention to microfinance and micro insurance through the Central Bank of Sudan. *Microtakaful* is of great importance, with around half of the population living below the poverty line. The Central Bank of Sudan recently increased the maximum amount of finance under microfinance allowed to a single person, from SDG10,000 (1665 USD) to SDG20,000 (3335 USD). Last year, Ta'awuniya launched its Comprehensive Micro Insurance Policy (CMP), which the Central Bank of Sudan (CBS) has endorsed and advised banks to use in their microfinance operations. Besides the standard liability protection of micro insurance policies, CMP provides health, personal accident and pension covers, in a bid to expand the focus beyond property to include individual protection.

3.4.6 POLICY RECOMMENDATIONS

According to (Mohammed, 2012), "the Sudanese Insurance market despite its historical position as a pioneer of Takaful continues to face low penetration ratios and economic challenges. Low income levels of the Sudanese, high inflations, lack of competent underwriting, among others continue to plague the market. Overall, the challenges facing the Sudanese market are similar to those in other Arab and African markets, and it would take some time to be overcome. However, with the local *Takaful* industry experiencing significant growth in recent years, the Sudanese market is poised to participate actively in international *Takaful* development. Not surprisingly, Sudan was the country chosen to base the headquarters of the Federation of Islamic Insurance and Takaful Companies (FIITC). The Vice President and Secretary General are from Sudan and are based in the Sudanese capital".

Hassan (2014) argues that *"Takaful* in the agriculture sector is facing many challenges in Sudan due to; lack of knowledge among the farming community, the high rates of cover due to high risk ranging from 5% to 9%, the high administrative costs because of the small areas covered in comparison with the potential available, the increase in the risk of climatic changes which has resulted in droughts, floods, and the increase in temperatures, the use of uncertified seeds and the negligence in the use of technological packages by farmers. The lack of coordination between financing institution and the management of the agricultural schemes to determine the volume of credit needed. The re-insurance treaties are sometimes a determent to the progress of Islamic insurance experience. This is done through offering of small capacities at very harsh conditions"

For addressing the main obstacles that prevents the diversification of Islamic financial Instruments and presents solution to Sudan:

- Low appetite for risk sharing: this resulted in depending on certain financial instruments like Murabahah and very low dependence on *Mudarabah* and *Musharakah* modes and other instruments used in agriculture sector, which is very important for Sudan, like *Muzaraa'* and *Musaqah*. This could be addressed by government policies that encourage these modes by exempting them from taxes or subsidies them or any kind on incentives that are given to the banks which apply them. The policymaker also could ask the banks to allocate a certain compulsory percentage of their financing and investment portfolios for each mode. This will be an effective approach to diversify the usage of Islamic financial instruments.

- Low awareness of the various Islamic financial instruments among investors and people in general also lead that they focus on famous modes like *Murabahah* and *Ijarah*. Related authorities should promote other modes (*Mudarabah*, *Salam*, *Istisna*, *Musharakah Mutanaqisah* …etc.) and present them in an easy-to-understand way and highlight their benefits and features. Academic institutions could also play an important role in this regard by organizing public lectures to increase people's knowledge of different structures of Islamic finance outside *Murabahah* and traditional banking services.

- Dealing with wide arrange of financial instruments and modes require sufficient and efficient human capital and Sudan should have more specialized academic and training institutions in all fields of Islamic finance (banking, *Takaful*, microfinance, capital markets, money markets, Waqf, zakat). Currently there're very few specialized institutions comparing the size of Sudan and its population and its history with Islamic finance.

- The absence of fintech startups, which require very low capital, in Sudan while other developing Muslim countries like UAE, Egypt, Malaysia, Indonesia have been active in this new trend of finance that depends on some of its sides on risk sharing and equity-based instruments (e.g. crowd-funding). Therefore, Sudanese's government should start encouraging such startups to enhancing financial inclusion through new modes of financing that is based on new technologies.

- It's obvious that the current technical side in Sudan is not as expected nor as efficient as it should be in a world where all aspects of running businesses and institutions are being digitalized and computerized, not to mention the rapid proliferation of the financial technology (fintech). This could firstly be noted from the websites of most Sudanese financial institutions and even government agencies. Most of these websites are either very limited in information or not working at all. Investors and even researches will find it very difficult and sometimes impossible to get the basic information or data they need. Therefore, we believe that urgent and serious attention should be paid to this issue which is crucial in any financial system, and any developing for the current financial practices, including increasing the diversification of Islamic financial instruments, can't be done without this basic technical infrastructure.

- Based on the above mentioned points and the current status of Islamic financial system in Sudan, it is believed that current legislations governing financial sector need to be reviewed comprehensively to take into consideration:

    - Incentives for more diversification in the financing and investing portfolios of financial institutions.
    - Incentives for more dependence on risk-sharing financial modes.
    - Incentives for fintech startups.
    - Instructions to all financial institutions to develop their websites in an attractive and informative way so that stakeholders could get real benefit and awareness from these websites.
    - Encouraging cooperation and coordination between different financial and academic institutions to build up a knowledgeable human capital.

3.5 CASE STUDY: TURKEY

3.5.1 SUMMARY

The introduction of Islamic Finance in Turkey goes back to 1984. The Special Finance Houses had been permitted to start their operations first, which were transformed into the Participation Banks (PBs) by the new banking law in 2005. Recent economic development and changes in regulations have contributed significantly to the growth of Islamic Finance in Turkey over the past 10 years. Sovereign Sukuk and participation banks' Sukuk have been issued and Islamic private pension companies have also been established. Not only has the growth in Islamic Finance been at a faster pace than the growth of conventional finance, these banks have succeeded in doubling their market share of total banking assets, reaching 5% in 2015[75]. The Sukuk market has also made noteworthy progress in recent years. The Turkish Treasury has been able to make eight sovereign issuances with an approximate value of US$7.71 billion and other corporate private issuances worth US$4.071 billion between 2011 and 2015 (Dey, 2016). The progress is a reflection of strong intent on the part of the government to promote and develop Islamic Finance in recent years, and the important tangible steps that have been taken, demonstrate their commitment in this regard.

First, state-owned banks, *Ziraat Katılım* and *Vakif Katılım* have been operating since May 2015 and February 2016 respectively. According to a recent S&P report, the emergence of these state-owned banks as new Turkish Islamic Lenders can be a game-changer[76]. Second, the Istanbul International Financial Center (IIFC) project as part of the 10th development plan covering 2014-2018 aims at making Istanbul among the top 25 centers in the Global Financial Center Index ranking. One of the important components of the IIFC project is to develop participation banking and Islamic Finance in Turkey (Borsa Istanbul, 2017). Third, an important legislation had been passed by the Parliament in June 2012 that has allowed public sector to issue Sovereign Sukuk. Fourth, the World Bank Global Finance Development Center branch was opened in Istanbul in November 2013. This will complement efforts in further reforming the regulatory and legal framework of the financial industry, including Islamic Finance. Fifth, Participation Banks Association of Turkey (PBAT), which is an official private professional body, has prepared a detailed strategy document, "Vision 2025", to help raise the market share of participation banks and in promoting new Shariah compliant financial products and services. (PBAT 2015). Finally, the 'Vision 2023' of the ruling party, sets an ambitious plan to make Turkey world's 10 largest economies by the end of 2023. According to one of the international reports (Thomson Reuters, 2014)[77] , PBAT has set a target of a 15% share of total financial assets of PB's by 2025 with expected total assets of over $100 billion. Another international study published by Ernst & Young has also endorsed similar vision of the Turkish Government (PBAT 2014). The vision aims at accessing a wider pool of investors in the global financial market through issuance of Sukuk by the corporate, banks and as well as Treasury (Nevzat Devranoglu, 2013).

Although there has been noteworthy growth in the Islamic Finance (IF) since 2005, after the enactment of various legal reforms in the country, the share of IF has been on the lower side

[75] PBAT (2014)
[76] Osman Orsal (2016), http://www.zawya.com/mena/en/business/story/ZAWYA20160626035454/
[77] Some of the strategic partners in the report include, Turkye Finans, IRTI, and Al Baraka.

and to-date developments in Islamic product diversifications have been limited. Despite the viability and eminence of Turkish Sukuk market, there have been limited domestic corporate Sukuk issuances other than the issuances of PBs. There have been no international corporate Sukuk issuances that have originated Turkey other than the banks (Dey 2016). Some of the factors attributed to the lack of product diversification include:

First, PBs using 'Murabahah' financing in 90 per cent of its transactions and 70 per cent of deposits collected by PBs has three months maturity (Taner 2011). Second, there is no exclusive Shariah board or body to regulate the development(s) of product diversification and innovations. BRSA is the main primary body regulating the affairs of the baking sector, both conventional and PBs (Aslan and Ozdemir 2015). Third, there is lack of public awareness about Islamic banking in the country, particularly in the rural sector.

Turkey, however, has great prospects and potential for the future of Islamic Finance. The development strategy prepared by the Participation Bank Association of Turkey (PBAT), a professional private body, in collaboration with other stakeholders to help promote and develop the sector is promising. The determined resolve and commitment on the part of the government in implementing wide range of policies, makes Turkey an important and interesting case to study.

3.5.2 INTRODUCTION

Turkey is a Eurasian country, a gateway between Europe and Asia, bordered by the Black Sea, the Marmara Sea, the Aegean Sea and Mediterranean Sea. Its land borders extend more than 2.6 thousand kilometers, Greece and Bulgaria in the northwest, Iran in the east, Iraq and Syria in the couth and Armenia, Georgia and Azerbaijan in the northeast. Turkey has more than 78 million population, 99% of them are Muslims, endowed with the largest youth population in the EU countries. Turkey with its growing young skilled labor force, with its endowments of natural resources, vibrant R&D program and its geographical location, can play an important and central role in promoting and developing Islamic Finance both among OIC member countries and world at large.

After a long history of being a centralized economy, Turkey started implementing series of structural reforms including liberalizing the financial markets in the 1980s. This also prompted the opening of Special Finance Houses (SFH) in 1984 through a cabinet decree legalizing interest-free banking operations in Turkey (Hardy, 2012). However, these institutions could not make any serious penetration into the market due to the weak legislative framework and lack of strong political will to promote Islamic Finance. With various legal reforms, that started in 1999, paved the way to bring these SFH into mainstream banking in the country. In 2005, new banking law officially replaced the term "Special Financing Houses" with "participation banking" and the Union of Private Finance Houses became "Participation Banks Association of Turkey" (PBAT). Further changes in the legislation allowed the deposits of participatory banks to get protection under the Turkey's bankruptcy laws. The introduction of these banking reforms brought PBs into the mainstream banking and contributed significantly to their overall growth. During 2002-2015, the overall growth in the asset size of PBs was around 29% while it was 18.5% for the overall banking sector in Turkey (Sakarya, 2016).

The strategy document prepared by the Participation Banks Association of Turkey (PBAT, 2015) has laid down a detailed plan to develop and support the growth of Islamic Finance. The strategy aims:

- To develop and improve product range and service quality;
- To improve corporate communication and perception about Islamic banking;
- To further develop legislation, standards and regulations related to the principles of Islamic banking.

Sukuk - in the form of asset-backed debt instruments (lease certificates) - were first introduced through an overseas issuance by Kuveyt Turk to the Turkish market in April 2010. The legal framework for local issuance was also initiated in the same year. However, this remained inapplicable until the enactment of Omnibus Bill in 2011 which introduced tax neutrality on Sukuk Ijra issuances (IFN 2016). In June 2012, another amendment to the Public Finance Law had been made to permit the issuance of sovereign Sukuk. The Turkish treasury issued $1.5 billion Sukuk, as a benchmark, in September 2012 (White and case 2016).

In 2009, the State Planning Organization initiated its plan(s) to implement "Istanbul Finance Center Strategy Document". The objective of the strategy is to make Istanbul a regional finance center in short-run and aiming to make it global financial hub in the long-run[78]. One of the objectives of the strategy is to significantly increase the market share of Participation Banks in the sector[79]. Furthermore, to complement the strategy, Borsa Istanbul has also prepared its policies to support the vision.

The chairman of Borsa Istanbul, has recently explained some of the 'exchange' future policies in response to Turkish vision to make Istanbul a regional financial hub (IFN 2016, pp13-14). The chairman explained that the exchange is working with the Turkish Capital Market Association to initiate an International Shariah Board and is planning to develop range of innovative new products. Some of these new products include Islamic real-estate certificates financing urban transformation projects in collaboration with Turkish real-estate agencies[80]. Furthermore, Borsa Istanbul is also thriving on a radically innovative idea of introducing asset-backed Sukuk, based on the revenues from large infrastructure projects. These Sukuk have been modeled for Public-Private- Partnership (PPP) projects, covering bridges, toll roads and other public sector projects that can generate stable and high-revenue (IFN 2016)[81].

By the end of 2016, five banks, two of which are state-owned, have been operational in providing Islamic finance services. The opening of these two state-owned participation banks is seen as an important step in promoting and developing Islamic Banking in Turkey. A recent report of S&P, entitled "The Emergence of New Turkish Islamic lenders: A Game Changer?" concluded that growth of Islamic banking may take a giant leap forward with the involvement of State-owned banks in Turkey.

The recent trends in the Islamic Finance sector are promising and country has great potential to make significant contributions in promoting and developing the sector. Recent studies have

[78] http://www.Islamicfinancenews.com
[79] The objective is also part of the strategy laid down on the "Istanbul International Financial Centre Program Action Plan (2015-2018)".
[80] The chairman expressed these views in one the exclusive interview, published in IFN (2016).
[81] These views may not necessarily reflect the official position of the Turkish Government.

documented some of the issues that may need to get addressed in realizing this potential. These include: formation of an official Shariah board to regulate and supervise the development of Islamic financial instruments, promoting academic research and involving educational institutions to study the related issues, media campaign to help improve the general public perceptions about Islamic banking and further diversification of financial instruments (Aslan, 2015).

Regulatory and Legal Framework

The Banking Law No. 5411 (BL) allowed establishment banking Regulation and Supervision Agency (BRSA) as the main body responsible for the supervision and regulation of the banking industry as well as financial leasing, factoring and consumer financing companies in Turkey.

The other authorities that also have a role in the regulation and supervision of the financial system are:

1) Undersecretariat of Treasury has a primary function to manage the public assets and liabilities. It regulates and supervises the insurance sector.

2) Banking Regulation and Supervision Agency (BRSA) has been established as a body with full administrative and financial autonomy to implement all measures for the purpose of protecting the rights and interests of depositors, maintaining confidence and stability of the financial markets. It is the primary body to regulate and supervise the banking sector.

3) Capital Market Board (CMB) defines the capital market activities and types of institutions allowed to operate in capital markets. It has been empowered for the setting of the necessary conditions to be met by the financial and banking institutions.

4) Savings Deposit Insurance Fund (SDIF) is an autonomous public institution to build confidence and provide stability to the financial markets. The body is also responsible to safeguard the rights of the depositors.

5) Central Bank of the Republic of Turkey performs the traditional functions of a central bank, including issuance of bank notes, implementation of monetary policies, managing gold and fore reserves and matters related to price and financial stability of the system.

In addition to the above official bodies, The Participation Banks Association of Turkey (PBAT)[82] is a private professional organization with its separate legal identity to help promote and develop interest-free banking in the country. It was founded in 2001 and it is primarily responsible in articulating the vision and approach in promoting and developing the role of participation banks. It is mandated to develop relations between participation banks and other public institutions to address the needs of the participation banks. It also looks after the development of product range and service quality of the industry and is the key body in facilitating coordination with industry stakeholders. Based on the strategy document prepared by PBAT (2015), the organization will play a pivotal role in restructuring its role to bring necessary competence. The membership is mandatory to all participation banks. PBAT has

[82] PBAT is a private professional institution. PBAT is member of the "Interest-Free Finance Coordination Board", established officially by the Prime Ministry in December 2015.

been instrumental in developing a detailed strategy document (2015-2025) in consultation with Treasury, BRSA, CMB and CBRT. The strategy has laid down a detailed 'Action Plan' to help promote Islamic Finance in Turkey.

The Undersecretariat of Treasury and BRSA, in the context of participation banks, are responsible for identifying the objectives of PBs in line with the sector strategies. They also determine the duties and responsibilities of public institutions in accordance with the sector strategies.

CBRT, the **Central Bank of Turkey**, is the Sui Generis Institution, looking after the price and financial stability of the economy as a whole. The Central Bank of Turkey (CBRT) has made changes in its operational framework to provide access to liquidity facilities to the participation banks (Undersecretariat of Treasury (2016)). These facilities are divided into two main sections, depending on their roles and functions. First, the maximum maturity of CBRT liquidity facility is for 91 days, these come under the Open Market Operations (OMOs) and Lender of last Resort. Second, the central bank can inject/sterilize liquidity into/from banking system as per requirement. This is done through purchase/sales of sovereign debt securities (Sukuk). However, some other provisions of liquidity support, such as deposit lending, intraday liquidity and late overnight liquidity deposits are only accessible by the conventional banks only. CBRT has also established the International Islamic Liquidity Management Corporation (IILM) to further facilitate the liquidity concerns of the Participation Banks in Turkey. These measures have been aimed at providing level playing field for these banks (Undersecretariat of Treasury (2016).

3.5.3 ISLAMIC BANKING IN TURKEY

The Banking Law (Law No. 5411) that was published in November 2005 in the official gazette brought these SFH into the mainstream banking in Turkey. The new law gave official acknowledgement to PBs and allowed treating these banks in line with the provisions for the conventional banks[83] (Birben 2013). The dual deposit insurance system was revised and the management of the Islamic deposit insurance system was given to Savings Deposit Insurance Fund (SDIF). BRSA has ensured implementation of Basel II and Basel III standards compulsory for all banks in Turkey, conventional and PBs. The statuary capital adequacy ratio is set at 8%. Banks are also required to maintain liquidity sufficiency according to the procedures of BRSA. All banks are required to prepare a consolidated financial report that includes information about the financial position[84].

The distribution of types of deposits and lending methods are summarized in the Table (Assets/ Liabilites of PBs). Murabahah takes the bulk of financial support extended by the participatory banks. Some of the reasons for the dominance of Murabahah include lack of legal framework and short-term nature of the deposits of the PBs.

[83] Until 1999, the establishment and functioning of the SFHs were regulated by decree. In 1999, with a sgnificant amendment to the decree, these houses were covered in the scope of the Banking Law. Prior to 2000, UnderSecretariat of Treasury was responsible in regulation of these banks. However, new regulations have made these banks subject to inspections by BRSA, the main regulatory body of the conventional banks.

[84] The Article 3 of the Banking Law No. 5411 defined 'bank' as deposit bank, participation bank, development bank and investment bank, so all legal requirements applicable to banks are also valid for participation banks (Kizmaz 2015)

PBs in Turkey, have applied Murabahah in different businesses and have been able to develop few products with this mode of financing.

Here is a summary of some of the products under Murabahah financing in Turkey:

- XYZ Commodity Murabahah: It is fixed payment investment based on the profits earned from first buying and subsequently selling the goods in London Metal Stock Exchange. It is short term investment with low return as return is fixed (Ulus, 2012), Customer has to sign an additional Murabahah agreement with the bank for tracking of its operations;

- XYZ Twin Currency Unit Murabahah: It is similar to XYZ commodity Murabahah, but it allows transactions in other currencies. It allows flexibility if currency types for investment and more profit. The capital is not guaranteed in this case.

The process of the XYZ Commodity transaction involves several steps. First, the potential customer will determine XYZ as an agency to both sell and buy the commodity, and signs legal agreement. Second, XYZ facilitates the purchase of the good from the potential supplier/vendor, and sells the same good at cost plus profit to the bank, with a maturity period (from one week to six months). Third, at the time of maturity of the contract, the bank pays the capital amount invested and profit to the customer through XYZ agency, which only gives some pre-determined commission for the transactions. This is a low risk investment product with low return, in which the initial capital is secured at the time of the maturity of the contract. The concept of XYZ Commodity Murabahah has also been extended as XYZ Tawarruq, for short-term financing of liquidity requirements of private enterprise. In this extension, XYZ buys certain commodity in London and sells the same commodity to the customer immediately. XYZ buys the commodity at cost and sells at cost plus profit as forward price. Customer pays both the cost and profit with an agreed schedule of payments.

Performance, Outlook and Future of Islamic Banks in Turkey

The total assets of PBs showed remarkable growth during post-2001 era. During 2002-2014 the growth in the asset size has been exponential. Almost on average of 29% annual growth has been achieved by the PBs compared to 18% average annual growth in the overall banking sector of Turkey (Sakarya 2016). However, with this significant growth in assets the share of the assets of PBs could reach around 5.2% of the total assets of the sector in 2014 (Table on Shares of Participation Banks).

The improved regulatory environment, removal of restrictions on operations and integration of Participatory banks in the main stream banking after the introduction of deposit insurance set the level filed foe these banks to grow.

Table 46: Assets/Liabilities of Participatory Banks (2015)

Assets			Liabilities	
Murabahah	90		Capital	15
Ijarah (Leasing)	5		PLSA	70
Istisna	2		Special Current Accounts	15
Salam	1			
Musharakah (P/L sharing)	1			
Mudarabah (P/L sharing)	1			
Total	**100**		Total	**100**

Source: Undersecretariat of Treasury (2016)

The number of branches increased from 110 in 200 to 829 in 2012 and to 1080 in 2015. The share of participation banks in total banking assets doubled during this period from under 2% to over 5% in 2015 (See Tables Balance Sheets of PBs and Branches of PBs).

Table 47: Share of Participation Banks in the Overall Banking Sector of Turkey

	2012	2013	2014	2015
Funds Collected	6.1	6.5	6.2	5.9
Funds Allocated	6.0	6.1	5.4	5.2
Asset Size	5.1	5.5	5.2	5.1
Equity Size	4.1	4.6	4.1	4.1
Net Profit	3.9	4.3	2.5	1.6

Source: BRSA, Gun (2016)

Table 48: Balance Sheet of Participatory Banks (TRY)

Balance Sheet Items of Participatory Banks				Change Over 2010-2015	
	2010	2014	2015	Amount	%
Loans	19,966.76	27,579.67	24,824.46	4,858	24.3
Total Assets	28,073.42	44,910.95	41,416.85	13,343	47.5
Deposits	21,435.96	28,077.63	25,566.58	4,131	19.3
Equity	3,533.47	4,165.45	3,666.18	133	3.8

Source: Undersecretariat of Treasury (2016)

Table 49: Branches of Participatory Banks

	2010	2014	2015	2010-2015	2014-2015
Branch	607	990	1,080	473	90
Domestic	605	986	1,076	471	90
Abroad	2	4	4	2	0
Off-shore	1	1	2	1	1
Personnel	12,677	16,280	16,554	3,877	274

Source: Undersecretariat of Treasury (2016)

Table 50: Selected Financial Indicators: Deposit Banks (Conventional) and Participation Banks

	Capital Adequacy Ratio			Return on Assets			Return on Equity		
Year	Sector	Deposit Banks	Participation Banks	Sector	Deposit Banks	Participation Banks	Sector	Deposit Banks	Participation Banks
2003	25.1	22.9	N/A	16.4	14.4	N/A	135.6	129	N/A
2004	30.9	28.2	N/A	2.5	2.4	N/A	18.1	19	N/A
2005	28.2	26.2	12	2.4	2.3	N/A	15.8	16.9	N/A
2006	23.7	21.6	12.5	1.7	1.5	3.5	12.1	11.8	36.9
2007	21.9	19.9	16.5	2.6	2.5	3.3	21	22.2	30.8
2008	18.9	17.4	16.1	2.8	2.7	3.1	24.8	26.6	30.7
2009	18	16.5	15.2	2	1.9	2.8	18.7	19.9	24.1
2010	20.6	19.3	15.3	2.6	2.6	2.4	22.9	25.2	19
2011	19	17.7	15.1	2.5	2.5	2	20.1	22.2	16.9
2012	16.6	15.5	14	1.7	1.7	1.6	15.5	16.8	14.8
2013	17.9	17.2	13.9	1.8	1.8	1.5	15.7	16.8	14.7
2014	15.3	14.6	14	1.6	1.6	1.3	14.2	15.1	13.8

Source: BRSA, Sakarya (2016)

A comparison of return on assets (ROA) and return on equity (ROE) reveals that the ROA and ROE were 1.3% and 13.8% respectively for the depository banks, while they were 1.6% and 15.1% for the PBs in the year 2014. It is noticeable that the profitability ratios were consistently higher of the PBs during 2006-2009. However, since 2009 and onward there has been overall decline in these ratios due to overall global and domestic macroeconomic conditions. The low economic growth of the real sector in recent years explains low profitability of PBs as the bulk of short-term financing of PBs are linked to the activities in the real sector of the economy.

Summary of Islamic Banking in Turkey

- The growth of Islamic Banking in Turkey has shown notable increase over the past 10 years. The banks were able to double their market share to over 5% in 2015 from 2.5% in 2005.

- The total assets of PBs reached US$42.2 billion by the end of 2015, which is five-fold increase compared to its assets in 2005.

- The dominant modes of financing are 'Murabahah' and 'Ijarah'. Murabahah mode of financing constitutes around 90%, while Ijarah (Leasing) mode of financing is 5%.

- One of the major reasons for using 'Murabahah' is its short-term investment mechanism. The overall market conditions in Turkey, where over 70% of funds collected by PBs have three months maturity period (Taner, 2011) limits these banks to resort to short-term investment financing modes.
- Mark-up in 'Murabahah' also allows PBs to earn comparable returns with the interest returns of the conventional banks.

- Lack of adequate legal and technical infrastructure also limits PBs to indulge in other modes of financing such as 'Musharakah'.

- Participation Banks Association in Turkey (PBAT) has proposed that the first step for the diversification Islamic products is formation a permanent and independent regulatory body to look after the regulations pertaining to the development of other products (PBAT, 2015)[85].

- One of the actions documented in the 2015-2025 strategy report of PBAT, is to ensure the physical exchange of commodities in the Borsa-Istanbul. This will open up an important opportunity for PBs (IFN, 2016).

- The two of the state-owned banks, Ziraat Katlim Bankasi and Vakif Katlim Bankasi, have also started their Islamic Banking operations in 2015. This is expected to contribute to the growth of the Islamic Banking in Turkey.

3.5.4 ISLAMIC CAPITAL MARKETS IN TURKEY

Despite encouraging developments in Turkish Sukuk market in recent years, there have been limited issuances of domestic corporate Sukuk with the exception of Participation Bank issuances[86]. However, given the demand for alternative sources of financing by the Turkish corporations, Sukuk market development may facilitate in reducing the financing gap in Turkey, particularly the planned mega projects and Public-Private-Partnership (PPP) projects. According to one estimate the Turkish corporations needed additional financing of US$350 billion to complete projects in line with the 2023 development plan[87].

In 2012, an important amendment was enacted by the parliament. It allowed for the first time the UnderSecretariat of Treasury to issue 'Sovereign Lease Certificates'. This provision allowed Sovereign to transfer public assets to SPVs in the sale-and-lease-back model of Islamic Finance. In this context assets held by the central banks, state-owned enterprises can be used to issue lease certificates both in the domestic and international markets. In the first issuance of the Sukuk, it was sold to the investors of Middle East region. 15 such Sukuk have been issued by the end of 2016. All these Sukuk were based on standard 'Ijarah' Sukuk model.

In the current legal framework, Sukuk holder obtains partial ownership over a specific asset getting the profit that such asset may generate and from the proceeds of its sale. The communiqué introduced five types of these certificates consisting of certificates based on ownership (Ijarah), management (Musharakah), trading (Murabahah), partnership (Musharakah) and engineering, procurement and construction (EPC) contracts (Istisna). The legislation also regulates the establishment of ALCs. The ALCs can be established by banks, intermediary institutions, real estate investment trusts and public corporations. Five types of

[85] PBAT is a private professional body, playing an important role in promoting and developing strategies to help future growth of Islamic Finance in this country.
[86] Debashis Day (2016), http://www.whitecase.com/publications/insight/sukuk-expereince-turkey
[87] Ibid: 1.

contracts had been prescribed for the issuance of Sukuk. Four of them come under the Lease Certificates (Sukuk), they include[88]:

- Ownership-based (Ijarah);
- Management Agreement-based (Ijarah/Wakala);
- Trading based (Murabahah);
- Partnership-based (Mudarabah/Musharakah).

Some of the characteristics of these lease certifcates are as follows:

- Ownership based lease certifcates: These are issued to provide fnancing for the acquisition of financil assets by the ALC from the originating institution.
- These certifcates are backed by management contracts. They are issued to transfer the proceeds generated to the ALC.
- Lease certifcates tha are backed by trading, the proceeds generated from the sale these assets are on deferred basis.
- Lease certifcates backed tha are backed by partnership are issued for providing fnancing to the ALC and become a shareholder of the joint-venture.
- EPC based lease certifcates are aimed to fnance the realization of the project for which the ALC shall be party to the EPC contract as well.

By the end of 2015 shows that Sukuk issuances have raised more than US$5.7 billion by the private institutions. In addition, between 2012 and 2015, the sovereign has issued eight Sukuk with a value of US$7.7 billion (IFN, 2016). However, given the overall size of the Turkish capital market, this growth of Sukuk by the PBs and sovereign has been limited. It is vital that new regulations are needed to promote Turkish corporate to issue Sukuk. The outstanding Sukuk issuances are mainly denominated in US dollars with an average maturity period of 5 years. Turkiye Finance, Kuyet Turk and Treasury are the leading issuers of US denominated Sukuk (see the two Tables on Sukuk issuances below).

Table 51: Sukuk Issuance in Turkish Market

	EURO	MYR	TRY	USD	TOTAL
Matured					
Domestic			74		74
Foreign			1	4	5
Outstanding					
Domestic			20		20
Foreign	1	6	2	7	16
Total	1	6	97	11	115

Source: Undersecretariat of Treasury (2016)

[88] The discussion on the structure of Sukuk issuance is primarily taken from, Erdem E. (2014), http//www.erdem-erdem.av.tr/publications/prominance-of-sukuk-in-Turkey-as-an-islamic-finance-instrument.

Table 52: Sukuk Issuances in Turkey by Contract Structure

	Tenor (Years)	Issue Size	Issuer Name		Year
Structure	5	US$500m	Turkye	Finans ALC	2014
Mudaraba	5	US$350m	Bereket	ALC	2014
Wakala / Murabaha	10	US$1bn	Treasury	ALC	2014
Ijra	728 days	TRY1.8bn	Treasury	ALC	2015
Ijra	2	TRY1.6bn	Treasury	ALC	2015
Ijra	10	US$250m	Albaraka	Sukuk Ltd.	2015
Murhabaha	10	US$350m	KT Sukuk	Co. Ltd.	2016
Wakala	729 days	TRY10m	Kuveyt Turk	ALC	2016
Wakala	179 days	TRY300m	Kuveyt Turk	ALC	2016
Ijra	5	US$1bn	Treasury	ALC	2016

Source: Capital Market Board (CMB, 2016)

Participation funds are an important vehicle, besides Sukuk, for the investors who prefer avoiding interest-based transactions. Under the legal provisions of these funds, a participation fund is defined when at least 80% of the net asset value of the fund is invested in lease certificates, participation accounts at PBs, corporate shares, gold and other precious metals and other non-interest bearing capital markets instruments approved by CMB (Under-Secretariat of Treasury, 2016).

There are **29 such participation funds** available in Turkey and net total value of these funds was USD 75 million in June 2016 (UnderSecretariat of Treasury, 2016).

Summary of Islamic Capital Markets in Turkey

- The Sukuk issuance is likely to grow with further development of PBs in future. However, due to regulatory limitations, PBs have been able to issue Sukuk based on leasing-receivables (51%) and Murabahah-based Sukuk (41%) only. The future prospects of Sukuk based on infra-structure projects is encouraging for the long-term growth of Islamic Finance in the country (IFN 2016)

- The most common types of Sukuk in Turkey are **Ijarah Sukuk**. One of the reasons of the dominance of lease certificates is because until 2013 the Capital Market Board only allowed the special-purpose vehicle (SPV) to issue these certificates. However, in 2013 CMB has permitted, in addition to lease certificates, other types of certificates including Mudarabah, Murabahah, Musharakah and Istisna. The Legislation passed by the Parliament in 2012 has paved the way for the establishment of **Public Asset-Leasing Companies**. By the end of 2014, US$3.75 billion, worth of Sovereign-Sukuk (Dollar denominated) have been issued.

3.5.5 TAKAFUL (ISLAMIC INSURANCE) IN TURKEY

In Turkey, the regulatory agency of insurance is the Undersecretariat of Treasury. Takaful Companies are not allowed to operate both life and non-life insurance divisions at the same time. Foreign insurance companies can also operate by first opening its branch. On the other hand, insurance companies owned by foreign capital have to be established as a joint stock or a cooperative like insurance companies owned domestic capital (Undersecretariat of Treasury 2016).

There had been no regulations specific to Takaful in Turkey until Turkish Treasury made regulation regarding Takaful sector in September, 2017. "Regulation on Working Procedures and Principles of Participation Insurance" (Takaful) that was published on 20.09.2017 in the Official Gazette. The purpose of the Regulation is to regulate the procedures and principles regarding the participation insurance activity in terms of operation, development and proper follow-up of the takaful system.

Prior to Regulation, takaful companies were subject to the same rules with conventional insurers in Turkey. After the Regulation, takaful companies are subject to the different rules related to takaful, such as segregation of funds, surplus distribution, establishing Shariah Board etc. However, in the cases where there is no provision in the Regulation, the relevant provisions of the insurance legislation will be applied for takaful sector.

Moreover, prior to Regulation, Turkish jurisdiction did not oblige any specific takaful model such as separate company model or window model. However, according to the Regulation, window takaful model is limited 3 years as from publication date of the Regulation.

The Takaful sector has made some progress in recent years in Turkey. The Tables below on Takaful Companies and Shares of GW Premiums provide information about number of Takaful providers.

Summary of Takaful Segment in Turkey

- There is good potential for Shariah-compliant insurance with predominantly Muslim population in Turkey. However, Takaful has a minimum presence in the Turkish market at present.
- Currently, eight takaful companies (four of them from general side and four of them from family side) operate in Turkey. In addition, there is no re-takaful company operating in Turkey yet.

Table 53: Takaful Companies (Including Windows)

Takaful Companies	2009	2010	2011	2012	2013	2014	2015
General Takaful Companies	2	2	2	2	2	2	4
Family Takaful Companies	0	0	0	0	1	2	4
Total	2	2	2	2	3	4	8

Source: Undersecretariat of Treasury (2016)

Table 54: Shares of Gross Written Premiums (TRY)

Gross Written Premiums (GWP)	2014	2015
Market Share of General Takaful	2.40%	4.18%
Market Share of Family Takaful (Life)	0.19%	0.64%
Market Share of Overall Takaful	2.13%	3.75%

Source: Undersecretariat of Treasury (2016)

3.5.6 POLICY RECOMMENDATIONS

The present regulatory structure of Islamic Finance in the country is devoid of an independent Shariah Council or Board to supervise the services and activities of participation banks in accordance with Islamic guidelines. Formation of such a council will be vital in promoting appropriate financial products in compliance with Islamic Shariah principles and help restoring the credibility of Islamic Financial Markets in the country[89]. The future of Islamic Finance in Turkey is promising with its predominantly Muslim population. One of the conferences on financial inclusion, organized by World Bank in 2014, noted that the unbanked proportion of population is around 48% in Turkey, and growth of Islamic Finance can help in improving financial inclusion[90]. HoweverHowever, dominance of conventional banking with their large market share, lack of general public awareness about interest-free banking and lack of qualified personnel in the industry, will be challenging in making this transition from conventional banking to Islamic Finance. In short:

- Turkey must establish a Shariah Advisory Board. This will bring clarity to the development of instruments compatible with Islamic Finance Principles. Furthermore this will create better awareness about Islamic Finance among general public and restore confidence and trust in these institutions;

- Takaful has great potential in Turkey, however the regulatory framework is quite new to make assessment of the reflections on the progress in this sector.

- PBs must 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 banks and PBs among customers, scholars and public.

- The deposit insurance clause is also applicable to PBs. PBs financing is based on the notion risk-sharing, provisions of such insurance are in conflict with the Shariah;

- Government, institutions and higher education institutions need to focus on improving the general literacy about the products of Islamic Finance and highlighting the differences with the conventional banking practices,

- Turkey has great potential in becoming Islamic Finance center with its size of Muslim population, macroeconomic conditions and its ambitions in making Istanbul as one of the leading financial centers of the world. Turkey may take the leading role in bringing top 5 Islamic countries (Saudi Arabia, Malaysia, Pakistan, Indonesia and Turkey) to form I-5 (Islamic-Five) group (Dar H, 2013). These countries can strategically form a block in developing Islamic banking and finance instead of indulging in unhealthy competition.

[89] Gun Musa (2016).
[90] World Bank (2014)

3.6 CASE STUDY: BANGLADESH

3.6.1 INTRODUCTION

Bangladesh's progress is a mosaic of solid achievements with some disappointments. Over the past 46 years since independence, Bangladesh has increased its real per capita income by more than 130 percent, cut poverty by more than half, and is well set to achieve most of the millennium development goals. The economy today is a lot more flexible and resilient, as indicated by the ability to withstand the global financial crisis with minimum adverse effects.

Higher private investment, exports, and wages underpinned GDP growth acceleration to 7.1% in FY2016 (ended 30 June 2016) from 6.6% in the previous year.

A sound financial sector is a key to a sustained economic development for any country as it facilitates the financial mechanisms between borrowers and lenders, helps expedite capital accumulation, and makes use of resources into productive sectors. The banking industry played a crucial role in mobilizing resources and economic growth. Financial system as a whole widened and deepened. New banks contributed in parallel to old banks in the economy. Banking system enhanced its resilience with the adoption of Basel III. In Bangladesh, the contribution of the financial sector has increased over the years. In FY2011, financial sector's share in GDP was 2.99 per cent at constant price which has increased to 3.41 per cent in FY2017. Commercial banks play the dominant role, possessing almost 80 per cent of the financial sector. In FY2017 the share of banking sector in GDP was 2.91 per cent. The contribution of other financial institutions including non-banking financial institutions and insurances was only 0.5 per cent of GDP. However, amid global economic shocks, the Bangladesh economy remained buoyant in 2016. Real GDP remained at 7% plus growth trajectory while inflation remained within the target of 5.8%. Despite declining inward remittance and moderating export growth, Bangladesh holds adequate reserves of foreign exchange which is equivalent to eight months of import cover. Robust domestic demand, stable exchange rate, and low debt-GDP ratio provide buffer against external vulnerability. Bangladesh Bank's continuous effort to upgrade the financial sector regulation and supervision in line with the global standards contributes to maintain a stable -financial sector. In the year 2016, the banking sector had sufficient liquidity, notable balance sheet growth, and moderate level of sectoral concentration of loans and advances. Non-bank -financial institutions also demonstrated resilience against various stress scenarios.

3.6.2 ISLAMIC BANKING IN BANGLADESH

The banking sector in Bangladesh continued its evenness in the calendar year 2016 (CY16) like as last couple of years. In CY16, banking sector's total assets grew steadily; among these assets, loans and advances occupied the largest portion as usual followed by investments and other assets. Credit growth was higher in CY16 than that of the previous year, though growth of investment in government as well as other securities slowed down. Despite rigorous efforts of Bangladesh Bank, non-performing loan of banking sector increases slightly in CY16 due to deterioration of quality of the assets of state-owned commercial banks and specialized development banks. Moreover, banking system experienced lower provision maintenance than the previous year.

Though the banking sector is implementing Basel III as per roadmap released in 2014, the banking industry was successful in maintaining capital to risk weighted asset ratio (CRAR) same as previous year. Moreover, most of the banks maintained the required leverage ratio, a simple and non-risk

Based-leverage ratio is adopted under the Basel III framework, to avoid build-up of excessive on- and 0-balance sheet leverage in the banking system. Low call money rate and low advance to deposit ratio (ADR) helped the banking sector edging liquidity stresses in CY16. The newly introduced Basel III liquidity indicators (LCR and NSFR) also revealed that banking industry was well set to absorb any liquidity shock. During the review year, operating profit decreased slightly, but net profit increased attributable to a decline in loan loss provision. PCBs performed well in terms of asset quality, capital adequacy and profitability while SCBs and SDBs found lagging behind the industry average and thereby required more vigilant supervision by their regulator.

Islamic banks are showing a steady growth over the last couple of years in terms of assets, deposits, investments (loans and advances); and shareholders' equity. The growth of Islamic banking sector decreased in CY16 compared to the previous year. In CY16, Islamic banking assets increased by 13.2 percent (16.3 percent in CY 15); investments (loans and advances) grew by 17.5 percent (18.6 percent in CY15), while the overall growth of loans of the banking industry was 15.3 percent. The liabilities also grew by 13.8 percent (16.6 percent in CY15), mostly due to a positive growth in the deposit base of 14.7 percent (13.6 percent in CY15) compared to growth of 12.8 percent in the overall deposit base of the banking industry.

The Islamic banking sector in Bangladesh has been continuously growing at a rapid pace which is reflected by the increasing branch network of Islamic Banks and the conventional banks having Islamic banking branches. Some other conventional banks had applied to convert their whole operations in line with the Islamic Sharia'h. Islamic Banking Industry in Bangladesh has been highly contributing to encourage economic growth and generate employment in the country to fulfill the vision of the government to reach the country at a Middle Income Level by the year 2021.Thereby, this banking industry with more than 23% market share and 29,176 employees have been playing a very dominant role in mobilizing deposits and financing in the real sector industries, services and other key sectors of the economy and collecting 39.95% of total foreign remittances in Bangladesh. The principal financial instruments used by the Islamic banks are Bai-Murabaha, Bai-Muajjal, Qard-e-Hasan, Ijarah-bil-Bai and HPSM (Hire Purchase under Sirkatul Melk). Role of the Islamic Banking industry, as a whole, in respect of Islamic Microfinance is commendable. Since the core objectives of Islamic banking industry is to fulfill the Maqasid-al-Sharia'h i.e. to help expedite the financial inclusion drives with Islamic financial literacy programs to associate the poor and disadvantaged people of the country in small types of income generating activities so that they can get a space to live as a respectable human being.

The Islamic NBFIs play an important role in the financial system of the country by providing financing facility to both retail and commercial clients. Since Islamic NBFIs cannot accept demand deposits, they incur higher cost of funds than banks which makes it difficult for them to compete. They try to make up for this by providing some special products usually not available from banks. The main obstacles preventing innovation of new products for developing a vibrant Islamic capital market in Bangladesh is the lack of initiatives from the concerned authorities and absence of guidelines based on Sharia'h based investment. There is no specific or customized Islamic Sharia'h- based products in Bangladesh Capital Market. To uphold the integrity of the market and meet the demand of an increasingly sophisticated investor class, there is a need to strengthen the policy and market practices of Islamic capital markets. The key components of the Islamic finance value chain have been firmly set in place, the industry is still facing various challenges at both regional and global levels given its nascent level of development. Many jurisdictions that operate Islamic finance sectors and offer Sharia'h-compliant financial solutions are yet to develop holistic regulatory frameworks and legislation that enable smooth functioning of the Islamic financial system. There is a critical need for regulatory support to drive the growth of Islamic finance. Pressing matters include the need for: (1) an appropriate supervisory environment that caters to the unique features of Islamic financial products; (2) a wider understanding of Sharia'h practices, and of the differences between the Islamic financial system and the conventional system; (3) the adoption of accounting and auditing standards that recognize the unique features of Islamic finance transactions; (4) the introduction of Sharia'h-compliant financial instruments to manage the excess liquidity of Islamic banks; (5) standardization of products and other-related documents; (6) the drafting of clear rules and practices for dispute settlement in transactions; and (7) the development of human resources that are well-versed in both Sharia'h matters and the dynamics of the financial industry.

Islamic Capital Market sector has high potential in Bangladesh. But this potential needs proper nourishment from both the organizations and regulatory body. The government should take some major steps for the betterment of this sector. The government itself can establish an Islamic Capital Market organization to improve the faith of people in this sector. This will also encourage people to become more aware of the products and scopes of Islamic Capital Market sector. This will drastically improve the condition of Islamic Capital Market sector in Bangladesh. More regulatory framework should also be developed, by the government, in favor of this sector.

Islamic insurance in Bangladesh has been facing numerous problems. The nature of the problems is lack of separate Takaful regulation, Shariah-based Islamic capital market for Islamic insurance etc. The present socio-economic scenario of the Bangladesh Takaful market appears to be not very conducive and supportive for its growth and development. The framework of Takaful regulations and guidelines in Bangladesh is almost absent. It takes a long time to formulate policies and guidelines. Furthermore, in the stock market, Takaful companies are under obligation to invest funds with Shariah compliant companies. Shariah compliant companies are not too many, which restricts the investments within limited circle and forcing them to receive lower rate of returns. But the biggest problem is regulatory requirement to invest 30% of the investable funds with Government Securities and Bonds.

Why Bangladesh is an Interesting Islamic Finance Case Study

Islamic bank has been established in Bangladesh in 1983 which was first step in the South East Asian region. The Islamic banking sector in Bangladesh has been continuously growing at a rapid pace which is reflected by the increasing branch network of Islamic Banks and the conventional banks having Islamic banking branches. Some other conventional banks had applied to convert their whole operations in line with the Islamic Sharia'h. Islamic Banking Industry in Bangladesh has been highly contributing to encourage economic growth and generate employment in the country to fulfill the vision of the government to reach the country at a Middle Income Level by the year 2021.Thereby, this banking industry with more than 23% market share and 29,176 employees have been playing a very dominant role in mobilizing deposits and financing in the real sector industries, services and other key sectors of the economy and collecting 39.95% of total foreign remittances in Bangladesh.

For the continuous increasing market share of Islamic banking and Takaful companies in Bangladesh qualifies to be selected as a test case for reviewing the development indicators and Islamic financial infrastructures of the country.

Market Share of Islamic Banks

Islamic banks' market share remains mostly static at about one-fifth of the total banking system. The aggregate market share of Islamic banks in CY16 (excluding Islamic banking branches/ windows of conventional banks) remained almost same as CY15. In a nutshell, at end December 2016, Islamic banks possessed 18 percent (18 percent in CY15) of total assets, 23 percent (22 percent in CY15) of investments (loans), 20 percent (19 percent in CY15) of deposits, 16 percent (15 percent in CY15) of equity and 19 percent (19 percent in CY15) of liabilities of the overall banking industry. Profitability of Islamic banking sector in CY16 was higher compared to the overall banking industry. The key indicators of profitability were very competitive with the banking sector. In terms of individual earning of banks, one of the Islamic banks ranked at third from the top in the entire banking industry. In 2016, the net profit of Islamic banks increased by 18.1 percent from CY15. In contrast, the net profitt of the overall banking system was increased by 4.9 percent in CY16 (31.7 percent in CY15). On the other hand, in the absence of an established Islamic bond market, these banks operate with a special liquidity arrangement, and that may also help them to generate more income with higher investment funds compared to loanable funds of conventional banks. During CY15, Islamic banks contributed to 21.2 percent of total industry profits. The profit income39 to total assets ratio of Islamic banks reached 7.3 percent, which is higher than that of the industry average (interest income to total assets ratio was 5.5 percent). On the other hand, the non-profit income to total assets ratio was only 0.9 percent as compared with the industry average of 2.4 percent, representing a lower income from off-balance sheet (OBS) transactions and service and fee-based incomes.

The ROA of the Islamic banking industry was 0.8 percent, a bit higher than the overall banking Industry in CY16, indicating a comparatively more efficient use of assets by the Shariah compliant banks. On the other hand, the ROE of the Islamic banking industry in CY16 stood at 13.1 percent, which is higher than the overall banking industry's ROE of 9.7 percent, indicating the higher earnings of Islamic banks with relatively lower amount of equity.

Islamic banks' liquidity: Islamic banks are found to have sufficient liquidity over the CY16 considering their Cash Reserve Ratio (CRR), Statutory Liquidity Requirement (SLR), and newly introduced Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) under Basel III accord. Islamic banks are allowed to maintain their statutory liquidity requirement (SLR) at a concessional rate compared to that of the conventional banks, as Shariah-compliant SLR eligible instruments are not widely available in the market. Islamic banks are consistently maintaining statutory liquidity requirement of CRR and SLR as 6.5 percent and 5.5 percent of their total time and demand liabilities40 respectively. According to the roadmap towards implementation of Basel III, banks are required to maintain at least 100 percent (the minimum standard) of Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) from January 201541. It may be mentioned that the banks in Bangladesh are maintaining LCR and NSFR, a new liquidity standard, introduced by the Basel Committee. LCR aims to ensure that a bank maintains an adequate level of unencumbered, high-quality liquid assets that can be converted into cash to meet its liquidity needs for 30 calendar days. On the other hand, NSFR aims to limit over-reliance on short-term wholesale funding during abundant market liquidity and encourage better assessment of liquidity risk across all on- and off-balance sheet items.

The aggregate Investment-Deposit Ratio (IDR) of Islamic banks was 86.3 percent at end-December 2016, higher from 83.2 percent at end December 2015. The ADR of the overall banking industry was 71.9 percent42, lower than that of the Islamic bank group, due to a higher SLR requirement for conventional banks but yet quite below the maximum permissible level of 90 percent. Since there are limited sources of Shariah-compliant funds, Islamic banks can borrow funds either from the Islamic inter-bank money market, which started in 2012, or from the Islamic Investment Bonds Fund issued by the Government.
Since the IDRs of Islamic banks were below the regulatory maximum level of 90 percent, it indicates no sign of liquidity stress in these banks in CY16. To address the excess liquidity holding in the Islamic banks, Bangladesh Bank amended the 'Bangladesh Government Islami Investment Bond (Islami Bond) Policy, 2004'. The objective of such amendment was to develop a solid base for the Islamic bond market and also to channel excess liquidity into investments through Islamic bonds. The Debt Management Department (DMD) of Bangladesh Bank also issued a circular to introduce the auction process of Islamic bonds, referring to a gazette notification of 18 August 2014.

With the amendment of the Islamic Bond Policy, the maturity periods of Islamic bonds were re-fixed at 3 months and 6 months to help the Islamic banks/FIs to manage their funds smoothly; previously which were 6 months, 1 year and 2 years. The bonds will be issued based on the Prot Sharing Ratio (PSR) through open auction, i.e., the profit earned by investing in these bonds will be shared by the buyer and by the Bangladesh Bank as issuer. The profit of Islamic bonds will be equal to the profit of a three-month fixed deposit scheme of the issuing Islamic banks, instead of the previous profit rate of savings (Mudaraba) deposits. In the case of selling Bangladesh Government Islami Investment Bonds (BGIIB), the government has to share the profit (or loss) with the investing banks that accrue from the use of fund collected from such sales, and the fund will be used by the government complying Shariah requirements. This aspect of concern will be taken care of by the government to the satisfaction of the investing banks. If the government wants to use the funds for a longer term and in specific projects, then this type of short-term bond would not be the right choice. Financial instruments like long-term bonds, complying with Shariah requirements, popularly known as 'Sukuk', would be more appropriate. From specific projects, it becomes easier to calculate profit and loss, and the profit (also loss) can be shared with the fund suppliers or Sukuk buyers on a pre-agreed terms. It can be noted here that Bangladesh is yet to issue any Sukuk.

Capital position of Islamic banks: Under the Basel-III framework of Bangladesh, given the minimum Capital to Risk weighted Assets Ratio of 10 percent; seven out of eight full-edged Islamic banks complied with the regulatory capital requirement in CY16. For the banking system to be more resilient and shock absorbent, Basel Committee on Banking Supervision (BCBS) recommended to raise the quality and levels of regulatory capital. In line with the international best practices, Bangladesh Bank introduces Capital to Risk Weighted Assets Ratio (CRAR) in its 'Guidelines on Risk Based Capital Adequacy' and instructed the banks to maintain their CRAR to a fair ratio of at least 10 percent. The stronger capital base maintained by Islamic banks indicates that these banks are strong enough to meet various kinds of shocks they are exposed to. Out of 8, 7 banks have CRARs more than 10 percent in CY16. However, from 2006, one Islamic bank's CRAR remained negative for historical huge cumulative loss and provision shortfall, and not changed much despite change of ownership. This bank has been operating under a restructuring plan since 2008.

Classified investments of Islamic banks: Islamic banks also showed a better position regarding the classified investments to total investments ratio in the review year 2016. The ratio was 4.3 percent, substantially lower than the industry score of 9.2 percent. However, if only private commercial banks are considered rather than the overall banking industry, the ratio drops to 4.6 percent from 9.2 percent. Islamic banks, therefore, had slightly less NPL compared to their closest peer group (PCBs). The classified investment to total equity was 49.7 percent for Islamic banks, as compared with 72.7 percent for the overall banking industry, indicating that Islamic banks were more resilient in case of possible losses from their investments (loans and advances) compared to the overall banking industry. From the stability point of view, Islamic banks are less vulnerable to risks as they are able to pass the negative shocks on the asset side (Loss in Musharaka a/c) to the investment depositors (Mudaraba a/c arrangement). Such arrangements proportionately transfer the credit, market, and liquidity risk of their assets to their depositors, and thereby, in principle, discourage the shareholders from taking excessive risks compared to conventional banks. In other words, depositors may provide a degree of market discipline. However, it is evident that Islamic banks, in practice, do not necessarily pass the risk from its assets to its depositors in stressed scenarios. Instead, Islamic banks smoothly distribute their profits to depositors at benchmark rates and thereby do pass the asset portfolio risk onto the shareholders.
Moreover, when investment revenues are substantially higher, Islamic banks usually provide a higher percentage of revenues to depositors as a rate of return in line with market deposit interest rates rather than the full profit due to them. On the other hand, they will do the opposite in years when investment revenues are low by reducing its own management (Mudarib) fee share to increase the share of distributions for the depositors.

Financial Instruments used by the Islamic Banks

The principal financial instruments used by the Islamic banks are Bai-Murabaha, Bai-Muajjal, Qard-e-Hasan, Ijarah-bil-Bai and HPSM (Hire Purchase under Sirkatul Melk). Role of the Islamic Banking industry, as a whole, in respect of Islamic Microfinance is commendable. Since the core objectives of Islamic banking industry is to fulfill the Maqasid-al-Shariah i.e. to help expedite the financial inclusion drives with Islamic financial literacy programs to associate the poor and disadvantaged people of the country in small types of income generating activities so that they can get a space to live as a respectable human being. As the bulk of the investments made by Islamic banks have been concentrated in trade and rent-related sectors, they may invest more in socially desirable and sustainable real sectors especially in micro, share-cropping, non-traditional agriculture and small enterprises. Islamic banks through profit and loss sharing mode of investment including Zakat, Awqaf (plural of waqf) and charitable activities have been able to create an alternative pathway to reduce poverty in Bangladesh. As the people of Bangladesh have strong desire to abide by the rules and principles set by Shariah so the demand for interest free banking in Bangladesh is increasing tremendously. As Shariah is the backbone of the Islamic banking industry, a comprehensive Islamic legal infrastructure with clear ground and commitment is necessary to help expedite Islamic financial industry to spur as it intended for ensuring human welfare.

Presently, it is seen that most of the Muslim countries have adopted common or western civil legal systems. The absence of a comprehensive legal system on the basis of Islamic Shariah for a long time resulted in the lack of legal infrastructure institutions that can support the use of Islamic commercial law during contemporary times. With the advent of Islamic finance, Islamic financial contracts are being used, but this is being done in an alien legal environment. For that reason, laws and courts are unable to interpret and enforce the form of these contracts. Successful application of Islamic law in contemporary financial transactions requires various supporting legal infrastructure institutions. To ensure the growth of the Islamic financial industry, there is a need to have dispute settlement institutions or Islamic courts that understand the form of the contracts so that these can be interpreted and enforced accordingly. While the whole court system for the practical reason is not expected to re-design as per Shariah, but a solution may be to have special Islamic bench at high court that may deal with, among others, Islamic financial transactions. A sound legislative framework is a precondition to ensure the financial stability of the Islamic banking sector and the safety and soundness of individual Islamic banks.

There is strong demand from the Islamic banking community in Bangladesh for a thorough review of the legislative framework for Islamic banking and Islamic NBFIs. A separate and completely self-contained legislative framework for Islamic banking is highly emphasized by all sorts of stakeholders because of the systemically importance the Islamic banking sector.

Islamic NBFI Sector

The Islamic NBFIs play an important role in the financial system of the country by providing financing facility to both retail and commercial clients. Since Islamic NBFIs cannot accept demand deposits, they incur higher cost of funds than banks which makes it difficult for them to compete. They try to make up for this by providing some special products usually not available from banks. The main problems confronting the Islamic NBFIs in Bangladesh are: they cannot avail Bangladesh Bank fund (SME financing, green banking etc.) due to absence of Shariah rules, they cannot invest in all sectors due to restrictions imposed by central bank, cannot issue cheques in their own name, cannot receive cash from the investment clients, cannot provide L/C commitment like Banks, cannot participant in foreign exchange trade, period of Bai-Muajjal facility (working capital and trade facility) is one year etc. to get rid of these problems central bank should provide some rules and regulations and amend the Financial Institutions Act.

3.6.3 ISLAMIC CAPITAL MARKETS IN BANGLADESH

In 2016, both the index value and the trade volume increased at the Dhaka Stock Exchange (DSE), the prime bourse in Bangladesh. The number of listed companies and issued securities also grew at a steady pace. At present, DSE has 294 companies and 560 securities listed with it81. The market capitalization of DSE stood at BDT 3,412.4 billion at end-December 2016, which is about 8.0 percent higher than that of the previous year-end balance of BDT 3,159.8 billion. Total issued capital at DSE, increased to BDT 1,145.3 billion at end-December, 2016 from BDT 1,106.1 billion of end-December, 2015, recording a rise of 3.5 percent over the period. In FY 2016, the market capitalization-to-GDP ratio declined to 15.1 percent from 17.9 percent of FY 2015. It is the lowest ratio recorded in the last financial years. This happened due to the dip in the market capitalization in the first half of 2016 while nominal GDP was higher than that of FY 2015.

During the last couple of years, growth of nominal GDP and market capitalization found to move in same direction. But the trend reversed in FY 2016. While nominal GDP growth rate was stable over the years, market capitalization growth was volatile. The overall weighted average price-earnings (P/E) ratio of the DSE was 14.3 in December 2016, which was 90 bps lower than that of the previous year. The P/E ratio has been decreasing since September 2014. The market for fixed income securities in Bangladesh still needs substantial development. It remained mostly dominated by government securities. In spite of several efforts of the regulators, bourses and market participants, a thriving market has not yet been established. Trading of bonds is important as it increases the efficiency and competitiveness of the financial system. This market also enhances the stability of the system by creating an alternative to bank finance and, of course, acts as a vehicle of transfer of information from credit market (including plausible benchmark interest rates) to policy makers and market participants. In 2016, long-term treasury bonds worth BDT 187.4 billion were issued, which was 21.6 percent higher than that of 2015. Out of the total issuance, 5, 10 and 2 years treasury bonds held 31 percent (BDT 57.7 billion), 24 percent (BDT 45.2 billion) and 21 percent (BDT 39.4 billion) share respectively.

Overall, the financial markets in Bangladesh were mostly stable in 2016 with adequate liquidity in the money market along with stable bond market as well as stock market. The low level of repo operations with BB during 2016 implies that the banking system enjoyed sufficient liquidity, which is also evident from a falling inter-bank repo rate and call money rate. As short-term interest rates came down along with decreased lending and deposit rates of banks, it is expected that long-term rates would also come down thereby facilitating potential long-term investments. In order to avoid any inflationary pressure stemming from liquidity perspective, BB remained vigilant throughout the year mopping up excess liquidity using BB bills heavily. Government borrowing from the financial system also did not create any pressure on private sector as indicated by declining sales of treasury securities. Besides, as no mandatory devolvement of treasury securities auction was made on PDs and non-PDs during the review year, the liquidity position of the financial system did not come under any unanticipated pressure. Stock market activities hinted growing investors' confidence reflected through an increase in market capitalization and DSE broad index (DSEX). However, lack of a thriving bond market continued to hurt businesses as they have to rely on costlier source of financing in the form of bank borrowing. As a whole, the Bangladesh financial markets remained well-positioned to absorb any liquidity shocks.

There is an expectation that the capital market of the country has already started to move upwards and the outlook for the next few years are quite optimistic. This will help NBFIs income both through capital gain from direct investment and provision savings from margin lending. The financially sound Islamic NBFIs with good asset quality and the ones with strong presence in the capital market through direct investment and/or capital market subsidiaries pose profitable investment opportunities for the investors in the coming years. But the regulatory framework for the Islamic NBFIs may also be in place for facilitating their activities at the desired level.

Capital Market plays a vital role in attracting savings and channeling them for productive purposes. Both primary and secondary markets are important in this regard. The issue of development of Islamic capital market is not separate from the issue of development of capital market in general. While the primary market directly effects the supply of funds for investment, the secondary market does the same indirectly. The capital market provides long-term capital through a series of short-term contracts. The subject of development of Islamic capital markets is very broad. It can include a variety of aspects such as: the state of regulatory system and possible approaches for further development; market micro-structure and practices; product range and product development; nature and preferences of market players; identification and development of support institutions; market performance evaluation; cost benefit analysis of market expansion and integration; designing of incentive and corporate governance system; evaluation of the nature and role of Islamic capital markets in the overall Islamic financial system; and many other dimensions. Priority must be given to the creation of an enabling financial infrastructure consisting of common international standards for development, supervision and regulation of Islamic capital market that may facilitate not only continuous development of a sound, resilient and stable Islamic capital market industry, but also one that promotes innovation and growth.

Islamic Capital Market sector has high potential in Bangladesh. But this potential needs proper nourishment from both the organizations and regulatory body. The government should take some major steps for the betterment of this sector. The government itself can establish an Islamic Capital Market organization to improve the faith of people in this sector. This will also encourage people to get more aware of the products and scopes of Islamic Capital Market sector. This will drastically improve the condition of Islamic Capital Market sector in Bangladesh. More regulatory framework should also be developed, by the government, in favor of this sector.

3.6.4 TAKAFUL (ISLAMIC INSURANCE) IN BANGLADESH

The factors preventing the development of Islamic insurance and its financial instruments diversification are investment system, financial instruments' interest, gambling, absence of Islamic insurance rules and regulations and ambiguity in Insurance Act. This is a big obstacle to promote the Islamic insurance industry in the country. However, the growth and development of the Islamic Insurance sector is being held back by several factors. The prominent factors are: a) Inadequate regulation: There's no separate regulatory body for overseeing Islamic Insurance sector. An increased number of government policies and government intervention in this sector can be proved as very beneficial for its growth and development. b) Lack of awareness: The target group is unaware concerning this sector. Many believe that Islamic Insurance is not compliant with Islamic Shariah and thus reluctant to subscribe. c) Lack of industry knowledge: There is also a lack of training and knowledge regarding this sector in our economy. Training must be provided to the new entrants of this sector so that they can get well identified with their future duties and responsibilities for performing their job. d) No integration of financial technology in the sector: A very small amount of technologies are being introduced by the practitioners of the Islamic Insurance. The table below shows the Islamic insurance companies present in Bangladesh.

Table 55: Evolvement of Islamic Insurance in Bangladesh Since 1999

	Name of Islamic insurance company	Year of establishment	Branch
1	Islami Insurance Bangladesh Limited	25 October 1999	38
2	Takaful Islami Insurance Limited	21 December 1999	32
3	Islami Commercial Insurance Company Limited	01 January 2000	28
	Islamic Life Insurance Companies		
1	Padma Islami Life Insurance limited	26 April 2000	8
2	Fareast Islamic Life Insurance Company limited	29 May 2000	1012
3	Prime Islami Life Insurance limited	22 April 2002	83
4	Alpha Islami life Insurance limited After	July 2013 –	
5	Trust Islami Life Insurance Company limited	After July 2013 –	
6	Protective Islami Life Insurance Company Ltd		
7	Zenith Islami Life Insurance Company Ltd.		
8	Mercantile Islami Life Insurance Company Ltd.		

Source: Annual Reports of Islamic Insurance Companies and their websites.

Islamic Insurance Segment

Insurance sector in Bangladesh emerged after independence of the country with 2 nationalized insurance companies- one life and one general; and one foreign insurance company. Under the denationalization move in mid 80s, private sector insurance companies started to enter in the industry and it got expanded. Presently, the insurance sector of the country is composed of 62 companies which are operating under 'Insurance Act 2010'. Out of them 18 are life insurance companies including one foreign company and one is state-owned company, and 44 general insurance companies including one state-owned company.

With an eye to boosting the insurance sector of Bangladesh, the initiatives so far taken by the Government since the independence, has not been able to drive any radical change, other than a few steps successfully enacted in 2010. Insurance Development and Regulatory Authority (IDRA) is the regulatory body to control, guide and supervise the insurance industry in Bangladesh. The government passed two insurance Acts on 03 March 2010 in a bid to further strengthen the regulatory framework and make the industry operationally vibrant. The new Acts, came into effect on 18 March 2010, are Insurance Act 2010 and the Insurance Development and Regulatory Authority (IDRA) Act 2010. Bank and Financial Institution Division of the Ministry of Finance has recently drafted the National Insurance Regulation, 2014. It is expected that the recommendations of the said regulation may improve the insurance market of Bangladesh as it has defined strategic long term and short term goals of the insurance sector.

Islamic Insurance Industry in Bangladesh

After the successful launching of Islamic Banking system in Bangladesh in 1983, Islamic insurance tends to be felt important to introduce. In Bangladesh Islamic insurance (Takaful) companies started functioning in the year 1999. At present 3 full-fledged Islamic Non-life insurance companies, 8 full-fledged Islamic life insurance companies and 16 conventional life insurance companies having Islamic insurance windows comprises the Islamic insurance sector in Bangladesh. Islamic insurance companies (both life and general) have established their own Shariah supervisory boards. All individual Shariah supervisory boards have formed a 'Central Shariah Council for Islamic insurance companies of Bangladesh' to co-ordinate and co-operate amongst the Shariah Councils.

There are 62 insurance companies operating in the country and as said earlier out of that 3 general and 8 life insurance companies are operating in line with Islamic Shariah. 14 Conventional Life Insurance Companies have opened their Islamic insurance windows alongside the conventional ones. Due to the uneven level playing field, Islamic insurance or Takaful companies have been facing different types of difficulties as they have to function under the conventional insurance Act and environment. The desired Takaful Act was not considered for promulgation by the government till date. As a result, Takaful operators cannot operate on an equal footing. For example, in the stock market, Islamic insurance companies are obliged to invest funds with Shariah-compliant companies, which are few, restricting investments avenues and returns. The Insurance Act 2010 provides for the appointment of Shariah consultants for the proposed Insurance Development and Regulatory Authority (IDRA) to function properly. Unfortunately, the government has not yet formed the 5-member board for devising Islamic insurance guidelines though the Act required that in March 2010. However, Insurance Act 2010 was formulated to meet demand of concurrent time for shifting the insurance industry in a better shape. Apart from that, several initiatives have been undertaken by IDRA for prohibiting the malpractices in the insurance industry regarding insurance commission, agent, premium etc. and address corporate governance issues.

In the last few decades Takaful (Islamic Insurance) has become very popular in Bangladesh as well as other Muslim countries. But the business of Takaful did not flourish up to the mark in Bangladesh. The Takaful industry was started its journey in Bangladesh in 1999. Now there are 11 full-fledged Takaful operators (3 General and 8 Life) and 14 conventional insurance companies of Bangladesh offer Takaful products through their Islamic insurance windows or projects alongside the conventional products.

Development of Islamic insurance (Takaful) in Bangladesh the basic concept of Islamic insurance (Takaful) is derived from ancient Arab tribal custom whereby if anybody was murdered by a member of a different tribe the closest relative of the killer would have to compensate with blood money. This type of financial help is a protection for the heir of the deceased against the unexpected death. Similarly, the practice of insurance was in existence since Islam’s earliest appearance.

Model used by Family Takaful Companies in Bangladesh

Presently, the takaful companies of Bangladesh follow three kinds of models. They are: Mudaraba, Wakalah and Mudarabah-Wakalah (hybrid) model. Insurance companies issue their own products. As such different companies have different kinds of products which are certified by the Actuary in consultation with the Shariah Council. It is noted that approval for product from Insurance Development and Regulatory Authority (IDRA) is mandatory for all insurance companies.

The concept of ta’awun (cooperation) originated in Sudan and Saudi Arabia. It was first established in 1979, when scholars realized that there is a need for cooperation in insurance. From this came the idea that members should donate their contribution to the fund. Both the operators and the contributors acknowledge their rights and responsibilities to the fund. The profit surplus is to be distributed entirely to the participants. Under the Mudaraba principle employed, the *takaful* company and the participants share the direct investment income, in which participants are entitled to the entire surplus with no deduction made prior to distribution. This model is applicable to life family *takaful* in Bangladesh has the fund is entirely distributed to the participants.

Problems of Takaful Companies in Bangladesh

Islamic insurance in Bangladesh has been facing numerous problems. The nature of the problems is lack of separate Takaful regulation, Shariah-based Islamic capital market for Islamic insurance etc. The present socio-economic scenario of the Bangladesh Takaful market appears to be not very conducive and supportive for its growth and development. The framework of Takaful regulations and guidelines in Bangladesh is almost absent. It takes a long time to formulate policies and guidelines. The government's bureaucracy and lack of understanding about the Takaful industry has made it extremely difficult for the operators and the regulator to prove dynamism. However, government has recently make provisions in the Insurance Act 2010 and may form committee to provide guidelines for Takaful industry. Due to present policy of the government, insurance companies are required for 30% compulsory investment in government securities and bonds. While the government securities (interest based) provide interest from 8% to 10% depending on the period, the Government Islamic Investment Bond (BGIIB) issued by the Central Bank provide profit to Islami Insurance Companies in between 2% to 3% only. Investment return of Islami insurance companies thus became too less than their competitors in the conventional insurance from compulsory investment portfolio.

There is no Islamic re-insurance (re-Takaful) company in Bangladesh. Takaful operators are forced to re-insure their money through conventional re-insurance. From the premium derived from these re-insurance companies at the end of the year, the conventional insurance companies distribute one part of this profit to the policy holders of the different companies as an original profit, while Islamic insurance companies cannot accept interest-based profit. Insurance companies in Bangladesh lack training institutions for their employees. There are eleven full-fledged Islamic insurance companies in Bangladesh. But they did not establish an apex training institute for imparting specialized training to their employees and there is no coordinated research for new product developments. General Islamic insurance companies (general Takaful companies) do not have any training institutions, although the Bangladesh Insurance Academy trains how to conduct Islamic insurance without interest but there is no opportunities for one-to-one teach training or to research the Islamic insurance system.

Prospect of Islamic Insurance in Bangladesh

Bangladesh is the third largest Muslim country in the world on count of population. It can be hoped that there are ample opportunities for Islamic insurance companies and grow in Bangladesh. Unfortunately, there is little published research on Islamic insurance in Bangladesh. If more articles and books would be published with media campaigns relating to Islamic insurance, these would generate greater awareness about Islamic insurance in Bangladesh. Bangladeshis are generally religious minded and tend to avoid things that contravene with Islam including in trade and commerce. If Islamic insurance is fair and transparent in their transactions, people might avoid conventional insurance. The Fareast Life Insurance Company is a good example of the revolution of the Islamic insurance sector in Bangladesh and is a fast growing insurance company.

Efforts should be made to change the legal framework for conducting insurance operations according to Islamic Shariah principles. Sufficient training and research institute having logistics of modern technology may be established to train up the manpower. To regain and maintain a positive public image, should practice appropriate marketing strategy and provide better service to its customers. To create people awareness, insurance companies should also arrange on regular basis seminar, symposium, road show etc. in different parts of the country.

The biggest problem is the regulatory requirement to invest 30% of the investable funds with government securities and bonds. While the government securities provide interest from 8% to 10% depending on the period, the Bangladesh Government Islami Investment Bond (BGIIB) issued by the Central Bank give Islamic insurance companies profit between 2% to 4% only. The investment returns of Islamic insurance companies are therefore 60% to 75% less than their competitors in the conventional insurance from compulsory investment portfolio. Furthermore, the funds which are invested in Sharia'h-compliant Islamic bonds are reinvested by the Central Bank to Islami banks of the country, which hold excess cash liquidity and seldom in need to buy Islami bonds. Therefore, a major portion of the fund of BGIB remains idle without investment. This is a real financial strangulation for the Islami insurance companies.

A strong Shariah framework is needed to enhance consumer confidence and which would provide Takaful operators with greater flexibility and innovativeness within the boundary of Sharia'h. Central Sharia'h Board of Islamic Insurance Companies of Bangladesh has proposed a Sharia'h framework for the Takaful industry of Bangladesh. The proposed Sharia'h framework allows operators to follow any of the prevailing operational models and combination of the models based on the Sharia'h concepts of Wakalah, Mudaraba, Jualah and so on. The rules for investment also allow Takaful operators to adhere to principles and injunctions of Islam as well as to operate on a level playing field. The nascent Takaful industry needs the special attention of the government and the regulatory body.

3.6.5 POLICY RECOMMENDATIONS

Islamic Banking Sector

The Islamic banking sector in Bangladesh has been continuously growing at a rapid pace which is reflected by the increasing branch network of Islamic Banks and the conventional banks having Islamic banking branches. Some other conventional banks had applied to convert their whole operations in line with the Islamic Shariah. These conversion applications have been proposed according to the Islamic Banking Guidelines, 1999. However, Islamic banking sector has been thriving effectively in the vibrantly growing Bangladesh economy with avid participation of the Islamic banks in the financial inclusion campaign. Islamic Banking industry in Bangladesh has contributed significantly to encourage economic growth and generate employment in the country, to fulfill the vision of the government of reaching a Middle Income Level by the year 2021. Thereby, this banking industry, with more than 23% market share has been playing a very dominant role in mobilizing deposits and financing in the real sector industries, services and other key sectors of the economy and collecting 39.95% of total foreign remittances in Bangladesh.

The principal financial instruments used by the Islamic banks are Bai-Murabaha, Bai-Muajjal, Qard-e-Hasan, Ijarah-bil-Bai and HPSM (Hire Purchase under Sirkat ul Mulk). The role of the

Islamic Banking industry, as a whole, with respect to Islamic Microfinance is commendable. Since the core objectives of Islamic banking industry are to fulfill the Maqasid-al-Shariah, this includes the aims to help expedite the financial inclusion drives with Islamic financial literacy programs, and to associate the poor and disadvantaged people of the country in small types of income generating activities so that they can get a space to live as a respectable human being. As the bulk of the investments made by Islamic banks have been concentrated in trade and rent-related sectors, they may invest more in socially desirable and sustainable real sectors especially in micro, share-cropping, non-traditional agriculture and small enterprises. Islamic banks, through profit and loss sharing mode of investments including Zakat, Awkaf (plural of Waqf) and charitable activities, have been able to create an alternative pathway to reduce poverty in Bangladesh. As generally, the people of Bangladesh have a desire to abide by the rules and principles set by Shariah, the demand for interest free banking in Bangladesh is increasing. As Shariah is the backbone of the Islamic banking industry, a comprehensive Islamic legal infrastructure with clear ground and commitment is necessary to help expedite Islamic financial industry to spur as it intended for ensuring human welfare.

Islamic banking sector, including Islamic NBFIs is an important pillar in the development of the Bangladesh financial sector. The Bangladesh Bank leadership is cognizant of the need to ensure that an appropriate enabling environment, in the form of an updated (in line with international standards) regulatory and supervisory framework, as well as effective day-to-day supervision, is in place to enable and preserve the Islamic banking sector's safety and soundness. Achieving a sound and high quality baseline legislative, regulatory and supervisory framework and effective day-to-day supervision, in line also with the minimum standards proposed by the Islamic Financial Services Board's (IFSB's) Core Principles for Islamic Finance Regulation, would provide a sound foundation. More foreign direct investment may be attracted in the form of new Islamic banks and takaful[91] entities, the development of Islamic capital markets and issuing of Sukuk.[92]

The absence of a comprehensive legal system on the basis of Shariah for a long time resulted in the lack of legal infrastructure institutions that can support the use of Islamic commercial law during contemporary times. With the advent of Islamic finance, Islamic financial contracts are being used, but this is being done in an alien legal environment. For that reason, laws and courts are unable to interpret and enforce the form of these contracts. Successful application of Islamic law in contemporary financial transactions requires various supporting legal infrastructure institutions. To ensure the growth of the Islamic financial industry, there is a need to have dispute settlement institutions or Islamic courts that understand the form of the contracts so that these can be interpreted and enforced accordingly. While the whole court system for the practical reason is not expected to re-design as per Sharia'h, but a solution may be to have special Islamic bench at high court that may deal with, among others, Islamic financial transactions. A sound legislative framework is a precondition to ensure the financial stability of the Islamic banking sector and the safety and soundness of individual Islamic banks.

[91]As per Islamic Financial Services Board (IFSB) definition of takaful: A contract whereby a group of participants (Mushtarikīn) agree among themselves to support one another by contributing a sum of money into a common fund, which will be used for mutual assistance of the members against specified loss or damage.

[92] IFSB definition of sukuk: Certificates that represent a proportional undivided ownership right in tangible assets, or a pool of assets that is Sharia'h-compliant.

There is strong demand from the Islamic banking community in Bangladesh for a thorough review of the legislative framework for Islamic banking and Islamic NBFIs. A separate and completely self-contained legislative framework for Islamic banking is highly emphasized by all sorts of stakeholders because of the systemically importance the Islamic banking sector.

Islamic NBFI Sector

The Islamic NBFIs play an important role in the financial system of the country by providing financing facility to both retail and commercial clients. Since Islamic NBFIs cannot accept demand deposits, they incur higher cost of funds than banks which makes it difficult for them to compete. They try to make up for this by providing some special products usually not available from banks. The main problems confronting the Islamic NBFIs in Bangladesh are: they can not avail Bangladesh Bank fund (SME financing, green banking etc.) due to absence of Sharih rules, they cannot invest in all sectors due to restrictions imposed by central bank, cannot issue cheques in their own name, cannot receive cash from the investment clients, cannot participate in foreign exchange trade, period of Bai-Muajjal facility (working capital and trade facility) is only one year etc. To get rid of these problems, the Central Bank should provide some rules and regulations and amend the Financial Institutions Act.

Islamic Capital Market Sector

There is an expectation that the capital market of the country has already started to move upword and the outlook for the next few years are quite optimistic. This will help NBFIs income both through capital gain from direct investment and provision savings from margin lending. The financially sound Islamic NBFIs with good asset quality and the ones with strong presence in the capital market through direct investment and/or capital market subsidiaries pose profitable investment opportunities for the investors in the coming years. But the regulatory framework for the Islamic NBFIs may also be in place for facilitating their activities at the desired level.

Capital Market plays a vital role in attracting savings and channeling them for productive purposes. Both primary and secondary markets are important in this regard. The issue of development of Islamic capital market is not separate from the issue of development of capital market in general. While the primary market directly effects the supply of funds for investment, the secondary market does the same indirectly. The capital market provides long-term capital through a series of short-term contracts. The subject of development of Islamic capital markets is very broad. It can include a variety of aspects such as: the state of regulatory system and possible approaches for further development; market micro-structure and practices; product range and product development; nature and preferences of market players; identification and development of support institutions; market performance evaluation; cost benefit analysis of market expansion and integration; designing of incentive and corporate governance system; evaluation of the nature and role of Islamic capital markets in the overall Islamic financial system; and many other dimensions. Priority must be given to the creation of an enabling financial infrastructure consisting of common international standards for development, supervision and regulation of Islamic capital market that may facilitate not only continuous development of a sound, resilient and stable Islamic capital market industry, but also one that promotes innovation and growth.

The main obstacles preventing innovation of new products for developing a vibrant Islamic capital market in Bangladesh is the lack of initiatives from the concerned authorities and absence of guidelines based on Shariah based investment. There is no specific or customized Islamic Shariah based products in Bangladesh Capital Market. To uphold the integrity of the market and meet the demand of an increasingly sophisticated investor class, there is a need to strengthen the policy and market practices of Islamic capital markets. Development would need to balance the needs of both parties, where, in Sukuk cases, issuers are seeking more options and flexibility to raise funds whereas investors are demanding more protection on their investments. The growth of Islamic capital markets is a direct effect of the growth of the Islamic banking industry. The need for liquidity management for Islamic banks and takaful operators drove a number of countries such as Malaysia, Kuwait and Bahrain to introduce Sukuk to facilitate management of assets by Islamic financial institutions. Growth is also attributed to growing awareness of, and demand for, investing in accordance with Shariah principles.

The key components of the Islamic finance value chain have been firmly set in place, the industry is still facing various challenges at both regional and global levels given its nascent level of development. Many jurisdictions that operate Islamic finance sectors and offer Shariah-compliant financial solutions are yet to develop holistic regulatory frameworks and legislation that enable smooth functioning of the Islamic financial system. There is a critical need for regulatory support to drive the growth of Islamic finance. Pressing matters include the need for: (1) an appropriate supervisory environment that caters to the unique features of Islamic financial products; (2) a wider understanding of Shariah practices, and of the differences between the Islamic financial system and the conventional system; (3) the adoption of accounting and auditing standards that recognize the unique features of Islamic finance transactions; (4) the introduction of Shariah-compliant financial instruments to manage the excess liquidity of Islamic banks; (5) standardization of products and other-related documents; (6) the drafting of clear rules and practices for dispute settlement in transactions; and (7) the development of human resources that are well-versed in both Shariah matters and the dynamics of the financial industry.

Islamic Capital Market has high potential in Bangladesh. But this potential needs proper nourishment from both the organizations and regulatory body. The government should take some major steps for the betterment of this sector. The government itself can establish an Islamic Capital Market organization to improve the faith of people in this sector. This will also encourage people to get more aware of the products and scopes of Islamic Capital Market sector. This will drastically improve the condition of Islamic Capital Market sector in Bangladesh. More regulatory framework should also be developed, by the government, in favor of this sector.

Takaful

The factors preventing the development of Takaful and its financial instruments' diversification are investment system, financial instruments' interest, gambling, absence of Islamic insurance rules and regulations and ambiguity in the Insurance Act. This is a big obstacle in promoting the Islamic insurance industry in the country. However, the growth and development of the Islamic Insurance sector is being held back by several factors. The prominent factors are:

a) Inadequate regulation: There's no separate regulatory body for overseeing Islamic Insurance sector. An increased number of government policies and government intervention in this sector can be proved as very beneficial for its growth and development.

b) Lack of awareness: The target group is unaware concerning this sector. Many believe that Islamic Insurance is not compliant with Islamic Shariah and thus reluctant to subscribe.

c) Lack of industry knowledge: There is also a lack of training and knowledge regarding this sector in our economy. Training must be provided to the new entrants of this sector so that they can identify their future duties and responsibilities for performing their job.

d) No integration of financial technology in the sector: A very small amount of technologies are being introduced by the practitioners of the Islamic Insurance.

In 1999, Bangladesh Islamic insurance companies were licensed under the Insurance Act 1938 which was not equipped to deal with Islamic insurance. This is because Islamic insurance is based on Shariah rules and regulations, while conventional insurance is based on conventional regulations. Although a committee was formed by the government of Bangladesh to draft separate insurance laws for Islamic and conventional insurance in 2007, the outcome of the effort has yet to materialize. Two insurance laws were passed in the parliament of Bangladesh on March 3, 2010 which came into effect as an Insurance Act on March 18, 2010 and IDRA Act 2010. However, the act only mentioned rules for investment assets of Islamic insurance. The lack of a legal and regulatory framework has stifled the Islamic insurance industry.

The biggest problem for the Takaful companies at present is that they have to invest 30% of the investable funds with government securities and bonds. While the government securities provide interest from 8% to 10% depending on their maturity period, the Bangladesh Government Islamic Investment Bond (BGIIB) issued by the Central Bank in 2004 give Islami insurance companies profit between 2% to 4% only. Another obstacle of Islamic insurance is lack of Islamic capital market. Islamic insurance companies do not have any alternative for investment as without Islamic banks all bonds and certificates are based on interest. Islamic insurance companies cannot participate in this kind of investment or capital market. As a result, Islamic insurance companies lag behind conventional insurance. To attain the desired level by both the Islamic Bank and the Islamic Insurance, a strong relationship needs to be built up between the Islamic Banks and the Islamic Insurance companies functioning in Bangladesh. Regarding developing new financial products and services in Islamic insurance, Islamic financial bond, investment in Islamic scheduled bank, share investment and pre-placement in national and global Islamic financial institutions or banks may be allowed to the Takaful companies.

Takaful companies should also diversify their Shariah based products, should introduce new products to satisfy customers' needs. But there is only one qualified actuary dealing with the Shariah based new product and their valuations for both life and non-life Islamic Takaful companies. Takaful companies have been facing extreme difficulties in getting certification from the actuary for new products, and thus have not introduced any new products in the last years.

To summarize the overall recommendations for Islamic finance in Bangladesh:

It is recommended that the Bangladesh regulatory authorities like BB, BSEC, IDRA, MRA etc., should ensure that there are sound enabling environments for the development and operation of Islamic money capital and takaful markets.

It is recommended that the Islamic banking legislative framework be bolstered by way of enacting regulation like Islamic Banking Act, insurance sector with the Takaful Act rather than just some provisions and guidelines.

It is recommended that initiatives should be taken by the appropriate authorities to undertake the necessary comprehensive and detailed review of the Banking Companies Act, 1991, Financial Institutions Act 2003, Insurance Act 1938 and 2000 to update them, and also ensure that they provide a sound foundation for Islamic banking, Islamic NBFIs, Takaful companies and for Shariah compliance.

It is recommended that Bangladesh Bank's Guidelines on Islamic Banking, Guidelines on Risk-based Capital Adequacy (2014), and Guidelines on Internal Control & Compliance in Banks (2016) contain the updated regulatory minimum capital adequacy requirements aligned to Basel III, Risk Factors relating to Islamic modes of Investment, application of Shariah audit, and that they list AAOIFI guidelines and the IFSB manual as policy documents to which banks must adhere. Those standards and legal instruments of IFSB and AAOIFI must be made compulsory to follow by the Islamic banks and Islamic NBFIs.

It is recommended that a National Shariah Supervisory Board be established at the central bank to formulate necessary policies to guide and supervise the central bank authorities. Alongside, Securities & Exchange Commission should also acquire necessary expertise to frame policies to facilitate Islamic capital market with products and instruments and regulate financial institutions engaged in capital market activities.

It is recommended that the Insurance Authority of Bangladesh (IDRA) should give its utmost attention to devise appropriate rules and regulations for the Islamic takaful industry (both for life and general takaful companies). They should clearly prescribe the Takaful models to be followed by the Takaful companies. To follow up the activities of the Takaful companies, IDRA must establish its own Takaful Department to monitor and supervise the activities of the takaful companies. IDRA may also advise the Takaful operators to establish their apex training and research academy to create necessary expertise for this sector.

It is recommended that to uphold the integrity of the financial market and meet the demand of an increasingly sophisticated investor class, there is a need to strengthen the policy and market practices of Islamic capital markets. The need for liquidity management for Islamic banks and Takaful operators drove a number of countries such as Malaysia, Kuwait and Bahrain to introduce Sukuk to facilitate management of assets by Islamic financial institutions.

Finally, we recommend that the government, along with the regulators of the financial sector of Bangladesh, should undertake a comprehensive program to strengthen the overall legislative, regulatory and supervisory framework. This is to ensure sound and stable Islamic banking sector, Islamic NBFIs sector, Islamic Capital market and Islamic Takaful sector in the country to achieve the goal of the country reaching income status in the year 2021. The

Bangladesh Government may seek technical assistance from IDB for initiating an extensive ***Islamic Financial Sector Reform Program (i-FSRP)*** to re-structure and re-design the Islamic financial architecture for smooth development of regulatory frameworks like Islamic Banking Act, Islamic Insurance Act, Islamic capital market instruments and products in line with international standards issued by AAOIFI and IFSB, application of sound project governance, risk management framework and internal controls to ensure sound foundation for Islamic banking, Takaful and capital market and Shariah compliance. I-FSRP may also take necessary initiatives to improve the regulators' capacity to respond to policy and regulatory issues pertaining to Islamic banking, Takaful, capital market and Shariah compliance, to ensure a sound enabling environment for the development and operation of Islamic NBFIs and Takaful sector and to ensure a sound enabling environment for the development and operation of Islamic inter-bank money market and capital market for the development and operation of Sukuk instruments.

3.7 CASE STUDY: OMAN

3.7.1 INTRODUCTION

Oman had a population of 4.0 million (2016) and a GDP of USD 66.2 billion[93] presents an interesting case study of an OIC member country with a fairly recent introduction to Islamic finance.

Oman's welcome adoption of Islamic banking and finance has created a valuable opportunity to reap desired economic benefits of risk sharing financing; potentially setting trends by resorting to innovative approaches to implement and promote the authentic Islamic finance. Although the Sultanate is GCC's last mover in the discipline, it thus far appears to have worked the last mover status into a last mover advantage. It is apparent that Islamic finance is ascending to greater prominence in the Omani financial system. This can be supported by the noticeable measures the country took to implement Islamic finance. The following gives a list of some robust institutional measures.

- Among the most prominent is Oman's Islamic Banking Regulatory Framework (IBRF) (IFN, 2015), a detailed and comprehensive document covering all aspects of Islamic banking. The framework has been well received in the international fora and is considered among the most stringent to govern Shariah compliant financing.

- The launch of the maiden Shariah index, to be known as the Muscat Security Markets Shariah Index. The index currently comprises of 31 listings with a market capitalization of around $30bn v/s a $72bn GDP (Shaukat, 2015).

- The Sultanate's adoption of AAOIFI, Accounting and Auditing Organization for Islamic Financial Institutions, accounting standards.

- In the area of governance and supervision, Oman's formalization of a Centralised Shariah Board as well as the mandatory practice of external Shariah audit

- The Sultanate issuance of its maiden Sovereign Sukuk and the Capital Market Authority's latest issuance of a separate legal and regulatory framework for the same; supporting further the plans of a second Sovereign Sukuk.

- Moreover, the Central Bank's College of Banking and Financial Studies, development of a dedicated unit for Islamic finance training, education, research, consultancy and capacity building as well as the initiative by Central Bank to soon institute a proper scheme of Islamic Deposit Insurance(Takaful).

It is on the basis of these solid measures that have led the latest Islamic Financial Development Index report (2015/16) to rank Oman as number 4 among the top performers, behind Malaysia, Bahrain and UAE[94]. Consequently, it becomes pertinent to express in details all given

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[93] Focus Economics indications, retrieved July 2017. See http://www.focus-economics.com/countries/oman

[94] See Shaukat, M and Hamdan Al-Raisi, A (2017). *"Risk Sharing Equity-Based Islamic Finance, Macroeconomic Resilience and Significance to Oman as a New Entrant".* The Journal of Finance, Accounting and Management, USA, Jan, 2017. Also see Shaukat, M (2017a).

measure that is helping an extremely young Islamic financial market of Oman, to enjoy a healthy global status in Islamic finance development. This could be achieved by breaking down the progress of each sub sector of the Islamic financial setup in the Sultanate and highlight the developments. Currently, the main sub sectors are, the Islamic banking sector, Capital Markets vis-à-vis Sukuk and the Takaful industry in Oman. The following section two starts by discussing the Islamic banking progress in Oman. Section three will highlight Oman's initiatives with regards to Islamic capital market instruments in from of Sukuk and regulation for the same. Section four dwells on Takaful industry in Oman followed by section five which gives cohesive coverage to the operational, policy and country constraints that need to be addressed for diversifying the product range, reach and appeal of Islamic finance. Section six provides policy recommendations.

3.7.2 ISLAMIC BANKING IN OMAN

The Royal decree number 69/2012 paved the way for dual banking system in Oman by amending the Banking Law No. 114/2000. This allowed for both conventional and Shariah compliant products. Currently, there are two full fledge Islamic banks and six windows operating in the Sultanate.

Table 56: Islamic Banking Institutions in Oman

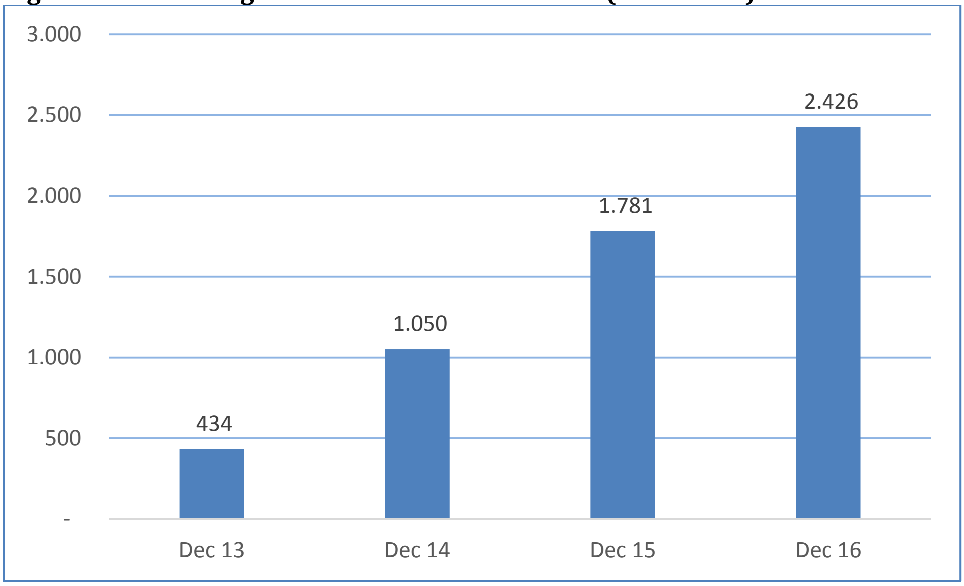
Name of institution	Islamic Brand	Market Share (Deposits)
Bank Nizwa	Full – fledge Islamic Bank	16%
Alizz Bank	Full – fledge Islamic Bank	11%
Bank Muscat	Meethaq	33%
Oman Arab Bank	Al Yusr	3%
Bank Dhofar	Maisarah	12%
Bank Sohar	Sohar Islamic	4%
National Bank of Oman	Muzn	7%
Ahli Bank	Al Hilal	14%

According to Shaukat and Hamdan (2017), recent estimates predict the Islamic banking sector to take a 10-12 percent share of the market over the next three years. Already the markets has touched 10.2% share[95].

Islamic Banking is experiencing steady growth both on the asset /financing side and the deposits side. The figures below highlight the growth trend.

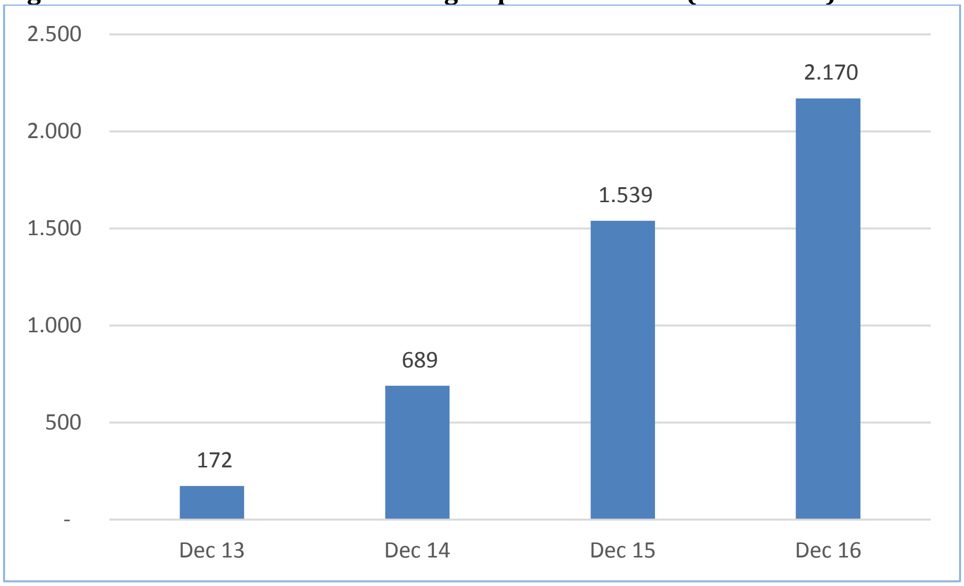
[95] See also the latest speech of the Executive President of Central Bank of Oman on Islamic Banking in Oman, delivered at the 4th AAOIFI Annual Meeting of Board of Ethics and Governance, 2017, Muscat, Oman.

Figure 15: Financing Receivables Growth for IBIs (RO Million)



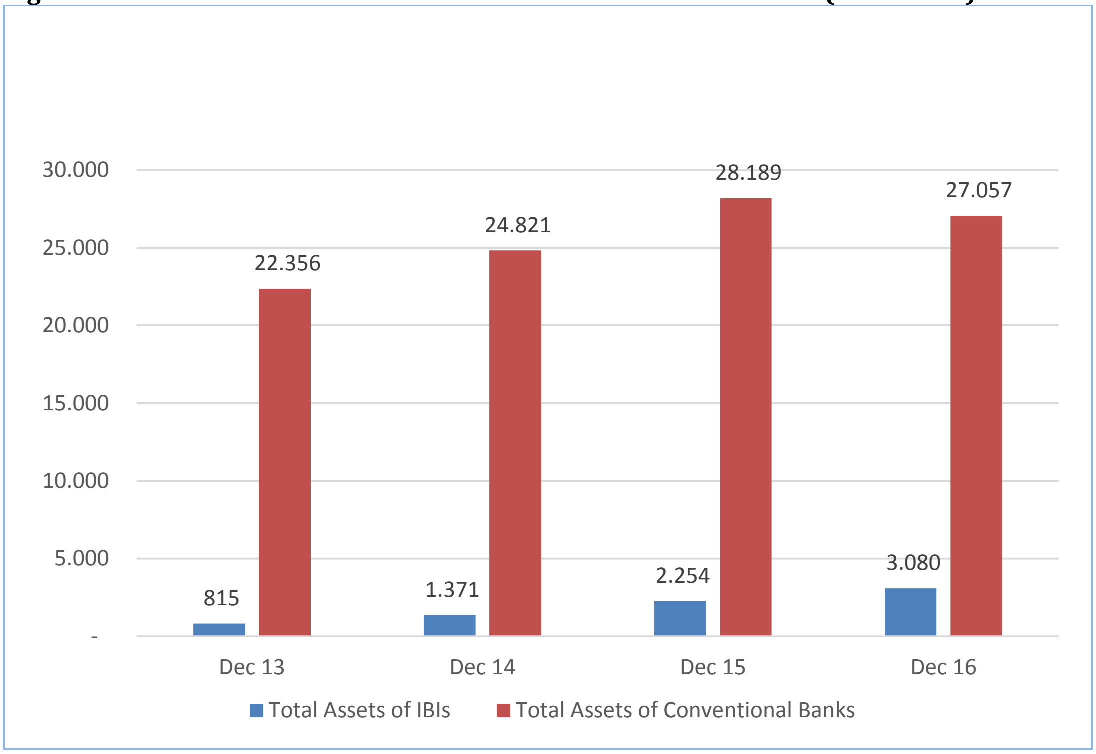
Source: Created by Author

Figure 16: Growth in Islamic Banking Deposits in Oman (RO Million)



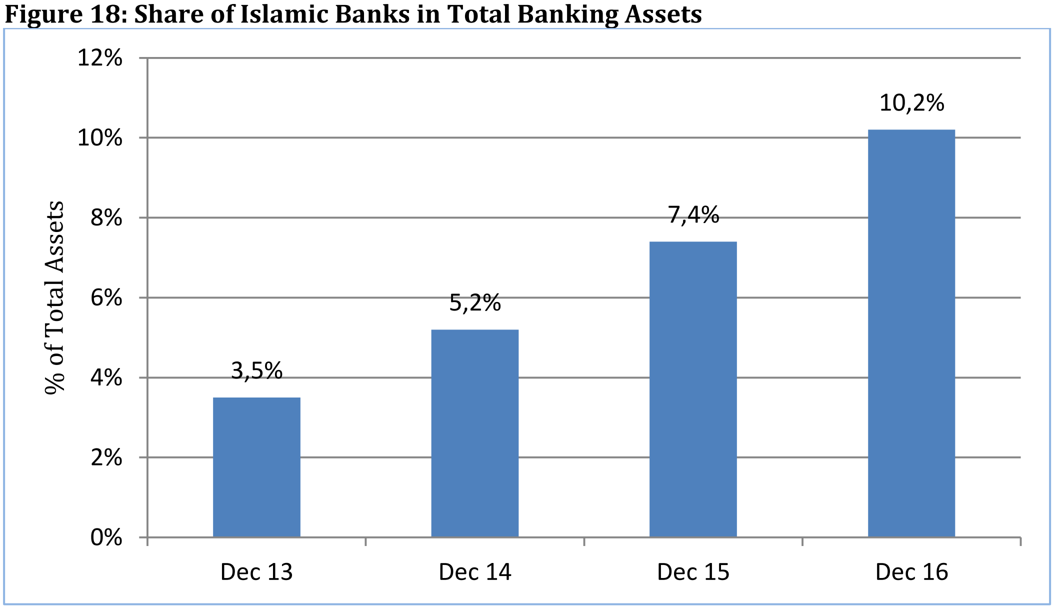
Source: Created by Author via the Central Bank of Oman: Monthly Statistical Bulletin, March 2017

Figure 17: Total Assets of Conventional and Islamic Banks in Oman (RO million)



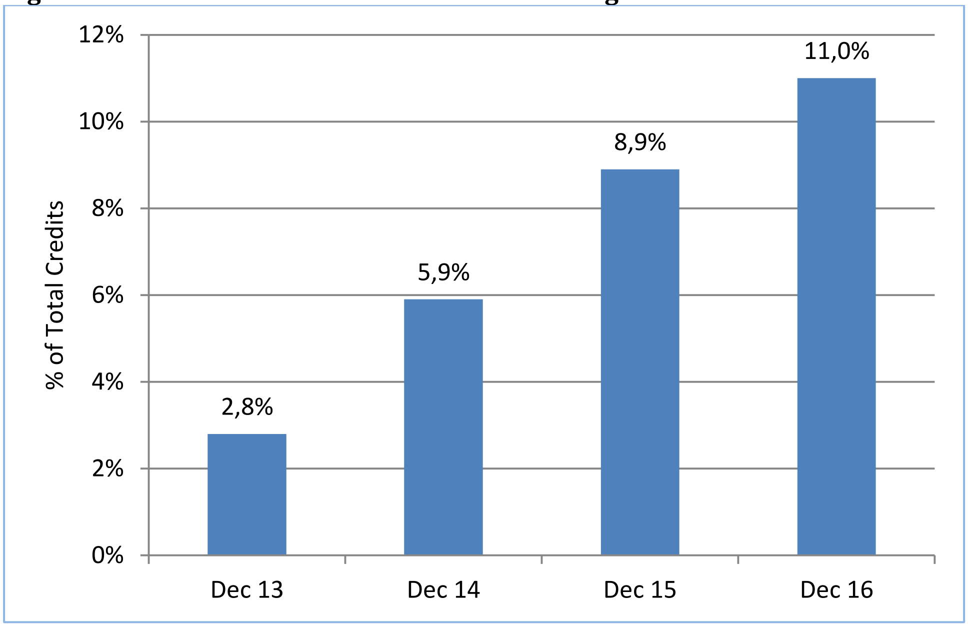
Source: Created by Author via the Central Bank of Oman: Monthly Statistical Bulletin – March, 2017

Figure 18: Share of Islamic Banks in Total Banking Assets



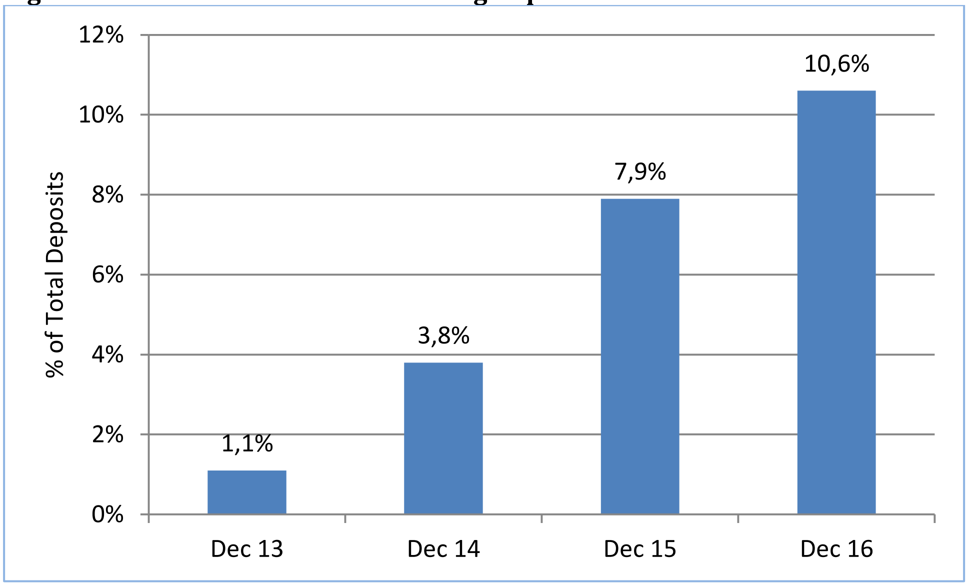
Source: Created by Author

Figure 19: Share of Islamic Banks in Total Banking Credits in Oman



Source: Created by Author

Figure 20: Share of IBs in Total Banking Deposits



Source: Created by Author

The projection is based on Oman's solid operating and regulatory environment, which is expected to increase general credit demand and the appeal of Islamic banking. The Islamic Banking Regulatory Framework (IBRF) is a detailed and comprehensive document covering all aspects of Islamic banking. The framework has been well received in the international fora and is considered among the most stringent to govern Shariah compliant financing. Following are the major highlights of the IBRF.

Table 57: Regulatory Requirements for Islamic Banks in Oman

Pre- Requirements	Brief Description
Minimum Capital Requirements	• For Islamic banking windows: RO 10 million • For full fledge Islamic banks: RO 100 million
Sharia Governance Structure	Islamic Banking Regulatory Framework has introduced a comprehensive Shariah Governance structure equally applicable to full-fledged banks as well as windows. The elements of Shariah Governance are: 1. Shariah Supervisory Board (minimum of 03 members with strict eligibility criteria) 2. Internal Shariah Reviewer 3. Shariah Audit Unit 4. Shariah Compliance Unit Moreover, the scholars are not allowed to serve in two competing Islamic financial institutions within the country, and they can work in a maximum of four non-competing institutions. They are also required to attend a minimum of 75 percent of board meetings or risk being disqualified; Shariah boards must meet at least four times a year, and must disclose the number of meetings in the bank's annual report. Shariah scholars will face performance assessments, both collectively and individually. CBO believes that these provisions will to go a long way in addressing complaints of potential conflict of interest and lax standards on Shariah boards. Nevertheless, to further strengthen Shariah governance Oman has also formalized a Centralised Shariah Board[96].
Restriction on Tawarruq	As a general rule, Commodity Murabaha Transactions (CMT) or Tawarruq is not allowed.
External Shariah Review	Besides annual financial audit, IBEs are bound to hire services of external auditors to perform Shariah review. This is in addition to routine internal Shariah audits and compliance reviews by the Shariah Audit and Compliance Units of IBEs.
Independent business Function	Islamic banking windows are required to hire dedicated staff for business functions. Moreover, windows are not allowed to offer Islamic banking products and services through conventional banking branches.
Separate core banking systems	The Central Bank of Oman encourages a separate core banking system for Islamic banking windows that is capable of handling Shariah compliant financing and investment activities. It is also to ensure non-commingling of funds between conventional bank and Islamic banking window.
Accounting Standards	The financial statement of IBEs shall be prepared under the guidance of Financial Accounting Standards issued by the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI)

Source: Created by Author

[96] See CBO Regulation No. BM/54/12/2013 regarding the establishment of the Supreme Shariah Audit Authority within the CBO.

The Sultanate's ban on tawarruq[97] did raise industry concerns skewed towards dampening options for placing liquid funds. As a result, banks continue to push the central bank to permit tawarruq, at least temporarily while the new industry found its feet. Central Bank of Oman, CBO, believes that lack of Shariah compliant products to place excess liquidity funds is a constraint and prohibiting the use of tawarruq may further reduce the options. However, it is believed that such a prohibition, instead of hampering innovation, may give rise to it which is indeed healthy for the growth of the industry. CBO is planning to create a task force, mandated to conduct exhaustive research and device ways and means in order to design financial instruments which can serve the purpose of managing liquidity in compliance with Shariah. Moreover, the Central Bank as well as the Capital market Authority, CMA is also working with IILM and other similar institutions for further support in order to address liquidity issues in the industry. Nevertheless, the ban remains inflexible and offers exemption only in emergency situations on a one-off basis for a period of no more than three months (Shaukat, 2014). Currently, interbank transactions which are allowed include Mudarabah, Musharakah and Wakala placements, all common Islamic finance structures.

This brings to discussion the array of overall Islamic Banking products in practice in Oman.

Product Offerings by the Oman's Islamic Banking Institutions

At present, IBEs are offering all basic products and services to its target customer base. On the financing side, Islamic contracts of Murabaha, Ijarah and Diminishing Musharaka are mostly used to structure the products. Islamic contracts of Mudaraba and Wakala are commonly used to structure deposit products. It is noteworthy that IBEs achieved a commendable growth in pocketing Unrestricted Investment Accounts (URIA) from its investment account holders. An Unrestricted Investment Account can be defined as:

"Unrestricted Investment Accounts are those types of accounts in which investment account holders (fund providers) did not attach any conditions as when, where and how their funds can be utilized. Unrestricted Investment Accounts are discretionary funds at the disposal of IBEs for investment in Shariah compliant financing and investment avenues in the light of Shariah guidelines. Normally Islamic contracts of Mudarabah and Wakala are used to accept URIA deposits."

In terms of percentage of total banking system deposits, URIA deposits were 1.1% and 7.3% in December 2013 and September 2015 respectively.

Akin to other GCC centers, Oman as the latest mover in Islamic finance in its given economic, demographic and specific economic set up, which is tending to open to the world, suffice the selection of the above mix of Islamic banking products. This has relevance to following the globally pervasive retail banking focused Islamic banking model.

[97] Original Tawarruq is where one party buys an asset from a vendor with payment deferred, and sells it to a third party for cash. Organised tawarruq, where transactions occur in exchange for a financial obligation, has been criticised by some Islamic scholars because of its weak link to real economic activity; rendering organised tawarruq as a "deception", hurting its acceptability in the industry (OIC Fiqh Academy, 2009).

Islamic Banking Products Snapshot

Here is a summary of the products that are used by Oman's Islamic Banking Financial Institutions to fulfill the customer requirements:

Table 58. Islamic Banking Products Snapshot of Oman

Liability Side Products	
Customer Requirements	Islamic Banking Product /Solution
Saving requirements with Profits	Mudarba based Savings Account
Transactional Banking requirements for Individuals	Qard based Current Account
Transactional Banking Requirements for Businesses	Qard based Business Current Account
Investment and Liquidity Management needs	Wakala Investments
Long Term Investment needs for Individuals	Wakala Investments
Corporate Finance Products	
Short Term Working Capital Financing	Murabaha Working Capital
	Service Ijarah (Under Development)
Bill Discounting	Murabaha Working Capital
	Service Ijarah (Under Development)
Long Term Financing for Property Plant & Equipment	Diminishing Musharakah
	Ijarah
Construction Finance	Forward Diminishing Musharakah
	Forward Ijarah
Off Balance Sheet Long Term Financing	Ijarah
	Forward Ijarah
Takeover from Conventional Banking	Ijarah Sale and Lease Back
Import Sight LC Non-Funded	Islamic Ujrah based LC
Import Usance LC Non-Funded	Islamic Ujrah based LC
Import Sight LC Funded	SLC Murabaha
Import Usance LC Funded	ULC Murabaha
Import Contract Funded	Contract Murabaha
Import LC long term Financing	Ijarah
	Forward Ijarah
	Diminishing Musharakah
	Forward Diminishing Musharakah
Retail Finance Products	
Car Financing	Auto Murabaha
Home Finance – Ready Purchase	Diminishing Musharakah
	Ijarah
Home Finance – Takeover	Ijarah Sale and Lease Back
Home Finance Construction	Forward Ijarah
	Forward Diminishing Musharakah
Islamic Personal Financing – Consumer Goods	Goods Murabaha
Credit Cards	Ujrah based

Source: Created by Author

3.7.3 ISLAMIC CAPITAL MARKETS IN OMAN

Although the Islamic banking in Oman is gaining ground, but in order for the system to grow further and sustain the same, complimentary support is necessary via other sub sectors. In the current Omani setup, this includes mainly the support for the capital markets and the insurance (takaful) sectors. Whereas Oman has formally entered the takaful industry, as will be discussed later, instituting an Islamic Capital Market, remains farfetched. However, few important developments provide some encouragement to witness an Islamic Capital Market in Oman. To this end, at an early stage, in 2013, Oman launched its maiden Shariah index, to be known as the Muscat Security Markets Shariah Index. The index currently comprises of 31 listings with a market capitalization of around \$30bn v/s a \$72bn GDP (Shaukat, 2015).

The Capital Market Authority- CMA is the regulatory authority regulating the secondary and stock market in Oman called the Muscat Securities Market. Royal Decree 59/2014 amended the then prevalent Capital market laws Oman's Capital Market Law (Royal Decree 59/2014) to pave way for Islamic modes. It is the first law to formally recognize Sukuk as tradable securities in Oman and granted the CMA authority to determine requirements for Sukuk issuance and provide incentives for Sukuk issuances. In April 2016 the CMA sought to further strengthen its Sukuk framework through an amendment stipulating the creation of a trustee structure and a limited liability company as a special purpose vehicle for issuing Sukuk. The new rules left the question of obtaining a rating optional for the issuer, and did not limit the Sukuk amount to a percentage of the issuer's capital, as some had anticipated. The purpose of the revised regulation is to bring greater transparency to Sukuk issuances, thereby safeguarding the interests of all concerned parties. This not only spurred the ambitions of corporate Sukuk issuances in the country but also helped the Sultanate to issue its maiden RO 250 million Sovereign Ijarah Sukuk, 2015 and is supporting further the plans of a second Sovereign Sukuk. The maiden Sukuk were nearly twice oversubscribed. As of now Sukuk rightly remains the main product for an infant and overall closed market like Oman[98].

3.7.4 TAKAFUL (ISLAMIC INSURANCE) IN OMAN

While the CMA is the main body mandated to regulate Islamic Capital Market initiatives and Sukuk, the same also has extensive powers to license, control and oversee Takaful operators. Oman's Takaful Insurance Law was approved on March 6, 2016 via Royal Decree 11/2016. The new law regulates all aspects of a Takaful operator's activities including oversight and reporting requirements, product standards and liquidity levels. It requires Takaful insurers to be publicly listed on the Muscat Securities Market (MSM) with a minimum capital of OMR10 million. The law is based on the AAOIFI guidelines and provides a robust and comprehensive framework covering all aspects of the Shariah-compliant insurance sector. According to the Capital Market Authority (CMA), Takaful insurance premiums in Oman totalled OMR39 million (US\$101 million), representing a market share of 8.7% of the insurance sector as a whole in 2015[99].

The Takaful law further mandates the CMA to supervise the conduct of Takaful insurance business and prevents conventional underwriters from setting up Islamic insurance windows

[98] For more detail, see Shaukat, M (2017a, b) and Shaukat, M (2017c), *"Islamic Finance, FinTech and opportunity for Oman".* Forth coming, College of Banking and Financial Studies, Muscat, Oman.
[99] For more detail, see, Insurance Market Review, 2015, Capital Market Authority-CMA, Oman.

(in contrast with the Islamic banking sector where the regulations allow non-Islamic banks to own and operate Islamic 'windows'). These combined capital-centered and market regulatory provisions aim to create a level playing field for Oman's fledgling takaful industry which, like in other GCC markets, faces the challenge of an established and fiercely-competitive conventional insurance industry.

The CMA has power to suspend issuance of new licenses at any time if it is of the opinion that the market is saturated and may, at any time, withdraw a license for breach of a condition. The regulator could to intervene in the management of a takaful insurer in certain circumstances, by conducting administrative investigations, requiring the company actuary or another actuary to report on the financial standing of the company, appointing a non-voting auditor to the board or dissolving the board and appointing a committee to run the company until a new board is constituted. Moreover, Shariah committee with a minimum of three members including Fiqh specialists in financial transactions and a takaful expert is obligatory by statue. Other provisions govern the maintenance of solvency margins, fund set-up and management and the transfer of takaful business from one company to another.

This latest regulatory development in the sector is expected to raise awareness and fuel consumer appetite for takaful insurance as well as other faith-based products and services. Industry analysts predict significant growth potential for takaful insurance in Oman due to the low current rate of insurance penetration (1.1%). The global takaful market led by Saudi Arabia and GCC (63%) and Malaysia and Indonesia (30%) has maintained double-digit growth since 2011 and is forecast to be worth $20bn by 2017 (ICD, 2016).

Table 59. Products Offered by Takaful Companies in Oman

Products Offered by Takaful Oman	Products Offered by al-Madina Takaful
1. Group Family Takaful Plan (Group Life) ***2.*** Group Health Takful Plan (Group Medical) ***3.*** Group Creditor Takaful Plan (Group Credit Life) ***4.*** Motor Insurance Takaful ***5.*** Property All Risk Takaful ***6.*** Fidelity Guarantee ***7.*** Erection all Risks Takaful ***8.*** Contractors Plant & Equipment Takaful ***9.*** Personal Accident Takaful ***10.*** Workmen's Compensation Takaful ***11.*** Marina Cargo Takaful ***12.*** Domestic Helper Takaful Plan ***13.*** Travel Takaful Plan ***14.*** Fire and Perils Takaful ***15.*** Money Takaful ***16.*** Public Liability Takaful ***17.*** Hotel Takaful	**Business Takaful** 1. Property and Commercial 2. Engineering and Construction 3. Motor Fleet Takaful 4. Liability Takaful 5. Cargo Takaful 6. Credit Takaful 7. Group Medical Takaful 8. Group Family Takaful
	Personal Takaful: 1. Motor Takaful 2. Travel Takaful 3. Domestic Help Takaful

Source: Created by Author

Business Performance of the Takaful Companies

It is noteworthy that even prior to the enactment of Oman's Takaful law, investor response to two takaful insurer IPOs, Al Madina Takaful, and Takaful Oman, at the end of 2013 indicate a strong appetite for Shariah compliant insurance products. Based on hybrid model of Wakalah-Mudaraba, both IPOs were heavily subscribed. Current estimates with regards to the performance of two takaful operators in Oman provides for an optimistic future. The net profit announced for the ninth month ending on September, 2016, by Takaful Oman was RO 2.13m or \$5.54m, an increase of 93% over the same period in preceding year. Similar is the trend for Al Madina Takaful. Although not as exuberant as the former, it recorded an increase in profit by 31% for the same period i.e. RO 1m or \$2.6m.[100]

[100] See annual reports (2016), Takaful Madina and Oman Takaful.

3.7.5 POLICY RECOMMENDATIONS

With the objectives of economic diversification, sustainable development and financial inclusion, resorting to a diverse and resilient and diverse financial setup will hold the key in providing the necessary means to meet the required ends. Oman adoption and implementation of Islamic finance serves the same and would do well to leverage on the lessons learned from the experience centers in the Muslim world. Being a new entrant, it could lay firm foundation of risk sharing implemented through a deliberate, slow and well-planned stage-wise design. As suggested by Shaukat and Alhabshi (2015), in the last three decades' important strides have been made in applying the rule of no riba based contracts to create an Islamic system. Much more effort needs to focus on the risk sharing aspect of the prescribed rule in the verse 275 of chapter 2. This potential move is referred to as moving Islamic finance from version 1.0 which only focused on the no-Riba part of the verse to now Islamic finance version 2.0; rendered to apply risk sharing in finance-the essence of Islamic finance.

The same has ordained IFIs to align and reorient the practices based on risk sharing finance. It could start with Islamic banks operating on risk-sharing basis. These banks could combine Islamic finance ideology with contemporary financial innovations as well as truly market-based allocation of financial resources that would reflect their opportunity cost. The mechanics have been described in number of relevant studies[101]. The balance sheet of an Islamic bank would be securitized on the basis of short, medium and long-term and sold in the market, tradable over the counter and in the secondary market. To serve the purpose of financial inclusion and asset building by lower economic classes, these securities would be low denominated to make them accessible for purchase by everyone. This way, all citizens would have an opportunity to share in the prosperity of the economy.

This could be achieved as a 'New Age Model of Innovative Islamic Fintech finance', branded from Oman. Model that is less focused on retail banking and more towards financial inclusion, entrepreneurship and sharply attuned to economic diversification vis-à-vis vision 2020[102]. In recent times, the impact of globalization and financial innovation has swept through the world in magnitude unprecedented, altering the very fabric of financial and economic behavior. Automation and mechanization has already disrupted the traditional financial means to meet the ends. This has not only created user flexibility but with it reduced transaction costs. The flexibilities that have consequently called time on the traditional 'business as usual approaches', could be referred to as the *'New Age innovative/automated financial order'.* World Bank (2015/16) predicts that automation is threatening jobs by for example, by 69% in India, 77% and 85% in China and Ethiopia.

If technology driven financial innovation is set to lead the fundamental transformations in economic behavior/growth, *resorting to novel and adaptive marketplaces* become a crucial component. The raison deter for enhanced and affordable financial flexibilities is the possibility of transacting without intermediation. This has helped neutralize the traditional business model frictions between the surplus and deficit units. Consequently, there is a clear

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[101] See, for example, Shaukat et al (2014/15); Shaukat, M (2015, 2016 & 2017a, c) Shaukat and Alahbshi (2015) and Shaukat and Mirakhor (2016, 2017).

[102] Vision 2020 is enshrined on Oman's 9th 5-year economic plan which hopes to mitigate its dependence on declining oil resources through economic diversification that would reduce the oil sector's share from about 45 percent of GDP to 9 percent by 2020.

orientation from a 'financer-intermediator-entrepreneur' towards a 'financer-entrepreneur' model. The ensued global focus on P2P lending, crowd funding, angel investing, mobile banking and other similar modes of financing is a proof. These not only have created better opportunities for financial inclusion but have tended to improve the overall social fabric via improved trusteeship and risk sharing. The same focus is recommend for Oman, particular in view of tanfeedh, the AlRafdh and Ethmar funds for SMEs and venture capital.

What is crucially noteworthy is the fact that the fintech driven, new age, finance is in complete actuality, application of basic Islamic Finance i.e. reliance on risk sharing based Mudaraba and Musharaka financing. In a typical risk sharing arrangement such as equity finance, parties share the risk as well as the rewards of a contract. Assets are invested in remunerative trade and production activities. The return to assets are not known at the instant assets are invested, akin to Arrow-Debreu securities. Oman's welcome adoption of Islamic finance has created a valuable opportunity to help meet its economic diversification needs by resorting and branding itself as a 'New Age Islamic Fintech Finance; that is oriented towards entrepreneurship and financial inclusion, research and innovation. The recent new age Waqf Forum (2017) in Oman and other similar preliminary initiatives via CBFS are steps in right direction. Moreover, initiative (WIFE, 2016), of amalgamating waqf with crowd funding via Fintech (see worldwaqf.org) is another insight for Tanfeed initiatives.

Moreover, to complement the achievement and pursuant sustainability of the above, innovative approaches to promote Islamic capital markets and other important areas are investment banking, stock markets, trade and crops financing, and the payments system. The promotion of stock markets can play an important role in Islamic finance[103]. This is so since in an Islamic system version 2.0, investment banks would not provide loans but would participate as shareholders. Depositors in these banks would own marketable equity shares that could be traded on the stock market according to market prices. Since depositors are generally risk-averse, they would invest only in shares that provide the risk-return profile they would seek. This will in turn lead banks to select the most profitable projects. Thus, financial resources would not receive their true opportunity cost where the surplus fund holder nor the entrepreneur would be exploited, complying with the Verse 275 Chapter 2 of the Qur'an (See, for example, Mirakhor and Shaukat, 2015 and Shaukat 2015/16).

Shaukat, (2016) suggest that, for example, oil revenue dried GCC countries like Oman and even debt ridden Eurozone countries can finance its capital spending through equity participation in the form of public-private partnership. One of the most promising instruments that would allow governments to improve risk sharing is the category of instruments called 'macromarket' securities that can allow people to mitigate risks to their income and countries to enhance international risk sharing[104]. Governments can easily tap the equity premiums: that is the excessive return on equity and equity instruments versus the returns on risk free assets such as government bonds. For example, a Eurozone country can finance its capital spending

103 As has been argued in Shaukat and Alhabshi (2015), the interest-based credit system has considerably reduced the efficiency of these markets as it provides credit for speculation and creates abundant liquidity which distorts the returns on equities and results in price crashes. Returns become more related to speculation and share prices appreciation and only weakly related to the fundamentals of the company.

104 This type of risk sharing instruments has been proposed by analysts for some time now. Shiller (2003), the first to suggest this type of "macromarket" instruments, believes that the benefits of risk sharing are substantial but have yet materialized due to the limited availability of appropriate instruments.

through equity participation in the form of public-private partnership. Instead of issuing a debt-based bond to mobilize funding, governments can use equity/musharaka participation Sukuk/securities for such funding. These instruments can be issued in low denominations and traded in the secondary markets. This would allow ordinary consumers and investors to participate in the process of owning a share of their government's activities. These instruments, with the incentive for wide participation of the population, could well enhance social solidarity and, perhaps, even provide an incentive structure for strengthened governance. However, in order to materialize the recommendations operational constraints, have to be addressed. The following section reveals some important constraints:

3.7.6 INDUSTRY CONSTRAINTS

- **First** is the challenge is lack of a level playing field between Islamic and conventional finance. There is an edifice of structural, institutional, administrative, fiscal, monetary and legal means favoring debt finance.

- **Second,** IFI lacks long term, low risk/Shariah compliant liquid instruments/product development. This imposes liquidity and hedging constraint on the ability of IFI to compete. As a result, Islamic financial industry is forced to replicate conventional instruments.

- **Third,** IFI has done remarkably well in expanding its global reach but it has had to do so in legal jurisdictions uninformed about or hostile to Islamic contracts. These are few among a number of challenges facing IFI. The question of long-term sustainability becomes crucial.

- **Fourth,** being a closed economy that is tending to open, greater structural reforms are still needed to improve the business environment. Bureaucracy and cumbersome regulations hinder entrepreneurial activity, and state-owned enterprises distort the economy. Consequently, according to Global Economic Freedom Index, 2017[105]. Oman is ranked 82 in the world based with an overall score of 62.1. This rather appears an offshoot of the conservative natured overall social fabric of Oman, also a distinguishing feature of country's social stability. The same could be reasoned as reflected also in the limited range of product line in Islamic Banking.

Consequently, to implement the recommended new age brand of Islamic finance and to reap the desired economic benefits, the above constraints need to be addressed via a cohesive and institutional strategy as national priority. For these reason, a well-developed and a vibrant stock market particularly the one based on the above characteristics, should increase saving and efficiently allocate capital to productive investments, which leads to an increase in the rate of economic growth. Mirakhor et al. (2015: 29, 2011a: 20) give conditions for a vibrant and robust stock market; arguing that these steps may help reduce cost of market participation, increase market credibility and reduce reliance on debt. The list includes inter alia;

- Policies to create a level playing field for equities like products to compete fairly with debt-based instruments; this means removing all legal, administrative, economic,

[105] See http://www.heritage.org/index/country/oman. Accessed on 28th April, 2017 at 21:29PM

financial and regulatory biases that favour debt and place equity holding in a disadvantage;

- Creating positive incentives for risk sharing via the Islamic capital/stock market;

- Investing in massive public education campaign to familiarize the population with the benefits of stock market participation. Effective use of new age media is also essential.

- Investing in human capital to produce competent, well-educated and trained reputational intermediaries – lawyers, accountants, financial journalists and Shariah scholars – which means investing in the creation of world class business and law schools;

- Limiting short sales and leverage (including margin operations) of non-bank financial institutions and the credit-creation ability of banks through prudential rules that effectively cap the total credit the banking system can create;

- Developing strong and dynamic regulatory and supervisory system for the stock exchanges that not only continuously monitor the behavior of markets and participants but stays a few steps ahead of those with penchant and motivation to use regulatory arbitrage to get around rules and regulations;

- Finding ways and means of regulating and supervising reputational intermediaries or, at least, mandating that they become self-regulating to ensure minimization of false reporting or misreporting under threat of liability to market participants;

- Ensuring completely transparent and accurate reporting of the day's trade by all exchanges; and

- Instituting legal requirements for the protection of the rights of minority shareholders.

- Most importantly is to view the development of required Human capital as core to overcoming growth challenges. The supply of specialized personnel, those who are aware of the core theoretical underpinnings and the practical philosophies of Islamic finance, was highlighted as the most crucial of needs. It is recommended that educational institutions have to play a significant role in providing a sustainable workforce for Islamic financial institutions through producing graduates and skilled staff with industry relevant knowledge. Moreover, the industry itself also needs to take up the responsibility and work in tandem with academia to cater the desired need.

3.8. CASE STUDY: MALAYSIA

3.8.1 SUMMARY

Malaysia, with a population of 30,949,962 (July 2016) is located in South East Asia. It is a peninsula bordering Thailand, Indonesia, Brunei and South of Vietnam, with a total area of 329,847 square km, where 328,657 sq. km represent land, and 1,190 sq. km represent water. The Malaysian major natural resources are tin, petroleum, copper, palm oil, and others. Malaysia is regarded as an upper middle–income country that has transformed from a raw materials producer into a multi-sector economy, targeting to be a high income nation by 2020. According to Bank Negara Malaysia (BNM), the Malaysian economy recorded a higher growth of 5.6% in the first quarter of 2017 (4Q 2016: 4.5%). Private sector activity was higher and remained as the main driver of growth. Growth was further lifted by higher exports, as increased demand for manufactured products led to a strong growth in real exports (9.8%; 4Q 2016: 2.2%). Real imports also increased at a faster rate of 12.9% (4Q 2016: 1.6%) on account of higher growth of capital and intermediate goods. On a quarter-on-quarter seasonally-adjusted basis, the economy recorded a growth of 1.8% (4Q 2016: 1.3%). Malaysia is an important case study for Islamic finance, as the Islamic financial sector represents one of the very important and prominent sectors in the Malaysian economy, and Malaysia is also regarded as one of the pioneers in the Islamic capital markets industry.

Figure 21: Financial Sector Bluepring 2011-2020 from Central Bank of Malaysia

Source: Central Bank of Malaysia, Financial Sector Blueprint 2011–2020

Malaysia aspires to transform into a developed and more competitive economy by 2020. This transformation will rely largely on the private sector to drive greater productivity and innovation to move up to higher value-added activities that will underpin and sustain strong economic growth.[106]

Malaysia's market with its current structure serves the regional market and the international market. The financial sector contribution to nominal GDP is expected to increase to 10-12% in 2020.[107] In Malaysia, Islamic finance market through long term vision continues to expand and grow across the different market segments: Islamic banking, Islamic Capital Market, Takaful industry, and other emerging industry such as wealth management and financial planning, through strong support from the regulator by providing conducive environment that enables the market players to operate in a very productive manner, producing world class instrument and products, innovative and tailored to the customer need cross the different market segment, within the global best practices in regulation and operations. According to the Central Bank of Malaysia, Malaysia has also placed a strong emphasis on human capital development alongside the development of the Islamic financial industry to ensure the availability of Islamic finance talent. All of these value propositions have transformed Malaysia into one of the most developed Islamic banking markets in the world.[108] As for the future direction the market will embark on fintech solutions and digital platform activities through a careful monitoring and supervisions from the regulators

3.8.2 INTRODUCTION

The Malaysian market is regarded as a well-diversified market in terms of products offered, which includes Islamic banking, Takaful and Islamic Capital Market. It also includes Islamic wealth management and Shariah financial planning. This market diversification creates a wide range of products and instruments that serve the needs of the different stakeholders and shareholders in the market.

Malaysia has a very comprehensive and diverse market that enables the Islamic financial institutions to operate in very efficient and effective manner.

The different shareholder and stakeholder of the Islamic financial system in Malaysia play a significant role to the development on the Islamic financial industry. As for the regulatory framework it is represented by the Ministry of Finance, the Central Bank (Bank Negara Malaysia), Securities Commission Malaysia, MIDC, Court and KLRCA. As for the Industrial & Market segment, it is represented by the Islamic Banking, Takaful and Islamic Capital market, which includes private equity, venture capital, asset management, financial advisory and financial planning. As for Markets it is represented by Stock market, Money Market and Bursa Malaysia Suq Al-Sila (BSAS). As for Shariah governance, it is represented by the main corporate governance organs, which include but are not limited to Shariah Boards/ Committee, Shariah Review and Shariah Audit. As for the Legal framework, it is represented by Islamic Financial Services Act (IFSA 2013) and Capital Market and Services Act 2007 (CMSA 2007). In addition

[106] Central Bank of Malaysia, Financial Sector Blueprint 2011–2020, P24.
[107] Ibid, P53.
[108] http://www.bnm.gov.my/index.php?ch=fs_mfs&pg=fs_mfs_bank. Retrieved 26/05/2017
[108] Monthly Statistical bulletin, March 2017, BNM, P8.
[108] http://www.bnm.gov.my/index.php?ch=fs_mfs&pg=fs_mfs_bank. Retrieved 26/05/2017

to that, there are other guidelines and standards issued by Bank Negara Malaysia (BNM) and Securities Commission Malaysia (SC). As for the International multilateral organization based in Malaysia, it is represented by Islamic Financial Services Board (IFSB) and International Islamic Liquidity Management (IILM) As for the Promotion initiative for Islamic finance, it is represented by Malaysia Islamic Financial Centre (MIFC) and Market place. As for the talent development segment it is represented by International Centre for Education in Islamic Finance (INCEIF), Islamic Shariah Research Academy (ISRA), Islamic Banking and Finance Institutions Malaysia (IBFIM), Finance Accreditation Agency (FAA), Securities Industry Development Corporation (SIDC), Leadership and Governance Centre (ICLIF), Asia Institute of Finance (AIF), Financial Sector Talent Enrichment Programme (FSTEP) and others. As for the market representation it is represented by different institutions and association such as Association of Islamic banking Institutions Malaysia (IBIM), Malaysia Takaful Association (MTA), Chartered Institute of Islamic Finance (CIIF), Association of Shariah Advisors Malaysia (ASAS), Malaysian Financial Planning Council (MFPC), Association of Financial Advisors (AFA), and others, the above market players contribute significantly in different ways to Islamic finance industry but all together heading to the same objectives and goals., that creates a comprehensive eco-system for Islamic finance in Malaysia.

3.8.3 ISLAMIC BANKING IN MALAYSIA

There is a wide range of products and instruments offered in the Islamic finance market, ranging from banking deposit, financing, trade financing, Islamic capital market products and Takaful. As for the Islamic banking segment below table showed the most popular products in deposit and financing offered by the Islamic banks, the tables highlighted both the products with their underlying Shariah contracts.

Table 60: Deposit Products

Type of Account	Principle / Contract
Current Accounts	Qard
	Commodity Murabahah/ Tawarruq
Investment Accounts	Mudarabah (profir sharing)
	Wakala (agency)
	Musyarakah (profit and loss sharing)
Fixed Income Deposit Account	Commodity Murabahah/Tawarruq

Source: Created by Author

Table 61: Financing Product

Products	Principles of Shariah
House Financing (asset financing)	Commodity Murabahah/ Tawarruq
	Istisna (parallel istisna)
	Ijarah Muntahiya Bittamleek
	Musharakah Mutanaqisah
Vehicle Financing (asset financing)	Murabahah
	Ijarah Muntahiya Bittamleek/ Ijarah Thumma al-Bay’
Working Capital Financing (asset or cash financing)	Commodity Murabahah/Tawarruq
	Ijarah Muntahiya Bittamleek/Ijarah Thumma al-Bay’
	Tawarruq

Products	Principles of Shariah
	Sale and Lease Back
Project Financing	Istisna' and Parallel Istisna'
	Combination of 2 or more of the following contracts: Mudarabah Ijarah Tawarruq Wakalah bil istithmar
Trade Financing	LC based on Wakala
	LC based on Murabahah
Credit Card	Ujrah
	Tawarruq
Overdraft	Tawarruq
Factoring	Bay' al-Dayn
Letter of guarantee	Kafalah
Personal financing	Tawarruq
Services Financing	Ijarah

Source: Created by Author

Islamic Banking Share in Total Banking Assets

As per the IFSB Report 2017[109], Malaysia is among the leading countries, where Malaysia's share of Islamic banking compared to the country's overall banking sector was 23.8% by the end of 2016.

Shares of Global Islamic Banking Assets

Regarding the shares of global Islamic banking assets, Malaysia is among the top leading countries, where Malaysia represents 9.3% of the shares of global Islamic banking assets.[110]

Islamic Banking Average Growth by Country (2Q2016)

As per the IFSB Report 2017, Malaysia's Islamic banking segment experienced a growth of 9.5% in terms of assets, in the second quarter of 2016, with Islamic banking deposits growing by 8.2% between 2Q2015 and 2Q2016. This growth was comparable with that of major OIC Islamic banking jurisdictions including Kuwait, Indonesia, Bangladesh and Saudi Arabia.111

Islamic Banking Products

The Islamic banking in Malaysia offered wide range of products, which includes Retail Banking, Corporate Banking, trade finance, wealth management products, and other products and services. As for the Islamic banking deposit represent the cash flow-in in the Islamic bank, it represents the surplus unit in the economic system. The Islamic bank used various contracts in the deposit, which includes, Qard, Mudarabah and Commodity Murabahah. Described below are the most popular products used by the Islamic bank.

[109] IFSB, Islamic financial services industry stability report 2017

[110] Ibid.

[111] Ibid

Qard saving account

Saving accounts based on qard refers to the contract of lending money by a lender (depositor) to a borrower (banks) where the latter is bound to repay an equivalent replacement amount to the lender. Under this contract, there should not be any contractual benefits offered by a borrower to alender unless it is based on the borrower's discretion and is not made conditional to the qard. In the case that the borrower wishes to grant lenders some amount of return, the return may be granted as Hibah (gift) to the lender.

Mudarabah Investment Account

The investment account product is based on Mudarabah contract, which is profit sharing based equity contract, the ratio is proposed by the Bank based on the market benchmark rate that reflect the performance of the underlying assets, the ratio and rate that have been offered to the customers are also benchmarked against rates by other competitors. Dividend Rates is agreed upon upfront and the ratio is pre-determined at the initial stage of concluding the contract. The difference between murabahah concept in term deposit and mudarabah in the investment account is that, for mudarabah, the bank will determine the rate upfront and will make it known to the customer since it is sale based contract, the rate is calculated based on selling price, whereas for mudarabah contract, the indicative rate displayed is based on the history/previous performance of the bank.

Fixed Rate Term Deposit

The fixed rate in Islamic Deposit is based on the contract commodity murabahah/ Tawarruq. The product of fixed deposit involves buying and selling of commodity using Bursa Malaysia Suq Al-Sila (BSAS). The selling price in the product of fixed deposit is fixed, where the Bank needs to pay the fixed selling price, which reflects fixed return to the customer.

The list of deposit products for Consumer Banking is shown below.

Table 62: Deposit Instruments in Consumer Banking in Malaysia

Category	Product	Shariah Contract
Saving Account	Saving Account	Qard/Tawarruq
Current Account	Current Account	Qard/Tawarruq
Term Deposit	Islamic Fixed Deposit	Commodity Murabahah/Tawarruq

Source: Created by Author

Financing Products

Financing represent the deficit unit in the economic system, the Islamic bank offered various facilities that benefit the customer needs. It includes home financing, vehicle financing, trade financing and other services such as credit card, and others, below is short descriptions on the most popular products in the financing side.

Home Financing

Home financing is financing product offered to the Islamic bank to finance the purchase of property, residential and commercial, the home financing is offered based on different Shariah contracts, as for the Home financing based on Equity or partnership basis, it is known as Musharakah Mutanaqisah in which the Islamic bank and the customer will jointly purchase the property based on the diminishing partnership structure, which ultimately end with full ownership by the customer.

Vehicle Financing

Vehiclefinancing is mostly offered based on the leasing, where the bank purchase and own the vehicle prior to lease it out to the customer based on the leasing agreement. Upon maturity, ownership of the vehicle is transferred to the customer based on specific arrangement agreed in the contract.

Islamic Overdraft (Cash line) Facilities

Islamic Overdraft is facility granted for Shariah compliant purposes. It is a product for liquidity management purpose, in Malaysia the Overdraft facility is based on commodity murabhah, by right the facility is granted to serve Shariah compliant business activities, however, if the usage of the facility is for Shariah non-compliant activities, then, it is beyond the bank's control. However, the bank has the right to terminate the facility if the Bank discovers that the purpose of the facility is for Shariah non-compliance activities.

Islamic Credit Card

The Islamic Credit Card is facility to provide payment service and easy the payment transaction of the customer through cash-less, the credit card has some benefit such as no Annual fee, non-compounding charges, incentive treat points on transactions, some gift that the Islamic bank may offer, such Takaful coverage. The credit card is used based on commodity Murabahah/ Tawarruq and Ijarah

We have highlighted some of the products offered in the market, however in addition to the above mentioned products there are other important products offered in the market mentioned in the above table but not highlighted here such as trade finance which include letter of credit and money market instruments that includes wide range of products such as Wakala placement and others.

3.8.4 ISLAMIC CAPITAL MARKETS IN MALAYSIA

Islamic capital market in Malaysia is regulated by the Securities Commissions Malaysia, it is regarded a dynamic and vibrant market that put Malaysian on the global map especially in the area of Sukuk issuance where Malaysia for many years is maintaining the leadership as number one (1) in the Sukuk market. The major products offered in the Islamic Capital Market are listed in the table given below:

Table 63: Major Instruments and Their Underlying Shariah Contracts

PRODUCTS	PRINCIPLES OF SHARIAH
Shares / Equity	Musharakah
Mutual Funds / Unit Trust	Musharakah (amongst the investor) and Wakala (between the investor and the fund manager)
Private Equity Fund	Musharakah and Wakala (as above)
REITs	Musharakah and Wakala (as above)
Specific funds e.g. aircraft leasing fund	Musharakah and Wakala (as above)

Source: Created by Author

As for the Sukuk products are highlighted below:

Table 64: Sukuk Products And Their Shariah Structures

Products	Underlying Shariah contract
Murabahah Sukuk **Tawarruq Sukuk**	Murabahah Tawarruq [112]
Sukuk Ijarah	Sale and lease – back
Sukuk Mudarabah	Mudarabah
Sukuk Musharakah	Musharakah
Sukuk Wakala	Wakala

Source: Created by Author

There are other types of Sukuk based on other different Shariah contract and innovative structure that have been offered in the Malaysian market, such hybrid Sukuk, convertible Sukuk, perpetual Sukuk, etc.

Size of the Islamic Capital Market [113]

The Malaysian Islamic Capital Market is sizeable market that combined different products and instruments, below table provide an indication on the size of the market.

Table 65: Size of the Islamic Capital Market in Malaysia

	2016 (MR Billion)	2015[114] (MR Billion)
Market capitalization of Shariah-compliant securities	1,030.56	1,086.18
Size of Sukuk outstanding	661.08	607.93
Total size of ICM	1,691.64	1,694.11
% ICM to total capital market	59.56%	60.08%

Source: Created by Author

The above table shows the size of the market capitalization of the Shariah compliant securities, along with the size of the Sukuk outstanding, which will be highlighted again as one of the major financial instruments in ICM. The size has grown from 59.56% to 60.08%, despite the slight increase but still indicate positive indication to the direction of the Islamic Capital Market.

Shariah-Compliant Securities

The Shariah-Compliant Securities on Bursa Malaysia shows an increase of the number of listed securities, but decrease in the total market capitalization from 64.09% to 61.81%, however the drop is not significant. Below table is an illustration of the status of the market.

[112] Tawarruq uses a Murabahah principle, but it is a tri-party arrangement.[113] The figures are in in billion, in Malaysian Ringgit currency unless mention otherwise

[113] The figures are in in billion, in Malaysian Ringgit currency unless mention otherwise

[114] Securities Commissions Malaysia, 2017.

Table 66: Shariah Compliant Securities on Bursa Malaysia[115]

	2016	2015
Number of Shariah-compliant securities	671	667
Total listed securities	904	903
% to total listed securities	74.23%	73.86%
Market capitalization (RM billion):		
Shariah-compliant securities	1,030.56	1,086.18
Total market capitalization	1,667.37	1,694.78
% to total market capitalization	61.81%	64.09%

Source: Created by Author

Islamic Fund Management

The Islamic Assets Management has increase from 19.82% to 21.49%, despite the slight increase still regarded as positive indication of the direction of the market. Below table is an illustration of the status of the market:

Table 67: Islamic Assets Under Management (RM billion)[116]

	2016	2015
Islamic AUM	149.64	132.38
Total AUM	696.27	667.88
% Islamic AUM to total AUM	21.49%	19.82%
Note: The AUM includes assets that are sourced from collective investment schemes as well as private mandates		

Source: Created by Author

Islamic Unit Trust Fund (UTF)

The Islamic Unit trust fund has recorded a positive growth from 193 Unit trust funds to 198. As for the Net Asset Value (NAV), it is has recorded a positive growth from 15.04% to 16.99%. The table below is an illustration of the status of the market: (in RM)

Table 68: Market of Islamic Unit Trust Funds[117] **in Malaysia**

	2016	2015
Islamic UTF	198	193
Total industry	627	612
NAV of Islamic UTF (RM billion)	60.91	52.12
NAV of total industry (RM billion)	358.47	346.58
% NAV of Islamic UTF to total industry	16.99%	15.04%

Source: Created by Author

Wholesale Fund (WF)

The total Islamic Wholesale fund industry has increased from 293 to 313, with a total industry NAV increase from 84.53 to 90.84, representing a growth from 37.45% to 39.31%, as depicted in the table below.

115 Ibid
116 Ibid
117 Ibid

Table 69: Glimpse of the Islamic Wholesale Fund Industry in Malaysia

	2016	2015
Islamic WF	97	93
Total industry	313	293
NAV of Islamic WF (RM billion)	35.71	31.66
NAV of total industry (RM billion)	90.84	84.53
% NAV of Islamic WF to total industry	39.31%	37.45%

Source: Created by Author

Islamic Private Retirement Funds

The total Islamic private retirement funds have increased from NAV of RM 0.8 Billion in 2015 to NAV 0.51 Billion in 2016, recording a growth from 32.25% to 33.55%. This is shown in the following Table:

Table 70: Glimpse of the Islamic Private Retirment Funds

	2016	2015[118]
Islamic PRF	25	20
Total industry	56	50
NAV of Islamic PRF (RM billion)	0.51	0.38
NAV of total industry (RM billion)	1.52	1.17
% NAV of Islamic PRF to total industry	33.55%	32.25%

Source: Created by Author

Islamic Exchange Traded Fund (ETF)

The Islamic ETF has recorded increase in the market capitalization from 21.05% in 2015 to 22.11% in 2016. The status of the market is hereby shown:

Table 71: Islamic Exchange Traded Fund (ETFs) in Malaysia

	2016	2015[119]
Islamic ETFs (number)	4	4
Total industry	8	8
Market capitalization of Islamic ETF (RM billion)	0.42	0.36
Market capitalization of total industry (RM billion)	1.90	1.71
% market capitalization of Islamic ETF to total industry	22.11%	21.05%

Source: Created by Author

Islamic Real estate Investment Trust (REIT)

The Islamic REIT maintain its position in term of total industry REIT of 17 in both years, however in term of market capitalization it has increased from 16.11 % to 18.53 %, despite its drop in terms of percentage market capitalization of Islamic REIT to total industry. Below table is an illustration of the status of the market

[118] Ibid
[119] Securities Commissions Malaysia, 2017.

Table 72: Islamic Real Estate Investment Trusts (REITs) in Malaysia

	2016	2015[120]
Islamic REIT	4	4
Total industry	17	17
Market capitalization of Islamic REIT (RM billion)	18.53	16.11
Market capitalization of total industry (RM billion)	44.19	37.48
% market capitalization of Islamic REIT to total industry	41.93	42.98

Source: Created by Author

Sukuk

Malaysia is pioneer in Islamic finance, particularly Islamic capital markets. It has contributed to spur the growth of Islamic capital market not only at national level but also at international level. This is due to the efforts of Malaysia International Islamic Financial Center which plays a crucial role in the regulation and development of Islamic capital market which helps in rapid growth of the Islamic capital market. This is also due to its Shariah compliant products and services collecting from equities, unit trusts, exchange traded funds, structured products, derivatives, fund management and stocks broking services that have increased in depth and breadth of the instruments of Islamic capital market in Malaysia. Currently, this contribution of Malaysia to Islamic capital market has been recognized by global financial market. This is because Malaysia's Islamic capital market instruments and derivatives have potential area of a high growth due to Bursa Malaysia's innovation for Islamic capital market products to meet the demand of investors and need of the markets. (Bursa Malaysia, 2008).

In addition to this, Malaysia has pioneered in Islamic capital market for the following reasons:

- Malaysia is the first Muslim country which established the first Islamic unit trust in 1993 which is called Arab Malaysian Ittikal

- Malaysia is the first Muslim country which has a full-fledged of Islamic stock broking company which was established in 1994 and called BIMB Securities Sdn Bhd

- Malaysia is the first Muslim country which has its own full fledge department of Securities Commission which was established in 1995 to regulate and monitor the activities of Islamic capital market by forming special Shariah Advisory Council (SAC) in 1996 to guide the market players to invest their securities in accordance with the principles of Islamic law.

- Malaysia is an international hub for Islamic capital market; thus, its Minister of finance has launched in 2001 the Capital Market Master Plan with 13 recommendations which were formulated to make Malaysia the center of Islamic capital market activities.

- Malaysia is the first Muslim country which introduced in 2001 the first global corporate Sukuk which brought a paradigm change in the international Islamic financial market.

[120] Ibid

- Malaysia is the first country which introduced in 2002 the first sovereign Sukuk, which was subscribed more than twice of normal Sukuk subscription.

- In 2004 Federal Budget, Malaysia implemented a comprehensive incentive package for Islamic securities which has similar function to conventional securities in order to promote Islamic capital market instruments. (Bursa Malaysia: 2011)

The development of Islamic capital market in Malaysia is different from the development of Islamic capital market in other countries around the world. This is because Malaysia has special concern and support not only from market players and investors but also from the government of Malaysia in order to make Malaysia a hub of Islamic financial market particularly Islamic capital market which plays an important role in the growth of economy of any country.

Hence, Sukuk is regarded as very active instrument in Islamic capital market, where Malaysia is still leading the Sukuk market issuance. Malaysia has issued multicurrency Sukuk US Dollar, Chinese Renminbi, Singapore Dollar and Japanese Yen. In the first quarter of 2015, Malaysia sustained its position as the leading issuer of Sukuk. Issuances from Malaysia accounted for 42.3% of total issuances, followed by the United Arab Emirates (18.2%), Bahrain (14.2%) and Indonesia (14.1%), respectively. The Government of Malaysia issued the world's first 30-year sovereign Sukuk in April 2015 based on the principle of Wakala bi al-Istithmar. The offering marked Malaysia's fourth US dollar-denominated sovereign global Sukuk issuance, following its successful global Sukuk issuances in 2002, 2010 and 2011. The issuance consists of a USD1 billion 10-year (due 2025) and USD500m 30-year Trust Certificates (due 2045).

Malaysia continued to lead the issuance of sovereign Sukuk in the global market. The Malaysian Sukuk market, including local currency and foreign currency denominated Sukuk, reached USD161.3 billion at end June 2015. An increase from USD58.8 billion in 2008 with an annual growth of 16.8%. At end June 2015, the total outstanding amount of Malaysia's government Sukuk reached USD67.4 billion, an increase from USD15.8 billion in 2008. In addition, the share of government Sukuk to Malaysia's aggregate Sukuk market increased from a share of 26.8% in 2008 to 41.8% at end June 2015. As for the corporate Sukuk market in Malaysia also continued to exhibit steady growth. Total outstanding corporate Sukuk reached USD93.9 billion at end June 2015, more than double the amount of USD43.0 billion in 2008. Malaysia's local currency corporate Sukuk now dominate the local currency corporate bond market with a share of about 72% of the total market.[121]

3.8.5 TAKAFUL (ISLAMIC INSURANCE) IN MALAYSIA

Takaful represent an important component in the composition of the financial system in Malaysia. Takaful is integrated in the banking and Islamic capital market, through the investment of Takaful, where they hold many investment assets in Islamic capital Market product, and other investment link product through the banking channel. The structures of the Takaful products, along with their contracts are listed as follows:

[121] IIFM Sukuk Report 2016

Table 73: General and Family Takaful Contract

Products	Contract Among Participants	Contracts Between Participants and Takaful Operation
General Takaful	Tabarru' (donation)	Wakala
	Waqf (endowment)	Mudarabah
Family Takaful	One portion for Tabarru' and another portion for investment.	Wakala and Mudarabah
	All portions for Tabarru'	Wakala

Source: Created by Author

Development of the Takaful Industry in Malaysia

The regulatory framework has witnessed evolution and development that position the Takaful market in Malaysia as a vibrant market supported with sound regulatory framework foundation and robust infrastructure market.

In 2012 Takaful Operational Framework & the revised Shariah Governance Framework was introduced to strengthen the governance and transparency and determine the reporting line to ensure clear responsibilities, in 2013 the new Islamic Financial Services Act 2013 was introduced to shift the market to next level as IFSA 2013 was a significant mile stone thathad a significant impact on the market operations especially Islamic banking and Takaful. In 2014 Risk Based Capital for Takaful was implemented to set the stage for prudent requirement and risk management, in 2015 Appointed Actuary & Goods & Services Tax (GST) was introduced, in 2016 Financial Condition Reports & Operationalization of Financial Ombudsman Scheme was introduced, in 2017 LIFE Framework & Phased Liberalization of Motor and Fire Tariffs was introduced, and next year 2018 Conversion to Single Takaful Business, where no more composite license is allowed, this will change the landscape of the market and have impact on the Takaful market in term of governance and operation, share services, and other aspects.

Malaysian Takaful industry Performance in 2016

The Malaysian Takaful industry performance in 2016 showed total RM 26.96 billion assets (i.e. only for takaful funds' total assets), which included RM 2.41 billion of General Takaful contributions, as per the MTA Takaful Annual Report 2016.

General Takaful had a gross contribution of 2.41 billion with penetration rate of 14.61% for Family Takaful, with 76,332 Registered Takaful agents in the Takaful market.

Malaysian Family Takaful Market Performance in 2016

The family Takaful certificate stood at RM 4.63 Million, versus business in force amounted to RM 3.88 billion, as for the new business it represents RM 3.95 billion was recorded as compared to 3.64 billion in 2015, representing a growth of 8.6%.

Distribution Channels: Family Takaful New Business

Takaful Family products are distributed in the market via different channels to ensure wide coverage and reach in the market, especially Family Takaful still has low penetration in the market.

The annual gross contributions are mainly generated from agents (88.3%) followed by bancassurance (8.2%), brokers (0.7%) and other channels (2.9%). As for the single gross contributions, the main channels are bancassurance (54.1%), followed by agents (14.8%), brokers (7.2%) and other channels (24.0%).

Malaysian General Takaful Market Performance in 2016

The General Takaful Market in 2016 shows a good performance in overall. According to the MTA Takaful Annual Report 2016, gross contributions of motor Takaful amounted to RM 1.46 Billions, and gross contributions for non-motor Takaful of RM 0.95 Billion, representing a growth of 2.3% and 8.6% respectively.

Banca versus non-Banca Takaful Products

The statistics on the Banca products and non-Banca products, between 2015 and 2016 showed that there is a various in the figures, where family Takaful non-banca perform well in 2016 with rati0 of 80% versus 2015 where the ratio of 78%, on the other hand General Takaful 2015 was performing better in banca and non-banca products with ratio of 22% and 53% respectively.

A Glance of Malaysia in the International Takaful Market

Malaysia is regarded among the countries that dominate the Takaful industry globally, where according to the world Takaful report 2016, by year-end 2014, the Takaful assets were estimated to be around USD 33 billion. Gross Takaful contributions were estimated to be around USD 14 billion by the end of 2014. However Takaful market still highly concentrated in the GCC and South East Asia with Saudi Arabia and Malaysia predominating these markets.[122] As for the Premium growth, operating ratio and combined ratio, Malaysia has combined ratio of 91%, and operational ratio of 92%, it comes after the following countries, Bahrain; Jordan ; Qatar; Saudi Arabia; and United Arab Emirates.[123]

Malaysia leads the Takaful industry in the South-east Asian region. It has 12 registered Takaful operators. The statistics showed that Malaysia's Takaful industry grew faster than conventional insurance, with general and family Takaful recording 8.3% and 9.7% growth, respectively, at end- June 2015, compared with conventional general and life insurance growth of 6.6% and -0.4%, respectively.[124]

The portfolio of Takaful operator is very diversified as it combined cash, equity, Sukuk, fixed deposit and others, that provides a balance portfolio in term of risk and return. The diversification of the products in the market provides a proper management portfolio of the Takaful operator to manage their investment and their assets and liabilities. Hence the breakdown of the investment portfolio of the Malaysia Takaful operator showed a healthy position in term of the distribution and the allocation of cash, fixed income and equity exposure which is always has a small allocation due the uncertainty of the stock market. The market portfolio allocation still shows the Sukuk represent a large portfolio for investment for the Malaysian Takaful operator, however some of the Takaful operator make significant placement in the fixed deposit, as it is also representing free risk compare to other investment assets.

[122] World Takaful report 2016. P6.
[123] World Takaful report 2016. P9.
[124] Ibid

According to the Takaful report 2016, most of the Malaysian Takaful operators' Sukuk allocations are held in unquoted instruments within Malaysia, most of which are likely to be the corporate Sukuk not listed on Bursa Malaysia and are able to deliver higher yields than the government Sukuk. Sukuk from outside Malaysia represent a small portion of the investment allocation to Sukuk within Malaysia.[125]

According to the Takaful report 2016, a comparison of GCC and Malaysian Takaful operators' investment allocation, particularly the allocation towards fixed income (or cash equivalents as the case may be), highlights some of the most important capital markets gaps relevant to Takaful operators. For the Takaful operators considered in this analysis, the problem is different than on the conventional side where excessive real estate market exposure is the most significant.[126]

Future Direction of the Islamic Finance Industry in Product Offering and Best Practices in the Market in Malaysia

A new wave of innovation which includes Fintech solutions started in 2016 in Malaysia by introducing a range of products under the Central Bank of Malaysia and the Securities Commissions Malaysia. In addition to that few initiatives from the regulators have been undertaken to ensure comprehensive and robust Islamic finance market. These products and initiatives are regarded as innovative measures in the market.

Toward Strong Shariah Compliance Operation of the IFI and Close Monitoring of Shariah non-Compliance Risk

The Islamic Financial Act (IFSA 2013) has shifted the legal framework and legislation in Malaysia to a higher level compliance and certainty. It marks a new face in the history of the Islamic banking and finance legislation in Malaysia. The objective of the new legislation is to: 1) Promote financial stability and Shariah compliance in the banking activities. 2) Strengthen the foundations for the entire business banking model, it is end-to end Shariah governance and compliance. 3) Support the Shariah compliance contracts in the Islamic financial products and services. 4) Strong warning followed by penalties in case of the failure to comply with Shariah mandate.

Following up, the issuance of IFSA 2013, the central of Malaysia has issued a series of Policy documents to ensure consistency and standardization in the Islamic banking operation. The policy document contains two distinctive parts, namely the Shariah requirements and operational requirements. Shariah requirement highlights the salient features, essential conditions and optional practices of the Ijarah contract including arrangement of the contract with other Shariah contracts or concepts. The operational requirements are based on the core principles of good governance and oversight, proper product structuring, effective risk management, fair business and market conduct and sound financial disclosures.

Malaysia as a Global Hub for Wealth Management

Great focus has been given to wealth management, in line with inspiration from the Securities Commissions Malaysia's launching of a 5-year Islamic Fund and Wealth Management Blueprint in Jan 2017 to identify strategies and key initiatives to strengthen Malaysia's positioning as a

[125] World Takaful report 2016. P20.
[126] World Takaful report 2016. P21.

global hub for Islamic funds and develop the country as an international provider of Islamic wealth management services.

Towards Values- Based Intermediation (VBI)

Bank Negara has introduced a new initiative known as Values Base Intermediation (VBI). VBI is defined as an intermediation function that aims to deliver the intended outcomes of Shariah through practices, conduct and offerings that generate positive and sustainable impact to the economy, community and environment, without compromising the financial returns to shareholders.[127] It has the objective of Strengthening the Roles and Impact of Islamic Finance in Malaysia.

3.8.6 POLICY RECOMMENDATIONS

Malaysia's Islamic finance industry has recorded significant development and growth since its inception; the market has reached a comprehensive structure with great degree of diversification in the products and services offered in the market. The products range from deposit, financing, trade financing, treasury products, money market products, Islamic Capital Market products and Takaful products. These products and services are supported by comprehensive regulatory framework along with the standards and guidelines that enable the market to operate in very efficient and effective manner.

Despite significant achievement, there are some key recommendations that might be contribute to the on-going development of the Islamic finance industry, they are as follows:

- The Financial instruments, products and services required more clear guidelines to ensure certainty, the Central Bank of Malaysia has engaged in series of Policy documents issuance, which include Shariah requirements and operational requirements. The exercise should cover the entire Shariah contracts used in the Islamic financial system; the Shariah standards should cover banking, Islamic capital market and Takaful.

- Encourage more collaboration between the different market players such as AIBIM, MTA, CIIF, FAA, AIF, ASAS, MFPC, AFA, and other market representatives to have clear and long term vision and collaboration to move the resources towards an ultimate objective, where each one will complement the mission and vision of the other organization.

- Wealth management and financial planning industry is a small industry but very prominent, and coming up in a very big way, that deserves more support and guidance from the regulators and the market to ensure its steady growth and development. In line with this, Securities Commissions Malaysia has launched a 5-year Islamic Fund and Wealth Management Blueprint in January 2017 to identify strategies and key initiatives to strengthen Malaysia's positioning as a global hub for Islamic funds and develop the country as an international provider of Islamic wealth management services.

[127] Bank Negara Malaysia, Value-Based Intermediation, p6.

- More structured products and investment in the deposit side to keep shifting the market from saving conduct to investment conduct, and the market from credit intermediation to investment intermediation.

- Encourage more innovative products to the customer and SME who are not within the Islamic finance system radar to widen the scope of the financial inclusion.

- Encouraging more Sukuk issuance based on small denomination that targets the retail market for financial inclusion. In Sept 2012, SC launched the Malaysian retail bonds and Sukuk framework that provides retail investors direct access to invest in bonds and Sukuk. To date, several retails Sukuk have been issued.

- Ensure consumer protection especially in the Takaful industry and schemes of investment offered in the market by companies and startup Fintech Company.

- Encouraging the Fintech solution as a new wave in the financial market, that include Islamic banking, Takaful and Islamic Capital Market. This encouragement should be based on close monitoring and supervision

- Encouraging technological innovation in financial services such as Mobile Banking, Payments, Financing, Distributed Database (Block chain), Asset Management, Financial Inclusion, Security, Islamic Finance, Big Data, Loyalty & Rewards, Document Management using block chain, Remittances, Mobile Payments, , and others in order to make the market more vibrant.

- Simplify the products and services offering through the Fintech applications in Islamic banking, Takaful and Islamic Capital Market

- More promotion to the Digital Platform offered by the Securities Commission Malaysia such as P2P, Crowd funding, and other retails market products in the Islamic Capital Market

- More promotion to the Investment Account Platform to widen the scope of investment and fund raising, this promotion should couple with easy process to widen the participation of the platform in the market
- Improve the accessibility, efficiency, security and quality of financial services;
- Enhance the efficiency and effectiveness of Malaysian financial institutions' management of risks;
- Address gaps in or open up new opportunities for financing or investments in the Malaysian economy. The above three points mentioned are within the aims regulatory sandbox offered by the Central Bank of Malaysia
- The direction of the Malaysian Takaful Association (MTA), in their initiatives, are as follows:

    - Gradual removal of limits on operational costs to promote product innovation while preserving policy/ certificate value family Takaful operators will be given greater flexibility to manage their operating expenses, commensurate with their business strategy. However, consumers' interests will remain protected through appropriate safeguards that will preserve their policy/certificate value.

- Diversified distribution channels to widen outreach family Takaful products will be accessible to consumers through a wider range of delivery channels that are most convenient and appropriate. Diversified distribution channels can also contribute towards lowering the cost of family Takaful products by promoting consumer choice and competition in the market

- Strengthened market conduct to enhance consumer protection. The level of professionalism of intermediaries will be enhanced to ensure consumers are given proper advice. At the same time, initiatives to facilitate informed decision making by consumers will be further pursued by strengthening product disclosure standards with greater transparency and clarity in order for consumers to better understand product features. This will be complemented by mechanisms introduced to facilitate meaningful and effective product comparisons.

- In Takaful industry more awareness should be done on the Takaful Annuity, Takaful Benefit (Nomination) in the Context of IFSA 2013, GST On Tabarru, Compensation of Late Payment Of Death Claim, Micro-Takaful and other related issues.

- Expand the scope of some business portfolio of some products such as Waqf, which contribute significantly to the Islamic finance market

3.8.7 CONCLUSION

The above Islamic financial sector provides a snapshot on the overall Islamic financial industry in Malaysia, which shows a diversification and comprehensiveness in the products and services offered in the market support by a long terms vision, that widen the scope of the Islamic finance market and enhance its function to operate within the international standards and requirements that ultimately benefit the stakeholders and the shareholders of the industry in Malaysia and the Ummah at large through cross border transactions and collaboration .

3.9 CASE STUDY: BAHRAIN

3.9.1 INTRODUCTION

Bahrain[128] is the smallest economy in the Gulf Cooperation Council with just over 1 million inhabitants, half of whom are expatriates. The energy sector remains the key driver of the kingdom's economy, generating the bulk of public revenues - albeit at a moderating percentage of total GDP as the country undertakes restructuring and seeks new income streams. Bahrain's economy weathers low oil prices and weakened public finances through its relatively diversified non-oil resources, resilient construction and tourism sectors and infrastructure investments by GCC funds.

Bahrain was selected as a case study due to its long standing achievements in Islamic finance and an unmatched concentration of Islamic banks globally. Despite increasing competition, the Kingdom was GCC's leading Islamic finance market and ranked second out of 92 countries worldwide according to ICD-Thomson Reuters Islamic Finance Development Indicator 2015[129]. In 2014, it was recognized as having the best governance in Islamic finance in the world with well-established regulatory framework covering all segments.[130] Bahrain marked another achievement with the recognition of its active role in the global economy in the fifth Global Islamic Finance Awards (GIFA) in 2015. In addition, the organizers of the 22nd annual World Islamic Banking Conference revealed that the top the Islamic Banks in the GCC FDI ranking included banks based in Bahrain[131]. Bahrain is also home to the reputed international standard setting body, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). All in all, it is a case worthy of investigation.

An Overview of Bahrain's Financial System

The Bahraini financial sector is fairly developed and diversified. Conventional and Islamic financial institutions and markets thrive in parallel. The wide spectrum of institutions includes retail and investment banks, insurance companies, finance companies, money changers and brokers. The Bahraini financial sector offers a wide array of financial products and services.[132]

Financial services are key drivers of growth in the country[133], contributing around 17.2% of Bahrain's Gross Domestic Product.[134] Overall, banking has played a pivotal role in Bahrain's economy[135], standing at USD 192.7 billion as of September 2016[136]. The sector performance

[128] Contributing author Dr. Aala Alabed. Chief Research Officer, Finocracy. Email: alaa@finocracy.com. The author wishes to thank Ms. Fatima Al Zain for her excellent research assistance

[129] ICD-Thomson Reuters, Islamic Finance Development Report 2015: Global Transformation, see http://www.zawya.com/ifg-publications/report/20151230100025914.pdf/

[130] ICD-Thomson Reuters, Islamic Finance Development Report 2015: Global Transformation

[131] Central Bank of Bahrain, The Review, accessed 13 March 2017, see http://www.cbb.gov.bh/assets/The%20Review/The%20Review%20CBB_Sept2015.pdf, p6

[132] Central Bank of Bahrain, Financial sector overview, accessed 27 March 2017, see http://www.cbb.gov.bh/page-p-overview1.htm

[133] Central Bank of Bahrain, Financial sector overview, accessed 27 March 2017, http://www.cbb.gov.bh/page-p-overview1.htm

[134] Central Bank of Bahrain, Financial sector fact sheet, accessed 28 March 2017, http://www.cbb.gov.bh/page-p-financial_sector_fact_sheet.htm

[135]eGovernment, Banking and finance, accessed 11 March 2017, see URL

[136] Central Bank of Bahrain, Financial sector fact sheet, accessed 28 March 2017, http://www.cbb.gov.bh/page-p-financial_sector_fact_sheet.htm

has been attributed in part to Bahrain's credible and robust regulatory framework, which is aligned with international best standards.[137]

The Central Bank of Bahrain (CBB) regulates and supervises the entire financial system in Bahrain. CBB's regulations are presented in the CBB Rulebook, which contains licensing requirements, capital adequacy requirements, risk management, business conduct, reporting and disclosure requirements and enforcement actions in seven volumes, each covering a different segment in the financial system.[138]

The CBB also regulates licensed exchanges and clearing houses and acts as the listing authority for companies and financial instruments in Bahrain.[139] As far as Islamic banking and finance is concerned, the CBB has a directorate dedicated to Islamic banking.

Financial Status of Islamic Banks, Islamic Capital Market and Takaful Industry in Bahrain

There are 64 Islamic Financial Intuitions in Bahrain[140], 31 of which are listed in the top 350 Islamic Financial Institutions in the Banker 2016 Report (see the Figure on Bahrain's top IFIs below)[141]. Islamic finance assets continue to grow at a faster rate than conventional bank assets.[142]

[137] eGovernment, Banking and finance, accessed 6 April 2017, see URL
[138] Central Bank of Bahrain, Financial sector overview, accessed 27 March 2017, http://www.cbb.gov.bh/page-p-overview1.htm
[139] Central Bank of Bahrain, Financial sector overview, accessed 27 March 2017, http://www.cbb.gov.bh/page-p-reg_overview.htm
[140] ICD-Thomson Reuters, "Islamic Finance Development Report 2016", p. 30
[141] The Banker, "Top Islamic Financial Institutions", 2016
[142] Central Bank of Bahrain, The Review, accessed 13 March 2017, see http://www.cbb.gov.bh/assets/The%20Review/The%20Review%20CBB_Sept2015.pdf

Figure 22: Bahrain's Top 31 Islamic Finance Institutions in 2015

Commercial	Wholesale	Investment	Insurance	Non-bank
1. Al Ahli Bank 2. Ithmar Bank 3. Al Salam Bank 4. Bahrain Islamic Bank 5. Khaleeji Commercial Bank 6. ABC Islamic Bank 7. Eskan Bank 8. Bank of Bahrain and Kuwait 9. Family Bank	1. Al Baraka Banking Group 2. Gulf International Bank 3. First Energy Bank 4. Bank Alkhair 5. Ibdar Bank 6. Bahrain Development Bank 7. Venture Capital Bank 8. International Investment Bank 9. Liquidity Management Centre 10. Seera Investment Bank 11. Global Banking Corporation 12. Gulf One Investment Bank 13. Investors Bank 14. Citi Islamic Investment Bank	1. Gulf Finance House 2. Arcapita 3. Investment Dar Bank	1. ACR Retakaful MEA 2. Takaful Internationa	1. Inovest 2. Reef Real Estate Finance Co. 3. Sakana Holistic Housing Solutions

Source: Created by Author

The table below provides an overview of Bahrain's Islamic Finance landscape in 2015.

Table 74: 2015 Islamic Finance Fact Sheet for Bahrain

Total Islamic Finance Assets (USD million)	**81,069**
Number of Islamic Financial Institutions	*64*
Islamic Banking Assets (USD million)	75,083
Number of Islamic Banks/Windows	*36*
Takaful/ReTakaful Assets (USD million)	372
Number of Takaful/ReTakaful Operators	*9*
Other Islamic Financial Institutions Assets (USD million)	795
Number of Other Islamic Financial Institutions	*19*
Value of Outstanding Sukuk (USD million)	4,803
Islamic Funds Under Management (USD million)	16

Source: ICD-TR Report 2016, p30-31

3.9.2 ISLAMIC BANKING IN BAHRAIN[143]

Bahrain is recognized as a pioneer in Islamic banking and finance with an evolution spanning over 35 years.

As early as 1978, the Organization of the Islamic Conference considered Bahrain a hub of Islamic banking due to its holistic approach. Bahrain was identified as the natural location to develop Islamic banking and finance. The Bahrain Monetary Agency (BMA) (now the Central Bank of Bahrain) played a leading role in the adoption of Islamic banking in Bahrain and establishing the necessary and enabling supervisory and regulatory framework.

In 1979, the first Islamic bank operating in Bahrain was founded, the Bahrain Islamic Bank (BIsB). The bank continues operations to date. As of November 2016, there were more than 25 Islamic banks registered in Bahrain, representing the largest concentration of Islamic banks globally. This comprises seven Islamic retail banks and 19 Islamic wholesale banks[144], (Financial Stability Report, 2017, p.16). Consolidations in recent years have led to some changes in the equity and ownership of Islamic banks. Mergers have occurred between Islamic banks and between conventional and Islamic banks. Recent examples include that of Islamic retail bank Al Salam Bank Bahrain with conventional retail bank BMI Bank in February 2014, and the consolidation of Elaf Bank, Capinvest and Capital Management House into Ibdar Bank in December 2013. The resulting institutions benefit from economies of scale, higher capital and the ability to broaden and deepen their business and product offerings. Notwithstanding this, many institutions have their Islamic banking business in Bahrain, including Al Baraka Islamic Bank, Khaleeji Commercial Bank, ABC Islamic Bank, Kuwait Finance House and the Islamic Bank of Asia[145].

143 Anwar Khalifa Al-Sadah, The Development of Islamic Banking in Bahrain, GTNews, https://www.gtnews.com/articles/the-development-of-islamic-banking-in-bahrain/

144 Despite increasing diversification attempts, Islamic wholesale banks' investment portfolios remain highly exposed to risky real estate sector. Major projects being financed by Islamic banks in Bahrain include Durrat Al Bahrain and Diyar Al Muharraq, by Kuwait Finance House, and the Financial Harbour, which is financed by Gulf Finance House.

145 Bahrain Economic Development Board (EDB), Islamic finance, accessed 2 May 2017, http://www.bahrainedb.com/en/investing/sectors/financial-services/Pages/Islamic-Finance--Banking.aspx#.WPsA0hKGPUo

Growth has been driven by customer and investor's confidence, transparent framework, supportive organizations, products and service innovations and skilled local workforce. This is not to mention the excess liquidity resulting from rising oil prices after the Gulf war. Moreover, the CBB was a pioneer in the Islamic window concept, allowing conventional banks to roll out Islamic banking business using available infrastructure.

To cater for the growing industry locally and abroad, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1990 to create standards for reporting and accounting that attended to the peculiarity of Islamic banking and finance. AAOIFI worked with organizations such as the International Accounting Standards Board (IASB). Bahrain was the first country to implement the standards for its local market. Sudan, Jordan, Qatar and other countries followed suit.

To further ensure the development of the financial services sector in Bahrain and produce well-trained and high-calibre Islamic finance professionals, the Bahrain Institute of Banking and Finance (BIBF) was founded by the BMA in order to train and educate individuals in Islamic finance. The Central Bank of Bahrain has also established an endowment (the Waqf Fund) in partnership with the industry to fund Islamic finance research, education and training. The fund is valued at US$7.5 million and has 22 member institutions.

Authorities in Bahrain have long recognized the importance of regulation and supervision for Islamic finance and the compliance of all transactions, products or services with Shari'ah law. It was, thus, the first regulator to develop and implement Islamic-banking-specific regulations in 2001 in the form of the Prudential Information and Regulatory Framework (PIRI).

3.9.3.1 Product Development and Diversity

According to industry experts, there is no shortage of retail products in the Bahraini and Gulf markets in general. Many of the retail needs of Shariah compliant customers are being met through a myriad of products, including Mudaraba, Musharaka, Murabaha, Ijarah, Ijarah Muntahia Bittamleek, Wakala, Istisna', Tawarruq and Salam

Retail Islamic banks, such as Ithmar Bank, provide **Mudaraba** investment accounts that are covered by the regulation protecting deposits and unrestricted Investment Accounts issued by the CBB in accordance with Resolution No. (34) of 2010. The account can be opened as an individual, Joint Personal, Sole Proprietorship, Body Corporate account or any other legal entity. It may be opened in Bahraini Dinars or United States Dollars. There are two options to open an account; either under general unrestricted Mudarabah or special restricted Mudarabah - for investors who seek higher rates of return. [146]

The retail banking arms of Islamic banks offer **Musharakah** financing where the bank invests capital in new and existing projects entitling it to a share of their profits. It may also contribute towards specific ownership of assets on a permanent or non-permanent basis.[147]

Murabahah is the most dominant financing contract in Bahrain's Islamic banking segment. It commanded 64.2% and 91.9% of Islamic retail and wholesale financings respectively, as at the end of September 2016 (CBB, 2017b, Pp. 50 and 53).[148] An example of common use of

[146] Ithmaar Bank website, Modaraba account, accessed 5 April 2017. See https://www.ithmaarbank.com/modaraba-account
[147] Al Salam Bank website, Musharaka, accessed 9 April 2017. See https://www.alsalam-bank.net/Musharaka.aspx.html
[148] Central Bank of Bahrain (2017b). Financial Stability Report- February 2017. Manama, Bahrain.

Murabahah in corporate banking is that of trade finance- mainly purchases from suppliers in the form of wire transfers, cash, Letters of credit and Letters of guarantee[149].

Ijarah agreement is the second most common financing instrument used by Bahrain Islamic retail banks. It made up 22.8% of the banks' financing portfolio as at the end of September 2016 (CBB, 2017b, p. 49). Ijarah allows corporations to fund machinery purchases and it can finance cars, housing and other equipment. The Ijarah period ranges between three to seven years. The lessee may have the right to purchase the leased asset at the end of the Ijarah period through an Ijarah Muntahia Bittamleek.[150]

Wakala is very commonly used in Islamic banking in Bahrain, especially in the deposit-taking operations of Islamic retail banks[151], where depositors act as principals and banks as investment agents who channel savings to investment activities on depositors' behalf for often a waive-able fee. Bahraini Islamic retails banks themselves can now benefit from a Wakala liquidity management instrument offered by the CBB for the purpose of absorbing excess liquidity.

Istisna is used to finance the construction of buildings. The price is paid in advance or in instalments as the work progresses[152]. According to the Financial Stability Report (2017), Islamic retail banks' exposure to "Real Estate/ Construction" remains high at 29.4% of their financing portfolio in September 2016.

Salam is a forward sale contract, where a commodity is sold for future delivery in exchange for full cash payment at the time of transaction. The seller is often the party seeking financing. Salam contract is used to finance farmers, industrialists, contractors and traders.[153]

The following two tables show the diversity of Islamic financial products and services offered by Bahrain's top Islamic banks:

Table 75: Islamic Banking Products - Bahrain

Islamic Banking Products (Full Fledged)		
Commercial		
Ithmar Bank Mudaraba Musharaka Murabaha Ijarah	**Al Salam Bank** Mudaraba Musharaka Murabaha Ijarah Muntahia Bittamleeek Wakala Ististna	**Bahrain Islamic Bank** Mudaraba Musharaka Murabaha Ijarah MuntahiaBittamleek Wakala
Khaleeji Commercial Bank Mudaraba Musharaka	**ABC Islamic Bank**[154] Mudaraba Murabaha	**Family Bank** Mudaraba Murabaha

[149] Ithmaar Bank website, Morabaha, accessed 5 April 2017. See https://www.ithmaarbank.com/morabaha
[150] Ithmaar Bank website, Ijara, accessed 5 April 2017. See https://www.ithmaarbank.com/ijara
[151] Al Salam Bank Bahrain website, Wakala deposits, accessed 5 April 2017. See http://www.alsalambahrain.com/en/RETAIL-BANKING/wakala-deposits
[152] Al Salam Bank Bahrain website, Glossary, accessed 9 April 2017. See http://alsalam.hami.net/Media_Centre/Glossary
[153] Bank website, Ijara, accessed 5 April 2017. See Salam, http://www.albaraka.bh/default.asp?action=article&id=48
[154] ABC Islamic Bank website, 2015 Annual Report, accessed 12 March 2017. See https://www.bank-abc.com/world/IslamicBank/En/Investment/Annual%20Reports/Bank%20ABC%20Islamic%202015%20Annual%20Report.pdf

Murabaha Ijarah Muntahia Bittamleek Istisna Wakala	Ijarah Muntahia Bittamleek Tabdeel[155]	
Wholesale		

Source: Author's compilation from respective banks' websites and annual reports

Table 76: Islamic Banking Products for Full Fledged Banks

Al Baraka Banking Group Mudaraba Musharaka Ijarah Muntahia Bittamleek Salam Istisna	**First Energy Bank** Murabaha Wakala Ijarah Commodity Murabaha	**Bank Alkhair** Murabaha
Ibdar Bank Musharka Murabaha Ijarah	**Venture Capital Bank** Mudaraba Murabaha Wakala	**International Investment Bank** Musharaka Murabaha Ijarah Wakala
Liquidity Management Centre Mudaraba Ijarah Wakalah	**Seera Investment Bank** Murabaha Ijarah Wakala	**Global Banking Corporation** Murabaha Wakalah
Gulf One Investment Bank Provides advice on Islamic finance including the structuring and execution of Shariah compliant facilities	**Investors Bank** Murabaha	**Citi Islamic Investment Bank** Murabaha Murabaha
Investment		
Gulf Finance House Mudaraba Musharaka Murabaha Ijarah Muntahia Bittamleek Istisna Wakala	**Arcapita** Murabaha	**Investment Dar Bank** Mudaraba Murabaha Wakala

Source: Author's compilation from respective banks' websites and annual reports

Furthermore, the Economic Development Board (EDB) developed an initiative to accelerate the growth of the Islamic banking segment in order to promote small and medium sized

[155] The bank seems to be unique in its offering of this contract as an underlying for profit rate risk hedging purposes. To do this, the bank enters into two transactions: Tawarruq financing asset and Tawarruq placement liability, which are recorded off-balance sheet (see ABC Islamic Bank. 2014 Financial Statements, p9, accessed 8 April 2017. Available at https://www.bank-abc.com/world/IslamicBank/En/Investment/Documents/2014/ABC_Islamic_Bank_2014_Financial_Statements-English.pdf

enterprises.[156] Tamkeen, the agency tasked with supporting SMEs and entrepreneurship in Bahrain, acts as guarantor for 50% of any financing made to a start-up or SME and upholds the Shariah-compliance of the product involved.

According to the most recent Financial Stability Report by the CBB, the Capital Adequacy Ratio (CAR) for Islamic retail banks stood at 17.1% in September 2016[157]. This compares to 19.6% for their conventional counterparts and 19.1% for Islamic wholesale banks[158]. The ratio of non-performing facilities (NPF) was 12.1% in Islamic retail banks, as of end of September 2016, well beyond the ratios of 4.7% in conventional retail banks and 2.9% in Islamic wholesale banks[159]. Despite showing signs of improvement, Islamic retail NPF remains high. The highest impairment was recorded in the construction sector (29.4%) followed by manufacturing (26.1%) and commercial real estate financing (20.2%)[160].

The return on assets (ROA) for Islamic retail banks was 0.2% in September 2016[161], which is lower than the conventional retail banks' average of 1.1% during the same period[162]. The contrasting difference can be explained in part with reference to the banks' operating expenses. The operating expenses as a proportion of total income stood at 82.9% for Islamic retail banks in September 2016, while it was only 47.5% in their conventional counterparts[163].

Bahrain's Islamic retail and wholesale banks are characterized by high asset concentration. The top recipient of Islamic retail financing in September 2016 was personal / consumer finance (23.6%), followed by commercial real estate financing (15.3%)[164]. Together, they accounted for 38.9% of total financings extended in September 2016[165]. Overall, real estate/ construction exposure stood at 29.4% in September 2016[166].

Personal/Consumer Finance was the top recipient of financing from Islamic wholesale banks as well, at 21.3%. It was followed by manufacturing at 19.2%[167]. Islamic wholesale banks' exposure to real estate/ construction sector was at 27.4% in September 2016[168]. Concentration renders banks vulnerable to weaknesses in these and increases the risk of simultaneous delinquencies among several clients for similar reasons.

[156] Oxford Business Group (2015). Changing Times for Bahrain's Takaful Industry. 20 Mar 2015. Available online at https://www.oxfordbusinessgroup.com/overview/standard-bearer-kingdom-maintains-its-position-regional-leader-islamic-finance-spite-increasing
[157] Central Bank of Bahrain (2017b). Financial Stability Report- February 2017. Manama, Bahrain. P.55
[158] Central Bank of Bahrain (2017b). Financial Stability Report- February 2017. Manama, Bahrain. P. 4
[159] Central Bank of Bahrain (2017b). Financial Stability Report- February 2017. Manama, Bahrain. P. 4
[160] Central Bank of Bahrain (2017b). Financial Stability Report- February 2017. Manama, Bahrain. P. 47
[161] This is the same rate of return-on-assets generated by Islamic wholesale banks in September 2016. Similarly, the two genres of Islamic banks had Return on equity (ROE) of 1.6% in September 2016.Locally-incorporated conventional retail banks had a return-on-equity (ROE) of 11.4%.
[162] Central Bank of Bahrain (2017b). Financial Stability Report- February 2017. Manama, Bahrain. P. 4
[163] Central Bank of Bahrain (2017b). Financial Stability Report- February 2017. Manama, Bahrain. Pp. 50 and 38
[164] Central Bank of Bahrain (2017b). Financial Stability Report- February 2017. Manama, Bahrain. P. 49
[165] Central Bank of Bahrain (2017b). Financial Stability Report- February 2017. Manama, Bahrain. P. 49
[166] Central Bank of Bahrain (2017b). Financial Stability Report- February 2017. Manama, Bahrain. P. 49
[167] Central Bank of Bahrain (2017b). Financial Stability Report- February 2017. Manama, Bahrain. P. 52
[168] Central Bank of Bahrain (2017b). Financial Stability Report- February 2017. Manama, Bahrain. P. 53

3.9.3 ISLAMIC CAPITAL MARKETS IN BAHRAIN

Further development of services and specialized Islamic products, including leasing, loans and investment schemes has enriched the sector.

Bahrain's flag-bearing initiatives in support of Islamic finance transcend borders and extend to other segments of Islamic finance, in addition to Islamic banking, including Islamic capital markets and Takaful. Bahrain issued the first international sovereign Sukuk in 2001, to manage the liquidity of Islamic banks on the basis of Salam and Ijarah. The issuance was a major catalyst behind the growth of GCC's Islamic capital market in recent years. The CBB "remains active in the sovereign Sukuk market through the issuance of medium to long term Sukuk, complemented by a regular program of short term issuance" (Al Baker, 2015)[169].

At the same year, Bahrain signed an agreement with Indonesia, Sudan, Saudi Arabia and Malaysia to establish the International Islamic Financial Market (IIFM), which supports the international secondary market for trading of Sukuk and other Islamic financial instruments. [170]

In 2002, the **Liquidity Management Center** (LMC) was developed in Bahrain in order to underwrite Islamic financial trading and provides Shariah compliant liquidity management. Its aim was to create a secondary market for short-term Shariah compliant treasury instruments for Islamic banks. LMC commenced its first commercial operations in May 2003. LMC has been instrumental in arranging a US$150 million Sukuk for the Bahrain Financial Harbor project and a US$120 million Durrat Al-Bahrain project[171].

Bahrain is also home to the **Islamic International Rating Agency** (IIRA), which rates Takaful and Islamic financial institutions, according to credit and Shariah quality parameters. IIRA was founded in 2005 with the aim of facilitating the growth of Islamic capital markets through more Sukuk issuance. Other active stakeholders in Bahrain's burgeoning and wholesome Islamic financial system include the Sharia Review Bureau[172], Thomson Reuters Global Islamic Finance Hub and Deloitte's Islamic Finance Knowledge Centre.

As part of its initiatives, CBB executed an MoU with Tokyo Commodity Exchange (TOCOM) in 2005 to enable financial institutions, brokers and other players in Bahrain to carry out transactions on TOCOM using Shariah compliant instruments. Furthermore, the Offering of Securities (OFS) Module under Volume 6 Rulebook contains detailed rules, procedures and regulation pertaining to the issuance of different types and classes of securities, including Sukuk.

In January 2015, Bahrain Bourse (Bourse) launched a mechanism that allows Bahraini and Non-Bahraini individuals and institutions to subscribe to government issuances of Sukuk and bonds through registered brokers and trade them in the secondary market. Therefore, the

[169] Al Baker, A. (2015) Building a Transparent and Robust Foundation to Facilitate Growth in the Islamic Investment Industry. Keynote Speech at the 11th Annual World Islamic Funds and Financial Markets Conferences 2015. Manama, Bahrain: 18 May 2015. Available online at http://www.cbb.gov.bh/page-p-11th_annual_world_islamic_funds_and_financial_markets_conferences_2015.htm

[170] http://www.islamicfinance.com/2015/02/an-overview-of-the-history-of-islamic-finance/

[171] Redmoney. 2008. Bahrain Report 2007. Kuala Lumpur, Malaysia. Available online at http://www.iifm.net/system/files/private/en/Islamic%20Finance%20news%20-%20Bahrain%20Report%202007.pdf, p. 4

[172] Central Bank of Bahrain, Islamic Finance, accessed 7 March 2017, see http://www.cbb.gov.bh/page-p-islamic_finance.htm

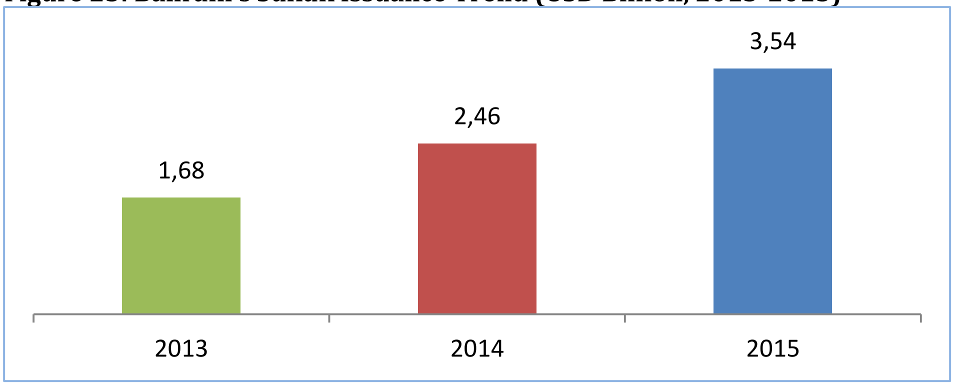
Islamic finance sector continues to grow boosted the by contribution of the Islamic banking and non-banking institutions.

Table 77: Bahrain's Sukuk Outstanding and Issued Volumes in 2015

Sukuk Volume Outstanding (USD million)	4,803
Number of Sukuk Outstanding	18
Sukuk Issuance Volume (USD million)	3,537
Number of Sukuk Issued	27

Source: Thomson Reuters, "Sukuk Preceptions & Forecast Study 2017", p. 25

Figure 23: Bahrain's Sukuk Issuance Trend (USD Billion, 2013-2015)



Source: TR report 2017

In keeping with Bahrain's leadership in Islamic finance, the CBB has taken initiatives to promote the development of the Islamic asset management industry. This includes the development of a new investment business rulebook that provides guidelines for asset management, fund administration and custody services. Furthermore, the Collective Investment Undertakings (CIUs) rule allows for a full range of investment funds catering to various types of investors, from retail to high net worth individuals and institutional investors. CBB also expanded the variety of funds that can be established in Bahrain, by introducing rules governing Real Estate Investment Trusts (REITs) and Private Investment Undertakings (PIUs), which target sophisticated investors such as High Net-Worth Individuals and Institutional investors exclusively.

As a result, the market in Bahrain has witnessed the development of a wide range of Shariah compliant funds including equity, commodity, real estate and Ijarah funds that caters to the needs of a growing middle class investors and structural reforms that encourage private and public pensions. Overall, there are 97 Islamic funds that are incorporated and registered in Bahrain with total assets under management amounting to US$1.2 billion, out of US$9 billion in total fund investment, as of March 2017 (Al Baker, 2017)[173].

All in all, the CBB has contributed immensely to the development of Bahrain's Islamic capital market products by designing a series of policy initiatives and regulatory changes and upgrades. The following are furthering examples of institutions which contributed in the evolution of the Islamic capital market:

[173] Al Baker, A. (2017) Strengthening the Regional Asset Management Industry. Keynote Speech at the Middle East Assets Management Forum 2017. Manama, Bahrain: 15 May 2017. Available online at http://www.cbb.gov.bh/page-p-middle_east_asset_management_forum.htm

Bahrain Bourse - Shariah-Compliant Index

In 2015, Bahrain Bourse introduced a trading index of Shariah compliant companies[174] to allow investors, brokers and advisors to take better investment decisions by tracking the performance of the companies' stocks listed on the index. CBB predicts that the index will encourage Islamic banks and other companies to participate in the capital market through mutual funds and trading of securities that are Shariah compliant[175].

The bourse also introduced a catalogue of product and service offerings, which includes investment and financing instruments to attract investors through providing a range of choices. Available products include stocks, Sukuk, Mutual Funds and REITs. Planned products include Exchange-Traded Funds (ETFs) and Stock Lending and Borrowing[176].

Eskan Bank Realty Income Trust was Bahrain's first Sharia-compliant REIT to be listed and traded on Bahrain Bourse in January 2017. The trust comprises two income-generating and unleveraged properties; a mixed retail and residential property; and the commercial components of a mixed-use property development. The Sharia-compliant REIT had a total value of US$53m approximately at inception[177].

Bahrain Financial Exchange

CBB regulated Bahrain Financial Exchange (BFX) to trade structured products, Shariah compliant and cash instruments. BFX developed an Islamic finance trading platform named Bait Al Bursa, which offers electronic exchange traded Islamic financial instruments as an innovative solution that meet the demand of today's Islamic finance market[178]. The range of products includes but is not limited to the following:

- **e-Tayseer**: a fully automated platform for transactions in the supply, purchase and sale of assets for facilitating Murabahah transactions. The platform allows suppliers to place their assets onto the platform ready to be purchased by financial institutions. Financial institutions can then purchase these assets and conduct Murabahah transactions with counterparties to fulfill their liquidity management requirements in a secure online environment[179].

  •**BFX product framework**: a platform for multi-asset class trading offers market participants the ability to trade multiple asset classes on one market. The BFX product has two main categories: Derivatives Instruments and Cash Instruments. The Shariah-

[174] The index comprised 17 Shair'ah compliant stocks at its inception.
[175] Bahrain website, Bahrain Bourse launches regions first Islamic Finance Index accessed 8 March 2017, see http://www.bahrain.com/en/media-centre/Pages/Bahrain-Bourse-launches-regions-first-Islamic-Finance-Index.aspx#.Vm7GsUp97IU
[176] Bahrain Bourse website. Bahrain Bourse Profile, accessed 15 March 2017. see http://www.bahrainbourse.com/resources/files/PDF/profile%20brochure.pdf
[177] Bahrain Bourse website. Eskan Bank REIT Units Commence Trading on Bahrain Bourse, accessed 1 April 2017. See http://www.bahrainbourse.com/eskan-bank-reit-units-commence-trading-on-bahrain-bourse
[178] Bahrain Financial Exchange website, Islamic markets, accessed 1 March 2017. See http://www.bfx.bh/En/Markets/IslamicMarkets.aspx
[179] Bahrain Financial Exchange website, e-Tayseer, accessed 1 March 2017. See http://www.bfx.bh/En/Markets/IslamicMarkets/E-Tayseer.aspx

compliant Financial Instruments fall under the Cash Instruments. It includes secondary Sukuk, Islamic Equities, Murabahah and Islamic ETFs[180].

3.9.4 TAKAFUL (ISLAMIC INSURANCE) IN BAHRAIN

The Takaful industry in Bahrain is one of the fastest growing segments in Islamic finance. There are currently six Takaful operators and two Re-Takaful companies in Bahrain, including Takaful arms of conventional insurance companies, such as Allianz Takaful Bahrain and Hannover ReTakaful. One of the major drivers of the industry's growth in recent years has been the implementation of compulsory health insurance schemes and compulsory insurance for motors (Third Party Insurance), as well as the increasing demand for Shariah compliant insurance, growing public awareness about Takaful and the existence of legislations that promote the development of Takaful in Bahrain.[181] CBB's insurance rulebook regulates the Takaful industry.

In 2014, the CBB revised the Operation and Solvency framework for Takaful and Retakaful industry. Revisions were aimed at keeping shareholders' Qard injection to a minimum and ensuring the adequacy of fees and charges levied in the hybrid Wakala-Mudharaba model operational in the kingdom. The revised model emphasises the creation of adequate reserves and ensures the solvency of participants' fund in an attempt to protect the interests of all stakeholders.

According to the CBB, the Takaful industry's gross contributions grew 3% in 2015 compared to the previous year, as a result of this change[182]. Takaful Firms in Bahrain contributed around 23% of the total gross premiums in the insurance industry in 2015, which was equivalent to USD 167 million[183]. This represents a remarkable growth when compared to a share of only for 3% of Bahrain's insurance premiums in 2001[184].

Re-Takaful firms in Bahrain contributed around 21% of the total reinsurance gross premiums in in 2015[185].

The commonly used Takaful products are family and general products as they benefit the policy holders and the community as a whole. The family Takaful enables families to ensure their future despite unforeseen circumstances. The general Takaful includes the protection of products, such vehicles and houses, and the needs of the business community. General Takaful remains dominant in the Bahraini Takaful industry. The share of family Takaful in the total

[180] Bahrain Financial Exchange website, Product Framework, accessed 1 March 2017. See http://www.bfx.bh/en/Markets/ProductFramework.aspx

[181] Central Bank of Bahrain, The Review (December 2014), accessed 13 March 2017, see http://www.cbb.gov.bh/assets/The%20Review/The_CBB_Review_Dec_2014.pdf

[182] Central Bank of Bahrain, Insurance Market Review (2015), p4, accessed 13 March 2017, see http://www.cbb.gov.bh/assets/Insurance%20Market%20Review/Insurance_Market_Review_2015.pdf

[183] Central Bank of Bahrain, Insurance Market Review (2015), p 10, accessed 13 March 2017, see http://www.cbb.gov.bh/assets/Insurance%20Market%20Review/Insurance_Market_Review_2015.pdf

[184] Mena Insurance CEO Club website, Takaful Market Profile - Bahrain: Setting its sights high on takaful, accessed 19 March 2017 http://www.menainsuranceceoclub.com/Article.aspx?id=12991

[185] Central Bank of Bahrain, Insurance Market Review (2015), p 30, accessed 13 March 2017, see http://www.cbb.gov.bh/assets/Insurance%20Market%20Review/Insurance_Market_Review_2015.pdf

Takaful industry increased from 15% in 2010 to 20% in 2013, driven by demand for investment-linked products[186].

Generally, the preferred investments of Takaful operators in the GCC are influenced by the economy such as real estate and equity assets[187]. The CBB continues to play an important role in promoting the Islamic Takaful industry both locally and globally, reaffirming Bahrain "as the jurisdiction of choice for Takaful and Re-takaful companies" [188].

3.9.5 BEST PRACTICES, ACHIEVEMENTS AND CHALLENGES

Best Practices

Bahrain has several organizations dedicated to improving Islamic finance policy and regulations and providing Islamic Finance training. Such organizations include the **Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)**, the **International Islamic Financial Market** (IIFM), the **General Council for Islamic Banks and Financial Institutions** (CIBAFI), the Islamic International Rating Agency (IIRA), the Thomson Reuters Global Islamic Finance Hub and Deloitte's Islamic Finance Knowledge Centre[189].

These key enablers, boosted by strong government support, have contributed to the development of an expanding Islamic capital market. Moreover, CBB regulates the banking industry to ensure economic growth and efficient allocation and mobilization of funds. For example, in 2015, CBB launched a Shariah compliant Wakalah liquidity management instrument aimed at absorbing the excess liquidity of local Islamic retail banks and placing it with the central bank. The instrument was developed on the basis of a standard International Islamic Financial market contract[190].

AAOIFI's standard-setting efforts continue to safeguard the industry's interests and those of its stakeholders through regular updates and revisions on the Shariah standards in the AAOIFI and the conferences they hold. In March 2017, AAOIFI published a draft of its accounting standard on Murabahah and Other Deferred Payment Sales to receive constructive feedback from the Islamic finance industry[191]. Similarly, in February 2017, it published a draft on the standards of Sukuk issuance to provide details of the draft and receive feedback[192].

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[186] Central Bank of Bahrain, The Review (December 2014), accessed 13 March 2017, see http://www.cbb.gov.bh/assets/The%20Review/The_CBB_Review_Dec_2014.pdf

[187] Thomson Reuters, Innovation in Islamic Liquidity management, p25

[188] Central Bank of Bahrain, The Review (December 2014), accessed 13 March 2017, see http://www.cbb.gov.bh/assets/The%20Review/The_CBB_Review_Dec_2014.pdf

[189] ICD-Thomson Reuters, Islamic Finance Development Report 2015: Global Transformation, see http://www.zawya.com/ifg-publications/report/20151230100025914.pdf/

[190] Central Bank of Bahrain, Press releases, accessed 17 March 2017, see https://www.cbb.gov.bh/page-p-the_central_bank_of_bahrain_launches_a_new_liquidity_management_instrument_(wakalah)_for_the_islamic_retail_banks.htm

[191] AAOIFI website, Announcement, accessed 16 March 2017, see http://aaoifi.com/announcement/aaoifi-publishes-exposure-draft-of-the-financial-accounting-standard-murabaha-and-other-deffered-payment-sales-and-invites-opinion-from-islamic-finance-industry/?lang=en

[192] AAOIFI website, Announcement, accessed 16 March 2017, see http://aaoifi.com/announcement/aaoifi-publishes-exposure-draft-of-the-financial-accounting-standard-sukuk-and-invites-opinion-from-islamic-finance-industry/?lang=en

In December 2016, IIFM held its 35th meeting in Bahrain and endorsed a detailed plan to improve IIFM's main initiatives of standardization of Islamic financial contracts and product templates[193].

Practical Challenges for Islamic Finance in Bahrain and its Relation to Conventional Finance

Islamic banks face liquidity management challenges because of the lack of Shariah compliant high quality liquid assets, which pressures its compliance with Basel III liquidity and funding ratios. The necessity of complying with Basel III, leaves the Islamic banks at a disadvantage to conventional banks[194].

The growth in the Islamic finance sector in Bahrain is partly constrained due to the fragmentation in Islamic financial products. Furthermore, it needs to have a larger share of the retail market to continue its provision of retail credit products. In order to further develop the Islamic finance in Bahrain, it is critical to have more qualified individuals in the market[195].

3.9.6 POLICY RECOMMENDATIONS

In light of the discussion above, a number of recommendations are proposed with the aim of strengthening the Bahraini Islamic financial system and fostering diversification in an overall environment characterized by increased competition.

- 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. It is worth noting the potential of Blockchain in this regard. Blockchain-enabled solutions are expected to eliminate significant components of banks' cost base, resulting in meaningful savings of up to 30, 40 and even 50 percent.
- Given the high rate of NPF at Islamic retail banks, policies should be aimed at controlling the credit risk of banks' financing portfolios, trying in this respect to 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 mitigate the sectorial concentration risk, the regulator may implement sector limits with reference to market studies and industry's best practices. Limits should be regularly reviewed and evaluated to account for changing economic and business conditions. Precautionary thresholds should also be introduced below the maximum limit; to necessitate reporting to regulatory authorities before concentration becomes excessively risky.

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[193] The International Islamic Financial Market (IIFM) website, News updates, accessed 24 March 2017, see http://www.iifm.net/news-updates/iifm-holds-its-0

[194] Central Bank of Bahrain, The Review, accessed 13 March 2017, see http://www.cbb.gov.bh/assets/The%20Review/The%20Review%20CBB_Sept2015.pdf

[195] Dilmun Times website. Islamic finance sector facing key challenges, accessed 25 March 2017, see http://www.dilmun-times.com/?p=17256

- Since concentration may be a reflection of lack of diversification, diversification strategy can be used to reduce portfolio's overexposure to construction and shift the focus of Islamic banks from real estates toward new asset classes and markets, such as SMEs. In addition to reducing NPF, advances in financial technology and innovative risk assessment models may prove instrumental here.
- In the face of continuing uncertainties and recurrent plunges in oil prices, broadening the base of issuers and investors of Sukuk can provide the necessary means to deepening Islamic capital market and reducing hydrocarbons-dependency. Oman's debut retail Sukuk sets an example in this regards. There is also a need for innovation in Islamic capital markets to mobilize capital beyond Sukuk.
- In this regards, it may be worth considering facilitating 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. In turn, this can further improve the Bourse's liquidity and depth, thereby strengthening its competitiveness and enhancing its appeal.
- Financial technology can also boost the penetration of Takaful companies allow provide access to traditionally underserved markets, such as blue-collar workers. It can also improve profitability and pricing of risks.

3.9.7 SUMMARY

The Bahraini market has shown marked progress over the years as a leading hub for Islamic finance. A robust regulatory framework and specialized Islamic financial institutions, along with strong government support, have contributed to the development of a wholesome Islamic financial system in the Kingdom. In addition to further developing existing institutions and frameworks, it would be apt for the CBB and other stakeholders to explore non-traditional market strategies that are in compliance with Shariah.

FinTech based platforms and solutions may serve as enablers for integration with a burgeoning global FinTech ecosystem, particularly with an Islamic financial relevance and in line with impact oriented strategies. The CBB has already taken steps in the form a white paper for consultation on a Regulatory Sandbox for Fintech. New and innovative products are critical not only to capture new markets but also to retain increasingly tech-savvy customers demanding convenience and immediacy. Islamic financial institutions may no longer successfully compete without investing in innovation.

FinTech may also prove instrumental amidst falling oil prices by saving banks huge amounts of transactions costs; tapping into new sources of funds and enhancing risk assessment methods. Not to mention the potential of actualizing the value proposition of Islamic finance and improving Takaful outreach.

3.10 CASE STUDY: UNITED KINGDOM

3.10.1 INTRODUCTION

The United Kingdom, an economy with a GDP of USD 2.619 trillion and a population of 65.6 million[196], has been the leading western Islamic Finance hub over the years. Its status as the hub has grown by leaps and bounds over the years as the penetration of Islamic financial products has increased in the local market as well. Islamic finance in UK is nearly 40 years old in one way of the other primarily in the form of professional and support services for the global Islamic finance industry. In the recent ICD Thomson Reuters, Islamic finance Development Report, ranks UK at an index value of 16.2, above the global average of 10.3 and the highest ranking of any non-Muslim-majority country.

In terms of numbers, the institutions offering Islamic financial services based in United Kingdom is about double of the ones located in the US and far ahead of other Western countries. A cautious estimate of the Islamic financial services assets in UK at the turn of the year 2016 was $4.5bn. In recent years' Islamic finance has played a crucial role in the domestic economy of the United Kingdom in infrastructural development. Some of the key projects which have been financed in Shariah compliant manner include the The Shard, Battersea Power Station regeneration, London Gateway, the Olympic Village and the redevelopment of Chelsea Barracks and nearly 6,500 homes in the North-West and the Midlands through financing bye Gatehouse Bank.

The main impetus for the growth has come from the UK government policies over the last decade which have created a fiscal and regulatory framework intended to broaden the market for Islamic products. This includes the removal of double tax and extension of tax relief on Islamic mortgages and the reform of arrangements for issues of debt. The regulatory framework under which Islamic finance operates is generic and applicable to all sectors, thus providing a level playing field for the industry. The Islamic finance retail market has developed in recent years with the launch of a series of Sharia compliant products including individual savings accounts, home purchase plans, a Sharia compliant pension scheme and business start-up financing. The Government is also developing Islamic student financing. There are now over 100,000 Islamic finance retail customers in the UK. There are currently five fully Sharia compliant banks licensed in the UK which puts it in the lead amongst Western countries. Assets of these banks totaled $3.6 billion at the end of 2014.

The government of the United Kingdome has also emerged in 2014 as the first western nation to issue a sovereign Sukuk in the global Islamic capital markets marking a beginning of a new era. In 2014, the UK Government sold £200m of Sukuk, maturing in 2019, to investors based in the UK and in major global hubs for Islamic finance. The UK's first sovereign Sukuk was oversubscribed with very strong demand and orders totaling around £2.3 billion. In addition to that, the London Stock Exchange has been a key venue for global Sukuk issuances by corporates and sovereigns with a total value of $48 billion being raised in Sukuk from the market.

[196] World Bank data (2016), United Kingdom. See http://data.worldbank.org/country/united-kingdom

Further expanding the scope of Islamic finance, from early 2015 the government has also announced a UK Export Finance (UKEF) provision of Sharia compliant support for UK exporters, in efforts to further strengthen London's status as Islamic finance hub of the western world. This effort was followed by UK Government-backed export credit guarantee agency underwriting its first Sukuk where they provided cover for a $916 million Sukuk issued by Dubai's Emirates Airline.

With the growth in the industry, United Kingdom has been at the forefront of the soft skills services by developing the human resource for the Islamic financial sector. UK is by far the largest provider of Islamic finance courses at both the undergraduate and postgraduate level, with offerings at around 70 educational institutions.

3.10.2 ISLAMIC BANKING IN UK

Within Europe, United Kingdom has been taking leaps and bounds to become the hub of Islamic finance with an aim for not only Europe but a global perspective. The history of Shariah compliant financial instruments in United Kingdom goes back nearly three decades, but it has been recent efforts which have brought it to limelight.

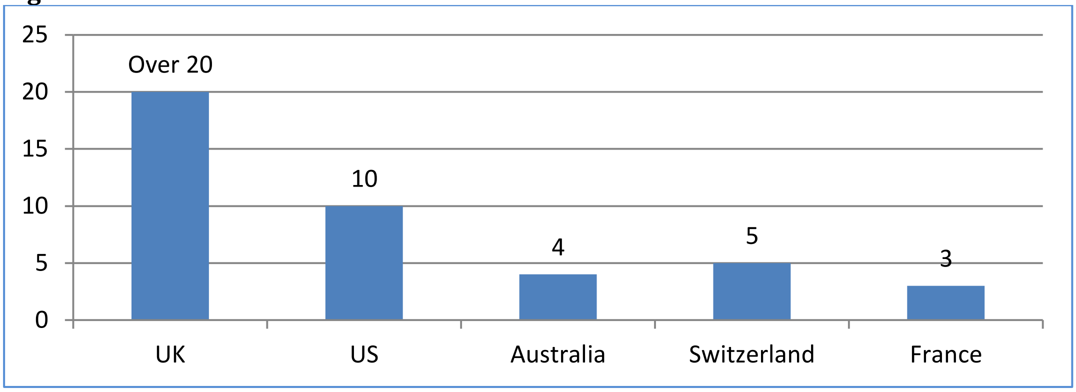
The factors which have contributed towards the development of UK as a focal point of Islamic finance in Europe has been brought forward not only with the demand from consumers but credit goes to the governmental support and a favorable regulatory environment. Some of these regulatory changes on behalf of the government have been started to attract the interest of global players. Some of the key changes in regulations which have contributed to the development are highlighted below.

- The removal of double tax on Islamic mortgages and the extension of tax relief on Islamic mortgages to companies, as well as to individuals;
- Reform of arrangements for issues of debt so that returns and income payments can be treated as if it were interest. This makes London a more attractive location for issuing and trading Sukuk;
- Initiatives by the Financial Services Authority (FSA) to ensure that regulatory treatment of Islamic Finance is consistent with its statutory objectives and principles.

UK stands as the leader of Islamic banking in European markets. (See the Figure below)

With these initiatives, western banks have ventured into Islamic finance within UK, and initiated offering of Shariah Compliant financial products to the Muslim consumers in United Kingdom. The beginning of this growth started in 1990s when Gulf banks entered UK by introducing Islamic mortgages based on the Murabaha principle and Ijarah financing to cater to the growing needs of housing of Muslims. Initially these instruments faced cost issues as cost concerns as double stamp duty would apply. The abolition of double taxation regime in 2004 paved the way for mainstreaming of these instruments. Ten major global banks operating in the UK have set up units to provide Islamic financial services. United Kingdom is also home to the first fully fledged Islamic Bank in the non-Muslim world. The number of truly standalone Islamic banks has grown in the past few years and in 2017, there are five fully fledged Islamic banks operating in the country.

Figure 24: Number of Islamic Banks in Western Markets



Source: The city UK

Out of the 5 fully fledged Islamic banks, only one of the banks Al Rayan Bank PLC (formerly known as Islamic Bank of Britain) established in 2002 is a retail bank. The other banks have focused more on investment banking and on more high net worth clients. The remaining four fully fledged Islamic banks (namely: European Islamic Investment Bank (EIIB), Bank of London and the Middle East (BLME), QIB (UK), Gatehouse Bank) are primarily investment banks with a business model relying on

- Fee-based services such as private banking or asset management.
- Proprietary trading.
- Providing finance to large customers where most of the finance provided is then syndicated to other banks or sold in the market (if constituted as marketable securities such as Sukuk) with some being retained on balance sheet.

All four of the other Islamic banks in the UK are investment banks. While established in London, their field of operations is not limited to the UK; instead they aim to operate internationally. Structurally these banks can be divided into two groups

EIIB and BLME do not have a single controlling shareholder. They also have a relatively large amount of shareholders' funds. This gives them much greater capacity (compared with the other two) to use their balance sheets when providing finance or engaging in proprietary trading and investment.

QIB (UK) plc was until recently called European Finance House Ltd but from inception has been a subsidiary of Qatar Islamic Bank. Both QIB and GB are subsidiaries and have a relatively small amount of shareholders funds. Accordingly, their business model will major on fee-based activities with a relatively small amount of proprietary trading. Where customer finance is provided, virtually all the finance provided will need to be syndicated as the bank's own balance sheet is relatively small.

Profiles of leading Islamic Banks in United Kingdom

Al Rayan Bank PLC (formerly known as Islamic Bank of Britain) is a commercial bank was established in 2004 to offer Sharia compliant financial service products to customers of any faith. The bank has branches in London, Birmingham, Manchester and Leicester and agencies in Blackburn, Luton, Tooting, Wembley, Ilford, Bradford and Glasgow. It is the first British bank claiming to operate, in its entirety, according to Islamic principles [2]. The bank welcomes people of all faiths and is becoming increasingly popular with non-Muslims, looking for an ethical alternative to conventional banks. The bank prides itself on its five value system, Sharia compliant, community oriented, secure, good value and pioneering. As of 2017 Al Rayan Bank serviced 77,000 customers

In 2005 the founders of the Islamic Bank of Britain (IBB) identified a market opportunity to create a new-style Islamic investment bank in London, leveraging London's leadership in financial services and its high regulatory standards. After extensive research, the European Islamic Investment Bank was founded, and in March 2006 the Financial Services Authority (FSA) authorised EIIB to become the first Islamic investment bank in the UK.

The other large Investment bank in UK is the Bank of London and The Middle East PLC (BLME) dedicated to offering Shariah-compliant investment and financing products to financial institutions, corporates and high net-worth individuals in Europe and the MENA region. It launched in July 2007 as a stand-alone, wholesale Shariah compliant bank. BLME's products and services are available to both Islamic and non-Islamic institutions, from those who use Islamic Finance regularly to those who have had no previous involvement with it. BLME focuses on four main business lines:

- Islamic Treasury and financial institutions – a complete package of products and services to help manage liquidity;
- Corporate banking – addressing all the financing needs of corporates, projects and institutions;
- Private banking and investment management – assisting high networth individuals with their banking and investment management requirements and;
- Investment banking – providing a wide range of investment products for institutions, banks and corporates as well as providing corporate finance advisory services.

QIB UK took on its new branding in 2010 to reinforce its identity within QIB's global network. QIB UK offers a range of Shariah compliant financing and investment products for both Islamic and non-Islamic clients alike. It provides Shariah compliant investment banking services including trade finance, private equity and asset management to clients ranging from high net worth individuals to sovereign wealth funds and other institutional investors.

Gatehouse Bank is a Shariah compliant wholesale investment bank operating in capital markets, real estate, asset finance, and treasury business and Shariah advisory services. The bank manages $1.7bn real estate assets across the US and UK. In 2012 the bank issued the UK's first ever real estate backed sterling Islamic instrument based on the concept of Sukuk Al-ljarah.

The other conventional banks which offer Shariah compliant services as windows are listed below.

Table 78: Conventional Banks in UK Offering Shariah Compliant Services

1.	ABC International Bank
2.	Ahli United Bank
3.	Bank of Ireland
4.	Barclays
5.	BNP Paribas
6.	Bristol & West
7.	Citi Group
8.	Deutsche Bank
9.	Europe Arab Bank
10.	IBJ International London
11.	J Aron & Co
12.	Lloyd's Banking Group
13.	Royal Bank of Scotland
14.	Standard Chartered
15.	UBS (United Bank Scotland)
16.	United National Bank

Source: Created by Author

Financial Instruments in Islamic Banks

As elaborated in the previous section the Islamic banking industry in UK comprises of three categories which in 2016 amounted to nearly USD 3.5 billion in assets.

1. One fully Shariah compliant Islamic Bank with retail banking.
2. 4 fully Shariah Compliant wholesale and Investment Banks
3. 16 banks with window operations or partial Shariah compliant instruments in their portfolios.

The instruments that are on the offer by these banks spread across multiple different legal contracts, and are all endorsed by their respective Shariah Boards. The broader classification of the instruments available in UK can be under three heads; retail banking, corporate banking and private banking.

The following section discusses the legal contracts that are used by the UK banks under two categories for standardization Deposit mobilization, and Financing.

Deposit Mobilization Products

Mudharabah: The products that are offered under retail banking include primarily Savings accounts which are based on the principles of *Mudharaba* and designed specifically to meet the requirements of customers who authorize the bank to invest their cash deposits. These accounts come both in the form of demand and time deposits. These deposits are mobilized and a deposit pool is created which is further invested in a Shariah compliant and ethical. Profit sharing by the bank with the customers is variant in terms of different nature of the account. In some accounts the profit is announced and shared monthly, and in some cases on a quarterly or yearly basis.

To cater to the growing long term saving needs of the Muslims in UK Al Rayan Bank has introduced fixed term deposits which are for 1 year, 2 year and 3 year, with expected higher profits. To inculcate savings behavior in youngsters, they have also introduced Mudarabah based deposit accounts for kids which are designed to start paying the profits either as the kid is of university age or marriage age depending on the initial understanding.

Musharakah: *Musharakah* which is a popular source of deposit account globally is used sparsely in the UK. It is mainly used by the wholesale banks primarily for attracting large customers. The types of accounts differ mainly on the minimum amount requirement, the tenor and the agreed profit sharing ratio. The tenor ranges between 6 and 9 months.

Qard Hassan: The Qard Hassan contract is the most popular contract in terms of Current Accounts being held at the Islamic banks and the Islamic windows. The benefit of this account is primarily the high frequency of usage this account allows to the customers. The introduction of Qard Hassan contract for Current Accounts in UK is credited to HSBC Amanah, who utilized their global experiences to introduce the a Qard Hassan contract to attract salaried individuals into the Islamic banking.

Wakala: *Wakala* is used mainly by the institutions to operate an investment account, *Zakat* accounts. This contract when used for investment account is normally targeted to corporate and individual that wants periodic and stable return on their investments. The bank receives deposits from its customers and invests the same in a specific business venture to agree with the customer. Another popular use of Wakala contract is in money remittance to other countries. With a large number of Muslims in UK being of origin of other countries, home remittance is a major sector which Islamic banks have started exploring over the last two years using a Wakala contract. Primarily in this arrangement, the bank acts as the agent of the customer to deliver the money to another location, and in return of the services charges a fee. The fee is fixed and agreed upon at the onset of the Wakala agreement.

Wadiah: The wadiah account while popular in other parts of the world is rarely used in the UK Islamic Banking industry. This contract is rarely used by wholesale banks for customer deposits, but the occurrence is rare.

Financing Products

Murabaha: This is a cost plus contract which is used by the institutions to finance acquisition of an asset for an individual or corporate customer. The institutions have different variants of *murabaha* to suit divergent customer needs. The Murabaha contract is one of the more popular contracts, and one of the older ones. In 1980s the London Metal Exchange had introduced this contract for liquidity management, thus the financial sector is well versed with it. Secondly Murabaha was one of the most popular contracts for home mortgages as a prelude to full-fledged Islamic Banks in UK. The Islamic banks in UK currently use this contract for personal finance, household appliances, vehicle, working capital, and international trade uses. The popularity of Murabaha contract can be judged from the fact that it nearly comprises 60% of the asset side of the balance sheets of UK Islamic banking operation that are available.

Ijarah/Ijarah wa Iqtina: *Ijarah* and its variants are generally lease contracts mainly used by the banks for asset financing. They are structured to meet the customers' needs at the point of transaction. The banks normally finance things such as Service using a typical *Ijarah* by purchasing/leasing the asset from the service provider and enter into lease agreement with the customer in consideration for lease rental). *Ijarah wa Iqtina* (lease to own) is one of the most popular *Ijarah* variants that is commonly used by the banks in Nigeria. It is used for home finance where the bank partners with its customer to jointly own a house identified by the customer. The customer in turn agrees to lease the bank's share of the house while gradually buying the bank's share of the house. Rent paid by the customer gradually decreases as customer's share of the house increases with buying out of the banks share. It is also used to provide customer with a medium term financing by way of leasing and final acquisition of items such as plant & machinery, property, equipment, heavy machinery, and other fixed assets.

Musharakah/Diminishinh Musharkah: *Musharakah* is one of the more popular contracts over the last couple of years. It is a mode of financing in the form of a partnership between the bank and the customer whereby each party contributes to the capital of the partnership in equal or varying degrees either to establish a new project or share in an existing project. The popularity of this contract is primarily in the home financing sector. Majority of the new home financing since 2014 at retail level is being undertaken using the Diminishing Musharakah contract.

Istisna: This contract is employed by the banks for project financing. This contract has become popular use by the 4 Islamic Investment Banks in catering to large financing needs of their clients. Under this arrangement Customer requests and the bank agrees to execute the project at the bank's selling price (cost plus profit margin) on deferred payment terms and thereafter the bank enters into parallel *Istisna* with another contractor to construct the project at the bank's purchase price (cost price / facility amount). Upon completion, the contractor hands over the project to the bank or the bank authorize the contractor to deliver the project directly to customer.

3.10.3 ISLAMIC CAPITAL MARKETS IN UK

The history of United Kingdom's role in the Islamic Capital Markets dates back three decades, in the 1980's when London Metal Exchange started providing Shariah-compliant overnight deposit facilities based on the Murabaha principle. While other Muslim majority countries have dominated the Sukuk markets in recent years, some of the earlier large scale issuances started in 2005 when Sanctuary Building Sukuk was launched. It became the first corporate Sukuk out of the western hemisphere, and became a landmark of the acceptance of Sukuk out of the traditional domain of Islamic countries in Asia and Middle East. In 2010 another corporate Sukuk issuance followed when International Innovative Technologies (IIT) Ltd issued a Sukuk. Recognizing the Sukuk as a major player in the capital markets, the British government undertook a consultation on the legislative framework for alternative finance investment bonds or Sukuk that are structured to have similar economic characteristics to conventional debt instruments. Following the consultation, the government introduced measures clarifying the regulatory treatment of corporate Sukuk, which reduced the legal costs for this type of investment and removed unnecessary obstacles to their issuance.

The governmental efforts further expanded in March 2013, when the UK Government established an Islamic Finance Task Force to deliberate on measures to bring London to the mainstream Islamic finance and work towards being the global hub of Islamic finance. The Shariah compliant capital markets of UK have been well supported by a strong sector of legal experts, with nearly 25 legal firms offering their expertise in Sukuk structuring globally headquartered in London. Specialist services are also available for advice on tax, listings, transactions, regulations, compliance, management, operations and information technology systems.

On the innovation side UK has been at the forefront. In 2015, the government of the United Kingdom and UK Export Finance participated as underwriters to their first global Sukuk its first Islamic bond, as a sign of London's growing role in the global market for Shariah compliant debt. Also, the export credit agency (ECA) of UK in 2015 provided a cover of GBP617 million (US$936.95 million) Sukuk issued by Dubai's Emirates Airline for purchase of Airbus A 380s. This was the first incident of a Sukuk issuance in the global market with the backing of an export credit agency and the largest offering of any kind of Debt instrument. The innovative arrangement allowed for opening doors to pre-funding the sale of aircrafts which is being copied by other upcoming Sukuk structures.

The highlight of the first Shariah compliant pre-delivery payment (PDP) helicopter financing deal was the role of Bank of London and the Middle East (BLME) as the Islamic financing party. This deal opened up the possibility to allow LCI Helicopters to complete the world's first secured helicopter PDP funding under an Islamic finance structure. The innovative multi-year financing arrangement covers approximately US$250 million worth of Airbus helicopter assets.

London Stock Exchange

London Stock Exchange is a key global venue for the issuance of Sukuk. As of March 2017, US$48 billion has been raised through 65 issues of Sukuk London Stock Exchange. The Exchange has diversified and currently offers the choice of two routes to market – the Main Market or the Professional Securities Market. The Main Market is the Exchange's flagship international market for established companies and offers access to deep pools of capital and the benefit of a high profile launch to market. The Professional Securities Market, which is Exchange-regulated, offers the benefits of listing with more flexible regulatory requirements. It allows the admission of debt securities and Sukuk without the requirement for a full prospectus as only listing particulars are required and the disclosure requirements are tailored to wholesale needs as they can be governed by domestic GAAP rather than IFRS.

The current Sukuk actively trading on the London Stock Exchange are listed in the Table (Actively Traded Sukuk on LSE) given below.

Table 79. List of Actively Traded Sukuk on London Stock Exchange

Issuer Name	Issue Date	Maturity	Coupon (%)	Amount Issued (USD)
IDB Trust Services Ltd	07/12/2016	07/12/2021	2.263	1,250,000,000
DP World Crescent Ltd	31/05/2016	05/31/2023	3.908	1,200,000,000
Hilal Services Ltd	13/04/2016	13/04/2021	2.468	300,000,000
IDB Trust Services Ltd	10/03/2016	10/03/2021	1.775	1,500,000,000

Issuer Name	Issue Date	Maturity	Coupon (%)	Amount Issued (USD)
IDB Trust Services Ltd	29/02/2016	01/03/2023	0.255	326,241,000
Khadrawy Ltd	31/03/2015	31/03/2025	2.471	913,026,000
IDB Trust Services Ltd	12/03/2015	12/03/2020	1.831	1,000,000,000
IDB Trust Services Ltd	25/09/2014	25/09/2019	2.111	1,500,000,000
IDB Trust Services Ltd	17/07/2014	17/07/2019	1.8118	1,000,000,000
HM Treasury UK Sovereign Sukuk Plc	02/07/2014	22/07/2019	2.036	343,220,000
IDB Trust Services Ltd	06/03/2014	06/03/2019	1.8125	1,500,000,000
IDB Trust Services Ltd	04/06/2013	04/06/2018	1.535	1,000,000,000
ADIB Capital Invest 1 Ltd	19/11/2012	Perpetual	6.375	1,000,000,000
SoQ Sukuk AQSC	18/07/2012	18/01/2023	3.241	2,000,000,000
SoQ Sukuk AQSC	18/07/2012	18/01/2018	2.099	2,000,000,000
EI Sukuk Co Ltd	11/07/2012	11/01/2018	4.147	500,000,000
IDB Trust Services Ltd	26/06/2012	26/06/2017	1.357	800,000,000
BSF Sukuk Ltd	22/05/2012	22/05/2017	2.947	750,000,000
Saudi Electricity Global Sukuk Co	03/04/2012	03/04/2022	4.211	1,250,000,000
Saudi Electricity Global Sukuk Co	03/04/2012	03/04/2017	2.665	500,000,000
MAF Sukuk Ltd	07/02/2012	07/02/2017	5.85	400,000,000
FGB Sukuk Co Ltd	18/01/2012	18/01/2017	4.046	500,000,000
EIB Sukuk Co Ltd	18/01/2012	18/01/2017	4.718	500,000,000
CBB International Sukuk Co SPC	22/11/2011	22/11/2018	6.273	750,000,000
DP World Sukuk Ltd	02/07/2007	02/07/2017	6.25	1,500,000,000

Source: Created by Author

Indices and Funds

UK has also been the leader in the Shariah Compliant Indices, with their FTSE Shariah Global Equity Index Series that has been designed to be used as the basis for Shariah-compliant investment products that meet the requirements of Islamic investors globally.

According to ICD Thomson Reuters[197], the net assets of Islamic funds in the UK amount to around $600 million. A total of seven Sharia compliant ETFs and two Sharia compliant ETPs are listed on the LSE. BLME launched the first Sharia compliant fixed income fund in March 2009 and it remains the only Shariah income fund that is rated A by Moody's, the international rating agency.

UK Sovereign Sukuk

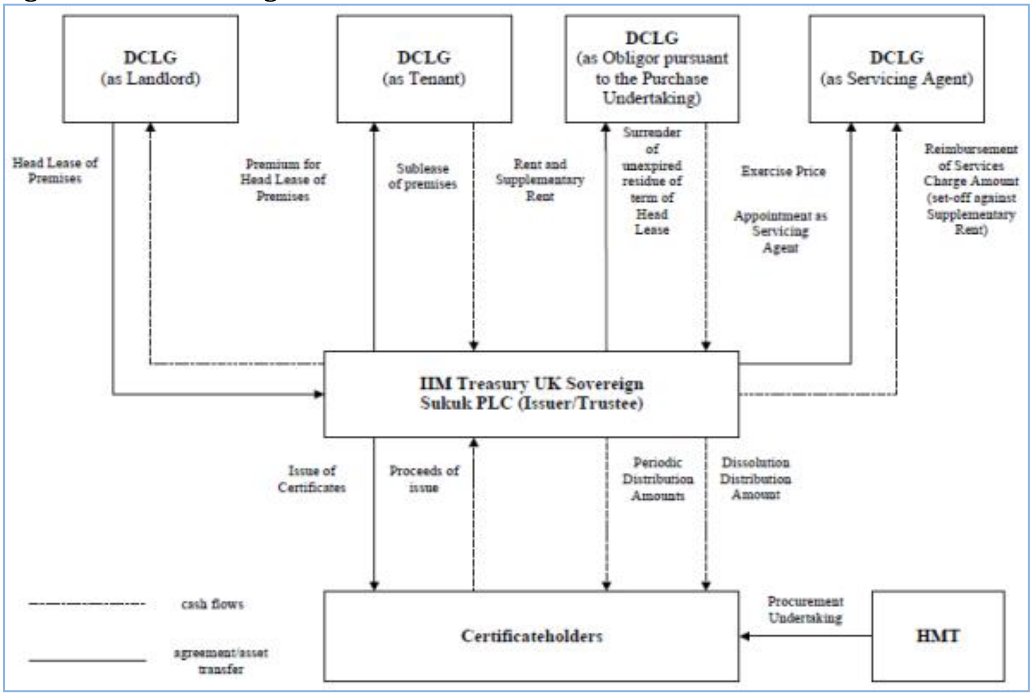
On 2nd July 2014, UK government became the first western country to issue a sovereign Sukuk capping an effort to mainstream Islamic Capital Markets in London. The issue by Her Majesty's Treasury through its wholly owned subsidiary HM Treasury UK Sovereign Sukuk PLC, of a £200 million Sharia-compliant trust certificate using a Sukuk al Jjarah structure constituted a seminal moment. The structure as taken from the offering document is provided below. Based on an Ijarah structure, the proceeds of this specific issue were used to acquire the lease of certain land and buildings from The Secretary of State for Communities and Local Government (DCLG). The properties were then sub-leased back to DCLG in return for DCLG making periodic rental payments. These rental payments are to be used by the issuer to fund its distributions to the Sukuk holders.

Briefly the steps included in the process are summarized below.

- UK crown established a subsidiary named HM Treasury Sovereign Sukuk PLC (HTSS) to issue the Sukuk.
- HTSS issues Sukuk certificates to public with total amount of £200 million in the form of Trust Certificates
- HTSS using the money raised buys land and buildings from the government within London district.
- Once the legal possession of the land and buildings is transferred to HTSS, the HTSS leases these building and land to DCLG.
- DCLG will make semin annual rental payment for the use of the land and buildings, which is transferred to the investors.
- At the maturity, DCLG has promised to buy the land and building from the investors, which will act as the redemption of the Sukuk.

[197] ICD-Thomson Reuters Islamic Finance Development Indicator (IFDI)

Figure 25. UK Sovereign Sukuk Structure



Source: Created by Author

3.10.4 TAKAFUL (ISLAMIC INSURANCE) IN UK

The Takaful industry is the youngest components of the Islamic financial services. While the industry is growing at a rapid pace worldwide, with estimates by Ernst and Young suggesting a size of nearly $20 billion by the end of 2017, the United Kingdom market has seen mixed results. Unfortunately, not much data is available on the Takaful industry in the United Kingdom. Despite the global development of Takaful industry, in UK, full-fledged retail Takaful companies as per our information are only two; Muslim Insurance Services (MIS) and Salaam Halal Insurance. MIS provides several Islamic insurance products ranging from personal insurance products to commercial insurance products. As personal products, they provide home insurance and travel insurance with different options to suit Muslim needs, e.g. single trip insurance, annual multi trip insurance, family travel insurance, pre-existing medical insurance, business travel insurance and Hajj/Umrah travel insurance. In addition, they also provide a package of products for commercial needs, such as business insurance, professional indemnity insurance, landlord insurance, mosque insurance and charity insurance. The last two are unique which aim to insure and protect the religious and charity buildings in the UK, including asset and liability cover. Prior to these companies, Principle Insurance Holdings Limited had ventured into Takaful in UK car insurance trading as ``Salaam Halal'' since July 2008. However, their business model did not pan out and they stopped taking in more clientele on Takaful side.

Over the last two years' efforts have been made to expand the Takaful industry in UK, with the establishment of the Islamic Insurance Association of London (IIAL) in 2015. Their members currently include Lloyd's, the Chartered Insurance Institute (CII), the London Market Group

(LMG), the London International Insurance Brokers' Association (LIIBA) and TheCityUK. The focus of the association has been more on commercial Takaful aspect, by providing support to the work of those in the UK re/insurance markets that are transacting Islamic finance.

The potential of Takaful industry in United Kingdom is huge, as London is one of the largest insurance markets in the world, and the leading global Centre for wholesale insurance and reinsurance. UK has historically been the pre-eminent home of specialty underwriting capacity and expertise. Banking on this experience and reputation, Takaful industry in UK is expected to grow in the coming years.

3.10.5 POLICY RECOMMENDATIONS

- To further expand the industry, in our opinion a more aggressive marketing and awareness campaign is required. With the increasing 'Islamophobia', the value system prevalent in Islamic banking needs to be further highlighted. The Islamic banking players need to think from a strategic perspective to diversify the product range they offer currently to consumer segment. Long term sustainability can only be derived from a strong retail banking base. Another possibility for the Islamic banks in UK is to further diversify towards zakat and Waqf based products through financial engineering to tap into the entrepreneurial and start-up businesses.

- UK is already one of the leaders in the innovations in Sukuk instrument, which needs to be further built upon to offer Sukuk which contribute towards the knowledge economy UK is moving towards. In this regard, various types of contracts based on *Murabahah*, *Salam, Istisna', Musharakah, Wakalah bi al-Istihmar*, and others can be used in structuring Sukuk as in other jurisdictions to attract investors.

- The Takaful sector which lacks the most within United Kingdom, needs to build more awareness and distribution channels which can be done on the window model by the existing Insurance providers. Another aspect which the policy makers should focus on for development is the micro-Takaful aspect to capture the lower segment in Indonesian society.

4 POLICY RECOMMENDATIONS

4.1 ISLAMIC BANKING

Islamic Banking has been the dominant component of the Islamic financial sector over the years, with its assets at nearly $2 trillion and with presence in almost 50 Muslim and non-Muslim countries. With the development towards more risk sharing instruments from the traditional risk transfer and risk shifting instruments, this is the right time for the Islamic banks to promote more financial inclusion by focusing on more risk-sharing. From an objectivity perspective, as Islam finds itself based in justice and equality, and shared prosperity, this can be achieved through expanding outreach to the micro, small, and medium enterprises (MSME) sector.

The Islamic banking structure is not structured in the same way as a traditional bank is: it's more focused towards being an intermediary offering banking and asset management services. The current model of Islamic banking which we are operating in is restricting the growth of the Islamic banking sector, as it is focused on replication of the conventional banking. Some of the challenges that Islamic banking faces which the policy makers need to address arise primarily of structural matters. These structural issues arise out of the prevalence of debt-based instruments and the aspirations of financing predominantly through equity and risk sharing, to the need for increased social capital, and the challenges of creating an enabling regulatory framework. From a policy-makers aspect, the focus should be on the following key measures, which are geared towards a mutually shared prosperity objective.

To contribute to shared prosperity, the following actions need to be undertaken.

- Creation of an enabling regulatory environment by supporting consistent regulations and development of standards to promote risk sharing.
- 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.
- Expanding Islamic finance's reach to the lower income group of society.
- Development and training of human capital and literacy in Islamic finance.

These policy recommendations are further broken down to specific steps and the implementing agency that should be responsible for them in the following table.

Table 80. Policy Recommendations for Islamic Banking Development

Recommendation	Specific Step	Implementing Agency
Regulatory Standardization	Enabling regulatory environment and laws. Standardized and harmonized laws across jurisdictions Ease cross-border Islamic financial transactions and banking activities	Central Banks of OIC member countries International Islamic Financial Bodies
Promoting Risk-Sharing	Develop Risk Sharing products on asset side. Reduce replication of conventional Banking products	Islamic Bankers, Shariah Scholars, Central Banks of OIC member countries
Shariah Governance	Create globally consistent Shariah standards. Monitor Shariah laws and new fatwas for harmonized opinions. Remove contrasting opinions in fatwas across jurisdictions.	Governments of OIC member countries. International Islamic financial agencies, including AAOIFI, IIFM.
Customer Base Expansion	Expand to lower income group of society. Create more products for poor people, for agricultural sector, for SMEs etc. Increase CSR activities for social well-being	Islamic Banking institutions Central Banks of OIC member countries
Human Capital	Develop trained Islamic banking professionals More Shariah scholars with sound financial knowhow More financial experts with sound Shariah knowledge	Islamic finance educational institutions. Central Banks of OIC member countries

Source: Created by Author

4.2 ISLAMIC CAPITAL MARKETS

With the focus of Islamic finance on risk-sharing instruments, the Islamic capital markets would play a crucial role as equity are the purest form of risk sharing finance. The development of this component (Islamic Capital Markets) through equity based finance can play a critical role in reduction of poverty, which is a main problem plaguing the Muslim world today.

Albeit Islamic Capital Markets are young and smaller relative to Islamic banking, they are growing at a fast paced and has the potential or promoting mutually shared growth and prosperity through providing a base for financing infrastructure, raising funds for new businesses, encouraging entrepreneurship, and supporting economic development. The further development of Islamic Capital Markets is an essential ingredient for the sustainability of Islamic financial sector truly based on a risk-sharing ideology. The policy direction and efforts that need to be undertaken for promoting Islamic capital markets are like an extent to those for Islamic banking sector but with a different focus.

- Variable and perverse tax regimes classify interest as a tax-deductible expense while equity dividends are not. This skews the playing field in favor of debt based instruments rather than equity. Taxation amendments is the need of the hour to create a level playing field.
- Tax neutrality for Sukuk structures is essential as Sukuk currently entail multi-layer legal transactions which increases the tax cost of the issuer.
- Governments need to be encouraged to either issue themselves, or through their agencies, Sukuk with varying maturities to develop a long-term yield curve and to develop a corporate Sukuk market, as well as to promote transparency and efficiency of the asset pricing.

These policy recommendations are further broken down to specific steps and who should be responsible for it in the following table.

Table 81. Policy Recommendations for Islamic Capital Markets Development

Recommendation	Specific Step	Implementing Agency
Tax Regime Management	Remove double taxation and tax loopholes for Sukuk issuances.	Governments of OIC member countries
	Allow tax breaks to Shariah compliant investments to make them more appealing.	Central Banks, Securities Commission and Governments
	Tax Neutrality for Sukuk Investors and Issuers	Central Banks of OIC member countries.
Yield Curve Development	Issue different tenors of Sukuk To create liquidity and a yield curve.	Governments of OIC member Countries
	Corporates follow a similar path to create corporate yield curve	Central Bank and Securities commission need to push corporates.

Source: Created by Author

4.3 TAKAFUL (ISLAMIC INSURANCE)

The future of Islamic Finance under a risk-sharing model relies on development and further strengthening of the Non-banking Financial Institutions Sector. Globally the importance of nonbank financial institutions (NBFIs) has grown as they have contributed towards specialty sectors such as housing finance, leasing, and asset management. Islamic finance with its risk-sharing and asset-backed nature suits the NBFI category and the right instrument to contribute towards economic development and providing access to all. This sector has been neglected and needs to be given special attention by the policy makers and regulators. Some important measures that policy makers and regulators can take on priority basis for the NBFI sector are as follows.

- The Takaful sector can be developed as it can play a critical role in enhancing financial inclusion, reducing poverty, achieving inclusive economic growth, and boosting shared prosperity. Takaful can provide important benefits to households and firms. Greater access to financial services for both households and firms may help reduce income inequality and accelerate economic growth.

- An extension of the Takaful sector is the micro-Takaful which can be focused on by the policy makers to protect the people from unexpected shocks to income and enhance productivity through better health for the poor and the vulnerable segment of the society
- Supportive institutions need to be established in order to promote NBFIs which can provide governance and leadership; promotion of risk sharing and entrepreneurship; and a sound regulatory and supervisory framework.

- The supply side issue of NBFIs can be addressed by the policymakers focusing on increasing the number and diversity of Islamic NBFIs, together with increasing the range of products offered to various segments.

- On the demand side, low levels of financial literacy about the products and services offered by Islamic NBFIs; cultural, social, and physical barriers; insufficient consumer protection practices; and reputation- and credibility-related challenges are the biggest obstacles hindering further improvement of Islamic NBFIs. A balanced and enabling regulatory and taxation framework that also fosters cross-border investments in the Islamic NBFI sector is also needed.

These policy recommendations are further broken down to specific steps and who should be responsible for it in the following table.

Table 82. Policy Recommendations for Development of Islamic Insurance-Takaful

Recommendation	Specific Step	Implementing Agency
Development of Takaful Sector	Develop laws that allow for establishments of Takaful Companies. Provide incentives to expand Takaful business. Provide tax advantage for Takaful investors. Ease cross-border takaful expansion.	Central Banks of OIC member countries International Islamic Financial Bodies
Development of Micro-Takaful	Develop laws that allow for establishments of micro-Takaful Companies. Provide incentives to expand micro-Takaful business. Provide tax advantage for micro-Takaful investors. Ease cross-border micro-takaful expansion.	Central Banks of OIC member countries International Islamic Financial Bodies
Increase Number of NBFIs	Incentivize expansion and creation of NBFI's. Develop infrastructural support for NBFI's in forms of NBFI parks and preferable laws. Assist in developing Shariah standards harmonized across jurisdiction for NBFI's.	Central Banks of OIC member countries International Islamic Financial Bodies
Enhance Islamic financial literacy	Develop trained Islamic banking professionals More Shariah scholars with sound financial knowhow More financial experts with sound Shariah knowledge	Islamic finance educational institutions. Central Banks of OIC member countries

Source: Created by Author

4.4 KEY LESSONS FOR KNOWLEDGE TRANSFER

Knowledge Transfer between Islamic finance destinations is crucial for sustainable and harmonized growth of Islamic finance. Some countries as earlier discussed in case studies like Malaysia, Bahrain and Turkey have taken the lead in developing the Islamic financial infrastructure and regulations. Knowledge transfer from these Islamic finance destinations to the developing countries is crucial. This has been initiated at multiple global forums but a concentrated effort needs to be undertaken for developing of best practices at different stages of development which allows for the countries initiating Islamic banking and finance to be able to learn from the challenges faced by relatively advanced Islamic finance destinations.

Some of these practices are highlighted below from which lessons can be learnt and diversified portfolio can be developed.

- Malaysian Islamic finance has been at the forefront of policy development and regulatory framework enhancements. Recently a new wave of innovation in the Fintech solutions started in 2016 in Malaysia by introducing a range of products under the Central Bank of Malaysia and the Securities Commissions Malaysia. The Securities Commissions Malaysia has recently introduced a digital platform for crowd-funding and P2P within regulatory framework. In addition, in 2017 the regulators in Malaysia also introduced comprehensive guidelines for Islamic FINTECH to stay up to date on the development of financial sector.

- Indonesian government paved way for retail investors and sovereign Sukuk for infrastructure development by issuing innovative Sukuk. This type of sovereign Sukuk are developed in line with a specific infrastructure project done by the government. In the PBS, project underlying Sukuk that utilizes infrastructure project that has been approved in the government budget is used as underlying asset for Sukuk issuance. The proceeds will be used to replace the revolving fund whereby the project is usually initially funded by the government from the sources of taxes or others, but once the Sukuk issued the proceeds will be utilized to replace the funds.

- Turkish Islamic financial institutions have introduced participation funds which are an important vehicle, besides Sukuk, for the investors who prefer avoidance of interest-based transactions. These funds have attracted small and large investors to the tune of USD 75 million in June 2016.

- To boost and provide support to Islamic financial institutions in countries where liquidity management instruments and markets are not developed yet, Nigerian experience lends insights. The regulators in Nigeria in the earlier days of Islamic banking in the country allowed a reduction in the liquidity ratio requirement from 30% to 10% for Islamic banks in view of their peculiar liquidity management challenges.

4.5 GLOBAL POLICY RECOMMENDATIONS FOR ALL ISLAMIC FINANCE DESTINATIONS

Some general policies which need to be adopted by all countries for the development of the Islamic financial sector are highlighted in this section.

- The legal infrastructure required to develop Islamic finance is essential for any jurisdiction. It's not only about creating a wide arching law but countries need to move towards having specific legal frameworks for each component of the Islamic financial sector. In addition to the legal framework to support, the legal system needs to be evolved to provide a level playing field to Islamic finance in comparison to its conventional counterparts. Some key elements of this legal system can be summarized in the following observations:

    - 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.

- Since Islamic finance has spread out of its traditional Muslim majority countries, the Islamic financial institutions operate in different legal environments. This has given rise to more complexity in terms of regulations and overarching law Islamic banking and finance operates in. There is a further need for ensuring a relevant regulatory framework for the Islamic financial sector. Islamic Financial Services Board (IFSB) and AAOIFI are undertaking such efforts, but there is more room for improvement. There is a lack of regulatory frameworks which can be applied on all components of the Islamic financial sector. Apart from this, there are differences in regulatory standards across different countries which need to be bridged for a global effort on the regulatory aspect of the Islamic financial sector.

- Since Shariah compliance is the unique differentiating factor of Islamic finance, there is an immediate need for having a **global Shariah governance framework** to ensure that the products and operations of Islamic financial institutions do not contradict the principles of the Shariah. Policy makers need to ensure a sound Shariah governance framework by making it a legal/regulatory requirement. Specific action plan which can be undertaken:

    - 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 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.

- The liquidity aspect of the Islamic financial sector needs immediate strengthening through provision of instruments, markets and the facilities. This is not only required for a single component but is crucial for growth and stability of Islamic Banks, Capital markets as well as the Takaful industry.

  This can be done through developing and issuing Shariah compliant liquidity instruments that Islamic financial institutions can use either to place surplus funds or acquire funds when necessary. These instruments of liquidity can either be issued by the government, or financial institutions with the support of government agencies.

  In terms of liquidity management, apart from Malaysia there is no national level Islamic money market to cater to short term liquidity needs of Islamic financial institutions. National level Islamic money markets is an urgent need to sustain the Islamic financial sector.

- With the evolution of Islamic financial instruments and more focus on risk-sharing, Islamic financial transactions give birth to more unique needs of book-keeping and financial reporting. A global adoption of Islamic finance accounting and reporting standards like AAOIFI is imminent. There is also a need for greater transparency and disclosure in the financial reporting of IFIs. Further developing of standards is required as well to keep pace with innovative Islamic financial instruments arriving in the market.
  - While AAOIFI and IFSB have identified standards, there is an urgent 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. While conventional rating agencies have delved into rating for Islamic financial products, there is a need to develop organizations which specialize in Islamic finance rating according to Shariah standards.

- Since Islam is founded in the concept of justice, in the same vein Islamic finance is focused on prevalence of justice. This leads to the concept of consumer protection regime which comes hand in hand with Islamic finance. Currently there is no specific legal regime which covers the consumer's protection in Islamic financial transaction. It becomes more important since Islamic financial transactions involve multiple layers of asset based transaction the laws and regulations must entail that specific consumers are protected.

- Information disclosure on transactions should be disclosed to all concerned parties with clear explanation of the risks involved. The reason being, a majority of consumers have religious convictions towards opting for Islamic financial products it is essential to protect consumers and not only ensure Shariah compliance but its full disclosure.

- Governments and international bodies should undertake coordinated efforts to enhance Islamic finance literacy to expand the reach of the sector. Islamic financial literacy does not only entails teaching Islamic finance concepts in school and college curricula, different stakeholders such as regulators, financial institutions, Islamic finance trade associations can use various methods to disseminate knowledge on Islamic financial products and operations.

- Critical to the growth of Islamic finance is the provision of adequate human capital to sustain the Islamic financial sector and to innovate for progress.

    - At the public level, governments and regulators can take initiatives to establish educational, training and research institutions. One area of that needs focus is policy related research and training including topics on the development of Islamic architectural institutions.

    - Private Institutions such as 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.

    - Universities and academic institutions will play an important role not only in providing education in Islamic finance but also in conducting research that can support the industry.

- The Fintech industry has started after the financial crisis of 2007-2008 and has gained popularity. The focus of policy makers and regulators has not been much on the new sector being developed as the financial crisis had all attention. Fintech have grown rapidly and are estimated to have surpassed $12 billion[198] in recent years.

  The Fintech companies have been primarily based on concept of peer-to-peer (P2P) lending, crowd-funding, money transfer, mobile payments and trading platforms. Islamic finance has also seen an interest in Fintech and a few companies have started operation over the past year like Dubai-based Beehive, Jakarta-based Blossom Finance, and Singapore-based KapitalBoost and ClubEthis. Apart from Malaysia, no Islamic financial jurisdiction has delved into a regulatory framework and Shariah guidelines for the sector.
  Since Fintech's penetration in Islamic finance is in its nascent state, policy makers need to address this sector. Till now the numbers are very small in Islamic finance, but the potential of disruption by Islamic Fintech to the traditional Islamic banking is quite huge. With innovation and technological advancement there are more risks involved which the policy makers need to address. Some key aspects that they need to address are as follows:

  - An Islamic legal framework needs to be introduced which provides cover for the establishment and running of Fintech companies. This legal framework needs to be on a global platform to allow for cross border operability of these companies. The main reason is, since Fintech are primarily based on the internet, they don't have any geographical boundaries.
  - Shariah governance is essential, as most Fintech innovation provides choices which are more aligned to individual needs. With consumerism involved the onus of faith based transaction falls on the policy makers to ensure its Shariah compliance.

FINTECH

Fintech, the abbreviation for financial technology, is a broad category that refers to the innovative use of technology in the design and delivery of financial services and products. The application of fintech cuts across multiple business segments, including lending, advice, investment management and payments. Many fintech companies harness mobile technologies, big data and superior analytics to tailor products for various customer segments.

Both start-ups and traditional finance companies are active in fintech.

These start-ups often don't look like a traditional bank or insurance company: they typically offer targeted solutions, as opposed to being

[198] https://www.islamicfinance.com/2016/04/impact-fintech-islamic-finance/

- The policy makers should also dwell on establishing a common technological platform to facilitate the development of Fintech companies. A common platform whereas would facilitate the companies it would also make it easier for policy makers to govern and regulate the industry.

- Education and awareness of the innovative and technology advanced Fintech is a need of the hour. This responsibility, while it lies primarily on the Fintech companies, also needs to be shouldered by the public sector and the academic institutions.

These policy recommendations are further broken down to specific steps and who should be responsible for it in the following table.

Table 83. Global Policy Recommendations

Recommendation	Specific Step	Implementing Agency
Development of Legal Infrastructure	Separate Islamic Banking, Islamic Capital Markets and Takaful Law. Neutral Tax Law. Creation of Dispute Resolution Mechanism and Center.	Central Banks of OIC member countries International Islamic Financial Bodies
Shariah Law prevalence	Implementation of Shariah law as governing law for all Islamic financial transactions. Develop a regulatory framework for managing difference in Shariah opinion across different jurisdiction.	Central Banks of OIC member countries International Islamic Financial Bodies
Shariah Governance Framework	Create a global Shariah Governance law and standards applicable on all Islamic financial institutions jurisdictions. Creating an independent Shariah supervisory board at national and global level. Creating separate national and global Shariah boards for each sub sector of Islamic finance.	Central Banks of OIC member countries International Islamic Financial Bodies International Shariah Bodies like OIC Fiqh Academy, ISRA etc.
Liquidity Management for Islamic financial institutions.	Introduce more instruments for liquidity management at national level. Development of national Islamic money markets. Further strengthening the International Islamic liquidity center through more instruments and more liquidity.	Central Banks of OIC member countries. International Islamic Financial Bodies Islamic Financial Institutions through issuing instruments Corporate Sector
Financial Reporting Standards	Develop more accounting standards for Islamic financial products. Develop financial and accounting standards for non-banking Islamic financial sector. Global acceptance and implementation of standards across different jurisdictions.	International Islamic Financial bodies

Recommendation	Specific Step	Implementing Agency
Consumer Protection Law	Create Islamic Finance consumer protection law. Set up an entity nationally and globally to handle consumer protection cases of Islamic financial institutions.	Central Banks of OIC Member Countries
FINTECH	Create laws for regulating the fintech companies in Islamic finance. Develop standards for fintech in Islamic finance Train human capital for working in Islamic financial fintech companies. Developing entrepreneurial incentives for creating and developing fintech for Islamic finance.	Central Banks of OIC member countries. International Islamic Financial Bodies Islamic Financial Institutions through issuing instruments Corporate Sector Islamic finance educational institutions.
Knowledge Transfer	Best Practice developments by established Islamic finance destinations. Global debates on challenges faced in development of Islamic banking and policies. Critical in harmonized and rapid global growth of Islamic banking and finance	Central Banks of OIC member countries. Global multilateral agencies, like World Bank, IMF, Islamic Development Bank Established global Islamic banking groups.

Source: Created by Author

4.6 RECOMMENDATIONS FOR NASCENT ISLAMIC FINANCE DESTINATIONS

The challenges and policies that the governments have to undertake towards developing Islamic finance vary with the level of development of Islamic finance. The previous section highlighted the policy recommendation for the global Islamic finance industry, which apply to all countries where Islamic financial sector is developing or thriving.

The following discussion highlights some key policy recommendation for countries, which are still young and small in terms of Islamic financial sector and aim to develop it further.

- Developing Islamic finance requires a separate legal framework for Islamic financial institutions. This will facilitate the regulatory bodies develop some instruments to deepen the Islamic financial sub-sector. It will make it easy for the Islamic financial institutions to document legal requirements during product development

- The regulatory frameworks for guiding the conduct of financial services should be amended to ensure that there are no overlaps of conventional and Islamic banking. A method of achieving that is through prohibiting Islamic banking windows. All OIC member countries who have a relatively larger Islamic financial sector have banned Islamic banking windows in order to avoid mixing of assets and liabilities.

- The governments and the Islamic financial institutions need to play their role in human capital development program in place to address the inherent knowledge gap that exists in Islamic financial instruments and products.

    - One of the reasons for risk-transfer based replicated products dominating the Islamic financial sector is the lack of understanding various Islamic financial instruments among investors and people in general. This has led to more asset side products are *Murabahah* and *Ijarah* mainly because it replicates similar products as available in conventional financial sector. An effort needs to be undertaken on promoting understanding of other modes (*Mudarabah*, *Salam*, *Istisna*, *Musharakah Mutanaqisah* …etc.) highlighting their benefits and features. Academic institutions could also play an important role in this regard by organizing public lectures to increase people's knowledge of different structures of Islamic finance outside *Murabahah* and traditional banking services.

    - The regulatory bodies can play their part in this regard by educating financial sector on Islamic financial engineering.

- 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* modes and other instruments used in agriculture sector, which can be used by agrarian economies in OIC, like *Muzaraa'* and *Musaqah*. This could be addressed by government policies through encouragement of these modes through tax exemptions or subsidies.
  Innovations in Sukuk instruments are need of the hour in the Islamic capital markets to diversify the products and meet the growing needs of the Sukuk issuer. Governments would need to invest in the Islamic capital market infrastructure to attract private sector as issuers. In this regard, various types of contracts based on *Murabahah*, *Salam, Istisna', Musharakah, Wakalah bi al-Istihmar*[199], and others can be used in structuring Sukuk as in other jurisdictions to attract investors.

- New policies need to be introduced to create a level playing field for equity in nature products to compete with debt-based instruments; This primarily refers to the removing of legal, administrative, economic, financial and regulatory biases that favor debt and place equity holding in a disadvantage;

- Development of Takaful industry through need based product development. Further the industry should also focus on building distribution channels, services and sales management to increase the size of the industry. Likewise, it is also recommended to develop the micro-Takaful aspect to capture the lower segment in Indonesian society.

These policy recommendations are further broken down to specific steps and who should be responsible for it in the following table.

[199] Wakala bil Istihmar is when an IFI manages funds on behalf of customers, providing their management services against specified fund management fees. The fee usually does not vary with the profits of the associated fund, and may be a fixed amount or percentage of the net asset value of the invested funds.

Table 84. Policy Recommendations for Nascent Islamic Finance Destinations

Recommendation	Specific Step	Implementing Agency
Legal framework	Separate Islamic Banking, Islamic Capital Markets and Takaful Law. Neutral Tax Law. Remove any overlapping of laws between Islamic and conventional financial services.	Central Banks with assistance from International Islamic Financial Bodies
Promote Risk Sharing Products	Develop policies which promote risk sharing products rather than risk transfer products. Create awareness amongst Islamic bankers on risk sharing as the key to Islamic finance.	Central Banks with assistance from International Islamic Financial Bodies
Takaful Development	Develop understanding of Takaful and its uniqueness. Create a purpose statement for Takaful. Incentivize Takaful companies and products.	Central Banks with assistance from International Islamic Financial Bodies.
Enhance Islamic financial literacy	Develop trained Islamic banking professionals More Shariah scholars with sound financial knowhow More financial experts with sound Shariah knowledge	Islamic finance educational institutions. Central Banks with assistance from International Islamic Financial Bodies

Source: Created by Author

The policy recommendations section entailed a diverse set of policies ranging from broad measures which are required at the governmental level to specific ones that need to be undertaken by different groups involved in the Islamic financial sector. The main crux of these polices focuses on a global coordinated effort for more legal and regulatory development and harmonizing practices in different jurisdictions. A concentrated effort also needs to be undertaken in further strengthening the Shariah governance frameworks, as the Shariah compliance of Islamic finance is the underpinning of the confidence in the system.

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