

## I. INTRODUCTION AND BACKGROUND

Islamic finance is growing within international finance. In its modern form, Islamic banking started with pioneering experiments in the early 1960s in Egypt. The Mit-Ghamr Islamic Saving Associations (MGISA) mobilized the savings of Muslim investors, providing them with returns that did not transgress the laws of the *Shari'ah*.<sup>2</sup> The MGISA attracted a flurry of deposits, which grew at the rate of more than 100 percent per year in the first three years of operations. Later, the Pilgrims Fund Corporation (PFC) enabled Malaysian Muslims to save gradually and invest in *Shari'ah*-compliant instruments, with the purpose of supporting their expenditures during the Hajj period (pilgrimage). In 2012, the PFC had eight million account holders and deposits of more than \$12 billion. Formally, Islamic banking started in the late 1970s with a handful of institutions and negligible amounts, but it has increasingly grown over the past two decades, with total assets reaching about \$2 trillion at end-2014.

The establishment of the Islamic Development Bank (IsDB) in 1975 was a watershed moment for Islamic banking, coming just after the establishment of the first major Islamic commercial bank—the Dubai Islamic Bank—in the United Arab Emirates. The success of the latter led to the establishment of a series of similar banks, including Faisal Islamic Bank (Sudan) and Kuwait Finance House (Kuwait)—both in 1977. As early as the late 1970s, steps were taken in Pakistan for making the financial system compliant with *Shari'ah* principles. The legal framework was then amended in 1980 to allow for the operation of *Shari'ah-compliant profit-sharing financing* companies, and to initiate bank finance through Islamic instruments. Similarly, Iran enacted a new banking law in August 1983 to replace conventional banking with interest-free banking. The law gave banks a window of three years for their operations to become compliant with Islamic principles. Sudan's efforts to align its entire banking system with *Shari'ah* principles began in 1984.

The financial infrastructure, including standards setting and regulatory institutions, has also been catching up with the rapid growth of Islamic financing. International standard-setting institutions were established to guide the operations of the industry around the world, although standardization of Islamic products across different countries remains a challenge. Since 1991, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), based in Bahrain, has been issuing accounting, auditing, and *Shari'ah* standards for financial reporting at Islamic financial institutions. The Islamic Financial Services Board (IFSB), established in 2002 in Malaysia, is responsible for issuing supervisory and regulatory

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<sup>2</sup> *Shari'ah* or Islamic jurisprudence is based on primary and secondary sources of law. The first primary source is the Quran, the divine revelation that contains legal injunctions, and the second primary source is the *Sunna*, which relates the practice or code of conduct of the Prophet. Secondary sources of law are *Ijma'* or consensus, *Qiyas* or analogical deductions, and *Ijtihad* or interpretations to explain the law, with differences among various school of thoughts (such as the *Sunni* and the *Shia*).

standards and guidelines.<sup>3</sup> It also promotes the adoption of these standards and guidelines by relevant regulatory authorities. In 2001, the International Islamic Financial Market (IIFM) in Bahrain was mandated to develop guidelines for the issuance of Islamic financial instruments and to encourage active secondary market trading. Most recently in 2010, the Malaysia-based International Islamic Liquidity Management Corporation (IILM) started issuing short-term *Shari'ah*-compliant financial instruments to facilitate cross-border Islamic liquidity management.

This paper is mostly intended to provide an overview of key policy issues and challenges facing practitioners and policy makers. It provides an overview of Islamic finance, discusses key macroeconomic implications from its expansion across the globe, and gives a broad perspective on key elements of Islamic finance and banking. Instead of exploring deeply a few controversial issues or introducing new solutions to current challenges in Islamic finance, it tries to provide a general overview of the Islamic finance industry which, as a relatively new branch of finance, is often difficult to understand and prone to being misunderstood. While Islamic finance has expanded beyond Muslim-majority countries, reaching Europe and Sub-Saharan Africa, *Shari'ah*-compliant financial assets remain concentrated in Iran, Malaysia, and a few Gulf Cooperation Council (GCC) countries, where it has become systemic. The paper raises a number of policy-related questions, but in many cases, it will defer the detailed answers to other, companion papers.<sup>4</sup>

The next section summarizes the fundamentals of Islamic finance and describes its key instruments. Section III presents stylized facts about the growth of the Islamic finance industry. Section IV briefly discusses the key drivers for the growth of Islamic finance, and Section V provides a brief comparison between Islamic and conventional financial systems. Section VI focuses on key macroeconomic and financial stability implications of Islamic finance, discussing its role in the conduct of monetary and fiscal policies, as well as financial stability. The last section presents conclusions and recommendations.

## II. THE FRAMEWORK OF ISLAMIC FINANCE

### A. Key Principles of Islamic Finance

Islamic economics and finance derive from immutable principles rooted in the rulings of the *Shari'ah* legal code. Unlike legal systems that are limited to secular aspects of daily life, *Shari'ah* jurisprudence does not distinguish between religious and other aspects of life,

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<sup>3</sup> As of April 2015, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has issued 88 *Shari'ah*, accounting and governance standards for Islamic institutions. Similarly, the Islamic Financial Services Board (IFSB) has issued 17 regulatory and prudential standards and six guidance notes.

<sup>4</sup> Over the last six months, IMF staff have produced a Staff Discussion Note (Kammer et. al., 2015) and a number of working papers addressing specific policy issues relevant for Islamic banking and finance (for example, Song, I. and Oosthuizen, C. (2014), López Mejía et al., (2014), Ben Naceur and others (2015).

including transactions falling under either the political, economic, or social sphere (*muamalat*). In Islamic economics, productive human activity is mandatory. Islam does not endorse every human wish, and it prohibits on moral grounds activities related to tobacco and other drugs, alcohol, pork products, gambling involving money and non-money assets (*maysir*), speculation, pornography, and armaments and destructive weapons.

### B. Three Principles Govern Islamic Finance

**Principle of equity:** Scholars generally invoke this principle as the rationale for the prohibition of predetermined payments (*riba*), with a view to protecting the weaker contracting party in a financial transaction. The term *riba*, which means “hump” or “elevation” in Arabic, is an increase in wealth that is not related to engaging in a productive activity. The principle of equity is also the basis for prohibiting excessive uncertainty (*gharar*) as manifested by contract ambiguity or elusiveness of payoff. Transacting parties have a moral duty to disclose information before engaging in a contract, thereby reducing information asymmetry; otherwise the presence of *gharar* would nullify the contract. The principle of equity and wealth distribution is also the basis of a 2.5 percent levy on cash or in-kind wealth (*zakat*), imposed by *Shari’ah* on all Muslims who meet specific minimum levels of income and wealth to assist the less fortunate and foster social solidarity.

**Principle of participation:** Although commonly known as interest-free financing, the prohibition of *riba* does not imply that capital is not to be rewarded. According to a key *Shari’ah* ruling that “**reward (that is, profit) comes with risk taking,**” investment return has to be earned in tandem with risk-taking and not with the mere passage of time, which is also the basis of prohibiting *riba*. Thus, return on capital is legitimized by risk-taking and determined ex post based on asset performance or project productivity, thereby ensuring a link between financing activities and real activities. The principle of participation lies at the heart of Islamic finance, ensuring that increases in wealth accrue from productive activities.

**Principle of ownership:** The rulings of “**do not sell what you do not own**” (for example, short-selling) and “**you cannot be dispossessed of a property except on the basis of right**” mandate asset ownership before transacting. Islamic finance has, thus, come to be known as asset-based financing, forging a robust link between finance and the real economy. It also requires preservation and respect for property rights, as well as upholding contractual obligations by underscoring the sanctity of contracts.

### C. Key Instruments of Islamic Finance

In Islamic finance, the term “loan” refers only to a benevolent loan (*qard al hasan*), a form of financial assistance to the needy to be repaid free of charge. Other instruments of Islamic

finance are not referred to as “loans” but rather as financing modes falling under one of the three categories: Profit-and-loss sharing (PLS), non-PLS contracts, and fee-based products.<sup>5</sup>

### PLS Financing Products

**PLS financing is closest to the spirit of Islamic finance.** Compared with non-PLS financing, its core principles of equity and participation, as well as its strong link to real economic activities, help promote a more equitable distribution of income, leading to a more efficient allocation of resources. There are two types of PLS financing: *musharakah* and *mudârabah*.

***Musharakah*** is a profit-and-loss sharing partnership and the most authentic form of Islamic financing.<sup>6</sup> It is a contract of joint partnership where two or more partners provide capital to finance a project or own real estate or movable assets, either on a permanent or diminishing basis.<sup>7</sup> Partners in *musharakah* have a right to take part in management; they seem to bear the greatest risk among all Islamic financing modes with the potential for earning the highest reward. However, whereas profits are distributed according to pre-agreed ratios, losses are shared in proportion to capital contribution.

***Mudârabah*** is a profit-sharing and loss-bearing contract where one party supplies funding (financier as principal) and the other provides effort and management expertise (*mudarib* or entrepreneur as agent) with a view to generating a profit. The share in profits is determined by mutual agreement but losses, if any, are borne entirely by the financier, unless they result from the *mudarib*'s negligence, misconduct, or breach of contract terms. *Mudârabah* is sometimes referred to as a sleeping partnership because the *mudarib* runs the business and the financier cannot interfere in management, though conditions may be specified to ensure better management of capital. Islamic banks mainly make use of *mudârabah* financing to raise funds; *mudârabah* contracts are also used for the management of mutual funds.

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<sup>5</sup> See Annex 1 for more details. A recent paper, Song and Oosthuizen (2014), surveyed cross-country practices related to legal and prudential frameworks governing Islamic banking activities.

<sup>6</sup> *Musharakah* can be limited (*shirkat al-inan*) or unlimited (*mufawadah*). In the case of *shirkat al-inan*, the *musharakah* is limited in scope to a specific undertaking; different shareholders have different rights and are entitled to different profit shares; and each partner is the agent only, but not the guarantor of the other partner. In the case of *mufawadah*, which is an unlimited and equal partnership, all participants rank equally in every respect (initial contributions and final profits), and every partner is both the agent and the guarantor of the other.

<sup>7</sup> Diminishing *musharakah* (*musharakah mutanaqisa*) is mostly used in home financing: one partner promises to buy the equity share of the other party gradually until the title of ownership of the equity is completely transferred to the buying partner. This type of contract is widely used in Iran.

## Non-PLS Financing Products

Non-PLS contracts are most common in practice. They are generally used to finance consumer and corporate credit, as well as asset rental and manufacturing. Non-PLS financing instruments include *murâbahah*, *ijārah*, *salam*, and *istisna'*.<sup>8</sup>

***Murâbahah***: is a popular *Shari'ah*-compliant sale transaction mostly used in trade and asset financing.<sup>9</sup> The bank purchases the goods and delivers them to the customer, deferring payment to a date agreed by the two parties. The expected return on *murâbahah* is usually aligned with interest payments on conventional loans, creating a similarity between *murâbahah* sales and asset-backed loans. However, *murâbahah* is a deferred payment sale transaction where the intention is to facilitate the acquisition of goods and not to exchange money for more money (or monetary equivalents) over a period of time. Unlike conventional loans, after the *murâbahah* contract is signed, the amount being financed cannot be increased in case of late payment or default, nor can a penalty be imposed, unless the buyer has deliberately refused to make a payment. Also, the seller has to assume any liability from delivering defective goods. *Murâbahah* transactions are widely used to finance international trade, as well as for interbank financing and liquidity management through a multistep transaction known as *tawarruq*, often using commodities traded on the London Metal Exchange (LME).<sup>10</sup> However, in some jurisdictions, *tawarruq* transactions are not considered compliant with *Shari'ah* principles.

***Ijārah*** is a contract of sale of the right to use an asset for a period of time. It is essentially a lease contract, whereby the leaser must own the leased asset for the entire lease period. Since ownership remains with the leaser, the asset can be repossessed in case of nonpayment by the lessee. However, the leaser is also responsible for asset maintenance, unless damage to the leased asset results from lessee negligence. This element of risk is required for making *ijārah* payments permissible. A variety of *ijārah* takes a hire-purchase form, whereby there is a promise by the leaser to sell the asset to the lessee at the end of the lease agreement, with the price of the residual asset being predetermined. A second independent contract gives the

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<sup>8</sup> These *Shari'ah*-compliant products are similar to conventional financial contracts based on mark-up sales and leasing contracts.

<sup>9</sup> The majority of Islamic financing (70 to 80 percent) takes the form of *murâbahah* (Demirgüç-Kunt, Klapper, and Randall, 2013). Recently, Sudan has set a 30 percent limit to *murâbahah* in banks' financing portfolios.

<sup>10</sup> *Tawarruq* means in Arabic the acquisition of minted silver, or *al wariq*, against another asset. However, *tawarruq* has become controversial among *Shari'ah* scholars because of its divergence of its use from the spirit of Islamic finance. Under commodity *murâbahah*, a customer in need of liquidity or financing arranges for an Islamic bank to buy metals for that amount on his behalf. The bank then sells the metals to the customer at a mark-up that is payable over a period of time (overnight, one month, 12 months, etc.). In turn, the client immediately sells the metals on the spot market and obtains the needed liquidity. *Tawarruq* is most disliked by *Shari'ah* scholars when the borrower sells the commodity back to the original seller.

lessee the option to buy the leased asset at the conclusion of the contract or simply return it to the owner.<sup>[11], [12]</sup>

***Salam*** is a form of forward agreement where delivery occurs at a future date in exchange for spot payment.<sup>13</sup> Such transactions were originally allowed to meet the financing needs of small farmers as they were unable to yield adequate returns until several periods after the initial investment. A vital condition for the validity of a *salam* is payment of the price in full at the time of initiating the contract, or else the outcome is a debt-against-debt sale, which is strictly prohibited under *Shari'ah*. The subject matter, price, quantity, and date and place of delivery should be precisely specified in the contract. In the event that the seller can neither produce the goods nor obtain them elsewhere, the buyer can either take back the paid prices with no increase, or wait until the goods become available. Should one of the parties fail to fulfill their contract, the bank will get back its initial investment, but will have to accept the lost profit. To reduce exposure to credit risk, the bank may ask for a financial guarantee, mortgage, advance payment, or third-party guarantee.

***Istisna'*** is a contract in which a commodity can be transacted before it comes into existence. The unique feature of *istisna'* (or manufacturing) is that nothing is exchanged on the spot or at the time of contracting. It is perhaps the only forward contract where the obligations of both parties are in the future. In theory, the *istisna'* contract could be directly between the end user and the manufacturer, but it is typically a three-party contract, with the bank acting as intermediary. Under the first *istisna'* contract, the bank agrees to receive payments from the client on a longer-term schedule, whereas under the second contract, the bank (as a buyer) makes progress installment payments to the producer over a shorter period of time.<sup>14</sup>

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<sup>11</sup> Innovations in Islamic finance combine contracts of *ijārah* and diminishing *musharakah* for house financing. In such a contract, both the bank and the client contribute to the acquisition of a property in a partnership. Then the property is leased to the client who redeems the bank's stake over time through lease payments.

<sup>12</sup> *Ijārah* and *murābahah* have many similarities and differences. In both financing modes, the bank is not a natural owner of the asset but acquires it upon receiving a request from its client. Like *murābahah*, *ijārah* rentals are paid in installments over time, and are supposed to cover the cost of the asset or value of investment for the bank and to provide a fair rate of return on investment. Thus, both contracts create debt. However, in *murābahah*, the benefits and risks of ownership of the asset are transferred to the client along with ownership, whereas in *ijārah* asset ownership remains with the bank. Further, unlike in *murābahah* where cash flows cannot be subsequently changed, *ijārah* rentals can be made flexible to reflect changing economic and business conditions, especially if the rental period is very long. *Murābahah* and *ijārah* are easily understood because of their close similarity to conventional financing (installment sales and leasing).

<sup>13</sup> *Salam* and *istisna'* are less frequently used debt-based Islamic financing instruments that do not meet the condition of physical possession of the asset for sale; these are the only two exceptions to the principle that one cannot sell a commodity before it comes into existence.

<sup>14</sup> There are four main differences between *istisna'* and *salam* contracts. (i) *istisna'* involves the sale of unique manufactured goods as opposed to *salam* that can be used in standardized goods; (ii) unlike *salam* which

(continued...)

## Fee-Based Products

Islamic banks offer a wide spectrum of fee-based services using three types of contracts, *wakalah*, *kafalah*, or *ju'ala*. They are usually auxiliary to the main *murâbahah* and *mudârabah* transactions, though they generate various types of fees and commissions. The fee-based services provided by Islamic banks include bank transfers, issuing letters of credit and guarantees, credit cards, and offering collection and safe-custody services, mostly used in trade financing. *Wakalah* results from the bank acting as the agent of a customer in a trade transaction or issuing a letter of credit facility.<sup>15</sup> *Kafalah* is a financial guarantee whereby the bank gives a pledge to a creditor on behalf of the debtor to cover fines or any other personal liability. It is widely used in conjunction with other financing modes or documentary credits. *Ju'ala* is essentially an *istisna'* contract that is applicable for rendering a specified service as opposed to the manufacturing of a product.

### D. Islamic Banking Model

In theory, the business model of Islamic banks differs from conventional banks. Islamic banking rests on a two-tier *mudârabah* and *wakalah* model (Table 1).<sup>16</sup> The first-tier *mudârabah* refers to contracts signed between an investment account holder and the bank, whereby the account holder provides capital and the bank acts as the manager of funds.<sup>17</sup> The second-tier *mudârabah* refers to contracts signed between the bank and a client, where the bank finances the entrepreneur who manages the businesses. Other sources of funds arise from setting reserves in a way unique to Islamic banks (profit equalization reserves (PER)

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requires the payment of full price up front, *istisna'* allows for spot, deferred, or even installment payments; (iii) an *istisna'* contract can be cancelled unilaterally until the date that the manufacturer starts working on the goods, while the *salam* contract can be cancelled only before the contract signature; and (iv) the time of delivery is fixed in *salam*, whereas *istisna'* can specify a maximum time for delivery after which the purchaser is no longer bound to accept the goods.

<sup>15</sup> In a *wakalah*-based trade financing, clients approach the bank to act as their agent or *wakeel* and to provide a letter of credit facility. The bank requires the client to place the full amount of the goods to be purchased in a *wadi'a* or deposit account. The bank then makes payment to the counterpart bank and the pertinent documents are released to the client, who pays a fee or commission under the principle of agency fee or *ujr*.

<sup>16</sup> It is common for Islamic banks to raise demand deposits (*wadi'a*) using *wakalah* contracts.

<sup>17</sup> Under the first-tier *mudârabah*, a bail-in system is expected, by default, in Islamic banking. As financiers, investment account holders are subject to losing some or their entire funds in case bank investments are not profitable, provided the latter are in compliance with *Shari'ah* and there was no negligence on the part of the bank in managing funds. In case of profits, investment account holders generally receive a share in the bank's overall profits (unrestricted *mudârabah*) after the bank deducts a management fee, but their return may also be tied to a specific bank investment (less likely) on the asset side of the balance sheet (restricted *mudârabah*).

and investment risk reserves (IRR)<sup>18</sup>), which carry the distinct characteristics of prudential tools without being included as part of equity capital.<sup>19</sup> Islamic banks may also raise *Shari'ah*-compliant wholesale funding, and they meet their liquidity needs through interbank *murâbahah* financing, a large volume of which is conducted through the LME.

**Table 1. Islamic Bank Balance Sheet**

<i>Assets</i>	<i>Liabilities</i>
Cash and liquid securities	Demand deposits ( <i>qard al hasan, wakala</i> )
	Interbank <i>murâbahah</i>
Interbank <i>murâbahah</i>	Unrestricted profit sharing investment accounts ( <i>mudârabah</i> )
Inventory (real estate, automobiles, commodities, etc.)	
Asset-backed transactions ( <i>murâbahah, ijârah, salam, and istisna'</i> )	
PLS transactions ( <i>mudârabah, musharakah</i> )	Restricted profit-sharing investment accounts ( <i>mudârabah</i> ) 1/
	Reserves (PER, IRR)
Fee-based services ( <i>wakalah, kafalah</i> ) 2/	Shareholders' equity capital

1/ Restricted profit sharing investment accounts are generally included off-balance sheet.

2/ Fee-based services include letters of credit, letters of guarantee, safekeeping of negotiable instruments and the collection of payments, internal and external transfer operations, hiring coffers, administration of real estate or projects, and administration of wills. Most of them are generally included off-balance sheet.

In practice, Islamic finance often involves structuring *Shari'ah*-compliant products that appear similar to conventional products. According to Krasicka and Nowak (2012) and Chong and Liu (2009), Islamic banks are not different from conventional banks in Malaysia. Other work by Beck, Demirgüç-Kunt, and Merrouche (2010) and Čihák and Hesse (2010)

<sup>18</sup> Profit equalization reserves (PER) are allocated from operating income for smoothing purposes, prior to deducting the the *mudarib*'s (bank's) share. Investment risk reserves (IRR) are set aside from the income share of investment account holders as a cushion for future losses that they may incur (see Section V for details).

<sup>19</sup> Risk-weighted assets (RWA) funded by PER and IRR of unrestricted profit sharing investment accounts also enter in determining banks' capital adequacy ratio using the IFSB supervisory discretion formula. This formula is different from that utilized by conventional banks.

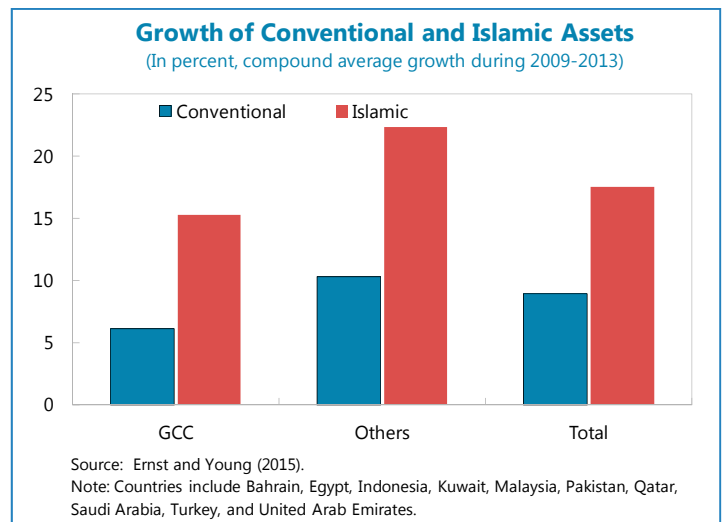


find few significant differences in business orientation, asset quality, efficiency, or stability. Similarities between the two banking models arise from the close alignment of the competitive rates paid by Islamic banks on investment deposits with deposit rates at conventional banks, as well as with the benchmarking of Islamic financing rates on the asset-side of the balance sheet to the LIBOR.

### III. STYLIZED FACTS ABOUT ISLAMIC FINANCE

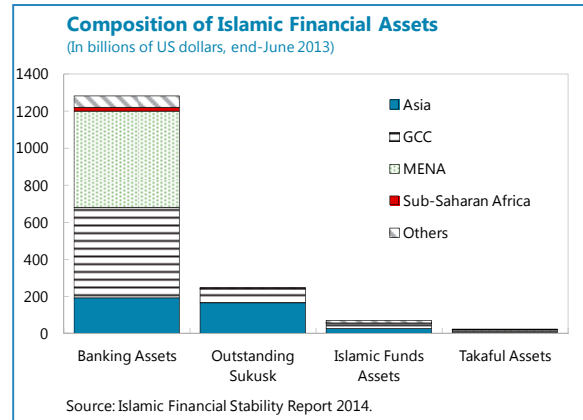
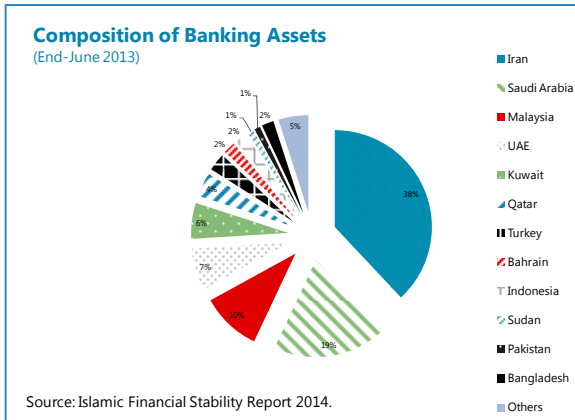
#### A. Islamic Finance and Banking

Global Islamic finance assets reached \$1.9 trillion by mid-2014 (ADB and IFSB, 2015), with about 75 percent of the industry concentrated in the Middle East North America (MENA) region (excluding Iran) where GCC countries accounted for 96 percent of it. Moreover, these assets are estimated to have surpassed the \$2 trillion milestone at end-2014. In terms of growth, the Islamic finance industry, including Islamic capital markets, grew, on average, by 17.5 percent since the onset of the global financial crisis in 2008 (Ernst and Young, 2015). The bulk of growth happened in countries outside the MENA region in countries with more Muslim populations, but most of the industry's growth in the MENA region was led by GCC countries. In particular, the Islamic finance industry grew, on average, by 43 percent in Indonesia, and by 19 percent in Turkey during 2009–13.

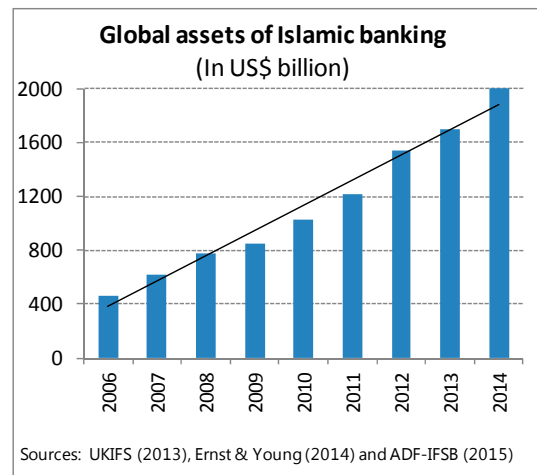


Islamic banks dominate the Islamic financial industry, despite continued growth in *sukuk* and other *Shari'ah*-compliant financial assets such as Islamic funds and *takāful*. Islamic banking assets account for about 80 percent of total assets of the Islamic finance industry, albeit representing less than 1 percent of global banking assets.<sup>20</sup> In 2013, Iran held the largest share of Islamic banking assets (about 38 percent), and Saudi Arabia and Malaysia accounted for nearly 29 percent of assets.

<sup>20</sup> IFSB stability report 2014.



At end-2013, there were about 410 Islamic banking institutions worldwide, including the fully *Shari'ah* compliant banking systems in Iran and Sudan. Most of these Islamic banks were established in the 1980s and 1990s. In recent years, Islamic banking has spread to Africa, Europe, and North America: Islamic banks are in operation in countries such as Denmark, France, Luxembourg, Nigeria, South Africa, Switzerland, and the United Kingdom. In addition, a number of large European and American banks (such as Citibank and HSBC) are operating Islamic banking windows to take advantage of this fast-growing sector. The Islamic banking sector has grown at an annual rate of about 17 percent in the period 2009–13, even allowing for the post-2008 global crisis period.<sup>21</sup> This sustained growth is seen as a sign of resilience of the industry.



At mid-2013, Islamic banking had reached a systemic stage in nine countries.<sup>22</sup> According to IFSB's banking assets data, these countries include Iran and Sudan (both with 100 percent Islamic banking), Bahrain, Kuwait, Malaysia, Qatar, Saudi Arabia, Turkey, and the United Arab Emirates. In a 2013 survey of central banks by the IFSB and the Islamic Research and Training Institute (IRTI), similar countries reported that Islamic banking assets comprised 10 percent or more of their overall banking assets.<sup>23</sup> According to the survey, of

<sup>21</sup> Ernst & Young (2015).

<sup>22</sup> The IFSB considers the Islamic financial sector as systemically important when the total Islamic banking assets in a country comprise more than 15 percent of its total domestic banking sector assets, or the country's Islamic banking assets are at least 5 percent of the global portfolio of Islamic banking assets. The Basel Committee on Banking Supervision (BCBS) refrains from setting a specific threshold.

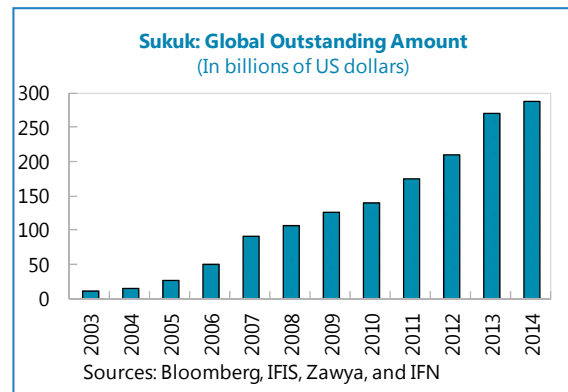
<sup>23</sup> IFSB, IsDB and IRTI (2014).

the institutions offering Islamic banking services, nearly 70 percent are “standalone” Islamic banks, while the remaining 30 percent are conventional banks offering Islamic banking services through “windows.” Except in Iran and Sudan, Islamic banks operate side by side with conventional banks, increasing the competitive intensity in the banking industry. Despite the wide reach of Islamic banking, industry assets remain highly concentrated in a small number of countries: Iran, Kuwait, Malaysia, Saudi Arabia, and the United Arab Emirates account for 80 percent of all Islamic banking assets worldwide.

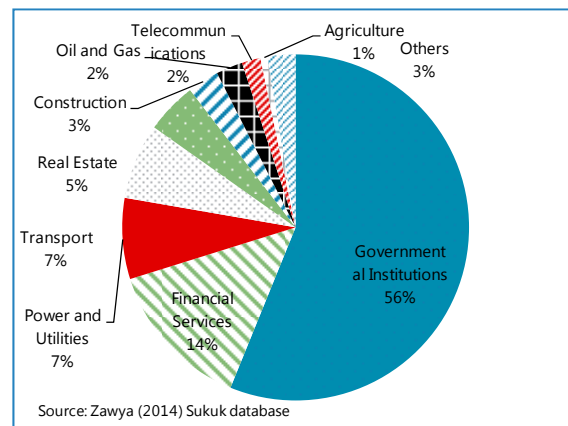
## B. Sukuk Markets

The first *sukuk* was issued in 1990 by a Malaysian company, and it took until 1996 for another firm in Malaysia (Kuala Lumpur Airport Company) to raise financing via a *sukuk*. From 1999 onwards, a number of public and private institutions started issuing *sukuk*. Malaysia was the main driver of the *sukuk* market in the early years; Bahrain, the second *sukuk* issuer, entered this market in mid-2001. The first *sukuk* issued by a Western government was by the State of Saxony-Anhalt of Germany in 2004.

In the past 10 years, the *sukuk* market has grown rapidly from about \$10 billion outstanding in 2003 to about \$270 billion outstanding in 2013. Despite a temporary slowdown in *sukuk* issuance in the aftermath of the 2008 global financial crisis, the market continues to grow, accommodating new participants and products. Prior to the crisis, gross issuance of *sukuk* had nearly quadrupled between 2004 and 2007 (rising from \$7.2 billion in 2004 to nearly \$39 billion in 2007). After a couple of years of reduced gross issuance, the *sukuk* market has rapidly expanded since 2010. When private issuances are considered, the size of the *sukuk* market across the world reaches as much as \$1.2 trillion—about 2 percent of conventional bonds (Iqbal, M., M. Ariff, and S. Mohamad, 2014).

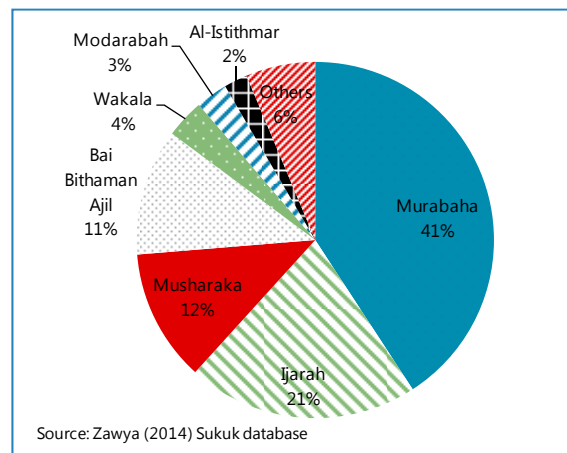
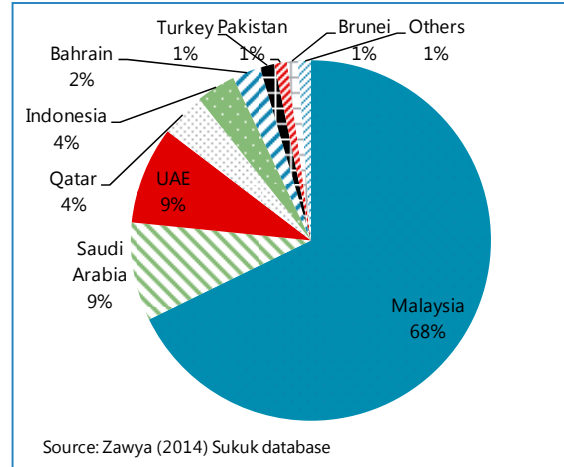


In the open primary *sukuk* market, sovereign issuers dominate with a 56 percent share compared to only 27 percent for nonfinancial corporate issuers. The remaining *sukuk* are mainly issued by quasi-sovereign institutions. Domination of sovereigns in the open primary market follows the trend in past years: sovereigns accounted for 66 percent of the market in 2013, up slightly from 62 percent in 2012. The prominence of sovereign and quasi-



sovereign *sukuk* appears to benefit from implicit sovereign guarantees. This is also evident from the average issue sizes: for example, quasi-sovereign *sukuk* are, on average, three times as large as the average corporate issuance. Although *sukuk* are linked to an underlying asset, investor appetite seems to be driven primarily by the sovereign nature of the risk; the underlying asset risk is likely to be almost incidental. The sectoral distribution of corporate *sukuk* is rather diverse. The financial services sector leads corporate *sukuk* origination with a share of 14 percent, followed by power and utilities (7 percent), and transport (7 percent).

As is the case with banking assets, gross issuance of *sukuk* is highly concentrated in a few countries. Malaysia, which pioneered *sukuk* investments, has, to date, remained a leader in total gross issuance of *sukuk*. While 27 countries have issued one or more *sukuk* as of early 2014, Malaysia accounts for more than two-thirds of total gross value. Together, Malaysia, Qatar, Saudi Arabia, and the United Arab Emirates also account for 90 percent of total issued value. Malaysia's share has been gradually declining as issuance activity in the GCC countries has picked up in recent years. When oil prices are high, many GCC sovereigns have limited funding needs. Nevertheless, quasi-sovereign and corporate issues in the GCC have been growing strongly. The Malaysian ringgit remains the leading currency of issuance (at 66 percent), while U.S. dollar issuance stood at 18 percent as of end-2013.



Certain *sukuk* types, with relatively stable return profiles, are more popular. Marked-up buyback (*murābahah*) and lease-based (*ijārah*) *sukuk* still dominate the market.

The *murābahah*-based *sukuk* account for 40 percent of total gross issuance, followed by *ijārah*-based *sukuk* (21 percent of gross issuance).<sup>24</sup> *Musharakah* contracts have grown strongly in recent years.

<sup>24</sup> *Ijarah*-based *sukuk* fund the long-term transfer of an asset or service for a specified rent and term, frequently conditional on the future repurchase of the assets for an agreed price.

Overall, rapid growth of Islamic banking assets and *sukuk* are leading to the opening up of new markets, such as sub-Saharan Africa and Europe.<sup>25</sup> In addition to the 27 jurisdictions that have already issued a *sukuk*, a number of other countries (for example, Luxembourg, Senegal, South Africa, and the United Kingdom) have just tapped into the primary *sukuk* market. Like the Islamic banking segment of the industry, *sukuk* have been growing, on average, by 17 percent a year during 2009–13. These developments during the short history of Islamic financing point to great opportunities for Islamic financial and capital markets. For example, *sukuk* are strategically important not only for the Islamic financial industry, but can be a significant source of financing for infrastructure development projects.

#### IV. GROWTH DRIVERS OF ISLAMIC FINANCE

The growing need of Muslims for a *Shari'ah*-compliant financial system seems to drive the growth of Islamic finance.<sup>26</sup> Early Muslims were not familiar with banking operations, and the concept of a bank as a modern institution is new to Islamic societies. Initially, many Muslims did not even understand the extent and importance of banks in their everyday lives, even if living in non-Islamic countries. However, once they realized that interest payments from conventional banking were at odds with the prohibited *riba*, they naturally looked for alternative modes of financing. Early initiatives in the 1960s led to the establishment of Islamic financial institutions in Egypt, India, Malaysia, Pakistan, Saudi Arabia, and later in Iran and Sudan, where Islamic finance was adopted as the only financial system country-wide. It is, thus, not surprising to see that Muslims continue to look for *Shari'ah*-compliant financial institutions around the world, as these become more mature and integrated in conventional financial systems, while offering a wider range of services.

Part of the industry growth is driven, naturally, by economic growth in the MENA region. Over the past decade, the MENA region has witnessed a solid growth path, which in turn has helped the Islamic finance industry, particularly banking assets. The average real GDP growth in the MENA region has been about 4 percent, with the highest growth rate of 11 percent in Qatar and 5.2 percent in Saudi Arabia. Although some argue that rising oil revenues and the real estate boom in some GCC countries may have also helped the industry to grow, pointedly, real non-oil GDP of GCC countries has expanded, on average, by only 3 percent, while the Islamic finance industry has seen double-digit growth in the past

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<sup>25</sup> See for example, Gelbard et al., (2014) and Khan and Porzio (2010).

<sup>26</sup> A recent report (Thomson Reuters, 2013) identifies four key Islamic market-based drivers of growth of Islamic finance: demographic (large and fast growing young population), economics (growing economies some of which have reached the emerging market status), Islamic values (values driving business practices), and growing trade among Organization of Islamic Countries. Four additional global environment-based drivers are also shaping the industry. These include participation of multinationals in the Islamic economy, seeking growth markets by developed countries, increasing focus on business ethics and social responsibility, and the global revolution in communication technology.

10 years. Many countries including from Europe, Singapore, and the United States are joining the band wagon to capture capital flows from the Middle East (Hesse, Jobst, and Sole, 2008).

The industry has grown at different speeds across countries. While the industry has enjoyed remarkable expansion in Bahrain, Kuwait, and Qatar (about 30 percent) have witnessed modest growth overall (less than 8 percent). Part of the reason might be the rapid economic growth in Qatar in recent years (about 12 percent annualized GDP growth rate), while Bahrain and Kuwait only grew by about 1.3–1.7 percent annually. Political support, better regulatory framework, and a level playing field may have also helped spur the industry’s growth, especially in Indonesia, Malaysia, and the MENA region.<sup>27</sup> However, the industry in the MENA region could grow even faster with improvements in regulatory and supervisory frameworks. Also, a level playing field is a prerequisite for sustainable penetration of the industry. The European solution to this challenge has been a policy of “no obstacles, but no special favors,” such as that initiated by authorities in the United Kingdom.

## V. COMPARISON OF ISLAMIC AND CONVENTIONAL FINANCE

### A. Efficiency and Profitability

The efficiency of Islamic banks tends to be comparable with that of conventional banks. Many argue that despite differences between the business models of conventional banks and Islamic institutions, at least for the period before the recent global recession, the efficiency of both banking systems was not significantly different (di Mauro et al., 2013). However, the story seems to have changed during the financial crisis. Recent studies show that the profitability of Islamic banks decreased more than for conventional banks during the crisis, mainly because of weaker risk management practices and financial crisis spillovers to the real economy (for example, Rashwan, 2012 and Hasan and Dridi, 2011). Although the international evidence suggests that both cost and profit efficiency of Islamic banks are on the rise, Islamic banks in advanced countries seem to be more efficient than those in other countries. This could be partly explained by well-established regulatory frameworks, more advanced human capital, and better risk management practices in these countries (Tahir and Haron, 2010).

### B. Risk Management

In addition to facing common risks with conventional financial institutions, Islamic banks also face their own unique risks. The *Shari’ah*-compliant nature of assets and liabilities distinguishes them from conventional banks while at the same time exposing them to similar market, credit, liquidity, operational, and legal risks. Notably, differences in opinion among

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<sup>27</sup> See Box 1 and Box 2 in Krasicka and Nowak (2012) for more discussion on actions taken by Malaysia to ensure level playing field for the Islamic finance industry.

religious scholars regarding the *Shari'ah* compliance of specific financial arrangements can expose Islamic banks to the risk of noncompliance with *Shari'ah* principles.<sup>28</sup> Further, operational differences across countries result in different permissible financial products, thereby raising legal uncertainty in the area of cross-border Islamic financial activities (Jobst, 2007). Islamic financing is also subject to high judicial risk, as clients may turn to *Shari'ah* courts that rule on a case-by-case basis, as well as seek redress in regular courts.<sup>29</sup> Additionally, Islamic financial institutions may confront commercial pressure to pay competitive rates of return that exceed returns on the assets that are actually being financed, with the result being that shareholders may have to forgo part, or all, of their share in profits to minimize the risk of funds withdrawal. Such exposure to rate of return risk (resulting from unexpected changes in rates of return) engenders a risk that is unique to Islamic banks known as displaced commercial risk. Finally, equity risk arises when Islamic banks enter into *musharakah* and *mudârabah* partnerships as providers of funds and they share in the business risk of the activity being financed.

Mark-up risk tends to rank highly for Islamic banks.<sup>30</sup> The 2001 Islamic Development Bank (IsDB) report contends that Islamic banks face more severe mark-up (interest rate) risk in fixed-income instruments like *istisna'* and *murahabah*. The report argues that operational risk, liquidity risk, credit risk, and market risk are next to mark-up risk for these institutions. All in all, profit-sharing investment accounts (PSIA), diminishing *musharakah*, *mudârabah*, *salam*, and *istisna'* tend to be considered riskier than *murahabah* and *ijârah*.

To mitigate risks, Islamic banks use a variety of prudential reserves.<sup>31</sup> PER are intended to smooth profits for investment account holders (IAH). These reserves are funded by setting aside a portion of gross income before the bank's profit share is deducted and are not part of equity capital. The Islamic bank can also use IRR, which are funded by a portion of the income to investors after allocating the PER, to cover future investment losses of account holders. Since IRR belong to the equity of IAHs, they are also not included under the bank's equity capital. Finally, fiduciary risk reserves (FRR), which are much less frequent and less popular than PER and IRR, are funded by a portion of the income to the bank before the payment of dividends to shareholders.

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<sup>28</sup> Noncompliance with *Shari'ah* may have serious implications on the industry, as evidenced by the significant decline in *sukuk* issuance following the pronouncement by a leading *Shari'ah* scholar in 2007 that most *sukuk* structures have strayed away from the spirit of *Shari'ah*.

<sup>29</sup> See Jobst (2007) for "double jeopardy" at Islamic banks.

<sup>30</sup> Once agreed upon, the mark-up on *murâbahah* transactions, which is usually determined in relation to a benchmark like the LIBOR, cannot be altered (even in the event of prepayment). Mark-up risk results from changes in the benchmark rate that could pose risk to the fixed income assets of the bank.

<sup>31</sup> These prudential reserves could be designed as countercyclical to address the problem of procyclicality.

Islamic banks use conventional risk management measures, but there is a need for additional risk mitigating tools to address their unique risk exposures. Conventional tools in use by Islamic banks that do not conflict with *Shari'ah* include internal rating systems, risk reports, internal control systems, external audits, maturity matching, and GAP analysis. However, the unique nature of Islamic financing, with a diverse set of instruments used as sources and uses of funds, calls for the development of new techniques, processes, institutional setup, and procedures to further enhance risk management practices and tackle Islamic finance-specific risks.

Corporate governance concerns are associated with these prudential reserves. While IFSB standards set rules on disclosure requirements on displaced commercial risks and smoothing practices, investment account holders generally have no control over the PER and IRR usage and, in some cases, are not informed of the Islamic bank's practices of maintaining these reserves. Also, an investment account holder with a short-term horizon may be negatively affected by the constitution of reserves that will most likely benefit someone else in the future. In addition, IRR may give rise to moral hazard akin to that arising from deposit insurance, as bank management may be encouraged to engage in excessive risk taking.

Further standardization for *Shari'ah* compliance would benefit Islamic financial institutions. Unlike conventional banking where a unified set of international standards help agents to identify risks associated with the bank's activities, Islamic financial institutions often face difficulties presenting internationally accepted Islamic instruments to their customers. While it seems challenging to standardize different interpretations of certain religious matters across jurisdictions and *Shari'ah* scholars, harmonizing differences in the *Shari'ah* compliance of different instruments would reduce uncertainty and foster industry growth. In this vein, the AAOIFI and IFSB have provided some *Shari'ah* standards and governance guidelines.<sup>32</sup>

### C. Sukuk and Conventional Bonds

*Sukuk* are usually asset-based financial securities. According to the AAOIFI, *sukuk* are certificates of equal value representing undivided shares in ownership of tangible assets, property right, and services. Another definition is provided by the International Islamic Financial Market (IIFM), which defines *sukuk* as a 'commercial paper that provides an investor with ownership in an underlying asset.' *Sukuk* are not debt certificates with a financial claim to cash flow, and they may not be issued on a pool of receivables. Rather, they are similar to a trust or ownership certificate with proportional or undivided interest in a project or an asset, and carrying the right to a proportionate share of cash flows. The underlying asset or project is a distinctive feature of *sukuk* compared with a pure debt

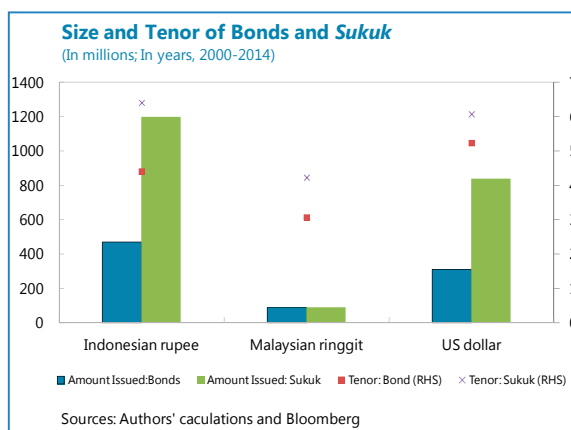
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While regulators in Bahrain, Qatar, Sudan, and Syria made the AAOIFI's standards mandatory for Islamic financial institutions, most other countries considered the AAOIFI standards advisable (for example, in Malaysia and Saudi Arabia).



obligation for the issuer created by conventional bonds, with monetized assets being *Shari'ah*-compliant in their nature and use.<sup>33</sup> As a result, *sukuk* prices should vary not just with the creditworthiness of the issuer, but also with the market value of the asset or project being financed. Further, unlike bondholders, *sukuk* investors may be held responsible for asset-related expenses. Moreover, whereas a bond-holder has to use a court of law to get ownership of assets in case of borrower's default, *sukuk* contracts envisage such transfer of ownership automatic in case of default on payments.

*Sukuk* represent a distinct class of securities with both bond- and stock-like features. Conventional financial instruments for raising funds in capital markets are debt (bonds) and equity (shares of stock). *Sukuk* are *Shari'ah*-compliant investment certificates issued by sovereign and corporate entities to finance their activities. Similar to bonds, *sukuk* have a maturity date with often a regular stream of income over the life of the



certificate, along with a final bullet payment at maturity. *Sukuk* and shares of stock are also similar for two reasons: they both represent ownership claims and are not guaranteed a return. However, *sukuk* must be related to a specific asset, service, and/or project for a period of time, whereas equity shares represent ownership claims on the whole company, with no maturity date. Using a sample of more than 11,000 conventional bonds and *sukuk*, the average issue amount and maturity are larger for *sukuk* than for conventional bonds.

However, some argue that *sukuk* financing instruments are not different from conventional bonds.<sup>34</sup> One view is that, being structured along the lines of conventional securitization, *sukuk* do not constitute financial innovation. Rather, they generally provide a return that is equivalent to interest payments on conventional bonds, with the difference being that *sukuk* returns are generated from an underlying asset rather than from the obligation to pay interest.

<sup>33</sup> Common to the bond issuance practice, a prospectus accompanies every *sukuk* specifying all details of the offering.

<sup>34</sup> See Miller and others (2007) and Wilson (2008) for details. In addition, in 2008, a controversy was ignited over whether *sukuk* actually comply with the precepts of *Shari'ah* with the implication that they were no different from conventional bonds. According to the President of the AAOIFI *Shari'ah* Council, the practices of issuing *sukuk* generally replicate the structure of conventional bonds in terms of lack of ownership, right to a fixed return, and the guarantee of repayment of principal, and thus make them non-*Shari'ah* compliant. The issue was later clarified by the Council that reference was being made to *musharakah sukuk* and not to *ijarah sukuk*. For more discussion on *sukuk* and their differences with conventional bonds, see Maziad and AlSaeed (2015).

Krasicka and Nowak (2012) observe that, although *sukuk* and conventional bonds are fundamentally different instruments, their returns are driven by common economic factors and their price behavior exhibits a similar pattern, implying that *sukuk* may not provide significant diversification benefits for investors. However, the opposing view is that *sukuk* are different from conventional bonds because the latter do not include the risk sharing element (Iqbal and others, 2014). Çakir and Raei (2007) show that *sukuk* provide diversification benefits when combined with conventional securities by the same sovereign issuer. Godlewski, Turk, and Weil (2013) show that *sukuk* are different from conventional bonds, at least in the eyes of investors, because the stock market reaction to the issuance of each type of corporate security is different.

## VI. MACROECONOMIC IMPLICATIONS OF ISLAMIC FINANCE

### A. Financial Stability

Islamic financial institutions largely escaped the direct impact of the global financial crisis and were initially insulated from its ravages, but they were not immune to its second-round effects. As the crisis became global and hit the real economy with a general downturn, the value of assets declined, real estate and property prices crumbled, and nonperforming Islamic financing rose, inflicting substantial losses on a number of Islamic banks.

In theory, Islamic banks are more resilient to shocks than conventional banks because *gharar* considerations prohibit them from investing in excessively risky subprime and toxic assets, as well as zero-sum betting on derivatives.<sup>35</sup> By promoting risk sharing (as opposed to risk transfer) and endorsing investment in wealth creating activities, the asset-based nature of Islamic financing naturally curbs excessive leverage. It also restricts banks from investing in highly leveraged assets and short selling, suggesting that they are likely to foster financial stability and render the global financial system less prone to financial distress. The direct link between the financial and the real or trade sectors may also prevent technical speculations and potential bubbles. Further, increased monitoring by investment account holders may help impose market discipline on banks and maintain financial stability. Some also contend that Islamic banks are likely to function in a more prudent manner because withdrawal risk may be higher compared to conventional banks. Also, since Islamic banks do not engage in interest-based operations, their financing seems to be less affected by interest rates changes compared with conventional banks, but they are not entirely isolated from interest rate risk. Finally, while a downturn in the real economy will affect the profitability of Islamic banks, the ability of these banks to share this risk, at least partly, with depositors provides a cushion against a widespread crisis.

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<sup>35</sup> See Siddiqi (2006), Chapra (2008) and IMF (2014).

The empirical evidence on Islamic banks' resilience is, however, mixed.<sup>36</sup> Islamic banks seemed to show greater resilience to the recent financial crisis compared with conventional banks, because they consistently held more capital and liquidity buffers.<sup>37</sup> In a cross-country study, Abedifar et al., (2013) report no significant differences in insolvency risk between Islamic and conventional banks, but results for credit risk are mixed and contingent upon the measure used. They also find no significant differences in terms of stability, and propose subjecting both types of financial institutions to the same macroprudential framework. Similarly, Krasicka and Nowak (2012) show that, while Islamic banks in Malaysia hold more capital and are more profitable than conventional banks, differences in practices were shrinking between them during the crisis as the market matured.

In contrast, Baele, Farooq, and Ongena (2012) find that loans from Islamic banks are less likely to be overdue or in default, suggesting that individual and systemic risk from loan defaults may be less likely to materialize in Islamic banking. Čihák and Hesse (2010) find that the relative stability of Islamic and conventional banks varies by the size of each institution: small Islamic banks seem to be more stable than similarly-sized conventional banks. Using the data from over 100 countries for the period 1995–2007, Beck et al. (2013) conclude that Islamic banks had a relatively higher intermediation ratio, higher asset quality, and were better capitalized during financial stress period. More recently, Farooq and Zaheer (2015) compared the behaviors of Islamic and conventional banks in Pakistan to show, empirically, that Islamic banks are less prone to withdrawals, and some even recorded deposit increases, during financial panics—both unconditionally and after controlling for bank characteristics. This evidence suggests that Islamic banks may bring more financial stability to the system during a stress liquidity period.

In a hybrid mode of banking, for financial stability purposes, the authorities may aim to ensure that Islamic banks are fully integrated with the rest of the financial system. Sole (2007) argues that Islamic banks need to be supervised at the same level as conventional banks, to ensure financial stability, especially with respect to addressing moral hazard considerations—for example, incentives for banks for excessive risk-taking as losses can be passed on to investment account holders—protecting demand depositors, and taking into account systemic considerations and *Shari'ah* compliance issues.

Using the results from a cross-country survey, Song and Oosthuizen (2014) show that, despite considerable progress on the legal and prudential framework of Islamic banking,

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<sup>36</sup> See Farooq and Zaheer (2015), di Mauro et al., (2013), Beck et al., (2013) and Hasan and Dridi (2011).

<sup>37</sup> In some cases, the evidence points to a more nuanced conclusion. For example, the 2014 Malaysia Financial Sector Assessment Program (FSAP) stress tests suggested that standalone Islamic banks held more capital (but not always) than conventional banks but that Islamic subsidiaries of conventional parents actually held much less and were more susceptible to failure in solvency stress tests.

differences in practices across countries are pronounced, and regulatory and supervisory authorities face a number of challenges, including enhanced oversight to identify emerging risks, integrated risk management frameworks and improved transparency. López Mejía and others (2014) provide policy recommendations for enhancing the supervision of Islamic banks. They recommend ensuring operational independence of the supervisory authority, a sound legal framework and governance structure, and robust accountability practices. For example, for strengthening governance, they favor a centralized *Shari'ah* Board (in addition to such boards at individual banks), which can help harmonize *Shari'ah* rulings within national jurisdictions and reduce compliance costs.

The Islamic finance industry requires a standardized and internationally recognized set of regulations to ensure financial stability at the global level. An international regulatory framework has emerged for achieving a higher level of regulatory convergence, thereby promoting global financial stability of Islamic financial operations. The IFSB is providing a comprehensive set of cross-sectoral prudential standards for banking, capital markets, and insurance. In 2010, it joined efforts with the IsDB to produce the *Islamic Finance and Global Financial Stability Report*. The report outlined a three-pronged strategy to enhance the industry's stability and resilience: (i) strengthening the Islamic financial infrastructure; (ii) accelerating the effective implementation of *Shari'ah* and prudential standards and rules; and (iii) establishing a platform for constructive dialogue among regulators. In its 2013 and 2014 stability reports, the IFSB focused on the need to strengthen financial safety nets for the Islamic financial services industry, including the establishment of a *Shari'ah*-compliant Lender of Last Resort (SLOLR) and deposit insurance, as well as an effective crisis management and resolution framework.<sup>38</sup>

Discussions among regulators and stakeholders are being held on the need to set up a macroprudential framework for further promoting the resilience and stability of the Islamic financial system. Initiatives are under way to create a common platform where regulators can engage in a constructive dialogue toward a mutual understanding of *Shari'ah* views on key issues across jurisdictions. Also noteworthy are efforts to adapt the Basel III regulations to cater for the specificities of Islamic financial institutions, especially with regards to giving *sukuk* the features of high-quality liquid assets entering the liquidity coverage ratio (LCR), as well as loss-absorbing characteristics to meet Tier 1 and Tier 2 capital requirements.<sup>39</sup>

Liquidity risk management and the financial safety net are two major challenges to the financial stability of Islamic financial institutions. Developing liquidity infrastructure

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<sup>38</sup> *Shari'ah*-compliant lender-of-last resort (SLOLR) and deposit insurance serve the macroprudential objective of financial stability, whether they are intended for Islamic or conventional banks.

<sup>39</sup> In 2005, the IFSB issued a guidance note to help Islamic banks compute a capital adequacy ratio that takes into account the profit-sharing feature of investment accounts at Islamic banks, and the capital adequacy standard was revised in 2014.

elements—such as a vibrant secondary market for trading of *Shari'ah*-compliant securities and a well-functioning money market and short-term instruments—will reduce the cost of intermediation for Islamic banks. These instruments would allow banks to be in a better position to manage liquidity risk and meet stringent requirements of the Basel III for assets, and reduce the likelihood of liquidity shortfalls and systemic contagion across markets.<sup>40</sup>

In the context of managing liquidity, the efforts of the IILM are noteworthy. Established in 2010 in Malaysia by central banks, monetary authorities, and multilateral organizations, the IILM is developing and issuing highly liquid, investment-grade short-term *Shari'ah*-compliant financial instruments that Islamic banks can use to manage their short-term funding needs. While the IILM could facilitate effective cross-border liquidity management for Islamic banks and develop a robust liquidity risk management framework, national authorities would have to take greater responsibility in establishing such frameworks. The high-quality, tradable, liquid, and low-risk *sukuk* issued by the IILM would help expand the range of collateral acceptable to central banks in return for providing liquidity, further strengthening market confidence in this nascent segment of the financial system.<sup>41</sup>

Finally, the crisis has shown that a lender-of-last resort (LOLR) facility is an important aspect of the crisis prevention framework. As Islamic banks become more integrated in the global financial system, and with a view to limiting spillover effects as evidenced by the crisis, a SLOLR capability will strengthen their resilience to liquidity problems if money market liquidity should dry up. The results of an IFSB survey among 38 regulatory and supervisory authorities provide useful insights into current SLOLR facilities and the challenges of further developing the financial safety net. There is evidence that, while different mechanisms were used in the crisis to inject liquidity into the market and limit contagion effects in the Islamic financial system, a SLOLR facility exists in only a minority of jurisdictions. Clear policy documents need to define the SLOLR structures and mechanisms, as well as the types of collateral that can be pledged and their applicable limits, to ensure the soundness and stability of Islamic financial institutions and make them less vulnerable to liquidity problems under stressed market conditions.<sup>42</sup>

The main building blocks for enhancing the stability of the Islamic financial system include:

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<sup>40</sup> In April 2015, the IFSB has released final guidance (known as GN-6) on liquidity risk management for Islamic banks, which may spur national authorities to issue more *sukuk* and establish *Shari'ah*-compliant deposit insurance schemes. The guidance note clarifies the tools that Islamic banks can use to meet the Basel III regulatory requirements.

<sup>41</sup> Since the inaugural \$490 million *sukuk* launch in August 2013 and pursuant to the granting of an A-1 public rating by Standard & Poor's Rating Services, the IILM has issued a total \$1.65 billion worth of short-term *sukuk* as at September 2014, and it has also lengthened maturities by auctioning six-month *sukuk* worth \$400 million.

<sup>42</sup> See IFSB (2014b) for more on SLOLR mechanisms and challenges.

- *Developing a robust liquidity infrastructure* for facilitating both liquidity risk management at Islamic banks and helping conduct monetary operations and liquidity management by central banks.
- *Strengthening the banking supervision and regulation* framework with a set of comprehensive, cross-sectoral prudential standards for *Shari'ah*-compliant institutions and markets, such as capital adequacy and the loss-absorbing feature of unrestricted profit sharing investment account holders, and corporate governance including *Shari'ah* governance issues.
- *Developing a Shari'ah-compliant financial safety net infrastructure*, including a SLOLR facility, emergency financing mechanisms, and deposit insurance, to support the soundness and resilience of Islamic financial institutions and the conventional financial services industry in times of distress.

## B. Monetary Policy

An interest-free financial system calls for a modified monetary policy framework. With the prohibition of interest in the economy, the design of *Shari'ah*-compliant monetary policy is the center of attention among Islamic bankers and economists. Islamic principles call for ensuring a level playing field among market participants, thereby allowing the economy to expand and helping to alleviate poverty. In a conventional economy, monetary policy traditionally seeks to curb inflation and mitigate output fluctuation. As noted by Khan and Mirakhor (1994) and echoed by others, monetary policy in an Islamic system is expected to facilitate the mobilization of savings and allocation of resources consistent with the economic development objectives of the system. Whereas the monetary policy objectives of the Islamic economy seem to be in line with those of the conventional economy, the monetary authorities in a *Shari'ah*-compliant system are prohibited from using any tool that involves a discount rate or other forms of interest rates. Nonetheless, open market operations, credit policies, reserve requirements, statutory reserves, equity-based instruments, refinancing ratios, and profit-sharing ratios have been suggested for the design of *Shari'ah*-compliant monetary policy tools.

The design of *Shari'ah*-compliant monetary policy instruments is proving to be challenging. There are two countries—Iran and Sudan—where the financial system is fully *Shari'ah* compliant. The challenge for the monetary authorities in these countries has been to design practical instruments that allow them to conduct efficient monetary policy. While there have been some innovative proposals for instruments that are comparable with conventional monetary policies, in practice the instruments have been limited to (i) direct control over banking activities using the central bank's regulatory powers; (ii) limits on lending and deposit rates; (iii) setting required reserve rates; (iv) issuing central bank certificates and *sukuk*; (v) special deposits in the central bank; and (vi) credit ceilings. In fact, it seems that designing financial instruments to absorb *excess liquidity* in the system, without being

directly linked to a specific underlying project, is key. The main difficulty is to identify a proper rate of return that could proxy the return on government and central bank securities (di Mauro and others, 2013).

Whereas most Islamic countries have been using conventional monetary policy tools as they try to develop new *Shari'ah*-compliant instruments, efforts to create new tools that comply with *Shari'ah* principles have picked up in recent years. However, the conduct of monetary policy remains a secular issue, with central banks having access to most of the conventional monetary policy instruments. In the meantime, the participation of Islamic banks in open market operations remains a challenge. The absence of an explicit framework for standing facilities in some countries, and the lack of instruments to manage liquidity and monetary policy operations, have caused Islamic banks to hold large excess liquidity and have impaired efficient liquidity management. While the monetary authorities require banks to hold *Shari'ah*-compliant reserve accounts with the central bank, the penalties levied on insufficient levels of reserves often differ for conventional and Islamic banks. Central banks are also using various kinds of government-issued *sukuk*, and some forms of central bank securities as monetary policy instruments, though their effectiveness is yet unknown.

Different countries show a variety of approaches and tools being used for conducting monetary policy. For example, Kuwait and Bahrain are actively using various forms of *sukuk*, *hbaha*, and reverse *murābahah*, whereas the United Arab Emirates relies heavily on foreign exchange swaps and Islamic Certificates of Deposits based on commodity *murābahah* contracts for liquidity and monetary policy implementation. In Malaysia, the central bank has introduced a number of instruments—*ijārah*, *mudārabah*, *murābahah*, and *bay' bithaman ajil* contracts—to facilitate Islamic banks' participation in open market operations, along with *Shari'ah*-compliant government securities used to finance government operations. The persistent difficulty in many countries with parallel banking systems is the proper setup of SLOLR facilities to allow for efficient management of short-term liquidity—that is, to avoid excess and shortage of liquidity in the system.

Iran and Sudan, where only Islamic banking operates in the financial system, have developed *musharakah*-type contracts for their monetary policy. The central bank of Sudan *Musharakah* Certificates, issued against the participation of the central bank in the equity of private banks, as well as *Ijārah* certificates, are used to manage the liquidity of the domestic banking sector through open market operations, though it has been an expensive instrument in practice. Authorities in Sudan also issued government *musharakah* certificates (*Shahama*) and government investment certificates (*Sarah*) to help conduct monetary policy.<sup>43</sup> In Iran, the

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<sup>43</sup> In Sudan, banks may hold liquid assets, at a percent not exceeding 25 percent, out of the outstanding finance portfolio in the form of the Central Bank *Ijārah* Certificates (*Shihab*), Government *Musharakah* Certificates (*Shahama*), Government Investment Certificates (*Sarah*), and Khartoum Oil Refinery *Ijārah* Certificates (*Shama*).

National Participation Paper issued by the central bank was designed primarily to finance government operations, but it was later used in open market operations. The Central Bank Participation Paper is also used this way by authorities to manage liquidity in the conduct of monetary policy; although inflexible, it is appropriate for mopping up liquidity. Further, similar to Sudan, banks in Iran are allowed to deposit excess liquidity with the central bank, which provides them with outright credit lines. However, once the credit line in Sudan matures, it is automatically converted into a *mudârabah*-type contract, whereas the central bank of Iran does not have a formal restriction on maturity. The central bank of Iran also recently announced that it will use *debt-purchase* contracts for monetary policy purposes.

Although Islamic banks are present in advanced economies, monetary policy and liquidity management are governed by conventional instruments. There are a number of regulatory and legal issues in designing *Shari'ah*-compliant instruments in an interest-based financial system: the introduction of widely used instruments like *mudârabah*, for example, needs regulatory review and approval. One exception is the United Kingdom where the Islamic financial market has been growing rapidly, turning it into a main destination for the establishment of foreign *Shari'ah*-compliant institutions.<sup>44</sup> Except for the Islamic Bank of Britain, which is a retail bank, all Islamic banks in the United Kingdom are wholesalers involved in trade finance, real estate, capital markets, and fund management. As for monetary policy, none of these banks have joined the reserve scheme, in part, because they do not meet the required minimum threshold to be subject to the cash ratio deposit regime,<sup>45</sup> and because of the conflict between the *Shari'ah* and the Bank of England's floor system, in which reserves are remunerated at the Bank rate. These obstacles have prevented Islamic banks from participating in open market operations in the United Kingdom and pushed them to the sidelines of the conventional banking system. By design, Islamic banks have not been able to use the central bank's standing facilities. To manage liquidity, they are forced to hold excess liquidity with the Bank of England and use *Shari'ah*-compliant instruments, such as commodity *murâbahah*. There are also Islamic banks established within conventional banks: these face fewer restrictions and, through a single group entity, are allowed to join the reserve scheme and participate in monetary policy operations. The situation is mostly similar in other advanced and non-Muslim countries.<sup>46</sup>

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<sup>44</sup> There are six *Shari'ah*-compliant banks in the United Kingdom: Gatehouse Bank, the Bank of London and the Middle East, the European Islamic Investment Bank, Qatar Islamic Bank (U.K.), the Islamic Bank of Britain, and Abu Dhabi Islamic Bank.

<sup>45</sup> The minimum threshold is set at total liabilities of £500 million by the Bank of England.

<sup>46</sup> Recently, the British government successfully issued a five-year £200 million *sukuk* structured as *ijārah*, partly to help Islamic banks in Britain better manage their liquidity needs. Also, the Bank of England has initiated work on developing *Shari'ah*-compliant liquidity facilities.



### C. Fiscal Policy

Independently of the objectives of an Islamic society, most conventional fiscal policy tools seem to be consistent with *Shari'ah* principles. In Islam, *zakat* could be a unique revenue instrument for the government, although not all countries collect *zakat* through the official revenue system. There is a common agreement that the government unambiguously could impose taxes as and when needed, and because *Shari'ah* does not prohibit any form of taxation, the government could also levy different forms of taxes. A basic pillar of Islam is *zakat*, which is intended to be a poverty reduction, income redistribution, and stabilization scheme.<sup>47</sup> While *zakat* could be an effective instrument for alleviating poverty, it is not the only means to achieve all the objectives of an Islamic government in need of financing a budget deficit. In fact, it seems *Shari'ah* would not prohibit the government from running a budget deficit. Nevertheless, the government could use *Shari'ah*-compliant instruments such as *sukuk* to finance capital or current spending. On the other hand, when it comes to tax policy, the prohibition of the *riba* could have tax implications for leveling the playing field, as unlike return on debt, return on equity is not a deductible cost for income tax purposes. As well, the transactional nature and the complexity of some Islamic products may lead to higher transaction taxes.

The conventional debt management framework may also offer guidance for improving the efficiency of *Shari'ah*-compliant public financing instruments.<sup>48</sup> As in conventional economies, synchronization between monetary policy operations and public debt management would not only improve macroeconomic stability, but also help develop primary and secondary debt markets, improve depository facilities, develop buyback of *Shari'ah*-compliant alternatives to repo facilities, and facilitate clearing and settlement arrangements. Regular issuance of government securities is also critical to establishing benchmark rates of return for the development of a *Shari'ah*-compliant money market.

## VII. CONCLUSIONS AND POLICY IMPLICATIONS

Three key principles govern Islamic finance: equity, participation, and ownership. These principles imply that in an Islamic financial system, financing can only be extended to productive activities, trade, and real assets—thus it is often considered an asset-based financial system. If fully complied with, these principles ensure appropriate leverage and help limit speculation and moral hazard.

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<sup>47</sup> *Zakat* is levied on those individuals whose wealth is beyond a certain exempted allowance. The wealth used for *zakat* purposes is broadly defined and includes cash, precious metals (such as gold and silver), animal stock (such as camels, sheep, and cows), and agricultural produce (like wheat, barley, dates, and grapes).

<sup>48</sup> In Sudan, the Government *Musharakah* Certificates and Government Investment Certificates were originally developed for bank liquidity management purposes, but these *sukuk* are also used for public deficit financing.

Consistent with these key principles, there are two sets of Islamic modes of financing, excluding fee-based services: (a) profit-and-loss-sharing (PLS) modes of financing; and (b) non-PLS contracts. A strong preference is attached to risk sharing modes of financing, as they are closest to the spirit of Islamic finance. In addition, even in debt-like modalities, financing is linked to real assets, thereby limiting the extent of leverage associated with financing.

Islamic finance has expanded rapidly and is spreading across many regions. Islamic financial assets grew, on average, about 20 percent annually over the past decade. Despite this growth, Islamic finance still represents a very small share of global financial assets. To this end, several factors still constrain the realization of the full potential of Islamic finance. A few are discussed in this paper, such as lack of liquidity management instruments and under-development of appropriate safety nets, notably *Shari'ah*-compliant deposit insurance scheme and lender of last resort facilities.

Islamic banks operating in many conventional systems do not have access to *Shari'ah*-compliant tradable short-term treasury instruments to channel excess funds to other Islamic financial institutions. The absence of such instruments restricts growth, forces banks to hold excessive reserves, and also curtails the central bank's ability to conduct monetary policy operations. The process of advancing *Shari'ah*-compliant lender of last resort facilities and deposit insurance schemes has been challenging. Developing a robust liquidity infrastructure to facilitate both liquidity risk management at Islamic banks, and help conduct monetary operations by central banks, is a priority policy and research area. Promoting the soundness and resilience of Islamic banking, particularly in times of distress, would require instituting a *Shari'ah*-compliant financial safety net infrastructure.

To further enhance financial stability of the Islamic financial systems, there is a need for strengthening the supervisory and regulatory frameworks, including with a set of comprehensive prudential standards. In this context, achieving full compliance with regulatory, and supervisory standards offered by two Islamic standard-setting authorities (AAOIFI and IFSB), should be a priority. Both AAOIFI and IFSB have issued multiple guidelines and standards, but much work is still needed to ensure compliance, including a transparent and credible assessment process for evaluating compliance with standards.

Conducting monetary operations through *Shari'ah*-compliant instruments is challenging. To this end, it is necessary to adapt monetary policy instruments and spur the development of Islamic interbank markets. *Sukuk* issued by governments appear to be suitable collateral for monetary operations in the context of Islamic banks (as currently practiced in Sudan and Iran). Monetary policy transmission mechanisms are, however, still not well understood and require further research.