DRAFT FOR DISCUSSION ONLY

The Islamic Financial Services Industry

TEN-YEAR MASTER PLAN (2006 – 2015)

A FRAMEWORK

A joint initiative of the

ISLAMIC RESEARCH & TRAINING INSTITUTE
ISLAMIC DEVELOPMENT BANK

&

ISLAMIC FINANCIAL SERVICES BOARD

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A FRAMEWORK

VISION

Facilitating sustainable economic development and just social progress through a stable, sound, efficient and resilient Islamic financial services industry.

MISSION

Development of a vibrant, comprehensive and progressive Islamic financial services industry closely supporting real economic activities and well integrated with the international financial system.

EXECUTIVE SUMMARY

This document aims to provide a framework for preparing Master Plans by national authorities and promote dialogue that can foster the development of an efficient, competitive, sound and sustainable Islamic financial services industry in a globalized environment.

The critical issues of poverty reduction and improvements in important aspects of human welfare such as health and education, reducing child mortality, youth insecurity and restlessness etc., are persistently facing our societies. The financial services industry must play a vital role in alleviating these perennial human development problems and in achieving sustainable economic development and just social progress by efficiently and equitably channelling financial resources towards productive opportunities and employment generation.

In view of the significant guidelines and regulations provided by Islam in the domain of economic, financial and commercial activities, *Shariah* compliance of financial services is needed for making them relevant for consumption by Muslims and broadening the public's access to such services. The Islamic financial services industry (IFSI) caters to this special need of the society. However, based on service quality, the Islamic financial services (IFSs) can also attract demand from a wider segment of population. By adding an additional item to the menu of choices IFSs also enhance competition. Promotion of the IFSI is also expected to successfully replace informal markets with formal and regulated ones and enhance financial sector development.

The contemporary IFSI is passing through its 30th anniversary year. During these years it has come a long way to provide the various financial services relating to banking, non-banking, insurance, and capital markets. Due to its inherent features, the industry offers significant potential in achieving the goals of sustainable economic development and just social progress supported by sound and stable financial institutions and markets. However, the industry also faces significant challenges emanating on one hand from its own special risk characteristics as well as unique governance requirements and on the other hand operating in a tax, legal, and regulatory environment that are designed for conventional financial services.

The systemic significance of the IFSI is growing rapidly in national, regional as well as in international financial markets. Strategic focus of national financial sector development policies and systematic and collaborative efforts among interested countries are needed to set an efficient, dynamic and sustainable future path for the industry.

Promotion of Islamic financial industry and institutions is one of the three strategic objectives of the Islamic Development Bank (IsDB) Group. The Group's Strategic Framework document entrusts the Islamic Research and Training Institute (IRTI) the responsibility of achieving the strategic objective by establishing suitable programs and networking. The Islamic Financial Services Board (IFSB) has also been entrusted by its members to cater to the needs of enhancing the soundness and safety of the IFSI. Hence, the IsDB/IRTI and the IFSB have undertaken the joint initiative to draft a Ten-Year Master Plan framework for the IFSI.

The aims and objectives of the Master Plan Framework are to:

i. Provide a general framework for IsDB and IFSB members and other interested countries to share experiences and consider the formulation of national and regional Master Plans to promote the IFSI in their respective jurisdictions so that economic development can be achieved side by side with justice, social progress and financial stability;

ii. Identify the challenges of the IFSI and suggest initiatives, ways and means through which the IFSI could interact with the conventional financial system and compete with it on equal terms;
iii. Enhance the role of the IFSI in redirecting financial resources towards real investment and creation of employment opportunities;
iv. Provide a framework for policy dialogue among national, regional and international financial and architectural institutions and the industry, and
v. Ensure the IFSI's growth, sustainability and competitiveness and its successful integration with the rapidly changing international financial markets.

This document comprises of four sections. The introductory section presents an overview of the past, present and future directions of the industry. The second section is captioned as "strategic landscaping" and addresses the challenges and opportunities of the various segments of the industry as well as the related financial infrastructure and architecture. Section three outlines strategic objectives and initiatives.

Finally, the following recommendations are summarized covering the broad strategies and initiatives to be undertaken for developing the various components of the Islamic financial services industry (IFSI), comprising, banks, non-banking financial institutions, inter-bank and capital markets, and insurance (*Takaful*) services and to provide the required support financial infrastructure:

i. Enhance the capitalisation and efficiency of IIFS to ensure that they are adequately capitalised, well-performing and resilient, and at par with international standards and best practices
ii. Enhance the effectiveness of *Shariah* and corporate governance and accountability.
iii. Develop the required pool of specialised, competent and high-calibre human capital and ensure utilization of state of the art technology.
iv. Promote the development of standardized products through research and innovation.
v. Comply with the international prudential, accounting and auditing standards applicable to the IFSI
vi. Develop appropriate legal, regulatory and supervisory framework that could effectively cater for the special characteristics of the IFSI and ensure tax neutrality.
vii. Develop comprehensive and sophisticated inter-bank, capital and derivatives market infrastructures for the IFSI.
viii. Promote public awareness of the Islamic financial services.
ix. Strengthen the international Islamic financial infrastructure institutions and enhance collaboration among them.
x. Foster collaboration among countries that offer Islamic financial services.
xi. Conduct initiatives and enhance financial linkages to integrate domestic IFSIs with regional and international financial markets.

CONTENTS

FOREWORD

ACKNOWLEDGEMENTS

The Islamic Development Bank (IsDB), Islamic Research and Training Institute (IRTI) and the Islamic Financial Services Board (IFSB) jointly organized a *Seminar on Challenges Facing the Islamic Financial Industry* held in Bali Indonesia on April 1, 2004 and facilitated by Bank Indonesia during the meeting of the IFSB Council. As a follow-up on the future challenges discussed in the Seminar, the IsDB/IRTI and IFSB undertook the joint initiative to approach the challenges in a more systematic manner by drafting a Ten-Year Master Plan Framework for the industry. Subsequently, preparation of the document was formally initiated by IRTI/IsDB and IFSB.

This document is based on the papers and presentations made to a Technical Workshop on the Ten-Year Master Plan Framework for the Islamic Financial Services Industry, jointly organized by IsDB/IRTI and the IFSB, hosted by the Dubai Financial Services Authority (DFSA), held on May 31 – June 1, 2005 in Dubai and a Policy Dialogue Seminar on the same theme organized by IsDB/IRTI and IFSB facilitated by the Bank Negara Malaysia, held on June 22, 2005 in Putrajaya, Malaysia. Subsequently, a drafting committee was constituted which held three meetings to finalize the document. A large number of personalities, practitioners and technical experts have contributed to the development of this document by providing policy guidance, technical write-ups and valuable comments. Special mentioning is required of the following people for their guidance, encouragement and valuable contributions.

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GLOSSARY OF ARABIC TERMS

Awqaf	Plural of *waqf*. For meaning, see below.
Fatawa	Plural of *fatwa*. Religious verdicts by *fuqaha'*.
Fiqh	Refers to the whole corpus of Islamic jurisprudence. In contrast with conventional law, *fiqh* covers all aspects of life, religious, political, social, commercial or economic. The whole corpus of *fiqh* is based primarily on interpretations of the Qur'an and the Sunnah and secondarily on *ijma[* (consensus) and *ijtihad* (individual judgement). While the Qur'an and the Sunnah are immutable, *fiqhi* verdicts may change due to changing circumstances.
Fiqhi	Relating to *fiqh* (See Above)
Gharar	Literally, it means deception, danger, risk and uncertainty. Technically it means exposing oneself to excessive risk and danger in a business transaction as a result of uncertainty about the price, the quality and the quantity of the counter-value, the date of delivery, the ability of either the buyer or the seller to fulfil his commitment, or ambiguity in the terms of the deal; thereby, exposing either of the two parties to unnecessary risks.
Ijarah	Leasing. Sale of usufruct of an asset. The lessor retains the ownership of the asset with all the rights and the responsibilities that go with ownership.
Istisna[	Refers to a contract whereby a manufacturer (contractor) agrees to produce (build) and deliver a well-described good (or premise) at a given price on a given date in the future. As against *salam*, in *istisna[* the price need not be paid in advance. It may be paid in instalments in step with the preferences of the parties or partly at the front end and the balance later on as agreed.
Mudarabah	A contract between two parties, capital owner(s) or financiers (called *rabb al-mal*) and an investment manager (called *mudarib*). Profit is distributed between the two parties in accordance with the ratio upon which they agree at the time of the contract. Financial loss is borne only by the financier(s). The entrepreneur's loss lies in not getting any reward for his services.
Murabahah	Sale at a specified profit margin. The term, however, is now used to refer to a sale agreement whereby the seller purchases the goods desired by the buyer and sells them at an agreed marked-up price, the payment being settled within an agreed time frame, either in instalments or in a lump sum. The seller bears the risk for the goods until they have been delivered to the buyer. *Murabahah* is also referred to as *bay[mu'ajjal*.

Musharakah	Partnership. A *musharakah* contract is similar to a *mudarabah* contract, the difference being that in the former both the partners participate in the management and the provision of capital, and share in the profit and loss. Profits are distributed between the partners in accordance with the ratios initially set, whereas loss is distributed in proportion to each one's share in the capital.
Qard Or Qard Al-Hasan	A loan extended without interest or any other compensation from the borrower. The lender expects a reward only from God.
Riba	Literally, it means increase or addition or growth. Technically it refers to the 'premium' that must be paid by the borrower to the lender along with the principal amount as a condition for the loan or an extension in its maturity. Interest as commonly known today is regarded by a predominant majority of *fuqaha'* to be equivalent to *riba*.
Sadaqah	An act of charity.
Salam	The short form of *bay[al salam*.
Shari[ah	Refers to the corpus of Islamic law based on Divine guidance as given by the Qur'an and the Sunnah and embodies all aspects of the Islamic faith, including beliefs and practices.
Sukuk	Plural of '*sakk*' which refers to a financial paper showing entitlement of the holder to the amount of money shown on it. The English word 'cheque' has been derived from it. Technically, *sukuk* are financial instruments entitling their holders to some financial claims.
Takaful	An alternative for the contemporary insurance contract. A group of persons agree to share certain risk (for example, damage by fire) by collecting a specified sum from each. In case of loss to anyone of the group, the loss is met from the collected funds.
Wakalah	Contract of agency. In this contract, one person appoints someone else to perform a certain task on his behalf, usually against a fixed fee.
Waqf	Appropriation or tying up a property in perpetuity for specific purposes. No property rights can be exercised over the corpus. Only the usufruct is applied towards the objectives (usually charitable) of the *waqf*.
Zakah	The amount payable by a Muslim on his net worth as a part of his religious obligations, mainly for the benefit of the poor and the needy. It is an obligatory duty on every adult Muslim who owns more than a threshold wealth.

LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
ARCIFI	Arbitration and Reconciliation Centre for Islamic Financial Institutions
BCBS	Basel Committee for Banking Supervision
BCPs	Basel Core Principles
CIBAFI	(General) Council for Islamic Banks and Financial Institutions
GCC	Gulf Cooperation Council
FATF	Financial Action Task Force
IAIS	International supervisor of Insurance Supervisors
ICM	Islamic Capital Market
IsDB	Islamic Development Bank
IFI	Islamic Financial Institutions
IFSB	Islamic Financial Services Board
IFSI	Islamic Financial Services Industry
IIFM	International Islamic Financial Market
IIFSs	International Islamic Financial Services
IIIIs	Islamic International Infrastructure Institutions
IIRA	International Islamic Rating Agency
IMF	International Monetary Fund
INBFI	Islamic Non-bank Financial Institutions
IOSCO	International Organization of Securities Commissioners
IRTI	Islamic Research and Training Institute
LMC	Liquidity Management Centre
NBFI	Non-bank Financial Institutions
OECD	Organization Economic Cooperation Development
OIC	Organization of Islamic Conference
WTO	World Trade Organization

I.
INTRODUCTION

The critical and persistent issues of poverty reduction and improvements in important aspects of human welfare such as health and education, reducing child mortality, youth insecurity and restlessness etc., are facing our societies at local, national, regional and international levels. The financial intermediation system must play a vital role in alleviating these perennial human development problems and in achieving economic development by efficiently channelling financial resources towards productive opportunities, hence enhancing production, investment and trade activities.

Historical evidences show that financial depth and diversity can affect economic growth and development positively, and development and efficiency of the financial system are closely linked to economic growth. At the same time, international evidence shows that financial instability can harm economic growth and create unemployment and social insecurity. The development of efficient and sound financial institutions and markets, with a policy and institutional framework to foster stability, is a basic prerequisite for resource mobilization and allocation to achieve and sustain the objectives of development policies.

1.1 THE NEED FOR A SOCIALLY INCLUSIVE FINANCIAL SYSTEM

The public's participation in the development process is essential for achieving sustainable economic development and a just social progress. The financial system can facilitate such a participation by making its services *accessible as well as acceptable* to the public.

The public's trust and confidence in financial institutions and markets serves as a primary determinant of the system's soundness and stability. A number of factors including the efficiency and transparency of institutions and markets, rule of law and contract enforceability, governance structures, effectiveness of regulatory and supervisory support and oversight, and the response of institutions to the qualitative requirements of the rapidly changing market, regulatory and technological environments contribute to enhancing the confidence of the public in the financial system.

In view of the significant guidelines and regulations provided by Islam in the domain of economic, financial and commercial activities, in Muslim societies and communities the people are also highly concerned with consistency of financial services with Islamic legal requirements. Thus broadening access to financial services in the Muslim communities and societies among other factors primarily depends on the consistency of the services with the public's religious beliefs. Therefore, successful financial sector development in such countries and communities requires the promotion of Islamic financial services within appropriate regulatory frameworks. Such strategies will enable large population segments all over the world to participate actively and effectively in the process of economic development.

While meeting such a special need of the society, the services provided by the Islamic financial services industry (IFSI) can also attract demand from other segments of the population on the basis of the quality of services it provides. As such, the IFSI adds an additional item to the menu of choices and hence enhances competition. Therefore, the services provided by the IFSI are compatible with the principle of "social inclusiveness", which is a basic requirement for ensuring a just social progress. Furthermore, such an inclusive financial sector development strategy with better service quality is expected to successfully replace informal markets with formal and regulated ones.

1.2 EVOLUTION OF THE ISLAMIC FINANCIAL SERVICES INDUSTRY: A SUMMARY

In the historical context, charging a return on loans and in lieu of a delay of their repayments (*Riba*) is prohibited in the Devine Scriptures of major religions including Islam. In addition, these religions also provide ethical proscriptions having significant bearing on economic, commercial and financial transactions. As a practical manifestation of these proscriptions the IFSI is passing through the third decade of its operations. The timeline of the landmark events in the industry's evolution are summarized here chronologically.

1890s	The Barclays Bank opens its Cairo branch to process the financial transactions related to the construction of the Suez Canal. This is understood to be the first ever commercial bank established in the Muslim world. As soon as the bank's branch was opened, Islamic scholars initiated the critique of bank interest as the prohibited *Riba*.
1900 - 30	The critique also spreads to other Arab regions, and particularly, to the Indian Sub-continent. In this debate, majority of scholars subscribed to the position that interest in all its forms constitutes the prohibited *Riba*.
1930-1950	For the first time, Islamic economists also initiated the first ever critique of interest from the Islamic economic perspective and tried to outline the *Shariah* compliant alternatives in the form of partnership.
The 1950s	Islamic scholars and economists start to offer theoretical models of banking and finance as a substitute to interest-based banking. By 1953, Islamic economists offered the first description of an interest-free bank based on two-tier *Mudarabah* (banks to collect funds on a *Mudarabah* basis and to extend these funds also on a *Mudarabah* basis). Later they showed that financial intermediation can also be organized on a *Wakalah* basis.
The 1960s	Practices of Islamic principles of finance started in Egypt and Malaysia. The landmark events include, rise and fall of Mitghamr (Egypt) Saving Associations during the 1961-64 period and the establishment of Tabung Haji Malaysia in 1967. Tabung Haji has flourished as the oldest Islamic financial institution in modern times. Operational mechanisms for Islamic financial institutions start being proposed and a number of books on Islamic banking based on profit and loss sharing, and leasing were published.
The 1970s	Islamic banks emerge with the establishment of the Dubai Islamic Bank in 1975 and the IsDB, also in 1975. Financial *Murabahah* was

developed as the core mechanism for the placement of Islamic banks' funds. Academic activities were launched with the First International Conference on Islamic Economics, held in Makkah in 1976. First specialized research institution, namely, the Centre for Research in Islamic Economics was established by the King Abdul Aziz University Jeddah in 1978. In 1975 the Fiqh Academy set out objections to conventional insurance, laying the ground for an alternative structure. The first *Takaful* company was established in 1979.

The 1980s	More Islamic banks and academic institutions emerge in several countries. Pakistan, Iran, and Sudan announce to transform their overall financial systems to be in compliance with the *Shariah*. For the first time, the governors of central banks and monetary authorities of OIC member countries in their Fourth Meeting held in Khartoum on 7-8 March 1981, jointly call for strengthening the regulation and supervision of Islamic financial institutions. The Islamic Research and Training Institute (IRTI) was established by the IsDB in 1981. In 1982, Pakistan legislates to establish Modaraba Companies. Other countries such as Malaysia and Bahrain start Islamic banking within the framework of the existing system. The IMF publishes Working Papers, and articles on Islamic banking; PhD research and other publications in the West on the Islamic banking increase. OIC Fiqh Academy and other Fiqh Boards of Islamic financial institutions engage in discussions and reviewing financial transactions. Islamic mutual funds and other non-banking financial institutions emerge towards the middle of the 1980s.
The 1990s	Public policy interest in Islamic financial system increases in several countries. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established and its standards issued. Development of Islamic banking products intensifies. Interest in Islamic finance increases in the Western academic circles. The Harvard Islamic Finance Forum was established. Large international conventional banks start operating Islamic windows. Dow Jones and Financial Times Islamic Indices were launched. Systemic concerns and regulation, supervision and risk management issues get momentum. Several countries introduce legislations to facilitate Islamic banking and its regulations. Commercial event organizers find Islamic banking and finance activities as a source of a lucrative business.
2000-2005	Sovereign and corporate *Sukuks* as alternatives to conventional bonds emerge and fast increase in size. Infrastructure institutions like the Islamic Financial Services Board (IFSB), International Islamic Financial Market (IIFM), International Islamic Rating Agency (IIRA), (General) Council of Islamic Banks and Financial Institutions (CIBAFI), and Arbitration and Reconciliation Centre for Islamic Financial Institutions (ARCIFI) were established. Recognition of systemic importance of Islamic banks and financial institutions raised in several jurisdictions.

1.3 THE PRESENT STATE OF THE ISLAMIC FINANCIAL SERVICES INDUSTRY

The above summary states the fact that during the past three decades, considerable progress has been achieved in almost all significant aspects of a comprehensive Islamic financial sector. The various segments of the industry and the related intellectual knowledge, institutions and policy initiatives have rapidly grown and attained maturity and international recognition.

1.3.1 Composition of the Industry

While passing through the third decade of its practical existence, at present, the IFSI and its institutional infrastructure are built up of the following:

i. Islamic banks including onshore and offshore commercial and investment banks; deposit-taking and financing institutions including full-fledged Islamic banks and Islamic windows and subsidiaries of conventional banks; asset management institutions, including investment banks, mutual funds, and brokerage houses;

ii. Islamic non-bank financial institutions including *Ijarah* and *Mudarabah* companies, Islamic finance companies, Islamic housing cooperatives, Islamic venture capital firms, microfinance companies, credit sale subsidiaries of trading companies and similar other institutions;

iii. Islamic insurance (*Takaful*) services;

iv. Islamic capital markets, and

v. Islamic financial architecture and infrastructure, including;

- Payments' systems and infrastructures;
- Financial markets and products, including market microstructures (*Shariah* screening and product identification systems), trading and clearance systems, and e-business infrastructure;
- Support facility providers, legal institutions and framework, safety net, Liquidity support providers;
- Regulators and supervisors including licensing authorities;
- Governance infrastructure , including *Shariah* governance institutions;
- Standard setters for financial supervision and infrastructure, including financial reporting, accounting and auditing, capital adequacy and solvency, risk management; transparency and disclosure, and corporate governance ;
- Rating and external credit assessment institutions;
- Financial statistics and information providers;
- Knowledge management and human resource development institutions and programs, and
- Research and development institutions and programs.

The interface between the Islamic and conventional financial services industries and their infrastructures and support institutions is significant. In a sound financial services industry, most of the above mentioned entities and factors are expected to be efficient and supportive. However, in developing country jurisdictions that host the

IFSI, there are serious gaps in the overall financial infrastructures, again shared by the industries for both Islamic and conventional services.

1.3.2 Size of the Industry

One of the most visible gaps in the infrastructure of the IFSI is the non-availability of systematic and reliable statistical information. Based on information scattered in different sources some observations can be made about the present size of the IFSI.

i. Concerning Islamic financial institutions (IFIs), CIBAFI is the only official source of information at the present. According to information released by CIBAFI[1] the industry includes 284 Islamic financial institutions (IFIs) operating in 38 countries and managing US dollars 178.5 billion. This does not include conventional banks' Islamic window operations, which are estimated by CIBAFI at US dollars 200 billion. Moreover, the above information does not cover non-banking financial institutions, *Takaful* and capital market activities.

ii. Concerning Islamic capital markets:

- Based on a comprehensive list provided by *The Islamic Banker*, London, it is estimated that more than 250 *Shariah-compliant* mutual funds are currently managing about US dollars 300 billion in assets.
- The Liquidity Management Centre (LMC) Bahrain lists 37 corporate and sovereign Sukuk issues on its website[2]. These Sukuk are worth US dollars 7.96 billion. Including other cases it is estimated that the total international Sukuk issues so far are US dollars 12-14 billion.
- The available data about the outstanding Malaysian domestic Islamic debt certificates shows these to be worth US dollars 17.1 billion and those of Bahrain worth US dollars 2 billion.
- A recent study conducted at IRTI[3] suggests that a sizable proportion of existing stocks of companies listed in the markets of IsDB member countries are *Shariah* compliant. Enhancement in *Shariah* screening technologies and market microstructures can further support this segment of the capital markets. Applying the Dow Jones Islamic Market Index (DJIMI) criteria to local markets of three IsDB member countries, the study suggested that total annual market capitalization of the stock meeting the DJIMI criteria in three IsDB member countries was US $ 104 billion during 2004. Assuming that these three countries constitute 30% of the stock market capitalization in IsDB member countries, the annual stock market capitalization meeting the DJIMI criteria in the member countries may exceed US dollars 300 billion.

iii. There is no established source of data for the *Takaful* segment of the industry. The authors of the background papers prepared for this document show that by the year 2005, 78 *Takaful* companies were operating

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[1] CIBAFI Ten-Year Master Plan, released during June 2005.
[2] http://www.lmcbahrain.com information downloaded on October 25, 2005.
[3] See, Salman Syed Ali, *Islamic Capital Market Products: Development and Challenges*, IRTI: 2005.

worldwide. These sources show that by the end of 2000 the total gross premium written by *Takaful* companies were worth US dollars 530 million. The same sources estimated that the annualized average growth for 1995-2000 was 63%. Given this historical information the present gross premium written by *Takaful* companies could be estimated at US dollars 5 billion providing insurance coverage to an estimated US dollars 20 billion of assets.

iv. Non-banking financial institutions, in particular, non-bank real estate financing and housing mortgages have also grown fast during the last 5 years. Systematic data provided by the Modaraba Association of Pakistan[4], placed the paid-up capital of the Modaraba Companies at US dollars 145 million and their assets at US dollars 300 million during 2004. Major provider of Islamic financial services in a number of countries are licensed as non-bank financial institutions. The estimated size of such services for 2005 is around US dollars 9-12 billions.

The above information needs to be considered as indicative only and not as an actual estimate of the industry's size. The information suggests that by the end of 2005, more than 300 institutions in over 65 jurisdictions are managing assets worth around US dollars 700 - 1000 billion in a *Shariah* compatible manner. A large part of the banking and *Takaful* concentration is in Bahrain Malaysia, and Sudan. A significant part of mutual funds concentrate in the Saudi Arabian and Malaysian markets in addition to the more advanced international capital markets.

1.4 THE FUTURE OUTLOOK FOR THE ISLAMIC FINANCIAL SERVICES INDUSTRY

The future outlook for the IFSI can be summarized based on the past developments and present status of the industry.

i. The average annual growth of the industry's assets during the last decade is variously estimated at between 10-15%. Table - 1 presents different scenarios of the size of assets in the IFSI during 2005-2015. Assuming the size of these assets during 2005 at US dollars 700 billion and assuming that annually the industry will continue to expend 15%, by 2010 the industry will grow to 1.4 trillion US dollars and by the year 2015 to US dollars 2.8 trillion.

ii. The transformation of the conventional financial services industry to *Shariah* compliance will continue at different paces in different national jurisdictions including the IsDB member countries. By 2015, in the GCC countries, a significant proportion of the conventional financial services are expected to transform to become *Shariah* compliant. In South Asian member countries this compliance is expected to constitute 15-25%. However, in other countries the compliance may remain as low as 1-2 % unless the benefits of the transformation become clearer. It is expected that in several Western jurisdictions, non-bank Islamic financial services, particularly, mortgages will continue to grow provided the relatively more sophisticated clients remain convinced of the credibility of the Islamic alternatives in terms of *Shariah* compliance and the regulators pursue the principle of "social inclusion" in the financial services industry as well.

[4] http://www.modarabas.com/ information downloaded on October 25, 2005.

Table - 1

Estimated size of the IFSI during 2005-2015 in billion US dollars

Years	Annual growth rate 10%			Annual growth rate 15%		
2005	700	800	900	700	800	900
2006	770	880	990	805	920	1035
2007	847	968	1089	926	1058	1190
2008	932	1065	1198	1065	1217	1369
2009	1025	1171	1318	1224	1399	1574
2010	**1127**	**1288**	**1449**	**1408**	**1609**	**1810**
2011	1240	1417	1594	1619	1850	2082
2012	1364	1559	1754	1862	2128	2394
2013	1501	1715	1929	2141	2447	2753
2014	1651	1886	2122	2463	2814	3166
2015	**1816**	**2075**	**2334**	**2832**	**3236**	**3641**

iii. The growth of the Islamic banking industry rests on the establishment of new banks, and the transformation of conventional banking services.

iv. Market driven as well mandatory size consolidations are expected to take place in view of the small size of capital of most Islamic banks.

v. Islamic capital markets are expected to grow faster because of financial development and deepening, as well as due to new issues of *Shariah* compliant stocks and Sukuk and identification of existing stocks as *Shariah* compliant through screening processes. The Sukuk markets are expected to receive a large boost from the dynamic real estate market, sovereign needs for financing social infrastructures and corporate needs for stable income financial instruments.

vi. Awareness and understanding both at the level of the public as well as those of regulators is expected to strengthen the demand as well as supply of the Islamic financial services.

vii. In view of the population growth, growing acceptance of *Takaful* by the public and practical success, the outlook for the *Takaful* services is also robust.

viii. Other non-bank financial services are also expected to receive a support from regulatory authorities in view of the need to make financial services accessible to a wider segment of the population. Institutions dealing with microfinance, venture capital, housing finance and social sector development are expected to benefit from regulatory response to the perennial developmental issues.

ix. Indeed the sustainability of the growth depends on the public's confidence and the public's confidence in its turn depends on *Shariah-compliance* as well as the international credibility of the services offered by the industry.

x. Based on its ethical orientation and market performance, Islamic financial services may not remain a niche for the Muslims only, but may also attract clients of other faiths as currently happening in some countries.

xi. Product development for both resource mobilization, liquidity management as well as risk management is expected to take a more dynamic path as institutions need to increase their investments in research and development in view of the growing size of the industry, response to rapidly changing regulatory requirements, globalization and competition.

xii. Integration of the IFSI with the international markets will largely depend on the credibility of the work done by the IFSB, AAOIFI, and other standards of best practices and the response of the industry to the rapidly changing regulatory, technological and market environments. Furthermore, standardization of *Shariah* guidelines and healthy interaction of *Shariah* with other legal regimes such as Common and Civil law will play an extremely important role in this regard.

1.5 THE TEN-YEAR MASTER PLAN FRAMEWORK

The systemic significance of the IFSI is growing rapidly in national, regional as well as in international financial markets. With this in mind, Bahrain and Malaysia have put in place elaborate Islamic financial infrastructures. A growing number of countries is implementing legal reforms to support the industry's development. Malaysia and Indonesia have already formulated and adopted long-term national plans to strengthen the industry.

Strategic focus and systematic and collaborative efforts among member countries are needed to chart a dynamic and sustainable future path for the industry as pointed out by H. E. Dato' Seri Abdullah Ahmad Badawi the Prime Minister of Malaysia (see, box - 1). Such a path is expected to ensure a number of preconditions for achieving efficiency and stability of financial institutions and markets and promoting investments in real economic activities, enhancing trade and employment opportunities, human development and ensuring a secure future for the present and coming generations.

Promotion of Islamic financial industry and institutions is one of the three strategic objectives of the Islamic Development Bank (IsDB) Group. The Group's Strategic Framework document entrusts the Islamic Research and Training Institute (IRTI) the responsibility of achieving the strategic objective by establishing suitable programs and networking. The Islamic Financial Services Board (IFSB) has also been entrusted by its members to cater to the needs of enhancing the soundness and safety of the IFSI.

1.5.1 PURPOSE OF THE MASTER PLAN FRAMEWORK

Hence, the IsDB and the IFSB have undertaken the joint initiative to draft a Ten-Year Master Plan Framework for the IFSI. The document attempts to provide a framework for preparing Master Plans by national authorities and promote dialogue that can foster the development of an efficient, competitive, sound and sustainable Islamic financial services industry in a globalized environment.

The aims and objectives of the Master Plan are to:

vi. Provide a general framework for IsDB and IFSB members and other interested countries to share experiences and consider the formulation of national and regional Master Plans to promote the IFSI in their respective jurisdictions so that economic development can be achieved side by side with justice, social progress and financial stability;

vii. Identify the challenges of the IFSI and suggest initiatives, ways and means through which the IFSI could interact with the conventional financial system and compete with it on equal terms;

viii. Enhance the role of the IFSI in redirecting financial resources towards real investment and creation of employment opportunities;

ix. Provide a framework for policy dialogue among national, regional and international financial and architectural institutions and the industry, and

x. Ensure the IFSI's growth, sustainability and competitiveness and its successful integration with the rapidly changing international financial markets.

Box-1

H. E. Dato' Seri Abdullah Ahmad Badawi the Prime Minister of Malaysia on the Ten-Year Master Plan Framework Initiative

A well-established global Islamic financial system, can efficiently intermediate between the financial resources of some and investment and employment opportunities of other IsDB member countries. Therefore, one of the most important areas for the IsDB member countries to collaborate on is in developing a comprehensive Islamic financial system.

The formulation of the Ten-Year Master Plan Framework for Islamic Financial Services Industry is timely and relevant, as we accelerate the development of Islamic finance in the world. The Ten-Year Master Plan Framework will provide a shared vision and a common goal to be achieved over the next 10 years. More importantly, the Master Plan Framework would provide a guided and sequenced approach to allow us to focus our energies and efforts towards achieving the vision.

In formulating the Master Plan Framework, it is important to have short and medium-term goals to ensure that any initiatives undertaken are consistent with the long term-objectives. While the Master Plan Framework charts a roadmap for the next decade of Islamic financial sector development, we must also remain ready to realign our strategies and actions when faced with changing economic and financial conditions.

Implementation of the Master Plan Framework requires the combined efforts of all the stakeholders, especially the member countries of the IsDB themselves, to ensure that the desired outcomes are achieved. I would like to take this opportunity to call upon all Muslim countries to contribute towards the formulation of the Master Plan Framework. It is important that we resist the impulse to go it alone and instead to work together in partnership to draw up the plans, not least because there is much to do for the Islamic financial system to catch up and keep pace with the conventional financial system. Indeed working together is not only desirable, but necessary in this demanding and highly competitive world.

Excerpts from the Keynote Speech of H. E. Dato' Seri Abdullah Ahmad Badawi, the Prime Minister of Malaysia, delivered at the Seminar on 10-Year Master Plan for the Islamic Financial Services Industry, jointly-organized by the Islamic Research and Training Institute, Islamic Development Bank, and the Islamic Financial Services Board, and facilitated by the Bank Negara Malaysia, held on June 22, 2005 in Putrajaya, Malaysia

The Master Plan Framework has to encompass the most significant segments of the industry in a comprehensive manner. The plan framework also requires focusing on considerations that are unique to the IFSI. Hence, this document addresses the subject from the perspective of four major components of the industry as well as the architecture and infrastructure arrangements that support the industry's effective functioning.

II.
THE ISLAMIC FINANCIAL SERVICES INDUSTRY: A STRATEGIC LANDSCAPE

The areas covered by the Master Plan Framework include:

i. Islamic banks including onshore and offshore commercial and investment banks and Islamic windows and subsidiaries of conventional banks;

ii. Islamic non-bank financial institutions including *Ijarah* and *Mudarabah* companies, Islamic finance companies, Islamic housing cooperatives, Islamic venture capital firms, microfinance companies, credit sale subsidiaries of trading companies and similar other institutions;

iii. Islamic insurance (*Takaful*) services;

iv. Islamic capital markets, and

v. Islamic financial architecture and infrastructure.

This section of the Master Plan Framework identifies the most important challenges faced by the different segments of IFSI.

2.1. ISLAMIC BANKING

Initiation of Islamic financing practices dates back to 1967 with the establishment of Tabung Haji Malaysia. However, Islamic banking started in 1975, when the Dubai Islamic Bank (DIB) was established as the first commercial bank mandated to operate in adherence to *Shariah* rules and principles. During the past 30 years, Islamic banking has made significant progress worldwide, particularly in South Asia and in the Gulf Cooperation Council (GCC) region.

2.1.1 Transformation Processes

A number of approaches are being utilized in different jurisdictions for providing the Islamic financial services. Among these two distinct approaches, namely, a) *policy framework approach* that requires legal reforms and distinct licensing initiatives and b) market driven *financial engineering approach* that encourages *Shariah*-compliant products and services within the existing legal and licensing regimes, have been adopted in different jurisdictions to allow Islamic financial services.

In the *policy framework approach*, in the GCC region and in South Asia, which are actually home to more than 50% of the total Islamic banking industry, as well as in other countries, the most dominant and dynamic strategy has been to allow mixed banking systems, whereby Islamic banking co-exists alongside conventional banking. In this framework, the Islamic banking services take four types of governance structures:

i. Full-fledged Islamic banks either newly licensed or transformed;

ii. Islamic banking windows of conventional banks, and

iii. Islamic banking subsidiaries of conventional banks.

In the Islamic banking windows and subsidiaries, the overriding regulatory concern has been the prevention of any mixing of *Shariah*-compliant and non-compliant income that could create confidence problem and deposit withdrawal. Hence, such windows and subsidiaries have to comply with firewall requirements, including separate capital for the two types of banking services in some countries.

iv. On the other hand, Iran and Sudan[5], where the public sector has a larger share in the banking system, have adopted the strategy of complete transformation of their banking systems into totally *Shariah* compliant ones without any room for conventional banking.

In the *financial engineering approach*, an increasing number of conventional financial institutions worldwide are confident that in the medium term, if allowed by regulators, most banks will be able to offer *Shariah*-compliant services alongside their conventional banking. The regulatory response has been positive. In an increasing number of jurisdictions the regulatory authorities approve contracts such as *Murabahah* and *Ijarah* which banks in their jurisdictions may use to offer financing to their clients.

There are two important differences between the two approaches. First, the financial engineering approach, does not allow profit sharing investment deposits. Instead, it encourages that *Shariah*-compliant investment opportunities may be offered in the form of mutual funds. Second, in this approach *Shariah* compliance is considered to be a matter of market discipline rather than a regulatory issue. In the policy approach, banks are allowed to offer profit sharing investment deposits and *Shariah* compliance is taken as a concern of regulation.

2.1.2 Factors Supporting the Industry's Growth

Islamic banking is viewed as one of the fastest growing industries. The industry has been growing in double digits and this growth has been spurred by licensing of new banks, largely in local markets, establishment of Islamic windows and subsidiaries by major international banks and partial or full transformation of conventional banks. Apart from the rising demand for the services offered by the industry due to growing awareness, population growth, continued success and economic reasons, a number of other factors work jointly in supporting the industry's growth. These factors include the following among others.

A) Ease in Implementation

The risk characteristics of the liabilities and assets of Islamic banks are different from those of the conventional banks. Nevertheless, Islamic banking is easy to implement.

i. On the liability side, owned funds, demand deposits and reserves of Islamic banks have similar risk characteristics as those of conventional banks. Unlike conventional banks, Islamic banks do not have tier-2 capital as syndicated medium term loans. Therefore, on the liability side, the only significant

[5] Initially, Pakistan was also in this group of countries and later has adopted the mixed banking strategy.

material difference between Islamic and conventional banking rests on the unique nature of profit sharing investment accounts. On the other hand, fee-based services (*Wakalah* contract) are more dominant in Islamic investment banking. Such-fee-based services constitute a large part of conventional banking services and are also well known to regulators.

ii. On the asset side, *Shariah-compliant* services take the form of deferred trading-based financing, leasing as well as taking ownership stakes. Most of these contracts are also familiar to banks and need to be suitably adapted to the *Shariah*. These funding practices of Islamic banks also make them similar to the activities of universal banks operating in some European countries. However, the *Shariah* does not permit taking ownership stakes in *Shariah* non-compliant businesses. This is a limitation faced by Islamic banks vis-à-vis universal banks. Nevertheless, stock screening and identification technologies have also relieved this limitation by providing readily updated information on *Shariah*-compliant businesses.

iii. On the international scene, banking is a universally known concept. Any form of banking, so long as it is conducted within the parameters of the laws and regulations of a jurisdiction for providing services to the public in the best interests of the society, is expected to be welcomed all over the world. Hence, the number of national jurisdictions that issue Islamic banking licenses is steadily growing.

B) ***Strengths of Islamic banking***

For a number of reasons the paradigm on which Islamic financial services rests is expected to contribute to a better utilization of the society's financial resources and to promoting financial stability. This is a source of strength for Islamic banking as its inherent features are consistent with the numerous efforts that are underway at various national, regional and international forums to enhance transparency, financial stability and efficiency.

i. Weak internal control and other corporate governance systems are important causes of failure of institutions and financial instability. Due to its emphasis on ethical premises and rigorous self regulation in terms of *Shariah* supervision, the Islamic finance paradigm is expected to strengthen internal control systems in financial institutions hence promoting their soundness and sustainability.

ii. Ethical considerations are also expected to divert financial resources to more socially responsible areas contributing to better human development.

iii. Recurring financial crises cause a large and unforeseen divergence in balance sheet and market values of assets, loss of wealth, employment opportunities and an increase in social insecurity. In addition to failure in corporate governance structures, such crisis is also caused by excessive and speculative flow of short-term funds, and high leverage. Islamic finance is based on "real" assets and equity type profit and loss sharing facilities. By promoting risk sharing through equity type facilities on the asset side and profit sharing investment accounts on the funding side, Islamic finance could contribute to better balance between debt and equity thereby fostering stability.

iv. Islamic financial services being based on "real" assets and services also impose limitations on the use of cash. It is in the nature of asset and project financing that financial institutions must fully know their clients and the uses of their funds. This process is controlled and rigorously monitored by the *Shariah* boards, a mechanism of self regulation. Hence, a better utilization of the society's vital resources could be ensured.

v. Providing banking services in conformity with the Islamic law will enhance an access to finance and hence has potential positive implications for justice, development and peace. Such a reform will also promote the development of formal and regulated financial markets. Without the availability of Islamic financial services, large Muslim communities in many countries would face a state of cultural, social and economic exclusion.

vi. Islamic finance also puts relatively more emphasis on the feasibility of projects and real economic activities as compared to relying only on the notion of the creditworthiness of their clients. This is also expected to contribute to enhancing the efficiency in resource allocation.

2.1.3 The Environment

The industry is evolving in the "globalization" era where market, technological and regulatory environments are rapidly changing. The characteristic features of the environment having implications for the future of Islamic banking can be summarized here.

A) Technology

Technological breakthroughs during the 1980s and the Internet and information revolution during the 1990s have completely changed the nature of the financial services industry. Three basic dimensions of this phenomenon having important implications for competitiveness and sustainability of Islamic banking are:

i. During the past two decades, there has been an unprecedented development in mathematical and quantitative treatment of financial variables with critical implications for banks. An important impact of this has been on decomposing risk through financial engineering and product development, which have made risk management as a serious scientific process. Securitization, credit and other derivatives are the result of this development. This has led to significant cost reduction for most financial institutions. However, at the same time this development has also created additional uncertainties which could have serious consequences for the development of Islamic banking.

ii. The tremendous impact of the technological breakthrough has been on reducing the boundaries of legal jurisdictions, transaction costs and information asymmetries by developing market micro-structures and improving the speed of transactions. Efficient e-business and electronic delivery systems must dramatically reduce costs and enhance quality of services.

iii. Technology creates new business risks and hence new opportunities. The spectrum and quality of services offered by a financial institution radically alters depending on its utilization of the state of the art technology. Inevitably, operational and business risks created by technology can be very cruel with some institutions, while others will thrive depending on their speed of adaptability and transformation of uncertainties into opportunities.

B) Markets

By altering the competitiveness of market players, technology also alters the market environment. The emergence period of Islamic banking during the last three decades also witnessed financial liberalization, globalization and the resultant recurring financial instabilities in conventional markets. These market conditions have forced firms to invest in research and development and develop technologies. In turn, technology has led to the sharp increase in the number of financial conglomerates in recent years. These entities sustain competitiveness by crossing traditional boundaries. As a result, a drastic transformation is taking place in the financial services industry in the form of a) cross-segment mergers, acquisitions and takeovers between banks and securities firms and between banks and insurance companies, b) acquisition of fund managers by banks and insurance companies, c) extension of financial services firms into new areas through internal growth such as insurance companies setting up banks and vice versa, insurance companies selling investment products, and banks setting up securities and fund management operations, and e) involvement of non-financial firms in the financial services business through the extension of credit and financial services to their clients.

These worldwide transformations in the financial services industry have very important implications for the development of Islamic banking. In view of the fact that most Islamic banks are very small, economies of scale dictate important strategic initiatives of mergers within the Islamic banking industry.

C) Laws and Regulation

The technological and the market environments outlined above can expose the financial services industry to serious systemic risks, unless the regulatory environment proactively responds to them. As a result, major developments are taking place worldwide in the supervisory and regulatory arena having implications for Islamic banking.

i. The philosophy of Islamic banking and finance could be considered closer to what is known as universal banking. A cursory look at the balance sheet of Islamic banks shows that there is no clear distinction between "banking book" and "trading book" activities. In their normal banking business, Islamic banks hold assets which can be classified as trading book activity in conventional banks. This nature of Islamic banks could have been a hindrance in the development of Islamic banks in the past because until recently, in many regulatory jurisdictions, activities of commercial banks, investment banks, insurance companies and mutual funds have been traditionally considered to be distinct from each other. On the pretext of protecting the soundness of each sector and its positive role in enhancing the stability of the financial system, traditionally, inter-segment activities are prohibited in many jurisdictions.

   However, to the benefit of the philosophy of Islamic banking, this type of strict segregation of the financial services no longer seems to be tenable for long, particularly after the repealing in 2000 of the Glass-Steagall Act in the United States. Banks and securities firms have traditionally undertaken cross-segment activities in most European countries. In some countries, banks and insurance companies have more interactive business linkages, while in some other countries, insurance companies and securities firms enter each others' business domain more frequently. This however requires adequate firewalls between different business segments to protect against consequent problems relating to investor protection and capital adequacy.

ii. In response to the market environment highlighted above, at the level of national jurisdictions, some countries have merged their regulatory infrastructure into one institution, like the Financial Services Authority (FSA) of the United Kingdom, and its counterparts in other countries. Some other countries, like the United States, have taken initiatives to identify a lead regulatory authority to coordinate the activities of other regulators and enhance cooperation among them. In view of the nature of Islamic banking in particular, such developments appear to be highly relevant as to provide a suitable supervisory framework for Islamic banks.

iii. At the international level, a strong cross-sector supervisory co-ordination between the activities of the Basel Committee for Banking Supervision (BCBS), International Organization of Securities Commissioners (IOSCO), and International Association of Insurance Supervisors (IAIS) has already been established within the framework of the Joint Forum on Financial Conglomerates (JFFC). With the objective to enhance financial stability, the Financial Stability Forum has been established. From this experience, important lessons could again be drawn for the IFSI and its infrastructure institutions.

iv. The coverage of consolidated supervision has been extended to the full range of activities of financial conglomerates. With such consolidated supervision that establishes effective safety nets with control on capital leverage, non-prudential connected businesses, and capital arbitrage while enhancing market discipline by proper exposures, the cross-segment activities of universal banks are expected to promote economies of scale and the efficiency of financial institutions and markets. Again, important lessons could be drawn in developing Islamic banking, which is closer in significant ways to the universal banking concept.

v. Basel II aims at encouraging better risk management by offering capital incentives as well as by its flexible and comprehensive coverage of all significant exposures, securitizations and operational risks. It also puts emphasis on empowering supervisors as well as enhancing disclosures, transparency and market discipline. An emphasis on the role of supervisors and their relationship with external auditors could indicate that more resources will be allocated to bank supervision. Basel II may be relevant for various jurisdictions and institutions differently. However, it has already increased the consciousness among banks concerning the importance of risk management. Like the adaptation to the technological environment, the adaptation to the new regulatory environment creates uncertainties and opportunities. Hence, competitiveness and businesses of some banks may be at serious jeopardy unless they try to adapt to the changes.

Two important points may be emphasized concerning Islamic banks with respect to this regulatory environment. As mentioned above, some of the activities of Islamic banks may not be banking in the strict form. As such, Islamic banks may be regulated simultaneously by different regulators. An appropriate regulatory response would be required to avoid over or under regulation. Second, the Islamic banks need to prepare themselves to adapt to this new regulatory environment.

2.1.4 Challenges Facing Islamic Banking

Islamic banking has come a long way over the past 30 years. However, it also faces a number of challenges that need to be tackled in order to set the future path on sound footing.

A) *Human Resource Requirements for Shariah Compliance*

Users of the Islamic financial services assign primary importance to *Shariah* compliance of the services they use. It is understandable that *Shariah* non-compliance entails a serious operational risk and can result in withdrawal of funds and in instability of an Islamic bank irrespective of its initial financial soundness. *Shariah* compliance is hence a serious matter for an Islamic bank in addition to its compliance with other regulatory requirements.

Therefore, the most basic and unique building block of the Islamic banking industry is its *Shariah* governance system (SGS) at national and international levels. The SGS has to make sure the *Shariah* compatibility of banking services and products and their trading. The SGS plays a critical role in ensuring the voluntary compliance of the Islamic financial institutions with the *Shariah*. Hence, it ensures the control of the institutions' reputation risk and builds the clients' confidence. Due to this systemic significance of the SGS, licensing authorities have an important concern to ensure that credible SGS are in place in institutions seeking Islamic banking licenses as well as those that offer Islamic banking services. The human resource requirements of SGS include:

i. Self regulatory systems, processes and oversight put in place by individual financial institutions. This encompasses the human resource requirements for the formulation of *Shariah* compatible contracts and products, financial engineering and risk management instruments, analysis of complex trading systems and transactions and other banking transactions, and

ii. The licensing authorities would need to put in place human resources commensurate at least with the requirements of confirming the SGS credentials of banks licensed to conduct Islamic banking.

iii. Therefore, the SGS's special human resource requirements constitute both of *Shariah* having knowledge of banking and finance and bankers having knowledge of the related *Shariah*.

The existence of a credible and well functioning SGS is a critical requirement for the development of the Islamic banking industry. Its need is not only critical for the operations of institutions, but it also determines the availability of appropriate legal framework. Suitable financial engineering and product development also largely depends on the efficiency and transparency of the SGS.

Without putting robust SGS in place, institutions will not be entitled to Islamic banking licenses. Regulators cannot test the SGS credentials of institutions without building their own minimum capabilities. Furthermore, if the SGS is not robust in a country, individual *fatwas* by religious may cause confusion, which could lead to financial instability and hamper financial sector development.

The institutional, technical and human resource requirements of the SGS are unique. Without a proper SGS in place, even if the demand for Islamic banking services increases, the supply of such services cannot be enhanced without ensuring the SGS. If highest standards of the SGS are not ensured, the credibility, competitiveness and stability of the Islamic banking industry will be at stake. Hence, the most important unique challenge of the IFSI is the development of institutional, technical and human resources to meet the *Shariah* governance needs of the IFSI.

B) Appropriate Legal Framework and Tax Neutrality

An appropriate legal, institutional and tax framework is a basic requirement for establishing sound financial institutions and markets. Like the Common law and Civil law systems, Islamic law offers its own framework for the implementation of commercial and financial contracts and transactions. Nevertheless, commercial, banking and company laws appropriate for the implementation of Islamic banking and financial contracts do not exist in many countries. In most countries, the Islamic banking contracts are treated as buying and selling properties and hence are taxed twice. In some countries like the UK, double stamp duty on some Islamic home finance schemes has been abolished providing tax neutrality.

Conventional banking laws also narrow the scope of activities of Islamic banking within conventional limits. In the absence of Islamic banking laws, the enforcement of agreements in courts may require extra efforts and costs. Therefore, banking and companies' laws in several countries require suitable modifications to provide a level playing field for Islamic banks. Furthermore, international acceptance of Islamic financial contracts requires them to be *Shariah* compatible as well as acceptable under the major legal regimes such as Common law and Civil law systems.

C) Enabling Supervisory Framework

Prudential regulation and effective supervision enhances the efficiency of financial institutions. It also promotes freedom of markets by protecting the rights of users of the financial services especially depositors. It ensures a level playing field and equal competitive opportunity to the market participants through the applications of best practices and offering support to financial institutions at times of need. Due to its relative infancy and the special nature of its liabilities and assets, credible and more supportive supervision and regulation of Islamic banks is needed. However, except for a few countries, such an encouraging regulatory environment still does not exist for Islamic banks. The Islamic banking supervision needs strengthening in a number of areas including enhancing of;

i. Transparency and disclosures;

ii. Risk management;

iii. Corporate governance, and

iv. Internal control systems

In addition, to ensure an equal opportunity, a number of support facilities need to be provided to Islamic banks in compliance with the *Shariah* including;

i. Liquidity support such as lender of last resort facility ;

ii. Neutrality of capital requirements to be accorded to assets of Islamic banks as compared to conventional banks;

iii. Return on deposits held with central banks;

iv. Appropriate treatment of investment accounts for mandatory reserves and capital requirements;

v. Investment opportunities in sovereign financial issuances;

vi. Proper understanding of the Islamic banking services and their equal treatment with conventional products;

vii. A clearer understanding of the *Shariah* governance structures and facilitating them further;

viii. Extension of safety-net systems such as deposit protection;

ix. Ensuring a supportive legal system, and

x. Ensuring tax-neutrality for Islamic financial contracts.

D) Unresolved Fiqhi Issues

Lack of standard financial contracts and products can be a cause of ambiguity and a source of dispute and cost. In addition, without a common understanding on certain basic foundations, further development of banking products is hindered. A number of such cases may be identified including:

i. Treatment of default in a deferred sale transactions is an important unresolved subject. A default whether due to genuine circumstances of the client or due to the client's unscrupulousness, is a cost for the bank. Credit risk management, regulatory treatment of capital and other important valuations of the assets depend on a clear treatment of such a default. However, in the absence of a uniform position, different banks may treat the matter differently.

ii. There is no specific direct discussion in the *fiqh* literature on the nature of a partner's liability – whether limited or unlimited, with respect to third parties**.** This is understandable because the nature of liability gains prominence only when there is leverage. Such leverage was not possible within the framework of the classical modes of *mudarabah* and *musharakah.* However, in Islamic banking, funding of assets through demand deposits has given rise to leverage and made it possible to build assets in excess of equity and investment accounts. In such a situation, it is important for equity holders as well as investment account holders to know the extent of their liability. Limited liability helps confine the degree of investors' risk to the extent of their contribution to total equity. This has given rise to the unresolved corporate governance issue in protecting the rights of investment accountholders vis-à-vis shareholders. It has important implications for the status of investment accounts as well as capital with respect to liability of assets financed by demand deposits.

iii. The *Shariah* scholars unanimously agree on the need for the lessor to bear significant part of the risk of lease financing to make the lease contract lawful. The kind of leasing which scholars have generally discussed in the classical *fiqh* literature, and about the permissibility of which there is no difference of opinion, is what is now called the operating lease. Nevertheless, there are differences of opinion among them on the permissibility of different types of lease contacts. For example, almost all Islamic banks use the financial lease by fulfilling, or at least making an effort to fulfil, the *Shariah* conditions. The residual value remains a problem but the banks have tried to overcome it by setting a small nominal value for the residual asset or transferring it as a gift from the lessor to the lessee. This does not satisfy those who are opposed to the financial lease because, according to them, it does not fulfil the *Shariah* requirements. Unless these differences are resolved, it may not be possible to prepare a clear and comprehensive legal framework for leasing.

iv. Receivables constitute a large portion of Islamic banks' portfolios. There are at least two opposing positions in practice with regard to selling these debts. Outside Malaysia, there is a general agreement among the scholars that the sale of debts is not allowed except at their face value. Hence, Islamic banks' assets remain highly illiquid, forcing them to resort to very short-term financing while maintaining high liquid assets. However, in Malaysia this prohibition is treated differently and Islamic banks are able to manage their receivables more freely.

v. Attitude towards hedging through forwards and futures is another example where there is a large divergence of opinions that do not benefit the industry.

E) Credibility and Sustainability

As the *raison d'etre* of Islamic banking is *Shariah* compliance, the core constituent of Islamic banks' clients is always expected to remain very sensitive to this consideration. Such a preference of clients may be expected to introduce market discipline among banks in providing products of high *Shariah* credibility. Since Islamic banking is an unprecedented experience, to maintain soundness and to remain competitive Islamic banks have no other option but to build on the experiences of the conventional banks. This forces their practices to have a great deal of resemblance to the services of conventional banks. This is in contrast with the vision of scholars and aspirations of clients. Some aspects of this challenge include:

Management of Investment Accounts

The most clearly unique feature of Islamic banking is the existence of investment accounts with a participatory aspect. These accounts are further classified as restricted investment accounts and unrestricted investment accounts. In their governance requirements, the management of restricted investment accounts is considered similar to the management of mutual funds and hence they cannot be considered as sources of funds available to banks. However, owners of unrestricted investment accounts offer their banks the complete freedom to utilize their deposits in *Shariah* compliant investment avenues. Hence these accounts are an important source of funds for the banks. Islamic banks often mix these types of funds with their own funds and invest in profitable investment opportunities. The profits are to be shared with the account-holders on a *pro rata* basis. The challenge in this area is one of determining the rights and obligations of investment accounts holders vis-à-vis shareholders, offering various types of deposits in compliance with the *Shariah*, ensuring the required transparency and disclosures in the distribution of profits and the sharing of risks.

Lack of Participatory Financing

It is a common understanding that the essence of Islamic banking is participation in the risks and returns of investment projects and businesses by utilizing the participatory Islamic financial contracts. Hence there is a general expectation for Islamic banks to manage the investment accounts by extending finance on the basis of participation. Such participatory finance is not only needed for promoting new businesses, entrepreneurship and sustainable economic development but is also considered as a true alternative to the conventional interest-based banking system. To strengthen the public's confidence on the IFSI and to ensure the industry's transparency, efficiency and stability, Islamic financial institutions need to promote risk sharing and participatory financing on the asset side. However, in practice, investment accounts behave like conventional deposits in terms of return profile, and there is no genuine partnership between investment accountholders and the bank due to the practise of smoothing of returns paid to such accountholders in line with market rates of return. Furthermore, the banks also need to find innovative ways of managing the capital impairment risk of assets engaged in participatory funding. Hence striking a proper balance between protecting the interests of the unrestricted investment accountholders and the aspirations of the common person poses another serious unique challenge faced by the Islamic banks.

Short-Term Financing

In order to remain solvent, banks need to maintain assets of short-term nature. In particular, since receivables of Islamic banks are non-tradable in nature, and liquidity support infrastructures are not available, Islamic banks need to be even more cautious about the maturity structure of their assets. Hence most of the assets of Islamic banks are short-term in nature. However, it is against the expectations of the scholars and the public as they aspire for Islamic banks to be different from conventional banks and finance long-term projects through a suitable balance between consumer finance and *Musharakah* and *Mudarabah* facilities for entrepreneurs. It needs to be emphasized that providing various types of funds is the function of the financial system as a whole. Other segments of the industry such as non-banking financial institutions and capital markets may be well placed to take care of the various requirements of the economy for funds.

Redirection of International Flow of Funds

There are considerable investment opportunities in a number of the IsDB member countries as well as in the developing countries in general and a large amount of financial resources held by another group of the member countries. One of the most important and commonly held aspirations from the IFSI including Islamic banks is to facilitate an efficient intermediation between these investment opportunities and financial resources. While Islamic banks have so far mobilized large financial resources, due to unfavorable legal and infrastructure conditions, these resources have not been able to meet the expectations and have rather found their way into more developed financial markets in the form of commodity *Murabahahs* or investments in equities. Hence, channeling savings towards investment opportunities in developing countries away from financial markets in developed countries is in fact a great challenge for Islamic banks without which their credibility and hence sustainability would be at stake in the long run.

F) Liquidity and Risk Management

Competitiveness and soundness of financial institutions depend on the readily availability of efficient financial products. It is more so for Islamic banks because of its need for financial products that can be in conformity with the *Shariah*. The Islamic banks urgently need these products meet a number of urgent needs including:

i. Short-term placement of funds and liquidity and asset-liability management;
ii. Hedging and financial risk management,
iii. Resource mobilization at a competitive cost, and
iv. Balance sheet management through securitization.

Due to their needs for developing new products, the Islamic banks need to invest more on their research and development as compared to the conventional banks. However, such investments are hardly sufficient in individual Islamic banks.

2.2 ISLAMIC NON-BANK FINANCIAL INSTITUTIONS

Non-bank financial institutions (NBFIs) cater to different risk, return, maturity, and liquidity needs of various agents in an economy. The NBFIs complement the activities of banks by providing various services that banks typically may not provide. In doing so, they add another layer of institutions that can compete with the banking sector, making financial institutions in the economy more efficient and customer friendly. A diverse financial sector also adds to the stability of the financial system as the existence of NBFIs as backup financial institutions may help stabilize the financial sector when negative shocks adversely affect the dominant financial institutions like the banks.

Broadly speaking the NBFIs cover all financial institutions other than commercial banks to include microfinance companies, deposit-taking institutions (building societies and credit unions), risk pooling institutions (insurance companies), contractual savings institutions (various types of mutual funds, pension funds, hedge funds), market makers (securities dealers, investment banks, stockbrokers), specialized sectoral financiers (general and sector specific finance companies, leasing and factoring companies, and financial service providers (advise, brokering, consultants). It may be noted that insurance and capital markets are discussed in this document separately.

2.2.1 The Present State

In contemporary times, the Islamic non-bank financial institutions (INBFIs) pioneered in introducing the practices of Islamic finance. In 1967 Tabung Hajji Malaysia started its operations. During 1961-64 Islamic Saving Associations were experienced in Mitghamr, Egypt. The Nasser Social Bank Egypt was established in 1971. These landmark experiences are examples of INBFIs.

Being nascent, the Islamic financial system lacks a comprehensive set of operational institutions and instruments compared to their conventional counterparts. Until recently the Islamic financial sector has been dominated by banks. While banks play an important role by providing liquidity and access to a safe and efficient payment system to depositors, there is a need to expand the type of institutions offering a wide menu of products that serve the various needs of the society. The case for having a stronger INBFI sector in the Islamic financial system is compelling.

In recent times, a number of INBFI are being established side by side with Islamic banks in different countries. While some of these institutions have counterparts in conventional financial sector, others INBFIs have unique Islamic features. The INBFIs that have counterparts in the conventional financial sector include insurance companies, different types of finance companies, cooperatives, investment banks, venture capital funds, leasing companies, and various types of funds (commodity, equity, hedge, etc). Examples of unique Islamic INBFIs with no counterpart in the conventional financial sector are Tabung Haji (Malaysia) type of institutions, Modarabah Companies (Pakistan), Qard Hassan Funds (Iran), Pawning Institutions (Malaysia), Waqf Foundations (Turkey and Indonesia) and other similar institutions.

2.2.2 Potential of INBFIs

i. Historically, the share of the NBFI sector in total financial sector activities grows along with financial development as banking loses its relative significance. Because of the special status of investment accounts, the licensing requirements for Islamic banks are very strict. Compared to this the geographic spread of the INBFIs is much more wider due to the highly specialized nature of services and hence relatively easier licensing requirements. Hence INBFIs are true backup Islamic financial institutions with a potential to take the practices of Islamic financing to most jurisdictions. In the 10-year perspective, it may be envisaged that the assets of the INBFI sector to the total IFSI should be around 8-10 percent.

ii. As compared to the transformation of conventional banks into Islamic and the development of Islamic banks, the transformation of conventional NBFIs into INBFIs and their development is relatively easier. Moreover, due to the differences in the licensing and regulatory requirements as well as asset-liability structures of the institutions, the development as well as transformation of INBFIs is expected to be different and relatively less challenging as compared to the Islamic banking industry. Transformation of conventional NBFIs involves, among others, eliminating the undesirable elements (like *riba* and *gharar*) from transactions. In this process, the functions performed by the Islamic NBFIs will be similar to their conventional counterparts, but the operations would be within the bounds prescribed by the *Shariah*. This method of creating Islamic financial institutions would keep the same institutional format and but will change the contracts used. Depending on the specific cases, this can be done at different levels of difficulty - sometimes by minor adjustments, while in other cases with extensive transformation.

iii. For transactions that do not have prohibited elements, adaptability is expected to be relatively easier. For example, venture capital firms providing private equity and equity based funds/indices would easily qualify as Islamic institutions. Cases where institutional structure of the conventional NBFIs is retained, but the contracts used are adapted to ones which are compatible with *Shariah* are leasing companies, mortgage finance institutions, finance companies, saving associations, microfinance institutions etc.

iv. The establishment of unique INBFIs, replicating for example, *Tabung Haji*, *mudarabah* companies, Qard Hassan Funds, Awqaf Foundations and Pawning institutions is also expected to be easier if encouraged by the public sector. These institutions have unique features serving different purposes in the economy. Development of social-oriented financial institutions, for example, by pooling obligatory charities (*zakah)*, and voluntary charities (*sadaqat* and interest-free loans) in an Islamic financial system will fall in this category.

v. INBFIs allow functional specialization of financial services. In their diversity, these functions range from providing risk and venture capital to offering social services. The Islamic banks are often called for to cater to these specific needs. However, banks are neither suitable to offer venture capital type of risk finance nor they can offer social services. The INBFIs framework allows the establishment of institutions catering to such diverse needs of the society. For, example, it is important to remember that socio-economic justice and equitable distribution of income are among the paramount goals of an Islamic economy and these goals must be reflected in an Islamic financial system. There are various institutions and structures Islam has instilled through which income and wealth can be redistributed to fulfil the basic needs for all in the society. Among others, z*akat*, *awqaf*, and *qard hassan* played important role in the past in increasing the welfare and mitigating poverty. These charitable acts have wide economic implications. The social objectives of the Islamic financial system can be served, if these important conventional Islamic institutions can be integrated into the contemporary financial sector. While, in the conventional sense such institutions are not a part of the financial sector, it cannot be ignored that they have a large potential for development as a part of the Islamic financial sector.

2.2.3 Challenges Facing INBFIs

i. Despite the above potentials, the INBFI segment faces a serious threat emanating from the image built as a result of a number of previous disasters caused by pyramid schemes in various countries. In these schemes the name of Islamic finance was misused and innocent small investors lost their precious savings. There is a possibility of such happenings again in some countries, while in other countries these incidents might have made regulators overcautious leading to over-regulation. Both these circumstances are detrimental to the development of the INBFIs.

ii. Legal framework is indeed again the single most important determinant for a sound INBFI sector. There is a need for acts/laws for both the regulators and the regulated. The laws should clearly specify the activities that various INBFIs can undertake. These should be complemented by supporting laws that assign regulatory powers to relevant institutions to supervise and regulate the INBFIs. Whereas commercial banks are highly regulated institutions and the related statutory laws and regulations are difficult to change, INBFIs due to their very specific functions and clear risk profile, can be established within the existing laws with relative ease. However, as INBFIs are expected to play an important role in an Islamic financial system, there is a need to have laws/statutes backing these institutions.

iii. Most IsDB and IFSB member countries have inherited the civil and common law regimes. The civil and common laws do not have specific laws/statutes to support the unique features of Islamic financial products. Under such circumstances, there may be two ways in which institutions offering Islamic financial services can operate. The first is to enact new laws or adjust existing ones to accommodate institutions that offer Islamic products. Apart from Islamic banking laws enacted so far in several countries, there are other specific laws that has led to the establishment of INBFIs. An example of this is the enactment of *Modaraba Companies and Modaraba Floatation and Control Ordinance* 1980 in Pakistan. This ordinance outlines the rules, regulations, and guidelines for *mudarabah* companies operating in the country. The second way to provide Islamic financial services in countries where specific laws related to Islamic financial activities do not exist would be to identify the institutions that can operate within the framework of the existing laws and regulations. In many jurisdictions where Islamic banks cannot operate due to legal and regulatory restrictions, there may be room for NBFIs to engage in Islamic finance. As laws related to NBFIs are less stringent than those of banking, the former institutions can provide Islamic financial services under existing laws and regulations. For example, finance companies, cooperatives, funds managers, etc. can offer Islamic products in countries that have no specific laws and regulations related to Islamic financial services.

iv. It is necessary to have a prudent regulatory and policy framework for a broad-based and efficient INBFI sector. This regulatory framework should, however, have the right balance. It should neither be too restrictive nor too lax. While the former will hamper the growth of the NBFI sector, an inefficient regulatory regime would lead instability in and impede the long term growth of the sector. Some regulatory overview may also be needed, not only to instil confidence and protect the stakeholders, but also ensure the healthy growth of the industry. Furthermore, tax neutrality can play an important role in the growth of INBFIs.

v. The development of modern financial institutions requires high quality human capital will the appropriate financial skills. The sector can grow only if there are skilled lawyers, accountants, financial experts and analysts who can comprehend the basic principles and manage various aspects of operations of the INBFIs. Specifically there is a need for skilled professionals who understand the risks in various Islamic financial instruments and the ways of mitigating them.

vi. Islamic finance is a relatively new concept and exchange and cooperation of institutions from across borders can help the growth of the industry. By allowing the establishment of foreign Islamic financial institutions from countries where the sector is more developed can be instrumental in the growth of the INBFI sector in countries where it is relatively underdeveloped. Foreign INBFIs can bring with them not only capital but the expertise on Islamic financial issues that the country may lack. Furthermore, more foreign financial institutions offering Islamic financial services will make the industry more competitive and increase the efficiency and quality of services provided.

vii. The challenges faced by the Modaraba Companies in Pakistan highlight the difficulties in accessing sources of appropriate funds due to lack of Islamic financial products and capital market support for such products.

2.3 ISLAMIC INSURANCE (*TAKAFUL*) SERVICES

As a *Shariah* compatible risk intermediation industry, *Takaful* offers highly valuable services to individuals, families, businesses and the economies. Without *Takaful* coverage Islamic banks and asset management institutions are exposed to insurable risks which adds to operational costs and competitiveness. Likewise, without a *microtakaful* coverage the micro-finance recipient's family will remain exposed to additional hardships in case of his death.

2.3.1 Present State of *Takaful*

The first *Takaful* company, namely, the Islamic Insurance Company was established in Sudan in 1979. At present, more than 78 companies are operating in various jurisdictions offering life and general insurance services in compliance with the *Shariah*. By 2005 the total gross premium written these companies exceeds US dollars 10 billion providing insurance coverage to an estimated US dollars 20 billion of assets. The companies concentrate in Malaysia, Sudan and Bahrain where separate regulatory frameworks for *Takaful* have been provided and hence the services have grown substantially in these countries.

In any developed financial services environment conventional insurance, be it general or life protection and savings, is an integral part of the financial services industry. On one hand there is a large demand for such services in the IsDB member countries. On the other hand, conventional insurance is widely believed to be against the injunctions of the *Shariah*. *Takaful* is not only a product that provides financial security, for example at times of death for one's family, but such products also enhance solidarity under the cherished Islamic principle of cooperation and mutual help. Hence, the worldwide potential market for *Takaful* is large.

Takaful life as well as general insurance and reinsurance are all in their infancy. This represents a major gap in the provision of Islamic financial services worldwide. Therefore, significant opportunities exist to develop the market for all types of *Shariah-compliant Takaful*. Moreover, conventional insurance operators are showing a great interest in *Takaful*. Islamic and conventional banks have the opportunity to create and develop *banctakaful* which will greatly enhance the ability to introduce *Takaful* worldwide. Adoption by one or two international players will see an immediate global development of *Takaful*.

Microfinance programs are on the rise all over the developing countries. These programs require *microtakaful* support for efficient functioning.

The synergy between life insurance and the asset management industries is well known. It is no different for the *Takaful* and Islamic asset management industries. The development of *Takaful*, especially life (family) *Takaful*, will greatly enhance the ability of Islamic fund managers to significantly increase assets under management as well as the number of clients in a fund. Similarly, the development of *Takaful* services will also strengthen Islamic banking by providing risk coverage to their clients and reducing the banks' exposure to risks.

2.3.2 Challenges Facing the *Takaful* Services

The *Takaful* industry confronts a number of critical challenges that can adversely effect its development and that need to be identified and addressed to.

i. Human resources having competencies in the *Shariah* and actuarial sciences is the most overriding challenge currently facing the *Takaful* industry.

ii. Like other segments of the industry, the single most important challenge faced by the *Takaful* industry is the non-existence of a supportive legal and regulatory framework. In countries other than Bahrain, Malaysia, and Sudan, *Takaful* is regulated within the regulatory framework of conventional insurance services. Furthermore, the legal framework usually treats *Takaful* like conventional insurance. As a result *Takaful* services providers face difficulty in competing with conventional insurance providers. Therefore, globally, no significant development of *Takaful* has taken place outside the areas that have a predominantly Muslim community.

    The establishment of institutions like the Islamic Bank of Britain can encourage the regulators as it helps to put in place a *Shariah* Supervisory infrastructure and increases the understanding of Islamic finance by the regulators. In this regard it is reassuring to note that the joint International Association of Insurance supervisors (IAIS)/IFSB working group on *Takaful* is has drafted a paper identifying four main themes for future work: a) corporate governance; b) financial and prudential regulation; c) transparency, reporting and market conduct; and d) the supervisory review process. Of these, corporate governance, in the widest sense is the first priority, because without a view of both the structural and the financial relationships between shareholders and policyholders, including the location of the various financial risks, it is difficult to make progress in other areas.

iii. The non-existence of uniform terminologies and the degree of unresolved Fiqhi issues is much more serious in the *Takaful* industry than any other segment of the IFSI. There are no *Shariah* guidelines on even very basic issues. The Fiqhi views differ widely often challenging even the basic concept of *Takaful*. Moreover, the lack of a uniform corporate governance standard and *Shariah* audit guidelines, which the industry can follow, leaves the industry open to criticism when companies fail or fail to protect the consumers. The potential to utilize participants' funds in a way, which contradicts good corporate governance within the *Takaful* industry, is a very real threat going into the future.

iv. For *Takaful* to succeed, it is essential that the industry provides services that are clear and transparent. Long term contracts in the *Takaful* life industry need to cope with transactions over the life time of a contract, which can be as long as forty years. Such facilities can only be assured where the level of technology implemented by the operator, can provide the participant with the assurances that his long-term interests are being met. Technology has driven conventional insurance development and there is no reason for it to not drive *Takaful* development forward. Many of the markets still to be developed by *Takaful* operators are not technology driven environments. The speed of technological development in *Takaful* industry must be matched by such developments in the general marketplace.

v. The success of *Takaful* depends on the availability of financial assets that can suit the long-term nature of the risks. Long-dated sovereign and corporate Islamic financial products are not available to place the funds available to *Takaful* companies.

vi. The non-existence of substantial rated *Retakaful* companies causes concern both inside and outside of the *Takaful* industry. Critics rightly point out that even with *Shariah* dispensation in supporting the use of conventional reinsurance, that the *Takaful* industry is a hybrid of conventional and Islamic. *Retakaful* facilities themselves depend on a sufficient pool of underlying *Takaful* business, but also on the availability of acceptable assets for investment.

vii. There is a severe lack of publicising of *Takaful* services and marketing *Takaful* products. For example, the very essence of *Takaful* is mutual risk protection between members on a cooperative basis, under *Shariah* compliant principles. The adoption of a savings element for individual participants is laudable but as in conventional insurance, such funds are not mutual or cooperative but belong exclusively to the member making the contribution. Therefore, these investment products are offered with little or no *Takaful* coverage. Furthermore, to move away from the very essence of *Takaful* is to lean too far towards a conventional insurance model, mimicking the tax advantages of products which are significantly more investment and tax avoidance vehicles than they are protection or *Takaful* products. The industry is open to criticism and credibility challenge if the roots of the *Takaful* concept as being mutual risk protection under *Shariah* law are not recognized.

2.4 ISLAMIC CAPITAL MARKETS

Capital markets provide the financial sector with three functions: risk management, liquidity management and specialization in resource mobilization and allocation. Development of a well-functioning capital market is critical for sound and efficient Islamic financial intermediation sector. Irrespective of the public sector's degree of encouragement of the Islamic financial sector, the fact that such a sector is growing in the domestic economy makes it imperative to be concerned about its soundness and, therefore, about the development of the Islamic capital market.

The key pre-requisites of well-functioning capital markets are (i) established standards and (ii) market depth. In a young industry, such as the IFSI, it is to be expected that capital markets be under-developed with weak standards and sub-scale markets.

Intervention by public or quasi-public institutions has historically been a critical factor in the development of capital markets. This is due to two principal factors: (i) the necessity of a favourable legal and regulatory framework; and (ii) the dynamics of "network externalities". The public sector (including central banks, securities commissions, etc.) therefore has the responsibility not only of *regulating* financial intermediaries involved in Islamic finance, but also of *enabling* them through initiatives that promote the development of the Islamic capital market. It is this perspective of the responsibility of public institutions in any country concerned by the development of the IFSI that forms the basis of the Master Plan Framework.

2.4.1 Present State of Islamic Capital Markets

The need for vibrant and efficient capital markets in the area of Islamic finance cannot be over emphasized. Islamic finance can claim to be a full-fledged financial system only when its capital markets have the depth and liquidity typically found in conventional markets. Since Islamic finance itself is, in relative terms, a new industry, it is not surprising therefore that the capital markets segment in the broader Islamic finance world is underdeveloped.

A) Recent Developments

There are certain recent developments that deserve to be mentioned. In the area of equities, for example, the Dow Jones has had the foresight to develop Islamic indexes to monitor *Shariah* compliant stocks in various jurisdictions around the world and various sectors. There are currently more than 40 indexes under the Dow Jones Islamic Market Indexes (DJIMI) umbrella. The Dow Jones set up a *Shariah* board which formulated a set of screening criteria to determine whether a particular stock is *Shariah* compliant. The screening process is transparent in the sense that it relates to certain publicly available ratios of the company, apart from the general business undertaken by the company.

In Malaysia, the Securities Commission of Malaysia, with the guidance of a *Shariah* board, has also developed a set of screening criteria to determine whether a particular stock is *Shariah* compliant. The stocks that meet the criteria are listed on the Kuala Lumpur *Shariah* Index. These criteria, however, are different to the criteria used for the Dow Jones Islamic Market Indexes. Another index in the Islamic equities market is the FTSE Global Islamic Index Series. This index has a different set of screening criteria to the ones mentioned earlier.

The International Organisation of Securities Commissions commissioned a fact-finding report on the Islamic capital market, which report was issued in July 2004. The report states that the Governments of Jordan and Pakistan had, in the late 1970's and early 1980's, made efforts to introduce rules and regulations for the issuance of Islamic bonds.

Though the authorities (in these two jurisdictions) had taken the initiative to provide a platform for the issuance of Islamic securities, there were no takers. It is beyond the scope of the present work to investigate the reasons for this situation but the point to note is that the Master Plan Framework will be successful only if there is follow through in terms of execution.

The report goes on to state that "the first successful issuance of Islamic bonds was initiated by the Malaysian Government in 1983 with the issuance of the Government Investment Issue (formerly known as the Government Investment Certificate or GIC)." The Malaysian Islamic capital market, which is widely regarded as being highly developed has benefited tremendously from the unwavering support and guidance of the authorities, namely the Securities Commission of Malaysia (SCM). The SCM has adopted a proactive approach to the development of the Islamic capital market whilst maintaining close contact with industry players such as issuers and investment banks. This two-pronged approach of being proactive and reactive has served the Malaysian market well.

From an equities perspective, more than 50% (in terms of market capitalisation) of the stocks listed on the Kuala Lumpur Stock Exchange is *Shariah* compliant. The stock screening criteria, as mentioned above, are those prescribed by the SCM.

The bond market also reveals some interesting numbers. As of March 2005, the total value of outstanding Islamic bonds in the Malaysian market was RM 64,904. million (US$17,080 million) compared to the total value of outstanding conventional bonds which was RM63,704.953 million (US$16,764,.461 million).[6] These figures relate primarily to corporate bonds.

The Bahrain Stock Exchange has several Sukuk listed on it. As of April 2005, the details of Sukuk listed on the Exchange are as follows:

Total number of listed Sukuk	12 (includes multiple issues by single issuer)
Outstanding amount	US$1,545 million (9 issues) BD 150 million (3 issues)
Type of issuer	Government – 11 issues Corporate – issue 1

The statistics above include securities issued by non-Bahraini issuers. Whilst the number of transactions and the aggregate value of the transactions are encouraging, these numbers pale in comparison to the size of the Islamic finance market in terms of available funds.

A review of the current Islamic finance landscape will reveal that the development of the industry has been sporadic. It can also be observed that these pockets of development often have little connection with each other. However, the establishment of international organisations such as the AAOIFI, IFSB and IIFM has, to a certain extent, addressed this situation. These organisations have helped to construct a common platform for industry players and the continuing efforts of said organisations will help establish a network between the pockets mentioned above.

B) Lack of Capital Market Instruments

The Table-2 presents the principal instruments available in the conventional capital markets and their *Shariah*-compliant alternatives.

[6] Figures obtained from the official website of *Bank Negara Malaysia*.

Table – 2

Shariah-Compliant Capital Market Alternatives

Conventional Instrument	**Characteristics**	***Shariah*-Compliant Alternative**
Equity	Equity holders are the owners of the firm and are responsible for conducting its affairs	Accepted
Preferred stock	A hybrid security that combines features of debt and equity	Emerging
Primes and scores	Equity is split into a prime component that has dividend and capital gains up to a stated price and a score component that has capital gains above this	Do not exist
Warrants	A long-term call option on a firm's stock issued by the firm	Do not exist
Synthetics	Securities that allow combinations of assets to be obtained with low transaction costs	Do not exist
Acceptances	A written promise to pay a given sum at a pre-specified date	Developed, but non-negotiable
Commercial paper	A short-term debt security that can be easily traded	Developed, but non-negotiable
Bonds	A term obligation to make a series of fixed payments	Emerging
Floating-rate bonds	The interest rate on the debt is based on LIBOR or the T-bill rate	Emerging
Securitized loans	Pools of mortgages or other types of loans that are publicly traded	Emerging
Index-linked securities	Bonds where the payment is linked to an inflation index or a commodity price	Do not exist
Convertibles	A bond that can be swapped for equity at a pre-specified ratio or vice versa	Do not exist
Swaps	Transactions in which different streams of income are exchanged	Do not exist
Options	The right to buy or sell a security on or before a specific date	Under development
Commodity futures	specified date Contracts for the future delivery of a commodity	Do not exist
Financial futures	Contracts for the future delivery of currencies, securities, or an amount of money based on an index	Do not exist

Table-3 lists some Islamic capital market products in a number of IsDB member countries. Although there are significant differences across countries, broadly speaking the following can be considered the currently developed Islamic capital markets instruments:

Table-3

Kinds of Capital Market Products Available (in various markets)

Bahrain	**Malaysia**	**Pakistan**	**Sudan**	**Saudi Arabia**
Ordinary Stocks Preferred Stocks	Ordinary Stocks Preferred Stocks/Warrants	Ordinary Stocks Preferred Stocks/Warrants *Mudarabahs* (or *Mudarabah Sukuk*)	Ordinary Stocks	Ordinary Stocks
	Futures Index Futures Contracts (if underlying asset is *Shari[ah* approved)	Single Stock Futures		
Bonds	Bonds	Bonds and Term Finance Certificates (TFC)		
Ijarah Sukuk	*Ijarah Sukuk*	*Ijarah Sukuk* (issued but not available in local market) Partnership *Sukuk* (Participation Term Certificates)		*Ijarah Sukuk*
Salam/*Istisna* based *Sukuk*	*Salam*/*Istisna* based *Sukuk*		*Salam*/*Istisna* based *Sukuk* Special Gov Inv Cert., Central Bank *Musharakah* Certificates, Government *Musharakah* Certificates	
Mutual Funds (Islamic/ Conventional)	Mutual Funds (Islamic/ Conventional) Discounting Products *Murabahah* Bonds (Securitized Debt)	Mutual Funds (Islamic/ Conventional)		Mutual Funds (Islamic/ Conventional)
Use of SPV structures to trap liabilities	Use of SPV structures to trap liabilities	Use of SPV structures to trap liabilities	Use of SPV structures to trap liabilities	

Observers who are familiar with the rich contemporary body of research on *Shariah* compliant financial schemes might be puzzled at the under-developed state of Islamic capital markets. The reality is that it is one thing to conceive of a financial scheme, and altogether another thing to develop a liquid market in standardized instruments based on this scheme.

C) Size of Islamic Equity Market

Market capitalization of Global DJIMI as of March 31, 2005 was estimated to be USD 10.65 trillion, and the universe of *Shariah* compliant stocks was 1942 stocks. Since the Global DJIMI takes up only those stocks in which an international investor can invest and repatriate the proceeds they exclude many local stocks. The Islamic capital market is not that global; it is rather segmented. By applying the DJIMI criteria to local markets of four IsDB member countries a recent study conducted at IRTI found that 6.4%, 12%, 42% and 60% of stocks respectively in the four countries met the DJIMI criteria. The total annual market capitalization of the stock meeting the DJIMI criteria in three countries was calculated to be US $ 104 billion. This constitutes about 42% of total market capitalization in the three countries. This indicates that *Shariah* compliant stocks constitute a significant part of the stock markets in the countries. This size is expected to grow through a wider application of the screening technology as well as through formalization of product identification marks.

2.4.2 Challenges and Key Areas for Product and Market Development

A) Leveraging the infrastructure and liquidity of conventional capital markets

The industry's practice has been to develop close substitutes to conventional capital markets instruments (commercial paper, bonds, derivatives or ABS) and utilize conventional pricing benchmarks (LIBOR, swap rates, etc.). As long as the resulting instruments satisfy core *Shariah* requirements (which often eliminates elements of *riba* or *gharar),* this strategy is driven by two key considerations. First, conventional instruments have developed to fulfil in an effective fashion one or more legitimate functions of financial markets, which *Shariah*-compliant instruments will also need to fulfil. Second, an emerging, subscale and fragmented Islamic capital market cannot afford not to leverage the existing liquidity and infrastructure provided by the conventional market. Creating near substitutes to conventional instruments allows the *Shariah*-compliant market to "borrow" the liquidity of conventional markets and utilize with adjustments the same infrastructure (payment systems, accounting and auditing systems, rating procedures, etc.).

B) Backbone for the Islamic capital market

The backbone on which the Islamic capital market will develop is the market for long-dated securities that represent asset-based obligations. One version of this market are *Sukuk,* which typically represent asset-based sale-and-lease back obligations by the issuer. Another version of this market that we expect to develop are true asset-backed securitizations (Islamic ABS), which represent a pool of asset-backed obligations where the obligor is unrelated to the issuer.

C) The Sukuk and Islamic ABS market

The S*ukuk* market provides a functional equivalent to the conventional government and corporate bond market. The Islamic ABS market provides a functional equivalent of the conventional MBS and ABS markets. Although at an embryonic stage of development, the latter has a great potential to develop in the form of residential and commercial mortgage-backed securitization. The reason is that real estate is the most appropriate asset type to back the development of the

Islamic capital market: and typically constitutes a very large portion of the national balance sheet in general, and of that of Islamic financial institutions in particular (as they typically avoid non-negotiable long-dated debts and many equities).

D) Development of money market

Development of a well-functioning market for *Sukuk* and Islamic ABS can be seen as a pre-requisite for the broader development of capital markets. In particular, the development of a functional equivalent of *money market* would likely be based on a pre-existing liquid market for high-credit, long-dated instruments.

E) Development of derivative market

Similarly, risk-management "derivatives" contracts can be based on *Sukuk* and Islamic ABS. For example, the functional equivalent of interest rate swaps can be implemented through an exchange of fixed-and floating rate instrument combined with an exchange of credit guarantees.

F) International vs. domestic Islamic capital markets

A key distinction should be drawn between the *international Islamic capital market,* which for the foreseeable future is primarily dollar based, and the *domestic Islamic capital markets,* which are based on each country's local currency. The former has the potential of being developed as a single, unified market. The latter is, by definition, segmented by currency, although it can greatly benefit from harmonization. Ideally, the standards established by a unified international capital market can become a benchmark for the standards on which the various domestic and regional capital markets are based.

2.5 ISLAMIC FINANCIAL ARCHITECTURE AND INFRASTRUCTURE

Islamic financial architecture and infrastructure (IFAI) refers to the legal and institutional arrangements needed for a sound and well functioning IFSI. IFAI covers both national and international components.

2.5.1 National Islamic Financial Infrastructures

A) Components of National Islamic Financial Infrastructures

At the national level, the IFAI includes the legal and institutional arrangements for the supervision and regulation of IFSI. It also includes a set of infrastructure components that are considered necessary preconditions for effective supervision and sound development of the industry. These components consist of:

i. Legal infrastructure underpinning laws, contracts, property rights, insolvency and creditor rights regime, and financial safety nets;

ii. Transparency, information and governance infrastructure, including monetary and financial policy transparency and neutrality, corporate governance, accounting and auditing framework, disclosure regime and market monitoring arrangements such as credit ratings, and credit reporting systems, and

iii. Systemic liquidity infrastructure, including monetary and exchange operations, payment and securities settlement systems, and microstructure of money, exchange and securities markets.

Much of the conventional infrastructure arrangements available for conventional finance, such as payment systems, trading arrangements, information systems, are accessible to the IFSI, although in some cases the operational modalities may need to be adjusted in varying degrees to accommodate its specific requirements.

B) Current State of National Islamic Financial Infrastructures

Progress so far in setting up an effective legal and institutional framework for the regulation and supervision of Islamic finance is encouraging, but remains uneven; at the same time, the effectiveness of supervision and sound development of the industry are impeded by pervasive weaknesses in the needed financial infrastructure. An increasing number of countries have enacted a distinct Islamic banking law (or a separate Islamic banking section of another law), and several countries provide for a separate regulatory treatment of Islamic banks within the overall regulatory powers available to the central bank. Nevertheless there are still many countries where legal and institutional framework is not explicit and transparent about Islamic finance, and the supervision framework for conventional finance continues to apply to Islamic banks, with some operational level variations to recognize their specific characteristics. Similar issues apply to other Islamic financial services segments. A key issue is whether such an approach would be sufficiently flexible to focus on the provision of Islamic financial services as a function that needs to be properly recognized and appropriately supervised to reflect its unique mix of risks and special operational features. In addition, there could be tensions between the architecture and reform priorities required for conventional finance with those required for Islamic finance.

Countries with Islamic banks are at various levels of compliance with Basel Core Principles (BCPs), and the process already underway for achieving compliance with BCPs and progressing towards IFSB standards, which supplement Basel II will greatly facilitate a more effective supervision of Islamic banks. But continued progress in setting supervisory and regulatory standards tailored to Islamic banks is necessary to support this process. Indeed, some of the areas of weaknesses that currently prevail in many countries – in risk management, recognition of market and operational risks, information sharing, and consolidated supervision – are particularly pertinent for effective supervision of Islamic banks and need to be addressed expeditiously. In addition, the greater use of equity type facilities and more effective management of investment accounts by Islamic banks call for a cross sectoral approach to their supervision. Such an approach would combine prudential rules and supervisory review on the one hand with investor protection arrangements and disclosure norms on the other. This will pose a challenge for designing effective supervision policies for Islamic banks, but provides an opportunity that, if well executed, can greatly facilitate the further development of equity-based instruments in the industry.

Significant weaknesses in legal, governance, and systemic liquidity infrastructure is impeding the spread of product innovations in Islamic finance, and preventing effective supervision and risk management. The still underdeveloped state of securities markets and insurance industry in many countries – in part reflecting the infrastructure weaknesses – is affecting greater use of equity based and asset backed facilities in IIFSs. Weaknesses in insolvency and creditor rights regimes and in contract enforcement, the limited adoption of AAOIFI accounting standards for Islamic institutions and the weaknesses in the content and scope disclosures, all affect further development of investment account management, and impede an equity culture necessary to support a greater use of equity based facilities in IIFS. Significant weaknesses in systemic liquidity infrastructure has raised liquidity risks for Islamic banks, and prevented the effective use of monetary operations with *Shariah* compatible money market instruments as a means to manage market liquidity and set a benchmark rate of return. The recent developments in Islamic asset securitization, however, have opened up opportunities to strengthen systemic liquidity arrangements (by fostering national money markets for suitably designed securitized assets) and for greater use of markets for securitized assets as a tool of risk management.

2.5.2 International Islamic Financial Infrastructure Institutions

A) Components of International Islamic Financial Infrastructure Institutions

At the international level, the IFAI includes:

i. International infrastructure institutions are those that collectively facilitate monetary and financial policy making at national level, and promote national development, financial stability, and international financial integration, by helping to develop standards, guidelines, and good practices, coordinating national policies, and organizing international financial and technical support. This includes many of the international and regional development banks, which also cover Islamic finance in the context of their surveillance, technical and financial assistance, and policy development work. *In particular, the IsDB plays a special role in the architectural hierarchy*.

ii. A number of initiatives have been taken in recent years, both nationally and internationally to strengthen the Islamic Financial Architecture. Some IsDB member countries have adopted comprehensive medium term strategies to foster institutions offering Islamic financial services and Islamic financial markets, as part of broader financial sector reforms. In addition, the IsDB in coordination with other institutions, has played a catalytic role in establishing Islamic international infrastructure institutions (IIIIs) comprising:

    - The Islamic Research and Training Institute established by the IsDB in 1981;
    - Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, set up in 1991)*;
    - International Islamic Financial Market (IIFM, set up in 2002)*;
    - (General) Council for Islamic Banks and Financial Institutions (CIBAFI, set up in 2001);
    - International Islamic Rating Agency (IIRA, set up in 2002);
    - Liquidity Management Centre (LMC, set up in 2002);
    - Islamic Financial Services Board (IFSB, set up in 2002)*, established by several central banks and monetary authorities, working together with the IsDB, IMF and AAOIFI, and;

- Arbitration Centre for Islamic Banks and Financial Institutions (ARCIFI, set up in 2005)*.

In addition, multilateral institutions and various standards-setting agencies have increasingly incorporated the features of Islamic finance, as needed, in their operational work, including in the Bank-Fund Financial Sector Assessment Program (FSAP), and the associated technical assistance.

B) The Present State of Islamic International Infrastructure Institutions

The existing infrastructure institutions for Islamic finance, together with contributions from IsDB, and other multilateral institutions provide a generally adequate basis to support national financial architectures for Islamic finance, but some gaps exist. While institutional arrangements to address the need for accounting and auditing standards for IIFS and to close the gaps in financial supervision and financial stability policies are in place, significant gaps exist in addressing the issues in strengthening some of the core infrastructures needed for a sound development of a diversified Islamic finance sector. Addressing these gaps requires additional coordination among existing Islamic infrastructure institutions, and further clarity on the objectives, instruments, governance arrangements of some of them.

i. All major Islamic international infrastructure institutions (IIIIs) are engaged in promotion, and building public awareness, of Islamic finance issues, through conferences, seminars and workshops. While this is quite appropriate, additional coordination is warranted to steer each institution to focus on its core objectives

ii. AAOIFI has played a pioneering role in designing key accounting, auditing and reporting standards for IIFSs, complemented these with *Shariah* standards for contracts and governance, and has built awareness of major risk and prudential issues in Islamic finance. However, the pace of adoption of standards is slow. Also, considerable challenges remain to upgrade the standards and develop new ones in order to support the rapid innovations in the industry, and to align more closely the accounting and auditing standards with the evolving regulatory standards.

iii. In order to promote suitable climate for the development of the required infrastructure an effective coordination arrangement for the *Shariah* standard setting and endorsement processes for both cross border instruments and national markets need to be evolved.

iv. The scope of the objectives of the IFSB is broad. This broad scope is appropriate owing to the cross sectoral features of IIFSs and the role of Islamic capital and money markets in providing effective risk mitigation arrangements. This is also consistent with the move toward integrated supervision in many countries, owing to increasing conglomeration and globalization in the industry. This broad scope, however, has certain organizational and operational implications. There is a need to broaden the representation in the governance and operations of IFSB by including all sectoral supervisors (not limited to banking supervision mainly, as at present).

v. The IIIs need to coordinate with each other in specific areas, in order to take into account different perspectives in setting supervisory and prudential norms

* These institutions fully meet the definitional criteria of a financial infrastructure institution.

without duplication of efforts. Furthermore, The IIIs need to develop a strategic alliance with BCBS, IOSCO, IAIS, IASC and other such standard setting institutions.

vi. In the absence of national/regional strategies to design and implement Islamic money and capital markets nationally (regionally), at the present there is no sufficient depth or volume to support a cross-border market in money market / capital market instruments. Thus the mission of IIFM to develop secondary markets globally is appropriate, but may be premature, unless supported by appropriate national or regional strategies.

vii. IIFM could fruitfully develop into a self-regulatory body - an association of players in Islamic capital markets in order to concentrate on a) designing product guidelines, b) code of conduct of market practices, and c) standardization of contracts in cooperation with private sector institutions and other IIIIs and developing other Islamic capital market related infrastructure.

viii. Lack of adequate Insolvency and Creditor Rights regimes (ICR) at the national level is a more pressing issue than cross national dispute resolution. The new ARCIFI could, in coordination with other IIIIs, also contribute to the broader objective of facilitating robust ICR regimes at the national or regional levels in addition to its primarily commercial functions – dispute resolution service for members.

ix. CIBAFI's core promotional and representational roles and their renewed efforts to contribute to training and human resource development are valuable; some of its research and policy development work that relates to standards setting or harmonization of practices – e.g. Model Islamic Banking Law – would require further coordination with other IIIIs.

x. The current objectives and associated work programs of Islamic infrastructure institutions, when compared with comparable infrastructure for conventional finance, reveal some gaps that remain to be addressed through future cooperation, and a resetting of objectives and instruments.

- Technical assistance to countries in designing and implementing national level Master Plans to develop Islamic finance as part of a broader financial sector reforms. This will provide a strategic focus on the industry, facilitate private sector planning, and help implement standards suited to Islamic finance.
- Developing standards, guidelines, good practices, and technical information on laws on Islamic banking, insurance, capital markets; on legal, accounting, and operational aspects of asset securitization; and on adaptations of existing laws and contracts to facilitate enforcement of Islamic contracts in various legal environments.
- Guidance on adapting capital market laws and regulations, insurance laws and regulation, and FATF AML/CFT recommendations to the specific context of Islamic finance.
- Research and analysis on access indicators for Islamic financial services, and design policies to enhance access, including Islamic rural and micro finance institutions.

- Developing guidance and good practices on developing credit reporting systems and credit rating firms to support IIFSs.
- Developing a work program to design Islamic hedging instruments.
- Guidelines on issuance and management of Islamic sovereign debt and guidance on developing markets in such instruments.
- Arrangements for monitoring and coordination of the work programs of IIIIs and setting priorities for their work in order to support emerging national priorities.

2.5.3 Responding to the Rapidly Changing Environment

The existing Islamic financial architecture requires further strengthening to reflect several external environmental factors as well as structural changes within the industry. These include:

i. Impact of globalization;

ii. Technological changes, with growing application of information technology for the delivery of services and management of risks;

iii. Changes in regulatory environment, with increased emphasis on risk focused supervisory approaches and market discipline, and

iv. Rapid growth in IIFSs and Islamic financial markets in response to market demand, government strategies to promote the industry in some countries, and product innovations based on securitization of Islamic finance contracts.

These factors have highlighted the unique mix of risks and special operating characteristics of Islamic finance, and the need to take these into account in the risk management by IIFS, in official supervision, and in formulating development strategies for Islamic finance. The unique operational features of Islamic finance derive from the contractual design of instruments based on *Shariah* principles, and the overall legal, governance, and liquidity infrastructure governing Islamic finance.

A review of supervisory and risk management arrangements and the infrastructure support for Islamic finance reveals significant gaps and weaknesses. These are in the early stages of being addressed by some national authorities, and by the Islamic international infrastructure institutions, most of which were established only recently (except AAOIFI, which was established in 1991 to develop Accounting & Auditing Standards for Islamic banks). AAOIFI has made a major contribution in establishing key accounting, auditing and reporting standards, and supporting *Shariah* contract and governance standards, but much remains to be done to support the rapid innovations in the industry.

The IFSB has begun to address a range of prudential supervision and financial stability issues in Islamic finance effectively, but significant challenges remain to address the cross sectoral features of the industry. However, significant gaps remain in addressing the weaknesses in key financial infrastructure components needed for the sound market development and product innovation in the sector. These infrastructure weaknesses also impede effective risk management and reduce the effectiveness of supervision.

Islamic finance is still a nascent industry in most countries and has not yet achieved a critical mass, or strategic focus needed for an effective recognition of its unique operational features in the national policy making process. *Therefore, Islamic international infrastructure institutions can and should play a key catalytic role in promoting the industry at the national level.*

III. STRATEGIC OBJECTIVES AND INITIATIVES

In the light of the stated vision and mission, and in view of the preceding strategic landscaping of the IFSI, the medium term focus of public policy's advice shall concentrate on the following goals:

1. Develop sound and efficient financial institutions to maximize the public's access to diverse and competitive Islamic financial services;
2. Develop Islamic financial products and markets;
3. Enhance national Islamic financial infrastructures and strengthen the activities of the international Islamic financial infrastructure institutions and ensure to integrate the IFSI with the international markets.

3.1 INSTITUTION DEVELOPMENT

3.1.1 Priority Areas

It is envisioned that the landscape of Islamic financial institutions (banks, non-bank financial institutions and *Takaful* companies) in 2015 would evolve as a full-fledged system or Islamic financial institutions that operate effectively and efficiently in parallel with conventional financial institutions to achieve the priority goals:

i. A critical mass of strong and highly capitalized Islamic financial institutions offering a comprehensive and complete range of Islamic financial products and services;

ii. Sufficient number of well-trained, competent caliber individuals and management teams with the required expertise;

iii. An active inter-bank market with the proper treasury operations and short-term Islamic financial instruments; and

iv. Well-informed individual and corporate consumers about Islamic banking and *Takaful*.

3.1.2 Initiatives

The prioritized initiatives for the development of Islamic financial institutions (banks, non-bank financial institutions and *Takaful* companies) include:

A) Balancing Diversification and Functional Specialization

The public's access to diverse types of competitive financial services is one of the basic requirements enabling them to participate in the process of economic development. The nature of Islamic banking is similar to that of universal banking whereby banks cross traditional boundaries in providing different types of financial services. In order to ensure systemic soundness such banks shall be strongly capitalized and of an appropriate economic size with suitable supervisory oversight. Most Islamic financial institutions are, however, very small in size. Yet, the society's needs for finance are diverse. Commercial banks, investment banks, *Takaful* and the various forms of INBFIs render diverse functions as required for deposit mobilization, asset management, risk intermediation, provision of risk capital and meeting the needs of social development. Islamic banks alone cannot be expected to efficiently provide these diverse types of funds. Therefore, at this initial stage of the industry's development, and in the medium-term, national policy interventions may have two-pronged approaches.

i. To ensure wide-ranging access to financial services and to meet the needs of the economy for various types of funds, the domestic markets shall encourage and promote functional specialization of the various segments of the industry as outlined in this document. This is expected to facilitate an extensive penetration of financial services without causing an unhealthy mixing of the various types of risks by relatively small and new institutions.

ii. At the same time, the process of market driven mergers and consolidation shall be encouraged so that strongly capitalized Islamic financial institutions can emerge within the Master Plan Framework period to safely offer a range of Islamic financial services as part of a single corporate group.

The two-pronged approach is also expected to strike a balance between institutional efficiency, systemic stability, providing risk capital and ensuring a better social development role for Islamic financial institutions.

B) Human Resources and Shariah Governance Systems

It is not possible to sustain the *growth and credibility* of the Islamic financial institutions without focussing on the very special human resource requirements of the industry. This priority area in the first instance is for the institutions themselves to make concerted efforts for capacity building and develop the combined competencies of finance and *Shariah*. Various private and public initiatives are underway, like the endowment recently established by Bank Negara Malaysia. Institutions like IsDB/IRTI, IFSB, regulators and the industry itself need to address the matter in a concerted manner.

C) Research and Development

This needs to cater to the product development requirements of the Islamic financial institutions and markets. Again, it is a primary responsibility of the institutions themselves to allocate resources to research and to develop products that can enhance their resource mobilization, liquidity and risk management capabilities. Policy intervention in the form of joining resources by the lead institutions with the industry for addressing the task is required.

D) Financial Soundness Indicators

For the operational efficiency and soundness of financial institutions and markets a reliable and consistent database of the global Islamic financial services statistics is required. Such a database is required for research and development as well as supervisory surveillance. IRTI, IFSB and CIBAFI are currently undertaking efforts to fill the existing gaps and meet the different needs of the industry for statistical information.

E) Standardization of Contracts and Settling Unresolved Issues

The industry also needs to address this subject in a concerted manner. Unless there is a reasonable level of understanding, agreement and clarity about the Islamic financial contracts, the industry will be perceived as one having higher contractual as well as systemic risk. Unless key pending issues are resolved from within the Islamic financial institutions, the integration of the industry with the competitive markets will not be possible. Medium term policy intervention needs to focus in alleviating this challenge and in developing contract structures that are not only widely acceptable from within the industry but also are recognized by the Civil and Common law regimes.

F) Changing the Perceptions about Takaful

Takaful is perceived by a large majority of the *Shariah* scholars and the public as something undesirable and incompatible with the *Shariah*. In fact, households, companies, governments, and the civil society institutions cannot function efficiently without having an access to risk intermediation services. Therefore, concerted efforts are needed by the industry as well as its regulators to favourably change the perception about *Takaful* in the medium run.

3.2 CAPITAL MARKET DEVELOPMENT

3.2.1 Priority Areas

i. A unified foreign and local currency *Sukuk* market for sovereign and corporate issuers that is based on common standards and offers genuine liquidity.

ii. Primary and secondary markets for Islamic residential and commercial property finance with sound foundations that offer financial institutions with effective liquidity and risk management opportunities and form the basis for local-currency Islamic ABS markets that are based on a standard security and offer genuine liquidity.

iii. Money market instruments in foreign and local currencies building on the development of liquid markets for long-dated, floating-rate Islamic securities and

iv. The depth and width of standardized *Shariah* compliant financial products and stocks and their markets.

3.2.2 Initiatives

A) Develop Legal, Regulatory and Institutional Framework

i. *Adapt the legal and regulatory framework to ownership-based financing and securitization.* For each country, this includes removing regulatory obstacles (including achieving tax neutrality). It also includes eliminating uncertainty on the enforceability of contract clauses or on tax treatment. This objective will typical involve the cooperation of the central bank, securities commission, finance ministry and other public agencies.

ii. *Develop the basic enabling conditions for a primary and secondary Islamic mortgage market, including an institutional channel through which the government will support the emergence of a secondary market.* The list of primary market enabling conditions is well-known (title and mortgage registration, foreclosure, credit information, removal of double stamp duties, etc.). There is less experience with the enabling conditions for the secondary market, although experience is being developed in certain markets (flow of ownership liabilities through the secondary market, "open-architecture" security structures that prevent market fragmentation between conventional and Islamic markets, etc.). A publicly sponsored institution to develop the secondary market is critical and would involve market reliance on some form of implicit or explicit government guarantees. For secondary market development there is also a need for a set of market institutions to provide liquidity, trading and market making services, an enabling regulatory environment, benchmarking, systemic liquidity arrangements, explicit guarantees, or public sponsorship to promote confidence in institutions offering secondary trading services.

B) *Public Sector's Participation in Capital Markets*

i. Government participation in the capital market through the regular issuance of sovereign Islamic bonds, in international or local currency depending of public financing requirements, and integrated with the national public debt management framework.

ii. *Allocation of a target share of publicly controlled portfolios to investment in Islamic capital markets.* This includes publicly controlled or sponsored saving institutions and covers the local and international equity and fixed-income markets.

iii. *Strategic commitment of a small share of foreign currency reserves to investment in high-quality, liquid Islamic fixed-income instruments if and when they become available.* Such instruments are unlikely to provide the same degree of liquidity and rating as conventional instruments, but they can correspond to the least liquid foreign exchange reserve tranche. The strategic use of a share of reserves to support the development of the international Islamic market is within the mission of central banks who look to cooperate internationally to support the creation of a capital market that ultimately will enable their domestic financial institutions to better manage their balance sheets. A commitment from central banks would provide an extraordinary impetus for quality international issuers to participate in the Islamic capital market. Such a policy is facilitated by the currently favourable international environment that has facilitated the accumulation of significant reserves amongst emerging markets.

C) *Promote International Cooperation*

Institute mechanisms for international cooperation in the creation of a unified international Islamic capital market and in the harmonization of domestic Islamic capital markets. Harmonization of the standards for international *Sukuk* is critical to create a unified market. It is facilitated by the relatively small number of investment banks involved. The rating agencies will also need to standardize their treatment of the manner in which ownership-related risks are managed in the *Sukuk*. The proposed coordinated strategic allocation of reserves to the Islamic capital market is an example of a cooperation mechanism that can be very effective. The cooperation can take the form of the

“Universal Sukuk” or any other modality to be agreed by the participating institutions. It is only through the combined commitment of several central banks that participation by key international issuers can be "jump started". A degree of harmonization can also be introduced in domestic equity screening, *Sukuk* and Islamic ABS markets. There is a need for standards in this area. Such standards will gain in effectiveness if they are derived from the "bottom up" (i.e., based on actual transactions) than from the "top down".

D) ***Market Openness***

Promote and encourage the participation of conventional issuers and investors in the Islamic capital market. The Islamic capital market would be highly inefficient if it were to developed as a closed system in which only Islamic financial institutions participate. A strategy of openness is essential to create an international Islamic capital market that is both characterized by liquidity and effectiveness in serving the needs of Islamic financial institutions. Coordinated initiatives will need to be undertaken to promote participation in the Islamic capital market among major international issuers (e.g., multilateral organizations, OECD governments or government-supported entities, large multinationals, etc.) and investors (large fixed-income houses, corporate entities with significant business interests in Islamic countries, etc.).

3.3 INFRASTRUCTURE DEVELOPMENT

3.3.1 Priority Areas

Islamic Financial Architecture – both its national components and the international infrastructure institutions – should be designed to foster a sound and orderly development of Islamic financial services industry that is well diversified, provides adequate access to a wide range of customers, and is well integrated with the national and global financial system. This goal is to be met over the medium term, by helping national authorities to develop:

iv. Legal infrastructure underpinning laws, contracts, property rights, insolvency and creditor rights regime, and financial safety nets;

v. Transparency, information and governance infrastructure, including monetary and financial policy transparency and neutrality, corporate governance, accounting and auditing framework, disclosure regime and market monitoring arrangements such as credit ratings, and credit reporting systems, and

vi. Systemic liquidity infrastructure, including monetary and exchange operations, payment and securities settlement systems, and microstructure of money, exchange and securities markets.

The instruments in this regard include organizing international technical and financial cooperation and information exchange, developing standards, codes of good practice, and guidelines on monetary and financial policies, and developing strategic alliances with other multilateral institutions.

Design of the financial architecture can have a first order impact on the development of the industry as well as on the effectiveness of supervision. It is important that the design be flexible enough to accommodate the prospective changes in the industry structure, including:

i. Increasing presence of non-bank financial institutions, including, in particular, *Takaful* operators;

ii. Greater integration of IIFS and money and capital markets in part reflecting the increasing use of asset securitization and other product innovation for balance sheet management; a growing share of Islamic financial market instruments, with a sizeable presence of sovereign and money market issues and securitized mortgages;

iii. Product innovations and risk management technology that permit a greater role for equity based finance facilities and more transparent profit sharing investment account products of different risk-return-maturity combinations, and

iv. Increased availability of *Shariah* compliant derivative contracts.

Design of financial architecture should promote a robust infrastructure at the national level, which is a prerequisite for greater cross border access to Islamic financial services and for greater global integration of both conventional and Islamic finance. Thus a goal of international infrastructure institutions should be to expedite national level institutional development through cooperation, information exchange, and developing standards and guidelines where needed.

The design should build on and ensure close coordination with the existing architecture for conventional finance. It should enable product innovations and risk management that fosters a deeper integration with the rest of the financial system. It should also help broaden access to the services of the industry by avoiding, where feasible, segmentation of the industry through separate products and services that are not comparable or competitive with conventional finance. Moreover, it should not result in a heavy compliance burden that is disproportionate to the size and scale of IIFSs, which are still small compared to conventional finance. *The developmental and financial stability considerations would need to be carefully balanced in the design of regulatory framework and the support institutions*.

3.3.2 Initiatives

A) National Level

A strengthening of the legal, information and governance infrastructure for Islamic finance at the national level is part of the broader policy strategy needed to develop efficient and liquid money and capital markets in Islamic finance instruments and enhanced access to a wide range of financial services. The policy strategy to develop institutions, markets and infrastructure needs to be properly prioritized, and be supported by appropriate risk mitigation policies in order to maintain stability. Key elements of this strategy are:

i. The public sector shall play an extensive catalytic role in developing *Shariah Governance Systems* within financial institutions and regulatory organizations through an effective education and an appropriate institutional reform;

ii. Recognize more explicitly the position of Islamic finance in financial sector laws, and in the supervisory regime, so that the unique operational features of Islamic finance can be recognized in the regulatory framework, and an enabling environment can be provided for product innovations and enhanced access, while safeguarding stability;

iii. Establish preconditions for greater use of equity-based facilities and more active investment account management;

iv. Strengthen corporate governance of IIFS and their disclosure regime;

v. Strengthen insolvency and creditor rights (ICR) regime, investor protection arrangements, and corporate governance of non-financial corporations;

vi. Reduce legal risks and improve legal certainty;

vii. Strengthen national institutional arrangements to harmonize *Shariah* interpretations;

viii. Strengthen ICR regime, and arbitration procedures;

ix. Facilitate effective enforcement of Islamic finance contracts in various legal environments;

ix. Establish a medium term program for raising the level of compliance with BCP, phasing in Basel II supplemented by the IFSB standards, and in parallel a program to strengthen Islamic banking supervision and regulation;

x. Strengthen credit information system;

xi. Upgrade risk measurement and risk management systems in banks;

xii. Establish a program to compile and disseminate financial soundness indictors and financial structure and development indicators for Islamic finance;

xiii. Establish a detailed and well-sequenced program for further development of money and capital markets and diversification of financial services (including insurance, pensions and various specialized financial services), with an emphasis on asset securitization. Some key elements of the program include:

- Give high priority to developing *Shariah* compatible instruments suitable for monetary operations, sovereign debt management, and money market trading
- Address legal, operational, accounting and supervisory issues in asset securitization
- Initiate a work program, in cooperation with Islamic infrastructure institutions, to design *Shariah* compatible hedging instruments.

B) Multilateral Initiatives

Strengthening the contribution of IIIIs in supporting national Islamic financial infrastructure development policies requires further coordination and partnership among the institutions and with the IsDB and other multilateral institutions.

i. Broaden the representation in the governance structure of IFSB to cope with the increasingly cross-sectoral aspects of IIFS operations.

ii. IFSB, IRTI, IIFM, working with IMF, and national authorities, to develop comprehensive guidance on the design of *Shariah*-compatible money market instruments, and government borrowing instruments, and market based monetary operations (and LOLR support) using such instruments; related guidance on Islamic asset securitization that are suitable for monetary and government borrowing operations; and the policy and operational requirements for fostering markets in these instruments.

iii. Broaden the representation in the governance structure of AAOIFI to include a greater role for national accountancy bodies and regulators with responsibility to design national A&A standards, and initiate a program for upgrading current standards and develop new ones

iv. IFSB, in collaboration with the IsDB, is developing a work program to design a database of financial soundness or prudential indicators and financial structure and access indicators.

v. IsDB, in consultation with other multilateral institutions, to help set up and/or promote a policy development and technical assistance program in Islamic finance. This could involve:

Incorporation of financial sector work as part of the operational activities of IsDB, and offering its own policy development and TA program, in coordination with the multilateral institutions.

vi. Mobilization and provision of external funding to support technical assistance (TA) activities in Islamic finance by the multilateral institutions.

viii. Review current institutional structure at the international level for *Shariah* endorsements / enhancements, and for the setting of *Shariah* standards for Islamic finance contracts; streamline the structure to achieve greater cohesion and minimize the potential for duplication. The governance structure for *Shariah* supervision and regulation, and internal audits at the national level can also benefit from strengthened standards and guidelines, building on AAOIFI work.

ix. Develop periodic meetings in sidelines of annual meetings of a Joint Forum consisting of IsDB, IIIIs, multilateral institutions and other stakeholders to coordinate work program of IIIIs, monitor progress in implementing the work program, identify gaps and set priorities for work program.

x. Encourage use of AAOIFI and IFSB standards in World Bank and IMF assessments and technical assistance

IV. RECOMMENDATIONS, IMPLEMENTATION AND FOLLOW-UP

4.1 RECOMMENDATIONS

These summary recommendations cover the broad strategies and initiatives to be undertaken for developing the various components of the Islamic financial services industry (IFSI), namely, banks, non-banking financial institutions, inter-bank and capital markets and insurance services (*Takaful*) and to provide the required support financial infrastructure.

4.1.1 INSTITUTIONAL DEVELOPMENT

Recommendation 1

Enhance the capitalisation and efficiency of IIFS to ensure that they are adequately capitalised, well-performing and resilient, and at par with international standards and best practices

Recommendation 2

Enhance the effectiveness of *Shariah* and corporate governance and accountability.

Recommendation 3

Develop the required pool of specialised, competent and high-calibre human capital and ensure utilization of state of the art technology.

Recommendation 4

Promote the development of standardized products through research and innovation.

Recommendation 5

Comply with the international prudential, accounting and auditing standards applicable to the IFSI

4.1.2 INFRASTRUCTURAL DEVELOPMENT

Recommendation 6

Develop appropriate legal, regulatory and supervisory framework that could effectively cater for the special characteristics of the IFSI and ensure tax neutrality.

Recommendation 7

Develop comprehensive and sophisticated inter-bank, capital and derivatives market infrastructures for the IFSI.

Recommendation 8

Promote public awareness of the Islamic financial services.

Recommendation 9

Strengthen the international Islamic financial infrastructure institutions and enhance collaboration among them.

Recommendation 10

Foster collaboration among countries that offer Islamic financial services.

Recommendation 11

Conduct initiatives and enhance financial linkages to integrate domestic IFSIs with regional and international financial markets.

4.2 Implementation and Follow-up

The implementation process needs to be developed in consultation with the industry and to be monitored by a joint standing committee.